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## **Informal Sector in India: A Review**

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# **Informal Sector in India: A Review**

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Abstract

*Improving the linkage between formal and informal manufacturing is a desirable need to develop a complementary relationship to solve the problems like unemployment, low productivity and less capital intensity in the informal sector.*

## **1.0 INTRODUCTION**

The growth of informal sector during the post liberalization period is quite puzzling a factor to be taken note of. Though the sector nearly covers the total industrial scenario, the formal part of manufacturing sector does not provide it any sufficient presence, neither in terms of employment nor in the number of enterprises. Hence it interestingly raises some engaging propositions to inquire that include — the role played by the informal sector and the reasons for its growth during the post liberalisation period; concerns such as, do formal and informal manufacturing sectors compete or complement each other, is the growth of informal sector really a distress phenomenon etc.? If so, then what are the major causes? This paper is an attempt to locate these economically intriguing issues through an analytical survey of literature.

The paper is primarily divided into six sections. Second section discusses the concept of informal sector. While the third section describes the growth of informal sector, the fourth section discusses the empirical and theoretical review of literature. Proximate factors for growth and evidence of subcontracting are further discussed respectively in the fifth and the sixth sections which are followed by conclusion.

## 1.1 THE CONCEPT OF INFORMAL SECTOR: AN OVERVIEW

Informal sector is rather a new jargon in the literature of economics that appeared in the late 1960's. The sector thereafter has been widely recognized by the academicians and policy makers, as the sector provides a chance of survival to a large number of people who have no option other than to remain openly unemployed. The term 'informal sector' was first launched by the Keith Hart in 1971, and he described the sector as that part of the urban labour force, which falls outside the organised labour market. The concept has been further redefined by the mission of International Labour Office (ILO) which studied the employment situation in Kenya within the framework of the world employment programme. The division of the economy into formal and informal sectors has a long heritage—Arthur Lewis in his seminal work *Economic Development with Unlimited Supply of Labour* published in 1950's was the celebrated paradigm of development for the newly independent countries in 1950's and 1960's. The model assumed that unorganized sector with the surplus labour will gradually disappear as the surplus labour gets absorbed in the organised sector. The Lewis model is drawn from the experience of capitalist countries in which the share of agriculture and unorganized sector showed a spectacular decline but it didn't find true in many developing countries including India. On the other hand, probabilistic migration models developed by Harris and Todaro in 1970s envisaged the phenomenon of informal sector as a transitional phase through which migrants migrates to the urban centers before shifting to formal sector employment. Hence it is not a surprise to see policy invisibility in the informal sector. Curiously, the informal sector does not find a permanent place in the Marxian theory since they anticipate the destruction of the pre-capitalist structure as a result of aggressive growth of capitalism. To them, in the course of development, 'the small fish is being eaten by the big fish'. Therefore, neither in the Marxian theory nor in the classical economic theory, the unorganized sector holds a permanent place in the economic literature. On the contrary, Indian scenario is quite different, where the share of

unorganized sector in national income has been declining but the number of enterprises and employment in the unorganized sector continues to swell. However, five decades of capitalist mode of development in India has not been able to absorb the growing labour force in the organized manufacturing sector yet.

In the Indian context, both the terms ‘informal manufacturing’ and ‘unorganized manufacturing’ have been used interchangeably. Unorganized sector received much importance due to second plan approach, confined only to one segment of the unorganized sector i.e. small-scale industries and it was assigned the main task of meeting the bulk of the additional consumer goods (Mathew, PM 1996).

## **1.2 SIGNIFICANCE OF INFORMAL SECTOR**

The informal manufacturing is undoubtedly a major part of the informal sector which can also be synonymously used for unorganized manufacturing with mild modifications. In 2000-01 (NSSO 56 round 2000-01), more than 99 percentage of manufacturing enterprises were in the unorganized segments alone. In terms of employment, the sector absorbed 84.3 percentage of work force in the manufacturing sector in 1984-85 and came down only marginally to 82.5 percentages in 2000-01. On the other hand, organized segment accounted for 15.7 percentage of manufacturing employment in 1984-85 and stood up only to 17.5 percentages in 2000-01. Therefore unorganized manufacturing nearly sums up the total industrial scenario in India both in terms of employment as well as in the number of enterprises.

The informal sector is characterized by variables such as; low capital intensity, low level of productivity, prevalence of family labour and the ease of entrance. The most distinguished feature is the employment opportunities facilitated by the informal sector in developing countries for solving the unique problems like poverty and unemployment as they conclusively use local materials, age old traditional methods that merely cater local demands.

### **1.3 THEORETICAL AND EMPIRICAL REVIEW OF INFORMAL SECTOR**

Stolper Samuelson theorem argues that trade benefits labour, if it is an abundant factor. Heckscher-Ohlin Samuelson framework argues, trade will lead to a redistribution of employment from importing to export sector of developing countries, which export mainly labour intensive products. However, one cannot easily fit this into actual world because of their restrictive assumption and also due to the absence of perfect competition. But according to structuralist school of thought the shift is not easily possible from import to export sector of developing countries as it is postulated that trade and trade policy shocks can affect employment permanently by destroying jobs.

On the contrary, Dollar and Kray (2001), Frankel and Romel (1997) have optimistic view of the impact of trade liberalisation on employment. To them, the elimination of the barriers to competition is the right way for developing countries to promote growth and eradication of poverty. There are other studies, especially Mundle in 1993 and Deshpande in 1992 that have argued that, increased competition in the world would force firm to cut their work force and shift towards more capital intensive advanced technology, thereby restricting employment and lead to casualisation or informalization of work force. Rodrik and Rodrigues in 2000, who has argued in the same line of thought, stated that liberalisation may even be detrimental to growth of infant industries. Melitz in 2003 showed the possibility of eradication of informal work through productivity effect. The high productivity firm stands better chance to resist the more competitive environment where as low productivity but low productivity firm more often lead to exit. Singh in 1993 and Papola in 1994, have argued that structural adjustment program (SAP) would lead to greater labor and product market flexibility, lead to a shift towards labor intensive technique and commodities, hence there would be a growth of employment potential and

job availability. They have also predicted that employment growth may suffer a setback in the initial transition phase of liberalization period but will be restored in the long run.

There are lot of studies that exist in literature regarding the effect of liberalization on the nature and characteristic of the employment. Krueger in 1983 and Feenstra and Hanson respectively in 1996 and 1999 have argued that the liberalization can also affect the nature and type of works and found that outsourcing from north to south results in a rise in real wages of skilled labour relative to that of unskilled workers

Marjit and Beladi (2008) argued that globalization would increase the size of the informal sector. This probably happens through the presence of liberal trade policy, especially in the form of declining tariff rates that would reduce open unemployment and an increase in informal wage and informal employment if capital is more mobile between the formal and informal sectors. But Rani and Unni in 2004 found that initial economic reform policies have adversely affected employment in unorganized manufacturing sector, but has got improved in the subsequent years.

Rao, Dutt and Papola respectively in 1994 and 1999, have argued that the policy shift towards greater openness is inherently biased towards organised industry that led to the absorption of better skilled people in the urban sector. This implies that the rural non-turn enterprises might not be able to compete and share the gains expected from the reform process. Papola and Mitra in 1981 and 1990, have found the common characteristic of informal sector manufacturing as; smallness of the size of the operating units, poor level of technology, perfect competition prevailing in the factor and product market, lack of protection by the government to the units / workers, lack of unionization of the work force, extensive use of contract labour through labour agencies, outsourcing activities by main firms on piece rate basis and finally casualisation of work force. Some possible causal factors for the growth of informal sector can also be found in literature. Mitra in 1994 and then in 2001 has argued that the overlap between informal sector employment and poverty are significant. Sastry in 2004 also showed high incidence of poverty among

households who finally sustain on employment in informal sector and his studies show that such incidents are higher in urban areas compared to the rural areas.

Mitra in 1998 found negative relationship with the urban informal manufacturing and organized manufacturing sector. Papola in 1981 has argued the large size of the informal sector in states with low level of industrialisation is mostly of residual type whereas the same in industrialized states reveal complementary relationship between the industry and informal sector

#### **1.4 FACTORS FOR THE GROWTH**

The informal sector is a manifestation of a distressed phenomenon especially in the urban segment. Urban informal manufacturing growth is negatively related to the growth of formal manufacturing sector (Mitra, 1998). On the other hand, there are many authors who relate the growth of informal sector and the performance of agriculture together. They argued that the agricultural distress in the rural areas can be attributed to the development of informal sector in the suburban areas. Growth of rural non-farm sector is crucially dependent on the performance of agricultural sector (Hazel and Haggablade, 1999). The farm - nonfarm linkage operates through improvement in agriculture performance leading to stimulation of demand for both consumer and agro inputs. Meaningful correlation can also be found among organized factory growth, urban poverty, agricultural growth (Dipa Mukherjee, 2007).

#### **1.5 EVIDENCE OF SUBCONTRACTING**

The major weakness attributing to the development of small-scale industry is the lack of strong complementary relationship between large and small firms. The relevance of subcontracting would make sense especially in a labour surplus dual economy like India. The incidence of sub contracting is very high for manufacturing activities such as tobacco products, chemical products, office, etc (NSSO 56 round (2000-2001). Industries

extensively using subcontracting facilities include those firms having labour intensive production processes such as textiles, tobacco products etc. Moreover, it has been found that they have multi-layered vertical production fowls such as office, accounts and computing.

The NSSO 2000-01 (56<sup>th</sup>) round survey of unorganized manufacturing enterprises is the first of its kind to give information about the magnitude of subcontracting separately in rural and urban India. About 28 percent of rural and 38 percent of urban enterprises in India showed evidence of subcontracting. However, most of the subcontracting works are located in the urban segment. In short, subcontracting is a kind of win-win solutions for many problems like improving employment opportunities, increase in the scale of production and improve market efficiency. If subcontracting is strengthened in rural and backward areas, it would reduce distress migration to urban areas, which will in turn reduce regional imbalance and indirectly improve socio-economic parity of the people in those areas.

## **1.6 CONCLUSION**

Though informal sector is characteristically featured by low productivity, the sector indisputably provides survival to a large number of people in India who have no other viable employment option. In addition, the unorganized manufacturing sector nearly sumps up the total industrial scenario in India, both in terms of employment and number of enterprises. The ample employment opportunities provided by the informal sector may perhaps be marked the most distinguished feature of the informal sector as it holds the potential to reduce poverty and allied economic imbalances as they mainly use as mentioned earlier the locally available materials, obsolete traditional methods that singularly cater local demands. Subcontracting to underscore, is a kind of win-win solutions for many problems, if it is unerringly strengthened in rural and backward areas through policy statements. It unconditionally reduces distress migration to urban areas, which will in turn reduce regional imbalance and improve socio-economic congruence. The informal sector is largely illustrated as a manifestation of a distressed phenomenon



especially in the urban segment and negatively related to formal manufacturing sector computing to urban poverty. Agricultural distress in the rural areas can positively give way to the development of informal sector in which correlation can be successively found between organized factory growth and agricultural growth. Given this background, to sum up, special attention has to be focused on technological enhancement, easy access to credit facilities, training needs, strengthening of rural infrastructure, promotion of subcontracting and the development of clusters, for improving the linkage between the formal and informal manufacturing.

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