CHAPTER-7

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In this study we have analyzed some major issues related to the role of informal sector in developing economies, especially in the context of various policy measures that are relevant in the context of trade liberalization regime of the developing economies. We have tried to analyze the welfare implications of different liberalization policies along with various policy measures, widely followed by the developing economies after the Uruguay round of discussions and the formation of WTO. The WTO has brought some revolutionary changes in liberalizing international trade across countries, whether developed or developing. According to WTO, liberalization involves both inflow of foreign capital as well as reduction of protection of domestic industries. Moreover, developing economies are plagued by various types of distortions. Commodity market distortion in the form of tariff protection of the import-competing sector, labour market distortion in the form of the unionized formal sector labour market and capital market distortion in the form of imperfection of informal capital market are the most common types of distortions prevalent in the developing economies. According to the conventional wisdom, removal of distortions enables more efficient distribution of economic resources which leads to an improvement in the level of welfare of the economy. Therefore, the developing economies are advised by the WTO to include various structural reforms in their globalization programme packages. Thus, in various chapters of this study we have tried to analyze the impact of foreign capital inflow, tariff cuts and increase in employment subsidies, which are undertaken by the developing economies in recent years, to examine their effects on the level of welfare along with the various other aspects of developing economies.

In chapter 3 of our study we have considered the effects of increase in foreign capital inflow in a neo-classical full employment model in the presence of informal sector which either produces a final traded good or an intermediate good for the formal manufacturing sector of the economy. In the chapter, we have dealt with the issue like impact of foreign
capital inflow on the skilled-unskilled wage gap which is one of the important aspects of a developing economy which is gaining momentum in recent years. The issue becomes more important when we take into account of the role of informal sector. We have also tried to analyze the welfare impact of foreign capital inflow in this framework. For this purpose we have considered a four sector small open economy. The four sectors of the economy are the two manufacturing sectors- one producing exportable and another import-competing sector, an agricultural sector and a final good producing informal sector. In case of developing economies, a large proportion of the informal sector produces intermediate goods for the formal sector on a subcontracting basis. To take consideration of this fact, we have extended our basic model, where the informal sector produces an intermediate good for the exportable good producing skilled manufacturing sector on a subcontracting basis. In the context of both the frameworks, we have analyzed the impact of investment liberalization in the form of foreign capital inflow. It has been observed that investment liberalization always widens the skilled-unskilled wage gap of the economy but improves the level of welfare of the economy, irrespective of the fact that informal sector produces a final traded good or an intermediate good on a subcontracting basis, under some reasonable assumptions.

In chapter 4 of the thesis, we have dealt with the social menace of child labour, which is the main constitute of informal sector of a developing economy. We have considered a three sector full-employment general equilibrium model to consider the impact of trade liberalization, both in the form of foreign capital inflow and structural reform in the form of reduction of protection to the formal manufacturing unit of the economy, on the level of child labour and the level of welfare of the economy. For this analysis, we have subdivided the economy into three sectors- an agricultural sector, a formal manufacturing sector and an intermediate good producing informal sector. The formal manufacturing sector is the import-competing sector and so is protected by tariff. A fourth sector is also considered in this chapter which produces child labour. In this sector child rearing activity has been considered similar to commodity production, the end product of which is child labour. Within this framework, it has been observed that whether trade liberalization has a favourable impact on the level of child labour or on the level of
welfare of the economy depends on the form of liberalization programme that has been adopted by the economy. Increase in foreign capital inflow improves the level of welfare of the economy but at the same time exaggerates the problem of child labour that prevails in the economy. On the other hand, reduction of protection to the formal manufacturing sector helps to curb the menace of child labour but it has a negative impact on the level of welfare of the economy.

According to WTO, liberalization policies enhance the level of welfare of the economy but leads to its environmental degradation. But, this conventional wisdom may not always hold good. In order to examine the predictions of WTO, we have considered a general equilibrium framework in Chapter 5. In this chapter the economy is basically classified into an agricultural sector, a formal manufacturing sector, which is further subdivided into two sub-sectors – one producing exportable and another is import-competing sector, and the intermediate good producing informal sector which produces intermediate good for the import-competing formal manufacturing sector on a sub-contracting basis. The formal manufacturing sector which uses the product of informal sector is the import-competing sector and so is protected by tariff. In this framework we have introduced the efficiency function of the workers, which has been borrowed from Wage Efficiency Hypothesis (WEH). In this chapter, the WEH has been modified and nutritional efficiency function has been introduced. It has been assumed that nutritional efficiency of a worker is inversely related to the level of pollution prevailing in the economy. In the context of such a framework, it has been observed that with the reduction in tariff protection to the import-competing formal manufacturing sector, the level of welfare of the economy rises and also leads to a decrease in the level of (urban) pollution of the economy, under some reasonable assumptions. Thus, the welfare implication of the tariff cut is consistent with the WTO predictions.

Another noticeable feature of the developing economies is the presence of high level of unemployment of labour, specially in the urban area of the economy. According to the conventional view, the informal sector acts as a labour absorbing sector, so that when a migrant from the rural sector fails to get a job in the formal manufacturing sector of the
economy, he gets himself absorbed in the informal sector of the economy. Hence, usually in the theoretical models in the presence of informal sector, there exists no scope for unemployment. But, empirical evidences show the simultaneous existence of unemployment and informal sector in the developing economy. However, very few theoretical papers capture this fact. In chapter 6 of this thesis we have considered the simultaneous existence of unemployment and informal sector in the urban area of the developing economy. We have considered a three sector HT (1970) framework instead of a neo-classical full employment framework. The three sectors of the economy are the urban formal manufacturing sector, the agricultural (rural) sector and the urban informal sector. In this chapter, we have not only considered the rural-urban migration but also have considered the migration of labourers from the urban informal sector to the urban formal manufacturing sector within the urban area. Another observed feature of the developing economies is the presence of capital market distortion in the form of imperfection of the informal capital market, which has also been taken into consideration in this chapter. In this framework, we have tried to analyze the impact of various development policies, like increase in employment subsidy of the formal manufacturing sector and the reduction of capital market distortion, on the level of NI (working as a proxy for welfare) and also on the rate of urban unemployment of the economy.

Increased employment subsidy to the formal manufacturing sector decreases the urban unemployment rate of the economy and increases the level of its NI (welfare). So this development policy seems to be beneficial for the economy. However, reduction in capital market distortion creates an adverse effect on the economy as it increases the rate of urban unemployment rate and also decreases the level of NI (welfare) of the economy. This result is contrary to the popular belief and so it is interesting from the point of view of policy makers.

To conclude, we can say that the welfare consequences of various liberalization policies, as prescribed by WTO, are not always beneficial for the economy, especially where the informal sector plays a crucial role. It is thus, argued that a proper choice among different policies prescribed by WTO should be adopted by the economy which is compatible with the internal institution, technological and trade related characteristics of the economy,
otherwise a drastic implementation of liberalization policies, as prescribed by WTO may produce counterproductive results for the welfare of the relevant country. This aspect is specially important for an economy where we find there is widespread existence of informal sector.

Let us now point out the limitations of our study and the scope for further research in this area. It should be mentioned at the outset that throughout the thesis our measure of welfare appears restrictive. We have proxied our measure of welfare by NI at world prices. It is a good measure when we take into account the cost of tariff protection from the production side. However, when we consider distortion cost of the consumption side, national income as a measure of welfare is overestimated. Again when we consider environmental factors (as in chapter 5), instead of national income or net domestic product one should consider environmentally adjusted net domestic product. Inspite of these limitations we should say that national income is a popular measure of welfare in the context of small open economy general equilibrium models and it is widely used in literature. So NI as our measure of welfare throws some important light in policy directions. However, for future research our task is to find out a well defined welfare function to analyze various policies that are relevant from the point of existence of informal sector.

In this thesis though we have tried to focus on some of the major aspects of informal sector in a developing economy, there are some important facts which are not taken into consideration in our study. For example, there are many informal activities like self-employed workers, street hawkers, petty businessman etc. and these have not been considered in our analysis. Theoretical modelling on informal sector by taking into account of all these aspects is really a difficult task. Out thesis is a preliminary attempt so far as modelling of informal sector is considered. Our future research will definitely focus on a more disaggregated version of informal sector to cover the various categories of this sector.
In chapter 4 of our study we have considered the role of child labour in the presence of informal sector in an economy. There we have considered that poverty is the main factor behind emergence of child labour. While poverty is an important cause behind emergence of child labour, other factors like capital and labour market imperfections, deficiencies of schooling opportunities etc are also important factors behind its emergence. Our future research on informal sector should take account of various types of child work and should relate them with the various factors regarding the emergence of child labour.

We have considered in our analysis that the efficiency function of a worker depends only on the amount of overall pollution of the economy, but in reality, we know that efficiency of a worker depends not only on the level of overall pollution of the economy, but also on many other factors like the amount of education/skill he has acquired, age of the worker etc. These issues can be considered as an extension of the present version of the paper.

In this study we have considered a static analysis. The work would be more interesting if our static analysis can be extended to a dynamic version. For example the child rearing activity by adult labour that we have explained in chapter 4 of our thesis is basically a dynamic process. Again for future research one can consider a dynamic optimization problem facing a social planner subject to the constraint of increasing informalization of the economy. Such a framework will help the academicians as well as policy makers to draw long run policy conclusions which they can compare with the short run static policy conclusions generated from the present study. The study would be interesting if the long run policy results are exactly opposite to the short run ones.

Finally, a theoretical analysis remains incomplete unless the theoretical propositions are empirically tested. Thus, empirical analysis of our theoretical structure can be considered as one of the most important items of our future research agenda.