



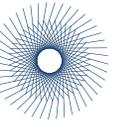
SARCE

*The Office of the Chief Economist
in the South Asia Region*

Informality in South Asia: Overview of emerging messages

MAURIZIO BUSSOLO & SIDDHARTH SHARMA

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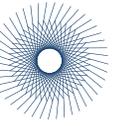
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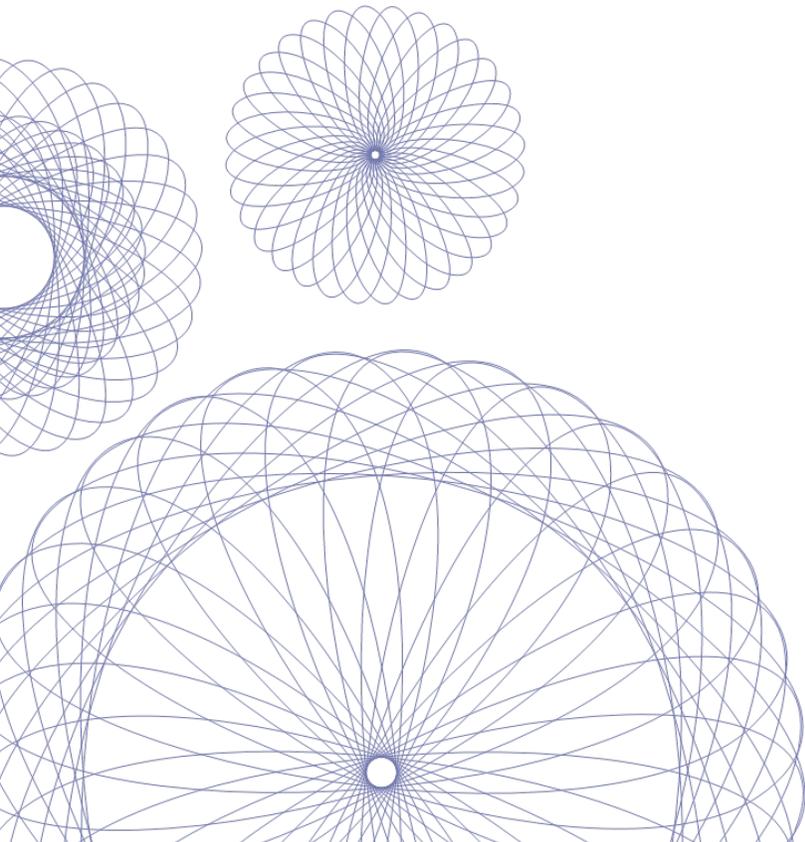
INTRODUCTION

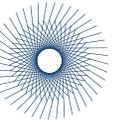


Informality a key development issue in South Asia

Three interconnected challenges when dealing with informality.

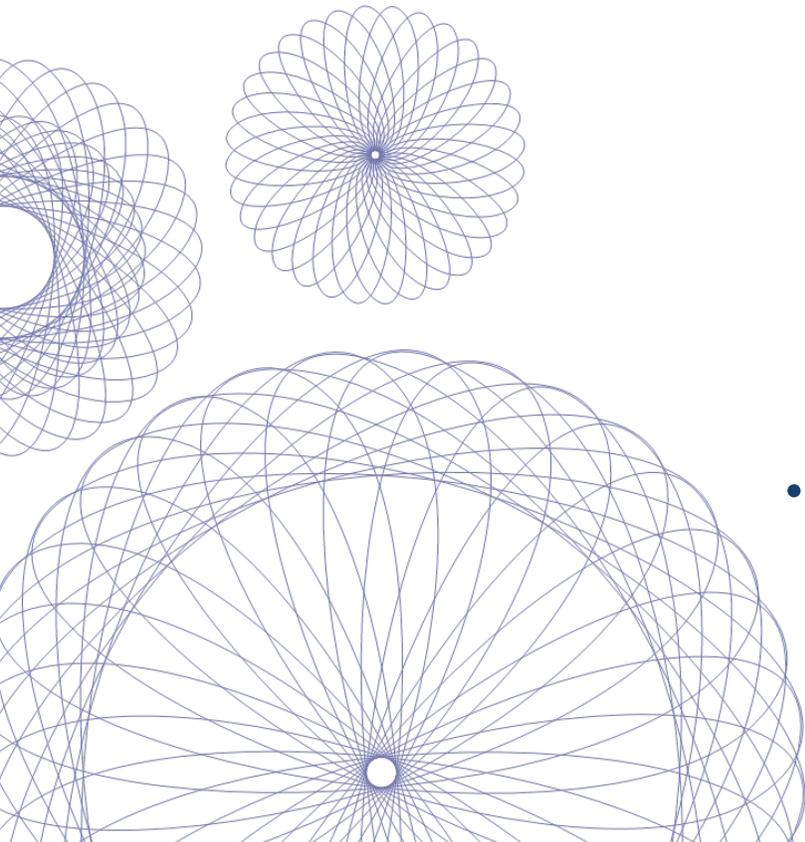
- Challenge 1: stymied growth. Entry barriers and distortions bring about misallocation of resources (informal firms are starved of capital and innovation in formal firms is limited);
- Challenge 2: balancing the flexibility of informal labor markets against the vulnerability of informal workers. [Low earnings trap]
- Challenge 3: taxation and public services. Limited investment in fiscal capacity is a key to low tax revenues nor the presence of a large informal sector. The extractive versus the productive role of the government.

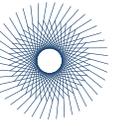




Our research program's approach

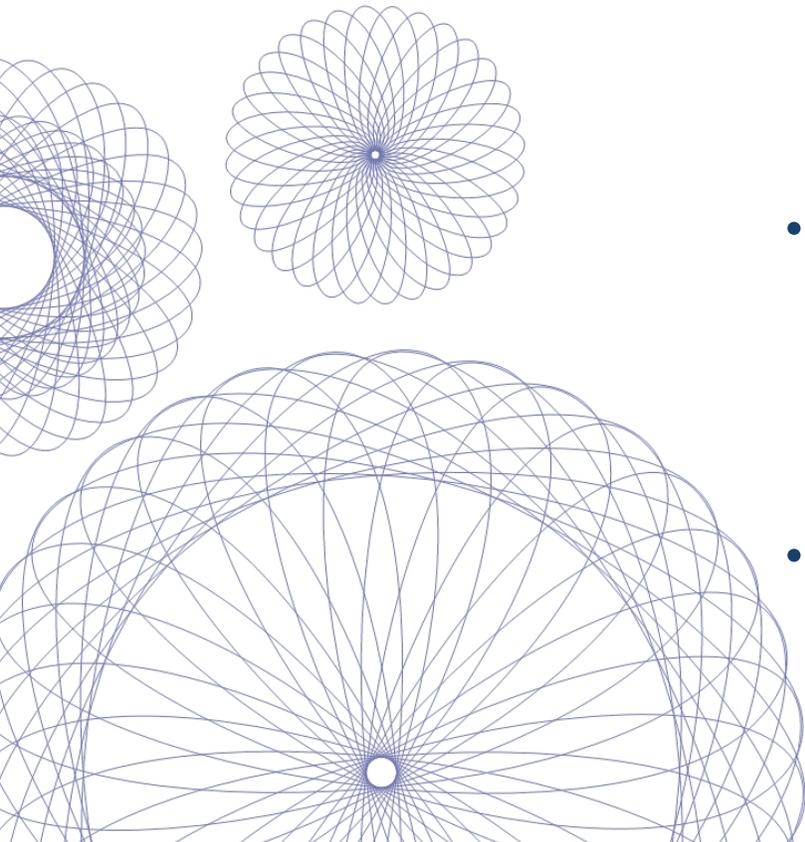
- It covers all the three challenges: firms, labor, and taxation.
- Informality as a symptom (rather than a constraint)
 - “Informality is an endogenous outcome, the result of firms’ and workers’ optimal behavior given their characteristics (e.g., ability) and the environment they face, which includes: institutions, in particular laws and regulations; government policies, such as [tax] enforcement and welfare programs; and the economic cycle.” Ulyssea (2020)
- It considers the interaction of digital technology and informality
 - (some) small informal firms seen more as start-ups than as enterprises choosing to dodge the grabbing hand.





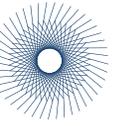
Some emerging messages

- Overall: formalization is not a policy objective in itself.
- Productivity:
 - Informality is a byproduct of size-dependent distortions, reduction of entry barriers can be helpful but not enough.
 - Digital technologies shift the cost-benefit balance, but not for all; and access and competition issues remain relevant.
- Social protection and labor
 - Social insurance is embryonic (issues of design, financing, incentives)
 - How to boost earnings of poor informal workers: non-cognitive skills, (maybe); economic inclusion.
- Taxation
 - VAT reforms have been helpful (mainly indirectly);
 - Increase the benefits from being in the tax system.



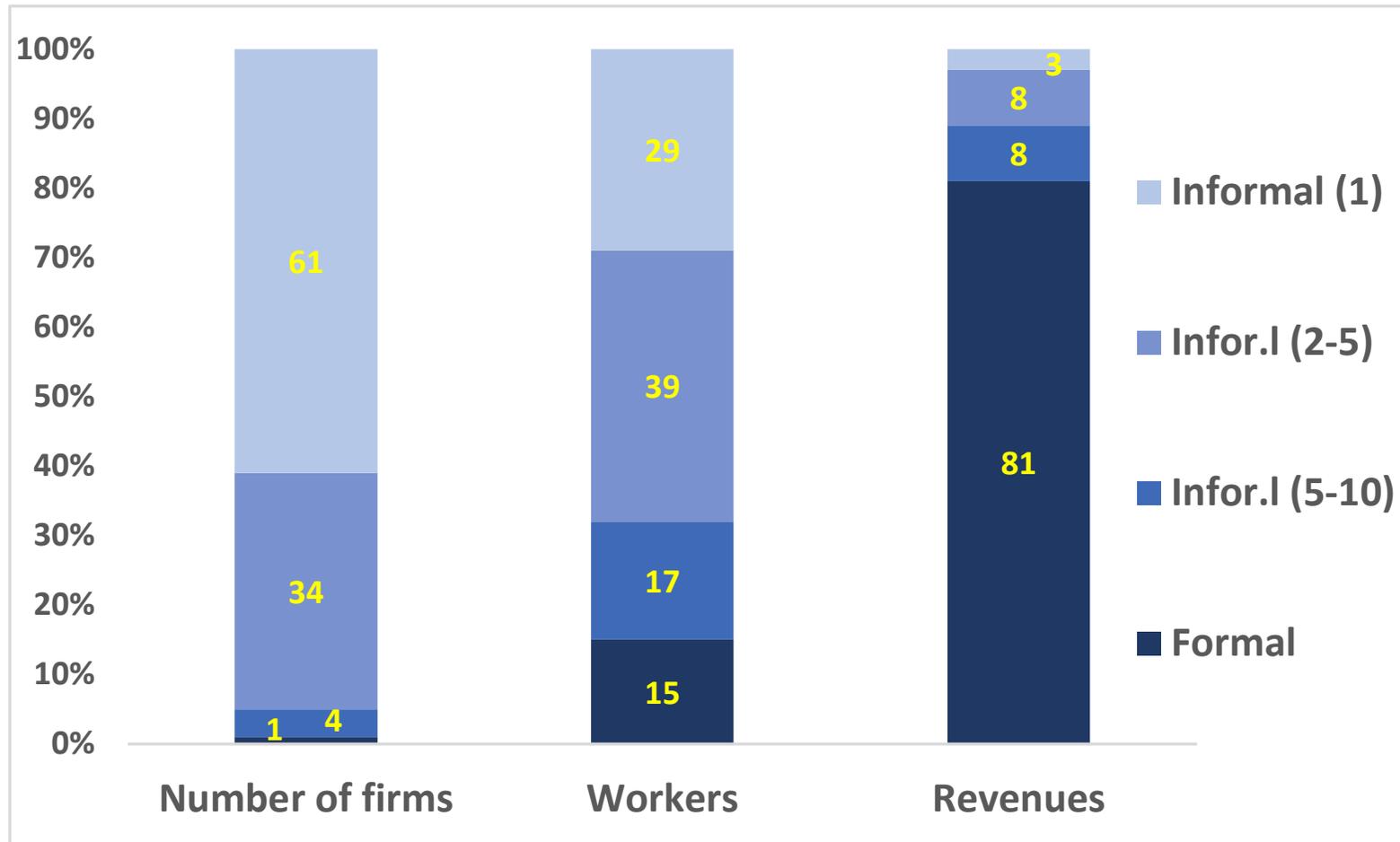


STYLIZED - FACTS
FRAMEWORK

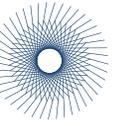


Stylized fact #1

Most South Asian firms are tiny, and have low labor productivity

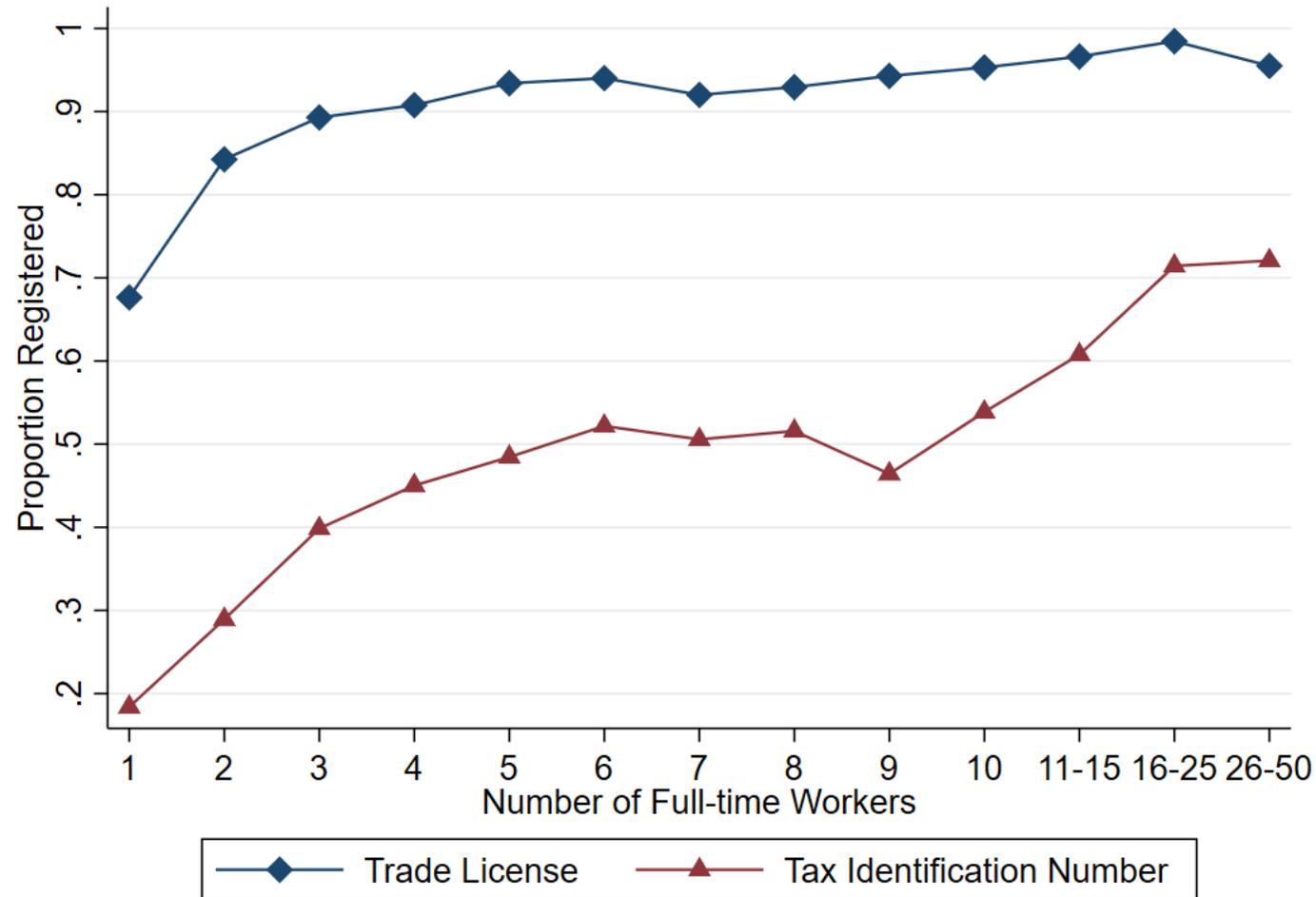


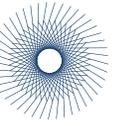
Source: India ASI and NSS surveys combined



Stylized fact #2

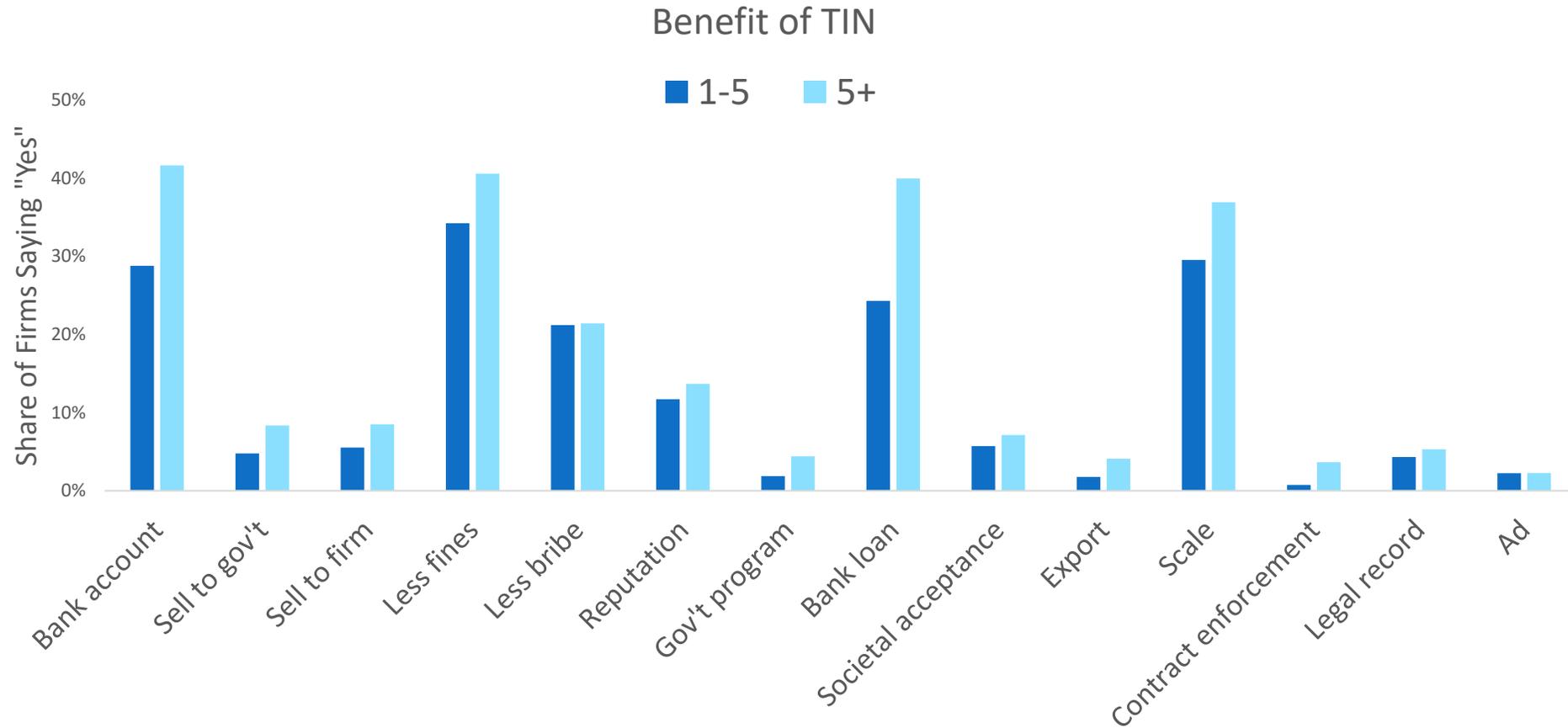
The degree of 'formality' increases with firm size

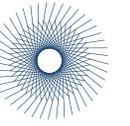




Stylized fact #3

Larger firms more likely to perceive benefits of formalization





Stylized fact #4

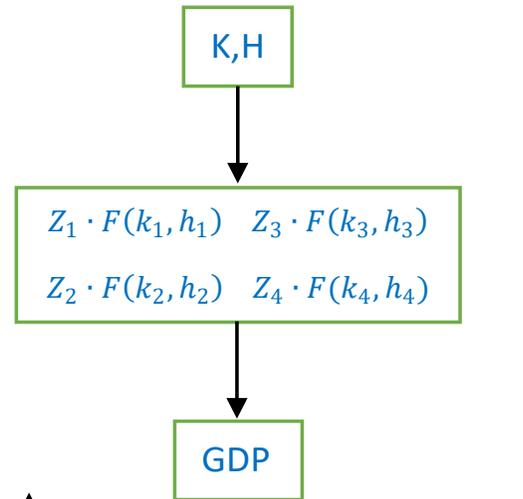
The intensive margin of informality (formal firms employing informal workers) is significant in South Asia

Bangladesh, 2015-16

<i>workers</i>	informal	formal	All
in formal firms	16	10	26
in informal firms	52	1	52
in households	22	0	22
all	89	11	100



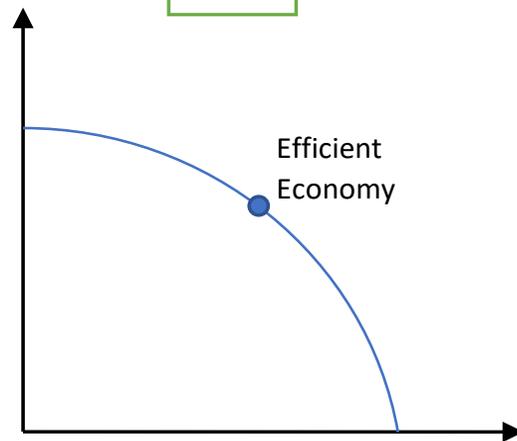
GDP depends on how well markets allocate resources across firms



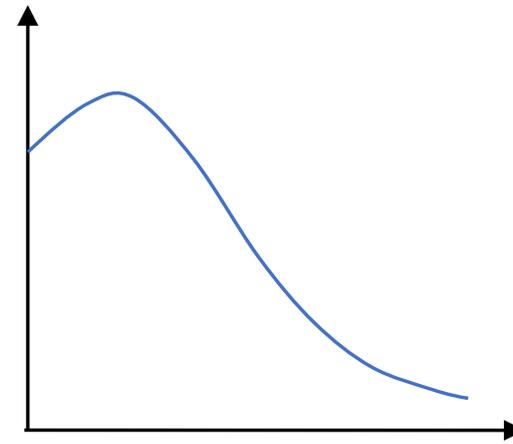
Efficient allocation equalizes Marginal Revenue Products across firms

$$MRP_i = MRP_j$$

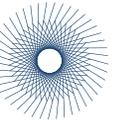
Optimal competition & innovation



Production Possibility Frontier

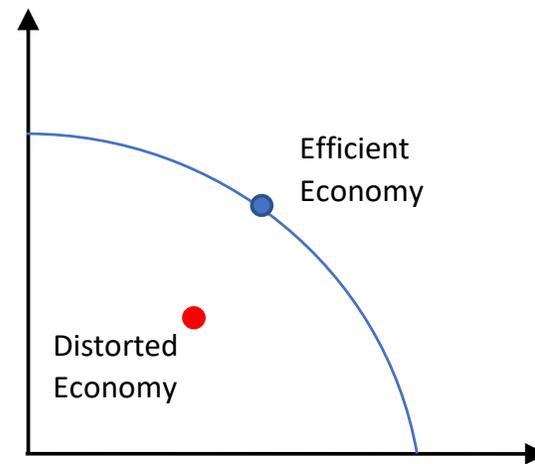


Size Distribution

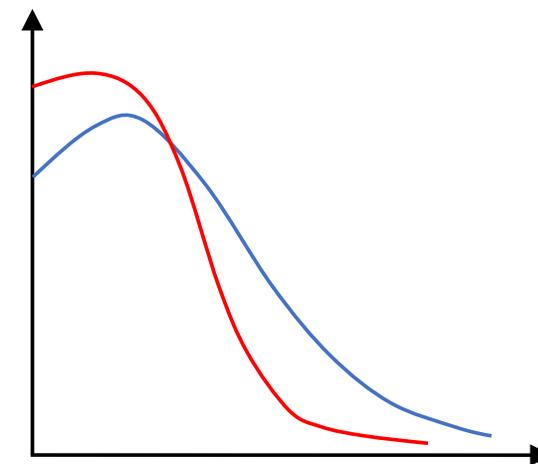


Market distortions can reduce GDP and its growth by causing resource misallocation across firms and stifling productivity-enhancing investments

$$MRP_i \cdot (1 - \tau_i) = MRP_j \cdot (1 - \tau_j)$$



Production Possibility Frontier



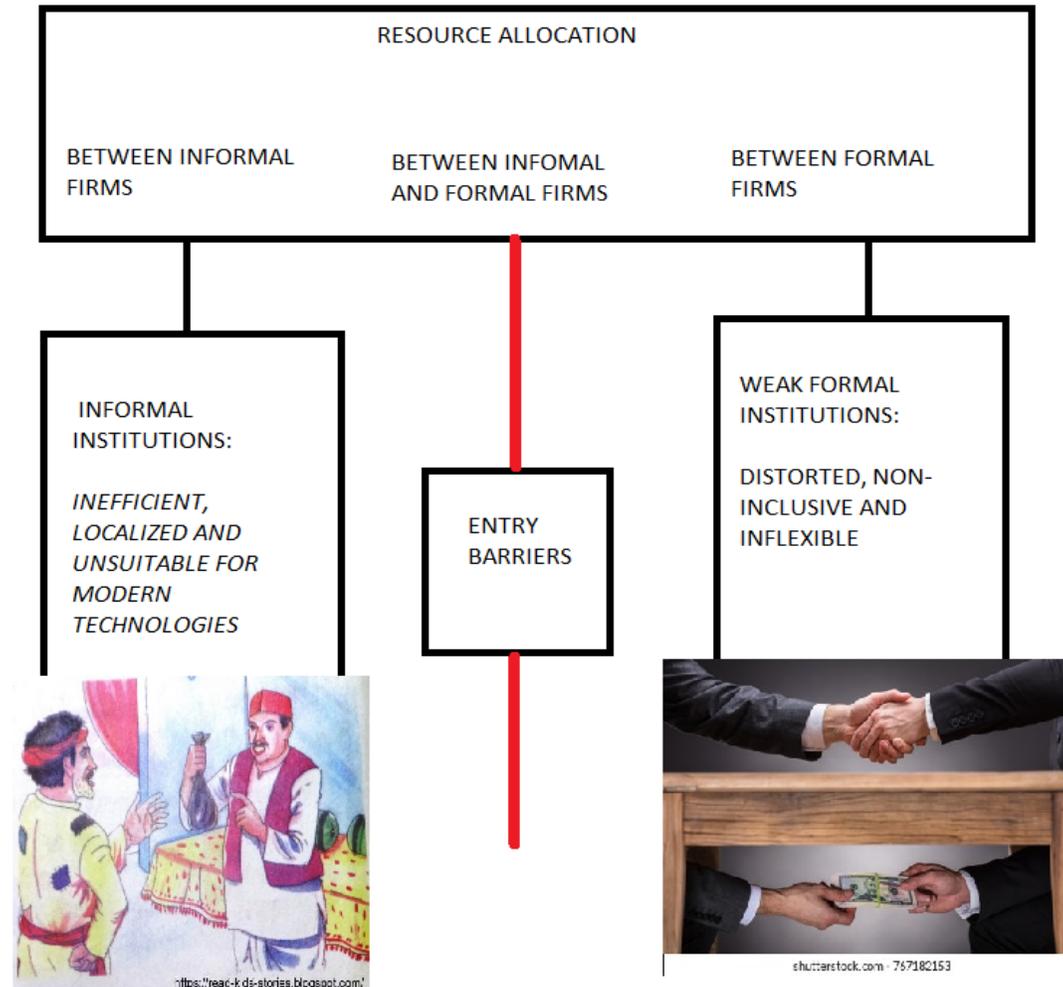
Size Distribution

- Fewer large firms in the distorted economy
- Allocative inefficiency: operate below the frontier



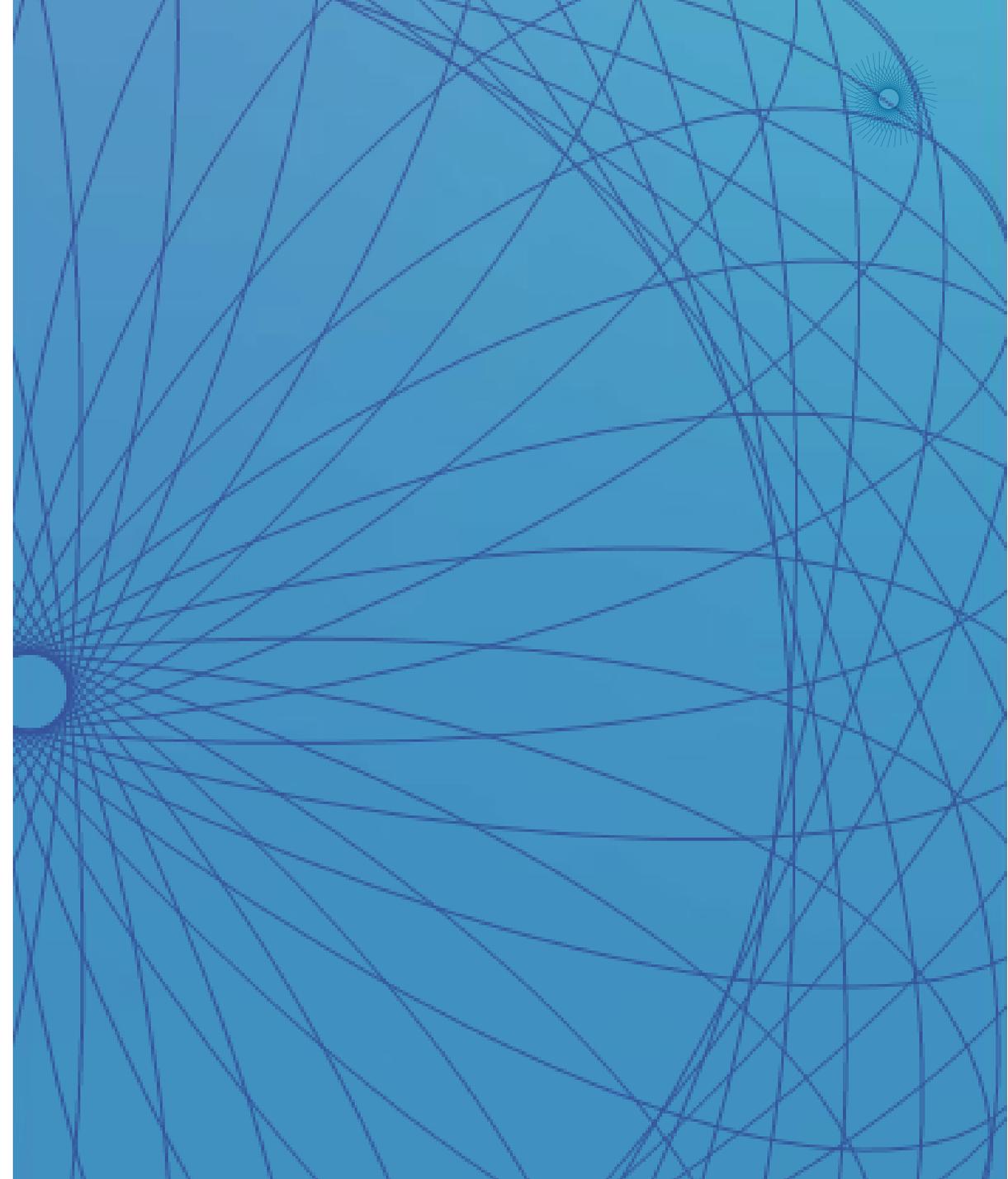
Dual Misallocation

Within and between the informal and formal sectors





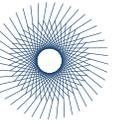
PILLAR 1
Raising
Productivity



Is informality the result of entry barriers and distortions?

- Making business entry easier by simplifying entry regulation has had limited impact on formalization and firm performance (e.g., Bruhn and McKenzie 2014)
- But there could be other entry barriers besides business entry licenses.
- The returns to becoming formal are attenuated when the formal sector is distorted.
- **Fattal-Jaef (2021)** estimates a structural model to infer entry barriers and distortions among firms in India, and their impacts on productivity and informality.

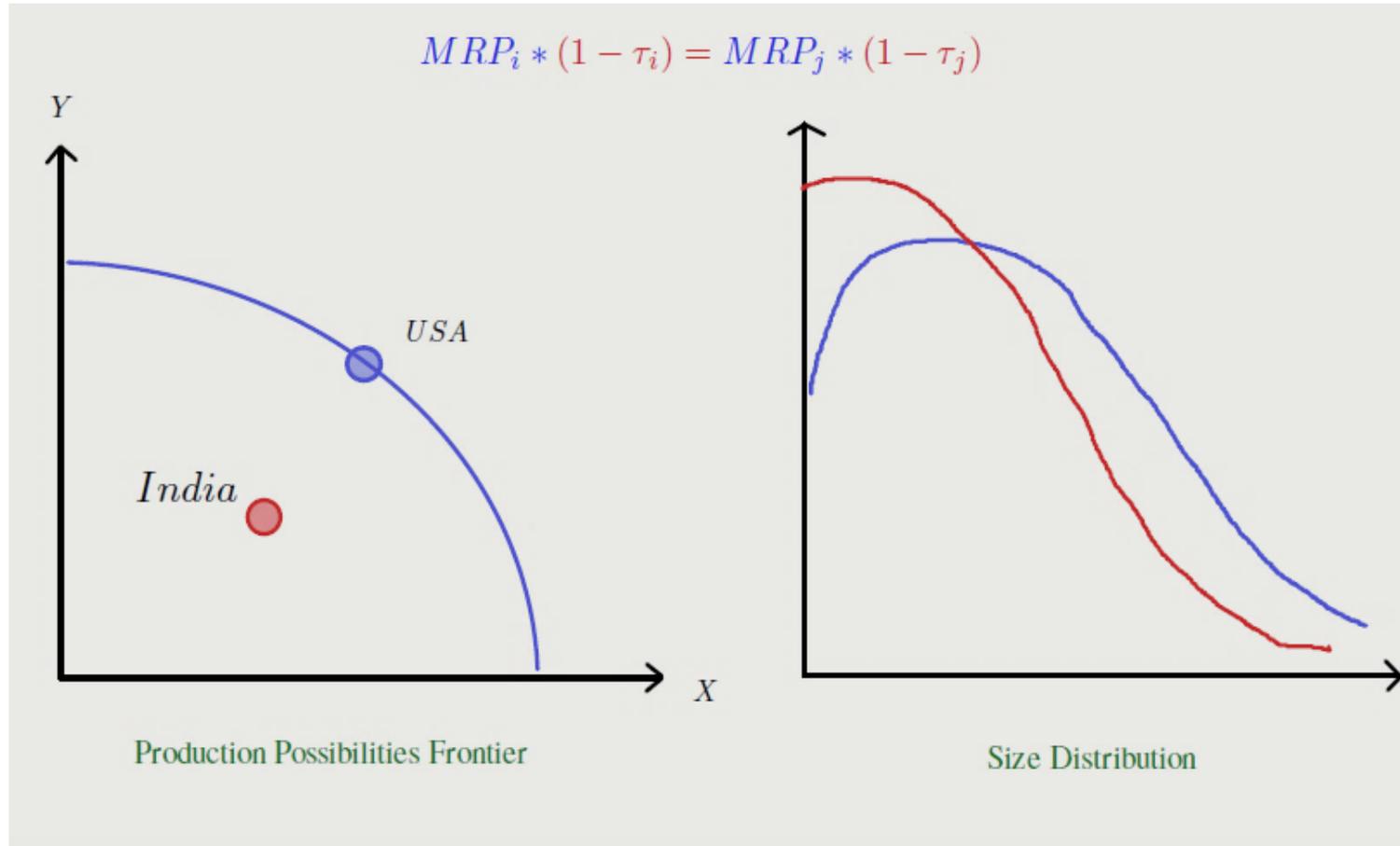


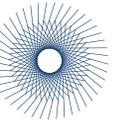


Size-dependent Distortions

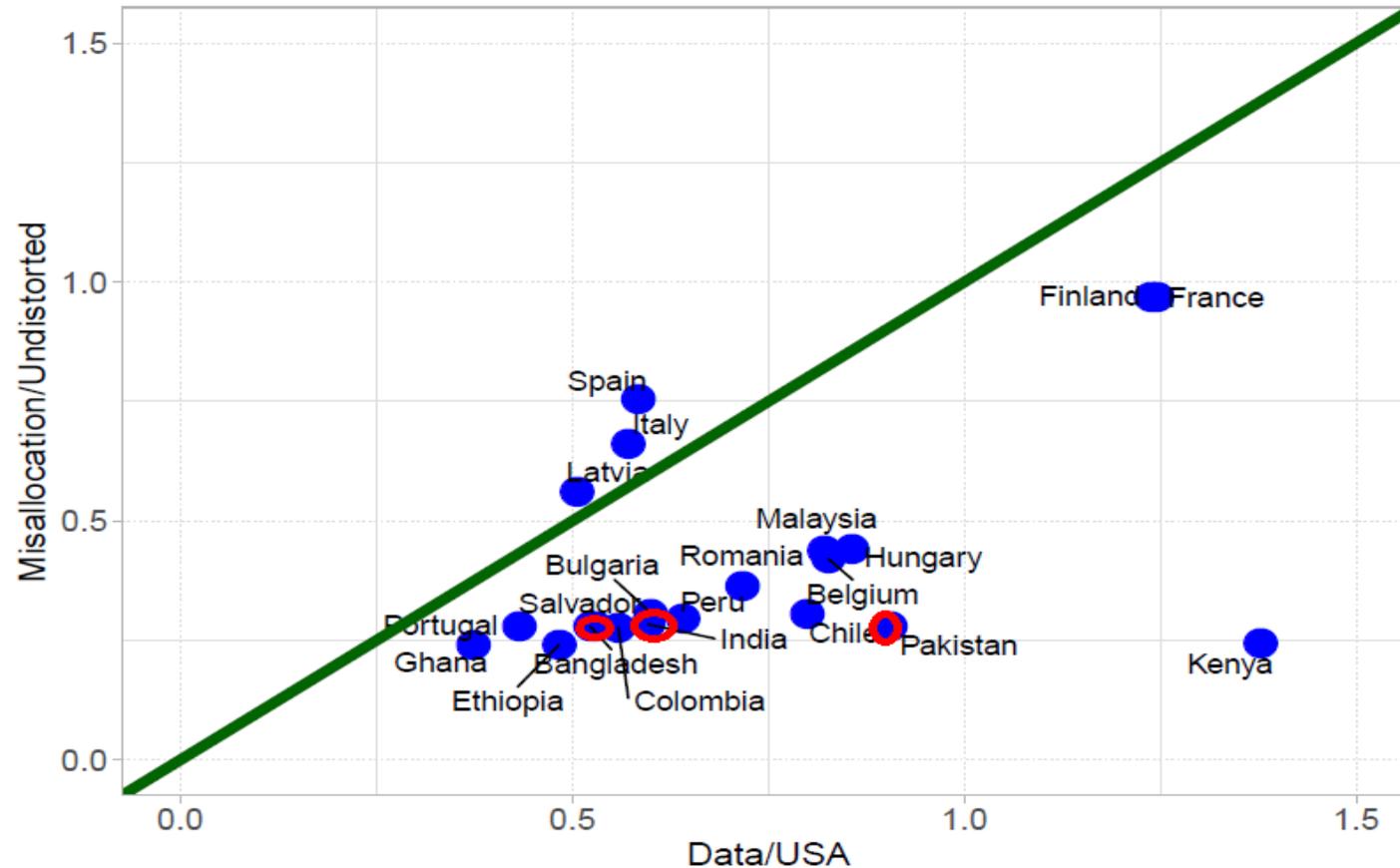


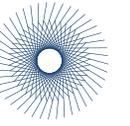
More stunted firms



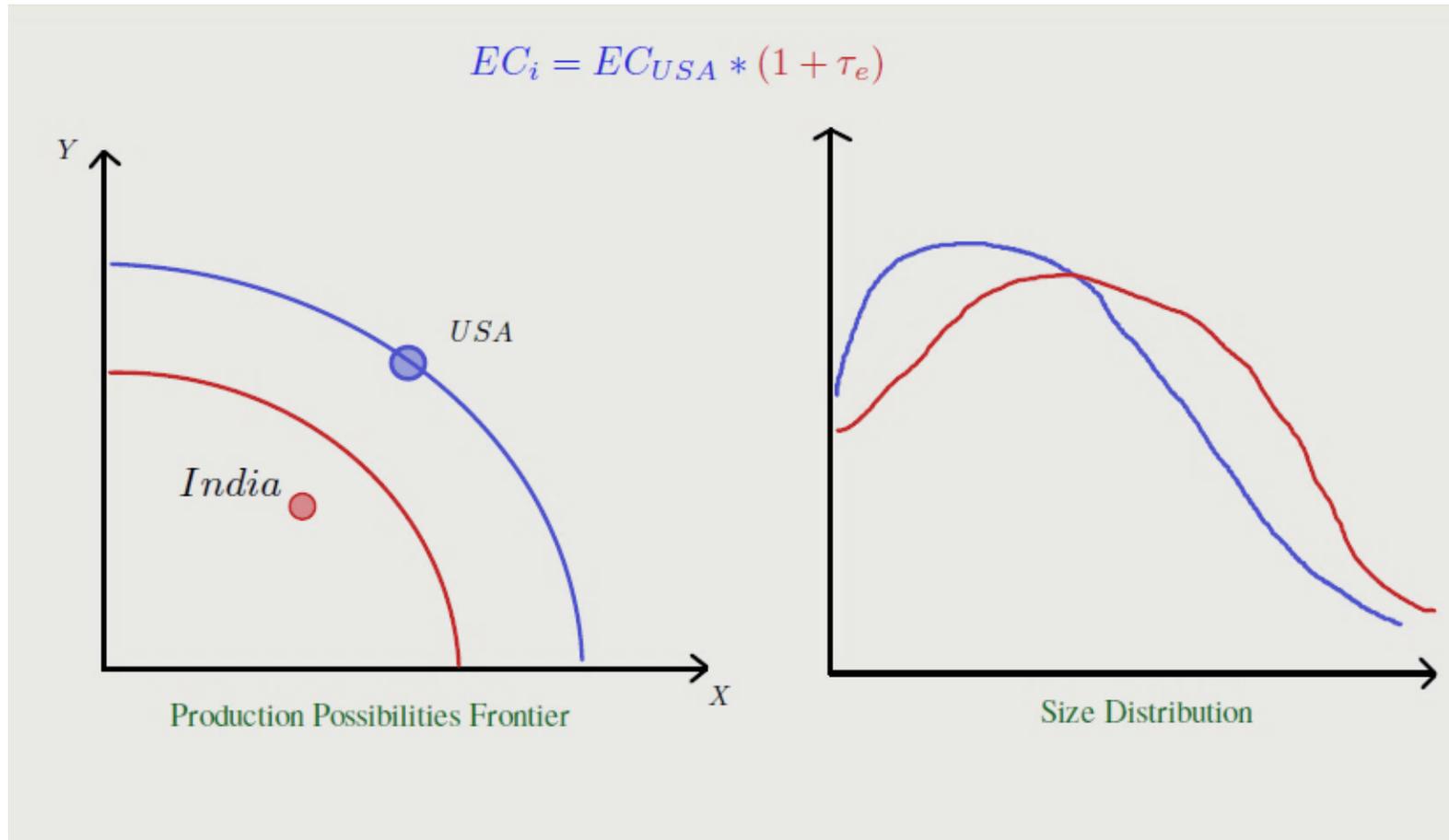


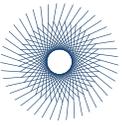
Firms in the formal sector are too large given the high level of estimated size-dependent distortions



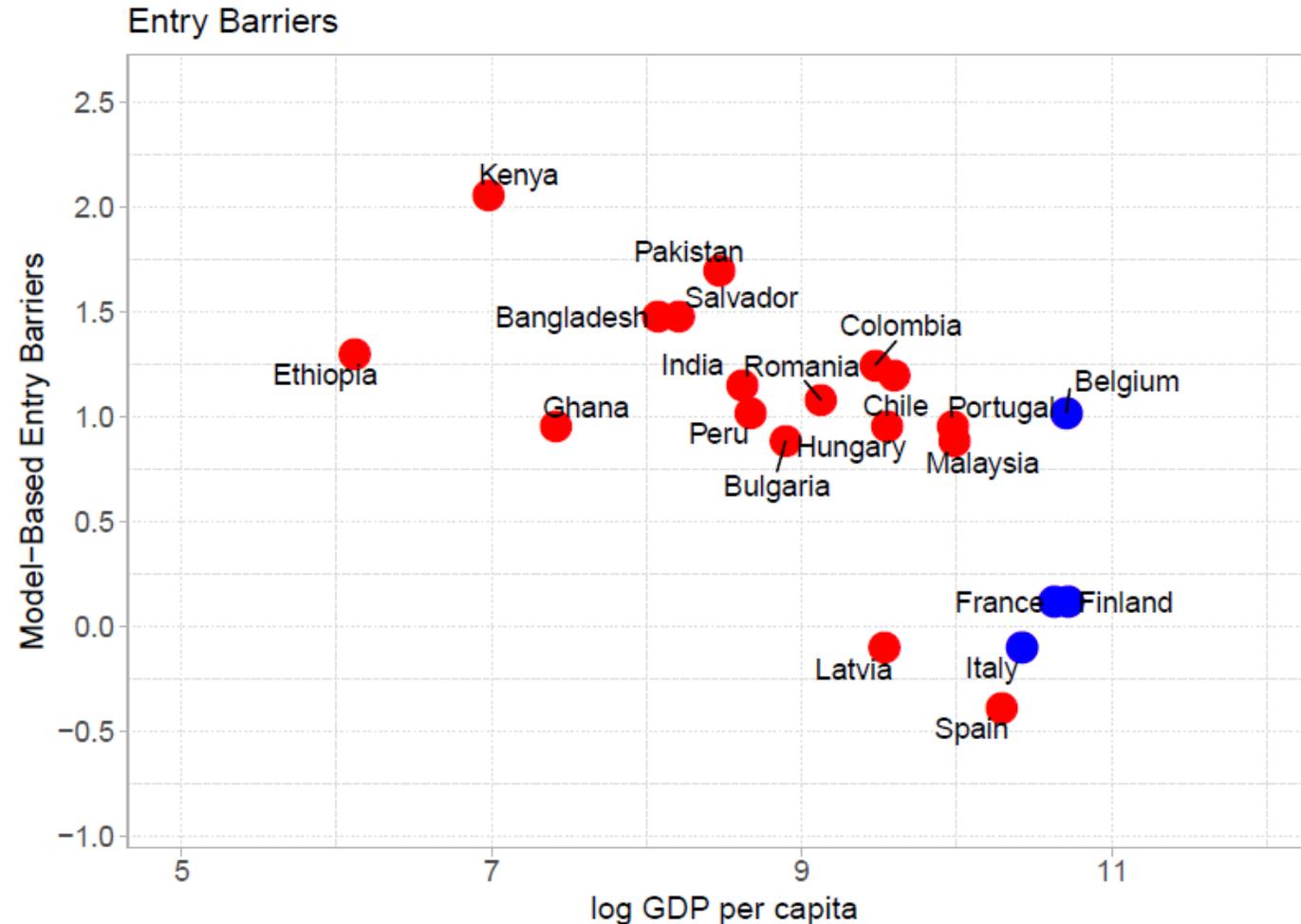


High entry barriers \longrightarrow Fewer small firms become formal





Estimated entry barriers too are high in South Asia, and can explain why formal firms are not as small as predicted by distortions



Distortions and entry barriers can account for more than half the size of the informal sector

Introducing India's entry barriers and distortions would increase US informality share to 54%

- **More than halfway to India's actual share of 85%**

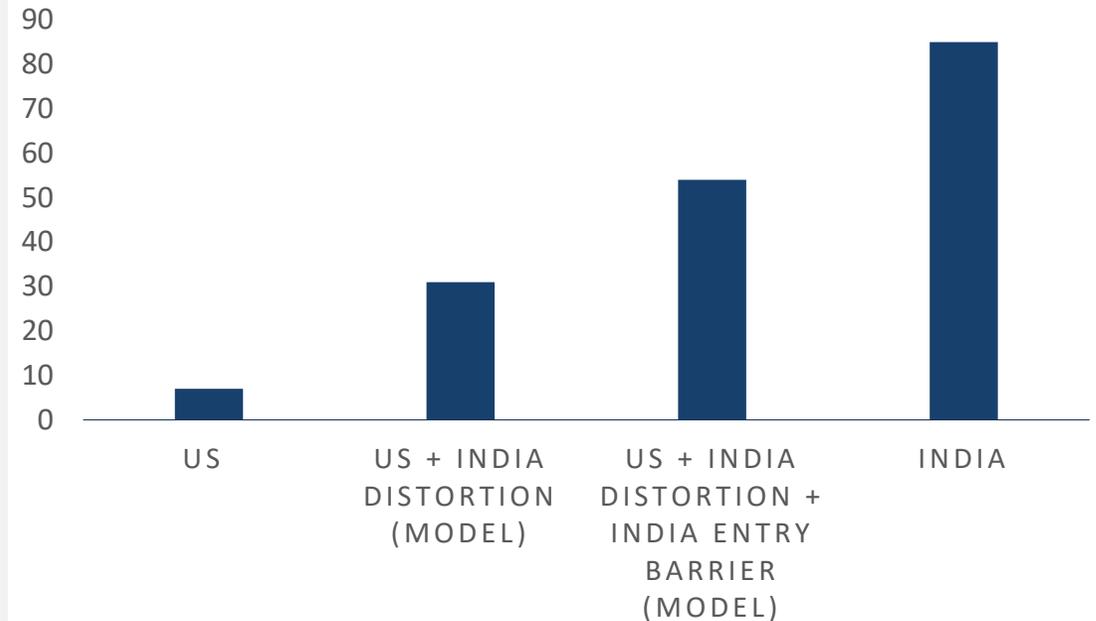
Entry barriers are higher than those implied by licensing procedures

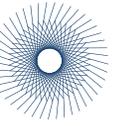
- **Recommends looking beyond business licensing reforms to address other licensing or infrastructure access costs**

Distortions in the formal sector increase room for informality because they make the formal sector inefficient

- **Informality a byproduct of the uneven playing field in the formal sector**

SIZE OF THE INFORMAL SECTOR
(% EMPLOYMENT IN MANUFACTURING)





Can digital platforms overcome market access barriers for informal firms?

Digital platforms, such as e-commerce websites, can help firms grow by reducing transactions cost and increasing access to markets

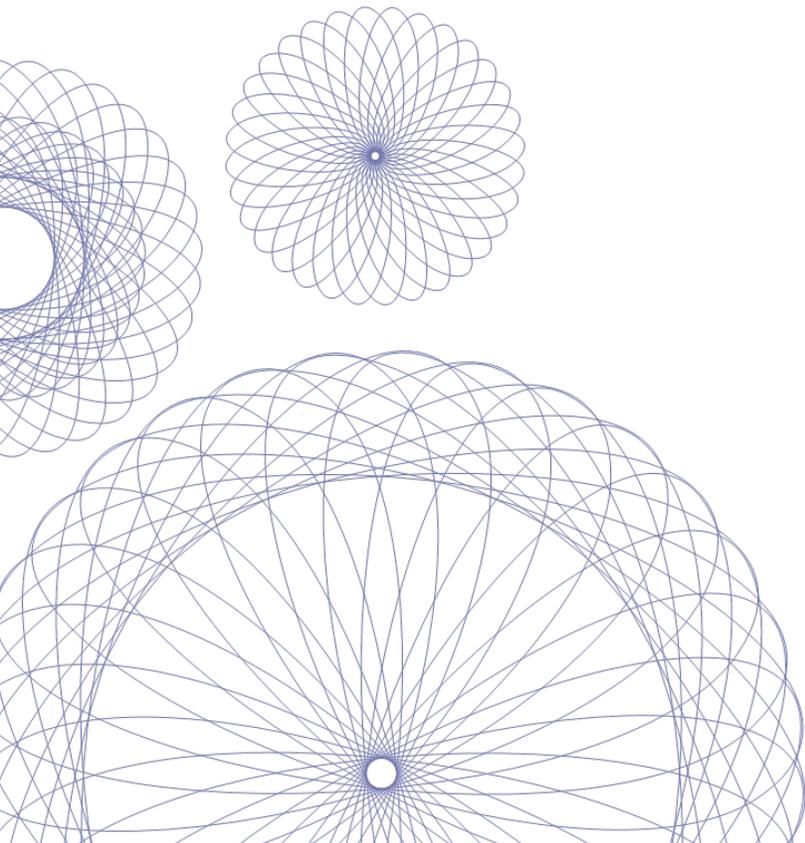
But limited evidence on this from low- and middle-income countries

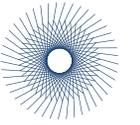
- **Do informal firms and entrepreneurs have the capabilities and access to complementary factors to benefit from e-commerce?**

e.g.: Couture et al. (2021) find little evidence for income gains to rural producers and workers from randomized access to e-commerce in China

Kanz (2021) uses a big dataset on sellers and their transactions on an Indian e-commerce platform to study firm dynamics on a platform

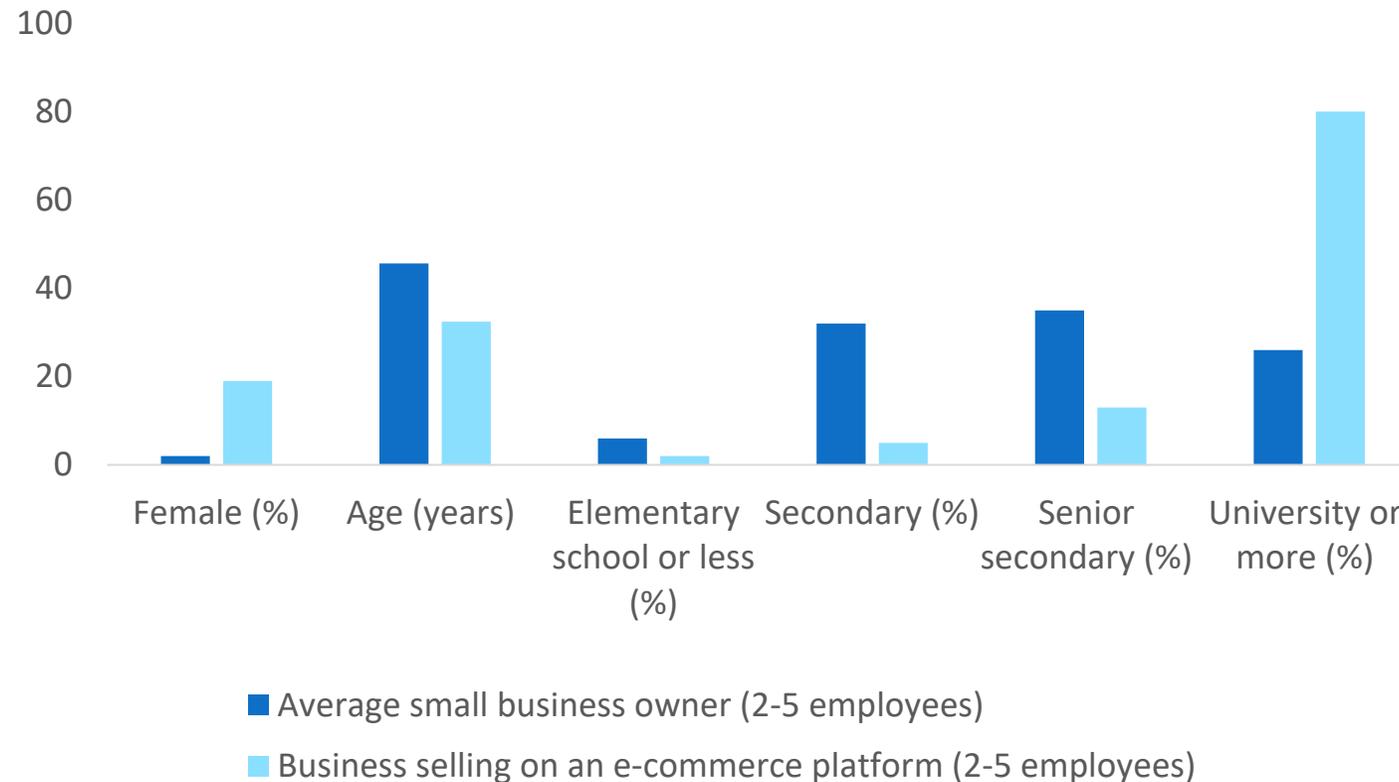
Majority of platform sellers are MSMEs

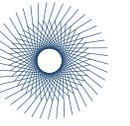




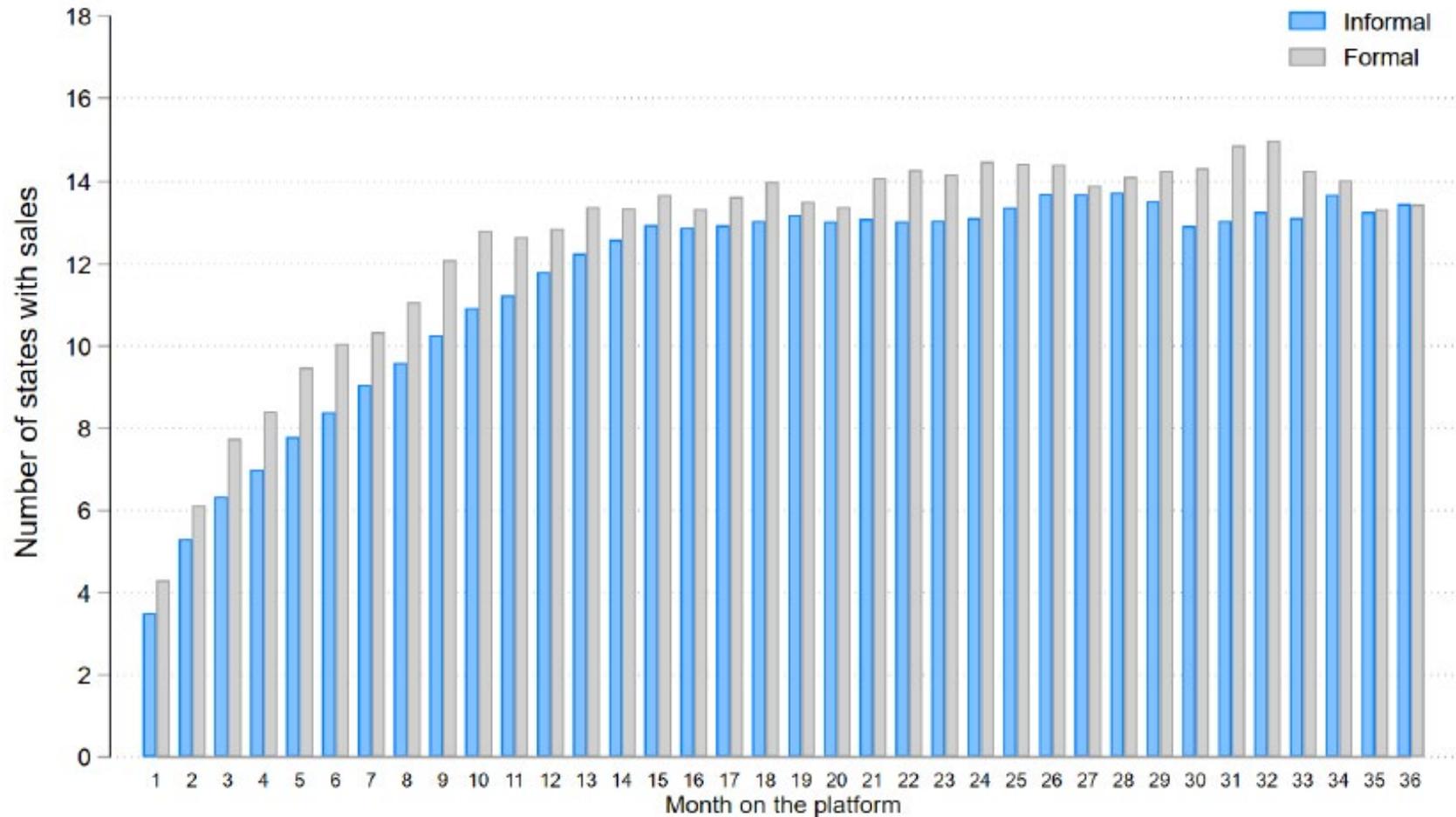
Only a selected group of firms are selling on e-commerce platforms

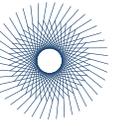
Entrepreneurs who sell on the platform are more educated, younger and more likely to be female than the typical small business owner in India





The geographical size of the market that businesses reach increases gradually over the first year upon joining





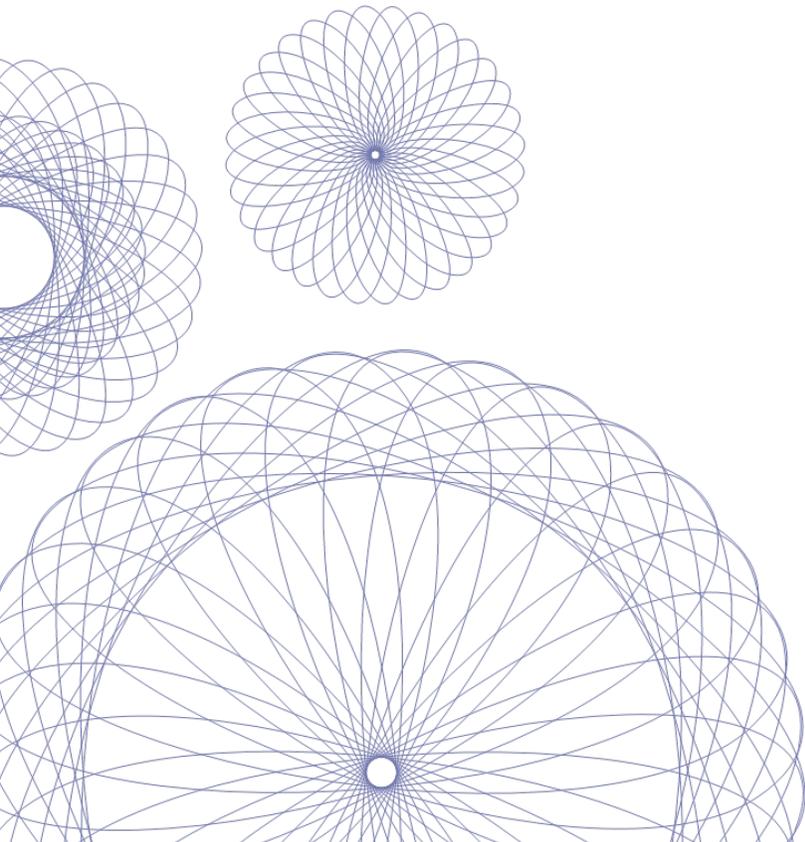
Informality is correlated with early exit from the e-commerce platform

Informal businesses are more likely to become inactive than formal businesses during their first year on the platform.

This could matter because experience on the platform is an important predictor of performance.

These emerging findings suggest a role for policies to address

- **ICT infrastructure access**
- **Informational barriers to digital adoption**
- **business training interventions that help small firms better navigate e-commerce platforms**

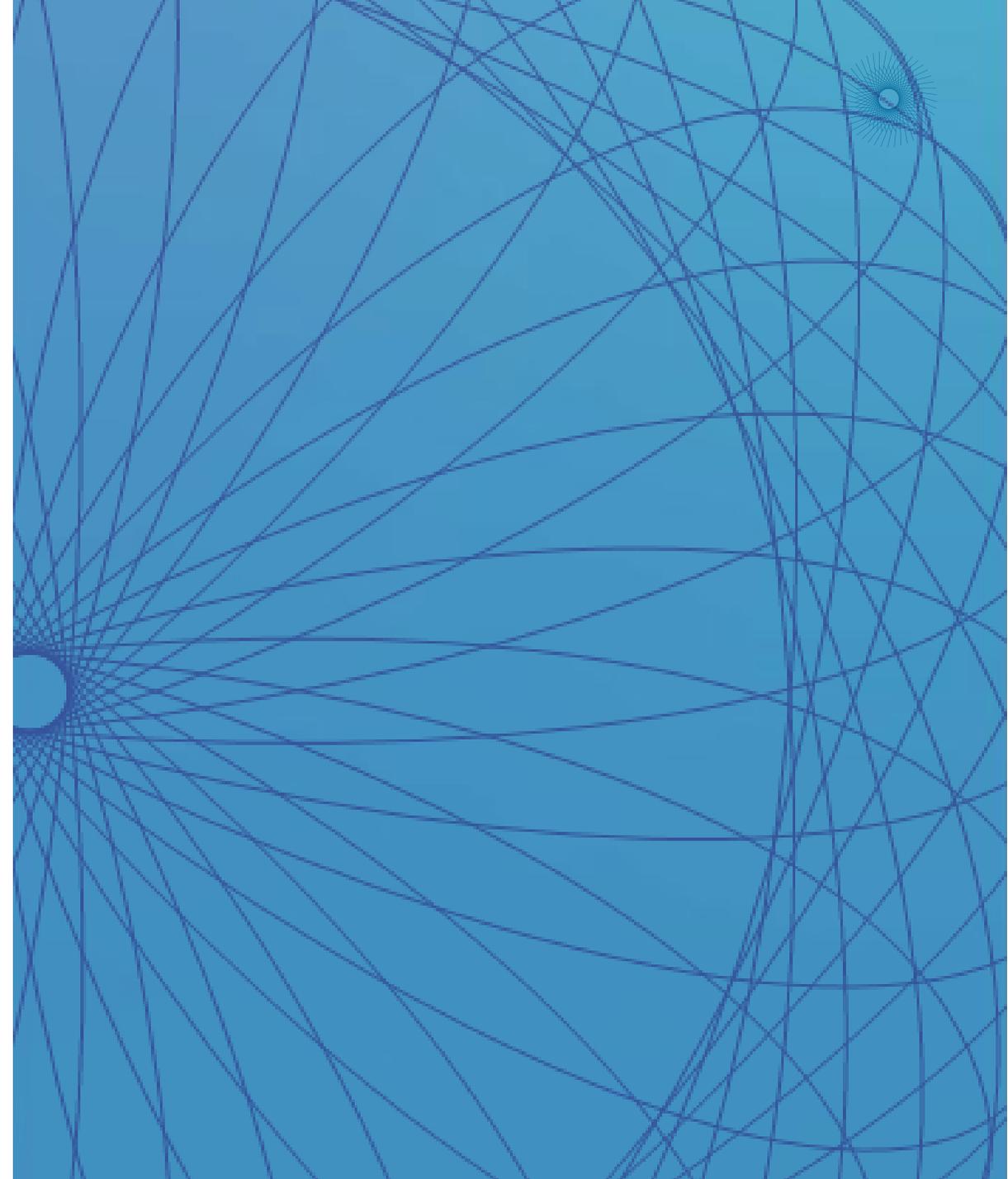




PILLAR 2

Building resilience:

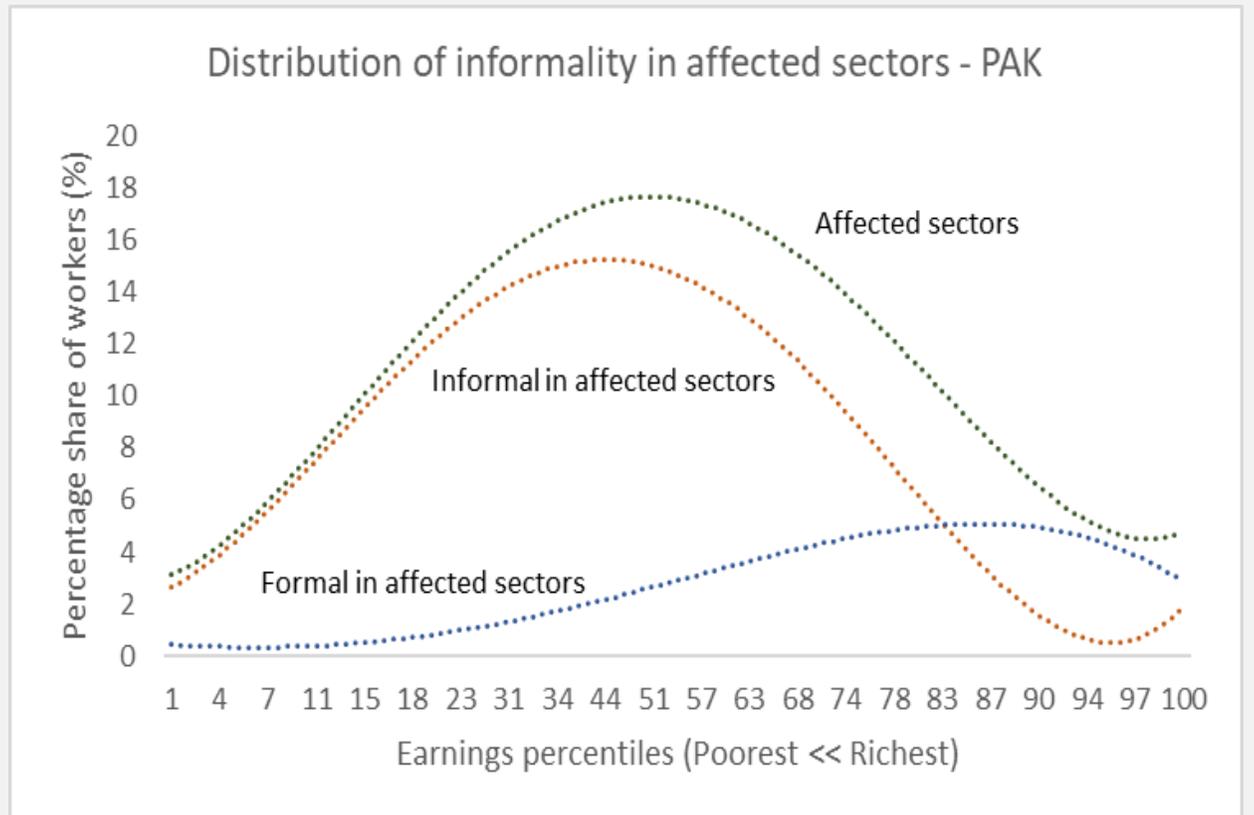
**Social protection,
economic inclusion, and
the informal labor market**



COVID-19 crisis highlighted structural weaknesses of the social protection systems

Informal workers in high-intensity face-contact sectors (the most affected by the pandemic) tend to live in urban households

The pandemic impacted the *middle* of the income distribution

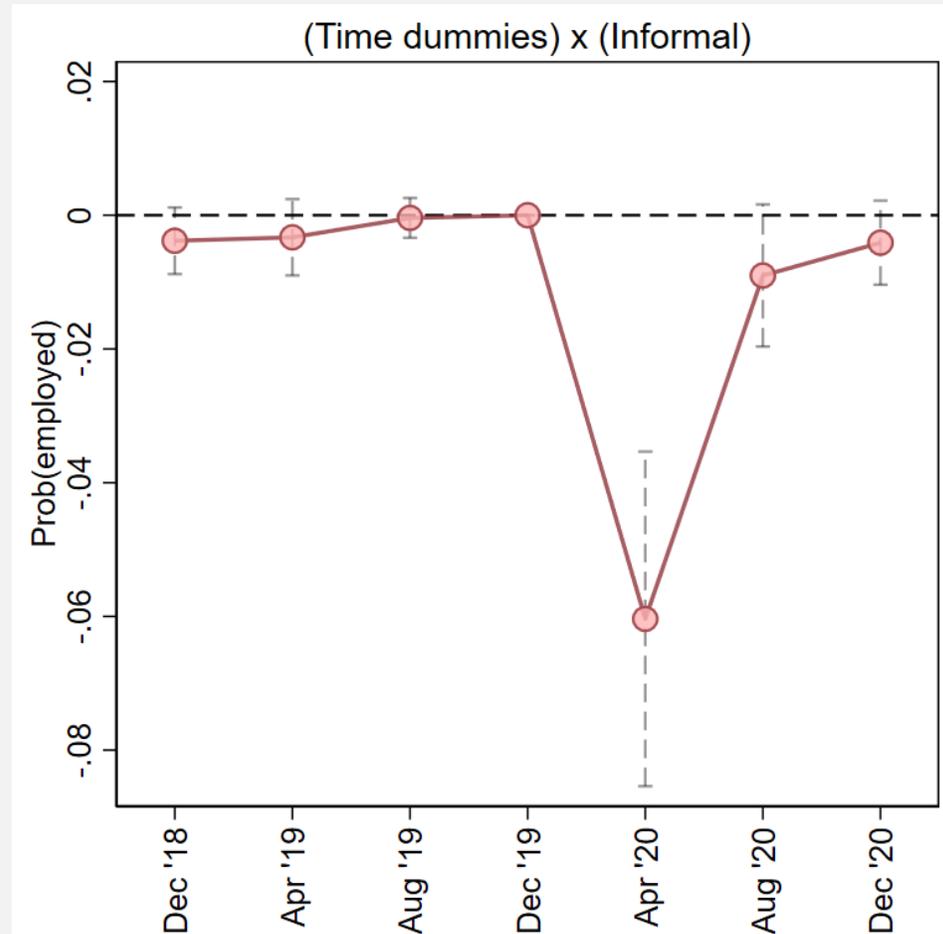


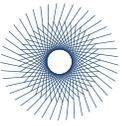
COVID-19 crisis highlighted structural weaknesses of the social protection systems

Informal wage workers were significantly more likely to lose a job than their formal counterparts.

- This excess vulnerability is not driven by informality being concentrated in specific industries or locations (which were disproportionately hit), but rather by the inherently greater risk faced by informal workers.

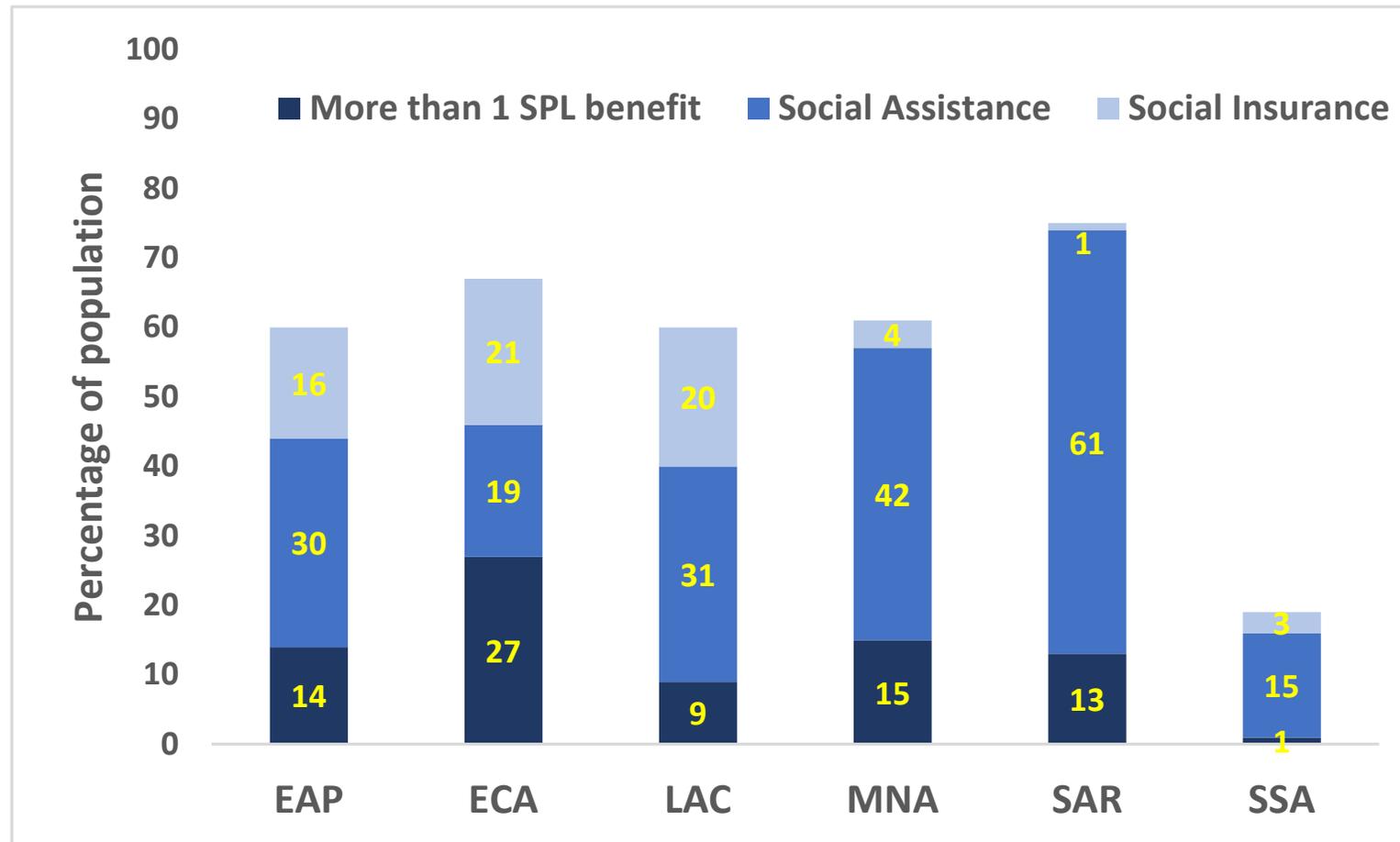
India: Probability of informal workers losing their job



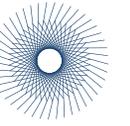


COVID-19 crisis highlighted structural weaknesses of the social protection systems

Composition of social protection by component



Source: ASPIRE database



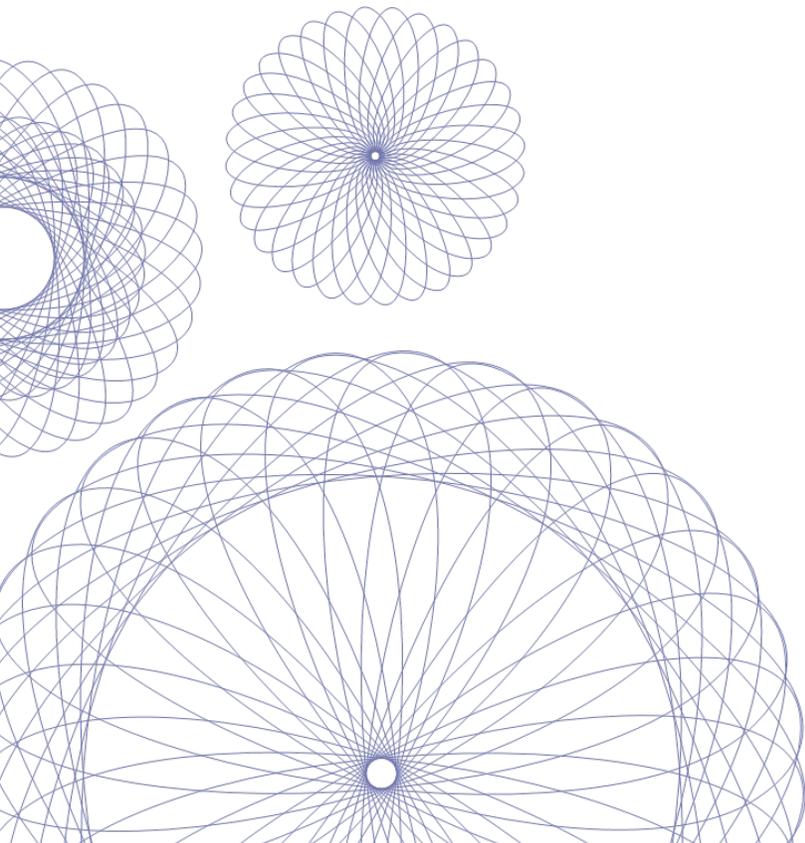
Beyond social assistance | A mix of instruments can better address the missing middle in social protection

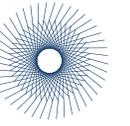
Social protection systems (and the financial sectors) need to be redesigned to be more inclusive of the informal sector.

Can the current, limited coverage be extended as is to a larger group, or should an alternative insurance system be designed for the informal population?

- *In Pakistan, WB is working to tailor different systems to three groups within the informal sector: the poor (economic inclusion programs); the vulnerable non-poor with potential saving capacity; and the vulnerable non-poor with capacity to save and develop small business.*

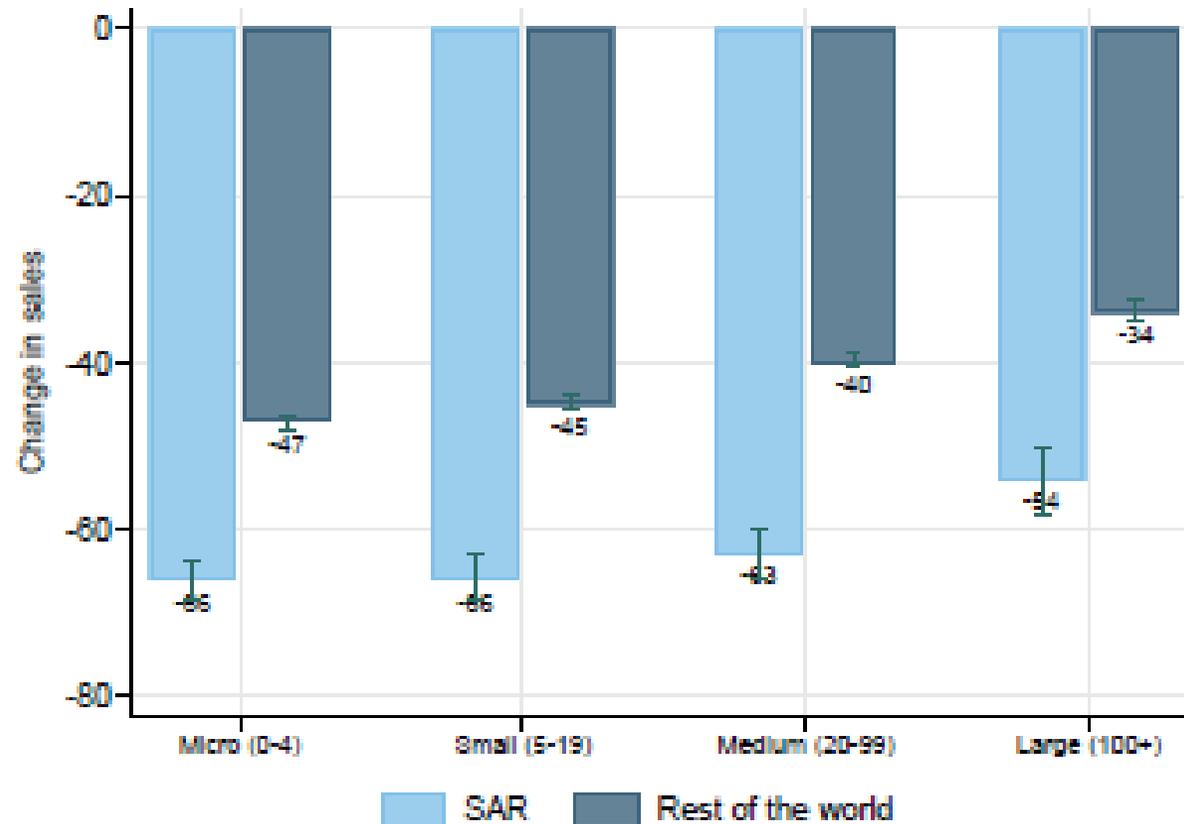
The idea of a Social Protection Assessment Program (SPAP) (Kanbur 2010, 2012): stress test the system to assess its flexibility and comprehensiveness.





COVID-19 crisis highlighted structural weaknesses also in the production sector

Impact of COVID-19 on firms' sales

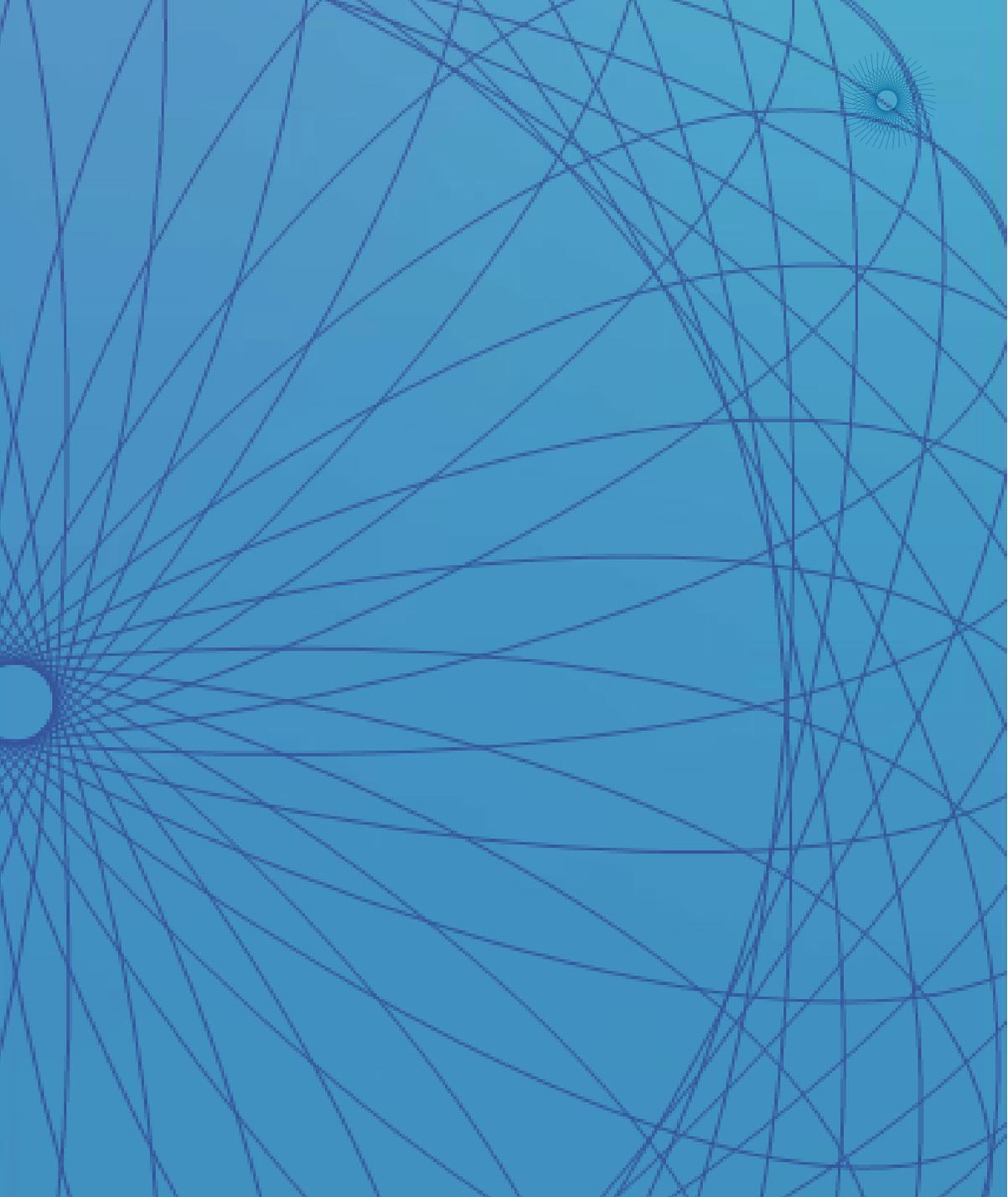


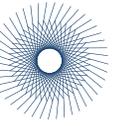
Source: Source: Brucal, Grover and Santiago Reyes (2021)



PILLAR 3

**Improving
taxation**





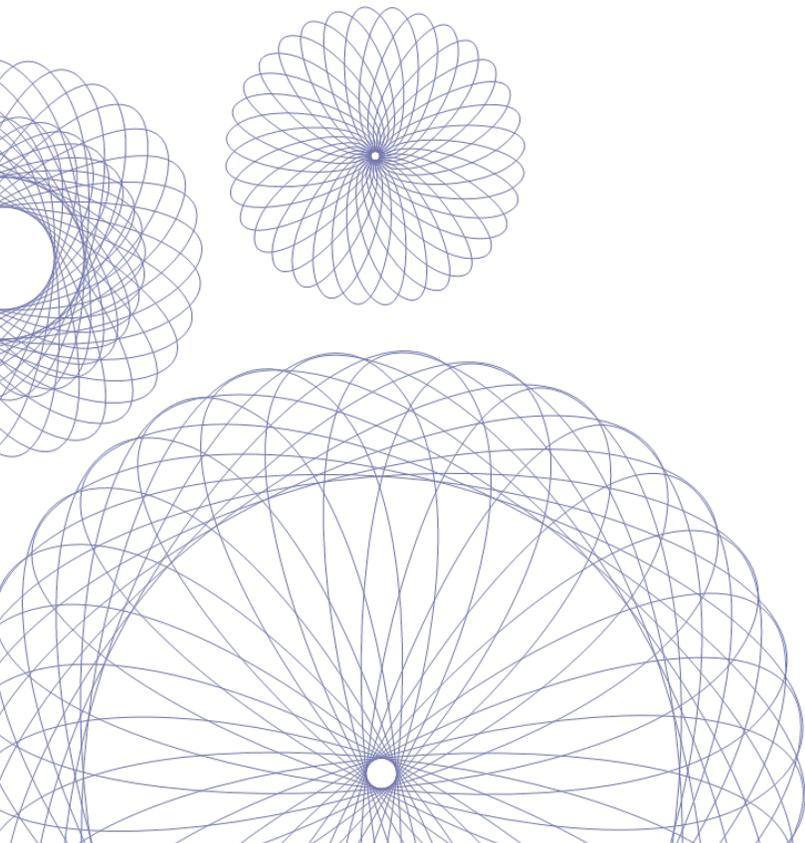
Taxation | Key issues

Widespread informality and limited fiscal capacity constrain tax policy options in South Asia.

South Asian governments rely heavily on indirect taxes, such as sales taxes and increasingly, the VAT, for achieving the objectives of tax policy.

How does informality influence the impacts of – and is affected by – tax design reforms such as the replacement of sales taxes with the VAT?

How can we increase tax morale and compliance in a dualistic economy with a large underserved informal sector and a small privileged formal one?

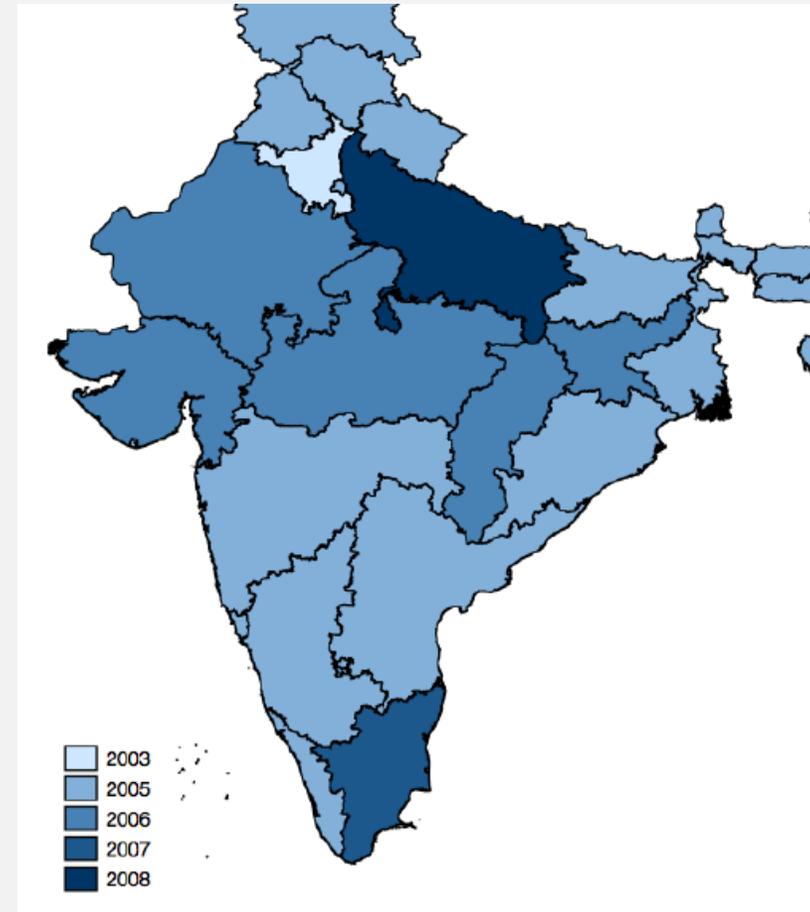


The impacts of VAT

VAT expected to:

- **Improve efficiency by removing double taxation along value chain**
- **Encourage informal firms to formalize to be able to sell to formal firms**

Zhou (2001) studies these impacts by developing a structural model & exploiting the staggered rollout of VAT in India



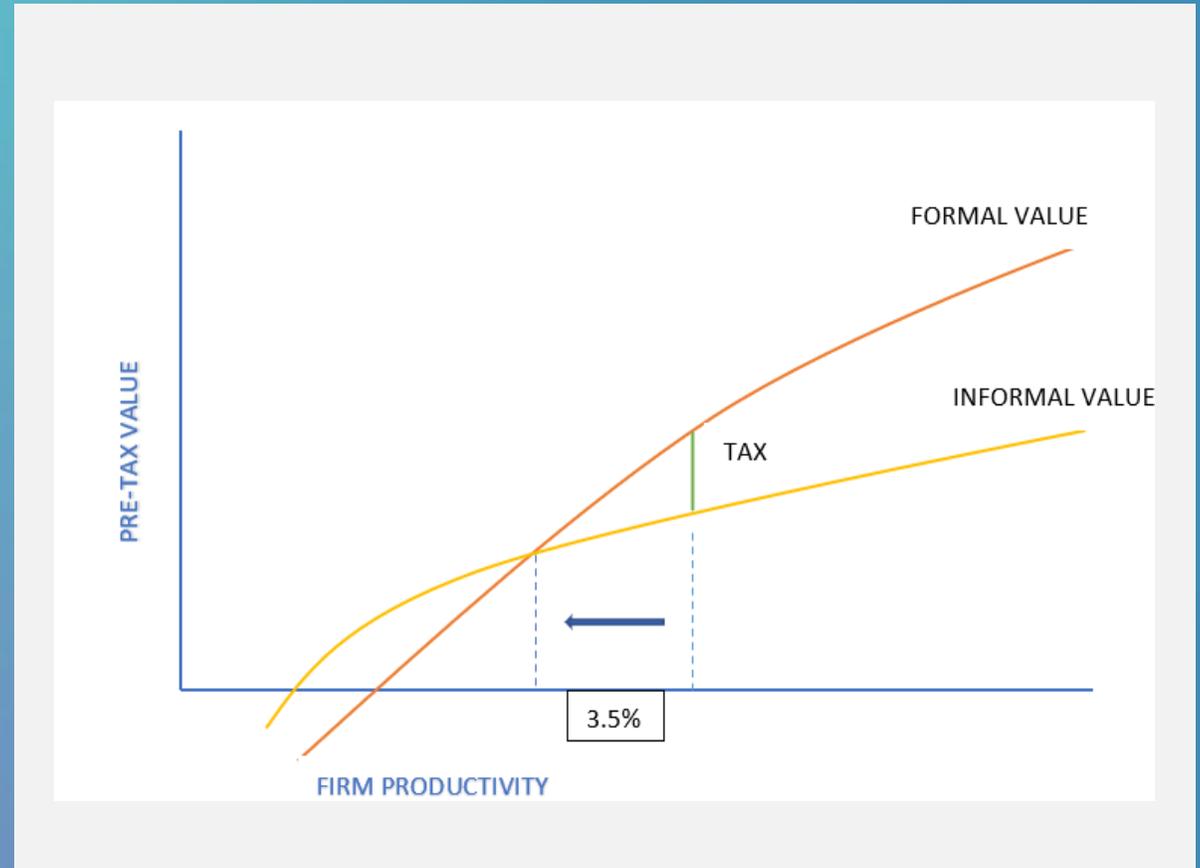
Timing of VAT adoption: 10 states in 2003, 19 in 2005, 4 in 2006-08.



Most informal firms in intermediate goods had too little to gain from formalizing

3.5% of informal firms could be induced to formalize by lowering taxes

96% did not formalize even after taxes drop to zero because entry barriers and other regulatory costs of formality were too high relative to benefits

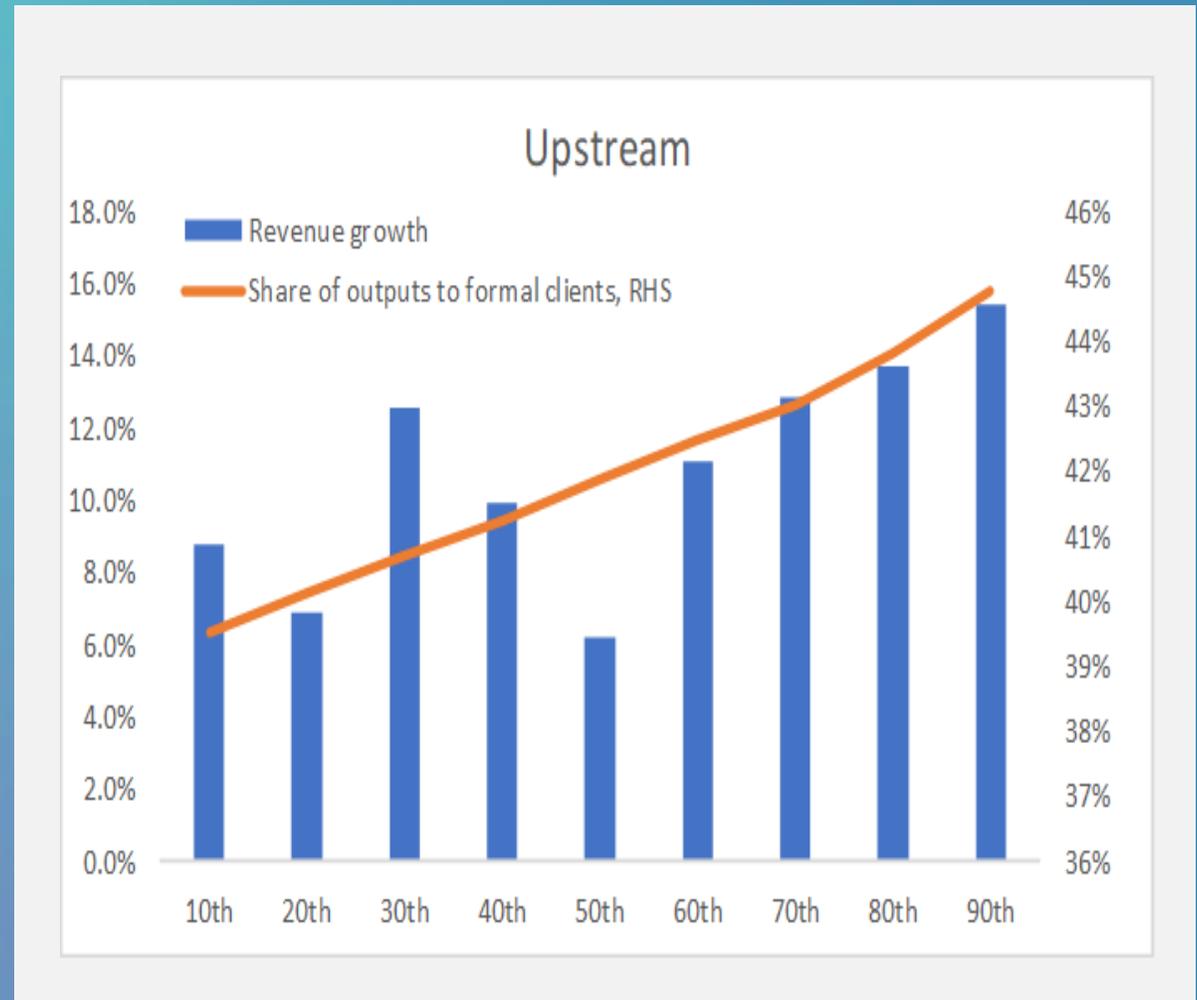


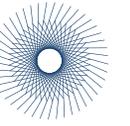
The VAT improved efficiency and reduced informality indirectly

Formal sector output expanded by 12% after VAT adoption

The efficiency-enhancing effect of the VAT shifted resources from the informal to the formal sector

The increase in revenue more than offset the reduced tax rate on intermediate goods, increasing tax revenue





What is the cost of multiple GST tax rates?

Given limited fiscal capacity, South Asian governments rely inordinately on indirect taxes for both equity and efficiency objectives.

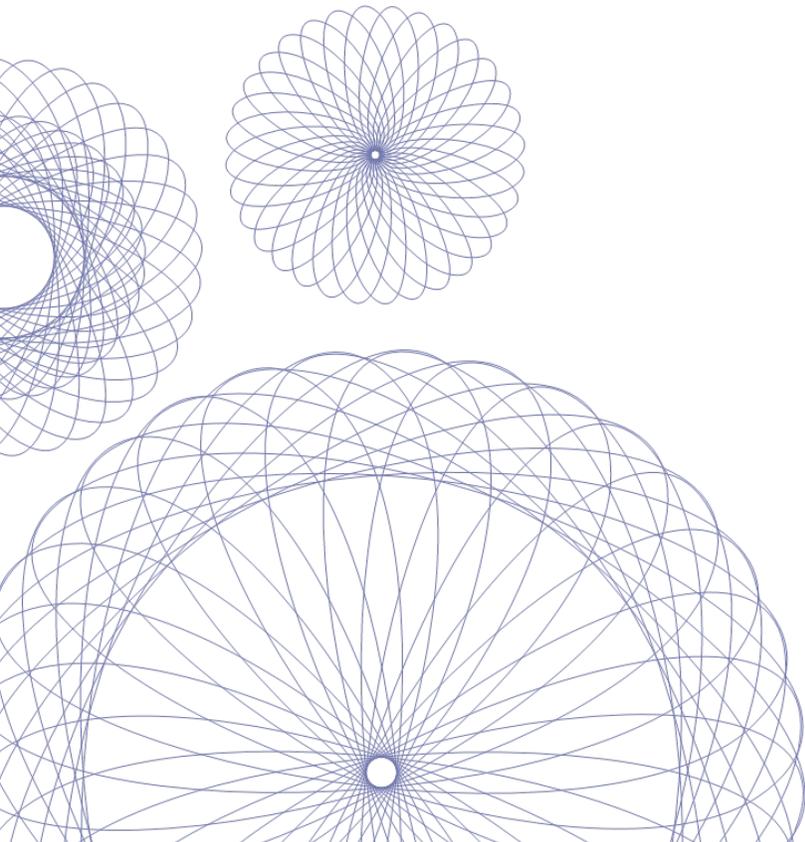
The equity objective has given rise to VAT systems with many exemptions and multiple rates, with lower rates for necessity goods and higher rates for luxuries.

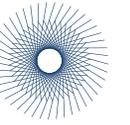
This creates incentives for tax evasion and tax avoidance.

This evasion might be aided by the prevalence of informality.

If so, to limit lost tax revenue, the tax rate on products often sold in informal markets should be kept low.

Bachas et al. (2021) examine this issue using detailed GST returns data from an Indian state.

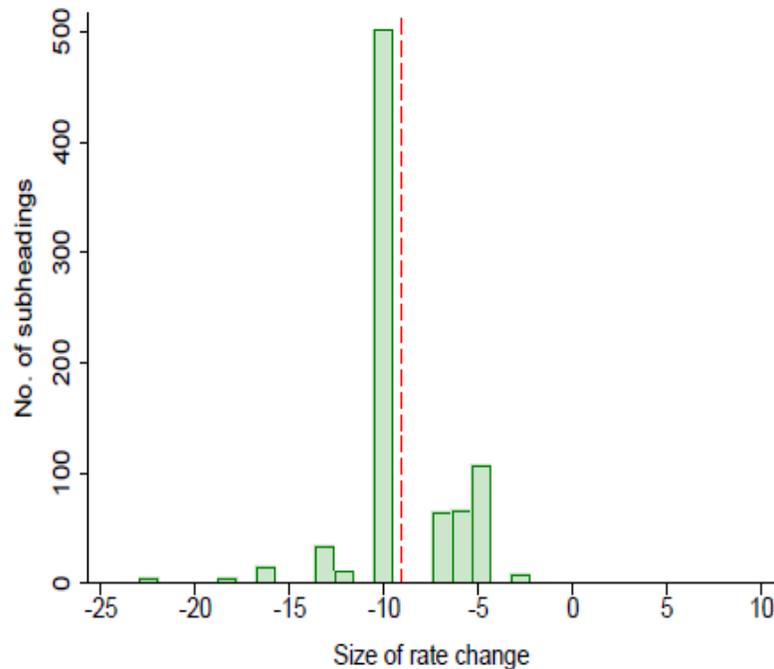




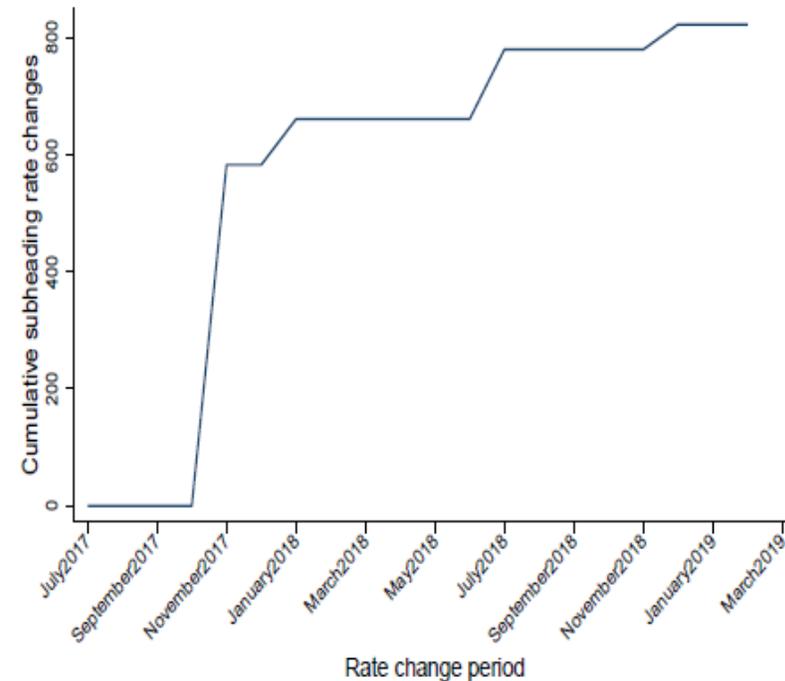
Frequent tax rate reductions for select products, undermining simplicity motive for VAT

Natural experiment: What was the elasticity of reported sales to the tax rate changes?

(a) Distribution of rate changes



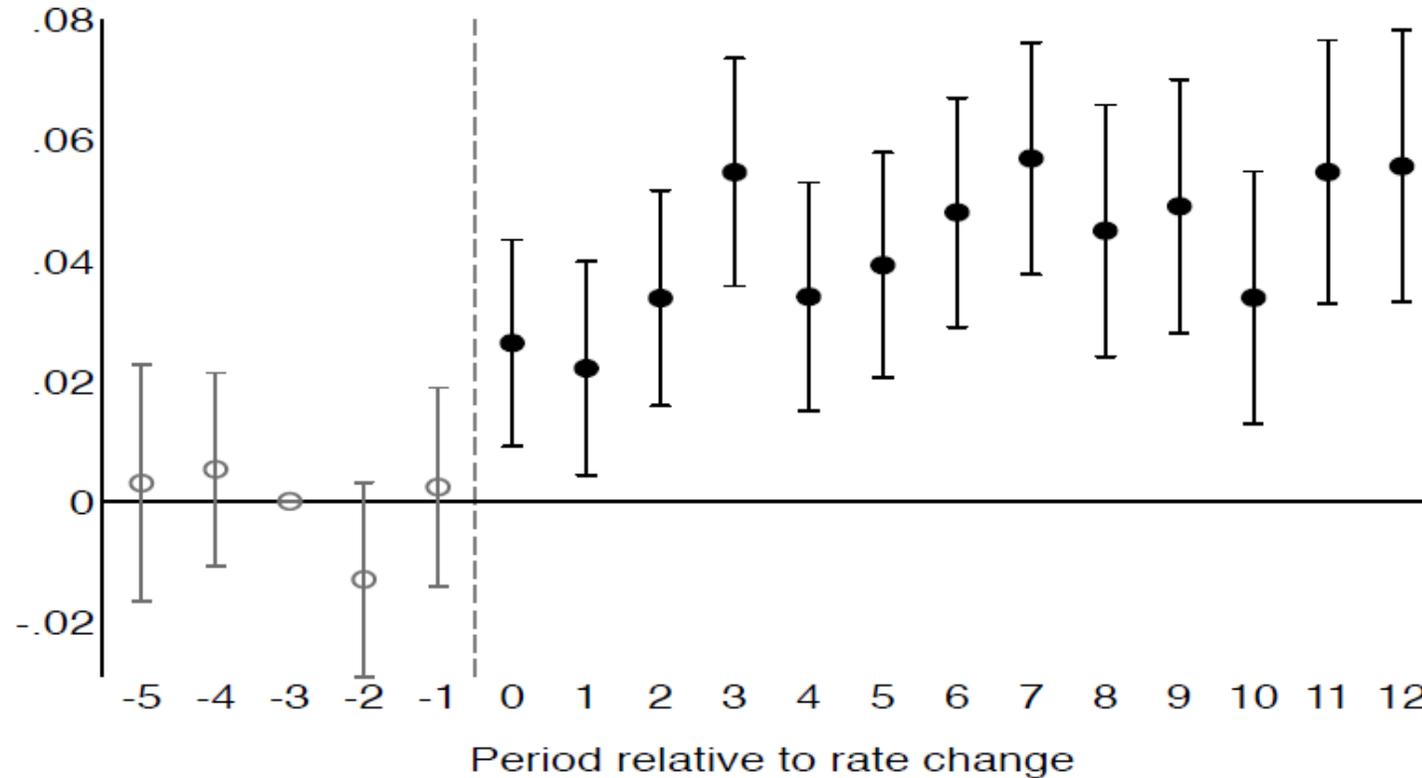
(b) Cumulative rate changes over time

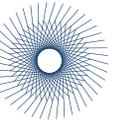




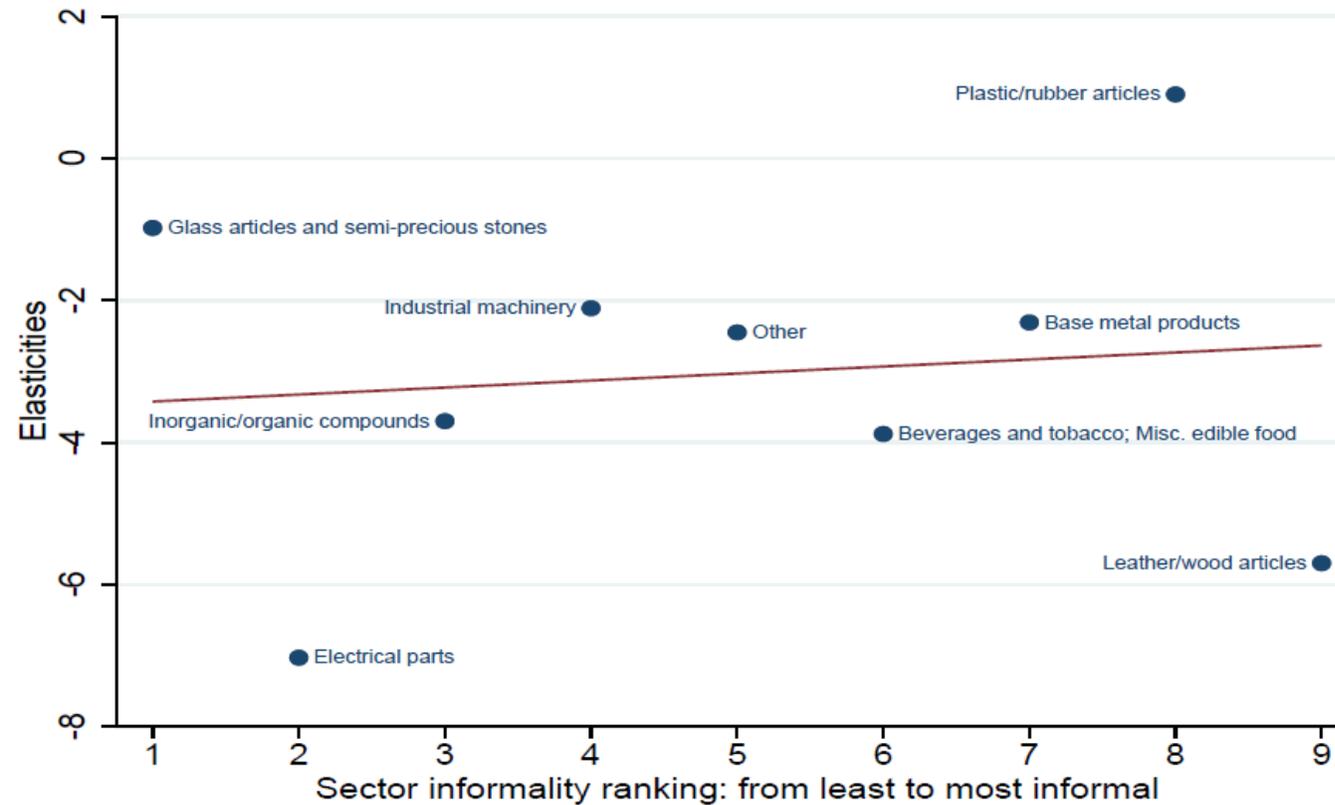
The tax elasticity of reported revenue is high

A 1% decrease in the rate increases reported sales by 2.4%
Is there a lot of evasion?



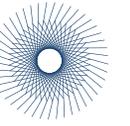


Informality is not associated with the elasticity of taxable revenue



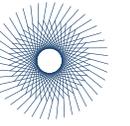


CONCLUSION



Emerging conclusions | Productivity

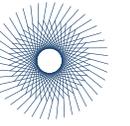
- To a large extent, informality is a byproduct of size-dependent distortions.
- Simplifying business licensing is helpful but may not be enough to address entry barriers.
- Digital platform can help growth-oriented informal firms access markets but only if barriers to adoption and complementary firm capabilities are addressed.



Emerging conclusions | Social Protection and Labor

- Social insurance is embryonic (issues of design, financing, incentives)
- How to boost earnings of poor informal workers: non-cognitive skills, (maybe); economic inclusion.





Emerging conclusions | Taxation

A more simple and uniform VAT design will increase efficiency and reduce informality indirectly.

- **Informality itself may be tangential to VAT design**

More consideration is due to

- **How to improve the motive for tax compliance among small firms by increasing their benefits from being in the tax system**
- **How to improve norms and intrinsic motives for paying taxes**

