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COMPETITION POLICY AND THE INFORMAL ECONOMY

Issues Paper by the Secretariat

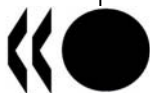
-- Session II --

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COMPETITION POLICY AND THE INFORMAL ECONOMY
ISSUES PAPER BY THE SECRETARIAT

1. Why do firms decide to operate informally?

1. The informal economy literature identifies numerous factors that lead firms to operate in either the informal or the formal economy. Research indicates that access to credit, government training programmes and strong regulatory enforcement encourage firms to operate in the formal economy. However, overly burdensome or inefficient regulation can significantly increase the cost of both joining the formal economy and operating within it¹. Factors that lead firms to operate informally include excessively burdensome requirements in registering their business and complying with labour and tax regulations. Without the constraints faced by their formal competitors, informal firms may have greater flexibility to be more responsive to the market and may be able to develop business models that substantially lower their supply costs. Greater flexibility and lower costs enable them to compete more vigorously with formal firms. For example, regulations that limit store operating hours or the locations in which they operate constrain formal firms but will not be adhered to by informal firms, thus providing them a competitive advantage.

What cross-sector regulations or factors encourage firms to operate informally?

What kinds of sector specific regulations or factors encourage firms to operate informally?

In some sectors, both informal and formal firms exist. In those instances, why do some firms choose to operate informally and others choose to operate formally?

2. Do informal and formal firms compete?

2. Whether informal firms affect competition law enforcement in the formal sector depends in part upon whether informal firms compete (or could quickly enter the market and compete) with formal firms. Research demonstrates that informal firms often operate on a small scale and in labour-intensive industries. Thus, informal firms are rarely found in industries where scale and scope economies are important, such as in the steel, telecommunication and banking industries. Conversely, informal firms are frequently found in industries such as construction, retailing and personal transport - industries that are often cash-based.

3. The degree to which formal and informal firms coexist in the same market and compete for the same customer base varies across sectors and markets. Some markets may be comprised only of informal firms and others may be comprised almost entirely of formal firms. In some sectors, small informal firms may be able to compete with large formal firms due to the costs that they can avoid. In other situations, economies of scale and scope will enable formal firms to price lower than informal firms. In some markets, informal firms may find they can compete with formal firms because they can position their products geographically closer to the customer than formal firms. For example, produce vendors may be

¹ Hernando De Soto (2000) *The Mystery of Capital*

able to drive to the customer and thus take away the productivity advantages of large scale, stationary formal firms.

In which sectors in your jurisdiction do informal firms serve the same customers as formal firms?

Do small informal firms compete with large formal firms?

In what sectors can informal firms locate themselves close to customers?

3. Is competition from informal firms beneficial or harmful?

4. One school of thought argues that consumers benefit from lower prices due to the existence of informal firms which evade taxes and other costly regulations. The low prices that informal firms offer may in turn increase the competitive pressure on firms operating in the formal sector. Thus, informality may have the effect of reducing prices in the formal sector, especially if there are numerous informal firms in the market. By evading regulations, informal firms may be able to reduce costs and potentially develop and supply products and services that formal firms cannot develop and supply.

5. Another school of thought points to research that shows that formal firms are more productive than informal ones, due to scale and scope economies, access to capital and technology and more advanced methods of production and distribution. This suggests that significant productivity gains could be achieved by transferring production from low-productivity informal firms to more productive formal firms or by facilitating the formalisation of informal firms. Competition from informal firms reduces competition in the long run by preventing more productive, formal firms from entering or expanding in the market. In the long run, prices could be, potentially, even lower if informality was eliminated. In addition, the incentive to innovate and invest (especially where intellectual property is concerned) can be significantly reduced by informal firms.

6. When assessing the benefits or harm to competition from informal firms, competition authorities should consider whether to focus their analysis on short- or long-run competition concerns. A further factor to consider is the circumstances under which the size of the informal economy will improve or hinder competitive pressures in the formal sector.

Does competition from informal firms intensify competition in the formal sector?

In which sectors are informal firms more (or less) productive than formal firms?

Do informal firms reduce or increase economic growth?

Do informal firms harm the development of intellectual property by formal firms?

4. What problems are encountered in competition law enforcement when informal firms are involved?

7. In principle, cartel, merger and abuse of dominance cases could arise in either the formal or informal economy. The existence of the informal sector may affect competition law enforcement in the formal sector. For example, competition authorities may have to contend with arguments that a cartel did not harm consumers or that a firm did not abuse its dominant position due to competition from informal firms. Similarly, firms involved in a merger may argue that they will not be able to raise prices because they would be constrained by both formal and informal firms.

Market definition

8. When there is a concern that competition may be harmed by a merger or an abuse of dominant position, competition authorities typically assess the extent to which other products act as constraints on the ability of a firm to exercise market power. In some instances, informal firms may sell products which are illegal because they infringe copyrights or patents, or are counterfeit. In other cases, an informal firm may devote a portion of its business to criminal activities such as money laundering, which enables it to lower prices on substitutes to the product in question. Even though informal firms may sell illegal products or are engaged in illegal activities, the products they sell may still be regarded by the competition authority as a constraint on the ability of a formal firm to exercise market power. Thus, including all important substitutes in the antitrust product market (regardless of whether they are illegal) may be warranted in some instances. On the other hand, if a very large proportion of consumers in the relevant market would not switch to illegal products produced by informal firms and as a result, it may be possible to define a market that only includes formal firms.

Under what circumstances can an antitrust market be defined that does not include informal firms?

What are the weaknesses and strengths of qualitative techniques for assessing market definition when informal firms are involved?

In what sectors are a significant number of consumers willing to switch their purchases to informal firms if formal firms raised their price by a SSNIP (or vice versa)?

Should products which infringe on copyrights or patents be included in product market definitions?

Market shares

9. Assigning market shares necessarily involves quantitative analysis. Formal firms can under report market sales which can frustrate efforts to assign market shares because information on each firm's output will be undercounted as will total market sales. Thus, both the numerator and the denominator for each firm will not accurately reflect the size of the firms in the market. Estimating sales of informal market participants can be even more difficult as there may be dozens or even hundreds of them.

How can market shares be assigned when quantitative data cannot be obtained from all market participants in the antitrust market?

How should market shares be calculated when there is a concern that some firms may under report revenues and sales?

What factors contribute to different concentration ratios in the formal or informal sector?

Entry barriers

10. It is well documented that there are barriers to entry to the formal economy. Extensive and costly procedures and processes (potentially involving bribes) hinder the entry of informal firms into the formal economy. However, although registry requirements may be sufficient to inhibit entry into the formal economy, they typically fall below the one- or two-year timeframes required by most competition authorities to establish a substantial barrier. World Bank research indicates that the estimated duration for an informal firm to complete registry requirements is often substantially less than three months in the more than 180 countries that they survey.

Are barriers to entry in the formal sector high or low?

Do entry barriers help some firms maintain their market power in the formal sector by inhibiting the entry or expansion of informal firms?

Market power

11. Assessing market power in abuse of dominance cases typically involves assessing market concentration and entry barriers. Quantitative techniques such as assessing profits, profitability, event study analysis, or undertaking complex econometric analyses may be impossible due to the lack of data. In these instances, how should market power by dominant firms in the formal sector be assessed? More fundamentally, competition authorities should focus on the reason why a firm has market power in the first place. In some instances, firms may have substantial market power due to legal restrictions which inhibit entry. Removing those restrictions may eliminate the market power of the firms.

How does informality affect the measurement of the market power of formal firms?

Does competition from informal firms substantially reduce the market power of formal firms?

When there are a significant number of firms in the informal sector, are competition cases in the formal sector irrelevant?

Market studies

12. Market studies can be a useful tool for providing competition authorities with a clearer picture of a market. Market studies can help authorities to learn about market structure, identify barriers to entry, restrictive government policies or anticompetitive conduct. Given the resource intensive nature of market studies, competition authorities should prioritise the sectors they study and attempt to estimate a priori the likelihood of success. Market studies that involve informal firms may be more complicated, however, due to the number of firms involved and the difficulty of acquiring reliable information on which studies can be based.

How should market studies that involve the informal sector be conducted?

Can market studies provide significant information about market performance in the formal or informal sector even when they are somewhat superficial?

Other issues involving informality that may impact cartel, merger, and abuse of dominance cases:

Even though cartels are often treated as a per se offense, does competition from numerous informal firms render the impact of a cartel in the formal or informal sector insignificant?

Can the argument that formal firms created a cartel in order to fight informality be used as a legitimate defence?

Should competition authorities be concerned about abuse of dominance or mergers in the informal sector? If so, in what sectors?

Are there any special factors that need to be accounted for in designing remedies when a case involves informal firms?

Are exemptions for small informal firms good antitrust policy?

Unfair competition

13. Firms in the formal sector are likely to complain to competition authorities about informal firms that evade taxes and other regulations. While these practices may artificially lower the supply costs of informal firms and give them an advantage over legitimate businesses, they also may lead to increased market output. Authorities should consider carefully how informal practices harm competition, even though it may be true that the output of formal firms is reduced.

Should the 'unfairness' of the informal economy be a driver of competition law enforcement?

How can competition authorities assess whether competition is harmed?

5. Advocacy in fighting unnecessary restrictions on competition

14. Competition authorities may consider undertaking advocacy efforts aimed at eliminating unnecessary restrictions on competition. In certain situations, advocacy efforts may lead not only to more vigorous market competition but may also reduce informality. For example, advocacy efforts aimed at removing taxi license limitations may not only increase competition but have the effect of reducing informality, as more firms will be able to obtain a license.

15. However, in some situations, competition authorities may make recommendations which on the one hand reduce informality but may lead to higher market prices, albeit with higher government tax receipts and contributions to social programmes. Should competition authorities make these recommendations or should their recommendations be focused only on situations where restrictions to competition are unnecessary?

How and in what sectors do restrictions on competition unnecessarily protect small informal firms from competition with formal firms?

In what sectors do restrictions on competition unnecessarily protect formal firms from competition?