

Policy Brief

Creating formal sector jobs in low-income countries

Researcher Brian McCaig, Nina Pavcnik
Project Number 180

Abstract

Difficulty in finding employment in the formal sector is commonplace in low-income countries, where informal businesses employ a large share of the workforce and provide livelihoods for the poor. Theory suggests that informal sector workers might transition to the formal sector as low-income economies develop. By examining Vietnam’s economic expansion and response to new export opportunities, our recent research sheds more light on patterns of individual transitions from the informal to the formal sector in low-income countries and the possible effect on aggregate productivity.

For many workers in low-income countries, obtaining a job in a factory in the formal sector is a significant improvement. For example, Dao Thi Sen works in a garment factory in Vietnam owned by a Korean company. “I was a freelance seamstress before. But the work wasn’t very stable. This is better”. The search for a better job is often associated with significant migration. Cong Nguyen struggled to find a stable job in his home province of Ha Tinh, in northern Vietnam. He moved more than 1,000 km to Cu Chi, near Ho Chi Minh City, and found work in a textile factory in their packaging department. Cong found a wife through his new work and is able to sustain his home and pay for

a good education for his son; he plans to return to his hometown one day to retire.¹

Informal employment in low-income countries and productivity

Difficulty in finding employment in the formal sector is commonplace in low-income countries, where informal businesses employ a large share of the workforce and provide livelihoods for the poor (*Banerjee and Duflo 2007, Gollin 2008*). Informal firms, which are firms not legally registered with the government, are primarily small, household-run businesses that often lag in productivity far behind formal firms, which are legally registered.² As a result, countries

characterised by an abundance of informal firms suffer from low aggregate productivity (*Hsieh and Klenow 2008*). Likewise, the prevalence of employment in informal businesses tends to decrease as countries become richer (*La Porta and Shleifer 2014*). This leads to questions about what role policy may play in either increasing productivity within small, informal firms or assisting the reallocation of workers away from these firms to higher-productivity, formal firms.

Significant research has focused on whether performance within informal firms can be improved, generally finding only small potential gains. For example, *McKenzie and Woodruff (2014)* summarise that few businesses implement business practices taught in training, while *Bruhn and McKenzie (2014)* conclude that most policies designed to induce informal firms to register as a formal firm lead to modest increases in registration, if any, and that most businesses do not gain from formalising. Furthermore, *Karlan and Zinman (2011)* report that access to microcredit does not promote microenterprise growth.

However, less attention has been paid to a second possible mechanism for improving aggregate productivity, namely workers moving from the low-productivity, informal firms to the higher-productivity, formal firms. Research on economy-wide transitions of individuals in and out of informality in low-income countries is scarce, with most studies confined to urban, middle-income settings (*Maloney 2004*).

Theory suggests that informal sector workers might transition to the formal sector as low-income economies develop (*Lucas 1978, Gollin 2008*). By examining Vietnam's economic expansion and response to new export opportunities, our recent research (*McCaig and Pavcnik 2015*) sheds more light on individual transitions from the informal to the formal sector in low-income countries and the possible effect on aggregate productivity.

Transitions from the informal to the formal sector in Vietnam: New evidence

Vietnam experienced a decade of rapid growth from 1999 to 2009, when GDP per capita increased by 78% from \$1735 (2005 USD in PPP) in 1999, the labour force grew by 35%, and the percentage of the workforce employed in the informal sector dropped

7 percentage points, from 86 to 79. Nationally representative data on workers from censuses and household surveys allow us to examine the characteristics of informal workers who are most likely to formalise in a fast-growing, low-income economy, and whether these workers engage in different job tasks as they switch to the formal sector.

First, young workers make a key contribution toward the aggregate decline in informality.

Young workers that enter the workforce between 1999 and 2009 are less likely to work informally than workers in older, exiting cohorts, highlighting the importance of changes in composition of workforce across cohorts in explaining declines in economy-wide informality. This channel accounts for 69% of the decline in aggregate informality.

In addition, younger cohorts experience greater declines in within-cohort informality than older cohorts. This channel accounts for 3% of the decline in aggregate informality. Internal migration also plays an important role in formalisation of the workforce.

For example, only 42% of workers that recently migrated were working in the informal sector (as compared to 79% of workers overall) and an even lower 14% of recent migrants in manufacturing were in the informal sector. The decision to migrate is much more common among the young, particularly among manufacturing workers. Across all industries, 12% of workers age 20 to 24 migrated during the five years leading up to 2009, while 29% of manufacturing workers in the same cohort migrated. Thus, the decision to migrate heavily influences the likelihood of holding a formal sector job.

Who switches to a formal job?

We find that workers who switch out of informality tend to have similar observable characteristics to workers already in the formal sector: young, highly educated, male, non-minority, and urban.

Meanwhile, poorly educated, rural, older, female workers are unlikely to make such transitions. However, although observable worker characteristics strongly influence whether a worker is likely to work in the informal or formal sector, the same characteristics poorly predict transitions out of the informal sector on an individual basis. Further research is

thus required to better understand why some workers leave the informal sector while others do not.

Importantly, workers that switch to the formal sector upgrade occupations.

Switchers from the informal sector to the formal sector increase employment in skilled occupations (e.g. skilled handicraftsman and manual workers, skilled service workers), as well as in assembly, mechanical, and professional occupations – all occupations associated with higher pay than elementary occupations prevalent in the informal sector. While many workers switch to low-skill manufacturing jobs in the formal sector, these jobs are more skill-intensive and offer higher compensation than jobs previously held by these workers in agriculture and in informal manufacturing or services. Thus, switches to the formal sector also tend to be correlated with upward job mobility. Similar analysis of workers that migrate provides further support for occupation upgrading.

Our analysis on birth cohorts, switchers, and occupational upgrading sheds light on changes in working conditions associated with formalisation in a low-income country. In addition, this ongoing reallocation of workers from informal, household-run businesses toward more productive establishments can increase aggregate productivity. As discussed earlier, many studies document a systematic negative relationship between the prevalence of informal employment and economic development, and attribute aggregate income differences across countries to inefficient allocation of inputs across sectors and firms. Policymakers may be inclined to search for additional ways to improve the transition out of informality in low-income countries. Such policies would need to account for the impact of global markets (*McCaig and Pavcnik 2014*), industrial policy, and preferences for small and medium enterprises (*Martin et al. 2014*).

For example, in previous research (*McCaig and Pavcnik 2014*), we study the impact of new export opportunities on the allocation of workers between the informal and formal sectors in Vietnam. The 2001 US-Vietnam Bilateral Trade Agreement shifted Vietnam's exports from Column 2 of the US tariff schedule to Most Favoured Nation status.

The reduction in tariffs was immediate and large. The average tariff reduction was 30.3 percentage points within manufacturing and a staggering 58.5 percentage points in garments. *McCaig (2011)* has shown that export opportunities reduced poverty in regions of Vietnam with higher concentration of industries that benefited from the lower tariffs on their exports to the US. The reductions in US tariffs increased the share of manufacturing workers in formal sector firms by 5.2 percentage points in two years. Within garments, the share of workers in formal firms increased by 9.6 percentage points. As the value of output per worker is about 6.5 times higher in formal sector manufacturing than informal sector manufacturing, this reallocation of workers is associated with approximately a 10% improvement in productivity within manufacturing.⁸

Conclusion

Overall, our results highlight the importance of policies that promote the growth of the formal sector and consequently draw workers out of the informal sector. Such policies not only provide for occupational upgrading and increased earnings for individuals who switch, but also facilitate gains in aggregate productivity in formalised sectors. We additionally demonstrate that the rate of formalisation of the workforce is intrinsically tied to shifting demographics. Over a ten-year period of rapid growth in Vietnam, over two-thirds of the decrease in informal sector employment was due to changing cohorts in the workforce. Elderly, rural, poorly educated workers are likely to always work in the informal sector.

References

- Banerjee**, A V, and E Duflo (2007), “The Economic Lives of the Poor,” *Journal of Economic Perspectives* 21(1): 141-167.
- Bruhn**, M, and D McKenzie (2014), “Entry regulation and the formalization of microenterprises in developing countries,” *The World Bank Research Observer* 29(2): 186-201.
- Gollin**, D (2008), “Nobody’s Business But My Own: Self-Employment and Small Enterprise in Economic Development,” *Journal of Monetary Economics* 55(2): 219-233.
- Hsieh**, C-T and P J Klenow (2008), “Misallocation and manufacturing TFP in China and India,” *Quarterly Journal of Economics*, 124(4): 1403-1448.
- Karlan**, D, and J Zinman (2011), “Microcredit in theory and practice: Using randomized credit scoring for impact evaluation,” *Science*, 332(6035): 1278-1284.
- La Porta**, R, and A Shleifer (2014), “Informality and Development,” *Journal of Economic Perspectives* 28(3): 109-126.
- Lucas**, R E Jr (1978), “On the Size Distribution of Business Firms,” *The Bell Journal of Economics* 9(2): 508-523.
- Martin**, L A, S Nataraj, and A Harrison (2014), “In with the Big, Out with the Small: Removing Small-Scale Reservations in India,” NBER Working Paper No. 19942.
- Maloney**, W (2004), “Informality Revisited,” *World Development* 32(7): 1159-1178.
- McCaig**, B (2011), “Exporting out of poverty: Provincial poverty in Vietnam and U.S. market access,” *Journal of International Economics*, 85(1): 102-113.
- McCaig**, B, and N Pavcnik (2014), “Export Markets and Labor Allocation in a Low-Income Country,” NBER Working Paper No. 20455.
- McCaig**, B, and N Pavcnik (2015), “Informal Employment in a Growing and Globalizing Low-Income country,” *American Economic Review Papers and Proceedings*, 105(5): 545-50.
- McKenzie**, D and C Woodruff (2014), “What are we learning from business training and entrepreneurship evaluations around the developing world?” *The World Bank Research Observer*, 29(1): 48-82.

Endnotes

- [1] These examples draw from Better Work Vietnam available at <http://betterwork.com/global/wp-content/uploads/Better-Work-Vietnam-Telling-the-Story.pdf> and <http://betterwork.org/vietnam/?p=2255>.
- [2] Creating an exact definition of informality is challenging for a number of reasons. For example, if a business has a tax code but not a license to operate, which can happen when more than one government agency is involved, is it formal or informal? If the business has all the legally required paperwork but hides some of its purchases and sales from the government, is it informal or formal? Despite this challenge, *La Porta and Schleifer (2014)* show that various measures of informality are highly correlated. For Vietnam, we define formal sector employment as working in a business that is officially registered under Vietnam's Enterprise Law.
- [3] The numbers reported here differ slightly from *McCaig and Pavcnik (2014)* and are based on an in-progress revision.



This document is an output funded by the UK Department for International Development (DFID) and the Institute for the Study of Labor (IZA) for the benefit of developing countries. The views expressed are not necessarily those of DFID or IZA.

The Growth and Labour Markets in Low Income Countries Programme (GLM | LIC) is a joint collaboration between IZA and DFID which aims to improve worldwide knowledge on labor market issues in low-income countries and provide a solid basis for capacity building and development of future labor market policies.

Based in Bonn, Germany, IZA is a local and virtual international research center and a place of communication between science, politics and society. IZA is an independent non-profit organization supported by the Deutsche Post Foundation.

The IZA research network is committed to the IZA Guiding Principles of Research Integrity. Research published in this series may include views on policy, but IZA itself takes no institutional policy positions.