

# Trade and the Informal Economy

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# Trade and the Informal Economy

## Major challenges:

- Modeling (definition) of the informal sector
- Data

⇒ Set of economic/policy experiments to be investigated is limited

⇒ CGE modeling is both modeling and data intensive

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## Modeling: segmented versus integrated views

### Common features:

- Self-employment / small size firms
- Essentially in non-tradable (nature or quality) goods sector

### Contrasting predictions:

- Constrained and counter-cyclical occupational choice in the dualistic view:  
earnings and size of the sector move in opposite directions
- Voluntary and pro-cyclical occupational choice in the integrated view:  
earnings and size move in the same direction

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## Empirical Evidence (Loayaza and Rigolini (2006); Fiess, Fugazza and Maloney (2010))

- A large component of the informal sector should not be viewed as somehow inferior or queuing for formal sector employment.
- However, it is also the case that rigidities in the formal salaried sector can become very binding
- Results suggest that the pro or countercyclicalities of the sectors may depend on the sectoral origin of the shocks, and the presence of binding wage rigidities (Numerous examples where either a positive productivity or demand shock to the nontradables/informal sector leads to its expansion are observed)

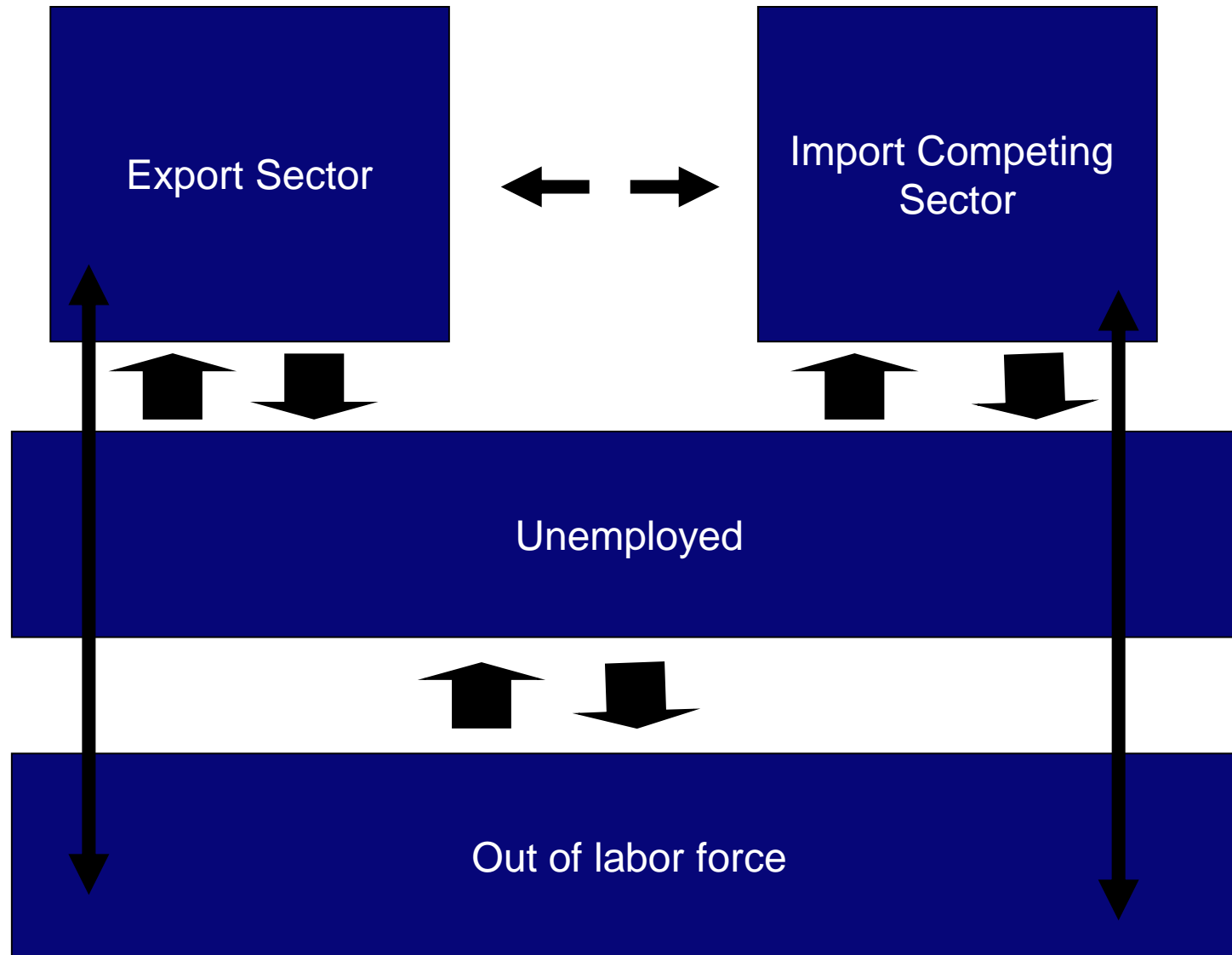
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## Trade Liberalization and Informality: modeling

- Conventional: Greater demand for informally produced inputs is expected to drive the extension of the informal sector following trade liberalisation (Goldberg and Pavnic (2003))
- Relationship is unclear in models with firms' heterogeneity (Aleman-Castilla (2006)): some informal firms may be attracted by the formal sector after a fall in trade costs
- Ambiguity remains in models with tradability exogenously determined (Fiess, Fugazza and Maloney (2010)): impact on the real exchange rate (?)

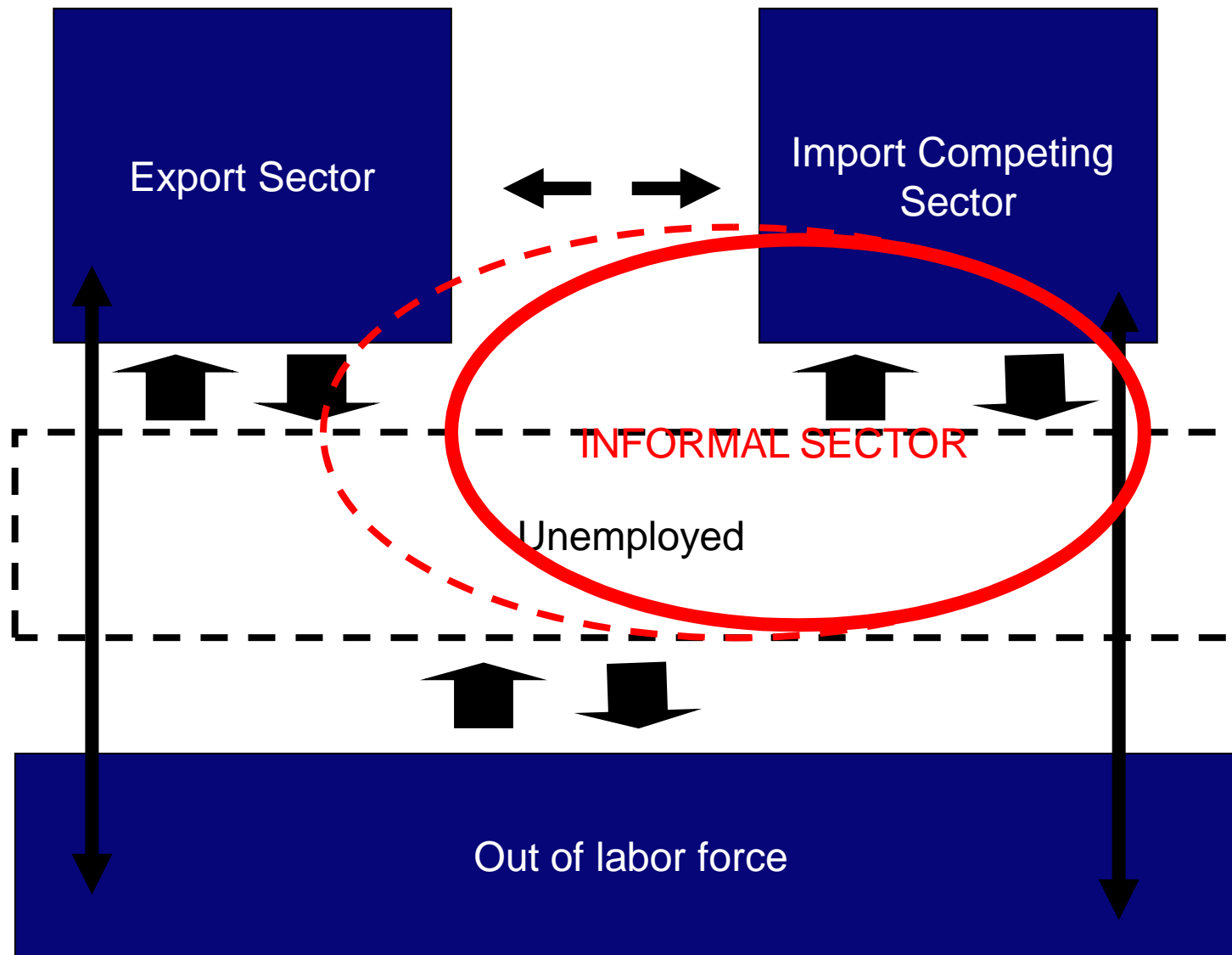
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Labor market dynamics: standard approach



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Labor market dynamics with informality



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## Empirical Evidence: micro *versus* macro

- Micro Empirical studies suggest that informality can respond to trade liberalisation either positively or negatively, depending on country and industry characteristics (economic and institutional)
- Contrasting evidence across macro datasets (different info measures) but not across indicators of openness to trade:
  - *Less restricted trade is associated with a larger share of informal output*
  - *Less restricted trade is associated with a lower share of informal labor*



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