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Financial Constraints and the Size of Informal Sector

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Abstract
This paper analyses the impact of financial constraints on the informal sector size. We develop a general equilibrium model of monopolistic competition with heterogenous firms in terms of productivity. In the model, financially constrained firms can choose to operate either in the formal or informal sectors depending on profitability. Financial frictions increases the cost of the borrowing which is an advantage of being a formal firm. On the other hand, being a formal firm increases the cost of regulation and tax payments. Model shows that financial frictions are one of the most crucial determinants of being either formal or informal. Besides the theoretical results, we calibrate the model to compare the model results with the actual data.

Keywords: Informal Economy, Financial Constraints, General Equilibrium
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