

# DISCUSSION PAPER

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## Informal Sector and Competition: A Comprehensive Agenda for Research and Action

*The existence of the informal sector has both positive and negative implications for the level of competition in the economy. The positive influences emanate from the fact that informal firms are usually small and, therefore, individually less likely to be the source of dominance than formal firms. Negative implications can arise in myriad ways: unmonitored price collusion and dominance by some informal sector firms, affecting other informal sector firms; formal sector being subjected to unfair competition by the informal sector, in the form of lower prices, facilitated by tax avoidance, hard-to-catch product adulteration and even physical obstruction; and, lastly, formal sector firms employing anti-competitive practices, such as predatory pricing, to eliminate informal competition.*

*The paper recommends that the decision to formalise the informal sector should be based on a cost-benefit analysis. It goes on to elaborate various methods of formalisation: reduction in the number of procedures/clearances involved or time involved in registration of firms in the formal sector; extent of corruption that determines the magnitude of bribery involved in the same process; and reduction of disincentives such as high tax rates, coupled with enhancement of incentives such as credit leveraging and entrepreneurial assistance/training provided by the government to the formal sector.*

### I. Introduction

In many developing countries, such as India, the informal sector accounts for a large chunk of economic activity. As informal firms are very different from formal firms in nature, management and scope for government control, the existence of a large informal sector can have significant implications for the level of competition in the economy.

This paper specifies a research and action agenda which examines the implications of the informal sector for economy-wide competition through a component by component examination of effects. It goes on to explain how such examination can help in deciding whether formalisation of this sector is desirable from the viewpoint of enhancement of competition. Last, it spells out the needed research and action in the implementation of a decision to formalise.

### II. Working Definition of the Informal Sector

Though the 'informal sector' has been defined in a many ways<sup>1</sup>, adding to the confusion in identifying it, a convenient and broad definition is "economic activity in a nation which is not administered in any substantial way by the government". Informal sector enterprises do not pay any taxes to the government or adhere to labour regulations nor are they the recipient of government provided/facilitated credit, entrepreneurial advice/training or other facilities. Though informal sector firms do not

have to adhere to formal rules laid down by the government, those in the same product line often follow a set of informal business norms arrived at by mutual consent.

The informal sector needs to be decomposed into various parts to facilitate better analysis of its behaviour:

- a) Activities that deal with the distribution and manufacture of products that are strictly banned (manufacture of mind-altering drugs, certain explosives, etc., and services such as prostitution);
- b) Cross-border trading in products which can be legally consumed, but is illegal on account of not being registered with the government and/or in violation of embargoes and official tariffs;
- c) Unauthorised internal distribution of services/amenities which are also being lawfully produced/distributed (power theft and distribution to unregistered customers);
- d) Production of goods/services which is not administered by the government (e.g., that by small workshops manufacturing shoes, small restaurants, etc.); and
- e) Hawking and vending activities, which the government finds difficult to account for or administer, because of small magnitudes and geographical mobility.

Note that a) is very different from the other categories which have a formal counterpart – businesses registered with the government producing the mentioned products.

### III. The Informal Sector and Competition

It is only the formal sector which is administered by the government. Thus, the government has records of the location, number and business activity of firms operating in this sector, but not of firms in the informal sector. Thus, the firms in the latter sector are generally outside the ambit of competition law. Because these firms usually do not maintain any written records or give receipts for payment, it would, in any case, be very difficult to punish these for anti-competitive practices. Usually their small size and large number ensure that detection of anti-competitive practices by informal sector firms and consequent punishment are not economically viable for competition agencies, because of enforcement costs exceeding economic benefits.

The following portion sums up the impact that the informal sector has on the level of competition on the economy.

#### A. Positive Impact

In many product lines, such as fruit and vegetable selling, the informal sellers in a market approximate a perfectly competitive set-up, as individual businesses are small, products are identical (for instance, cauliflower sold by seller A is very similar to that sold by seller B) and sellers are physically proximate to each other.

Such perfect competition is often not seen in the formal sector because of various reasons: larger businesses, product differentiation either because of distinctive content or packaging, etc. The assumption here, of course, is that more competition is desirable, with perfect competition constituting an ideal state in which competition among firms is maximised, i.e. a frictionless world.

#### B. Negative Impacts

Again these are of different kinds:

- A larger size of the informal sector in any product line implies a smaller formal sector. A smaller number of firms in the formal sector increases the market power of individual firms and, therefore, has a deleterious impact on competition (B1)<sup>2</sup>.
- Because the government does not have a list of informal firms, it is often difficult for the competition authority to identify abuse of dominance from the formal sector, impacting the informal sector (B2). This can be a powerful anti-competitive force when the number of formal firms is small and these are geographically spread out, giving rise to strong monopolistic or oligopolistic tendencies.

For example, consider a single formal producer/distributor of milk competing against numerous informal producers (these are milkmen not registered with the government). The formal producer/distributor might try to wipe out competition from the rival milkmen through predatory pricing. The competition authority might not be able to rigorously establish

‘abuse of dominance’ because of the absence of statistical data on prices charged by informal producers or even of their existence, the reluctance of informal producers to lodge complaints because of their unofficial status and the difficulty in comparing informal product quality to formal product quality.

A real life version of this example was noticed in Peru, where predatory pricing by the major milk industrialist against small dairy producers brought down the price of milk in Peru to US\$0.26, while it was US\$0.38 and US\$0.43 in neighbouring Chile and Brazil<sup>3</sup>.

- Anti-competitive practices originating within the informal sector and impinging on informal sector firms (B3): Competition inside the informal sector will be high if it is made up of a large number of small producers/distributors selling/producing identical products. Whether that is indeed the case in the informal sector for every product line is a question which begs further research. For example, vegetable markets and their resident sellers often belong to the informal sector. The fact that they sell visually indistinguishable products and are not separated by any considerable physical distance leads to an equalisation of prices for their product, over the level of which each seller exhibits very little control.

But, whether all product-specific informal sectors have the same characteristics as the mentioned vegetable market is an interesting question that needs to be explored. The most important feature that needs to be examined is the size distribution of players operating within the informal sector. Consider an informal seller of sweets who is suddenly faced with competition from another sweet seller who sets up his shop nearby. If the former seller has enough cash balances to fall back on, he can resort to predatory pricing, thus squeezing the second seller out of the market. The important question is whether such differences in the size of wealth exist among agents in the informal sector.

What about collusion in the informal sector? Again the unorganised nature of processes makes it very difficult to ascertain whether there is collusion inside the informal sector, say a vegetable market. However, systematic research which covers different vegetable markets can determine whether there are any unexplained differences in prices across vegetable markets (the assumption being that within a vegetable market, proximity leads to identical prices for a given product across sellers, but also might facilitate collusion). If such unexplained differences do exist, then price collusion, which holds product prices artificially above the competitive level, is a major possibility.

Another major source of distortion in competition is product adulteration. Most items of consumption, be these food items or furniture, can be adulterated without the consumer knowing that this is the case. Adulteration can be employed to augment profits as the consumer’s

lack of knowledge about product inputs can be used to cut costs, without commensurate change in prices.

Adulteration not only detracts from consumer welfare, but its differential application by producers implies that competition is often unfair and results in a low equilibrium level of product quality. Misleading advertisements in the informal sector (signs on shops, etc.) can also be treated as ‘product adulteration’.

Thus, anti-competitive practices originating in the informal sector and impinging only on informal sector firms are possibly of three types:

- Abuse of dominance (B3a);
  - Price collusion (B3b); and
  - Product adulteration (B3c).
- Anti-competitive practices originating within the informal sector impinging on the formal sector (B4): Not only does the existence of the informal sector have implications for the extent of competition among constituent agents but it also influences the sales of the formal sector. Note that many products are sold by both formal and informal sector firms. Because informal firms do not pay any taxes, they might be able to out price formal sector firms. This amounts to unfair competition.

Informal sellers, such as neighbourhood vegetable vendors, are often more mobile than formal sellers selling the same product who are fixed in space. Purchase of products from such informal sellers might be more convenient for customers. In many cases, informal sellers might physically block access to formal sellers. For example, hawkers and peddlers outside formal sector shops or on footpaths leading up to these shops might create difficulties for parking of cars

or even for pedestrians trying to access these shops.

A real life example of unfair competition provided by the informal to the formal sector can be cited from the Peruvian experience. In the 1970s, the 30 largest bus companies in Peru commanded 70 percent of the bus fleet and 60 percent of the routes. After the 1970s, numerous small/informal bus operators entered the industry and depleted the market share of the large bus companies, given that they did not have to pay much of the taxes required from the formal sector or adhere to many of the formal quality norms. As a result, in 2000, the mentioned top 30 percent commanded only 30 percent of the fleet and 12 percent of the routes<sup>4</sup>.

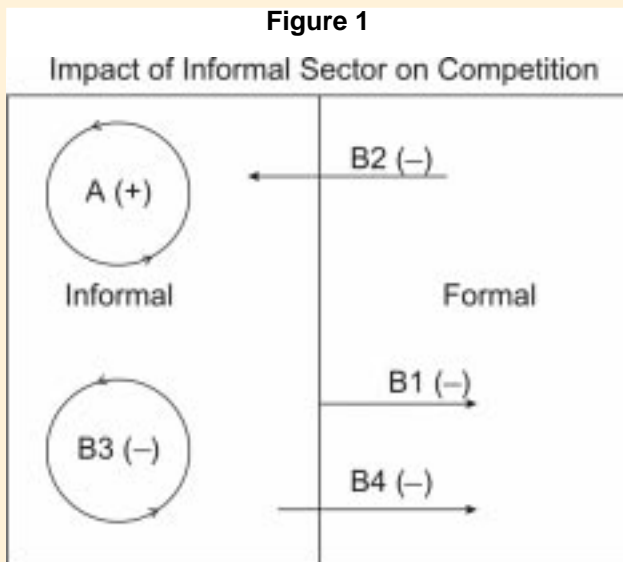
The net impact of the informal sector on the level of competition in the economy is an algebraic sum of the positive and negative effects. It is a matter for research to investigate the relative magnitudes of these effects to determine whether the net effect is positive or negative. Interestingly, the answer could be qualitatively different across countries and could be a function of the economic, geographic and demographic characteristics of the country.

Table 1 summarises the various impacts of the informal sector on economy-wide competition. Note that effects outlined in bold font represent broad categories of effects, the constituent sub-categories, if any, are outlined in ordinary font. The Figure 1 presents a more visual depiction of these effects. Arrows that go from the informal to the formal sector or vice-versa depict inter-sectoral effects, while circular arrows refer to ‘within sector’ effects. The arrow that emanates from the boundary between sectors illustrates the effect that the shifting of the boundary has on formal sector competition.

**Table 1: Impact of Informal Sector Expansion on Economy Wide Competition**

Type of Effect	Description/Component	Symbols
<b>Positive</b>	<b>Caused by small geographically proximate firms selling uniform product</b>	<b>A</b>
<b>Negative</b>	<b>Depressing the number of formal firms</b>	<b>B1</b>
<b>Negative</b>	<b>Increase in incidence of abuse of dominance by formal firms</b>	<b>B2</b>
<b>Negative</b>	<b>An increase in the size of the informal sector increasing the scale of associated anti-competitive practices</b>	<b>B3</b>
Negative	Abuse of Dominance	B3a
Negative	Price Collusion	B3b
Negative	Product Adulteration	B3c
<b>Negative</b>	<b>Increase in unfair competition from the informal sector for the formal sector</b>	<b>B4</b>

*Note: The meaning of symbols remains unchanged in the Figure 1*



Note: Refer to Table 1 for classification of impacts

#### IV. When Do We Need to Tackle Informality?

Because informality is often synonymous with small size (a characteristic which aids competition) and formality is associated with larger sizes, in many cases, formalising the informal sector might not be desirable for competition. It is only when the sum of the magnitudes of negative effects (B1-B4) overwhelms the positive effects of small size that accompany informal activity that formalisation of the informal sector might be advocated.

In other words, any decision to formalise the informal sector must be preceded by a rough cost-benefit analysis with respect to the implications for competition. Given a policy objective of maximisation of competition, a general policy decision to formalise is recommended, if the net expected benefit in competition terms is positive.

Alternatively, a broader decision framework can be used: net benefits from competition can be added to those in terms of tax revenues, etc., to arrive at a more holistic measure of net benefit from formalisation. The decision to formalise then rests on whether this measure of net benefit is positive or negative.

Another way to make this approach more nuanced would involve taking the decision of formalisation separately for the different sectors of the economy (dairy, fruits and vegetables, construction, etc.) on the basis of separate cost-benefit analyses.

#### V. A Guide to Formalisation

Once the decision to formalise is taken, it obviously has to be implemented by nipping the motives for running/establishing informal firms in the bud. The various reasons why individuals set up informal firms might be the following:

- Too many procedures and clearances required for setting up formal firms;

- Time-consuming nature of the above procedures with attendant opportunity costs of time borne by the entrepreneur;
- Corruption at the entry points to the formal sector; i.e. money has to change hands to get the required clearances;
- Credit and other facilities provided by the government for formal sector firms not large enough to entice entrepreneurs into the formal sector; and
- High tax rates in the formal sector.

Each of these barriers to formalisation has to be tackled<sup>5</sup>. For example, the number of procedures and clearances required for setting up of firms can be pruned by following the example of countries which require fewer procedures/clearances. The *Doing Business 2008*<sup>6</sup> Report published by the World Bank can help in identifying countries with the fewest required procedures and their example could be followed.

While pruning the number of procedures, legal or constitutional costs have to be taken into account, i.e. the removal of procedures/clearances from the list of requirements should be sought only if: a) these are not central to the process of setting up business and its economic ramifications; and b) their removal is not associated with prohibitive legal or constitutional costs in terms of both time and money.

Total procedural time costs can be reduced substantially by identifying procedures that involve the highest costs. Again the *Doing Business* Reports of the World Bank might be helpful in this regard. In reducing the time costs, removal of the procedures with high time costs from the list of requirements might be a possibility, but only if criteria a) and b) are met. The second way is to institute organisational changes, i.e. clubbing procedures under common windows or instituting a single window system of clearances.

The removal of corruption requires a systemic analysis specific to each country. Such analysis is bound to reveal different causes of corruption. The first step in this regard is to ascertain whether the level of corruption is indeed high. Indicators such as the Corruption Perception Index estimated by Transparency International might be useful in this regard.

Once indices reveal the level of corruption to be high, then the involved researchers face the difficult task of ascertaining the underlying reasons. The literature on corruption points to many possible causes of corruption – the existence of all of these has to be verified.

The list of possible causes, as pointed out by the economics literature, may be as follows:

- Low salaries of government officials;
- Inadequate efforts/expenditure devoted to monitoring of government officials;
- Inadequate punishment or legal barriers in punishing government officials; and
- Deeper causes, e.g. corruption at the entry points of government service, forcing recruited government



officials to turn corrupt for repayment of debts thus incurred.

If any of the above factors is/are found to be present and linked to the problem of corruption, then suitable remedial steps can be taken. The existence of deeper causes, if ascertained, can be helpful in working out a strategic approach for the elimination of corruption.

For example, if corruption at the entry points<sup>7</sup> is a significant cause for government officials turning corrupt then a strategic approach can concentrate on trying to remove corruption at the entry points only, rather than trying to remove it everywhere. This is because anti-corruption programmes involve costs in terms of human capital and money.

Cost and benefits of formal operation relative to that of informal operation might be another factor determining entry. If tax rates are very high then the government might consider reducing these. As a lower tax rate encourages entry into the formal sector, therefore, contrary to common perception, it might result in higher revenues for the government. In that case, tax reduction might be a win-win measure for government and business.

The ability of the government to leverage easy credit for formal firms from the formal credit market and at rates much below those corresponding to the informal financing sector (suppliers of credit to the informal sector) might also encourage firms to enter the formal sector. Good entrepreneurial advice and training provided by the government might be another factor.

## Conclusion

According to the paper, the informal sector can be broadly defined as those producers/sellers who fall outside the scope of government control for various reasons. The existence of the informal sector has both positive and negative implications for the level of competition in the economy.

The paper then goes on to elaborate on the positive and negative influences. The positive influences emanate from the fact that informal firms are usually small and, therefore, individually less likely to be the source of any dominance. Negative implications can arise in myriad ways: price collusion and dominance by some informal sector firms, affecting other informal sector firms; formal sector being subjected to unfair competition by the informal sector, in the form of lower prices facilitated by tax avoidance, hard-to-catch product adulteration and even physical obstruction; and, last, formal sector firms employing anti-competitive practices such as predatory pricing to eliminate informal competition.

The paper recommends that the decision to formalise the informal sector should be based on a cost-benefit analysis – the positive effects can be termed as competition-related benefits and the negative effects as cost. A net negative effect justifies formalisation; otherwise continuation of informality might be desirable.

The paper goes on to elaborate on the various methods of formalisation: reduction in the number of procedures/clearances involved or time taken in registration of firms in the formal sector, corruption that determines the magnitude of bribery involved in such processes; and reduction of disincentives such as high tax rates and enhancement of incentives such as credit leveraging and entrepreneurial assistance/training provided by the government to the formal sector.

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## Endnotes

- 1 Sethuraman, S V (1974), "Towards a Definition of the Informal Sectors", *ISEP Working Paper (Geneva: ILO, 1974)*
- 2 Note these letter-number combinations are used to denote various categories of effects of informality on economy-wide competition and sub-categories within these.
- 3 Via Láctea (2007), "Boletín Informativo del Sector Lechero-Ganadero", No 42, Noviembre, 2007
- 4 Roca S, Rojas JF and E Vila (2008), "Eficiencia, Competencia y Seguridad en el Funcionamiento del Mercado de Transporte Terrestre Interprovincial de Pasajeros: Evaluación y Propuestas, APOIP
- 5 Mitra, S (2005). "Controlling Informalisation: Punitive versus Strategic Measures", *Indian Journal of Labour Economics*, January- March, 2005
- 6 World Bank (2007), "Doing Business 2008: Comparing Regulation in 178 Economies", World Bank, Washington DC
- 7 Mitra, S (2003), "Corruption as Cascades", *Social Change*, Volume 33, No. 4

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This Discussion Paper is written by **Siddhartha Mitra**, Director (Research), CUTS International. Comments on the paper received from Cornelius Dube and Verity McGovern of CUTS International have been suitably incorporated.

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