What Do We Know About the Informal Economy?

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The informal economy has long been at the center of academic and policy debates because of both its pervasiveness and its complex links with development outcomes. The informal economy, comprising activities that have market value and would add to tax revenue and GDP were they recorded, is a widespread global phenomenon. According to the International Labour Organization (ILO; 2018) about 2 billion workers, or 60 percent of the total employed population age 15 years and older, operate in the informal sector. Recent estimates place the size of the informal economy at about one-third of the global economy.

So, what is informality? Informality is a complex and multifaceted phenomenon that is difficult to measure and analyze. By definition, informal activities are not recorded or are underrecorded, and participants do not want to be accounted for. As Kanbur (2009, 2) writes:

> Informality is a term that has the dubious distinction of combining maximum policy importance and political salience with minimal conceptual clarity and coherence in the analytical literature. There is a plethora of definitions, which leads to incoherence in analysis and, at its worst, major policy failures.

Informality covers a large range of situations within and across countries, and it arises for a broad spectrum of reasons. At one end of the spectrum, informality can be the result of a deliberate choice, with individuals and firms deciding to remain outside the formal economy to avoid taxes, social contributions, or compliance with standards and licensing requirements (Schneider 2015; Hassan and Schneider 2016; Williams and Schneider 2016). This choice relates to the often-held but misconceived view that informality is mainly caused by firms and individuals "cheating" on the system to avoid paying taxes. At the other end, informality can exist when some individuals are too poor or too uneducated to access formal employment, public benefits, and financial services, and therefore need to rely on informal activities as a safety net.

Informality can thus take many forms. Not all informal workers are poor, and not all poor workers are in the informal sector. Some workers can be simultaneously or successively employed in the formal and informal sectors. Informal firms range from precarious (hand-to-mouth) one-person operations to thriving small businesses.

The drivers of informality are similarly multifaceted, as highlighted in this book. They vary from low economic development; to inequality of access to health, education, and other basic public goods; to the state of the legal and regulatory environment, notably in labor and product markets; to the design of the tax and social protection system; and to the quality of institutions. In fact, informality can be best understood as a response to a broad set of institutions, which can explain the high persistence of informality, the wide cross-country variations in the size of informal economies, and the equally large within-country variations in types of informality.

This book's chapters advance the discussion on informality by illustrating that the high incidence and persistence of informality, particularly in emerging market and developing economies, is an obstacle to sustainable development because of its close but complex links with economic growth, poverty, and inequality, including gender inequality. Informal firms do not contribute to the tax base and tend to remain small, with low productivity and access to finance. Countries or regions with high informality thus tend to grow less than their potential (La Porta and Schleifer 2008, 2014). Informality also deprives governments of sizable tax revenue that could be used to improve basic public services (the lack thereof, in turn, contributes to informality).

Because informal workers lack formal contracts and social protection and tend to be less educated, they are more likely to be poor and to lack decent work conditions compared with peers in the formal sector. High informality is, moreover, associated with high inequality: workers tend to earn less in the informal sector than formal sector peers with similar skills, and the wage gap between formal and informal workers is higher at lower skill levels. This explains why the large decline in informality in Latin America observed over the past 20 years was associated with significant reductions in inequality.

Informality is also related to gender inequality: in two out of three low- and lower-middle income countries, women are more likely than men to be employed informally and to be in the most precarious and low-paid categories of informal employment. For example, UN Women (2016) finds that the gender wage gap is 28 percent in the informal sector in sub-Saharan Africa, far higher than the 6 percent gap in the formal sector.

The ILO (2018) estimates that, globally, 85 percent of informal workers are precariously employed in small, informal firms, with only 11 percent of informal workers employed in formal firms. Providing workers with decent jobs and facilitating the transition of small firms to formality is thus urgently needed to support inclusive development, as acknowledged in the United Nations' Sustainable Development Goals.[1]

[1] Sustainable Development Goal 8 is to "promote sustained, inclusive, and sustainable economic growth, full and productive employment and decent work for all." In particular, Target 8.3 aims to promote development-oriented policies that support productive activities and decent job creation, and to encourage the formalization and growth of micro, small, and medium enterprises, including through access to financial services.

This sense of urgency has only been reinforced by the coronavirus disease 2019 (COVID-19) pandemic. The pandemic has crushed informal activities, particularly in developing countries, where large segments of the population are not covered by existing social protection schemes. The need to provide a lifeline has emerged as an urgent priority for governments. Strict lockdowns destroyed the livelihoods of taxi and minibus drivers, street and market vendors, and bar and restaurant owners depending on daily incomes for survival. Yet countries with thin or nonexistent social safety nets have formulated ad hoc and sometimes innovative cash or in-kind transfer plans in a matter of weeks. Since March 2020, 139 countries and territories around the globe have planned, implemented, or adapted cash transfers to support their citizens (Rawlings, Jean-François, and Macleod 2020).

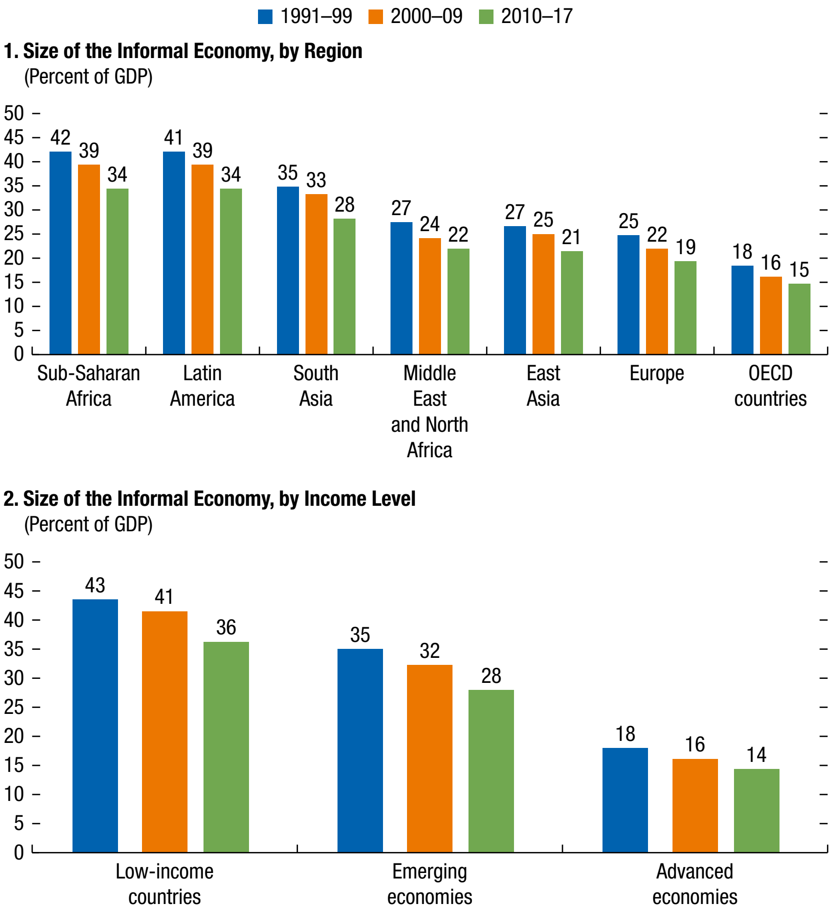
As discussed in Chapter 10, this crisis like no other can be an opportunity to leverage digital solutions to (1) set up more permanent mechanisms to expand social protection and (2) provide vulnerable individuals or firms with adequate incentives to join a national register as a step toward formalization. Other tools can include a combination of support to small and medium-sized enterprises (incubators, preparation of financial accounts), as well as tax policy, and administration measures (adequate minimal threshold for VAT, simplification of tax payment procedures, incentives to be part of the taxpayer registry).

Gaining a better understanding of the causes and effects of informality is thus central for policymakers to be able to tackle key economic development challenges. However, understanding is complicated by obvious measurement difficulties because participants in the informal sector either do not wish to be accounted for or are difficult to reach. Multiple methods, which can be categorized as either direct or indirect approaches, have been used to measure the size of the informal economy. The direct methods depend mainly on surveys and samples based on voluntary replies, tax audits, or other compliance methods; the results, therefore, are sensitive to the way a questionnaire is formulated or the willingness of respondents to cooperate.

The availability of direct microeconomic data has, nonetheless, much improved. For example, the ILO's 2018 report *Women and Men in the Informal Economy* compiles comparable data on informal employment and employment in the informal sector for more than 100 countries, representing more than 90 percent of the world's employed population age 15 years and older. The indirect approaches, as applied in the first section of this book, suggest the size of the informal economy in total output through alternative measures or indicators, such as the consumption of electricity or the cash in the economy.

Both approaches lead to similar conclusions regarding the size and evolution of informal economies within and across countries: (1) the informal economy is large and represents, on average, one-third of the global economy; (2) informality tends to decline over time and to be lower but still significant in more advanced economies, as compared with lower-income countries (although the declining trend is not universal, and informality has increased over the past decade in several countries, such as Ecuador, Namibia, and Venezuela); (3)

Introduction Figure 1. Size of the Informal Economy



Source: Medina and Schneider (forthcoming).
Note: OECD = Organisation for Economic Co-operation and Development.

informality varies significantly across regions and countries. Latin America and the Caribbean and sub-Saharan Africa stand out as the two regions of the world with the most informality. For low-income countries, the average size of the informal sector remains large at 36 percent (14 percent for advanced economies) (Introduction Figure 1).

The design of effective policies to address informality is complicated by the multiple causes and forms of informality, both across and within countries. Informality is shaped by each country's unique socioeconomic and institutional setting, which means that no one formula can address informality. Nonetheless,

the findings presented in this book indicate common guiding principles for policy design. Four broad policies can effectively address the root causes of informality:

- *Improved access to and quality of education is probably the single-most powerful way to lower informality.* Education reforms aimed both at enhancing equality of access and ensuring that students remain in school until the end of the secondary cycle are particularly important. Ample technical and vocational training opportunities will also help.
- *Tax system design should avoid inadvertently increasing incentives for individuals and firms to remain in the informal sector* (Levy 2010). It is generally recognized that simpler value-added and corporate tax systems (with lower rates and no or minimal exemptions and loopholes), as well as low payroll taxes, help reduce informality. Supportive social protection systems, including progressive income taxes and protection for the poorest, help address distributional aspects.
- *Policies to enhance financial inclusion by promoting expanded access to formal (or bank-based) financial services can help lower informality.* For informal firms and entrepreneurs, lack of access to finance is a key constraint, stifling productivity and the growth of their businesses. Countries where access to finance is broader tend to grow faster and have lower income inequality.
- *A range of structural policies can help increase incentives and lower the cost of formalization.* Labor market regulations can be simplified to ensure greater flexibility and facilitate informal workers' entry into formal employment. Competition policy can boost entry of small firms in some sectors by eliminating monopolies. Elimination of excessive regulations and bureaucratic requirements also helps.

Digital platforms, including government-to-person mobile transfers, can support these policies and contribute to inclusive growth by bringing financial accounts to the unbanked, empowering women financially and helping small and medium enterprises grow within the formal sector.

In sum, informality is a widespread and persistent phenomenon that critically affects how fast economies can grow, develop, and provide decent economic opportunities for their populations. Sustainable development requires a reduction in informality over time, but this process is inevitably gradual because the informal sector is currently the only viable income source for billions of people. Informality is best tackled by steady reforms—such as investment in education—and policies that address its underlying causes. Attacks on the sector motivated by the view that it is generally operating illegally and evading taxes are not the answer.

This book, a collection of recent research by IMF staff and renowned academic researchers, takes a fresh look at informality through an economic lens and examines some of the main questions regarding the informal economy: what do we know about the informal economy? What are the main reasons for an individual or a firm to operate in the informal sector? How does informality relate to growth and inequality, including gender inequality? Can tax and social protection

systems be designed to avoid pushing workers and firms into the informal sector? Why are individuals often using formal and informal financial services simultaneously, particularly in developing countries? By covering the many facets of informality, this volume provides a unique perspective on this complex phenomenon and contributes to the vast but uneven literature dedicated to the topic.

THE SIZE OF THE INFORMAL ECONOMY AND ITS RELATIONSHIP WITH ECONOMIC DEVELOPMENT

The first section of the book presents new estimations of the size of the informal economy around the world and then discusses its main characteristics and determinants, including the complex relation between informality and GDP per capita.

Chapter 1 uses a novel method to estimate the size of the informal sector in 158 countries over the past 25 years. Leandro Medina and Friedrich Schneider apply the multiple indicators, multiple causes (MIMIC) model, an indirect estimation method based on proxy variables for informality that include data on satellite-measured night lights. MIMIC estimates have been used by recent cross-country studies of informality, including chapters of this book.

In Chapter 2, Ben Kelmanson, Koralai Kirabaeva, and Leandro Medina empirically estimate the drivers of the informal economy in European countries. They find that regulatory quality, poor governance (corruption and weak judicial systems), and tax burden tend to be associated with higher informality, whereas factors such as trade openness and higher productivity are associated with lower informality. The chapter suggests that European countries require comprehensive regulatory and institutional reforms to successfully deal with the informal economy.

Chapter 3, by Dong Frank Wu and Friedrich Schneider, examines long-term determinants of development. They find that informality declines when development increases, but only up to a certain threshold, beyond which informality increases again. The notion of a threshold suggests that potential rewards of shrinking informal sectors are greater at lower development levels and when informality is a large part of the economy. Wu and Schneider also find that education is closely associated with economic development, suggesting that policies directly focused on improving human capital, rather than aimed at reducing the size of the informal sector, best support long-term inclusive growth.

INFORMALITY AND ITS RELATIONSHIP WITH PRODUCTIVITY, LABOR MARKETS, AND GENDER GAPS

The second section of the book focuses on the relationships between informality, productivity, labor markets, and gender gaps.

Chapter 4 by Manabu Nose estimates the allocative efficiency of land and labor in 40 sub-Saharan African countries. Empirical results suggest that improving factor market efficiency, particularly by allocating land to more productive

firms, would help sub-Saharan African firms move out of the informal sector and gain significant scale and productivity. Nose finds that improving regulations to formalize land allocation and labor contracts with social insurance benefits effectively supports firm growth when legal capacity is weak.

Chapter 5, by Antonio C. David, Frederic Lambert, and Frederik Toscani, shows that informality dampens unemployment movements over the business cycle in Latin America compared with advanced economies. This is attributable to the presence of dual labor markets, with a well-protected formal labor market and a highly flexible informal one. Countries with higher redundancy costs and cumbersome dismissal regulations exhibit "excess" informality above what would be expected based on income and educational levels. In that regard, David, Lambert, and Toscani find that labor market and tax reforms can greatly affect the informality rate. However, the authors also caution against overoptimism: when GDP per capita is low, informality remains high, as long as demand for formal goods is also low. In other words, a country's productivity, specifically the productivity of its formal sector compared with that of its informal sector, is a key determinant of informality.

Chapter 6, by Arina Viseth, assesses immigration's effect on native employment in the formal and informal sectors in three sub-Saharan African countries. When foreign and native workers have substitute skills, immigration increases labor supply in the formal sector, reducing native employment in that sector and triggering native workers to search for jobs in the informal sector. When native and foreign workers have complementary skills, immigration increases labor demand in the formal sector, resulting in higher employment and greater economic expansion, which in turn stimulates job creation in the informal sector.

In Chapter 7, Vivian Malta, Lisa Kolovich, Angelica Martínez Leyva, and Marina M. Tavares investigate the factors that can explain the larger presence of women in the informal sector. The authors show the association between female overrepresentation in the informal sector and gender gaps in education, social and legal norms biased against women, and the legal framework. In particular, they find that low education is usually more relevant for women as a driver of informal employment.

INFORMALITY AND FISCAL POLICY

The third section of the book studies the links between informality and fiscal policy.

Chapter 8, by Hilary Devine, assesses the relationship between informality and the quality of political and fiscal institutions in emerging market and developing economies. The analysis finds that political and fiscal institutions matter, in addition to economic development, macroeconomic stability, and measures of human capital. In particular, measures of government accountability, constraints on the executive, and property rights are associated with lower informality. The quality of fiscal institutions matters too: measures of VAT efficiency and fiscal sustainability are also significantly associated with lower informality.

In Chapter 9, Ehtisham Ahmad addresses the two dimensions of informality mentioned earlier: (1) "cheating" by firms to evade taxation on transactions, wages, and profits; and (2) informal workers who live in informal settlements and do not pay taxes but are also excluded from public services and benefits. Ahmad shows that national tax reforms, including to VAT systems, can generate information on "hidden" taxpayers. Subnational reforms include property taxes linked to an accountable provision of the Sustainable Development Goals that can provide incentives for migrant workers to move out of informality.

Chapter 10, by Sonja Davidovic, Soheib Nunhuck, Delphine Prady, and Herve Tourpe, studies how to scale up social protection to reach informal workers and firms during a pandemic using digital technologies. The authors introduce a framework to guide policymakers in building sustainable government-to-person mobile transfer programs. Together with other programs, mobile transfer platforms can strengthen social safety nets, allowing for adequate and effective coverage of vulnerable households and workers.

INFORMALITY AND FINANCIAL INCLUSION

The final section of the book assesses the relationship between the informal economy and the financial sector.

Chapter 11, by Corinne Deléchat, Lama Kiyasseh, Margaux MacDonald, and Rui Xu, analyzes the use of formal versus informal financial services in emerging market and developing economies. The chapter shows that individuals often combine types of financial access (formal and informal), and that this choice is driven by individual characteristics, such as gender and education, but also by country characteristics and policies, including monetary and financial policies. In particular, the chapter finds that strict macroprudential policies (that apply to formal financial services) tend to "leak" by pushing individuals to informal financial services.

The last chapter, by Azanaw Mengistu and Hector Perez-Saiz, studies how the adoption of several financial products affect competition and financial soundness, and thus financial inclusion, in sub-Saharan Africa. Mengistu and Perez-Saiz find that more competition tends to increase the probability of access to these financial products and that this effect is also observed for individuals in the informal economy.

By presenting the reader with this volume, we aim to help close remaining gaps in the academic literature and policy discussions, as well as to provide policymakers and practitioners with empirical evidence, lessons learned, and policy options to address informality and its economic consequences, and thus promote sustainable and inclusive development.

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