Trade and Informality

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Informality at a Glance

• General definition:
  – Informal firms do not comply with government regulations and are unregistered
  – However, informal activities can be conducted by registered firms (share of production hidden from fiscal authorities)

• Main characteristics of informal (unregistered) firms:
  – Small size (less than 5 employees, large share of self employment)
  – Low productivity compared to their registered counterparts
  – Limited access to finance and public goods
  – Do not export (self-employed produce essentially non tradables)
  – Participation can be voluntary

• More informality is not a good sign whatever the view we have of the role of unofficial firms in development
Informality and Trade

• What is the role of informal firms in the production of exported goods?
  – At best they produce inputs but sounds like an exception

• What is the impact of trade liberalization on informal firms and informal activity?
  – The conventional view poses that trade liberalisation would cause a rise in informality
  – However recent theoretical developments and empirical evidence have challenged this view
Informality and Trade Liberalisation: Empirical Evidence (micro)

– Empirical evidence on the relationship between trade liberalisation and informality is limited and generally country specific (micro data)

– Most of the evidence relates to Brazil, Colombia and Mexico for which rich, relevant and reliable micro datasets are available

– Empirical studies suggest that informality can respond to trade liberalisation either positively or negatively, depending on country and industry characteristics (economic and institutional)
Informality and Trade Liberalisation: Empirical Evidence (macro)

- Less restricted trade is associated with a larger share of informal output
- Less restricted trade is associated with a lower share of informal labor
- Results are obtained in a dynamic panel set-up and are robust to a series of changes in specification, controls and reference sample
- Results can suggest that unregistered activity has fallen with trade liberalisation but underground activity in registered firms has increased
Research Agenda I: Theory

• No existing theoretical framework is able to replicate macro empirical findings: the sign of the relationship is the same for any dimension of informality in all models

• The real (modeling) issue seems to be undeclared production (/employment) in registered firms:
  – Lower informal employment (ILO definition) may be seen as a good news if workers move to formality (higher labour productivity)
  – However, the overall incidence of precarity may have remained the same or even worsened
Research Agenda II: Empirics

• More needs to be known about the relationship between informal firms and the external sector: increase the country coverage of World Bank’s Micro and Informal surveys (and perhaps adapt the questionnaires)

• Establishment of a reference database based on macro (indirect) estimated measures of informal activity across countries
Research Agenda III: Policy

• En vogue: “Formalization” of informal firms

• However, formal entrepreneurs are better skilled than informal ones => main constraint to formalization

• The best way to formalize may be to promote and support job creation in the formal sector especially in times of policy reform like trade liberalization