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Informality: Why Is It So Widespread and How Can It Be Reduced?

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In a typical developing country, about 70 percent of workers and 30 percent of production are informal. Informality is a cause and a consequence of the lack of economic and institutional development. It implies productive inefficiency and a culture of evasion and noncompliance. Informality, however, exists because it offers the advantages of flexibility and employment in economies with low labor productivity and an excessive regulatory burden. Under these conditions, if there were no informality, there would be greater unemployment, poverty, and crime. A well-conceived formalization strategy should seek to make formality more attractive. As the causes of informality are complex and interrelated, the reforms to reduce it must include all relevant areas. A formalization strategy should consist of making labor markets flexible, reforming social protection, increasing labor productivity, making the regulatory framework and the justice system efficient, and rationalizing the tax system.

What Is Informality and Why Does It Exist?

"Informality" is a term used to describe the set of firms, workers, and activities that operate outside the legal and regulatory framework or outside the modern economy (Loayza 2016). Informality thus denotes two aspects, one related to noncompliance and evasion of State rules, and the other related to the precariousness and isolation of informal activity (Perry et al. 2007). Although informality can occur in the range that goes from legally constituted companies to workers in subsistence activities, it is more prevalent in smaller firms, more marginal locations, more rudimentary activities, and among less educated people (Perry et al. 2007; ILO 2018).

Informality is both a cause and a consequence of the lack of economic and institutional development (Schneider and Enste 2000; Oviedo, Thomas, and Karakurum-Özdemir 2009; Kose, Ohnsorge, and Yu forthcoming). It is a problem because it implies that a large number of people and a considerable share of economic activity do not fully benefit from appropriate technologies and efficient production methods, access to essential public services such as police and judicial protection, and the possibility of sharing and mitigating risks such as old age, illness, and unemployment. Informality is also a problem because informal firms, workers, and activities contribute insufficiently to the State and the generation of public goods.

Informality, however, exists because it offers the advantages of flexibility, creativity, and employment in economies constrained both by low labor and business productivity and by a State that does not offer efficient services but imposes an excessive regulatory and tax burden. Under these conditions, if there were no informality, there would be greater unemployment, poverty, conflict, and crime.

This brief reviews the prevalence of informality around the world; describes its consequences for productivity, growth, and risk diversification; analyzes its causes in terms of lack of economic and social development; and presents a strategy to formalize the economy, from objectives to guiding principles and specific reforms.

How Prevalent Is Informality around the World?

The informal economy is commonly defined and measured in relation to two areas: employment and production. In the first area, a key measure is the percentage of employment that is not subject to or does not comply with labor legislation, does not pay income taxes, or performs subsistence activities (ILO 2018). In the second area, a key measure of the size of the informal economy is the percentage of the country's production that is generated informally (Medina and Schneider 2018).

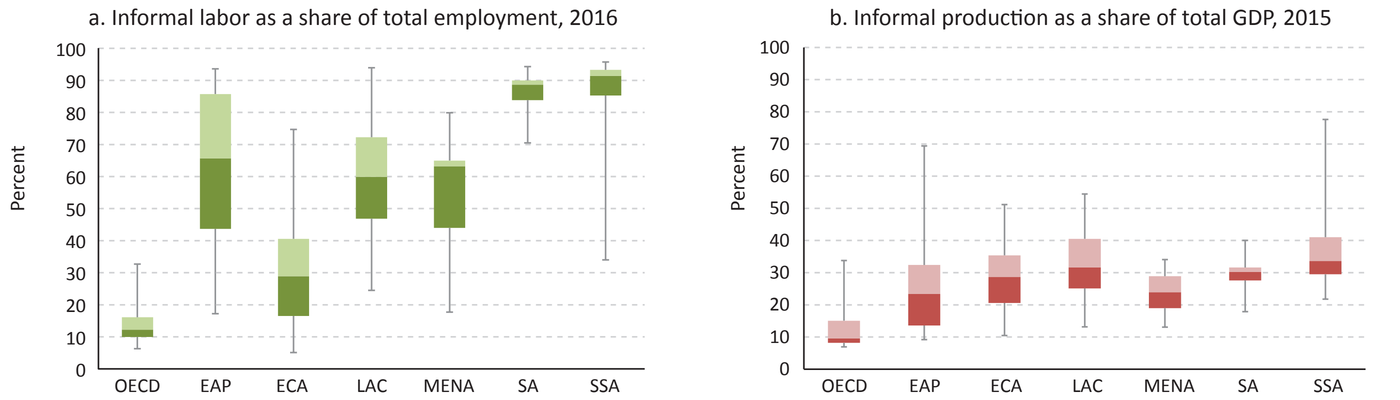
Informality is widespread in developing countries. It is one of the most important characteristics of their labor and production markets. In the typical country, the informal sector employs about 70 percent of the labor force and produces around 30 percent of GDP. There is, however, considerable heterogeneity across and within regions (see figure 1). Informal labor is highest in Sub-Saharan Africa and South Asia (with medians across countries in each region of around 90 percent of the labor force); still considerably high in East Asia and Pacific, Latin America and the Caribbean, and Middle-East and North Africa (with regional medians of 60 to 65 percent); lower in Eastern Europe and Central Asia (regional median of nearly 30 percent); and lowest in the rich countries of the OECD (group median of just over 10 percent). Informal production as a share of GDP is also substantial in developing countries, though lower than in terms of employment, a reflection of the informal sector´s lower productivity (see below).

Informality is persistent over time. In many countries, however, the trend, though high, is declining (see figure 2). Of the 36 developing countries for which the ILO (2018) reports informal employment for 2005–17, 60 percent have reduced the share of informal employment and 17 percent have done so by more than 1 percentage point per year. Similarly, of the 134 developing countries for which Medina and Schneider (2018) report informal production for 2005–15, 79 percent have lowered the share of the informal sector in total production and 8 percent have done it by more than 1 percentage point per year.

The Consequences of Informality

Informality brings positive and negative consequences for firms and workers in the economy (Schneider and Enste 2000). On the positive side, by avoiding the burden of regulation and taxation, informal sector enterprises enjoy more flexibility in personnel decisions, location, resource management, and market competition. Thus, informal firms and workers are often characterized by their dynamism and creativity (De Soto 1988). From a social perspective, no less important is the fact that the informal sector fulfills the function of generating employment, especially during economic recessions (Fiess, Fugazza, and Maloney 2007; Loayza and Rigolini 2011; Kose, Ohnsorge, and Shu forthcoming).

Figure 1. Informal Labor and Informal Production by Region



Source: For panel a, ILO (2018) and Loayza and Meza-Cuadra (2018); for panel b, Medina and Schneider (2018).
Note: OECD includes high-income countries that have been members of OECD for more than 40 years. Other regions include East Asia and Pacific (EAP), Europe and Central Asia (ECA), Middle East and North Africa (MENA), Latin America and Caribbean (LAC), South Asia (SA) and Sub-Saharan Africa (SSA).

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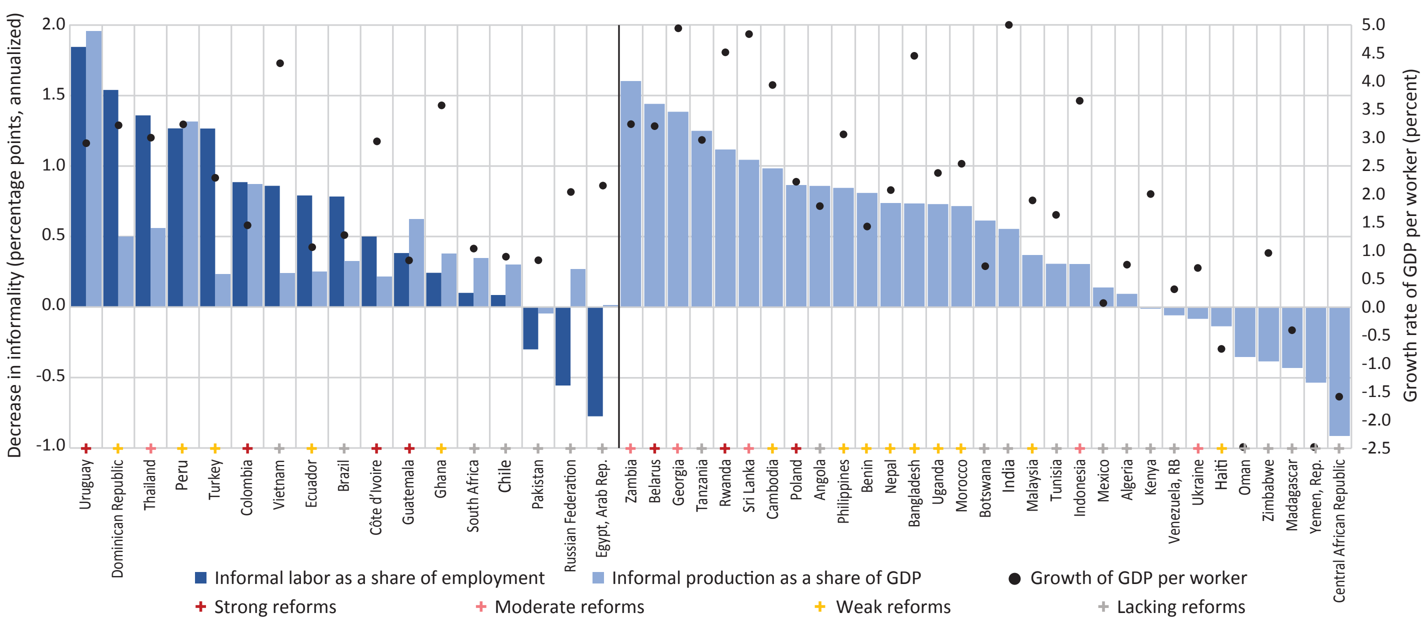
Figure 2. Decrease in Informality in Relation to Economic Growth and Formalization Reforms, circa 2005-2015



Source: Author's calculation based on ILOSTAT (2018), TURKSTAT (2018), and Medina and Schneider (2018) for informal labor and production; World Bank World Development (2018) for growth of GDP per worker; Kim and Loayza (2018) for market flexibility and governance; World Bank ASPIRE Indicators (2018) for social protection; and World Bank Doing Business (2018) for taxes.
Note: Reforms are measured using indicators in the areas of market flexibility, social protection, governance, and taxation. Considering the period 2005–15, progress of at least 10 percent in three or four areas is labeled "Strong"; in two areas, "Moderate"; in one area, "Weak"; and in no area, "Lacking." Growth rates are truncated at −2.5 percent and 5 percent.

On the negative side, firms in the informal sector suffer the costs and risks of not having the protection and services that the law and the State can provide (for instance, protection by the police against crime or by the judicial system against breach of contracts). This results in high levels of inefficiency as most informal enterprises remain small, have limited access to banking services, use irregular channels to acquire and distribute their goods and services, and must spend additional resources to cover up their activities (La Porta and Shleifer 2014). Figure 3 provides a rough estimation of labor productivity in the informal sector for a large group of countries. For most of them, informal productivity is between 25 and 75 percent of total labor productivity in the economy—and informal productivity decreases as informality rises.

For workers, informal employment, although it is generally preferable to unemployment, often involves poor working conditions and restricted access to social protection. Informal employment is characterized by the possibility that the agreed wages will not be paid, the obligation to do overtime or extraordinary shifts, dismissals without notice or compensation, an unsafe working environment, and the absence of benefits such as retirement pensions, or health and unemployment insurance (Oviedo, Thomas, and Karakurum-Özdemir 2009). In Colombia, for instance, informal salaried and self-employed workers are generally more dissatisfied with their jobs than their formal counterparts, particularly regarding fringe benefits (Perry et al. 2007).

At the social level, the informal sector generates a negative externality because informal activities use and congest public infrastructure without contributing the necessary tax revenues to fund it (Loayza 1996; Johnson, Kauffman, and Shleifer 1997). In many countries, tax evasion can be substantial. For Ghana, for instance, Danquah and Osei-Assibey (2018) calculate a tax gap of about 70 percent (the difference between actual and potential revenue collected from the informal sector).

The Causes of Informality

There are two main schools of thought about the causes of informality (Schneider and Enste 2000; Loayza 2016). The first considers that informality is a symptom of underdevelopment (ILO 2018). Under this approach, the informal economy is the result of low productivity of workers and firms. This is due to structural factors, including lack of physical capital, low educational level, and certain sociodemographic factors (such as a high incidence of young and rural populations). According to this perspective, policies to reduce informality should be aimed at increasing labor and business productivity (La Porta and Shleifer 2014).

The second school of thought considers that informality is the result of bad governance. Thus, informality is the response of the private sector to an overly regulated economy and an inefficient State (De Soto 1988). Under this approach, firms choose to operate within the informal sector when the costs of complying with regulations exceeds the benefits from accessing public services offered to formal companies. If informality is the result of poor governance, policies should focus on improving the regulatory environment and public services (Djankov et al. 2002).

Both schools of thought are correct. Informality should be understood as a complex and multifaceted phenomenon that is not due to a single cause. Lack of economic development (and low productivity in particular) and poor governance are relevant, in proportions that vary from country to country. For example, examining the higher labor informality in Peru compared to Chile, Loayza and Wada (2010) estimate that 75 percent of the difference is due to causes related to poor governance and the remaining 25 percent to structural causes of low productivity. In contrast, when comparing the higher informality in Indonesia to the lower level in the Republic of Korea, they find that 75 percent of the difference is explained by factors related to lower productivity.

One way to appreciate that both lack of economic development and poor governance can be responsible for the high level of informality in a country is to consider the international relationship between informality and per capita income (see figure 4). The comparison shows that less economically developed countries tend to exhibit larger informality. However, some countries have a significantly higher level of informality than their level of GDP per capita would predict. This suggests that informality is not only driven by economic development but also by other idiosyncratic factors, arguably connected to the quality of government and regulatory environment. Take, for example, the case of Nigeria. Its fraction of informal workers in total employment is about 90 percent, that is, over 20 percentage points higher than what could be expected according to its income level; and the fraction of informal production in GDP is 50 percent, also 20 percentage points larger than expected. In other regions, excessive labor informality can be identified in India, Indonesia, Peru, and Qatar; while excessive production informality can be detected in Haiti, Georgia, Myanmar, Thailand, and Zimbabwe.

Objectives of a Formalization Strategy

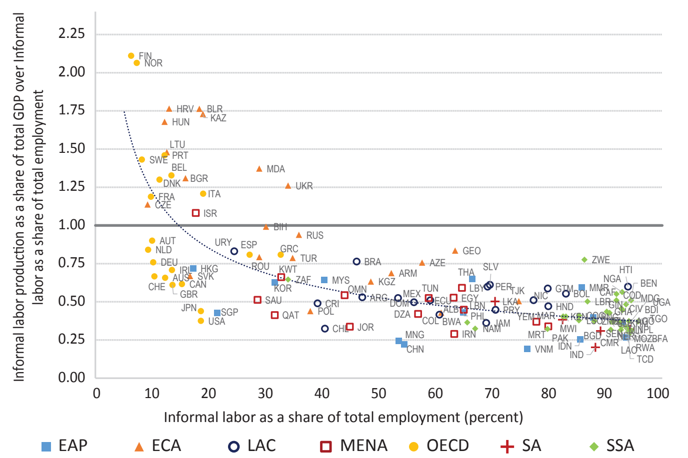
Before a strategy to formalize the economy can be designed, its long-term objectives should be clear. In principle, formalization should achieve the following goals:

1. *Increase the productivity of workers, businesses, and the economy in general*. The transition from informality to formality can represent a substantial efficiency gain (see figure 3). This is realized as firms grow in scale and diversity, adopting new technologies, inducing workers to collaborate with complementary skills, and reaching new domestic and foreign markets. Moreover, an expansion of the tax base can imply larger and more stable resources for funding public infrastructure and services. The implication for economic growth can be strong and significant (Levy 2018; Loayza, Oviedo, and Servén 2006).

2. *Reduce the vulnerability to systemic and idiosyncratic risks*. The reforms that bring about formalization can not only lead to greater economic growth but can also increase the ability of the national economy, firms, and workers to adjust to the changing conditions of the world economy, to recover from adverse shocks, and to avoid unnecessary risks to health and safety (World Bank 2013). The combination of market flexibility with broad and effective social protection encourages formalization and decreases vulnerability.

3. *Promote a culture of respect for law and order*. Formalization requires improving the legal and regulatory systems. This can help economic agents change their perspective and behavior with respect to laws and regulations, as well as the institutions responsible for enforcing them. If economic agents see these institutions as reasonable and fair, they will perceive a clear personal and social benefit in respecting them. Moreover, the reforms entailed in a formalization strategy can radically reduce the incentives and the possibilities for official corruption and abuse (Friedman et al. 2000).

Figure 3. Informal Labor Productivity Relative to Total Labor Productivity (2016)



Source: Author's calculation based on ILO (2018), Loayza and Meza-Cuadra (2018), and Medina and Schneider (2018).
Note: Data labels use the International Organization for Standardization (ISO) country codes. OECD includes high-income countries that have been members of OECD for more than 40 years. Other regions include East Asia and Pacific (EAP), Europe and Central Asia (ECA), Middle East and North Africa (MENA), Latin America and Caribbean (LAC), South Asia (SA), and Sub-Saharan Africa (SSA).

Guiding Principles of a Formalization Strategy

Before defining the specific reforms that compose a formalization strategy, the principles underlying these reforms should be presented. These principles consider the fundamental causes and most relevant consequences of informality, the prevalence and size of the informal economy, and the objectives to be achieved through formalization. The guiding principles should include the following:

1. *Reduce informality, but not at all costs or in any possible way*. An indiscriminate reduction of informality can lead to unemployment, poverty, and the social evils they bring, from criminality to social conflict (Fernandez et al. 2017). These alternatives are clearly inferior to informality. Informality has existed in the labor markets of developing countries in symbiosis with the rest of the economy, to the point that it can be regarded as "normal" (World Bank 2012). This condition can and should be improved, without losing the benefits it has brought to economic activity and people's welfare.

2. *Make formality attractive, rather than only penalize informality*. The strategy should emphasize the positive aspects of formalization, making formality more attractive. It should, therefore, seek to increase the benefits of formality and reduce its costs, as well as discourage informality: that is, a series of "carrots" alongside "sticks" can be adopted, depending on the characteristics of a country's informal sector (Oviedo, Thomas, and Karakurum-Özdemir 2009). Enforcement of rules and regulations is important, of course, but only to the extent that they are economically and socially sensible. Moreover, enforcement should be directed to both formal and informal firms and activities–monitoring and supervision only of formal firms tilts the playing field and discourages formality.

3. *Formalize labor and economic activity, not necessarily all firms*. The vast majority of microenterprises in heavily informal economies are inefficient and would gradually exit the market as development proceeds (La Porta and Shleifer 2014; Bruhn and McKenzie 2014). Concentrating the formalization effort on microenterprises is misguided. Instead, formalization should be sought through the generation of employment and production mainly in emerging, medium, and large firms. These are the enterprises that can generate greater growth in productivity and greater diversification of risks. A healthy economy is characterized by the entry of young companies that boost its productivity (Haltiwanger, Jarmin, and Miranda 2013; Cirera and Maloney 2017). Dynamic firms, whether new or established, can be the source of formal jobs if the conditions are favorable.

4. *Implement a comprehensive, not a piecemeal, formalization strategy*. No policy or isolated reform on its own can bring about a significant reduction in informality (Oviedo, Thomas, and Karakurum-Özdemir 2009). To succeed, a formalization strategy must include well-integrated reforms that address the complexity and particularity of informality in each country. The contribution of each reform can enhance and complement the positive effect of the rest, so that the benefit of implementing a comprehensive formalization strategy can be greater than the sum of the isolated effects of its components. Integration of reforms may be necessary not only for these technical reasons but also for political economy considerations: reforms may be more socially acceptable as a package than as piecemeal. The countries whose economies have formalized the most in the last decade are those that have implemented extensive reforms and/or grown rapidly (see figure 2).

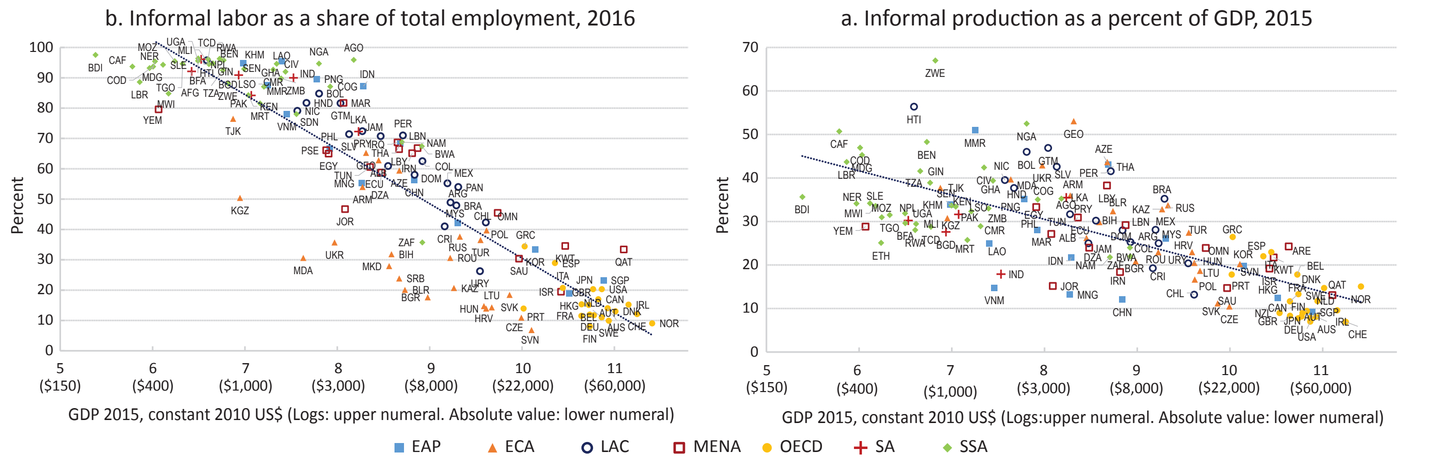
Reform Components of a Formalization Strategy

The main reform components of a formalization strategy can be grouped into five large areas. With different degrees, all of them seek to confront the two main causes of informality –lack of development and poor governance—and to make formality attractive in a comprehensive yet realistic way.

1. *Make the labor market more flexible*. In an economy with a large and growing workforce, it is essential that the labor market has the capacity to generate enough formal employment opportunities. To do this, labor markets must be flexible to adjust to changing conditions in labor supply (including the numbers, skills, and demographic profiles of workers) and in labor demand (such as technological innovations and preference changes that induce sectoral production shifts and entry and exit of firms) (Caballero et al. 2013). Companies must retain the ability to determine their workforce without major restrictions on hiring and firing. Likewise, the wage and nonsalary costs that firms face must correspond to the productivity of workers and market conditions, rather than mandated wages and benefits introduced without a clear economic rationale. Once the labor market is flexible, the enforcement of regulatory compliance should be effective and directed to both formal and informal employment, with an emphasis on health and safety in the workplace.

2. *Reform social protection*. Labor flexibility can be politically and socially viable only if it is accompanied by labor reinsertion systems and encompassing social protection aimed at the worker, regardless of employment status. The amalgamation of labor flexibility, social protection, and labor reinsertion amounts to a new social pact, best exemplified by the Danish flexicurity system (World Bank 2013). There is a vicious circle between poorly designed social protection and high informality: Payroll taxes imposed to fund social protection programs (for health care and retirement pensions, for instance) make formal labor expensive and generate informality; in turn, informality implies low coverage of social protection programs; and the response to low coverage is to establish parallel noncontributory systems, which further encourage informality (Levy 2008; Maloney 2004). This vicious circle must be broken. Social protection reform can not only help in achieving its primary objectives but also contribute to formalization of workers and enterprises. It must be based on the following principles: it should benefit people regardless of employment status; target the most vulnerable; be fiscally viable; and not discourage self-sufficiency (World Bank 2013). Although the optimal design can vary according to social preferences and resources, social protection programs

Figure 4. Informal Labor and Informal Production versus GDP per capita



Source: For panel a, ILO (2018); Loayza and Meza-Cuadra (2018); for panel b, Medina and Schneider (2018).
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should feature two components: universal basic coverage (mostly funded with general taxes) and complementary coverage (funded through voluntary contributions for supplementary benefits).

3. *Increase labor productivity*. The demand for formal workers depends not only on their costs or the ease of hiring and firing, but also on the productivity of workers and firms (Maloney 2004). At the individual level, labor productivity depends on the technical and social skills acquired at home and school. Educational reform—from better school infrastructure to improved teachers' incentives and more suitable curriculum—is badly needed to transform schooling into learning (World Bank 2018). For workers already in the labor force, retraining to adjust to changing market conditions is necessary to sustain and improve their productivity (Card, Kluve, and Weber 2018). For those who have lost their jobs, labor reinsertion systems, including orientation and retraining, are needed in a timely way to prevent the harmful consequences of prolonged unemployment. At the firm level, labor productivity depends on the quality of management, the usefulness of capital investment, and the capacity to adopt and develop new technologies, processes, and products (Cirera and Maloney 2017). Finally, at the economy-wide level, labor productivity is also determined by the quality of public infrastructure and government institutions, as well as competition in and access to global markets (Kim, Loayza, and Meza-Cuadra 2016). It is not surprising, then, that one of the positive consequences of sustained economic growth is the gradual formalization of the economy (McCaig and Pavcnik 2015) (see figure 2).

4. *Make the regulatory framework and the justice system more efficient*. The regulatory framework should promote business development, market competition, and the protection of workers and consumers. An outdated or inadequate regulatory framework can, on the contrary, be an obstacle to growth and formality (Loayza, Oviedo, and Servén 2006). For instance, regulations that favor small firms can stunt growth and induce informality (Dabla-Norris et al. 2018). To promote formalization, the regulatory framework must be simple, clear, and modern at all stages of the firm's life, from its formation to its exit from the market (Friedman et al. 2000; Divanbeigi and Ramalho 2015). The modernization of the regulatory framework must involve the use of new information technologies and the constant refinement of all institutions involved in regulatory processes, including central and local governments. Likewise, the justice system can have a direct impact on formality, making formality not only attractive but also feasible. Formality is often constrained by the lack of legally recognized ownership and usage rights over urban and rural land (De Soto 1988), with highly polluting informal mining and indiscriminate and disorganized city growth as two palpable examples. What is needed is a consistent and agile justice system that lays the rules for property and use of the territory, resolves commercial and labor disputeseffectively, enforces contractual agreements fairly, and protects citizens from crime and predatory behavior.

5. *Rationalize the tax system*. The tax system has two primary objectives. The first is the collection of the necessary resources for the State to provide public goods and services to society, such as infrastructure, education, justice, and social protection. The second is that the collection of taxes should not be obtained at the expense of economic efficiency, by introducing distortions and unwarranted incentives or disincentives to particular activities. A poorly designed tax system can represent a barrier to investment and growth and can induce evasion and informality. To promote formalization, the tax system should tend toward simplicity, gradual increases in the tax cost with the size of the firm (so as not to discourage growth), and reduction of marginal tax rates (to encourage investment and employment in growing and large companies) (OECD 2004). Value added taxes (VAT) have proven to be strong tax collection mechanisms. They can also promote formality by creating a chain between inputs purchases and outputs sales that encourages tax payment. To strengthen this mechanism, VAT exemptions should be kept to a minimum, if not eliminated altogether, and enforcement maintained throughout the value chain (De Paula and Scheinkman 2010). Finally, the tax enforcement agency must be made more efficient through the use of information technologies and address not only formally registered firms but also informal activity.

From Strategy to Plan and Implementation

The strategy presented above contains the principles but not the specific measures that are needed for a concrete plan. These must be country specific (Fernandez et al. 2017; Campos, Goldstein, and McKenzie 2018). For each reform component, first, a diagnosis of the country´s current situation is required, possibly contrasting it with other countries; and, second, specific reforms to address the main weaknesses should be formulated.

These reforms would consist of a combination of measures that vary in terms of their economic cost, technical complexity, and political difficulty: From relatively straightforward procedural improvements (modernizing the regulatory environment), to more difficult executive measures (justice system reform), to politically challenging legislative changes requiring popular support (labor market and social protection reforms). In addition to specific and well-grounded measures, for implementation to succeed, a formalization plan should explicitly state the costs and difficulty (procedural, budgetary, and political) of each reform; a timeline for their realization and potential effects; and the entities responsible for their execution, monitoring, and evaluation.

Formalizing the economy without losing the advantages of flexibility and employment is a task of epic proportions. It is, nonetheless, feasible provided policy makers possess sufficient expertise and, above all, political will. The long-term benefits of formalization for growth and prosperity can be vast and enduring.

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