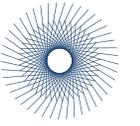


Hidden Potential:

Rethinking Informality in South Asia

Maurizio Bussolo and Siddharth Sharma | November 2022





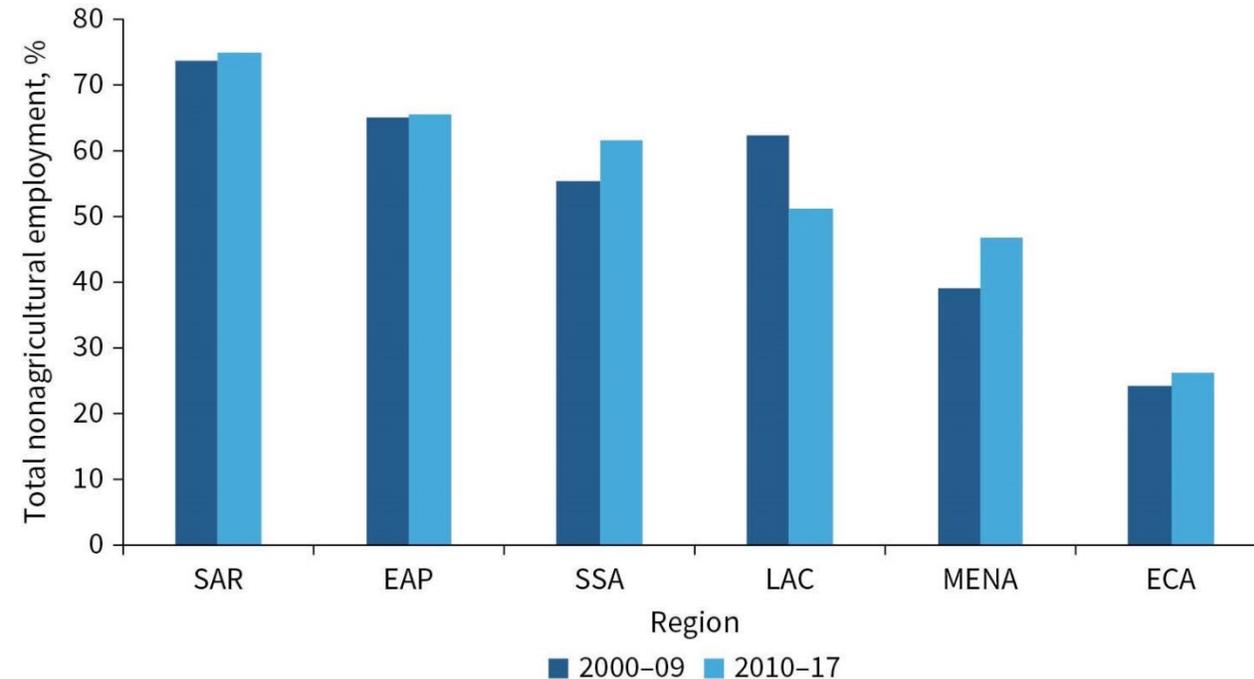
Persistent informality is a major development issue in South Asia

Informality remains widespread despite decades of economic growth in South Asia.

It is a major development issue because it is associated with

- Low earnings and labor productivity
- High vulnerability
- Smaller tax base

Share of Informal Employment in Total Nonagricultural Employment

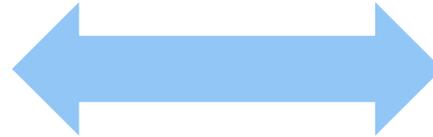




Debate polarized into simple, opposing views

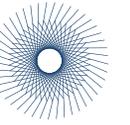
Choice

- Informality is a hindrance to development.
- Informal firms choose to remain small and avoid regulations and taxation.
- This may be because of their intrinsic characteristics, such as limited business skills.
- Focus is on enforcement and changing intrinsic characteristics so that this hindrance can be eradicated.



Exclusion

- Informal firms and workers are discriminated against in a dualistic economy.
- Entry barriers, rules and regulations benefit a few privileged insiders.
- Focus is on the removal of the entry barriers to promote deregulation and increased competition should be central in reform



These dueling views neglect the heterogeneity of the informal sector

These polarized views generate unambiguous policy guidance:

- *Choice* → Change firms' decisions through interventions and enforcement

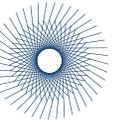
Versus



- *Exclusion* → Remove the barriers to entry and fair competition

But such guidance may be ineffective because it misses some key aspects:

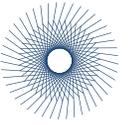
- Informal sector is heterogenous
- The informal sector and a formal sector coexisted for a long time (complex linkages between the two)
- The political economy of the existing institutional setting may constrain meaningful reform.



Rethinking informality

This volume rethinking of informality entails:

- Recognition of the heterogeneity of the informal sector (and its different determinants):
 - In some cases, informality is linked to evasion/avoidance of regulation, but in others it is linked to misallocation of resources due to barriers and lack of competition.
- Are new approaches to the development challenges of informality possible?
 - Yes, digital technology can and do help to connect the informal sector to markets;
 - But complementary interventions are needed;
- How to reduce vulnerability?
 - The development challenge associated with informality has less to do with a low tax base and more to do with insecure jobs and low productivity



New contributions to these questions

<i>Broad themes (chapters of Hidden Potential)</i>	<i>Contributing researchers</i>
Determinants of informality	
Formal Sector Distortions, Entry Barriers, and the Informal Economy: A Quantitative Exploration	Roberto N. Fattal Jaef
The Value Added Tax, Cascading Sales Tax, and Informality	Yue Zhou
Responses of Firms to Taxation and the Link to Informality: Evidence from India's GST	Pierre Bachas, Lucie Gadenne, Davi Bhering, and Radhika Kaul
Harnessing digital technology and complementary interventions	
Small Businesses and Online Sales in India	Martin Kanz and Romina Quagliotti
What Is the Role of Socioemotional Skills in Supporting South Asia's Informal Sector Poor? Insights from Pakistan and Sri Lanka	Syud Amer Ahmed, Pinyi Chen, Zaineب Majoka, and Jyotirmoy Saha
How to reduce the vulnerability of workers in the informal sector	
Workers at Risk: Panel Data Evidence on the COVID-19 Labor Market Crisis in India	Maurizio Bussolo, Ananya Kotia, and Siddharth Sharma
Social Insurance among Informal Workers in South Asia	Gustavo Demarco, Ernesto Brodersohn, Miglena Abels, Clement Joubert, and Emilio Basavilbaso



Four Main messages

Informality in South Asia is dominated by firms that happen to be outside the purview of regulations because they are small, as opposed to those that remain small to escape regulations.

Reforms of business regulations tend to have small direct effects on the informal sector, although they could have sizable indirect impacts on it if they succeed in removing major inefficiencies in the broader economy.

E-commerce platforms and similar technologies offer new opportunities to informal firms and workers, but many of these also need complementary skills or credit to benefit from such technologies

A combination of contributory and noncontributory programs recognizing the heterogeneous saving capacities of informal workers may be necessary to reduce vulnerability in the informal sector



The conceptual framework

The conceptual framework follows recent research (Kanbur 2017, 2021; Ulyssea 2018, 2020) with heterogenous firms

The Baseline Economy

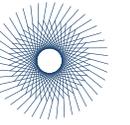
Hypothetical economy with no government interventions nor regulations.

Firms employ labor (and other inputs) to produce a homogeneous product and differ only in their total factor productivity (TFP).

Market interactions, diminishing returns to scale in firms, and the initial distribution of TFP produce a “natural” size distribution of firms.

Firms with higher TFP are larger in terms of employment (and other inputs).

This creates an efficient allocation of labor across firms, and maximizes total output.



Three types of informality

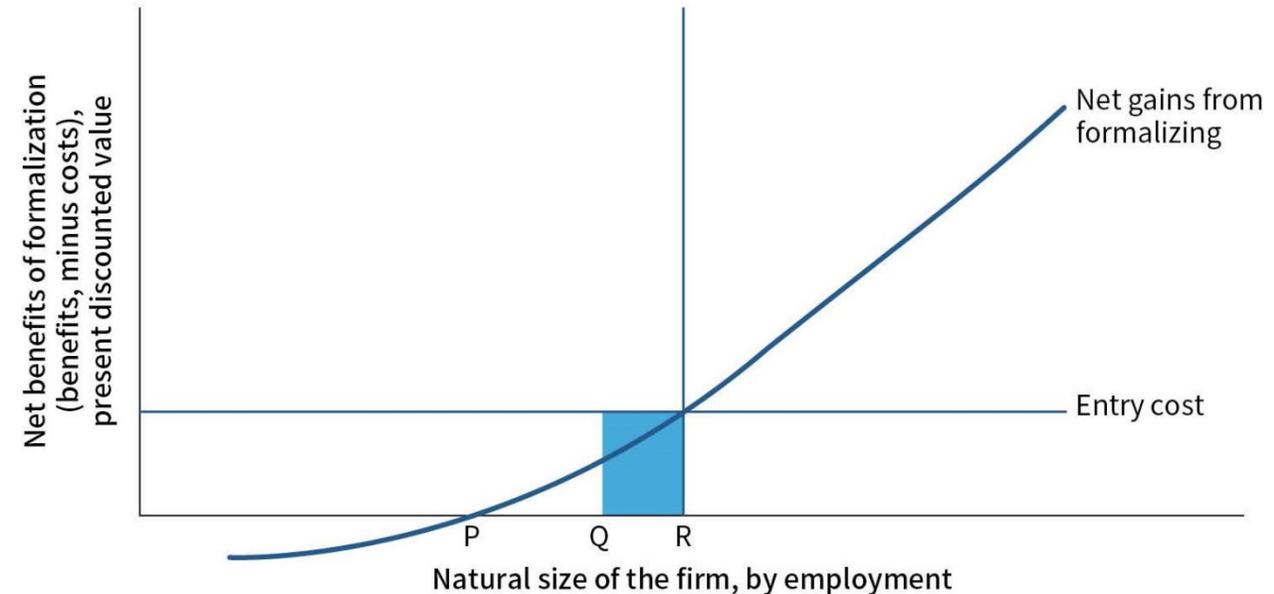
Introduce a regulation in this economy

Impose an entry fee and labor taxes on firms above a size threshold Q.

Firm split into formal firms and three types of informal firms: outsiders, evaders and avoiders

- Formal: Firms that were naturally above R comply and formalize.
- Outsiders: Firms that were naturally below Q do not need to change anything- they are neither asked to formalize nor desire it.
- Evaders and avoiders: Firms that were between Q and R in size do not want to formalize and either “evade” the regulation by hiding or “avoid” it by shrinking below Q.

Labor allocation is no longer optimal.





Main messages

Informality in South Asia is dominated by firms that happen to be outside the purview of regulations because they are small, as opposed to those that remain small to escape regulations.

Reforms of business regulations tend to have small direct effects on the informal sector, although they could have sizable indirect impacts on it if they succeed in removing major inefficiencies in the broader economy.

E-commerce platforms and similar technologies offer new opportunities to informal firms and workers, but many of these also need complementary skills or credit to benefit from such technologies

A combination of contributory and noncontributory programs recognizing the heterogeneous saving capacities of informal workers may be necessary to reduce vulnerability in the informal sector

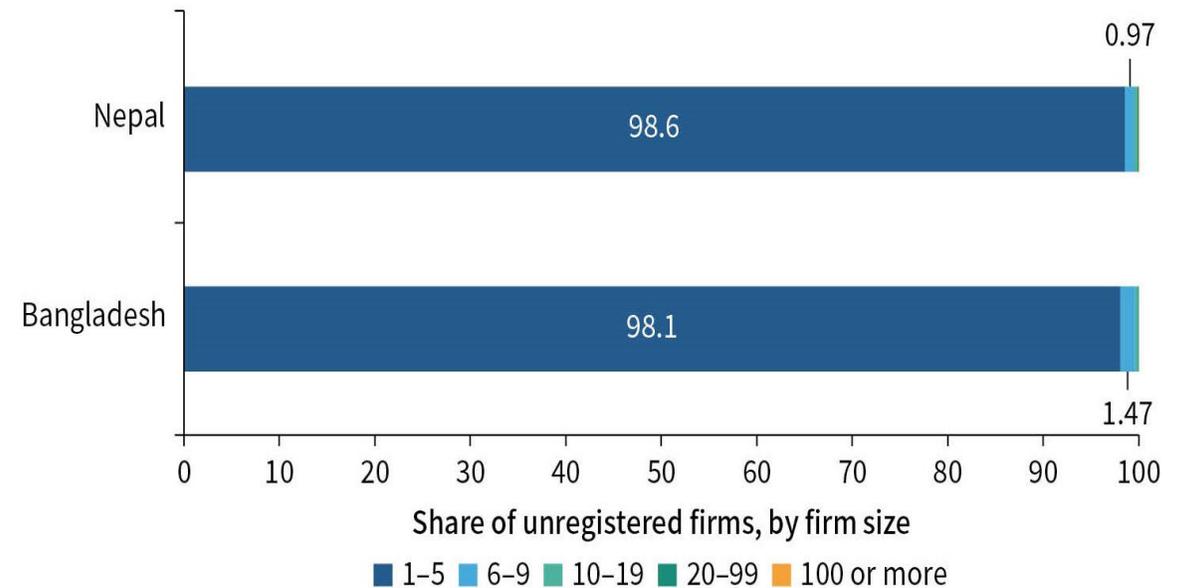


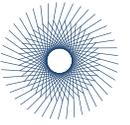
Most firms in South Asia’s informal sector are “outsiders”

Most informal firms are microenterprises – far from regulatory thresholds.

Chatterjee and Kanbur (2014) estimate that only 1.5 percent of all manufacturing firms are evaders and fewer than 1.0 percent are avoiders. About 97 percent of factories appear to be outsiders.

Most Informal South Asian Firms Are Microenterprises



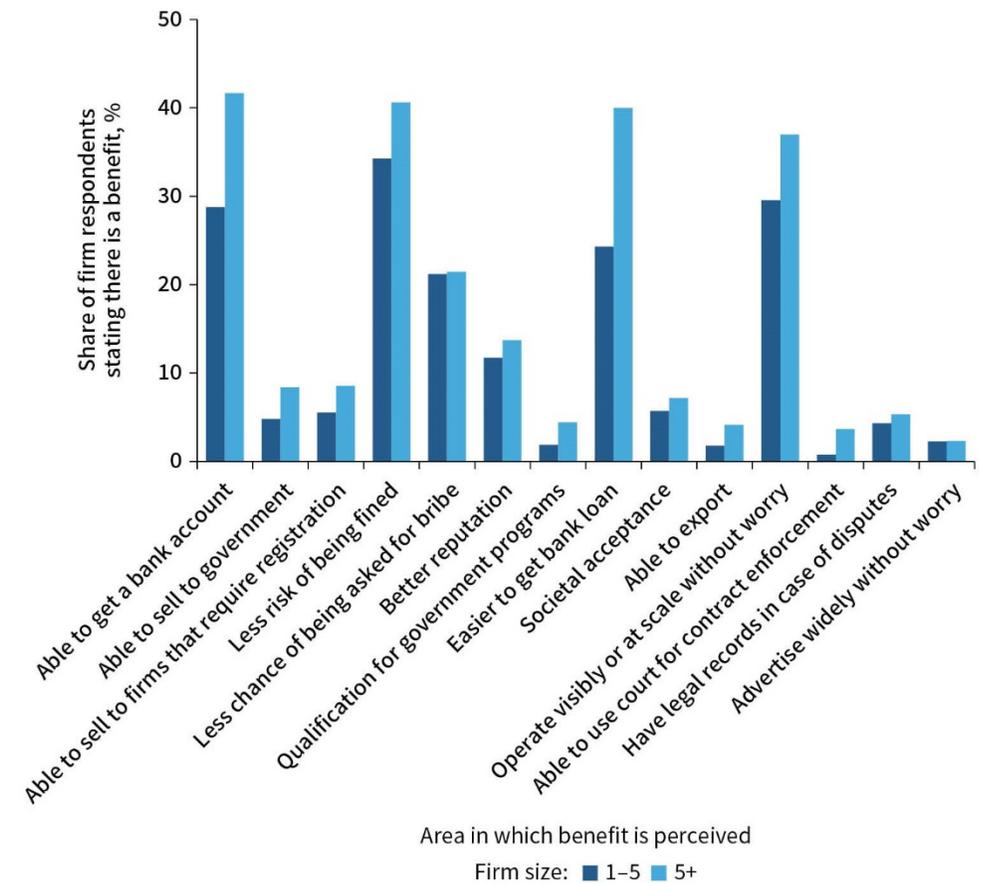


The gains from formalizing vary among informal firms

In Bangladesh, informal firms employing more than five individuals are more likely than firms with fewer than five individuals to perceive benefits from tax formalization

Esp. regarding access to credit and operating at scale without worry

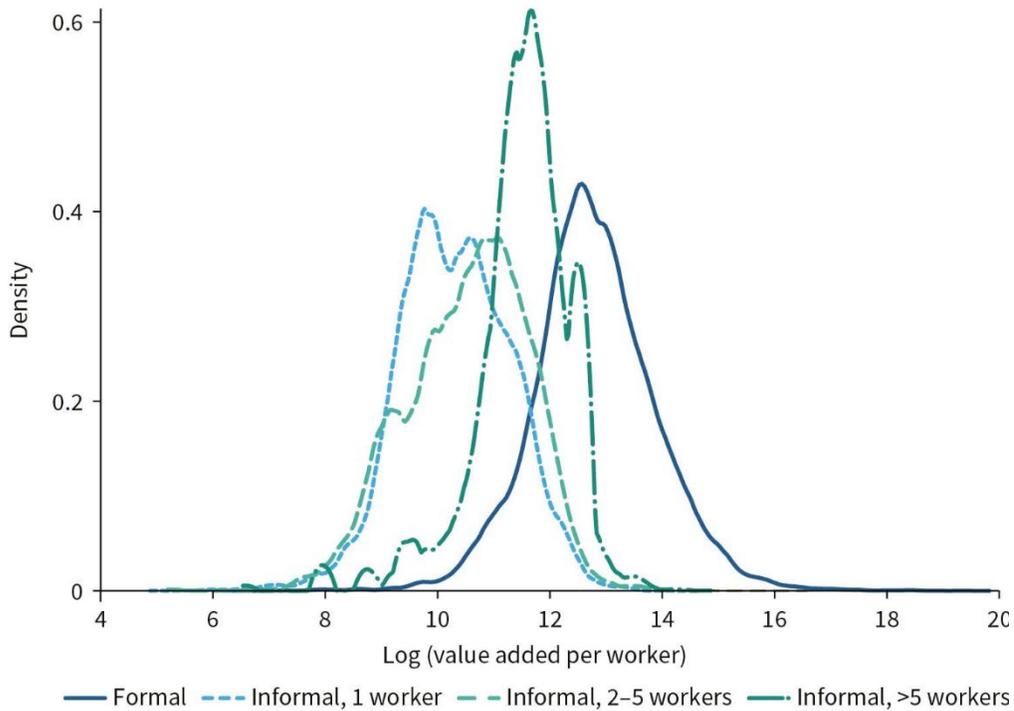
Smaller Firms Are Less Likely to Perceive Benefits from Obtaining a Tax ID



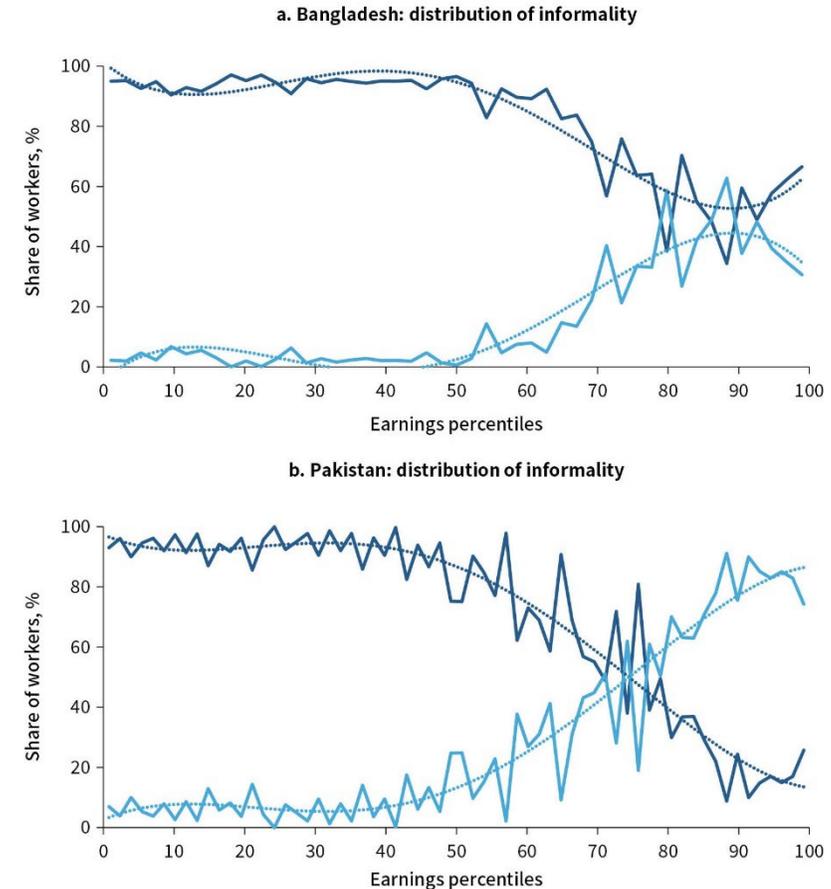


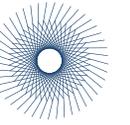
A large earnings gap between informal and formal sectors, but with overlaps

Overlaps in labor productivity



Overlaps in earnings





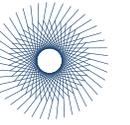
Main messages

Informality in South Asia is dominated by firms that happen to be outside the purview of regulations because they are small, as opposed to those that remain small to escape regulations.

Reforms of business regulations tend to have small direct effects on the informal sector, although they could have sizable indirect impacts on it if they succeed in removing major inefficiencies in the broader economy.

E-commerce platforms and similar technologies offer new opportunities to informal firms and workers, but many of these also need complementary skills or credit to benefit from such technologies

A combination of contributory and noncontributory programs recognizing the heterogeneous saving capacities of informal workers may be necessary to reduce vulnerability in the informal sector



Business licensing reforms have limited impacts

The simplification of business entry procedures is a popular reform for addressing informality

- For example, in 2004–11, governments and stakeholders in 54 countries introduced new technology to simplify company registration processes

The impacts on formalization (registration) rates of informal firms are modest

- When informal firms in Sri Lanka were provided information about the registration process and reimbursement of the direct costs of registration, their registration rate did not increase (RCT by de Mel, McKenzie, and Woodruff 2013).
- A large-scale reform in Mexico that reduced the number of days taken to start a business from 30 to 1 increased firm registration by only 5 percent (Bruhn 2011; Kaplan, Piedra, and Seira 2011)

Informal firms which do register in response to such programs do not experience major improvements in business performance

But there are evidence gaps: indirect impacts and hidden entry barriers not addressed



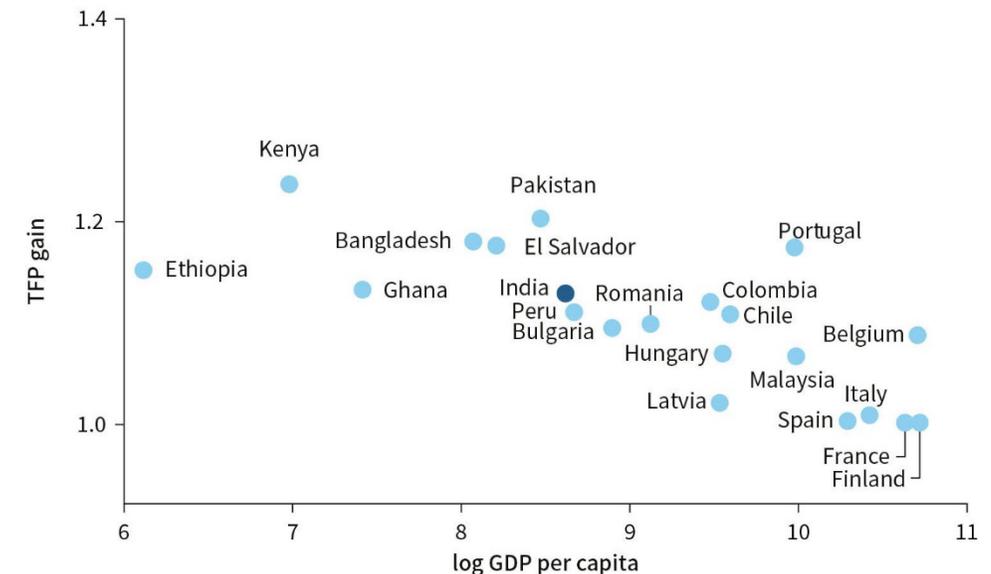
Reforms to economic distortions may have major indirect impacts on the informal sector

Fattal Jaef (2022, in this volume) quantifies *magnitude* and *impacts* of de facto entry barriers and firm-level resource distortions in Indian manufacturing with a dynamic GE model with heterogenous firms.

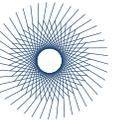
He finds:

- More than half the current size of India's informal sector can be explained in equal measure by entry barriers and distortions.
- If the benchmark economy had India's higher level of entry costs and distortions, it's share of the informal sector would go up to 54 percent, more than halfway to the actual share of 85 percent in India.
- These are long-term indirect impacts: removing distortions unlocks innovation, which eventually drives unproductive formal and informal entrepreneurs out of business.

Total productivity (TFP) gains from removing distortions



Sources: TFP gains calculated from the model's equilibrium; the logarithm of GDP per capita stems from the Penn World Table Database, version 10.0.
Note: TFP = total factor productivity.



Identifying specific drivers of distortions and implementing reforms is not easy

- Limited knowledge of what drives entry barriers and distortions
 - De facto entry costs inferred by the model in Chapter 3 are higher than those implied by explicit licensing costs
- No single reform on its own is transformative:
 - For example, Zhu (2022, in this volume) estimates that replacing sales tax by VAT can increase productivity in the formal sector by reducing the distortion caused by double taxation along the value chain.
 - But it may have a relatively small indirect impact on reducing informality.
- Political economy issues also constrain the possibilities for meaningful reform.



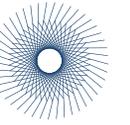
Main messages

Informality in South Asia is dominated by firms that happen to be outside the purview of regulations because they are small, as opposed to those that remain small to escape regulations.

Reforms of business regulations tend to have small direct effects on the informal sector, although they could have sizable indirect impacts on it if they succeed in removing major inefficiencies in the broader economy.

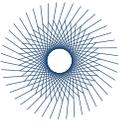
E-commerce platforms and similar technologies offer new opportunities to informal firms and workers, but many of these also need complementary skills or credit to benefit from such technologies

A combination of contributory and noncontributory programs recognizing the heterogeneous saving capacities of informal workers may be necessary to reduce vulnerability in the informal sector



Digital platforms offer a new pathway for informal firms

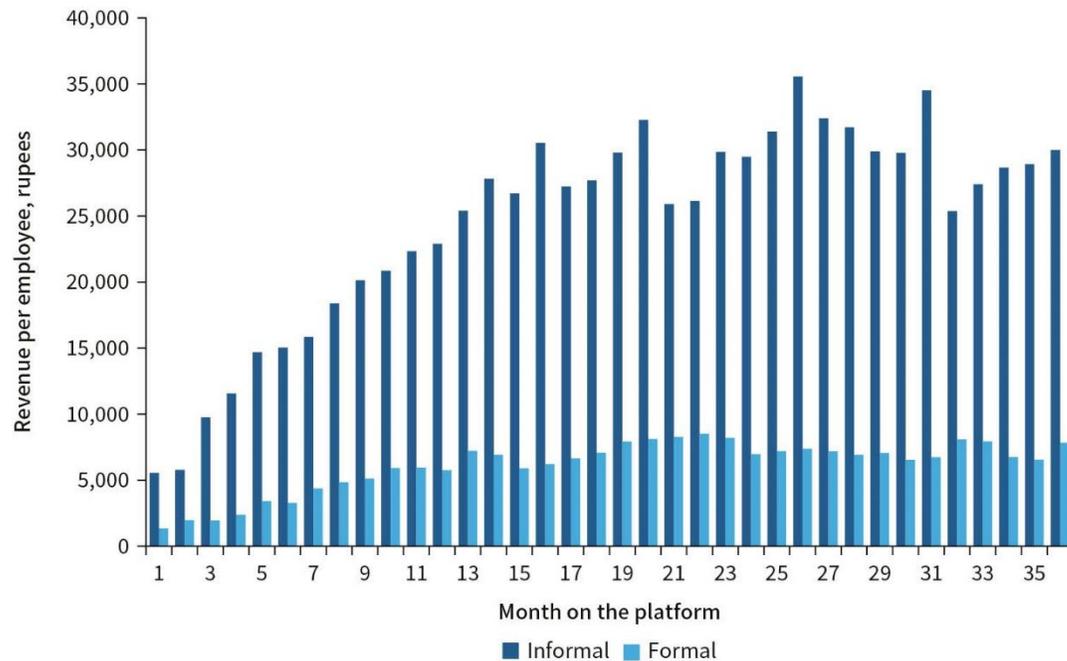
- Outsider-type informal firms may find it difficult to meet the upfront costs of marketing, warehousing and transportation (de facto barriers)
- Two effects linked to joining an e-commerce platform:
 1. Reduction of de facto barriers (increased market access):
 - Platforms provide infrastructure at low cost and reduce transaction costs related to market search, transportation, tracking, and verification.
 - They also improve access to information on new technologies and business practices; generate data to enable firms to track their revenues, costs, and other performance indicators; build credit worthiness.
 2. Increase of incentives to formalize.
- Digital platforms are growing in other predominantly informal sectors such as ride hailing and domestic work.



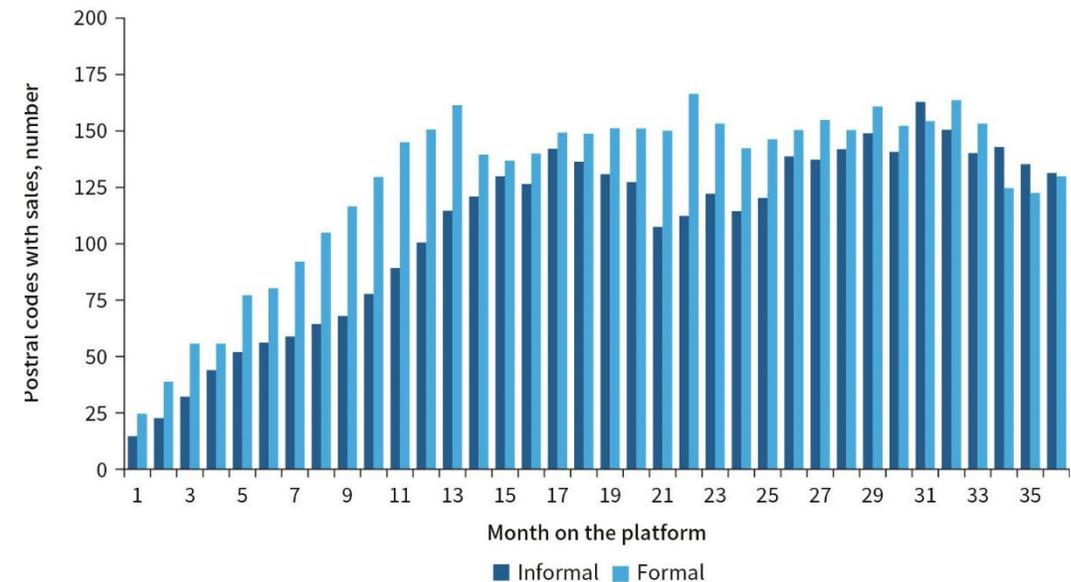
Digital platforms are helping connect informal firms to markets

Kanz (2022, in this volume) finds that formal and informal firms experience *similar* growth in sales and geographic market penetration after joining an e-commerce platform

Monthly revenue



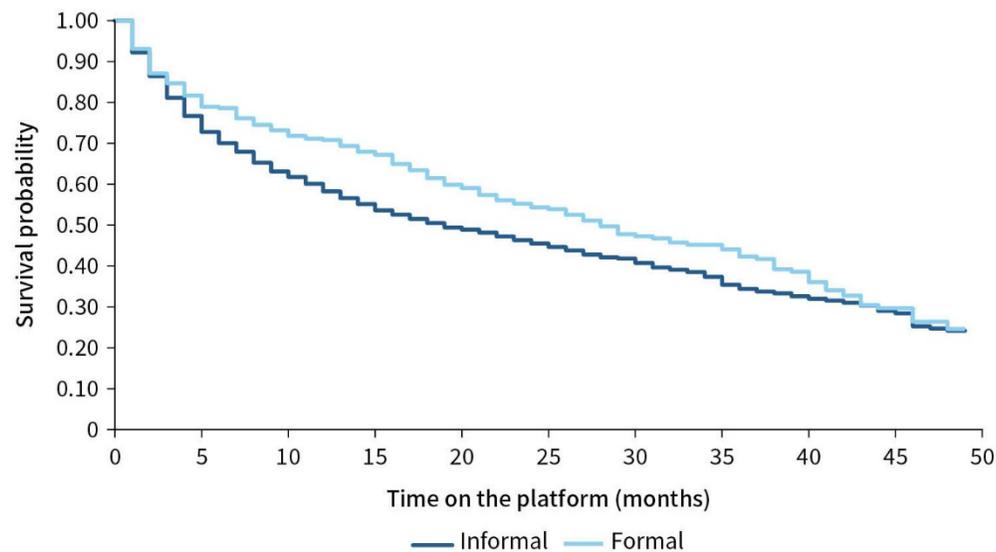
of zip codes with sales





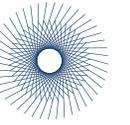
Digital platforms are not for all informal firms

Low survival rates on platform



Informal firms on the platform are a *selected* group of informal firms

Indicator	Partner firm survey data			Consumer Pyramids Household Survey		
	0-1 employee	2-5 employees	6-15 employees	0-1 employee	2-5 employees	6-15 employees
Woman	0.20	0.19	0.22	0.04	0.02	0.02
Age	30.83	32.43	32.26	43.90	45.63	44.68
Elementary school or less	0.03	0.02	0.04	0.17	0.06	0.06
Secondary	0.08	0.05	0.04	0.43	0.32	0.25
Senior secondary	0.19	0.13	0.11	0.23	0.35	0.24
University or more	0.70	0.80	0.80	0.15	0.26	0.44
Observations	555	945	428	21,789	3,203	234



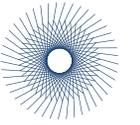
Main messages

Informality in South Asia is dominated by firms that happen to be outside the purview of regulations because they are small, as opposed to those that remain small to escape regulations.

Reforms of business regulations tend to have small direct effects on the informal sector, although they could have sizable indirect impacts on it if they succeed in removing major inefficiencies in the broader economy.

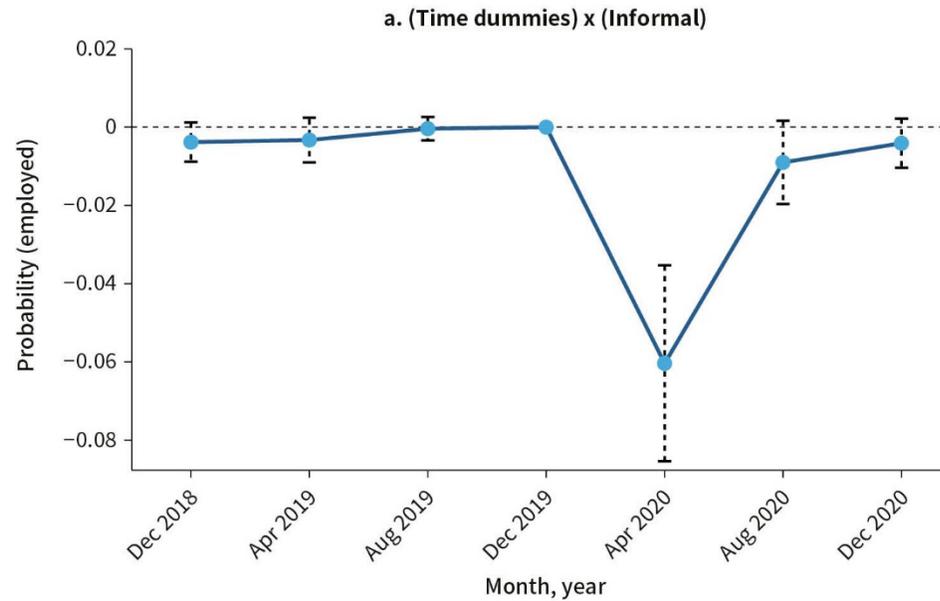
E-commerce platforms and similar technologies offer new opportunities to informal firms and workers, but many of these also need complementary skills or credit to benefit from such technologies

A combination of contributory and noncontributory programs recognizing the heterogeneous saving capacities of informal workers may be necessary to reduce vulnerability in the informal sector

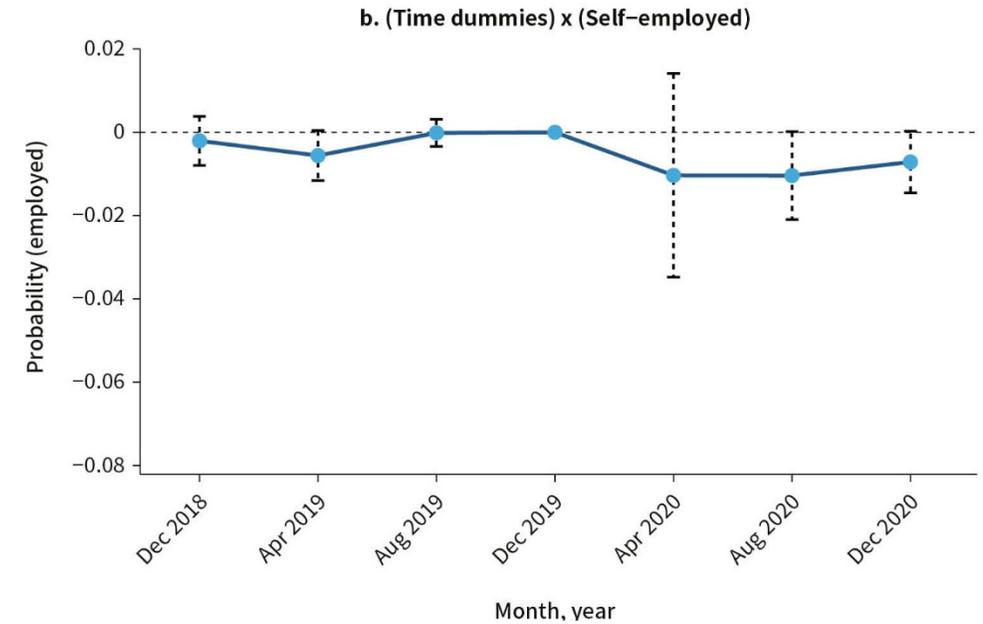


Informal sector workers are disproportionately vulnerable to shocks

Informal workers probability to lose a job was 6 percent higher relative to formal workers in the same location (district) and industry



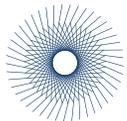
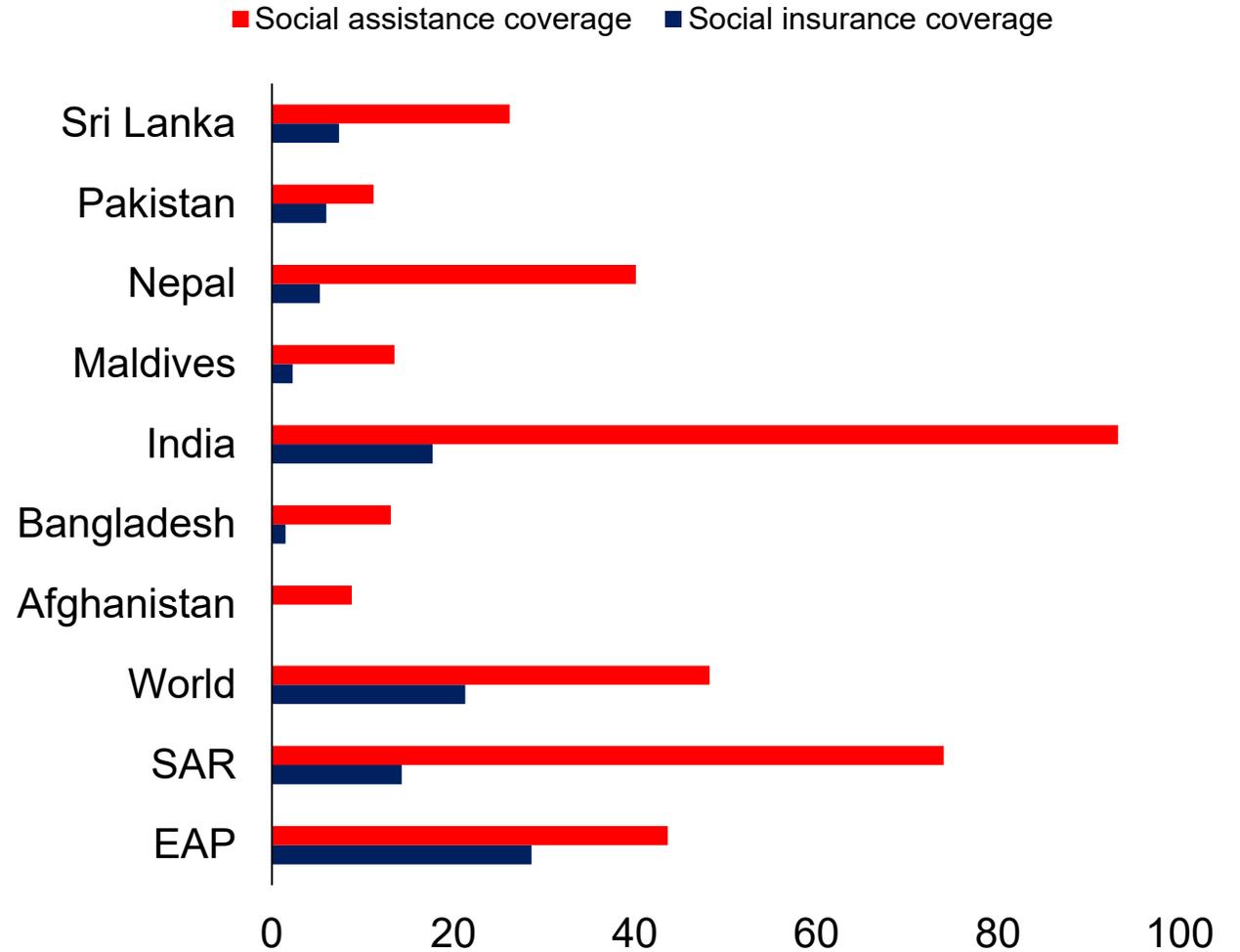
Self-employed individuals were also more vulnerable than formal workers, but to a lesser extent



Lack of safety net

Individuals working in South Asia's informal sector typically lack access to social insurance programs that help cover risks such as job loss, illness or injury, and old age.

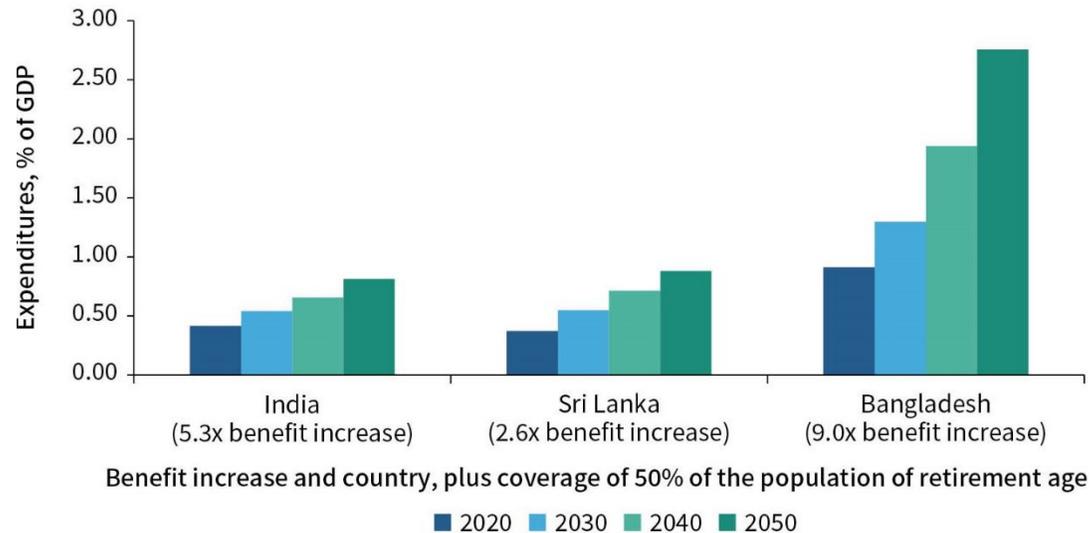
The heterogeneity of income and savings capacity among informal sector workers calls for a multifaceted approach to extending social insurance to these workers.





A multipronged approach to expanding social protection programs is required

Projected Expenditures from Higher Benefit and Wider Coverage of Noncontributory Schemes



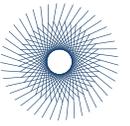
Note: numbers on India underestimate the real level of current benefits and expenditures because only the Indira Gandhi National Old Age Pension Scheme (IGNOAPS) is considered, not the additional programs in the states and territories

Countries could consider an expansion of existing noncontributory pensions targeted at the very poor in terms of both greater coverage and higher benefit levels.

DeMarco et al. (2022, in this volume) look at scenarios in the case of pensions.

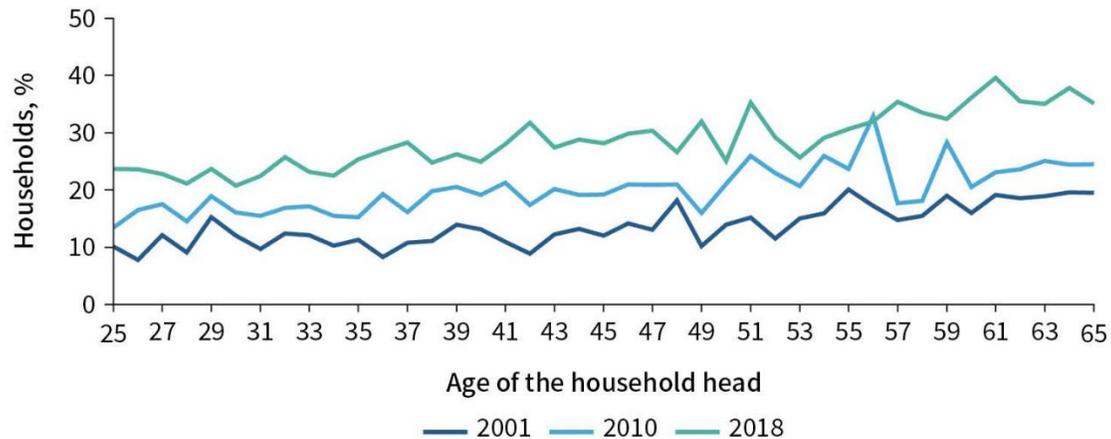
Need to determine what is affordable and set benefit levels and age and other eligibility requirements accordingly

This will not be enough, and a multipronged approach is required



Innovative contributory schemes could help expand coverage to those with savings capacity

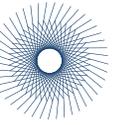
Share of households with accumulated net worth equivalent to at least 5 year of consumption needs, by year and age of HH head (Pakistan)



In 2001, 20 percent of Pakistani households had accumulated net worth equivalent to at least 5 years of consumption needs by age 65. By 2018, this went up to 35 percent.

But much of this was locked up in real estate.

Suitably designed programs could help those in the informal sector who have capacity to save for retirement but lack access to suitable financial instruments, knowledge or other incentives to save.



A summary

After almost three decades of sustained growth, informality is still pervasive in South Asia.

Ignoring its complex causes and consequences means ignoring a central development issue in South Asia and other developing countries.

A clear message from the collective effort behind *Hidden Potential* is that there is a need of a policy shift *from* a focus on reducing informality because it is a hinderance for the rest of the economy *toward* “the removal of the underlying constraints” in order “to improve the lives of informal workers and the growth opportunities for informal firms”. There is indeed a hidden potential

Efforts to support firms and workers need to consider the heterogeneity of informality by sectors of the economy, income and wealth quintiles, skills, ability to save, and more.

Recognizing the heterogeneity of the informal sector and adapting policy interventions to different cases is important when the objective is inclusive growth but also when the aim is building resilience.