

# Informal Economy in Pakistan: Causes & Way Forward

## Outline

### I Introduction

Thesis: The informal economy of Pakistan stems from multifarious factors ranging from one's desire to evade taxes and complicated bureaucratic hurdles to his inability to make into the formal sector, necessitating multifaceted and context-driven strategies to curb this economic menace.

### II What constitutes the informal economy of Pakistan

### III Causes of the informal economy in Pakistan

a) Tax evasion and non-compliance with the legal regulations pertaining to business.

Case in point: The tax-to-GDP ratio in Pakistan is only 9.2%, indicating widespread tax evasion.

b) Lack of access to credit and reliance on informal financing methods.

Case in point: Only 21% of adults in Pakistan have access to formal banking institutions.

c) Paucity of employment opportunities in the formal sector

Case in point: The industrial base in Pakistan is limited with manufacturing sector contributing only 12.4% to the GDP.

d) Lengthy and cumbersome process of business registration

Case in point: The "Ease of doing business" index places Pakistan at 72<sup>nd</sup> position out of 180 countries, indicating the dire state of establishing business in Pakistan.

e) Reliance of a large number of women on home-based labour accounting a large significant share in informal economy.



Case in point: Pakistan has approximately 12M home-based workers and 50% of them are women.

IV Strategies to alleviate the menace of informal <sup>economy</sup> sector of Pakistan.

a) Simplification of taxation process

Case in point: Low and progressive tax regimes for small and medium enterprises.

b) Incentivisation of the startup culture

Case in point: Tax exemptions for installing incubators nationwide and other entrepreneurial ventures like that in Silicon valley, US

c) Access to credit and microfinancing facilities

Case in point: Microfinancing facilities in Grameen Bank, Bangladesh lifted 2M people out of poverty.

d) Establishment of a robust industrial base and IT sector to create employment opportunities for the indigents.

Case in point: A more gender-inclusive employment opportunities, catering to various social strata, can help expand the formal economy.

e) Establishment of one-window operation for business registration and other investment opportunities

Case in point: SIFC should be further expanded to attract investment and ease the setting of businesses in Pakistan.

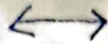
f) Provision of skill-centric education and TVET (Technical and vocational education training) programs tailored to meet the demands of market.

Case in point: Norway, with a curriculum centered on conceptual learning and problem solving



has a literacy rate of 100% and a high employment rate.

## V Conclusion



On a bustling evening in Karachi Empress market, a multitude of street vendors, proclaiming their wares as the finest grains, set their goods on wooden carts. Amidst this cacophony was Ahmed, a fifteen year old boy, diligently segregating the fruits on his cart, apprehensively wondered if the profits of that day would fulfill the needs of his five-membered family. Like Ahmed, there were countless others who despite their years of toil, remained invisible in official records - unregistered, untaxed and unprotected. They operated within a brazen informal economy in Pakistan; a system that thrives on accessibility and flexibility but deprives its participants of social security and opportunities. This presents a dark reality of the informal sector within Pakistan which constitutes fifty percent of the total GDP and employs about seventy-five percent of the workforce yet deprive the labourers of social security net and fair wages. According to the International Labour Organization (ILO), approximately two billion people globally function within informal economy. Now one can wonder how and why did an economy, informal in its nature, mushroomed to the extent of employing this significant proportion of the total workforce of the world. Well, the reasons are multifarious. The informal economy is an easy way out to evade taxes and other regulatory frameworks of a country. The workers may not be proficient, educated and skilled but can earn scores of money through unregistered



businesses. This gets furthered in an agrarian economy, like that in Pakistan where there is little industrial base and majority of the livelihood comes from unregistered agricultural practices. In Pakistan, the context in which the informal economy functions is heterogeneous, ranging from a cumbersome business registration process to tedious bureaucratic hurdles. This precarious state of operability of businesses encourages the informalisation of economy and calls for a multifaceted and context-specific solutions to mitigate this crisis. The solutions vary from incentivising the startup culture, providing credit facilities to blooming business and introducing a simplified tax regime which has low and progressive taxes for small businesses. Moreover, skill oriented education and capacity building of labour can integrate the workforce into the formal economy. This essay delves into the causative factors of the prevalent informal economy of Pakistan and presents strategies based on the context of economic practices within for Pakistan to step out of the vicious cycle of untaxed and unregistered economic practices.

Before expounding upon the causative agents of the informal economy in Pakistan, it is imperative to understand what really constitutes the informal sector in Pakistan's economy. It comprises of the goods and services which have market value and would add to the GDP of Pakistan if they were recorded. These goods and services fall out of the ambit of our taxation and regulatory frameworks, making them unregistered, undocumented and untaxed. A wide array of unregistered



Untaxed activities like small-scale trading, agriculture, street vending and undocumented freelancing are prevalent in Pakistan, stifling economic growth and creating unhealthy competition. This economic situation is grave as seventy percent of the workforce is employed in the informal sector. Therefore, the need of the hour is to delineate the systemic deficiencies within the economic fabric of Pakistan. **Write with proper subject verb and object formation.** Does this suggest the incapacity of our formal economic system to cater to a burgeoning youth population of the country or are there underlying structural factors responsible for the lacking of our current economic system.

The foremost reason for the prevalent informal economy in Pakistan is the inclination of people towards tax evasion and non compliance with legal requirements. The evidence of the widespread tax evasion in Pakistan is the tax-to-GDP ratio which stands only at 9.2%, making Pakistan one of the countries with the lowest tax revenue across the globe. The reasons of these flawed tax mechanisms is are decaying tax morality and the desire of people to grow their businesses in an unregulated manner. It is perceived among the masses, particularly those associated with informal economic activities, that it is appropriate rather heroic to get away with tax evasion. This signifies a deeprooted societal issue and challenges the effectiveness and efficiency of the institutions responsible for collecting taxes. This menace is further inflated by the outlook of people towards the growth of the businesses which they believe is indirectly proportional to the tax paid. In simple terms, people are of the view that the growth of



enterprises is hindered and downsized if they pay the respective tax imposed. This stifles the tax revenue collection in return and furthers the informalisation of economy.

The second reason behind people's tendency to work in the informal sector is the lack of credit and financing methods available in Pakistan, particularly for small businesses and low-income individuals. Formal credit is crucial for businesses to scale up, invest and comply with legal requirements. However, in Pakistan, only 21% of adults have access to formal banking institutions. This implies that about 80% of the individuals lack the financial literacy and ability to secure loans from formal institutions. Consequently, these small businesses and individuals resort to informal channels such as unregistered money channels, lenders to meet up their financial needs. These alternatives, while accessible, perpetuate the informal economic activities by bypassing documentation and regulatory compliance. Not only do these informal practices exist to elude the documentation but also arise out of systemic inefficiencies and institutional gaps in the formal economy.

A major institutional failure of Pakistan's formal sector is the paucity of employment opportunities which accounts for the third reason for the rampant informal economy in Pakistan. This predicament stems from the fact that the industrial base in Pakistan is limited with manufacturing sector contributing only 12.4% to the GDP. The IT sector is grappling



With a dearth of skilled labour. The question arises why are we short of resourceful individuals who can meet the needs of the industry. The answer is very simple; our educational curriculums and training programs are centered on rote memorisation, disregarding the skills required by the contemporary industry demands. With a literacy rate of only 62.5%, Pakistan <sup>annually</sup> produces graduates inept at problem-solving and communication, only for them to sit idle post graduation. The lack of employment opportunities in formal sector translates into a surge of informal economy where the individuals easily find means of livelihood outside the regulated frameworks of the formal economy.

Even if an individual plans on establishing a business within the bounds of the formal sector of Pakistan, a lengthy and cumbersome process of business registration awaits him. The bureaucratic checks and regulatory hurdles act as a major deterrent to formalizing enterprises, fuelling the growth of informal economy. This is corroborated by World Bank's ease of doing business index which places Pakistan 7<sup>th</sup> out of 180 countries. The extensive documentation procedures, exacerbated ~~with~~ <sup>by</sup> high costs and bribes, and red tapism encourage the entrepreneurs to choose informal economic practices. Small and medium enterprises (SMEs), which form over 90% of Pakistan's business base, are the most affected as they lack the resources and expertise to navigate the complex registration process. Furthermore, the informal setups in the rural areas of Pakistan face limited access to online portals and legal assistance, making formalisation onerous.

**Plz write more substantive paragraphs**



Another significant factor behind the growth of informal economy, which serves as the fifth reason, is the gender exclusion in formal work platforms, translating in a spur of home-based labourers. The society of Pakistan is entrenched with cultural taboos, confining women to their homes. This predicament is further compounded when the formal workplaces and manufacturing set-ups are ~~un~~ are entwined with gender inequities such as wage gap and difficult promotions. This presents extremely unwelcoming circumstances for women, who despite of being 48.51% of the total population, indulge in unpaid labour. According to a report, Pakistan has 12 million home-based labourers out of which 80% are women. These workers, who are involved in low-income and low-skill activities such as stitching, embroidery, cleaning and handicrafts, account for a large proportion of the labour in informal economic sector. These jobs are insecure, poorly paid and lack social protections. Hence, the reliance of women on home based labour further exacerbates the prospects of formalising the economic sector of Pakistan.

Having explored the root causes of the informal economy, it is ~~is~~ of prime importance to delineate solutions, in accordance with the context in which the informal economy operates, to curb this ~~area~~ menace of informality. The primary solution to alleviate informality of economy is to ~~erad~~ curb tax evasion. This can be realised by the introduction of simplified tax processes. The tax systems should be digitized and streamlined to eliminate redundant



Procedures Moreover, small and medium enterprises, which are expected to pay exorbitant taxes, should be charged with low and progressive taxes. This will boost their confidence in the tax authorities of the countries, furthering their compliance with the tax regulations.

Secondly, the start-up culture and entrepreneurial ventures, responsible for driving economic prosperity, should be incentivised. This incentivisation can take place in the form of tax exemptions and subsidies. A national level endeavour to install incubators with tax exemptions can be a step in the right direction. It will be pertinent in the informalisation process as most of the entrepreneurial ventures in Pakistan operate outside the bounds of formal economy. The example of Silicon Valley in US, home to a various multi-national companies such as Google, Apple and Meta, is highly relevant as it incentivised these startups and provided an ecosystem conducive to their growth. Implementing a similar strategy for the startups can broaden the informal economic sector.

Incentivising startups with tax exemptions <sup>in isolation</sup> can not ensure their retention in the formal economic sector of Pakistan. This calls for more sustainable solutions like provision of credit and microfinancing facilities to the blooming businesses. These credit opportunities can ensure loans and resources to the growing businesses in Pakistan, precluding them to resort to informal financing options. A pertinent case study of this is the Grameen bank in Bangladesh, with its diverse microfinancing options for investors and



businesses, it pulled two million people out of poverty. Pakistan microfinancing institutions should be bolstered, in terms of resources and capital, to support small and medium enterprises (SMEs) with microfinance and credit opportunities.

The fourth solution gravitates around the idea: if there are <sup>adequate</sup> employment opportunities for individuals in the formal sector, he would be less enticed by the informal economic activities. This necessitates the establishment of a robust industrial base and a more large IT sector to employ the youth of Pakistan which constitutes 63% of the total Pakistan's population. Adding Employing 63% population means in the formal sector will reduce the likelihood of them transitioning into informal sector by many times. This is because the formal sector provides safer working conditions, fair wages, health benefits and other social security privileges. Not only expansion of industrial base, but also creation of more gender-inclusive environments to curb the glass ceiling phenomenon and other gender inequities, can accommodate a large proportion of home-based female workers in the formal economic frameworks.

Where multiple employment opportunities are required to curb the informal economy; steps to attract the investors and businesses are equally important - the fifth solution lessen the informality. This can be achieved through a mechanism of one-window facility for business registration and investment procedures. This would significantly dampen red-tapism and procedural hurdles.



attracting investors for long-term business ventures. The recently launched "Special Investment Facilitation Council" (SIFC) is a prudent reform which should be further expanded to accommodate more investors. If utilised cognizantly, this one-window facility has the potential to increase investments and hence employment rate, curbing the informal practices.

The sixth solution is to build capacity for our industries in terms of skilled and educated labour. The education curriculum of Pakistan, devoid of problem solving and conceptual learning, needs to be overhauled. Norway, with a literacy rate of 100% and a high employment rate is an exemplar of having an educational curriculum tailored to meet the contemporary needs of industry. Pakistan should replicate this to revise the curriculum to produce **Kindly try to write with proper explanation and examples** ~~skilled~~ graduates annually. Being educated, these individuals will be more rational and cognizant of the costs of joining an informal setup over formal ones. This will not only increase the employment rate but will also significantly curb the informality of economy in Pakistan.

In conclusion, the informal economy of Pakistan stems from multifarious factors ranging from systemic lacking such as the paucity of employment opportunities in the industrial and manufacturing sectors, to social dilemmas like home-based labour largely dominated by women, indicating broader societal inequities. The menace of the burgeoning informal economy in Pakistan require a multi-faceted and context driven