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Factors Contributing to India's Informal Economy

Introduction:

Formal-Informal employment is spread across two sectors, organized (formal) and unorganized (informal). According to the National Commission for Enterprises in the Unorganized Sector (NCEUS), Informal/Unorganized sector is defined as "all unincorporated private enterprises owned by individuals or households engaged in the sale and production of goods and services operated on a proprietary or partnership basis and with less than ten workers". Informal workers are spread both in organized and unorganized sector the definition of informal worker according to NCEUS is, "Informal workers consist of those working in the informal sector or households, excluding regular workers with social security benefits provided by the employers and the workers in the formal sector without any employment and social security benefits provided by the employers".

The informal or unorganized sectors are the ones where the employees or the workers do not have regular working hours and wages and are exempted from taxes. It is mainly concerned with the primary production of goods and services which acts as a base for formal sector to build finished goods and provide services. The primary aim of informal sector is to generate employment and income on a small scale. It does not take into account the welfare of workers and decisions are based only on the benefits to the employer. For example: A street vendor selling his farm products on the street to earn his daily bread is an example of informal economy.

Informal Economy(Present Scenario):

The Indian labor market is characterized by predominance of informal employment with more than 90 per cent of India's informal workforce working as self-employed and casual workers. India's informal sector is the backbone of the economy. Ever since the initiation of the liberalization policies in the early nineties, informalization of jobs has become a matter of concern. Growing competition combined with increased market opportunities and limited resources have led to the emergence of an informal economy. It employs the vast majority of the workforce, and the formal sector depends on its goods and services. The informal sector consists of low skilled and unskilled workers who are primarily deprived of the benefits that formal class workers enjoy a sense of job security.

The Indian economy lacks the necessary infrastructure and resources for digitized transactions making it very difficult for formal businesses to operate. The people associated with informal sector are not tracked by any form of government and the earnings in the informal economy are neither taxed nor included in the GDP (Gross Domestic Product) of the country. While the corporations and big enterprises have bodies that don't just represent them at a central level but also regulate laws to keep an order within the organization, the informal sector has been devoid of such regulatory bodies.

Formal Economy:

The formal sector consists of licensed organizations that pay taxes and must obey labour laws. It is also called the “organized” sector. It provides the employment that is good in the sense of being well paid and linked to benefits such as vacations, sick leave as well as social protection such as health insurance and pension schemes. The jobs within formal sector has a fixed number of working hours, regular wages and the worker’s job is assured with a contract signed by both the parties. The workers are employed by the government, state or private sector enterprises which is a licensed organization and is liable to pay taxes.

Regulations in Informal Economy:

Informal markets are not regulated by any government run organization, instead these markets are socially regulated. The vastness of the sector has made it impossible so far to encapsulate all of them under a body which doesn't just regulate them but also looks into the needs of the sector. Because of these reasons there are thousands of chambers of commerce and tens of thousands of small business associations that exercise regulatory activities within their small scope. However, this has also been a reason for the growth of the informal sector. Away from the chains of labour laws enforcement and any regulatory bodies, the informal sector has managed to squeeze itself within different sectors of the economy offering employment opportunities to millions.

Informal economy away from the hustle and tussle of laws and regulations has found a comfortable grey area where they enjoy the benefits like hiring and firing anyone without any formal agreement or notice, no strict requirement of documentation and licensing for running any kind of business, flexibility in paying taxes. These factors have played a major role in making the informal economy flourish and grow on its own. The government has adopted some measures to bring a structure to this economy with policies like Goods and Services Tax, but the informal sector has still continued to grow. The other most important reason for the informal economy to grow severely in India is its cash driven nature, informal sector operates in cash transactions which are not often accounted for, allowing the small businesses to cook books and save taxes.

According to the International Labour Organization, the level of education is a key factor affecting the level of informal employment. Globally, when the level of education increases, the level of informal employment decreases People who have completed secondary and tertiary education are less likely to be in informal employment compared to workers who have either no education or completed primary education. People living in rural areas are almost twice as likely to be in informal employment as those in urban areas. Agriculture is the sector with the highest level of informal employment – estimated at more than 90 per cent. The informal sector currently accounts for over half the global employment. In developing countries like India, the informal economy predominates as a livelihood activity for poorer people. The main reason for the growth of informal economy appears to be that formal labour markets have not been able to generate sufficient jobs to absorb a continuously growing workforce, particularly for unskilled labour leaving scope for informal practices to operate freely.

Conditions of Workers in Informal Economy:

The people working in the informal economy tend to have a lower level of labour organizations as well as poorer access to public infrastructure and benefits. This leaves them highly vulnerable to harassment and abuse. Some employers may also take advantage of the absence of formal contracts by not complying with government standards, such as ensuring adequate working conditions and paying the minimum wages. These people lack security both legally and economically, making them highly vulnerable to the outside world where they can be exploited by employers in the absence of any economic security and social protection system.

In parallel the market mechanisms and competition led to closure of obsolete industries such as textile mills, reducing formal jobs. The newer industries that were rising was capital intensive rather than labour intensive, thus absorbing lesser workforce then the usual industries and depending mostly on the machines. Lack of an exit mechanism such as insolvency and bankruptcy laws has led to firms remaining small, barely breaking even, and not scaling up. Such small firms can circumvent formal sector laws such as mandatory registrations with the EPFO etc. rendering them informal. The advent of the Fourth Industrial Revolution and automation poses even more dangers to present formal sector jobs since workers with current skills will be rendered obsolete unless they undergo skill reorientation.

India v/s World:

India, with increasing integration into global economy, also suffered during various global crises such as the Southeast Asian crisis, Global Financial Crisis in 2008 and the Eurozone crisis in 2011. This shelved corporate expansion plans and led to closure of several industries, reducing formal sector employment. Recently, there have been a number of top-down attempts to improve the welfare and protection of workers in the informal sector by the government including the introduction of Goods and Services Tax (GST) as unified tax to be imposed on all businesses in order to bring the informal sectors in the formal economy, financial inclusion through flexible banking policies like no frills account.

According to Industrial Disputes Act (IDA) firms with 100 or more workers requires government permission to retrench or lay off any worker. This permission is rarely granted. The Industrial Employment Act, 1946 requires employers in firms with 100 or more workers (50 or more in certain states) to seek permission even for reassigning a worker from one task to another. And the Trade Unions Act allows any seven employees to form a union, thereby using up a large proportion of the firm's managerial resources in dealing with several unions within itself. Through this regulation, unions have the right to strike and represent workers in legal disputes with employers. Last but not the least, the contract labour (Regulation and Abolition) Act, 1970 restricts, and even prohibit, the use of contract workers for certain tasks. Thus, these labour regulations effectively prevent firms from using labor-intensive methods of production. Also, since these laws hold above a certain threshold employment levels, firms often have an incentive to remain small and "informal".

However, though the growth of the service sector in India is in line with global trends, there are two unique characteristics of India's service sector growth. First, the entire decline in the share of agriculture sector in GDP, i.e., from 32 % in 1990 to 22 % in 2003, has been picked up by the service sector while manufacturing sector's share has remained more or less the same. In general, such a trend is mainly experienced by high-income countries and not by developing countries. And second, in spite of the rising share of services in GDP and trade, there has not been a corresponding rise in the share of services in total employment. This jobless growth of

India’s service sector, with no corresponding growth in the share of manufacturing sector, has raised doubts about its sustainability in the long run.

India ranks second among the BRICs nation, 13th in Asia and 33rd in the overall world in terms of share of manufacturing sector to GDP in 2013. Compared to other countries, while India’s manufacturing share to GDP is low, it has witnessed an increase in share along with Korea over the past decade as against the decline in share witnessed by the other major SouthEast Asian and BRICs countries. In China, the manufacturing sector’s contribution is more than twice than that of India. India’s growth story differs from other economies like Japan, South Korea and China because of its service sector driven growth rather than by labour- intensive manufacturing sector.

Reasons for Informalization:

One of the probable reasons for this lopsided growth in services is the fact that reforms in India at the sectoral level have evolved in an ad-hoc way rather than as part of a coherent overall strategy. Though there exists an overall industrial policy and agricultural policy in India, there is no integrated service policy. Consequently, the pace of reforms and their impact lacks uniformity across sectors. Moreover, most of the services have for a long time been in the public domain and they suffer from both external constraints in terms of high barriers to trade, as well as domestic constraints in terms of being highly regulated services with state monopolies. These services consequently suffer from inefficiencies and low growth.

Growth in the share of service sector in GDP is often followed by a corresponding growth in the share of service sector in total employment in the economy. However, in India we find that though there has been a phenomenal growth in the service sector, this growth has not been followed by a corresponding high growth in employment in the 1990s. And this rise in the share of services in employment has been much slower than the decline in the share of agriculture and manufacturing in total employment. This shows that while output generation has shifted to services, employment generation in services has lagged far behind.

A probable reason for fall in employment in faster growing services can be improvements in their labour productivity. But very few studies have estimated productivity growth in services because of the reasons highlighted above. Of the few studies, a report by Mckinsey & Co. (2001) estimates labour productivity in six segments of India's services sector-telecommunication, software, retail banking, housing construction, energy distribution (electricity) and retail distribution. It finds that India's software services have the highest productivity levels amongst all segments, followed by telecommunication, banking and construction. These are also the services that are growing faster and have high shares in GDP and employment. There is a possibility that higher labour productivity in these segments may have led to slower growth in employment in the services sector.

Challenges in Policy Making:

India's transition from its agricultural to a service driven economy (bypassing industrial sector) has led to it being the 3rd largest country in terms of Purchasing Power Parity (PPP). Developing its manufacturing sector would thus enable India to accelerate its growth rate towards its high long-term potential by gainfully engaging its workforce. Developing its manufacturing sector would thus enable India to accelerate its growth rate towards its high long-term potential by gainfully engaging its workforce.

Policymakers should still be concerned about the impact of technology on employment, but rather than worrying about quantitative changes in employment, the main lesson is qualitative: technological change has historically hurt some workers while benefiting others. In developing countries, most people can't afford to remain jobless. As a result, improving the quality of employment is a greater challenge than outright unemployment. As technology further advances, it will increasingly pay to be highly skilled. For this reason, enhancing educational outcomes and ensuring that skills development systems are demand driven continue to be key priorities. Labour market entrants and existing workers need the right skills to be complements rather than substitutes for new technologies.

Conclusion:

Without necessarily comparing the advantages and disadvantages of the informal economy with those of the formal economy, it is evident that the former has increased in share and volume over the past three decades, playing different roles for different players. And while it is not easy to accurately predict the exact share of the informal economy in the long-term future, the available evidence shows that it is likely to remain significant in the coming two or more decades. It is obviously beneficial to its many legal, and illegal, participants, including the poor and marginalized groups.

It is important to distinguish between the different types and causes of an informal sector in order to prescribe the appropriate mix of:

1. Regulations (and taxation)
2. Protection, both legal and social to the workers and employers, ensuring they have a better voice in governance and are protected from exploitation
3. Promotion which would allow the informal economy more and better opportunities, including more secure assets (physical, financial and human), better terms of doing business and reduced constraints, in supply-side, demand-side and institutional-side.

The aim should be to take full possible advantage of the positive impact of the informal economy, while minimizing any negative effects that might result from it.

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