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Formalization of the Economy is a Form of Coercion

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Here we will analyze the importance of the informal sector in an economy and what should be the motives and methods of formalization.

The growth curve of Indian economy has been essentially a dichotomous one, with the informal branch occupying more than 80% of the economy despite continued efforts to formalize it, while the other branch dominated by law-abiding big firms, seen as a source of revenue to the state and thus, nurtured and supported. In recent years, there has been increasing focus on a formalization of economy and financialization of savings. However, it is still debatable that how smooth this transition is going to be, given its coercive and compulsive nature.

Informal Sector:

- NSSO defines the informal sector enterprises as all unincorporated proprietary and partnership enterprises.
- National Accounts Statistics (NAS) defines the unorganised sector in addition to the unincorporated proprietries or partnership enterprises, includes enterprises run by cooperative societies, trust, private and limited companies. The informal sector can, therefore, be considered as a subset of the unorganised sector.

The Problems Posed by Informal Economy

- **Productivity:** The informal sector basically comprises of MSMEs and household businesses which are not as big as firms like Reliance. They are unable to take advantage of economies of scale.

Economy of scale: When more units of a good or a service can be produced on a larger scale, yet with (on average) fewer input costs, economies of scale are said to be achieved. Alternatively, this means that as a company grows and production units increase, a company will have a better chance to decrease its costs.

- **Inability to raise tax revenue:** As the businesses of the informal economy are not directly regulated, they usually avoid one or more taxes by hiding incomes and expenses from the regulatory framework. This poses a challenge for the government as a major chunk of the economy remains out of the tax net.
- **Lack of control and surveillance:** The informal sector remains unmonitored by the government. Further, no official statistics are available representing the true state of the economy, which makes it difficult for the government to make policies regarding the informal sector in particular and whole economy in general.
- **Low-quality products and less value-addition per employee:** Although the informal sector employs more than 75% of the Indian population, the value-addition per employee is very low. This means that a major portion of our human resource is under-utilized.

The Problem with Formalization

Although the informal sector is often blamed for competing unfairly with the formal sector, it needs to be seen as a characteristic of underdevelopment rather than the cause. In this light, we need to take a look at the issues faced by the informal sector.

- **Red-Tapism:** According to a 2015 study by Centre for Civil society, starting an MSME requires 12 licenses, 27 construction permits and 7 property registration requirements. There are 44 central statutes and over 150 state statutes governing every aspect of the employee-employer relationship. The process of formalization is too burdensome and costly for small enterprises to remain competitive.
- **GST:** The imposition of Goods and Services Tax has added to the woes of small entrepreneurs. The aforementioned study says that almost 61.7% of the profit goes into taxes which is way beyond what is affordable for MSMEs. The complexity and the cost of adhering to it are very high. The required computational skills, frequent filing and navigating an impossible classification system lead the small businesses to fall into the trap of middlemen and incurs further costs.
- **Demonetization:** Demonetization proved to be a double-edged sword for the informal sector. On one side it pulled the customers away from the cash-reliant informal sector and on the other hand created a negative **demand-side shock** for the informal sector. It also pushed informal sector workers out of their jobs, the worst affected being the daily-wage earners. According to Economic Survey 2016-17, Demonetization triggered a rush for distressed labour under MGNREGA.

- **Demand Shock:** A demand shock is a sudden surprise event that temporarily increases or decreases demand for goods or services. A positive demand shock increases demand while a negative demand shock decreases demand. Both a positive demand shock and a negative demand shock have an effect on the prices of goods and services.

- **Low level of human capital of the entrepreneurs:** The informal sector suffers from the low level of human capital of its entrepreneurs and workers. Most of them are uneducated and unskilled.
- **Compromising labour rights:** The focus on making the economy competitive via formalization is often met with accusations of compromising with labour rights, discouraging unionization, and favouring the rich at the cost of poor. At the same time, the informal sector often employs workers on a contractual basis and a low-pay and the employer is not bound to not provide the workers with any social security. Outright formalization is therefore not a solution for the workers as well as the employers of the informal sector.

The Solution

- **Simpler regulatory framework:** The transition of the informal sector to the formal sector can only occur when the informal sector is given relief from the burden of regulatory compliance and is given enough time to adjust with the modern, digitized formal system.
- **Skilling the labour:** Unless the labour force is not skilled and educated, they will not be accommodated in the formal sector and the efforts to formalization will result in unemployment.
- **Social security:** Investing in social security schemes like Atal Pension Yojna, PM Jeevan Jyoti Yojana, Rashtriya Swasthya Bima Yojana, Aam Aadmi Bima Yojana can help improve the condition of workers. The mention of Universal Basic Income in Economic Survey 2016-17 is a positive step in this direction.
- **Financial support:** Giving financial support to help small-scale industries stand on their own is a crucial step in bringing them to the organized sector. Schemes like MUDRA loans and Start-up India are helping the youth carve a niche in the organized sector.
- **Policy reforms:** The structural policies designed to promote formality should be implemented with caution, aimed at encouraging formalisation rather than explicitly discouraging informal activity.
- **Labour law reforms:** The archaic labour laws need to be dealt afresh so that they are more flexible. This should be done along with upkeeping the rights of the labourers and not allowing for their exploitation.

It is important to highlight the fact that the **informal sector employs the majority of the uneducated and unskilled labour force** which, otherwise, may not find a place in the formal sector. So, any effort to formalize the informal economy coercively is fraught with serious socio-political ramifications and backlash. Therefore, it is important to ensure that the transition to formal economy is a smooth, encouraging process and not a process of vitiating or punishing the informal sector. The aim of formalization should not be surveillance but rather the growth of individuals and firms of the country.