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## **The Informal Sector in India: Indicator of Resilience or a Malaise?**

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*The informal sector accounts for over 92 per cent of the labour force, over 40 per cent of output, and 99 per cent of businesses in India. The range and size of informality in India is arguably larger than for any other economy, compared to other economies at a similar stage of development. The informal economy primarily comprises of millions of self-employed, and small and tiny, relatively inefficient enterprises that detract from India's growth potential. Informal enterprises have deep and intricate links with formal sector enterprises and are affected by developments in the domestic and global economies. The spread of informality is symptomatic of much that ails the Indian economy. Yet, it is also a powerful safety valve, offering employment and income generation avenues for tens of millions who are unable to secure jobs in the formal sector. This paper reviews the reasons leading to the growth of the informal sector. It finds that a nuanced approach, cognisant of the wide differences across the informal sector, should identify segments that should be allowed to exist as informal entities and those that should, with improving conditions for doing business, be induced to enter the formal economy.*

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## Introduction

The informal sector accounts for 92 per cent of employment, nearly 40 per cent of gross domestic product (GDP) and more than 99 per cent of business establishments in India.<sup>2</sup> Yet, it remains poorly understood and confounds policymakers. The challenge arises from the amorphous and shifting nature of informal activities. As most activities are taking place beyond the reach of official monitoring, household and enterprise-level data on the activities in the informal sector is extremely difficult to collate.

The National Commission for Enterprises in the Unorganised Sector (NCEUS) set up by the Indian government in 2004, defined the unorganised sector as consisting “of 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 10 total workers (or twenty, if not using electricity)”. Informal workers “consist of those working in the unorganised sector or households, excluding regular workers with social security benefits, and the workers in the organised sector without social security benefits. Contract workers in the organised sector are not covered by social insurance systems and, thus, count as informal workers” (NCEUS, 2009). The informal sector comprises informal enterprises and informal workers. Entities in the formal sector are registered, regulated and accounted for in GDP calculations. Workers in the formal sector enter into formal contracts, are protected by labour laws and pay taxes. In this paper we define the informal sector or the informal economy to encompass all entities that are not registered, and workers that are not protected by contracts. It comprises of all entities and individuals outside the rubric of the formal sector.

The size and economic importance of India’s informal sector raises several key questions. Why is the informal sector so large in India compared to other economies at a similar stage of development? Do constraints on formalising business arise from structural factors or are they induced by policies? The poor and the women participate actively in the informal sector. How do activities in this sector impact the lives of the poor and the women? What are the implications of such a large informal sector on economic efficiency, productivity and growth? Is the growth of the informal sector a symptom of deeper problems in India? Do these factors impinge on prospects for social stability?

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<sup>2</sup> Data from the National Commission for Enterprises in the Unorganised Sector [NCEUS] (2009).

From a social welfare perspective, some pertinent questions are: Does the informal sector fill a missing market that the formal sector cannot provide? Is it welfare enhancing? Since most participants in the informal economy are from marginalised and economically vulnerable groups, can a case be made for letting segments of the informal sector continue as they are with minimal regulatory oversight that does not impair the entrepreneur's and worker's incentive structures? Or should the informal sector be curtailed and policies designed to bring informal activities under the aegis of the formal sector? What role can policymakers play in mitigating the ill effects of the informal sector? Finally, is an economy's welfare enhanced with the co-existence of an informal sector alongside the official sector?

This paper reviews the literature on the informal sector. The answers to these questions are important as they provide insights useful for policymakers seeking to understand how the policy framework could enhance income generation prospects and resilience, to a diverse and large cohort of informal workers. While wage workers in the informal economy may have little choice, the millions of micro-entrepreneurs embark on tiny businesses to survive, drawn also by the flexibility and independence it may offer.

## **The Informal Sector**

The informal economy is heterogeneous, encompassing the spectrum from freelancing white collar professionals<sup>3</sup> to mobile vendors barely able to make a subsistence living. It is argued that the growth of the informal economy stems from an accumulation of regulations, particularly labour laws that have stifled enterprise and the growth of the formal manufacturing sector. Low levels of development, low literacy levels and an environment that is inimical to business are other factors contributing to the growth of the informal economy.

It comprises activities ranging from the ordinary to the illegal. The illegal side of informality involves drugs, human trafficking, sex trade, smuggling and money laundering. These are law and order problems beyond the scope of legitimate economic activity and are, thus, not incorporated into official statistics. The informal sector is remarkably diverse – a growing

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<sup>3</sup> A large part of the 'gig' economy, arising from start-ups and other firms drawing upon digital technologies, are considered to be in the informal sector. In India, however, this is a small sector, most software engineers are in the formal.

segment of the labour force in the formal sector is deemed to be informally employed. Young professionals seeking flexible contracts to exercise more control over their time, contract workers employed in factories or the services sector to avoid high costs associated with stringent employment regulation, street vendors and part-time drivers for Uber (the ride-sharing app) share a common trait – they are deemed to be in the informal sector. Such a diverse group does not lend itself to uniform policy analysis and recommendations.

The informal sector is characterised by low barriers to entry and exit, small scale operations, low capital investment, inability to access formal finance or benefit from government subsidies or business promotion programs. The vast majority of workers are from the poorest sections of society, including migrant workers. They lack any social or legal protection, often working under miserable and risky conditions. They may lack proper pay protection and even be subject to physical abuse.

## **The Informal Sector in India**

The informal sector in India is pervasive (Table 1). Aside from nearly the entire labour force in agriculture and fishing, it accounts for nearly 99 per cent of workers employed in wholesale trade, 92 per cent in construction, 88 per cent in manufacturing and 97 per cent of workers in hotels and restaurants are employed in the informal sector. The latter two are professions where workers are expected to be formally employed. So why are these and nearly a third of the workforce in financial intermediation, almost 40 per cent in education and over half the workers in health and social work unable to secure formal employment?

**Table 1: Share of labour input in unorganised sector and gross value added by economic activities (2004-05)**

| <b>Category</b>                               | <b>Share of Unorganised Sector (Per cent) 2004-05</b> | <b>Gross Value Added (Per cent) 2004-05</b> |
|---|---|---|
| Agriculture and Forestry                      | 99.9  | 94.5  |
| Fishing                                       | 98.7  | n. a.                                       |
| Mining  | 64.4  | 18  |
| Manufacturing                                 | 87.7  | 26.8  |
| Electricity, Gas, Water supply                | 12.4  | 3   |
| Construction                                  | 92.4  | 46.3  |
| Wholesale and Retail Trade                    | 98.3  | 75.1  |
| Hotels and Restaurants                        | 96.7  | 50.8  |
| Transport, Storage and Communication          | 82.2  | 44.5  |
| Financial Intermediation                      | 32.4  | 9.3   |
| Real Estate, renting and business activities  | 81.4  | 63.4  |
| Public Administration and Defence, etc.       | 2.6   | 0.4   |
| Education                                     | 37.9  | 12.3  |
| Health and Social Work                        | 55.1  | 23.2  |
| Other Community, Social and Personal Services | 92.5  | 69.4  |
| Private household with employed persons       | 100   | 95.34                                       |
| Extra territorial bodies and organisations    | 87.8  | n. a.                                       |
| Total   | 93  | 49.9  |

*Source: National Statistical Commission (2012), Government of India.*

Figure 1 describes the convention developed at the International Labour Organization (ILO) for measuring the quantum of informal employment in the economy. In addition, informal employment is widespread in the formal sector, accounting for over 60 per cent of jobs in the private sector (Table 2).

**Figure 1: Conceptual framework: Informal employment**

| Production units by type                   | Jobs by status in employment |        |           |        |                             |           |        |                                    |        |  |
|--|------------------------------|--------|-----------|--------|-----------------------------|-----------|--------|------------------------------------|--------|--|
|  | Own-account workers          |        | Employers |        | Contributing family workers | Employees |        | Members of producers' cooperatives |        |  |
|  | Informal                     | Formal | Informal  | Formal | Informal                    | Informal  | Formal | Informal                           | Formal |  |
| Formal sector enterprises                  |                              |        |           |        | 1                           | 2         |        |                                    |        |  |
| Informal sector enterprises <sup>(a)</sup> | 3                            |        | 4         |        | 5                           | 6         | 7      | 8                                  |        |  |
| Households <sup>(b)</sup>                  | 9                            |        |           |        |                             | 10        |        |                                    |        |  |

(a) As defined by the Fifteenth International Conference of Labour Statisticians (excluding households employing paid domestic workers).

(b) Households producing goods exclusively for their own final use and households employing paid domestic workers.

Note: Cells shaded in dark grey refer to jobs, which, by definition, do not exist in the type of production unit in question. Cells shaded in light grey refer to formal jobs. Un-shaded cells represent the various types of informal jobs.

**Informal employment:** Cells 1 to 6 and 8 to 10.

**Employment in the informal sector:** Cells 3 to 8.

**Informal employment outside the informal sector:** Cells 1, 2, 9 and 10.

Source: Table from Report of the Committee on Unorganised Sector Statistics, National Statistical Commission, Government of India, February 2012.

The NCEUS report estimated 86 per cent of the work force outside agriculture in 2005 (395 million out of 485 million workers) in the informal sector, producing over 50 per cent of the country's output.

Our focus is on individuals who find themselves in the informal sector out of necessity, unable to secure the predictability and security of a formal contract and all the associated social and economic benefits, and on enterprises that, despite the high opportunity cost, choose to remain informal. A candid assessment by the Chief Economic Advisor (Economic Survey, 2014-15) implicitly suggests that this distribution is unlikely to change in the near future as prospects for rapid industrialisation in India are bleak. In fact, India may already be de-industrialising before

it has even industrialised. This is reflected in the shrinking share of manufacturing in state GDPs, with the exception of Himachal Pradesh and Gujarat.<sup>4</sup>

## Why is the Informal Sector so Large in India?

Poor countries have large informal sectors. Workers enter the informal sector for want of opportunity or choice in the formal sector. The reasons are manifold. In the case of micro-entrepreneurs, the decision is driven by subsistence needs and want of choice; for many working in the construction sector or seasonal agricultural activities, it is out of necessity. Small scale enterprises are driven to this sector by onerous regulation and labour restrictions that make it economically unviable to compete as a formal enterprise. In India, infrastructural constraints deter large investments, forcing a distortion towards small-sized firms that are nimble in coping with electricity shortages or constraints in the transport network.

**Table 2: Labour input matrix, and formal and informal jobs at institutional level, 2004-05**

|                 | Sector                                | Per cent to Total Jobs within Institution |               |            |
|-----------------|---------------------------------------|---|---------------|------------|
|                 |                                       | Formal Jobs                               | Informal Jobs | Total      |
| Formal Sector   | Public Sector                         | 66.4                                      | 33.6          | 100        |
|                 | Private Corporate Sector              | 37.4                                      | 62.6          | 100        |
|                 | Household (Excluding Informal Sector) | 5.4                                       | 94.6          | 100        |
| Informal Sector |                                       | 0.1                                       | 99.9          | 100        |
| <b>Total</b>    |                                       | <b>4.5</b>                                | <b>95</b>     | <b>100</b> |

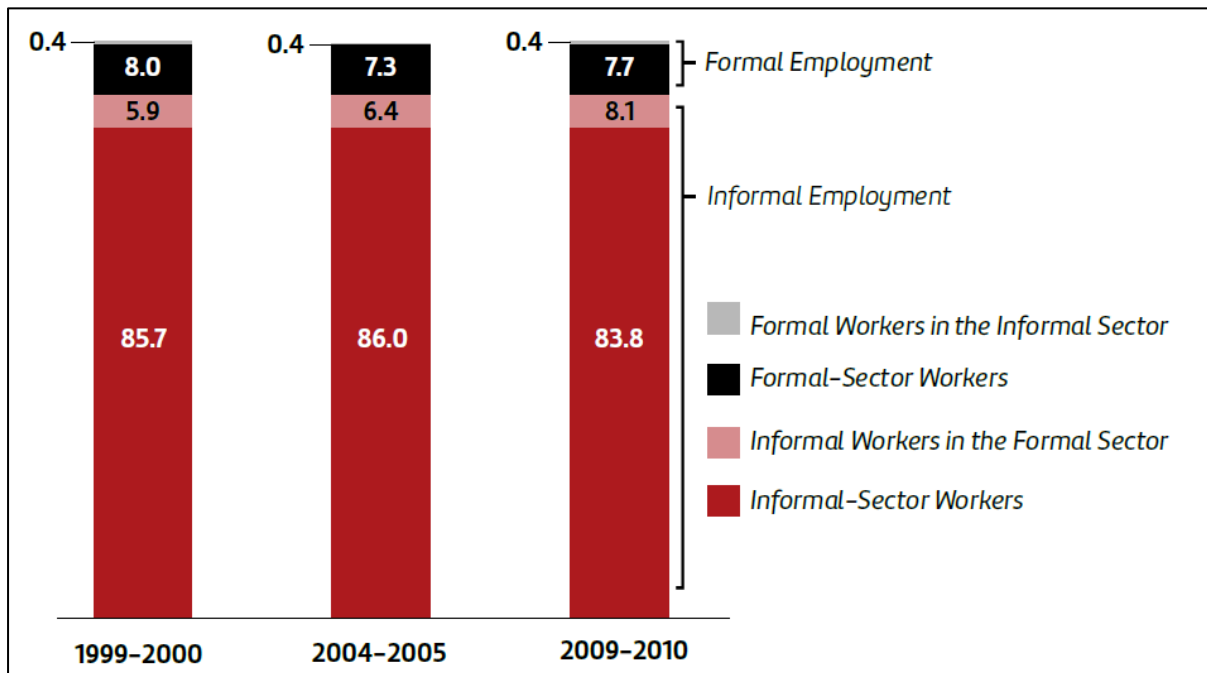
*Source: National Statistical Commission (2012), Government of India*

The informal sector does matter in India. More than 92 percent of the work force (Figure 2), including 99.9 per cent of farmers and workers in agriculture are in the informal sector. The monsoon rains have a significant bearing on rural incomes and, consequently, rural demand for goods and services. Employment and productivity in the informal sector impacts the economy's performance. Nearly two-third of the workers in manufacturing are in the informal sector due to the absence of jobs in the formal sector and the accelerating trend towards deploying contract labour (Table 2). The high costs of registering a business, tight regulatory oversight, and a ponderous and intrusive regulatory regime that requires permission from multiple government

<sup>4</sup> Economic Survey, Ministry of Finance, Government of India, 2014-15.

departments even for the smallest businesses, induce many businesses to operate in the informal space. This is reflected in the World Bank’s Ease of Doing Business index, where despite reforms over the past two years, India still ranks 130<sup>th</sup> among 189 economies (World Bank, 2016).

**Figure 2: Percentage distribution of workers by type of employment**



Sources: K P Kannan (2012), cited in Trilok S Papola and Partha P Sahu (2012), “Growth and Structure of Employment in India: Long-Term and Post-Reform Performance and the Emerging Challenge”, New Delhi: Institute for Studies in Industrial Development; and National Commission for Enterprises in the Unorganized Sector (2009), “The Challenge of Employment in India: An Informal Economy Perspective”, New Delhi: NCEUS. Table culled from ‘India Exclusion Report, 2013-14.

A large underemployed young population, a severe paucity of skills, a million migrating from rural to urban centres (India Labour Year Book, 2011-2012) every month in search of work, an ecosystem that has traditionally been inimical to business, the marginalisation of women in the labour force, cumbersome regulations that raise the cost of doing business – all these factors contribute to the increasing number of workers entering the informal sector. The size of the informal sector in India is a reflection of the inability of policymakers to encourage entrepreneurship and generate jobs in the formal economy.

Workers employed in the informal sector have little job security, no entitlement to social security payments and protection under labour laws. In the extreme case, they may lack



physical security. Forced labour in agriculture, mines and quarries, and small factories is, despite being illegal, widespread in India (India Exclusion Report, 2014).

### Labour Regulation

Labour regulation is on the concurrent list of the Indian constitution, making it the joint responsibility of the union government and state governments. This bifurcation of responsibilities and overlapping jurisdictions, coupled with regulations that are outdated and ill-suited to the 21<sup>st</sup> century or even the latter half of the 20<sup>th</sup> century, have created a confusing and an often opaque labour regulation structure, raising labour costs (Bhagwati and Panagariya, 2013). The complexity of labour regulation has substantially raised the cost of compliance. The Indian government itself has attributed the poor performance of manufacturing to stringent labour regulation (Economic Survey 2012-13).

The NCEUS survey revealed that over half of workers in the formal sector were employed informally. Despite low direct labour costs, complex labour regulations, especially employment protection legislation in the case of large firms, raises implicit costs and injects inflexibility into labour recruitment policies. Companies react to this uncertainty by substituting capital for labour, staying small, or relying on informal or “contract” labour (Dougherty, 2008). This has resulted in a distorted industrial structure amongst a cohort of developing and developed economies, with millions of small and tiny firms, and a small number of large firms, and very few mid-sized firms (Dougherty, et al. OECD, 2014). Ironically, legislation intended to protect labour’s interests may well be hurting labour in the longer run. By raising the cost of firing workers, sections of the Industrial Disputes Act (IDA) may well be inhibiting the growth of labour-intensive industries. This may well be undermining the ‘Make in India’ campaign. Chatterjee and Kanbur (2015) find a high incidence of non-compliance with the onerous requirements of the 1947 IDA, as firms either avoid compliance or remain informal. The resultant distortion in factor costs (higher implicit wage costs in a labour surplus economy) encourages companies to adopt capital intensive technologies. It also prevents enterprises from achieving economies of scale, rendering them uncompetitive in international markets. Unscrupulous contractors even employ children at lower wages and provide no safety equipment or protection in hazardous working conditions.

This should be a matter of concern to policymakers as it signals intent to evade regulation and detection of economic activity. In order to avoid high fixed costs associated with a permanent labour force, employers, from large automobile companies to local restaurants, employ workers on temporary contracts, often for periods as short as six months. The usual mechanism is to seek middlemen (employment contractors) to hire workers for fixed periods. These workers are not protected by labour laws. Rather, they are deemed employees of the contractors, with rights equivalent to those of casual labour. In this regime, the workers are deemed to be on their own, with no health, education and pension benefits, or even accident insurance offered beyond the contract period. The contractor's sole responsibility is to ensure the requisite labour is available and fulfils the assigned task.

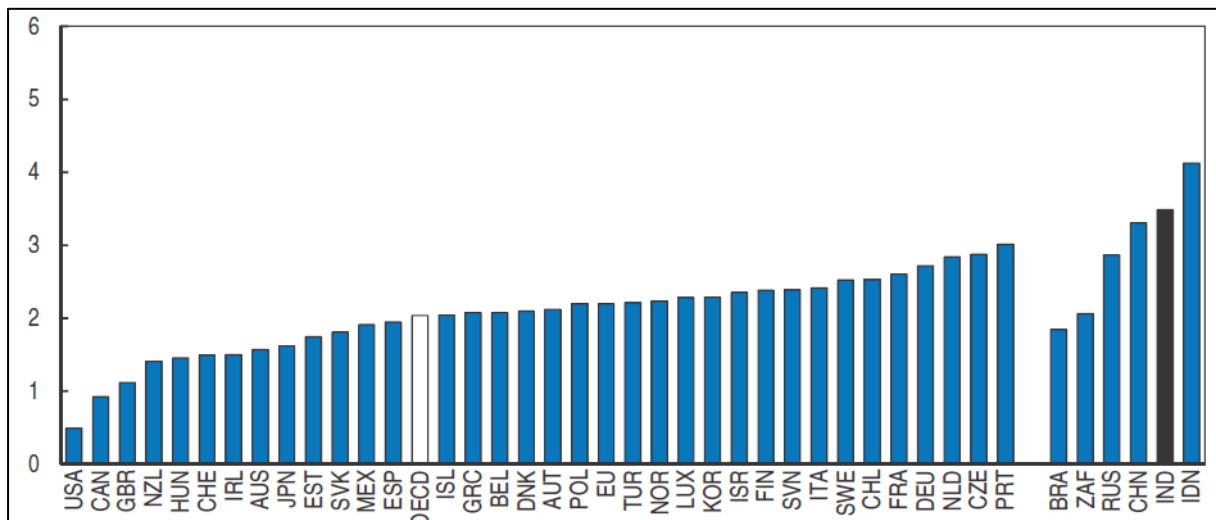
With a prior understanding, these workers are then laid off, and then re-employed at a different firm or at the same firm after a period where the contract would be construed as a new job. Companies, thus, evade high fixed costs and onerous labour market restrictions that require substantial benefits to be extended to workers.

#### Low Female Participation in the Formal Sector

Female participation in the labour force in India is amongst the lowest in the world and has declined further over the past decade. According to the ILO's Global Employment Trends 2013 report, female labour force participation rate in India fell from 37 per cent in 2004-05 to 29 per cent in 2010. India ranks 121 out of 131 countries surveyed. The low participation rate reflects latent gender bias, related sociological factors and diminishing opportunities. As incomes increase, the women may choose not to work. This is deemed to be a sign of social privilege. A rise in household incomes also results in the women opting out of the work force for domestic work. While these mores may be changing gradually, gender discrimination persists in recruitment and compensation. There are considerable differences across regions. The Southern and North-eastern states have higher female participation in the labour force. However, even in Kerala, a state with the highest literacy and gender equality in the country, Matthew (2015) finds a high incidence of skilled women dropping out of the labour force, discouraged by difficulties in finding work compatible with their skills and qualifications, and widening gender pay differentials.

Figure 3 shows the heavy dependence of women on informal work. In all sectors, more women than men depend on the informal sector for a livelihood. One of the most troubling sights across India is the sight of women at construction sites carrying loads of bricks on their heads while keeping an eye on infants and young children left nearby under open skies. The construction sector has absorbed a large part of the labour rendered surplus in the countryside but there has been no visible effort to improve work conditions.

**Figure 3: Highly restrictive employment protection legislation, 2013**



Note: The OECD indicator of employment protection legislation (EPL) for regular employment measures the procedures and costs involved in dismissing individual regular employees. The indicator runs from 0 to 6, representing the least to most restrictive EPL. The last available data refer to 2012 for BRIICS countries.

Source: OECD Employment Protection Database, 2013 update.

India has passed extensive legislations to eliminate labour market discrimination against women. However, weak implementation of these laws persists, resulting in a low ranking on measures on gender equity. The gender bias is reflected in India's poor ranking on the Organisation for Economic Co-operation and Development Social Institutions and Gender Indicator which measures institutionalised bias stemming from socioeconomic and religious factors (OECD, 2014).

### Micro-entrepreneurs

Rising rural incomes, migration to cities and the resultant agglomeration of workers in informal and formal urban areas create opportunities for providing basic services, including food, personal services and provision of basic household goods and services. These micro-

entrepreneurs may not aspire to grow their business beyond meeting the family's needs. They are too small to bear the high costs of registration and the benefits it offers but they fill an important gap due to missing markets for the urban poor. They remain vulnerable to harassment from the police and local city departments. The reasons for staying in this sector vary – low operating costs, flexibility in operations, low sunk costs, independence and a sheer inability to cope with the demands of registering a business. The businesses are generally deeply integrated with the local community and depend on its support for survival. Community support also imparts resilience. Business in this sector is driven by opportunity as well as need.

Micro-entrepreneurs and small-scale businesses are deterred from registering their activities for a host of reasons. Tiny entrepreneurs that have mobile vending operations, for example, selling prepared food, fruits or vegetables or providing basic household services, are unlikely to have the capital or will be deterred by high registration costs or regulations. Research has shown that these vendors are self-regulated. Repeat customers in the community compel them to maintain basic sanitary conditions and serve fare that appeals to their clientele. The incentives for self-regulation are strong. As an illustration, even in the poorest parts of Southeast Asia, the odds of a tourist falling ill due to unhygienic food are higher in restaurants than street food vendors.<sup>5</sup> This market segment needs a light approach to regulation, ensuring basic zoning, timing and sanitary conditions.

Studies by the ILO in Thailand, Cambodia and Mongolia (Kusakabe, 2006) indicate street vending is an important tool for keeping families out of poverty. In some areas, successful entrepreneurs have expanded business to launch franchises and formally incorporate the business. Because of their informal nature, these enterprises are always vulnerable to the risk of harassment from officials, and sometime even eviction. Access to finance, insurance and other potential benefits arising from the Prime Minister's Jan Dhan Yojana (Financial Inclusion Programme) may offer a palliative to these concerns.

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<sup>5</sup> Observation based on Lonely Planet reporting, travel blogs, and extensive personal experience. The high faecal content is a major cause of water contamination in India.

## Poverty

Despite impressive strides since 1991 in poverty alleviation, the incidence of absolute poverty and malnutrition in India is the highest among major emerging market economies. Coupled with low literacy levels and poor education outcomes, it has rendered large proportions of the labour force ill-equipped for modern manufacturing. The 2015 policy document on skills development points to the challenge of dealing with a large surplus of unskilled labour and “a paucity of highly trained workforce, as well as non-employability of large sections of the conventionally educated youth, who possess little or no job skills” (MSDE, 2015). With a small manufacturing sector, this leaves most workers dependent on the informal sector for livelihoods.

## **Concomitant of Early Stages of Development and Urbanisation**

Agriculture and the rural economy continue to play an important role in the Indian economy. As India grows, rural workers migrate to cities in search of better opportunities with the expectation of better lives for themselves and their children. Migrants move in search of better education, healthcare and economic advancement. No city has been able to plan for migration on this scale. Urban areas and urban planners, and policymakers are almost always ill-prepared for the surge of migrants. As a result, urban shantytowns and the informal sector grow. Large countries like China and India are experiencing the fastest growth in urban population and the informal economy in modern times.

## **Consequences of Informality**

### Impact on Productivity and Growth

Informal sector firms are inefficient compared to their formal sector cohorts. The lack of access to electricity, formal finance, advertising, government incentives not only raises the cost of doing business and reduces productivity. These firms are also unable to exploit economies of scale. In a comprehensive study of formal and informal manufacturing enterprises, Hasan et al.

(2012) find that the industrial landscape is dominated by small-sized firms. Amongst these, the firms in the formal sector were more productive. Labour regulations dissuade firms from consolidating; hence, inefficiencies are sustained over time. The firms remain small to evade stiff labour regulations. The study also found that larger firms are concentrated in states with flexible labour regulation.

Labour regulations have also created an incentive for firms to stay small and to rely on informal labour. Employment in firms with less than 10 employees accounted for 65 per cent of total manufacturing employment in 2011-12 (OECD, 2014), a large share by global standards.

Only 10 per cent of the labour force aged 15 to 59 is vocationally trained. In manufacturing, 10 per cent of those trained received formal vocational education, while in services, this share is 40 per cent. The rest receive non-formal on-the-job training. The skill deficit reflects the large size of the unorganised sector, which tends to have low-paid, low-productivity jobs with limited access to training. It is, therefore, important to target formal training also for the workers in the unorganised sector.

The inefficient utilisation of resources, low productivity and low levels of capital expenditure reduce potential for growth. The size of the informal economy can be seen as symptomatic of the pervasive regulatory and structural inefficiencies that permeate India, depriving hundreds of millions of a chance to a decent livelihood. While a large proportion of the informal sector could shrink as the economy develops, there is a large and visible segment that needs to be allowed to sustain. These are informal rural and urban markets, fuelled by gradual growth and the migration to cities in pursuit of better opportunities.

#### Impact on Poverty, Income Distribution and Opportunities for Women

The overall impact of the large informal sector on poverty and income distribution is complex. In retail services, trade the informal sector provides opportunities to the marginalised. For many women in disadvantaged socioeconomic groups, informal employment may be the only option for a subsistence level living. The informal sector is beneficial for women in the countryside but gender discrimination is pervasive, reflected in low labour force participation rates. Chen et al. (2004, 2005) believe that supporting poor working women can go a long way to reduce poverty and gender inequality.

The agricultural sector, as well as a large part of the urban economy, is characterised by endemic underemployment, seasonal employment and disguised unemployment. In agriculture, the demand for labour is high during planting and harvest of crops. In the intervening time period, when demand for the workers is low, labour has to compete for whatever work is available. The Mahatma Gandhi National Rural Employment Guarantee Act has fulfilled a critical role in providing meaningful work for 100 days a year.

Workers in informal manufacturing in large firms have some contractual protection but employment conditions for those in traditional smaller enterprises, including household enterprises, are determined almost unilaterally by the employer. Wages are considerably lower than in the formal sector with little or no protection. The preponderance of the labour force in the informal sector contributes to the high degree of inequality in the economy.

#### Inability to Access Finance and State Programmes

Informal enterprises are unable to access finance in the formal sector. Lacking a legal entity, they cannot produce collateral or any other form of guarantee. As a result, they are forced to tap far more expensive sources in the informal sector. This high cost of capital and the inability to access long-term sources of finance inhibit the firms' size and growth of productivity. These firms also cannot participate in government-sponsored programmes or avail of any incentives or benefits offered by the state.

### **Case for Formalisation**

Policymakers do not tread in areas where they cannot measure inputs and outcomes. The informal sector is bedevilled by such problems. However, rather than deny their existence, it may be time to think differently and accept the fact that the segment of the informal sector that engages in legal activities is here to stay. There is a pressing need for research on the 'why' and 'how' of informal sector activities. Extending basic protection to the workers in informal sector enterprises would be a useful start in helping mitigate the most egregious violations of rights.

Dichotomising the formal and informal sector carries little meaning in today's world and can even lead to counter-productive outcomes. There is a profound need for governments to recognise that the informal sector is an integral thriving part of the economy, certainly in the medium term. Over the longer run, with prosperity, as markets develop, regulatory abilities improve. The case for enterprises to formalise will acquire a rationale and momentum of its own.

### **Why is Research on the Informal Sector Important?**

The case for paying attention to the informal sector has been bolstered by recent research findings which show that, in many countries and across a number of sectors, informal activities contribute to income generation, help alleviate poverty and enhance the resilience of the households. Participation in informal activities is particularly beneficial to women in developing countries who require flexible hours to take care of their children. Informal activities also allow the multitudes of underemployed to find gainful work or income-earning activities.

The informal sector does not exist in isolation. The linkages with the formal organised economy are reflected in the value chains, for example, in the garments, handicrafts, food processing, hospitality and retail. One would be hard pressed to find a sector in which policy initiatives or developments in the domestic and global economies do not have an impact on the informal economy.

The informal sector is closely tied to the global economy. The prices of raw metals on the Chicago Board impact how much a family scavenging metals from machines and industrial waste can make (Boo, 2014). A rabbi in Israel declaring hair collected from Indian temples was not kosher and could not be used for wigs by Israeli women had a dampening effect on the incomes of hair collectors (Doron, 2015). The terror attacks in Mumbai in 2004 had a profound impact on food and street vendors in the region as well as on tourist traffic. The fall in the Russian ruble following sanctions imposed on Russia over the Ukraine crisis severely dampened Russian tourist arrivals in Goa – the mainstay of the local tourist economy – affecting tens of thousands depending directly and indirectly on tourism.



## **The Challenge for Policymakers**

Policy and regulatory initiatives have a direct impact on the level and type of activities in the informal sector. As economies grow, the proportion of GDP generated by the informal sector falls. This is attributed to more efficient institutions, especially regulatory institutions, and a better provision of public goods. Conversely, a large informal sector may be symptomatic of poorly functioning institutions that deter businesses from registering, low levels of development, lack of opportunities in the formal sector and rapid urbanisation.

Governments would prefer the growth of the formal sector as the latter can directly respond to policy initiatives, benefit from policy initiatives, grow and compete domestically and eventually in international markets. Thus, an understanding of why firms choose to remain informal is important. As discussed, large parts of the informal sector remain informal as a cost-benefit analysis of the informality suggests it is optimal for them to remain so.

As such, what should policymakers do? It is important to understand the reasons why firms opt for this sub-optimal status. The decision to stay informal is based on a cost-benefit calculus. The policymakers' challenge is to reduce the costs of formalising. The task is challenging. The heterogeneous nature of the informal sector and the varied causes underlying its growth in different economies warrant a deeper and clearer understanding of the factors that lead to growth of the informal sector and a granular approach to policy formulation.

The most vulnerable are the workers in irregular enterprises, for example, in privately-owned coal mines, quarries and construction. These workers, who sometimes have to queue up for jobs daily, face endemic uncertainty and have virtually no bargaining power. Without bringing these enterprises under the ambit of formality, there is a profound need for the state to step in to ensure minimum wages, safety and better living conditions for workers living on site. There are prescribed safety codes that apply throughout the economy. For millions of street vendors, tiny shops and mobile vendors, studies at the ILO provide useful insights. These enterprises are best left alone, subject to minimal regulation to ensure basic safeguards and facilities.

The Indian government has undertaken a series of reform measures, including simplifying procedures and creating a single window for clearance of new business. Info-communication

technology is increasingly used to expedite administrative matters and provide transparency in dealings with businesses and the public. The efficacy of these measures in inducing businesses to register formally will be known when they percolate down to the states and small cities.

## **What does the Future Hold?**

With one of the youngest demographic profiles in the world, the average age is predicted to be 29 by 2020, in contrast to 37 years in China, 45 years in Western Europe and 48 years in Japan, and a working population estimated to be nearly 500 million by 2022, India has a huge demographic dividend which could possibly enable it to rival China's remarkable growth experience over the past three decades. However, the challenges in productively deploying this huge cohort are formidable. Growth in formal employment has been slowing down, to the point where data shows that the period of fastest growth in post-independence history, 2004-10, was a period of nearly jobless growth. The growth in employment during that period was almost entirely in the informal sector.

As India develops, and migration to urban and semi-urban areas accelerates, the informal sector will grow further. Cross-country experience shows that informal urban settlements grow rapidly with overall economic growth, as workers and families move in search of jobs or opportunities to do business. Urban informal markets are an integral part of the landscape. Micro-entrepreneurs in this sector lack the capital or business wherewithal to register with the authorities. Studies by the ILO over the past 15 years have repeatedly shown that these markets fulfil an important social and economic function.

The prognosis for job creation in the global economy has been bleak for the past several years. Structural transformation, disaggregation of manufacturing, increasing automation and use of capital intensive technologies are all contributing to a low rate of job creation and a shift to value creation in the informal sector. This requires careful detailed research into labour market dynamics as well as the eco-system for entrepreneurship.

The global economy may indeed be going through a paradigm change as the effects of growth work in a different manner through factor markets and institutions. In developed as well as

developing economies, an incremental increase in output is leading to a lower rate of job creation. Few jobs are being created in the formal sector, and existing jobs in the formal sector are being pushed into the informal sector. Much of the shift of contractual and part-time work nudges the workers into the informal sector. For professionals, it may offer much desired flexibility, for blue collar workers and those beyond the purview of the formal sector, it implies low wages, endemic uncertainty and an inability to plan for the future with a degree of confidence.

These factors are contributing to increasing inequality within economies – a phenomenon that could result in increasing social instability. Even the International Monetary Fund has declared widening disparities as a critical threat to growth and stability. Trends in the developed and developing world point towards low rates of employment generation than expected from high growth rates in emerging markets, and a steady increase in the size of the informal sector.

Contrary to prior beliefs, growth policies do impact the informal sector directly as do changes in regulations and market conditions. There is a need for a clearer understanding of the effects of outsourcing, a shift to short-term contracts, indeed of the power relationship between the owners of capital and the owners of labour, and the sort of contractual arrangements that would lead to the highest social benefits. To do this in a meaningful manner, policymakers need to be in a position to assess how policy initiatives translate into action at the grassroots (enterprise and worker) level.

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