**The informal riddle**

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Pakistan is the world’s 23rd largest economy in terms of GDP based on purchasing power parity (PPP). It is classified as a low-income developing economy. The country is also ranked poorly in most development indicators set by the UNDP and World Bank.

Over recent decades, there has been no sizable improvement in employment and poverty alleviation in Pakistan. One of the major reasons for this is the massive challenge of the informal economy, whose profits are undocumented and untaxed. As per global economics reports for 2022, the size of Pakistan’s informal economy is estimated to be 35.6 per cent which represents approximately $457 billion at GDP–PPP levels.

Most of the developed countries in the world have below 10 per cent informal economy. The middle-income countries predominantly have this ratio below 20 per cent and the majority of low-income countries have more than 30 per cent of their economy as informal economy. Only a few countries in the world are ranked below Pakistan in their informal economy. However, the gravity of the situation can be estimated from the fact that as per some country reports by PIDE economists, the ratio of Pakistan informal economy is not 35.6 per cent but its ratio is more than 90 per cent.

Looking at its impact on a policy level, the transactions made in the underground economy go unreported, and distort the accuracy of key economic measurements. A nation’s GDP is calculated by totaling the following four components: personal spending, business spending, government spending and net exports.

None of these components record transactions that occur within the underground economic system. This is significant because these numbers, accurate or not, are used to set government policies. Transactions in the shadow economy escape taxation, thus keeping tax revenues lower than they otherwise would be. If the tax base or tax compliance is eroded, governments may respond by raising tax rates encouraging a further flight into the shadow economy that further worsens the budget constraints on the public sector.

Now the constraint in Pakistan is that 35.6 per cent (or more than 90 per cent) of our economy is not documented. It’s not paying taxes; its profits are more than the formal economy. The people owning this underground economy are getting richer and the country is growing poorer. They are utilizing all resources without paying for them. They are using roads, water, bridges, schools, security, hospitals, parks, electricity and gas connections, etc without contributing a penny of tax to build or repair the infrastructure of these utilities.

The larger groups in this underground economy are: smugglers, cash dealers, real-estate agents, undocumented sellers of precious metals, landlords etc. The smaller players of it are: domestic workers, daily wage earners, agriculture labour force, seasonal workers, undocumented cottage industry workers, underage labourers, illegal migrants etc. Therefore, on the one hand, for poor and uneducated people the informal economy may be a ray of hope as they get employed where others refuse to work due to exploitative work conditions and low wages. On the other hand, it traps them in a vicious circle of enslavement.

Several studies have found strong evidence that the intricacy of the tax regime influences the shadow economy. Studies by IMF economists show that the marginal increase in income tax rate by one percentage point, other things being equal, the shadow economy grows by 1.4 percentage points. A few studies empirically investigate the relationship between corruption and the shadow economy and establish that countries with more corruption have relatively large shadow economies.

To mainstream the informal economy, the government of Pakistan should emphasize legalizing certain shadow economy activities – for example by liberalizing the labour market. Hence, reforms that liberalize regulations and make the economy more competitive reduce the incentives for corruption, and encourage firms to move from the shadow economy into the official one.

Honest and competent tax officers may be deputed for tracing and mapping of major informal sectors, real-estate agents, builders, cash dealers etc. The focus of documentation of the economy should be on strict enforcement of a minimum necessary set of regulations, rather than on increasing the number of regulations.

More frequent tax audits and heavier penalties for tax evasion may reduce the size of the shadow economy. Incentives for taxpayers should also be introduced to discourage cash holdings. A discounted sales tax approach can be followed for consumers who make payments through banking channels instead of cash payments. Lastly, smuggled goods may be traced and confiscated. Effective monitoring of cross-border trade with Afghanistan, Iran and stopping illegal imports from China is crucial for discouraging smuggling.

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