

BOX 2.5.1 Informality in South Asia

South Asia's share of informal employment is the largest among EMDE regions, despite a below-average share of informal output. Heavy tax burdens, above-average corruption, and low government effectiveness have contributed to high employment informality. Informal employment is concentrated among low-skilled, young, female and rural workers. The sizable informal sector is associated with lower productivity, lower government revenues, and higher poverty in the region. Policy options to address these challenges include investing in human capital in the form of training programs and improving access to finance.

Introduction

South Asia (SAR) is the EMDE region with the highest average share of informal employment among EMDE regions, despite a below-median and declining share of informal output. Nonetheless, there is significant heterogeneity in the share of employment as well as output informality among South Asian countries.

Against this backdrop, this Box examines the following questions:

- How has informality evolved in South Asia?
- What have been the macroeconomic and social correlates of informality?
- What policy options are available to address challenges associated with informality?

Evolution of informality

Informality in SAR. In aggregate, output informality in the SAR region is below the average of other EMDE regions—the size of informal sector relative to official GDP was on average 30 percent in South Asia compared with 35 percent in average EMDE during 2008-2016 (Figure 2.5.1.1). During the same period, 96 percent of workers lacked pension coverage and 63 percent were self-employed.

Evolution of informality in SAR. Output informality declined from 37 percent in 1990s to 32 percent in the 2010s, broadly in line with the decline in informality in other EMDEs. However, labor informality over the same period persisted or rose depending on the measure of informality. For example, the share of the labor force without pension coverage rose from 88 percent to 96 and self-employment remained around 63 percent.

Regional heterogeneity. The extent of informality varies substantially across countries in South Asia. Sri Lanka had

the highest degree of informality (output in the informal sector is about 40 percent of total output) in 2016 and India had the lowest share (below 20 percent). However, this ranking is reversed using labor market indicators of informality: Sri Lanka has the lowest share of self-employment (42 percent) and India the highest (76 percent) as of 2016. These differences are reflected in lower labor productivity in the informal sector (relative to the formal sector) in India than in Sri Lanka.

Correlates of informality

Business climates. Costs to doing business—such as tax burdens, labor regulation, and cost of starting business—are among the main drivers of informality identified in the empirical literature (FICCI 2017; Goldar and Aggarwal 2012). Over the past decade, SAR has suffered from greater corruption and weaker government effectiveness than other EMDE regions (Figure 2.5.1.2). Tax burdens and indicators of ease of doing business have also been less favorable than in the average EMDE (World Bank 2017c). Among costs to doing business, heavy tax burdens were particularly strongly associated in India and Pakistan with a larger fraction of firms operating unregistered (Ghani, Kerr, O'Connell 2013; Waseem 2013).

Worker characteristics. South Asia's informal labor force consists predominantly of low-skilled, female, rural, and young workers (Bahadur and Parajuli 2014; Goldar and Agarwal 2012; Gunatikala 2008; Williams, Shahid, and Martinez 2015). The intensity of informal employment in South Asia reflects a lack of formal jobs and skills, as well as a preference towards self-employment (Arby, Malik, and Hanif 2010; Williams, Shahid, and Martinez 2015). This means that informal firms are usually small, agricultural, and consist mostly of self-employed workers (FICCI 2017).

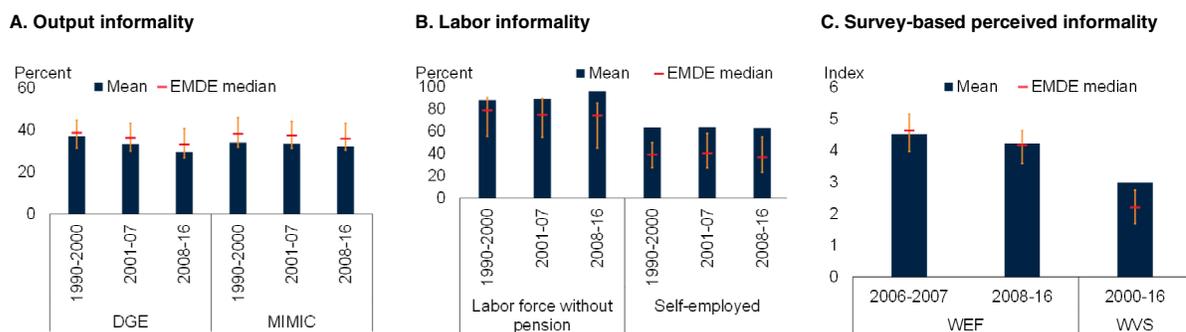
Lower productivity and incomes. In South Asia, informal workers have had lower earnings, fewer skills, and less access to social protection systems; this has been reflected in lower productivity and higher poverty (Kanbur 2017; Likhi 2013). Informal employment among underrepresented groups in labor markets, such as women and the young, has grown over the past decade and

Note: This box was prepared by Temel Taskin. Research assistance was provided by Brent Harrison and Jinxin Wu.

BOX 2.5.1 Informality in South Asia (continued)

FIGURE 2.5.1.1 Informality in South Asia

South Asia's share of informal employment is the largest among EMDE regions, despite a below-average share of informal output.



Source: Elgin et al. (forthcoming); World Bank.

A. DGE = dynamic general equilibrium model. MIMIC = multiple indicators multiple causes model. Both DGE and MIMIC estimates measure the informal output in percent of official GDP.

B. Labor force without pension is the fraction of the labor force that doesn't contribute to a retirement pension scheme, which is derived from the original data on pension coverage obtained from WDI. Self-employed is the share of self-employment in total employment.

C. WEF = World Economic Forum. WVS = World Values Survey. WEF index is the average responses at the country-year level to the following question (surveyed by World Economic Forum): "In your country, how much economic activity do you estimate to be undeclared or unregistered? (1=Most economic activity is undeclared or unregistered; 7= Most economic activity is declared or registered)." WEF indices are re-ordered (i.e. 1= Most economic activity is declared or registered; 7= Most economic activity is undeclared or unregistered) so that a higher average at the country level indicates a larger informal economy. The index does not use data for year 2004-2005 due to inconsistency in survey methods. The World Value Survey asks whether respondents can justify cheating on taxes, with responses ranging from 1 (never justifiable) to 10 (always justifiable). The average responses at the country-year level are used as a measure for attitudes towards informality (or tax morality, Oveido et al. 2009), labeled as WVS. A higher average at the country level implies that people find cheating on taxes more justifiable.

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constrained these groups' income security. Low earnings and limited options available to informal workers constrain their benefit from economic growth, which means that growth has been less inclusive than otherwise (ADB 2016; Heintz 2012). Conversely, in India, an easing of labor market restrictions and measures to foster gender equality—such as increasing female education and strengthening law enforcement against gender discrimination—have been associated with stronger growth as well as larger formal employment (Goldar and Aggarwal 2012; Khera 2016).

Lower government revenues. Large informal sectors—in addition to other factors such as inefficient tax administration and narrow tax base—weigh on tax revenues in South Asian economies (Cevik 2016; Ilzetzi and Lagakos 2017). On average, tax revenues as a percent in GDP have historically been below the EMDE average. The lack of tax revenues ultimately affects the ability of governments to fund its infrastructure investment, social programs, etc., and therefore limiting their ability to tackle poverty and inequality (Chapter 3).

Policy challenges

In South Asia, informal employment is concentrated among young, low-skilled, female, and rural workers. Policies targeting training and education of these groups, especially in rural areas, could help their transition to formal employment (Khera 2016).

There is significant room to improve the ease of doing business in South Asia. This could reduce informality by reducing the cost of entry and cost of operating in formal sector. Measures to reduce the time, cost, and complexity of registration would also improve the business climate and foster growth (FICCI 2017).

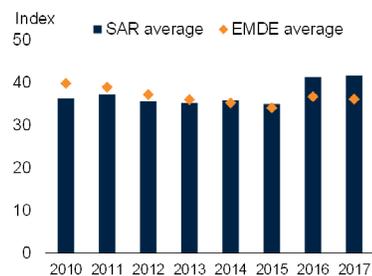
High quality public services can also provide an incentive for informal firms to become formal in order to access these services. Enhanced monitoring and enforcement, including of tax regulations, could help discourage informality (Ilzetzi and Lagakos 2017). Also, in India the recent introduction of a Goods and Services Tax and steps toward demonetization are expected to encourage a shift from the informal to the formal sector.

BOX 2.5.1 Informality in South Asia (continued)

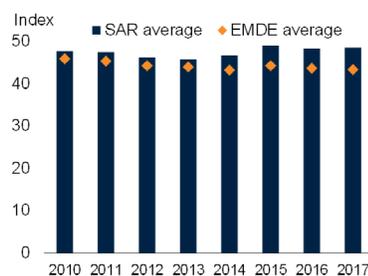
FIGURE 2.5.1.2 Drivers of informality in South Asia

Heavy tax burdens, above-average corruption, and low government effectiveness likely have contributed to high employment informality. The sizable informal sector is associated with weaker government revenues and higher poverty in the region. Youth unemployment is much higher among women who represent a higher share of informal workers than men.

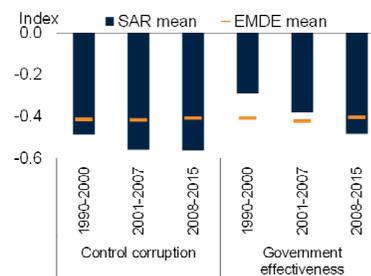
A. Doing business tax burden indicator: DTF



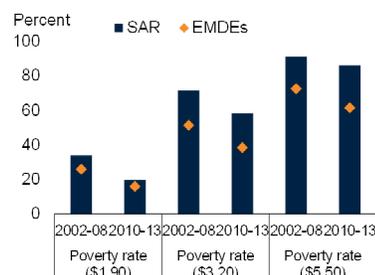
B. Doing business overall indicator



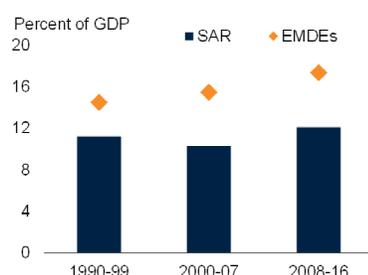
C. Government effectiveness and control of corruption



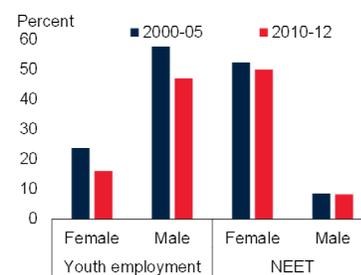
D. Poverty



E. Government revenues



F. Youth employment and NEET



Source: World Bank, World Development Indicators.

A.B. Index denotes Distance to Frontier Score (100-regional score), where 100 equals international best practices. Greater distance indicates further below best practice score.

D.E. Episodes are determined based on data availability.

F. NEET stands for the share of youth Not in Employment, Education, or Training. Youth is defined as the population between ages of 15 and 24.

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South Asia's self-employed, which account for about 80 percent of informally employed, have limited access to financial resources that could finance growth- or productivity-enhancing investment (Ghani, Kerr, and O'Connell 2013). Greater access to credit for the self-

employed and household enterprises could help them grow into formality (Beck and Hoseini 2014). Microfinance can be an effective instrument for providing financial access to informal firms, as many of them are self-employed enterprises (ILO 2013; Likhi 2013).