

# Pakistan's Informal Economy: Way Forward

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## Outline:

### 1. Introduction:

Thesis statement: Pakistan's burgeoning informal economy, even though taken in both good and bad senses, is still one of a major contributor in further pushing the country's already 'standing on the verge' economy. However, by addressing the root causes and by adopting inclusive policies the informality can be transitioned into formality.

### 2. Background of Pakistan's informal economy:

i- Traditional economic sphere (1950s - 1960s)

ii- Traditional sector became Informal sector. (1960-70s)

iii- Expansion of Informal sector. (1970s - 80s)

iv- Informal economy as an integral support to formal economy. (Recent years)

3. Informal economy as a work opportunity for deflowers.

4. Causes:

- i- Burdensome regulations of state.
- ii- Resistance towards the government.
- iii- Weak enforcement of implemented laws.
- iv- Public Sector corruption.
- v- High tax rate.
- vi- Low tax morality.
- vii- Lack of awareness of tax regulation system.
- viii- Lack of education.
- ix- Economic Marginality.

5. Wayforward:

- i- Developing trust between people and government.
- ii- Inclusive policies.
- iii- Quick detection and creating deterrence.

iv. Tackling corruption.

v. Low tax rate.

vi. Increase tax morality.

viii. Awareness of tax reg-  
-ulation.

ix. Equal provision of edu-  
-cation.

x. Equal job opportunities.

#### 6. Conclusion.

The informal economy is an open and close-knit entity. Win-win co-operation is the only forward way; while a closed door policy, exclusion, confrontation and division would only lead to a dead end.

According to the first ever published global record by International Labour Organization in 2018, sixty-one per-cent of the workers in the world earn their livings through the informal economy; i.e: 2 Billion people in total, out of which 62.2 million are from developing countries. And, according to local estimates of Pakistan's ~~expanding~~ informal economy, its size appears to be the highest in developing countries.

The burgeoning informal economy of Pakistan is taken in both good and bad senses; nonetheless, it is the major contributor of further dismantling the country's economy. The government and policy makers of the country need to understand the dynamics causing this perpetual rise of informality. Many people in Pakistan are



deprived of the education/skills required to enter into formal sector, and educated ones are left behind either because of lack of space or because of prevalence of corruption in public sectors. Minor start-ups get stuck between the never ending regulatory formalities; that they find informality a more viable option. Authorities, instead of adapting strict policies and excluding these informal enterprises, need to address it with inclusive policies. If given recognition, these sectors can help to stabilize the country's economy on a major scale.

This essay contains the definition and history of informal economy, its good and bad sides, the causes behind its expansion, and the ways to address these issues, that can help in stabilizing the economy of the country.

1 Informal economy is diversified set of economic activities, enterprises, jobs, and workers that are not regulated by the state. (WIEGO).

In the 1950s and 1960s, the impression of the informal economy was that of 'traditional economic sphere' that was bound to be disappear with the prevalence of what is then called 'modern economy'. This perspective was based on the economist Arthur Lewis's prediction. He argued in his 1954 essay, that economic development in the developing countries would create a huge space for accommodating traditional economic sphere's labour. However, this was not seen in the case of developing countries. On contrary to Arthur's opinion, Hans Singer another economist predicted an 'employment crisis' is near that would lead to the formation of a complete

-ly new labor market.

Based on the concerned employment crisis prediction, International Labor Organization (ILO) started its employment mission in developing countries. The first employment mission was led by Hans Singer and Richard Jolly in Kenya in 1972. They found that traditional sector has <sup>not</sup> only persisted but also expanded to include many autonomous and lucrative enterprises. They named it 'informal sector', rather than the already known traditional sector, to highlight the significance of these small and unregistered economic activities in the <sup>developing</sup> countries.

In 1980s, this debate of informal economy started to take a new shape. Many large companies purposely began to outsource their operations to small units, in attempt to achieve more. Standard jobs were

being turned into non-standard jobs, with hourly wages and no social security for the workers. In the process, the informal economy became permanent. In short, the period of 1980s - 1990s witnessed a significant growth in size of informal economy in contrast to the predictions made earlier.

In the millennial period, informal economy has become an integral support to the formal economy. Informal economy contributes to overall economy by facilitating the creation of new enterprises and by accommodating poor workers to reduce the poverty in the developing countries.

It is because of this reason that the debate of informal economy is not only restricted to the economic literature only. Many recent scholarships revolve around the idea of informal economy, its link with formal economy, its role

with regards to poverty alleviation etc. This resurgence has made informal economy and its debate vital.

By linking informal economy with formal economy, many debate about its role in poverty alleviation by accommodation of the poor people. Pakistan is facing many problems with respect to the human development; behind which lack of education and unemployment are major aggravating factors. Formal sectors of Pakistan lack enough space to fill in the over-populated country; this pushes the people towards informality. The informal sectors of Pakistan accounts for 71.7 per-cent of the employment in main jobs outside the agriculture sector (ILO). This suggests that Pakistan has <sup>one of</sup> the largest informal economy sector in the world, with accommodation of three-fourth of its total labor population.



There are many factors that contribute in the burgeoning informality in Pakistan. The entrepreneurship in Pakistan has primarily suffered due to excessive regulatory and administrative burdens of formal economy. It is due the factors, such as: decentralised land title records, complicated tax system, number of procedures and time taken to register for labor regulations, and troublesome process of business registration, that most of the startups in Pakistan tend to take place in informal sector. In 2022, the value of informal economy was at \$457 billion, accounting for 35.6 per-cent of country's total GDP-PPP levels.

(World Bank report, 2022). In short due to these never-ending regulatory processes enforced by the state over formal sector, there is now a growing recognition of positive aspect of

informal economy.

These enforced regulations have created discontent among the people to opt for the job in the formal sector. This creates resentment and resistance in people and they seek the ways of informality.

Neo-Marxist theory argues that the informal economy is primarily a space of resistance which offers an alternative to the existing capitalist system.

The neo-Marxist logic is based on the idea that the growing number of marginalised poor people will eventually overthrow the existing capitalist structure and create an alternative survival mechanism that lies in the informal sector. This idea suggests that informal economy is a form of expression of resistance against corrupt and inefficient state.

This resistance and resentment grows deeper and deeper, and

further enlarges the space for informality. In Pakistan, due to corruption, the laws are not followed or implemented strictly, which further unleashes the informal sectors. The majority of the cases related to informal economy in Pakistan are handled easily by bribes and gifts, instead of compliance with the law. According to the study conducted by Dr Shehryar Shahid, workers who settled their problems via payment of gifts were more likely to work in the informal sectors.

(Dr Shehryar Shahid, Lahore University of Management Sciences). This highlights the state of Pakistan has become weak, because of corruption, when it comes to the enforcement of law.

In Pakistan, the extent of corruption is really high, and this substantial corruption by government officials is one of the main reasons behind the high participation of its

people in the informal economy. Pakistan in the corruption perception index list is scored 127 out of 157 countries. (Transparency International, 2013). This suggests that corruption is one of the strongest barriers in the growth of formal economy.

Another reason behind the mushroom growth of informal economy in Pakistan is the high level of tax rate. It is observed in the literature that as the level of tax increases, the cost of working in the formal sector also increases, this motivates people towards informality.

Higher taxes pushes workers to work in the informal economy, in an attempt to evade taxes and boost profits.

According to many studies, high tax rate is an important determinant affecting the magnitude of informal economy in Pakistan. Hence, the bigger

the difference between after tax earnings, the larger the size of the informal economy.

Besides high tax level, many are observed to be unaware about the tax system regulations, which also adds into the expansion of the informal sector. In Pakistan, the people working in the corporate sector or running medium sized businesses are mostly well acquainted with the tax regulation systems; but, the small sized enterprises are oblivious. (FBR, 2008). A survey report shows that majority (42%) of small businesses held the belief that there is no advantage of registration (The informal economy of Pakistan, Dr Shemyar Shahid). These findings suggest lack of awareness of tax regulation amongst small business owners in Pakistan, which serve as fuel in the acceleration of informal economy.



Alongwith the lack of awareness regarding tax <sup>regulations</sup> morality, there also seems to be low tax morality in the people of Pakistan. Tax morality is the existence of intrinsic motivation to pay taxes. There is a negative correlation between the tax morality and the size of informality. Informal workers argue that unfavourable external factors such as market norms, customer demands, and corrupt government officials undermine their level of tax morality. According to a study, increasing the tax morality of people is a viable policy option for reducing the size of informal economy (Chaudhry and Yasin, 2010). Hence, the low tax morality is an obstacle in the way of formal economy.

Alongside the structure defaults, ~~causes~~ there are individual factors as well that show the incompetence of state and enhancement of informality.

Lack of education and skills is one of a major pusher of the informal economy. Due to low level of education people find themselves handicapped in terms of being unable to fit in the formal economy.

This suggests that magnitude of the informal economy decreases with the increase in the level of education among workers. According to Shyq et al. 2010, lack of education leads to an increase in the informal economy. This shows the informal economy is inversely proportion to the education.

It's not always the lack of education that contributes in the expansion of informal economy, but also the lack of opportunities <sup>not</sup> act as a factor as well; this is called Economic Marginality. Inability of workers to find a job results in their involuntary exclusion from the formal

sectors, causing them to find escape in the informal sector. The economic conditions of Pakistan like low GDP growth rate, high unemployment rate drive the expansion of informal economy in the country. According to a survey report all this pushes people to find economic alternatives, scores of people are forced to rely on the informal economy. (Kernal 2003; FBR report). Hence, economic marginality is a huge enhancer of informal economy in Pakistan.

Aforementioned causes along with many other causes are behind the burgeoning informal economy. However, with collective efforts of state and public sectors/ servants, they can be addressed, and by this the economy of the country can become lucrative and stable. Few of the suggestions are undermentioned, that will help to put a stop on

the informal economy, or atleast slow down its progression in the country.

One of the many reasons behind the low number of people in the formal sectors in Pakistan is the lack of trust of people in the country's government. Developing the trust among the people on the government would effectively increase the participation in the formal sectors or would atleast motivate them to think about working with formality. By putting into consideration the Neo-Marxist logic, the development of trust would decrease the resistance and hence decrease the informality.

While addressing the informality, the major focus is always on pointing out and excluding the informal sectors. It would be beneficial for Pakistan, or any other country for that matter, if they focus more

on finding the way to formalize these informal sectors. As majority of the country's women labor, and significant number of men workers rely completely on the informal economy. The exclusion, hence would only increase in poverty, unemployment and devaluation of the country. In short, the inclusive policies; the recognition and formalization is the only suitable option.

As mentioned before, the prevalence of corruption is the major cause of informality. This needs to be tackled, as it is the reason of lack of law enforcement as well. As the studies have suggested that informal sectors flourish fearlessly because they have found their escape in bribing the authorities. In Pakistan almost one-third of the informal business owners believe that it is either 'easy' or 'very easy' to



bribe a government official in the business affair (Informal Economy of Pakistan, Lahore University of Management Sciences).

Quick detection of these concepts and creating deterrence by complying them with law enforcement would help decreasing the informal economy.

There is a dire need to actively handle the corruption and creating a fear among the concepts that they would have to face law. Same fear should be awoken amongst the informal sector as well. As evading business law is a crime, punishable by fines and even prison sentences, there is always a risk involved. This risk of detection will create deterrence that would help in putting a brake on corruption and informal economy.

As discussed earlier, there are many issues related to tax payment that contribute in the

creation of fiscal issues and an <sup>in</sup>critical need to be resolved. Increasing tax morality by making people believe that the tax payments are utilized for their own benefit; lowering tax levels will incentivise the people to pay taxes; awareness regarding the tax payment system and guiding people that it is not time consuming or costly; all these would decrease the expansion of informality and would help to resolve all the fiscal related problems.

Education is necessary to stabilize the formal economy. Lack of education is directly related to the augmentation of informal economy. Higher level of education would also increase the Human Development Index that in turn would stabilize the economy. According to Mahabub-ul-Haq HDI is the best tool to measure the social and economic dimensions of the country. So grappling with

This one issue can help stabilizing the Pakistan in many dimensions.

As seen in many cases, many highly educated people find an alternative in the informal sector, due to already packed formal sectors. By creating space for the workers that too on the basis of merit would be essential in the growth of formality. The <sup>creation of</sup> space for employment is difficult as Pakistan is the fifth largest population in the world, but with the adaptation of inclusive policies a good amount of space can be created, or a good number of informal workers can be converted into formal workers.

To sum everything up, Pakistan is stuck between the informal economy which is bearing its economical conditions even more. There are many causes behind this escalation of informal economy; lack of education, lack of job opportunities

burdensome administrative regulations, weak law enforcement, corruption etc, to mention a few. By acknowledgment of these issues, there is a hope that Pakistan can undertake the burden of informal economy. Informal economy, if one look through an optimistic lens, can be seen as a blessing in disguise; as only by acknowledgment and state level recognition informal sectors can be formalized, which in turn has the tendency to increase and stabilize the economic condition of Pakistan; this would also help in reducing the size of informal economy.

The informal economy is an open and close-knit entity. Win-win cooperation is the only right way forward, while the closed door policy, exclusion, confrontation and division would only lead to dead end. (Xi Jinping, Asia-Pacific Economic Cooperation, 2021).