

Formalising the Indian Economy on the Wings of Demonetisation, GST and Technology

*M.M.K. Sardana**

[Abstract: Demonetisation set the pace for cashless transaction in business and the implementation of GST creates traceable trail of business transactions. Thus, the sector of economy termed as informal sector that thrives on short-changing of taxes comes under strain and makes way for increased role of formal sector which boosts the tax revenues of the government. During transformation from informal to formal, there would be job losses in the informal sector. With increasing resources at its command, government spending on infrastructure, education and health will get a boost and it could devise programmes for both job creation and skill development. Concurrently, the deployment of technology towards creation of aggregation platforms of service providers and e-commerce is also helping in the formalisation of Indian economy in a big way, thus creating jobs in the process.]

Informal sector is that part of economy which short-changes on taxes and mostly does everything in cash with very little paper trail. The informal sector is almost 40 per cent of the Indian economy and employs almost 75 per cent of the workforce. This is where most of the job growth has taken place as informal sector companies can hire low-skilled workers on a mass basis. For most companies in this segment, their competitiveness arises from their ability to evade taxes and disregard statutory provisions on minimum wages and other benefits allowable under labour laws. Lacking in technology and scale, this is the only way these companies are able to compete with the large organised players.¹

A combination of demonetisation, implementation of GST, disallowance of cash transaction above a prescribed ceiling and other steps to reduce the cash intensity of the economy has put the informal sector under strain as these are taking away much of the arbitrage of the operators in this sector. Rules are being framed to compel all units to pay salaries to workers through direct transfer into their bank

* The author is a Visiting Fellow at the Institute.

¹ Prakash, A. (2017), "Formalisation of the Indian Economy," *Business Standard*, March 13.

accounts as today no party in its supply chain wants to deal in large volumes of cash. Above board dealings with workers and vendors create paper trail for the authorities to scrutinise. The implementation of GST will further reinforce the trend of rapid formalisation of economy. As GST is implemented, a paper trail will be established and most companies will not be able to operate unless they are part of the formal economy.² In the GST regime, reverse charge is applicable for both services and goods and would be payable by the receiver of goods or services. In case an unregistered dealer sells or supplies to a registered dealer, the latter will have to pay GST on the supplied goods or services. Such a provision would discourage the registered business to deal with unregistered entities in the informal sector. Correspondingly, the informal sector entity is encouraged to get itself registered, i.e. to join the formal sector to remain in the supply chain even though it may not be under any obligation to register because of its turnover being below the threshold of Rs 20 lakh per annum. Thus, with the implementation of GST, the informal sector entity would be incentivized to enter the formal sector to remain in the supply chain. The businesses in the organised sector would like to deal with entities in the organised formal sector only as they tend to comply with regulations and pay taxes. Thus, the share of formal sector in the economy will increase at the cost of the informal sector. If and when the losing out informal sector supplier wishes to remain in the supply chain under the GST era, it would be faced with taxes, lower margins and increase in the compliance costs which would bring down its profits. Some in the informal sector may either struggle or not survive by confining their businesses to similarly placed unregistered entities in the informal sector which would push it to the subsistence level. Overall, in the informal sector there would be job losses across manufacturing and dealership units.³

Formalisation of the economy will worsen the job crisis as the formal sector has not been able to create jobs. With the loss of jobs in the informal sector, lower end consumption will also come under pressure and thus entities that are more

² *Ibid.*

³ Jethmalani, H. (2017), "The Flip Side of GST: Its Impact on the Informal Economy," *Livemint*, June 22.

focused on budget products catering to rural and semi urban segments would face challenges.

With the formalisation of economy, the tax base of the government is bound to go up. The government would have better resources to spend on infrastructure as well as on health and education; besides, fiscal deficit would also be stable. Government spending will remain the driver of economic growth. With enhanced resources at its command, the government would be required to invest judiciously in the creation of more jobs and towards improvement of skills.

Informal economy is also being transformed through the application of technology for developing aggregation platforms of service providers like Amazon, Flipkart, Uber, Ola, etc. These platforms not only create jobs, but also lead to formalisation of economy. For example, as soon as a taxi driver becomes a part of Ola or Uber, he also becomes a part of the formal economy. He uses data, becomes eligible to get loans for buying a car and becomes liable to pay taxes. Through these aggregators a substantial number of persons have been pushed into the formal sector economy. E-commerce retailers have been successful in bringing a large number of merchants including those from tier II towns and beyond to join them as suppliers. Their transaction data has been utilised to create credit history, making them eligible for business loans. Thus, these bands of merchants joining the e-retail platform have been embedded firmly in the formal economy and have access to easy credit from banks on the strength of the data of their activities created on the portal.

Role of technology in furthering the formalisation of Indian economy will be cascading with the joining of more and more data users owing to the expansion of telecom services and wi-fi networks. The formalisation of economy through the application of technology is accompanied by job growth and this is a big plus factor and may counter balance job losses described in the preceding paragraphs.