Executive Summary

Informal activity is widespread in emerging market and developing economies (EMDEs). In EMDEs, informal economic activity, on average, accounts for about one-third of output and more than two-thirds of employment (chapter 2). The phenomenon extends across all EMDE regions.

Widespread informality has long been associated with a whole host of development challenges (chapter 4). Most prominently, more widespread informality has been associated with significantly poorer governance and greater lags in achieving every dimension of the Sustainable Development Goals. Countries with larger informal sectors tend to have less access to finance for the private sector, lower labor productivity, slower physical and human capital accumulation, and smaller fiscal resources. Informality is associated with higher income inequality and poverty and less progress toward the Sustainable Development Goals.

Informal firms are, on average, less productive than formal ones because they tend to employ more low-skilled workers; have more restricted access to funding, services, and markets; and lack economies of scale. Informal workers tend to be paid less than formal workers, in part because they are lower-skilled. Female and young workers make up a disproportionate share of workers in the informal sector.

Pervasive informality is particularly pernicious at the current juncture. In the severe global recession caused by the COVID-19 (coronavirus) pandemic, the informal sector has been hit hard by the lockdowns and changes in consumer behavior triggered by the pandemic. Informal firms account for almost three-quarters of firms in the services sector, compared with one-third of firms in the manufacturing sector. With low incomes and little savings to fall back on, informal workers struggle to comply with lockdowns, and government support programs often cannot reach them.

Going forward, widespread informality may hold back the recovery to a green, inclusive, and resilient development path. Countries with high informality struggle to muster the fiscal resources to support economic activity, to implement effective monetary policy in a shallow financial system, and to generate informal-sector income growth or formal-sector employment in a recovery.

Government revenues in EMDEs with above-median informality are about 5-12 percentage points of gross domestic product (GDP) below those in other EMDEs, and so are their expenditures. The lack of fiscal resources constrains

governments' ability to develop fiscal support packages that can help bring the pandemic under control and generate a robust recovery. Indeed, in 2020-21, EMDEs with above-median informality implemented discretionary fiscal support packages that were only three-quarters the size of those in EMDEs with below-median informality.

In countries with widespread informality, shallow financial systems limit the reach and effectiveness of monetary policy. In EMDEs with above-median informality, domestic credit to the private sector is only one-third of GDP—significantly less than in other EMDEs where it is more than one-half of GDP—and many firms do not rely on the formal financial system at all. For example, in EMDEs with above-median informality, only 19 percent of firms can access bank financing for their investment needs, significantly lower than the 29 percent of firms in other EMDEs.

If history is any guide, large informal sectors will dampen the recovery. Historically, informal-economy output and, hence, incomes have fluctuated with formal-economy output, but they have done so less than proportionately (chapter 3). For every 1-percentage-point increase in formal-economy output, informal-economy output has risen only by 0.4-0.8 percentage point over the following year. While this muted co-movement dampened past recessions, it also held back past recoveries.

Moreover, informal employment historically has been largely unresponsive to formal-economy business cycles. This suggests that workers do not easily switch between formal and informal employment; instead, once they are informally employed, they tend to expand or curtail their working hours with the business cycle. It also suggests that whatever increase in informal employment the COVID-19 pandemic has induced—and we will not have the data to know for sure for many months—may not be unwound in the recovery from the pandemic.

This book offers a wide menu of policy options to address these challenges associated with informality. Improved access to education, markets, and finance can help informal workers and firms become sufficiently productive to move to the formal sector. Labor productivity in EMDEs with above-median informality is less than a third of the level in other EMDEs. This in part reflects low human capital: in EMDEs with above-median informality, the average number of years of schooling amounts to 5-6 years—1-3 years less than in other EMDEs.

In addition, improved governance and business climates and streamlined—but well-enforced—regulations can lower the cost of operating formally and

increase the cost of operating informally. In these dimensions, EMDEs with high informality clearly lag those with low informality. For example, the average score on bureaucracy quality in EMDEs with above-median informality is one-third lower than in other EMDEs.

Policy measures that help to lower informality also spur growth more broadly. To protect vulnerable groups, they may need to be accompanied by stronger basic social safety nets (chapter 6).

These options are most likely to be effective when they follow two principles:

First, reform packages need to be comprehensive. Over the past several decades, 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 higher labor market flexibility and a more skilled labor force.

Second, reform packages need to be tailored to country circumstances, informed by the drivers of—and challenges posed by—informality and carefully tailored to country circumstances. In Sub-Saharan Africa, South Asia, and the Middle East and North African economies that are not part of the Gulf Cooperation Council, for example, general education and training programs to raise human capital could be prioritized (chapter 5). In Latin America and the Caribbean, reducing particularly high tax and regulatory costs to businesses could incentivize firms to join the formal sector. In Europe and Central Asia, improving government effectiveness and reducing corruption could be policy priorities.