A brave new India

The Narendra Modi government is ushering in a fundamental shift in the relations between the state and the informal economy. The tentacles of the state are now reaching deep into the informal sector.

The vast majority of Indian businesses are in the informal sector. The Sixth Economic Census found that 94.6% of non-agricultural establishments in the country employed five workers or less. Two-thirds of all non-agricultural businesses were what the census termed “own account establishments”, which means they didn’t hire any workers.

As the population grew and farms became subdivided into smaller and smaller fragments, agriculture became a losing proposition for most farmers, who were forced off the land to migrate to city slums, or they scratched out a precarious living by supplementing their income by wage labour or by setting up petty businesses, or they took their own lives. The huge informal sector is, for the most part, a vast sink of disguised unemployment, a reflection of the failure of the formal sector to create jobs for the masses. It is a symptom of the arrested development of Indian capitalism.

As capitalism develops, the informal sector is supposed to wither away. Its stubborn persistence is a scandal. The theory was that as the economy grows, the informal sector would shrink and people would find better and more productive employment in modern industry and services. Alas, reality for most latecomers to industrialization is a far cry from that rosy picture.

The postcolonial Indian state has always had an ambivalent relationship towards the informal sector. While the earlier reservations for small industries have been withdrawn, the state still helps through bank lending, interest subventions, the occasional farm loan waiver and the provision of welfare services and schemes such as the rural jobs guarantee programme. On the other hand, it views the sector as an outmoded relic and often attacks it through dispossession. But the dominant attitude has so far been benign neglect for small capitalists and malign neglect for workers. The government ignores the terrible work conditions in most informal enterprises, while turning a blind eye to widespread tax evasion. The Modi government is set to change all that—it isn’t bothered about work conditions, but wants to make petty capitalists pay their dues to the state.

The informal sector is linked in many ways to the formal segment of the economy. Many small firms do work that is contracted out by large companies. Some are suppliers to large units. Companies in the organized sector benefit from the low labour costs in the informal economy and from its flexibility. Small traders sell products manufactured by the formal sector. Informal enterprises have their own hierarchy and the bigger businessmen among them are by no means poor. Many of them have been able to accumulate substantial surpluses, as well as indulge in conspicuous consumption.

These businesses have been the worst hit by demonetisation and the goods and services tax (GST) and by the attempts to clean up real estate. While the demonetisation shock was one-off, GST with its self-policing mechanism and its clear audit trail is a big threat to these firms and traders.

It’s no wonder that they have been the most vocal protestors against the new tax. The real problem for them is not so much high tax rates or cumbersome procedures, but how to suddenly report profits that are in excess of last year’s declared revenues.

One consequence of the introduction of GST and some of the other measures to tackle black money will be increased market share for the corporate sector. Stockbrokers have been celebrating the opportunities opened up. A Citibank research report says: “The Indian government’s ongoing structural initiatives (and the GST rollout) will accelerate the transition toward the organized sector. Moves towards a less-cash economy, indirect tax changes through GST, direct tax compliance, e-commerce, and some progress on labour law reforms, among others, will prove disruptive to traditional structures in the medium term and result in accelerated formalization as well as economies of scale in the long term.” It’s no surprise that big business has backed these changes to the hilt.

A report by India Ratings says that small and medium units will be hit by GST due to their weak credit profile. While larger firms will benefit from a seamless national market and more rational warehousing, small businesses will see a rise in working capital requirements. But quite a few firms straddling the formal and informal economies will successfully migrate to the organized sector, albeit with some loss of surplus. This will include firms that act as suppliers to companies in the organized sector and many export units.

Many small firms, however, could go belly-up, as their costs rise and they become uncompetitive.

These units have little capital, borrow at exorbitant rates, have no economies of scale and use obsolete technology. The Sixth Economic Census said that 78.2% of non-agricultural enterprises were self-financed. It would be a leap of faith to expect these firms to suddenly acquire the capital and the skills to compete in the formal sector.

A fallout of the attack on the informal economy will be a loss of jobs as some of the less nimble firms flounder. That could affect demand. Reports are already trickling in of job losses in small enterprises. These workers don’t have the skills to find employment in the formal sector. In any case, the capital-intensive formal sector has a dismal record in job creation and is increasingly hiring contract workers.

This victory of corporate capital is therefore likely to result in increasing distress for workers in the informal economy. If the distress is widespread enough, the government will remember it needs votes and it may use some of the increase in tax revenues it hopes to get to boost public works. Many will slip through the cracks, especially as some of the cracks may become gaping holes. But in the march towards a Brave New India, they are mere collateral damage.

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