Informality in the Malaysian economy

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Introduction

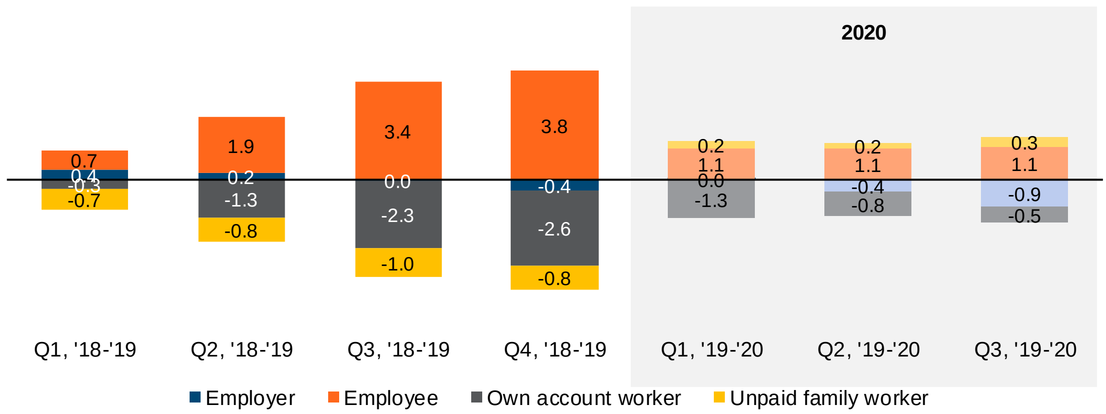
Despite Malaysia's economic progress, the informal economy continues to persist. The size of the informal sector (employment with unregistered firms) has marginally increased, from about 9.2% of total non-agriculture employment (1.0 million) in 2011 to 9.3% (1.3 million) in 2019[1]. The size of informal employment (employment without social protection, regardless of enterprise status) was estimated to be more than two times larger, around 16.8% of total employment (2.5 million) in 2019[2]. In another estimate using administrative data, the shares of workers without social security and retirement arrangements were larger, between 34% and 39% in 2019[3].

[1] DOSM (2020b)
[2] Ibid.
[3] Hawati and Nur Thuraya (2020)

The informal economy consists of both the informal sector and informal workers[4]. It is an essential element of understanding economic progress and informality is said to be a fundamental characteristic of underdevelopment[5]. Work in the informal economy is tracked in the Sustainable Development Goals (SGDs) as it is more likely to face decent work deficits such as unsafe working conditions, long working hours, irregular income, and limited access to training, among others[6]. High concentration of informal firms could also indicate loss of tax revenue, either due to firms being too unproductive that they do not reach taxable income status, or they purposely evade paying taxes by staying informal.

The COVID-19 pandemic will likely create more informality. The economic disruption caused by the pandemic reduced economic activities significantly and made many unemployed. While some could return to formal employment as the economy recovers, the pace might not be fast enough. People might resort to informality to sustain livelihoods because the barrier to enter the market is much lower i.e., people do not need to go through complex processes to register their businesses. Some policies, such as the creation of 'free trade zones' for small-scale enterprises[7] to set up shop can further encourage this. The cost of hiring is also cheaper as enterprises do not make employment-related social protection contributions, or even resort to using unpaid labour. As seen in Figure 1, there has been some expansion of unpaid family worker (yellow bar); the share of unpaid family worker consistently declined for each quarter between 2018 and 2019, but between 2019 and 2020 (during COVID-19), the share of unpaid family worker increased, although just slightly.

Figure 1: Quarterly percentage point difference of employment share, by employment status, 2018–2020



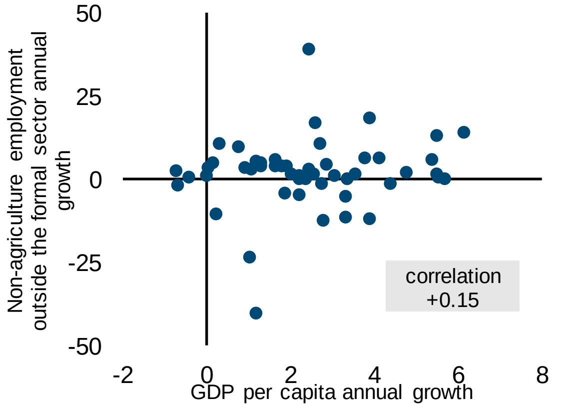
Source: DOS, author's calculations.

[4] Nur Thuraya and Tan (2019)
[5] Loayza and Rigolini (2006)
[6] ILO (n.d.-a)
[7] Astro Awani (2020)

Informality in the economy

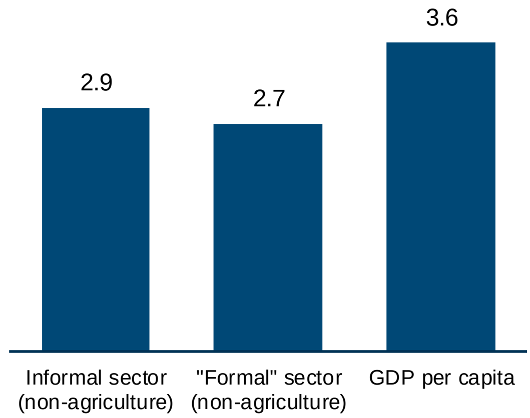
Informality could conveniently be associated with low-productivity activity and lower economic growth. Evidence is often mixed[8], although richer countries tend to exhibit lower levels of informality[9]. Figure 2 shows that even with positive economic growth, some countries still experience growth in informality, and often at much larger growth rates. This is not the case for Malaysia, however. Between 2011 and 2019, GDP per capita expanded by 3.6% per year, and informal sector employment expanded by a lower rate of 2.9% per year. Worryingly, however, is the *faster* informal sector employment growth rate compared to non-informal sector (loosely indicate "formal" sector) employment of 2.7% per year (Figure 3). Simply put, employment did not grow as fast as national income, and even with slower growth, the expansion of formal jobs tends to be limited.

Figure 2: Annual growth of non-agriculture employment outside formal sector and GDP per capita, selected countries (%)



Source: ILO (n.d.-b), World Bank (n.d.) and author's calculations

Figure 3: Annual growth of non-agriculture employment in informal and "formal" sectors, and GDP per capita, 2011–2019, Malaysia (%)



Source: DOSM (2020b) and author's calculations

National income, or gross domestic product (GDP), covers not only income from employment activities or labour inputs. It also includes the utilisation of capital inputs and technology. However, national income measurements disregard informal work, and identifying the contribution of an economy that is largely outside the purview of many regulations is important. It could represent loss of government revenue because some enterprises are not taxed, and signal potential employment precarity since the lack of government oversight might enable abuses of workers' rights by some employers.

How big is the informal sector in national production? Statisticians can use estimates of gross value added (GVA) from the cross-classification by industries and institutional sectors in the System of National Accounts (SNA). The informal sector is within the household institutional subsector, but not all countries report GVA by industries and detailed institutional sectors, especially for the household institutional subsector. Additionally, statisticians can rely on indirect

[8] Charmes (2012)
[9] Loayza (2018)

methods to estimate the informal sector GDP contribution. Considering most informal enterprises do not keep consistent and reliable record of their economic activities, directly measuring the GVA of household institutional subsectors might be unreliable. In this indirect method, known as the 'labour input method', statisticians will have to firstly estimate the size of the informal sector employment, then estimate the output and value added per unit worker of different economic activities, and finally multiply the informal sector employment numbers with the output and value added per unit numbers for the different economic activities. This method relies of the use of establishment and labour force (informal sector) surveys, developing a 'labour input matrix' where the productivity estimates of formal/informal workers in formal/informal sector is developed[10]. However, the production of informal workers in formal subsectors is excluded, under-estimating the true contribution of the informal economy (not just informal sector) in national production[11].

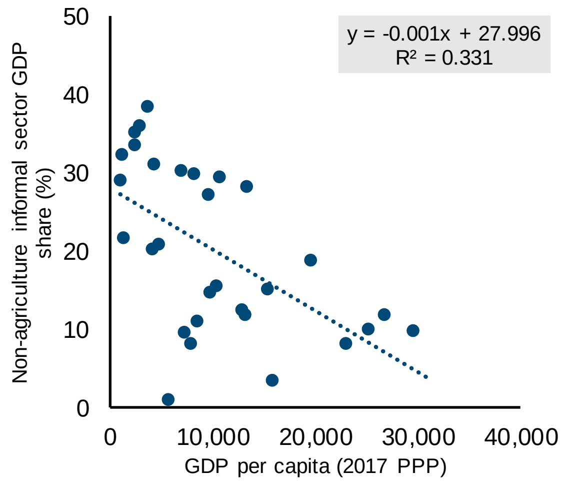
Malaysia has yet to have an official estimate of the informal sector contribution to GDP, although the Department of Statistics has measured the size of the informal sector workforce in its Informal Sector Workforce survey reports, and mentioned that this will be used to measure the contribution of the informal sector to GDP[12], likely using the 'labour input method'[13].

Charmes (2012) estimated the contribution of the informal sector GVA directly for some developing countries. Based on the unconditional association between estimates for non-agriculture informal sector GDP for these countries and their GDP per capita level (Figure 4), the size of Malaysia's informal sector GDP share is expected to be about 5.8% in 2019. This is much lower than estimates in Charmes (2012) (the informal economy was between 25% and 46% of non-agriculture GDP) likely because countries covered in the study were mostly lower-income developing countries.

Loosely following the logic of the indirect method, Table 1 shows the estimated production contribution of the informal sector by different economic activities, by assuming constant labour productivity among workers regardless of their formal/informal sector status. In this method, the contribution of the non-agriculture informal sector is around 7.8% of GDP in 2019. Construction, which has about 19% informal sector workers within the industry, has the highest informal sector production contribution of 15% of the industry's GDP.

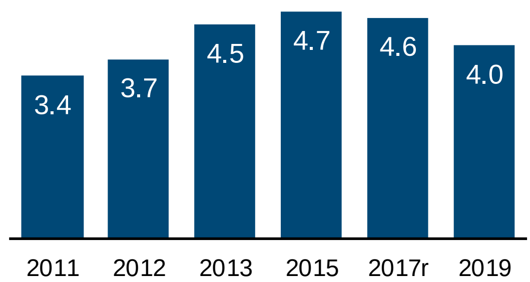
[10] ILO (2013)
[11] Charmes (2012)
[12] DOSM (2020b)
[13] Razaman and Salmiah (2009)

Figure 4: Non-agriculture informal sector GDP share and GDP per capita, selected countries



Source: ILO (n.d.-b), World Bank (n.d.) and author's calculations

Figure 5: Estimated income share of informal sector per GDP, 2011 – 2019, Malaysia



Source: DOSM (2020a) and author's calculations

Table 1: Estimated non-agriculture informal sector GDP share by economic activities, 2019

Economic activity	Informal sector workforce	Informal sector per total non-agriculture employment	Value added per employment[p]	Labour input estimate[e]	GDP[p]	Share per GDP[e]
Manufacturing	200,400	7.5%	RM123,896	RM24,829m	RM323,934m	**7.7%**
Construction	237,700	18.6	45,293	10,766	70,868	**15.2**
Services	812,200	8.8	89,513	72,702	859,853	**8.5**
Others	5,900	1.7	93,973*	554		
Total	**1,256,200**	**9.3**	**93,973**	**118,049**	**1,510,693**	**7.8**

Source: Author's estimate based on DOSM (2020b), DOSM (2020c) and DOSM (2020d).
Notes: Exclude agriculture because informal sector workforce survey excluded agriculture sector. *Due to data limitation, Others uses **total** value added per employment. [p] refers to predicted values, [e] refers to author's estimate.

GDP can be measured through several ways, using the production approach (sum of value added of economic activities), the expenditure approach (sum of consumption, investment, and trade surplus) and the income approach (sum of compensation, surplus and net government income)[14]. Previous estimates in the earlier section of this article was based on the *production* appoach of measuring national income. Another way to look at the GDP contribution of the informal sector is based on the *income* approach. Based on the published GDP by Income Approach statistics[15] and assuming that everyone in the informal sector earns the same as the average employee in the economy, the informal sector is about 4.0% of national income in 2019 (Figure 4). However, this could be an overestimation if the compensation of workers in the informal sector is lower than the average employee in the economy. For this reason, more accurate income and compensation

[14] DOSM (n.d.)
[15] DOSM (2020a)

information of the informal sector workforce is necessary to reflect their contribution to national income.

Some have even attempted to measure the "shadow economy", defined as *all* economic activities hidden from official authorities, which includes the informal economy because enterprises and workers are unregistered. Medina and Schneider (2018) estimated the "shadow economy" to be about 26.1% of Malaysia's total GDP in 2015[16]. If we linearly extend this relationship with the current level of Malaysia's GDP per capita, the estimated size of the shadow economy would be about 23.0% of GDP of 2019. However, the high estimate is because the informal sector is a subset of the estimated "shadow economy"; and many have cautioned that the informal economy should be separated from the underground or hidden economy[17].

Concluding remarks

Given Malaysia's status as a middle-income developing economy expected to reach high-income status[18], the size of the country's informal employment and production is relatively small, expected to be less than 10% of GDP. However, COVID-19 might increase the extent of informality as it is an avenue to sustain livelihoods during the economic recession period caused by the pandemic. But expansion of informality must not be a long-term incidence. For informal workers, remaining outside of the social protection schemes could make them more vulnerable in the future because they will not have access to insurance coverage unemployment or any employment-related injuries. For informal firms, invisibility from the authorities mean that enterprises cannot access government assistance or grants when they need it most; and profitable firms that are not contributing via paying taxes could further threaten the country's long-term ability to provide social protection.

As such, formalisation of the economy as we recover along the way is key—and it needs to be done in a meaningful sense. For example, the bundling of assistance for informal workers with registration to social protection institutions is one way to reduce informal employment. We could also consider channelling regular assistance for some informal workers (e.g. assistance during rainy season for fishermen and rubber tappers who cannot go to work because of weather conditions) through existing social protection institutions rather than a separate government agency, to further streamline the management of social protection in the country. However, we need to further incentivize regular contributions too, because simply having them "in the system" is not enough to ensure they are protected throughout their working life. Registering informal firms as they receive government assistance is also another way to formalise the informal sector, but policymakers must leverage on this relationship to further help enterprises grow productively and provide decent employment. For instance, could firms also be introduced to other SME assistance and initiatives that can help them be more profitable? Are firms paying

[16] Authors focus only on legal and productive activities that would contribute to national GDP if they were recorded, excluding illegal or criminal activities and other household activities. Source: Medina and Schneider (2018)
[17] ILO (1993) quoted in Charmes (2012)
[18] Lim (2020)

decent wages, the required social protection contributions, and taxes; and if not, could we make them abide by these conditions when we disburse these assistances? Ultimately, the formalisation of employment and enterprises should aim to create a sustainable social protection ecosystem where risks and rewards are justly shared between workers, firms and the government in the economy.

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