Trade and Informality in the Presence of Labor Market Frictions and Regulations

Rafael Dix-Carneiro  Pinelopi Goldberg  Costas Meghir
Gabriel Ulyssea
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Abstract

Motivated by recent work on the labor market effects of trade, we build a model of trade with labor market frictions and regulations that are not perfectly enforced by the government. Heterogeneous firms decide whether to operate formally or informally, allowing for a link between globalization, informality and unemployment. We estimate the model using several data sources from Brazil, including matched employer-employee data from formal and informal firms and workers. We perform counterfactual analyses to understand how increasing trade openness affects informality, unemployment and welfare under different scenarios of labor market regulations and levels of enforcement. Our results suggest that domestic policies leading to a reduction in informality have the potential to strongly increase aggregate productivity and welfare, at the expense of modest increases in unemployment. These policies have a much larger effect on welfare relative to policies aiming to reduce international trade costs. The informal sector works as a buffer in the event of negative economic shocks. However, the welfare gains from eradicating informality are so significant that it is hard to justify lenience toward the informal sector on the basis that it works as a buffer following negative economic shocks.

*Dix-Carneiro: Duke University, NBER and BREAD; email: rafael.dix.carneiro@duke.edu. Goldberg: Yale University (on leave), NBER (on leave) and World Bank Group; email: penny.goldberg@yale.edu. Meghir: Yale University, NBER, IFS, IZA and CEPR; email: c.meghir@yale.edu. Ulyssea: University of Oxford; email: gabriel.ulysssea@economics.ox.ac.uk. This project is currently being supported by award SES-1629124 from the National Science Foundation and by an Early Career Research Grant from the W.E. Upjohn Institute for Employment Research. We thank seminar participants at CEMFI, Central Bank of Chile, Dartmouth, Duke, FGV-EESP, FGV-EPGE, Inspex, Oxford, Penn State, Princeton, PSE, PUC-Rio, Rice, UCL/IFS, Wisconsin, World Bank and Yale for helpful comments. Goldberg is currently Chief Economist of the World Bank Group. Any opinions and conclusions expressed herein are those of the authors and do not necessarily represent the views of the World Bank Group.