

Formal to Informal (MSME) Transition in India: Drivers, Challenges, and Policy Implications

***Mohd Aaqib**
***Dr. Kamal Kishor Jangid**

Abstract

Micro, Small, and Medium Enterprises (MSMEs) are very important for India's economy, helping create jobs, boost exports, and contribute to the country's GDP. Even though there have been efforts by the government to make these businesses more formal, especially after the introduction of GST and digital initiatives, many MSMEs are moving back to informal operations. This paper looks into why this is happening, examining factors like heavy regulations, lack of finance, complicated tax systems, and uncertain markets. It uses existing data and ideas from theories about institutions and the informal economy to understand how this shift affects productivity, workers' conditions, and overall economic growth. The paper ends with suggestions for policies that can encourage businesses to stay formal while making it easier and cheaper for them to comply with rules.

Keywords: MSMEs, Informal Economy, Formalization, GST, India, De-formalization

1. Introduction

MSMEs form the foundation of the Indian economy, contributing around 30% to the GDP and providing jobs to more than 110 million people. The government has introduced various programs, such as the implementation of GST, promotion of digital payments, and the Udyam Registration scheme, to encourage MSMEs to operate within the formal system. Yet, both personal accounts and new research indicate that some MSMEs are moving back to informal practices to manage the difficulty of following regulations and dealing with financial stress.

This situation, where efforts to bring businesses into the formal sector are causing some to return to informal methods, brings up important questions about how policies are created and how well institutions can support these efforts in countries like India that are still developing.

1.1 Formal vs. Informal MSMEs

- Formal MSMEs: Registered entities complying with taxation, labor laws, and regulatory frameworks.
- Informal MSMEs: Unregistered or partially compliant enterprises operating outside formal regulations.

Formal to Informal (MSME) Transition in India: Drivers, Challenges, and Policy Implications

Mohd Aaqib & Dr. Kamal Kishore Jangid

2. Literature Review

2.1 Concept of Informality

The informal economy is marked by a lack of official registration, no social security benefits, and little adherence to rules. Some experts, like Hernando de Soto, say that too many regulations force businesses to operate informally.

2.2 Formalization in Developing Economies

Formalization is usually linked with better productivity, easier access to money, and stronger legal rights. But research shows that making businesses formal too quickly or against their will can make it harder for small companies to run their operations.

2.3 MSMEs in India

Studies also point out bigger problems like difficulty getting loans, poor infrastructure, and a lack of skilled workers. Research after the GST implementation shows mixed results, with some businesses gaining advantages while others find it hard to meet new rules.

3. Theoretical Framework

This study is grounded in:

- **Institutional Theory:** Firms respond to regulatory pressures and institutional constraints
- **Cost-Benefit Framework:** MSMEs weigh costs of formalization (taxes, compliance) against benefits (credit access, legal protection).
- **Dual Economy Model:** Coexistence of formal and informal sectors with fluid boundaries.

4. Methodology

- **Research Design:** Qualitative and analytical
- **Data Sources:** Secondary data from government reports (e.g., Ministry of MSME, NSSO), World Bank, and academic studies
- **Approach:** Thematic analysis of drivers and impacts of formal-to-informal transition

5. Drivers of Formal to Informal Transition 5.1 Regulatory Burden

The complicated rules under GST, labor laws, and licensing make it hard for businesses to stay in the formal sector.

5.2 Taxation Pressures

High tax rates and delays in getting back taxes paid create financial difficulties for small and medium businesses.

Formal to Informal (MSME) Transition in India: Drivers, Challenges, and Policy Implications

Mohd Aaqib & Dr. Kamal Kishore Jangid

5.3 Limited Access to Finance

Even though they are officially registered, many small businesses struggle to get loans from banks, which make them less likely to stay formal.

5.4 Digital Divide

The need to use digital tools like e-invoicing and online tax filing is tough for small businesses that don't have the tech skills or resources.

5.5 Economic Shocks

Events such as demonetization and the COVID-19 pandemic hit small businesses hard, leading many to switch to informal ways of operating to survive.

6. Impacts of De-formalization 6.1 Productivity Decline

Informal firms often operate at lower productivity levels due to limited scale and investment.

6.2 Labor Vulnerability

Workers in informal MSMEs lack social security, job stability, and legal protection.

6.3 Fiscal Losses

Reduced tax compliance leads to lower government revenues.

6.4 Distorted Competition

Informal firms may gain cost advantages, creating an uneven playing field.

7. Policy Analysis

7.1 Government Initiatives

- GST and digital compliance systems
- Udyam Registration Portal
- Credit schemes like CGTMSE and Mudra loans

7.2 Gaps in Policy Implementation

- High compliance costs relative to firm size
- Limited awareness and outreach
- Weak enforcement balanced with over-regulation

8. Recommendations

8.1 Simplification of Compliance

Introduce a system where compliance requirements vary depending on the size of the business and its turnover.

Formal to Informal (MSME) Transition in India: Drivers, Challenges, and Policy Implications

Mohd Aaqib & Dr. Kamal Kishore Jangid

8.2 Incentive-Based Formalization

Give tax breaks, financial support, and better access to loans to businesses that choose to operate formally.

8.3 Strengthening Digital Infrastructure

Offer training and assistance to help small and medium-sized businesses adopt digital tools and technologies.

8.4 Improved Access to Credit

Promote lending through financial technology and decrease the need for physical assets as collateral.

8.5 Social Security Integration

Connect formal business registration with real benefits for workers, such as health insurance and retirement savings.

9. Conclusion

The transition from formal to informal operations among MSMEs in India highlights the unintended consequences of policy design that prioritizes regulation over facilitation. A balanced approach that reduces compliance burdens while enhancing the benefits of formalization is essential. Policymakers must adopt a nuanced, MSME-centric framework to ensure sustainable economic growth and inclusive development.

***Research Scholar**
****University of Technology**

References

1. Ministry of MSME Reports (Government of India)
2. World Bank (Informality Studies)
3. NSSO Survey Data
4. De Soto, H. (2000). *The Mystery of Capital*
5. OECD Reports on SME Formalization

Formal to Informal (MSME) Transition in India: Drivers, Challenges, and Policy Implications

Mohd Aaqib & Dr. Kamal Kishore Jangid