Reviving the informal sector from the throes of demonetisation

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2017-2-28

*While recent measures announced by the government indicate some awareness of the hardships inflicted on the informal sector by the note ban, more needs to be done. In this article, **Kaushik Bhattacharya**, **Siddhartha Mitra**, **Sarmistha Pal** and **Bibhas Saha** summarise the emerging evidence on the significant adverse impact of demonetisation on the informal sector, and suggest policy measures to ensure a steady recovery.*

More than three months have passed since the announcement of demonetisation. While we appreciate the government's intentions behind the move, we cannot overlook the real hardships inflicted, particularly on the informal sector. In view of the overwhelming evidence of such pain (that is also consistent with economic arguments), we discuss the inadequacy of recent government responses, and recommend some urgent remedial measures. We feel that these measures are necessary to ensure that the pain is only transitory and does not spill over to the formal sector and impede the projected economic recovery.

Informal sector

If defined as consisting of hired labour and self-employed individuals working in the unorganised sector (unregistered enterprises) as well as wage and other casual labour working in the organised sector, the informal sector accounts for 92% of total employment and about 50% of GDP (gross domestic product). The significant capacity of this sector for employment generation – especially at a time when the formal sector is experiencing jobless growth and facing considerable domestic and international challenges – necessitates its revival.

Largely excluded from the formal financial world, the informal sector falls mostly outside the ambit of digital transactions. The demonetisation move on 8 November 2016 withdrew 86% of the cash in the economy; however, remonetisation in the immediate post-ban period has been extremely slow, resulting in significant adverse implications for expenditure, especially of low-income households and small business units. Digital payments constitute only a partial solution to the problem as there is still a strong case for sustaining small-value transactions in cash, especially by the poor. While it is premature to assess the benefits of digitalisation and demonetisation, the substantial costs borne by this sector need closer attention before rushing to policy formulation, especially because short-term changes in the sector are beyond the government radar.

Economic arguments

Textbook macroeconomics does not point to major economic benefits of the note ban. Accordingly, economists Dipankar Dasgupta (Ashoka University) and Amartya Lahiri (University of British Columbia) use the aggregated demand-supply framework and the money supply equation respectively, to highlight that demonetisation will lead to a significant reduction in the growth rate of GDP. Amartya Lahiri estimates this reduction to be 1.5-2 percentage points (from a base level of 7.6% in 2015-16) while Ashok Lahiri (National Institute of Public Finance and Policy (NIPFP)) has estimated a drop of 0.7–1.3 percentage points. Arvind Subramanian, the government's Chief Economic Adviser, has lowered the growth projection to 6.5% (slightly lower than the International Monetary Fund forecast, and 0.6 percentage points lower than government's earlier projection) for 2016-17. This estimate, however, does not account for the recessionary impact of demonetisation and, therefore, the actual growth rate for the year is likely to be much lower – probably around 5%.

Arguably, the growth rate of the informal sector would be even lower because of the predominant use of cash in sales and purchase in this sector, and its overwhelming dependence on informal cash credit (that equalled 40% of total formal bank lending and 26% of GDP before the note ban), which has now reportedly dried up. In fact, economic reasoning suggests that all major economic variables (example, prices and profit incomes; wage and employment rates; input and infrastructure expenditures; and expenditures on essential items, consumer durables, and health and education) would be affected adversely. Further, strong backward and forward linkages imply that the informal economy would be entrapped in a vicious recessionary cycle. The growth expectation for the sector in the post-demonetisation period would therefore be low – possibly negative.

Emerging evidence

The above propositions are not just based on armchair theorising, but are supported by newspaper reports and independent surveys. In Ranchi, a survey led by Jean Drèze (Delhi School of Economics and University of Ranchi) reports a 45% decline in earnings of small shopkeepers/businesses; in Amritsar, Prateek Sibal (Paris Institute of Political Studies) reports a similar figure of 46%. In Delhi, a survey of small shopkeepers and casual labourers by Vyom Anil (Jawaharlal Nehru University) finds a much larger drop in average income about 60%. Another study for Delhi, by social activist Harsh Mander, points to a 60% cut in supply of jobs to labourers, a decline in wages, and loss in profits for small shops.

In Mumbai, Deepa Krishnan (SP Jain Institute of Management) and Stephan Siegel (Michael G. Foster School of Business, University of Washington) report a very significant loss of 44% in the earnings (relative to the pre-note ban period) of the self-employed in slum areas. Some of the surveys also indicate huge income losses for casual workers: 50-70% in Jaipur (conducted by PUCL Rajasthan), and 72% among domestic workers in Delhi (by Vyom Anil). A larger survey by India Development Foundation (IDF) covering nine states asked owners of small and medium enterprises (SMEs) whether there were output and job losses (Chaddha et al. 2017). With regard to output loss, 61% of respondents in Telengana, 94% in Andhra, and 80% in Gujarat answered in the affirmative. For job losses, the corresponding incidence was similar in Telengana and Gujarat, slightly lower in Andhra, but very high in Uttar Pradesh (87.5%), which also saw significant wage decline.

The income losses reported by these independent surveys are large and mutually consistent. There is also no sign of remission over the weeks since demonetisation; some newspaper reports even suggest that the ban is biting more with the passage of time and there are spillover effects on the formal sector. These adverse changes have been accompanied by a 60% spike in the demand for MNREGA (Mahatma Gandhi National Rural Employment Guarantee Act) work in December 2016 (as per report of the Ministry of Rural Development), confirming the accuracy of independent surveys, and necessitating urgent policy action.

Way forward

While the government announcements on 31 December and 1 February reflect some awareness of the pain suffered by the poor, there are some obvious inadequacies. We, therefore, recommend three palliative policies for immediate implementation, using the existing economic and financial infrastructure. Otherwise the poor – hard hit by the ban – would not be in a position to take advantage of government's proposed investment in credit markets, infrastructure, and housing.

Increase supply of formal finance

Given the drying up of informal finance, there is an urgent need to expand the reach of formal finance to prospective borrowers in rural and semi-urban areas. Unfortunately, government response in this respect has been inadequate: all the announced policies for helping small and medium farmers and small businesses cater to those with bank accounts or Kisan credit cards[1]. While the impetus provided to cashless payments is desirable, we strongly believe that forcing poor people to adopt the cashless mode in making small transactions is not only unfair but might crash the economy. Given that only about 50% of Indians have bank accounts and 40% of the rural Indian population

(27.2% of total Indian population) does not have access to banking services, the announced policies appear vacuous. Thus, measures to expand the reach of formal finance to rural and semi-urban areas are urgently needed to break the vicious recessionary cycle. These would involve, among others, a simplification of the procedures for applying for bank accounts and loans, introduction of mobile ATMs, promotion of financial literacy among the poor, and enhancement of the role played by microfinance institutions.

Given that it may take time for the rural credit market to boost investment, output, and employment, there is also a need to adopt measures that provide immediate safety nets against losses of jobs and incomes (which in turn cause losses in consumption, nutrition, and health). Therefore, we make two further recommendations.

Raise MNREGA entitlement

MNREGA is a well-run social security measure in operation since 2005 that offers at least 100 days of wage employment in a financial year to every household whose adult members volunteer to do unskilled manual work. Given the 60% increase in demand for MNREGA jobs after the note ban (associated with an estimated 50% loss, on average, in informal-sector earnings and casual jobs), the latest budget announcement of a 25% increase in allocation to MNREGA seems woefully inadequate. Our recommendation would be to increase MNREGA employment guarantee from 100 to 150 days, with a doubling of 2016-17 budgetary allocation immediately.

Expand PDS

The expansion of MNREGA needs to be accompanied by augmentation of subsidised essential supplies to the rural and urban poor through the Public Distribution System (PDS), which has a proven track record of providing relief to the poor. This would help in raising the level of consumption, nutrition, and quality of life almost instantly and also enable the poor to undertake other expenditures, thereby generating direct and indirect economic benefits.

While these short-term recommendations will impose a temporary strain on public finances, we believe that they will boost both demand for and supply of output over time, thus arresting the downward spiral of the informal sector (and also the overall economy) following the note ban.*Note:*

1. The Kisan Credit Card (KCC) programme was introduced in India in 1998. Initially, it was just meant to be a credit line with a bank where farmers had to visit a bank branch to withdraw cash and use it at their discretion. Eventually, it graduated into a full-fledged credit card with features such as ATM withdrawal and the ability to swipe at the point-of-sale. The idea was to give out these cards to farmers all over the country with the objectives of providing easier access to credit via simpler eligibility norms, more flexible credit via looser monitoring criteria, and cheaper credit via lower interest rates.

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The authors are grateful to Jean Drèze and Udayan Roy for their comments on an earlier draft. This article originally appeared on Ideas for India and is posted with the Editor's permission. It gives the views of the authors, and not the position of the South Asia @ LSE blog, nor of the London School of Economics. Please read ourcomments policy before posting.

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