

Growth and Informality: Evidence from Bangladesh

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Abstract

The informal sector accounts for the majority of employment in many developing countries, yet its role in growth, and its links with the formal sector, remain poorly understood. One view of the informal sector – the substitutability view – characterizes it as stagnant and unproductive and predicts that the sector will disappear as an economy develops. An alternative view – the complementarity view – characterizes the sector as allowing entrepreneurship and providing supply links to the formal sector, and predicts that the informal sector will exist (maybe even thrive) as economies develop. We use the experience of Bangladesh to examine the role that the informal sector plays in growth. Demand for Bangladesh’s exports – particularly from the ready-made garments sector – has risen rapidly over the past two decades. We exploit exogenous variation in demand for exports, coupled with supply chain links that propagate these export-driven demand shocks throughout the economy, to examine the effect of sectoral growth on formal, informal, unpaid, and self-employment. Our results suggest that export-led growth increases employment levels in all four employment categories. However, in terms of employment *shares*, we find that sectoral growth causes a reallocation away from formal and informal employment towards self-employment. These results stand in contrast to the conventional view that as economies grow, employment shifts towards the formal sector, and suggest that the informal sector – and in particular self-employment – might play an important role in growth.

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