Labor Informality, Redistribution, and Development: A Political Economy Perspective

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Summary

This dissertation proposes a political economy explanation, validated with empirical evidence, for high labor informality in developing countries, with a focus on jobs lacking social security coverage. Politicians choose not to enforce formality for personal benefit. This framework can be employed to explain the persistently high levels of informality in developing countries, particularly in the presence of high inequality, and why sustained economic growth may not necessarily lead to reductions in informality. Additionally, the framework can contribute to the design of policies aimed at reducing informality. We develop a two-period OLG model featuring heterogeneous agents and two policies determined through probabilistic voting (Lindbeck & Weibull, 1987): the amount of a basic non-contributory pension for low-income retired workers, funded with lump-sum taxes (consider them as consumption taxes), and the probability/intensity of enforcement for contributions to a mandatory provident pension fund (compulsory savings). In Chapter 2, we present a general version of the model where income inequality within a generation acts as the primary driver of labor formality in the economy. This model helps explain the high informality rates in developing countries, particularly in the presence of substantial income inequality. Calibrating the model to Chile yields a labor formality rate of 67%, close to the observed 62%. Counterfactual analysis reveals that increased inequality results in reduced formality. Empirical analysis supports the model's predictions. We highlight the case of Chile's public-sector employees, a significant portion of whom is exempt from pension contributions. Additionally, using a panel covering more than 60 countries from 1998 to 2019, we highlight a robust negative correlation, both cross-country and over time, between inequality and the labor formality rate. In Chapter 3, we extend the model

introduced in Chapter 2 to its dynamic version by incorporating economic growth. We do this because a mainstream branch of literature explaining the origins of informality posits that economic growth should lead to strong reductions in informality. However, recent empirical evidence shows that the connection is very weak (La Porta & Shleifer, 2014). The dynamic model helps rationalize the persistence of informality despite rapid economic growth in many developing countries. Calibrating the model to Chile, where the share of employment contributing to the pension scheme only increased from 64% to 68%, despite a tripling of GDP per capita between 1996 and 2017, we conduct counterfactual analysis. This analysis reveals that stagnant labor formality results from the opposing effects of two transformations, applicable to many developing countries in recent decades: a rise in long-term economic growth (e.g., due to sustained productivity growth) and an increase in the proportion of older citizens (e.g., initially due to improved health conditions and life expectancy, followed by a decrease in natality). The predictions of the calibrated model find empirical support with panel data from 63 developing countries between 1998 and 2019, utilizing different proxies of income inequality and controlling for country fixed-effects. In Chapter 4, we briefly discuss policy insights that can be derived from the theoretical and empirical analyses presented in the previous chapters, as well as potential avenues for future research.