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Thursday: 2-3pm

RURAL AND URBAN

AN IMPORTANT FEATURE OF DEVELOPING COUNTRIES

- Distinction between the rural and urban sector.
- Typically, in developing countries, significant share of population lives in rural areas.
- Of this fraction, a majority is connected to agriculture as a way of life.
- In the first part of this lecture, we're interested in the interconnection between agriculture and the industrial sector.
- As economic development proceeds, people move from rural to urban areas.

FORMAL AND INFORMAL URBAN SECTORS

- In developing countries, **two forms of urban economic activity** are apparent (although line between them can be hard to define precisely)
- **Formal sector:** firms under the umbrella of accepted regulations imposed by the government; workers may belong to unions; minimum wage; minimum standards of safety; firms pay taxes.
- To sum up, these firms adhere to government imposed rules, and receive in turn the benefit of state economic support (access to things such that courts of law, etc.). There is cost to enter in this sector (maybe you need a license, you need to keep records, ect)

FORMAL AND INFORMAL URBAN SECTORS (2)

- The **informal sector**: a loose amalgam of (usually small scale) organizations escaping the cover of many regulations (no taxes, no minimum wage, etc) and receiving little or no government support.
- Not illegal in the strict sense, but would be way to complicated to regulate, enforce tax payment, etc. (street vendors, rickshaw pullers, young boys carrying your bags at the market, etc.)
- To sum up, these informal firms have low set up costs (no license or tax records necessary, etc.), but do not have access to state support (ex: almost no access to court of law if a customer does not pay you, etc.)

AGRICULTURE

- In most cases, agriculture is a giant informal sector itself: really hard to know how much farms produce, so hard to make them pay taxes; almost impossible to enforce minimum wages; no old age security, no unemployment insurance of any kind...
- But usually, a number of informal institutions act as substitutes for these missing sources of support. (informal insurance among villagers, working grown ups take care of their old parents, etc.
- The primary activity is of course farming, and production serves both self-consumption and market sales.

AGRICULTURE (2)

- Production is organized in a variety of ways: family farms; large landowners using modern techniques and hiring labor; tenant farmers leasing land from a nonfarming landowners, paying him rent; sharecropping; people working both on their family farm and working for a wage on the land of others, either short of long term.
- Uncertainty is a key factor in the life of people in the agricultural sector.
- Unequal access to inputs such as fertilizers and seeds, differences in soil fertility and rainfall patterns.

RURAL URBAN MIGRATION

- Classic theory based on Harris and Todaro (1970)
- Formal sector usually pays much higher wages than the informal urban sector and the rural sector.
- In Harris and Todaro model, migration is viewed as a response to the significant wage gap between the formal urban sector and the rural sector.
- Since everybody cannot be absorbed by the formal urban sector, some people survive in the informal sector, hoping that they'll eventually find a job in the formal sector.

HARRIS – TODARO (1)

- Assume 2 sectors in the economy: rural sector and formal urban sector.
- And for now, as a benchmark, assume that wages in both sectors are fully flexible.
- Figure 10.4 Debraj Ray: market equilibrium with flexible wages.
- As long as wages in both sectors are different, people migrate towards the sector where the wage is higher. An equilibrium is attained once nobody has an incentive to migrate, which is when wages in the two sectors are equalized.

HARRIS – TODARO (2)

- However, as argued above, the formal urban sector may be characterized by a wage too high for market equilibrium to occur as described previously.
- Now, assume that there is a minimum wage in the formal sector that \underline{w} that is too high for market equilibrium w^* to occur.
- Adding this constraint to the previous graph, it follows that firms in the formal sector will hire no more than L_f as any wage below \underline{w} is illegal.
- Where do the rest of the people go?
- Now look at the other notes for more details on the model.