Formalization of Economy

1) Introduction
- India’s economy is largely informal.
- This is where the bulk of our low skilled workers find employment.
- Informal sector includes unpaid family labour, self employment, street vendors, etc.
- Formalization processes result in a move towards greater formality of firms and/or jobs.
- The Economic Survey 2017-18 provides evidence of how the Indian economy is becoming more formalized.

2) Recent Trends
- The introduction of the goods and services tax (GST) has brought more firms into the tax net and will further push formalization of the economy.
- The number of enterprises paying indirect taxes has gone up by 3.4 million, an increase of 50%.
- The GST system is creating a vast repository of data that could be useful in policymaking.
- For example, it is now possible to know the state-wise distribution of international exports.
- Now, technology is forcing a change. It is enabling the entry into the formal economy.
- Nearly a third of the non-farm Indian workforce of 240 million has some social security coverage.
- Employees’ Provident Fund Organisation (EPFO) and the National Pension System (NPS) data show 2.2 million formal jobs added in 6 months.
- Due to Demonetization people are putting a greater proportion of their savings in the formal financial sector.
- Also government push for cashless economy through digital India, Aadhaar streamlined the businesses and brought them into the formal sector.

3) Government push for formalization
- Informal operations pose many challenges to the government, like the inability to raise tax revenue, collect data, and regulate firms.
- India’s informality is one reason why its tax-to-GDP ratio has been stuck at 15% or so for decades, impacting education and health care.
- Formalization will help individuals and firms grow and achieve scale and productivity.
- Due to more revenues to the government the tax to GDP ratio will increase which might lead to more investment in social sector.
- Transitioning economy towards formality could bring benefits by establishing the rule of law and the equality of rights between citizens, entrepreneurs and workers.
- Formalisation will spur growth.
- 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 becomes tough to involve in money laundering and illegal activities as transparency will increase.

4) Opportunities
- A young population—65% of India is less than 35 years of age—of which a greater proportion are more literate.
• Growing Indian economy.
• Adoption of mobile-based apps.
• A push towards a cashless economy.

5) **Why firms want to remain informal**
- Most businesses hide from the regulatory system, which imposes too high a burden.
- If firms actually comply with all the regulation, their costs are too high to offer competitive prices to the customers.
- Customers look elsewhere (usually imports or the informal economy) and the firms go out of business.
- The worst affected are the micro, small and medium enterprises (MSME).
- They require licences, construction permits, property registration requirements and comply with labour laws.
- The problem is of costs imposed by regulatory compliance.
- On average, firms spent 243 hours a year filing and paying taxes and the total tax payment is 61.7% of profit. GST has not reduced these compliance costs.
- GST imposes a new system of compliance that requires frequent filing and a dysfunctional receipt matching mechanism under the GST network.
- Slow judicial system, which takes more time to settle disputes.

6) **Concerns / Challenges**
- One of the biggest challenges facing the Indian economy is the size of the informal sector.
- At present, only 10% of India's over 470 million workforce is in the formal sector.
- As the economy formalises, GDP and its growth rate will increase, that may not represent the true state of affairs in the economy.
- A forced shift from the informal to the formal sector can lead to job losses.
- Formalisation can have serious political ramifications, if not managed well.

7) **Way Forward**
- It is important for India to simplify the tax structure.
- Policymakers should build on its success and address the drawbacks to ensure GST achieves its full potential.
- The government must fix the regulatory system and ease the compliance burden.
- The target should be to move to at least a three-rate GST structure.
- Some of the operational issues, such as those related to ease of filing and refund, need to be resolved.
- The GST council will need to work on bringing items such as electricity, petroleum products and real estate into the GST net.
- Need for Labour law reforms to reduce the regulatory cost of employment.
- Capacity building and helping business to strengthen so that they are able to formalize.
- Complying with law must become easier and in parallel law enforcement should become more effective.
- For example in Chile and Peru inspectorates provide training for micro and small enterprises (MSEs) to comply with the law.