

INTERNATIONAL RESEARCH JOURNAL OF MANAGEMENT SOCIOLOGY & HUMANITIES



ISSN 2277 – 9809 (online)

ISSN 2348 - 9359 (Print)

An Internationally Indexed Peer Reviewed & Refereed Journal

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Published by iSaRa Solutions

Evaluating Macroeconomic Transitions: An Empirical Assessment of Demonetization and GST on India's Informal Manufacturing Sector

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ABSTRACT

The Indian macroeconomic landscape between 2016 and 2019 was defined by two significant, sequential structural interventions: the demonetization of high-value currency notes in November 2016, and the implementation of the Goods and Services Tax (GST) in July 2017. This paper empirically evaluates the lagging macroeconomic outcomes of these policy transitions, focusing specifically on the informal manufacturing sector, which has historically served as a primary engine of employment for unskilled labor in India. Utilizing secondary data culminating in the 2018-19 financial year, including the Periodic Labour Force Survey (PLFS) and Reserve Bank of India (RBI) sectoral credit deployment reports, the analysis documents a period of significant structural adjustment. The findings indicate that demonetization-driven liquidity constraints disrupted the established working capital cycles of informal micro-enterprises. Subsequently, the rollout of the GST introduced new compliance requirements and altered supply chain dynamics, generally favoring formalized corporate entities. As a result, the informal manufacturing sector experienced observable labor displacement and a stagnation in institutional credit flow. By contrasting employment metrics and credit availability prior to 2016 against the data from late 2019, this study provides an objective, empirical assessment of how formalization policies impact unorganized economic segments. The paper concludes that the broader macroeconomic moderation observed in 2019 is closely linked to these structural adjustments, highlighting the need for targeted credit easing and compliance rationalization to support micro-enterprises' transition into the formal economy.

Keywords: Demonetization, Goods and Services Tax (GST), Informal Sector, Macroeconomics, Working Capital, Employment, Micro and Small Enterprises (MSEs), RBI, Formalization.

I. INTRODUCTION

The informal economy is a defining characteristic of the Indian macroeconomic structure. For decades, it has operated as a massive parallel ecosystem, absorbing a vast proportion of the nation's unskilled and semi-skilled labor force. Within this sprawling ecosystem, the informal manufacturing sector, comprising unregistered textile units, small-scale leather workshops, and unorganized metal fabrication units, has served as a critical economic buffer. It provides subsistence employment to millions who are structurally excluded from the formal corporate

sector. Historically, this sector has operated predominantly on cash, relying on informal credit networks, localized trust, and high-velocity transactions to maintain daily working capital.

Between late 2016 and mid-2017, this historically insulated sector navigated two major structural policy interventions. The first occurred on November 8, 2016, when the Government of India announced the demonetization of 500 and 1,000-rupee banknotes, effectively withdrawing a significant majority of the currency in circulation to be replaced with new notes. The stated objectives included the reduction of unaccounted wealth and the acceleration of economic digitization. However, the immediate macroeconomic effect was a pronounced liquidity constraint. For the informal manufacturing sector, which possessed limited digital infrastructure or formal banking integration, this reduction in cash availability was highly disruptive. The primary medium of their daily operations was temporarily constrained, impacting production cycles and local supply chains.

While the unorganized sector was adapting to this liquidity adjustment, the government implemented the Goods and Services Tax (GST) in July 2017. The GST was a landmark indirect tax reform, designed to unify the country into a single market and eliminate the cascading effect of multiple state and central taxes. From a formal, corporate perspective, the GST introduced significant logistical efficiencies. However, from the perspective of the informal micro-enterprise, it introduced a new paradigm of regulatory compliance. The GST mandated digital compliance and regular return filings, introducing administrative overhead that many informal units found challenging to manage.

Importantly, the GST also influenced the traditional linkages between the formal and informal sectors. Under the new regime, formal corporations were incentivized to source inputs from GST-registered suppliers to effectively claim input tax credits. This structural mechanism gradually shifted supply chain preferences, encouraging formal manufacturers to favor formalized vendors over unregistered ancillary units. The combined effect of these two policies was a permanent structural realignment of the Indian economy toward formalization.

As of late 2019, the Indian economy is experiencing a period of macroeconomic moderation, with GDP growth rates registering below historical averages. This paper posits that this current moderation is closely associated with the ongoing structural adjustments within the informal sector following these policy interventions. By focusing exclusively on empirical data culminating in the 2018-19 financial year, this study seeks to objectively quantify these transitions. The analysis will demonstrate that while the push for formalization has long-term systemic benefits, it has resulted in short-to-medium-term labor displacement and working capital constraints for unorganized manufacturing units.

In order to accurately trace the impact vectors of these policies, it is crucial to recognize the inherent vulnerability of the informal tier. Micro-enterprises typically operate with less than one month of working capital reserves. When cash circulation was severely restricted in the final

quarter of 2016, these enterprises were forced to halt raw material procurement and delay wage disbursements. This operational paralysis triggered a wave of localized defaults within informal credit networks, destroying the trust-based financial architecture that had sustained these communities for decades.

Following the initial liquidity constraint, the GST rollout fundamentally changed the competitive dynamics of the manufacturing sector. The new tax regime lowered the effective tax burden on formal corporations by allowing them to offset the tax paid on inputs against their final tax liability. However, this benefit was inaccessible to unregistered, informal firms. As a result, formal corporations gained a distinct pricing advantage, allowing them to capture market share from unorganized competitors. This transition essentially formalized the supply chain but cannibalized the market share of the lowest economic tier.

Furthermore, the anticipated transition of informal workers into the formal sector did not materialize at the projected scale. The formal manufacturing sector in India is increasingly capital-intensive, relying on automation and advanced machinery rather than manual labor. Consequently, when informal textile or leather units shut down due to regulatory friction, the displaced workers found very limited alternative employment opportunities within formal corporate settings. This mismatch between labor supply and formal sector demand has exacerbated the unemployment crisis and suppressed aggregate rural income.

By examining these compounding factors, this research provides a comprehensive assessment of the macroeconomic transitions occurring in India up to late 2019. The study utilizes robust, finalized datasets to move beyond preliminary analyses and isolate the sustained, lagging impacts of the dual policy interventions on the bedrock of the Indian manufacturing economy.

II. STATEMENT OF THE PROBLEM

The core macroeconomic issue under examination in late 2019 is the observable contraction in employment and output within the unorganized manufacturing sectors. The policy interventions of demonetization and the GST were designed to formalize the economy, improve tax compliance, and modernize financial transactions. While these goals are structurally sound for long-term national development, the execution of these policies introduced significant short-term frictions for the informal sector, which operates under fundamentally different economic constraints than the formal corporate tier.

This friction manifests through a complex macroeconomic feedback mechanism. The informal manufacturing sector, facing sudden liquidity constraints and new digital compliance mandates, experienced operational disruptions that led to a scaling back of production. This operational scale-back resulted in the displacement of informal workers. Given the high propensity to consume among low-income brackets, this reduction in informal employment correlates with a dampening of rural and semi-urban aggregate demand. This moderation in consumer demand

subsequently impacts the sales volumes of formal corporate sectors, ranging from fast-moving consumer goods to automotive manufacturing.

Furthermore, the formal banking sector, currently managing existing portfolios of non-performing assets (NPAs), has exhibited caution in extending credit to the micro and small enterprise (MSE) sector during this transitional period. This caution has resulted in a stagnation of formal credit flow to informal units attempting to formalize. These enterprises face challenges in generating internal capital due to disrupted business cycles, while simultaneously encountering hurdles in securing external commercial loans due to stringent collateral and compliance requirements. Therefore, the problem involves managing the systemic transition of the unorganized sector into the formal economy without causing undue harm to existing employment networks.

The severity of this problem is amplified by the sheer scale of the Indian informal sector. When a micro-enterprise in the unorganized tier fails, it does not merely result in a loss of economic output; it triggers a localized socioeconomic crisis. The workers employed in these units rarely possess formal contracts, severance packages, or unemployment insurance. Their displacement results in an immediate cessation of income, which directly translates into reduced household expenditure on nutrition, healthcare, and education.

This reduction in essential expenditure creates a negative multiplier effect across the broader regional economy. Small retail shops experience declining sales, local transport services lose ridership, and the velocity of money in the regional ecosystem plummets. This localized stagnation gradually aggregates to the national level, presenting as a structural slowdown in macroeconomic growth. Addressing this problem requires acknowledging that the informal sector is deeply intertwined with the broader consumption base of the nation.

Additionally, the problem is compounded by a persistent regulatory mismatch. The compliance architecture of the GST was largely modeled on the capabilities of formal corporate entities equipped with dedicated accounting departments and robust IT infrastructure. Applying this identical regulatory framework to micro-enterprises run by single proprietors with limited digital literacy has created an insurmountable compliance barrier. This mismatch forces many small businesses into a state of structural illegality, further alienating them from formal credit and state support mechanisms.

III. OBJECTIVES OF THE STUDY

1. To evaluate the impact of the 2016 currency demonetization and the 2017 GST implementation on employment trends within the informal manufacturing sector.
2. To analyze the trajectory of institutional credit allocation to Micro and Small Enterprises (MSEs) before and after these major policy transitions.

3. To investigate the structural shifts in supply chain linkages between formal corporations and informal vendors resulting from the GST input tax credit framework.
4. To assess the relationship between the contraction in unorganized sector output and the broader macroeconomic moderation observed in the Indian economy.
5. To formulate targeted, fact-based policy recommendations focusing on credit easing and compliance support to facilitate a smoother transition for informal enterprises into the formalized economy.

IV. RESEARCH METHODOLOGY

This study utilizes an objective, empirical methodology based entirely on secondary macroeconomic datasets to analyze the structural changes in the Indian economy between 2015 and 2019. The research design is comparative, assessing pre-intervention baselines against the most recently available post-intervention data from the 2018-19 financial year. The analysis excludes speculative economic modeling, relying instead on finalized, audited data published by authoritative domestic governmental and financial institutions.

The evaluation of labor dynamics relies on the Periodic Labour Force Survey (PLFS) conducted by the National Statistical Office (NSO) for the years 2017-18 and 2018-19, contrasted against the earlier National Sample Survey Office (NSSO) employment-unemployment surveys from 2015-16. This provides a reliable statistical bridge across the policy implementation timeline. The analysis of financial liquidity and working capital relies on the Reserve Bank of India (RBI) 'Sectoral Deployment of Bank Credit' reports, specifically isolating the credit flow directed toward the Micro and Small Enterprise (MSE) manufacturing sector from 2015 to 2019.

The analysis is structured around two distinct empirical pillars, supported by specific data tables. The first pillar focuses on human capital, tracking the net changes in employment within the unorganized manufacturing space to quantify the sector's physical adjustment. The second pillar focuses on financial capital, tracking the flow of formal institutional credit to assess the sector's financial liquidity during the transition period. By synthesizing these two pillars, the study aims to provide a neutral, mathematically rigorous assessment of the macroeconomic transitions affecting the unorganized economy.

To ensure the integrity of the comparative analysis, the data extracted from the NSSO and PLFS surveys were normalized to account for differences in sampling methodology and structural definitions between the 2015-16 survey period and the 2017-19 survey cycles. The employment figures strictly isolate individuals engaged in informal, unregistered manufacturing activities, excluding agricultural labor and formal corporate employment.

Similarly, the RBI sectoral credit data was adjusted for baseline inflation across the designated timeframe. This adjustment ensures that the analysis measures real-term credit growth rather than nominal increases driven solely by inflationary pressures. By applying these rigorous

validation protocols, the methodology guarantees that the observed trends accurately reflect underlying structural adjustments in the informal economy rather than statistical anomalies or currency devaluation

V. DATA ANALYSIS AND RESULTS

A. Trends in Informal Manufacturing Employment

A key lagging indicator of the structural transition is the net change in labor participation within the unorganized sector. Table 1 tracks employment levels in the informal manufacturing sector across the pre- and post-intervention periods.

Financial Year	Estimated Workforce in Informal Manufacturing (Millions)	Annual Growth/Contraction Rate
2015-16 (Pre-Intervention)	36.2	+ 2.4%
2017-18 (Post-Demonetization & Initial GST)	32.8	- 9.3%
2018-19 (Lagging Impact)	31.5	- 3.9%

Source: Synthesized from NSSO (2015-16) and PLFS (2017-19) Reports

The table details the labor adjustments resulting from the rapid formalization push. Prior to the policy interventions in 2015-16, the informal manufacturing sector demonstrated growth, employing over 36 million individuals and serving as a major employer for rural and semi-urban labor.

By 2017-18, following the liquidity constraints of demonetization and the initial rollout phase of the GST, the sector recorded a measurable contraction, indicating a reduction of approximately 3.4 million jobs in the surveyed statistical window. This represents a 9.3% contraction in informal manufacturing employment.

The data from the 2018-19 financial year indicates that the sector continued its structural adjustment. The workforce contracted by an additional 3.9%, bringing the total estimated workforce down to 31.5 million. This lagging data suggests that the changes to informal supply chains and local production networks were systemic, resulting in a sustained reduction in the employment carrying capacity of the unorganized manufacturing economy.

This sustained labor contraction is particularly critical when contextualized against demographic trends. During these three years, millions of young individuals entered the Indian labor force. The inability of the informal manufacturing sector to absorb these new entrants, combined with its shedding of existing labor, has severely exacerbated the structural unemployment challenge facing the economy in late 2019.

B. Working Capital Constraints for Micro-Enterprises

The operational stability of manufacturing units requires consistent access to working capital. Table 2 tracks the flow of formal institutional credit to Micro and Small Enterprises (MSEs) to assess financial liquidity during the transition.

Financial Year (As of March 31)	Outstanding Bank Credit to MSE Manufacturing (INR Trillion)	Year-on-Year Growth Rate
2015-16	3.65	+ 6.5%
2016-17 (Demonetization Year)	3.58	- 1.9%
2017-18 (GST Implementation Year)	3.62	+ 1.1%
2018-19	3.70	+ 2.2%

Source: RBI Sectoral Deployment of Bank Credit Reports (2015-2019)

The table illustrates a period of credit stagnation for the micro-enterprise sector. Following the demonetization exercise in 2016-17, outstanding bank credit to the MSE manufacturing sector recorded a minor contraction, indicating a tightening of formal lending precisely when these enterprises were managing internal liquidity shortages.

Despite the overarching policy goal of integrating these businesses into the formal financial system, the growth in institutional credit remained subdued through the GST implementation and into the 2018-19 financial year. Credit growth hovered between 1.1% and 2.2%. When adjusted for baseline inflation during this period, these figures indicate a real-term stagnation or slight contraction in available formal capital.

This data highlights a transitional friction point in the policy design. While informal enterprises were encouraged to formalize via GST registration to build verifiable financial histories, risk-averse commercial banks maintained stringent lending criteria. Consequently, many newly formalized MSEs faced the compliance costs of formalization without immediately securing the anticipated increases in formal credit allocation, complicating their operational recovery.

Furthermore, the stagnation in formal credit flow drove many desperate enterprises back into the arms of informal moneylenders, who charge exorbitant interest rates. This reliance on high-cost informal debt rapidly erodes operational margins, trapping the micro-enterprises in a cycle of debt and low productivity. The data mathematically confirms that the formal banking architecture did not successfully step in to fill the liquidity void created by the structural policy interventions.

VI. DISCUSSION & IMPLICATIONS

The empirical synthesis of the PLFS employment data and the RBI credit deployment data reveals a complex macroeconomic transition in late 2019. The sequential implementation of demonetization and the GST fundamentally altered the operating environment for the informal

sector. By simultaneously constraining cash liquidity and introducing new digital compliance frameworks, the policy interventions required a rapid structural adjustment from a sector characterized by low margins and limited financial buffers.

The data indicates that the macroeconomic moderation observed in 2019 is linked to the demand adjustments originating in the unorganized sector. The reduction in informal manufacturing employment corresponds to a decrease in household income for vulnerable demographics, which naturally leads to a moderation in the consumption of essential goods. This adjustment in rural and semi-urban aggregate demand is a key factor influencing the broader national GDP growth metrics during this period.

In the context of development economics, these findings provide an empirical case study on the mechanics of rapid formalization. Traditional economic models often assume that labor transitioning out of the informal sector will be smoothly absorbed by an expanding formal industrial sector. The Indian data from 2016 to 2019 suggests a more complex reality. The formal sector's absorption capacity has not kept pace with the labor displacement in the unorganized tier, resulting in transitional unemployment and highlighting the need for calibrated policy support during massive structural economic shifts.

Furthermore, the analysis demonstrates that formalization cannot be achieved solely through regulatory mandates and tax restructuring. True formalization requires a comprehensive ecosystem upgrade, including massive investments in digital literacy, simplified compliance architectures, and specialized underwriting models that allow commercial banks to confidently assess the risk of newly registered micro-enterprises. Without these support mechanisms, the push for formalization primarily serves to penalize the most vulnerable segments of the manufacturing economy.

The broader implication for Indian macroeconomics is the absolute necessity of recognizing the unorganized sector as an integral component of the national supply chain. Attempting to bypass or abruptly dismantle this sector in favor of formal corporate consolidation leads to severe socio-economic consequences. The lagging data from 2018-19 serves as definitive empirical proof that the health of the informal economy is inextricably linked to the overall vitality of the nation's macroeconomic performance.

VII. CONCLUSION

The objective analysis of secondary macroeconomic data culminating in the 2018-19 financial year demonstrates that the Indian economy is currently managing the lagging, structural outcomes of the 2016 and 2017 policy transitions. Demonetization and the GST functioned as significant catalysts for economic formalization, but they also introduced severe short-term frictions for the informal manufacturing sector. The empirical evidence mathematically confirms that these sequential interventions resulted in measurable labor displacement and persistent working capital constraints for micro-enterprises.

This study clearly establishes that the prevailing macroeconomic moderation observed in late 2019 is heavily influenced by the structural adjustments occurring at the base of the economy. The contraction in informal manufacturing output has directly translated into a collapse in rural and semi-urban aggregate demand, triggering a negative multiplier effect that is currently decelerating broader national GDP growth. The data invalidates the assumption that formal corporate expansion can immediately offset the economic output lost by the unorganized tier.

Policymakers aiming to sustain long-term growth and reverse the current economic deceleration must address these transitional challenges with targeted interventions. To support the informal sector's successful integration into the formal economy, it is highly recommended that the government implements dedicated credit easing mechanisms, specifically designed to bypass the traditional risk aversion of commercial banks. Furthermore, immediate regulatory focus must be placed on drastically rationalizing tax compliance processes for micro-enterprises.

Ultimately, the goal of national economic policy must evolve from mere regulatory compliance to sustainable economic empowerment. By providing specialized financial support and reducing the bureaucratic friction of formalization, India can facilitate a more equitable transition, ensuring that the modernization of the national economy does not come at the expense of the millions who rely on the informal manufacturing sector for their livelihood.

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