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# Economic liberalization, capital mobility and informal wage in a small open economy: A theoretical analysis ☆

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**Abstract**

Empirical evidence suggests that the size of the informal sector in the developing countries has increased considerably during the liberalized economic regime. The present paper purports to analyze the consequences of economic reforms on the wellbeing of the informal sector workforce using a three-sector general equilibrium model with two informal sectors. The theoretical analysis finds that different liberalized policies produce diverse effects on the informal wage and that these results are independent of the nature of capital mobility between the informal and the formal sectors. It also shows that labour market reforms, contrary to the common wisdom, are likely to produce favourable effects on the informal wage.


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*Keywords:* Informal sector; Formal sector; Informal wage; Economic reforms; Capital mobility; General equilibrium model

## 1. Introduction

Informal labour market characterized by competitive wage formation rather than unionized process of negotiations has emerged as an important institution in the entire developing world. It is beyond any doubt that the informal sector plays a very significant role in employment in

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developing countries constituting at least 70% of total employment of the working population (Agenor, 1996). In case of India this figure is over 90% if one includes agriculture. The informal economy absorbs surplus labour, provides income-earning opportunities for the poor, provides goods and services unavailable in the formal sector, and helps in maintaining a low cost of living by providing cheaper sources of food and services. Early research on the informal sector showed that its primary role was to provide a livelihood for the urban poor while later studies showed that informal economy fulfils other crucial roles that aid overall economic development.

The ongoing process of economic reforms has increased significantly the role played by informal sectors in determining the pattern of employment in the developing countries. Many of the developing countries have been facing substantial adjustment costs in implementing economic liberalization programs, particularly in the employment front. Empirical evidence suggests that in South Africa and in many of the Latin American and other developing countries, trade liberalization during 1990s was associated with falling employment and hence economic insecurity for the formal sector labour force (ILO, 2006). Reformatory policies contract the formal manufacturing sector and drive labour out into the informal segment of the labour market. Empirical studies e.g. Bhalotra (2002), Dev (2000), ILO (2006) and Leite et al. (2006) have reported that the size of the informal sector in the developing countries has increased considerably in the post-reform period. But the expanding informal sector has not been able to absorb the huge number of retrenched workers from the formal sector. The consequence has been a steep rise in the level of open unemployment in many of the developing economies.

When the size of the informal sector in the developing countries is increasing at a brisk pace, it is important to know how the liberalized economic policies have affected the working conditions and welfare of the informal sector workforce. As economic wellbeing of the workers and wage earnings are strongly correlated, the issue boils down to the study of the consequences of economic reforms on the informal sector wage. There are not enough direct empirical evidences as yet in understanding clearly the direction of movement of the informal sector wages in response to economic reforms. While Bhalotra (2002) and National Sample Survey (NSS), various issues data for informal manufacturing for 1989–1990 and 1994–1995, state that the real wage in the informal manufacturing sector has increased in the period of reforms, empirical studies of Khan (1998) and Tendulkar et al. (1996) have found that the incidence of poverty has increased in India in the post-reform period. As informal sector workers belong to the poorer section of the population, an increase in poverty implies deterioration in their wage earnings. Besides, Leite et al. (2006) have reported a significant decrease in average real wage for informal workers in South Africa during 2000–2004.

The enormous theoretical literature on the informal sector[1] has not adequately examined the consequences of economic reforms on the wellbeing of the vast section of the working population engaged in the informal sector of a developing economy. An important exception in this context is Marjit (2003) who has examined the outcome of trade liberalization on the informal wage using a three-sector general equilibrium model with two informal sectors. In his model one of the two informal sectors produces a non-traded input for the formal sector and capital is mobile only between the two informal sectors of the economy. Marjit (2003) has found that trade liberalization

[1] This includes works of Chandra and Khan (1993), Gupta (1993, 1997), Beladi and Yabuuchi (2001), Kar and Marjit (2001), Chaudhuri (2000, 2003), Chaudhuri and Mukherjee (2002), Chaudhuri et al. (2006), etc. But, none of these papers has exclusively examined the consequences of economic reforms on the wage rate and the wellbeing of the informal sector labour force and the role of the capital mobility between the formal and the informal sectors in this context.