The informal sector and the location of economic activity: in search of the missing links

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Abstract

The informal sector absorbs on average 50\% of employment in developing countries. However, it has not been considered in New Economic Geography (NEG) models that try to explain urbanization and agglomeration in developing countries. To bridge this gap, we develop a NEG model that incorporates the informal sector. Besides an increasing returns to scale formal manufacturing sector, our model allows for an informal manufacturing sector producing non-traded goods under constant returns to scale. We investigate the competitive role of the informal sector. To do so, we model competition on the demand side by allowing substitution between manufacturing and informal sector goods. We find that the relative size of the informal sector depends on the substitutability between formal and informal goods, as well as on the productivity gap between the formal and informal sectors. Finally, we analyze the long-run distribution of footloose workers. We show that the core NEG model’s predictions regarding the location of economic activity are significantly altered by the introduction of an informal sector.

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