The Carrot or the Stick? How Variation in Free Trade Agreements Affect the Size of the Informal Economy

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Abstract

The worldwide informal economy consists of over two billion individuals and often includes the most dangerous and low paying jobs, leading to many detrimental outcomes for both countries and individuals. Unfortunately, we know little about how international agreements shape informal employment. Conventional economic theories would suggest that informal employment in developing countries should decrease due to trade liberalization and increased foreign economic investment. However, empirical research has found mixed results, with some finding liberalization increases informality and others finding liberalization decreases informal work. To address this inconsistency, we develop a theory that considers variation within trade agreements, including the presence of labor provisions and the robustness of enforcement mechanisms. We argue that trade agreements with strong enforcement mechanisms coerce countries to improve labor rights, which in turn decreases the informal economy. We test our theory through the use of matching within a difference-in-differences design with staggered treatment timing on a sample of countries from 1990-2018. Additionally, we investigate several case studies of individual trade agreements utilizing synthetic control analyses to show the effect these agreements have on informal employment for particular trading partners. Our preliminary results shows that labor provisions in trade agreements play a meaningful role in reducing the size of the informal economy. Furthermore, we expect to find that this effect is driven by agreements with strong enforcement mechanisms compared to agreements with weak enforcement mechanisms. This work expands our knowledge on the causes and consequences of informal work while highlighting a pathway to sustainable growth.

Theory

We argue that enforceable FTAs with explicit references to labor provisions are a key determinant to reducing informal employment. As labor protections and enforcement increase, informal workers are incentivized to seek formal employment, gaining the legal protections, safer working conditions, and higher wages that accompany such work. Moreover, trading partner governments and firms are incentivized to incorporate previously informal workers into the formal labor force to avoid monetary sanctions or the removal of trading privileges.

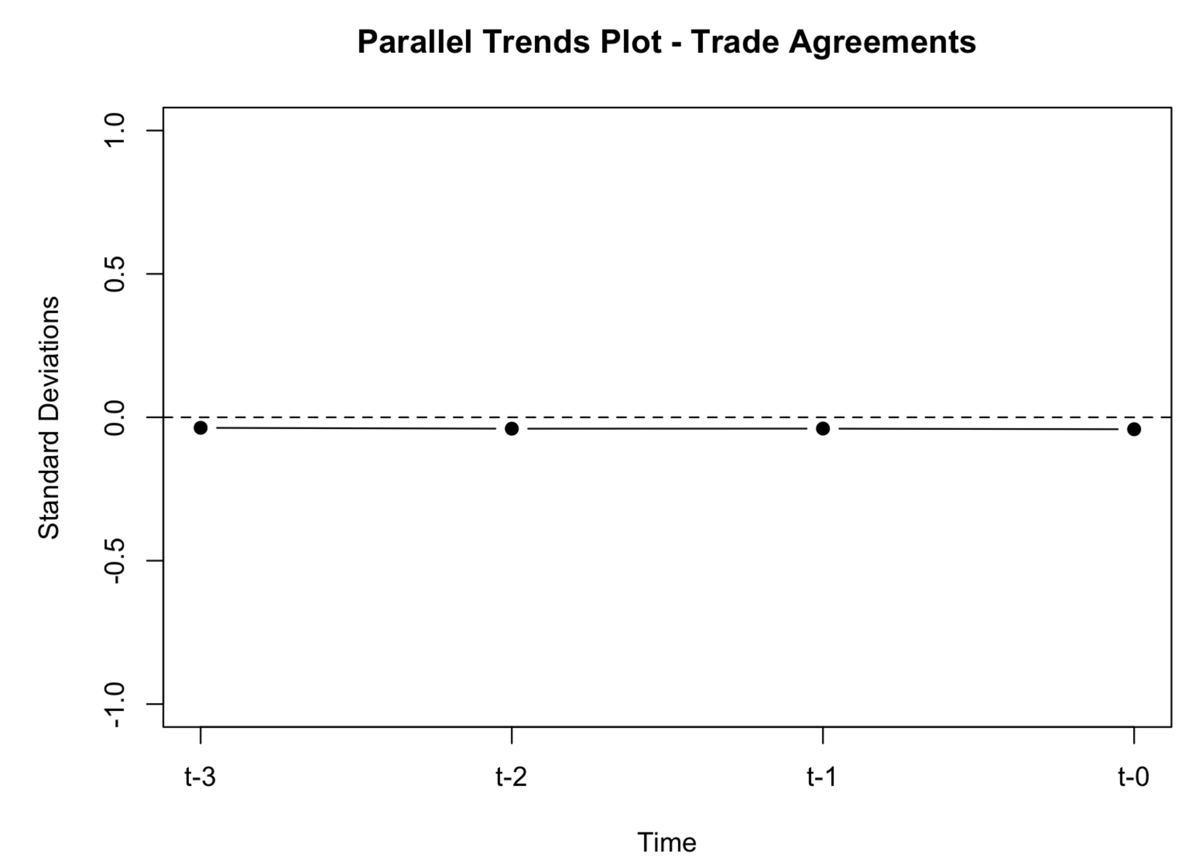
Hypothesis

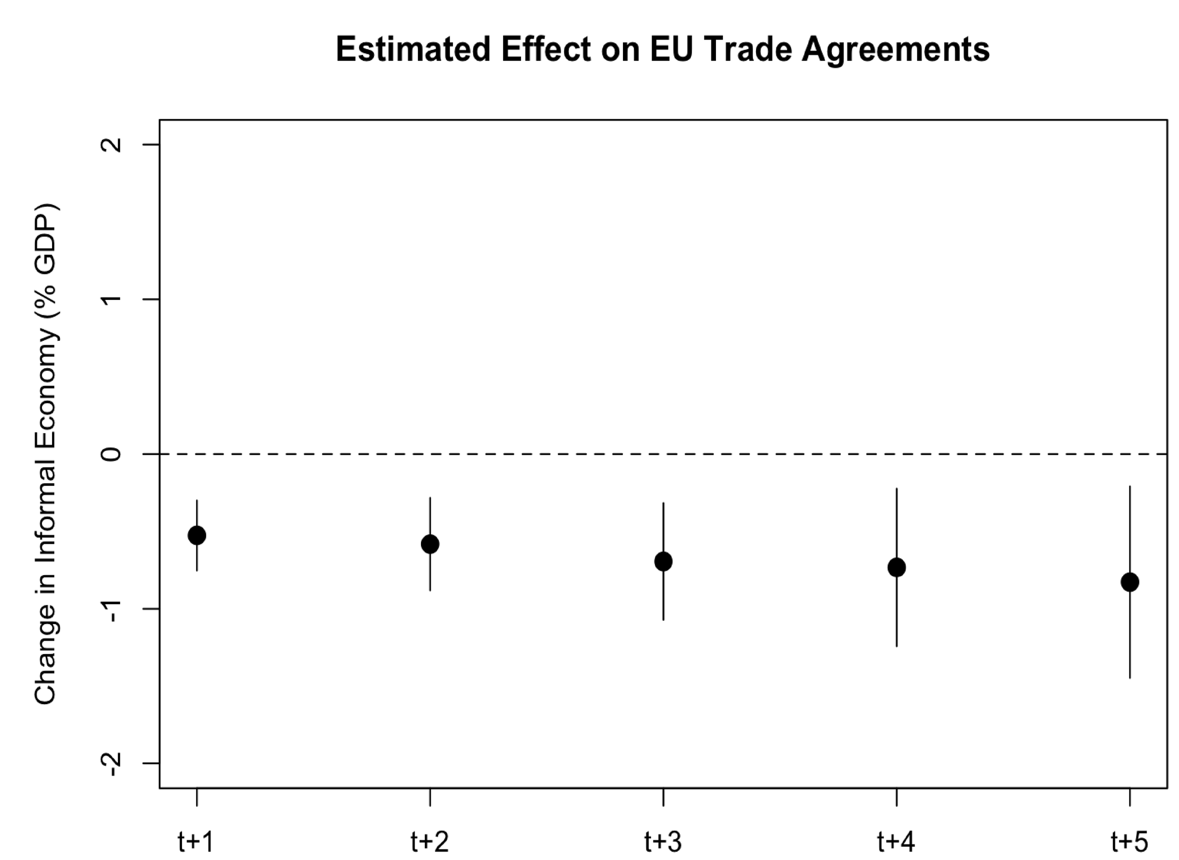
H1: Countries that enter into a free trade agreement with labor provisions will see a decrease in the size of their informal economy compared to countries do not, or have not yet, entered into such an agreement.

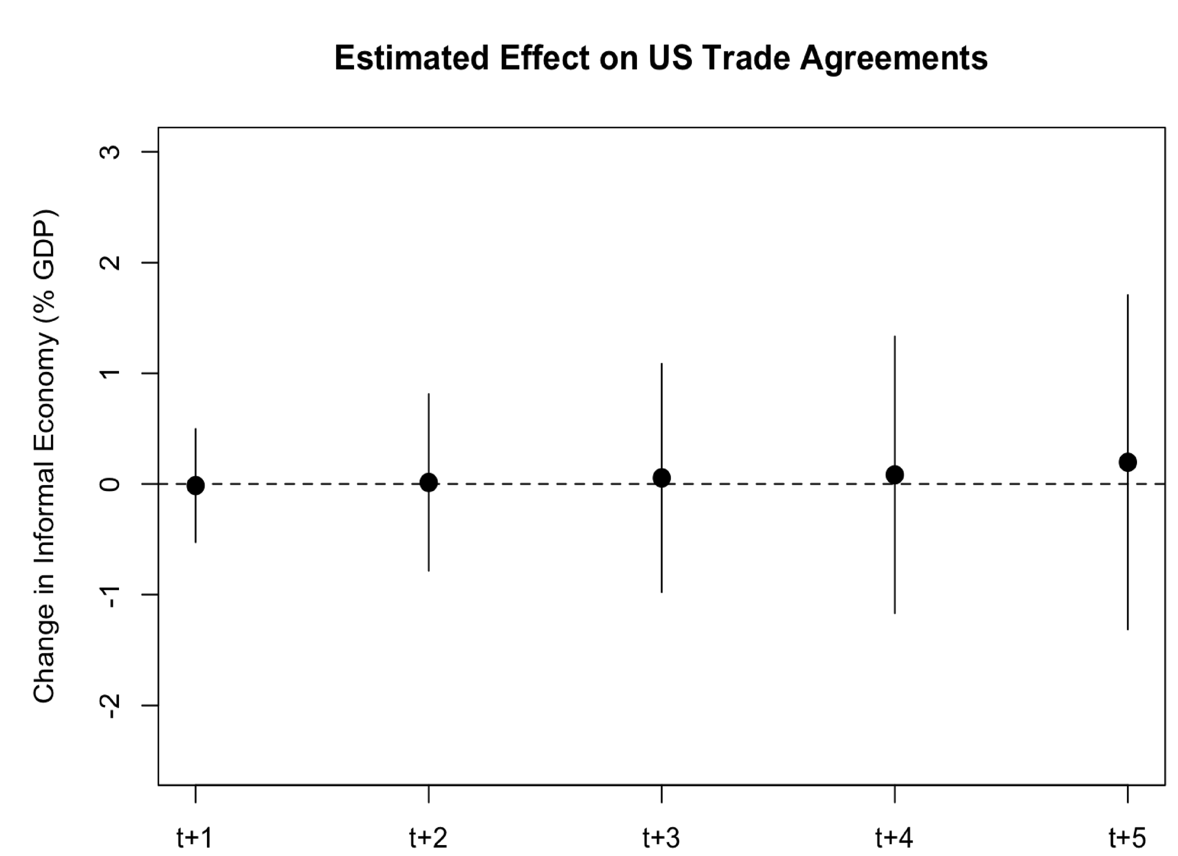
H2a: Countries that enter into FTAs with weak labor enforcement mechanisms will see a minimal effect on the size of the informal economy compared to countries that do not, or have not yet, entered into such an agreement.

H2b: Countries that enter into FTAs with strong labor enforcement mechanisms will see a significant decrease in the size of the informal economy compared to countries that do not, or have not yet, entered into such an agreement.

Preliminary Results







Methods

To test our theory, we perform a matching and difference-in-differences analysis on a sample of 156 countries from 1990-2018. Countries are coded in a dichotomous fashion based on whether they have entered into a trade agreement with labor provisions, as well as if these agreements are with the United States or the European Union. Moreover, to account for changes over time in the enforceability of EU and US trade agreements, countries are coded to account for enforceable labor provisions within trade agreements. Data on the scope of trade agreements was taken from the Design of International Trade Agreements (DESTA) database, while data on the informal economy comes from the World Bank's Informal Economy Database and is measured as a percentage of GDP. Countries are matched on a wide range of political and economic indicators such as regime type, GDP per capita, Foreign Direct Investment, Trade flows, Official Development Assistance, Unemployment, Inflation, as well as previous levels of informal economic activity. The data used for matching is taken from either the Polity V database or the World Bank's World Development Indicators database. Lastly, we perform multiple case studies using synthetic control analyses to show the effect of particular US and EU trade agreements on the size of the informal economy for various trading-partner countries. Similar to the matching and difference-in-differences method used above, we match trading partner countries with countries that have not entered into trade agreements with labor provisions to give us a realistic counterfactual scenario. After matching we create a synthetic version of a country to see what the size of the informal economy would have been, had that country not entered into a trade agreement.

Discussion and Future Implications

This work speaks directly to the question of the role globalization and international agreements have on the informal sector. Our findings suggest an answer to the empirical puzzle mentioned above. Namely, it is not trade liberalization alone that aids in reducing informality. Rather, the institutional design and variation within these agreements matters a great deal. FTAs with enforceable labor provisions aid in reducing the size of the informal economy by providing a pathway to formal employment in trading-partner countries. On the other hand, FTAs that incorporate aspirational language with no enforceable provisions have a minimal effect on the informal sector. This research speaks to the broader questions around the role international agreements have on domestic outcomes while providing a blueprint on "what works" for future treaties. By ensuring enforceable labor provisions are included in trade agreements, countries can reap the benefits of the distributional effects of liberalization while also promoting sustainable growth and protecting the most vulnerable in society

References