

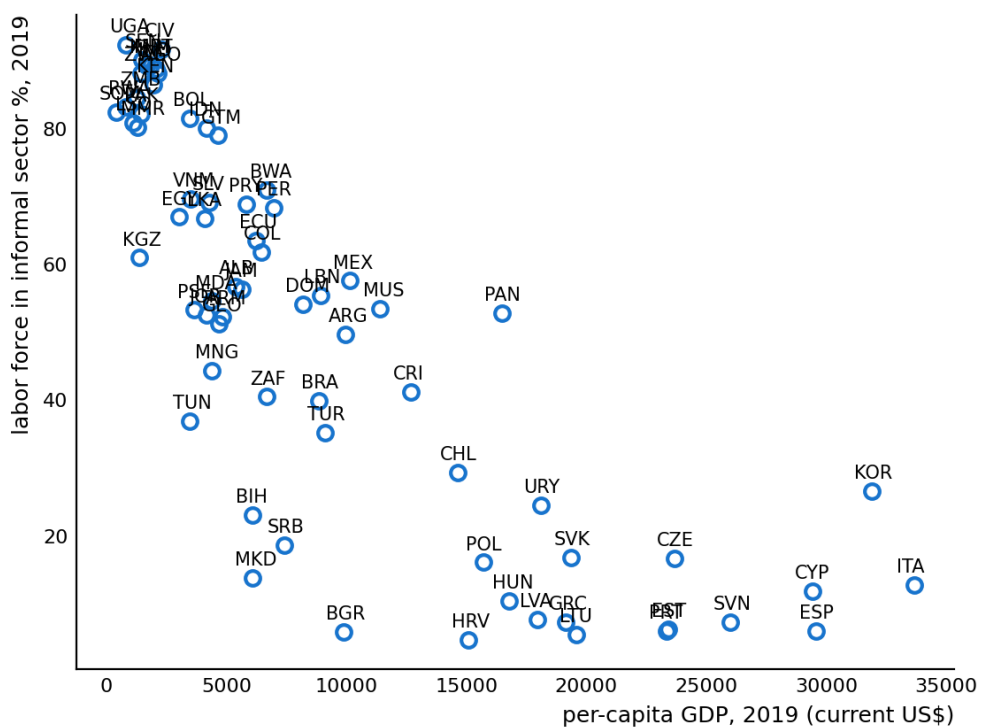
Development Economics

Slides 8

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Harris-Todaro: Structural Change as Spillover into Informal Sector

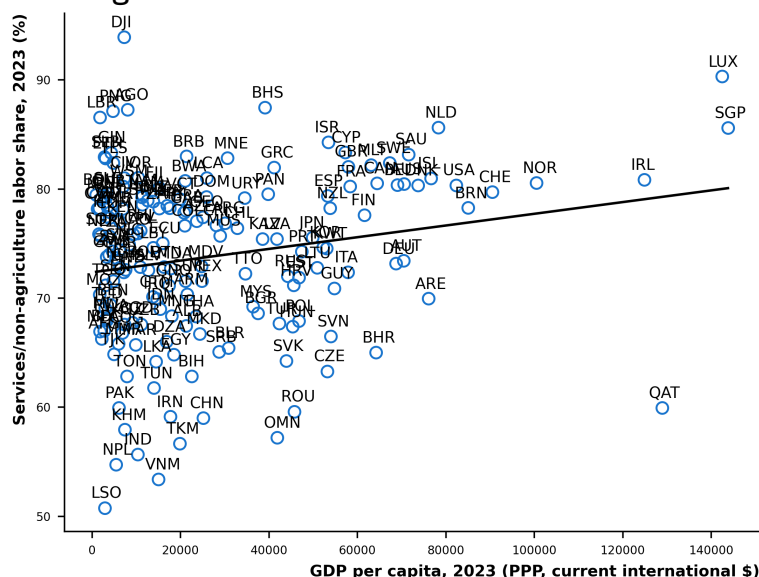
■ Share of the labor force in the informal sector:



Harris-Todaro: Structural Change as Spillover into Informal Sector

■ The informal sector abounds in services.

- Muddies the waters of the services transformation.
- “Services” could grow simply as the result of a failure to absorb labor that’s spilling out of the agrarian sector.



Harris-Todaro: Structural Change as Spillover into Informal Sector

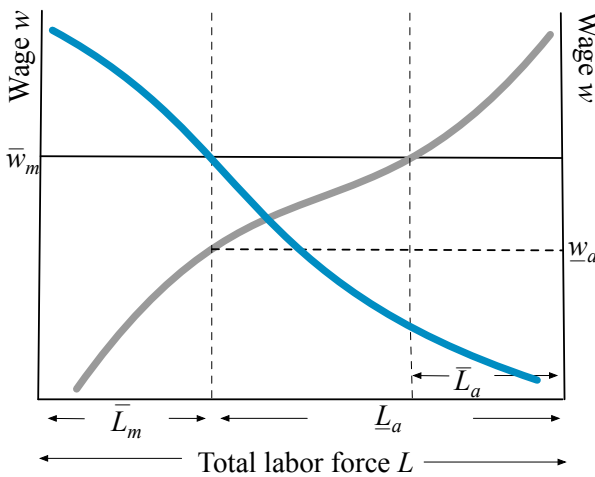
■ Starting point of the Harris-Todaro model:

- Formal m -wages $\bar{w}_m$ are pegged “too high” relative to market-clearing levels:
- Unionization, minimum wage policy, pension schemes, worker incentives ...

■ Two sectors other than the formal or m -sector:

- An a -sector, as before, with flexible wages.
- An urban informal sector that soaks up job-seekers in m .

Harris-Todaro: Structural Change as Spillover into Informal Sector



- Where do the $L - \bar{L}_m$ people go?
- To the a -sector?
- Then $w_a = \underline{w}_a < \bar{w}_m$.
- But full employment with unequal sectoral wages and full mobility of labor isn't possible.
- So $(\bar{w}_m, \underline{w}_a)$ can't be an equilibrium.

- How about equalizing wages? Then a -sector can only absorb $\bar{L}_a$.
- The unemployed can't be in a (w_a is flexible and will be bid down), nor can they be in m (wages across the two sectors are equal).
- This is where the informal sector comes in.

Harris-Todaro: Migration Equilibrium as a Lottery

- Rural-urban migration viewed as choice between:
 - employment at low but sure w_a , or
 - a lottery ticket: formal outcome ($\bar{w}_m$) or informal outcome ($w_i < \bar{w}_m$):

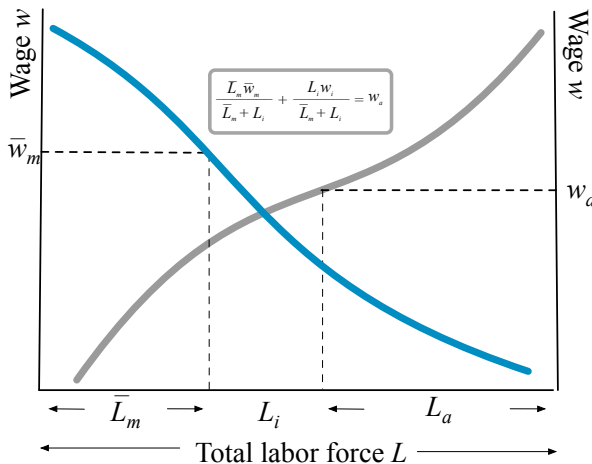
$$w^e \equiv p\bar{w}_m + (1 - p)w_i,$$

- where p = probability of getting an m -sector job.
- **Remark:** Can extend to cover formal, informal and openly unemployed

$$w^e \equiv p\bar{w}_m + (1 - p)[qw_i + (1 - q) \cdot 0],$$

- or even further to include the possibility of returning home (at some cost).

Harris-Todaro: Migration Equilibrium as a Lottery



Let L_i = informal labor. Then:

$$\frac{\bar{L}_m}{L_i + \bar{L}_m}.$$

- is the probability of a formal job.
- So the **Harris-Todaro equilibrium** is:

$$\frac{\bar{L}_m}{L_i + \bar{L}_m} \bar{w}_m + \frac{L_i}{L_i + \bar{L}_m} w_i = w_a.$$

- where w_i is the informal wage (assumed to be exogenous).
- Can easily extend this idea to include open unemployment.

Harris-Todaro: The Paradox of Job Creation

- **Not our usual vision of structural change:**
- (Informal) services an outgrowth of lack of jobs in the m -sector.
- **Job creation:** $\bar{L}_m \uparrow$ to $\bar{L}'_m > \bar{L}_m$.

- New equilibrium:

$$\frac{\bar{L}'_m}{\bar{L}'_m + L'_i} \bar{w}_m + \frac{L'_i}{\bar{L}'_m + L'_i} w_i = w'_a.$$

- But $w'_a \geq w_a$ (why?), so it must be that

$$\frac{L'_i}{\bar{L}'_m + L'_i} \leq \frac{L_i}{\bar{L}_m + L_i}.$$

- $\Rightarrow$ ratio of informal sector to overall non-agricultural employment cannot rise
- a beneficial implication of the policy. **But ...**

Harris-Todaro: The Paradox of Job Creation

- Look at the old and new equilibrium conditions side by side:

$$\frac{\bar{L}_m}{L_i + \bar{L}_m} \bar{w}_m + \frac{L_i}{L_i + \bar{L}_m} w_i = w_a, \text{ and}$$

$$\frac{\bar{L}'_m}{\bar{L}'_m + L'_i} \bar{w}_m + \frac{L'_i}{\bar{L}'_m + L'_i} w_i = w'_a.$$

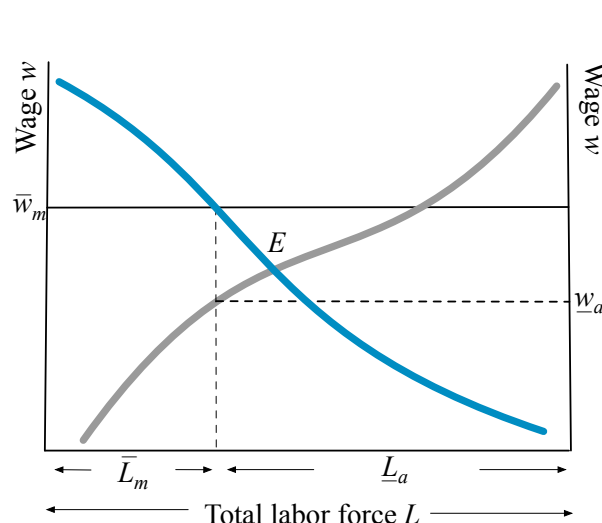
- In the Lewis surplus labor phase, $w'_a \approx w_a = z$.
- But then, because $\bar{L}'_m > \bar{L}_m$, it must be the case that:

$$\frac{L'_i}{L} > \frac{L_i}{L}.$$

- The informal sector expands relative to the economy as a whole.
- Paradox of job creation:**
- Also applies to: urban congestion, pollution, health facilities etc.

Harris-Todaro: Migration Restrictions

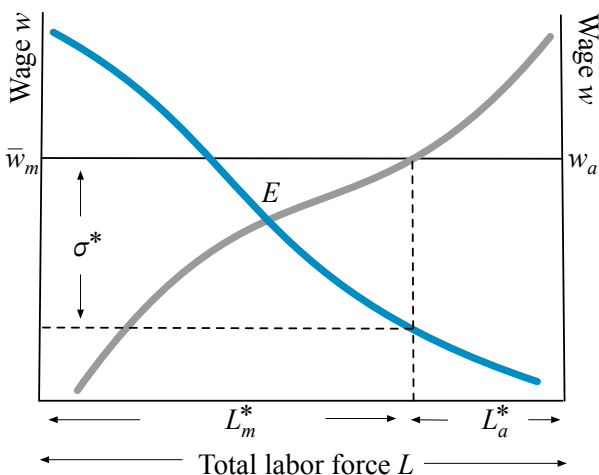
- No individual without a formal job can enter the urban zone;
- China, Vietnam, the erstwhile Soviet Union, even the US.



- $\bar{L}_m$ in m -sector
- $L_a = L - \bar{L}_m$ and $L_i = 0$.
- Is this an efficient policy?**
- Point E equalizes MPL over sectors.
- Migration restrictions overuse a and underuse m .
- So we should be able to do better than migration restrictions alone.

Harris-Todaro: Wage Subsidies

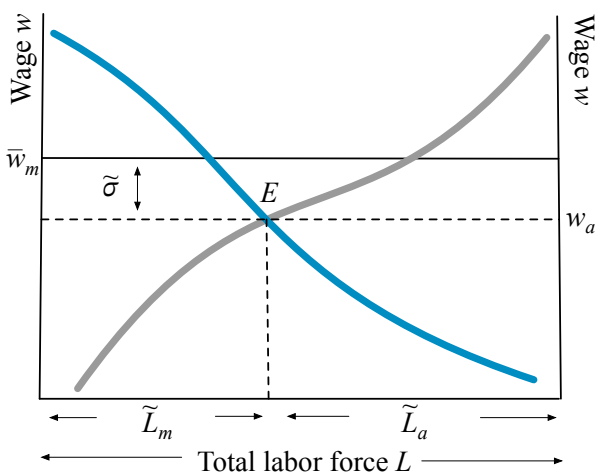
- **Subsidize** σ dollars of the formal wage for every labor hour hired.
- So employer effectively pays $\bar{w}_m - \sigma$, worker gets the full $\bar{w}_m$.



- **Expands labor demand** at $\bar{w}_m$.
- $L_a \downarrow, w_a \uparrow$.
- w_a can be made to climb to $\bar{w}$:
- No need for migration restrictions
- the informal sector also vanishes
- But still inefficient relative to E .
- Subsidies overuse m and underuse a (compare last two figures)

Harris-Todaro: Wage Subsidies + Migration Restrictions Combo

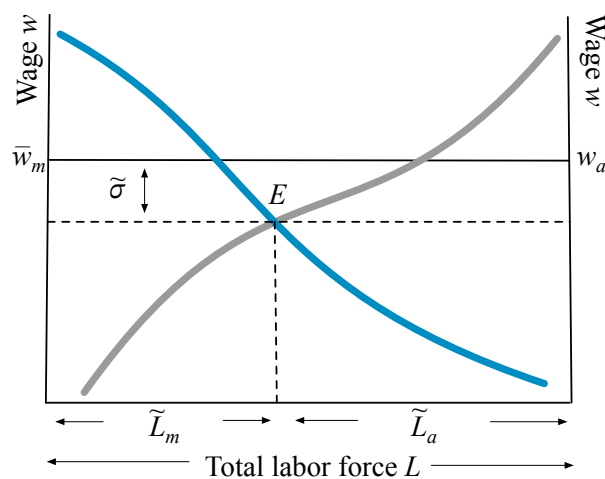
- **Mixed policy combines migration restrictions with wage subsidies.**



- Subsidy $\tilde{\sigma}$ hikes up L_m to $\tilde{L}_m$, at E .
- Restrictions used to ensure that the rest are in the a -sector.
- **This outcome is efficient!**
- But relies on physical restrictions that can be hard to enforce.

Harris-Todaro: Uniform Wage Subsidies

- **A uniform wage subsidy:** efficiency without migration restrictions:



- Wage subsidy of σ to **both** sectors.
- Demands for L_a and L_m increase.
- When subsidy hits $\tilde{\sigma}$, $w_a \uparrow$ to $\bar{w}_m$!
- The outcome is efficient.
- **Notes**
 - Funding of the subsidy
 - Fine details of parameters