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Understanding Informality and its Cycles

This paper introduces a comprehensive database of informal economic activity and studies the degree of synchronization between formal- and informal-economy business cycles. The database focuses on measures that have strong cross-country and over-time coverage: it includes both model-based and survey-based measures of informality and covers more than 160 economies for the period 1990-2018. It illustrates two applications of the database. First, it distills stylized facts of informal activity, including its declining trend and pervasiveness in emerging market and developing economies (EMDEs). Second, it documents the cyclical features of the informal economy. Overall, informal economy recessions (recoveries) do not differ significantly from those of formal economy. Like formal-economy business cycles, informal-economy business cycles tend to be shallower in advanced economies than in EMDEs. Informal employment in both advanced economies and EMDEs appears to be largely acyclical. With respect to the business cycles, we report two major results. First, fluctuations in informal-sector output are strongly positively correlated with those in formal-sector output. In contrast, fluctuations in informal employment are largely uncorrelated with those in formal-sector output. Second, movements in the formal economy tend to spillover to the informal economy. Using a novel set of instrumental variables, we also show that fluctuations in formal-sector output “cause” movements in informal-sector output.