**Globalization and the Political Benefits of the Informal Economy**

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# I. Introduction

Does global market integration help or hinder government efforts to improve the livelihoods of the world’s poorest citizens? Standard trade theories suggest that government interventions become less imperative as developing countries liberalize. This is because labor in developing economies is abundant and cheap; export products that utilize this factor of production will employ large populations of low-skilled workers who will experience increases in the purchasing power of their wage income. Consumption increases, and the country as a whole is better off. For several decades now, developing economies have embraced this rationale for free trade and its welfare-enhancing effects on the majority.

Empirical data and research provides some confirmation for a number of these predictions. Developing countries have joined the global economy and raised their shore of total world exports from 21% to 43% between 1992 and 2008 (Hanson 2012). Moreover, absolute poverty as measured by the percent of people earning below $1.25 per day (2005 PPP) has dropped substantially, from around 36% in 1990 to 14.5% in 2011.[[1]](#footnote-1) With liberalization and concomitant global market integration, economic growth rates in developing economies have been improving (Wacziarg and Welch 2008, Ferreira and Rossi 2003, Krishna and Mitra 1998, Edwards 1992) , and absolute poverty shows signs of declining (Owen and Wu 2007, Dollar and Kraay 2004).

Yet, the United States Secretary –General Bank Ki-moon recently presented a report to all member states entitled *A Life of Dignity for All*, underscoring the many dimensions of poverty that still persist in the current era of globalization. The Report was consistent with the development community’s efforts to encourage scholars to turn away from the standard measures of growth and poverty and critically assess progress in broader aspects of basic human development. Amongst the list of the General Secretary’s appeals to governments of developing countries, ensuring ‘decent work for all’ ranked amongst the top.

To date, we have very little understanding of how the globalizing environment affects ‘decent work’ opportunities and know even less how politics might play a role in mediating this relationship. This paper is a first attempt to shed light on the potential links between globalization, politics, and ‘decent work’. Specifically, we focus on the informal sector as a proxy for in *in*decent work. This is because the informal economy is associated with minimal job security, lower income, absence of social benefits, lack of social mobility, and poor work (and living) conditions overall . In short, the informal sector represents the gross negligence of decent work opportunities. It is alarming that by most accounts, the informal sector seems to be increasing (or staying constant) as economies advance towards greater global market integration (Charmes 2012, Schneider 2002, OECD 2009).

We propose that international market expansion may positively impact government incentives to maintain informal sector populations, particularly in countries attracting high levels of foreign direct investment (FDI) and exporting goods that demand a higher skill premium. In this environment, the informal sector has several political advantages: it can encourage social stability by serving as the employer of last resort to large populations of unskilled labor; it can discourage large-scale business lobbying for labor market reforms by supplying firms with cheap, flexible labor and low cost intermediate inputs; and, by the same token, it is likely to reduce pressures on organized labor to accept radical labor market reforms. For politicians, globalization brings together this informal coalition of interests between unskilled labor, organized labor, and firms, dampening their motivations to change the status quo of informal sector activity.

# II. Existing literature

The official definition of the informal sector by the International Labor Organization adopted in 1993 is “household enterprises (or equivalently, unincorporated enterprises owned by households) owned and operated by own-account workers, which may employ contributing family workers and employees on an occasional basis” (ILO 1993). These jobs offer limited if any benefits and no social protection. The ILO (1993) reports this sector has the following core characteristics: low levels of labor organization, little or no division between labor and capital as factors of production on a small scale; labor relations based mostly on causal employment, kinship, or personal and social relations rather than contractual arrangements with formal guarantees. They tend to be associated with temporary or part-time work, lack of access to capital markets, no formal training, and low productivity and wages. All these characteristics make them highly vulnerable to jobs providing precarious livelihoods. Most interestingly, their economic activities seem to interact increasingly closely with the formal sector in developing countries.[[2]](#footnote-2)

A relatively small group of economists have explored the possible linkages between globalization and informal sector. These studies find that the size of the informal sector is not necessarily reducing with globalization, as conventional economy theory would predict (see Bacchetta, Ernst, and Bustamante 2009). Reasons why liberalization is failing to lower the size of the informal sector are as follows: (1) the skill premium has increased in developed and developing countries because of trade and FDI, making unskilled workers relatively worse-off (Acemoglu 2003, Feenstra and Hanson 1999, Thoenig and Verdier 2003, Bernard and Jensen 1997); (2) exporting firms are adjusting to international market competition by reducing employment and raising productivity (Currie and Harrison 1997); (3) businesses are outsourcing to the informal sector to reduce labor costs (Maloney 1998, Wahba and Moktar 2000, Unni and Rani 2003, Ramaswamy 2003); (4) strong labor market regulations in some developing countries are discouraging firms from hiring formal sector workers (Goldberg and Pavcnik 2003).

Overall, however, the existing evidence on the connections between trade and the informal sector is both understudied and tenuous. Most of the studies cited above use evidence from country specific case studies. We still do not know if the findings are generalizable. Also, estimated effects are quantitatively small and often not robust (see Goldberg and Pavcnik 2003). It may well be that the relationship between globalization and informal sector activity is spurious. One glaring omission from these analyses is the role of government and their political incentives linked the presence of an informal sector. Governments of LDCs can play a key role in simultaneously promoting trade liberalization and discouraging informal sector activity.

Ultimately, the expansion of ‘decent work’ for all in developing countries that are struggling to competed in the global economy demands rigorous political commitment. Policymakers must have incentives to prioritize reforms that encourage the development of training and educational institutions geared towards providing informal sector workers with the necessary skills for successful transition to the formal labor market. This is a daunting and costly task since the incidence of informality is highest amongst very low-skilled workers (Baker 2008; [Adams](http://elibrary.worldbank.org/action/doSearch?ContribStored=Adams%2C+A+V), [de Silva](http://elibrary.worldbank.org/action/doSearch?ContribStored=Da+Silva%2C+S+J), and [Razmara](http://elibrary.worldbank.org/action/doSearch?ContribStored=Razmara%2C+S) 2013), and the skill premium continues to increase with globalization (Acemglu 2003). The World Bank estimates that more than 30 percent of the developing world’s gross domestic product (GDP) and 70 percent of workers are outside the official economy (Palmade and Anayiotos 2005). We consider below the extent to which growing international market competition might impact government incentives to prioritize costly informal sector reforms.

# III. Globalization, politics, and informal sector

We propose that governments of developing economies have several political *dis*incentives to prioritize informal sector reforms, particularly as their economies undergo the process of liberalization. Unskilled workers, privileged (organized) labor, and businesses (both big and small) operate an informal coalition of interests in support of an informal sector that benefits each in the globalization process. First, for unskilled workers, the informal sector can serve as a (cheap) safety net for workers who cannot get jobs in the formal sector. Recall that reabsorption into the formal sector becomes harder for these less-educated workers as the skill premium increases in nations exporting labor-intensive goods and attracting foreign investment. Added to this, competition for formal sector jobs has intensified with liberalization. Workers in many poor nations experienced job losses after adoption of liberalization policies, as local firms were either unable to continue in the face of international competition, or they responded by laying off workers who subsequently found employment in the informal sector. It is well documented that sub-Saharan African countries, for example, experienced relatively rapid deindustrialization on the heels of structural adjustment (Stein 1992, Jalilian and Weiss 2000). The informal sector then serves as employer of last resort, relieving pressure on policymakers to compensate these ‘losers’ of globalization.

Second, large informal sector presence may help governments avoid large-scale lobbying by firms who would otherwise demand labor market deregulation so they can improve productivity and be more cost-effective in the global economy. Studies show that one strategy firms are adopting in response to international market competition is subcontracting work to the informal sector (Maiti and Marjit 2008; Cimoli, Primi, and Pugno 2005). In effect, globalization is encouraging vertical linkages between the formal and informal sectors as the former embraces cost-efficient strategies and outsources parts of the production process to informal economy. Evidence further suggests that the informal sector is more dynamic than passive, successfully responding to changing demands of the economy and significantly contributing to income and output (Bhattacharya 1996, Nataraj 2011). In sum, as this dualism in the production structure remains economically beneficial to firms, they have less incentive to pressure governments to engage in labor market reforms. The informal sector can thus help governments meet (formal sector) firm demands for low-cost, flexible and productive unskilled labor without political backlash from organized labor.

As a result, organized labor may find, somewhat ironically, that they share firm preferences towards the persistence of the informal sector. It is common for organized workers to be at political odds with informal workers in developing economies.[[3]](#footnote-3) Organized labor prefers to maintain the generous labor market protections they were granted during the era of import substation industrialization, while informal workers can only covet such benefits. According to recent ILO estimates, organized labor constitutes only 2-10% of total employed population in developing economies (for which data exists).[[4]](#footnote-4) Labor reforms that call for labor market flexibility and a reduction of social security and wage benefits primarily impact this very small and privileged segment of the workforce in developing economies. If informal sector presence is reducing business incentives to lobby for these labor market reforms, it is also playing a key role in helping organized labor preserve their often generous social benefits granted to them prior to trade reform. Indeed, as Goldberg and Pavcnik (2003) observe, strong labor market protections and informal sector employment tend to coexist in liberalizing economies.

As a result of these overlapping interests, policymakers are more likely to find that the benefits of informal sector presence far outweigh the costs of prioritizing ‘decent work’ in the globalizing economy. The political advantages of using the presence of the informal sector to maintaini even tacit support from formal and informal workers *and* formal sector firms are likely to exceed the costs of upskilling workers and/or monitoring these small informal firms for relatively limited increases in tax revenue. Weak tax administration systems and scarce public revenues in developing nations make it even more challenging for government to pursue widespread formalizing of the economy. On the contrary, policymakers may find it easier to welcome the informal sector in the globalizing environment. Take, for instance, a recent statement by the Minister of National Planning in Nigeria, Bashir Yuguda: “the informal sector in Nigeria has great potential and is contribution to the nation’s GDP growth aspirations by providing employment for Nigeria’s teeming youth population and reducing poverty.” It certainly helps politicians that, as studies show, urban slum dwellers-- who comprise the bulk of the informal sector- are happier and richer than their counterparts in the rural sector (Glaeser 2011).

# IV. Preliminary evidence

To get an initial sense of whether our hypothesis is correct, we did some preliminary data explorations. First, we regressed the percentage of surplus (informal) labor (see Rudra 2008) on gross domestic product per capita (GDPcap).[[5]](#footnote-5) We are most interested in observing the pattern of residuals in this model; the residual is the error component not systematically explained by the regression equation. It represents the extent to which the size of the surplus labor population is not explained by the economic component . Since GDP per capita is highly correlated with key macroeconomic indicators of the economy, we consider this residual as a rough proxy for the ‘political’ variables associated with the size of informal sector (e.g., support for current government labor/informal sector policies),. Figure 1 suggests that political motivations linked to surplus labor (i.e, the residuals) show a positive, although not monotonic trend upwards in this recent era of globalization.

# IV. Next steps

In this paper, we argue that the informal sector in globalizing economy relieves policymakers from immediate pressures to generate unskilled jobs in the formal sector, provide formal (and costly) benefits and protection to informal workers, and adopt drastic labor reforms at the national level that would keep labor costs low. The demand for informal work, which is likely increasing with globalization, may provide governments some reprieve from diverting scarce government resources towards generating formal employment and safety nets for this group in globalizing environment. Ultimately, we propose informal sector presence makes it easier to respond to the needs and demands of stronger interest groups in the globalizing environment, while still pacifying marginalized populations. Our next step is to develop a research design and collect data to analyze the empirical validity of this hypothesis. The challenge ahead is to find empirically testable measures of the political incentives proposed in this paper. Doing so would allow us to rigorously test our intuition that the presence of urban informal sector in globalizing environment may not be transitory, as international trade theory predicts.

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1. http://www.worldbank.org/en/publication/global-monitoring-report/poverty-forecasts [↑](#footnote-ref-1)
2. <http://www.ilo.org/wcmsp5/groups/public/---dgreports/---dcomm/---publ/documents/publication/wcms_222979.pdf>. P. 3-5 [↑](#footnote-ref-2)
3. See for examples Carnes (2014) discussion of the rivalry between the formal sector workers represented by the Confederacion General de Trabajadores (CGT) and (some) informal workers represented by Central de los Trabajadores (CTA) in Argentina. [↑](#footnote-ref-3)
4. ILO labor statistics, accessed on line December 10, 2014 <http://www.ilo.org/ilostat/faces/help_home/data_by_subject/subject-details/indicator-details-by-subject?subject=SOD&indicator=TUM_DEMP_ECO_RT&datasetCode=YI&collectionCode=YI&_afrLoop=520926433418247#%40%3Findicator%3DTUM_DEMP_ECO_RT%26subject%3DSOD%26_afrLoop%3D520926433418247%26datasetCode%3DYI%26collectionCode%3DYI%26_adf.ctrl-state%3Dvecay0wea_307> [↑](#footnote-ref-4)
5. Surplus labor is calculated as the working age population (minus students enrolled in secondary education minus students enrolled in 'post-secondary' education) minus active labor force participation, divided by the working age population. [↑](#footnote-ref-5)