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WORLD BANK GROUP

Hidden Potential

Rethinking Informality in South Asia

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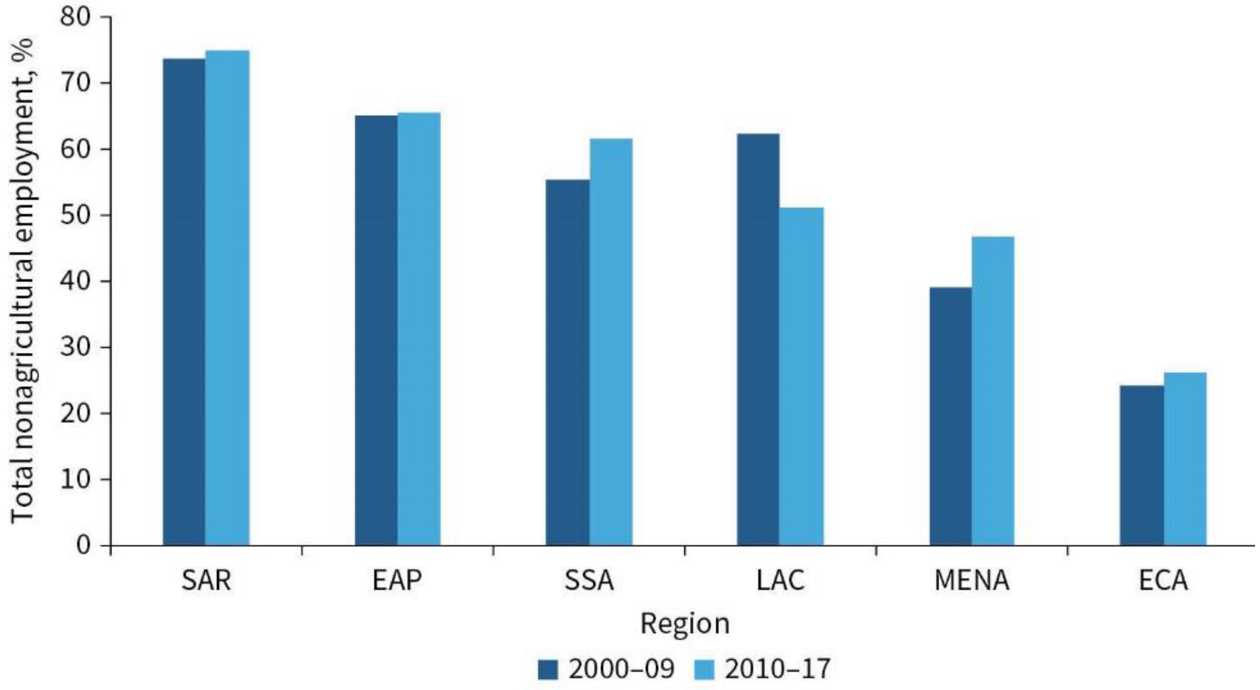
Persistent informality is a major development issue in South Asia

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.

Exclusion

- Informal firms and workers are discriminated against in a dualistic economy.
- Entry barriers, rules and regulations benefit a few privileged insiders.

A rethinking of these views may be helpful because the informal sector is heterogenous and technologies such as digital platforms potentially offer new opportunities.

New contributions help rethink these questions

Broad themes (chapters of Hidden Potential)	*Contributing researchers*
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, Zaineb 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

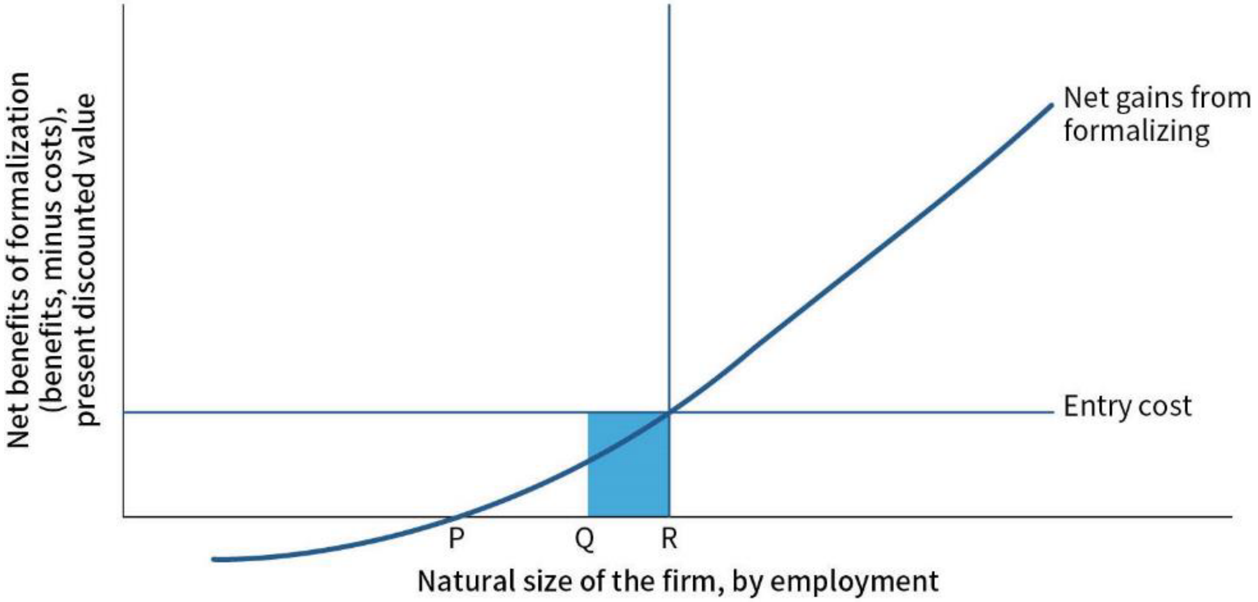
Introduce a regulation in this economy

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.



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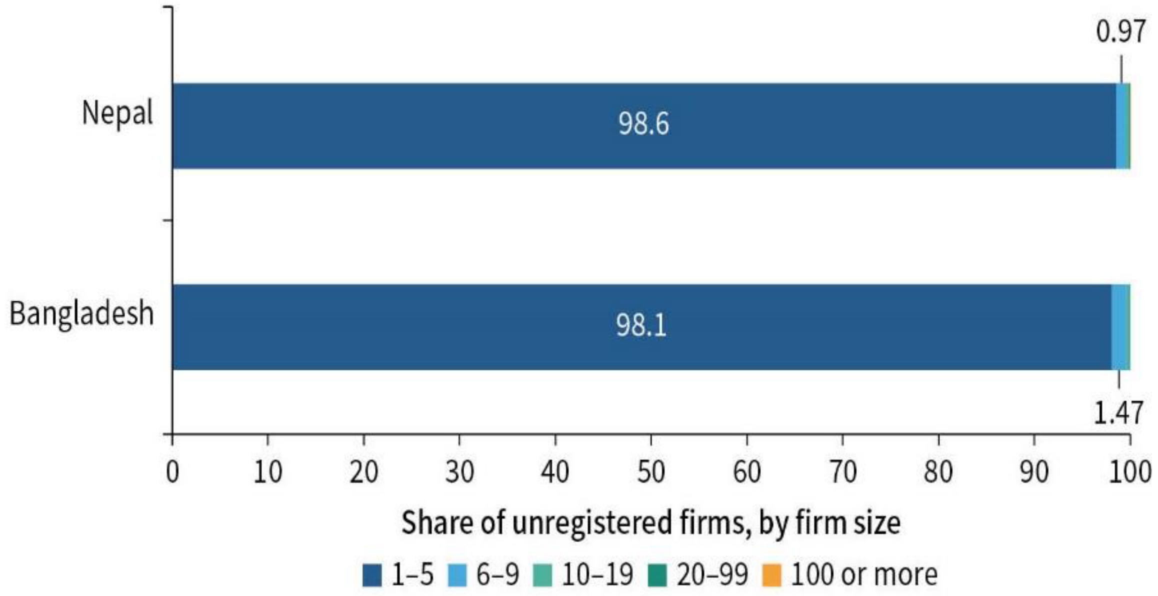
Most firms in South Asia's informal sector are "outsiders"

- 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



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Business licensing reforms have limited impacts

- The simplification of business entry procedures is a popular reform for addressing informality
- But studies generally find that the impacts on formalization (registration) rates of informal firms are modest
- Registration itself does not improve small business performance.
- Credit and business training interventions are more impactful.

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.

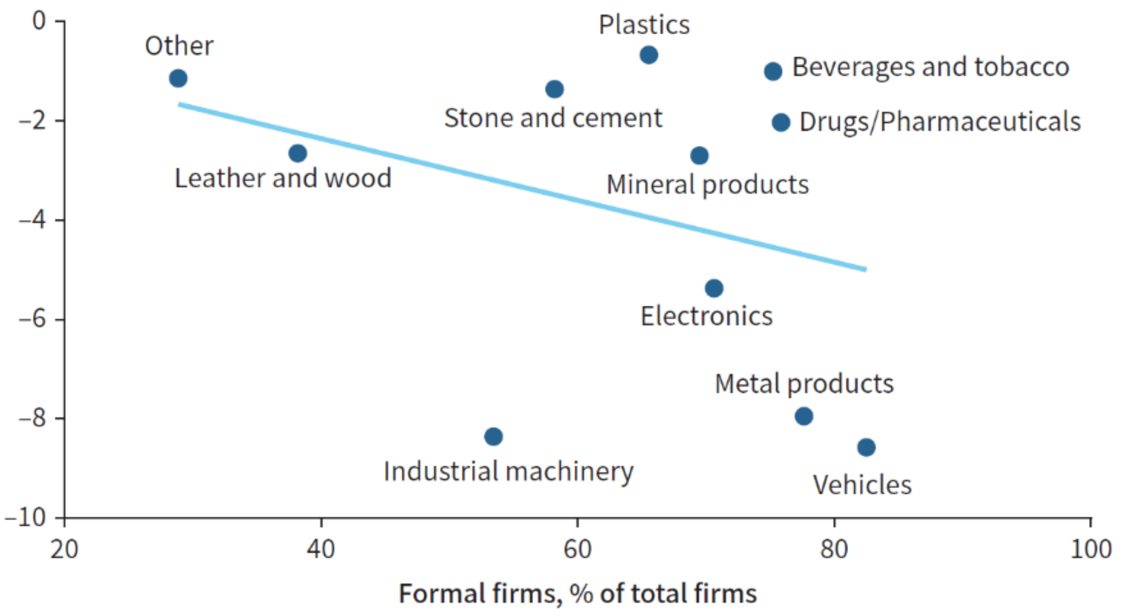
Findings:

- Sizable aggregate productivity gains from removing distortions
- 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, its share of the informal sector would go up to 54 percent, more than halfway to the actual share of 85 percent in India.
- Removing distortions unlocks innovation, which eventually drives unproductive formal and informal entrepreneurs out of business.

The relationship between informality and the impact of changes in tax design may be limited

- Widespread hypothesis that the sales of formal firms are more tax-elastic in sectors with more intensive competition from the informal sector, constraining potential tax revenues.
- Bachas et al. (2022, in this volume) look at the links between informality and tax elasticity of reported sales by exploiting product-specific changes in VAT rates in India.
- Zhou (2022, in this volume) finds that replacing sales tax by VAT increased productivity in the formal but had little impact on the informal sector.

Sectors with greater informality exhibit more moderate tax elasticities



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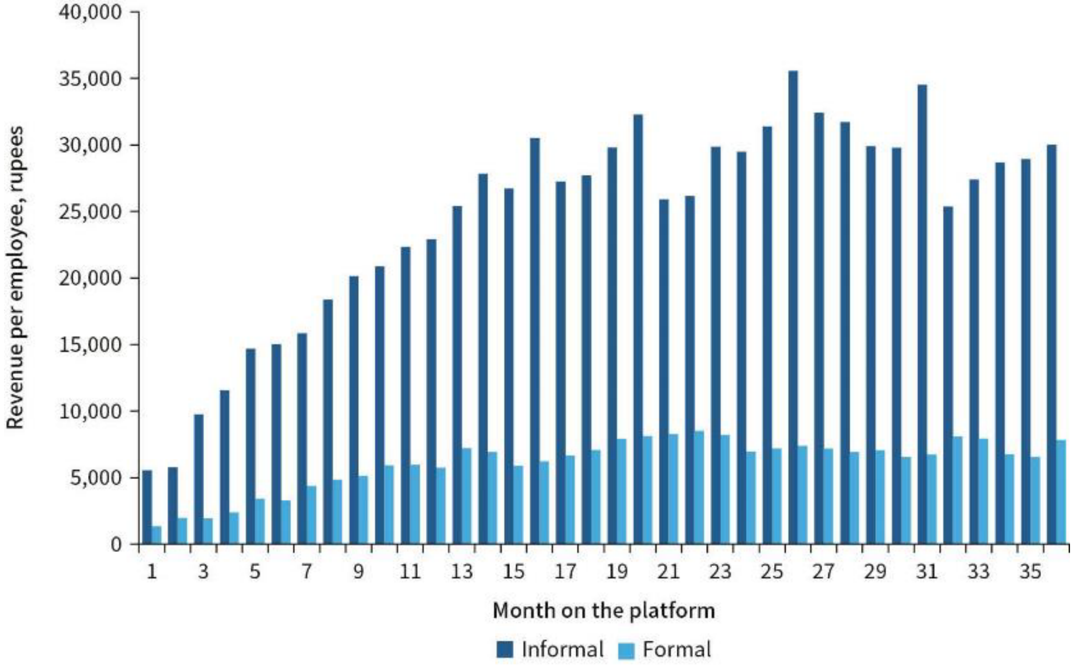
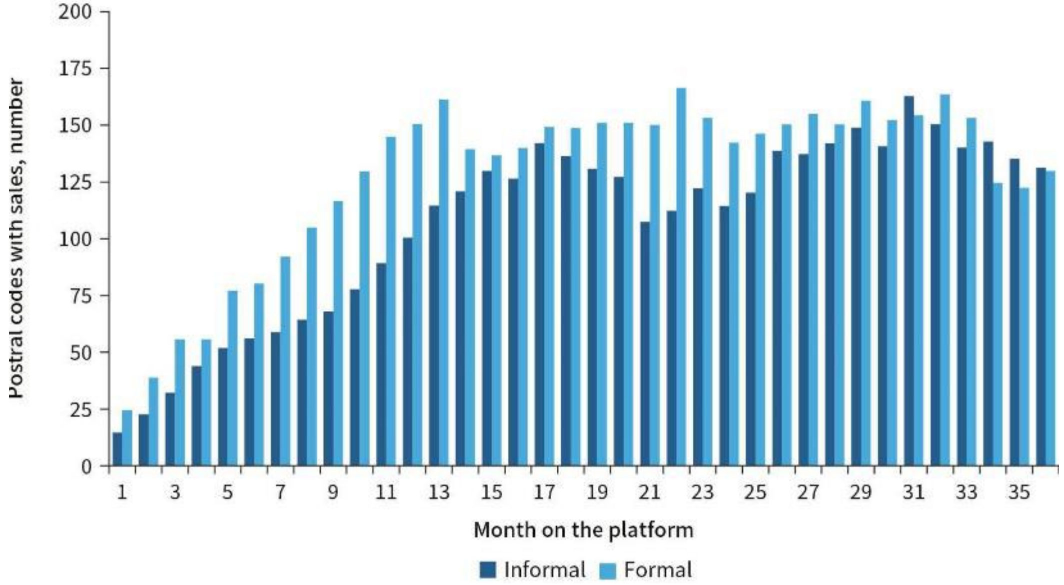
Digital platforms are helping connect informal firms to markets

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

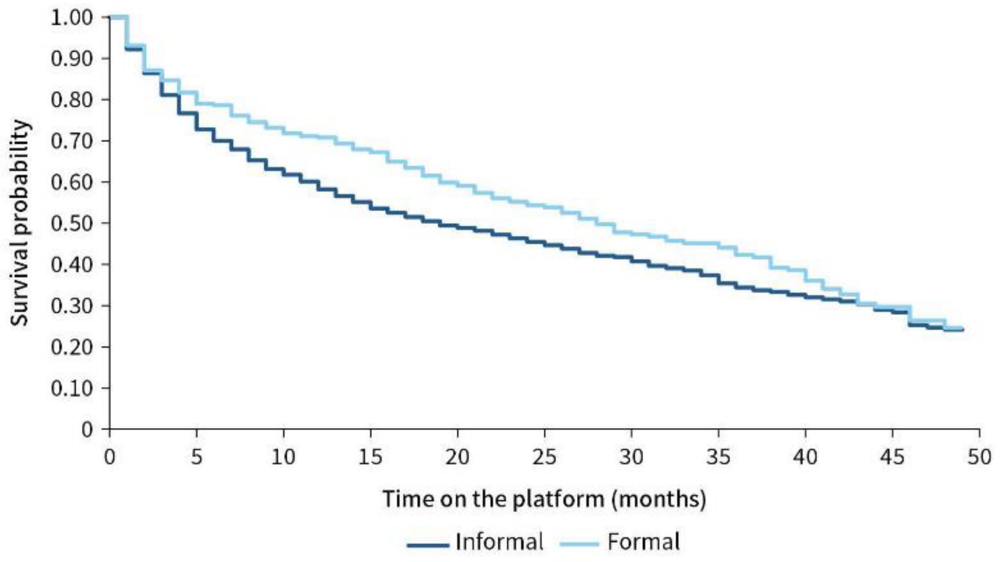


# of zip codes with sales



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

	Partner firm survey data			Consumer Pyramids Household Survey		
Indicator	**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

A summary

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

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 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”.

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.