Informality Trends and Cycles

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This paper studies informal employment in the long and short runs. It first presents a theoretical model where the size of informal employment is determined by the relative costs and benefits of informality --in terms of regulatory burden, enforcement, and access to public services-- and the distribution of workers' skills. In the long run informal employment varies with the trends in these variables, and in the short run it reacts to accommodate transient shocks and to close the gap that separates it from its trend level.

The paper then examines empirically these relationships. For this purpose, it uses country-level data at annual frequency for a sample of developed and developing countries. With the share of self-employment in the labor force as proxy for informal employment, the paper identifies long-run relationships using the cross-country variation of the data and short-run relationships using the within-country variation (see graph below).

The empirical results are in line with the model's predictions. Regarding the long run, informality is larger in countries that have lower GDP per capita and impose more costs to formal firms. The short-run results indicate that informal employment follows a trend-reverting process. Moreover, informal employment is found to be counter-cyclical for the majority of countries. The degree of counter-cyclicality decreases with the level of informal employment and, independently, declines with the quality of policy and judicial services. The empirical results are robust to changes in the sample and the influence of outliers, even when only developing countries are considered in the analysis.

Informal Employment and the Level of Economic Development