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Will Demonetisation Shrink the Informal Economy?

On November 8, in one of the most radical monetary policy initiatives in recent decades in a growing economy, India demonetised Rs 500 (S$10.50) and Rs 1000 (S$21) currency bills accounting for over 86% of the currency in circulation. The main objective was to curb the parallel economy. As the objectives of demonetisation were further clarified, it was evident that the government sought to create an environment in which the informal sector, where nearly all transactions are carried out with cash, was induced to 'formalise' and brought under the scrutiny of tax and regulatory authorities, thereby shrinking a large inefficient segment of the economy.

This insight finds that demonetisation is neither a necessary nor a sufficient condition for persuading firms to incorporate. The market imperfections that induced informality are still very much present. At best demonetisation has reduced the volume of cash that lubricates the informal economy, raising the cost of doing business, and in many cases shutting down enterprises as the entire cash driven supply chain shut down. The effects on measurable output are likely to be temporary, but the damage to a segment of the informal sector may be permanent.

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Introduction

On November 8, in one of the most radical monetary policy initiatives in recent decades in a growing economy, India demonetised Rs 500 (S$10.50) and Rs 1000 (S$21) currency bills accounting for over 86% of the currency in circulation. The main objective was to curb the parallel economy. As the objectives of demonetisation were further clarified, it was evident that the government sought to create an environment in which transactions were recorded digitally. This would help bring the informal sector, where nearly all transactions are carried out with cash, under the scrutiny of the tax authorities, thereby helping broaden the tax base and boost tax revenues in an economy facing serious fiscal constraints.

The informal sector[2] encompasses economic activity carried out beyond the purview of regulators and the legal framework in an economy. It accounts for 96% of business enterprises in India and 93% of employment (Table 1). A recent World Bank study (Loyaza, 2016[3]) indicates that the informal sector in developing economies generates about 35% of Gross Domestic Product (GDP) and employs 70% of the work force. It is extremely heterogeneous, comprising a wide spectrum of businesses ranging from tiny vendors, single-owner enterprises to unlicensed factories and moonlighting professionals. It is also deeply and inextricably linked to the formal economy. Over the years, despite robust growth, the informal sector in India hasn't contracted. On the contrary, data suggests most new jobs over the past two decades have been generated in the informal economy[4].

Table 1: Formal-Informal Employment across Organised-Unorganised Sector (Millions) 2011-12

	Organised	**Unorganised**	**Total**
Formal	37.18 (45.4)	1.39 (0.4)	38.56 (8.1)
Informal	44.74 (54.6)	390.92 (99.6)	435.66 (91.9)
Total	81.92 (17.3)	392.31 (82.7)	474.23 (100)

Source: NSSO CII-IES: An Analysis of the Informal Labour Market in India 2014.

2 The informal sector is vast and heterogeneous. This insight focusses on small and tiny firms in the manufacturing and allied sectors that employ up to 20 workers and generate a bulk of output outside agriculture. It does not examine the millions of single owner micro enterprises, street and mobile markets and the self-employed.

3 "Informality in the Process of Development and Growth" *Norman V. Loayza*, Development Research Group. Macroeconomics and Growth Team October 2016 WPS7858.

4 Economic Survey, 2015-16, Volume 2, Chapter 9 "Social Infrastructure, Employment and Human Development.

Informal sector enterprises are not registered or licensed as legal entities. Activities in the informal sector are not captured by government statistics.[5] The impact of demonetisation on the informal sector was immediate, sharp and severe. Policymakers hoped that the inconvenience of cash-based transactions would induce informal enterprises to formalise.

This raises questions about the likely impact of demonetisation on the informal sector. Does demonetisation create incentives for firms in the informal sector to formalise? If formalisation is a value enhancing proposition, then why do firms remain informal? How well are entrepreneurs equipped to formalise? Is demonetisation the best path to formalising the economy?

The Informal Sector

In an ideal state with ease of entry and exit, low transaction costs, reliable information flows and a regulatory structure that aims to ensure competitive markets, there would be no informal sector. The incentives for informality would disappear. Formalisation of economic activity yields benefits for the economy, manifest in greater efficiency in the utilisation of resources, increased investment, and thus higher growth rates and tax revenues. Firms, including small businesses, would have access to credit and government assistance programs, and the freedom and ability to expand. It would be easy for a new entrant to do business, with lower registration costs, reasonable regulations that help enhance efficiency in a level playing field.

However, the environment for business in India is not business friendly. The informal sector exists because of the high costs of registering and conducting a formal business in India, as well as efforts to evade regulatory oversight. Millions of micro-entrepreneurs seeking a subsistence living lack the opportunities, knowledge and capabilities to enter the formal sector. The consequences of the large informal sector are a narrow industrial base and low tax revenues. India's tax to GDP ratio is amongst the lowest for emerging market economies[6]. Informality also results in inefficiency in the use of capital and labour by small informal enterprises, constraining growth. The uncertainty about their legal status dissuades long-term investment decisions. The misallocation of resources, inability to access government

[5] The Government of India conducts a periodic survey of enterprises through the National Sample Survey, some enterprises are covered by the Annual Survey of Industries (ASI), as well as periodic NCEUS surveys ad studies. However entities in the informal sector do not report to any government authority.

[6] IMF Fiscal Debt Monitor.

programmes and participate in international markets has adverse long-term consequences for the economy. Due to the prevalence of the informal sector, firms tend to be smaller and inefficient compared to cohorts in the formal sector (Figures 1 and Table 2). Their presence also constitutes a fiscal 'black hole' in the economy. 'Formalising' is thus deemed desirable and necessary for raising the growth potential of the economy. It is these considerations that motivate the government's desire to bring the informal economy under the ambit of 'formality'.

The statistics on the informal sector are stark. 83% of the work force outside agriculture is employed in the informal sector producing over 40% of GDP. The share of informal employment in the organized sector increased during the period of fastest growth between 2004-05 and 2011-12[7]. In the 21 years between 1989 and 2010, only one-third of new jobs were in the formal sector. Most significantly, of the 4.2 million enterprises established over this period, only 1.2% were in the formal sector. Since 2000, the marginal growth in employment in the formal sector is primarily due to the increasing use of 'contract labour' – labour hired for short periods, below the threshold to be categorised as 'permanent' employees, to escape regulatory oversight.

Raison d'etre for Informality

Firms in the informal sector are informal because they need to be so. Registering a business entails high costs, raising barriers to entry for new firms. Choosing to remain informal also carries high risks as well as direct and indirect costs. Property rights are insecure, unregistered firms cannot obtain credit from banks, nor can they avail government incentives and business promotion programs. Informal sector firms are not subject to regulatory oversight that mandates adherence to complex environmental, safety guidelines and regulation of labour markets, which in India, are amongst the most stringent in the world[8]. Labour market regulations are reflected in conditions for hiring or retrenching labour and the quantum and types of benefits to be offered to labour. Stringent conditions on shutting down an enterprise, even if it is unproductive make the process expensive and time-consuming. The absence of a clear exit policy results in firms remaining sub-optimally small[9]. The idealised notions of small

7 Economic Survey 2015-16, Ministry of Finance, Government of India, Vol 2, Page 197-98.

8 OECD Economic Survey: India, OECD 2014.

9 The Economic Survey (2015-16) refers to this as 'Chakravyuha', an allusion to a legend in the Mahabharata (one of the two major Sanskrit epics from ancient India) about the ability to enter, but not exit. Firms opt to stay away from the formal sector.

‘village republics’ and self-sufficiency resulted in several sectors, including handicrafts, khadi (raw cotton) weaving, reserved for small and mediums sized enterprises. The consequence of these reservations and the absence of a clear exit policy is a highly fragmented, inefficient manufacturing sector that is barely regulated, and operates mostly in cash to evade taxes and other mandatory payments. It is these tiny informal enterprises — many of which supply parts or products used by larger, more tightly regulated formal sector companies — that have been hardest hit by the cash crunch. The Economic Survey refers to the pervasiveness of rules and regulations that require multiple levels of clearance as ‘regulatory cholesterol[10].

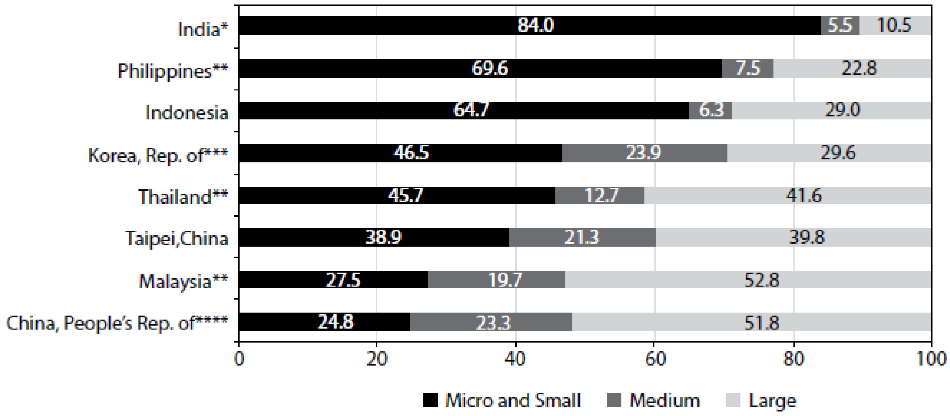
In the absence of official protection, labour costs in the informal sector are low - a consequence of low bargaining power in a labour surplus economy. Informal enterprises are also characterised by low level of skills development and productivity. With low barriers to entry and no restrictions on exit, informal sector businesses operate in conditions approximating perfect competition. Profit margins are very low, and due to lack of access to formal finance, the cost of capital is high. Conversely, in the formal sector, wages are high, while access to formal finance keeps interest costs low.

Demonetisation and the Informal Sector

Demonetisation does not address the causes of informality, rather, one of the narrow manifestations – the prevalence of the use of cash to escape regulatory scrutiny. Evidence on the extent to which demonetisation may persuade firms to formalise will not be available for years. It takes a long time to establish a firm in India, and then for an ongoing firm to transition

[10] Economic Survey, 2015-16, Ministry of Finance, Government of India, Vol 1. Page 141.

Figure 1: Share of Manufacturing Employment by Enterprise Size Groups (percent)



*India's manufacturing employment includes workers in own-account manufacturing enterprises.
**Includes imputation for the self-employed based on differentials between labor force survey and enteprise survey/census data.
***Data on Korean microenterprises are not available.
**** Adds 5.9 million self-employed (see ADB 2009 for more details).
Note: Micro and small: 1–49 workers in all economies except Thailand (1–50 workers); medium: 50–199 in all economies except Thailand (51–200 workers); large: 200 or more workers in all economies except Thailand (more than 200 workers).
Source: ADB (2009).

to a 'legal status' would, at best, be complicated. Firms may choose to shut down operations altogether, before starting afresh. These firms would have to build up a history to obtain credit and access government programs. The question of how many firms are able to follow this path is a moot point. With ongoing reforms to ease conditions for doing business, new business registration may in the years to come, reflect a shift to 'formalising'. While it will take years

Table 2: Employment in the manufacturing sector is concentrated in very small firms

	Number of Employees		
	0 to 9	10 to 19	20 +
Austria	6.94	6.81	86.26
Belgium	7.32	6.62	86.07
Brazil	6.31	8.19	85.50
Czech Republic	6.90	5.99	87.11
Denmark	7.91	7.29	84.80
Estonia	11.83	8.18	79.99

Finland	8.04	6.45	85.51
France	13.59	6.60	79.81
Germany	5.65	8.53	85.82
Hungary	10.36	7.21	82.43
Ireland	5.08	7.08	87.84
Italy	15.22	15.32	69.46
Netherlands	10.99	8.90	80.11
Norway	9.33	8.22	82.45
Poland	9.50	4.32	86.18
Portugal	15.68	13.21	71.11
Slovak Republic	6.28	7.88	85.84
Slovenia	10.44	6.33	83.22
Spain	16.56	11.45	72.00
Sweden	9.10	6.91	84.00
Turkey	25.35	0.00	74.65
United Kingdom	8.76	6.73	84.52
Average OECD	11.29	7.99	80.72
India	64.32	8.02	27.67

Source: OECD database for OECD countries and Brazil, NSSO for India.

to gauge the impact of demonetisation on formalisation, i.e. how many new firms are established, the main inhibitors are the high regulatory and compliance costs for doing business. Cross-country evidence[11] clearly indicates the size distribution of firms and the

[11] Economic Survey: India. OECD, 2014; Enterprises in Asia: Fostering Dynamism in SMEs, Asian Development Bank, 2009.

emergence of large firms is closely related to the ease of doing business. On that count despite efforts in recent years, India's rankings have remained static[12].

Immediate impact

The impact on cash flows was swift. Within days production was disrupted across a wide swathe of sectors as businesses were unable to pay suppliers, debtors faced problems meeting repayment obligations, and employers were unable to pay employees. The paucity of cash was more severe in sectors with a high turnover and requiring steady cash flows, such as transportation, trade and construction, resulting in a near cessation of activities.

Systematic data on the informal sector is extremely difficult to compile. Informal enterprises do not collate data to report to any government or other agency. A number of government agencies, including the National Sample Survey (NSSO) conduct periodic surveys, but the dataset is not longitudinal thereby precluding studies on how firms fare over time with changes in external conditions. Anecdotal evidence and short studies carried out by the media indicate that demonetisation has hurt the informal sector badly, choking credit and disrupting the entire supply chain. Lacking access to formal financial institutions, firms in the informal sector operate on a few days credit. Businesses in this market have low levels of resilience. The invalidation of 86% of the money supply seems to have an immediate impact on the supply chain and production lines, and completely shut down informal credit lines.

The informal sector is inextricably linked to the formal sector. A number of manufacturing clusters across the country comprise of intricate networks of formal and informal enterprises. The links are both backward – manifest in purchase of raw materials and intermediate goods from informal entities, and forward - reflected in sale of finished goods. The supply chain for many industries, including leather goods (clusters across the country), sports goods (Ludhiana, Punjab), brassware (Moradabad, U.P.), hosiery (Ludhiana, Punjab), sericulture and jaggery (Mandya, Karntaka), garments (Surat, Gujarat; Varanasi, UP; Trichur (Tamil Nadu), tea and bidis -a local variant of cigarettes (Bengal), agro-based industries across the country, all involve an intricate network of informal and formal enterprises. The latter are generally at the last stage of the supply chain, the point at which the final goods enter the domestic retail market or are exported, e.g. in Dharavi, a slum in Mumbai, raw leather is processed, cleaned and sewn by

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12 "Ease of Doing Business' World Bank, 2015, 2016, 2017.

tiny enterprises, often households, and then sold on to the final retailer, perhaps an exporter. In the entire chain, only the exporter or the final retailer is a formal entity, the rest operate primarily on cash payments, and lack the scale, resources and information to incorporate. Taxes are paid only by a registered firm at the end of the value chain.

The shortage of currency has caused a loss of income, employment and the ability to spend from one's income/savings for a wide section of the population. In Mathura and Surat, the country's two major textile centres, nearly half the power-looms closed, with workers, mostly migrants returning to their villages. Leather, handicrafts, small machine parts manufacturers were similarly affected. Press reports indicate that in some areas, more than 50% of enterprises were forced to stop operations. Even in situations where employers had money in the bank, they were unable to obtain cash to pay wages.

Annual rainfall, a major source of irrigation, continues to have a profound impact on agricultural output, which in turn impacts agricultural incomes. This has a strong impact on the formal sector via demand for consumer products, but also for machines needed in agriculture, and the value chain in industries such as food processing. A good harvest following a normal monsoon season, stimulates demand for goods, with a direct bearing on industrial production. A good monsoon in 2016 ensured a good harvest. However, the shortage of cash at the beginning of the sowing season resulted in a sharp fall in the area under cultivation with farmers at the beginning of the *rabi*, or winter crop season. The default rate among farmers would have soared were it not for relief measures announced by the government.

Demonetisation had a highly disruptive impact on poor, who despite having bank accounts, do not have access to credit. They cannot obtain credit from the formal sector due to lack of collateral and inability to cope with tedious documentation. It had a particularly severe impact on women. In most households in India, the 'lady of the house' sets aside money, essentially precautionary savings for use in emergencies. Demonetisation brought these savings out in the 'open', and depending on intra-household allocation of power, a loss of control over carefully nurtured family savings.

The contraction in output may be temporary until cash is restored in the economy. The loss in output and employment is almost impossible to compute. It will take time to estimate how many enterprises have shut down. However, evidence collated by the media suggests, the impact has been widespread, and often, severe.

Policy Implications

The informal sector is a reflection of the inability of the state to provide basic services in education and healthcare that would enhance skills and productivity, create incentives for formalising, and provide the disenfranchised with opportunities to move up the economic ladder – to decent livelihoods.

It is desirable and socially and privately optimal to reduce the size of the informal sector. To achieve this objective policymakers have to alter the calculus of costs and benefits of remaining informal, to induce firms to formalise. This calls for expediting reforms in labour laws and in the company act, and implementation of measures to ease conditions for doing business that have been initiated, but are proceeding at a very slow pace. Compelling firms to formalise may induce some to do so, but a vast majority are likely to go deeper underground, or shut down operations.

Demonetisation is neither a necessary nor a sufficient condition for inducing informal sector firms to formalise. The market imperfections that induced informality are still very much present. At best demonetisation has reduced the volume of cash that lubricates the informal economy, raising the cost of doing business, and in many reported case shutting down enterprises as the entire cash driven supply chain shut down.

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