# The Long Shadow of Informality

**Policy Brief**

## Chapter 6: Tackling Informality: Policy Options

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*To address the wide range of root causes of informal activity, policy packages need to be comprehensive and tailored to country circumstances. In countries where informality is predominantly a reflection of poor governance, an appropriate policy package could streamline regulatory and tax frameworks while improving government efficiency, regulatory enforcement, and strengthening public service delivery to bolster tax morale. In countries where informality predominantly reflects underdevelopment, an appropriate policy package could include measures to expand access to finance, markets, and inputs to foster firm productivity and growth; better education to facilitate formal sector employment; and enhanced safety nets to cushion risks.*

**A decade of reforms**. In the past two to three decades, emerging market and developing economies (EMDEs) have made progress in reducing tax burdens, improving governance and regulatory quality, and enhancing access to finance, education, and public services (**figure 1**). This has been accompanied by a steady decline in the share of informal activity.

**Need for long-term development focus**. Several policy improvements that are associated with declines in informality also foster long-term development. Policies that seek to streamline tax regulation, strengthen tax administration, and improve public service delivery have been associated with declines in informality. Policies aimed at invigorating private sector activity more broadly, such as measures to increase labor market flexibility, streamline procedures for firm start-up, expand access to finance, and improve governance have also been associated with declines in informality.

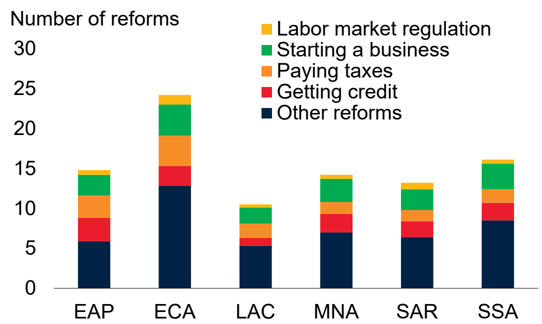
**Need for comprehensive reform packages.** Many EMDE governments implemented policies at the microeconomic level and found that the implications for informality were more benign when these reforms were implemented in a supportive institutional and macroeconomic environment. For instance, trade liberalization programs that raised real wages and reduced firms' profitability in the tradable sector were associated with greater informality in the short term—unless they were accompanied by measures to increase labor market flexibility and raise labor force skills.

**Need for tailored reform packages.** Country experiences suggest the need for a reform package that is informed by the country-specific drivers of, and challenges posed by, informality and carefully tailored to country circumstances. In Sub-Saharan Africa, for example, policies have focused on unlocking the latent economic potential of the informal sector through investing in human capital and improving access to resources to increase labor productivity. In contrast, in Europe and Central Asia, Latin America and the Caribbean, and non-GCC economies in the Middle East and North Africa, successful policies have centered around easing regulatory and tax burdens and building more effective and accountable institutions—in particular, strengthening enforcement and reducing corruption.

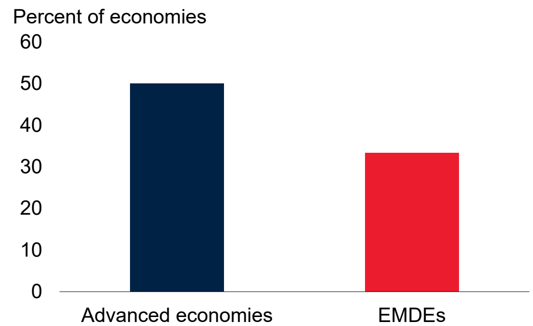
**Figure 1. Policies to address challenges of informality**

*Governments have implemented a wide range of reforms that could affect informality. Regulatory and tax burdens on firms remain higher, access to finance and infrastructure lower, and human capital poorer in EMDEs with high informality.*

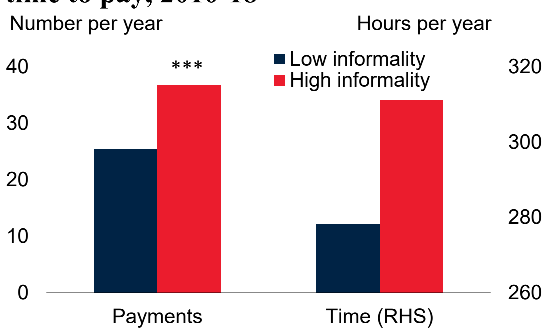
**A. Reforms across EMDE regions, 2008-18**



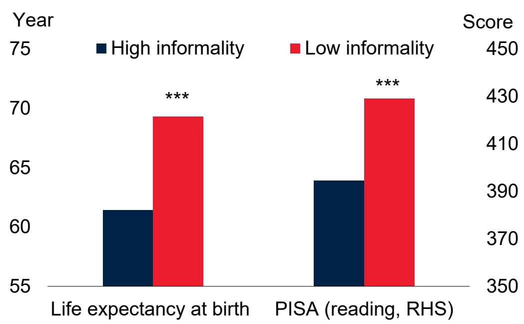

**B. Economies with improvement in control of corruption, 2010-18**



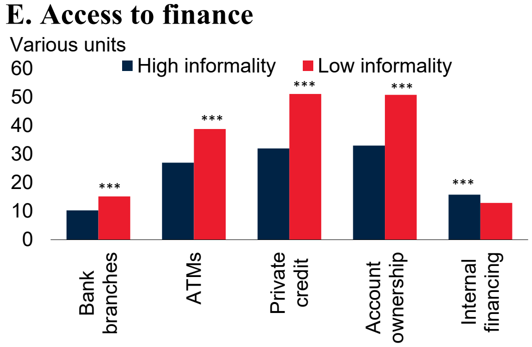

**C. Informality and number of payments and time to pay, 2010-18**



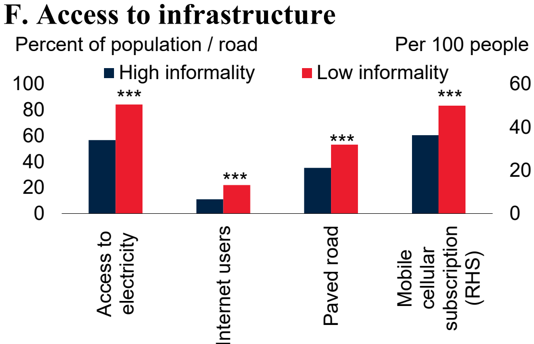

**D. Health and education outcomes**




**E. Access to finance**




**F. Access to infrastructure**




*Sources: International Country Risk Guide (ICRG);* Ohnsorge and Yu (2021); Programme for International Student Assessment (PISA) database; Sachs et al. (2020); World Bank (Doing Business, Global Financial Development Database, World Development Indicators).

*Note:* DGE = dynamic general equilibrium model-based estimates on informal output as a share of official GDP; EAP = East Asia and Pacific; ECA = Europe and Central Asia; LAC = Latin America and the Caribbean; EMDEs = emerging market and developing economies; MNA = Middle East and North Africa; SAR = South Asia; SSA = Sub-Saharan Africa. *** denotes 10% significance. In B and D, "high informality" ("Low informality") are EMDEs with above-median (below-median) informality proxied by DGE estimates over the period 1990-2018.

A. For an average economy, the number of policy reforms that have been implemented after year 2008 and are regarded as "improvement" in the ease of doing business or "neutral" (that is, "labor market regulation") by Doing Business 2008-18. B. Bars show the shares of economies with improved control of corruption over 2010-18. C. Bars are simple group means for EMDEs with above-median ("high") informality and those with below-median ("low") informality (proxied by DGE estimates) over the period 2010-18. D. Bars show simple group averages. E. Bars are unweighted averages for EMDEs with above-median ("high") informality and those with below-median ("low") informality (proxied by DGE estimates) over the period 2010-18. "Bank branches" ("ATM") measures the number of commercial bank branches (automated teller machines) per 100,000 adults. "Private credit" measures domestic credit to private sector in percent of GDP. "Account ownership" is the percentage of survey respondents (aged 15 or above) who report having an account (by themselves or together with someone else) at a bank or another type of financial institution or report personally using a mobile money service in the past 12 months. "Internal financing" is captured by the percentage of respondents (aged 15 or above) who report saving or setting aside any money in the past 12 months to start, operate, or expand a farm or business. F. Bars show simple group averages.