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World of Labor
Evidence-based policy making

Inequality and informality in transition and emerging countries

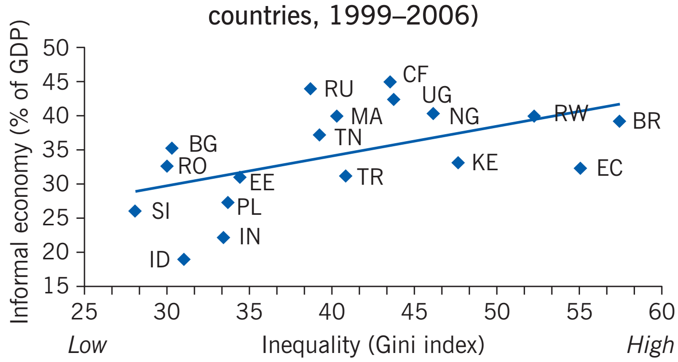
Higher inequality decreases capital accumulation and increases informality, which, in turn, raises the income of the poor

Keywords: informality, inequality, shadow economy

ELEVATOR PITCH

Higher inequality reduces capital accumulation and increases the informal economy, which creates additional employment opportunities for low-skilled and deprived people. Despite this positive feedback, informality raises problems for public finances and biases official statistics, reducing the effectiveness of redistributive policies. Policymakers should consider the links between inequality and informality because badly designed informality-reducing policies may increase inequality. However, convincing empirical evidence is still lacking and is usually limited to correlations rather than causal effects.

Informality vs inequality (emerging and developing countries, 1999–2006)



Source: Informal economy [1]; Gini index: World Bank, World Development Indicators. Online at: http://data.worldbank.org/indicator/SI.POV.GINI

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KEY FINDINGS

Pros

- The informal economy increases human capital accumulation due to the provision of employment opportunities to low-skilled workers, especially in developing countries.
- Informal activities that provide employment to lower-income workers likely lead to beneficial effects on income distribution.
- Informal activities can help to maintain economic activity when rent-seeking and excessive regulatory burdens raise the cost of formal production.

Cons

- Higher inequality decreases human and physical capital accumulation, which may increase informality.
- Widespread informality can lead to severe problems for public finances and reduce the resources available for redistributive policies, potentially leading to less effective redistribution.
- Public policies aimed at reducing informality can increase inequality.
- Informal workers can be locked into informal jobs, thus decreasing their social mobility.
- Due to measurement errors in informality and inequality data, empirical analyses on this issue should be interpreted with caution.

AUTHOR'S MAIN MESSAGE

Analyzing the relationship between inequality and informality is challenging due to an influential third factor: the official economy. Omitting the different causal mechanisms between these three variables may inhibit effective policy making. The informal economy can provide sources of income and opportunities to accumulate human capital for marginalized workers. For transition and emerging countries, this means that informality-reducing policies based only on tax reduction and enhanced enforcement of tax and regulatory rules may lead to disappointing economic outcomes, such as increased inequality, and higher rates of long-term unemployment.

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