Promoting labour formalization and decent work

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Introduction

Developed countries are understandably concerned about new forms of labour relations, in particular how they are affected by new technology, and their limited coverage by labour regulations designed to guarantee decent work through a formal contract, the provisions of which are defined by law.

In developing economies, informal work is not a recent phenomenon created by new types of labour relations that are not covered by existing legislation; many of the challenges surrounding labour formalization have structural roots in these economies. However, new types of work and labour relations are also emerging in those countries

Developing economies are highly heterogeneous, owing to a lack of diversity in the productive structure, which tends to be dominated by natural-resource-based sectors. There are obstacles to the diffusion of new technology which in turn widens internal productivity gaps, gaps that are significantly larger than those in developed economies (Porcile, 2011).

Modern high-productivity industries and firms account for a large share of gross domestic product (GDP), but employ only a small proportion of the labour force. There is a significant productivity gap between the leading economic sectors and the mainly small and medium-sized firms that have intermediate productivity levels and often lack competitiveness. Many of these firms contain costs by, among other things, not formalizing the status of their workers, which is why the International

Labour Organization (ILO) includes workers holding informal jobs in formal sector enterprises in its definition of informal employment.

Lastly, a significant proportion of the labour force hold informal jobs or earn subsistence-level income. This group of workers has very low levels of productivity, to the detriment of income distribution and average income in the national economy (ECLAC, 2012b).[1] Policies to formalize these workers face structural obstacles.

This paper discusses aspects of the structurally roots of informal work and of cost-cutting efforts that contribute to informal conditions, focusing on Latin America and the Caribbean. These aspects exacerbate the regulatory and legal difficulties associated with informal work. The first section shows how informal employment in Latin America is linked to the structure and workings of the labour market, which mirrors to a high degree the characteristics of the productive structure. Different policy options for formalizing employment and their limitations are discussed in the second section. The third section briefly examines informal employment as a result of cost-cutting efforts, and the final section discusses some policy considerations.

1. High levels of informal employment, linked to structural features of the economy and the labour market

The high levels of informal employment in Latin America and the Caribbean are related to the structure of the labour market and to the gaps between the levels of formality and informality in the different occupation groups.

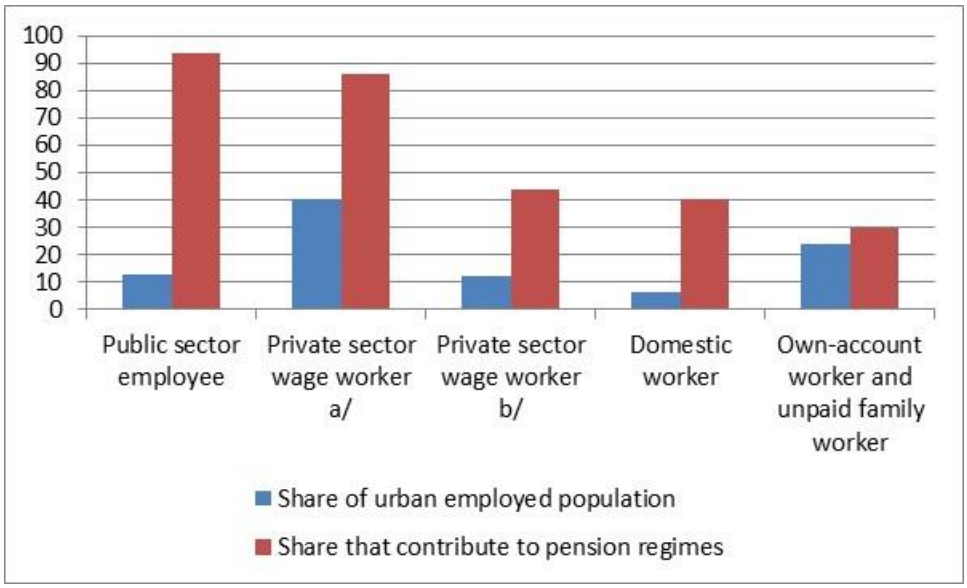
As a proxy indicator of formality, figure 1 shows the distribution of Latin America's urban employed population by occupational group, and the proportion of those workers that contribute to pension regimes.[2] While public sector employees and wage workers in small, medium-sized and large private firms represent a small majority of the urban employed population, own-account workers make up a significant proportion of the labour force, and micro-enterprise and domestic workers also account for a relatively high proportion of that population.[3]

[1] According to the estimates by Infante (2011, p. 71), the output of workers in the low-productivity segment is only about 18% of the Latin American average and 3.6% of high productivity sectors.
[2] The advantage of this proxy variable is that it can be applied to any category of worker, while other proxies, such as having a formal work contract that respects legally recognized labour rights, only for apply to employees.
[3] The information is limited to urban areas due to data availability. It should be borne in mind that levels of informality are even higher in rural areas.

Figure 1

Latin America: share of urban employed population and the proportion of that population who contribute to pension regimes, by occupational group

(Percentages)



Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of International Labour Organization (ILO), *2015 Labour Overview: Latin America and the Caribbean*, Lima, 2015.

[a] Establishments with six or more workers.

[b] Establishments with a maximum of five workers.

This occupational analysis is relevant as levels of informality are higher among groups such as own-account workers, domestic workers and wage workers in micro-enterprises. Meanwhile, workers in the public sector or in small, medium-sized and large private businesses enjoy higher levels of formality, although even in these categories there is a significant proportion of informal workers.

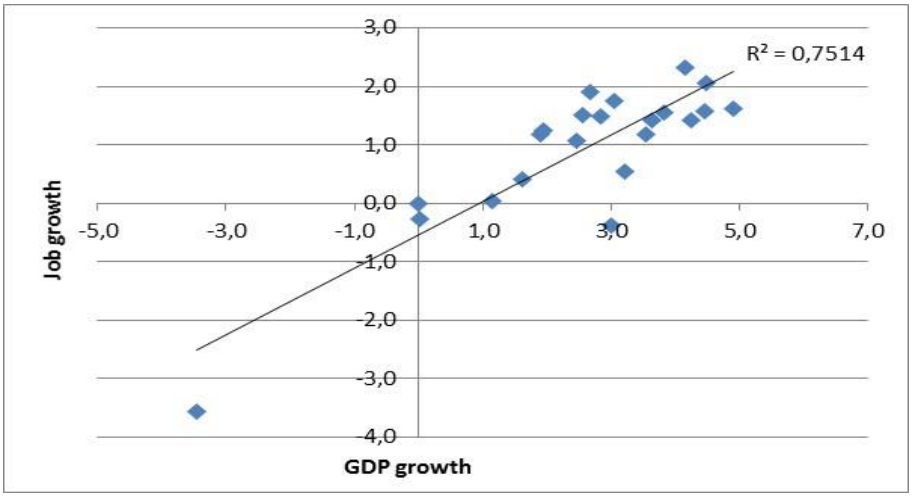
Similar proportions of male and female urban workers contribute to pension regimes. However, female participation is lower among wage workers in small, medium-sized and large businesses, and higher in some of the categories with the lowest level of formalization, especially domestic service and unpaid work in income-generating activities in family-run enterprises.

The structural differences between the labour markets of developing and developed economies can also be seen in employment and labour productivity trends at different points in the growth cycle. These structural differences are reinforced by the characteristics of labour market institutions, such as unemployment insurance. As can be seen in figure 2, job creation is strongly correlated with economic growth (R^2=0.75) in the United States and Canada. Specifically, in times of economic crisis, lower demand for labour leads to lower job creation rates or, in extreme cases, a fall in the number of jobs in absolute terms, as was the case in 2009. The highly procyclical nature of job creation, supported by labour legislation and unemployment insurance, prevents average labour productivity from falling during crises; in periods of zero economic growth, labour

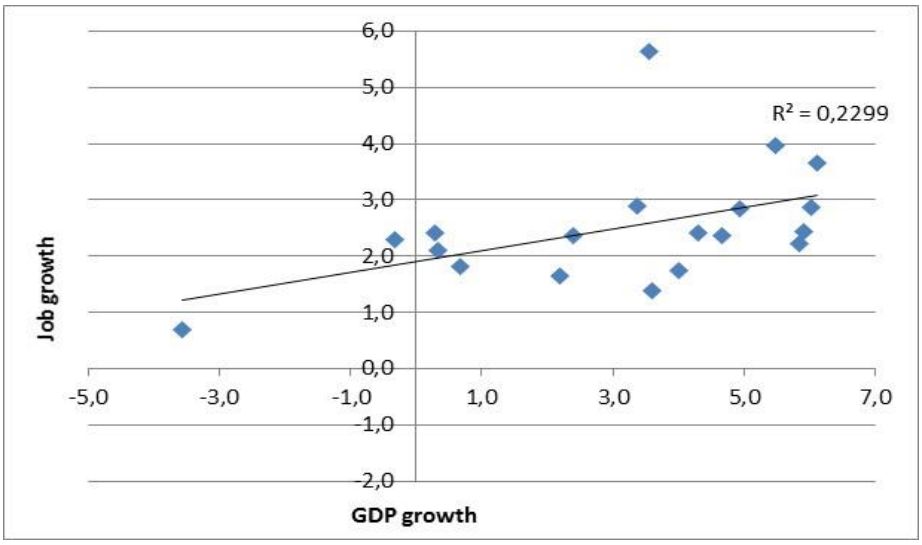
productivity tends to rise by 0.6%. However, as jobs are the main adjustment variable there is greater dispersion in the relationship between labour productivity and economic growth (see figures 2 and 3).[4]

Figure 2
Economic growth and job creation, 1992-2010
(Percentages)

A. United States and Canada



B. Latin America and the Caribbean



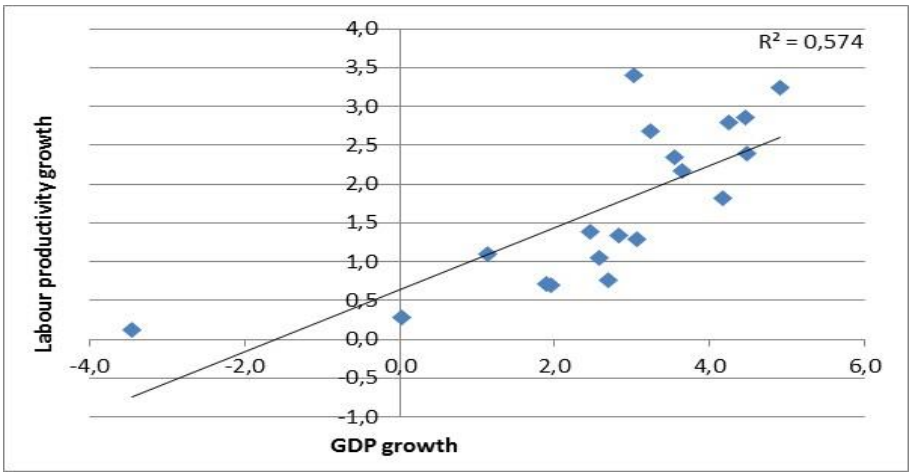
Source: Economic Commission for Latin America and the Caribbean (ECLAC)/International Labour Organization (ILO), "Labour productivity and distribution issues", *The Employment Situation in Latin America and the Caribbean*, No. 6, Santiago, May 2012.

[4] Wage adjustments are not taken into account in this exercise.

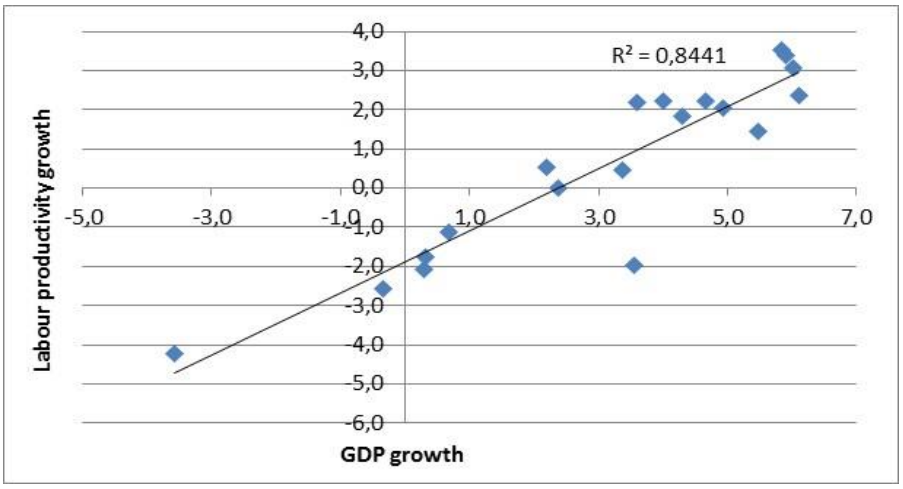
Figure 3

Economic growth and changes in average labour productivity, 1992-2010
(Percentages)

A. United States and Canada



B. Latin America and the Caribbean



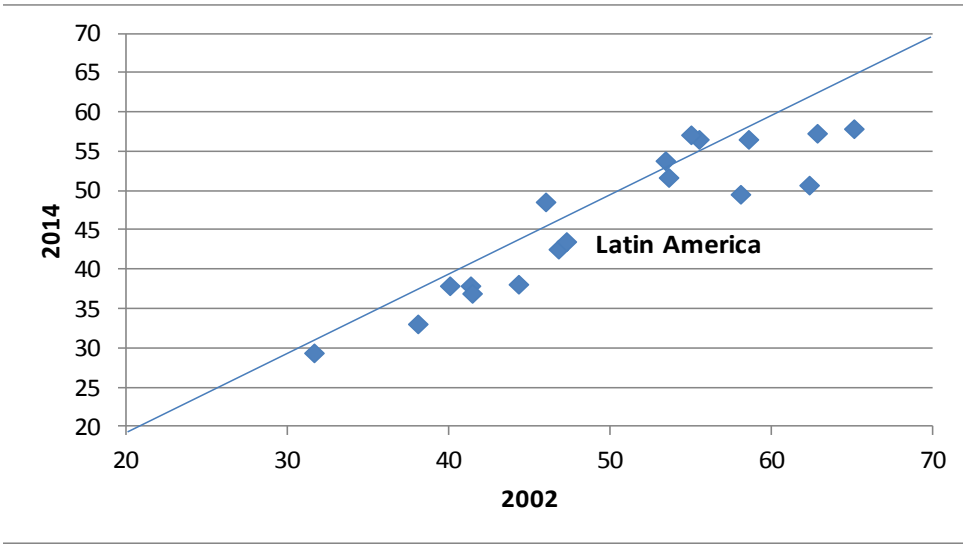
Source: Economic Commission for Latin America and the Caribbean (ECLAC)/International Labour Organization (ILO), "Labour productivity and distribution issues", *The Employment Situation in Latin America and the Caribbean*, No. 6, Santiago, May 2012.

The situation is completely different in Latin America. A significant proportion of the workforce is not directly affected by shifts in demand for labour, given that the needs of low-income households create a labour-supply-driven dynamic that weakens the correlation between economic growth and job creation, and even in situations of very low growth, the number of jobs

created tends to rise in absolute terms (R^2=0,23).[5] The other side of this coin is the strongly procyclical behaviour of average labour productivity (R^2=0.84), as the jobs created in response to labour supply in a low-growth phase tend to be low productivity jobs. Thus, the structurally-determined high proportion of low productivity jobs increases even more during economic crises, but it usually falls as economic growth picks up.

As information at the productive unit level is not readily available, ECLAC uses a combination of information on employment category, occupation group and size of establishment as a proxy for low-productivity jobs.[6] Nearly half of the urban employed population was working in low-productivity jobs at the beginning of the century. However, thanks to relatively high economic growth in recent years, demand for labour has increased leading to relatively strong wage-job creation, especially in small, medium-sized and large firms, which in 2014 employed a larger share of the urban labour force in nearly all Latin American countries, reducing the share of low-productivity jobs from 47.3% to 43.3% in Latin America as a whole (weighted average) (see figure 4).

Figure 4
Latin America: proportion of urban employed population in low productivity jobs, 2002 and 2014
(Percentages)



Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of data from national household surveys.

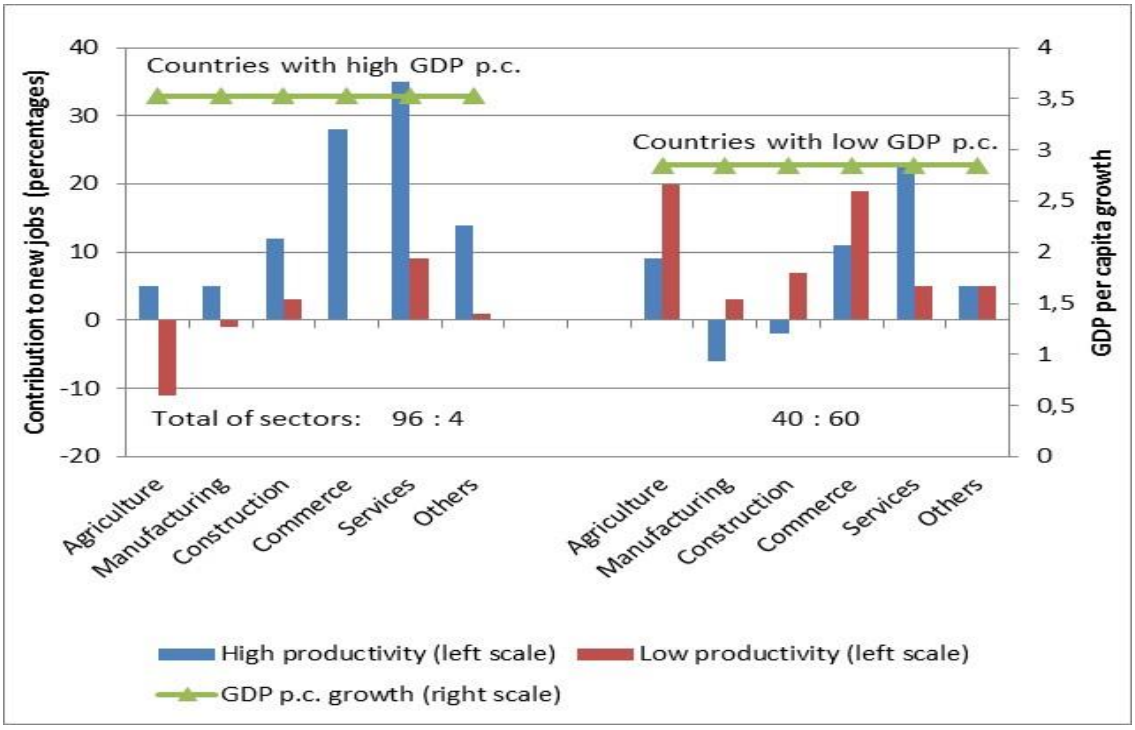
[5] Sabarwal, Sinha and Buvinic (2010) discuss the countercyclical behaviour of labour supply in poor households.
[6] For the purposes of this report, own-account workers (excluding professionals and technicians), employers and wage workers in micro-enterprises (up to a maximum of five workers), domestic workers and unpaid family workers serve as proxies for the low-productivity segment.

However, this positive trend was quite uneven among Latin American countries, as it was affected by countries' structurally-defined starting point. Figure 5 illustrates this issue by comparing industries' average contribution to job creation in the period 2002-2011 in two groups of Latin American countries —one with higher, the other with lower per capita GDP—. In addition, all industries are divided into two segments based on their level of productivity, in accordance with the methodology used for this report.

Figure 5

Latin America (selected countries): contribution to total job growth, by industry and productivity level, simple average, 2002-2011

(Percentages)



Source: Economic Commission for Latin America and the Caribbean (ECLAC), *Economic Survey of Latin America and the Caribbean, 2014* (LC/G.2619-P), Santiago.

Note: The countries with high per capita GDP are Argentina, the Bolivarian Republic of Venezuela, Brazil, Chile, Costa Rica, Mexico and Panama; the countries with low per capita GDP are Ecuador, El Salvador, Honduras, Peru and the Plurinational State of Bolivia.

Per capita GDP growth was slightly higher among the first group of countries, which probably contributed to stronger job creation in the high- and medium-productivity segments in those countries. However, the differences between the two groups of countries are so striking that they

cannot be explained by economic growth alone. Among the first group of countries, 96% of all new jobs were created in high- and medium-productivity segments, while this was the case only for 40% of the jobs created in the countries with lower per capita GDP.

Among the countries with higher per capita GDP, job growth was concentrated in the high- and medium-productivity segments of the tertiary sector, but a significant number jobs were also created in the high- and medium-productivity segments of the construction, agriculture and manufacturing sectors. Meanwhile, employment fell in the segment that usually has the lowest productivity level, small farm *(campesino)* agriculture, mainly because workers moved to higher productivity and income activities (Weller, 2016).

Among the countries with low per capita GDP, high and medium productivity tertiary sector activities also contributed a significant proportion of new jobs, as did agriculture, but no jobs were created in higher productivity activities in manufacturing or construction. Weak job growth in the high- and medium-productivity segment forced many people to work in low-productivity areas, leading to the creation of more new jobs in those areas, especially in agriculture, commerce and construction.

Thus, among the low per capita GDP group, even when economic growth was relatively high, labour supply continued to exceed demand in high and medium productivity activities, and there was a significant increase in new jobs in the low-productivity segment in order to meet the subsistence needs of many households.

A contributing factor is the fact that, in general, the working age population is growing faster in countries with low per capita GDP, so even more new jobs are required to incorporate new job seekers into the labour market, while fewer jobs are created in the high- and medium-productivity segments in these countries.

However, the main explanation for the diverging result between the two country groups lies in the differences between their productive structures. In structurally heterogeneous countries, high- and medium-productivity sectors account for a large proportion of GDP,[7] while the contribution of the low-productivity segment is limited. Among these countries, in those with higher per capita GDP, the high- and medium-productivity segments account for a larger share of the productive structure and employment than they do in low per capita GDP countries.[8] So, with a similar elasticity between output and employment in the high- and medium-productivity segments, absolute job growth in those segments will be stronger in countries with high per capita GDP, leaving a smaller proportion of job seekers forced to work in low-productivity activities. In contrast, in countries with low per capita GDP, even when job growth rates were higher in the high- and medium-productivity segments due to relatively strong economic growth, they were

[7] Using an industry-based definition of productivity segments, Infante (2011) estimates that in Latin America the high-productivity segment accounts for 62% of GDP.
[8] See ECLAC (2012a) for a comparison of heterogeneity indicators for different Latin American country groups.

insufficient to absorb the high number of job seekers and, in absolute terms, those segments created fewer jobs than the low-productivity segment.

Until the beginning of the present decade, countries had seen positive changes in employment structure, albeit at different paces. However, in recent years, the low and —in 2015 and 2016— negative economic growth in the region and the resultingly weak job creation in the high- and medium-productivity segments put that trend into reverse. Consequently, the proportion of wage jobs has been falling and the percentage of own-account workers increasing.[9]

2. Policy options for formalizing employment and their limitations

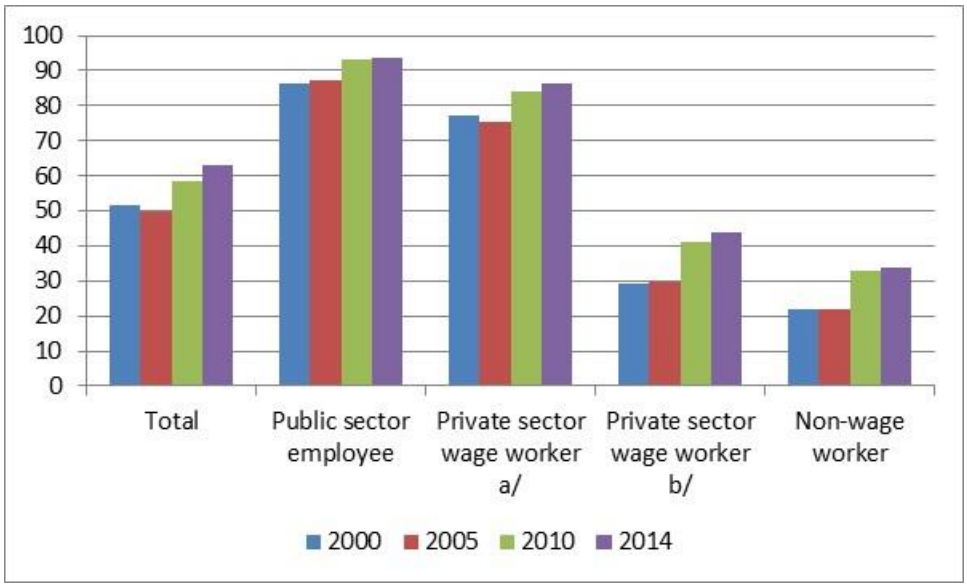
Since the 2000s, many Latin American countries have made greater efforts to formalize companies and employment. With regard to employment, three main policies were pursued. First, national authorities strengthened their labour inspection services, sometimes redefining their role (Pires, 2008; Bensusán, 2009). Second, they made employment formalization less expensive, for example with special rates for the social security contributions paid by micro-, small and medium-sized companies. Third, they made efforts to expand the coverage of contributory pension regimes (often in conjunction with the adoption of pension regimes that are not based on beneficiaries' previous contributions).

As can be seen in figure 6, there was a general increase of the coverage of contributory pension regimes thanks to both the creation of new jobs in formal sectors and the formalization of existing jobs.

However, figure 6 also confirms that, despite the increase in coverage in highly informal groups, especially among own-account workers, the number of workers affiliated to contributory pension regimes is still very low, and a huge gap persists when compared with more formal job groups.

[9] The number of wage earners and own-account workers grew by 0.3% and 3.1%, respectively, in 2015, by -0.4% and 2.0% in 2016, and by 0.4% and 1.1% in the first three quarters of 2017 (ECLAC, 2017a).

Figure 6
Latin America: proportion of urban employed population that contributes to pension regimes, by category of occupation group, 2000, 2005, 2010 and 2014
(Percentages)

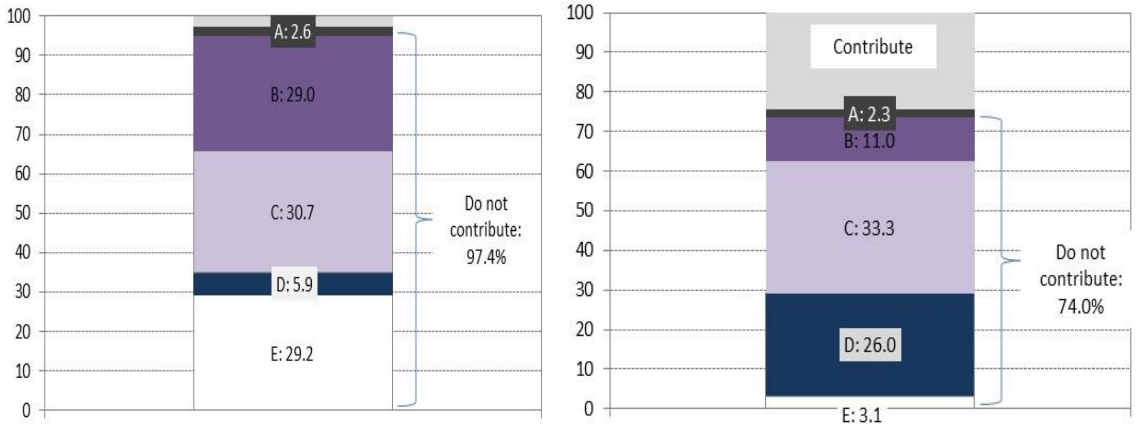


Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of International Labour Organization (ILO), *2015 Labour Overview: Latin America and the Caribbean*, Lima, 2015.
[a] Establishments with six or more workers.
[b] Establishments with a maximum of five workers.

While this progress shows that it is not impossible to formalize a certain segment of informal workers, obstacles to further improvements remain, some of them structural. As this group of workers is highly heterogeneous, the prospects for formalization are very different, depending on the specific characteristics of these workers. Taking Brazil and the Plurinational State of Bolivia as examples, figure 7 shows the proportion of own-account workers who contribute to a pension regime (used as an indicator of formality) as well as the characteristics of those that do not contribute, in order to assess efforts to formalize employment and their limitations.

Figure 7
Proportion of own-account workers who contribute and do not contribute to a pension regime, by type of work
(Percentages)

A. Plurinational State of Bolivia B. Brazil



Source: S. Gontero and J. Weller, "Consideraciones para aumentar la participación de los trabajadores por cuenta propia en los sistemas contributivos de protección social en América Latina", *Macroeconomics of Development series*, No. 189 (LC/TS.2017/69), Santiago, Economic Commission for Latin America and the Caribbean (ECLAC), 2017.

Note: Of those own-account workers who do not contribute to a pension regime, group A comprises professional own-account workers who earn more than three times the poverty line. Group B consists of non-professionals who earn more than three times the poverty line and have a certain amount of stability because, for example, they have permanent commercial premises (e.g. a shop or garage). Group C comprises own-account workers who do not fall into any of the other groups. Group D consists of own-account workers with earnings below the poverty line. Group E comprises own-account workers whose earnings are below the poverty line, and who have a low level of education and work relatively few hours.

Own-account workers in groups A and B are more likely to have their employment situation formalized. In these cases, the main policy instrument used to foster their formalization and, specifically, their affiliation to contributory pension regimes, appears to be better information and inspection systems.

While Brazil has a relatively high contribution rate among own-account workers (26.0%), it is extremely low (2.6%) in the Plurinational State of Bolivia. However, quite a large proportion of Bolivian own-account workers could potentially be formalized with relative ease (particularly those in group B), while the sum of groups A and B is a lot smaller in Brazil, probably as a result of earlier progress in formalization.

At the other end of the scale, it is extremely difficult to fully formalize own-account workers in groups D and E, as these workers tend to earn subsistence level incomes which makes saving for their pension nearly impossible. Given that formalization does not seem to be a realistic option for these workers, non-contributory pension regimes would appear to be an appropriate alternative. A relatively high proportion of own-account workers who devote fewer hours to income-generating work are women, because they have to perform additional domestic tasks. As a result, many women do not have access to a contributory pension; regimes must therefore be developed that take into account part-time income-generating work and unpaid domestic and care work (ECLAC, 2017b).

The percentage of own-account workers in groups D and E is quite large in both countries (35.1% and 29.1%, respectively), which suggests that traditional formalization strategies would probably have little impact on a significant proportion of own-account workers.

Lastly, a significant proportion of own-account workers who do not contribute to a pension system do not belong to any of these groups (group C). For these workers, a mixed system, with incentives for formalization and a non-contributory supplement to their pension would probably be a suitable policy option (Gontero and Weller, 2017).

3. Informality as a cost-cutting strategy

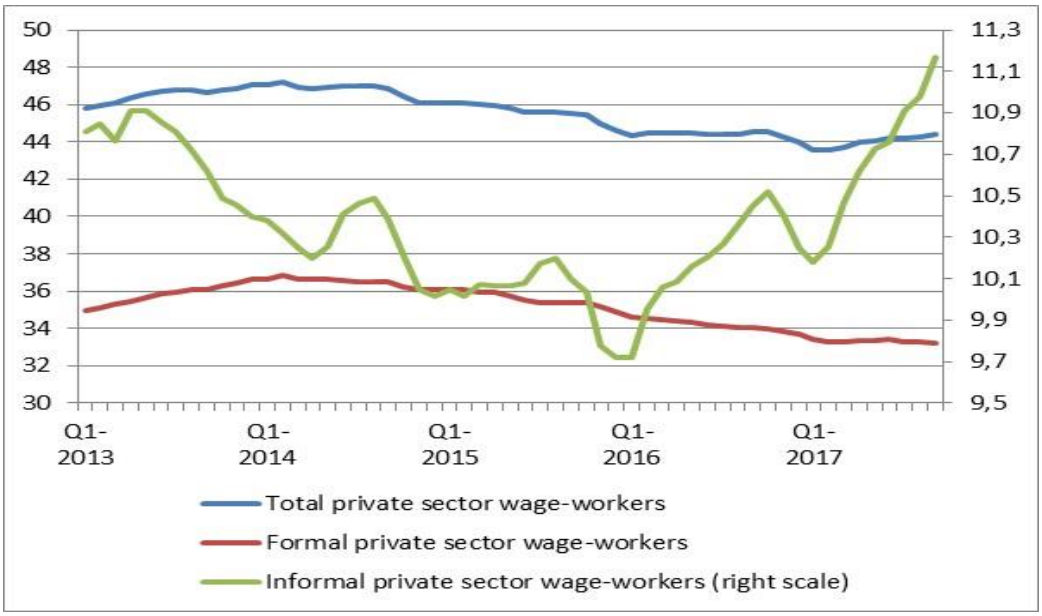
In addition to the informality linked to the productive structure and the size of the low-productivity segment, informality can also be found in the high- and medium-productivity segments and in formal corporations, possibly because information on the existing rules is not widely available, but more probably as a result of firm's cost-cutting strategies. As a result, a number of countries have implemented tax reforms that provide incentives to encourage labour formalization.

The impact of cost-cutting strategies can be clearly seen during economic crises. Figure 8 shows the evolution of private sector wage jobs in Brazil, from the first quarter of 2013 to the three months from September to November 2017. As the Brazilian economy contracted (down 3.5% in 2015, and again in 2016), the private sector lost about 2.6 million jobs between the third quarter of 2014 and the first quarter of 2016. This destruction of private sector jobs affected formal as well as informal employment, with 1.9 million formal jobs lost and around 700,000 informal ones (see figure 8).

Figure 8

Brazil: number of private sector wage-workers, formal and informal, first quarter of 2013 to September-November 2017

(Millions of people)



Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of Brazilian Institute of Geography and Statistics (IBGE), "Pesquisa Nacional por Amostra de Domicílios" [online] https://ww2.ibge.gov.br/home/estatistica/pesquisas/pesquisa_resultados.php?id_pesquisa=40.

The rate of job losses slowed from the second quarter of 2016, and over the course of 2017 the private sector gradually began to create jobs again. In the three-month-period from September to November 2017, the number of private sector jobs was close to the levels seen in the first quarter of 2016. However, between the first quarter of 2016 and this last period, the number of formal private sector wage jobs continued to fall by an additional 1.4 million, which was offset by a similar increase in informal wage jobs.

As it is highly unlikely that all the formal job losses were due to job destruction processes, or that the increase in informal wage jobs was due to the creation of new jobs alone, it can be assumed that this reconfiguration of private sector jobs can be attributed in part to the informalization of existing, previously formal jobs, emanating from companies' cost-cutting strategies in response to the economic crisis. In many cases, workers probably did not have any choice but to accept this informalization in order to keep their jobs.

4. Some policy considerations

The policy implications of this analysis are wide-ranging. Instead of offering a "laundry list" of policy advice, this final section contains just six policy suggestions.

The deep-rooted links between the high levels of informality in Latin America and the existing productive structure suggest that, in addition to adopting instruments to promote job formalization, steps must be taken to address structural obstacles to formalization. Reducing heterogeneity in productivity levels and job quality, and thus providing broader access to decent work and formal jobs, will require a competitive diversification of the productive structure. This kind of structural change will create new sectors and activities capable of absorbing more workers in higher productivity, better quality and better paid jobs. In this context and in view of the actions that will be needed to give effect to the 2030 Agenda for Sustainable Development, ECLAC (2016) has proposed, among other policies, increased investment for an "environmental big push".

A new set of industrial policies will be needed that takes into account the impact, opportunities and challenges of the technological changes arising from a digital economy. To stop productivity gaps widening and to take advantage of new technologies' productive potential, these policies must seek to transform small and medium-sized enterprises so that they can create more formal jobs.

With regard to the formalization of existing jobs, the analysis shows that the right policy instruments can produce improvements, especially in highly informal job categories. Formalization strategies that include easy access to relevant information, incentives (for example, simplified tax schemes and special rates for micro- and small businesses) and less red tape have proven to be reasonably successful in many countries of the region. While these policies may now be yielding fewer additional gains (most of the low hanging fruit has already been harvested), it makes sense to pursue them to moderate the costs of formality, and thus encourage the creation of new businesses.

However, the analysis also indicates that it is unrealistic to expect a certain proportion (varying in magnitude among countries) of jobs to be formalized. Instead, other instruments should be applied to improve the quality of these jobs and other job-related aspects, such as pension coverage. Specifically, countries should develop a tool-kit that contain instruments for productive development, oversight mechanisms and incentives, and combine aspects of different pension regimes.

In this context, the partial formalization of part-time own-account activities, mostly performed by women who also have to carry out domestic and care duties, poses a considerable challenge. It is therefore particularly important to establish pension access rights [Author: please confirm] based on part-time income-generating activities but also on the recognition of domestic work, and thus tackle deep-rooted gender-based inequalities.

In the event of an economic crisis, advances made in job formalization may be lost very quickly. The experiences of developed countries (such as Germany in 2008/09 (Burda and Hunt, 2011)) but also of Latin American countries (for example Argentina and Uruguay (Bertranou and Mazorra, 2010; Casanova, 2010)) with policies that reduce labour costs while preserving formal jobs should be reviewed and adapted to countries' specific situations.

Lastly, while this paper focuses on informality arising from developing countries' productive structure and businesses' cost-cutting strategies, policymakers in Latin America and the Caribbean and other developing regions should also address the obstacles to decent work that are dominating discussions in developed countries, such as the increase of non-standard forms of employment, many of which are the result of technological change.[10]

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[10] See Maurizio (2016) for a review of non-standard forms of employment in Latin America.

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