



Modeling functional and juridical informality: a guide for data-driven policy

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ABSTRACT

This paper reviews a methodology for integrating the informal sector into social accounting matrices and a simple computable general equilibrium model. The model distinguishes informality according to whether the presence of the informal sector is due to capital limitations, *functional* informality, versus *juridical* informality, which may arise as an illegal or quasi-legal competitive strategy that runs the risk of state sanctions. The goal is to offer policymakers some perspectives on how the informal sector could be incorporated into the economy without first repressing it in a way that inhibits its transformation.

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1. Introduction

The informal sector is often criticized as an economic second class citizen, with respect to productivity and real wages, as well as working conditions and compliance with labor and environmental standards.¹ Setting aside a normative critique of informality for the moment, this paper focuses on how the informal sector can be included objectively in a social accounting matrix (SAM) and associated macroeconomic models. When properly accounted for, it is seen that the informal sector adds to GDP, stimulates *formal* sector output and employment and generally contributes to economic well-being. This conclusion is inescapable when one quantifies the presence of the informal sector in a formal model and examines various counterfactuals with respect to its size and modes of interaction with the formal economy. It follows that using legal or juridical means to suppress the informal sector will likely be counterproductive to the goals of those who seek to eliminate it. Gibson and Flaherty (2016) develop a theoretical framework for analysis of the informal sector, firmly grounded in fundamental economic concepts. The distinction between *functional* and *juridical* informality is developed, based on Gibson and Flaherty (2016). It is argued there that informal sector *workers* rarely choose informality and would prefer formal sector employment were it available. Informal shop *owners*, however, may elect to avoid labor and environmental standards as a competitive strategy, but this is not *functionally* informal according to Gibson and Flaherty (2016). Legally, these firms are unquestionably informal and may not be registered or even counted in the economic censuses or national income and product accounts (NIPA). This is *juridical* informality according to Gibson and Flaherty (2016).