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The Urban Informal Sector and Poverty: Effects of Trade Reform and Capital Mobility in India

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Studies on formal-informal interactions in the labor markets of developing countries claim that economic reform increases the level of informal activity. Although the extent of such claims differs across countries, it is generally believed that reform is likely to depress informal wage by contracting the formal sector and driving labor onto its informal counterpart. However, available empirical evidence suggests that real wage and real fixed assets in the informal manufacturing sector have risen significantly across most states in post-liberalization India. Using this as a benchmark, we explore a relationship between inter-sectoral capital mobility and informal wage and argue that with limited degree of capital mobility, trade reform reduces the informal wage. This is the conventional wisdom usually obtained when the labor market is treated in isolation from the rest of the economy. However, with increased mobility of capital the informal wage rises with the process of trade liberalization. Furthermore, the effect of an improvement in the annual wage growth in the informal sector has negative and significant impact on the incidence of poverty across states and union territories in India, particularly in the post-reform decades.

In other words, an important policy implication that follows from the theoretical and empirical observations is that formal-to-informal capital mobility can be a crucial factor in guiding wage movements within the informal sector. Unhindered flow of capital into the informal sector can outweigh the negative impact on wage due to large employment pressure. It may be instructive, therefore, that measures may be taken to improve the flow of funds into such production activities. This also offers a more positive approach to the case of informal activities, which more generally is considered as adding to the litany of woes in most poor countries. For example, the real estate boom in India has drawn enormous formal capital and informal labor in the recent period. On the one hand, it has drawn a large section of the labor force, mainly as construction workers, into the system, and on the other has led to rapid urbanization and displacement of poor workers. Thus, additional research is necessary to fully comprehend the risk-return trade off facing any financial intermediary considering direct investment in the informal sector as well as for the economy in general. It is well known that the very nature of the informal sector creates a standard moral hazard problem, which is rather difficult to surmount. In the absence of direct financial flows only possible solutions are perhaps community based micro-finance schemes where peer group monitoring plays an important role in keeping the schemes operative. Since, a considerable section of the urban informal sector workers are engaged in self-employment activities, the source of credit is an important feature for sustenance. In this regard, while some individuals utilize their own resources, many get indebted to private unlicensed moneylenders charging high interest rates. In many cases, the situation looks similar to the infamous agricultural labourer-money lender interactions that continue to cause irreparable damages to the economic conditions of many in rural India. An important first step in this regard is the recognition by the state that the informal sector is a fact of life and it might be easier to improve than reverse their conditions of existence. In fact, there are relatively prosperous pockets even within the informal sector that evade payments of direct or indirect taxes by simply maintaining the informal nature of their trade and by settling for handsome bribes with the law enforcement authorities. Thus, the uncontrolled expansion of the informal sector has largely been a product of corruption and often, passive acceptance at the state level in the absence of employment generating formal industries. There should be little doubt that, if instead, the enormous capacity tapped within the informal sector can be used to its own advantages, the greatest beneficiaries would be the poorest of the poor both in terms of living and working conditions.

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