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Facilitating Market-Based Financing for the Informal Economy

Introduction

The recent COVID-19 pandemic has caused a multidimensional global crisis. It has adversely affected economic growth and caused a sudden halt of business operations due to closure of external borders by many countries. However, the most visible effect of the pandemic outbreak has been to the self-employed, casual and gig-workers, and small-scale entrepreneurs and businesses, which can be commonly described as those people and enterprises in the informal economy. In the developing world, the informal sector is a pervasive phenomenon, with more than 2 billion people, representing 60% of workers and 80% of enterprises.[1]

The term informal economy has no generally accepted definition. While the official definition of the International Labour Organization (ILO) states that the informal economy is "all economic activities by workers and economic units that are — in law or in practice — not covered or insufficiently covered by formal arrangements", globally, many terms have been used to illustrate the informal economy, such as "underground", "shadow", or "parallel" economy. Yet, whatever images come to mind, the informal economy typically encompasses a broad range of unregulated and unreported income from the production of legal goods and services, either from monetary or barter transactions.

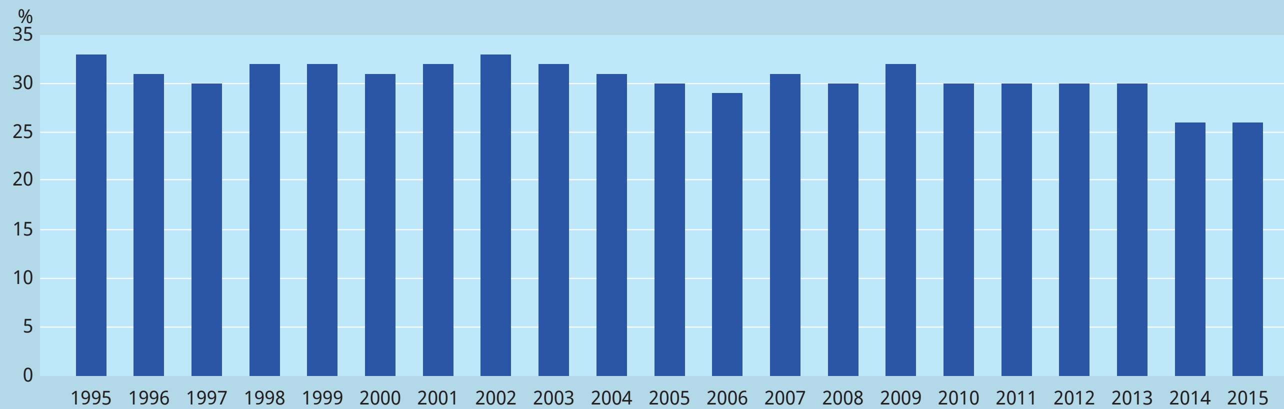
For instance, an airline crew member with a second job retailing craftwork on the web, a social media influencer (also known as a Key Opinion Leader [KOL]) undertaking a livestream marketing job for a renowned brand, or an individual engaging in livestream e-commerce who does not declare his earnings to the national inland revenue board are all examples of the informal economy. These activities add up to billions of dollars that take place off the books and out of the gaze of tax collectors and government statisticians.

Informal economic activities have long been a fact of life—and are ever increasing around the world. According to Friedrich and Christopher (2003),[2] the Asia Pacific region's informal economies have grown considerably since 1989-90, and may potentially threaten the veracity of the fundamental information system that monitors economic activity and forms the basis of both business and governmental policymaking. While there is no single accurate methodology for estimating the size of the informal economy, since much of the action takes place out of sight, the presence of a vast informal economy may distort measures of growth, unemployment, inflation, savings, and productivity, as well as accurate measures of income inequality.

For Malaysia, discussions around the informal economy are crucial. The existence of a massive informal economy is both a driver of its economic growth as well as a hindrance. According to an International Monetary Fund (IMF) study,[3] while the informal economy in Malaysia has been trending lower from an estimated 33% of gross domestic product (GDP) in 1995 to 26% in 2015, the average share for the period 1995-2015 was 31.5% (Figure 1). The working paper published in January 2018, analysed the results of the informal economy for 158 countries for the period 1991-2015 and found that Malaysia's informal economy is particularly significant compared to other Southeast Asian countries such as Singapore (11.9%), Vietnam (18.7%), and Indonesia (24.1%), and even more acute compared to members of the Organisation for Economic Cooperation and Development (OECD) — where it averages around 13-15% of GDP. According to the latest estimates by the Malaysian government, the country's informal economy accounts for 21% of GDP, or around an estimated RM300 billion,[4] and makes up 8.3% (or over 1.2 million workers) of the labour market.[5]

While this large informal sector has undeniably created jobs, it also came at a cost for both the government as well as the business sector in general. First, it deters the development of inclusive economic development as it deprives potential tax revenues to finance socio-econom-

Figure 1: Malaysia Shadow Economy as a Percentage of GDP



Source: IMF Working Papers, Shadow Economies Around the World: What Did We Learn Over the Last 20 Years?

ic development projects for the public. Second, it is exceedingly challenging for the informal businesses to access any incentives provided by the government as well as formal financing facilities as they continue to operate under the business registry radar and outside government purview.

The current pandemic outbreak has clearly demonstrated the severity of this conundrum. For the government, the fiscal response and debt incurred on COVID-19 relief has added to the considerable red ink already on its ledger following the pandemic-driven global restraint order and border closures. However, with an estimated shadow economy of RM300 billion, for example, a 1% increase in tax collection can translate into RM3 billion in additional revenue for the government to support its development expenditure and obligated operating expenses. For the informal businesses, its implications are straight-forward. Absence from formal business registry and poor transparency will significantly impair the sector's capacity to enter into legally binding contractual obligations and access to capital markets, if needed, for further growth. And that is not all. Rapid globalisation, fast evolving business ecosystems shaped by the acceleration in technology development and adoption, as well as the rise of the gig or sharing economy have further complicated matters for the policymakers to track, measure and provide necessary support for the informal economy. Policymakers' ability to improve engagement with the informal sector is therefore integral to enhancing overall financial inclusion which supports the 2030 Sustainable Development Goals (SDGs) in terms of sustainable development, poverty reduction, decent work and more inclusive societies.

It should be emphasized that what is relevant to policymakers is not just the size of this sector, but also to come up with models that allow the informal economy to coexist alongside the formal economy. Whether it is a street trader, a social marketeer, or a white-collar professional taking on side-line entrepreneurial jobs, these people really do contribute to the economy and to their country. The question is how do we make space for them? And how do we help the informal sector to become more productive, more efficient, and more effective?

A New Deal for Financing the Informal Economy

The economic consequences of the recent spread of coronavirus are severe and are still unfolding. Nonetheless the crisis has brought the future forward by driving increased demand for digital transformation in both the business and financial services sectors. It has led to many crucial innovations in the way businesses and financial services operate and has undeniably accelerated the digital transformation agenda on all accounts. It has spawned new consumer behaviours that in turn spur new ways of working.

Take the recent example of a KOL for instance. A regular girl in Taiwan named Hung Chien-shu, better known by her YouTube handle Chien's Eating, rapidly became a popular influencer and entrepreneur. Chein's Eating does not dance or sing. She has made her name — and a fortune — posting videos of herself tasting and promoting different types of food around her neighbourhood. Through her postings, she has managed to garner hundreds of thousands of followers. Difficult as it may be to believe that online viewers throng to watch strangers eating, Chien's Eating has surged in popularity and her videos have attracted over 700,000 views — roughly the same number as her 800,000 subscribers at the time.[6] Amongst her videos, there is one in which Chien laughs and goofs around while eating a dozen packs of ginger paste black sesame oil noodles — a noodle that she manufactured herself. The noodles were later marketed to the public as Sui Ooh Noodles. In the months after the video was released, Sui Ooh Noodles were mass produced and quickly offered on many retailers' shelves across Taiwan, Korea[7] and Singapore.[8]

Behind Chien's success is not just her creativity and a conducive business environment accelerated by technology advancement, but also the presence of PressPlay — one of Taiwan's big YouTube management companies. The name PressPlay probably means little to some people, but to the online community, it represents content creation and sharing. The platform focuses on helping influential YouTubers forge their own brands by helping them to create original and valuable content, employing the foremost creative minds in development, production, post-production, and quality improvement. PressPlay handles not just content management and operations, but also attempts to unearth and develop any potential young stars (YouTubers).

Chien's example illustrates that the social variant of a KOL is open to everyday people who gain significant social influence. Many others hope to one day make a living through online activities based on their "social capital" as well. Such activity has become part of the informal economy and is likely to stay in the years ahead.

To move forward in an increasingly challenging environment brought about by the recent pandemic outbreak, businesses and markets within the informal economy must reinvent themselves. The sector needs to create structures in which participants can pool their resources and extend their reach and power. Finance needs to be redefined as well to create solutions that enable better outcomes for the informal economy. Policymakers can consider the following initiatives and strategies to support as well as broaden the financing options for the informal economy.

Formalising the informal — co-operatives to promote inclusive development

The traditional cooperative business has long been in existence as a form of organisation in which members voluntarily come together to satisfy their common needs with due regard to individual capacity, autonomy, and equality. Now, with advancements in technological platforms it is even more possible for this business model to provide a simple yet effective solution to formalise the informal economy and for cooperatives to operate in new ways with greater opportunities to scale. As more and more people manage their work and resources through digital platforms, cooperatives can offer far more benefits than any individual business unit could ever achieve on its own. A report by Nesta and Co-operatives UK[9] highlights a typology of the different platform co-op types which are emerging in the UK as well as the way forward in terms of a new funding model for platform co-operatives.

In all cases, the goal of cooperatives has been to enable members of an under-served community to improve their economic condition by working together in ways that are more productive. These are businesses where ownership rests with their cooperative members, and not with distant investors as in the case of corporations. Thus, the overriding aim of cooperatives goes beyond maximising financial returns. It prioritises other aims such as member involvement in decision-making, long-term planning, and more equitable pay.

Globally, cooperatives are effectively being adapted to lift people out of poverty and carry out the transition of smaller businesses to the formal economy. Whether they are providing financing for informal sellers and traders on the street in Nairobi to upgrade their activities,[10] improving income of homeless shoe-shiners in Uganda,[11] or empowering artisan women to become self-reliant in Canada,[12] cooperatives have proven to provide people effectively and efficiently with a voice, representation and empowerment, while also generating an array of instruments for entrepreneurial development.

According to the 2019 World Cooperative Monitor, the top 300 global cooperatives collectively reported a total turnover of over USD2 trillion.[13] As such, cooperatives should be seen not only as a constellation of small enterprises that provide limited jobs, but also as a considerable potential force for local and regional development. For instance, Japan's Consumer Cooperative Union — comprising over 320 consumer cooperatives with 29 million members — not only manages its members' product development and supply, it also carries out various activities and educational programs for members such as planning and promoting campaigns jointly held by member co-ops nationwide as well as publishing educational materials.

In today's economic uncertainty, where individuals or small businesses may feel powerless to change their livelihood, cooperatives represent a strong, vibrant, and viable economic alternative. Similarly, the cooperative movement model is not something new to Malaysia. It has been able to elevate its position as a powerful economic model as some examples in the agricultural, brewery purchases and financial services industries show. Today, Bank Kerjasama Rakyat Malaysia has become one of the top 300 cooperatives in the world and the biggest Islamic cooperative bank in Malaysia with turnover in 2017 totalling USD1.63 billion. This illustrates how cooperative models can be utilised to raise the social and economic status of rural communities, as well as promote equitable distribution of wealth and opportunities — a jurisprudence that is aligned with the country's Islamic finance principles.

The proposed recommendation concerning the transition from the informal to the formal economy can be an important opportunity to recognise and promote the contribution of cooperatives in this respect. Appropriate regulation of cooperatives makes it possible to organise their constituents, i.e., the informal economy, and subsequently have them, both individuals and entrepreneurs, take decisive steps towards onboarding the formal economy. Policymakers could encourage the formation of cooperatives by providing incentives for members to move downstream in the value chain to gain access to new markets and consumer information. Policymakers could then impose more meaningful tax obligations on cooperatives instead of taxing individuals and entrepreneurs within the informal economy.

Dig deep into the data

Imagine a scenario where a self-employed YouTuber like Chien was in a fix and had applied for a loan but her application was rejected as her credit score did not generate enough data to establish her creditworthiness. Like Chien, many hopeful loan applicants are facing difficulties due to lack of credit history. And this happens to be a vicious cycle. In the case of a low or non-existent credit score, they are unable to get loans, and hence cannot further improve their credit profiles. The World Bank Global Findex Database reports that almost two billion adults do not have a bank account, let alone a FICO or other scoring methodology assessing their creditworthiness.[14] In the absence or scarcity of data, is it possible to accurately determine someone's creditworthiness and if not, what are the options available to overcome this challenge?

One can look at alternative credit scoring to improve his or her chances of successful loan application and subsequent disbursement. Underwriting of the risk in borrowing has traditionally focused on the applicant's capacity to repay. Even with absent or low credit scores, the alternative credit score can be utilised to bolster chances of procuring loans from banks and financial institutions. The model shifts towards a "propensity-to-pay" approach that incorporates broader non-financial characteristics and behaviour of an applicant, rather than the typical parameters such as collateral, repayment history etc., employed in the traditional credit rating framework. Alternative credit scoring utilises a broader set of data on the loan applicant such as utilities payment history, banking activities, e-commerce shopping experience, financial literacy, and spending patterns to indicate a person's understanding of debt and responsible borrowing. It involves substantial application of technology and digital footprints like social media and mobile and internet usage to determine if the prospective applicant meets repayment requirements.

The benefits of alternative credit scoring are two-fold. By extending access to credit, applicants who are new to the credit and loan ecosystem can still avail themselves to loans irrespective of sufficiency of credit scoring data in traditional channels. Lenders too can employ alternative credit scoring to increase their penetration in previously uncharted territory like semi-urban areas or green field sectors while keeping fraud and default risk at bay with more meaningful data.

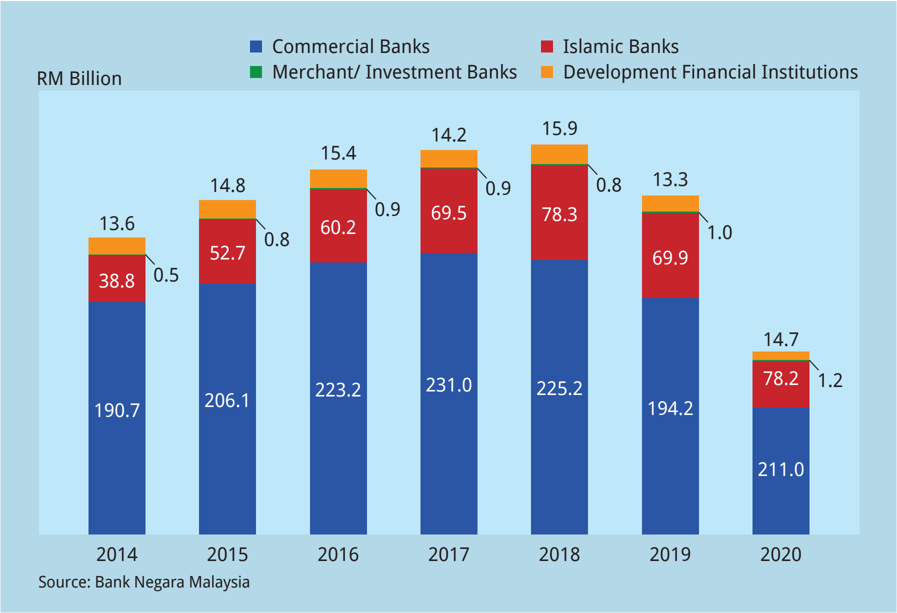
With the advent of big data and the ever evolving domain of information and communication technology (ICT), the way people view lending, credit, and financing has undergone a sea change over the last few years. Be it payday loans, invoice financing, or business-to-business (B2B) financing, the way businesses access credit today is far different from what it was almost a decade ago. Traditional scoring frameworks have not been able to keep up with this radical shift in the way of assessing the creditworthiness of a potential loan applicant. This lag may potentially widen the gap between demand and supply of financing for smaller businesses or micro, small and medium-sized enterprises (SMEs). Smaller businesses' loans outstanding at Malaysia-based financial institutions witnessed trivial increments over the last few years, from a total of RM243.6 billion in 2014 to RM305.1 billion in 2020 (Figure 2). Between 2014 and 2020, SME loans outstanding at commercial banks and development financial institutions recorded minor increases in annual growth of 1.7% and 1.3% respectively. Comparatively, SME loans outstanding for Islamic banks and merchant banks recorded higher annual growth rates of 12.4% and 15.7% respectively over the same period. Although financial institutions today are better capitalised and have sufficient liquidity to manage mortgage delinquencies compared to during the 1997 Asian Financial Crisis, many FIs have exercised prudent judgement in underwriting risks for smaller business loans, particularly in a low interest rate environment — when investment income is likely to be impacted.

Additionally, alternative fundraising avenues such as equity crowdfunding (ECF) and peer-to-peer (P2P) financing were introduced to help meet the needs of smaller businesses to finance working capital or fund business expansion. To date, there are a wide variety of small businesses issuers, ranging from manufacturing to retail trading, that have successfully raised financing through ECF and P2P financing platforms. Since the frameworks' debut in 2016, ECF and P2P fundraising activities have grown rapidly, from RM70 million in 2017[15] to RM1,334.9 million[16] collectively in 2020 (Figure 3). Over this period, the ECF and P2P markets marked cumulative annual growth rates of 82.4% and 212.5% respectively.

Despite the positive progress made to broaden financing avenues in Malaysia, these developments have only scratched the surface when it comes to addressing the SME funding gap, let alone the funding gaps in the informal economy. The regulatory requirements spelled out under the ECF and P2P frameworks only allow public incorporated companies to raise capital and exclude smaller proprietary businesses or individuals like Chien in the informal economy from participation. The reason is obvious and understandable — to ringfence assets and protect investors. However, more work needs to be done if the country intends to make the system more inclusive moving forward.

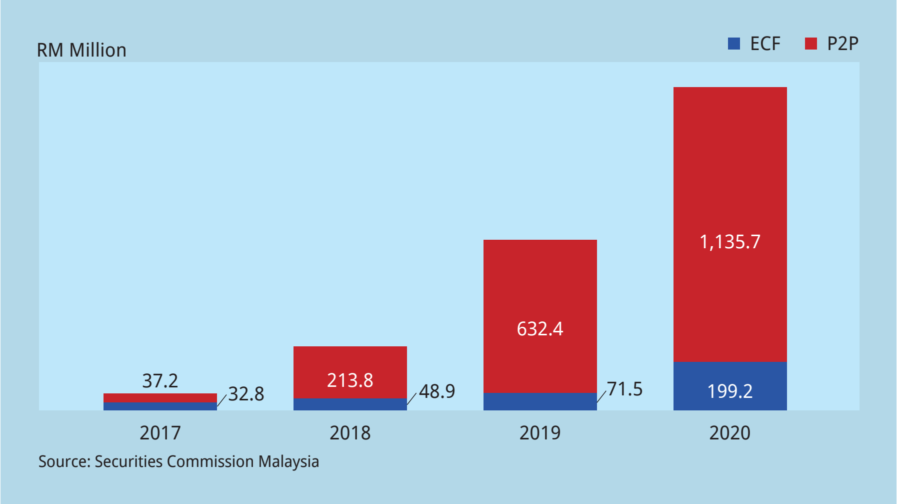
There is a whole host of data not being captured by traditional credit scoring methodology, which is inherently back-

Figure 2: 2014-2020 SME Loans/Financing Outstanding



Source: Bank Negara Malaysia

Figure 3: Total Amount Raised Successfully



Source: Securities Commission Malaysia

ward looking. It does not assess behaviour metrics or a person's future potential. The various interactions that a person like Chien has with her psychometrics and social capital, can help paint a picture of how likely she is to repay a loan. When you turn to big data for solutions to construct financial identities for individuals who have little or no traditional credit history, different answers can be derived. Capital providers could vacuum up every item of data they can legally use—blocked only by the limits of technology and, in some cases, by laws like the Personal Data Protection Act (PDPA) 2010 that govern sensitive information and disclosure of client data—to provide a better assessment of applicants in the informal economy. Instead of sniffing out only credit blacklists, alternative credit scoring offers a glimpse into positive financial behavior that was previously not captured by traditional credit scoring methodology.

Good data analysis and widening the information parameters that could help establish a financial identity for participants in the informal economy are critical steps towards financial inclusion. With the rise of big data and innovation in credit scoring methodologies, the "all data is credit data" approach could become a reality that is just around the corner. The enrichment of applicable credit data—by considering wider behavioral factors and digital footprints—would certainly increase the informal economy's visibility and access to capital market products.

Catalysing investments through a strategic fund

Since the commencement of the national emergency lockdown in March 2020, the Malaysian government has proactively introduced various measures under the PRIHATIN Economic Stimulus Packages and the National Economic Recovery Plan (PENJANA) to cushion the impact of COVID-19 on businesses and reinvigorate the country's economic growth. Focus has been given to encouraging domestic investments, support smaller businesses as well as enhancing the provision of credit through Bank Negara Malaysia's RM4 billion Targeted Relief and Recovery Facility, RM200 million Disaster Relief Fund, RM1 billion collateral-free High-Tech Facility,[17] etc. Additional measures include granting of stamp duty exemption on instruments relating to approved mergers and acquisitions[18] among SMEs to help strengthen the capacity of local companies and prevent the hollowing out of companies caused by the recent pandemic outbreak.

To assist with the smooth functioning of Malaysian capital markets such that they remain a viable fundraising avenue for businesses, the capital market regulator has provided temporary relief from its listing requirements, allowing for waivers on listing-related fees for initial public offerings (IPOs) and annual listing fees, liberalisation of the obligations set forth under listing rules for companies seeking regularisation plan, as well as lowering the requirements on public securities holding spread from 25% on a case-to-case basis to encourage fundraising and listing on Bursa Malaysia.

To encourage greater investment and diversification into the alternative investment industry such as ECF and P2P, the country's Budget 2021 has allocated RM80 million to match private sector investments in these two channels. In addition, investors under any registered ECF platform will be given a 50% tax break, with a cap of RM50,000, for their investments. The crisis financing provided under the country's pandemic stimulus packages no doubt provided some relief to small businesses. However, it has not reached deep enough to benefit every fabric of society, particularly the informal economy.

In searching for alternatives to mainstream finance, some attention is increasingly being paid to the private markets funds for meeting private sector credit demand. In the US for example, middle market deals have steadily accelerated in both number and value over the last decade, from 1,315 deals in 2010 to more than 3,100 deals in 2019, and from USD193 billion to USD531 billion in enterprise value in 2019.[19] And with global private equity dry powder amounting to USD1.9 trillion as at December 2020,[20] the private funds industry has not only proven its versatility in stepping up investment activities in diverse industry verticals, but also provided abundant liquidity directed to support small business activities affected by the recent COVID-19 pandemic outbreak.[21]

However, it requires distinctive instruments, project pipelines, and measurement ability to be able to channel private capital to more sustainable and equitable financing solutions. Public authorities could focus on catalysing and directing private investment opportunities towards the informal economy by creating a strategic investment fund. To encourage participation from a broader range of investors, the strategic fund could be structured with initial commitment by the government that co-invests alongside private investors. The fund could pool funding through issuance of community shares,[22] for example, to encourage like-minded investors or communities to "buy-in" to a certain project.

In addition, the fund could be structured in various phases and sectors to address the different needs and priorities of economic growth. Together with the enhancement in risk-reward due to the first-loss protection, this could encourage private investors—such as institutional funds, corporates, and family offices—to invest and finance business activities in the informal economy, where growth is constrained by a lack of access to follow-on financing.

Conclusion

The devastating effect of COVID-19 has not only affected how businesses—ranging from big conglomerates, through smaller establishments to the informal economy—pursue their fundraising and capital deployment activities, it has also highlighted the constraints on public spending in countering the consequences brought about by the pandemic outbreak. While some would argue that a growing informal economy represents a sign of instability and unpredictability, nevertheless it is undeniable that an economically efficient and democratically organised informal economy can bring about the much needed radical changes required for a country's development to go forward. Alternative evaluation and a new way to attract financial resources to develop the informal economy are needed, especially in times like these.

Disclaimer and Acknowledgement

This ICMR report is produced to encourage the exchange of ideas on the issues highlighted in the report, and to facilitate interaction among market participants, policy makers and academics. The views expressed are not those of any of the institutions with which ICMR is affiliated.

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The ICMR welcomes any questions or suggestions. Please address your comments to Cheam Tat Hong at thcheam@icmr.my

Notes

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22 In the UK, community shares refer to the sale, or offer for sale, of more than £10,000 of non-publicly tradeable shares or bonds to communities of at least twenty people, to finance ventures serving a community purpose.

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