

## Informality, Regulation and Taxation

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### Notes for Session on Informality and Economics, WIEGO 20<sup>th</sup> Anniversary Conference

*Framing Question: “There is a common assumption that informal operators are avoiding or evading regulations and taxation. You have examined this assumption in your recent work. In what ways does this standard assumption need to be modified to reflect the realities of informal operators and enterprises?”*

I am in an eternal search for a clear conceptual definition of informality. In a paper written with the late Lin Ostrom, I argued that in there are multiple conceptualizations and definitions of informality in the literature, causing considerable confusion in the policy arena. For enterprises and operators, these definitions range from smallness per se, to poverty per se, to not paying taxes per se, to something else per se, and so on.

For me conceptual clarity came from Keith Hart’s famous characterization of his field site in Ghana:

“Following Weber, I argued that the ability to stabilise economic activity within a bureaucratic form made returns more calculable and regular for the workers as well as their bosses. That stability was in turn guaranteed by the State’s laws, which only extended so far into the depths of Ghana’s economy. ‘Formal’ incomes came from regulated economic activities and ‘informal’ incomes, both legal and illegal, lay beyond the scope of regulation.”

Thus formality and informality of operators could only be conceptualized relative to a particular set of state regulations. The definition of formality was that which came within the ambit of the state so defined. Informality was that which lay outside. Of course, this still leaves open the question of which regulations, and what it means to be outside their ambit. I still think that this, or something like this, has to provide the conceptual anchor. Otherwise, the concept of informality loses its analytical cutting power, becoming what anyone wants it to be.

In my work, I have illustrated the workings of the above conceptualization with a particular example. Imagine a world with no regulation. In this world, let enterprises vary in employment from very large to very small. Now suppose a regulation is introduced which says that enterprises with more than X workers (10, say) will have to register and pay their workers certain benefits and conform to certain regulations. (You may recognize this as a stylized description of India’s Factories Act). How will the previously unregulated enterprises react?

Those who would in any case have had fewer than 10 workers will be unaffected. Call this category D, the outsiders. Those who would have had more than 10 workers without the regulation now face a choice—avoid, evade or comply. Call these categories C, B and A. Avoiders will hire less than 10 workers and so not have to register—perfectly legal. Evaders will hire more than ten workers but not register—illegal. Compliers come within the ambit of the regulation and comply. They register and are of course what we mean by “formal”.

The choice of each enterprise on what to do will depend upon a consideration of the costs and benefits of each decision. The problem can be stated and solved formally mathematically but that detail is not the focus here. The point is that the regulation creates four categories of enterprises:

- A. Those who come within the ambit of the regulation and comply.
- B. Those who come within the ambit of the regulation and evade.
- C. Those who come within the ambit of the regulation but avoid by adjusting out of the ambit.
- D. Those who are outside the ambit of the regulation.

In Keith Hart's conceptualization, category A is formality. Categories B, C and D therefore together constitute informality: "Formal' incomes came from regulated economic activities and 'informal' incomes, both legal and illegal, lay beyond the scope of regulation."

I have used this classification for theoretical, empirical and policy excursions into the informality discourse. I have argued, for example, that it is very important for informality to be disaggregated into components B, C and D—indeed, for India we have tried to provide an estimate of this breakdown.

Turning to the framing question, it should now be clear that the question assumes that informality is defined independently of regulations and taxation, and we then look to see whether and to what extent "informal operators are avoiding or evading regulations and taxation." But if being "beyond the scope of regulation" is the essence of informality, then the question doesn't make sense. If an operator is paying tax, then by the Hart conception that operator is formal because its activities come within the purview of the state and comply with regulations.

However, suppose formality and informality is first decided upon with reference to one set of regulations, and only this set of regulations, say registration. Then we could go beyond this and ask if those who are so defined as informal also do or do not pay taxes, this payment or non-payment having nothing to do with the definition of informality. Then the question as posed may make sense, but to what purpose? This then raises the next question, in a world of multiple regulations, which are the ones to define informality, and why these and not others? If there is compliance with some and not with others, how is one to define and measure informality, and what does informality mean?

The regulatory entry point to conceptualizing informality should also highlight the fact that the policy instrument is not informality, but regulation (and other interventions). Further, it should also highlight the fact that informality cannot by itself be "good" or "bad". At best it is an intermediate objective which is not necessarily tightly connected to final objectives of policy. Thus "reducing informality" or "formalizing the informal" are commonly espoused goals which need to be interrogated before adoption. Thus, for example, an appropriate policy problem might be to choose the parameters of regulation (for example, the threshold level of employment at which registration is mandated, and what this mandating implies) to minimize, say, poverty, or to maximize, say, employment. Whether informality, defined as those who are outside the remit of regulation (legally or illegally), may or may not increase. Whether it does or does not is perhaps of analytical interest. But a focus on it as an indicator of policy success is irrelevant at best and misleading at worst.

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