



Lurking in the cities: Urbanization and the informal economy



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ABSTRACT

This study investigates the empirical relationship between the level of urbanization and size of the informal economy using cross-country datasets proxying GDP and employment shares of urban informal sector. Our estimation results indicate that there is an inverted-U relationship between informality and the level of urbanization. That is, the share of the informal sector grows in the early phases of urbanization due to several pull and push factors; however, it tends to fall in the latter phases. We also show that factors like level of taxes, trade openness, and institutional quality tend to affect the size of the informal economy.

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1. Introduction

Urbanization is a process, which is often observed as a frequent consequence of economic development. New industries in urban areas create new job opportunities, stimulating the shift of labor from rural to urban areas. Nevertheless, the growth in formal sector employment might not keep pace with the growing population of new urban dwellers. Still migration toward urban sector continues. As a result, many of the new dwellers end up in informal urban activities.

Informal sector or economy, sometimes also titled shadow, hidden, black, parallel, second or underground

economy (or sector) is defined by Hart (2008) as a set of economic activities that takes place outside the framework of bureaucratic public and private sector establishments. Another paper by Ihrig and Moe (2004) defines it as a sector which produces legal goods, but does not comply with government regulations. Similar definitions are provided by Schneider and Enste (2000), Schneider (2005, 2007) and Schneider et al. (2010) as well.

Informality is a widespread phenomenon and poses serious social, economic, cultural and political challenges across the world; however many issues about its nature and consequences still remain largely under-explored or unresolved. (See Schneider and Enste, 2000; Schneider, 2005, 2007; Buehn and Schneider, 2012; Elgin and Oztunali, 2012 among others.) For example, the evidence presented in the existing literature, has failed to generate a consensus around the determinants of the informal sector among researchers. There are also many other open questions including even such basic ones such as whether informal sector size would be larger in low income or high income nations (see Dreher and Schneider, 2010); whether taxes are positively correlated with informal sector size or not

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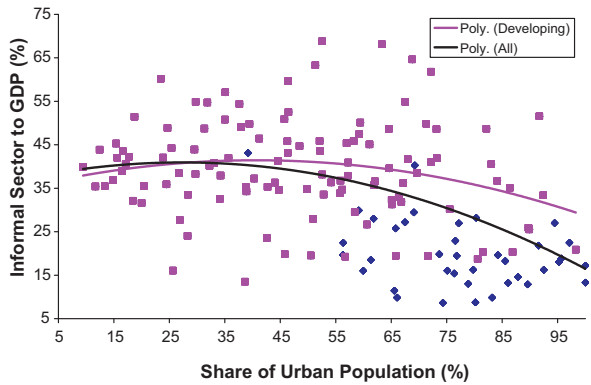


Fig. 1. Informality and urbanization: developed and developing economies.

(See Schneider and Enste, 2000; Friedman et al., 2000; Elgin, 2010) or whether shadow economy and corruption are substitutes or complements (Dreher and Schneider, 2010). As the number of papers in the growing literature on informality indicates, there is an increasing attention on the economic analysis of the informal economy.

The shift from the rural to the urban informal sector can be explained by several pull and push factors. In many cases, the urban informal sector offers better opportunities than the rural sector. Earnings can be higher in urban informal employment than in rural occupations and urban areas tend to offer better public services due to an urban bias in policies (Lipton, 1976). Even in the cases in which conditions between two sectors are similar, many individuals prefer the urban informal sector with the expectation of finding a job opportunity in the formal sector in the future (Banerjee, 1983).

The technical changes that industrialization brings to urban industry are joined by technical improvements in the rural sector. However, the technical change might be unbalanced and reduce the incomes of small scale producers (Boyce, 1993). It also can damage the non-agricultural activities in the rural sector (Hymer and Resnick, 1969). In addition, in many cases the technical changes in the rural sector are labor-saving (De Janvry, 1981; Boyce, 1993) and pull down the demand for agricultural labor. These processes can lower the incomes of many rural dwellers and push them to the urban informal sector.

The pull and push factors that foster the growth of urban informal activities can be greater than any counteracting factors during the early phases of development that involves urbanization stimulated by early industrialization. Therefore, in many cases the first phases of urbanization feature a greater growth in the urban informal sector than in the urban formal sector (e.g. De Janvry, 1981; Furtado, 1976; Moser, 1978).

However, as urbanization and industrialization continue, the share of the informal urban sector tends to dwindle. First, as the urban share of population increases the migration process can slow down. The move toward the urban sector increases the per capita incomes of rural dwellers; therefore, many of these dwellers might cease to prefer the earnings offered by the urban informal sector. In

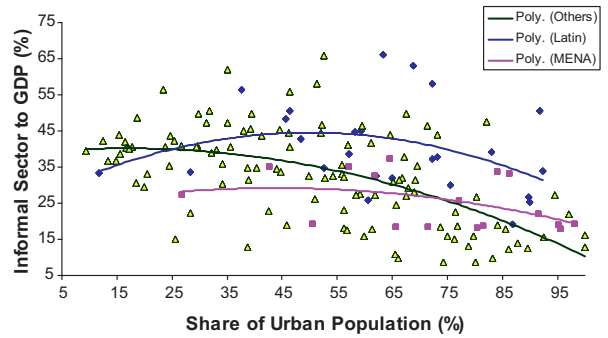


Fig. 2. Informality and urbanization: different regions.

addition, according to Marxian literature (e.g. Marx, 1867, 1932; Baran and Sweezy, 1966; Aglietta, 2000) capitalist development leads to greater concentration and centralization of capital. Hence, capitalist accumulation reduces the share of small scale informal activities, which have weaker links with the growing formal sector.

In summary, we propose that there is an inverted-U curve relationship between urbanization and the share of urban informal sector. The share of informal sector first increases in the early phases of urbanization and then decreases as urbanization continues. We observe such a tendency for urban informal sector's output share in Fig. 1 using Schneider et al. (2010)'s averaged data from 1999 to 2007 for a set of 152 countries which is fitted with polynomial trend lines (indicated by Poly (All)). Using the same dataset, we also draw the polynomial regression line using data from only 114 developing countries.⁴

In a similar fashion, Fig. 2 illustrates the same tendency for a different group of countries: Latin American and Caribbean countries, MENA (Middle Eastern and North African) countries and others.⁵ Our proposed inverted-U curve is also consistent with Kuznets (1955)'s hypothesis, which underlines the unbalanced gains of early development and "the agricultural and industrial revolutions" dislocating effects. Kuznets claims that there is a tendency for economic positions of new urban dwellers and their descendants to change in time and for labor markets to become more homogenous during the later stages of development.

Indeed, the existence of an inverted U relationship between urbanization and the share of the urban informal sector was first proposed and tested by Rauch (1993). However, Rauch's data was limited to the share of self-employment in Latin American countries; it excludes informal activities operated by wage-workers. In this study, we empirically test the existence of the inverted U all for output and non-agricultural employment shares of informal sector and for share of non-agricultural self-employment. We also use significantly larger number

⁴ The method of choosing the developing countries will be explained in detail in the next section.

⁵ Sources of the data and a more detailed empirical analysis will be provided in the next section.

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