Viewpoint

Linkages between Informality, Competition and Economic Growth

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The large informal economy that continues to exist in many developing countries despite economic development has made it a stimulating subject for research and analysis. Conventional views and existing empirical work show that formalisation is always a positive contributor to economic growth, i.e. formalisation of any hitherto informal segment of the economy would increase the rate of economic growth. A problem may exist with inadequacy of capturing different channels of growth stemming from this sector and/or with the fact that a large portion of informal enterprises are not accounted for in national measurement schemes. Though evidence of a direct positive relationship between informality and growth may be largely absent in the literature, the informal sector may have growth implications through indirect channels such as the level of competition in the economy. This viewpoint paper presents an argument as to how the informal sector may impact economic growth by altering the degree of competition.

Competition and Economic Growth

Generally, a higher level of competition in an economy contributes to economic growth due to firms undertaking innovation to enhance competitiveness, as a result of the so called 'compulsion factor'. Competition compels firms to innovate and come up with new products/services or produce existing ones more cheaply than other firms in order to survive and stay ahead of the game.

The 'ability factor', on the other hand, indicates a firm's capability to invest and innovate. Firms which have surplus profits as a result of some monopoly power are able to make the investments required for innovation. Increase in competition erodes away such profits. Which of these factors (compulsion or ability) dominates the other is seemingly dependent on sector specific characteristics. However, recent empirical evidence points towards the presence of a positive effect of competition on economic growth, indicating that competition does stimulate innovation and hence, economic growth[1].

Informality, Competition and Economic Growth

Positive linkage

The informal economy may affect competition through myriad channels both enhancing and/or impeding competition. Increase in the level of competition stems from the fact that a large number of producers in the informal sector selling almost identical products (for instance,

[1] Aghion, P and R. Griffith (2008), 'Competition and Growth- Reconciling Theory and Evidence', MIT Press, March 2008

in certain product lines such as vegetables and fruits) would imply a small market share for each existing supplier[2]. This constitutes the positive effect of informality on the level of competition. The higher degree of competition associated with informality has positive implications for growth through two channels.

First, rise in the level of competition and consequent reduced market power of each firm implies a reduction in mark up of price over cost. Low prices will increase consumer surplus and can contribute to household savings and/or increased demand for other products. Both rise in household savings and increase in demand contribute to economic growth. Second, as mentioned, increase in the degree of competition may incentivise or compel firms to innovate in order to compete effectively. Rise in innovation in turn has a positive effect on economic growth.

Moreover, there is evidence that a sector can accommodate both formal and informal units in peaceful and often complementary co-existence. Case studies from West Bengal and Jharkhand in India have shown that consumers who shop at big supermarkets also buy goods from the small informal retailers in the area, thereby distributing their purchase between the two modes[3]. The unorganised retailers sell similar products which are cheaper but of inferior quality. There is evidence of both 'conflict' and 'co-existence' between formal and informal enterprises in this study. Moreover, such co-existence has generated competitive pressures to be creative and innovative on both sectors as these try to entice customers. This positively affects economic growth.

Negative Linkage

A large informal sector may crowd out formal enterprises in certain industries, generating a small number of formal firms, each with considerable market power. This may have an adverse impact on competition within the formal segment of a dual economy. Firms in the informal sector may also engage in anti-competitive practices such as price collusion and product adulteration with their informal nature contributing to their lack of accountability. Such practices may have detrimental impact on both formal as well as rival informal competitors, thereby reducing the degree of competition in certain product lines.

Informal firms are usually small, operate with obsolete technology and are mostly a part of the household. Hence, anti-competitive practices such as predatory pricing, abuse of dominance and collusive pricing by formal firms can drive informal enterprises out of the market. For example, the mentioned study on the retail sector in West Bengal and Jharkhand has shown that the unorganised small retailers were affected by discounts offered by organised supermarkets on items sold by the former which were facilitated by higher prices on other goods characterised by a lack of competition. In addition, these offer gifts and other benefits and display signboards with price comparisons that are often inaccurate, thus misleading consumers.

[2] Mitra, S (2009), 'Informal Sector and Competition: A Comprehensive Agenda for Research and Action', Discussion Paper, CUTS International, Jaipur, India

[3] Haldar, T and S Chakrabarti (2009), Supermarket and Micro-retailing: A field-based cost benefit analysis', Visva-Bharati University, West Bengal, India

To recapitulate, the negative impact of informality on the level of competition may stem from:

1. Anti-competitive practices of informal firms towards formal firms
2. Anti-competitive practices of informal firms towards other informal firms
3. Anti-competitive practices of formal firms towards informal firms

As mentioned, these cases cannot be effectively dealt with by a competition authority due to the intractability of informal firms. Abuse of dominance, predatory pricing and price collusion lead to lower output/choice and higher prices for consumers, thereby reducing consumer surplus and the level of household savings, and potentially reducing growth. Product adulteration also adversely impacts consumer welfare by way of harmful health effects which can have negative growth implications.

In addition to these anti-competitive practices, firms in the formal sector may face unfair competition from informal enterprises due to tax avoidance and regulatory non-compliance by the latter. Higher mobility and location advantages of informal firms can also impact businesses of formal firms. Such unfair advantages enjoyed by informal firms may leave formal enterprises less competitive. This may reduce entry into the formal sector as well as decrease incentives and ability of existing formal enterprises to innovate and grow, consequently creating an environment conducive to lack of enterprise which hinders economic growth. However, it should be noted that the extent to which informal enterprises are an obstruction to formal sector competitiveness depends on a host of factors such as entry barriers and fixed costs in the sector of operation, legal and regulatory requirements for enterprise operation and the government's ability to enforce such rules and regulations[4].

While formal and informal firms may compete in the same final product market, they also operate as a part of the vertical supply chain and are positioned at different stages of the production process. Informal firms with limited market power may have to sell their products to formal firms with monopsony power, wherein the former may face exploitation as the latter tries to squeeze them and dictate prices. Informal firms may also have to buy inputs from monopoly suppliers, thereby increasing their cost of production and rendering them uncompetitive. Hence, various anti-competitive practices by the formal firm can drive out informal sector firms. To that extent, formal firms do not always contribute positively to economic growth.

Conclusion

While concrete and rigorous empirical support for the informal sector contributing to economic growth is almost absent, this paper argues that growth implications may still stem from informal enterprises via an indirect channel, that is, through the informal sector's role in altering the degree of competition in an economy.

The presence of a sizable informal sector, however, may either increase or decrease the level of competition in a product line. The

[4] Gonzalez, A S and F Lamanna (2007), 'Who Fears Competition from Informal Firms? Evidence from Latin America', Policy Research Working Paper 4316, World Bank

direction of the outcome depends on sector specific characteristics and the relative strength of resultant positive and negative effects on competition. When positive effects outweigh the mentioned negative effects, informal enterprises would increase the degree of competition in an economy. Therefore, positive implications for growth would follow.

To conclude, it needs to be pointed out that in certain cases synergies between the formal and informal sectors might have the most favourable implications for both competition and growth. The supply chain ending with India's formal automobile companies often involves the intermediate services of informal producers of auto parts. Such outsourcing enables these companies to remain cost effective and compete effectively – competition as well as contribution to economic growth is enhanced.

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