INSTITUTE OF ECONOMIC GROWTH
POLICY BRIEF
2/2025

From Margins to Mainstream: Subcontracting in Informal Manufacturing

Srishti Gupta[1], *Assistant Professor, Tata Chair Unit, Institute of Economic Growth, Delhi, India*

Introduction

India's informal manufacturing sector is central to employment generation and enterprise creation. According to the National Sample Survey (2015–16), nearly 90 percent of micro-enterprises operate within this sector. Most of these units are family-run, small in scale, and have limited access to credit, technology, and markets. Despite their small size, they collectively contribute significantly to the country's industrial output and provide livelihoods to millions.

A key way informal enterprises connect with larger firms is through subcontracting. Subcontracting occurs when a producer outsources part of its production process to another firm. For informal enterprises, this arrangement provides access to markets, assured orders, and a measure of stability. It also allows smaller units to participate indirectly in value chains led by larger firms. However, participation in subcontracting has historically been limited. Data from 2001 to 2016 indicate that fewer than 30 percent of informal manufacturing enterprises engaged in subcontracting, with rural participation slightly increasing and urban participation declining.

The discussion around subcontracting often presents two contrasting views. One perspective, the "exploitation view," sees informal enterprises as vulnerable. Larger firms may pay low margins, delay payments, or use smaller units as a buffer to cut costs. In contrast, the "accumulation view" argues that subcontracting creates opportunities for informal firms to access technology, develop capabilities, earn steady incomes, and eventually grow. Understanding the true impact of subcontracting requires careful examination of firm-level data, performance outcomes, and how benefits are distributed across gender, location, and enterprise type. Our recent study, published in the Journal of Developing Areas (Gupta, 2023), uses data from the NSSO 73rd round to shed light on this debate. The study examines whether subcontracting helps or harms informal firms, how different firms benefit from these arrangements, and what lessons this holds for policymakers, development practitioners, and industry stakeholders.

Findings

Our analysis reveals that overall participation in subcontracting is modest. Only nine percent of owner-run manufacturing firms reported engaging in subcontracting, and participation among firms that hire workers is similar. Interestingly, female-owned firms are slightly more likely to subcontract than male-owned firms, and home-based enterprises are more likely to subcontract than firms operating outside the home. These patterns suggest that subcontracting is not only a market-driven strategy but also a response to the structural constraints faced by small and informal units, particularly those run by women or located in rural or home-based settings.

Table 1. The Subcontracting Penalty or Gain of the Subcontracted Firms

ATET((Annual GVA)/ Sales)	
Full Sample	0.155*** (0.005)
OAME	0.117*** (0.007)
Non-OAME	0.205*** (0.010)
Rural	0.140*** (0.009)
Urban	0.162*** (0.009)
Female	0.091*** (0.008)
Male	0.192*** (0.008)

[1] Corresponding author: srishti@iegindia.org

Table 1 above shows that firms that participate in subcontracting earn higher profit margins compared to non-subcontracted firms. On average, subcontracted firms earn about 15 percent higher profits, providing clear evidence that subcontracting can be beneficial. However, the gains are not evenly distributed. Male-owned firms capture around 19 percent of the profit premium, while female-owned firms gain only about nine percent, despite their higher participation rates. The gender gap likely reflects differences in access to credit, technology, business networks, and training opportunities. Family-run firms retain a larger share of subcontracting gains compared to firms with hired workers, since the former does not have to share profits with employees as later on does. Rural and home-based firms benefit significantly from subcontracting. These firms often face unstable demand and delayed payments when operating independently. Subcontracting reduces these risks by providing assured orders and predictable cash flow, allowing small enterprises to plan production and manage resources more efficiently. While buyer power exists, the benefits of stability and market access often outweigh the potential disadvantages.

Taken together, these findings suggest that subcontracting generates a measurable "premium" for informal enterprises. It can help stabilize incomes, reduce risk, and provide access to larger markets. At the same time, the distribution of benefits remains uneven, highlighting the need for targeted policy support.

Policy Perspectives

It is important to note that subcontracting has significant implications for industrial growth and structural change. As formal enterprises shift toward more capital-intensive and technologically sophisticated industries, informal enterprises increasingly occupy low-end markets. Subcontracting allows informal firms to participate in value chains while taking over segments that are no longer profitable or attractive to larger firms. Strengthening the subcontracting ecosystem can therefore support inclusive growth and industrial development.

One way to achieve this is through cooperative and collective models such as the Amul model in dairy market demonstrate how collaboration can enhance bargaining power, improve market access, and stabilize incomes for small milk producers. Applying similar models in informal manufacturing, especially in sectors such as textiles, handicrafts, and small-scale electronics, could help informal firms scale up, access resources collectively, and negotiate fairer terms with larger firms. Closing gender gaps is a priority. Women-owned firms, although more likely to subcontract, often capture a smaller share of the benefits. Expanding access to credit through targeted schemes, strengthening women's networks that provide market access, savings, and insurance, and digital literacy can help women entrepreneurs capture more gains from subcontracting. This approach aligns with broader objectives of gender equity and inclusive growth. Since, ensuring fair and timely payments is also essential, large firms can be encouraged or required to disclose payment practices, adopt transparent supplier codes, and share resources such as training and equipment. Similarly, the tax or CSR incentives should motivate large firms to invest in subcontractor capacity, thereby benefitting the small firms. Home-based and rural subcontractors, who often lack bargaining power, can benefit from collective forums, better access to credit, digital connectivity, and links to cluster-based infrastructure, such as common facilities and design centres.

From a broader perspective, well-designed subcontracting policies support key national priorities. They can advance Atmanirbhar Bharat by integrating local enterprises into larger value chains while maintaining their independence. By stabilizing small enterprises, subcontracting sustains livelihoods and contributes to employment generation. It also provides a pathway for gradual formalization of informal enterprises, allowing policymakers to support small firms without imposing abrupt compliance requirements.

The way forward is not to discourage subcontracting, but to reshape it. When implemented thoughtfully, subcontracting can become a powerful tool for inclusive industrial growth, helping India's vast informal sector transition toward stability, profitability, and resilience.

References

- Basole, A., Basu, D., and Bhattacharya, R., "Determinants and Impacts of Subcontracting: Evidence from India's Unorganized Manufacturing Sector", 2015, International Review of Applied Economics, Taylor & Francis Journals, vol. 29, No. 3, pp. 374-402.
- Kumar, R.A., "Subcontracting in Unorganised Manufacturing Sector: Overview and Linkage with Industrial Agglomeration" , 2017, SARVEKSHANA: Journal of National Sample Survey Office, Vol. 57, No. 102, pp. 64-87.
- Maiti, D., and Sen, K., "The Informal Sector in India: A Means of Exploitation or Accumulation?", 2010, Journal of South Asian Development, Vol. 5, No. 1, pp. 1-13.
- Ramaswamy, K. V., "Do Size-dependent Tax Incentives Discourage Plant Size Expansion? Evidence from Panel Data in Indian Manufacturing" , 2021, Margin: The Journal of Applied Economic Research, Vol. 15, No. 4, pp. 395-417.
- Sahu, P., "Subcontracting in India's Unorganised Manufacturing Sector: A Mode of Adoption or Exploitation?", 2010, Journal of South Asian Development, Vol 5, pp. 53- 83.

INSTITUTE OF ECONOMIC GROWTH
University of Delhi Enclave,
(North Campus), Delhi - 110007, India.
91-11- 27662404, 27667570,27667365, 27666364, 27667424, 27667288
Website : www.iegindia.org
facebook / InstituteofEconomicGrowth twitter @iegresearch linkedin.com/company/institute-of-economics-growth