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The informal sector and tax on employment: A dynamic general equilibrium investigation

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Abstract

This paper elaborates on the evolution of the informal sector vis-à-vis the evolution of agricultural and formal sectors in a developing country economy in process of growth. The analytical contribution of this essay extends the Ramsey theory of growth into a framework that includes an informal sector and household preferences that display Engel effects in agricultural and in informally produced goods. Besides showing that the informal sector's importance diminishes over time as the country's economy grows, the results from the model demonstrate that a country can successfully reduce its informal employment by reducing tax on employment in the formal sector.

JEL classification: O41; C61; O17

Keywords: Informal sector; Economic growth; Engel effects; Employment tax; Turkey

1. Introduction

Until the early 1970s, less developed countries were often characterized by dual economies, with a traditional agricultural sector and a more modern, urban sector. The dichotomy within the urban sector (traditional urban versus modern urban) in

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these countries was considered to be a temporary phenomenon by most authors, that is, the traditional urban employment was considered to be a temporary mode of employment for the unskilled agricultural labor en route to a permanent modern urban employment (Lewis, 1954; Ranis and Fei, 1961; Todaro, 1969). However, studies first by Hart (1973) on urban employment in Ghana and later by the International Labour Office (1973) redefined the traditional urban sector as the 'informal' sector, and argued that in less developed countries, informal sector employment was a permanent rather than a temporary source of employment, and should be treated separately from employment in the 'formal' sector. Following these studies, the analysis of dualism between formal and informal sectors, particularly analyzing the informal sector in less developed countries, has gained much momentum, and created a sizeable literature.[1]

In the literature, several terms have been used to describe informal economic activity around the world: unofficial, shadow, hidden, underground, illegal, unrecorded, unreported, parallel, and black. Although there may be nuances in these terms, they all have a common denominator: 'those engaged in (such) activities circumvent, escape, or are excluded from the institutional system of rules, rights, regulations and enforcement penalties that governs those agents engaged in formal production and exchange' (Feige, 1990). Particularly in less developed and developing countries, informal economic activity, or the term 'informal sector' has additional connotations: this term usually describes a small scale, traditional industry sector, characterized by ease of entry, reliance on indigenous resources, family ownership of enterprises, labor intensive technologies, skills acquired outside the formal school system, and unregulated and competitive markets (Bromley, 1978). Several empirical studies (including Schneider and Enste, 2000; Loayza, 1996; Friedman et al., 2000; World Bank, 2002) have found a large informal sector to be an important characteristic of less developed and developing economies. Schneider and Enste compare the size of the informal economy in 76 countries between 1989 and 1993, and find that on average, in developing countries (Africa, Central and South America, Asia), the size of the informal economy is between 35% and 44% of official GDP, in transition countries (former Soviet Union and Eastern Europe), between 21% and 35% of official GDP, whereas in OECD countries, it is merely about 15%. Loayza estimates the size of the informal sector in Latin America to be 39% of official GDP on average for the early 1990s, ranging from 18% in Chile to 66% in Bolivia. In his famous study on Lima, Peru, de Soto (1989) estimates the size of the informal sector to be 39% of official GDP in the early 1980s, and to grow to 61% in year 2000. He has also reported that some 61% of total work hours have been devoted to informal economic activity during the early 1980s in Lima. These findings, among others, imply a strong negative relationship between the level of economic development and the size of the informal sector. Furthermore, a negative relationship can be observed between GDP per capita (US$, PPP adjusted) and the share of informal urban employment in total urban employment (as an indicator of informal activity) amongst developing countries, as depicted by Fig. 1 for the 1995–1999 average.

[1]Please see Danesh (1991) for a comprehensive research guide on the informal economy.