Formalization: Have Demonetization, GST helped?

Renu Kohli*

Formalization has been in focus in India for more than a year. Widely understood as a process that is organized, regulated, taxpaying and operating through official mechanisms, formalization or formality is distinguished by these attributes from the informal sector, which is often characterized as avoiding taxes and regulations. In India, cash transactions serve as the key operational mechanism for the latter. Literature[1] points to other distinctions such as educated entrepreneurs, managerial and technological knowhow that enable scale efficiencies and make formal firms highly productive. Against this, informal enterprises are small and micro, manned by typically uneducated entrepreneurs, lack capital and skills, adding little value therefore. Formalization, which involves transition and change of the informal sector, is thus viewed by many as a positive development: an efficient, productive formal sector is perceived as the main driver of growth (Farrell, 2004, *McKinsey Global Institute*).

In India, formalization surfaced into the spotlight after demonetization in November 2016, and then at the institution of goods and services tax (GST) system. Both, it was argued, would accelerate formalization of the economy to several advantages. The enforced withdrawal of currency would bend public behaviour by depriving agents required amounts of cash to execute transactions, thus pushing them to transact in non-cash modes of payments and transfers. Official recording of activities would then rise, widening the tax base and increasing revenues, apart from additions to GDP growth from productivity gains in the medium-term from enhanced aggregate efficiency. The GST system too is expected to induce a somewhat similar shift to legal channels through its design – interlinked input credit claims accrued at each rung of the supply chain - and electronic platform for executing all transactions.

Formalization is anticipated through two key shifts as result of these changes. One, drawing in informal or unregulated firms into the official mainstream; two, an increase in the existing size of the formal sector from expanded market shares as informal ones at the margin become uncompetitive. It is obvious the above changes would cause the cash intensity of the economy to decline as more economic transactions are executed through banks, or formal financing system. In other words, the currency in circulation would be at least one critical indicator of formalization.

This article examines India's progress at formalization through the prism of this particular monetary aggregate. In the next section, it discusses formalization in the development process and the available international evidence on reduction of informality. Thereafter, trends in currency in

*Consultant-Economist and former staff member, IMF & RBI

[1]La Porta and Shleifer, 2014 provide a comprehensive overview

circulation or CIC are analyzed. India's informal economy and cash-dependency is considered thereafter, while the concluding section makes an attempt to interpret the return of currency to pre-demonetization levels to assess where formalization stands.

I. Does the Informal Economy Formalize? International Evidence

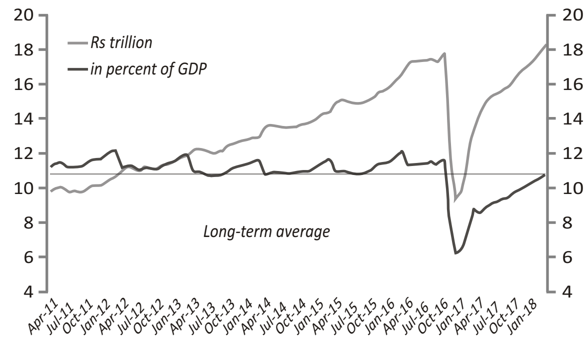
La Porta and Shleifer (LPS, 2014) have considered the important question of shrinking of the informal economy in developing economies. After collating the findings of numerous studies and two decades of *World Bank Enterprise Surveys,* they arrive at two important insights on formalization: One, the informal sector rarely, if ever, transits to formal. Two, formalization is essentially demand-driven, which is by consumers' preferences for high-quality, higher-priced products as per capita incomes rise. Formalization accompanies the level of economic development and rising incomes. And concomitant with this process, the informal sector gradually dies out as rising income levels reduces demand for inferior goods produced by this sector.

Five critical facts about the informal economy derived by LPS provide the rationale of this process.

1. **The informal economy is huge in developing countries,** with a typical 30–40 percent share in total economic activity and the highest employment shares in the poorest countries. Informal economy shares fall to 15-20 percent in the richest quartile countries.
2. **Informal firms are small, unproductive and stagnant because of human capital, not size.** The median productivity difference between informal and formal firms is 15 percent; informal firms the same size added just 21 percent of value per employee of formal ones. Such low productivity reflects very low quality products sold at low prices to low-income customers; a small fraction, 14 percent, sold its output to formal firms (Enterprise Surveys). Given a chance, many informal entrepreneurs would shut their businesses and work as formal sector employees, pay income tax. But few have this opportunity.
3. **Regulation is not what keeps informal firms down.** Lack of access to finance is the biggest obstacle because informal entrepreneurs lack skills, business and accounting systems that banks value for credit appraisal. Land is another reason, partly because of illegal occupation and fear of eviction. Regulation, taxes are way lower concerns than corruption, electricity, licence-permits and crime. Informal firms think the biggest benefit of registration is financial access!
4. **Informal firms rarely become formal, almost never.** They start out and die in informality. By contrast, the majority of registered or formal firms started off as registered. Informal businesses are not 'reservoirs of entrepreneurial energy' but rather, 'swamps of backwardness", according to LPS. But they allow their owners to survive.
5. **As countries develop, informality becomes less important.** The informal economy as measured by the degree of self-employment (a proven, reliable measure) shrinks as per capita income rises. This is intuitive, given association between consumer incomes and demand for better quality, higher priced goods produced by the modern, organized sector.

The broad evidence in the literature is thus consistent that informality declines, although slowly, with development. Against this finding, LPS advocate caution in structural policies designed to promote formality, arguing that the wisdom in policies depends in part, whether they encourage formalization, or discourage informal activity. They are also sceptical of all policies that might tax or regulate informal firms; rather than encourage them to become formal, these could instead drive them out of business, leading to poverty and destitution of informal workers and entrepreneurs. This is because despite all their benefits of avoiding taxes and regulations, they simply cannot compete with formal firms. Growth that kills the informal sector is driven by the formation and expansion of formal firms managed by educated entrepreneurs.

India: Currency in Circulation



Note: March is projection - Rs 450 billion increase over Feb. 23 figure - using average rise in currency in circulation in the last 4 years.
Source: RBI & author's calculations

II. Currency in Circulation: Trends

As discussed in the introduction, the policy goal of formalization in India has sought achievement by explicit targeting of currency amounts available to the public (demonetization) and compelling shift to electronic and banking channels through new systems and rules (GST). Trends in the monetary aggregate, currency in circulation (CIC), the key component of reserve money, should then serve as a good, immediate measure of formalization. It has been widely noted recently that CIC almost returned back to its pre-demonetization levels at 99.2 percent on February 23, 2018. In all likelihood, it will very soon overshoot the Rs 17.98 trillion in circulation on November 4, 2016. Observed from other perspectives too, i.e. normalized to GDP and relative to historical trends, the accompanying chart clearly illustrates that India's CIC-GDP ratio has reverted to its long-term mean. It is projected to cross the threshold in March, in repetition of its past pattern.

This development is contrary to an expected, permanent decline post- demonetization and GST. A return to previous levels of circulation currency indicates that the public or economic agents in general have resumed their previous cash practices. It challenges policy claims and expectations: an accelerated shift to formality was expected not only from demonetization but the additional, similar impact of the closely-clubbed GST reform. All the more puzzling then to see as much currency circulating in the economy as before these two big changes!

The mystery is compounded because of several evidences presented as proof of formalization following demonetization and GST. *Inter alia,* tax base enlargement as seen from increase in the number of taxpayers, higher tax collections from transition of more transactions to formal mechanisms as well as improved compliance from better information and scrutiny by authorities, digitization of transactions with more use of non-cash payment and transfer modes and so on.

If all these effects have come about because of demonetization and GST, why has the CIC-GDP ratio not settled at a permanently lower level?

Where is this cash deployed? Which segments or activities continue to be cash dependent and why? Taking the commonly proffered proofs of formalization at face value, has cash intensity in some parts of the economy increased? What is the real status of formality in the Indian economy in the post-demonetization and GST period? The next section considers some aspects.

III. What does India's Informal economy look like?

India's informal economy closely corresponds to features observed internationally and presented by LPS (2014). According to the Reserve Bank (RBI, 2017), 45 per cent of India's gross value added (GVA) originates from the unorganised sector and is distributed across agriculture, industry and services as respective shares of 95, 15 and 42.4 percent. The informal economy has a very large, 82 per cent share in total employment - agriculture accounts for 49 percent, services at 25 percent and industry, 9 percent. Note that India's informal sector size is above the median 30-40 percent reported by LPS, whereas education and productivity levels are much lower than the median values arrived at by LPS. For instance, in comparing education levels across formal and informal firms in the *Enterprise Surveys* data, 89 percent of formal firms surveyed for India were headed by college-educated managers against none in the informal firms in the *Enterprise Survey* data. Again, the median productivity difference between informal and formal firms in India was found higher at 18 percent.

India's informal economy thus seems more 'informal' than the international average. Most of it depends upon cash is a well known fact. Currency flows from legal operations in the formal sector "...eventually percolate to the informal sector, where it provides a part of the essential liquidity for virtually all transactions within the informal sector and between the informal and formal sectors (Sen, 2016)." For various reasons, three sub-segments are reported to be the most cash-intensive: One, the small and micro enterprises operated by mostly the uneducated and dominating agriculture, trades and many parts of services. These segments are the largest sources of self-employment - informality in the traditional sense seen across developing countries. Two, the real estate and construction segment, which have long been improperly or loosely regulated and which serves as the major store for illicit wealth and tax-evading incomes. Cash transactions have dominated here, giving rise to a sizeable parallel/black economy. Three, gold and jewellery segment, the other physical store for genuine savings, illegal wealth and incomes.

In the pre-demonetization period, a sizeable quantum of currency financed three segments. But its hard to believe that post-demonetization and GST, currency requirements would be the same as before. This is because of a prolonged, visible slowdown in these very sectors more than a year after demonetization and seven months after the arrival of GST. Consider each by turn.

The rural-informal economy sector has been under consistent pressures in the period. In the first round, the source was demonetization-linked liquidity squeeze that hurt businesses, caused many closures and job losses, disrupted and/or broke down wholesale-retail supply-chains and adversely impacted agriculture markets and prices. The next disturbance to this segment was from GST, from which market share and volume gains have been reported by large, organized firms at the expense of numerous informal firms and suppliers that have either been unable to adapt to the new environment or are under transition, while still others have opted out altogether. For example, some large consumer goods' firms have established their own direct distribution channels, bypassing previous wholesale chain structures that have either not recovered and are overall, not expected to restore to pre-demonetization/GST levels. Equally in many farm produce markets, traders are reported to exploit farmers' preferences for cash payments by depressing purchase prices. The prolonged contraction in consumer durables' even as non-durables, two-wheeler and farm vehicle sales have recently revived. Such trends would suggest less transaction demand for currency than before demonetization and GST.

Likewise, the slowdown in real estate and construction is all too visible in large inventory pileups, subdued property sales and transaction volumes as well as demand for cement, steel, and construction materials. Sector estimates in the national accounts statistics match these trends. Moreover, the adverse effects of demonetization and GST, the former drying up liquidity and latter pushing up costs, are further magnified by new, tighter regulation (RERA, Benami Properties Act) adding fear and risk-aversion. Pulled down as result, this segment is unlikely to need the cash-financing levels seen in the pre-demonetization and GST period because activities and operations have declined. Last of all is gold and jewellery segment where too, stricter regulation and monitoring of cash purchases have pulled down sales. Again, the fear of tax authorities on the trail has also restrained volumes.

So, given that the three large cash-intensive parts of the informal economy have fared poorly in post-demonetization and GST, where is the previous magnitude of currency now deployed? Has formalization really occurred as believed from other indicative trends? Or have demonetization and GST have had the unintended consequence of increasing informality instead? The final section attempts some answers and explanations.

IV. Formalization: What may have happened?

Hard data for the informal sector, which would establish the extent of formalization due to demonetization and GST, is infrequent in India. Indeed, it is the organized, corporate sector information and data that is used by the national statistical agency to extrapolate output and value added for the informal sector from a base period benchmark survey. This is supplemented with other proxy indicators and past trends (RBI, 2017). In its absence, one can only hazard a guess, based upon the reversion of currency circulating in the economy, coupled with intrinsic features of the informal economy that are integral to the success, or otherwise, of policies and actions to fasten formalization. Amongst these are the large shares of informal employment.

The preceding section drew attention to three large segments that were major users of cash in the pre-demonetisation and GST period but where the intensity of transactions in the later period cannot be reconciled with a currency-GDP ratio at previous trend levels. It is possible this is what has happened instead: a portion of transactions in these segments have become completely informal in the sense of a clean divide between formal and informal activities compared to the previous situation in which cash operations and exchanges flowed easily between formal and informal sectors. In other words, the formal and informal parts that were closely intertwined through a mix of cash and other payment-transfer mechanisms have completely separated after demonetization and GST. The cleavage has occurred because of higher probabilities of detection under GST and that interlinkages between cash and non-cash operations would increase chances of scrutiny, income assessment and taxation.

A completely parallel but segmented informal economy now perhaps operates off the radar, in cash. One reflection of may be the perceived underreporting of transactions under the GST system. On the other hand, the formal economy, which ironically would also include such informal operations on the sidelines, executes through proper legal channels. This possibility cannot be ruled out because a transition to formality, which is what would be expected from GST especially, would significantly raise costs for informal firms; much more than they can expect to recoup from raising volumes and prices given market constraints or which they cannot lower at existing levels of managerial skills (LPS, 2014). This inability to adapt is also manifest in different ways, besides the reversion to cash (higher costs of digital transactions, lack of computer knowledge and access). For example, reports of aversion to online compliance to GST by textile, construction, transport, trade and other segments marked by large informality (lack of managerial, IT skills, accounting systems, additional costs threatening viability, loss of business from formal buyers, etc.), pleas for fiscal support, and so on.

Is this configuration the 'new normal'? Put succinctly, has informality increased? Time will shed more light on formalization effects of demonetization and GST. For now, the evidence is veering more towards the available cross-country evidence on reducing informality through explicit efforts, which is quite discouraging.

References

La Porta and Shleifer (2014) “Informality and Development”, *Journal of Economic Perspectives,* 28-3, 2014).

Farrell, Diana (2004). “The Hidden Dangers of the Informal Economy.” *McKinsey Quarterly* 3: 27–37.

RBI (2017) “Macroeconomic Impact of Demonetisation: A Preliminary Assessment” Reserve Bank of India, March 10, 2017.

Sen, Pronab (2016) “Shock and Oh Damn” November 14, 2016. http://www.ideasforindia.in/article.aspx?article_id=1720