



Thus, the studies included in this symposium tackle some of the unanswered questions of the globalization–poverty debate, with a particular focus on how politics plays into the relationship between the two. These articles do not necessarily aim to provide answers; rather, they hope to initiate a dialog and offer suggestions for further research in areas that have so far been understudied.

Globalization and the Political Benefits of the Informal Economy

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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 share 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 2011.⁸ With liberalization and concomitant global market integration, economic growth rates in developing economies have been improving,⁹ and absolute poverty shows signs of declining (Dollar and Kraay 2004; Owen and Wu 2007).

Yet, the United Nations Secretary-General Ban 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. Among

⁸<http://www.worldbank.org/en/publication/global-monitoring-report/poverty-forecasts>

⁹Edwards (1992); Krishna and Mitra (1998); Ferreira and Rossi (2003); Wacziarg and Welch (2008) Milner, Helen V., and Nita Rudra. (2015) Globalization and the Political Benefits of the Informal Economy. *International Studies Review*, doi: 10.1111/misr.12268

the list of the General Secretary's appeals to governments of developing countries, ensuring "decent work for all" ranked among 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 article 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 *indecent* work. This is because the informal economy is associated with minimal job security, lower income, the 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 toward greater global market integration (Schneider 2002; OECD 2009a; Charmes 2012).

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.

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 that 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; and 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.¹⁰

A relatively small group of economists have explored the possible linkages between globalization and the 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: (i) the skill premium has increased in developed and developing

¹⁰http://www.ilo.org/wcmsp5/groups/public/-dgreports/-dcomm/-publ/documents/publication/wcms_222979.pdf. pp. 3-5.

countries because of trade and FDI, making unskilled workers relatively worse off;¹¹ (ii) exporting firms are adjusting to international market competition by reducing employment and raising productivity (Currie and Harrison 1997); (iii) businesses are outsourcing to the informal sector to reduce labor costs;¹² and (iv) 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 whether 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 to the presence of an informal sector. Governments of least developed countries (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 compete 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 toward 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 among very low-skilled workers (Baker 2008; Adams, de Silva, and Razmara 2013), and the skill premium continues to increase with globalization (Acemoglu 2003). The World Bank estimates that more than 30% of the developing world’s gross domestic product (GDP) and 70% 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.

Globalization, Politics, and the Informal Sector

We propose that governments of developing economies have several political *disincentives* 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.

¹¹Bernard and Jensen (1997); Feenstra and Hanson (1999); Acemoglu (2003); Thoenig and Verdier (2003).

¹²Maloney (1998); Wahba and Moktar (2000); Unni and Rani (2003); Ramaswamy (2003).

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 (Cimoli, Primi, and Pugno 2005; Maiti and Marjit 2008). 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 toward the persistence of the informal sector. It is common for organized workers to be at political odds with informal workers in developing economies.¹³ Organized labor prefers to maintain the generous labor market protections they were granted during the era of import substitution 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).¹⁴ 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 maintain 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 contributing to the nation’s GDP growth aspirations by providing employment for Nigeria’s teeming youth population and reducing poverty.”

¹³See for examples Carnes’s (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.

¹⁴ILO 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&_afriLoop=520926433418247#%40%3Findicator%3DTUM_DEMP_ECO_RT%26subject%3DSOD%26_afriLoop%3D520926433418247%26datasetCode%3DYI%26collectionCode%3DYI%26_adf.ctrl-state%3Dveca0wea_307

(June 24, 2014)¹⁵ 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).

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 (GDP cap).¹⁶ 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 (that is, the residuals) show a positive, although not monotonic trend upwards in this recent era of globalization.

Next Steps

In this article, we argue that the informal sector in the globalizing economy relieves policymakers from immediate pressures to generate unskilled jobs in the formal sector, provides formal (and costly) benefits and protection to informal workers, and adopts 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 toward generating formal employment and safety nets for this group in the globalizing environment. Ultimately, we propose informal sector presence makes it easier to respond to the needs and demands of stronger

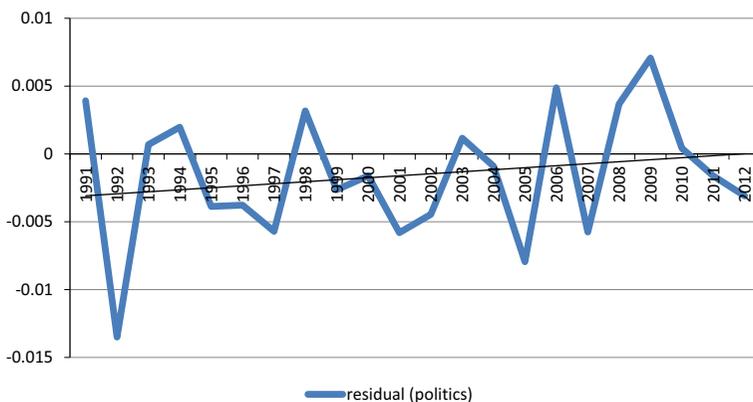


FIG. 1. Surplus Labor: What GDP cap Does *Not* Explain in Developing Economies

¹⁵<http://allafrica.com/stories/201406271101.html>, last accessed July 20, 2015

¹⁶Surplus labor is calculated as the working-age population (minus students enrolled in secondary education, minus students enrolled in “postsecondary” education), minus active labor force participation, divided by the working-age population.

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 article. Doing so would allow us to rigorously test our intuition that the presence of urban informal sector in the globalizing environment may not be transitory, as international trade theory predicts.

Transfer Pricing and Global Poverty

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A persistent puzzle in international political economy (IPE) is the lack of a robust correlation between foreign direct investment (FDI) and poverty alleviation in emerging markets. This is especially confusing given the compelling theory that predicts poverty reductions following FDI increases (Moran 1999). At least three general channels have been hypothesized linking FDI inflows to reductions in the poverty level (Hanson 2001). FDI is thought to contribute to poverty alleviation through (i) spillovers of labor productivity, technology, and corporate governance practices; (ii) market effects, as foreign invested enterprises (FIEs) contract domestic producers and sell their products in the host country, reducing consumer costs through competition; and (iii) revenue effects, as taxes paid by FIEs increase host country coffers and subsidize transfers to poorer citizens of the country. For all of the hypothesized channels, the empirical support is mixed at best. Figure 2 demonstrates the lack of observed correlation using a variety of poverty cutoffs, and the analysis is robust to using changes in FDI stocks as well.

By far the weakest support has been found for the revenue channel. There has been very little convincing work demonstrating that FIEs offer substantial increases in revenue above domestic firms, and even less evidence that FDI spurs equalizing welfare transfers. At a distance, this non-finding is the greatest enigma, as budget data are the easiest of the dependent variables to collect and analyze.

Explanations are possible to explain the inability of FDI tax revenue to reach the poorest. The first basket of answers is methodological, including measurement error in poverty rates data, biased selection of foreign investors into wealthier states where poverty increases would be less obvious, and differing reporting rules for FDI in host countries leading to noisy estimates. The Beramendi and Wibbels contribution to this volume is a great example, as they demonstrate persuasively that data on social policy are suspect and especially overlook the importance of tax expenditures. A second set of explanations accepts the empirical basis for the non-finding, but has sought to explain it theoretically. These answers include (i) generous tax incentives and subsidies to attract foreign firms that often exceed the long-term revenue generated by FDI inflows (Head, Ries, and Swenson 2000; Wells et al. 2001); (ii) transfer targeting that misses the poor-