

Good news: The Indian economy is getting formalised

The new Economic Survey written by the team of finance ministry economists led by Arvind Subramanian provides compelling evidence of how the Indian economy is becoming more formalized. The reason this shift is important is not just because of the possibility of higher tax revenues for the government to spend; it is also about a profoundly different social contract between citizens and the state.

There are four key shifts that are mentioned in different parts of the Economic Survey.

First, the introduction of the goods and services tax (GST) has brought more firms into the tax net. The number of enterprises paying indirect taxes has gone up by 3.4 million, an increase of 50%. The bulk of the new entrants are enterprises that are in the business-to-business or export sectors, or what economists would call the production of intermediates.

Second, only around a quarter of the 240 million Indian working outside farms file their income tax returns. The controversial demonetization decision taken in November 2016 seems to have led to a statistically significant increase in the number of new income tax filers, after controlling for obvious problems such as the previous trend as well as seasonal patterns of change.

Third, the Indian workforce is more formalized than most people believed till recently. Nearly a third of the non-farm Indian workforce of 240 million has some social security coverage. And more than half of the non-farm workforce is employed in firms that now pay taxes.

Fourth, the demonetization shock is one reason—and perhaps not the only reason—why Indians are putting a greater proportion of their savings in the formal financial sector. Bank deposits swelled after November 2016, though the booming stock market has also made financial savings through mutual funds more attractive compared to gold or real estate.

These four shifts—more firms paying indirect taxes, more individual filing income tax returns, a big increase in the proportion of formal jobs and the increase in savings in the formal financial sector—can have profound effects on the Indian economy if they are sustained. It is quite likely that these claims will be the source of heated debate in the coming weeks.

It is useful to point out that much of the data offered by the finance ministry comes from the GST system, rather than from surveys. The mining of GST data is part of the welcome introduction of Big Data into Indian policy discourse. The Economic Survey released a year ago had similarly used Big Data and satellite images to estimate issues as diverse as interstate migration to the extent of Indian urbanization. The finance ministry economists deserve kudos for their methodological innovations.

What does such an overdue shift to formal economic activity potentially mean?

The Indian nation state sits on a very weak fiscal base. It is neither able to invest in national security or provide public goods or create a social security system without running up destabilizing fiscal deficits. A careful [data analysis](#) by Tadit Kundu and Primit Bhattacharya that was recently published in this newspaper showed that India has a tax-to-GDP ratio that is broadly similar to what other countries had at a similar stage of development. The question is whether that ratio can be increased as India gets richer, which is difficult unless more economic activity moves into the formal sectors. The new data offers hope.

However, the issue is not just about fiscal capacity. Modern social contracts are built on a wide

base of tax payers. Almost all Indians pay regressive indirect taxes but too few of us pay progressive direct taxes. This newspaper hopes that more direct tax payments by individuals as well as enterprises will not only create fiscal space for lower GST rates but also provide incentives for citizens to demand better governance.

It is quite possible these four changes will lead to partisan debate about whether the formalization of the Indian economy can be explained by the two big policy risks taken by the Narendra Modi government—demonetization as well as the decision to push for a compromised GST. These debates will generate more heat than light. What is far more important at this juncture is to look at the claims made in the new Economic Survey more closely, ask how the process of formalization can be accelerated and figure out what the deeper effects of this overdue change is.

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