

Firm Dynamics and Economic Growth with the Informal Sector*

Masakazu Emoto[†]

First Draft: January 2021

Abstract

In this study, we analyze the effect of the informal sector on firm size distribution, misallocation of resources, and economic growth. To this end, we extend [Luttmer\(2012\)](#), which tracks the relationship between firm size distribution and economic growth, to include the informal sector and analyze these effects. Moreover, we calibrate the model to match the relevant statistics of the informal sector and firm distribution in the United States and Mexico. There are several contributions of the study to the literature. First, we show, based on the data for the U.S. and Mexico, that economic growth rate has slowed due to the presence of the informal sector. Second, we find in both the U.S. and Mexican cases that a reduction in the tax rate has a positive impact on economic growth and social welfare. On the other hand, a reduction in the operating costs of the formal sector is found to have similar consequences to a reduction in tax rates in the Mexican case, but to have a positive impact on economic growth and a negative impact on social welfare in the U.S. case.

Keywords : Endogenous Growth, Firm Dynamics, Informal Sector, Misallocation

JEL Classification : E26, L11, O17, O41

*I would like to thank my advisor, Tamotsu Nakamura, for his guidance and insightful comments. I have also greatly benefited from continuous discussions with Takashi Kamihigashi and Tomomi Miyazaki, and Tatsuya Asami. All remaining errors are mine.

[†]Graduate School of Economics Kobe University Rokko-dai 2-1 Kobe 657-8501, Japan Email : masakazu.emoto@gmail.com