

Shadow Economy, The Way Forward

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Essay:

"Informality is not a crime but a verdict of the people to the obstacle that the state places in their way" economist Hernando de Soto.

Shadow economy is a double-edge-sword, on one hand, it deprives state of the revenues, on the other hand, it also somehow indirectly contributes to formal sector. Comparing positive with negative, negative stands negligible, making it entirely disadvantageous for state.

However, informal economy does not strengthen itself in a vain. They are multiple-drivers which compel most of the people to prioritize economic operation in shadow economy rather than in formal economy. These causes include weak governance and bureaucratic red-tape, unfair tax regimes and lax implementation of the tax policies, unfettered border areas and smuggling, and it also entails shrinking opportunity for low-skilled labor in formal market. Besides its causes, the existence of black economy have severe repercussion for a state. It does not only strip of contribution to national GDP but also increases income-poverty gap. Furthermore, labors who work in informal market - mostly unskilled people - often deprive of legal protection. Given the negative side and risk it carry

for state and for its people, it becomes need of the hour to make informal formal. They forward consisting of digitalization of the economic sector, simplification of the registry process, strengthening tax regimes, provision of special incentive to encourage registration and reforming financial institution to ensure efficiency and effectiveness. Thus, despite having some positivity, unregulated economy cost states heavy price. To tackle the root causes way forward is prerequisite.

The term 'shadow economy', which also known as underground economy, black economy and informal economy, refers to the economic activities of all types that operate beyond state control. In informal businesses taxes are evaded, irregularities exist ubiquitously, and labor rights are often violated. It is not limited to one or two states, but to all with varying nature. Even in some countries it overpass formal economies. Pakistan's informal economy is case on the point. According to a study compiled by small and medium enterprises development authority (SMEDA) Pakistan's informal economy is projected to be an enormous \$457 billion in sharp contrast to the size of formal economy.

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furthermore, despite making large sum of the national income, it does not contribute to the development of states, making it a sword of damocles for a state. However, there are multiple cause for it. The below are the paragraphs that detail causes.

Weak governance and bureaucratic red-tape is main cause for informal economy. In a state like Pakistan, operation of any business has become a rocket science. The lengthy registration process, bureaucratic hurdles, rampant corruption and institutional overreach have made registration process more complex and in some cases, even exhausted, encouraging people to opt more easy way. Moreover, once if any business goes through that registry process, it start facing new challenges. Institutional overreach and government regulatory procedures make operational businesses easy prey to bribery and arbitrary practices. These altogether make formal businesses more costly and unreliable. In contrast to this, black market start providing a better opportunity and alternative to people. Hence, weak governance and bureaucratic red-tape pave ways to undocumented economy.

Unfair tax regimes also encourage people to not to document their businesses. In Pakistan, tax regimes are mostly regressive in nature, meaning tax laws treated both the affluent and low-income class equally. Even in some cases, it burdens middle-class and provide safe escapism to wealthy class. High reliance on withholding taxes and high cost taxes are the prime examples of the fact how unequal is Pakistan tax system is. Furthermore, this issue is not only limited to people but also to sectors. Some sectors despite making large proportion of the GDP enjoy tax exemption, leading to burdening of other sectors. According to State Bank of Pakistan, salaried class pays more than 300% tax compared to wealthy -gaints, reflecting fault-lines in existing tax system. This, then, do not only compel low-income class to evade taxes but also spur them to operate in black economy. Therefore, existing tax system is another cause of the expanding informal economy.

Apart from this, unfettered border smuggling also spur informal economy. When goods are being smuggled, imported without custom duties and poured into market with any restriction, then, it becomes rational for people not to register their

their businesses. The goods and services being smuggled from other countries often attract large market demands. It is because, they are far more cheap or than that goods and service which are being taxed. Furthermore, this does not only deprive state of the taxes but it also even degrades formal businesses more irrational and unprofitable. The case of Iran-oil-smuggling is case on the point. According to SPO-data, smuggling Iran-oil has made reduction in demands for Pakistani-oil (import by government). Hence, uncontrolled-smuggling enhances informal economy.

The above paragraphs elucidated in detail the cause of informal economy, the preceding paragraphs shed-light on the impacts it has for state

Informal economy, besides other repercussions, it does not contribute to national gross domestic product (GDP). It is because it operates without formal registration. The operators of black businesses, unlike those of formal ones, do not compel by state or ^{by} any financial institution to pay tax, depriving state of the large sum of collection. Moreover, in a formal businesses, state often intervenes, regulate the irregularities, protect

ects labor rights. In addition to this, state also in some cases fix salary range for workers. In contrast to this, in an informal economy, workers are often paid for lesser wages, their rights are mostly violated, and they enjoy no social security. This altogether leads to increased income-parity gap. Hence, black economy along depriving state of economic revenues, also increases income-gap.

Moreover, when taxes are not being paid, it limits state's capacity to invest on social development. States, in most of the cases, often rely on taxes to finance its expenditures. The issue morphs more disastrous, when a state, despite to pay large sum of its budget in repayment to external borrowers, still getting less or nothing in taxes because of the informal economy. In contrast to this, when state get high taxes, it directly results in investing on social development programs. According to the economic survey of 2024-25, Pakistan has to pay 48% of its budget to foreign lenders, leaving very little with it to invest on social development. Thus, shadow economy limits capital for social services.

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Given its severe implication both for the state and workers' rights, it's important to make informal formal. The below paragraphs explain the way forward to tackle the menace of black market.

Digitalization of the economic sector helps in formalizing the underground economy. It does not make the institutions more effective while delivering services but also help citizen to get rid of the lengthy registration process. Furthermore, digitalization also provide greater access to finance and banking services, making it easy for small and medium business to get loans for expanding their businesses. Moreover, digitalization also provide with the e-on-hand services to businesses. These on-hand services include E-payment facility, E-feedbacking service and most importantly E-campaigning service. These altogether would reduce public official encroachment and make services more better. Besides, digitalization also help government to easily keep and trace businesses and their records, ensuring compliance with laws and curbing informal businesses. Therefore, digitalization helps in controlling and formalizing shadow business activities.

Besides, simplification of the registry process paves way to formalizing the informals. Most of the informal economic activities take place because of the difficulties they have to face during registration process. Alternatively, informal economy present itself more easy to go with or proceed through. For a small business, it even required the approval of different departments. On the other hand, simplified registration and operational approvals would spur informal market to operate formally. In this regard government could establish 'A single-window' approval system. Thus, simplification of the registry and approval process would help in arresting the issue.

In addition to this, the provision of special incentive to informal sector to encourage them to register is another helpful way forward. When those businesses that are operating informally see incentives and opportunities, then it become rational for them to formalize their business. These incentives include tax exemption, registration fee free or other amnesty schemes. These amnesty schemes provide them an one time opportunity to white their black money. This could be a win-win

situation both for them and for state. On their parts, they will get amnesties and state protection. On the other hand, state would get large registration of businesses, ultimately resulting in greater tax collection. Hence, provision of special incentives would help expanding state control over informal market.

Apart from this, reforming financial institutions will help in formalizing black market. As already discuss in course part that institutional weakness, bureaucratic red-tape and official overreach are some the main behind informal economy. If the institutions are reformed, vibrant monitoring of the official conducts are in place and bureaucratic red-tape is limited, without an iota of doubt, people would by themselves show interest in formalizing their businesses. As proverb goes that bad governance is the mother of all evils. Therefore, for government if they truly desired to arrest this menace, reforming financial institution is one of the suitable way to do.

To conclude the debate, it's proved that shadow economy is not something taking place in a vain but it is a direct

result of people response to governance. There are various factors helping black economy to strengthen its root. These factor include weak governance, bureaucratic red-tape, unfair tax regimes, unfettered border control and shrinking opportunity for low-skilled labor in informal market. Besides, shadow economy has severe implication for a countries like Pakistan. These repercussion entail non-contribution to national Gdp, increases income-poverty gap, nonavailability of legal shield for labor and limited capital for social services. To arrest the peril, the way forward include digitalization of economic services, simplification of registration process, strengthening tax regimes and provision of special incentives to encourage informal business to formalize their businesses. Unless and untill the notion - informal economy exist because of free market - change, the issue could not bottled. Therefore, its never late, Pakistan is only a single sincere step away from resolving the issue.

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