**BOX 2.5.1 Informality in South Asia**

South Asia’s share of informal employment is the largest among EMDE regions, despite a below-average share of informal output. Heavy tax burdens, above-average corruption, and low government effectiveness have contributed to high employment informality. Informal employment is concentrated among low-skilled, young, female, and rural workers. The sizable informal sector is associated with lower productivity, lower government revenues, and higher poverty in the region. Policy options to address these challenges include investing in human capital in the form of training programs and improving access to finance.

**Introduction**

South Asia (SAR) is the EMDE region with the highest average share of informal employment among EMDE regions, despite a below-median and declining share of informal output. Nonetheless, there is significant heterogeneity in the share of employment as well as output informality among South Asian countries.

Against this backdrop, this Box examines the following questions:

- How has informality evolved in South Asia?
- What have been the macroeconomic and social correlates of informality?
- What policy options are available to address challenges associated with informality?

**Evolution of informality**

*Informality in SAR.* In aggregate, output informality in the SAR region is below the average of other EMDE regions—the size of informal sector relative to official GDP was on average 30 percent in South Asia compared with 35 percent in average EMDE during 2008-2016 (Figure 2.5.1.1). During the same period, 96 percent of workers lacked pension coverage and 63 percent were self-employed.

*Evolution of informality in SAR.* Output informality declined from 37 percent in 1990s to 32 percent in the 2010s, broadly in line with the decline in informality in other EMDEs. However, labor informality over the same period persisted or rose depending on the measure of informality. For example, the share of the labor force without pension coverage rose from 88 percent to 96 and self-employment remained around 63 percent.

*Regional heterogeneity.* The extent of informality varies substantially across countries in South Asia. Sri Lanka had the highest degree of informality (output in the informal sector is about 40 percent of total output) in 2016 and India had the lowest share (below 20 percent). However, this ranking is reversed using labor market indicators of informality: Sri Lanka has the lowest share of self-employment (42 percent) and India the highest (76 percent) as of 2016. These differences are reflected in lower labor productivity in the informal sector (relative to the formal sector) in India than in Sri Lanka.

**Correlates of informality**

*Business climates.* Costs to doing business—such as tax burdens, labor regulation, and cost of starting business—are among the main drivers of informality identified in the empirical literature (FICCI 2017; Goldar and Aggarwal 2012). Over the past decade, SAR has suffered from greater corruption and weaker government effectiveness than other EMDE regions (Figure 2.5.1.2). Tax burdens and indicators of ease of doing business have also been less favorable than in the average EMDE (World Bank 2017c). Among costs to doing business, heavy tax burdens were particularly strongly associated in India and Pakistan with a larger fraction of firms operating unregistered (Ghani, Kerr, O’Connell 2013; Waseem 2013).

*Worker characteristics.* South Asia’s informal labor force consists predominantly of low-skilled, female, rural, and young workers (Bahadur and Parajuli 2014; Goldar and Agarwal 2012; Gunatikala 2008; Williams, Shahid, andMartinez 2015). The intensity of informal employment in South Asia reflects a lack of formal jobs and skills, as well as a preference towards self-employment (Arby, Malik, and Hanif 2010; Williams, Shahid, and Martinez 2015). This means that informal firms are usually small, agricultural, and consist mostly of self-employed workers (FICCI 2017).

*Lower productivity and incomes.* In South Asia, informal workers have had lower earnings, fewer skills, and less access to social protection systems; this has been reflected in lower productivity and higher poverty (Kanbur 2017;Likhi 2013). Informal employment among underrepresented groups in labor markets, such as women and the young, has grown over the past decade and
Policy challenges

In South Asia, informal employment is concentrated among young, low-skilled, female, and rural workers. Policies targeting training and education of these groups, especially in rural areas, could help their transition to formal employment (Khera 2016). There is significant room to improve the ease of doing business in South Asia. This could reduce informality by reducing the cost of entry and cost of operating in formal sector. Measures to reduce the time, cost, and complexity of registration would also improve the business climate and foster growth (FICCI 2017).

High quality public services can also provide an incentive for informal firms to become formal in order to access these services. Enhanced monitoring and enforcement, including of tax regulations, could help discourage informality (Ilzetzki and Lagakos 2017). Also, in India the recent introduction of a Goods and Services Tax and steps toward demonetization are expected to encourage a shift from the informal to the formal sector.
BOX 2.5.1 Informality in South Asia (continued)

FIGURE 2.5.1.2 Drivers of informality in South Asia

Heavy tax burdens, above-average corruption, and low government effectiveness likely have contributed to high employment informality. The sizable informal sector is associated with weaker government revenues and higher poverty in the region. Youth unemployment is much higher among women who represent a higher share of informal workers than men.

South Asia’s self-employed, which account for about 80 percent of informally employed, have limited access to financial resources that could finance growth- or productivity-enhancing investment (Ghani, Kerr, and O’Connell 2013). Greater access to credit for the self-employed and household enterprises could help them grow into formality (Beck and Hoseini 2014). Microfinance can be an effective instrument for providing financial access to informal firms, as many of them are self-employed enterprises (ILO 2013; Likhi 2013).