Integration, Informalization, and Inequality in Developing Countries: Some General Equilibrium Explorations in Light of Accumulating Evidence

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Abstract

Recent post-liberalization decades have seen increasing gaps between wages and profit income, rising skill premia, and disappointing formal sector employment growth in many developing countries. This paper presents an attempt to reconcile some of these developments with the help of modified versions of simple standard trade theory factor endowment models. Measures undertaken to enhance public sector efficiency and attract investment in the export sector can create a conflict of interest between the owners of capital and labor, and increase the rental-wage and skill-unskilled wage gaps, contra the predictions of the Heckscher-Ohlin-Samuelson model. Moreover, increasing inequality can exist side-by-side with increasing informalization of the economy. The greater unskilled labor intensity of the informal sector, factor market rigidities in the formal sector, and the sector specificity of some factors crucially influence the outcomes of policy experiments. Even within a simple framework that assumes full employment of resources, large segments of labor may have good reason to fear the consequences of reform.

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Keywords: Specific factors model, Ricardo-Viner model, Heckscher-Ohlin model, informalization, international production networks, elasticity of factor substitution, nominal wage rigidity, income inequality, skill premium.

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