

# Essays: The Informal Economy: The Way Forward

## Outline

### Introduction

I. Definition of the informal economy

II. An overview of the informal economy

III. The causes of the incidence of the informal economy of Pakistan

A. Crisis of education

26.2 million out of the school children, and 23% primary level drop-out students,

Pakistan Education Statistics, 2022.

B. High proportion of youth working in the informal economy  
49% of the informal workers in Pakistan are young, USAID report.

C. Low levels of income of the informal workers

Only 30% of the informal sector receive minimum wage, Majid Aziz, former President of Employees Federation

This is not the directly asked part,  
just give 2-3 arguments for it

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#### D- High levels of public sector corruption

29/100, Pakistan's score in Corruption Perception Index, 2023  
One-third of workers believe it's either 'easy' or 'very easy' to bribe a government officials, LUMS study

#### E. Regressive tax structures

Fixed tax rates on SMEs, irrespective of the revenue

### IV. The way forward for the informal economy of Pakistan

#### A- Improving access to education, skills, and life long learning

Education expenditure as percentage of GDP should be 4% to 6%, World Bank.

i- South Africa's Kha Ri Gude (Case Study) on second-chance education programs

ii- Technical and vocational training programs

#### B- Rooting out corruption

Investment in information and communication technologies and free press

#### C- Restructuring the tax system

Withholding tax base on revenue rather than legal structure of SMEs

#### D- Increasing awareness

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of tax registration system

Mass media campaigns and community outreach programs

E. Increasing risk of detection by replacing cash-based transaction with digital systems

60% businesses does cash-based transactions (State Bank of Pakistan)

Introduce incentives for digital transactions, and develop infrastructure for digital payments

F- Reducing barriers of doing business

A coordinated regulatory framework, and increasing financial inclusion

V. Conclusion

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According to the International Monetary Fund, the informal economy comprises of the activities that have market value, and would add to tax revenue and Gross Domestic Product, if they were recorded. It is a globally widespread phenomenon. Today, the informal sector accounts for about a third of low- and middle-income countries' economic activities and 15% in advanced economies (Finance and Development Journal). In Pakistan, this shadow economy values 40% of the country's GDP (ILO). The high incidence of this undocumented sector is due to the lack of access to education, high levels of public sector corruption, and regressive tax structures. It is imperative to improve the access to education, skills, and lifelong learning. This will build foundation for the informal workers to do transition to the stable and better-remunerated work in the formal economy. Furthermore, the menace of corruption needs to be eradicated from the core. Enhancing transparency and thereby, increasing accountability are essential to

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root out corruption. Moreover, tax structure should be reformed so that it incentivizes the undocumented enterprises to enter the formal sector. Another effective way to attract the informal businesses toward formalization is by enhancing the financial inclusion. Thus, the multiple ways to formalize the informal economy of Pakistan include providing education and skills, implementing new tax reforms, raising tax awareness, eradicating corruption, increasing the risk of detection, and promoting ease of doing business.

This essay begins with the definition of the informal economy. It then provides an overview of the informal sector in Pakistan and across the globe. Next, the causes of the incidence of the informal economy in Pakistan are discussed. Finally, it provides the way forward to formalize the informal economy of Pakistan.

Informal economy refers to the economic activities that fall outside the ambit of state-imposed regulations, taxation, and observation.

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Hence, their market value is not recorded in the country's GDP. These informal activities may or may not have any backward or forward linkages with the organized sectors. Various entities, such as street vendors, domestic workers, small and medium enterprises, and large sections of real estate sector, operate in the shadow economy.

All countries in the world have a parallel sector operating alongside their formal economies. However, its scope and magnitude vary from country to country. Generally, lower- and middle-income countries contain a larger proportion of undocumented sector in their economies. According to Finance and Development Journal, today, it forms about 33% of underdeveloped and developing countries' economies. In contrast, for advanced economies, it accounts 15% of their economic activities (Finance and Development Journal). In case of Pakistan, the informal economy has immense value, as it makes 40% of the country's GDP.

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(ILO). More importantly, it is the primary source of livelihood for about 72.5 percent of the labor force ~~in Pakistan~~ ~~outside~~ outside agriculture sector in the country (ILO). Hence, it is generating income for a significant proportion of the households throughout Pakistan that are not accommodated by the formal sector.

The crisis of education in Pakistan is ~~the~~ one of the primary causes of the incidence of the informal economy in the country. As per Pakistan Education Statistics, 2021-22, 26.2 million children of age 5-16 are out of the school. This means that approximately 39% of the country's future generation is not going to develop basic skills, such as functional literacy and numeracy. Therefore, they lack the foundation for any other learning and the decent work. Among those who manage to enter primary schools, 23% of them are not able to reach grade 5 (Pakistan Education Statistics, 2021-22). As a result, there are out-of-the-school children, as

well as primary level dropout children, enter the informal economy. This is because it is their last resort to earn livelihood.

This is why Pakistan's shadow economy mainly comprises of the young population. According to a report by USAID, 49% of the informal workers are young in Pakistan. A huge proportion of children that is denied the access to education remain forever handicapped to enter the formal sector. Hence, they grow up working in the informal economy.

These dynamics have serious implications for Pakistan's economic growth. Almost half the country's burgeoning population that holds the sea of potential, is being consumed by the unskilled sector. This means that their full potential is not being realized.

Another cause of the persistence of the informal sector is the low income levels of informal workers. A survey conducted by LUMS reports that as the total monthly income of informal workers increases, they



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become more inclined to work in the formal economy. However, in case of Pakistan, workers in the informal sector have very low wages. As Majid Aziz, former President of Employees Federation said, "If I am being very generous, about 30 percent of the informal sector receives the minimum wage." This means majority, that is 70% receive it far below the minimum wage. Hence, making them stay in the shadow economy.

High levels of public sector corruption is a big contributor to the growth of the informal economy in Pakistan. This is because the acts of bribery and rent-seeking increase the cost of doing business in the documented sector. In Pakistan, corruption is remarkably high. In Corruption Perception Index, 2023, Pakistan had a score of 29 out of 100. This score is far below the global average of 43. The lower is the score, the more lucrative alternative will be the informal sector for entrepreneurs. Another reason due to which

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Corruption serves as a barrier to formalization is lack of transparency and accountability on the part of public officials. Businesses may operate informally because they know they have officials who would facilitate them ~~avoid~~ evade the legal repercussions. According to ~~the~~ the findings of a research paper, 'The Informal Economy of Pakistan' by Dr. Muhammad Shehryar Shahid, one-third of the informal workers believe that it is either 'easy' or 'very easy' to bribe a government official. These perceptions highlight how entrenched corruption is on the institutional level, and its direct contribution to the rise in the size of the informal economy.

In addition to that, regressive tax structures ~~taxes~~ for businesses has bolstered shadow economy in the country. Although Small and Medium Enterprises form 90% of the business operations in the country but majority of them are in informal economy (Small and Medium Enterprises Development Authority report). This is because registered SMEs are taxed

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at a fixed rate, irrespective of their income. This creates an uneven playing field where these businesses face reduced profit margins and increased operating costs. Ultimately, such policies discourage formalization and corporitization of Small and Medium Enterprises.

The preceding paragraphs discussed the causes of the growth of the informal economy in Pakistan. The proceeding section will shed light on the way forward to formalize the informal economy of Pakistan.

First of all, the government should ensure that no children is deprived of the access to education. This means both reducing the number of out-of-the-school children, and minimizing school drop out rates. For that it to accomplish that, it needs to increase its budget up to 4% to 6%, as recommended by the World Bank. With the current 1.5% education <sup>expenditure</sup> budget as percentage of GDP, no further

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development is possible in the sector; all the spending is exhausted merely on the functioning of the sector at its current below full capacity. An access to education would ensure that everyone has the foundational literacy and numeracy that would enable them to undertake other learning required to move into the formal economy. For those already in the informal sector, second-chance education programmes focused on foundational skills can be introduced. Key design features seen in successful implementations of second-chance education programmes include the use of practical curricula and less formal instruction methods, flexible mode of delivery, and reduce costs to participants. Successful basic skills interventions South Africa's Kha Ri Gude mass literacy campaign, which aimed to cut the national illiteracy in half. The campaign involved training volunteers and community members as facilitators to teach literacy skills in their local communities. To make it accessible to a diverse population, learning

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materials were developed in all 11 official languages of South Africa. ~~Further~~ Moreover, classes were conducted in various settings, including community centres and churches, to accommodate participants' schedules. The program reached almost 4 million illiterate adults in its first 7 years of operation with a high completion rate (World Bank).

In addition, to reduce the economic marginality for informal workers, the government should heavily finance the technical and vocational training programs. They should be accessible to informal workers through targeted grants, subsidies, allowances, or training vouchers. The training delivery models should be flexible so that they do not limit the acquisition of skills for informal workers. Other considerations should be geographic location of where the training is delivered, and the course length, given that longer courses increase the opportunity cost of participation for workers.

Second, ~~it~~ rooting out

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Corruption should also be among the top priorities of policymakers. A high level of investment is required to promote transparency. Transparency improves law enforcement, brings better accountability, and trust in processes and institutions, and deters wrongdoing by increasing risk of detection. One effective way to increase transparency is ~~to~~ to invest in information and communication technologies. For example In Chile and Korea, for instance, electronic procurement systems have been powerful tools to improve transparency and curtail corruption. Another effective way is to promote free press. The press that would not just release data but ensure ~~to~~ ~~certainty~~ ~~class~~ that it must be widely disseminated and explained. This enhances the benefits of fiscal transparency in curbing corruption.

Third, tax system design should avoid inadvertently increasing incentives for individuals and firms to remain in the

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informal sector. Simpler value-added and corporate tax systems with lower rates as well as low payroll taxes, help reduce informality. It is particularly important to maximize the inclusion of small and medium enterprises in the formal sector as they form 90% of the business in Pakistan (SME:DA report). To do that, the withholding tax for small and medium enterprises should be based on revenue threshold rather than their legal structure, which is ~~the~~ ~~case~~ ~~no~~ currently the case.

Fourth, the government should introduce targeted public awareness campaigns to increase the knowledge regarding tax registration system. It is very important because 42% of the small business owners believe that there is no advantage of registration while 27% of them are oblivious to any advantages (USAID). Hence, radio, television and social media platforms should be utilized to run awareness

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campaigns that explain the importance and benefits of tax registration. Furthermore, community-based education should be promoted. Government should partner with local leaders, community groups and NGOs to conduct face-to-face information sessions in markets, villages, and urban neighborhoods. These sessions can address myths, answer questions, and demonstrate how easy it is to register.

Fifth, it is very important and rather urgent to increase the risk of detection of the informal work. In Pakistan, more than 60% of the business is conducted in cash (State Bank of Pakistan).

This ~~is~~ ~~prevents~~ ~~it~~ limits the government's ability to detect and bring the informal businesses under law. To counter this, the government should introduce incentives for digital transactions. This includes providing tax benefits, discounts or cash back rewards for individuals and



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businesses that use digital payment methods instead of cash. It is also important to expand digital payment networks. Investments should be made in the infrastructure needed for digital payments, such as point-of-sale (POS) systems, mobile payment platforms, and increased internet access to the underserved areas.

Finally, the government should reduce barriers to doing business. A coordinated regulatory platform should be established. Currently, businesses face multiple regulatory requirements from different government agencies. This results in regulatory overlaps and increased compliance costs. A more streamlined regulatory framework that consolidates requirements and reduces redundancies could ease the burden on businesses to formalize themselves. Improving access to finance is also a related policy strand that should be focused upon. Informal businesses often lack access to formal financial

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Services, which hinders their growth and development.

Enhancing financial inclusion by making it easier for small businesses to obtain loans, open bank accounts, and access other financial services can encourage them to formalize.

In conclusion, there are many factors in place that are contributing to constant growth of the informal economy in Pakistan. This includes lack of access to education, high levels of public sector corruption, and regressive tax structure. However, there are solutions to these problems in the face of formalizing the informal economy. The way forward is to improve access to education, skills and lifelong learning. It is imperative to curtail corruption so that informal workers do not feel that they would be exploited if they formalize their work. The tax structure should also be reformed, and government should ease the doing of business through

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regulatory simplification  
and enhanced financial  
inclusion.