Issue Brief

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Formalising Finance, Informalising Labour: Demonetisation and the Informal Economy

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ISSUE BRIEF

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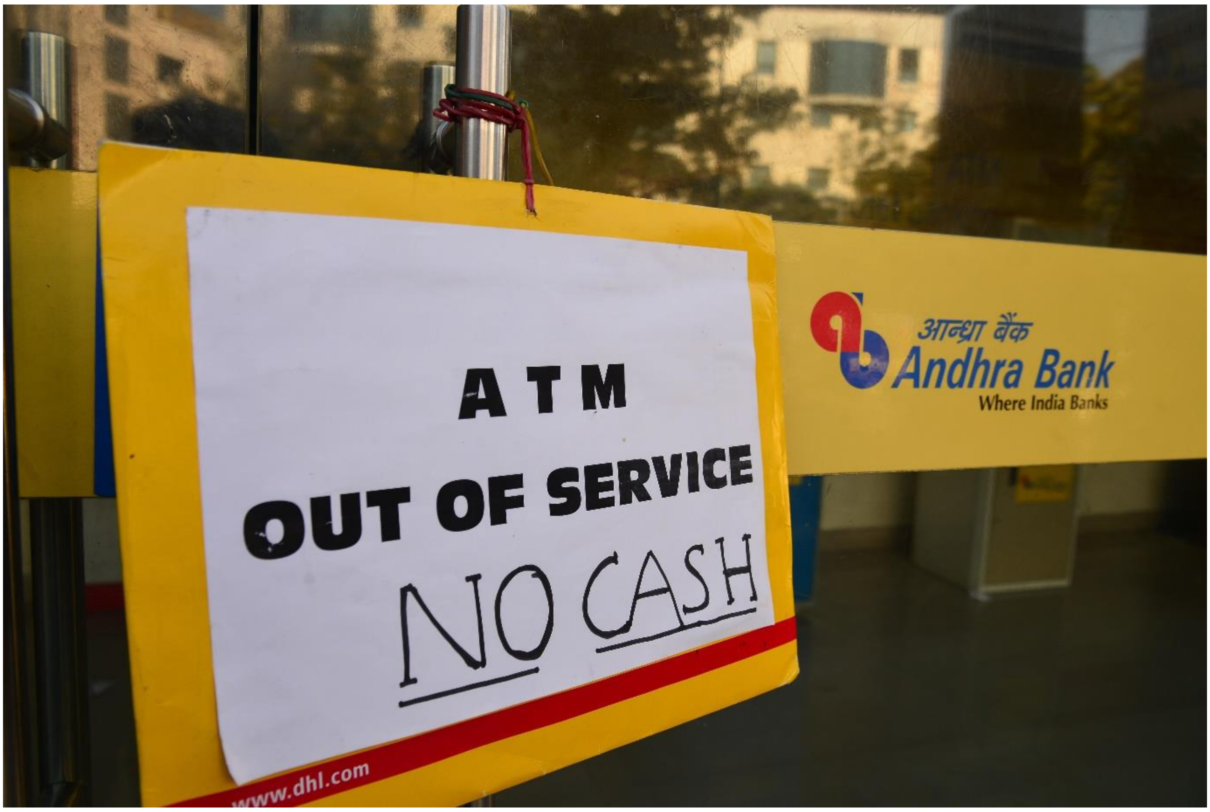

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ABSTRACT

The Prime Minister of India, Narendra Modi's announcement over television on the night of November 8, 2016, withdrawing from circulation currency notes with denominations of Rs. 500 and Rs. 1000, has had a cascading effect on the economy.

This Issue Brief maps the pathways through which demonetisation impacts the informal economy. A distinction is made between sectors and categories of labour such as the self-employed, the casually employed and the micro and small enterprises operating below the realm of formal regulation.

This Issue Brief points to the paradox of justifying demonetisation in terms of formalising financial markets even it has informalised labour markets.

Finally, it also points out that there is little likelihood of the move benefiting the informal economy even in the long run.

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I. INTRODUCTION

It is customary for industry associations to provide immediate estimates of losses incurred by a sector, or the entire economy, to the media in the wake of disruptions such as a strike or a natural disaster. For instance, Cyclone Vardha hit Chennai on December 12, and there were estimates of losses the very next day. It is in this context that despite the abrupt withdrawal of Rs.1000 and Rs.500 notes on November 8, unarguably the biggest economic disruption in independent India, the silence of industry bodies for a good two weeks after the late night announcement of demonetisation was telling.

It is only recently that the Centre for Monitoring Indian Economy (CMIE) has come up with estimates of what the process of demonetisation and remonetisation entail for the government at least in the short run.[1] Adding up the costs of printing new notes, transporting these to respective bank branches across the country, payments to be made by the government to the toll collecting agencies for having waived tolls till December 31, 2016, and costs of human resources and overheads, the CMIE reckons that demonetisation exercise costs the Reserve Bank of India (RBI) and the Indian government about Rs.168 billion. The CMIE has also assessed the loss of income incurred by working people as a result of being forced to spend time in queues to exchange their currency notes rather than work.[2] Estimating an average daily wage of Rs.327 per day for the 407 million employed in India, they adopt two methods to calculate the days lost due to standing in queues. One method assumes that each working person stands for an average of 8 hours during the entire 50-day period. Another method involves calculating the average number of persons standing per day in each of the branches, Automated Teller Machines (ATMs) and post offices. Taking an average of the two, they conclude that it will imply a loss of Rs.150 billion rupees to the entire working population. The CMIE mentions but does not calculate the environmental cost of photocopying all the sheets of paper required to establish one's identity. Importantly, such macro-estimates do not adequately capture the losses and impacts on specific segments of workers.

[1] Centre for Monitoring Indian Economy Pvt. Ltd., 2016. *Demonetisation to cost Rs.168 billion to RBI and Government.* [Online] [Last Accessed 13 December 2016].
[2] Ibid. *Cost of queues to exchange currency is an estimated Rs. 150 billion.* [Last Accessed 13 December 2016].

From being a move to 'flush out' 'black' and 'terror' money, the de-remonetisation exercise that is underway in the country is now being justified in terms of being the first step towards establishing a 'cashless economy' or a 'less cash' economy. The irony of this dream cannot be lost among the nearly 800 million people who do not earn enough to even meet their basic needs and the many millions who are just above the poverty line and always an 'illness away' from falling into poverty. As we know, most of them are employed in what is referred to as the informal economy that accounts for close to 93 per cent of the workforce in the country.

Straddling the self-employed, the casually employed, underemployed and largely from marginalised social groups, it warrants that we pay attention to how this ongoing effort is likely to impact them in the short and not so short term. Some commentators have viewed it primarily as a political move rather an economic one[3], Nonetheless, its impact is on the economy and on livelihoods, more so in a predominantly cash-dependent economy.

Against this backdrop, this Issue Brief attempts to spell out some of the key linkages between demonetisation and the informal economy and the pathways through which the economic shock transmits to the millions engaged and surviving in the informal. Though I focus mostly on those employed in the informal economy, I also hint at issues confronting micro and small enterprises that employ labour but operate below the realm of formal regulations.

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[3] Mukhopadhyay , N., 2016. Post demonetisation, Narendra Modi turns focus on vikas, of and for the poor. *Firstpost*, November 29.

II. PROFILE OF LABOUR IN THE INFORMAL ECONOMY

The informal economy comprises the following segments: the self-employed, the casually employed, those running micro and small enterprises with wage labour, and workers who are informally employed in the formal economy. The following table, based on sample surveys on employment and unemployment conducted by the National Sample Survey Office (NSSO) provides an idea of shifts in the workforce categories in India between 2000 and 2011-12.

Table I

Per 1000 Distribution of Usually Employed by Category of Employment across States- 2000 (Total Workers 1000)								
No		**Tamil Nadu**	**Andhra Pradesh**	**Gujarat**	**Karnataka**	**Kerala**	**Maharashtra**	**All India**
1	**Self-employed**	345	403	456	436	359	381	469
2	**Regular wage/ Salaried**	286	228	210	229	238	301	244
3	**Casual labour**	369	369	334	335	403	318	287
4	**Total**	1000	1000	1000	1000	1000	1000	1000

Source: *Employment and Unemployment Situation in India, NSS 55th Round

Table II

Distribution (per 1000) of Workers according to Usual Status (ps+ss)[4] by Broad Employment Status 2011-12 (Total Workers- 1000)								
No		**Tamil Nadu**	**Andhra Pradesh**	**Gujarat**	**Karnataka**	**Kerala**	**Maharashtra**	**All India**
1	**Self-employed**	317	444	514	478	377	469	522
2	**Regular wage/Salaried**	255	179	247	225	225	265	179
3	**Casual labour**	428	377	239	297	398	266	299
4	**Total**	1000	1000	1000	1000	1000	1000	1000

Source: * Key Indicators of Employment and Unemployment in India, NSS 68th Round

[4] 'PS' refers to 'Usual Principal Status' and indicates the status of work undertaken during the previous year (365 days). 'SS' refers to 'Subsidiary Status' and indicates the status of any other work undertaken for a shorter period (less than 30 days) within the same period. The employment status provided in the two tables, therefore, indicates the combined work status of a worker in the year under consideration.

As Tables I and II illustrate, between 2000 and 2011-12, the share of the self-employed in the entire workforce increased in all major States, and at the national level, except in Tamil Nadu. Though the self-employed as a category was expected to disappear over time with the expansion of capitalist development, in India as in other parts of the transitioning world, this is far from the truth. Self-employment, between 2000 and 2011-12 has actually increased its share in the total workforce from about 47 per cent to 52.2 per cent. Similarly, the share of casual workforce too has increased during this period at the expense of those regularly employed. It, therefore, appears that the growth process is actually generating a process of exclusion from the formal economy for majority of the working population.

In terms of sectors, while the self-employed is normally associated with cultivating households in agriculture, it needs to be remembered that for the first time in India, both the share and absolute numbers of cultivators fell between 2001 and 2011 suggesting that a growing number of the self-employed are in the non-agricultural sector such as vending, petty trade and other services. Within agriculture, there are actually nearly nine million fewer farmers now than there were in 2000. It would, therefore, imply that the self-employed outside agriculture are those who are forced to exit agriculture but are unable to find their way into employment.

As in previous decades, the proportion of agricultural labourers has increased. At present, there are 144 million agricultural labourers accounting for 30 per cent of the total worker population as against 26.5 per cent in 2001, this increase being reflected in the share of the casual labour force. The regular salaried are distributed between manufacturing and services, with sizeable numbers employed on short-term contracts in manufacturing and in services.

III. THE AGRARIAN INFORMAL

The vulnerability of the self-employed in agriculture is best exemplified by the predominance of marginal and small holdings in the country. Marginal and small holdings account for 85 per cent of the landholdings, with the former accounting for 67 per cent of all land holdings in the country. The spate of suicides among farmers that continues unabated clearly suggests that for most, returns are inadequate to sustain themselves. A recent report by the National Bank for Agriculture and Rural Development (NABARD) observes that nearly 52 per cent of the cultivating households are indebted to one agency or the other.[5] In other words, despite several efforts to extend formal credit to cultivating households, a large number of cultivators have been unable to access any credit.

Importantly, the report points out that even among the borrowing households, 69 per cent of the credit came from non-formal sources and cooperative banks with the latter accounting for 14.8 per cent of the credit requirements. Though formal bank and other institutional lending has increased marginally between 2002 and 2012, cultivating households continue to rely on non-formal sources in substantial measure for their credit requirements. While inter-linked contracts such as lending by the land lord or the buyer/trader are present, the report points out that only 3.7 per cent of the borrowing in 2012 are from landlords or trader/shopkeeper, suggesting that other institutions such as the local money lender are key actors in mediating credit access among the agricultural households, in addition to relatives and friends. Informal institutions also draw upon collateral such as trust that has no value in the formal banking system. As can be expected, those with smaller landholdings tend to rely more on such informal institutions and thereby forced to pay a higher rate of interest on their debt.

Dependence on informal credit also has to do with high opportunity costs of engaging with formal institutions. My fieldwork in rural Tamil Nadu suggests that often small and marginal farmers prefer to sell to traders rather than sell directly in *mandis* because of costs incurred by staying away from farm work. In fact, there were instances when farmers avoided selling their produce in the farmers'

[5] Satyasai, K., 2015. How Indian farmers borrow, produce and earn? Evidence from recent NSSO Surveys. *NABARD Rural Pulse*, March-April. [Last Accessed: December 13, 2016.]

markets initiated by the State government simply because it involved staying away from the farm for a day that was too costly a loss, the gains in prices notwithstanding.

Demonetisation was announced at a crucial phase in the agricultural cycle in the country. In large parts of India, due to back to back droughts, agriculture has taken a beating. Further, the current year drought in some of the poorest parts of country like eastern Uttar Pradesh and Bundelkhand imply that the rural poor are already working in extremely adverse conditions.

The sector actually witnessed a negative growth of 0.2 per cent in 2014-15 and grew by only 1.2 per cent in 2015-16.[6] With relatively better monsoon in parts of the country this year, there were expectations of a revival in the economy. However, as reports suggest, farmers have not taken to sowing in the upcoming *rabi* season (winter season) on account of liquidity crunch.[7] Further, the prices have also fallen for the *kharif* harvest (monsoon season) for most products due to fall in demand triggered by demonetisation. Such fall in prices and an inability to raise credit for the next sowing season imply not only a loss in income but is also likely to tie them to new and higher order debt cycles.

When 86 per cent of the total value of currency of a country is demonetised, there will be a squeeze in supply among informal lenders. Pranob Sen, country director of the India Central Programme of the International Growth Centre, points out[8] that informal money lending, accounting for 40 per cent of the formal lending and 26 per cent of the Gross Domestic Product has been hard hit. We also know that the rural poor disproportionately rely on such lending, the growth in micro-credit and micro-finance institutions notwithstanding. Further, apart from the money lender, the move is likely to also adversely affect chit funds and other kinds of informal saving and lending institutions that abound in the economic landscapes of most poor households with little access to formal credit.

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[6] Waghmare, A., 2016. Demonetisation will hit agriculture, informal sector workers the most: Study. *Firstpost*, November 15.

[7] Vishnoi, A., 2016. Sowing season hit by demonetisation: Central team red-flag loss of rural jobs. *The Economic Times*, November 30.

[8] Sen, P., 2016. Modi's Demonetisation Move May Have Permanently Damaged India's Informal Sector. *The Wire*, November 16.

In fact, access to such credit has been made possible by reliance on norms of trust[9] that efforts to move towards a cashless formal financial system may actually undermine!

Assuming that households may also combine formal with informal lending, and cooperative banks being kept out of the currency exchange process, this squeeze in supply can lead to the following:

1. Cost of informal borrowing is likely to go up given the squeeze in supply.

2. There is likely to be a shortage of funds available for lending leading to a huge credit squeeze, or a combination of both.

3. The long queues and transaction costs involved may deter farmers from accessing formal credit. According to data from the RBI, there are only 7.8 branches per lakh population in rural areas.[10] Average losses from standing in queues tend to therefore conceal the differences and costs incurred in relation to household incomes. As Vikas Dhoot (2016) points out, Regional Rural banks, with 25 crore accounts, have received on an average what would amount to a mere Rs.350 of new notes per account holder during the period November 10 to November 30, 2016.

4. Finally, borrowers may reduce their borrowing owing to fears of their inability to repay anticipating production and marketing issues. There is already micro-level evidence to show that the latter has actually happened, with fewer takers for borrowing, and lenders not able to collect their dues from the borrowers.

Despite late relaxation of norms for farmers to exchange notes, the squeeze is far from over. Another factor that the move overlooks is that the reasons for rural borrowing are not confined to agricultural production. The NABARD report points out that between 2002 and 2012, the share of loans taken for agriculture has declined whereas that for household expenses, especially for education and health care expenditure has increased. With growing privatisation of these segments, this shift in borrowing is understandable, with more than half of the rural population relying on private healthcare because of the declining quality of public healthcare provisioning.

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[9] Bhosale, J., 2016. Demonetisation: In planting season, trust and credit in full bloom in fields. *The Economic Times*, December 02.
[10] Reuters, 2016. Demonetisation: India's Rural Economy Battered As Informal Lending Breaks Down. *The Huffington Post*, November 27.

Another transmission route is via the output market through price movements of agricultural commodities.[11] By and large, wholesale prices for most agricultural crops have collapsed in both rural and urban areas, with empty and 'frozen' *mandis*. However, though retail prices have fallen in rural areas due to fall in demand, urban retail prices have either held on or dipped only marginally. This suggests that while farmers have been forced to sell in distress, the traders/middlemen have gained through higher margins in markets. In other words, this move has not only affected the poor adversely but may well have contributed to greater inequity. Worryingly, the fall in demand in rural areas indicates a reduction in food consumption.

While the farmers are affected by poorer returns or an inability to invest in production, the larger segment is that of agricultural workers who are affected by loss of employment and loss of wages. Given the squeeze on farmers, they can either choose not to pay workers or not to engage them at all because of absence of access to other inputs, especially credit. The Mahatma Gandhi National Rural Employment Guarantee Scheme (MGNREGS), a major succour for the marginal farmers and landless agricultural workers, too has run into trouble because of the cash crunch. Chitravanshi (2016), points out that eight States have raised concerns about their inability to pay workers under the scheme for want of adequate liquidity.

The strategies adopted by agricultural workers to cope with this income shocks are unclear. Going by literature on coping strategies among poorer households one can expect a reduction in consumption expenditure as an important outcome. When confronted by economic shocks, households are found to adopt one or few or all of the following coping mechanisms: sale of household assets, borrowing, and reduction in investments in health and education.[12] Often coping mechanisms involve cutting back on health expenditure and on food lead to long term health implications.[13] While there is evidence emerging on how demonetisation has posed problems to access healthcare in the short term, the impact of lowering of consumption on long term health is yet to be understood. While regions with relatively better access to public healthcare may not be unduly affected, in states with poor health infrastructure, the damages can well be long term. Even

[11] Varma, S., 2016. Veggie wholesale rates crash, retail prices only dip in cities. *The Economic Times*, December 02.
[12] Silbert, M. & Usecheb, M. d. P., n.d. *Repeated Natural Disasters and Poverty in Island Nations: A Decade of Evidence from Indonesia.* [PDF]
[13] UNICEF, 2009. *How economic shocks affect poor households and children*. [PDF]

in States such as Tamil Nadu, known for relatively better health care infrastructure, there are variations in access across districts. Importantly, in a country where its demographic dividend is held to be its primary source of growth going forward, the consequences of reduction in food consumption and inequity in access and quality of public healthcare delivery are problematic.

While this cash squeeze may not be a factor in the long term, expectations of a contraction in the economy over the next year by about two per cent implies that the ripples of the shock wave may last longer than the short term. The pathways are, therefore, via lower income, lower employment and wages and lower access to credit to sustain farming. The appeal to the poor to bear the hardship in the short run is odd when their earnings are on a daily basis and any shock can push them into greater deprivation.

IV. THE NON-AGRARIAN INFORMAL

It is well recognised that there has been a deterioration in the quality of jobs generated outside agriculture in post-reform India. In the non-agricultural sector, bulk of the employment has been generated in the construction sector. While employment in the entire non-agricultural sector during 2004-05 to 2011-12 has grown only at a rate of 3.5 per cent, with manufacturing and services sector employment increasing only at 1.5 per cent and 2.5 per cent respectively, employment in the construction sector has grown at 10.1 per cent. This sector, as is well known, generates jobs largely in the casual labour segment. As reported by several observers, the real estate sector is likely to be the hardest hit. Even industry bodies like the Confederation of Real Estate Developers' Associations of India (CREDAI) acknowledge this problem and concede the need to provide rations to workers in the early days of demonetisation.[14]

Comprising largely of migrant workers, this sector is likely to shed the largest number of jobs and loss of income after the agricultural sector. While in the case of the agricultural sector, there is a relatively better chance of some recovery in the medium term with injection of cash into the system, contraction in the construction sector is likely to last much longer. Interestingly, this is tied to the 'success' of demonetisation. Since the real estate sector is one that is most closely tied to circulation of black money, success implies a reduction of flows into the sector and hence a contraction. The return of the migrant construction worker to the villages implies a spatial shift of crisis of reproduction [the need to re-create economic conditions necessary for survival] from the work site to the rural households

Within manufacturing, labour intensive sectors such as textiles, leather and gems and jewellery have already reported considerable job losses due to supply chain and market disruptions. In Tiruppur, for example, firms producing for the domestic market and the 'seconds' market are reported to have been affected. Close to 60 per cent of the powerlooms in Tamil Nadu are reported to have closed down.[15] Clusters of micro and small enterprises that are seen by the Swadeshi Jagran Manch as quintessentially 'Indian' business organisations are, in reality, all struggling to access inputs, market

[14] Janardhanan, A., 2016. Demonetisation effect: Massive layoffs, Tamil Nadu construction workers have no cash or food. *The Indian Express*, November 23.
[15] Mallya, S. R., 2016. No pay for Tirupur textile workers after demonetisation. *The New Indian Express*, December 04.

and pay their workers.[16] Reverse migration is reported from several of these clusters. Importantly, given that cash-based transactions link various nodes in these value chains, as in the case of agriculture, disruptions to the supply chain may not be sorted out in the short run given the informal nature of most enterprises in such clusters.

The entire trucking industry responsible for transport has been affected because of the cash crunch. In the case of services too, it needs to be remembered that growth in the Indian economy has been driven by private consumption in the last few years. Given reports that households are reining in non-essential consumption, the segment of services that is reliant on such expenditure will be affected. The National Hawkers' Federation issued a statement pointing out that 50 per cent of street vendors do not have access to bank accounts and how even loss of a day's earnings by standing in a queue undermines their ability to reproduce themselves.[17]

In addition to workers already trapped within the informal economy, it is also important to understand that the move has also worked to push segments of labour from the formal to the informal sector, a phenomenon that sits in well with trends in the Indian labour market. Since 1999-2000, even additions to employment in the formal sector has come through informal employment. The share of formally employed workers in the formal sector actually declined from 58 per cent to 49 per cent during this period. Papola (2013) has argued that the share of contract labour in organised or formal manufacturing has increased from 16 per cent of total workforce in 1999 to 33 per cent in 2009-10. He goes on to say that two-thirds of the new workers employed during 2000-10 are employed through contractors, and are not on the payroll of enterprises either as permanent, temporary or casual workers.

It is, therefore, indeed paradoxical that the state simultaneously informalises labour contracts but seeks to formalise their access to the financial system! Slump in demand from sectors such as automobiles, tourism and hoteling have led to loss of jobs and a possible push into the informal economy. Owing to accumulation of inventories, Renault-Nissan plant in Chennai, for example, has resorted to a permanent reduction in shifts from three to two and with a potential loss of about

[16] Das , S. & Dave, V., 2016. Demonetisation impact: Migrant workers head back home. *Business Standard*, December 10.
[17] National Hawker Federation, 2016. Demonetisation Paralysed The Informal Economy: National Hawker Federation. *Countercurrents.org*, November 16.

1980 jobs. What we also need to recognise is that apart from overall contractions leading to reductions in income for those relying on the informal economy, there are also equity implications.

Divides: Digital and otherwise

That digital divides often translate into economic divides is well accepted and several national level policies are actually aimed at addressing the digital divide. With 78 per cent of the country's population not having access to the internet, how this divide translates into unevenness in access to the 'cashless' economy is to be seen. However, there is enough micro-level evidence to show that it is indeed aggravating with those with access to card-based payments choosing to shop in organised retail firms to the detriment of those who cannot accept such payment methods. As Sriram, visiting faculty member at the Centre for Public Policy, IIM Bangalore says, "We are abandoning the auto-rickshaws for cab aggregators, the roadside eateries for card-based home delivery, the local *kirana* store for on-line groceries and buying vegetables from the superstore instead of the push carts. We are holding on hoarding a few hundred rupee notes, not even parting with them as tips."[18] Moving towards a cashless economy also involves loss of employment given the reduced intermediation that it is supposed to bring about. While efficiency of transactions may improve due to technology mediated disintermediation, it also has equity implications at least till the medium term because of loss of jobs. Such losses of jobs are likely to affect the less skilled. Handling and moving cash and making cash payments require employing people who need not possess excellent skill sets but can be trusted. Further, if remonetisation is not complete, regions with poorer infrastructure in banking and information technology will lose vis-a-vis the better endowed regions.

[18] Sriram, M. S., 2016. As queues lengthen and banks run out of cash, the danger is of India losing patience. *Scroll.in*, November 13.

V. LIGHT AT THE END?

The promise that short-term losses are meant for the longer term national good mean nothing for the people who have died standing in queues across the country. Even two months is a long term for the poor, unlike macro-economic temporal scales that operate under a different notion of the short and long term. While we need to look closely at the differences in temporal scales of the lives of the poor and that of the macro-economy, it is also worth reflecting upon what the long-term prospects are likely to be.

The government has said that this move is meant to generate resources for investing in social and economic infrastructure for the poor such as irrigation, housing and education through recovery of black money. While the reasons for the government not undertaking such measures earlier are not clear, there are reports trickling in that almost the entire value of money held in Rs.500 and Rs.1000 have actually come into the banking system. This means that whatever meagre black income that has been held as Indian currency has already entered the banking system.

Real estate is expected to revive because of the fall in prices reviving demand. Further, banks flush with funds are likely to lower their interest rates heralding a regime of easy credit that will fuel growth, demand and employment. Neither scenario, can however, be taken as a given. In the case of real estate, lowering of prices may also lower the willingness of sellers given fall in expectations of returns from such sales. It may only be those who are pushed into sales on account of economic distress may actually want to sell, generating new inequities in the land market.

In the case of access to formal credit, as studies have repeatedly shown, the inability of those working in the informal economy to access formal credit is not only due to lack of banking infrastructure. Collateral to access credit has been a major factor. While the government may initiate a one-time transfer of a small amount to the accounts held under the *Pradhan Mantri Jan Dhan Yojana* (PMJDY), it is clear that it simply cannot translate into 'financial inclusion' as it is expected to. Studies have shown that formal credit tends to be disproportionately lent to the larger enterprises and there is little to suspect that this will be reversed.

People may, therefore, be pushed into the financial system in desperation if the government chooses to not remonetise all that has been demonetised. While this may mean 'inclusion' in a symbolic sense, it will mean little else for the large segments of those who have been excluded from access to formal employment opportunities. Given that it is the same government which has pushed for labour reforms that weaken the protection given to formal workers through 'model' reform laws passed in Rajasthan, it is hard to buy the argument that demonetisation may actually work in favour of even those currently employed in the formal segment leave alone those in the informal economy. As Satyaki Roy (2014) shows, the share of wages in gross value added in organised manufacturing has steadily fallen from 25.9 per cent in 1980/81-1989/90 to 13.5 per cent in the period 2000-01 to 2004-05 and further to 9.9 per cent in the period 2005-6 to 2011-12. Given these developments, 'financial inclusion' may mean little if anything for social and economic inclusion.

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