

LISTENING TO THE CALL OF THE INFORMAL

Relevant for: Indian Economy | Topic: Issues Related to Poverty, Inclusion, Employment & Sustainable Development

A second-hand clothes market in Kolkata. | Photo Credit: [NurPhoto](#)

A week after the Budget, it is clear that successive policies of the government over the years have left the informal sector stigmatised. The government and its policy advisers want to dress the sector up to their preferred versions of formality. However, in the process, they could dampen its growth potential, as two recent papers reveal.

In the first paper, published by the National Bureau of Economic Research, economist Seema Jayachandran argues that there is no strong evidence from studies conducted in many developing countries that formalisation improves business outcomes. In the second article, a background paper for the International Labour Organisation (ILO), economist Santosh Mehrotra calls formalisation an evolutionary process during which small, informal enterprises learn the capabilities required to operate in a more formal, global economy. He says they cannot be forced to formalise.

The key question here is: Who benefits from formalisation of informal firms? Formalisation does reduce the last-mile costs for banks. The state finds it easier to monitor and to tax the firms that adopt its version of formality. However, the process can also produce adverse outcomes for the informal sector firms themselves, as anthropologist James C. Scott explains in *Seeing Like a State: How Certain Schemes to Improve the Human Condition Have Failed*.

In India, which currently faces an unemployment problem, the informal sector provides the vast majority of opportunities both for its youth and for people coming off the farm to earn incomes. Hence, India's policymakers need to look at the demerits of formalisation from the perspective of informal sector enterprises.

Ms. Jayachandran's study reveals that most of the formalities imposed from above, while making it easier for the state and the formal sector to do business with the informal sector, add to the costs of the firms that outweigh the benefits of formalisation.

She also finds that informal firms are able to improve their ability to do business in various ways. For example, small entrepreneurs gain from forming effective associations with their peers. They benefit greatly from 'mentoring'. Skills of small entrepreneurs and their employees are best developed on-the-job. This is because they cannot afford the loss of income by taking time off for training. 'Soft' skills, to form associations, manage enterprises, matter as much for the success of the enterprises as 'hard' resources of finance and facilities. In fact, the productivity of enterprises depends on their soft skills.

There is a desire to connect small firms in India more firmly with global supply chains. Mr. Mehrotra points out that the primary motivation of multinational companies for expanding their global supply chains is to tap into lower cost sources of supply. Supply chains compete with each other. When wages and costs increase in their source countries, they look for other lower cost sources. The lowest cost firms at the end of supply chains are generally informal. Thus, the push by the state to formalise firms is countered by the supply chain's drive to lower its costs.

The thrust of the Indian government's policies should not be to reduce the size of the informal sector. Rather, it must be to improve working conditions for the citizens who earn incomes in the

sector. Their safety at work, their dignity, and their fair treatment by employers must be the thrust of any reform. Indeed, even in developed industrial countries, the informal sector is growing with advances in technologies, emergence of new business models, and growth of the gig economy. There too, policymakers are struggling to invent new systems to protect the rights of workers while maintaining the dynamism of an entrepreneurial economy.

Hence, India's jobs, incomes, and growth challenge necessitates a reorientation of policies towards the informal sector.

First, the government and its policy advisers must stop denigrating the informal sector and trying to reduce its size. Second, the development of an economy, from agriculture to the production of more complex products in industry, is a process of learning. Informal enterprises provide the transition space for people who have insufficient skills and assets to join the formal sector. Large schemes to provide enterprises with hard resources such as money and buildings, which the government finds easier to organise, are not sufficient for the growth of small enterprises.

Policymakers must learn how to speed up the process of learning within informal enterprises.

Third, policymakers must learn to support informal enterprises on their own terms. And they should not impose their own versions of formality on them for their own convenience. Making it easy for MNCs and large companies to invest will not increase growth of the economy if enterprises and incomes at the bottom of the pyramid do not grow. The voices of tiny entrepreneurs in the rural heartlands and on the fringes of Indian cities must be listened to while developing policies for 'ease of doing business'.

Fourth, networks and clusters of small enterprises must be strengthened. They improve the efficiency of small firms by enabling sharing of resources; they give them more clout to improve the terms of trade in their favour within supply chains; and they reduce the 'last mile costs' for agencies and providers of finance and other inputs to reach scattered and tiny enterprises.

Fifth, the drumbeat for labour reforms must be changed. A vocal crowd has been harping on the need for bold reforms to make it easier for employers to hire and fire workers. They advocate the raising of the size of enterprises (in terms of numbers of employees) to which laws should apply. These hire and fire laws are already not applicable to the small sector, where the vast majority of enterprises employ less than 10 persons. Hence, there is an urgent need for labour reforms in other ways. The laws should be simplified, and their administration improved. And, their thrust should be to improve the conditions of workers.

Finally, the social security framework for all citizens must be strengthened, especially for those who have to scramble for work in the informal sector. Health insurance and availability of health services must be improved, and disability benefits and old-age pensions must be enhanced. The purpose of 'labour reforms' must be changed to provide safety nets, rather than make the workers' lives even more precarious with misdirected attempts to increase flexibility.

Small enterprises need other forms of support to play their vital role in increasing employment and incomes at the bottom of the pyramid.

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