3

Informal employment and the social contract

This chapter proposes a holistic approach to understanding informality through the prism of the social contract. Social contracts have a procedural and a substantive dimension. The extent of informality in a given country may be linked to an underdeveloped procedural dimension, a weak substantive dimension, a misalignment between the two, or all of these situations at once. Linkages between informality and the substantive dimension are empirically shown by relating the level of corruption, mistrust in public institutions, and dissatisfaction with various public services to the extent of informality among different types of workers. Informality is also shown to positively correlate with lower public spending on public goods and services and with poorer social outcomes. The social contract approach to informality can unify previous theories of exit and exclusion. As such, it offers a novel look at tools to tackle informal employment and the vulnerabilities of informal workers and their families.

Informality is intimately linked to the notion of the social contract

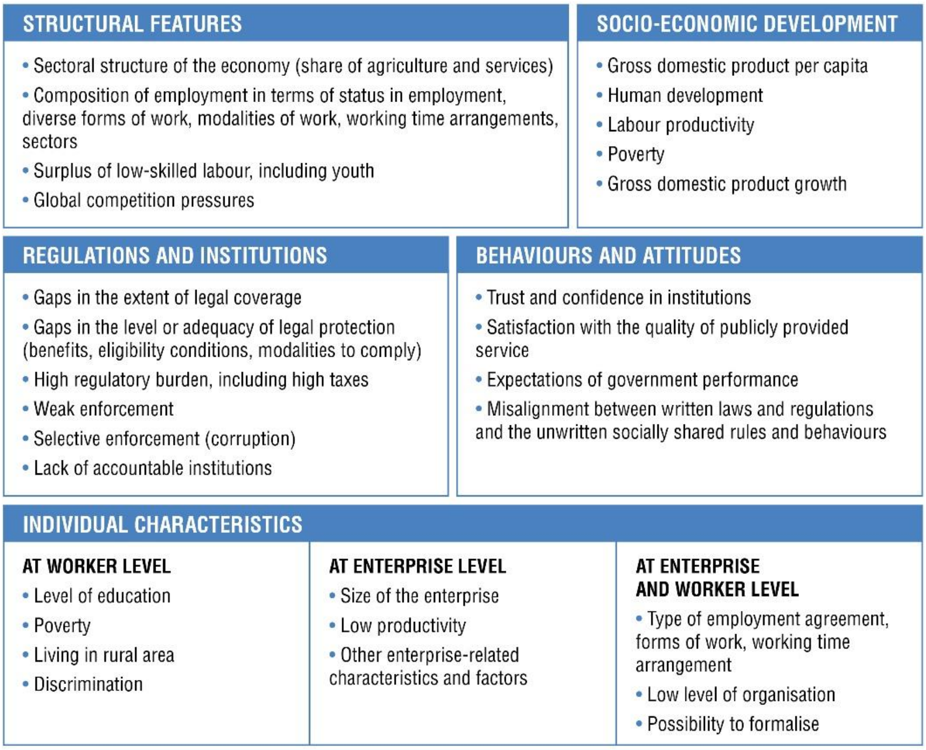
Informality is a complex, dynamic phenomenon, influenced by many factors (Figure 3.1). These include structural features of the economy; the level of socio-economic development; regulations and institutions; behaviours and attitudes; and drivers at the individual and enterprise level (OECD, 2009[1]; OECD/ILO, 2019[2]; IMF, 2021[3]; World Bank Group, 2021[4]). The linkages between structural, socio-economic and legal factors have been widely documented [see for instance (OECD/ILO, 2019[2])]; it has been shown that the relative importance of these factors varies across countries. Also, the importance of some factors may not hold in the dynamics within countries. For example, the decline of poverty, or long-term growth within countries is not always associated with the reduction of informality.

Notwithstanding these factors, informality is increasingly regarded as a manifestation of a weak or dysfunctional social contract (OECD, 2018[5]). The social contract is an implicit social agreement that takes the form of a broad set of social norms, conventions and mutual expectations from various actors in a society. It reflects a common understanding of how to distribute power and resources between such actors – citizens, the state, workers, and enterprises – in order to achieve common goals (ILO, 2016[6]). This implicit common understanding also provides the guiding principles for building political institutions and social and economic policies (UNRISD, 2022[7]).

The social contract has both substantive and procedural dimensions (ILO, 2016[6]).[1] The substantive dimension pertains to the manner by which common goals, such as equity, fairness, freedom and security, and eventually social justice, are framed and prioritised in a society. As such, it is an implicit pact between the state and the citizens, characterised by various rights and obligations regarding what individuals and different socio-economic groups give to and receive from the state (Shafik, 2021[8]). The procedural dimension pertains to the legal frameworks, institutions and procedures that help to make this implicit pact explicit, to legitimise the common goals, and to spell out the common understanding of mutual rights and obligations.

The question of formality arises only in relation to the existing laws and regulations, as well as their implementation in practice, with the protection, advantages and obligations that this entails. Informality is a phenomenon encompassing workers and enterprises that are either not covered by formal legal frameworks (procedural dimension), are insufficiently covered, or are not complying with them (for various reasons, including the lack of possibilities for doing so or the disagreement with the substantive dimension of the social contract). As such, informality is a symptom that the social contract is not functional for all citizens, or at least that its procedural dimension does not properly reflect the implicit substantial dimension or is simply lacking.

Figure 3.1. Drivers of informality on macro- and microeconomic levels



STRUCTURAL FEATURES

- Sectoral structure of the economy (share of agriculture and services)
- Composition of employment in terms of status in employment, diverse forms of work, modalities of work, working time arrangements, sectors
- Surplus of low-skilled labour, including youth
- Global competition pressures

SOCIO-ECONOMIC DEVELOPMENT

- Gross domestic product per capita
- Human development
- Labour productivity
- Poverty
- Gross domestic product growth

REGULATIONS AND INSTITUTIONS

- Gaps in the extent of legal coverage
- Gaps in the level or adequacy of legal protection (benefits, eligibility conditions, modalities to comply)
- High regulatory burden, including high taxes
- Weak enforcement
- Selective enforcement (corruption)
- Lack of accountable institutions

BEHAVIOURS AND ATTITUDES

- Trust and confidence in institutions
- Satisfaction with the quality of publicly provided service
- Expectations of government performance
- Misalignment between written laws and regulations and the unwritten socially shared rules and behaviours

INDIVIDUAL CHARACTERISTICS

AT WORKER LEVEL

- Level of education
- Poverty
- Living in rural area
- Discrimination

AT ENTERPRISE LEVEL

- Size of the enterprise
- Low productivity
- Other enterprise-related characteristics and factors

AT ENTERPRISE AND WORKER LEVEL

- Type of employment agreement, forms of work, working time arrangement
- Low level of organisation
- Possibility to formalise

Source: Own elaboration based on (IMF, 2021[3]; OECD/ILO, 2019[2]; World Bank Group, 2021[4]) and literature review.

In some settings, informality is the norm as part of a social contract that has only a recent or an underdeveloped procedural dimension

The nature of social contracts, their strength, and their relevance differ widely across countries. Important differences are observed across regions of the world, across stages of economic and social development, and across democratic and authoritarian countries. But even in the poorest or in authoritarian countries, social contracts presuppose that certain socio-economic benefits exist, at least for some population groups, in return for political support (Hinnebusch, 2020[9]).

In some of the least developed countries, the logic for informal employment in relation to the social contract is profoundly different as compared with richer and more developed countries. In many instances, the procedural dimension of the social contract, which takes form of legal arrangements and frameworks, is not yet developed enough to reach out to all citizens or to be relevant to all of them, especially where castes or tribal traditions are still strong. It may not cover some specific sectors (such as agriculture or waste picking) or some specific workers (such as traditional farmers, fishers, indigenous communities, or domestic workers). When legal frameworks exist, governments do not always have the capacity to enforce them. Governments may also lack the infrastructure and the capacity to deliver the benefits of adherence to the formal social contract (such as education and health infrastructure), or the qualified specialists to deliver the services.

But this does not mean that no social contract exists in such settings. The substantive dimension may exist and function well, taking the form of social norms and arrangements at the community, neighbourhood or village level, and is often related to the kinship. Often, such arrangements also act as a substitute for the poor or nonexistent provision of public services and goods. In these settings, informal employment is a social norm because labour markets are governed by implicit rather than explicit rules and behaviours. Work is often exchanged against other services delivered through non-state, intra-communal channels. This includes the informal provision of childcare and healing, as well as informal access to production means and informal skill acquisition and learning. In these settings, workers may also place less value on the "formalisation" prospects (adherence to the procedural dimension of the social contract) because the relative benefits from such formalisation are low. Unlike in more developed countries, formalisation may not necessarily give individuals an increased capacity to seize opportunities or to participate in and contribute to social and economic development. Workers may also perceive little value in their individual formalisation because throughout their work activities they are maximising collective rather than individual informal social protection, such as taking care of children or sick elderly people in their family or the neighbourhood.

From a policy perspective, this means that standard approaches to the individual formalisation of workers and enterprises in these settings may be neither appropriate nor attractive, since this would mean that newly formalised workers or enterprises would no longer fit into their informal system of aids and protections. In such contexts, broader collective solutions to formalisation are needed. For example, recognising the activity of waste pickers in developing countries as an occupation can help include them in cities' waste management systems, and thus not only serve as a one-off formalisation of individual workers but also change their collective relationship with the state and state-provided protections (Parra, 2020[10]).

In some settings, informality also persists because there is a misalignment between the procedural dimension (formal institutions) and the substantive norms of the society, as well as between institutional responses to the true needs of workers, their families, and citizens at large (Gërxhani, 2004[11]; Williams, 2015[12]). This misalignment may be historic, reflecting colonial legacies. It may also reflect the fact that the state is not catching up with the challenges that the evolving world presents – as is the case in countries undergoing substantial socio-economic and political transformation. This misalignment further justifies the existence of the informal economy, and legitimises informal practices in the eyes of the community, even if they are not seen as legitimate in relation to the state (Van Schendel and Abraham, 2005[13]).

In these settings, one of the ways to address informality is to ensure that the procedural dimension adequately reflects the substantive one. The most effective way to achieve this is through social dialogue involving all parties, including informal workers, in order to find the right solutions for restoring an adequate procedural dimension of the social contract.

In other settings, informality may be a symptom of the weakening of the procedural and substantive dimensions of the social contract

The development rhetoric since the 1960s led to the belief that economic development would rhyme with the improvement of social contracts in terms of both the substantive and procedural dimensions. As countries became more developed, they would also enact better laws and regulations, as well as provide better services from the state, reflecting the needs of all citizens.

However, this has not happened uniformly. Moreover, various economic, social and political challenges can present both opportunities and challenges to the effectiveness and relevance of both the procedural and substantive dimensions of a social contract. Prior to 2020, social contracts around the world had already been challenged by a variety of idiosyncratic factors, including rising inequality, heightened income insecurity, lower social mobility, and the weakening of social dialogue and institutions where previously they had been stronger. Among others, long-term structural factors such as globalisation and technological change (including digitalisation) were considered important game-changers for social contracts. At the same time, there has been a stagnation (and sometimes an increase) of informality in several parts of the world, coupled with a growing resentment that the social contract does not work well for all citizens. The latter has manifested in a persistent, and often growing, dissatisfaction with public services, perceptions of corruption, and low confidence in public institutions.

For example, in Latin America and the Caribbean (LAC), according to Gallup surveys, public satisfaction with healthcare declined from 55% in 2007 to 49% in 2018, while satisfaction with the education system and schools dropped from 65% in 2007 to 53% in 2020 (OECD et al., 2021[14]; OECD, 2021[15]). In Africa, more people were dissatisfied than were satisfied with access to quality healthcare, public transport, roads and housing in the 2010-es (AfDB/OECD/UNDP, 2017[16]). Southeast Asia is the only region where the level of satisfaction with healthcare has increased over the first two decades of the 21st century. There, an average of 79% of respondents were satisfied with healthcare provision and 83% were satisfied with the education system and schools around 2018 (OECD/ADB, 2019[17]).

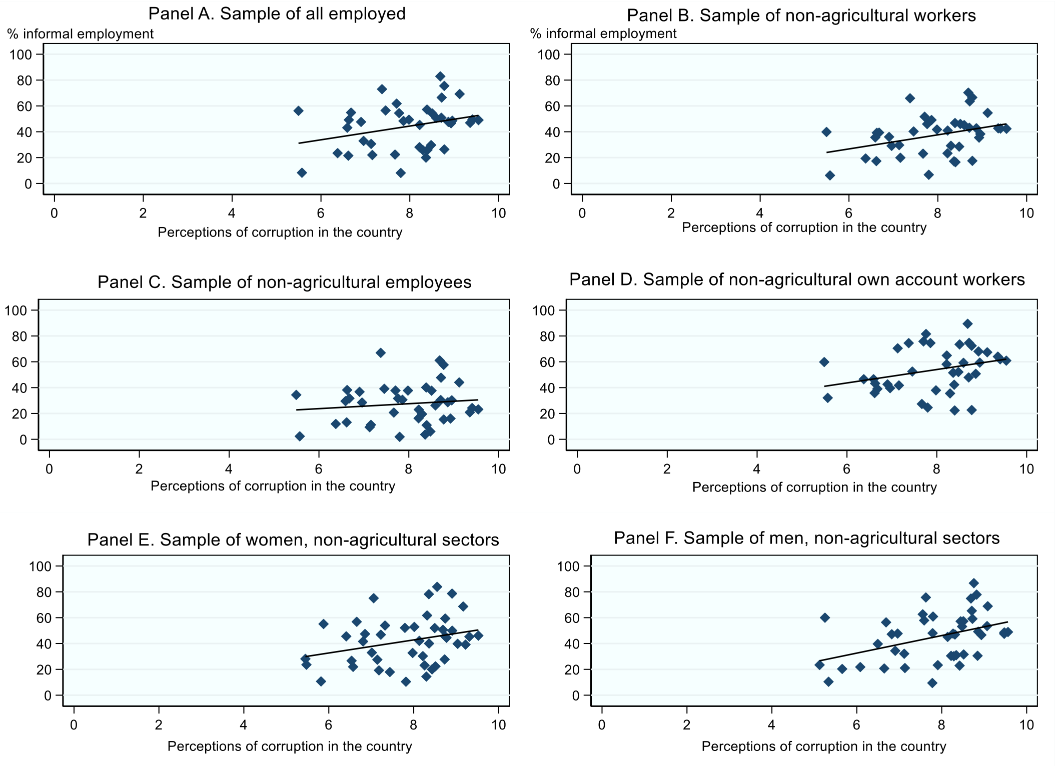
The three years since early 2020 have presented multiple new and cascading challenges – from the COVID-19 crisis, to the accelerated consequences of climate change, to the world-felt consequences of Russia's war of aggression against Ukraine – which have considerably eroded social contracts in many parts of the world. In many settings, the COVID-19 crisis underscored the extent to which social contracts were weak or even broken, often weakening them further (UNRISD, 2022[7]; Plagerson, Alfers and Chen, 2022[18]; Berkhout et al., 2021[19]). Strong feelings of exclusion and unequal treatment regarding the measures adopted during the COVID-19 crisis, especially as part of immediate responses, contributed to the feeling that social contracts do not work well for all citizens, and specifically for informal workers. Those in the informal economy felt "invisible" and left out (ILO, 2021[20]). Informal "essential" workers in many countries – those that allowed economies to run during the global pandemic and amidst the lockdowns – often resented social injustice as they did not feel sufficiently recognised (ILO, 2023[21]). The COVID-19 crisis also highlighted the massive economic costs of inadequate social protection (in terms of both coverage and access to good-quality services); the vulnerability of education and skills-provision systems and their financing; and the vulnerability of different actors to disruptions in global production, especially in global value chains built according to subcontracting models. In sum, the COVID-19 crisis highlighted the need to review and enhance the substantive dimension of social contracts in many countries.

Persistent and growing informality goes hand in hand with corruption, mistrust in institutions and dissatisfaction with public services

The substantive dimension of the social contract is strong when the majority of citizens perceive that the pact with the state is reliable, beneficial for them, and fair (Shafik, 2021[8]). In such settings, individuals have a possibility to adhere to such social contracts and generally see value in doing so, by complying with the rules and regulations. A strong social contract between the state and its citizens is an essential condition for sustaining development over time (Bussolo et al., 2018[22]; OECD, 2011[23]). Conversely, the social contract is weak when most citizens see it as non-reliable, non-beneficial or unfair. The latter perception manifests in low satisfaction with access to and the quality of state-provided services, and low levels of trust and confidence in public institutions. Another key aspect of a strong social contract is the expectation that taxes and social security contributions are not misused. In other words, misuse of public funds and corruption weaken social contracts.

Indeed, several macroeconomic studies have also shown that informality is widespread when perceived corruption is high and when governance is poor (Buehn and Schneider, 2011[24]; Dreher and Schneider, 2009[25]; Dutta, Kar and Roy, 2013[26]; Friedman et al., 2000[27]; Schneider and Enste, 2000[28]), and when there is a lack of trust in public institutions (Iyanatul and Lapeyre, 2020[29]). That informality is one of the manifestations of the social contract has also been shown by linking informality to institutional quality (Schneider, 2010[30]); to taxes and political turnover (Elgin, 2013[31]); to direct democratic institutions (Teobaldelli and Schneider, 2013[32]); to political instability (Elbahnasawy, Ellis and Adom, 2016[33]); to the business and political environments (Devine, 2021[34]); to tax morale (Alm and Torgler, 2006[35]; Torgler and Schneider, 2009[36]); or to several of these aspects at the same time (Torgler and Schneider, 2009[36]; Torgler and Schneider, 2007[37]).

Figure 3.2. Informality correlates positively with the perception of corruption



Note: Predicted values of informal employment (International Labour Organization (ILO) definition). Controls include seven geographical regions (sub-Saharan Africa; South Asia; North America; Middle East and North Africa (MENA); LAC; Europe and Central Asia; and East Asia and Pacific); gross domestic product (GDP) per capita, PPP constant 2017; income share held by the lowest-income 10% of the population; population growth; trade as a percentage of GDP; the Human Development Index (HDI); ease of doing business as of 2018; and political rights and civil liberties. Perception of corruption is computed as an average of individual responses to the question: “How much corruption is there in your country?” Answers ranged from 1 to 10, with 1 meaning “There is no corruption in my country” and 10 meaning “There is abundant corruption in my country”. Then, averages were taken (by country) within subsamples of all workers (Panel A), non-agricultural workers (Panel B), non-agricultural employees (Panel C), non-agricultural self-employed workers (Panel D), women in non-agricultural work (Panel E), and men in non-agricultural work (Panel F). Informal employment: latest available data. The sample includes 34 countries (see Annex 3.A for the full list).

Source: For six measures of informal employment: (ILO, 2023[38]), *Women and Men in the Informal Economy: A Statistical Update*, https://ilostat.ilo.org/en/; for geographical regions, GDP per capita, population growth, and trade as a percentage of GDP: (World Bank, 2021[39]), *World Development Indicators* (database), www.data.worldbank.org/products/wdi; for ease of doing business: (World Bank, 2022[40]), *Doing Business Indicators* (database), www.doingbusiness.org; for political rights and civil liberties indices: (Freedom House, 2019[41]), *Freedom in the World* (database), freedomhouse.org/report/freedom-world; and for perception of corruption: own computations based on (World Values Survey, 2020[42]), *Wave 7* (database), worldvaluessurvey.org.

The majority of these studies were conducted at the macroeconomic level. These studies usually recognise that the causality may run both ways between informality, and perceptions of and attitudes towards institutions. However, these studies have been missing one key fact: that informal economies, as well as the informal workers that are part of them, are highly heterogeneous (OECD/ILO, 2019[2]; Plagerson, Alfers and Chen, 2022[18]). Indeed, an informal worker is not only characterised by their economic activity; they are also a citizen, a parent, a member of the household (which may have other informal or formal economy workers), and a member of the community. Individual informality status, as well as perceptions regarding the social contract, can thus vary depending on these roles. Different individual characteristics, as well as other roles of the individual, can give a different perception of the relevance of different aspects of the social contract, and also determine the individual's informality status.

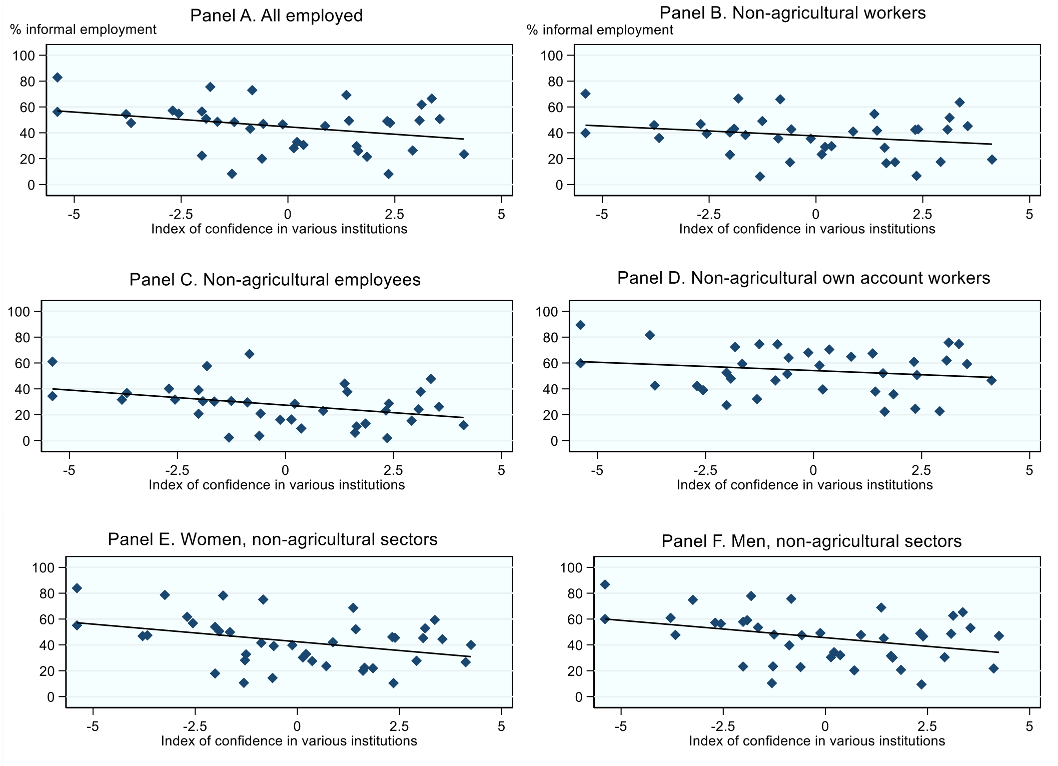
Accounting for this important heterogeneity means that informality and various aspects of the social contract should be examined within different heterogeneous groups. Figure 3.2 explores this heterogeneity. It includes shares of informality for all workers (Panel A), as well as separately for non-agricultural workers (Panel B), non-agricultural employees (Panel C), non-agricultural self-employed workers (Panel D), women in non-agricultural work (Panel E), and men in non-agricultural work (Panel F), and gives the averages of individual responses to the World Values Survey question: "How much corruption is there in your country?", computed within the same subsamples of workers in each country.

A positive correlation between informality and the perception of greater corruption is observed in each of these subsamples. This positive correlation is the strongest in the subsample of self-employed individuals and of men.

Similarly, informality is strongly negatively correlated with confidence in various institutions, including the armed forces, police, the justice system, the government, political parties, and parliament, as well as the press, labour unions, and the civil service (Figure 3.3). In particular, lack of confidence in the justice system and in the police have the strongest positive correlation with the share of informal employment. The correlation holds separately between the subsamples of men and of women, of employees and self-employed workers, and of all workers and non-agricultural workers.

Correlations at the macroeconomic level presented in Figure 3.2 and Figure 3.3 also hold at the individual level. Examples of this (which are available for a few selected countries) are presented in Box 3.1. Moreover, recent studies show that individual informality status not only correlates with a higher level of dissatisfaction with publicly provided services, but also that there is a causal relationship between these variables (Aleksynska and Wojcieszynski, 2022[43]). In other words, not only is it possible that lower confidence may lead to informality, but it also appears that informal workers are more likely to have lower confidence in institutions, and to have a lower level of satisfaction with publicly provided services. This further erodes the social contract from the point of view of those workers who were forced into informality rather than choosing it.

Figure 3.3. Informality correlates negatively with confidence in institutions



Note: Predicted values of informal employment. Controls include seven geographical regions (sub-Saharan Africa; South Asia; North America; MENA; LAC; Europe and Central Asia; and East Asia and Pacific); GDP per capita, PPP constant 2017; income share held by the lowest-income 10% of the population; population growth; trade as a percentage of GDP; the HDI; ease of doing business as of 2018; and political rights and civil liberties. Index of the confidence in institutions is first computed on an individual level using the principal component analysis (PCA) procedure, and extracting the first principal component. The PCA is applied to nine questions, asking about the degree of confidence the person has in: armed forces, the press, the labour unions, the police, the justice system, the government, political parties, parliament, and the civil service. The answers are measured on the scale from 1 to 4, where 1 refers to no confidence at all, and 4 refers to full confidence. Then, averages were taken (by country) within subsamples of all workers (Panel A), non-agricultural workers (Panel B), non-agricultural employees (Panel C), non-agricultural self-employed workers (Panel D), women in non-agricultural work (Panel E), and men in non-agricultural work (Panel F). The sample includes 34 countries (see Annex 3.A for the full list).

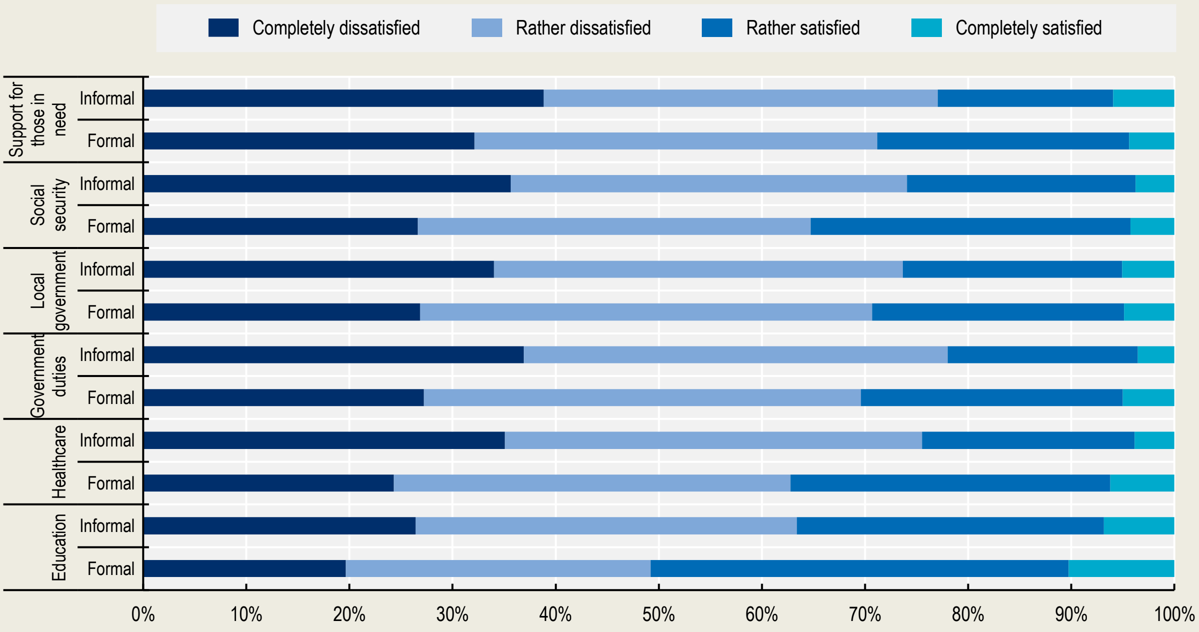
Source: For six measures of informal employment: (ILO, 2023[38]), *Women and Men in the Informal Economy: A Statistical Update*, https://ilostat.ilo.org/en/; for geographical regions, GDP per capita, population growth, and trade as a percentage of GDP: (World Bank, 2021[39]), *World Development Indicators* (database), www.data.worldbank.org/products/wdi; for ease of doing business: (World Bank, 2022[40]), *Doing Business Indicators* (database), www.doingbusiness.org; for political rights and civil liberties indices: (Freedom House, 2019[41]), *Freedom in the World* (database), freedomhouse.org/report/freedom-world; and for confidence in institutions: own computations based on (World Values Survey, 2020[42]), *Wave 7* (database), worldvaluessurvey.org.

Box 3.1. Weak social contract from an individual's perspective

The notion that a greater share of informality is a sign of a dysfunctional social contract can be better understood through a micro-level analysis. The advantage of this approach is that, if done within countries, it eliminates any possible cross-country differences and naturally incorporates country-specific contexts, such as the level of development, as well as structural, socio-economic, legal and institutional country features. It also allows accounting for the important consideration of heterogeneity across informal workers. A special module of the World Values Survey database, conducted just prior to the COVID-19 outbreak in four MENA countries (Egypt, Iraq, Jordan and Lebanon), enables such analysis.

Figure 3.4 and Figure 3.5 explore differences across formal and informal workers in the degree of satisfaction with their country's healthcare and education systems, the way the government performs its duties in the national office, the way the local authorities are responding to regional affairs, the system of social security, and state-provided support for those in need, as well as with the quality of healthcare, schools, roads and highways, air, water, housing, and the physical setting of the area in which they live. All answers to these satisfaction questions are measured on a scale from 1 to 4, where 1 means completely dissatisfied and 4 means completely satisfied.

Figure 3.4. Distribution of satisfaction with various aspects of public services, across formal and informal workers



Note: Averages across countries: Egypt, Iraq, Jordan and Lebanon.
Source: Own computation based on (World Values Survey, 2020[42]).

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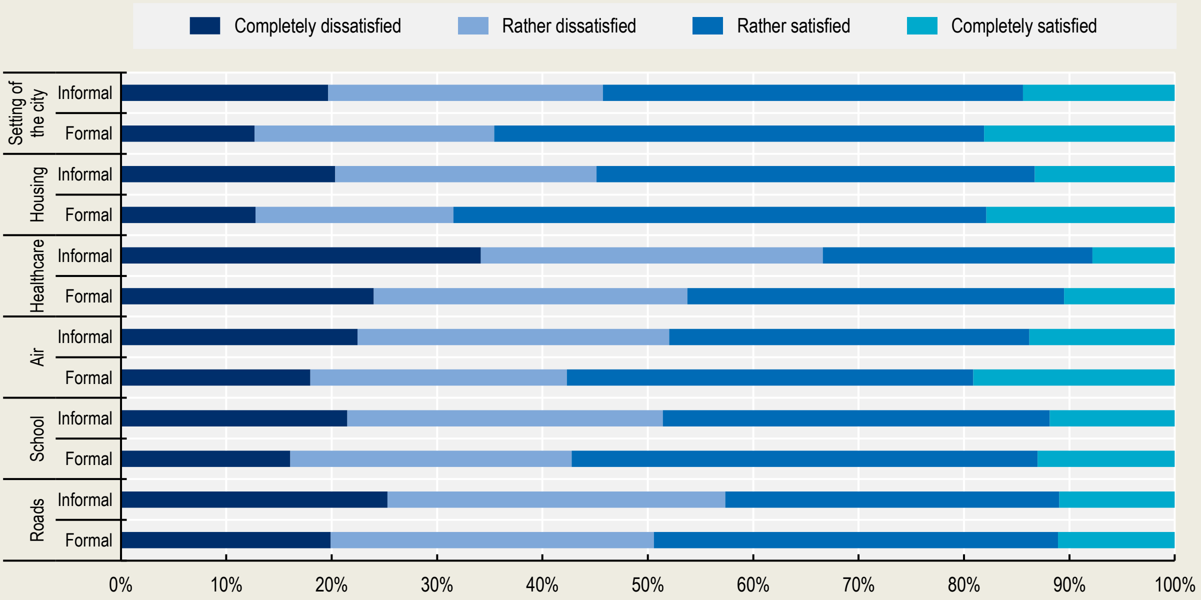
A higher percentage of informal workers than formal workers were completely dissatisfied and rather dissatisfied with every aspect of the functioning of the public system. Very few individuals – whether formal or informal – were completely satisfied; however, the share of such individuals was higher among formal workers. There was also a higher rate of dissatisfaction with the quality of the provided services among informal workers. The satisfaction gap is particularly pronounced with respect to the quality of healthcare: 67% of informal workers felt completely or rather dissatisfied compared with 53% of formal workers. There is a 10-percentage-point satisfaction gap (comparing completely and rather dissatisfied with completely and rather satisfied) between formal and informal workers in terms of satisfaction with the quality of schools, air, and city setting, and a 13-percentage-point gap in satisfaction with the quality of housing.

Figure 3.5. Distribution of satisfaction with the quality of services, across formal and informal workers



Note: Averages across countries: Egypt, Iraq, Jordan and Lebanon.
Source: Own computation based on (World Values Survey, 2020[42]).

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These linkages can be further explored using regression analysis, controlling for a range of individual socio-economic characteristics. Such analysis suggests that individual informality status is associated with lower satisfaction with the education system, the healthcare system, and the way the government performs duties in the national office, as well as less satisfaction with the quality of the healthcare system, housing, and the city setting. In other words, publicly provided services (including healthcare) and public institutions are not always responding to the demands and aspirations of many citizens, and particularly those of informal workers. Informal workers more acutely perceive injustice and are less satisfied with the system and its quality. As such, compared with formal workers, they more systematically consider the social contract to be weak.

In light of the continuing COVID-19 pandemic, reinforcing the social contract will mean dedicating a discernible effort not only to the recovery of health but also to that of work, including formal employment opportunities. It will also require rethinking institutions and publicly provided services in order to ensure that they are accessible, fair, reliable, predictable and trustworthy, placing the demands of all citizens, including informal workers, at the heart of the system.

Source: (Aleksynska and Wojcieszynski, 2022[43]).

Higher informality is associated with low public spending on public goods and services, and with inadequate social outcomes

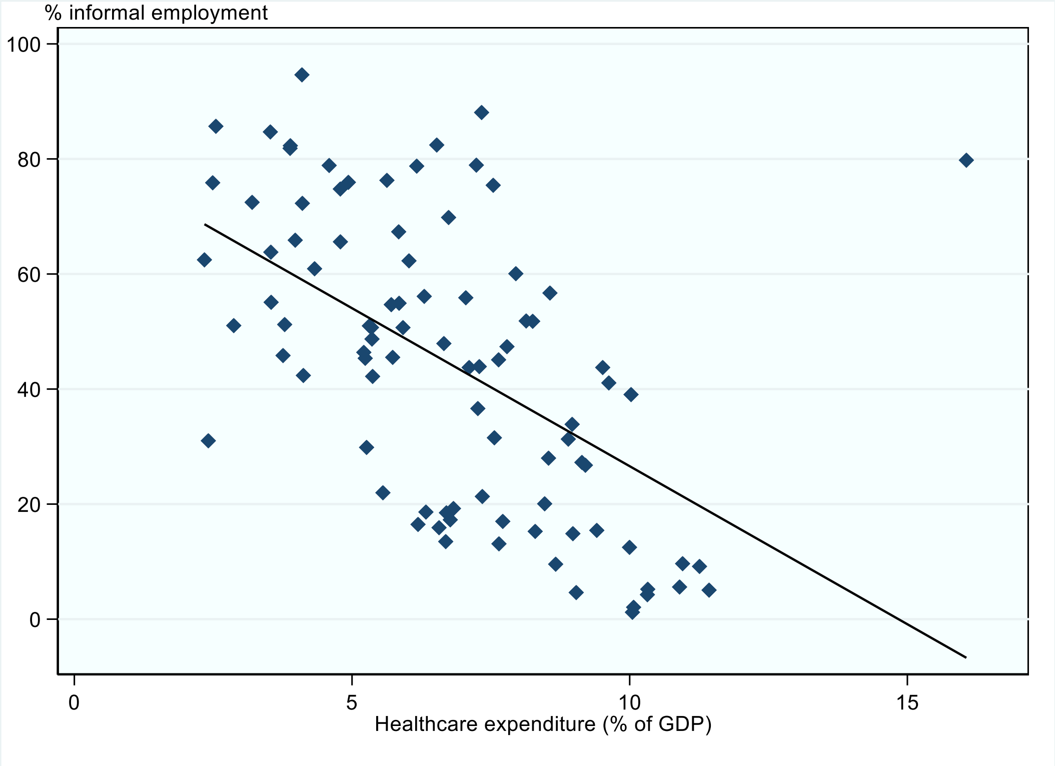
One of the main components of the social contract is the agreement that citizens comply with laws (including labour and social security laws), pay taxes and make social security contributions. But another no less important component of the social contract is that, in exchange for this, citizens receive good-quality public goods and services, such as education, healthcare, security and a clean environment. Access to good-quality public goods and services is also one of the key components of redistribution and of promoting equality of opportunity.

Low, or declining, satisfaction with the quality of publicly provided services can set a spiral of higher informality – lower quality of services – higher informality. The mechanism for this dynamic is as follows (Perry et al., 2007[44]; World Bank, 2017[45]; Oviedo, Thomas and Karakurum-Ozdemir, 2009[46]; OECD, 2011[23]; Hujo and Bangura, 2020[47]): individuals as well as businesses with high income who are dissatisfied with the quality of the provided services have a lower incentive to fulfil their obligations to the social contract through paying taxes or social security contributions. They may opt out of contributing to and consuming state-provided services, and substitute them with private services. In so doing, they may choose to demand and to perform informal activities (including under-reported, undeclared, or partially declared activities), and consider this rational and justifiable, in order to avoid double-paying for both the public and private services. This, in turn, leads to a decline in state receipts and undermines the state's capacity to improve the quality of public services, such as access to good-quality water and air, healthcare, education, or justice. As a result, there is also a growing dissatisfaction among those individuals and businesses who cannot afford to opt out of public services. This further enhances fracturing in the society, and further erodes trust and the social contract (Ferreira et al., 2013[48]; Hujo and Bangura, 2020[47]). Moreover, as the tax base narrows, the state may be obliged to levy higher taxes in order to cover the non-compliant, at the risk of rendering compliance too costly for poor and vulnerable workers and enterprises. The resulting outcome is an inconsistency between workers' demands and the institutional supply of social protection and high-quality public services. It is a narrow-based equilibrium of low tax receipts, high inequality, low satisfaction with the quality of publicly provided services, low trust, and high informality. Greater informality, along with its wider acceptance and tolerance, threatens and challenges existing social contract models (Plagerson, Alfers and Chen, 2022[18]).

To illustrate the association between low public spending on public goods and services and informality, Figure 3.6 and Figure 3.7 relate the share of informal employment to government healthcare expenditure and government education expenditure. The reason for highlighting these public services in particular is that access to better healthcare services comes first in the ranking of demands for state services in many developing countries, especially where the gaps in healthcare protection coverage are the highest. This is followed by better education (Traub-Merz et al., 2022[49]). In order to isolate these relationships from other confounding factors, predicted values of country-level informal employment, obtained from multivariate analysis and controlling for other factors associated with informality, are reported instead of actual values.

Both figures show that, when comparing otherwise similar countries, there is a strong negative correlation between the share of informality and the share of healthcare or education expenditure. In countries where social expenditures on healthcare and education are higher, informality is lower.

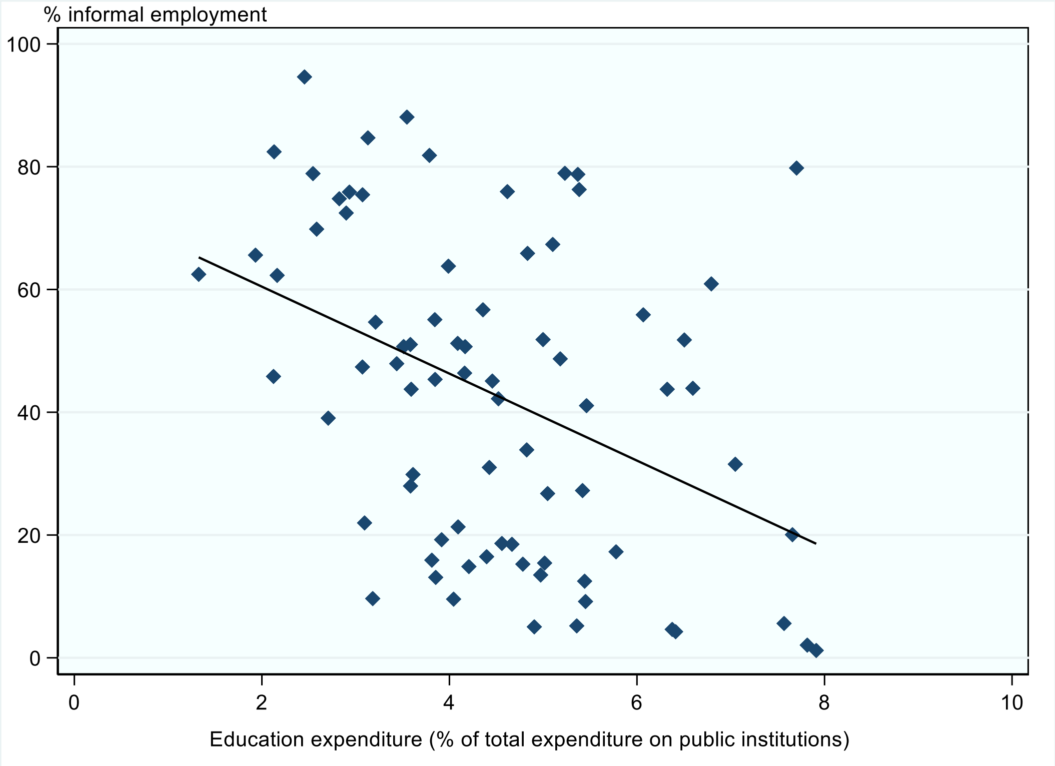
Figure 3.6. Informality negatively correlates with greater healthcare expenditure



Note: Own computation. Predicted rather than actual values of informality are reported. They are obtained from multivariate analysis controlling for seven geographical regions (sub-Saharan Africa, South Asia, North America, MENA, LAC, Europe and Central Asia, and East Asia and Pacific); GDP per capita (2017 PPP); life expectancy; population growth; age dependency ratio; 2018 ease of doing business; and trade. Informal employment: latest available data. For the full list of countries, see Annex 3.A.

Source: Informal employment: (ILO, 2023[38]), *Women and Men in the Informal Economy: A Statistical Update*, https://ilostat.ilo.org/en/; for GDP per capita (2017 PPP), life expectancy, population growth, age dependency ratio, trade and healthcare expenditure: (World Bank, 2021[39]), *World Development Indicators* (database), www.data.worldbank.org/products/wdi; for ease of doing business: (World Bank, 2022[40]), *Doing Business Indicators* (database), www.doingbusiness.org.

Figure 3.7. Informality negatively correlates with greater education expenditure



Note: Own computation. Predicted rather than actual values of informality are reported. They are obtained from multivariate analysis controlling for geography, GDP per capita (2017 PPP), life expectancy, population growth, age dependency ratio, 2018 ease of doing business, and trade. Informal employment: latest available data. For the full list of countries, see Annex 3.A.

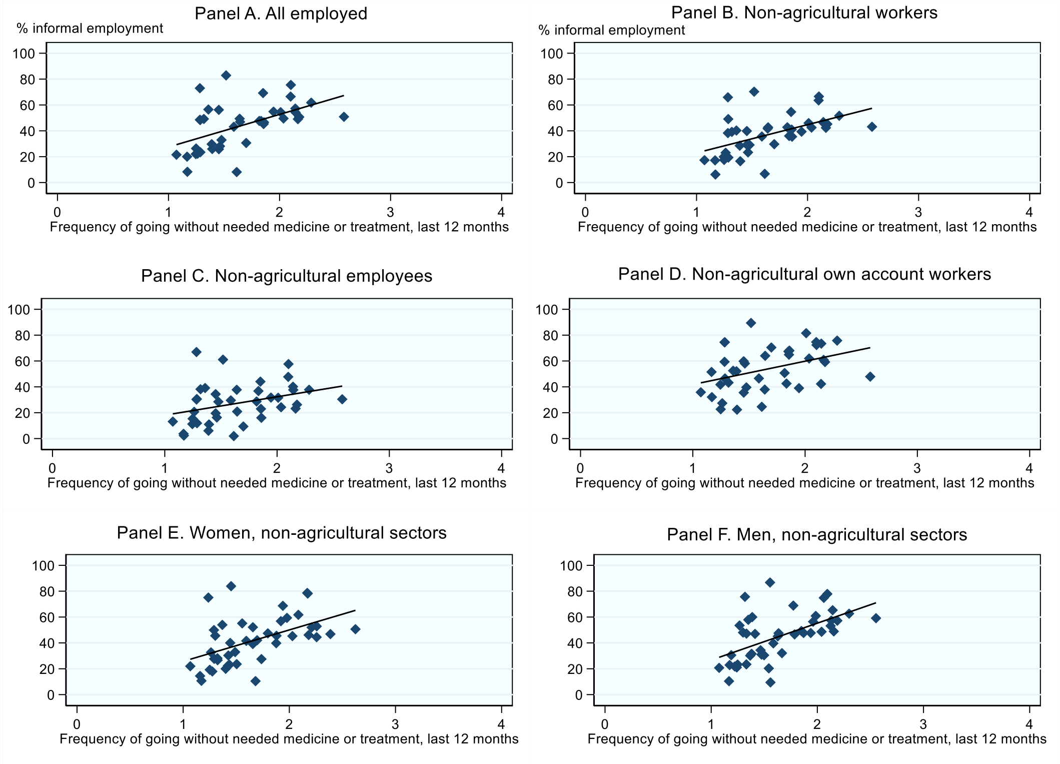
Source: Informal employment: (ILO, 2023[38]) *Women and Men in the Informal Economy: A Statistical Update*, https://ilostat.ilo.org/en/; for GDP per capita (2017 PPP), life expectancy, population growth, age dependency ratio, trade, and education expenditure: (World Bank, 2021[39]), *World Development Indicators* (database), www.data.worldbank.org/products/wdi; for ease of doing business: (World Bank, 2022[40]), *Doing Business Indicators* (database), www.doingbusiness.org.

The link between informality and poor public service delivery is also visible when looking at social outcomes – either actual or perceived. Access to services, as well as perceptions about their quality, is what matters for political support as well as for voicing concerns (OECD, 2021[50]).

Figure 3.8 and Figure 3.9 relate informality to individual responses to the following questions: “How often you or your family have gone without needed medicine or treatment in the past 12 months” and “To what extent do you worry about not being able to give one’s children a good education?”. Reflecting the need to account for informal worker heterogeneity, the answers to these questions are averaged within subsamples of men and women, of employees and self-employed workers, and of all workers and non-agricultural workers, and are related to the share of informal employment within the same population subgroups.

The share of informality, regardless of the subgroup within which it is computed, shows a strong positive correlation with medical treatment deprivation within the same population subgroup (Figure 3.8). The distinction between employees and self-employed workers with regard to access to healthcare is important: self-employed workers may forego medical treatment more often if they have to forego work in order to travel to healthcare facilities or use care services without receiving compensation. Yet, correlations between the share of informal employment and medical treatment deprivation are equally high among employees and self-employed workers. The lack of employment protection and fear of losing jobs or pay may equally preclude informal wage employees from undergoing medical treatment while foregoing wage work.

Figure 3.8. Informality strongly correlates with medical treatment deprivation



Note: Predicted values of total informal employment, and of informal employment among non-agricultural workers, non-agricultural employees, non-agricultural self-employed workers, women in non-agricultural sectors and men in non-agricultural sectors. Controls include seven geographical regions (sub-Saharan Africa; South Asia; North America; MENA; LAC; Europe and Central Asia; and East Asia and Pacific); GDP per capita, PPP constant 2017; income share held by the lowest-income 10% of the population; population growth; trade as a percentage of GDP; the HDI; ease of doing business as of 2018; and political rights and civil liberties. Frequency of going without necessary medicine or treatment is computed as an average of individual responses to the question: "How often you or your family have gone without needed medicine or treatment in the past 12 months", with answers measured on a scale from 1 to 4, where 1 means never and 4 means often. Averages were taken (by country) within subsamples of all workers (Panel A), non-agricultural workers (Panel B), non-agricultural employees (Panel C), non-agricultural self-employed workers (Panel D), women in non-agricultural work (Panel E), and men in non-agricultural work (Panel F). The sample includes 34 countries (see Annex 3.A for the full list).

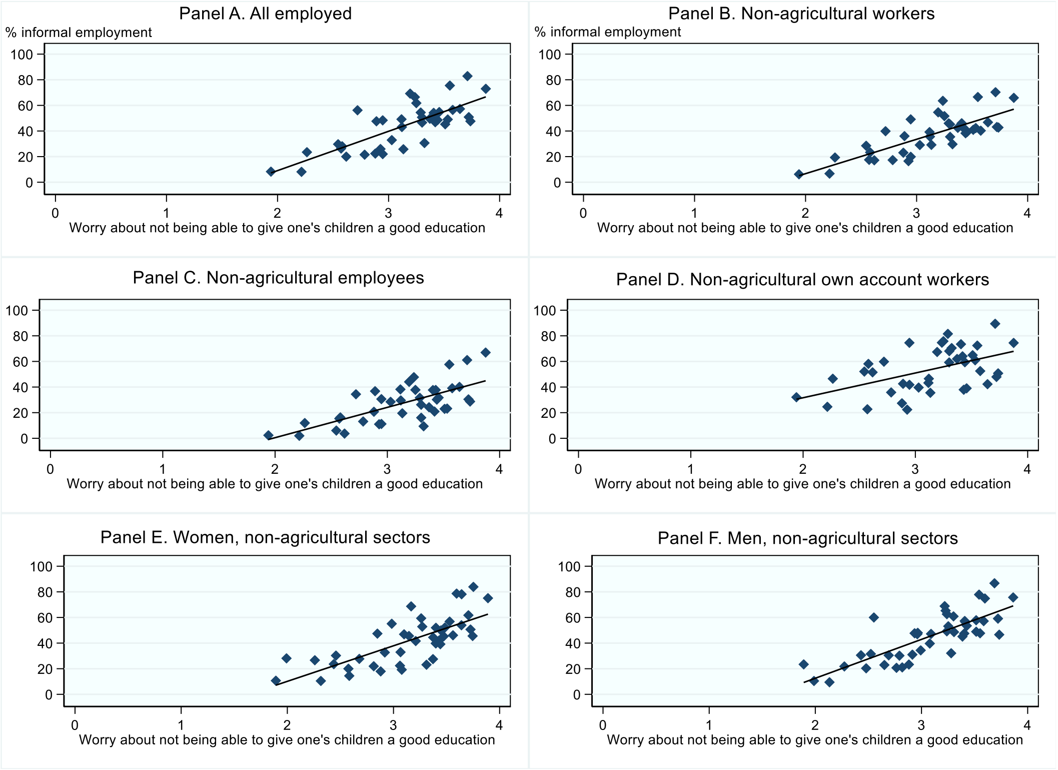
Source: For six measures of informal employment: (ILO, 2023[38]), *Women and Men in the Informal Economy: A Statistical Update*, https://ilostat.ilo.org/en/; for geographical regions, GDP per capita, PPP constant 2017; income share held by the lowest-income 10% of the population; population growth; trade as a percentage of GDP; the HDI: (World Bank, 2021[39]), *World Development Indicators* (database), www.data.worldbank.org/products/wdi; for ease of doing business: (World Bank, 2022[40]), *Doing Business Indicators* (database), www.doingbusiness.org; for political rights and civil liberties indices: (Freedom House, 2019[41]), *Freedom in the World* (database), freedomhouse.org/report/freedom-world; and for frequency of going without necessary medicine or treatment: own computations based on (World Values Survey, 2020[42]), *Wave 7* (database), worldvaluessurvey.org.

More generally, these high correlations in all subgroups of workers, including men and women, reflect poorer access of informal workers to many public health facilities. Even if healthcare may be available generally in a country, it may be unavailable to informal workers specifically for numerous reasons. They may be excluded from health insurance programmes; they may not be able to afford health insurance; they may live in remote areas; their access to healthcare may be linked to their place of residence rather than their place of work where they spend most of their time; or they may have specific occupational health needs (Alfers, 2015[51]; Traub-Merz et al., 2022[49]). Even within Organisation for Economic Co-operation and Development (OECD) member countries, rural regions, where informality is more widespread, "tend to be equipped with fewer hospital beds (…) In 2018, regions close to metropolitan areas had almost twice as many hospital beds per 1 000 inhabitants than remote regions. This gap has grown significantly since

2000" (OECD, 2020[52]). In many instances, out-of-pocket medical expenses are simply unaffordable to poor informal workers. For example, in Bangladesh, despite progress towards universal health coverage, 72% of current healthcare expenditure comes from out-of-pocket spending (Oliveira, Islam and Nuruzzaman, 2019[53]).

The combination of these factors made it particularly difficult to contain the spread of COVID-19. It also resulted in the double burden of the crisis for informal economy workers, who disproportionately suffered both from employment and income losses due to lockdown measures, and from inadequate access to healthcare.

Figure 3.9. Informality strongly correlates with poor education prospects



Note: Predicted values of informal employment. Controls include seven geographical regions (sub-Saharan Africa; South Asia; North America; MENA; LAC; Europe and Central Asia; and East Asia and Pacific); GDP per capita, PPP constant 2017; income share held by the lowest-income 10% of the population; population growth; trade as a percentage of GDP; the HDI; ease of doing business as of 2018; and political rights and civil liberties. Worry about not being able to give one's children good education is computed as an average of individual responses to the question: "To what extent do you worry about not being able to give one's children a good education", with answers measured on a scale from 1 to 4, where 1 means not at all and 4 means very much. Averages were taken (by country) within subsamples of all workers (Panel A), non-agricultural workers (Panel B), non-agricultural employees (Panel C), non-agricultural self-employed workers (Panel D), women in non-agricultural work (Panel E), and men in non-agricultural work (Panel F). The sample includes 34 countries (see Annex 3.A for the full list).
Source: For six measures of informal employment: (ILO, 2023[38]), Women and Men in the Informal Economy: A Statistical Update, https://ilostat.ilo.org/en/; for geographical regions, GDP per capita, PPP constant 2017; income share held by the lowest-income 10% of the population; population growth; trade as a percentage of GDP; the HDI: (World Bank, 2021[39]), World Development Indicators (database), www.data.worldbank.org/products/wdi; for ease of doing business: (World Bank, 2022[40]), Doing Business Indicators (database), www.doingbusiness.org; for political rights and civil liberties indices: (Freedom House, 2019[41]), Freedom in the World (database), freedomhouse.org/report/freedom-world. For frequency of worry about not being able to give one's children a good education: own computations based on (World Values Survey, 2020[42]), *Wave 7* (database), worldvaluessurvey.org.

The share of informality within various population subgroups also strongly correlates with poor education prospects of future generations perceived within the same population subgroups, and measured by the degree of worry that individuals express regarding the education of their children (Figure 3.9). This worry relates to both the quality of available schooling and the unequal access to education between children from vulnerable and non-vulnerable households, including those where the primary wage earners are in informal employment. Even where schooling is compulsory, for many informal workers in poor households the burden of household expenditure on education may be particularly heavy, leading to their children dropping out of school at higher rates and impeding the intergenerational transition out of poverty and out of informal employment (UNESCO, 2017[54]; OECD/CAF/ECLAC, 2016[55]). Government education subsidies to these families, such as in-kind or cash transfers to the families (specifically intended for school meals, school materials and clothing), even if schooling is free, may not be provided in an inclusive manner, or may be insufficient. Again, the COVID-19 crisis presented unique challenges to education prospects in many developing countries. School closures over 2020-21, the lack of broadband connectivity in the rural areas, the lack of computers, and unequal preparedness of teachers have particularly compromised education in rural areas, of children from vulnerable backgrounds (including those from households where the primary wage earners are in informal employment), and of girls (De Giusti, 2020[56]).

Exit and exclusion co-exist as important drivers of informality and often reflect the nature of the social contract

Until now, much of the debate about informality has focused on whether informality is a result of an “exclusion” or an “exit” strategy from formal working arrangements. According to the “exclusion” view, workers are in informal employment not by choice but because of either legal exclusions or the inability to comply with existing regulations (involuntary non-compliance). Some workers may be excluded from specific regulations by the regulations’ design. For example, this has historically been the case of domestic workers in many countries (ILO, 2021[57]). In practice, even if laws are applicable, compliance with them may be prohibitively costly (De Soto, 1989[58]), thus leading to the de facto exclusion of those workers who in principle would wish to be formal. For many workers, especially poor self-employed workers with few options outside the informal economy, the choice of becoming formal is so constrained that it can be considered as non-existent, leading to their de facto exclusion. For workers who are employees, limited bargaining power also means that their formality status often depends on the employer.

The “exit” view of informality presumes that workers consciously choose informal arrangements and prefer to stay informal because they see more benefits to this. As pointed out by Perry et al. (Perry et al., 2007[44]), “there is a continuum in the relative importance of exclusion and exit among individual workers and firms within countries” (p. 2). Indeed, even within the same country, there may be workers choosing informality because they view it as superior to formality, just as there may be workers with no other options but to remain informal. Knowing whether informality is the result of a choice or of an exclusion is important, as it would trigger different policy responses to address informality (Perry et al., 2007[44]).

Cross-country evidence on the reasons for informal employment is slim and inconsistent. Most of it dates back prior to the 2008 economic crisis. Examples show that voluntary informal employment is most often found among self-employed as compared with salaried workers. It is relatively frequent in LAC (Table 3.1). Still, in the vast majority of countries with available data, including in LAC, the main or the most frequently stated reason for being in informal employment is because the worker could not find a different job (Table 3.2).

Table 3.1. Reason for being in informal employment: a choice

Region	Country	Year of study	Surveyed workers	Finding
LAC	Argentina	2005-06	Independent workers	28.5%
LAC	Argentina	2005-06	Salaried workers	19.5%
LAC	Plurinational State of Bolivia (hereafter: Bolivia)	2005-06	Independent workers	40.2%
LAC	Bolivia	2005-06	Salaried workers	4.8%
LAC	Colombia	2005-06	Independent workers	51.1%
LAC	Colombia	2005-06	Salaried workers	7.0%
LAC	Dominican Republic	2005-06	Independent workers	52.0%
LAC	Dominican Republic	2005-06	Salaried workers	15.0%
LAC	Brazil	2003	Entrepreneurs	16.5%

Note: Own compilation. For Argentina, Bolivia, Colombia, and the Dominican Republic, "choice" for independent workers includes any of the following answers: having autonomy/no boss; having flexible hours/less responsibility; family tradition; higher earnings; and/or better mobility/benefits/prospects; for salaried workers, "choice" includes any of the following answers: less responsibility; more earnings; or better mobility/benefits/prospects. For Brazil, "choice" refers to "having independence" as the reason for informal work.
Source: For Argentina, Bolivia, Colombia, and the Dominican Republic: (Arias and Monserrat, 2007[59]; Arias, Landa and Yáñez, 2007[60]); for Brazil: (Williams and Youssef, 2013[61]).

Table 3.2. Reason for being in informal employment: could not find a different (formal or salaried) job

Region	Country	Year of study	Surveyed workers	Finding
LAC	Argentina	2005-06	Salaried workers	48.4%
LAC	Argentina	2005-06	Independent workers	43.0%
LAC	Bolivia	2005-06	Salaried workers	64.2%
LAC	Bolivia	2005-06	Independent workers	25.3%
LAC	Colombia	2005-06	Salaried workers	43.0%
LAC	Colombia	2005-06	Independent workers	55.3%
LAC	Dominican Republic	2005-06	Salaried workers	38.9%
LAC	Dominican Republic	2005-06	Independent workers	44.3%
LAC	Brazil	2003	Entrepreneurs	Main reason; 31.1%
Asia	Pakistan	2012-13	Informal sector workers	53.4%
Asia	India	2007-10	Women entrepreneurs	Main reason
Africa	Ethiopia	1996-2003	Informal sector workers	Main reason
Africa	Ghana	2009	Informal business owners	Main reason
Africa	Kenya	2009	Informal business owners	Main reason
Africa	Lesotho	2019	Informal business owners	24.7%
Africa	Mauritania	2017	Informal business owners	29.6%
Africa	Nigeria	2009	Informal business owners	Main reason
Africa	South Africa	2013	Informal business owners	Main reason
Africa	Uganda	2021	Independent workers	36.2%
Africa	Uganda	2021	Informal independent workers	37.1%

Note: Own compilation.
Source: For Argentina, Bolivia, Colombia, and the Dominican Republic: (Arias and Monserrat, 2007[59]; Arias, Landa and Yáñez, 2007[60]); for Brazil: (Williams and Youssef, 2013[61]); for Pakistan: (Williams, Shahid and Martínez, 2016[62]); for India: (Williams and Gurtoo, 2011[63]); for Ethiopia: (Siba, 2015[64]); for Ghana, Kenya, Nigeria, and South Africa: (Benzing and Chu, 2009[65]); for Lesotho: own computations based on Enquête Nationale sur l'Emploi et le Secteur Informel (ENE-SI); for Mauritania: own computations based on labour force survey; for Uganda: own computation based on labour force survey.

While some workers may engage in the informal economy because of a constraint, while others as a voluntary choice, what is remarkable is that in all cases informality mirrors the nature of the social contract. If too many individuals are excluded from the social contract, it means that the procedural dimension of the social contract is weak or misaligned with the substantive dimension. If too many individuals choose not to comply, it is likely that both the procedural and the substantive dimensions of the current social contract are weak (or are weakening).

Moreover, the social contract framework also embraces other reasons for informality, including reasons with direct reference to the social contract and the role of the state, and which cannot be classified as a "choice" in a binary way. For example, 15.4% of Bolivian independent workers are informal because of the lack of trust in public institutions (Arias and Monserrat, 2007[59]; Arias, Landa and Yáñez, 2007[60]). In Pakistan, 21.6% of workers operate informally because of the corruption of public authorities, and 44.3% of workers find it socially acceptable (Williams, Shahid and Martínez, 2016[62]).

Key policy messages

The social contract approach to informality allows us to think differently about the tools to address this old phenomenon. It allows us to step out of the blaming rhetoric, such as shaming non-compliant workers and businesses, and suggests the need for holistic and coherent policy solutions to render the procedural dimension of the social contract more adequate and relevant, and to ensure that the substantive dimension is strong and inclusive of all.

In this regard, country-specific reviews and tailored policy solutions are important in order to diagnose the exact nature of informality and the extent to which it is influenced by inadequacies in either the procedural or substantive dimensions.

Depending on the country, strengthening social contracts and making them inclusive of informal workers would require continuous efforts to strengthen the procedural dimension by expanding coverage of formal legal frameworks, by ensuring sufficiency of protections, and by improving compliance with formal arrangements. Strengthening the substantive dimension can be achieved by improving access to and the quality of those services that are most valued by all workers, such as healthcare, education and skills development. Moreover, in light of high prevalence of informality, this should be done in accordance with the needs and conditions of the informal economy workers, who are predominant in rural areas and often disregarded by urban planning. Fighting corruption, strengthening the trustworthiness of the judiciary system and the police, and improving how the government performs its duties, including towards informal workers, are equally important long-term efforts that should continue. To build trust, governments also need to recognise informal workers' organisations where they exist, help them become more visible, engage in constructive dialogue with these organisations, and ensure their participation in the construction of a new social contract that is inclusive, adequate, relevant and fair for informal workers and their families (Chen et al., 2022[66]).

Indeed, this chapter showed that in many developing countries, public institutions and publicly provided services, such as healthcare and education, are often not responding to the demands and aspirations of citizens in general, and even less so to those of informal workers specifically. Informality goes hand in hand with lower social spending. At the same time, informal workers – whether they are informal voluntarily or not – are more dissatisfied with the public systems and the quality of provided services than formal workers. Involuntary informal workers perceive injustice more acutely than formal workers, and are less satisfied with the public system and its quality. In certain settings, those who can choose their type of employment (formal or informal) do not perceive sufficient benefits linked to formality, and may see fewer incentives to engage in the obligations associated with the social contract, fuelling their disengagement from public institutions in a feedback loop. Reinforcing the social contract in the post-COVID-19 era in order to make it more resilient to new crises will mean dedicating a continuous effort to the recovery of people's livelihoods and their trust in society. Importantly, it will require rethinking institutions and publicly provided services in order to ensure that they are accessible, fair, reliable, predictable and trustworthy, placing the demands of all citizens, including informal workers, at the heart of the system.

The strength and relevance of any social contract may be influenced not only by internal factors, but also by the international environment (UNRISD, 2022[7]; Plagerson, Alfers and Chen, 2022[18]). Changes in the world of work, globalisation, uneven spread of technologies, and the emergence of new forms of employment (including through digital labour platforms) have been continuously shifting financial and economic risks onto individual workers' shoulders. In many instances, these changes have also undermined the quality of the social contract and called for its reimagining (World Bank, 2019[67]). In all countries, regardless of their level of development, governments should remain vigilant about the concurrent weakening of the social contract and informality as its manifestation.

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Annex 3.A. Lists of countries included in the analysis of selected figures

List of countries included in Figure 3.2, Figure 3.3, Figure 3.8 and Figure 3.9:

Argentina
Bangladesh
Bolivia
Brazil
Chile
People’s Republic of China
Colombia
Cyprus[2]
Ecuador
Egypt
Germany
Greece
Guatemala
Indonesia
Iraq
Japan
Kazakhstan
Korea
Kyrgyzstan
Mexico
Myanmar
Nicaragua
Pakistan
Peru
Philippines
Republic of Türkiye
Romania
Serbia
Tajikistan
Thailand
Tunisia
United States
Viet Nam
Zimbabwe

List of countries included in Figure 3.6 and Figure 3.7:

Albania
Angola
Argentina
Armenia

Austria
Bangladesh
Belgium
Benin
Bolivia
Bosnia and Herzegovina
Botswana
Brazil
Brunei Darussalam
Bulgaria
Burkina Faso
Cabo Verde
Cambodia
Cameroon
Chad
Chile
People’s Republic of China
Colombia
Comoros
Costa Rica
Croatia
Cyprus
Czech Republic
Denmark
Dominican Republic
Ecuador
El Salvador
Estonia
Finland
France
Germany
Ghana
Greece
Guatemala
Honduras
Hungary
Iceland
India
Indonesia
Iraq
Italy
Japan
Jordan
Latvia
Liberia
Lithuania
Madagascar
Mali
Malta
Mexico
Mongolia

Morocco
Myanmar
Namibia
Nepal
Nicaragua
Niger
Nigeria
Norway
Pakistan
Panama
Paraguay
Peru
Poland
Portugal
Republic of Türkiye
Romania
Rwanda
Samoa
Senegal
Serbia
Sierra Leone
Slovenia
South Africa
Spain
Sri Lanka
Sweden
Tajikistan
Timor-Leste
Togo
Tunisia
Uganda
United Kingdom
Uruguay
Viet Nam
Zambia

Notes

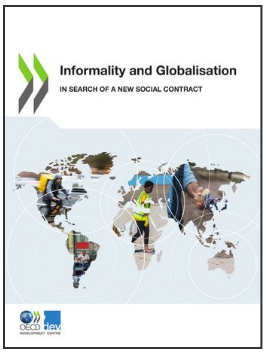
[1] Some authors single out four dimensions: procedural, substantive, participatory and recognition-related (Loewe, Trautner and Zintl, 2019[68]) (Plagerson, Alfers and Chen, 2022[18]).

[2] Note by the Republic of Türkiye

The information in this document with reference to “Cyprus” relates to the southern part of the Island. There is no single authority representing both Turkish and Greek Cypriot people on the Island. Türkiye recognises the Turkish Republic of Northern Cyprus (TRNC). Until a lasting and equitable solution is found within the context of the United Nations, Türkiye shall preserve its position concerning the “Cyprus issue”.

Note by all the European Union Member States of the OECD and the European Union

The Republic of Cyprus is recognised by all members of the United Nations with the exception of Türkiye. The information in this document relates to the area under the effective control of the Government of the Republic of Cyprus.



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