HIGHLIGHTS from CHAPTER 3:
GROWING IN THE SHADOW: CHALLENGES OF INFORMALITY

Key Points

- *The informal sector accounts for about a third of GDP and 70 percent of employment (of which self-employment is more than a half) in emerging market and developing economies (EMDEs).*
- *While offering the advantage of employment flexibility in some economies, a large informal sector is associated with low productivity, reduced tax revenues, poor governance, excessive regulations, and poverty and inequality.*
- *Comprehensive policies that take into account country-specific conditions can address some of the challenges of pervasive informality. This includes measures aimed at reducing regulatory and tax burdens, expanding access to finance, improving education and other public services, and strengthening public revenue frameworks.*

Prevalence of informality in EMDEs. In 2016, the informal sector in EMDEs on average accounted for 32 percent of GDP and, 70 percent of employment, with self-employment accounting for 43 percent of total employment (Figure 1). One-half of the world's informal output and 95 percent of its informal employment is in EMDEs. Both informal output and employment have declined since 1990, particularly in countries with higher output growth, rapid physical capital accumulation, and larger improvements in governance and business climates.

Informality and development outcomes. Higher informality is associated with lower output growth, lower productivity, and higher poverty and income inequality. The informal economy tends to employ lower-skilled and less productive workers. As a result, workers in the formal economy earn, on average, about 19 percent more than workers in the informal economy.

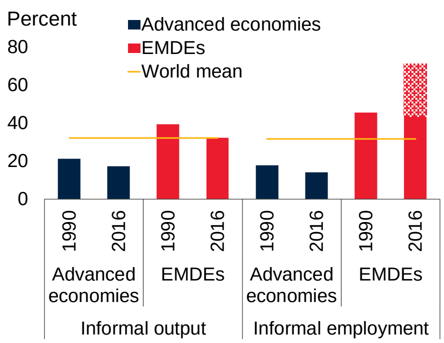
Informality and firm productivity. The average informal firm in EMDEs is only one-quarter as productive as the average firm operating in the formal sector. This is only in part explained by informal firm characteristics such as their younger age, less experience, and smaller size. Moreover, firms in the formal sector that face informal competition are, on average, only three-quarters as productive as those that do not. Better business climates can mitigate some of these productivity differentials.

Policy implications. Overcoming the challenges of informality requires designing comprehensive policies that take into account country-specific conditions. For example, past policies implemented for reasons unrelated to informality unintentionally raised informality when they were poorly coordinated or accompanied by an unintended relaxation of regulatory enforcement. Policies that adversely affect vulnerable groups can be mitigated by stronger safety nets, greater labor and product market flexibility, and better access to resources for informal firms. In addition, policies to spur development, as a collateral benefit, can help reduce informality. Specific measures include streamlining tax codes and enhanced enforcement of revenue collection; easing firm and labor regulations to create a level playing field for both formal and informal participants; as well as greater access to finance and public services to help increase productivity in the informal sector.

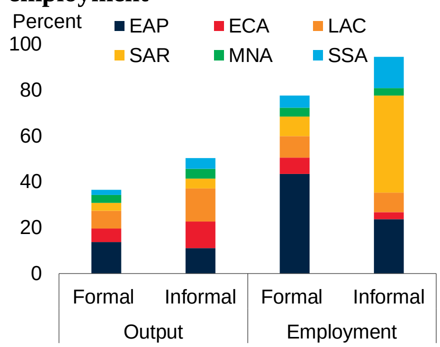
Figure 1. Growing in the shadow: Challenges of informality

The informal sector accounts for about a third of GDP and 70 percent of employment (of which self-employment is more than a half) in emerging market and developing economies. South Asia hosts almost half of the world's informally employed. A larger informal sector is associated with lack of development, lower productivity, more burdensome regulations, weaker governance, and greater poverty and income inequality. Government revenues and expenditures tend to be lower in countries with widespread informality.

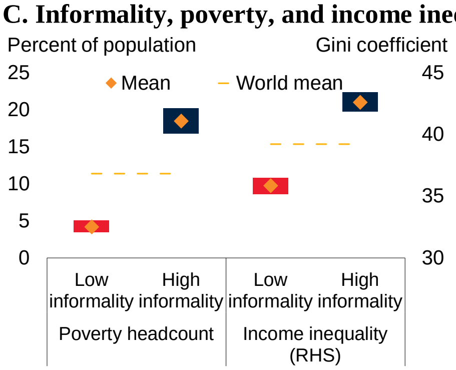
A. Share of informal output and employment



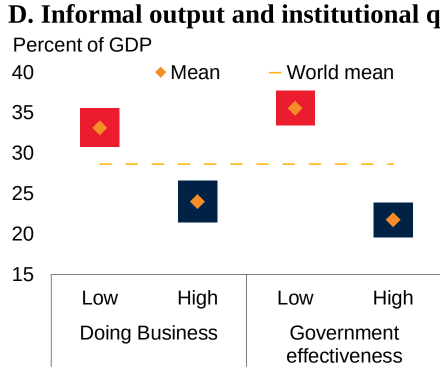
B. Share of EMDE regions of world output and employment



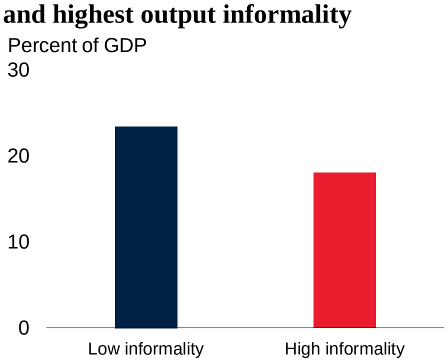
C. Informality, poverty, and income inequality



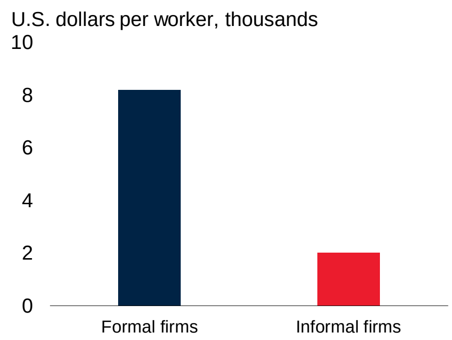
D. Informal output and institutional quality, 2016



E. Government revenues in EMDEs with the lowest and highest output informality



F. Average productivity in formal and informal firms



Sources: Elgin et al. (forthcoming); International Monetary Fund, World Economic Outlook; International Labour Organization; World Bank (Doing Business, World Development Indicators, World Governance indicators).

Notes: EAP = East Asia and Pacific, ECA = Europe and Central Asia, LAC = Latin America and the Caribbean, MNA = Middle East and North Africa, SAR= South Asia, and SSA = Sub-Saharan Africa, EMDEs=emerging markets and developing economies. DGE-based estimates are used for informal output shares (in percent of official GDP), and self-employment shares are used for informal employment shares (in percent of total employment).

A. Unweighted averages. Informal employment (in red) uses self-employment shares (with additional informal employment shares in shaded red) in the closest (latest) available year around 1990 and 2016. World averages between 1990-2016 are in orange.

B. Informal output (employment) in each region as a proportion of total informal output (employment) based on their respective average shares (2010-16).

C. The 1990-2016 group means (diamonds) and 95 percent confidence intervals (bars) are shown for poverty headcount ratio at $1.90 a day (2011 PPP, percent of population) and Gini coefficients. "High (Low) informality" indicates countries with above-(below-) median informal output.

D. Group averages of informal output in percent of official GDP in year 2016 are shown in diamonds, with bars showing 95 percent confidence intervals. Dashed line shows the world average. "High" ("Low") indicates countries with above- (below-) median values in the following two measures: Doing Business distance-to-frontier and governance effectiveness (World Governance Indicators).

E. Average government total revenues in percent of GDP among the top and bottom thirds of EMDEs by the level of DGE-based informal output, shown as "High Informality" and "Low Informality", respectively. Data are averaged over 2000-16. Sample includes 70 non-energy exporting EMDEs.

F. Labor productivity (in U.S. dollars per worker, thousands) in average formal and informal firms, controlling for firm characteristics and country fixed effects.