



The informal sector in India: Boon or bane for developing economies?

Dr. Sharmila Ahlawat

Associate Professor, Department of Economics, Government P. G. College Ambala Cantt, Haryana, India

Abstract

This paper examines the dual nature of India's informal sector as both a potential driver of economic growth and a challenge to sustainable development. Using data up to 2022, we analyze the informal sector's contribution to employment, GDP, and social welfare, while examining its limitations regarding productivity, worker protection, and tax base expansion. The paper highlights how the COVID-19 pandemic exposed vulnerabilities within India's informal economy and explores policy options that could maximize benefits while mitigating drawbacks. We conclude that the informal sector plays an essential but transitional role in India's development pathway, requiring calibrated formalization strategies that preserve employment while enhancing productivity and protection.

Keywords: Informal sector, economic growth, sustainable development, formalization strategies, COVID-19 pandemic

Introduction

The informal sector comprises economic activities that operate outside formal institutional boundaries, government regulation, and taxation systems. In developing economies like India, this sector represents a substantial portion of economic activity and employment. The International Labour Organization (ILO) estimates that over 80% of India's workforce participates in the informal sector, contributing approximately 50% to the national GDP (ILO, 2022).

The persistent dominance of informality presents a paradox for policymakers. On one hand, the informal sector provides livelihoods for millions who would otherwise face unemployment in the formal economy. It offers flexibility, acts as a social safety net, and demonstrates remarkable resilience during economic downturns. On the other hand, informality presents significant challenges to economic development, including low productivity, limited access to finance, poor working conditions, and constraints on government revenue generation.

This paper investigates whether India's informal sector should be viewed primarily as a boon—providing employment opportunities and economic flexibility—or as a bane—limiting productivity growth and perpetuating vulnerability. We analyze this question through multiple dimensions including employment, productivity, social protection, revenue generation, and crisis resilience, with particular attention to impacts through 2022.

Literature Review

The academic discourse on informality reflects evolving perspectives. Early theorists like Lewis (1954)^[16] and Hart (1973)^[10] viewed the informal sector as a transitional phenomenon that would diminish with economic development. However, subsequent research has shown remarkable persistence of informality despite economic growth (Chen, 2012).

The "dualist" perspective (Fields, 2004) frames the informal sector as a disadvantaged segment disconnected from the modern economy. In contrast, the "structuralist" view (Portes *et al.*, 1989)^[24] sees informality as integrated with formal enterprises through subcontracting relationships that reduce costs for formal firms while maintaining precarious conditions for workers.

The "legalist" perspective, championed by de Soto (1989), attributes informality to excessive regulatory burdens that exclude small entrepreneurs from formalization. Meanwhile, the "voluntarist" approach (Maloney, 2004)^[17] suggests that many workers and firms choose informality to avoid taxation and regulation.

Recent literature increasingly recognizes the heterogeneity within the informal sector (Chen, 2012; Kanbur, 2017)^[13]. Some informal activities represent "survival entrepreneurship," while others display "growth entrepreneurship" with productivity levels approaching formal enterprises (LaPorta and Shleifer, 2014).

In India specifically, scholars like Harriss-White (2003)^[9] and Kannan (2009)^[14] have documented how informality interacts with social structures including caste, gender, and regional disparities. Recent work by Mehrotra (2019) and Srivastava (2020)^[25] has mapped the impacts of economic reforms and the COVID-19 pandemic on India's informal workforce.

Methodology and Data Sources

This paper employs a mixed-methods approach combining quantitative analysis of secondary data with qualitative insights from existing case studies. Primary data sources include:

1. Periodic Labour Force Survey (PLFS) data from the National Sample Survey Office (NSSO) for 2017-2022
2. Annual reports from the Ministry of Micro, Small and Medium Enterprises (MSME)
3. Economic Survey of India (2018-2022)
4. ILO databases on informal employment
5. World Bank Enterprise Surveys
6. Studies from the National Commission for Enterprises in the Unorganized Sector (NCEUS)
7. E-Shram portal registration data for informal workers (2021-2022)

We analyze trends in employment, productivity, wages, and working conditions, with particular attention to sectoral and regional variations and the impacts of major policy interventions like demonetization (2016), GST implementation (2017), and COVID-19 response measures (2020-2022).

The Indian Informal Sector: Size and Structure

1. Definition and Measurement

In the Indian context, the informal sector is typically defined as consisting of unincorporated private enterprises owned by individuals or households engaged in the production and sale of goods and services operated on a proprietary or partnership basis with fewer than ten total workers (NCEUS, 2008). Informal employment extends beyond the informal sector to include unprotected jobs in formal enterprises.

2. Size and Contribution

According to PLFS data for 2021-2022, approximately 83% of India's workforce remains employed in the informal sector (NSSO, 2022), representing about 390 million workers. The sector's contribution to GDP is estimated at 43-44% as of 2022, showing a slight decline from pre-pandemic levels of approximately 50% (Economic Survey of India, 2022).

3. Sectoral Distribution

Agriculture continues to host the largest share of informal workers (around 44%), followed by services (35%) and manufacturing (21%). Within non-agricultural sectors, construction, retail trade, transportation, and household services represent major employers of informal labor (PLFS, 2022).

4. Regional Variations

The concentration of informality varies significantly across Indian states. States like Bihar, Uttar Pradesh, and West Bengal show informality rates exceeding 90% of the workforce, while states like Kerala, Tamil Nadu, and Maharashtra exhibit relatively lower rates (75-80%). Urban informality (approximately 75%) is lower than rural informality (88%), though urban informal workers often face higher costs of living (PLFS, 2022).

The Informal Sector as a Boon

1. Employment Generation

The informal sector's most significant contribution is its capacity to absorb labor that the formal sector cannot accommodate. With approximately 10-12 million new entrants to the workforce annually and formal job creation averaging only 2-3 million per year (CMIE, 2022), the informal sector provides critical livelihoods for those who would otherwise be unemployed.

2. Low Barriers to Entry

The informal sector provides entrepreneurial opportunities with minimal capital requirements and without formal educational qualifications. This accessibility is crucial in a country where approximately 74% of the workforce lacks secondary education (PLFS, 2021).

3. Economic Flexibility and Resilience

The informal sector demonstrates remarkable adaptability to changing economic conditions. Unlike formal enterprises constrained by regulatory frameworks, informal businesses can rapidly adjust their operations, products, and labor utilization. This flexibility was evident during the first wave of COVID-19, when many informal enterprises shifted to producing masks, sanitizers, and other essential items.

4. Social Safety Net Function

In the absence of comprehensive social security systems, the informal sector functions as a social safety net. Extended family networks often operate informal enterprises together, sharing risks and resources. This social insurance function was critical during the pandemic when approximately 32 million jobs were lost in the formal sector between March and August 2020 (CMIE, 2020).

5. Cost Advantages and Market Access

Informal enterprises provide goods and services at lower costs, making essential products accessible to lower-income consumers. Street vendors, for instance, provide affordable food to urban workers, while informal manufacturing units produce low-cost alternatives to branded products.

The Informal Sector as a Bane

1. Low Productivity and Limited Growth

Productivity in India's informal sector is estimated at only 10-15% of formal sector levels (Economic Survey, 2021). This productivity gap stems from limited access to capital, technology, and markets. Small-scale operations prevent economies of scale, while informal firms' inability to enforce contracts limits their growth potential.

2. Precarious Working Conditions

Informal workers face significant deficits in decent work conditions. PLFS data (2021-2022) indicates that 71% of informal workers lack any written contract, 54% receive no paid leave, and 52% have no social security benefits. Average wages in the informal sector are approximately 50% lower than in the formal sector for comparable skills (ILO, 2022).

3. Limited Tax Base

The large informal economy constrains government revenue generation. India's tax-to-GDP ratio stands at approximately 17% as of 2022, significantly below the OECD average of 34%. This limited fiscal capacity restricts public investments in infrastructure, education, and healthcare necessary for long-term development (Ministry of Finance, 2022).

4. Restricted Access to Credit and Capital

Informal enterprises typically operate outside the formal financial system. Only about 16% of MSMEs have access to formal credit (MSME Ministry, 2022), forcing reliance on informal lenders who charge interest rates ranging from 24% to 120% annually. This credit constraint limits investment, innovation, and expansion.

5. Environmental and Regulatory Concerns

Informal enterprises often operate without environmental safeguards, contributing to pollution and resource degradation. Studies of informal manufacturing clusters show significantly higher levels of untreated effluents and hazardous waste compared to formal counterparts (Central Pollution Control Board, 2020).

Impact of Recent Developments (2016-2022)

1. Demonetization and GST Implementation

The 2016 demonetization and 2017 GST implementation created significant short-term disruptions for informal enterprises. Cash-dependent informal businesses reported 20-50% revenue declines during demonetization (NCAER, 2017). GST compliance costs disproportionately affected smaller businesses, though the composition scheme provided some relief for enterprises with turnover below ₹1.5 crore.

2. COVID-19 Pandemic Impact

The COVID-19 pandemic exposed the vulnerability of informal workers. During the national lockdown (March-May 2020), approximately 91% of informal workers experienced income losses averaging 50-80% of pre-pandemic earnings (Azim Premji University, 2021)^[1]. The pandemic triggered reverse migration of an estimated 30 million urban informal workers to rural areas (ILO, 2021).

Recovery has been uneven, with urban informal employment still 5% below pre-pandemic levels by December 2022, while rural informal employment exceeded pre-pandemic levels by 3%, indicating distress-driven participation in agricultural activities (CMIE, 2022).

3. Digital Transformation and Formalization Efforts

Recent years have witnessed accelerated digital adoption among informal enterprises. By 2022, approximately 37% of informal businesses reported using digital payment systems compared to just 11% in 2018 (MSME Ministry, 2022). The e-Shram portal registered over 280 million informal workers by December 2022, creating the first comprehensive database of the informal workforce.

Policy Approaches and Recommendations

1. Graduated Formalization Strategy

Rather than pursuing rapid formalization that might threaten livelihoods, policies should adopt a graduated approach. This includes:

- Simplified registration procedures with incentives rather than penalties
- Tiered compliance requirements based on enterprise size and capacity
- Transitional support for enterprises moving toward formalization

2. Enhancing Productivity Within Informality

While working toward long-term formalization, policies should support productivity improvements within the informal sector through:

- Cluster development approaches for informal enterprises
- Technology access programs and skill development initiatives
- Market linkage platforms connecting informal producers to formal markets
- Formalization of land tenure and business premises rights

3. Extending Social Protection

Decoupling social protection from employment status is essential for protecting informal workers. The expansion of programs like:

- Universal health coverage through Ayushman Bharat
- Portable benefits accounts linked to e-Shram registrations
- Contributory pension schemes with government matching for informal workers
- Targeted income support during economic shocks

4. Differential Approach by Subsector

Policies should recognize the heterogeneity within the informal sector:

- For subsistence enterprises: Focus on social protection and basic services
- For growth-oriented informal enterprises: Emphasize access to finance, skills, and markets
- For wage workers in informal enterprises: Strengthen labor protections and portable benefits

5. Leveraging Digital Infrastructure

India's digital public infrastructure offers opportunities for inclusive formalization:

- Integration of e-Shram with direct benefit transfers and credit provision
- Digital platforms for informal service providers with rating systems and dispute resolution
- Simplified GST compliance tools designed for semi-literate operators
- Mobile-based skill certification and job matching for informal workers

Conclusion

The informal sector in India represents neither an unmitigated boon nor an absolute bane for economic development. Rather, it plays a complex, multifaceted role that evolves with the country's development trajectory. In its current form, the informal sector provides essential livelihoods for hundreds of millions while also constraining productivity growth and perpetuating vulnerability.

Our analysis suggests that the policy approach should neither idealize informality nor demonize it, but rather recognize its transitional role in India's development pathway. The optimal strategy involves selectively formalizing aspects of informal activity—particularly those related to social protection, financial inclusion, and skills recognition—while preserving the employment-generating and flexible characteristics of the sector.

The evidence through 2022 indicates some progress in creating bridges between formal and informal economies, particularly through digital initiatives. However, the pandemic highlighted the urgent need to strengthen social protection systems for informal workers while maintaining their livelihood opportunities.

Future research should focus on identifying the specific conditions under which formalization benefits different segments of informal workers and enterprises. Additionally, more granular analysis is needed to understand the interactions between informality and other structural features of the Indian economy, including caste dynamics, gender disparities, and regional inequalities.

As India pursues its ambition of becoming a developed economy by 2047, managing the transition of its vast informal workforce represents one of its most significant challenges and opportunities. The success of this transition will substantially determine whether economic growth translates into inclusive development.

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