

The Informal Sector Needs Better Books

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Could the key to India's MSME growth be hiding in plain sight? Even as the government considers a ₹2000 crore technology upgradation scheme for MSMEs, one must acknowledge that these schemes, while a step in the right direction, can still only reach a fraction of India's vast number of MSMEs. Over 90% of MSMEs operate in the informal sector, making them largely invisible to policymakers and generally unable to access government schemes. At the same time, this sector faces a persistent credit gap that leaves millions of microenterprises struggling to access capital.

The prevailing policy response is to push informal enterprises toward formality by encouraging them to register and meet compliance requirements. However, the solution to informality might not be that simple. Studies show that merely reducing registration costs and making it easier to comply does not generally work as informality is often a deliberate choice.

Many small entrepreneurs prefer to operate under the radar. Take for instance Kumar, who runs a general provisions store in Bara Bazaar in Shillong, largely self-financed and staffed by members of his family. He has never availed of any government schemes, even when the Covid lockdown forced his store to shut for months, pushing him to the brink. Kumar's doubts about formal credit are echoed across the informal sector where distrust in the system runs deep. "If I take a loan, I will be trapped," he says. "I will have to pay every month and what if I can't pay some months?"

Beyond distrust, formal systems often do not factor in the informal arrangements on which these businesses depend – relying on family labor, borrowing from community members, and operating flexibly to cover expenses. Formal systems are not designed to recognize or replace these practices. Replacing deeply entrenched norms, such as community-based risk-sharing,

with formal structures could leave entrepreneurs worse off. They would be stripped of their traditional support systems without necessarily gaining the benefits of formality.

THE REAL PROBLEM IS LOW PRODUCTIVITY

A key difference between informal and formal firms is productivity, not just legal status. Formal businesses get more from their labor and capital investments. A registered factory with access to bank credit can hire well-trained workers and invest in better machines. An informal business, by contrast, uses low-skilled workers instead of better equipment because loans are either unavailable or perceived to be too risky. Thus, these businesses remain unproductive and stagnate.

Informal businesses face numerous constraints, including limited access to capital and unreliable infrastructure – challenges largely beyond their control. One practical solution, however, lies within reach: improving accounting and bookkeeping practices. We often think of accounting as a compliance necessity. But quality accounting systems do more than just meet compliance requirements. They are also decision-making tools. Even within the same industry, productivity gaps across firms can be traced in part to accounting differences. In case of unexpected shocks, higher quality accounting can help firms adapt faster. Accounting helps entrepreneurs understand which activities are profitable, where to invest scarce resources, and how to respond when problems arise. It transforms gut feelings into informed choices. And unlike improving infrastructure or expanding credit markets, better bookkeeping can be achieved at low cost. It is within reach.

THEY KNOW HOW TO KEEP BOOKS BUT SEE NO BENEFIT

Many informal sector entrepreneurs do not need to be taught record-keeping. They generally understand basic accounting concepts but do not see the value in adopting better bookkeeping practices. This is especially true among retail traders who are a significant part of the informal sector. As Kong Mertina who runs a small textile shop in Bara Bazaar put it, “I know how much I buy for and how much I sell for. At the end of the day, I know if I’ve made money or not. Writing it down won’t change that.” In surveys we conducted, 60% of retail traders did not maintain any type of record-keeping, or relied on rudimentary tools when they did.

This skepticism mirrors the broader distrust of formal financial systems. Just as many entrepreneurs ask “Why should I take a bank loan when I can borrow from my neighbor?” they question why they should maintain detailed records when they already have an intuitive sense

of their finances. Formal tools are perceived as unnecessary complications that serve external interests rather than their own. Left to their own devices, many would never adopt better bookkeeping practices. They would need to be shown, through demonstration or peer example, that these tools solve problems they care about: tracking credit to customers, identifying profitable products, or simply knowing whether the business is making money or not.

BETTER ACCOUNTING ENABLES INFORMED DECISIONS

Rather than dragging informal firms into formal structures that they are not ready for, they must be met where they are. Existing practices in informal markets can be enhanced by making them more systematic and more useful through minimally disruptive, technology-enabled tools.

While compliance is important, the primary goal should be capability. Better information leads to better decisions which leads to higher productivity – eventually making formality worth pursuing. This is a patient approach, but one that respects the wisdom embedded in informal systems while offering a genuine pathway forward. The informal sector cannot be formalized by fiat. But it can grow its way there one better decision at a time.

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