

Types of Informality: Causes, Consequences, and Policy Responses

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- Tax Policy and Informality
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Some Writings

- Basudeb Guha-Khasnobis, Ravi Kanbur and Elinor Ostrom (Editors), *Linking the Formal and Informal Economy: Concepts and Policies*, Oxford University Press, 2006.
- Ravi Kanbur, “Conceptualising Informality: Regulation and Enforcement,” V.V. Giri Memorial Lecture, *Indian Journal of Labour Economics*, Vol. 52, No. 1, pp. 33-42, 2009.
- Arnab Basu, Nancy Chau and Ravi Kanbur, “Contractual Dualism, Market Power and Informality,” 2011, forthcoming in *Economic Journal*
<http://kanbur.dyson.cornell.edu/papers/BasuChauKanburContractualDualism.pdf>
- Ravi Kanbur, “Avoiding Informality Traps”, in E. Ghani (ed.), *Reshaping Tomorrow: Is South Asia Ready for the Big Leap?*, pp. 260-278, Oxford University Press, 2011.
- Anushree Sinha and Ravi Kanbur, *Informality: Concepts Facts and Models*, Special Issue of *Margin: The Journal of Applied Economics Research*, NCAER, Delhi, May 2012.
- Urmila Chatterjee and Ravi Kanbur, “Regulation and Non-Compliance: Magnitudes and Patterns for India’s Factories Act,” <http://dyson.cornell.edu/research/researchpdf/wp/2014/Cornell-Dyson-wp1405.pdf> , 2014.
- Ejaz Ghani and Ravi Kanbur, “Urbanization and (In)Formalization,” in Edward Glaeser and Abha Joshi-Ghani (Eds.) *The Urban Imperative: Towards Competitive Cities*. Oxford University Press, 2014.
- Ravi Kanbur, “Informality: Causes, Consequences and Policy Responses,” Paper prepared for Reserve Bank of India, 2014, <http://dyson.cornell.edu/research/researchpdf/wp/2014/Cornell-Dyson-wp1418.pdf>
- Ravi Kanbur and Michael Keen, “Reducing Informality”, *Finance and Development*, March, 2015, Vol. 52 No. 1.
- Ravi Kanbur and Michael Keen, ““Thresholds, Informality and Partitions of Compliance” *International Tax and Public Finance*, Vol. 21, pp. 536-559, 2014.

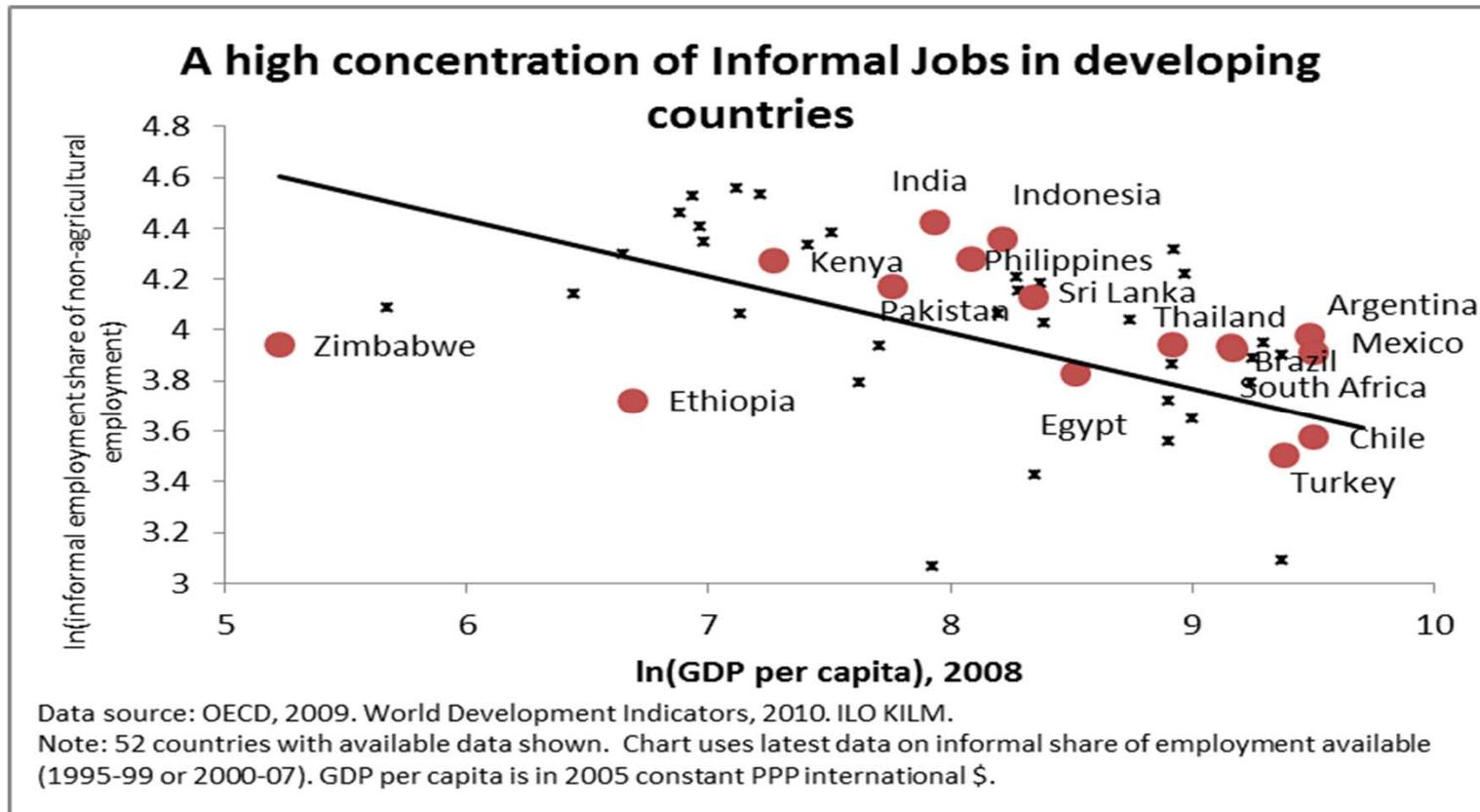
Introduction (1)

- One does not get far in the development literature without coming across the dualism between “Formality” and “Informality.”
- Indeed, the discourse on formality and informality has a long tradition, and is intertwined with the discourse on dualistic development, and development in general.

Introduction (2)

- The policy interest in informality arises because it is seen as being associated with low productivity and with poverty.
- Most recently, interest in informality has sharpened because despite the prediction of standard development models, informality as conventionally measured is not declining.

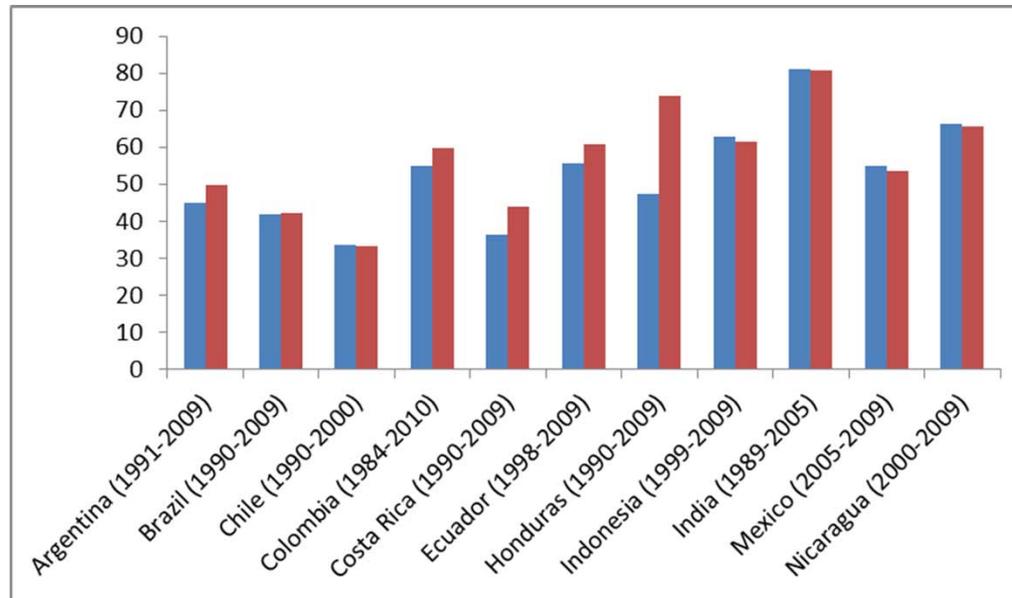
Introduction (3)



Introduction (4)

Informal sectors are exceptionally persistent

(share of population in informal employment, earliest and latest data points available)



Source: ILO 2011; Government of India

Introduction (5)

- This has led the OECD to ask the question “Is Informal Normal?”. (They answer in the affirmative)
- This persistence of informality as conventionally measured has led to policy angst on what to do about it, for which we need to know the causes of informality.

Introduction (6)

- The title of my talk is “Types of Informality” and the title encapsulates my basic theme.
- It is that informality as an overall aggregate concept or measure is not particularly useful analytically, and indeed policy objectives to “Reduce Informality” can be misleading for policy.
- I want to illustrate my basic theme primarily from the world of labor, but secondarily from the world of taxation and revenue.

Informality: A Brief History (1)

- 1940s. The Dutch anthropologist and colonial administrator J. H. Boeke introduced a notion of a “dualism” which has echoes in the modern discourse on formality and informality, although those terms were not used.
- Expectation that as the colonial boundary was extended (with “development”), “informality” would decline.

Informality: A Brief History (2)

- 1950s (and 1960s). Lewis model of dualism, between a modern capitalist sector (with profit maximization and market orientation), and a traditional sector (in rural and urban areas) following different, non-market, rules, and acting as a reserve pool of labor for the modern sector.
- Again, with the growth of the capitalist sector the traditional sector would decline as development proceeded.

Informality: A Brief History (3)

- 1970s. Anthropologist Keith Hart—credited with introducing the term “informality”
- “Following Weber, I argued that the ability to stabilize economic activity within a bureaucratic form made returns more calculable and regular for the workers as well as their bosses. That stability was in turn guaranteed by the State’s laws, which only extended so far into the depths of Ghana’s economy. ‘Formal’ incomes came from regulated economic activities, and ‘informal’ incomes, both legal and illegal, lay beyond the scope of regulation.”

Informality: A Brief History (4)

- 1970s. ILO begins process of approaching a uniform international definition. ICLS process.
- “[Informal enterprises] are private unincorporated enterprises..., that is, enterprises owned by individuals or households that are not constituted as separate legal entities independent of their owners, and for which no complete accounts are available that would permit a financial separation of the production activities of the enterprise from the other activities of its owner(s).”

Informality: A Brief History (5)

- 1970s. Harris-Todaro. Another perspective on dualism.
- Formal sector is that which is subject to regulation (eg minimum wage regulation) and non-competitive behaviour (eg trade unions). Informal sector is that which is competitive, with no market power.
- Harris-Todaro is an extremely influential mindset. Deregulation as the route to addressing informality.

Informality: A Brief History (6)

- Bottom line—there is no single conceptualization. Rather, a range of “mind sets”.
- One strand is that informality is something to do with the economic activity per se—its smallness, its internal form of organization, the competitiveness of the sector, etc. etc.
- But the dominant strand is that informality is something to do with relation of the activity to the laws and regulations of the state. Informality is that which is outside of the purview of the state. This further crystallizes the connection between regulation and the presence of informality.

A Framework (1)

- First, imagine a world without state laws and regulations.
- Into this, specified laws and regulations are introduced. Economic agents then have to decide how to respond.
- For concreteness, consider a law which says that all enterprises with 10 or more workers have to register and give certain benefits and protections to their workers.

A Framework (2)

- This regulation/law has two aspects in the analysis of informality.
 - First, simply, it serves in the definition of informality and measurement of informality.
 - But, second, and very importantly for the policy discourse, it changes behavior and thereby also affects the extent and nature of measured informality.
- The behavioral response creates several categories of enterprise. Let us look at them one by one.

A Framework (3)

- A. Within the ambit of the laws and complying.
- B. Within the ambit of the laws but not complying.
- C. Adjusted activity to go outside the ambit of the law.
- D. Always outside the ambit of the law.

A Framework (4)

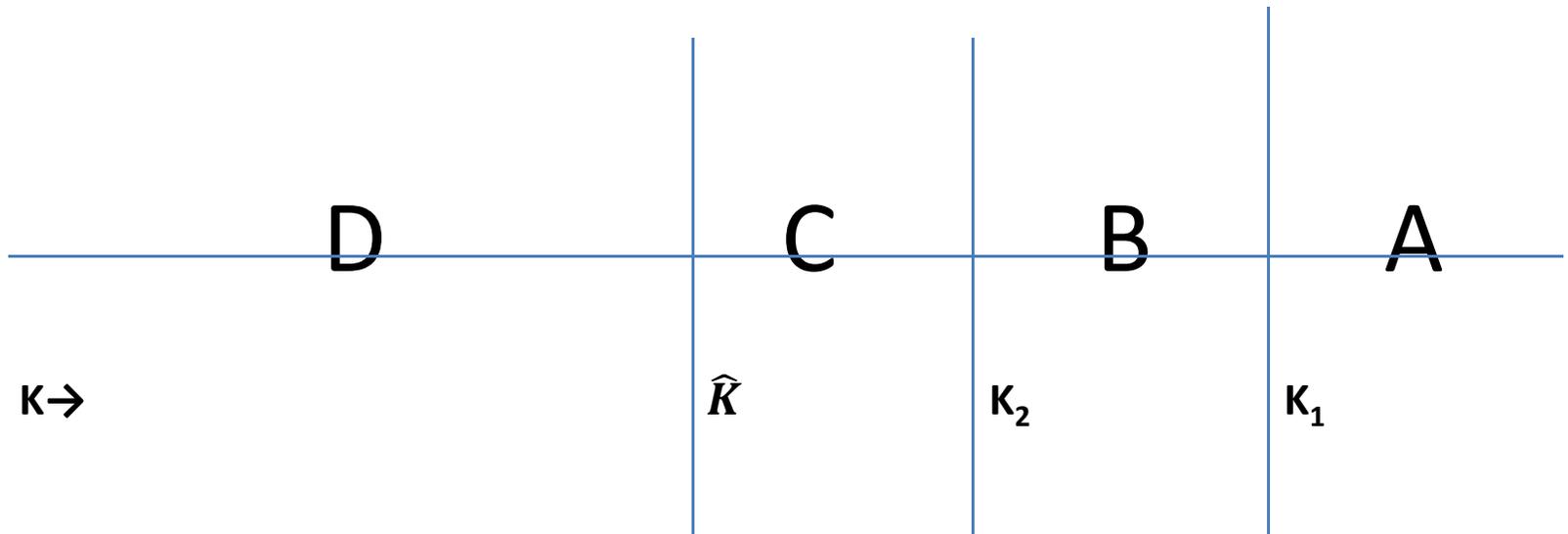
- $\pi = F(L, K) - wL$

- $\pi = \begin{array}{ll} F(L, K) - wL & \text{if } L \leq \hat{L} \\ F(L, K) - wL - T & \text{if } L > \hat{L} \text{ and} \\ & \text{registration} \\ F(L, K) - wL - p(L)C(L) & \text{if } L >, \hat{L} \text{ and no} \\ & \text{registration} \end{array}$

A Framework (5)

- It can be shown that there are intermediate ranges of p , T and C where under certain conditions there exist values of K , $K_1 > K_2 > \hat{K}$ with the following properties:
 - For K greater than K_1 , the firm registers.
 - For K between K_1 and K_2 , there is non-compliance--firm is required to register but does not and is thus illegal.
 - For K between K_2 and \hat{K} the firm puts itself outside the regulation by employing \hat{L} workers.
 - For K less than or equal to \hat{K} the firm would employ less than \hat{L} workers even without the regulation, and so is outside the remit of the regulation.

A Framework (6)



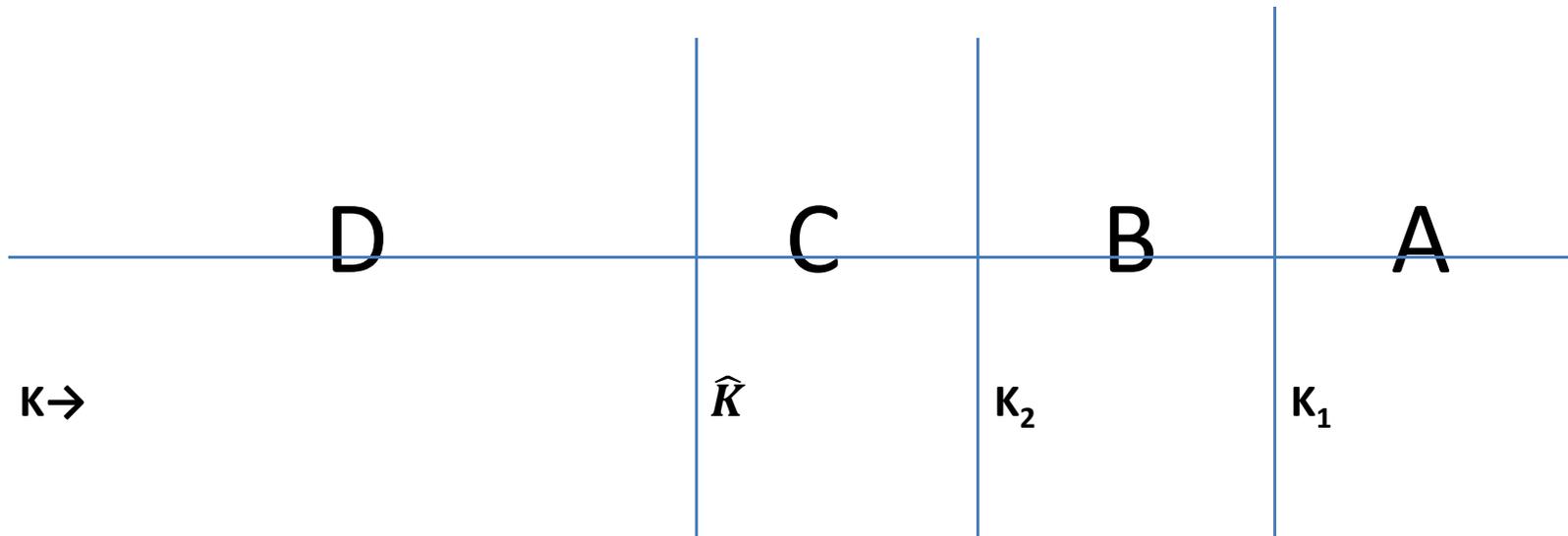
A Framework (7)

- A is Formal. B + C + D is Informal.
- But the key point is that Informality itself is of three types: Evaders (B), Avoiders (C) and Outsiders (D).
- Discussion of Informality Policy, will have to disaggregate to (at least) these three categories. But, usually, it does not.

A Framework (8)

- “Thanks largely to baroque regulation, half the labour force toils in the informal economy, unable to reap the productivity gains that come from technology and greater scale.”
– *The Economist (2010)*
- “.....labour market rigidities alone cannot explain the extent of informal employment...”
– *Chen and Doane (2008)*

A Framework (9)



Some Numbers for India (1)

- Some numbers from ongoing research by Chatterji and Kanbur (2014), for India, 2009-10.
- Focus on Factories Act. Applies to Manufacturing. All enterprises with 10 workers or more are required to register. This is the “organized sector” in Mfg.

Some Numbers for India (2)

- Registered enterprises are covered by the Annual Survey of Industries (ASI).
- Other manufacturing enterprises, the “unorganized sector” are covered by the quinquennial NSSO Enterprise Survey.
- (Technical point re electricity usage)

Some Numbers for India (3)

- A (Formal): Firms in ASI.
- B (Informal-Evaders): Firms in NSSO with 10 workers or more
- C (Informal-Avoiders): Firms in NSSO with 9 workers (an overestimate).
- D: (Informal-Outsiders): All other Firms in NSSO (an underestimate).

Some Numbers for India (4)

Year: 2009-2010	A	B	C	D
	ASI Firms	NSSO Firms, 10 or more workers	NSSO Firms, 9 workers	All other NSSO firms
Share of Firms	0.8%	1.5%	0.4%	97.3%
Share of Employment	24.8%	9.8%	1.3%	64.1%
Median Employment	21	13	9	1
Median Gross Value Added per Worker (Rs.)	135,626	59,820	74,000	23,400

Some Numbers for India (5)

Year: 2005-6	A	B	C	D
	ASI Firms	NSSO Firms, 10 or more workers	NSSO Firms, 9 workers	All other NSSO firms
Share of Firms	0.7%	1.4%	0.4%	97.5%
Share of Employment	19.5%	8.9%	1.3%	70.3%
Median Employment	20	12	9	2
Median Gross Value Added per Worker (Rs.)	81,884	32,748	37,744	9,432

Some Numbers for India (6)

- Note:
 - Lower productivity in informal sector.
 - Small number of “avoiders” or adjusters.
 - Significant problem of enforcement
 - Huge number of “outsiders”.
 - Two prongs of policy: (i) deregulate and (ii) help productivity amongst the “outsiders.”

Policy: Regulation, Enforcement and Informality (1)

- Our basic framework for policy should of course be to specify (i) the social welfare function, (ii) the policy instruments and (iii) the constraints, to derive optimal policy or directional improvements in the policy instruments.
- In this framework, informality can at best be an intermediate indicator, not something of direct interest in and of itself.
- But how good an intermediate indicator is it?

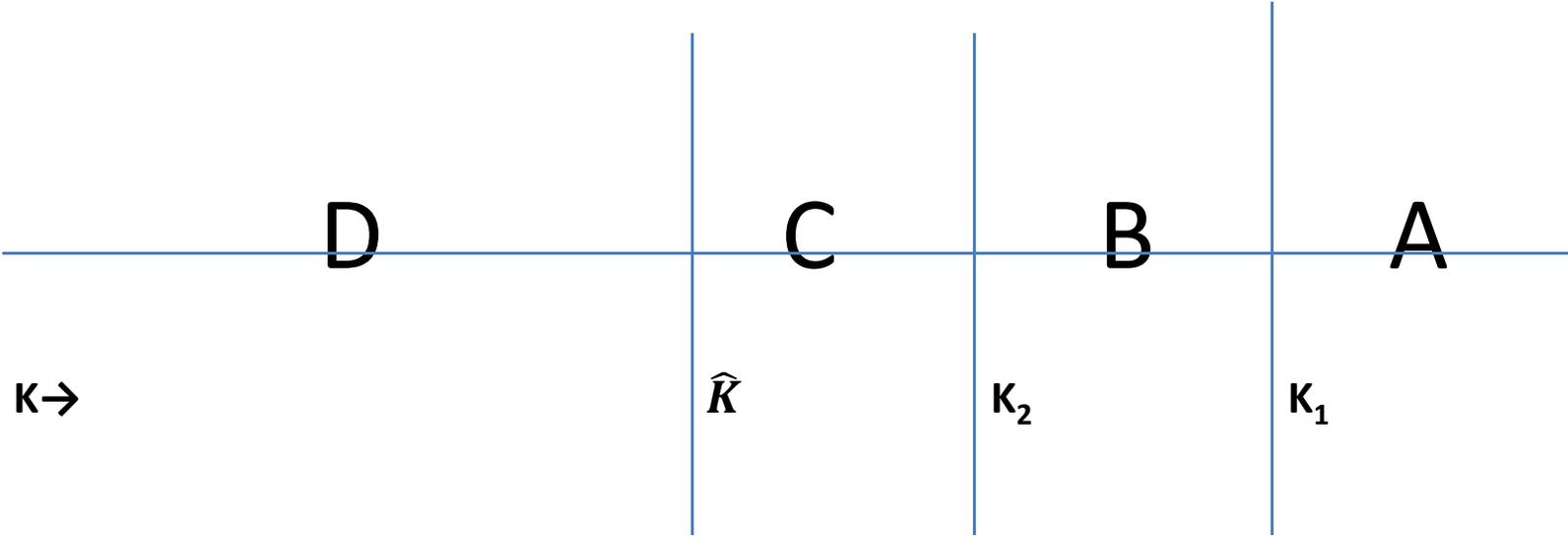
Policy: Regulation, Enforcement and Informality (2)

- For a start, aggregate informality as conventionally measured has not declined, or not declined very fast, during periods of rapid growth for many developing countries in the last twenty years.
- At the same time, there is an argument in the policy domain that excessive regulation of enterprises is holding back efficiency and growth, and a measure of the impact of regulation is the high degree of informality.
- Does this argument hold water? Consider three dimensions of regulation policy in our framework: the regulatory threshold, the cost of regulation, and the enforcement intensity.

Policy: Regulation, Enforcement and Informality (3)

- It can be shown that (under certain conditions):
 - The regulatory threshold does not affect aggregate informality, only its composition between evaders, avoiders and outsiders.
 - Higher cost of regulation does indeed increase aggregate informality but, crucially, also changes its composition.
 - Higher enforcement intensity will decrease total informality but will increase the amount of adjustment out of the regulatory net.

Policy: Regulation, Enforcement and Informality (4)



Policy: Regulation, Enforcement and Informality (5)

- So, all in all, focusing on the aggregate level of informality as a key intermediate indicator for positive prediction and for normative policy (“reduce informality”) is somewhat problematic.
- If anything, the disaggregated composition of informality proves a better guide.
- For policy, it would be far better to go directly for the policy objective and the impact of each policy instrument on that objective.

Policy: Regulation, Enforcement and Informality (6)

- A final point. A major complaint of many NGOs is that the regulation issue is irrelevant for the vast majority of the informal sector—the “outsiders”.
- As shown by the analysis, their numbers and their outcomes are not affected at all by costs of regulation and enforcement of regulation.
- For them a whole other set of policies are relevant and important, policies which will directly raise their productivity. Financial inclusion, and changing the practices of financial institutions which exclude them for financial services becomes the key policy challenge.

Tax Policy and Informality (1)

- “Informality” is almost always at or near the top of lists of tax challenges in developing countries. “Taxing the informal economy” leads the African Development Bank’s tax priorities.
- “Reducing informality” Is often seen as a central objective of tax reform. But what exactly does this mean, and (once that has been worked out) is it a useful guide to policy?

Tax Policy and Informality (2)

- In so far as any precise meaning is given to the term in discussions of taxation, “informality” is usually taken simply to mean non-remittance of tax due—failure to pay.
- But there are all kinds of reasons why a firm or individual might pay no tax. Maybe they are simply below the threshold (of size, or income) above which they are legally obliged to; or maybe they are evading.

Tax Policy and Informality (3)

- Might not *why* no tax is paid matter for policy making at least as much as the fact of it not being paid?
- And how should tax systems be structured when it is recognized that their design may affect not only how much tax is paid, but the different ways in which it is not paid?
- These questions lead, in our view, to a more useful strand of analysis than generalities about aggregate informality and objectives of reducing informality.

Tax Policy and Informality (4)

- Consider for example the VAT. In almost all countries, this has some threshold level of sales above which the enterprise pays a fixed rate of tax on all of its sales (including those below the threshold). In addition it faces some fixed compliance costs in paying tax.
- Firms differ, suppose, in the maximum amount they can sell, though they can choose to sell less than that. They can also choose to pay less than the amount due on their true sales, but there is some cost to them--potential penalties and maybe others too-if they do so.
- Within this setting, a few reasonable assumptions imply that firms will plausibly fall into five categories, ranging from the smallest to the largest in pre-tax sales (the mathematical details are in Kanbur and Keen (2014)).

Tax Policy and Informality (5)

Label	Size by Pre-tax sales and Response to tax
Microenterprises	Smallest of all; below the tax threshold so tax does not apply
Adjusters	Next size up; adjust by lowering sales to just below the tax threshold
Ghosts	Next size up; not pay any tax at all
Partial Evaders	Next size up; under declare sales to evade taxation partially
Compliers	Largest firms—full declaration of sales and remittance of tax

Tax Policy Informality (6)

- As in the labor regulation case, the formal enterprises are those who are complying. The other four categories are all informal—but each is informal in its own way and will respond to policy differently.

Tax Policy Informality (7)

- Consider the key policy choice of setting the tax threshold with the objective of improving social welfare, defined in the usual way as private net of tax income plus government revenue with a weight reflecting the marginal social value of tax revenue.
- We show that changing the threshold does not change the measured aggregate informality, but does change welfare because of its effect on the composition of informality.

Tax Policy and Informality (8)

- Juxtaposition of labor regulation and tax policy raises the important question of how we think about informality when there are multiple sets of regulations.
- What is informality then? Informal relative to either, or both? And how does optimal policy response in one dimension of regulation depend on the situation in the other dimension?
- Kanbur and Keen (2014) show that answers to these questions are possible, but have little to do with “reducing informality.”

Conclusion (1)

- “Informality” is not going away anytime soon.
- The term “informality” is not going away from the analytical and policy discourse either.
- However, it is important to be clear about concept and definition, especially in the context of policy.
- An aggregative concept and measure of informality captures some aspects of reality, but obscures more than it reveals.

Conclusion (2)

- Much of the interesting positive and normative analysis lies in the composition of informality.
- For policy, an objective like “reducing informality” does not necessarily emerge as an intermediate indicator corresponding to an underlying social welfare function.
- In fact, such an intermediate goal can mislead and obscure. Far better to think directly about objectives, instruments and outcomes. If intermediate targets are needed, they are more likely to emerge from the composition of informality rather than an aggregate.

Thank You!