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# Informal Sector, Regulatory Compliance, and Leakage

Soham Baksi\* and Pinaki Bose\*\*

## Abstract

The paper models a vertically related formal and informal sector, and endogenizes the size and regulatory compliance status of the informal sector. When the formal sector can circumvent costly regulations by outsourcing polluting intermediate goods from the informal sector, stricter regulations increase (when the “composition effect” of regulation dominates its “scale effect”) or decrease total pollution, and may even have a non-monotonic impact. We identify conditions under which a partially compliant informal sector acts as a source of leakage, and examine implications for optimal enforcement policy. Further, we show that price discrimination by the formal sector, when it purchases the intermediate goods from the informal sector, can worsen regulatory compliance by the informal sector and lead to more pollution.

*JEL codes:* O17; Q56; K42

*Keywords:* Formal and informal sectors; Emission intensity reduction; Price discrimination; Regulatory compliance

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