

Original article

UDC 331.526

doi: 10.17223/19988648/71/2

The persistence of the informal economy: Causes, consequences and pathways to formalization

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Abstract. In many countries, the informal economy constitutes a significant part of the labor market and plays a vital role in production, employment, and income generation. On average worldwide, 6 out of 10 workers are engaged in the informal sector, with the figure rising to 7 in Asia-Pacific countries and 9 in Africa. In the case of Mongolia, approximately 4 out of 10 workers, including those in agriculture, belong to this sector. As of the end of 2023, about 70% of herders and 45% of self-employed individuals are not covered by social insurance. Informal workers and their sales or services are often not included or are underreported in official records. As a result, there is limited data on the informal economy. The ILO recommends a "diagnosis–implementation–analysis" cycle for planning efforts to formalize informal sectors. After diagnosing the current state of the formal sector, appropriate measures should be taken. Both domestic and international researchers have conducted relevant studies, noting that although informal employment presents challenges, it also offers some advantages. For self-employed individuals and employers, the lack of resources and vulnerability to risks are major issues, while informal wage workers face social protection exclusion, poor working conditions, and violations of labor rights. On the other hand, employers benefit from lower labor costs and fewer regulatory pressures in the informal sector. Despite high contribution rates, the benefits derived from them are inadequate. Small and medium-sized enterprises often lack full-time accounting personnel, and the process of registering officially – ranging from taxation to paying contributions – is fraught with difficulties and hardships. These are the main reasons why individuals and organizations in the informal sector do not contribute to social insurance. Workers in this sector are often left out of social protection, so to implement effective comprehensive policies aimed at them, it is essential to establish a unified database on informal workers and to implement intersectoral policies and strategies based on fair, equitable, and worker-friendly principles.

Keywords: informal economy, informal workers, social insurance, poverty levels, self-employed individuals, labor relations

For citation: Baasanjav, E. & Saikhanaa, M. (2025) The persistence of the informal economy: Causes, consequences and pathways to formalization. *Vestnik Tomskogo gosudarstvennogo universiteta. Ekonomika – Tomsk State University Journal of Economics*. 71. pp. 27–37. doi: 10.17223/19988648/71/2

Научная статья

doi: 10.17223/19988648/71/2

Сохранение неформальной экономики: причины, последствия и пути формализации

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Аннотация. Во многих странах неформальный сектор экономики составляет значительную часть рынка труда и играет определяющую роль в производстве, занятости и генерации доходов. В среднем по миру 6 из 10 работников заняты в неформальном секторе, при этом в странах Азиатско-Тихоокеанского региона этот показатель возрастает до 7, а в Африке – до 9. В случае с Монголией, примерно 4 из 10 работников, включая занятых в сельском хозяйстве, принадлежат к этому сектору. По состоянию на конец 2023 г. около 70% животноводов и 45% самозанятых лиц не охвачены социальным страхованием. Неформальные работники и результаты их деятельности (продажи или услуги) часто не включаются в официальную отчетность или отражаются в ней не в полном объеме. В результате данные о неформальной экономике ограничены. МОТ рекомендует цикл «диагностика – внедрение – анализ» для планирования усилий по формализации неформальных секторов. После диагностики текущего состояния формального сектора следует принимать соответствующие меры. Как отечественные, так и зарубежные ученые в своих трудах по данной теме отмечают, что, хотя неформальная занятость создает проблемы, она также имеет некоторые преимущества. Для самозанятых лиц и работодателей основными проблемами являются нехватка ресурсов и уязвимость к рискам, в то время как неформальные наемные работники сталкиваются с ситуацией исключения из системы социальной защиты, плохими условиями труда и нарушениями трудовых прав. Работодатели же получают выгоду от более низких затрат на рабочую силу и меньшего регуляторного давления в неформальном секторе. Несмотря на высокие ставки взносов, получаемые от них выгоды неадекватны. Малые и средние предприятия часто не имеют штатного бухгалтерского персонала, а процесс официальной регистрации – от налогобложения до уплаты взносов – сопряжен с трудностями и лишениями. Это основные причины, по которым физические и юридические лица в неформальном секторе не делают взносов в систему социального страхования. Работники этого сектора часто остаются за рамками социальной защиты, поэтому для реализации эффективной комплексной политики, направленной на них, крайне важно создать единую базу данных о неформальных работниках и осуществлять межсекторальную политику и стратегии, основанные на принципах справедливости, равноправия и дружелюбия к работнику.

Ключевые слова: неформальная экономика, неформальные работники, социальное страхование, уровень бедности, самозанятые лица, трудовые отношения

Для цитирования: Baasanjav E., Saikhanaa M. The persistence of the informal economy: Causes, consequences and pathways to formalization // Вестник Томского государственного университета. Экономика. 2025. № 71. С. 27–37. doi: 10.17223/19988648/71/2

Introduction

The term "informal sector" was first used by economic anthropologist Keith Hart in a research report conducted in Ghana in the early 1970s. In 2002, at an ILO conference, the concept of the informal sector was further refined and referred to as "informal economy" to denote "all activities that are not adequately covered by official regulations, either in law or in practice" [1]. The informal economy occupies a significant position in developing and transitioning countries, with nearly half of the labor force engaged in the informal sector. In Asian countries, the quality and accessibility of social protection activities are directly linked to the expansion of the informal sector, which is a common pressing issue. [2] To transition workers from the informal to the formal sector, it is essential to fulfill occupational health and safety standards that meet worker needs, utilize resources from the formal economy, and establish a legal environment prioritizing health and social protection. [3]

As of 2023, in Mongolia, out of approximately 1.3 million employed individuals, 531.1 thousand (around 41% of total workers) include herders, while 194.1 thousand (21% without herders) are informal workers.

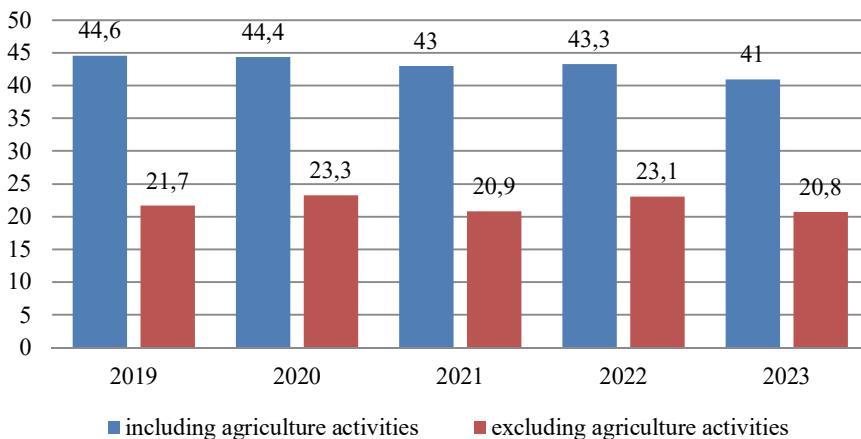


Figure 1. Informal employment rate, 2019–2023

When examining the level of informal employment by employment status, one in every two workers in the construction and transport service sectors, two out of every five workers in the accommodation, housing, and food service sectors as well as other service sectors, and three out of every ten workers in manufacturing, wholesale and retail trade, and repair service sectors are informal workers. Moreover, about 50-80% of occasional and assistant workers, unpaid workers, and those engaged in market-oriented household economic activities are considered informal workers. As of December 2023, more than 152,000 people were voluntarily enrolled in social insurance. However, about 70% of herders and 45% of

self-employed individuals remain uninsured. The persistent high number of informal sector workers is mainly attributed to weak governance, ineffective and poorly targeted macroeconomic and social policies, and inadequate legal frameworks and implementation.

There is a lack of detailed statistical data and research on the informal economy. The National Statistics Office conducted evaluations of the contribution of the unregistered or hidden economy to the gross domestic product in 2013 and 2020, and also conducted "Surveys on Informal Employment" in 2010 and 2015. Due to the scarcity of numerical data, studies on Mongolia's informal economy are limited. The first major study was conducted by researcher Anderson in 1998 on Ulaanbaatar's informal sector. It analyzed attitudes, scale, causes of increase, and the legal environment of the informal sector. The study found that the informal sector was small in scale, mostly family-based, and largely excluded from official registration, reporting, and statistics. It concluded that about 30% of Ulaanbaatar's working-age population was engaged in the informal sector, with over 80% of them unregistered in official statistics. The main reason for the growth of the informal sector was its easy access and low bureaucracy [4]. Subsequent studies in 2001 and 2010 aimed to define and measure Mongolia's informal sector more broadly, including informal wage workers, self-employed informal workers, and unpaid family workers. These studies noted that while informal employment brings many challenges, it also offers certain advantages. For self-employed individuals and employers, challenges include limited resources and financing for business expansion and vulnerability to risks. For informal wage workers, exclusion from social protection, poor working conditions, lack of safety at the workplace, and associated violations of rights were identified as disadvantages. On the other hand, employers benefit from avoiding costs related to employment such as taxes and social contributions, and find it easier and less pressured to operate in the informal sector [5]. In 2013 and 2021, the Institute of Labor and Social Protection Studies conducted surveys on the structure and conditions of informal employment, revealing that key reasons for working in the informal sector included poor job availability, the flexibility to work at one's own pace and interests, and the potential for higher income than in the formal sector [6].

Employees identified the advantages of informal employment as flexible working hours, better wages, and alignment with their skill sets. However, they cited the lack of social protection, income instability, and limited access to healthcare services as key disadvantages.

For employers and self-employed individuals, the main advantages included flexible working hours, income generation, and the ability to work with family members. On the other hand, they noted income instability, lack of access to social protection, and absence of job security as major disadvantages.

One in six employers and self-employed individuals reported being unable to obtain loans due to insufficient collateral, strict formal requirements, and high interest rates. Among those who did manage to access loans, the majority received them from formal sources such as commercial banks and non-bank financial institutions. Voluntary participation in social insurance often yields limited results, largely due to adverse

selection issues that arise during the enrollment process. In contrast, a mandatory insurance system that incorporates features such as subsidies for contributions and differentiated contribution categories tailored to individuals with limited payment capacity tends to produce more effective and credible outcomes.

The government first adopted a policy on informal employment in 2006. This policy was included in Mongolia's short- and medium-term plans and the country's economic and social development guidelines, specifying its principles and implementation methods. Additionally, the Government Action Plan (2020–2024), the "Employment Policy of Mongolia (2016–2025)," the "Three-Pillar Development Policy," and the long-term development policy "Vision 2050" all include measures aimed at improving labor and social protection for all workers. However, the number of informal workers has not decreased. Policies aimed at transitioning informal employment to the formal sector seem poorly coordinated, with noticeable discrepancies between policy objectives and actual outcomes.

Research objectives

The article aims to (1) assess the implementation of policy actions aimed at improving the working conditions of informal employment and overcoming barriers; (2) identify opportunities and pathways for transitioning to formal employment.

This research primarily examines the outcomes of tax and social protection policies aimed at transitioning the informal sector to the formal sector. To derive results, comparative and quantitative analysis methods were employed.

Factors affecting the expansion of the informal sector and results of efforts to address them

Based on the various features of Mongolia's economy and the principles of the International Labour Organization's "Decent Work Agenda" and the "Declaration on Fundamental Principles and Rights at Work," the government adopted a policy to address informal employment in three phases from 2006 to 2015. The aim of this policy is to shift informal workers to formal employment through state services, establish legal, economic, labor, and social protection guarantees against risks, and enhance the country's economic growth. The policy outlines 23 action plans under five main directions. One of the key factors influencing the transition of informal workers to the formal sector is the tax and social protection policy, as evidenced by international best practices.

Thus, we will focus on the following four activities related to tax and social insurance reforms from these policy actions, assessing their implementation level and their impact on the informal sector:

1. Enhance opportunities for individuals, households, and groups to transition their work and services to formal status through flexible tax policies.
2. Increase formal employment by gradually reducing social insurance rates and improving wage and salary structures.

3. Develop and implement projects to expand the scope and types of social insurance, including informal workers.

4. Support initiatives and proposals to integrate informal workers into voluntary social protection structures and micro-networks that align with international standards.

Several factors affecting informality

– The most significant and primary factor is poverty, where limited livelihood opportunities and job scarcity directly correlate with the lack of job opportunities for the working poor. There is a direct relationship between job scarcity and poverty, which is a main cause of income sources. Increasing job supply through tax and monetary policy, along with the expansion of permanent job opportunities, is one step toward reducing the number of informal workers. The number of informal sector workers tends to increase during high unemployment years (see Fig 2). An informal report indicates that more than half of informal workers are engaged in irregular jobs without any social protection and earn inadequate income. Employers have little interest in enrolling these employees in social insurance, and due to low and irregular wages, employees also face challenges in paying social insurance.

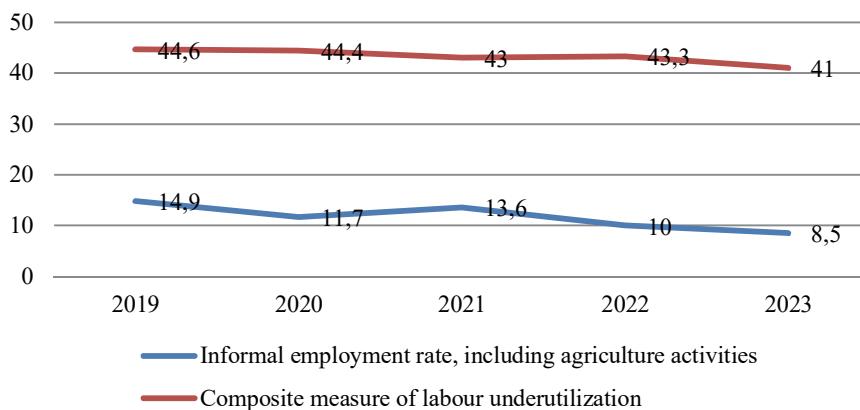


Figure 2. Composite measure of labour underutilization, % and informal employment rate, % [7]

– Economic instability, limited industrial diversification, and incapacity to absorb the labor force contribute to poor quality employment in the service sector. This results in increased inequality, expanded informal employment, and deepening vulnerabilities. Although the country has taken policy measures to promote domestic production rather than being a consumer-led economy, the progress in the production sector is overly dependent on mining, with only about 20% of total employment being in the production sector (see Fig. 3). The newly created jobs mostly comprise seasonal, hourly, and part-time informal positions that do not afford full social protection.

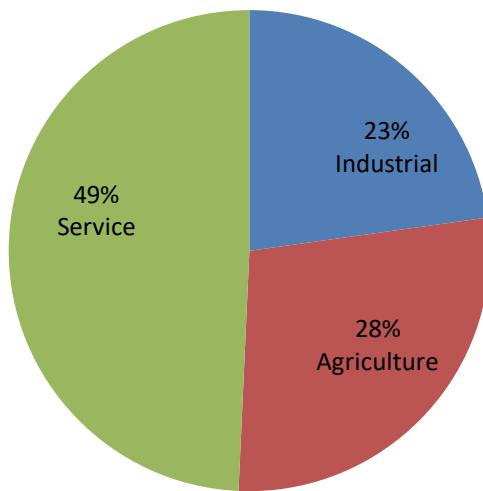


Figure 3. Employees, by classification of economic activities, 2023 [7]

– Various legal regulations have been criticized for creating rigidity in the labor market, which in turn leads individuals to voluntarily choose informal employment. To address this, the Government of Mongolia set a goal to increase formal employment by gradually reducing social insurance contribution rates and improving the wage and salary system. When social insurance contribution rates decreased, the number of voluntarily insured individuals increased, while the number of insured individuals overall also grew. Conversely, there is an inverse relationship between the increase in contribution rates and the number of insured individuals, including those formally employed. The level of social insurance contributions directly affects the expansion of the informal sector. In other words, higher contribution rates increase the cost of formal employment, which pushes both employers and employees toward the informal sector. Although the contribution rate was reduced and maintained at a stable level starting from 2007, the rate was gradually increased again from 2019 onward. This led to greater financial burden on both workers and employers, limiting their access to social protection. As a result, the number of voluntary contributors decreased (see Fig. 4).

The General Law on Social Insurance also includes income from wages and salaries, as well as payments agreed upon under wage-based or similar contracts, in the category of income subject to social insurance contributions. This provision has increased the burden of social insurance contributions for both self-employed individuals and legal entities that contract their services. Although intended as a strict measure to regulate and reduce self-employment, it is believed to have had the opposite effect by contributing to the expansion of the informal economy.

– The insufficiency of benefits from social insurance: Efforts to broaden the scope and types of social insurance have not adequately met the demands of informal sector workers, creating another barrier to formal transition.

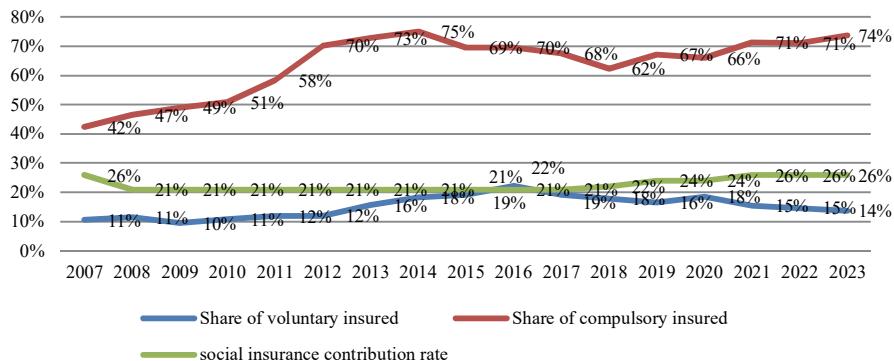


Figure 4. Social insurance contribution rate and proportion of insured individuals, 2007–2023

As of 2022, Mongolia ranked second in Asia after Japan (17.1%) in terms of social protection expenditure, allocating 15.4% of its gross domestic product (GDP) to social protection [7]. In the Republic of Korea, social protection spending has generated cumulative GDP growth, producing 3 dollars after 10 quarters—the highest among Asia-Pacific countries. In Mongolia, the cumulative multiplier effect is 1.5 dollars after 8 quarters [8]. Although Mongolia's social protection spending is relatively high, it has limited positive impact on productivity and production, indicating the inefficiency of its social protection policies.

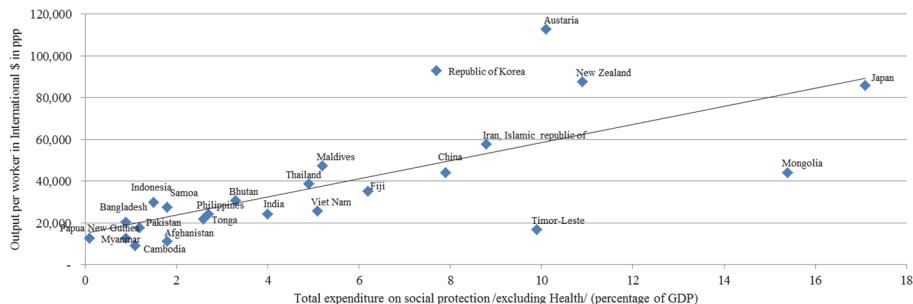


Figure 5. Output per worker and government actual expenditure on social protection excluding health, latest available year, 2020–2023 (percentage of GDP)

According to a study by the International Labour Organization (ILO), unemployment benefit coverage in Mongolia is relatively higher than in some South, Central, and North Asian countries [9]. However, it is lower than that of East and Northeast Asian countries, standing at around 30%. This is due to the exclusion of those without labor contracts, temporary and part-time workers, self-employed individuals, and informal workers from receiving unemployment benefits [10].

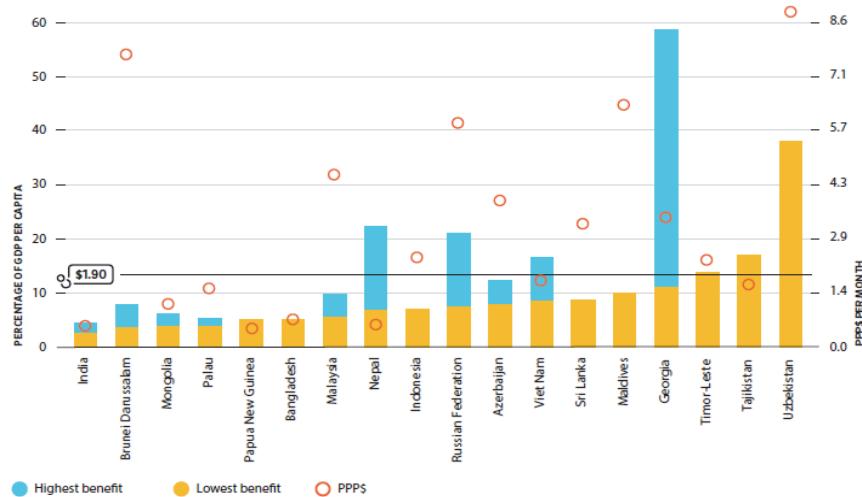


Figure 6. Share of disability benefits in per capita GDP (%) and daily consumption per adult (\$) (latest available year)

The share of per capita disability benefits in GDP is around 6%, which is low compared to other countries. These benefits are insufficient to cover even the minimum daily consumption needs of an adult. Although old-age pensions account for 18% of per capita GDP, they also remain inadequate for meeting daily consumption needs.

Based on the experience of many developing and developed countries, part of social insurance contributions is covered by the government to expand coverage and improve social protection. These countries assessed the working conditions, income, and income risks of informal workers and grouped them accordingly, providing larger subsidies to low-income individuals than to high-income ones. By subsidizing employers' social insurance contributions, they have successfully encouraged transitions from the informal to the formal sector.

Conclusions

– The national population information system should be expanded and updated regularly to reduce the invisibility of informal workers and allow for better planning and implementation of tailored policy actions. Policy measures should be based on the findings and recommendations from research conducted by international organizations like the ILO and ADB, as well as domestic institutions like the Labor and Social Protection Training, Evaluation, and Research Institute.

– Informal workers often have unstable jobs and fluctuating incomes. Policies must reflect this by offering flexible conditions. Based on international experience, clearly categorizing informal workers, improving registration systems, and tailoring pension benefits to contribution levels can enhance social insurance coverage and protection. Encouraging higher-income self-employed individuals to

transition into the formal sector through incentives without imposing burdens, while prioritizing the inclusion of low-income groups into social protection, can lead to economic growth, increased tax revenue, and improved living standards.

– It is necessary to expand stable employment opportunities and domestic production to reduce poverty and unemployment, which are major drivers of informal employment.

– The benefits received from contributions—such as healthcare services, pensions, and allowances—must be improved. Additionally, awareness campaigns on insurance benefits should be intensified in remote areas to foster positive attitudes toward taxes and contributions.

– Preventing the shift of jobs from the formal to the informal sector requires improving accounting, inspections, audits, and the effectiveness of social insurance and tax controls.

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Авторы заявляют об отсутствии конфликта интересов.

*The article was submitted 18.04.2025;
approved after reviewing 29.08.2025; accepted for publication 12.09.2025.*

*Статья поступила в редакцию 18.04.2025;
одобрена после рецензирования 29.08.2025; принята к публикации 12.09.2025.*