

## ADDRESSING THE CHALLENGE OF PAKISTAN'S INFORMAL ECONOMY

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### Introduction: The Scale of the Informal Economy

Pakistan's Informal Economy is vast, dynamic, and deeply embedded in the fabric of the nation's socioeconomic life. According to the study, titled "Mapping of Barriers and Opportunities to Reduce the Informality of Enterprises in Pakistan," collaboratively undertaken by the Small and Medium Enterprises Development Authority (SMEDA) and the International Labour Organization (ILO), informal economy constitutes nearly 40% of the country's GDP, representing a staggering \$457 billion.<sup>1</sup> Despite this significant contribution, the informal economy remains largely undocumented, unregulated, and outside the tax net. It supports millions of livelihoods but also poses a severe threat to fiscal stability, governance, and long-term economic development.

The roots of Pakistan's informal economy can be traced back to its early post-independence period, when weak industrialisation and limited access to formal financial services made informal activity a necessity. Political instability, lack of enforcement, and institutional fragility provided fertile ground for its growth. The Afghan war of the 1980s further entrenched informal practices by facilitating

<sup>1</sup> "Mapping of barriers and opportunities to reduce the informality of enterprises in Pakistan," ILO & SMEDA, May 16, 2024, [https://www.ilo.org/sites/default/files/2024-05/ILO\\_Pakistan\\_SMEDA%20mapping%20informality%20enterprises\\_WEB\\_FINAL\\_v2\\_0.pdf](https://www.ilo.org/sites/default/files/2024-05/ILO_Pakistan_SMEDA%20mapping%20informality%20enterprises_WEB_FINAL_v2_0.pdf)

unregulated financial flows through systems like hawala. The economic sanctions and mismanagement of the 1990s pushed even more activity underground.<sup>2</sup>

The informal economy encompasses a wide array of activities—including from street vending, domestic work, and small-scale retail to segments of real estate, manufacturing, and industrial production. While it often serves as a buffer against unemployment and poverty, its expansion has created a parallel economic system that operates beyond the reach of institutional oversight, undermining state legitimacy and weakening formal economic structures.<sup>3</sup> According to Pakistan Labour Force Survey 2020-21, 68% of the workforce (89.42% male and 10.58% female) remains engaged in informal employment. Agriculture, which employs over 40% of the population, remains chronically under-taxed despite its central role in consumption and income generation.<sup>4</sup>

### **Sectoral Composition and Economic Distortions**

The informal economy in Pakistan is not homogenous—it cuts across multiple sectors, each contributing uniquely to the shadow economy's persistence.

#### **1. Real Estate and Construction**

One of the most significant contributors is the real estate sector. In urban centres, up to 70% of property transactions are conducted using undeclared or black money.<sup>5</sup> These transactions often involve underreported valuations, forged documentation, anonymous accounts, and untraceable cash flows. Construction activities, labour hiring, and rental earnings frequently escape regulatory scrutiny, weakening the ability of authorities to enforce taxation and track capital movements.

#### **2. Retail and Small Enterprises**

According to a recent study by the Sustainable Development Policy Institute (SDPI), thousands of small retailers and microenterprises function without registration, licenses, or even basic accounting, costing the government more than Rs1.5 trillion each year in lost revenue.<sup>6</sup> These businesses often cite bureaucratic hurdles, high compliance costs, and harassment from officials as

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<sup>2</sup> Jawad Saleem, "Shadow Economy," Daily Times, December 7, 2024, <https://dailytimes.com.pk/1245847/shadow-economy/>

<sup>3</sup> "Informal economy," Dawn, October 23, 2024, <https://www.dawn.com/news/1867035>

<sup>4</sup> "Pakistan Labour Force Survey 2020-21," Pakistan Bureau of Statistics, Accessed on May 21, 2025, [https://www.pbs.gov.pk/sites/default/files/labour\\_force/publications/lfs2020\\_21/LFS\\_2020-21\\_Report.pdf](https://www.pbs.gov.pk/sites/default/files/labour_force/publications/lfs2020_21/LFS_2020-21_Report.pdf)

<sup>5</sup> Ahmad Fraz, "Real Estate Myths in Pakistan and the Truth Behind Them," PIDE, Accessed on May 21, 2025, <https://file.pide.org.pk/uploads/discourse-vol3i3.pdf>

<sup>6</sup> "Informal economy to cross \$500b," SDPI, April 20, 2025, [https://sdpi.org/9206/blogs\\_detail](https://sdpi.org/9206/blogs_detail)

disincentives for formalization. Consequently, a substantial portion of retail trade remains beyond the tax net.

### 3. Manufacturing and Industry

Informality is prevalent in the manufacturing sector, particularly among small-scale units in textiles, leather, and steel. These operations routinely underreport output, pay wages in cash, and circumvent labour and environmental regulations. Entrepreneurs argue that the regulatory burden makes full compliance financially unviable.<sup>7</sup>

### 4. Financial Sector Distortions

Pakistan's financial system reflects similar imbalances. With 88% of total deposits invested in public debt and only 12% extended as private credit,<sup>8</sup> access to capital for small businesses is severely constrained. Furthermore, the lack of credit history for informal enterprises exacerbates their exclusion from formal banking channels.

### 5. Tax System Inefficiencies

Pakistan's tax regime, heavily reliant on indirect taxation, inadvertently encourages informality. In the tobacco sector, for instance, over 40 manufacturers exist, yet only two multinationals are fully compliant accounting for 98% of tax revenue. The remaining entities exploit loopholes to avoid taxes.<sup>9</sup> Despite contributing nearly 20% to GDP, the retail and wholesale sectors contribute just 4% to the national tax base.<sup>10</sup> In contrast, salaried individuals bore Rs243 billion in taxes in the first half of FY2024–25 alone, with the annual burden projected at Rs570 billion—highlighting inequities in the tax structure.<sup>11</sup>

### Digital Finance: A Pathway to Formalization

Digital financial services are increasingly seen as transformative tools for formalizing economic activity. Platforms like Raast, Easypaisa, and JazzCash have significantly enhanced financial inclusion. In 2024, digital transactions surged by 35%, with volumes rising from 4.7 billion to 6.4 billion and the

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<sup>7</sup> Shahram Haq, "Informal economy to cross \$500b," Tribune, April 20, 2025, <https://tribune.com.pk/story/2541032/informal-economy-to-cross-500b>

<sup>8</sup> "Pakistan Economic Survey 23-24," Accessed on May 21, 2025, [https://finance.gov.pk/survey\\_2024.html](https://finance.gov.pk/survey_2024.html)

<sup>9</sup> "Govt urged to review tobacco taxes," Tribune, May14, 2025, <https://tribune.com.pk/story/2545740/govt-urged-to-review-tobacco-taxes>

<sup>10</sup> "Govt struggles to expand tax base as illicit trade surges," Tribune, September 10, 2024, <https://tribune.com.pk/story/2494859/govt-struggles-to-expand-tax-base-as-illicit-trade-surges>

<sup>11</sup> Irshad Ansari, "Salaried class likely to pay Rs570b in taxes," Tribune, February 9, 2025, <https://tribune.com.pk/story/2527363/salaried-class-likely-to-pay-rs570b-in-taxes>

value increasing from PKR 403 trillion to PKR 547 trillion. By mid-2025, 88% of retail transactions were conducted digitally.<sup>12</sup> Raast, Pakistan's instant payment system, now has over 20 million users.<sup>13</sup> These platforms reduce reliance on cash, improve transparency, and open access to credit, government assistance, and tax documentation for informal businesses.

Prime Minister Shehbaz Sharif has called for the full digitization of the economy. Building on earlier successes in digital wallet distribution for social relief, a working group has been created to drive the transition towards a cashless, transparent economy.<sup>14</sup> However, gaps remain. Digital adoption is uneven, particularly in rural and low-income areas. Broader access to smartphones, improved financial literacy, and stronger digital infrastructure are essential to ensuring inclusive growth.

### **Policy Recommendations: Towards an Inclusive Formal Economy**

Addressing the informal economy requires a multi-pronged, long-term strategy rooted in institutional reform, digital transformation, and public trust.

#### **1. Formalising Informal Enterprises**

To bring informal enterprises into the formal fold, the government should simplify business registration and licensing procedures by introducing one-stop digital portals and mobile-friendly platforms for micro and small enterprises. Tax holidays and targeted financial incentives—such as subsidised utilities or preferential procurement access—can encourage registration and reduce initial compliance burdens. Amnesty programs that allow businesses to declare previously undeclared assets should be rolled out with legal guarantees and time-bound protections, ensuring trust and broad participation without fear of reprisal.

#### **2. Digital Financial Integration**

Expanding mobile banking infrastructure, especially in rural and under-served regions, is essential to bridge the financial access gap; this can be achieved through public-private partnerships that deploy mobile banking units and improve telecom connectivity. Pakistan can replicate India's UPI (Unified Payments Interface) model by enabling interoperable, real-time payments across banks and Fintech's, using Raast as the foundational infrastructure. Additionally, integrating informal savings

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<sup>12</sup> Mahnoor Raza, "Pakistan's Fintech Revolution: Driving Financial Inclusion and Economic Growth," Friday Times, May 3, 2025, <https://thefridaytimes.com/03-May-2025/pakistan-s-fintech-revolution-driving-financial-inclusion-and-economic-growth>

<sup>13</sup> ibid

<sup>14</sup> "PM orders full digitisation of economy to eliminate informal sector," Profit, April 17, 2025, <https://profit.pakistantoday.com.pk/2025/04/17/pm-orders-full-digitisation-of-economy-to-eliminate-informal-sector/>

and transactions into the formal economy can be facilitated by promoting low-fee digital wallets and incentivising their use through cashback offers and government disbursements.

### **3. Financial Literacy and Incentivised Compliance**

A large-scale, government-backed financial literacy campaign targeting women, youth, and informal workers should be launched through TV, radio, schools, and community networks, with support from NGOs and microfinance institutions. To incentivise participation in formal markets, brokerage fees and transaction costs should be reduced through regulatory adjustments and partnerships with digital platforms. Community banking models, including microcredit schemes backed by guarantees or subsidies, can support informal earners in accessing capital and transitioning into the formal financial system.

### **4. Tax Policy Reform**

Tax reform must move toward a fairer, simplified regime by eliminating excessive indirect taxation and broadening the base through inclusive, transparent policies. A flat tax scheme for SMEs with minimal paperwork and low compliance costs can be implemented using digital filing systems and AI-assisted tax advisory services. A tax reward system—featuring benefits such as rebates, fast-track services, or public recognition—should be introduced to encourage voluntary compliance, while clear and consistent penalties can deter chronic evasion and reinforce a culture of accountability.

### **Conclusion: From Liability to Lever of Growth**

Pakistan's informal economy, while providing resilience in times of crisis, remains a double-edged sword. It sustains livelihoods but at the cost of fiscal integrity, equity, and development. The persistence of informal activity reflects deeper problems—economic exclusion, institutional weakness, and social mistrust.

A digital, inclusive, and transparent economy—underpinned by institutional accountability and equitable taxation—can transform informal activity into a foundation for inclusive growth. The formalisation of the economy must be treated as a national priority, not a bureaucratic exercise.

With a young, tech-savvy population and increasing digital adoption, Pakistan stands at a pivotal moment. The tools to integrate informal enterprises and workers into the formal economy exist. What remains is the political will, policy consistency, and institutional courage to build an economy that works for all.