

Services sector's informal trap

What's holding back formal job growth — supply or demand?

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A recent NITI Aayog report on employment trends in India's services sector has put the spotlight on the evolution of jobs in this key area that accounts for the largest share of the country's gross domestic product (GDP). The report highlights the role of the services sector in employment generation in the country, with its share in total employment rising from 26.9 per cent in 2011-12 to 29.7 per cent in 2023-24. It examines the profile of employment across seven dimensions: Spatial distribution, gender participation, employment type, age profile, education, informality, and earnings. These profiles are used to identify structural challenges. The report also provides a menu of policy options to address the challenge of enhancing productive and gainful employment in the economy. In this piece, we explore the implications of one of these profiles — formal versus informal employment.

To begin with, we look at the comparison of elasticities of employment presented in the report, for different sectors, before and after Covid. The results are significant: There has been an increase in elasticity across all three sectors — agriculture, manufacturing, and services — in the post-Covid period. For the services sector, elasticity has risen from 0.35 to 0.63. The increase is heartening, but since the elasticity remains below 1, it suggests that growth in output and value added does not translate into a commensurate rise in employment.

On the other hand, the elasticities reported for both agriculture and manufacturing are greater than 1. The increase could be due to the recovery in economic activity following the shock of the Covid-19 pandemic and may moderate once the economy

stabilises. However, the high elasticity for agriculture is worrisome, since it reflects poorly on overall employment opportunities. The need to focus on productive employment, therefore, is paramount.

Turning to the formal-informal profile of employment in the services sector, 51 per cent of the jobs are reported to be regular wage jobs while 45 per cent are self-employed. In trade and transport, the share of self-employed is significantly higher. Defining informal jobs to include regular wage jobs without social security benefits, the number of informal jobs climbs to 69 per cent in the services sector. The Annual Survey of Unincorporated Sector Enterprises shows that in the services sector, there is a predominance of owner-driven and family-based enterprises — they account for 82.5 per cent of total number of enterprises.

In this context, one of the priorities identified in the report is "Address Formalisation and Job Security." This is a laudable goal. The policy suggestions towards this goal, however, focus on more and improved regulation, along with access to social security. Two questions need to be explored: What are the constraints to formalisation? And what is the likely impact of artificial intelligence (AI) on formal sector employment?

Constraints to formalisation: Informal employment has two components — informal enterprises and formal enterprises which provide jobs without social security. The constraints to formal jobs can be different for these two categories of informality. For informal enterprises, formalisation represents a cost — compliance with various regulations and taxes, without perceived commensurate or upfront benefits.

The cost of labour or returns to effort too would be affected, thereby impacting the viability of the enterprise. On the other hand, the availability of a reserve pool of low-skilled workers also implies limited bargaining power for the workforce. For both demand- and supply-side agents in the labour market, therefore, there is little incentive to change the status quo.

In this context, can we think of formalisation as related to the scale of demand in the economy? Rapid expansion in demand can create conditions where formalisation is viewed as both desirable and feasible. Income transfers, which stimulate demand of the first few quintiles (i.e. the lowest) of the income distribution might work. Governments choosing to create these income transfers to women are perhaps addressing this niche need.

At the same time, for formal enterprises, providing social security coverage for employees could add to long-term costs, limiting their flexibility to deal with contingencies in an uncertain economic environment. Over the past three decades, governments and institutions have chosen to outsource cleaning, security, and transportation services to reduce such costs. To address this concern, can we think of social security as a service provided by the government? The Union government has initiated a few schemes in this direction. Augmenting the level of protection or insurance provided by these schemes to ensure a minimum quality of living, and creating evidence of easy access to such protection in times of need, could induce workers to adopt them without imposing additional costs on employers. A question remains: How to finance large-scale programmes of this kind? Rationalising income-tax regimes with a far wider base — lower exemption thresholds — could be one way.

Turning to the other question, AI is expected to have a significant impact on employment. The NITI report refers to a study by A Kumar in the *International Journal of Innovative Research in Technology* to suggest that 40-50 per cent of white-collar jobs could be lost. It is argued that demand for AI and big data specialists would rise, but by its very nature, the aggregate impact on employment is likely to be negative, since the technology needs fewer people. This is a concern since a large segment of the formal sector employment is related to the IT and fintech sectors. Widespread adoption of AI could create a few high-paying jobs. It is time to reskill and upskill where feasible to take advantage of such opportunities. However, there is a short-term risk of more people turning to the informal sector. There is a need to stimulate this segment — both to promote formalisation and to support resilient employment generation.

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