Foreword

In emerging market and developing economies (EMDEs), far too many people and small enterprises operate outside the line of sight of governments—in a zone where little help is available to them in an emergency such as the COVID-19 crisis. This "informal" sector constitutes more than 70 percent of total employment in these countries and roughly one-third of output.

Policy makers have long had good reasons to worry about this sector: Its participants are vulnerable even under normal conditions. Informal businesses rely heavily on family members and moneylenders for working capital, leaving them exposed to sudden income disruptions. These enterprises constitute 72 percent of firms in the services sector. Informal workers are predominantly women, and they are usually young and low-skilled. When they lose their jobs or suffer severe income losses, they often have no recourse to social safety nets.

COVID-19, however, has heightened the need for prompt and comprehensive action. The pandemic increased global poverty for the first time in decades—and it hit informal firms and informally employed workers particularly hard: they struggled to adjust to lockdowns and the shift to business connected over the internet. Data on this matter may not be fully available for some time, but the damage to households and firms in the informal sector poses a significant threat—to the global economic recovery and to long-term efforts to achieve green, resilient, and inclusive development.

Widespread informality hampers development progress in a variety of ways. It is broadly associated with weaker economic outcomes. Countries with larger informal sectors have lower per-capita incomes, greater poverty, less financial development, and weaker growth in output, investment, and productivity. GDP per capita in countries with above-average informality tends to be just one-quarter to one-third the GDP per capita of countries with below-average informality.

Moreover, informality curbs government revenues, constraining governments' ability to provide services, conduct countercyclical policies, service debt, or implement crisis-response measures. Measured as a percentage of GDP, government revenues in EMDEs with above-average informality were 5 to 12 percentage points lower than those of EMDEs with below-average informality between 2000 and 2018. Not surprisingly, higher informality was also associated with lower public spending on education and health, contributing to the slower accumulation of human capital.

Yet the record shows informality *can* be tackled in EMDEs. In fact, it had been on a declining trend for decades before the onset of COVID-19. Between 1990 and 2018, on average, informality fell by about 7 percentage points of GDP to 32 percent of GDP. The decline partly reflected policy reforms: Over the past three decades, many EMDE governments implemented a wide range of policy reforms either to increase the benefits of formal-sector participation or to reduce the costs of such activities. These included tax reforms, reforms to increase access to finance, and stronger governance.

The key, however, is to recognize informality as a phenomenon that reflects broad-based underdevelopment—rather than a challenge that can be considered in isolation. For that reason, measures to address informality need to be equally broad-based.

This book offers the first detailed road map to cope with informality for policy makers in developing countries. Above all, it underscores the need for an encompassing approach. A comprehensive policy package tailored to country circumstances offers the greatest chance of success. Depending on country circumstances, such a package should include the following components:

- *Improvements in macroeconomic policies, governance, and business climates*. In the past three decades, EMDEs have made progress in reducing tax burdens, improving governance and regulatory quality, and enhancing access to finance, education, and public services. These actions haved helped reduce the extent of informality, but additional reforms are needed to make further progress.

- *Streamlined tax regulation and administration and improved public service delivery*. Policies aimed at invigorating private sector activity—such as measures to increase labor market flexibility and streamlining regulatory frameworks for firm start-up—have also been associated with declines in informality.

- *Attention to unintended consequences of policy reforms*. For instance, trade liberalization that raised competition in the tradable sector has been associated with greater informality in the short run—unless it is accompanied by measures that increase labor market flexibility.

- *Acceleration of financial sector development.* Such development has been associated with declining informality—because it reduces the average cost of access to external financing and creates incentives for firms to invest in higher-productivity projects and join the formal sector.

- *Campaigns to expand public awareness.* Reductions in informality have tended to be greater for reforms that have been accompanied by business development and training programs, public awareness campaigns, and stronger enforcement.

Rebuilding the global economy in the aftermath of COVID-19 will mean mobilizing every available reserve of productive power to generate green, resilient, and inclusive development. That effort must begin now—and it cannot succeed without full consideration of the challenges of the informal sector.

Mari Pangestu
Managing Director of Development Policy and Partnerships
The World Bank