Essays on Fiscal Policy, Monetary Policy and Currency Unions: Exploring the Role of Informality and Labor Mobility

Mahama Abdel Samir Sidbéwendé Bandaogo

Chairs of the Supervisory Committee:
Associate Professor Yu-chin Chen, Co-chair
Department of Economics
Professor Fabio Ghironi, Co-chair
Department of Economics

Abstract:

In this dissertation I study how economic activity outside of government control –informality– impacts policy-making in a small open economy. I also study the impact of labor mobility in a currency union on the welfare of the union.

Chapter 1 is concerned with the impact of informality on the Ramsey optimal fiscal and monetary policy. In particular, I ask: how does economic activity outside of government control affect the conduct of fiscal and monetary policy? I study this question in a New Keynesian, small open economy model. The model is assumed to feature informality in both goods and labor markets. A non-traded sector produces a non-taxed informal good. The traded sector produces a formal good and is subject to taxation, but it can hire workers using both formal and informal contracts. I show that the presence of informality decreases the optimal tax rate and increases macroeconomic volatility. Moreover, when the country cannot credibly precommit to the optimal policy, informality significantly increases the incentive to peg the currency. This result can help explain why many sub-Saharan African countries have plans to either expand existing currency unions or to form new ones.

In Chapter 1 I also investigate the impact of the informal sector on fiscal policy: the tax rate levied by the government in the formal sector and the amount of public debt. With the steady state of the theoretical model described above, I show that the presence of informality decreases the optimal tax rate and increases the level of public debt. Using a panel data of developing countries, I empirically document the negative relationship between the size of the informal sector on the tax rate and its positive relationship with public debt.

Chapter 2 is concerned with how migration within a currency union affects welfare across the union. In particular, I study this question in this paper with a New Keynesian currency union model. The union consists of two countries whose economies are characterized by labor market frictions. One country member has a higher job-finding rate and a lower unemployment rate compared to the other country, hence unemployed agents in the latter have an incentive to relocate to the former. I show that when firms have the ability to hire workers from abroad and when unemployed agents can relocate to a different country, the negative impact of asymmetric shocks is significantly reduced, improving welfare across the union on average.