The Long Shadow of Informality

Policy Brief

Chapter 4: Lagging Behind: Informality and Development

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Informality is associated with a wide range of development challenges. Emerging market and developing economies (EMDEs) with greater informality have greater poverty, weaker governance and public service provision, poorer human development outcomes, and more limited access to public infrastructure. This wide range of correlates suggests that any policies to address informality need to be embedded in a broader development agenda.

A host of developments challenges. Widespread informality is associated with a plethora of development challenges: higher poverty, lower per capita incomes, less progress towards the Sustainable Development Goals, less human capital, weaker governance, weaker productivity and investment, and lower quality of, and access to, public infrastructure. About one-quarter of the population of EMDEs with above-median informality lives in extreme poverty, much more than the 7 percent of the population in EMDEs with below-median informality (**figure 1**). The broad range of development challenges associated with informality call for any policy measures to address informality to be embedded in a broader development strategy (see Ohnsorge and Yu 2021).

Lower wages. In countries with greater informality, income inequality is higher, in part reflecting the wage gap between formal and informal workers and less progressive tax policies. A review of past studies shows that, on average, informal workers are paid 19 percent less than their formally employed peers. This wage gap mainly reflects the difference in worker characteristics such as education or work experience. Informal workers are more likely to be young, inexperienced, and lower-skilled. Once these characteristics are taken into account, the wage gap between formal and informal workers becomes negligible.

Weaker policy effectiveness and governance. Informality is associated with less effective public institutions, more burdensome tax and regulatory regimes, and weaker governance. Government revenues in EMDEs with above-median informality are 5-12 percentage points of GDP below those with below-median informality. Limited fiscal resources constrain governments' ability to cover their citizens' through social protection programs, provide broad access to public sector services, and smooth business cycles. These are accompanied by significantly weaker governance. For example, EMDEs with above-median informality scored 15 percent lower than those with below-median informality on ICRG's index of control of corruption.

Figure 1. Development challenges and informality in EMDEs

EMDEs with widespread informality face a host of development challenges, ranging from extreme poverty to lack of public infrastructure. Those with more pervasive informality lag behind in Sustainable Development Goals (SDGs).
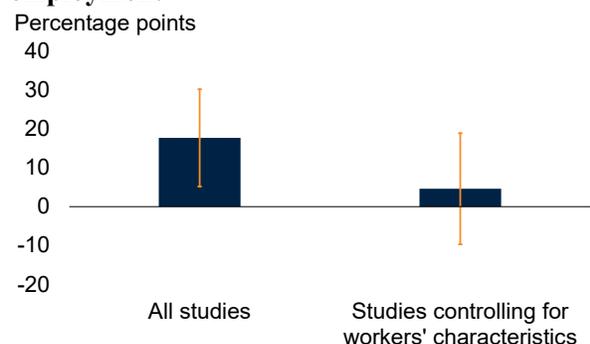
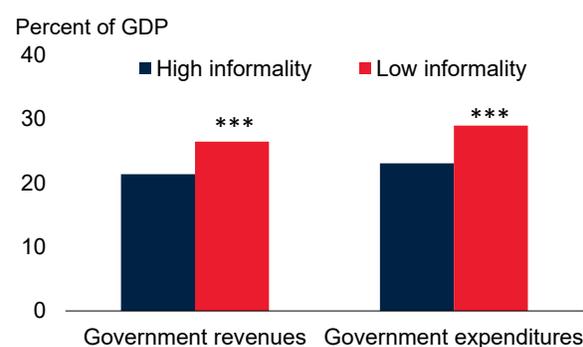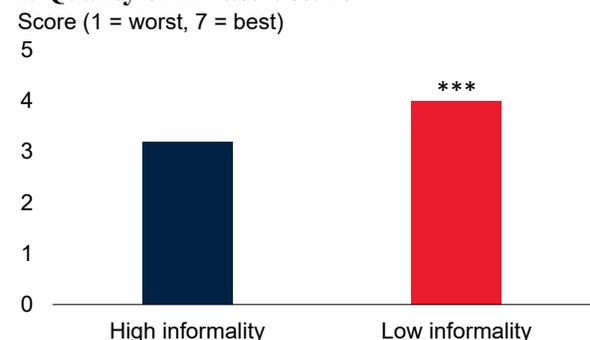### A. Extreme poverty headcount

Percent of population

B. Human capital

Years of schooling
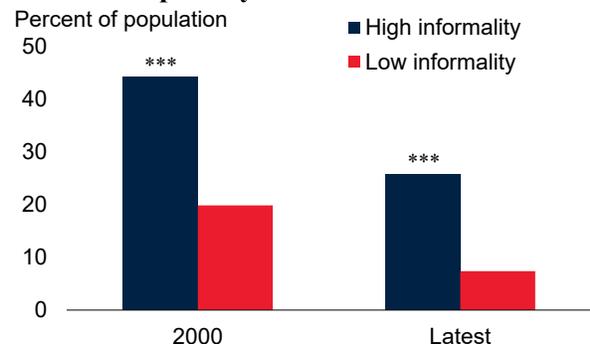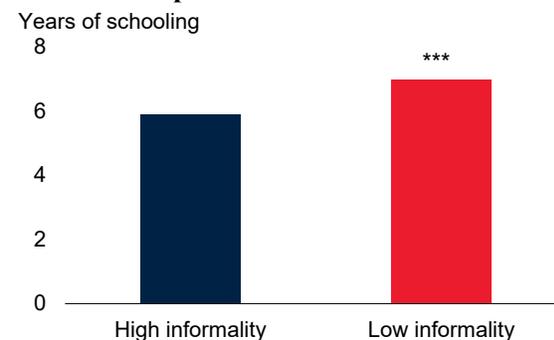
C. Wage premium for formal over informal employment

Percentage points

D. Fiscal indicators and informality

Percent of GDP

E. Quality of infrastructure

Score (1 = worst, 7 = best)

F. Governance

Index (0 = worst, 4/6 = best)
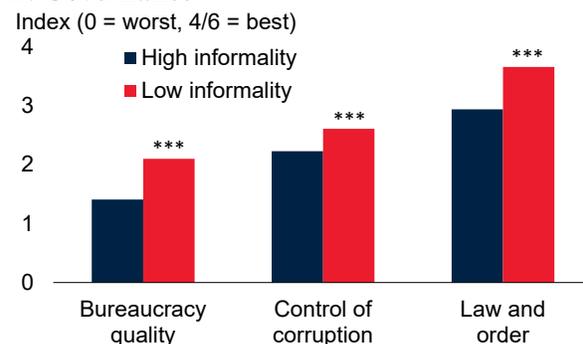
Sources: Barro and Lee (2013); *International Country Risk Guide (ICRG)*; Ohnsorge, Okawa, and Yu (2021); Sachs et al. (2018); World Bank (World Development Indicators).

Note: Data are for 1990-2018 and emerging market and developing economies (EMDEs). "High informality" ("Low informality") are EMDEs with above-median (below-median) dynamic general equilibrium model (DGE)-based informal output measure (in percent of official GDP) over the period 1990-2018 (unless otherwise specified). *** indicates that group differences are significant at the 10 percent level.

A. Bars show simple averages. "Latest" refers to data from latest year available (2018 or earlier). Poverty headcount ratio is the percent of the population living on less than $1.90 a day at 2011 international prices. B. Bars show simple averages. "Human capital" is proxied by average years of schooling. C. The wage premium (shown in bars) is obtained from 18 empirical studies on the wage gap between formal and informal workers. The whiskers show the 90 percent confidence intervals. See box 4.1 in Ohnsorge, Okawa, and Yu (2021) for details. D. Bars show simple averages for 2000-18 for EMDEs with populations above 3.5 million. E. Bars show simple averages for the latest year available (Sachs et al. 2018). F. Simple group averages are in bars over the period 1990-2018. "Bureaucracy quality," "Control of corruption," and "Law and order" are from *ICRG*, with higher values corresponding to better outcomes.