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AND LEGAL FAILURES**  
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WP 20-04

December 2004

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# Accounting for the hidden economy: barriers to legality and legal failures\*

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November 29, 2004

## Abstract

This paper examines how much of the difference in the size of the informal sector and in per capita income across countries can be accounted by regulation costs (*barriers to legality*) and contractual imperfections in financial markets (*legal failures*). It constructs and solves numerically a general equilibrium model with credit constrained heterogeneous agents, occupational choices over formal and informal businesses, contractual imperfections and a government sector which imposes taxes and regulations on formal firms. The premium from formalization is better access to outside finance. Differences in regulation costs and the degree of enforcement in financial contracts endogenously generate differences in the size of the informal sector and in total factor productivity (TFP). The numerical exercises suggest that: (i) regulation costs and not financial market imperfections account for the difference in the size of the informal sector between United States and Mediterranean Europe; (ii) this is not the case for countries with very weak enforcement systems, such as Peru, as both contractual imperfections and regulation costs account for the observed difference in the size of the informal sector. Regarding output per capita, regulation costs and the strength of enforcement explain roughly 60% of the difference in observed international incomes.

*JEL Classification:* E6; O11; O17

*Keywords:* inequality; credit constraints; corruption; informal sector