
The Impact in Informal Economy from the Emulation and Creation of Corruption

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Abstract: *In former communist countries, corruption has very often been endemic. One of these countries is India. Few studies in the past have addressed the relationship between corruption and informal economy in this country. How to explain corruption through informal economy? This article highlights the impact different economic policies had on informal economy. Changing legislation on tax policies and other legislation impacted corruption since it created a vacuum used by private firms who avoid paying their taxes or declaring their employees. In this article, 15 cities are studied through a data collection that shows this interaction between corruption and informal economy.*

Keywords: *India, corruption, informal economy, tax laws*

1. INTRODUCTION

In India, corruption, both active and passive, remains one of the most notorious black phenomena of Indian society. Corruption has been subject to many debates and reports (European Union), OECD etc. Nevertheless, very little debate was organized on its impact on Indian economy as well as in Indian society. Corruption is always difficult to analyze because it is not an easy measurable factor and there is still a limited viable data about this phenomenon. Corruption is a characteristic of most former communist countries. Many of these countries faced difficulties to build stable markets and an appropriate economic and market legislation. Many of them continue to face this problem even today, almost two and a half decades after the fall of communism. It does not mean that these countries do not have regulation legislation but, very often; this new legislation adopted after the fall of communism is not the most appropriate one to deal with the problems these countries face. For instance, in India, laws that have been adopted in this context were laws that are applied to countries that have a completely different economic structure and markets. Furthermore, we can say that the adoption and application of these laws has created a judicial vacuum which creates a deliberate leeway for active and passive corruption (Cities Alliance: Cities without Slums (2002). [[http:// www.unchs.org/programmes/housingrights/expert_group_meeting.asp](http://www.unchs.org/programmes/housingrights/expert_group_meeting.asp) *Expert Group Meeting on Urban Indicators, Secure Tenure, Slums and Global Sample of Cities, Monday 28 to Wednesday 30 October 2002*]. Nairobi, Kenya: United Nations Human Settlements Programme). Nevertheless, even if we are aware that corruption is difficult to prove in India, we decided to do it through a comparison of the informal economy data and its impact on corruption rise. This is much easier to do because of the availability of viable data that can allow us to confront and understand how they affect or do not affect the other (Sassen, Saskia (2009). *"The Global City – Strategic Site/New Frontier" in Dharavi: Documenting Informalities*. Delhi: Academic Foundation. p. 20.) Therefore, the main purpose of this study is to find and to compare available data which can lead us to prove if informal economy and corruption are related. In order to do this, we should first consider in formal economy data. This task is difficult since measuring informal economy in India is not always easy. The same thing is true also for corruption data.

What makes it more difficult is that most of the published data on informal economy or in corruption are done on political bases, either "to show" the efficiency of a government policy or to fight the political opponents. Therefore, very few data can give us a true picture or the informal economy or corruption. It is generally well known that corruption effects on economy but it is little known what the effect of market change on corruption is. The aim of this study is to try to show what the connections between them are.

2. INFORMAL ECONOMY

Contrary to formal economy, informal sector or informal economy is that part of economy that is not taxed or monitored by any government institution and it is not part of any data about the Gross National Product (GNP) of a country. Archaic examples of this kind of economy are barter and gifts. (Lewis, William (1955). *The Theory of*

Economic Growth. India: Allen and Unwin). This is by the way the most simplified definitions of what is informal economy. In this study, our intention is not to consider informal economy as a social or economic issue but as a factor that contributes grandly to emulation and corruption rise in India. Informal economy is also closely linked to a country's (non) development (Carr, Marilyn and Martha A. Chen. 2001. "Globalization and the Informal Economy: How Global Trade and Investment Impact on the Working Poor". Background paper commissioned by the ILO Task Force on the Informal Economy. Geneva, Switzerland: International Labour Office). Informal economy exists also in developed countries but its impact is much lesser than in underdeveloped countries. In these countries, informal economy is a real problem (Williams, Colin C. (2005). *A Commodified World: Mapping the limits of capitalism*. India: Zed Books. pp. 73, 74). To understand corruption, we should previously understand what is its correlation with informal economy in countries in transition. There are generally three types of correlations. An economic one, a judicially one and the third one is connected to citizens' awareness.

When we speak economy, we think about countries that do not have a stabilized market share. In these underdeveloped countries, market share changes constantly. New firms are created and disband mostly in a year or two, even though a few of them manage to survive a few years (Jonatan Habib Engqvist and Maria Lantz, ed. (2009). *Dharavi: documenting informalities*. Delhi: Academic Foundation). Nevertheless, even those firms that survive longer, they tend to be unstable and are characterized with risky factors such as inability to pay their debts or inability to pay the salaries of their employees in a regular basis. In this context, these companies can hardly find professional employees since they tend to recur to employees who agree to work for a much smaller salary and without working contracts. These legally inexistent employees allow to these firms not to declare their incomes and taxes. Their undeclared employees are priviledged from their basic protections and services (*Report on conditions of work and promotion of livelihoods in the unorganised sector*. 2007 New Delhi: National Commission for Enterprises in the Unorganised Sector). The undeclared employees are obliged to accept these situations because in a poor country such as India for instance, to have a job is much more important than having a job security or insurance. Since jobs are rare and employment possibilities even more scarcely, employees accept these situations, which makes it possible for the companies to refuse to admit that these employees work for them. This situation creates a whole gap in the tax system. It is well known that undeclared jobs exist also in developed countries, but in these countries, firms are much more controlled and even if some employees work additional jobs "in black", these jobs are a good occasion for the employees to earn more and escape the taxes. Undeclared jobs are very often considered as a way for small firms to reduce the high tax charges that exist in these countries. In India, there is a labor legislation that has been voted and enforced many times but very few companies declare all their staff or even when they declare them, they declare their staff part time (<http://www.economist.com/node/2766310>).

The second area in which informal economy interrelates with corruption in underdeveloped countries is Law (tax laws). The implementation of new tax policies has a direct impact on the rising or reduction of informal economy. A good illustration of this are the two different policies applied in India from 2005 to 2010 ("The Informal Economy: Fact Finding Study". Department for Infrastructure and Economic Cooperation. Retrieved 20 November 2011). In India, up to 2007, as far as income taxation is concerned, there was much more pressure put upon the companies than upon their employees. This allows the companies to avoid declaring their entire staff to the Agency of Taxation of India (ATA). Statistics show that average companies usually declared only 10-20 employees. New tax policy voted in 2007, shifted pressure from companies to individuals. This policy had a positive impact since companies started to declare from 40 to 200 employees. This shows how important are laws and how these laws impact the way the informal economy behaves.

The third area that we mentioned is the citizenship awareness of corruption. This has to do with the moral development of the citizenship concept. This is a phenomenon that is characteristic for countries that had authoritarian backgrounds like India. In India there was a lack of anti-corruption education which is a vital component of any anti-corruption strategy. The goal of this anti-corruption education is to rise citizen awareness to ask for accountability. Anti-corruption education promotes values, attitudes and expectations that condemn corruption, and skills to resist it. Anti-corruption education develops people's understanding of their rights and responsibilities for preserving the public good. It highlights the damage done by minor acts of corruption. In India, very often, traffic police officer let drunk drivers to go in exchange of small bribe. Nurses very often deny patients

treatment if they are unable to pay 'an additional fee', the customs officer who extorts payments from small traders and enterprise: These acts potentially damage and ruin small enterprises, and deprive people of their human rights for health, education and security. Therefore, an informed citizen is much more effective in preventing corrupt and unethical behavior of public servants than the most sophisticated codes of conduct, laws and regulations. Anti-corruption laws and institutions need people who do not tolerate corruption and who actively act against it: Without reports of corruption, corrupt acts cannot be sanctioned, ombudsmen cannot follow up on complaints, and the judiciary cannot prosecute (Anti-corruption education, *Transparency international*, available at: <http://archive.transparency.org>).

3. CORRUPTION

An improper and unlawful conduct is intended to secure a benefit for oneself or another. In India, the most common forms of corruption involving citizens include bribery, extortion, and misuse of secret information. The main cause is the lack of enforcement policies ("Corrupt | Define Corrupt at Dictionary.com". Dictionary.reference.com. Retrieved 2010-12-06). In societies with ritualized gift giving culture, it is hard to draw the line between acceptable and unacceptable gifts. In former communist countries, corruption arises due to the delegation of authority from government to bureaucrats. These delegations have to do with the implementation and enforcement of regulations aimed to abate potential externalities that arise. Such entrepreneurial activities include: labor exploration, illegal entrepreneurship, low quality products and pollution. The restriction of such entrepreneurial activities is done to improve social welfare. However even though different studies have proved that informal economy negates the effects of corruption in economic growth, it still has to be proved that informal economy has a strong impact on corruption emulation and corruption rise. In the table of data below, we tried to show the interrelation between informal economy and corruption in India from 2000-2010 (Agenor, P. R. and Montiel, P (1996), *Development Macro economics*. New Jersey: Princeton University Press). This data analyzed different sources. The level of employment in the informal sector was taken from Indian Institute of Statistics. The reports and publications in this database are based on the Annual Survey of Industries (AIS) and on the Economic Census as well as on secondary data that were available.

In this analysis, we considered a proportion (per 1000) of the informal sector (property and partnership) workers within each industrial group across the country. We consider the total number of employees in both urban and rural sectors and then we consider separately employees of the urban sector and those of the rural sector. We analyzed different industrial sectors starting from manufacturing, construction, real estate, education, etc. Corruption parameters are taken from Transparency International's database on corruption. This database considers corruption only in the public sector. Eleven different public sectors are considered in the study starting with Police (Crime/Traffic), Judiciary (Lower Courts), Land Administration, Municipal Services, Public hospitals, Electricity (Consumers), PDS (Ration Card/ Supplies), Income Tax (individual assesses), Water Supply, Schools (up to 9th Std.) and Rural Financial Institutions (for farmers). The data on State Domestic Product (SDP) is taken from the Central Statistic Organization (CSO, GoI.). The other studies include population, literacy and Human Development Index (HDI). Data on population and literacy are taken from the Economic Survey 2008 – 2009. The HDI data has been taken from National Human Development Report 2001. The impact of corruption on the informal sector is measured in 15 Indian cities. For our study specifications, we consider ordinary least squares (OLS) specifications. Furthermore and due to the data constraints, we will consider cross sectional specifications (Besley, Tomothy and Burgess, R (2004), "Can Labor Regulation Hinder Economic Performance? Evidence from India," *The Quarterly Journal of Economics*, MIT Press, vol. 119(1), 91-134). Although data on informal activities is available over a span of about 25 years from the AIS at 5-year intervals, matching data on corruption is hard to find. Therefore, we reduce this analysis to the cross-section of 2004-05 and we intend to understand the long run implications, once subsequent rounds of AIS will be available in the future. Therefore, our empirical question is: where is the level of informal employment per 1000 employees (for both propriety and partnership activities) per city, during the census period 2004 – 2005? Is there a composite score of corruption for a city during the period 2004 – 2004 which denotes the SDP for years 2000-2001 (Brunetti, A and Weder, B (2003), *A Free Press is Bad News for Corruption*, *Journal of Public Economics*, 87, 1801-1824). The aim is to show the non-linear impact of the SDP on employment level of employment in the informal sector. As far as corruption and SDP are concerned, we focused on the

interactive impact of corruption and SDP on employment level in the informal sector. A positive coefficient implies that for a given level of SDP, a unit rise in corruption will raise the level of employment in informal economy.

Table1. Impact of corruption in the informal sector

Independent Variables	(1)	(2)	(3)
	Rural + Urban	Urban	Rural
Corruption	0.283* (0.153)	0.562*** (0.179)	0.207 (0.174)
SDP	0.00605*** (0.00154)	0.00836*** (0.00218)	0.00598*** (0.00169)
SDP sq	-1.67e-08*** (2.75e-09)	-1.79e-08*** (3.56e-09)	-1.89e-08*** (2.88e-09)
SDP*Corruption	-4.30e-06 (2.77e-06)	-8.27e-06** (3.58e-06)	-3.10e-06 (2.94e-06)
Constant	444.7*** (82.09)	233.0** (98.85)	499.8*** (99.03)
Observations	20	20	20
R-squared	0.564	0.678	0.630

Robust standard errors in parentheses
*** p<0.01, ** p<0.05, * p<0.1

Table2. Impact of corruption in the informal sector

Independent Variables	(1)	(2)	(3)
	Rural + Urban	Urban	Rural
Corruption	0.240 (0.157)	0.562** (0.190)	0.197 (0.178)
SDP	0.00667*** (0.00162)	0.00837*** (0.00220)	0.00612*** (0.00167)
SDP sq	-1.76e-08*** (2.88e-09)	-1.79e-08*** (3.61e-09)	-1.91e-08*** (2.92e-09)
SDP*Corruption	-5.22e-06* (2.91e-06)	-8.28e-06** (3.61e-06)	-3.31e-06 (2.96e-06)
HDI	-195.1 (178.0)	-2.427 (172.4)	-43.87 (131.0)
Constant	540.7*** (116.0)	234.2 (138.2)	521.4*** (124.4)
Observations	20	20	20
R-squared	0.594	0.678	0.631

Robust standard errors in parentheses
*** p<0.01, ** p<0.05, * p<0.1

Table3. Impact of informal sector in corruption

Independent	IV			GMM		
	(1) Rural + Urban	(2) Urban	(3) Rural	(4) Rural + Urban	(5) Urban	(6) Rural
Corruption	0.523 (0.350)	0.569* (0.300)	0.598 (0.407)	0.433 (0.341)	0.575* (0.300)	0.478 (0.378)
SDP	0.00879*** (0.00302)	0.00843*** (0.00246)	0.00914*** (0.00333)	-8.39e-06 (5.74e-06)	-8.75e-06** (4.46e-06)	-7.47e-06 (6.21e-06)
SDP sq	-1.87e-08*** (2.73e-09)	-1.80e-08*** (3.00e-09)	-2.07e-08*** (2.81e-09)	0.00830*** (0.00299)	0.00853*** (0.00246)	0.00825*** (0.00313)
SDP*Corruption	-0.00001 (0.00001)	-0.00001* (0.000004)	-0.00001 (0.00001)	-1.89e-08*** (2.73e-09)	-1.80e-08*** (3.00e-09)	-2.06e-08*** (2.81e-09)
HDI	-164.7 (182.3)	-1.635 (150.1)	-0.713 (159.6)	-218.5 (176.2)	-46.22 (147.0)	-40.81 (151.4)
Constant	387.7* (228.2)	230.2 (186.9)	304.2 (263.7)	460.1** (219.4)	250.8 (186.3)	388.5 (241.3)
Observations	20	20	20	20	20	20
R-squared	0.564	0.678	0.575	0.574	0.674	0.598
Sargan Statistic	1.16 (p = 0.28)	2.29 (p = 0.13)	0.49 (p = 0.48)	---	---	---
Hansen J Statistic	---	---	---	1.33 (p = 0.25)	2.17 (p = 0.14)	0.63 (p = 0.43)

Robust standard errors in parentheses
*** p<0.01, ** p<0.05, * p<0.1

4. CONCLUSION

This study offers an analysis of the informal sector by adopting a political and economic framework. The analysis is new since there is very few literature and empirical investigation on the link between corruption and the informal sector in India (Senior, I. (2006), *Corruption - The World's Big C.*, Institute of Economic Affairs, India). More precisely, the results show that a higher level of corruption leads to a larger informal sector and account for a high level of employment. Interestingly, as state-level productivity rises, the positive impact of corruption on the size of the informal sector reverses itself. In fact, for higher levels of state domestic product prevalence of high corruption shrinks the informal sector under all specifications considered (Lorena Alcazar, Raul Andrade (2001). *Diagnosis corruption*. pp. 135–136. ISBN 978-1-931003-11-7). The study is also an attempt to generalize isolated cases on such linkages. It also verifies and explains previously inexistent explanations on state characteristics (such as implementation of labor laws and industrial laws) and the existence of the informal sector in India (Legvold, Robert (2009). "Corruption, the Criminalized State, and Post-Soviet Transitions"). In this case, corruption undoubtedly raises the size of the informal sector when we have states with an SDP under the critical level. To determine a critical level of SDP below which, corruption and informal activity reinforce each other is an important step towards policy targeting (United Nations Handbook on Practical Anti-Corruption Measures for Prosecutors and Investigators". United Nations Office on Drugs and Crime (UNODC). Retrieved 3 November 2012). To show that high SDP shrinks informal activities, the message is clear. However, in recent times, states such as West Bengal for instance, reported that 42% of its SDP is generated in the unorganized sector (Human Development Report, 2004).

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