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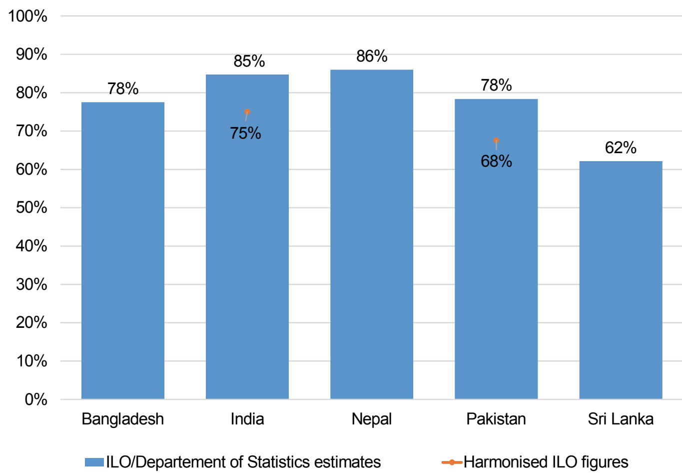
The persistence of informal employment in the South Asian economies

- Amongst major emerging regions, South Asia stands out in terms of the sheer size of the informal sector which is estimated to cover nearly 275 million non-farming jobs, or four out of five positions. If farming jobs are taken into account, its share rises to more than nine jobs in ten.
- While familiar to labour economists, the phenomenon of informality remains difficult to quantify accurately and can be defined in a number of ways. It encompasses both the activity of undeclared companies and informal labour relations within the formal sector.
- Although informal employment exists in most economic sectors, it is particularly prevalent in the least productive companies and occupational sectors. Therefore, the informal sector has a higher share in employment than in value creation.
- The persistence of high informal employment in South Asia after several decades of strong growth is inconsistent with conventional development models, which predict that marginal returns to capital between the traditional and modern sectors would gradually even out.
- This puzzle can be attributed to the combination of an early transition to the service sector, a lack of investment in public goods (human capital and infrastructure), and the poor functioning of the goods and factor markets. These factors help explain the duality of the labour market, which may have been increased by the opening up of these countries in the 1990s.
- The extent of the informal sector poses considerable challenges in terms of long-term growth, fiscal policy and social protection. Its diversity, its socio-economic importance and its contribution to socio-economic stabilisation call for an in-depth examination of the structural determinants of formalisation rather than for a repressive approach.

Share of non-farm employment in the informal sector



Source: ILO/Department of Statistics.

1. Informal employment retains a predominant role in the South Asian economies[1]

1.1 A phenomenon that is difficult to measure

Although the first statistics on informality date back to the 1950s in India, the phenomenon has long been poorly documented. The work undertaken by the International Labour Organization within the Delhi Group has, however, made it possible, since the Group's creation in 1997, to clarify and harmonise a definition.[2] Informal jobs are jobs that are not governed by labour law, are not taxed and do not make the recipient eligible for social benefits.[3] Informality covers informal employees in the formal sector as well as domestic workers, undeclared employees, self-employed workers and parts of the self-consumption economy. This definition is often supplemented by a functional perspective — jobs covered by a benefits fund, an employment contract or that grant entitlement to social benefits are considered formal jobs. A final definition has to do with the "unorganised" sector, which covers companies that do not have a separate legal personality or do not keep separate accounts as well as those with between ten and twenty employees, which dictates the application of labour law.

However, the ambiguity of the "grey zone", difficulties in collecting information in rural areas (distinction between subsistence and commercial farming) and practical obstacles to understanding employment relations in the domestic sphere limit the comparability of statistical data over time and between countries. Although periodic household censuses (India, Bangladesh) allow for the collection of detailed data, they do not lend themselves to the study of short-term trends and are of limited use when it comes to steering public policy (it proved, difficult, for this reason, to capture the precise effect of the demonetisation of 8 November 2016 in India on the informal economy).) Surveys of manufacturing facilities (Sri Lanka), on the other hand, are easier to carry out, but are less comprehensive.

Combined more generally with a lack of reliable labour market data, these difficulties often lead to multiple and sometimes contradictory definitions coexisting within the same country. In this respect, recent efforts to make better use of the registers of cooperatives, microfinance institutions and pension funds, as well as data on indirect taxation (the Goods and Service Tax in India), should make it easier to harmonise these definitions.

Table 1: The informality spectrum: the example of India
Breakdown of the employed population (%), by labour market status and type of employer, based on 2011/2012 census figures

Type of employment	Labour relation	Formal sector enterprises	Informal sector enterprises	Households	Total
Own account workers	Informal		32.3	n.a.	32.3
	Formal	0.5			0.5
Employers	Informal		1.3		
	Formal	0.1			0.1
Contributing family workers	Informal	0.1	17.9		18
Employees	Informal	9.6	30	0.8	40.4
	Formal	7	0.4[a]	0.01	7.4
Members of producers cooperatives	Informal		n.a.		n.a.
	Formal	n.a.			n.a.

a. This situation may arise in the absence of a formal legal connection between the company and its employees or in cases where the concept of informality relates only to the size of the company.

Source: Table from ILO, India Labour Market Update, June 2016 (based on NSSO figures). The light grey cells represent formal sector workers.

(1) See "*Le travail informel dans les économies d'Asie du Sud*", a cross-country analysis by the Colombo, Dhaka and Islamabad Economic Affairs Departments and the New Delhi Regional Economic Affairs Department, *Document de Travail de la DG Trésor*, forthcoming.
(2) For this purpose, a consolidated manual was published in 2013.
(3) As a result, the concept of informal employment is wider than that of an informal company.

1.2 An oversized share of the labour market

Despite their limitations, all of these surveys show that informality remains the predominant way in which labour relations are structured in South Asia, accounting for nearly 275 million non-farming jobs, including at least 190 million in India. The total share of informal non-farming labour is estimated at 45% in Bhutan, 55% in Sri Lanka, 80% in Bangladesh, 75% in Pakistan, 75-85% in India and at least 85% in Nepal. In most countries, these rates would exceed 90% if farming jobs were included.[4] Although it is often associated with urbanisation and the phenomenon of urban sprawl, informality also, indeed mostly, affects rural areas (with seasonal migration flows). The share of informal workers in rural secondary and tertiary employment is thus estimated at 76% and 85%, respectively, by Indian and Pakistani statistical departments.

Driven by a generally low-skilled workforce, the growth of the informal sector is concentrated in sectors with low productivity. The role of this sector in the labour market is therefore inflated in relation to its contribution to economic value creation. The share of the informal economy in total value added is estimated at around 40% in Bangladesh and Sri Lanka, between 40% and 50% in India and around 50% in Nepal. For Pakistan, estimates vary from 40% to 90% depending on the calculation method. This can largely be attributed to farming and construction activities. The share of informal companies (more than 60 million) in India would fall to only 12.5% of value added outside of these two sectors (although it would be higher if informal employment in formal companies were taken into account). In Bangladesh, it is estimated that only one third of the secondary and tertiary sectors value added is due to the informal sector. This results in large wage differentials, with workers in the formal sector earning more.

The gap between contribution to employment and value added creation could be even wider if the contribution of female employment could be measured more accurately. In Pakistan, less than 10% of identified informal non-farming jobs are held by women, although their sizeable contribution to some sectors, such as textiles via home-based employment, is well-documented. More generally, the economics and statistics of the informal sector often flag up major social divides, whether in terms of gender, education, ethnicity, caste or geography.

1.3 A phenomenon that shows no signs of subsiding

Since it began being measured, the use of informal labour has shown "exceptional persistence" (World Bank, 2014). Far from being reduced by higher growth, its share in employment has remained nearly stable since the 1990s and its contribution to value added has declined only slowly.[5]In the absence of longitudinal studies, most empirical efforts confirm the existence of a vast, constantly changing informal sector.

This persistence, which is common to all South Asian countries, including their most developed regions, seems paradoxical in view of the area's growth momentum (annual weighted growth of 6% between 1980 and 2016). The combination of high growth, a gradual loosening of regulations and increased factor mobility should have resulted in an expanded formal sector, capable of capturing a larger share of capital formation, but also of investment in public goods. The dualist theories of economic development (such as the Lewis and the Fei and Ranis models) would suggest that the gradual absorption of extra labour from the traditional farming sector into the more modern productive sector would, over time, equalise marginal returns between the two sectors. Although this theory does not exclude the presence of a modernising component within the informal sector,[6] it runs contrary to the flourishing of the least productive parts of the informal sector.

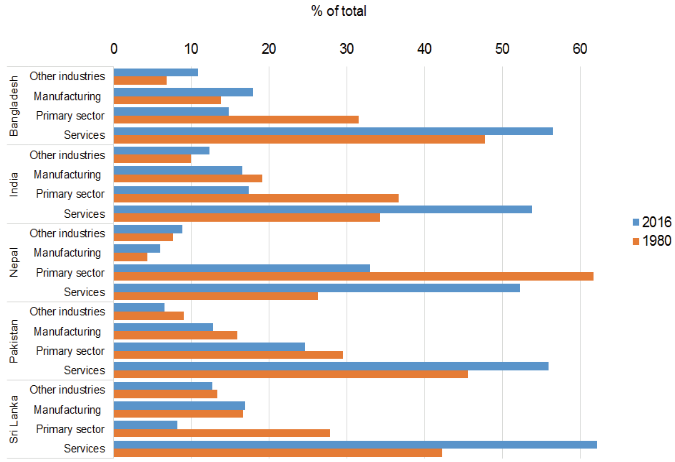
At macroeconomic level, this apparent paradox can be explained by several stylised facts:

- Capital formation is highly varied. Although its contribution at aggregate level is significant (2.4 percentage points annually over the last two decades, compared with 3.5 percentage points in East Asian economies)[7], fixed capital formation did not surpass 30% of GDP on a regular basis until the early 2000s. The presence of the informal sector puts a damper on investment: informal companies have only limited access to the credit and factor market. Moreover, due to a lack of legal certainty and a restricted ability to pool risks, these companies operate within a relatively short time horizon. Infrastructure investment, estimated at around 5 to 6% of GDP in a country like India, seems to be insufficient in view of the positive externalities that it could generate.

(4) The ILO harmonised series where available, otherwise the Department of Statistics series.
(5) In the early 1990s, 80% in manufacturing jobs in India were informal.
(6) See in particular the work of G. Fields, as well as that of G. Ranis and F. Stewart on "V-goods".
(7) World Bank, Economic Outlook, January 2018.

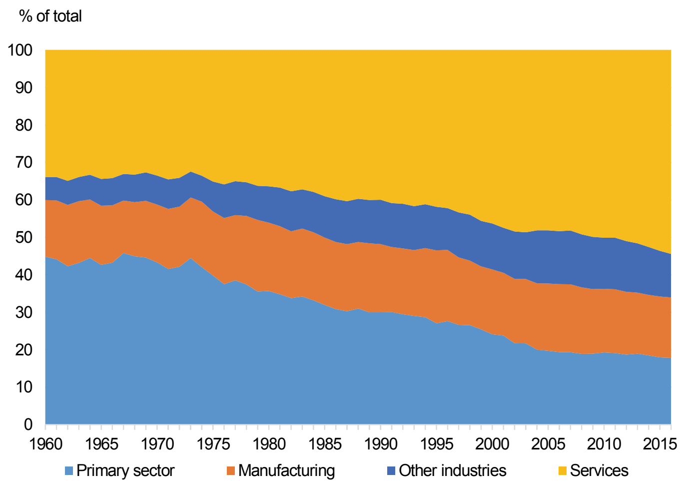
- Factor productivity, which is robust in the formal sector (contributing an estimated 3.2 percentage points to annual GDP growth, according to the World Bank), appears to be stagnating in the informal sector, indicating a productivity gain gap between the formal and informal segments that are likely to increasingly exacerbate the labour market's dual nature.
- The contribution of the labour factor is positive, but lower than expected due to a still modest labour market participation rate (55% on average). Buoyant demographics (the percentage of 15-49 year-olds is not expected to fall below 50% until after 2050) is further offset by low public investment in education and health (with the relative exception of Sri Lanka), in comparison to East Asia.
- Growth, which is shielded by high customs barriers, remains mainly focused on the domestic market. Consumer-oriented growth, driven in several countries by worker remittances, fosters the expansion of protected sectors (construction, retail) with high informal labour intensity. The consequences of liberalisation measures in the early 1990s are mixed. They have led to the expansion of formal employment in some sectors (IT), but they also seem to have accentuated the dual nature of the labour market to the extent that the export sector has a fairly narrow base and international competition has crowded out firms with mid-level productivity.
- The transition to the service sector took place too early on, in contrast to the "flying geese" pattern followed by East Asian economies, where the secondary sector generated an extensive demand for middle-level skilled jobs. The share of the manufacturing sector in gross value added is only 15% on average, while that of services is 54%, up 15 points in relation to 1991.

Chart 1: Breakdown of value added by activity sector (1980-2016)



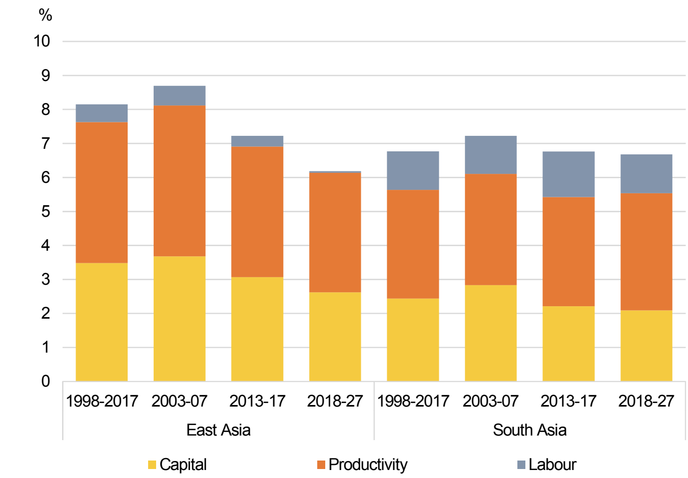
Source: World Bank.

Chart 2: Value added by activity sector (1960-2016) South Asia



Source: World Bank.

Chart 3: .Potential growth 1998-2027



Source: World Bank.

Table 2: Formal and informal sector employees by activity branch, India (2011-2012)

	Urban		Rural	
	Informal	Total	Informal	Total
Non-farming primary sector	2.1%	1.6%	14.0%	11.4%
Mines and quarries	0.4%	0.8%	1.0%	1.2%
Manufacturing	27.4%	24.9%	24.2%	21.3%
Energy	0.1%	0.7%	0.0%	0.3%
Water and waste management	0.7%	0.7%	0.1%	0.2%
Construction	11.1%	9.8%	23.7%	27.3%
Wholesale and retail trade	28.0%	20.7%	17.5%	13.9%
Logistics	8.4%	7.8%	7.9%	7.1%
Hotel and restaurants	5.3%	4.0%	2.6%	2.2%
ICT	1.3%	2.7%	0.2%	0.3%
Finance, insurance	1.0%	2.6%	0.4%	0.8%
Real estate	0.7%	0.6%	0.2%	0.2%
Professional, scientific and technical activities	1.7%	1.7%	0.4%	0.4%
Administrative support	1.7%	2.0%	0.5%	0.6%
Public administration, defense	0.0%	4.3%	0.0%	1.9%
Education	2.8%	5.8%	1.7%	5.1%
Health and social services	1.8%	2.3%	0.7%	1.2%
Arts, culture	0.5%	0.5%	0.3%	0.3%
Other services	4.9%	4.0%	4.5%	3.7%
Domestic employment	0.0%	2.5%	0.0%	0.7%
Total	100%	100%	100%	100%

Source: NSSO.

2. A complexe issue related to major structural imbalances

2.1 A phenomenon affecting much more than agriculture

In the farming sector, which is the source of nearly half of the region's jobs, labour relations are overwhelmingly informal: 98% of the agricultural labour force in Bangladesh (for 94% of value added), 86% in Sri Lanka, 99% in India and Nepal. A distinction should also be drawn between farmers who own land and agricultural labourer. The number of labourers, whose jobs are more precarious, has recently exceeded that of farmers in India (144 million, against 119 million in the 2011 census). The increasing decline in agriculture's share of the economy (growth of less than 2% in India since 2013) and structural changes in the labour market are driving an increasing number of jobseekers to turn to informal industries and services. An estimated 1 million Nepalese, 3 million Pakistanis and 12 million Indians enter the labour market each year, and almost half are former farmers.[8]

This trend clearly surpasses the capacity of the formal sector to absorb these numbers; the sector's low employment has led several observers to worry about the risk of "jobless growth" and the rise in underemployment or hidden unemployment (25% of Indian households depend on a public employment programme). Whereas in the late 1990s, one percentage point of GDP growth in India went hand-in-hand with the creation of 0.5 percentage points of employment growth (formal and informal), this latter figure would now be less than 0.2 percentage points. The employment elasticity of growth would be barely 0.1 in the tertiary sector and even negative in grain farming. This mismatch gives rise to strong competition for skilled jobs in the formal sector. It also accounts for significant emigration flows in countries such as Nepal and Sri Lanka.

A sector's share of informal workers tends to decrease as productivity rises. The public sector, which is unevenly productive but the focus of a large majority of formal jobs,[9] is an exception in this regard. However, expanded use of service contracts has recently introduced elements of informality in public employment. The share of informal employment is also low in the ICT and financial services sectors (34% in India, 22% in Bangladesh). It is higher in the manufacturing industry (weaker in the electronic materials, motor vehicles and computer components occupational sectors, higher in textiles and bricks). It reaches its highest levels in construction and intermediation services (retail,

(8) In this respect, the construction sector has played a very important role in the reconversion of agricultural jobs. According to estimates, it accounts for 10% of non-agricultural employment in Bangladesh, 16% in Pakistan and almost a quarter in India, whereas it is responsible for almost all jobs created over the past two decades. In this context, public capital formation (especially in the area of infrastructure) and employment guarantee programmes play a major stabilising role.
(9) 17.6 million out of a total of 29.6 million formal jobs in India (2011/2012 census). Its relative share seems, however, to have slightly declined since then.

hotels and restaurants, logistics), which account for some three-fourths of informal workers in India, Pakistan and Bangladesh. These jobs, which are often filled by self-employed workers, are diverse in nature: street vendors (estimated at 10 million in India), rickshaw drivers, domestic workers, street cleaners, and so on.

According to the most conservative estimates,[10] the average productivity of informal workers is two to four times lower than their formal sector counterparts. This gap is widening, with an annual growth differential of several points in total factor productivity, reflecting the allocation of a growing share of production factors (capital, human capital, land) to the formal sector and increasing returns. It reaches its highest levels in such sectors as agri-food and textiles, where differentials of 1 to 15 have been posited for India and more than 1 to 30 for Bangladesh. On the other hand, the productivity differential is estimated to be lower in occupational sectors with high entry costs (metallurgy).

2.2 The symptom of an unbalanced transition

The causes of this duality have been widely discussed in microeconomic literature. These include extremely fragmented value chains (the average Indian company has 2.2 employees), burdensome red tape, high entry costs and the oligopolistic anti-competitive structure of a number of sectors, inefficient financial intermediation systems (heightened by interventionist policies) and segmentation of the goods and factor market (strong pressure on land in connection with demographics, low labour mobility and weak infrastructure networks, the latter thought to cost the region at least two points of potential growth each year).

Taken together, these factors contribute to significant threshold effects that concentrate growth on a limited number of capital-intensive firms. The structural result is an increasingly dual business environment, where the absence of a strong middle layer ("missing middle") does not necessarily preclude relationships between formal and informal sectors throughout the value chain.

At sectoral level, the most thriving occupational sectors have generally been (with the exception of Bangladesh) those with the lowest employment concentration, in contrast to East and Southeast Asia, where the electronic components and textile sectors have been at the heart of a catch-up momentum. Within these occupational sectors, value added has also been increasingly focused in the downstream part of the value chain, which has relegated part of its upstream activities to the informal sector (particularly through the expanded use of subcontracting).

Compared with other regions, South Asia's deficiencies in human capital training seem to be the most convincing explanation for the persistence of the informal sector. Although children are staying in school longer and illiteracy has declined significantly over the past 20 years (25% of 15-24 year-olds in Pakistan, 10% to 15% in Bangladesh, India and Nepal, less than 1% in Sri Lanka), training quality remains problematic. With the exception of Sri Lanka, a significant proportion of the cost of training remains borne by households, and vocational training courses are often poorly adapted to the needs of the labour market.

3. A major public policy challenge

The costs of informality are numerous and well-known: higher transaction costs, inefficient financial intermediation, low productivity, difficulties in urban, environmental and natural resource management, difficulties in implementing social policies; lower monetary policy transmission given the presence of informal credit networks, poor tax collection and inefficiency of automatic stabilisers, extreme forms of exploitation (slavery and child labour), and even the financing of illegal activities. However, the informal sector also acts as a stabiliser due to its ability to absorb the shocks that affect the formal sector and to redistribute income beside social policies, which renders a purely repressive approach undesirable. Finally, public policies must factor in the extensive diversity of the informal sector, in which formalisation is not always a realistic goal.

3.1 Lowering regulatory barriers and lightening the tax burden would reduce formal sector entry costs

The South Asian economies are characterised by complex business environments and very strict regulation of the goods and factor market. This cumbersomeness, as well as the lack of means to enforce these rules otherwise than on a case by case basis, or even via compromise settlements (which results in strong legal uncertainty), encourage many companies to remain informal. This results in significant threshold effects, increased use of outsourcing and

(10) *Cf.* work carried out on the KLEMS database by Goldar *et al.*

temporary employment, and ultimately more fragmented value chains.

Labour law, which is both complex (governed by more than 30 ministries and agencies in Bangladesh) and rigid (particularly with regard to dismissal approvals) is a characteristic example of this. While rarely applied and offering little real protection, it nevertheless helps discourage long-term contractual relations. A 2016 IMF study[11] suggested that, in India, bringing the operating conditions of formal and informal enterprises into line could reduce informality by about a quarter if carried out concurrently with goods market reforms. In recent years, this widely-shared observation has led to a series of reforms: labour law liberalisation in several Indian states, especially in the manufacturing sector, and the adoption of a Labour Code in Nepal and Bangladesh. In India, several studies (notably by the Indian Chamber of Industry) have noted a favourable effect on employment, but no clear correlation has been observed between the changes in informality rates and the reforms implemented at individual state level.[12]

Reducing the tax wedge, which is particularly burdensome for SMEs, is another avenue for reform in a region where the tax base is quite narrow[13] — half of India's corporation tax revenue is derived from a group of some 350 companies. The difficulties linked to tax collection (lack of regular accounting statements, unreliable land registry records) have spurred several states to consider taking an incentive-based approach, including tax credits, paying social contributions, or rolling out streamlined schemes to encourage the formalisation of mid-tier firms and self-employed entrepreneurs. This issue has been central in India as part of the introduction of the Goods and Services Tax (GST) on 1 July 2017, which includes an exemption mechanism to encourage companies to file tax returns. Almost 10 million suppliers and resellers are now registered in this system, which does not, however, prevent them from resorting to informal labour. The rise of digital technologies is, likewise, encouraged by public authorities, who see them as the key to greater transparency in economic life.

3.2 Informality invites rethinking social protection

Informality is also an important part of discussions about strengthening social protection. Social security mechanisms focus mainly on formal-sector workers and leave the protection of the rest of the population to individual and family initiatives and traditional solidarity. However, changes in the labour market call for an in-depth re-examination of this model in view of demographic changes that will, over the long term, result in an increase in dependency ratios. These discussions, which are still underway, are shaping up along three main lines (see Box 1).

However, these systems are often excessively fragmented (nearly 150 social programmes in Bangladesh and some 950 in India), which undermines their effectiveness without ensuring cover for the most vulnerable — 30 to 40 per cent of potential beneficiaries in Nepal remain outside the scope of these programmes. This fact has led to discussions on the implementation of a universal income.

An intermediate approach, one that combines regulation and protection, involves improved oversight of informal sector activities as part of joint efforts to draft standards. This is the case with Indian street vendors, whose activity since 2009 has been governed by the Street Vendors Act. The Act provides for the payment by street vendors — at the discretion of the municipal authorities — of a contribution towards maintaining collective goods, while also laying the groundwork for specialised public actions in terms of training and skill formation, access to credit and social security cover.

The phenomena of informality must, in the longer term, be an integral part of discussions on the inclusiveness of growth. Beyond sectoral policies, whose effectiveness has not yet been demonstrated and whose distorting effects should not be disregarded, three approaches appear possible: *(i)* increasing investment in collective goods (education and research, health, infrastructure) that are likely to increase the productivity of all economic stakeholders; *(ii)* strengthening factor mobility in order to accelerate inter-sectoral reassignments; and *(iii)* reducing formal sector entry costs, both in terms of regulations and access to credit, to encourage productivity gains within occupational sectors.

(11) Anand R., Khera P. (2016), "Macroeconomic Impact of Product and Labor Market Reforms on Informality and Unemployment in India", *IMF Working Paper* WP/16/47, March.
(12) Sirja A., Shirke S.V. (2014), "An Analysis of the Informal Labour Market in India", *Economy Matters*, September-October.
(13) 11.5% of GDP in Sri Lanka, 12.4% in Pakistan, 17% in India and only 8.5% in Bangladesh.

Box 1 : Three approaches to social protection

Historically, social security cover for informal workers has been organised mainly at occupational sector level. These mechanisms, which in Sri Lanka are legislative in nature (the Farmers' Pension and Social Security Benefit Scheme Act of 1987, the Fishermen's Pension and Social Security Benefit Scheme Act of 1990), have also spread to India in the form of the Worker Welfare Funds, whose history dates back to the creation of the Palm Wine Workers Fund in Kerala in 1969. They offer services financed at occupational sector level, usually in the form of repayment of a pre-determined share of revenue into a common fund, to which the public authorities may, where appropriate, make a contribution. The ILO is working to introduce a similar scheme in Bangladesh.

Several countries have made significant efforts to extend insurance plans financed by individual contributions to the informal sector. Informal workers have the chance to contribute to a social security fund, to which the authorities then also agree to contribute. This is the case of the Pradhan Mantri Suraksha Bima Yojana accident risk cover programme in India or the Samurdhi social security fund in Sri Lanka. At the same time, the contribution rules for formal sector cover schemes are made more attractive.

Universalist protection schemes, partly or entirely financed by tax revenue, are finally gaining a growing number of supporters in the region. Such mechanisms would, according to their proponents, contribute to internalising the cost of externalities created by imbalances in the growth model and allow for better distribution of profits, particularly with respect to the informal sector. Although most countries in the region already have non-targeted social safety nets, they are still far from the idea of a genuine universal income.

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