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Global Forum on Competition

COMPETITION POLICY AND THE INFORMAL ECONOMY

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-- Session II --

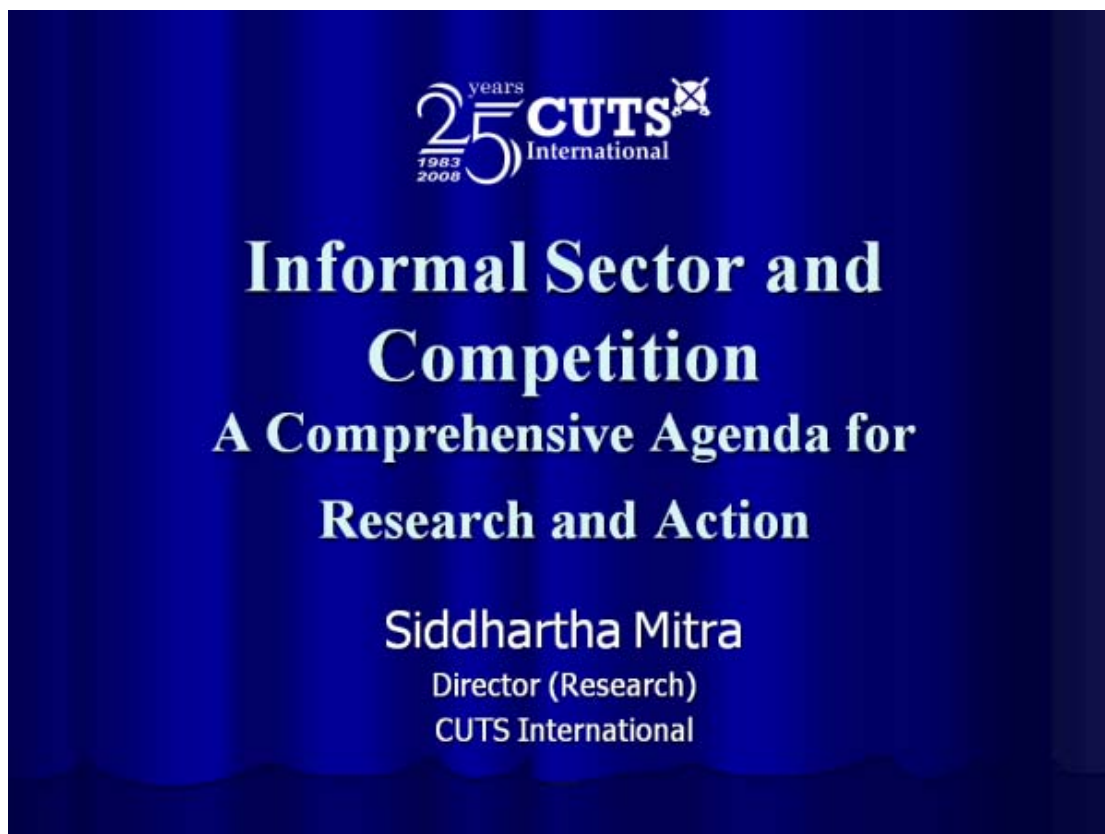
This presentation was submitted by Mr. Siddhartha Mitra under session II of the Global Forum on Competition which was held on 19 and 20 February 2009.

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Outline

- Working definition
- Classification arising out of working definition
- Informal sector and competition: peculiarities of the relationship
- Effects of informal Sector on competition
 - Positive effects
 - Negative effects
 - Dynamic effects
 - Static effects

Outline (2)

- Deciding to formalise: cost-benefit analysis
- Explanation for co-existence of formality and informality
- Facilitation of formalisation
 - Reasons for the existence of the informal sector
 - Formalisation by neutralising motives
- Conclusion



Informal Sector: Working Definition

- Defined in many ways
 - Size
 - Number of employees
 - Capital stock
 - Legality
 - Nature of functioning: informal norms versus rules
- Working Definition

Economic activity in a nation which is not administered in any substantial way by the government



Classification Arising out of the Formal Definition

- Distribution and manufacture of banned products
- Illegal cross-border trading in products otherwise legal
- Unauthorised internal distribution of services /amenities otherwise legal
- Production of goods/services not administered by the government
- Hawking and vending activities



Informal Sector and Competition: Peculiarities

- Small size and undifferentiated products might imply closer approximation of perfect competition
- Such characteristics might not be seen in all sectors (vegetable selling versus restaurants)
- Lower surpluses: productivity enhancement through innovation/investment is less probable
- Competition law difficult/impossible to enforce in some informal sectors characterised by large numbers, small size, mobile nature of firms, lack of records, non-standard products



Impact of Informal Sector on Economy Wide Competition

- Positive Effects
 - Physical proximity of sellers, small size, identical products
- Negative Effects
 - Dynamic Effects
 - Lower surpluses: competition through innovation is impeded
 - Static Effects
 - Smaller formal sector
 - Intra-informal sector anti-competitive activity
 - Unfair competition for the formal sector
 - Abuse of dominance held by formal sector firms over informal firms



The Decision to Formalise: Cost Benefit Analysis

- Aggregate algebraically all effects to arrive at net effect of informal sector on economy wide competition
- Negative effect can be used to justify formalisation: otherwise continuation of informality is advised
- Qualifying statements
 - Aggregation might throw the baby out with the bath water: sector analyses are advisable
 - Addition of other effects such as tax revenues foregone because of informality might be advisable



Co-existence of Formality and Informality: Explanation and Implications

- Initial differences in wealth
 - Less wealthy entrepreneurs cannot incur registration costs
 - They cannot pay the necessary bribes to gain entry
- Presence in other sectors might make the time costs needed to enter the formal sector more bearable (?)
- Equilibrium might be attained: unfair competitive advantage of informal firms might freeze the structure of a sector



Facilitation of Formalisation

Reasons for the Existence of the Informal Sector

- Too many procedures/ clearances required for setting up formal firms
- Time consuming nature of the above procedures
- Corruption at entry points to the formal sector
- Credit and other advantages provided to formal sector firms not large enough
- High tax rates in the formal sector



Facilitation of Formalisation

Formalisation by neutralising motives

- Lower the number of procedures – strategic approach directed towards areas of least resistance
- Lower time costs – single window or bunching of procedures
- Lower corruption
 - Increase salaries of government officials
 - Increase monitoring efforts/expenditure
 - Increase punishment and remove associated barriers
 - Tackle deeper causes through strategic approach
- Lower tax rates



Conclusions

- Informality has both positive and negative effects
- Formalisation needs to be preceded by a cost-benefit analysis
- Sector analysis is necessary – aggregation might lead to inappropriate decisions
- Initial wealth differences might lead to sectors with mixed presence – a self-perpetuating phenomenon
- Formalisation requires a multi-pronged attack – deregulation, administrative restructuring and lubrication, campaign against corruption, more liberal tax regime etc

