Trade Liberalisation and Informality: New stylized facts

Norbert Fiess
The World Bank and University of Glasgow

and

Marco Fugazza
UNCTAD
1. Introduction

• The relationship between trade liberalisation and informal activity has not received the attention, whether theoretical or empirical, that it may deserve.

• The conventional view poses that trade liberalisation would cause a rise in informality.

• This paper uses three different data sets to assess the sign of the relationship.

• Empirical results suggest that while informal output increases with deeper trade liberalisation, informal employment falls.
Plan

2. Insights from the Literature
3. Data and Empirical Strategy
4. Results
5. Discussion
2. Insights from the Literature

2.1 What is informality?

– Share of a country’s production of goods and services which does not comply with government regulation
– However, we should distinguish unregistered firms from underground activities in registered ones
– Common feature of developed and developing countries
2.2 Informality and trade liberalization: theory

– 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
2.3 Informality and trade liberalization: empirical evidence

– 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)
3. Data and Empirical Strategy

No evidence in a multi-country sample

- 3 measures of informality
  - The ILO survey-based measure: provides a directly observable measure of the share of informal employment (32 countries, 1990-2004)
  
  
  - The macro-eclectic approach (Kaufmann and Kaliberda, 1996) another indirect measure of informal output in total GDP (66 countries 1990-2004)
- 4 measures of openness to trade:

- Trade/GDP (WDI) (+)
- Effectively Applied external tariff rate (weighted and unweighted average) (TRAINDS in WITS) (-)
- KOF Index of Globalization components: actual economic flows (trade, FDI and portfolio investment) and trade/capital restrictions (mean tariff rates, taxes on international trade, index of capital controls, hidden import barriers) (+)
– **Other explanatory variables:**

  – GDP per capita (WDI)
  – Labor Flexibility index of Fraser Institute (composite of four equally weighted components: minimum wages, rigidity of hours, difficulty of firing redundant employees and the cost of firing redundant workers)
  – Measure of freedom of corruption (ICRG country guide)
Macroeconomic Informality and Trade Openness (means)
Schneider (2007) Informality and Trade Openness (means)
4. Results

• *Contrasting* evidence across datasets but not across indicators

• 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 robust to a series of changes in specification, controls and reference sample
Results from dynamic panel analysis (macro eclectic informality measure)

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## Results from dynamic panel analysis (ILO informality measure)

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5. Discussion

- Results may suggest that unregistered activity has fallen with trade liberalisation but underground activity in registered firms has increased.
- It is unlikely that productivity has increased in the unregistered sector and the size of the underground labour force (within the boundaries of registered firms).
5. Discussion

• The real 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
• Moreover tax evasion by registered firms have increased
• We may want to see these results as an evidence of smoother adjustment with eventually some possible improvements in overall labor productivity
• But the consequent fiscal cost is likely to be high with desastrous consequences for the financing of public goods and services
Policy Implications

• Not straightforward

• Usual candidate: safety nets also covering informal workers (avoid desperate choices)

• ISSUE: financing + efficiency & effectiveness
• Alternative: focus on measures able to contain tax evasion & stimulate hiring
  – e.g.: temporary tax reductions/exemptions to firms hiring new employees + controls

• Formalization