POLITICAL ECONOMY RESEARCH INSTITUTE

PERI

University of Massachusetts Amherst

Good Intentions, Better Outcomes: Shifting the Debate About Social Protection and Informality

James Heintz and Jayati Ghosh

February 2024

WORKINGPAPER SERIES

Number 596

POLITICAL ECONOMY RESEARCH INSTITUTE

Good intentions, better outcomes: shifting the debate about social protection and informality[1]

James Heintz and Jayati Ghosh
University of Massachusetts, Amherst
February 2024

Recent economic crises, such as the Covid-19 pandemic, have highlighted the dual need for (1) a universal social protection floor, something that has been talked about and even internationally accepted[2] for more than a decade now, and (2) specific protection for workers, particularly those in more vulnerable segments of the labor market. Looking forward, the challenge is to ensure basic levels of food, health, income and livelihood security, not only in periods of crisis such as the pandemic, but also in the "normal" course of social dynamics and economic development. This has become a major concern because of the dramatically increased economic inequality and greater vulnerability of people to adverse events and processes, as well as the heightened fragility of material life. It has been compounded by the large (and often growing) share of informal workers in almost all economies, which means that, even among those in some form of paid employment, there are few forms of legal protection or social security that they can automatically access in periods of difficulty.

At the same time, attempts to introduce such protection frequently come up against arguments that such measures would have an adverse impact on employment, and thereby effectively reduce access to "formal" jobs. The general argument is that, while well intentioned, such social policies generate significant economic costs that either leave some workers worse off than they would have been in the absence of such protection, or the interventions become a drag on overall economic performance, encumbering the process of development. In what follows we consider such arguments and provide some responses. We also consider the challenges involved in providing social protection to different types of workers, including not only those employed by others but specifically the self-employed and unpaid workers.

Unintended consequences? Do social protection contribute to informality?

There are two broad categories of arguments that purport that social protection policies lead to greater informality. One set of theories focuses on the demand-side of the formal labor market. Labor market regulations are said to artificially raise the cost of employing formal workers and reduce formal job opportunities. Informal activities are not subject, by definition, to regulatory protection, and individuals displaced from formal jobs work informally. A second set of theories focus on the supply-side of the labor market. In these frameworks, individuals are able to choose the type of employment they prefer. Social protection policies, and other interventions such as tax systems, create incentives that cause more people to work informally than would otherwise

[1] We would like to thank Florian Florian Juergens-Grant, Laura Alfers, Mike Rogan, Sally Roever and Marty Chen. The WIEGO Social Protection Program, supported by the Swedish International Development Agency (SIDA), initiated the project that resulted in this paper.
[2] See the ILO Social Protection Floors Recommendation No 202, 2012. https://www.ilo.org/secsoc/areas-of-work/legal-advice/WCMS_205341/lang--en/index.htm

be the case. Although both these general arguments have the same outcome – social protection leads to greater informality – their explanations of why this would be the case differ in substantive ways. We consider each category in turn.

a. Demand-side theories

An early example of a version of the demand-side approach can be found in a 1975 paper by Gary Fields, which provides a clear exposition of this argument (Fields, 1975; for a similar approach, see Harris and Todaro, 1970). The paper argues that social protection policies in the form of labor market regulations, such as minimum wage laws, raise the cost of hiring and employing workers. Because of these interventions, labor costs in the formal labor market rise above an assumed market-clearing level – a theorized equilibrium point where labor demand equals labor supply and everyone who wants a formal job gets one. When labor costs exceed this market-clearing point, demand for labor falls short of supply and there are not enough formal jobs to go around. People still need paid work and many of those displaced from formal jobs work in informal employment.

This same theoretical framework is frequently applied to labor markets in high-income, developed economies. In these scenarios, labor market regulations are still employment-displacing, but instead of leading to informality, they lead to unemployment (Neumark and Wascher, 2008; Neumark and Shirley, 2021). The argument is almost identical for developing economies, except that people may instead work in informal activities (they are "underemployed"). There are a few dimensions of this argument that are worth highlighting. It assumes that barriers to entry into informal work are so low as to be virtually non-existent. In other words, people have an accessible alternative to unemployment – market work in the informal economy. Informal work is also assumed to be lower-productivity and lower paid. People in informal work are not employed to their full potential – hence the use of the term "underemployed." Low barriers to entry plus displacement from formal jobs lead to crowding in informal activities (i.e. a form of excess labor supply) which contributes to low earnings and low productivity.

There are variations on the demand-side approach. One involves regulatory evasion by employers. If employers find that labor market regulations (and related social protection – such as social security contributions) are overly onerous, they may simply not comply. Non-compliance effectively increases informality, since fewer workers are de facto covered by social protection (even if they are covered de jure). If non-compliance simply increased the profit share of the employers (and the policies have a negligible dis-employment effect), then it is not social protection per se, but rather a lack of enforcement, that is driving higher levels of informality. In contrast, if the enforcement of labor regulations would lead to lower levels of formal employment, non-compliance supports higher levels of labor demand than would be the case with strict enforcement and the theory reverts back to the simple demand-side argument.

One important aspect of the basic demand-side argument is that informality is involuntary. People seeking paid work would prefer to work in a formal job but, because of distortions caused by social protection, have no choice but to work informally. This is an important distinction from many supply-side arguments linking social protection to informality (discussed below). The demand-side argument is associated with efficiency losses – capable workers are trapped in lower-productivity employment compared to the jobs they otherwise would have and this generates real economic costs. In demand-side approaches, people would prefer a formal job but cannot get one. In supply-side approaches, people seeking paid employment prefer informal work because of the incentives in place.

If we take the demand-side argument at its face value, what could be done about the distortions caused by social protection and labor market regulations? The answer is straightforward: deregulating labor markets should increase demand for labor among employers offering formal jobs. Since informal workers prefer formal jobs, new opportunities for formal employment would cause people to move from informal work to formal work. However, it is important to keep in mind the primary distinction between formal and informal employment in this framework: formal jobs are subject to regulation while informal jobs are unregulated. If the "solution" to distortions in the formal labor market is to remove such protection, formal jobs are effectively informalized. If we begin with the assumption that the most significant labor market problem is the gap between formal and informal employment, this problem disappears when all jobs become informal – but does this really address the fundamental issues of the well-being of people engaged in paid employment?

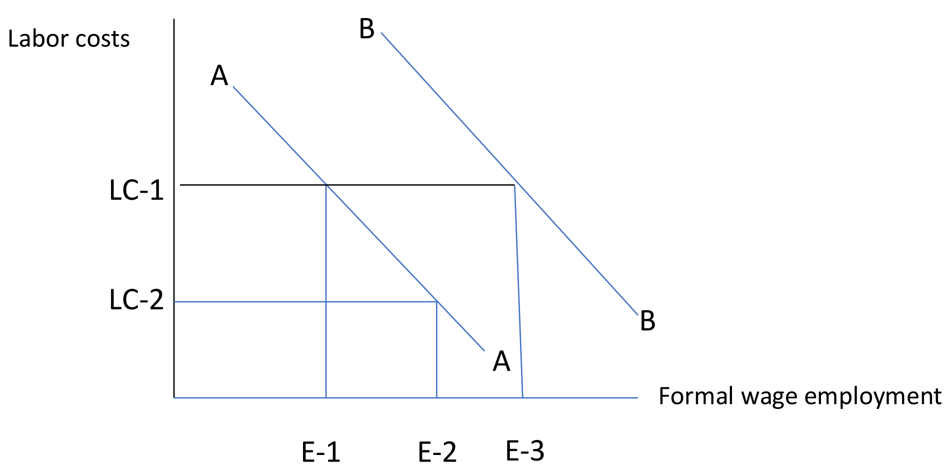
Many demand-side approaches adopt the position that the primary sources of disturbance to a well-functioning formal labor market in a developing country context are labor market regulations. However, labor markets, formal and informal, are far from perfect, even if we were to imagine them operating without regulations. These imperfections affect labor demand and prevent market-clearing outcomes. The non-regulatory imperfections are legion: asymmetric information, uncertainty, spatial dynamics and transportation costs, turnover, monitoring and enforcement, and a range of transactions costs. These factors can raise costs and affect formal employment even in the absence of social protection (e.g. Stiglitz, 1974; Stiglitz, 1976). In addition, power relationships are critical. When formal jobs are scarce, employers are able to exercise a degree of power, including monopsony power, over their workforce – another source of market imperfection. Instead of seeing social protection policies as a source of distortion, they may be more accurately portrayed as a response to the myriad of imperfections in developing country labor markets.

Moreover, there are demand-side approaches that do not rely on labor market regulations to explain a dearth of formal sector job opportunities. Perhaps the best-known alternative framework is W. Arthur Lewis's influential 1954 article (Lewis, 1954). There are parallels between Lewis's theory and other demand-side arguments regarding informality. In both the Lewis model and the regulatory distortion approach, limited formal job opportunities cause many people to involuntarily work in informal activities. However, according to Lewis, the rationing of formal jobs has a different explanation. Limited investment in the formal sectors of developing countries, not social protection policies, is the cause of a dual labor market with widespread informality. The solution? Reducing informality requires the development of the formal economy through capital investment, public infrastructure, and other interventions.

The primary difference between the Lewis approach and the approaches inspired by Fields is where to place the emphasis. The regulatory distortion framework focuses on the *slope* of a demand curve for labor – the relationship between labor costs and formal employment. Lewis emphasizes the *location* of a demand curve for labor – how much formal labor is hired at prevailing wages. In a scenario in which the formal economy is relatively small and underdeveloped, it is unclear how much formal employment will actually be created through deregulation and the removal of social protection. In the Lewis model and related approaches, the challenge of informality is not well-characterized as a labor market problem. It is more correctly diagnosed as a developmental challenge requiring a broader range of strategies and interventions. This broader set of policies can be perfectly compatible with social protection systems.

Figure 1 illustrates this point. The line AA represents a demand curve for formal wage labor, showing the theorized relationship between labor costs and formal employment. Suppose we begin with of level of labor costs, LC-1, which is associated with a level of employment, E-1. If the demand curve remains fixed, the only way to increase formal employment, and thereby reduce informality, is to lower labor costs – for example, by rolling back social protection such as the minimum wage. In the figure, this is illustrated by moving to lower labor costs, LC-2, associated with more formal employment, E-2. But this is not the only way to increase formal employment. Investment in the formal sector of the economy will support higher levels of labor demand – illustrated by the line BB. If we shift from AA to BB, formal employment increases (to E-3) without having to roll back social protection as a strategy for lowering labor costs.

Figure 1 – Labor demand, employment, and labor costs



Evidence regarding demand-side approaches that focus on social protection is mixed. Most studies find a small or negligible effect on employment of labor protection that could raise the cost of labor to employers. Perhaps the most direct examples of this kind of labor market regulation are minimum wage laws. Depending on the context, the employment effects of minimum wage policies are characterized by reduced formal employment, greater unemployment, or high levels of informality. International reviews of studies of minimum wages in both developed and developing countries find at most very slight employment effects and potentially large welfare effects in terms of workers' earnings or poverty levels (e.g. Dube 2019, Saget 2001). The effects vary depending on the design and level of minimum wages. These weak employment impacts are likely due to other labor market factors complicating the picture, producing outcomes that differ from the simple neoclassical model. These factors include monopsony and other types of market power, non-regulatory market imperfections, and unevenness in enforcement. While the findings do not preclude the possibility that labor market regulations could potentially contribute to informality (particularly if they are poorly designed), they are not robust enough to support a claim that labor protection is a primary determinant of the overall level of informality.

b. Supply-side theories

The second set of approaches that connect social protection to higher rates of informality are the supply-side approaches. While demand-side theories focused on formal employers and their willingness or capacity to hire, supply-side frameworks emphasize the decisions of informal workers. Specifically, informal workers choose to work informally (i.e. supply their labor to informal activities) because they are assumed to be better off by doing so. Within these approaches, there could be many reasons why informal work is assumed to carry greater benefits than formal employment. When these incentives are tied to social protection policies, supply-side theories predict that more workers will choose informal employment in order to take advantage of some kind of asymmetry with respect to social protection.

One of the best-known supply-side theories linked to social protection is that of Santiago Levy (Levy, 2008). He argues that the social policies that exist in Mexico differ between formal and informal workers – with the package of policies offered to informal workers being preferable to those for formal workers. Moreover, the formal social protection system is financed by a contributory system based on payroll taxes, while the informal system is non-contributory. In effect, formal employment is taxed while informal employment is subsidized. Because of these incentives, enterprises and workers prefer to operate informally. In Levy's analysis, it is not the existence of social protection that contributes to higher rates of informality, but rather asymmetries in the benefits provided by social policies and the way in which social protection is financed.

Arguments asserting that informality is freely chosen by labor force participants due to asymmetric incentives tied to formal and informal employment do not always emphasize social protection systems. A more common argument is that informality can be reduced to a tax avoidance strategy or an effort to evade other regulations (Mahoney, 2004; Loayza, 1996). The argument is the same as in Levy's broader analysis of the Mexican case: when formal enterprises are required to contribute to public revenues and informal enterprises can avoid such payments, it provides an incentive for firms to operate informally, everything else being equal. Individuals engaged in the production and exchange of illegal or illicit goods or services similarly would, de facto, operate informally to avoid formal restrictions. Note the difference between these supply-side and the demand-side arguments linking social protection to informality: with supply-side approaches, the *informal* firms or workers choose informality, with demand-side approaches, the *formal* firms or employers chose to limit the number of workers employed.

Supply-side arguments regarding the impact of social protection on informality tend to focus on enterprises, rather than the people employed in the enterprises. In these explanations, the assumption is that there is a large subset of enterprises sharing common characteristics (e.g. size, branch of activity, location) regardless of whether they conduct business formally or informally. For these enterprises, they would be free to choose how to operate – and the decision to become informal would have a relatively small impact on the other characteristics of the firm. Not all enterprises belong to this group. For example, large-scale businesses may not be able to operate under the regulatory radar and would not have the option of informality.

Within the supply-side approaches, the primary benefits of operating informally are the avoidance of costs associated with regulatory and taxation systems – and in the case of Levy's analysis, access to preferable social protection benefits. What is often missing from the calculation are the costs of operating informally. The cost of informality could include: insecurity of business activities (including location of operation), restricted access to financial services and credit, legal uncertainties and lack of legal protection, reduced access to certain public services or business development policies, harassment by public officials, and constraints on expansion or scaling up. Earnings tend to be lower in informal enterprises relative to formal enterprises (Chen et al., 2005). This also represents an economic cost. If the costs of informality exceed the benefits of regulatory avoidance, then it is no longer rational for these enterprises to operate informally – some additional barrier to formality would need to exist.

An important aspect of the supply-side approaches is the characterization of informality as a voluntary choice, given a particular set of incentives. The existence of other structural barriers to formality (e.g. inability to secure a permanent site for a business) would naturally constrain such choices. But putting aside consideration of these structural factors, the supply-side theories importantly stress the role of incentives, rationality, and agency. Most informal workers operate in an extremely resource- and income-constrained environment and, as a result, are resourceful and enterprising. They will respond to incentives and make strategic choices within the constellation of constraints that they face, and it is important to recognize the agency of informal workers themselves in any consideration of social protection. However, it is equally critical to incorporate into the analysis the full range of costs of informality and the structural barriers that these workers face.

Levy's original analysis of the Mexican social protection system and informal employment raises an important question: what are the social consequences of his argument? With regard to the well-being of the individual workers, the outcome appears to be almost inconsequential if we take the social protection system as given and we accept the assumption that informality is freely chosen. If all participants in the labor market are voluntarily making the best choices for themselves, then at the individual level there is no problem with people choosing informality since, by assumption, they would be better off by doing so. However, Levy's concern about informality is about the aggregate consequences of these choices. He argues that informal firms tend to be less productive (with regard to the market value of output relative to inputs), have lower earnings, and capture fewer economies of scale. If a large number of enterprises choose to operate informally, the macro-level result would be slower economic growth as measured by traditional variables such as GDP. These aggregate effects are the source of the loss of social welfare in Levy's framework. However, it leaves an important question unanswered. If productivity, earnings, and the scope for upgrading are lower among informal firms, what explains these differences? It suggests that informal firms face constraints that formal firms do not. Identifying the source of these disadvantages and addressing them should be an important component of the policy package – not simply the social protection system.

Recall that, in Levy's analysis, it is not the existence of social protection per se that is the issue, but rather problems in the design of the system that create asymmetries between formal and informal workers. Questioning the design of social protection systems is an important policy initiative, particularly since may social protection policies exclude individuals working informally or those specializing in unpaid household work. Levy argues that the asymmetries he identifies in the Mexican social protection system are unjustified, but he does not argue for rolling back such protection (unlike some of the demand-side approaches already discussed). Rather he supports a unified social protection system that makes social protection universal across the population – for both formal and informal workers – and financed through public revenue generation where people in similar economic positions make comparable contributions. This raises a critical question: are universal social policies the solution to extending protection to informal workers or is there a need for some protection to be linked to status in employment? We explore this issue later in the paper.

What evidence supports the argument that social protection extended to informal workers may actually increase informality? Franco et al. (2022) provide an important overview of recent empirical research that looks at this question. The studies surveyed consider policies that extend social protection to informal workers, such as Mexico's *Seguro Popular*, and tax policies. Over all, the majority of the studies reviewed by Franco et al. find a positive impact on informality of the social protection policies examined and a negative impact on informality of reforms that reduce the tax burden. These findings are consistent with supply-side arguments. However, the size of the effects tend to be small or almost negligible. For example, Aterido, Hallward-Driemeier, and Pagés (2011) found that *Seguro Popular* increased informality by just 1.5 percent. Similarly, a study by Camacho, Conover and Hoyos (2009) of health policy in Colombia found small, and, with appropriate controls, insignificant effects on informality. It would be disingenuous to argue that these studies support the argument that social protection systems are a major cause of informality.

Not all studies find that social protection policies, such as *Seguro Popular*, increase informality. A recent study, Seira et al. (2022), found no evidence of an impact of *Seguro Popular* on informal employment. Other studies reveal a more nuanced set of findings. For example, a study of

Thailand's universal health policy, Wagstaff and Manachotphong (2012), found a modest positive impact on informal employment, but no significant effect on formal employment. The effects were also particularly strong for women. This suggests that people were not moving from formal to informal employment (there was no "informalization") but rather moving into paid employment from some other activities (e.g. unpaid, non-market work). From the point of view of women's empowerment, this is not necessarily a bad thing.

Moreover, the framing, interpretation, and methods used are important to consider when evaluating these studies. Some studies do not examine informal employment directly, but infer changes from shifts in formal employment. Others only look at a subset of informal workers (e.g. certain types of enterprises, male workers only, etc.). And the methods used vary. These variations are critical to acknowledge before making broad claims about the links between social protection systems and informality.

Consider the article by Bosch and Campo-Vazquez (2015) which aims to rigorously test the analysis of Santiago Levy (2008) as an illustration of the limitations associated with these studies. The primary variable in the Bosch and Campo-Vazquez study is formal employment. Informal employment is not directly measured and changes in informality are inferred by changes in formality (i.e. decreases in formal employment are assumed to correspond to increases in informal employment). This assumption does not necessarily hold. For example, decreases in formal employment could be associated with changes in labor force participation. Moreover, their analysis shows no significant effects on total formal wage employment of the introduction of *Seguro Popular* in Mexico, but finds declines in formal wage employment in smaller enterprises.[3] Since total formal wage employment does not appear to change, these findings are consistent with a redistribution of formal employment from smaller firms to larger firms. If these larger firms enjoy economies of scale or other productivity advantages, then the Levy claim that *Seguro Popular* has a sizeable negative effect on aggregate productivity is questionable. Finally, the analysis looks at changes in formal employment at the municipal level, not in terms of individual workers. Therefore, the study does not provide insight into the decisions and characteristics of individual enterprises and workers.

The Bosch and Campo-Vazquez study is consistent with the idea that some informal employers, particularly those operating smaller firms, may have begun to operate informally when *Seguro Popular* was introduced in response to the differential incentives created. As discussed above, incentives are important for informal workers who must operate under forceful constraints. However, given the relatively modest impact on formal employment found in the study, the introduction of social protection covering informal workers cannot be said to have caused informality (or even triggered a dramatic increase), particularly at the aggregate level – and other explanations of the results of the study are plausible.

c. Hybrid approaches

---

[3] See Table 4 in Franco et al. 2015.

Some recent theories explaining informal employment have combined demand-side and supply-side approaches into a single hybrid approach. Consider the example of a model developed in the World Bank report, *Informality: Exit and Exclusion*, which aims to explain informality in Latin America (Perry et al., 2007; a similar approach can be found in Fields, 1990). The various assumptions and caveats associated with the individual demand- and supply-side frameworks also apply here. In the hybrid approaches, a degree of heterogeneity is introduced to the characterization of informal employment.

To summarize this version of a hybrid model: employment is divided into three categories – formal employment, upper-tier informal employment, and lower-tier, subsistence informal employment. Few if any barriers to entry exist in the low-end, subsistence activities. There are barriers that make movement into upper-tier informal work or formal employment difficult. Therefore, informal employment is segmented into upper-tier and lower-tier activities, with limited mobility between the two segments. As with some of the demand-side approaches, formal regulations and protection reduce labor demand and limit job opportunities in the formal economy. The barriers to mobility into formal jobs and reduced labor demand in the formal economy result in the *exclusion* of one group of workers from formal employment (i.e. they involuntarily work informally). Formal employment and upper-tier informal employment are roughly equivalent in terms of job quality. Therefore, if faced with higher costs of formalization, some, relatively privileged, individuals will work or operate their enterprises informally. They choose to *exit* the sphere of government regulation and social policy (i.e. they voluntarily choose informal employment).

The hybrid models represent an advance over some of the simpler, earlier approaches in that they recognize a degree of heterogeneity among informal activities and allow for barriers to mobility, not only between formal and informal employment, but also between different types of informal jobs. They also combine individual agency and choice with structural features of developing countries' labor markets. Within this particular hybrid approach, the social protection system represents a structural aspect of the economy that impacts formal labor demand and the incentives associated with engaging in different types of employment. The degree to which social protection and related tax policies can be seen to contribute to more pervasive informality depends on the extent to which they are determined to be the underlying cause of multi-segmented labor markets in developing countries, relative to other causes such as insufficient capital accumulation, non-regulatory market imperfections, and other barriers to labor market mobility. The earlier review of demand-side and supply-side approaches suggests that social protection policies are not the primary culprit when it comes to explaining the existence of informality and why it persists – even in hybrid models.

Status in paid employment and social protection

The relationship between informality and social protection systems is strongly influenced by status in employment. Status in employment determines which paid workers are covered by existing social protection, and it is a critical aspect when considering how social protection systems *should* be designed. Status in employment had been defined by the broad categories (1) wage employment/paid employee and (2) self-employment (with subcategories employer, own-account worker, and contributing family worker). Differences in social protection between these categories are evident. To give a clear example, labor standards and much of labor law regulates employment relationships between employers and employees – e.g. minimum wage laws, but usually does not extend to the self-employed. Including informality in the analysis adds a further dimension. Informal wage employees, by definition, do not enjoy the same social protection as formal wage workers.

The traditional international classification of status in employment (ICSE-93) described above was revised at the 2018 International Conference of Labor Statisticians and a new classification system was adopted (ICSE-18).[4] Under the revised classification system, the broad categories of "wage employee" and "self-employment" were replaced by "independent workers" and "dependent workers". Some forms of employment under the previous category of self-employment – specifically dependent contractors and contributing family workers – were placed in the category dependent workers, along with wage and salaried employees.

In order to incorporate informality into the concept of status in employment, it is useful to move away from the established categories and look at the underlying characteristics that determine status in employment, regardless of the classification system used. Differences in status in employment are driven by two factors: (1) degree of autonomy/authority and (2) degree of risk (Hussmanns, ICSE-18)

Under the ICSE-93 definitions, which emphasized wage employment versus self-employment, wage employment was deemed to be characterized by low autonomy/authority and low risk – low-autonomy because the activities of wage employees are overseen by a supervisor or boss, low risk because employees receive a predictable amount of income for a given amount of work (e.g. a paycheck). In contrast, self-employment was deemed to be characterized by high autonomy and high risk – high autonomy because self-employed workers are assumed to be their own boss and high-risk because income from employment is unpredictable (i.e. based on volatile revenues and costs rather than predictable wages).

The classification of wage employment as low-autonomy/low-risk more correctly applies to formal wage employment with standardized conditions of employment – where labor and legal protection reduce risks. In the absence of these protection, as in the case of informal wage employment, wage employment would more correctly be characterized by low-autonomy/high-risk. Similarly, not all forms of self-employment can be said to involve high degrees of autonomy

[4] The earlier status in employment categories are based on the ICSE-93 framework (ICSE = international classification of status in employment). These categories were further elaborated with the adoption of the ICSE-18 classification. The ICSE-18 classification includes two broad categories: independent workers (instead of self-employed) and dependent workers (which includes wage employees). The sub-categories of independent workers are: employers (in corporations or household enterprises), owner-operators of corporations without employees, and own-account workers. The categories of dependent workers are: dependent contractors, employees (permanent, fixed-term, short-term/casual, and apprentices), and contributing family workers. https://ilostat.ilo.org/resources/concepts-and-definitions/classification-status-at-work/icse18-manual/

or authority. Some self-employed workers have only a few (or even one) clients and, under these conditions, are highly dependent on the decisions of those clients. Self-employed workers in the "gig" economy, like Uber drivers or home-based piece-rate workers at the lowest end of value chains, set some of their own conditions of employment (such as hours of work) but not others (such as the rates they charge for their services). Therefore, some self-employed workers should also be included in the category of low-autonomy/high-risk.

The degree of autonomy/authority directly relates to the degree of power which workers experience in their employment relationships. When workers have a low degree of autonomy or authority, this is equivalent to saying that other actors have some degree of power over their activities. Clearly, wage employees have less power than their employers in labor markets, with labor standards and unionization helping to create a more balanced distribution of power for formal wage workers. Informal self-employed workers also can face imbalances of market power. Although they do not formally exchange their labor for wages, they do realize the value of their labor through a variety of market transactions. Street vendors operate in extremely competitive conditions, yet depend on suppliers for the goods they sell. The suppliers often have greater market power than the vendors. Very small-scale manufacturers sell their output to larger intermediaries – and these intermediaries frequently enjoy more market power than the informal enterprises. This kind of unequal distribution of market power indicates that self-employed individuals are subject to forms of dependency that limits their autonomy.

Table 1 summarizes this discussion. Standardized formal wage employment is characterized by low autonomy and low risk, while traditional conceptualizations of self-employment (the "entrepreneurs") are characterized by high autonomy and high risk. However, there are many forms of precarious, informal, and dependent employment that do not fall into either of these categories and are more correctly characterized by low autonomy and high risk. Employment arrangements that enjoy high autonomy and low risk are relatively uncommon. Examples would include high-end professional jobs with strong employment protection (e.g. tenured university professors).

Table 1. Risk, autonomy, authority, and status in employment.

	High risk	Low risk
Low autonomy (limited power/degree of agency)	Dependent self-employment, precarious wage employment, unpaid, non-market work	Standardized formal wage employment
High autonomy (high degree of agency)	"Entrepreneurial" or independent self-employment	High-end professional jobs with employment protection

Although Table 1 focuses almost exclusively on paid market work, unpaid, non-market labor represents a category of work that also involves low autonomy and high risk. Unpaid labor is subject to household and community dynamics, which are distinct from, but influenced by, market dynamics. Moreover, gender roles and inequalities play a dominant role in determining the division of labor between market and non-market work. These issues cannot be sidelined in a discussion of status in employment and social protection policies.

What is the relevance of delving into the intricacies of status in employment for social protection policies? Social protection policies are specifically linked to employment (and tied to status in employment) when they aim to help workers manage risks (e.g. unemployment insurance) or to address power imbalances (e.g. minimum wage policies to address the market power of employers). Although labor protection is frequently designed with wage employees in mind, the need to address power imbalances and manage risks also applies to forms of self-employment, particularly to those in the "low autonomy/high risk" category.

This places limits on "delinking" social protection from status in employment. When the protection is specifically aimed at addressing concerns with the employment relationship itself, they cannot be delinked in any meaningful sense. However, not all social protection aims to specifically address risks or power dynamics within employment relationships. They can be broader in scope, such as access to healthcare, a basic income, or core social security benefits. For these types of social protection, a universal approach which does not make certain social protection conditional on employment status represents a better outcome.

Social protection policies that aim to correct power imbalances or mitigate risks have less possibility of negatively affecting labor market participants or the degree of informality. A less volatile economic environment would allow informal workers to make better economic decisions and make investments (in their own skills, their enterprises) that would improve, rather than erode, the quality of their employment. Concentrated market power, such as the monopsony power of employers, represents a market failure leading to worse labor market outcomes for paid workers. Social protection that reduces an unequal balance of power will not necessarily lead to greater informality or worse outcomes for informal workers. On the contrary, in these situations, good intentions lead to better outcomes.

Social protection for self-employed workers

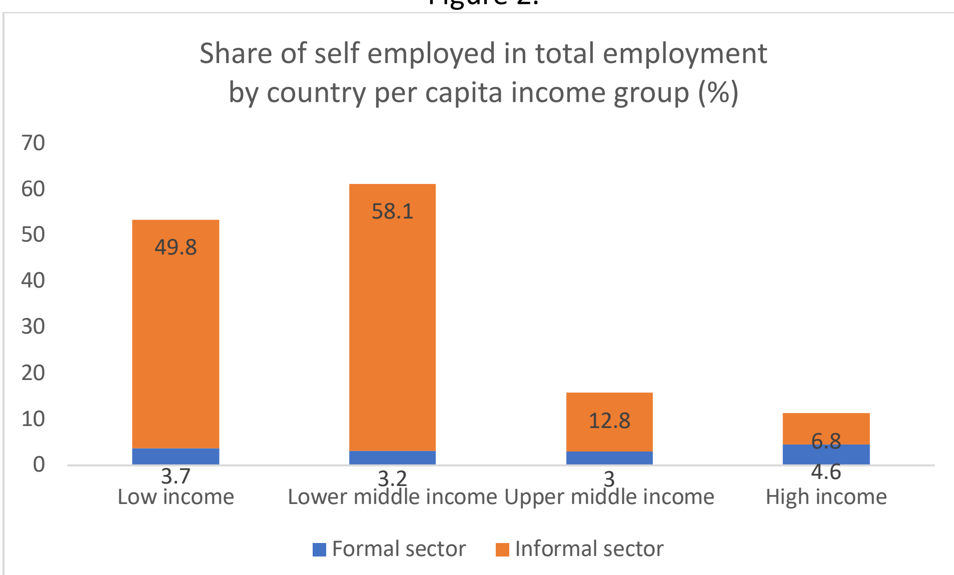
Raising the issue of status in employment highlights the importance of recognizing the challenge of appropriate social protection for self-employed workers. While the problems of providing social protection for informal workers in general are obviously significant and varied, they are even more acute in the case of self-employed workers. For such workers, there are no declared employers who could be seen as even partly responsible for providing either legal or social protection. Moreover, labor law and labor market regulations are often designed with wage employees in mind, and do not apply to the self-employed.

It is true that there is widespread prevalence of outsourcing of both goods and services, and an increasing tendency to label small producers of goods and services as "independent contractors", even when they are effectively dependent on a particular company. This means that though there is some sort of employment relationship, this is effectively concealed, certainly for legal and policy purposes. Therefore, even those who are tied to particular companies as suppliers do not have legal recourse and end up being responsible for their own remuneration, safety and other conditions at work, and social security. Again, they represent low-autonomy, high-risk workers.

This is a much more extensive concern than is often realized. Figure 2 shows the proportion of self-employed workers to total (recognized) employment, disaggregated by per capita income group of countries. (These are based on ILO estimates made in 2019, using the most recent available data at the time.) It should be noted that even these are significant underestimates, because they exclude all those engaged in unpaid work, whether within households or in communities. Such workers are clearly no less deserving of social protection. In some countries (and especially in regions like South Asia) such unpaid workers, especially women, even constitute the dominant share of people of working age, even though they are typically classified as “not in the labor force”.

In low- and lower-middle income countries, self-employed workers represent more than half of recognized workers. In lower-middle income countries, they constitute nearly two-thirds of employment. A very small share of such workers are those working in the formal sector, although this proportion is much higher among all self-employed workers in upper middle and high income countries.

Figure 2.



Source for Figures 2-4: Calculated from ILO 2019, https://www.ilo.org/wcmsp5/groups/public/---dgreports/---dcomm/---publ/documents/publication/wcms_723282.pdf accessed on 7 January 2023

The fact that lower-middle income countries show such a high proportion of self-employment is largely attributable to their massive presence in two regions in particular: South Asia (SA) and the Middle East and North Africa (MENA). Figure 3 suggests that nearly 9 out of every 10 employed persons in South Asia and 3 out of every 4 in MENA are self-employed. These indicate a staggering domination of self-employment in these regions. But even in other developing regions, self-employment is a very significant proportion of total employment, with the lowest presence in

East Asia and the Pacific still accounting for nearly a quarter. Obviously, social protection through employment contracts would barely touch the surface of ensuring protection in such a context.

Figure 3.

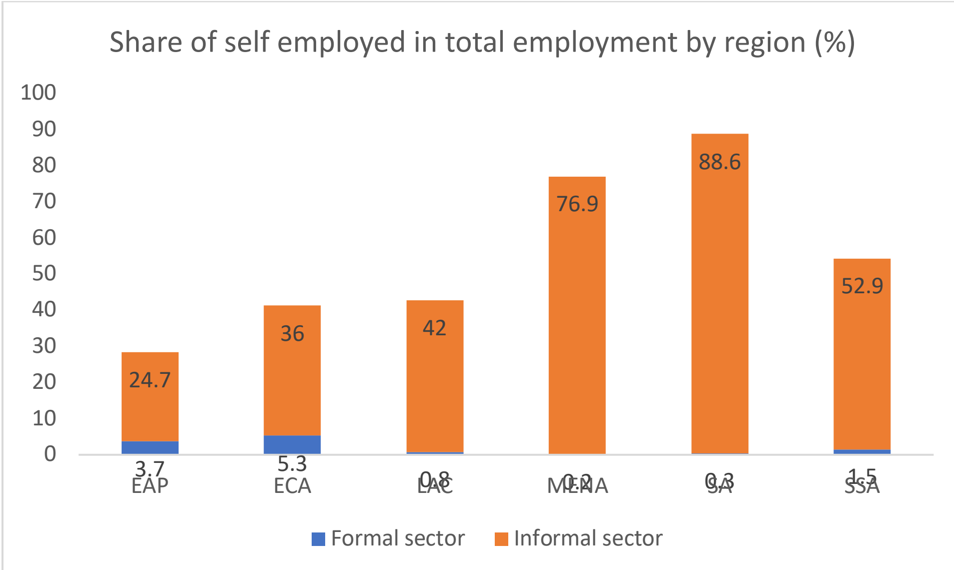
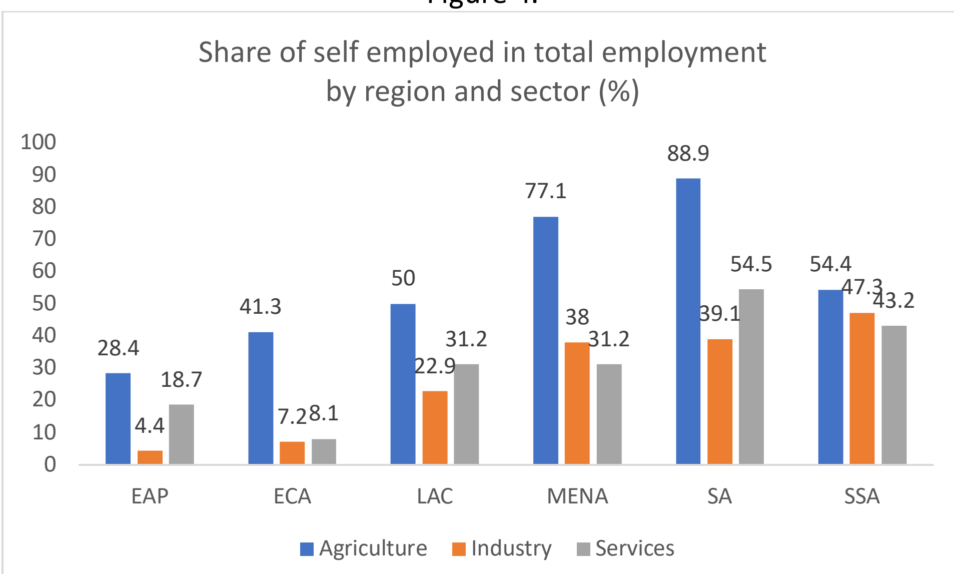


Figure 4.



It is often believed that most self-employed persons tend to work in agriculture or in petty services, whereas industry (including manufacturing, construction and utilities) is more likely to have other forms of employment. But Figure 4 belies such simplistic conclusions. It is certainly the case that agriculture shows the highest proportion of self-employment among the three sectors, across all developing regions. In South Asia and Sub-Saharan Africa, the self-employed account for more than half or nearly half of services employment. But industry also shows significant shares of self-employment: in Sub Saharan Africa nearly 48 per cent, in South Asia and the MENA region nearly 40 per cent. Even in Latin America and the Caribbean self-employed workers are 23 per cent, or nearly a quarter, of total industrial employment.

How can such workers be provided with social protection based on their employment status? To begin with there is the issue of classification: the fact that many self-employed workers who are actually dependent on a particular company or enterprise are treated for legal purposes as independent, as noted above. Classic recent examples of this are Uber drivers or Amazon delivery persons, whom these companies have tried to treat as "independent contractors" with whom they deal, in particular jurisdictions. But such examples have also proliferated in manufacturing, where large companies outsource particular parts of the production process to home-based workers or micro enterprises, often in very complex and global value chains. The recent expansion of online-based platform work has created many more such disguised employment relationships. Dealing with these requires regulatory changes that recognize the impact of new technologies on the organization of processes of production.

Self-employed workers bear all the risks of production, because of which their incomes also tend to be more casual, volatile and intermittent. Most often—and especially in the informal sector—their work is likely to be relatively low productivity and low remuneration. All this makes it even harder for them to contribute to social security schemes that implicitly rely on both employer and worker contributions that are rigid in terms of amounts and schedules. This in turn means that there is a case for dedicated social security schemes for self-employed workers, which would provide greater flexibility in contributions.

However, all this still leaves out the hundreds of millions of unpaid workers (dominantly but not only women) who also deserve social protection, regardless of their status in employment. This makes the case for a universal social protection floor even more compelling. As has been repeatedly emphasized, this can contain many elements, but there are some basic features that they must contain in all societies. These include access to essential health care, including maternity care; ensuring basic needs of children through basic income security, such as through child grants, which would provide access to nutrition, education, care and any other necessary goods and services; basic income security for persons in active age who are unable to earn sufficient income, in particular in cases of sickness, unemployment, maternity and disability; and basic income security for older persons in the form of pensions.

The evidence for positive outcomes

As noted above, the evidence that social protection reduces labor market outcomes in terms of employment opportunities for workers is limited at best, and typically show very little impact, with some studies showing positive impact. Cross-country empirical studies on the impact of social protection on employment and formalization have produce extremely varied and even divergent results, which depend significantly on the countries and time periods chosen, as well as the specific nature of the regressions or other methods used. In any case, such studies tend to have various analytical and methodological concerns, largely because of the difficulties in attribution when many factors are simultaneously in play, and the problems of aggregating across very different national or local socio-economic contexts. Some of the critiques have already been noted and do not require further elaboration. In what follows, we consider instead some positive examples of how social protection and greater formalization have occurred in practice. These largely reinforce some of the theoretical points made above.

Uruguay provides an interesting recent example of significant formalization and provision of social security to the workforce proceeding apace, along with increased employment levels. Informality in employment, measured as non-registration to social security, went from 40 percent in 2002 (35 percent in 2006) to 25.3 percent in 2016, with similar levels of informality for men and women. Registered (formal) jobs increased from 1 million in 2006 to 1.45 million in 2016 (Government of Uruguay 2018). One element of the institutional changes that enabled this was the creation of an administrative alliance between the tax authority and the social security institution. The resulting Monotax regime established a simplified and unified collection scheme for small contributors, and allowed for extended coverage to those companies that usually pay taxes, but are outside of the social security contributory system, or vice versa. This proved to be an effective tool for the formalization of micro- and small enterprises, as well as for the extension of social security coverage to independent workers, especially women.[5] The more flexible financing and contributory mechanisms addressed the issue of the low and/or variable contributory capacity of informal workers. The scheme enabled the subsidization of social security contributions for individual independent workers and micro-enterprises by incorporating low-income people into pension and health benefits schemes. While the scheme is not gender-specific, Monotax enterprises include a greater proportion of women, who make up nearly 60 percent of Monotax affiliates either as salaried workers or as employers.

The success of this initiative has led to similar schemes being developed in Brazil (SIMPLES - a simplified taxation scheme designed for micro and small business) and Ecuador (RISE or *Régimen Impositivo Simplicado* de Ecuador, which includes a discount of 5 per cent in social security contributions for affiliated workers who are up-to-date with tax payments).

It is important to remember that this particular tax-cum-social security scheme in Uruguay was put in place in the context of a broader policy focus on employment-generating economic growth, ensuring workers' rights and increasing their bargaining power and expanding various other social protection schemes.[6] Again, this illustrates that informality cannot be reduced to a by-product of labor market interventions or social protection policies. Rather, informality depends on a broader set of factors impacting on the development process. In addition, collective bargaining was assisted by the reinstatement and expansion of Salary Councils. The social security system was modified in several ways: reducing the years of work required to achieve retirement from 35 to 30 years, with the same retirement age of 60; reforming the unemployment benefit; computing an additional year of work for women for each child (with a maximum of five); extending special licenses, such as for maternity, paternity and study;

[5] https://www.social-protection.org/gimi/RessourcePDF.action?ressource.ressourceId=48020

[6] https://www.ilo.org/wcmsp5/groups/public/---asia/---ro-bangkok/---ilo-manila/documents/presentation/wcms_635189.pdf

increasing flexibility in the criteria for persons with partial or total disability; and changes in the contribution of single-person enterprises. Since all these benefits are provided only to formal or registered workers, the expansion of formalization meant a significant increase in these forms of social protection for workers. The creation of a National Integrated Health System in 2007 led to significant expansion of both coverage and benefits. All this was associated with not just a significant increase in formal employment, but in higher levels of employment in the aggregate. There is also evidence that this was also associated with declines in wage inequality over this period (Amarante et al 2016).

With regards to social protection for self-employed workers, the experience of several countries identifies various mechanisms that can be adopted (Durán-Valverde et al 2013). One significant innovation—exemplified in the Monotax scheme in Uruguay—is that of ensuring differentiated categories for social security contributions, with more flexible and gradated requirements according to type of work and income level. Such categories could be extended to include non-contributory mechanisms as well. Effectively these differences must be financed through public subsidies, but the evidence from Brazil, Cape Verde and Costa Rica suggests that these need not be onerous and can contribute to significantly increased coverage, especially for health insurance.

Collective registration mechanisms, which enable independent workers grouped into independent organizations, such as producers' associations or cooperatives to enter into collective or group insurance agreements with a social insurance scheme, have also been found to be useful. This has been used for farmers in Costa Rica and health insurance policies in Colombia. For independent agricultural workers, fisherfolk and other workers in primary activities, several schemes like Ecuador's Peasant Social Insurance and the Social Agricultural Mutual Fund in France have been successful.

There are clearly practical difficulties in ensuring wider coverage of different social protection and social security schemes. It has been argued that mandatory registration can be an important means of bringing this about. The advantages of this have to be considered in specific contexts, since in some cases they could be outweighed by disadvantages. But clearly the responsibility and accountability for this must lie with the social security authority concerned, rather than participants.

However, attempts to regulate and formalize particular types of informal work, such as paid domestic work in both Uruguay and Argentina, have been less successful (Gonzalez-Francese et al, 2021). This points to the difficulties of applying traditional models of paid work protection without adequate recognition of the specific social and economic circumstances, the gendered differences and power relationships in each place. Such concerns are evident also from other country studies of attempts to formalize informal women's employment, such as in Thailand, Morocco, Ghana, India and South Africa (Ghosh, ed 2021). These concerns are underlined by a study examining the use of existing social protection systems to provide emergency aid to informal workers in the aftermath of the COVID-19 pandemic in South Africa. There are difficulties in capturing informal workers in bureaucratic systems that lack sufficient flexibility.

This reinforces the case for extending social protection to informal economy workers based on systems that involve equal representation, universal social protection, and progressive and sustainable financing (StreetNet International et al, 2021).

Conclusions

The two main approaches linking social protection policies to heightened levels of informality – the demand-side and supply-side arguments – often cast the question in terms of a trade-off, with social protection to protect paid workers introducing undesirable distortions into the labor markets of developing economies. This paper questions this framing. Accepting this trade-off provides little basis for exploring policy alternatives. Reducing informality would require rolling back social protection which, perversely, increases the informality of paid work – since one of the hallmarks of informal employment is the lack of social protection. The empirical evidence suggests that the negative relationship between the level of informality and the extent of social protection linked to employment is relatively modest or negligible. Therefore, blaming social protection for informality is misplaced. A much broader range of factors influence the level of and changes in informal employment. Informality should be seen as a development challenge, not simply a labor market problem.

This is not to say that social protection policies do not, or cannot, have an impact on informality. However, much depends on how the social policies are designed. Social protection policies that fail to recognize the context in which they are introduced can have unintended consequences. A more fruitful line of inquiry would be to explore how to design effective social protection policies, rather than pitting social protection against formal job creation. Social protection that can be delinked from status in employment – i.e. a universal social protection floor – is clearly a step in the right direction. However, not all social protection can be delinked from employment status. They are needed to address the heightened risks and asymmetric distribution of power in employment relationships. Importantly, the question of risk and power is relevant for both wage employment and self-employment. Often self-employment is not well integrated into social protection policy discussions, even when it represents the majority of informal employment.

Our conclusion: good intentions with regard to maintaining and extending social protection can yield better outcomes. This paper has sketched ways in which unintended consequences can be avoided, and the case study of Uruguay provides an important example of how this has happened in practice. The bottom line is that it is important to move away from the assumption of a stark trade-off, and to adopt a new approach to the issue of social protection and informality.

References

Amarante, V., R. Arim and M. Yapor. 2016. “Decomposing inequality changes in Uruguay: the role of formalization in the labor market”. *IZA Journal of Labor & Development*, 5(1), 1-20.

Aterido, Reyes, Mary Hallward-Driemeier, and Carmen Pagés. 2011. “Does expanding health insurance beyond formal-sector workers encourage informality? Measuring the Impact of

Mexico's Seguro Popular". *The World Bank Development Research Group, Policy Research Working Paper*, 5785.

Bassier, I., Budlender, J., Zizzamia, R., Leibbrandt, M., & Ranchhod, V. (2021). Locked down and locked out: Repurposing social assistance as emergency relief to informal workers. *World Development*, 139, 105271.

Bosch, Mariano and Raymundo Campos-Vázquez. The trade-offs of social assistance programs in the labor market: the case of the "seguro popular" program in Mexico. Documento de Trabajo XII -2010. Centro de Estudios Económicos, El Colegio de México.

Camacho, Adriana, Emily Conover, Alejandro Hoyos. 2009. Effects of Colombia's social protection system on workers' choice between formal and informal employment. Documento de Trabajo 2009-18. Centro de Estudios sobre Desarrollo Económico (CEDE). Universidad de los Andes.

Chen, Martha, Joann Vanek, Francie Lund, James Heintz, Renana Jhabvala, Christine Bonner. 2005. *Women, Work and Poverty: Progress of the World's Women*. New York: UNIFEM.

Dube, Arindrajit. 2019. Impacts of minimum wages: review of international evidence. Report prepared for Her Majesty's Treasury, Government of the United Kingdom.

Durán-Valverde, Fabio, Jorge Flores Aguilar, José Francisco Ortiz Vindas, Daniel Muñoz Corea, Ana Carolina de Lima Vieira and Lou Tessier. 2013. "Innovations in extending social insurance coverage to independent workers Experiences from Brazil, Cape Verde, Colombia, Costa Rica, Ecuador, Philippines, France and Uruguay", *ESS Document No 42,* International Labor Office, Geneva.

Fields, Gary. 1975. Rural-urban migration, urban unemployment and underemployment, and job search activity in LDCs. *Journal of Development Economics* 2(2): 165-87.

Fields, Gary. 1990. Labour market modelling and the urban informal sector: theory and evidence. In D. Turnham, B. Salomé, and A. Schwarz, eds. *The Informal Sector Revisited*. Paris: OECD, pp. 49-69.

Franco, Javier, Daniel Mendoza, Melanie Marchant, Mónica Orozco, Roberto Vélez-Grajales. 2022. "A critical review of the literature of the impact of social protection and informality". Report prepared for the WIEGO Social Protection Program.

Ghosh, Jayati. ed., *Informal Women Workers in the Global South: Policies and Practices for the Formalisation of Women's Employment in Developing Economies*, Routledge 2021.

Gonzalez-Francese, Rocio, Lorena Funcasta and Karina Boggio. 2021. "The formalization of paid domestic work in Uruguay and Argentina: lessons and challenges to public health", *Saude e Sociedade,*Vol 30 No 4. https://www.revistas.usp.br/sausoc/article/view/190633

Government of Uruguay. 2018. *Informality and Policies for Labor Formalization in Uruguay, 2005-17.* Ministry of Employment and Social Security. https://www.ilo.org/wcmsp5/groups/public/---asia/---ro-bangkok/---ilo-manila/documents/presentation/wcms_635189.pdf

Harris, John and Michael Todaro. 1970. Migration, unemployment and development: a two-sector analysis. *American Economic Review*. 60(1): 126-42.

Levy, Santiago.2008. *Good Intentions, Bad Outcomes: Social Policy, Informality and Economic Growth in Mexico.* Washington, DC: Brookings Institution.

Lewis, Arthur. 1954. Economic development with unlimited supplies of labor. *The Manchester School*. 22(2): 139-91.

Loayza, Norman. 1996. The economics of the informal sector: a simple model and some empirical evidence from Latin America. *Carnegie-Rochester Conference Series on Public Policy* 45: 129-62.

Mahoney, William. 2004. Informality revisited. *World Development*, 32(7): 1159-78.

Neumark, David and William Wascher. 2008. *Minimum Wages*. Cambridge, MA: MIT Press.

Neumark, David and Peter Shirley. 2021. Myth or measurement: what does the new minimum wage research say about minimum wages and job loss in the United States?. NBER Working Paper 28388. National Bureau of Economic Research, Cambridge, MA.

Perry, Guillermo, William Maloney, Omar Arias, Pablo Fajnzylber, Andrew Mason, Jaime Saavedra-Chanduvi. 2007. *Informality: Exit and Exclusion*. Washington DC, World Bank.

Saget, Catherine. 2001. Is the minimum wage an effective tool to promote decent work and reduce poverty? The experience of selected developing countries. Geneva: International Labor Office. Employment Paper 2001/13.

Seira, Enrique, Isaac Meza, Eduardo González-Pier, and Eduardo Alcaraz. 2023. Did Seguro Popular Reduce Formal Jobs? Paper prepared for WIEGO. https://www.wiego.org/sites/default/files/publications/file/wiego-working-paper-no46_1.pdf

Stiglitz, Joseph. 1974. Alternative theories of wage determination and unemployment in LDCs: the labor turnover model. *Quarterly Journal of Economics*. 88(2): 194-227.

Stiglitz, Joseph. 1976. The efficiency wage hypothesis, surplus labor, and the distribution of labour in LDCs. *Oxford Economic Papers*. 28(2): 185-207.

StreetNet International, IDWF, HomeNet International, Global Alliance of Waste Pickers, WIEGO. 2021. Position Paper on Extending Social Protection to Women and Men in the Informal

Economy. https://www.wiego.org/resources/position-paper-extending-social-protection-women-and-men-informal-economy

Wagstaff, Adam and Wanwiphang Manachotphong. 2012. Universal health care and informal labor markets: the case of Thailand. World Bank Policy Research Working Paper, (6116).