Informal Sector and Poverty

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This paper develops a general equilibrium model with heterogeneous agents to analyze the poverty impact of different policies aimed at reducing informality. The model features occupational choice with self-employment, minimum wages and a split labor market that are characteristic of developing countries. The counterfactual analyses using Madagascan data show that reducing entry costs into the formal sector or tightening enforcement of formality slightly increase the scope of the formal economy but fail to reduce poverty. Lowering the revenue tax rate or the minimum wage, in contrast, entail growth, a larger formal sector with more formal employment and lower poverty levels.