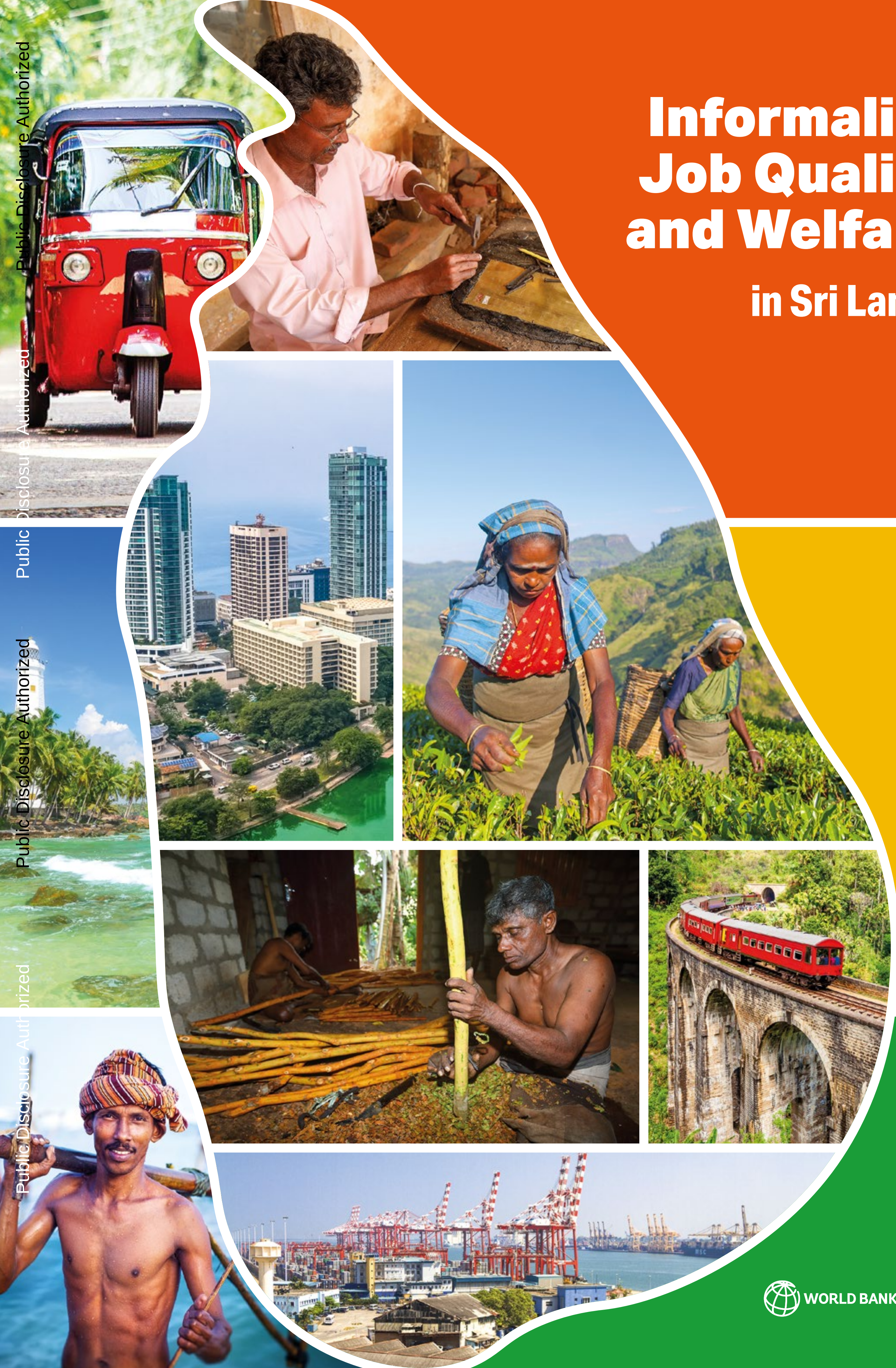

Informality, Job Quality, and Welfare in Sri Lanka

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in Sri Lanka

Poverty and Equity Global Practice
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Acknowledgments

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Abbreviations

DCS	Department of Census and Statistics
DoL	Department of Labour
EPF	Employees' Provident Fund
ETF	Employees' Trust Fund
ILO	International Labour Organization
LFS	Labour Force Survey
MSE	micro and small enterprises
OECD	Organisation for Economic Co-operation and Development
SOEA	Shop and Office Employees Act
TEWA	Termination of Employment of Workmen Act
WBO	Wages Boards Ordinance

Executive Summary

Informal employment remains a salient and persistent feature of the Sri Lanka labor market, with around 70 percent of the work force informally employed. There are generally three reasons to be concerned about high informality: poverty, productivity and public finance. This report focuses on the poverty and vulnerability aspect of informal employment, by showing that informal jobs are more precarious in nature than formal jobs and are associated with inferior working conditions and lower earnings. The following three key messages emerge from the analysis.

Message 1:
The quality of informal jobs is much lower than that of formal jobs. Informal workers have more precarious employment arrangements and inferior working conditions. Their low earnings levels elevate the risk of poverty.

The Sri Lanka labor force is segmented into three strands: (a) formal public sector workers who enjoy high remuneration, shorter work hours, many holidays, paid leave as well as other benefits, and overall job security; (b) formal private sector workers who make up a middle group, with access to social security and some paid leave but longer work hours and an earnings distribution that is closer to that of informal workers; and (c) informal workers, a group that includes informal employees as well as informal self-employed workers, most of whom are in precarious employment arrangements. Few informal workers have a permanent contract or access to benefits, and they tend to work excessively long hours. There exists a persistent earnings gap between formal and informal workers, even when comparing workers of similar characteristics. Moreover, the risk of extremely low pay and thus poverty is significantly higher for informal workers. However, it should be noted that the overall earnings distribution of formal private sector workers is much more similar to that of informal workers than that of public sector workers.

Message 2:
Stringent labor laws, along with the high cost of compliance and complexity of labor regulations, have encouraged informality. But formalization does not necessarily ease other constraints such as access to credit, reducing the incentive to formalize.

The Termination of Employment of Workmen Act (TEWA), which regulates dismissal conditions and compensation, has been long criticized for making it difficult and expensive to dismiss employees. In fact, Sri Lanka has the second-highest redundancy cost in the world. Gratuity payments, contributions to the Employees' Provident Fund, Sri Lanka's social security scheme, and the Employees' Trust Fund, and generous paid leave and holidays add to the labor cost borne by the employer. Multiple and overlapping types of coverage for workers owing to different regulations create a complex operating environment for firms, making compliance costly. As a result, compliance tends to be incomplete, even for larger firms. Enforcement is generally weak due to manpower shortages in enforcing agencies, and the many lines of enforcement render the existing institutions inefficient and ineffective, while the labor dispute settlement system can lead to lengthy and costly processes. Moreover, there appear to be few benefits to formalization. The prevalence of the informal sector can be explained by a trade-off between firms' costs for labor and capital: that is, informal firms have higher capital costs and lower labor productivity, but can avoid certain labor costs associated with mandated taxes and benefits. But evidence suggests that while being informal likely precludes firms' access to formal credit institutions, formalization itself does not guarantee easier access because of high collateral requirements and other bureaucratic procedures. This means that streamlining the business registration process alone will not suffice to decrease informality.

Message 3:
Rather than reducing informality itself, the focus of reforms should be on increasing productivity and jobs growth. Regulatory reforms that aim to reduce the cost and increase the benefits of formality would further encourage the creation of formal jobs.

The following reform components are suggested in line with recommendations from around the world:

- Invest in human capital to promote productivity gains and reduce the wage gap.
- Increase flexibility in labor markets and quality of jobs by reducing labor taxes and streamlining regulations, which would support job creation more broadly.
- Build an adequate and effective social protection system.

A well-conceived formalization strategy would aim at increasing the benefits and reducing the cost of formalization through a policy mix that tackles the interrelated causes and consequences of informality together, ultimately leading to the creation of more and better jobs. This is based on evidence from other countries that found that formalization efforts focusing on easing entry regulations yielded limited success.

The imperative for Sri Lanka to implement these reforms is driven, among others, by the rapid aging of the labor force. The employment protection legislation that imposes a prohibitively high cost on the employer for dismissals of employees with long tenure encourages high turnover and early exit from the labor market. The regulatory and incentive scheme needs to be restructured to encourage more working-age individuals to join and remain in the labor market productively. This would help meet the labor demands in a country that still needs to grow significantly but is undergoing rapid aging.

1.

Introduction

The informal sector represents an important part of the economy in many countries and plays a major role in production, employment creation, and income generation. Informality can be described as "the collection of firms, workers, and activities that operates outside of the legal and regulatory frameworks or outside the modern economy" (Loayza 2016). Informality in developing countries around the world accounts for 60–70 percent of employment and about 30 percent of gross domestic product (GDP) (Gatti et al. 2014; Loayza 2016).

There are broadly three reasons to be concerned about informality: poverty, productivity, and public finance.[1] The first, poverty, relates to the perception that informality is correlated with or a cause of poverty. A few studies also suggest that informal workers have lower subjective well-being than formal workers, as they tend to be less satisfied with their jobs (Kim, Matytsin, and Freije-Rodriguez 2018; Perry et al. 2007). In Sri Lanka, where public health care is universal and free, the main source of concern is the lack of protection and benefits, in particular social security, afforded by the informal sector. As this report will show, the precarious nature, low quality, and low wages of many informal jobs lead to higher poverty and vulnerability. The second concern, productivity, relates to the resource misallocation that occurs as a result of a firm's informal status: informal firms have limited access to credit and rely on informal networks for the sourcing and distribution of goods, leading to lower productivity and growth. Evidence has also shown that informal firms tend to remain suboptimally small as they try to avoid becoming subject to regulations; this could account for a significant share of the output per capita differences between rich and poor countries (La Porta and Shleifer 2014; cited in Loayza 2016). Moreover, credit access by formally registered firms could be constrained by the presence of informal firms in states where the rule of law and control of corruption are weak (Distinguin, Rugemintwari, and Tacneng 2015). Finally, the public finance concern relates to the fact that informal firms operate largely outside of the state's regulation, where tax evasion is the norm. Informality therefore undermines state revenue collection and fiscal sustainability.

While informality raises a common set of concerns, it is a complex, multifaceted phenomenon. A fundamental characteristic of underdevelopment of the economy and its institutions, informality is an outcome determined by low levels of human and physical capital. These are inherent to less developed countries and influenced by the state-agent relationship—specifically, by the state's regulation, monitoring, and provision of public services such as health care and social security (Loayza 2016).[2] In the public debate, informality is often regarded as something "bad" that countries need to reduce. However, informality also has positive aspects: for example, in the absence of better alternatives and of a formal unemployment insurance scheme supported by a well-functioning market for job matches, the informal labor market provides a viable source of livelihood for many poor and vulnerable groups and thus helps reduce unemployment and poverty. Informal jobs may offer a necessary survival strategy in countries that lack social safety nets and have few formal jobs, especially when the job creation capacity of the economy is constrained. From employers' perspective, informality also has some advantages: though it limits employers' access to police and judicial protection and to formal credit, it provides for flexible employment or remuneration arrangements that cushion adverse impacts on their operations in response to changes in market conditions. In countries with high rates of population growth or continued urbanization, the informal sector tends to absorb most of the expanding labor force in the urban areas. In such settings, indicators such as the unemployment rate and time-related underemployment are not sufficient to assess the quality of employment and to reflect the contribution of all workers to the economy; statistics on informal employment are also necessary. This is especially the case for women, many of whom work as unpaid family workers.

1. These are collectively referred to as the "three P's" in Kanbur (2014).

2. Informal economic activities were first analyzed by an International Labour Organization employment mission in 1972. The term "informal sector" was coined by Keith Hart's study of economic activities in Ghana (Hart 1973).

Informality is broadly understood to be either a result of "exclusion" or "exit." The exclusion view maintains that workers and firms are excluded from the formal sector because labor markets are segmented and because burdensome tax and regulatory barriers prevent small firms from formalizing and encourage some large firms to remain partially informal, potentially at the expense of growth and efficiency gains. On the other hand, the exit view presumes that informality is an outcome chosen by firms and workers as the optimal level of engagement with the state, especially when the cost of formalization outweighs the benefits. That is, informality is a large-scale opting out of formal institutions by firms and individuals based on their valuation of the net benefits from formality and the state's service provision and enforcement capability. These two viewpoints are generally best understood as complementary given that contexts differ across countries and that the informal sector itself can be tremendously heterogeneous, with some informal workers choosing to be informal and others being involuntarily excluded from the formal sector (Perry et al. 2007).

Although informality in Sri Lanka has been a long-standing concern, few studies have sought to understand it. Information to measure and analyze informal employment in Sri Lanka became available with an expanded Labor Force Survey (LFS) in 2006. Gunatilaka (2008) is the first study (and one of very few to date) to analyze the extent and the determinants of informal employment and wages. ILO (2014), while published not long ago, uses only 2006 survey data (which is quite outdated) and focuses on the impact of labor laws on firms' decision to formalize. De Mel, McKenzie, and Woodruff (2013) uses a field experiment to investigate firms' incentives to formalize. Overall, the literature on Sri Lanka is very scarce, particularly on informal employment (as distinct from informal firms). Since informal workers represent a significant share of the labor force, the causes and consequences of informality need to be properly reflected in development policies. Currently, the evidence base for proper policy formulation is relatively small, and this report aims to fill some of this gap.

This report shows that informal employment in Sri Lanka is persistently high and that the quality of jobs differs significantly for formal and informal workers. Informal jobs account for nearly 70 percent of jobs in Sri Lanka, and this figure has not changed much since 2006, the first year such estimates became possible. Workers who are informally employed can be classified into different groups, depending on factors such as access to social security, employment status, and the firm's registration status. Once different types of formal and informal workers are defined, the quality of jobs is measured along two dimensions: (a) contracts and working conditions, which capture the nonpecuniary aspects of a job; and (b) the risk of poverty and vulnerability, which specifically examines the risk of extremely low pay and the incidence of working poverty. By these measures, the Sri Lanka labor market appears to be segmented into three strands: (a) formal public sector workers who enjoy high remuneration, shorter work hours, many holidays, paid leave as well as other benefits, and overall job security; (b) formal private sector workers who make up a middle group, with access to social security and some paid leave but longer work hours and an earnings distribution that is closer to that of informal workers; and (c) informal workers, a group that includes informal employees as well as informal self-employed workers, most of whom are in precarious employment arrangements with little access to any benefits and low remuneration. A key message of this report is that reforms should not focus on formalization itself, but on regulatory reforms that aim to reduce the cost and increase the benefits of formality, as well as on measures that enhance productivity.

The rest of this report is organized as follows. Chapter 2 describes measures of informal employment, recent trends, and the demographic and socioeconomic profiles of informal workers using comparable data over time. Chapter 3 analyzes the possible drivers of informality. Chapter 4 examines the relationship between informal employment and job quality. Chapter 5 summarizes the findings and proposes some key components for reform. Appendix A includes a set of detailed tables of labor market indicators for formal and informal workers.

2.

Informal employment: Measures and trends

Defining informal employment

Informal aspects of the economy are known to be difficult to measure, and specific definitions are determined by country context. There is no single correct definition of what is meant by "informal," and different measures can be used depending on the context, purpose, and available data. There is broad agreement that several criteria must be considered, including registration, legal incorporation, size, coverage by statistical surveys, borderline of activity, illegal activity, location, and terms of employment. The word "sector" in this context refers to production activities and not to a grouping of institutional units in the System of National Accounts (SNA) sense. Importantly, both production and employment can be characterized as formal or informal. For example, it is possible for formal production units to have informal employees. There is also a distinction between a job and a worker, as one worker can hold several jobs.

The focus in this report is on informal employment rather than the informal sector. If labor informality is measured only with respect to those working in firms, many people who are self-employed or work in a household enterprise would likely be missed. The primary reason for focusing on informal employment in this paper is that the information available from household surveys allows for identification of informal employment from the workers' side. A comprehensive analysis of informality would also need to consider firm-side decisions and would thus require the use of firm-level data. However, such an analysis is outside the scope of this report. For the purposes of the analysis undertaken here, a legalistic definition of informal employment is adopted, which considers compliance with labor regulation and the right to social protection (e.g., pension, health care) in its definition of informal workers. In comparison, a productivity-based measure categorizes workers by job type, such as unskilled self-employed, salaried in a small firm, or zero-income worker. Hence informal employment refers to "the total number of informal jobs, whether carried out in formal sector enterprises, informal sector enterprises, or households, during a given reference period" (ILO 2016).[3] If the focus was on informal firms, a closer look at the trade-off between taxes and public service provision would be warranted.[4]

In Sri Lanka, several informality-related definitions are currently in use. The Central Bank of Sri Lanka classifies as informal private sector organizations those organizations that do not contribute to the general Employees' Provident Fund (EPF) or do not maintain their own provident funds with the approval of the Commissioner General of Labour. The Department of Census and Statistics (DCS) monitors informal sector employment (i.e., employment in informal firms), where the formal sector is defined as firms that are registered, keep formal accounts, or have 10 or more employees. Since the EPF Act requires only firms with more than 15 workers to pay into the EPF, the informal sector definition adopted by DCS is somewhat less stringent than that of the Central Bank of Sri Lanka. DCS introduced its own definition of informal employment starting with the 2017 LFS report, which broadly follows the ILO guidelines that are shown in table 1.[5] The DCS definition includes (a) all unpaid family workers; (b) all employers/own-account workers in the informal sector; (c) all paid employees who do not have a permanent employer; and (d) all paid employees whose employers do not contribute to pensions. The International Labour Organization (ILO) recently operationalized its own guidelines for measuring informal employment, which include suggestions for specific, step-wise procedures (ILO 2018).

3. For a full description of concepts and definitions related to informality, see ILO (2016), chapter 8 ("Employment in the Informal Economy"); see also UN DESA (2009), chapter 25 ("Informal Aspects of the Economy").

4. See Loayza (2016) for a detailed review of the literature on informality.

5. Table 1 omits members of producers' cooperatives that are difficult to identify in the Labour Force Survey.

Table 1 ILO conceptual framework of formal and informal employment

Production units by type	Jobs by status in employment						
	Own-account workers		Employers		Contributing family workers	Employees	
	Informal	Formal	Informal	Formal	Informal	Informal	Formal
Formal sector enterprises							
Informal sector enterprises							
Households							

Source: Adapted from Hussmanns 2004.

Note: The table provides a framework for categorizing different types of formal and informal workers, by type of production unit and status in employment. The cells shaded in orange do not exist by definition. The cells shaded in green refer to formal jobs. Unshaded cells represent various types of informal jobs.

The main source of data for the analysis is the Labour Force Survey for the years 2006 to 2017.[6] Quarterly survey data are collected and combined into an annual survey that is representative at the district level. The surveys use detailed information—on labor force participation, individual and job-related characteristics, wages, and training received—to estimate key labor force statistics in Sri Lanka. The mode of data collection changed from paper-based to computer-assisted personal interviews in 2017. Due to the civil war, the Northern and Eastern Provinces were excluded from the survey in 2006 and 2007. The 2008, 2009, and 2010 surveys included the Eastern Province but not the Northern Province. Complete national coverage was achieved in the 2011 survey and has continued. Because the Northern and Eastern Provinces account for a small share of the population and thus the country's labor force, the exclusion of these two provinces had a relatively small impact on national-level estimates.

Questions related to informal employment were first included in 2006, and more detailed questions were added in 2013. In 2006, the survey asked whether the employer contributed to a pension scheme—a key piece of information in defining informal employment in Sri Lanka.[7] The more detailed questions added in 2013 asked (among others things) whether the worker had a written contract. In 2013, the survey also changed the response categories for the firm size question, which allowed for a clearer identification of domestic workers. Specifically, the firm size question now clearly asks whether an individual is "working for household," whereas previously the closest response for domestic workers was "no specific institution." The revision in the responses likely provides a more accurate trend for domestic workers. Finally, an added question on the job status of a worker's secondary job has allowed for a more granular measurement of informal employment and jobs.

The definition of informal employment adopted in this report follows ILO guidelines and is closely aligned with the DCS definition. Consistent with DCS's definition, a worker is employed in the formal sector if the firm is registered, maintains a formal account recording system, or has 10 or more employees.[8] All others are considered to be in the informal sector. Formality in job status for own-account workers and employers is determined by the formal or informal nature of the economic unit they own. For employees, the distinction is based on whether the employer contributes to a pension scheme or provident fund on their behalf. For the purpose of this report, workers are classified into

6. The LFS is conducted by the Department of Census and Statistics (DCS); annual surveys can be found on the DCS website at http://www.statistics.gov.lk/page.asp?page=Labour%20Force.

7. The word "pension" throughout this report refers to pension schemes (such as the EPF) or provident funds that disburse a one-time payment upon retirement.

8. In Sri Lanka, business registration at the DS (Divisional Secretariat) level does not in itself make the firm liable for taxes, as there is an annual exemption threshold of SL RS 300,000 in annual net profits, and in theory taxes are payable regardless of registration status. A survey conducted by ILO (2014) suggests that most micro and small enterprises had at least one registration to facilitate the operation of their businesses, while only a very small percentage of surveyed firms was unregistered.

the following groups: (a) formal public sector employees; (b) formal private sector employees; (c) formal self-employed; (d) informal self-employed; (e) informal employees working in formal firms; (f) informal employees working in informal firms; (g) unpaid family workers; and (h) domestic workers. The self-employed include own-account workers and employers. The heterogeneity of informal workers also means that some discussions are outside the scope of this report. A large share of self-employed are characterized as informal (based on their firm's status), but different labor regulations apply to them, and the survey does not record the same information for them as for employees. For this reason, the discussion on job quality in chapter 4 is mainly relevant for paid employees.

Informal employment as a salient and persistent feature of the Sri Lanka labor market

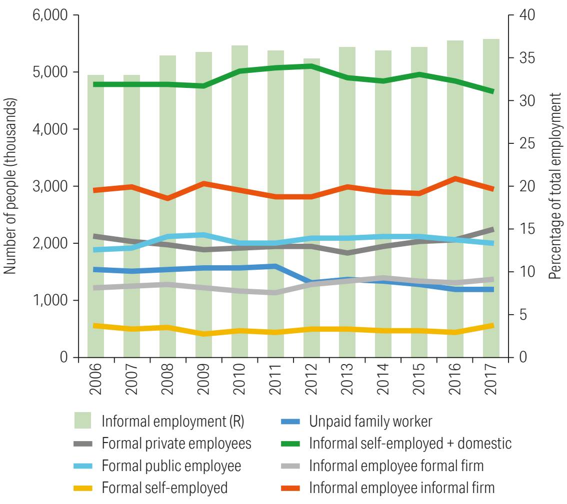
Labor force participation trended slightly downward in the last decade, despite a small improvement among women. In 2017, 54 percent of the adult population ages 15 years or above participated in the labor market—three percentage points less than in 2006. Having fallen continuously from 2006 to 2012, total labor force participation started to increase again after 2012, driven by improvements among females. Male labor force participation has been stagnant since 2009 after declining slightly (table A.1).

Nevertheless, the labor market added more than 1.1 million jobs as the size of the working-age population continued to grow. The decline in labor force participation was countered by the influx of labor market entrants. The working-age population ages 15 and above grew by almost 2.6 million over the last decade, which contributed to a net job creation of 1.1 million, an equivalent of 16 percent growth in the number of jobs. The share of public sector jobs saw a distinct increase between 2006 and 2008, after which it remained largely stable (table A.2).

The majority of jobs created between 2006 and 2017 were informal. More specifically: of the roughly 1.1 million jobs created during this period, slightly more than half were informal. The largest contributor was informal wage employment, with about 21 percent of jobs coming from an increase in the number of informal employees working in informal firms; another 17 percent came from an increase in the number of informal employees working in formal firms. Together, the total number of informal employees grew by more than 400,000. The number of unpaid family workers, most of whom work in agriculture, declined by about 10 percent over the same period, in line with the structural transformation in the economy.

Informal employment has been persistent in the Sri Lanka labor market, with nearly 70 percent of workers employed in such arrangements. The share of informal jobs in total employment was 69.8 percent in 2006 and remained fairly stagnant until it slightly decreased to 68 percent in 2017 (figure 1; see also table A.3). The public sector is almost entirely formal, with only a few workers reporting themselves as informally employed. These workers are captured as informal employees in formal

Figure 1 Trend in formal and informal employment, 2006–17: Number of people (thousands) and share of total employment (%)



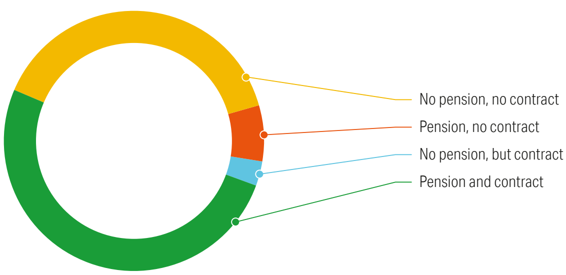
Source: World Bank staff estimation using LFS data for 2006–17.

firms.[9] When only private sector workers are considered, the share of informal employment amounts to nearly 80 percent. Of the 8.2 million Sri Lankans employed in 2017, almost 5.6 million were informal workers, including about 2.5 million self-employed workers (about 31 percent of total employment) and almost 2.4 million informal employees (about 29 percent of total employment). Unpaid family workers, most of them women, constituted almost 8 percent of the workforce. Domestic workers, defined as those reported to be "working for a household," accounted for a little more than 50,000 workers (or 0.7 percent of total employment). Detailed statistics with breakdown by type of worker are presented in table A.2.

Under a broader definition of informality that also considers the nature of the secondary job, the share of informal workers increases by a small increment, from 68 percent to 69.8 percent. The number of workers who have a secondary job has steadily declined between 2006 and 2017, with the number in 2017 standing at around 692,000. This means that about 8.4 percent of employed have another job on the side (table A.4). Almost all of these secondary jobs are informal. However, most workers who have an informal second job already have an informal main job, which explains the small increase in the share of overall informal employment even when secondary jobs are taken into account (table A.5). The majority are self-employed (60.4 percent in 2017) and about 18 percent work as unpaid family workers in their secondary job.

While having a written contract and being entitled to formal pensions are typically closely corelated, an important divergence is found among estate sector workers. Among paid employees in general, almost 90 percent have both pensions (including EPF) and a written contract, or have neither (figure 2). The anomaly comes from the roughly 282,000 workers who have pensions but no written contract. This group mainly consists of estate sector workers, who have historically had strong collective bargaining power and access to formal pensions. As generations of estate workers have spent their lifetime on plantations, signing formal contracts may not have been common practice.[10] A small number of employees have a contract but no pension, likely because they work in a small firm that is not obligated to enroll their employees in a formal pension scheme.

Figure 2 Workers with pension entitlements and contracts



Source: World Bank staff calculation using LFS data for 2017.

The latest estimates show that domestic workers make up a very small part of the labor force. In this report, domestic workers are defined as those who work for a household; use of this definition became possible only in 2013, when the responses to the question on firm size (i.e., total number of employees at the respective place of work) changed. Prior to 2013, the options were "less than 5," "5 to 9," "10 to 15," "16 to 49," "50 to 99," "100 or more," "No specific institution," and "No paid employees/regular employees." As suggested above, these responses made it difficult to distinguish domestic workers from own-account workers. Replacing "no specific institution" with "working for household" allows for a clearer identification of domestic workers, who include paid employees and own-account workers. While it is difficult to assess a long-term trend in the number of domestic workers because of the change in the firm size question, the latest figure for 2017 indicates that there are slightly over 50,000 domestic workers in the labor market.

9. This explains the difference between this report and the official Labour Force Survey report in the number of public sector workers. The number of formal public sector workers in the latter report can be replicated with the assumption that all those working for the public sector are formal, regardless of whether they are entitled to pensions or not.

10. This distinction is similar to the categorization in Kanbur (2009), in which the introduction of regulation creates four categories of enterprises: (a) those that are covered by regulation and comply; (b) those that are covered by regulation but do not comply; (c) those that adjust out of the coverage of the regulation (e.g., firms that are smaller than they otherwise would be); and (d) those that are outside of the coverage of the regulation.

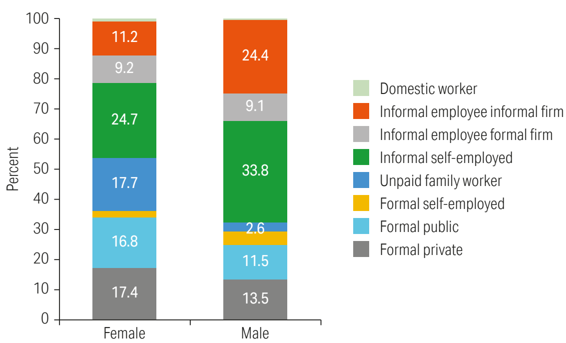
Despite their small number, domestic workers require attention because lack of protection and inferior working conditions render them especially vulnerable. Currently, domestic workers comprise only a small fraction of the labor force, but an overwhelming share of them are women, and they continue to be outside the scope of most labor law protection and the social security framework. Domestic workers are rarely viewed as employees with the same rights and privileges as other employees. The Wages Boards Ordinance (WBO) regulates fundamental working conditions for particular trades, yet no wages board has been set up for the regulation of domestic work in Sri Lanka. Given the ambiguity in the scope of the ordinance, it can be argued that the ordinance does not apply to work performed in private households, and thus that domestic workers are not entitled to any legal protection with regard to the payment of wages. Domestic workers are excluded from social security based on both the Employees' Provident Fund Act and Employees' Trust Fund Act; the former applies to employers with 15 or more workers. The Employees' Trust Fund was intended to serve as an unemployment insurance scheme but is currently used to provide life insurance, housing, and other welfare benefits to its members. Sri Lanka currently has no labor law that regulates working time in the domestic work sector. It also has no law that governs the living conditions of domestic workers, meaning that domestic workers are often forced to live in inadequate or unsafe environments. While the Factories Ordinance regulates the working conditions of factory workers, no equivalent protection framework has been established for domestic workers. They are also excluded from any compensation for injuries sustained during the course of work (Verité Research 2015).

Informal workers: Older, less educated, and primarily engaged in agriculture and low-end services

Informal workers comprise a very heterogeneous group, with stark differences by age cohort, gender, and other dimensions. The previous section categorized workers by various types of formal and informal jobs. This section explores in further detail the differences and similarities among the different groups of workers. In Sri Lanka, women are less likely than men to be working informally, which sets the country apart from many other developing countries. Compared to formal workers, informal workers are on average older and less educated. Informal employment is common in industries with a high concentration of small firms and with low-value-added activities that tend to be carried out by own-account workers.

The types of informal jobs differ significantly by gender, and women are less likely than men to be in informal jobs. Informality rates for women and men are at 64 percent and 70 percent, respectively, as of 2017. This contrasts with the trend globally, where women tend to be overrepresented in informal employment (Chen and Doane 2008; ILO 2013). The proportionately higher representation of women in formal wage employment (34.2 percent of women, compared to 25 percent of men) was helped by a recent inflow of mostly highly educated women into the public sector. In fact, female employment grew most strongly in the formal public sector, with an additional 130,000 women working in this sector in 2017 compared to 2006. Overall, the distribution of women and men differs among the different types of informal jobs: about a third of men are in informal self-employment, and another quarter work as informal employees in informal firms. On the other hand, women are more likely than men to work as public sector employees or unpaid family workers (figure 3).

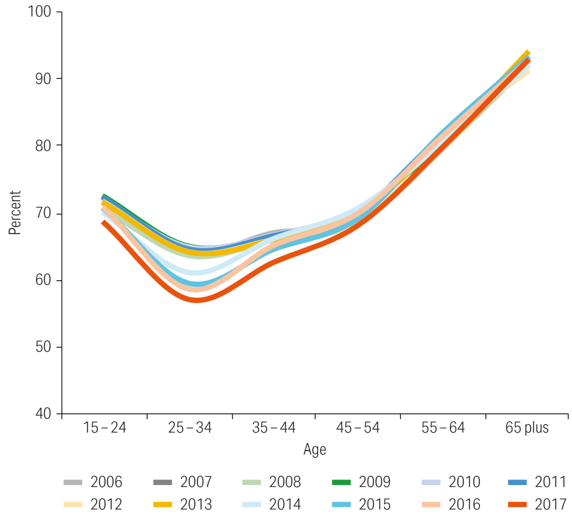
Figure 3 Formal and informal workers by gender



Source: World Bank staff calculation using LFS data for 2017.

Older workers are significantly more likely than younger workers to be informally employed, primarily because they are disproportionately employed in agriculture. Informal employment has a J-shaped relationship with age: the informal employment rate starts out at around 70 percent for the 15-to-24-year-old cohort, then initially falls, but increases again to over 80 percent for workers ages 55 and above. The general pattern has not changed much in the past decade, except that those in the age group 15–34 are less likely to be in informal jobs now than a decade ago (figure 4). While one would need longitudinal data to precisely understand whether this is a life-cycle pattern or a cohort-specific pattern, it appears that the significantly higher rates of informal employment among older workers could be due to differences in the sector and type of informal activity where older workers are concentrated. Specifically, older workers (ages 55 and above) are much more likely than younger workers to be employed in the agriculture sector and work as own-account workers. The likelihood of being engaged in own-account work increases significantly with age: among workers ages 55–64, 80 percent are in informal employment; among those ages 65 and older, the share is 93 percent. On the other hand, almost half (49 percent) of younger workers (ages 15–24) work as informal employees in either formal or informal firms. There has also been an increase in formal public sector jobs among those in the 15–34 age group, likely as a result of higher educational attainment and extended queueing for those jobs. Informal workers are on average 45 years old, which is higher than the average age of formal workers (40 years).

Figure 4 Informal employment by age group

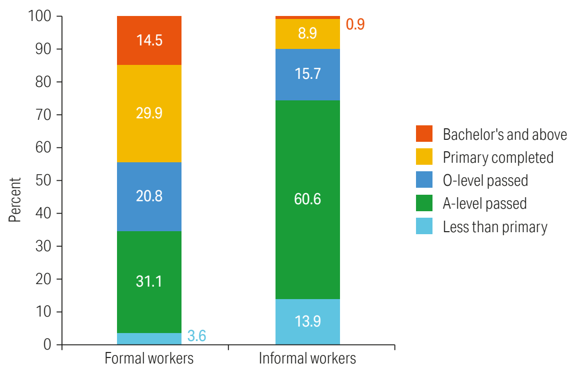


Source: World Bank staff calculation using LFS data for 2006–17.
Note: Year in legend indicates survey year from which age profile is drawn.

Low levels of education are highly correlated with working informally. Almost 75 percent of informal workers had primary education or less, compared to only 35 percent of formal workers. Less than 10 percent of informal workers had obtained A-level certification or above, compared to about 45 percent of formal workers (figure 5). Put differently, among workers with a bachelor's degree or above, almost 90 percent held a formal job, whereas most workers with primary education or less were working informally. Public sector workers have the highest concentration of highly educated workers, with 60 percent of them having obtained A-level certification or above.

Analysis by sector of activity shows that more than 70 percent of workers are informally employed in agriculture, construction, commerce, and transport and communications. The most informal sector by far is the agricultural sector, where 89 percent of workers are informal. The sector is characterized by a large proportion of informal self-employed (48 percent) and unpaid family workers (18 percent). Likewise, the commerce sector and transport and communications sector have comparatively high proportions of informal self-employed workers (39 percent and 44 percent respectively), most

Figure 5 Educational attainment of formal and informal workers



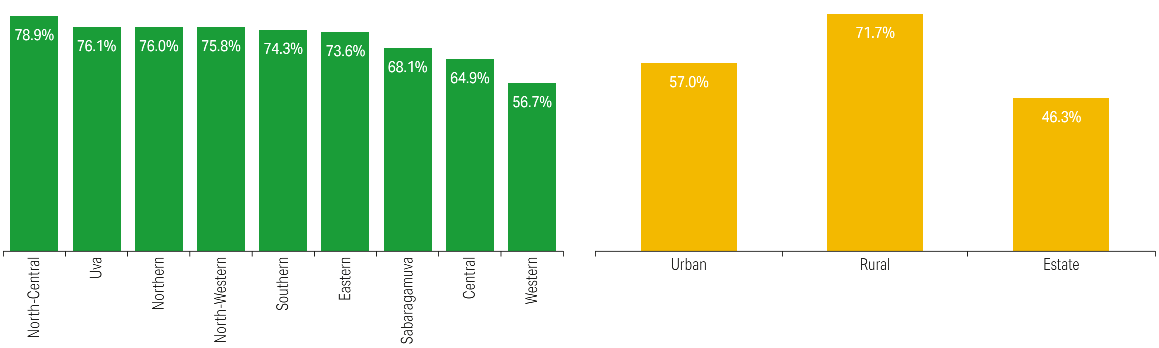
Source: World Bank staff calculation using LFS data for 2017.

of whom are performing own-account work. Informal work is much less common in the public utilities sector and in the community and family-oriented services sector due to the predominance of public sector workers—47 percent and 70 percent are civil servants, respectively. Informal employment is also much less prevalent in the financial and business-oriented services sector (25.5 percent), which also has the highest share of formal private employees (51 percent) (table A.6). Overall, sectors with higher productivity tend to have lower informality rates.

This sectoral concentration of informal workers is not unusual, as activities in the relevant sectors are generally low-value-added and are usually performed by low-productivity micro and small enterprises (MSEs). In fact, most informal employment (88 percent) is concentrated in smaller firms (with five or fewer workers). Whereas informal wage workers are more likely to be found in smaller firms, formal firms of all sizes hire workers informally: around 16 percent of workers without pension are employed by firms with 100 or more employees (table A.7). The main sectoral drivers of growth in recent years—i.e., construction, transport, and manufacturing—have a high concentration of informality and a tendency to favor employment growth among men over women. Male employment grew strongly in informal wage work during 2006–17, adding 370,000 jobs. This increase is in line with the growth over this period in the construction sector, which predominantly employs men, and on an informal basis. Manufacturing also expanded, contributing to growth and job creation, but many workers are informally employed without access to pensions, even among larger firms. Unlike the public sector, construction, transport, and manufacturing are also less conducive to the creation of jobs for women. Three sectors account for almost 60 percent of all informal workers: agriculture (26 percent), manufacturing (19 percent), and commerce (14 percent) (table A.8).

Informal employment is high almost everywhere except the Western Province. The North-Central Province has the highest share of informal workers, at around 79 percent, followed by the Uva, Northern, North-Western, Southern, and Eastern Provinces, all of which have an informal employment rate of around 75 percent. The Western Province has the lowest share of informal workers at around 57 percent, which is still considerable but substantially lower than in most other provinces (figure 6, left). Analysis by geographic sector shows that the rural sector has the highest share of informal workers and the estate sector the lowest share—likely because most plantation workers are entitled to pension benefits (figure 6, right).

Figure 6 Informal employment share by province (left) and geographic sector (right)



Source: World Bank staff calculation using LFS data for 2017.

3.

What explains the high rate of informality in Sri Lanka?

The high rate of informality has long been attributed to the stringency of labor laws in Sri Lanka.[11] The Termination of Employment of Workmen Act (TEWA) in particular, which makes dismissing employees difficult and expensive, has been at the center of the debate. It has been argued that the TEWA increases informality, as its provisions are difficult to enforce in the informal sector, and that it reduces job creation in firms with more than 15 workers, which may wish to avoid high visibility and monitoring by the authorities and unions (Abidoye, Orazem, and Vodopivec 2009; Heltberg and Vodopivec 2009; Rama 1999). Stringent labor regulations are associated with high rates of informality across countries (World Bank 2017).

This chapter argues that a more nuanced understanding is needed regarding what motivates firms to operate and hire labor informally. The chapter begins with an overview of key labor laws and their application in practice to describe the extent of direct and indirect costs associated with overly stringent labor laws. Two key labor regulations that are particularly pertinent to female employment are also described, along with how they are applied in practice. Even though these regulations have become less stringent in practice over time, they present a challenge to the hiring of women in general and create additional incentives to hire female workers informally. As the regulations themselves are described in length elsewhere, the focus is on understanding how the stringency of and high cost resulting from compliance with these regulations induce many firms to operate informally (or in some cases, operate formally but employ some workers informally).

As described in more detail below, the high cost of compliance induces various evasions and avoidance behaviors. The impact of labor regulations depends not only on the rigidity of the regulations, but also on the level of monitoring and enforcement. While enforcement is overall low, litigation can be lengthy and very costly, providing incentives to firms to avoid it whenever possible. The prevalence of informality reflects a fundamental asymmetry between high labor costs (for formal firms) and high capital costs (for informal firms). In the Sri Lanka context, it appears that formal status itself would contribute little to easing access to credit—that is, the benefits to formalization are too low for most smaller firms. From the workers' perspective, an informal job becomes a viable option when most jobs offered are informal and when the alternative is unemployment without any income. Slow changes to a rigid institutional environment, one formed decades ago when circumstances were drastically different, have contributed to persistently high rates of informality in Sri Lanka.

Key labor regulations: Application in practice and implications for labor cost

The Termination of Employment of Workmen Act of 1971 regulates dismissal conditions, including compensation, and is considered highly restrictive.[12] TEWA applies to employers with 15 or more workers that seek to terminate the services of an employee for nondisciplinary reasons. It was enacted during a period of inward-looking economic policies in the 1970s, which was characterized by an import-substitution industrialization policy, stringent exchange controls, a wide range of price controls on many commodities, and the nationalization of firms. The statute aimed to mitigate the impact of these policies on employment, as many firms had been forced to reduce the number of workers. Even though the intention then was to prevent mass retrenchment, the statute itself does not call for such a limitation and also applies to individual terminations. This means in effect that the employer is required to seek either the written consent of the worker or the written authorization of the Commissioner

11. The negative association was first proposed by Lazear (1990).

12. This section draws heavily on Ranaraja (2019).

General of Labour for each individual layoff. "Prior consent" is not defined in the law, but decisions in previous court cases have excluded the following from the application of TEWA: voluntary resignation, written consent of the employee at the time of entering into contract for the termination upon a specific event (such as retirement upon reaching the age of 55 or the expiration of a fixed-term contract), and retirement under the terms of a collective agreement. The result is an arbitrary and lengthy separation process. While most employment contracts contain a clause stating that the employer may terminate the services of the worker for any reason with notice of a particular period (generally stated as one month) or with payment in lieu of such notice, this clause is inoperative as it is not considered "prior written consent" within the meaning of TEWA.

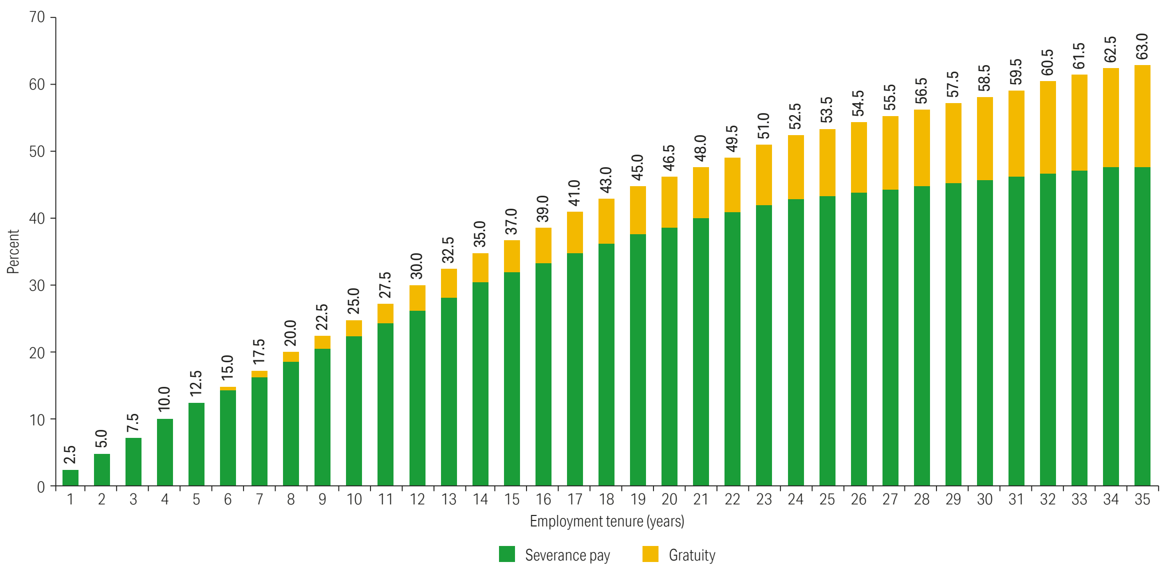
The amount of the TEWA-regulated compensation payable upon separation presents a heavy financial burden to employers. The compensation is mainly a function of the worker's tenure (table 2). The basis for the current formula, which dates from 2005 after several attempts at reform, reduces the arbitrariness of the compensation level. Under this system, a worker with two years of service would be entitled to a separation payment equivalent to five months of salary, while a worker with 25 years of service would be entitled to 43.5 months of salary (figure 7). How does this compare with other countries? The World Bank's (2017) *Doing Business* report, which presents internationally comparable measures of redundancy costs, shows that Sri Lanka ranks second from the top, after Sierra Leone, making it one of the costliest and most restrictive countries in the world to dismiss a worker (figure 8). The redundancy payments do not take into consideration mandatory contributions made by employers as EPF and Employees' Trust Fund (ETF) benefits.

Table 2 Severance pay by tenure

No. of years of service at date of termination	No. of months' salary paid as compensation for each year of service	Maximum payment (cumulative) (no. of months' compensation)
1–5	2.5	12.5
6–14	2.0	30.5
15–19	1.5	38.0
20–24	1.0	43.0
25–35	0.5	48.0

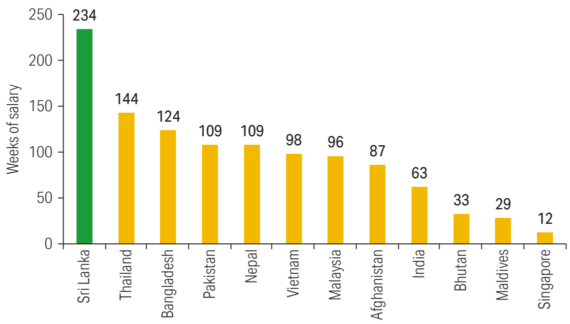
Source: Gazette Extraordinary no. 1384/07, March 15, 2005.

Figure 7 Cumulative compensation payable as severance and gratuity upon dismissal (no. of months' salary by length of tenure in years)



Source: Based on Ranaraja 2019.

Figure 8 Comparison of redundancy costs across countries (weeks of salary)



Source: World Bank 2017.
Note: Redundancy costs measure the cost of advance notice requirements and severance payments due when terminating a redundant worker, in weeks of salary.

The difficulties and costs associated with dismissals under TEWA discourage formal employment. The biggest impediment imposed by TEWA is that an employer is unable to dismiss an employee, except for serious disciplinary infractions, without prior written consent by the employee or prior written approval by the Labour Commissioner. In practice, this provision makes it very difficult and very expensive to restructure a firm's workforce in response to changes in market conditions. This provision has been criticized for a long time for discouraging private sector investments. The Investment Policy Review of Sri Lanka, prepared by the United Nations Conference on Trade and Development (the trade, development, and investment arm of the United Nations Secretariat), called this provision "an inappropriate imposition on private investors to make their staff retrenchment decisions dependent on government approval" (UNCTAD 2004). Following this review, the TEWA was subsequently amended to remove the Labour Commissioner's discretion to decide compensation on a case-by-case basis; but other provisions remain in place, including the requirement to seek approval for the nondisciplinary termination of even one employee.

Gratuity payments were introduced as an interim form of social security but present yet another cost to employers. The Payment of Gratuity Act of 1983 was enacted to provide a minimum level of income security to workers terminated from employment. The statute provides for half a month's salary per year of service, subject to a minimum qualifying period of five years of continuous service. For example, an employee who ceases to be employed after 10 years would receive five months of salary as gratuity. It was originally designed decades ago to help reduce high turnover at enterprises in Export Processing Zones (EPZs), where very few employees completed a qualifying period of five years of service. However, the act is applicable to all private sector employers and was seen as an interim measure in the effort to create a social security system. Gratuity is payable even when employees are terminated due to misconduct, subject only to possible deductions in the event losses or damages led to the termination.

Gratuity payments are compulsory for employers with 15 or more workers, but the threshold is not strictly binding. This is because any worker who does not get paid gratuity, including one from a smaller firm, can apply to the Labour Tribunal, which will rule on whether any gratuity is due and the amount of such gratuity. Therefore the 15-employee threshold is not strictly binding as it is for TEWA, and a worker may be deemed entitled to higher or lesser gratuity amounts as decided by the Labour Tribunal. Some companies opt to pay higher gratuity than required by law as a means of rewarding long-serving employees and reducing turnover. The cumulative compensation payable upon dismissal under TEWA and the Payment of Gratuity Act increases with tenure and presents a significant cost to the employer (figure 7).

The Employees' Provident Fund Act of 1958 established a contributory scheme for all private sector employees, but the law's lack of clarity invites disputes on what constitutes earnings. The system is maintained through contributions by employer and employee based on the employee's monthly earnings. The minimum contribution is 12 percent of earnings by the employer and 8 percent by the employee. While the law prescribes what is included under earnings,[13] there is considerable uncertainty about which components of the emoluments should be included in the cal-

13. Earnings include (a) wages, salary, or fees; (b) cost of living allowance, special living allowance, and other similar allowances; (c) payment in respect of holidays; (d) the cash value of any cooked or uncooked food provided by the employer to employees in prescribed employments and any such commodity used in the preparation or composition of any food as is so provided; (e) meal allowance; and (f) such other forms of remuneration as may be prescribed.

culation of the base wage for EPF contributions. For instance, it is not clear whether paid commissions or incentives should be added to the base wage for calculating EPF contributions. Other disputed areas include payments in respect of travel, insurance, and location as well as contingency payments; even when these are part of regular remuneration, some employers do not label them as such in an effort to evade or avoid higher EPF contributions.

While all workers are required to be members of the EPF, own-account workers and entrepreneurs are not covered, as they are not considered "workmen" under the act, leaving a large gap in coverage. The EPF scheme differs from the noncontributory pension scheme applicable to public servants, where payments are made upon retirement based on the last-drawn salary in employment. With the EPF, the entirety of accrued contributions can be withdrawn when workers cease to be employed—starting at age 55 for men and age 50 for women. The EPF Act allowed for privately managed pension funds provided that the contribution rates and benefits were not less beneficial than the EPF.[14] However, the Commissioner General of Labour has ceased to approve the establishment of such private provident funds, and all contributions are now mandated to be made to the EPF.

The Employees' Trust Fund was established to help provide unemployment benefits in the absence of social security and an unemployment insurance scheme, but it does not serve its intended purpose and presents an undue burden to employers. The ETF Act of 1980 was established to promote employee ownership and welfare through participation in financing and investment and to provide noncontributory benefits to employees on retirement. The act requires employers to remit 3 percent of the employee's gross monthly earnings to the fund. The fund has grown rapidly in the past four decades and achieved a total size of about SL RS 306 billion by end-2018. The ETF has more members than the EPF, as employers who operate a private provident fund are also required to contribute to the ETF. The amount lying to the credit of an employee can be withdrawn once every five years if the person ceases to be employed (in order to help the person cope with a period of unemployment). However, the fund has never served this specific purpose and is currently used to provide members with a range of welfare benefits, such as life insurance, housing, and selected health benefits.

Under the Employment of Women, Young Persons and Children Act of 1956, an employer seeking to hire a woman for work at night must seek formal permission from the Commissioner General of Labour.[15] Although the original law was established such that written consent and approval was required for every instance of night work, the Department of Labour (DOL) has over time reached a more practical arrangement, where requests for approval are submitted by the employer every six months. When the law was established, there may have been concerns about exploitation of women and children, but such protective measures are less relevant today and effectively discourage the employment of women.

Female workers who are regulated by the Maternity Benefits Ordinance (MBO) and the Shop and Office Employees Act (SOEA) are entitled to maternity benefits, but the costs are entirely borne by the employer, discouraging the employment of female workers, whether formal or informal. In Sri Lanka a female worker in the private sector is entitled to paid leave of 84 working days after childbirth, of which up to 14 days can be utilized before confinement. The ordinance covers all female workers who are employed in any trade[16] and receive wages, and the maternity provision in the SOEA applies to all female workers employed for a wage in a shop or an office. This excludes female domestic workers

14. The benefit of a private fund to the employee was that all accrued contributions could be withdrawn at the time the employee ceased to be employed, rather than at a specified age. For employers, the remission of contributions and the ability to manage the fund was perceived as an advantage.

15. Written consent is required in order to establish that the female worker is not employed on overtime against her will, as provided in section 2A of the act.

16. "Trade" refers to any industry, business, undertaking, occupation, profession, or calling other than an institution providing training to disadvantaged persons.

and self-employed or unpaid family workers from maternity benefits. Both statutes contain restrictions on working conditions during pregnancy and on termination of employment of a pregnant employee. Payment during maternity leave is to be made by the employer, with neither the worker nor the state making any contributions. This is in breach of the Maternity Protection Convention of the International Labour Organization (C183) ratified by Sri Lanka, which provides in Article 6(8) that "in order to protect the situation of women in the labour market, benefits in respect of the [maternity] leave . . . shall be provided through compulsory social insurance or public funds . . . An employer shall not be individually liable for the direct cost of any such monetary benefit to a woman employed by him or her."[17]

High cost of compliance and complexity of labor regulations as motivating factors of informality

Most formal workers are entitled to generous paid leave and holidays, adding to the cost of labor borne by the employer (table 3). There are also requirements to provide an even higher rate of overtime pay for work on holidays, such as 1.5 times the hourly pay for the first eight hours of work on a public holiday and double the hourly pay for work thereafter, and an extra half-day's pay for work performed on a Poya day[18] regardless of hours worked. Casual and sick leave tend to be taken as an entitlement and not on a needs basis.

Notably, the multiple and overlapping types of coverage for workers create a complex operating environment for firms, making compliance difficult and even more costly—that is, employers incur costs in addition to the direct costs described in the previous section. In some cases, employers use overlapping coverage to deny benefits to workers when application and coverage are uncertain. For example, working hours are regulated under several different laws, and there are different provisions applicable to payments for overtime and holidays. This creates difficulties and confusion for employers if they have different categories of workers in one workplace: some workers could be covered by the SOEA by virtue of working in the office of a factory, while the rest of the factory workers are covered by the provisions of the WBO. Table 3 and Table 4 show how employees governed by different regulations end up with different entitlements in terms of leave, holidays, and working hours. Employees covered by the SOEA have 246 working days a year, which is significantly lower than the 279 days of those working in trades covered by a wages board. Public sector employees have the fewest working days, at 191 days a year. The number of maximum working hours, restrictions for overtime for males as well as females, and compensation for overtime also vary substantially.

Table 3 Paid leave and holiday regulations

Types of holiday & leave	Number of days for employees covered by SOEA	Number of days for trades covered by WBO	Number of days for public sector
Holidays			
Weekly	78[a]	52[b]	104[c]
Statutory	8	8	13
Poya	12	12	12
Total holidays	**98**	**72**	**129**
Leave			
Annual	14	14	24
Sick/casual	7	0	21
Total leave	**21**	**14**	**45**
Total nonworking days per year	**119**	**86**	**174**
Total working days per year	**246**	**279**	**191**

Source: Ranaraja 2019.

a. Under the SOEA, a worker who is employed for 28 hours a week is entitled to 1.5 days of paid weekly holidays, to be taken on any day of the week as required by the employer.

b. The WBO provides for one unpaid weekly holiday, which is usually Sunday.

c. Public servants in Sri Lanka are entitled to two paid weekly holidays.

17. The full text is at International Labour Organization, "C183—Maternity Protection Convention, 2000 (No. 183)," https://www.ilo.org/dyn/normlex/en/f?p=NORMLEXPUB:12100:0::NO::P12100_ILO_CODE:C183.

18. A Poya day is the monthly holiday observed to mark the full moon.

Table 4 Working hours, overtime, and payments

	SOEA	WBO[a]
Maximum working hours	45 hours over five days and one short working day	48 hours over six days
Daily working hours	Not more than eight hours, with a one-hour meal interval. Eight hours can be spread over a period of 12 hours, provided there is one break of not more than three hours (excluding the meal interval); this applies only to employees in residential hotels, clubs, theatres, places of entertainment, or any shop or office of an airline in an airport.	Not more than eight hours, with a one-hour interval. Eight hours can be spread over 12 hours if the interval is more than one hour. Note that different wage boards may have different working hours subject to minimums/maximums. Factories Ordinance: Not more than 4.5 hours without a break of at least 0.5 hours.
Overtime for males	Maximum number of overtime hours per week is 12.	No restriction.
Overtime for females	No overtime work is possible except on short working days of up to 8 hours.	No restriction. But the Factories Ordinance provides that for females over 18, • Total hours worked (normal + overtime) cannot exceed 12 hours in a day and 60 hours in a week • Maximum overtime a month is 60 hours, except for pregnant women, who are exempt from working overtime for three months after childbirth, and nursing mothers, who are exempt for a year — unless they consent to waive the exemption
Night work for females	Women cannot be employed before 6 a.m. or after 8 p.m., whether as normal hours or overtime, except as follows: (a) between 8 p.m. and 10 p.m. in hotels/restaurants; or (b) before 6 a.m. or after 10 p.m. in airline offices at an airport as a ground hostess, or in a residential hotel as a receptionist/ladies' cloakroom attendant/ladies' lavatory/linen room attendant.	No restriction in WBO. But under the Factories Ordinance, • Female workers cannot be required to work at night without their consent • Commissioner General of Labour must give permission in respect of every worker for a specific period • If female has worked at any time between 6 a.m. to 6 p.m., she cannot be employed after 10 p.m. • Night work must be paid at 1.5 times the normal rate • No more than 10 days of night work are allowed each month • Female wardens, women's restrooms, and refreshments must be provided
Holiday pay and days in lieu of time worked		
Weekly holiday or half-holiday	1.5 times the normal hourly wage for eight hours or normal working day 2 times the hourly wage for any additional work AND Paid holiday within next six days	Rate of overtime specified by each wages board, but if not specified, not less than 1.25 times normal pay with a holiday in lieu OR 1.5 times with no holiday in lieu
Statutory holiday	An additional day's pay irrespective of time worked OR Day off before the end of the year	Each wages board differs, but usually eight public holidays are provided
Full-moon Poya	If monthly rated, additional half day's pay irrespective of time worked, but NO DAY OFF If paid daily, 1.5 times the daily rate	If monthly rated, additional half day's pay irrespective of time worked, but NO DAY OFF If paid daily, 1.5 times the daily rate

Source: Ranaraja 2019.

a. Some key differences between the Wages Board Ordinance and the Factories Ordinance are also described in this column.

The high cost of adhering to such labor laws incentivizes firms to avoid compliance with them. ILO (2014) characterizes the types of avoidance behavior as follows: (a) not maintaining a record of employment, such as letters of appointment; (b) concealing the employment relationship; (c) employing workers in nonformal, temporary arrangements; (d) ensuring that the firm has less than 15 workers; and (e) maintaining a low basic wage rate. Some of the regulatory avoidance behavior is costly, as it can be a drag on productivity. For example, firms could be induced to remain arbitrarily under the 15-employee threshold to avoid a large hike in labor costs; or instead of continuing to grow, the firm might establish several smaller firms in order to remain below the TEWA threshold.

The evidence on such behaviors for Sri Lanka is mixed (Abidoye, Orazem, and Vodopivec 2009; ILO 2014). In addition to avoidance behavior, various forms of evasion are also practiced. ILO (2014) reports that of the MSEs surveyed that were above the threshold level, 84 percent reported that they had never made gratuity payment to their workers. The reasons for failing to do so included "Workers have not demanded it" (64 percent) and "It is legally required, but not enforced" (32 percent).

Even when firms are large enough to be visible and operate with some degree of formality, compliance has been incomplete. Practices include registering only some employees to avoid coverage by labor laws, resorting to casual employment arrangements, periodically discontinuing employment relationships to avoid compliance, and finding ways of avoiding involvement with authorities, including through informal payments to officials (ILO 2014). Such practices are consistent with the finding that a notable number of informal workers are employed by firms that are formally registered.

A lack of awareness also contributes to low compliance. For example, in a survey of MSEs, ILO (2014) found that a considerable proportion of 64 percent claimed that they were not aware of value added tax (VAT) regulations, with little difference across sectors. Only 18 percent of MSEs were aware that there were penalties for noncompliance with the retrenchment regulation, and a similar percentage knew what the penalties were. Moreover, 64 percent of all sole proprietorships and unregistered businesses reported that they were not aware of income tax regulations requiring them to pay income tax if their earnings exceeded SL RS 500,000. About 36 percent of respondents in the same survey were not aware that they had to pay EPF/ETF.

Enforcement is weak due to manpower shortages in enforcing agencies, and the many lines of enforcement render the existing institutions inefficient and ineffective. Stringent laws coupled with weak or discretionary enforcement lead to a gap between regulations and their practical applications, and in developing countries in particular very strict rules may have little effect if they are circumvented. The level of enforcement, which defines the gap between the rules and practice, is determined by several factors, including the institutional capacity of law enforcement agencies and the demand for enforcement, including litigation practices. In Sri Lanka, there are several agencies that enforce compliance with labor laws, but the key institution is the Department of Labour. Under the direction and guidance of the Commissioner General of Labour, the DOL has responsibility for administering most employment protection legislation. It has only limited capacity for inspections, as there are only about 600 officials to carry out inspections and dispute settlement functions nationally. Moreover, enforcement is problematic, and inspections are not universal for several practical reasons, which include the lack of records, the transient nature of employment in many cases, evasion by the enterprise, or the location of the enterprise in a rural or remote area. Besides dispute settlements by the DOL, enforcement is also carried out through Labour Tribunal proceedings, where a worker can make a written application concerning the termination of services and any gratuity that is due; arbitration/industrial courts; appellate jurisdiction of the High Court, Court of Appeal, and Supreme Court (when a decision or order of the Commissioner General of Labour, Labor Tribunal, or Arbitrator/Industrial Court is challenged); and collective agreements (Ranaraja 2019).

Any employment-related dispute can be brought before the DOL, and the labor dispute settlement system relies on litigation and adversarial resolution, leading to lengthy and costly processes. While the Industrial Relations Division under the Commissioner of Labour is mainly responsible for dispute resolution, the broad definition of an "industrial dispute" allows for any employment-related dispute to be brought before the Department of Labour. Those proceedings have no time limits or set procedures, so that their duration and cost are uncertain for both employers and employees. The labor dispute settlement system is focused on litigation rather than mediation or prevention of disputes. Litigation costs are high, as lengthy processes incur costs at several points. The cost of litigation under TEWA includes the cost of retaining legal counsel on both sides; and when the application for termination is made by the employer, the worker continues to receive wages while the inquiry is pending.

Labor Tribunal proceedings can also be initiated with respect to dismissals and any benefits that are due, and these, too, can be costly—because of lengthy procedures as well as arbitrary rulings on benefits. An employee or a trade union can make a written application to the Labour Tribunal concerning the employee's termination, specifically whether any gratuity (or other benefit) "as may appear just and equitable" is due. The "just and equitable" provision is considered problematic because it leaves room for nontransparent and arbitrary decisions. The only guidelines on this provision are those established in decisions of higher courts when decisions of Labour Tribunals have been appealed. In effect, a contract of employment entered into between employer and employee, with the consent of both, can be ignored by the Labour Tribunal in deciding a complaint by the employee about his termination under that contract. At the time the Industrial Disputes Act was enacted in 1950, the goal was to ensure that the employer could not benefit from the disadvantaged position of an employee, whose bargaining power was very limited by the social and economic conditions that prevailed then. The circumstances are very different today, when employees have a far more empowered bargaining position and can demand and obtain beneficial terms. An additional factor that increases the cost and uncertainty of Labour Tribunal proceedings is the lack of any procedure to agree on witnesses or evidence prior to a hearing or arbitration.

While all labor regulations technically apply to all workers, in practice the protection generally does not extend into the informal sector, leaving an important gap in coverage. Regulations apply to all workers, employers, and workplaces as defined in each law, regardless of whether the economic activity takes places in the formal or informal sector, and regardless of the enterprise's size. The two exceptions are the TEWA and the gratuity, which are applicable only to enterprises that employ more than 15 people—though as described above, the threshold is not strictly binding for gratuity. In practice, the labor agencies are largely focused on workers and enterprises engaged in the formal economy, and many practical difficulties affect the extension of labor protection to workers engaged under nontraditional arrangements and in the informal economy.

Limited benefits of formalization in Sri Lanka

The benefits of being formal include easier credit access, participation in government contracts and programs, fewer fines, and less harassment by law enforcement officials, while the costs include the one-time registration cost required for formalization and the ongoing taxes, paperwork, and other costs associated with compliance (Bruhn and McKenzie 2014).

The imposition of stringent labor regulations already poses a significant cost to formality, and there appear to be few additional benefits to formalization. The prevalence of the informal sector can be explained by a fundamental trade-off between firms' costs for labor and capital.[19] Informal firms have higher capital costs (as they are unable to enter contractual agreements due to their informal status) and lower labor productivity, but they can avoid certain labor costs associated with mandated taxes and benefits, such as labor taxes, minimum wages, firing constraints, and social security. Formal firms face higher labor costs but enjoy lower capital costs (Loayza 2016). In other words, informality is a rational choice by firms that perceive the benefits of formalization to be low relative to the additional costs involved (Maloney 2004). This means that streamlining the business registration process alone

19. Loayza (2016) notes that the informality literature can be divided into two strands: one that takes a public finance perspective, with an emphasis on the trade-off between taxes and public services; and another that takes a labor perspective, focusing on the trade-off between labor and capital costs—that is, the perspective that informal firms avoid mandated labor costs (including minimum wages, labor taxes, firing constraints) at the expense of higher capital costs (due to the firms' inability to enter contractual agreements). For understanding informal labor, the second approach is more suitable.

will not suffice to decrease informality. Reforms also need to focus on increasing the benefits of formality. In fact, there is some evidence that formalization alone will not substantially increase access to credit: for example, de Mel, McKenzie, and Woodruff (2011) find that many high-return firms are constrained by an inability to find a personal guarantor and by other bureaucratic procedures. Credit growth is constrained by the large needs of the public sector, an inefficient banking sector, and an underdeveloped nonbanking financial sector. Accessing finance is particularly difficult for smaller firms that have to post collateral equivalent to 200 percent or more of the loan amount; this is an insurmountable obstacle for many firms (World Bank 2015). These findings imply that while being informal likely precludes firms' access to formal credit institutions, formalization itself does not guarantee easier access.

Support for the conclusion that formalization alone may not lower the barriers to accessing formal credit comes from the 2011 Enterprise Survey on Sri Lanka (World Bank 2012). The survey ranks access to finance as one of the most important challenges to conducting business, second only after "practices of the informal sector." Commercial banks still rely on traditional lending processes with different approval stages and requiring substantial collateral, rather than applying cash flow–based lending processes. The lengthy approval process and the absence of collateral and reliable book records of many SMEs make lending either unattractive or inaccessible to many creditworthy firms (Sirimanna 2011). According to de Mel, McKenzie, and Woodruff (2013), firms that did not respond with formalization even when offered increased financial benefits cited land tenancy as a major issue. Relatedly, most banks prefer land as collateral, but more than 80 percent of land belongs to the government, and the land owned by SMEs does not have the clear deeds needed to bank them as collateral (Dasanayaka 2011).

Informal employment arrangements may also be preferable from the worker's perspective. Social insurance benefits that typically come with a formal job include health insurance, pensions, and unemployment benefits. But in Sri Lanka, health insurance coverage is universal and does not depend on employment status, so this coverage is unlikely to be an incentive. There is also no formal unemployment insurance scheme in Sri Lanka, which makes unemployment untenable for many; the Workmen's Compensation Ordinance applies only to public servants (excluding armed forces and the police).[20] Instead, informal employment increases current net take-home pay, which is preferred by many workers over any benefits. At the same time, while many informal jobs can be considered subsistence jobs, given the lack of job security and the low level of compensation, they still represent a viable alternative to unemployment. This is especially true during recessions or in contexts where there are few good jobs and otherwise no formal income support scheme, and where violations of minimum wage regulations are widespread. From the firm's perspective, informal labor provides flexibility and reduced labor costs.

In sum, stringent labor regulations make compliance difficult and costly, and neither firms nor workers perceive significant benefits to formalization. The many holidays and overlapping coverage by multiple regulations contribute to higher labor costs (including for compliance) in Sri Lanka. The procedures for dismissal are complex, and the associated costs are among the highest in the world. While enforcement of regulations is relatively limited, the potential cost of litigation is onerous and imposes a high risk to the firm. As a result, firms engage in a variety of avoidance behaviors, ranging from not maintaining employment records and concealing employment relationships to maintaining a low basic wage to minimize social security payments. Moreover, the benefits of formalization to employers are likely not substantial, given that constraints to growth are weakly related to the informal status of the firm. Constraints to credit access, a major challenge to firm growth, are due less to informality than to firms' inability to put up sizable collateral or show proof of land tenancy. The role and size of the primary sector (mainly agriculture and fishery) is also a contributing factor, though an in-depth discussion of this topic is beyond the scope of this report.

20. It requires the payment of compensation in the event of an accident, injury, illness, or death suffered in the course of work.

4.

Informal employment, job quality, and poverty

Informality and job quality

As seen in chapter 2, the number of jobs has continued to increase, though the pace of job creation has not been fast enough to absorb proportionately more of the new labor market entrants. Having more people work in productive jobs is critical in a rapidly aging society—one whose demographic window is closing just when the country has transitioned to upper-middle-income status according to World Bank classifications. Considering that overall unemployment is low, it may seem that the urgency for job creation is low. But this is not true in a context where levels of informality are high and where most workers cannot easily afford open unemployment. Understanding the nature of informal employment is key to assessing the quality of employment and to understanding the full extent of the jobs challenge in the country.

The key message in this chapter is that Sri Lanka's economy needs to simultaneously create more jobs and improve the quality of available jobs. The public sector has played an important role in creating jobs over the past decade, but this trend is not sustainable. One problem is that better-educated youth are now queueing for public sector jobs because of better benefit packages (e.g., pensions), and as further shown in this chapter, public sector workers are also better remunerated; all this has led to biased incentives toward the public sector. A second problem occurs when subsistence-level jobs are preferred over unemployment. In this situation, both the absolute shortage of jobs and a continuum of "insufficiencies" related to job quality need to be considered when it comes to assessing job creation. The remainder of this chapter provides an assessment of the quality of jobs, in particular by comparing formal and informal jobs.

The quality of jobs is assessed by looking at contracts and working conditions as well as the risk of poverty and vulnerability

A two-pronged approach is adopted to analyze job quality. What constitutes a "good job" can vary, but this approach makes it possible to include common, fundamental indicators of job quality that are measurable in the Sri Lanka household survey data:

- **Contracts and working conditions.** The metrics included here are indicators related to workers' contractual status, job-related benefits, and underemployment. Measures related to nonpecuniary aspects of job quality fall into this group.

- **Risk of poverty and vulnerability.** This dimension of job quality considers the wage gap between formal and informal workers, the incidence of poverty among informal workers, and the risk of extremely low or inadequate pay. These measures primarily capture the remunerative aspect of job quality.

Informal jobs and contracts and working conditions

Very few informal workers have permanent contracts, even when working full-time

Job stability is a major attribute of a formal job, but nonstandard contracts prevail among informal workers. To capture a worker's contractual status in employment, a continuum of contract types is considered: (a) permanent, full-time; (b) permanent, part-time; (c) temporary, full-time; (d) temporary, part-time; (e) casual; and (f) no permanent employer.[21] Table 5 shows the distribution of formal and informal workers among these different contract types for 2017. The contrast between formal and informal workers is stark: an overwhelming majority of formal workers hold full-time, permanent jobs (77 percent), with another 14 percent employed in part-time, permanent arrangements. Very few, in fact only 9 percent of formal workers, report having temporary or causal working arrangements. On the other hand, 40 percent of informal workers are employed in full-time, temporary arrangements, with another 12 percent in part-time temporary arrangements. Only 4 percent of informal workers have permanent contracts; 16 percent report being in full-time casual employment (table 5). The trend over time shows that this segmentation has become stronger, as most new informal jobs have been accompanied by temporary contracts (table A.9).

Table 5 Formal and informal workers by type of contract

	PF	PP	TF	TP	Ca	NPEF	NPEP
				Formal workers			
Number	1,795,360	317,593	135,207	8,752	61,939		
% formal employees	77%	14%	6%	0%	3%		
% paid employees	38%	7%	3%	0%	1%		
				Informal workers			
Number	83,543	19,270	963,602	278,758	379,541	430,755	249878
% informal employees	3%	1%	40%	12%	16%	18%	10%
% paid employees	2%	0%	20%	6%	8%	9%	5%

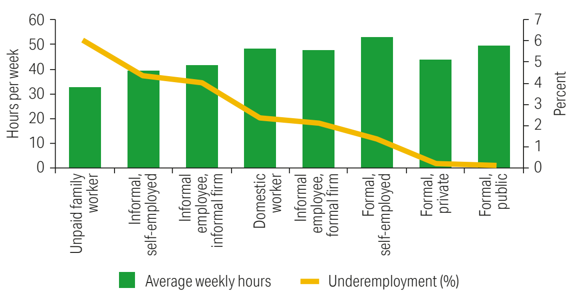
Source: World Bank staff estimation using LFS data for 2017.

Note: PF = permanent, full-time; PP = permanent, part-time; TF = temporary, full-time; TP = temporary, part-time; Ca = casual; NPEF = no permanent employer, full-time; NPEP = no permanent employer, part-time.

Underemployment is an issue only for some informal workers, while excessively long hours pose a more significant problem

The issue of time-related underemployment is relevant only for a small fraction of informal workers. Sri Lanka has relatively low unemployment rates, but underemployment has received little attention despite its relevance for productivity and wages. Underemployment can take several forms, including underutilization of skills; but in this context time-related underemployment is considered, as it is a visible measure of labor underutilization. Specifically, a person is considered to be underemployed when she is (a) currently working less than 35 hours and (b) available for additional work. Figure 9 shows the distribution of work hours by type of worker. Across workers, the work hours are skewed toward the lower end, with a good share of employed working less than 35 hours. However, once the willingness to take on additional work is taken into account, the extent of underemployment is significantly lower. It tends to be higher among informal workers (e.g., 5.9 percent for unpaid family workers and 4.3 percent for informal self-employed) and for those workers with shorter work hours (figure 9). With a steady increase in the number of working hours for informal workers, underemployment has been improving, declining from 7.7 percent in 2006 to 4.1 percent among informal workers in 2017.

Figure 9 Average weekly work hours and underemployment (%)

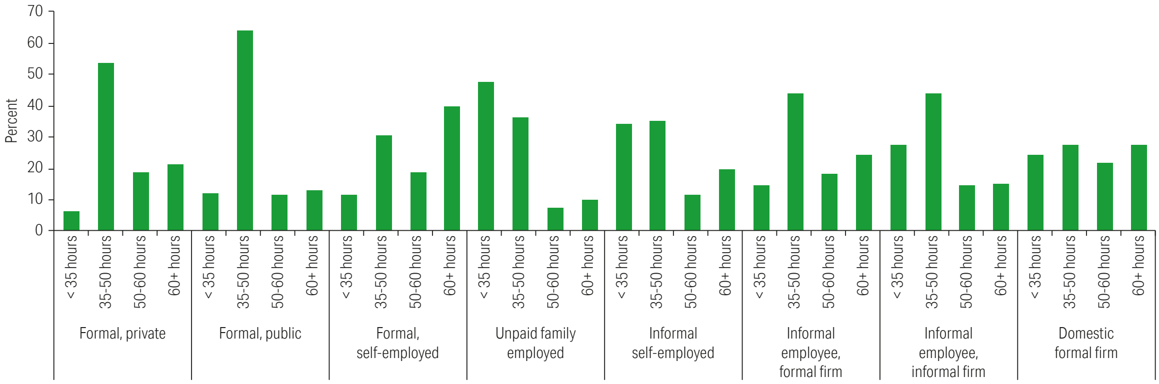


Source: World Bank staff calculation using LFS data for 2017.

21. Part-time is defined as less than 35 hours of work per week.

At the same time, many informal workers work excessively long hours. "Excessively long hours" is defined as 60 hours or more of work per week; according to the Wages Boards Ordinance, a normal working week cannot exceed 48 hours, and a maximum of 12 hours of overtime is permitted. Despite these regulations, the practice of working very long hours is quite widespread, including among formal private sector workers. The share of such workers is similar among formal and informal employees, at 17–18 percent (figure 10). The highest incidence is found among self-employed (particularly employers).[22]

Figure 10 Distribution of weekly work hours



Source: World Bank staff calculation using LFS data for 2017.

Entitlement to benefits such as paid leave is much rarer among informal workers than among formal workers

Very few informal wage workers receive paid leave, in stark contrast to formal workers. Almost 97 percent of formal public sector workers and around 76 percent of formal private sector employees reported being entitled to paid leave as part of their job benefits. By contrast, only about 7 percent of informal employees working in formal firms and less than 1 percent of informal employees working in informal firms reported the same (table 6). This indicates not only a large gap in benefits between informal and formal workers as groups, but also differences among workers who may be working for similar formal firms.[23] What is more, both types of formal workers have seen their benefits improving over time, as the share of formal workers with access to paid leave has increased in the last decade; but the opposite trend is observed among informal workers, where the same share is declining.

Table 6 Entitlement to paid leave among paid employees (%)

	Formal employee, public	Formal employee, private	Informal employee, formal firm	Informal employee, informal firm
2006	86.9%	73.0%	8.0%	2.4%
2007	89.9%	71.3%	5.4%	1.1%
2008	92.8%	70.9%	4.8%	1.3%
2009	92.9%	72.3%	5.7%	1.5%
2010	96.6%	73.2%	5.9%	2.8%
2011	96.2%	73.7%	7.2%	1.4%
2012	96.4%	77.2%	6.0%	1.9%
2013	86.8%	75.4%	6.7%	0.6%
2014	89.5%	75.6%	6.8%	0.8%
2015	92.5%	73.6%	5.2%	0.5%
2016	94.7%	73.8%	7.1%	0.7%
2017	96.7%	75.6%	6.5%	0.7%

Source: World Bank staff calculation using LFS data for 2006–17.

22. International evidence shows that self-employed workers work much longer hours than employees; see for example OECD (2015).
23. Information on job-related benefits is collected only from paid employees.

An important distinction is to be made between noncoverage and noncompliance. The relevant regulation (TEWA) prescribes that workers in firms with 15 or more workers are entitled to social security, regardless of the formal status of the firm. This means that smaller firms (fewer than 15 workers) that do not provide access to social security are not in violation of regulations. Their actions would technically constitute noncoverage and not noncompliance. In 2017, about 40 percent of workers had no pension but were working in firms with less than 15 employees ("noncoverage"). A further 40.2 percent worked in larger firms and had access to pensions ("compliance"). On the other hand, some workers in larger firms do not have access to social security even though they are covered by the law—these firms are the biggest offenders ("noncompliance"). This group included 10.3 percent of workers. The remaining 9.5 percent of workers worked in small firms but had access to pensions. Over the last decade, the "noncoverage" group experienced the largest increase. This coverage gap in pension participation requires attention. A large number of these workers not covered by social security are employed in manufacturing and commerce. By number of workers, noncompliance with pension contributions is most common in the manufacturing sector. Such noncompliance could be reduced with closer and better monitoring.

Informal jobs and the risk of poverty and vulnerability

Public sector employees earn much more than formal private sector employees and nearly twice as much as informal employees

Wages are the most important attribute of any job, whether formal or informal, and low wages significantly raise the likelihood of living in poverty. Previous analyses of the wages of formal and informal workers and the wage gap between them are very limited and outdated. The analysis in this section updates estimates by using the most recently available Labor Force Survey data and more complete information on earnings for different types of informal workers. Some descriptive analysis of wage differentials is first presented, followed by more in-depth analysis that controls for differences in firms' and workers' characteristics.

In line with continued economic growth, real wages grew consistently between 2006 and 2017. Overall, real wages grew at an annualized rate of around 4.3 percent per year between 2006 and 2017 among informal employees, and 3.3 percent among formal employees (table A.10). Formal and informal self-employed, for whom earnings data were not collected prior to 2013, experienced an annualized wage growth of around 10 percent and 9 percent, respectively, between 2013 and 2017.

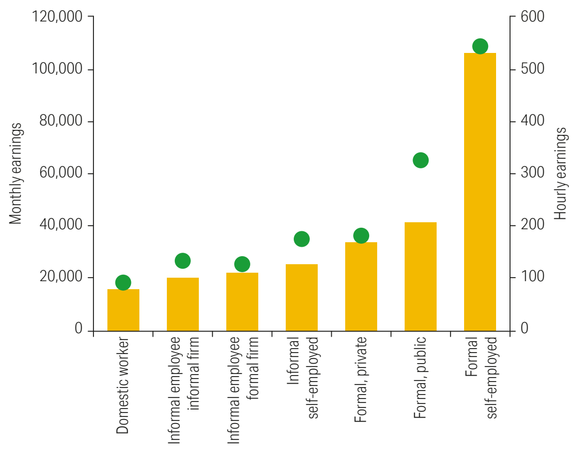
Both men and women benefited from broad-based wage growth during this period. Men's wages (for employees only) increased by an annualized 3.7 percent between 2006 and 2017. The equivalent figure for women was 4.1 percent. Despite sustained wage growth for both men and women, there exists a distinct gender gap in wages (figure A.1). Wages are almost at parity in the public sector, with the difference largest among informal employees (table A.11). The recent widening in the gap is likely due to the difficulty of women finding good jobs in the private sector, in part because of rigid labor market regulations that discourage the employment of women—a situation exacerbated by traditional norms that impose the burden of household chores and child/elderly care on women, and by the lack of alternative arrangements for the latter.

A static wage profile shows that the monthly earnings of formal employees are significantly higher than those of informal employees—well over SL RS 30,000–40,000 for the former, compared to slightly more than SL RS 20,000 for the latter in 2017.[24] Formal public sector workers earn on average about SL RS 40,000 every month.

24. The survey collects gross earnings data.

These are followed by formal private sector employees, who receive about SL Rs 34,000 per month. Among all employees, public sector employees earn about twice as much as informal employees. Formal self-employed have the highest average earnings, at over SL Rs 100,000 per month, though they represent only a very small fraction of the labor market (less than 4 percent in 2017). Informal self-employed, who are primarily own-account workers, earn about SL Rs 26,000. Domestic workers earn the least, around SL Rs 16,000 per month. Estimates of hourly earnings present a similar picture, with the rankings among the workers unchanged (figure 11). It should be noted, however, that while monthly earnings of formal public sector and formal private sector workers are not significantly different, hourly earnings are considerably higher among public sector workers. This is attributed to their shorter working hours; they work on average three hours less per week than private sector workers (43.4 versus 46.4 hours).

Figure 11 Monthly and hourly earnings of formal and informal workers

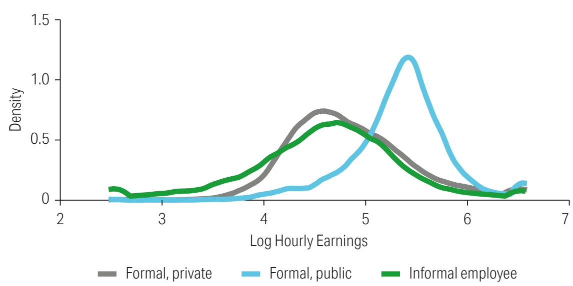


Source: World Bank staff calculation using LFS data for 2017.
Note: Monthly and hourly earnings are in 2017 nominal prices.

But averages mask large variation among formal workers — the wage distribution of formal private sector employees is actually much closer to that of informal employees than that of public sector workers

Mere averages mask the fact that the wage distribution of formal private sector workers is actually much more similar to that of informal workers than that of formal public sector workers, which suggests that productivity levels remain broadly low. Figure 11 suggests that public sector and formal private sector workers earn on average about SL Rs 42,000 and SL Rs 34,000 per month respectively, whereas informal employees earn on average slightly more than SL Rs 20,000. However, the full distribution of hourly earnings, shown in figure 12, reveals a different picture: the public sector wages are highly concentrated around the mean with little dispersion, whereas the overall earnings distribution of formal private sector and informal workers is actually very similar, except for a few outliers that inflate the private sector earnings average. The earnings distribution of private sector workers is highly dispersed compared to that of public sector workers. The median earnings of formal private sector workers are much closer to those of informal workers.

Figure 12 Distribution of log hourly earnings for formal and informal workers

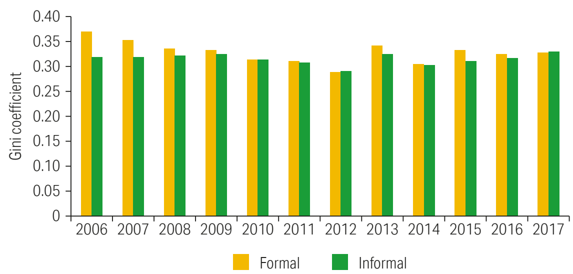


Source: World Bank staff estimation using LFS data for 2017.
Note: Wages are spatially deflated, and 1 percent outliers are trimmed from both tails.

Despite some improvements, there is considerable variation in wages between workers, regions, and industries

Earnings inequality among formal workers has overall decreased over time, while that among informal workers has remained largely unchanged. The Gini coefficient of monthly earnings among formal workers steadily decreased until 2012, after which it fluctuated somewhat but remained around 0.33 (figure 13). The downward trend was likely driven by an increase in public sector jobs in the earlier years, among which the earnings distribution is more compressed. On the other hand, the Gini coefficient of earnings among informal workers did not improve from a decade ago.

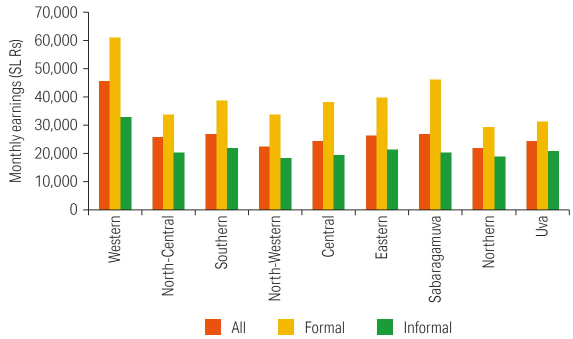
Figure 13 Gini coefficient of monthly earnings



Source: World Bank staff calculation using LFS data for 2006–17.

There is considerable variation in wages across regions, even among formal workers. Formal workers in the Western Province earn almost SL Rs 61,000 per month, which is significantly more than their counterparts everywhere else. In fact, formal workers in the Uva, Northern, Sabaragamuva, and Eastern Provinces earn only SL Rs 26,000–30,000. Similar differences are observed among informal workers as a group, with those residing in the Western Province earning almost SL Rs 33,000, compared to less than SL Rs 20,000 for those in the Northern, Central, and North-Central Provinces (figure 14).

Figure 14 Monthly nominal earnings by province, formal and informal workers (SL Rs)



Source: World Bank staff estimation using LFS data for 2017.

Across industries, the formal-informal wage gap as a share of informal wages is the largest in construction and commerce. In construction, formal workers make almost three times as much as informal workers on average, though a large part of this difference is likely explained by differences in occupations. A large difference is also present in commerce, where formal workers earn more than twice as much as informal workers. Significant gaps are observed in most other services sectors, including transport and community services. On the other hand, the gap is very small in agriculture (where most workers are informal) and financial services (where most workers are formal) (table 7). These are unconditional differences in wages and do not reflect differences in firm or worker attributes that could be driving some of the gaps.

Table 7 Formal-informal wage gap by industry (SL Rs)

	All	Formal	Informal	Gap	Gap, %[a]
Agriculture	16,335	18,064	16,063	2,001	12%
Mining	21,694	44,914	17,574	27,340	156%
Manufacturing	28574	39,297	21,431	17,866	83%
Public utilities	41,739	47,669	30,545	17,124	56%
Construction	33,374	77,218	27,906	49,313	177%
Commerce	45,190	76,586	33,141	43,445	131%
Transport and communications	35,472	50,266	30,174	20,092	67%
Financial and business-oriented service	45,479	47,209	40,287	6,922	17%
Community and family-oriented services	40,451	43,346	26,013	17,333	67%
Other services, unspecified	33,320	44,391	22,824	21,567	94%

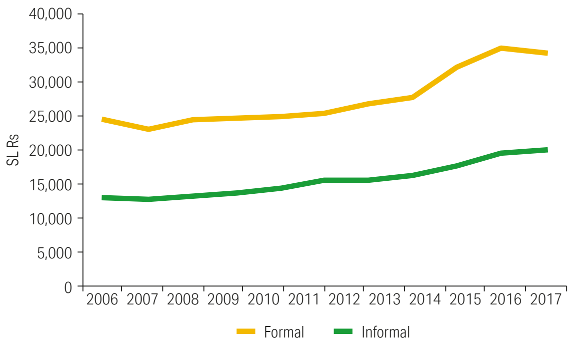
Source: World Bank staff calculation using LFS data for 2017.

a. Indicates the formal-informal wage gap as percentage of average informal wages. All wages are in nominal values.

The formal-informal wage gap persists even after adjusting for workers' and firms' characteristics

The wage gap between formal and informal workers has been persistent, and it has continued to widen in recent years. Figure 15 shows the trend in real monthly wages of formal and informal employees for the period 2006–17.[25] It should be noted that information on self-employed earnings was not available until 2013. For this reason, figure 15 presents the longer-term trend for employees only. While wages have grown steadily since 2006, the gap between formal and informal workers has widened in recent years: the 2006 wage gap of around SL Rs 11,400 has grown over time to reach SL Rs 14,300 in 2017. A similar trend consisting of a distinct and widening wage gap is observed when looking at hourly wages, or when considering all formal and informal workers (including self-employed workers for whom there was no earnings information prior to 2013) for the years 2013–17.

Figure 15 Formal-informal wage gap, 2006–17



Source: World Bank staff calculation using LFS data for 2006–17.
Note: Wages are in 2017 prices.

Formal regression analysis is employed to further investigate whether there exists a wage premium for formal workers after accounting for observable characteristics. This analysis would make it possible to account for wage differentials that are due to observable individual and firm characteristics. The latter includes worker's gender, ethnicity, education, geographic sector and district of residence, experience, sector of activity, occupation, employment status, and firm size. Two sets of analyses are conducted, one that pools all data for 2006–17 for paid employees only (because information on earnings of self-employed workers was not collected until 2013); and another that pools earnings data from all workers for 2013–17. Within each set of regressions, either one indicator variable for all informal workers is added, or multiple variables are added to indicate the type of formal or informal employment of the individual.

The adjusted wage gap remains at around 30 percent. Results suggest that there remains a wage premium associated with formal employment, even after controlling for worker and firm characteristics. Full regression results are shown in table A.12 in the appendix. The results in column (1) distinguish between different types of formal and informal workers, with formal private sector workers as the reference group. The earnings of the formal private sector workers and formal self-employed are not different in a statistically significant way. Formal public sector employees enjoy a wage premium even after controlling for worker and firm characteristics. The wage gap is the largest for domestic workers, followed by informal self-employed and informal employees in formal firms. The estimates in column (2) compare all formal workers against all informal workers. As a group, informal workers are subject to a wage penalty of about 30 percent after taking into account a range of observable factors. Being a woman, being less educated, and being less experienced lead to lower earnings. Across industries, earnings are lower in manufacturing and commerce, and higher in construction (relative to agriculture and after controlling for worker and firm characteristics). By ethnicity, Sri Lanka Moors and other non-Tamil minorities earn on average more than Sinhalese workers. As the results by occupation suggest, earnings also fall with skill level, with the largest gap found among those unskilled workers in elementary occupations. Workers in larger firms tend to be better compensated; this empirical regularity, which is observed among otherwise observationally equivalent workers, is also referred to as the "firm-size wage gap" in the literature. In fact, accounting for firm size absorbs a large portion of the wage gap between formal and informal workers.[26]

25. All wages are spatially deflated and temporally adjusted using the monthly Colombo CPI (2017 = 100) unless specified otherwise.
26. For public sector workers the firm size is set to 100 or more.

The wage gap appears to be larger at the bottom of the earnings distribution. Given the heterogeneity of informal workers, it is plausible that the formal-informal wage gap varies across the earnings distribution. This possibility is investigated by means of quantile regressions (table A.13). The latter confirm that the adjusted gap is indeed wider at the top.

Almost half of the wage gap is attributed to differences in group means, with the rest "unexplained." The wage gap attributed to differences in group means is due to differences in characteristics such as education, experience, firm size, sector, occupation, and so on. The unexplained difference refers to the part of the wage gap that comes from differences in the return to those observable characteristics. An Oaxaca decomposition is employed to estimate how much of the wage gap is owing to either differences in the group means or differences in returns to those characteristics (based on differences in estimated coefficients) that are otherwise unexplained. These results, which also take into account selection of different types of individuals into formal and informal jobs, are presented in table 8. Of the total gap of 0.495 (differences in log of hourly earnings), 0.224 is explained by differences in characteristics, which is equivalent

Table 8 Oaxaca decomposition results on log of hourly earnings: Formal versus informal workers

Overall	
Group 1: Formal workers	4.873 ***
Group 2: Informal workers	4.378 ***
Difference	0.495 ***
Threefold decomposition	
Total gap, %	11.31%
Endowments	0.031 ***
Coefficients	0.0793 ***
Interaction	0.3843 ***
Twofold decomposition	
Explained	0.224 ***
Unexplained	0.271 ***
Observations	160,417

Gap		100
Explained		**45.25**
Female	-0.029 ***	-5.86
Years of education	0.086 ***	17.37
Experience	0.008 ***	1.62
Firm size	0.079 ***	15.96
Ethnicity	-0.002 ***	-0.40
Sector	-0.003 ***	-0.61
Industry	-0.006 **	-1.21
Occupation	0.120 ***	24.24
Region	-0.003 ***	-0.61
Year	-0.020 ***	-4.04
Mills ratio	-0.007 ***	-1.41
Unexplained		**54.75**
Female	0.063 ***	12.73
Years of education	0.405 ***	81.82
Experience	0.131 ***	26.46
Firm size	0	0.00
Ethnicity	0.009	1.82
Sector	-0.003	-0.61
Industry	-0.084 ***	-16.97
Occupation	-0.012	-2.42
Region	0.025 ***	5.05
Year	-0.005 ***	-1.01
Mills ratio	0.130 ***	26.26
Constant	-0.387 ***	-78.18

Source: World Bank staff estimation using LFS data.

Note: Decomposition with Heckman selection conducted on paid employees only.

Significance level: * = 10 percent, ** = 5 percent, *** = 1 percent to around 45 percent of the gap (in the case of a twofold decomposition). The rest of the wage gap is unexplained.[27] While these estimates are for employees only for the period 2006–17, qualitatively similar results are achieved when including all self-employed workers and conducting an estimation for the years 2013–17.

Education accounts for an overwhelming portion of the unexplained wage premium for formal workers. In other words, the returns to obtaining more education are larger for employment in formal arrangements. Education is also the second most important contributor to the wage difference (after occupation) that is explained by differences in group means. In fact, education accounts for most of the wage gap between formal and informal workers, whether this is owing to the difference in educational attainment or the returns to the same. Overall, closing the education gap could improve productivity and earnings and help close the earnings gap.

The risk of extremely low pay is significantly higher for informal workers, who are also more likely to be experiencing in-work poverty

The risk of extremely low pay and resulting vulnerability is measured using the country's minimum wage as a benchmark and applied to employees only. The minimum wage was first defined by the National Minimum Wage of Workers Act of 2016, which set forth a national minimum wage at SL RS 10,000 per month. In the same year, the Budgetary Relief Allowance of Workers Act mandated a SL RS 2,500 allowance for all workers earning less than SL RS 40,000 per month, setting the effective minimum wage threshold at SL RS 12,500 per month (equivalent to US$79.28). While it is difficult to compare minimum wage levels across countries, the ratio of minimum wage to value added per worker is only 0.18 for Sri Lanka, which is much lower than that of comparator countries (World Bank 2016).

The risk of extremely low or inadequate pay is significantly higher for informal workers. Open unemployment is not very common in Sri Lanka, and in the absence of a formal unemployment scheme, workers may be pushed into subsistence jobs with very low pay. As of 2017, 27.1 percent of informal workers earned less than the stipulated monthly minimum wage. Among formal workers, 5.8 percent fell under the same threshold. Since the regulation was enacted in 2016, the share has slightly decreased, from 31.6 percent to 27.1 percent for informal workers; this is not surprising given that the threshold is set at a nominal level and does not increase unless an amendment is passed in Parliament.[28] Ad hoc revisions can also create unforeseen anomalies on the part of the employer. This implies that the share of workers falling below this threshold is naturally set to fall over time as long as there is any positive wage growth in this segment. The legislation does not provide for any indexation of minimum wages, and benefits have already started to erode since 2016 (at the rate of general inflation). This decrease is also indicative of the extent of firms' noncompliance with the regulation on minimum wages.

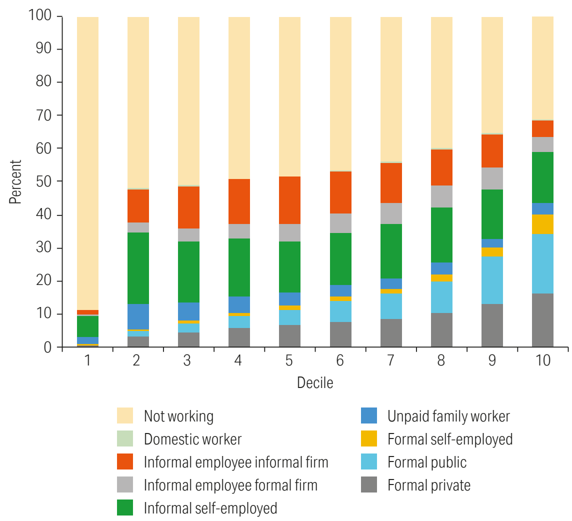
Consistent with the above findings, the incidence of working poverty is higher among informal workers. "Working poverty" in this context is defined as being in the bottom 10 percent of the per capita household earnings distribution. The latter is calculated using earnings from all household members and dividing them by the entire household size, including members of the household who are not working or are in unpaid jobs. Figure 16 shows the distribution of working-age individuals by per capita household income. The bottom decile consists largely of households with

27. A Nopo decomposition is used to check the robustness of the results. This nonparametric tool, devised by Nopo (2008), calculates matching comparisons to estimate wage differences by taking into account differences in the supports of the distributions of observable characteristics, thus providing further insights into the unexplained wage difference. According to the Nopo decomposition results, the size of the unexplained gap shrinks somewhat but is still significant at 34 percent. For further details, see Nopo (2008).

28. An amendment to increase the minimum wage to SL RS 16,000 is pending parliamentary approval at the time of writing.

few workers (mostly employed on own account as unpaid family workers) and many nonworking individuals. Very few formal workers fall in the bottom decile of the earnings distribution, making them the least likely to be poor. In fact, the majority of public sector workers fall in higher income deciles. Formal private sector employees are more spread out across the distribution, though again very few are likely to be in the bottom 10 percent of the distribution (figure 16).

Figure 16 Distribution of working-age population by employment status and income decile



Source: World Bank staff calculation using LFS data for 2017.
Note: Working-age individuals are distributed according to their per capita household income.

The analysis in this section suggests that the Sri Lanka labor market is broadly stratified into three segments, each with significantly different pay and job quality. Workers in the public sector enjoy high monthly pay, shorter working hours, a large number of holidays in addition to paid leave, formal social security, and a high level of job security. Formal, private sector employees enjoy slightly lower monthly wages, but their earnings distribution is in fact more similar to that of informal employees than to that of public sector workers. They are entitled to social security but work longer hours, reducing their average hourly pay. Most but not all of them receive paid leave. The last group comprises informal workers, the most vulnerable group by any measure. Heterogenous as they may be, most of them have subsistence-level jobs (except for informal employers who report the highest earnings of all but make up only a very small share in the labor force) with low pay, few benefits, and little protection.

5.

Conclusion and policy implications

Informal employment has remained persistently high in Sri Lanka. Between 2006 and 2017, the share of informally employed workers has remained almost unchanged, at around 60 percent. Adopting a "poverty" perspective on informality, this report investigates the quality of formal and informal jobs, based on two dimensions: (a) contracts and working conditions, which capture the nonpecuniary aspects of a job; and (b) the risk of poverty and vulnerability, which examines the risk of extremely low pay and the incidence of working poverty. Overall, the Sri Lanka labor market is stratified into three segments according to the quality of the jobs: (a) formal, public sector workers who enjoy high remuneration, comparatively short work hours, long holidays, entitlement to paid leave as well as other benefits, and overall job security; (b) formal, private sector workers who make up a middle group, with access to social security and some other benefits but with an earning distribution closer to that of informal workers; and (c) informal workers, consisting mainly of informal employees as well as own-account workers, most of whom are in precarious employment arrangements with little access to any benefits and with low remuneration.

Stringent labor regulations have long been criticized as encouraging informality, but there also appear to be few benefits to formalization. In Sri Lanka, dismissals are not only difficult but also expensive, resulting in redundancy costs that are the second highest in the world. These costs hamper firms' adjustment in response to changes in market conditions. While enforcement of regulations is limited, nontransparent laws leave room for arbitrary decisions, making litigation costly and risky. Moreover, access to formal credit—in theory a major benefit of formalization—is constrained by other structural factors, including stringent collateral requirements and land tenancy. These issues would not be resolved by formalization alone.

Formalization efforts around the world have focused on easing entry regulations, but they have generally yielded limited success. Following a slew of research that showed that informality led to a large loss in potential tax revenues, resource misallocation, and unfair competition between the formal and informal sector, many countries implemented business entry regulation reforms to reduce informality. However, evidence to date suggests that easing entry regulations and providing information on the formalization process have only a very limited impact on the formalization of existing informal firms. While many regulatory reforms have taken place in the past decades, the majority of businesses in developing countries remain informal (Bruhn and McKenzie 2014). A few studies in Latin America have found that a large reduction in the cost and time needed for business registration has a modest impact on the number of formal firms (for example, Bruhn [2011] for Mexico). The effect of business entry reforms on the formalization of informal firms is also found to be rather small (Bruhn 2013). Interventions that combine information, waived costs, and enforcement also found little to no effect on tax registration (for example, De Giorgi and Rahman [2013] for Bangladesh).

Larger impacts were found when business registration did not involve tax registration or when large changes to tax rates were implemented. Alcazar, Andrade, and Jaramillo (2015) found that offering a subsidy for the cost of a municipal license in Peru led 10–12 percent of informal businesses to obtain one. On the other hand, reducing tax rates and lessening the complexity of taxes for small firms led to no significant overall effect in Brazil (Monteiro and Assuncao 2012). In Pakistan, moreover, a large increase in the tax burden led more than half of tax-paying firms to leave the formal system; those that remained had substantially reduced reported earnings (Waseem 2018). A field experiment in Sri Lanka by de Mel, McKenzie, and Woodruff (2013) found that providing information about the registration process and reimbursing up-front for registration costs had no effect on firm registration at the Divisional Secretary Division level, the relevant registration for tax purposes. These findings reinforce the argument that firms are rationally choosing to be informal because the costs outweigh the benefits of formalization (Benhassine et al. 2016).

Given the limited success in getting firms to formalize, there have been few opportunities to directly measure the benefits of doing so. De Mel, McKenzie, and Woodruff (2013) also did not find evidence of benefits accruing to firms—such as access to bank accounts or loans, participation in government training programs, increased receipt of government contracts, or increased certainty over taxes—as a result of formal status. Benhassine et al. (2016) offered a full package of supplementary benefits to firms, which boosted registration rates when formalization was linked with access to government training programs, support to open bank accounts, and tax mediation services, in addition to information on registration. However, these services were perceived to be of limited benefit to the firms, indicating that even enhanced formalization efforts may not be sufficient to induce formalization at large scale.

The available evidence highlights the fact that reducing informality should not be in itself a policy goal. Existing research finds that informality tends to decrease with development, but growth alone does not ensure a reduction in informality. In fact, deindustrialization and the expansion of the services sector has contributed to a rise in informality in some countries. Sri Lanka has seen continued economic growth in the past 15 years, including a period of high growth, yet informality levels remain almost unchanged. On the one hand, the role and size of the highly informal primary sectors (mostly agriculture and fishery) also matter. On the other hand, even as the size of the primary sector shrunk, the additional jobs created in industry and services were predominantly informal, even when growth was high. To some extent, the persistence of informality also has to do with the sectors that generate economic growth and jobs. Thus it is important to address the root causes and correlates of informality rather than strictly focusing on formalization alone. Strategies that promote aimless formalization can lead to higher poverty, unemployment, and crime levels.

A well-conceived formalization strategy would aim at increasing the benefits and reducing the costs of formalization through a policy mix that tackles the interrelated causes and consequences of informality together. Informality tends to be higher when the regulatory and tax burden is heavy, enforcement is weak, and the tax-benefit system does not favor formality (Loayza 2016). The government's policy toolkit includes regulatory, credit, and labor market policies that all affect the decisions of workers and firms about whether to be formal or informal. Thus reform packages should be implemented in an integrated rather than piecemeal way, which would also make the reforms politically and socially more acceptable (Loayza 2018).

The following reform components are suggested to make formalization more attractive in line with recommendations from the international literature. They respond to the diverse characteristics and causes of informality, as well as to interrelated issues such as inferior job quality, lack of social protection, and low productivity (all of which require investment in human capital and access to credit and technology):

- **Increase flexibility in labor markets and quality of jobs by reducing labor taxes and simplifying compliance.** Labor costs, especially those associated with dismissal, are high, effectively reducing the demand for formal labor. TEWA was introduced during a time when the economic and social environment was drastically different from today, and it needs to be reconsidered so firms can adjust their workforce in response to worker productivity and changing market conditions. Maintaining both high severance pay and a formal social security (EPF) system can be prohibitively expensive for employers. Streamlining and simplifying labor regulations to lessen the law's ambiguity, increase its transparency, and reduce overlapping coverage would make compliance easier and less costly. Enforcement efforts should focus more on mediation than on litigation, which can drastically increase uncertainty and costs for both workers and employers. There have been recent efforts to combine existing labor laws into a single labor law but the proposed legislation failed to obtain final approval.

- **Build an adequate and effective social protection system.** Social protection reform can reduce the vulnerability to economy-wide and idiosyncratic shocks—yet if poorly designed it can work to reinforce high informality. Thus it is critical to balance work incentives and workers' protection. The ETF contributions could be converted into an unemployment insurance fund to serve the ETF's original intended purpose. Increased flexibility for workers, firms, and markets to adjust to changes in broader economic conditions, combined with an effective social protection system, will lead to greater economic growth. The increase in workers in smaller firms who are outside of lawful coverage is an issue that merits more attention.

- **Increase human capital to promote productivity gains and reduce the wage gap.** Decomposition analysis showed that a large part of the wage gap is due to differences in educational attainment or the returns to it. Improving the skills of the labor force could help reduce the wage gap. To that end, education reforms are needed to align the curriculum to the demands of the labor market; the workforce also needs continuing training to upgrade skills, adapt to changing market conditions, and prepare for a longer working life than in the past.

- **Streamline regulations while strengthening monitoring.** Strengthening monitoring alone could lead to more informality (as firms might more actively try to conceal unlawful employment); it could also drive higher unemployment and even smaller firms. At the same time, leveling the playing field is important—e.g., enforcement activities should extend to both formal and informal firms. (The latter are currently not covered by such activities.) These reforms can be achieved in the short run.

In response to long-standing challenges and complaints stemming from the multiplicity of laws regulating labor, a Unified Employment Law was approved in the cabinet in June 2018, but failed to obtain final parliamentary approval. The law aimed to consolidate the SOEA, the WBO, the Maternity Benefits Ordinance, and the Employment of Women, Young Persons and Children Act into one labor law, without reducing any of the rights or benefits under the individual laws. Further, the draft law included definitions for statuses and concepts—such as casual labor, fixed-term contracts, a mandatory retirement age (which is a matter for contract at present), and probation in employment—that were previously defined only in practice. It also extended coverage of employment protection legislation to all workers, including domestic workers and informal sector workers; prohibited avoidance strategies such as use of undocumented workers; and addressed inward migrant workers and employment placement agencies, which were hitherto not included. The law was also intended to encourage women's labor market participation, by providing a framework for flexible work arrangements, home work, part-time work, etc. Current provisions state that all workers must receive the same benefits regardless of whether they are employed full-time or not; this may be a disincentive to employ women, who may not be able to work full-time. Removal of restrictions on night work for women, overtime work in some sectors, and equal pay for equal work, as well as provisions to take action against sexual harassment, were all aimed at expanding employment opportunities for women and providing them with a safe and dignified working environment.

The imperative for Sri Lanka to implement these reforms is driven by its demographic context, specifically the rapid aging—combined with early retirement—of the labor force. The majority of men in the labor force exit the labor market starting at around age 55; the age is even lower for women (figure 17). Labor force participation can be increased by increasing the number of workers joining the labor force and facilitating longer working lives. The employment protection legislation that imposes a prohibitively high cost on the employer for dismissals, combined with a relatively low retirement age

Figure 17 Male and female labor force participation rate by age

Source: World Bank staff calculation using LFS data for 2017.

by international standards (55 for men and 50 for women), introduces an incentive structure that leads most of the workforce to exit the labor market early. Most of those who remain part of the labor force beyond average retirement age work in agriculture. While there is no formal mandatory retirement age in the private sector, because of the "prior consent" clause in TEWA (see chapter 3) employment contracts typically specify 55 as retirement age for men (Ranaraja 2019). Despite the lack of income support, the elderly tend to exit the labor market rather prematurely. Pension is an entitlement that is reserved for public sector workers and a few private sector employees.

Reforms should attempt to make labor regulations compatible with the challenges posed by an aging labor force. The regulatory and incentive scheme needs to be restructured to encourage more working-age individuals to join the labor market and extend their working lives. This would help meet the labor demands in a country that still needs to grow significantly but is undergoing rapid aging. Needed reforms include raising the formal retirement age (including harmonizing the age for men and women), and structuring incentives to be consistent with the legislation. Firms need to have the flexibility to adjust their workforce according to skills and market needs, and to promote and pay workers based on merit. The latter is particularly a concern in the public sector. Reforms should also aim to bring down the cost of labor, which currently makes it prohibitively expensive to retain workers for an extended period of time. Adjustments are needed from both employers and workers: employers need to adapt to the aging of the workforce, and workers have to invest in expanding and upgrading their skills. Allowing elderly workers to remain longer in the labor market also allows them to maintain a decent living standard and prevents them from falling into poverty, especially when social security maintains limited coverage. Women are particularly vulnerable because many work as unpaid family workers and are much more likely than men to become dependent earlier in the life cycle. More research is needed to identify a set of concrete policies that strengthen the incentive to extend one's working life while also allowing for flexible wages.

It should be noted that this report addresses only the first of the "three P's" mentioned in the introduction—poverty. The other two—public finance and productivity—are interrelated with the first and are equally important aspects of informality. While they are beyond the scope of this report, they warrant thorough analysis to fully understand the role of informality in the economy.

Appendix A

Table A.1 Labor force participation rate, age 15 and over (%)

	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Total	57.1	55.5	55.1	54.1	53.4	52.9	52.5	53.7	53.2	53.8	53.8	54.1
Male	76.7	76.2	76.1	74.7	75.0	74.0	74.9	74.9	74.6	74.7	75.1	74.5
Female	39.5	37.0	36.6	36.2	34.4	34.3	32.9	35.4	34.6	35.9	35.9	36.6

Source: World Bank staff calculation using LFS data for 2006–17.

Table A.2 Summary of labor market indicators

	2006	2007	2008	2009	2010	2011
Population (age 15 and above)	13,265,380	13,456,542	14,625,844	14,876,264	15,166,284	14,976,135
Labor force participation rate (%)	57.1	55.5	55.1	54.1	53.4	52.9
Total employed	7,086,364	7,025,268	7,627,999	7,579,835	7,696,143	7,591,404
Formal (total)	2,142,041	2,088,519	2,351,606	2,236,973	2,239,280	2,216,138
Formal, private employees	1,000,177	950,362	1,003,009	950,450	974,563	976,076
Formal, public employees	885,579	899,657	1,083,163	1,085,553	1,022,744	1,019,483
Formal self-employed	256,285	238,501	265,434	200,970	241,973	220,579
Informal (total)	4,944,323	4,936,749	5,276,393	5,342,862	5,456,863	5,375,266
Unpaid family worker	727,718	712,117	784,226	789,705	796,221	804,880
Informal self-employed	2,259,143	2,238,959	2,429,209	2,396,692	2,566,314	2,564,051
Domestic worker [a]	—	—	—	—	—	—
Informal employee formal firm	571,622	590,900	650,502	618,187	588,799	576,676
Informal employee informal firm	1,385,840	1,394,772	1,412,456	1,538,279	1,505,528	1,429,659

	2012	2013	2014	2015	2016	2017
Population (age 15 and above)	14,857,153	14,958,006	15,134,483	15,281,945	15,448,679	15,843,735
Labor force participation rate (%)	52.5	53.7	53.2	53.8	53.8	54.1
Total employed	7,488,704	7,680,621	7,700,490	7,830,976	7,947,683	8,208,179
Formal (total)	2,250,968	2,261,302	2,328,580	2,393,995	2,408,174	2,623,417
Formal, private employees	970,958	940,489	994,177	1,052,431	1,090,722	1,220,832
Formal, public employees	1,036,553	1,064,399	1,090,222	1,100,388	1,088,116	1,101,729
Formal self-employed	243,457	256,414	244,180	241,176	229,336	300,855
Informal (total)	5,237,736	5,419,318	5,371,910	5,436,982	5,539,509	5,584,762
Unpaid family worker	654,249	695,962	683,360	660,064	623,141	655,655
Informal self-employed	2,541,954	2,449,283	2,427,588	2,532,900	2,499,630	2,506,270
Domestic worker	—	59,392	59,150	47,843	57,505	53,572
Informal employee formal firm	641,324	684,693	721,176	696,092	695,740	752,212
Informal employee informal firm	1,400,208	1,529,988	1,480,637	1,500,083	1,663,494	1,617,053

Source: World Bank staff calculation using LFS data for 2006–17.

Note: — = Not available.

a. Due to changes in the questionnaire, domestic workers are measured only after 2013, and some are included as informal self-employed prior to 2013.

Table A.3 Formal and informal employment as share of total employment (%)

Share of total employment (%)	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Formal												
Formal, private employees	14.1%	13.5%	13.1%	12.5%	12.7%	12.9%	13.0%	12.2%	12.9%	13.4%	13.7%	14.9%
Formal, public employees	12.5%	12.8%	14.2%	14.3%	13.3%	13.4%	13.8%	13.9%	14.2%	14.1%	13.7%	13.4%
Formal self-employed	3.6%	3.4%	3.5%	2.7%	3.1%	2.9%	3.3%	3.3%	3.2%	3.1%	2.9%	3.7%
Informal												
Unpaid family worker	10.3%	10.1%	10.3%	10.4%	10.3%	10.6%	8.7%	9.1%	8.9%	8.4%	7.8%	8.0%
Informal self-employed	31.9%	31.9%	31.8%	31.6%	33.3%	33.8%	33.9%	31.9%	31.5%	32.3%	31.5%	30.5%
Domestic worker [a]	—	—	—	—	—	—	—	0.8%	0.8%	0.6%	0.7%	0.7%
Informal employee formal firm	8.1%	8.4%	8.5%	8.2%	7.7%	7.6%	8.6%	8.9%	9.4%	8.9%	8.8%	9.2%
Informal employee informal firm	19.6%	19.9%	18.5%	20.3%	19.6%	18.8%	18.7%	19.9%	19.2%	19.2%	20.9%	19.7%
Informal employment, total	69.8%	70.3%	69.2%	70.5%	70.9%	70.8%	69.9%	70.6%	69.8%	69.4%	69.7%	68.0%

Source: World Bank staff calculation using LFS data for 2006–17.
Note: — = Not available.
a. Due to changes in the questionnaire, domestic workers are measured only after 2013, and some are included as informal self-employed prior to 2013.

Table A.4 Number of workers with secondary job (thousands) and share of total employed, 2006–17

Secondary job: formal/informal	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	% share in 2017
Formal, private								5	1	1	1	1	0.2%
Formal, public								1	1	0	1	0	0.1%
Formal self-employed								20	20	17	25	22	3.1%
Unpaid family worker								127	126	124	129	125	18.1%
Informal self-employed								470	416	445	589	418	60.4%
Informal employee formal firm								12	16	16	17	21	3.1%
Informal employee informal firm								100	85	98	114	90	13.1%
Domestic worker								1	1	0	2	13	1.9%
Total with secondary job	759	683	799	766	750	713	516	736	667	700	878	692	
Total employed	7,086	7,025	7,628	7,580	7,696	7,591	7,489	7,681	7,700	7,831	7,948	8,208	
% of workers with second job	10.7%	9.7%	10.5%	10.1%	9.7%	9.4%	6.9%	9.6%	8.7%	8.9%	11.0%	8.4%	

Source: World Bank staff calculation using LFS data for 2006–17.
Note: Detailed data on secondary jobs are available only after 2013. Years with no estimate are in gray.

Table A.5 Distribution of workers with formal/informal main and secondary jobs

All employed	Distribution in 2017
Formal main job, formal secondary job	0.2%
Formal main job, informal secondary job	1.7%
Informal main job, formal secondary job	0.1%
Informal main job, informal secondary job	6.4%
Only one formal job	30.0%
Only one informal job	61.5%
Informality when only main job is considered	68.0%
Informality when main & secondary jobs are considered	69.8%

Source: World Bank staff calculation using LFS data for 2006–17.

Table A.6 Formal and informal workers by sector of activity (%)

	Formal, private	Formal, public	Formal self-employed	Unpaid family worker	Informal self-employed	Informal employee formal firm	Informal employee informal firm	Domestic worker	% informal
Agriculture	8.1%	1.9%	1.0%	17.8%	48.4%	3.0%	19.4%	0.4%	89.0%
Mining	4.4%	3.2%	6.9%	1.5%	15.9%	26.9%	40.8%	0.3%	85.5%
Manufacturing	32.9%	1.2%	3.1%	6.0%	27.4%	12.8%	16.3%	0.2%	62.7%
Public utilities	15.2%	46.9%	2.6%	0.6%	6.5%	19.9%	8.3%	0.0%	35.3%
Construction	5.9%	2.8%	2.4%	0.5%	14.5%	7.1%	66.5%	0.3%	88.9%
Commerce	12.2%	1.5%	10.8%	11.2%	38.8%	12.1%	13.3%	0.1%	75.5%
Transport and communications	10.5%	10.7%	4.9%	1.0%	43.8%	10.4%	18.2%	0.5%	73.9%
Financial and business-oriented services	50.5%	22.6%	1.4%	0.2%	6.3%	16.9%	2.0%	0.0%	25.5%
Community and family-oriented services	10.4%	69.7%	2.5%	0.6%	3.5%	9.1%	4.0%	0.2%	17.4%
Other services, unspecified	10.3%	33.4%	3.2%	3.3%	17.6%	10.8%	18.3%	3.1%	53.1%

Source: World Bank staff calculation using LFS data for 2017.

Table A.7 Formal and informal workers by firm size (%)

	Formal, private	Formal self-em-ployed	Unpaid family worker	Informal self-em-ployed	Informal employee formal firm	Informal employee informal firm	Domestic worker	Formal	Informal
Less than 5	4.5%	24.8%	6.9%	5.5%	21.2%	45.4%	0.0%	8.5%	19.3%
5 to 9	5.7%	8.1%	1.3%	0.5%	12.4%	7.8%	0.0%	6.1%	4.2%
10 to 15	8.9%	5.6%	0.9%	0.0%	21.6%	0.0%	0.0%	8.3%	2.8%
16 to 49	16.1%	1.7%	0.1%	0.0%	17.0%	0.0%	0.0%	13.3%	2.1%
50 to 99	11.7%	0.6%	0.0%	0.0%	7.8%	0.0%	0.0%	9.5%	1.0%
100 or more	52.6%	1.8%	0.1%	0.0%	16.2%	0.0%	0.0%	42.5%	2.0%
No paid employee	0.6%	57.3%	87.2%	94.0%	3.7%	45.5%	0.0%	11.8%	67.0%
Working for household	0.0%	0.1%	3.5%	0.0%	0.1%	1.3%	100.0%	0.0%	1.8%

Source: World Bank staff calculation using LFS data for 2017.

Table A.8 Sectoral distribution of formal and informal workers (number and share)

	Formal, private	Formal, public	Formal self-employed	Unpaid family worker	Informal self-employed	Informal employee formal firm	Informal employee informal firm	Domestic worker	Total workers	Share of all informal workers	Sectoral informality rate
Agriculture	172,803	41,588	20,866	380,324	1,035,896	64,477	415,425	8,807	2,140,185	26%	89.0%
Mining	2,767	2,029	4,343	973	10,043	16,948	25,697	214	63,014	1%	85.5%
Manufacturing	520,322	19,445	49,754	95,419	432,589	201,847	258,068	3,492	1,580,936	19%	62.7%
Public utilities	7,327	22,534	1,249	270	3,134	9,549	4,000	-	48,062	1%	35.3%
Construction	37,719	17,867	15,239	3,057	92,522	45,588	425,446	2,045	639,482	8%	88.9%
Commerce	141,832	17,376	125,369	130,023	450,433	139,905	154,068	1,438	1,160,444	14%	75.5%
Transport and communications	61,280	62,493	28,309	5,916	255,722	60,894	105,891	2,752	583,255	7%	73.9%
Financial/business-oriented services	88,816	39,724	2,468	284	11,152	29,700	3,592	-	175,735	2%	25.5%
Community/family-oriented services	77,910	521,821	18,756	4,120	26,459	68,411	29,868	1,319	748,663	9%	17.4%
Other services, unspecified	110,058	356,853	34,502	35,268	188,322	114,894	195,000	33,506	1,068,404	13%	53.1%

Source: World Bank staff calculation using LFS data for 2017.

Table A.9 Formal and informal workers by contract type and full-/part-time

	Formal							
	Permanent		Temporary		Casual		No permanent employer	
	Full-time	Part-time	Full-time	Part-time	Full-time	Part-time	Full-time	Part-time
2006	1,393,708	294,490	102,280	10,133	58,334	12,004		
2007	1,333,364	309,098	107,632	14,702	58,532	8,855		
2008	1,417,847	419,055	133,280	15,220	59,384	7,298		
2009	1,393,534	431,249	109,689	16,464	49,547	12,332		
2010	1,403,292	356,799	123,774	20,857	52,188	8,965		
2011	1,352,620	424,656	110,205	12,544	65,160	9,363		
2012	1,494,476	315,901	114,181	9,166	53,060	8,436		
2013	1,437,711	322,838	132,995	19,460	64,405	10,099		
2014	1,484,800	400,851	113,870	13,627	49,286	8,635		
2015	1,584,620	370,856	110,470	12,883	50,515	9,194		
2016	1,690,611	295,953	113,906	9,496	49,020	6,362		
2017	1,795,360	317,593	135,207	8,752	55,586	6,353		

	Informal							
	Permanent		Temporary		Casual		No permanent employer	
	Full-time	Part-time	Full-time	Part-time	Full-time	Part-time	Full-time	Part-time
2006	94,584	25,501	588,595	222,510	287,531	128,469	345,899	352,308
2007	84,292	17,981	692,785	264,399	261,751	104,921	367,390	309,934
2008	81,262	19,950	732,476	283,883	252,770	110,543	403,004	324,327
2009	67,449	20,624	772,459	301,536	286,100	115,754	412,490	341,820
2010	62,605	13,237	792,479	268,403	266,677	89,422	407,990	351,964
2011	82,272	12,251	747,319	284,085	235,064	89,733	439,442	286,146
2012	92,782	14,659	875,625	237,499	245,678	68,384	433,965	244,717
2013	67,563	20,439	813,744	262,364	314,253	86,968	428,331	269,075
2014	78,560	17,275	826,809	262,663	318,226	103,258	405,674	238,271
2015	69,441	17,018	861,410	281,375	273,032	100,529	384,529	239,567
2016	65,446	13,340	956,542	264,627	295,396	89,412	474,740	244,659
2017	83,543	19,270	963,602	278,758	282,767	96,774	430,755	249,878

Source: World Bank staff calculation using LFS data for 2006 – 17. Note: There are no formal workers who report having no permanent employer.

Table A.10 Monthly earnings in real terms for formal and informal workers

	Monthly earnings (real, in 2017 prices)												Annualized growth rate	
	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2006–12	2013–17
Formal, private	20,355	20,531	19,159	20,230	21,055	22,048	22,340	25,589	25,780	28,999	31,715	31,740	2%	6%
Formal, public	29,453	30,636	26,902	28,275	28,316	27,774	27,772	29,471	30,648	37,459	41,052	40,988	-1%	9%
Formal self-employed								46,048	48,941	56,275	81,955	95,133		20%
Informal self-employed								16,686	18,200	19,939	24,739	24,888		11%
Informal employee formal firm	14,085	14,228	13,950	14,350	14,528	15,112	15,987	16,572	17,469	18,539	20,435	21,761	2%	7%
Informal employee informal firm	12,654	12,577	12,530	12,817	13,393	14,243	15,373	15,730	16,300	17,756	19,584	20,167	3%	6%
Domestic worker								12,532	11,756	13,054	13,857	15,668		6%

Source: World Bank staff calculation using LFS data for 2006–17.
Note: Cells are empty when relevant information was not collected.

Table A.11 Average male wages as % of female wages

Formal, private	163%
Formal, public	103%
Informal employee formal firm	176%
Informal employee informal firm	195%
Domestic worker	140%
All employees	122%

Source: World Bank staff calculation using LFS data.

Table A.12 Wage gap regression results

	For 2013–17		For employees	
	(1)	(2)	(3)	(4)
Informal		-0.296 *** (0.01)		-0.297 *** (0.01)
Formal, public	0.213 *** (0.01)		0.209 *** (0.01)	
Formal, self-employed	-0.125 (0.16)			
Informal, self-employed	-0.349 ** (0.16)			
Informal employee, formal firm	-0.303 *** (0.01)		-0.265 *** (0.01)	
Informal employee, informal firm	-0.151 *** (0.01)		-0.166 *** (0.01)	
Domestic worker	-0.423 *** (0.03)		-0.294 *** (0.02)	
Female	-0.367 *** (0.01)	-0.368 *** (0.01)	-0.273 *** (0.00)	-0.274 *** (0.00)
Years of education	0.0278 *** (0.00)	0.0286 *** (0.00)	0.0347 *** (0.00)	0.0363 *** (0.00)
Experience	0.0231 *** (0.00)	0.0252 *** (0.00)	0.0247 *** (0.00)	0.0271 *** (0.00)
Experience squared	-0.000316 *** (0.00)	-0.000339 *** (0.00)	-0.000320 *** (0.00)	-0.000347 *** (0.00)
Firm size				
5–9 employees	0.0185 (0.01)	-0.0247 ** (0.01)	0.00678 (0.01)	-0.0240 *** (0.01)
10–15 employees	0.0606 *** (0.02)	-0.0517 *** (0.01)	0.0257 ** (0.01)	-0.0598 *** (0.01)
16–49 employees	0.0755 *** (0.02)	-0.0363 *** (0.01)	0.0423 *** (0.01)	-0.0476 *** (0.01)
50–99 employees	0.0872 *** (0.02)	-0.0186 (0.01)	0.0604 *** (0.01)	-0.0268 *** (0.01)
100 or more employees	0.107 *** (0.01)	0.0913 *** (0.01)	0.0838 *** (0.01)	0.0660 *** (0.01)
0 paid employee	0.0703 *** (0.01)	0.0871 *** (0.01)	0.0669 *** (0.01)	0.0765 *** (0.01)
Working for household	0.101 *** (0.02)	-0.0536 *** (0.02)	0.138 *** (0.02)	0.0335 *** (0.01)
Industry				
Mining	-0.347 *** (0.03)	-0.342 *** (0.03)	-0.307 *** (0.03)	-0.295 *** (0.03)
Manufacturing	-0.0856 *** (0.01)	-0.116 *** (0.01)	-0.0748 *** (0.01)	-0.109 *** (0.01)
Public utilities	0.104 *** (0.03)	0.130 *** (0.03)	0.111 *** (0.02)	0.152 *** (0.02)
Construction	0.190 *** (0.01)	0.197 *** (0.01)	0.254 *** (0.01)	0.261 *** (0.01)
Commerce	-0.0805 *** (0.01)	-0.0934 *** (0.01)	-0.0572 *** (0.01)	-0.0691 *** (0.01)
Transport and communications	0.0247 * (0.01)	0.0337 ** (0.01)	0.0445 *** (0.01)	0.0589 *** (0.01)
Financial and business-oriented services	0.114 *** (0.02)	0.111 *** (0.02)	0.0535 *** (0.01)	0.0502 *** (0.01)

	For 2013–17		For employees	
	(1)	(2)	(3)	(4)
Community and family-oriented services	-0.00925 (0.01)	0.0526 *** (0.01)	-0.00622 (0.01)	0.0742 *** (0.01)
Other services, unspecified	-0.0222 * (0.01)	-0.00953 (0.01)	-0.0234 *** (0.01)	0.00849 (0.01)
Employment status				
Employer	0.802 *** (0.16)	0.618 *** (0.02)		
Own-account worker	0.116 (0.16)	-0.0741 *** (0.01)		
Ethnicity				
Sri Lanka Tamil	0.0107 (0.01)	0.00126 (0.01)	-0.00285 (0.01)	-0.0127 (0.01)
Indian Tamil	-0.0127 (0.02)	-0.00745 (0.02)	-0.0222 ** (0.01)	-0.0179 * (0.01)
Sri Lanka Moor	0.0663 *** (0.01)	0.0660 *** (0.01)	0.0247 *** (0.01)	0.0244 *** (0.01)
Other	0.141 *** (0.03)	0.122 *** (0.03)	0.125 *** (0.02)	0.105 *** (0.02)
Sector: Rural	-0.0783 *** (0.01)	-0.0746 *** (0.01)	-0.0434 *** (0.00)	-0.0400 *** (0.00)
Sector: Estate	-0.178 *** (0.02)	-0.185 *** (0.02)	-0.163 *** (0.01)	-0.172 *** (0.01)
Occupation				
Professionals	0.226 *** (0.02)	0.264 *** (0.02)	-0.0274 ** (0.01)	0.0183 (0.01)
Technicians	-0.0495 *** (0.01)	-0.0442 *** (0.01)	-0.312 *** (0.01)	-0.298 *** (0.01)
Clerks	-0.143 *** (0.02)	-0.131 *** (0.02)	-0.398 *** (0.01)	-0.379 *** (0.01)
Service and market sales workers	-0.298 *** (0.01)	-0.300 *** (0.01)	-0.629 *** (0.01)	-0.619 *** (0.01)
Skilled agricultural workers	-0.422 *** (0.02)	-0.420 *** (0.02)	-0.551 *** (0.02)	-0.534 *** (0.02)
Craft workers	-0.229 *** (0.01)	-0.215 *** (0.01)	-0.519 *** (0.01)	-0.499 *** (0.01)
Machine operators	-0.247 *** (0.01)	-0.251 *** (0.01)	-0.511 *** (0.01)	-0.503 *** (0.01)
Elementary occupations	-0.324 *** (0.01)	-0.319 *** (0.01)	-0.638 *** (0.01)	-0.622 *** (0.01)
Armed forces	-0.194 *** (0.03)	-0.158 *** (0.03)	-0.410 *** (0.02)	-0.371 *** (0.02)
Others			-0.488 *** (0.07)	-0.507 *** (0.07)
Constant	4.452 *** (0.03)	4.509 *** (0.03)	4.454 *** (0.02)	4.482 *** (0.02)
Observations	136,104	136,104	162,370	162,370
R-squared	0.236	0.233	0.403	0.397

Source: World Bank staff estimation using LFS data.

Note: Dependent variable is log of hourly earnings. All estimations include year dummies. Reference groups (omitted categories) are as follows: formal private sector workers in columns (1) and (3), and all formal workers in columns (2) and (4); agriculture (industry), employee (employment status), Sinhalese (ethnicity), urban (geographic sector), managers (occupation), year 2006 (year), and Colombo (district—admin level 2).

Significance level: * = 10 percent, ** = 5 percent, *** = 1 percent

Table A.13 Quantile regression results: 95% confidence interval of coefficient on informal dummy

	Coefficient	[95% Confidence Interval]	
q25	-0.219	-0.227	-0.210
q50	-0.199	-0.210	-0.189
q75	-0.187	-0.199	-0.176

Source: World Bank staff estimation using LFS data.
Note: Specifications for quantile regressions are the same as in table A.12.

Figure A.1 Male-female earnings gap (employees only)

Source: World Bank staff calculation using LFS data for 2006 – 17.

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