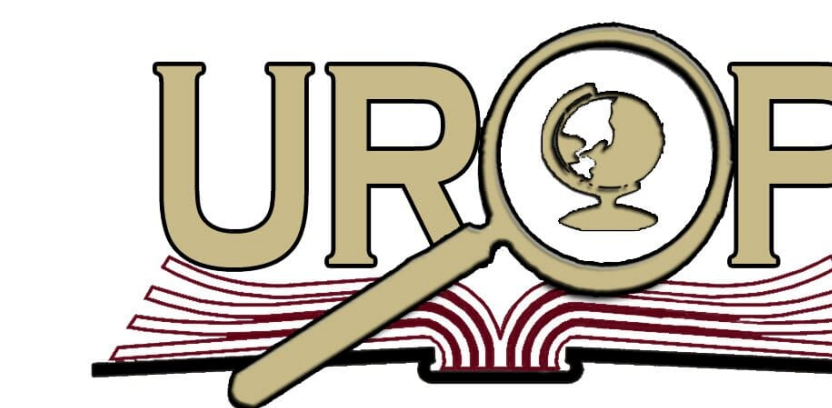




# Assessing the Influence of Labor Provisions on Informal Economy Dynamics: A Comparative Analysis



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## Abstract and Theory

What are the downstream economic effects of globalization? One of the most visible aspects of globalization can be seen in the stark increase in free trade agreements since the mid-1990s. Traditional economic theory argues trade results in both winners and losers within countries. However, trade's effect on informal work (unregistered and untaxed legal activities deliberately concealed from public authorities) is less clear. We argue that trade agreements with explicit labor provisions (LPs) help reduce the informal economy's size compared to agreements without LPs. An extensive informal economy contributes to heightened poverty, and inequality, and hinders development by limiting access to formal employment opportunities and economic stability. Specifically, trade agreements with labor provisions address the exclusion channel for informal work by protecting individuals from exploitation, discrimination, inadequate wages, and unsafe working conditions.

## Hypotheses

H1: Developing countries that sign Free Trade Agreements *with* labor provisions will see a decrease in the size of the informal economy compared to countries that sign trade agreements without labor provisions.

## Methods

Using NAFTA as our primary case study, we conducted a quantitative analysis to examine how trade agreements with labor provisions (LPs) affect a country's informal economy. Our focus was specifically on comparing Free Trade Agreements (FTAs) that include labor provisions with those that do not, aiming to offer a clear comparison of the impact of LPs on a nation's informal economy. To test our argument, we investigate one trade agreement with labor provisions, the North American Free Trade Agreement (NAFTA). Utilizing synthetic controls, we show that signing NAFTA results in a significant reduction in the size of the informal economy for Mexico, compared to the counterfactual scenario where Mexico never joined NAFTA.

## Results

The decrease in Mexico's informal economy following the signing of NAFTA was significant, as evidenced by our quantitative analysis using synthetic controls. Our study demonstrates a substantial decline in the size of Mexico's informal economy by as much as 5% of GDP, compared to the counterfactual scenario where NAFTA was not signed. Such a large decrease appears to be short-lived though, within a few years the size of the informal economy slowly increased. However, it is important to note that by the end of the temporal span, Mexico still experiences a decrease in the size of its informal economy compared to a scenario in which Mexico never signed NAFTA.

## Discussion

As hypothesized, trade agreements with labor provisions can decrease the size of a country's informal economy. Our study aims to contribute to the understanding of the downstream economic effects of globalization, particularly concerning the informal economy in developing countries. By examining the impact of trade agreements with labor provisions, we provide valuable insights for policymakers seeking to promote inclusive economic growth and reduce poverty through international trade agreements.

## Future Research and Implications

Although preliminary, the results above offer correlational evidence that trade Agreements with labor provisions can lower the size of the informal economy. Future research can utilize the synthetic control approach for other trade agreements such as the South African Development Community (SADC) trade agreement to test whether the specific mechanisms, in combination with trade liberalization, can explain why some agreements help to reduce informality, while others have a negligible or diminished effect. The relationship between labor provisions and the informal economy helps to address some of the complex and multifaceted aspects of globalization, with significant implications for economic development and policy formulation.

## References

