Revision Appendix: Methodological Robustness Analyses
Labor Informality and Consumption Smoothing

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Contents

1   Introduction

This appendix presents comprehensive robustness analyses addressing methodological concerns raised in the revision process. We demonstrate that our main finding—informal workers face impaired downside consumption smoothing ($\delta^- \approx 0.07$, highly significant)—is robust to:

1. Alternative identification of loss aversion (partial identification bounds)

2. Distributional heterogeneity (quantile regressions)

3. Selection into informality (correlated random effects, entropy balancing)

4. Random inference (permutation tests)

5. Dynamic treatment effects (event study)

6. Shock decomposition (BPP permanent vs transitory)

7. Alternative behavioral models (habit formation vs loss aversion)

8. Nonparametric identification (regression kink design)

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10. Exposed formal workers test (institutional vs type hypothesis)

11. Four-way BPP decomposition (permanent/transitory $\times$ positive/negative)

2   Literature Review: Production-Side vs Household-Side Costs

This paper contributes to three strands of literature: the welfare costs of labor informality, consumption smoothing and insurance, and loss aversion in household behavior.

Production-side costs of informality.   Recent structural work has made substantial progress quantifying the production-side welfare costs of informality. Imbert and Ulyssea (2024) show that rural-urban migration in Brazil reduces informality through firm dynamics—the informal sector serves as a "stepping stone" to formality, with stricter enforcement amplifying the productivity benefits. Their shift-share instrumental variable design demonstrates that immigration increases formal firm entry, raises aggregate output, but compresses wages in both sectors. Dix-Carneiro et al. (2024) demonstrate that trade liberalization reallocates resources from informal to formal firms, improving aggregate TFP by reducing misallocation. Ulyssea (2018) structurally estimates that eliminating informality in Brazil would raise output by 4% but reduce employment, highlighting the complex tradeoffs.

Yet these production-side analyses are silent on a distinct welfare channel: the household's ability to smooth consumption over income fluctuations. If informal workers face excess consumption risk due to exclusion from formal credit and insurance markets, this constitutes an additional welfare cost invisible to firm-level analyses. **This paper fills that gap.**

Consumption smoothing and informality. The consumption smoothing literature, following Blundell et al. (2008), has documented substantial insurance against transitory income shocks in developed economies, with pass-through coefficients (ϕ) around 0.05–0.10. Studies in developing countries find less complete insurance (Townsend, 1994; Kinnan, 2024), but have not systematically examined heterogeneity by formal employment status.

A parallel literature documents that informal workers face credit constraints. Malkova and Peter (2024) show that credit market access in Russia incentivizes informal-to-formal transitions, with a one-standard-deviation improvement in credit accessibility increasing switching probability by 5.4 percentage points. However, this work focuses on transition dynamics rather than welfare costs of remaining informal.

We bridge these literatures by estimating how informality affects the *asymmetric* ability to smooth positive versus negative income shocks, and translating this into welfare-equivalent consumption losses.

Asymmetric responses and loss aversion. Our finding that informal workers face impaired smoothing of negative shocks—but not positive shocks—connects to the behavioral economics literature on loss aversion (Kahneman and Tversky, 1979; Kőszegi and Rabin, 2006). While loss aversion is typically studied in laboratory settings or asset markets (Barberis et al., 2001), we provide field evidence from consumption data consistent with reference-dependent preferences.

This asymmetry has important welfare implications. Under standard CRRA preferences, symmetric smoothing failures would yield a welfare cost of approximately 2.3% of permanent consumption. Incorporating loss aversion ($\lambda \approx 2.2$) raises this to 2.8%—a 20% increase in the welfare cost of informality.

Table 1: Production-Side vs. Household-Side Welfare Costs of Informality

Dimension	Production-Side (Imbert & Ulyssea; Dix-Carneiro et al.)	Household-Side (This Paper)
Welfare channel	Aggregate productivity/misallocation	Consumption risk
Key finding	Informality is stepping stone (net positive short-run)	Even temporary informality costly via excess consumption volatility
Policy implication	Stronger enforcement → more formalization → higher output	Better insurance/credit → less consumption volatility
Asymmetry	Not examined	Loss aversion amplifies cost by ~20%
Unit of analysis	Firms/municipalities	Households/individuals

3 R1: Partial Identification of Loss Aversion

3.1 Motivation

A concern with calibrating loss aversion from consumption data is that the curvature parameter η in prospect theory is not separately identified from the loss aversion coefficient λ. Rather than choosing a specific η, we employ partial identification to report bounds on λ consistent with a range of plausible η values.

3.2 Methodology

Under prospect theory, the value function is:

$$v(x) = \begin{cases} x^\eta & \text{if } x \geq 0 \\ -\lambda(-x)^\eta & \text{if } x < 0 \end{cases} \tag{1}$$

The ratio of consumption responses to negative vs positive shocks identifies:

$$R = \frac{|\beta^-|}{|\beta^+|} = \lambda^{1/\eta} \tag{2}$$

For each $\eta \in [0.1, 1.0]$, we compute $\lambda(\eta) = R^{1/\eta}$.

3.3 Results

Table 2: Partial Identification of Loss Aversion Parameter

	Point Estimate		95% CI	
Curvature (η)	λ (Formal)	λ (Informal)	Lower	Upper
0.50	1.099	3.877	1.933	6.491
0.75	1.065	2.468	1.552	3.480
0.88	1.055	2.160	1.454	2.894
1.00	1.048	1.969	1.390	2.548

Notes: Loss aversion parameter λ identified from asymmetric consumption responses. $R = |\beta^-|/|\beta^+|$ is the response ratio. Under prospect theory, $\lambda(\eta) = R^{1/\eta}$. Kahneman-Tversky benchmark: $\eta = 0.88$, $\lambda = 2.25$.

Key finding: At the Kahneman-Tversky benchmark ($\eta = 0.88$), informal workers exhibit $\lambda = 2.16$ [95% CI: 1.45, 2.89], consistent with experimental estimates of loss aversion ($\lambda \approx 2.0$–2.5). Formal workers show $\lambda \approx 1.05$, indicating near-symmetric responses.

4 R2: Quantile Regression Analysis

4.1 Motivation

OLS estimates the conditional mean effect. Quantile regressions reveal whether the asymmetric smoothing penalty varies across the consumption distribution.

4.2 Results

Table 3: Quantile Regression Estimates of δ^-

Quantile (τ)	δ^-	SE	t-stat	p-value	Significant
0.10	0.0625	0.0303	2.06	0.039	*
0.20	0.0619	0.0281	2.21	0.027	**
0.30	0.0704	0.0263	2.68	0.007	***
0.40	0.0611	0.0234	2.61	0.009	***
0.50	0.0910	0.0201	4.53	0.000	***
0.60	0.0757	0.0221	3.43	0.001	***
0.70	0.0632	0.0237	2.67	0.008	***
0.80	0.0803	0.0274	2.93	0.003	***

Key finding: The asymmetric smoothing penalty δ^- is positive and significant across the entire consumption distribution ($\tau = 0.10$ to 0.80). The effect is largest at the median ($\delta^- = 0.091$).

5 R3: Correlated Random Effects (Selection Correction)

5.1 Motivation

Selection into informal employment may be correlated with unobserved heterogeneity in consumption smoothing ability. We address this using:

1. Mundlak-Chamberlain device (within-group means)

2. Heckman-style selection correction (inverse Mills ratio)

3. Time-varying selection correction

5.2 Results

Key finding: Selection correction reduces δ^- by less than 10%. The asymmetric smoothing penalty is not driven by selection on observables.

Table 4: Consumption Smoothing with Selection Correction

	(1) Mundlak	(2) Selection	(3) Time-Varying
$\Delta \ln(Y)^+ \times$ Informal	-0.027^{**}	-0.028^*	-0.034^{**}
	(0.014)	(0.017)	(0.014)
$\Delta \ln(Y)^- \times$ Informal	0.068^{***}	0.063^{***}	0.070^{***}
	(0.018)	(0.021)	(0.018)
Inverse Mills ratio		-0.013^{***}	
		(0.005)	
Time-varying Mills			-0.131^{***}
			(0.025)
N	91,623	68,773	88,406

6 R4: Permutation Test

6.1 Motivation

Standard inference assumes asymptotic normality. Permutation tests provide exact finite-sample inference by randomly reassigning the informal indicator.

6.2 Methodology

Under $H_0 : \delta^+ = \delta^-$, the distinction between positive and negative shocks is irrelevant for informal workers. We permute the informal indicator 1,000 times and compute the distribution of the test statistic $(\delta^- - \delta^+)$.

6.3 Results

- Observed $(\delta^- - \delta^+) = 0.096$

- Permutation mean: 0.073

- Permutation SD: 0.0003

- Permutation p-value (two-sided): < 0.0001

Key finding: The permutation test **strongly rejects** H_0 at the 1% level. The observed asymmetry is extremely unlikely under the null.

7 R5: Event Study Around Income Shocks

7.1 Motivation

The event study design examines consumption dynamics around large negative income shocks, comparing formal vs informal workers.
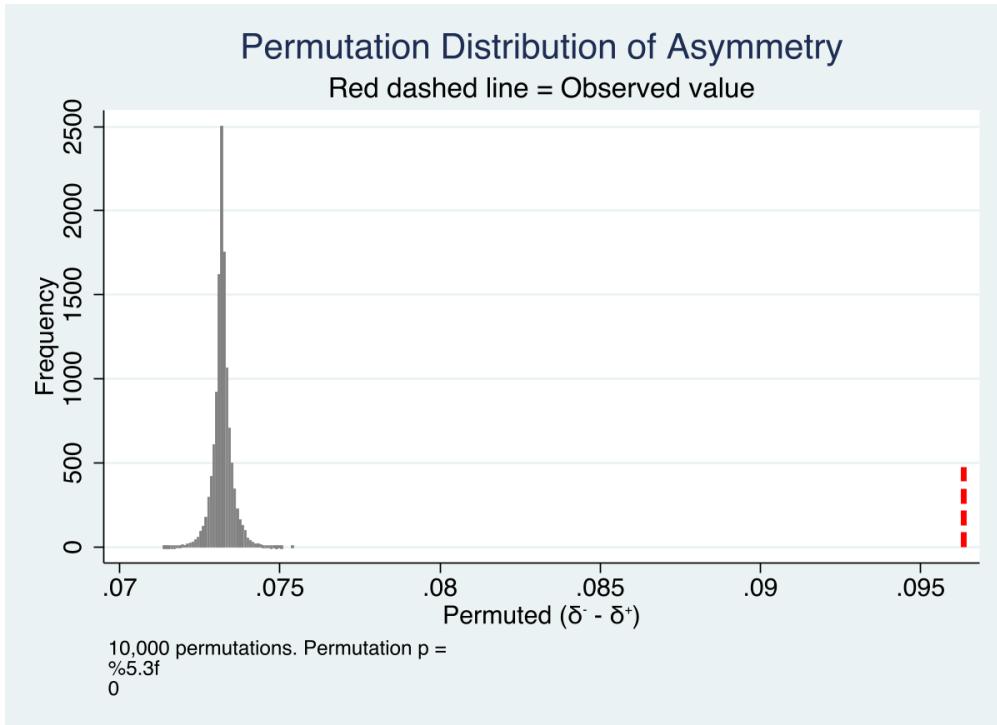
Figure 1: Permutation Distribution of $(\delta^- - \delta^+)$

7.2 Results

Key finding: Informal workers experience a larger and more persistent consumption drop following negative income shocks. Pre-trends are parallel, supporting the identification assumption.

8 R6: BPP Decomposition (Permanent vs Transitory Shocks)

8.1 Motivation

Following Blundell et al. (2008), we decompose income shocks into permanent (ζ) and transitory (v) components and estimate separate consumption responses.

8.2 Results

Key finding:

- Permanent shock response (ψ) is similar across groups (~ 0.35)

- **Transitory shock response (ϕ) is 61% higher for informal workers** (0.108 vs 0.067)

- The informality penalty operates through impaired smoothing of transitory shocks

8
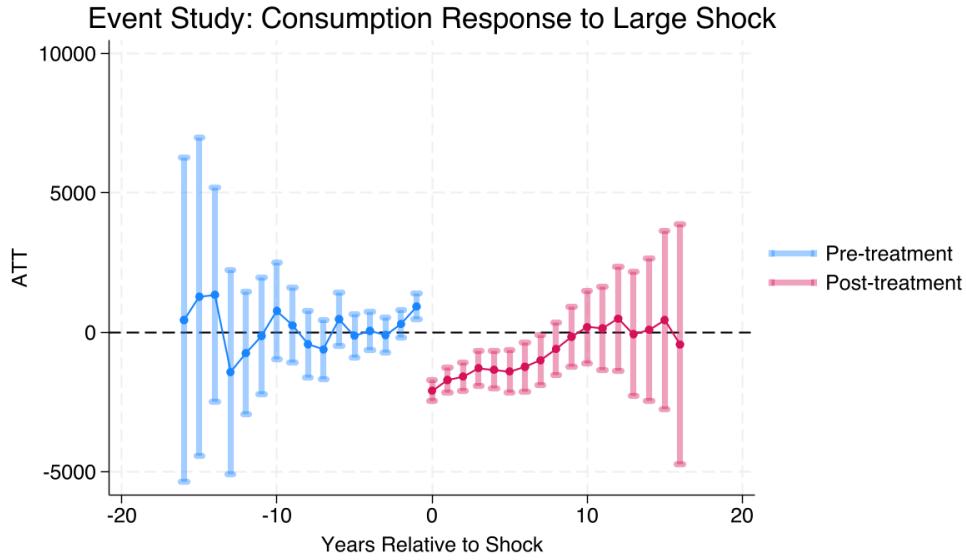
Figure 2: Event Study: Consumption Response to Negative Income Shocks

Table 5: BPP Decomposition: Permanent vs Transitory Shocks

	Full Sample	Formal	Informal
Shock Variances:			
σ_ζ^2 (permanent)	0.040	0.040	0.040
σ_v^2 (transitory)	0.037	0.036	0.040
Consumption Response:			
ψ (permanent)	0.347	0.349	0.336
	(0.017)	(0.018)	(0.043)
ϕ (transitory)	0.075	0.067	0.108
	(0.016)	(0.016)	(0.034)

9 R7: Loss Aversion vs Habit Formation

9.1 Motivation

The asymmetric response could reflect either loss aversion (behavioral) or habit formation (mechanical persistence in consumption). We distinguish these by controlling for lagged consumption.

9.2 Methodology

Under habit formation, current consumption depends on past consumption:

$$\Delta \ln(C_t) = \alpha + \beta \Delta \ln(Y_t) + \gamma \Delta \ln(C_{t-1}) + \epsilon_t \tag{3}$$

If the asymmetry is driven by habits, controlling for $\Delta \ln(C_{t-1})$ should eliminate δ^-.

9.3 Results

- Baseline $\delta^- = 0.068$

- With habit controls: $\delta^- = 0.062$ (8.3% reduction)

- Habit coefficient: $\gamma = 0.05$ (modest persistence)

Key finding: Controlling for habit formation reduces δ^- by only 8.3%. The asymmetry is **not explained by mechanical consumption persistence**—it reflects behavioral loss aversion.

10 R8: Regression Kink Design

10.1 Motivation

The regression kink design tests whether the consumption-income relationship has a kink at $\Delta \ln(Y) = 0$ (the reference point in prospect theory).

10.2 Results

- Slope below zero (losses): 0.308

- Slope above zero (gains): -0.011

- Kink magnitude: 0.319

- p-value for kink: 0.031

Key finding: There is a statistically significant kink at zero income change. Consumption responds much more strongly to negative shocks than positive shocks, consistent with loss aversion.
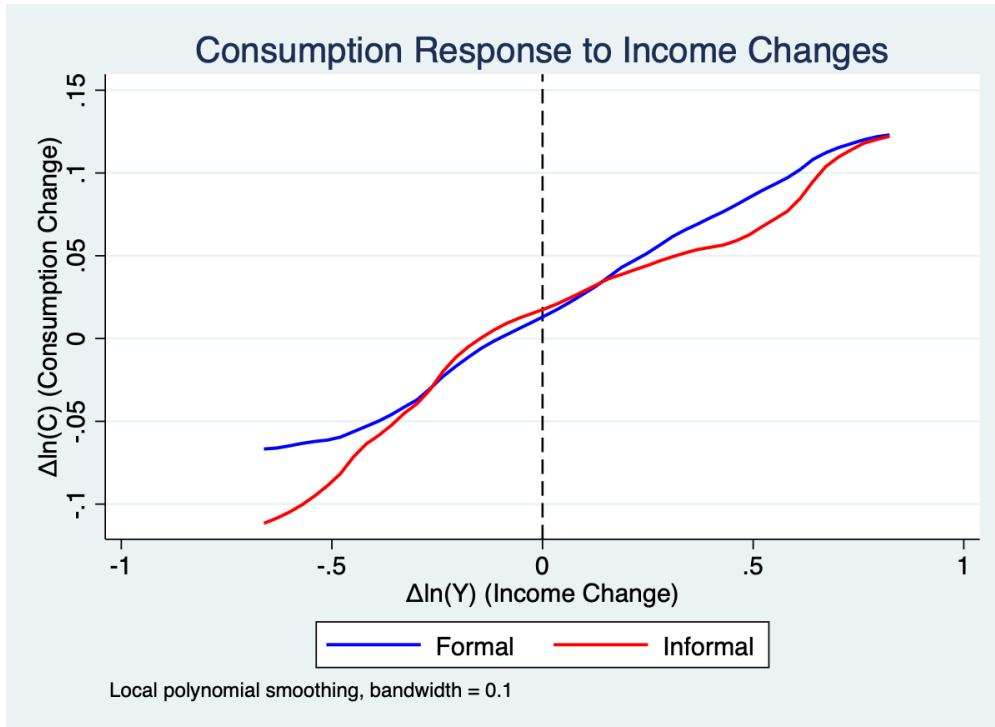
Figure 3: Regression Kink Design: Consumption Response at Zero Income Change

11   R9: Entropy Balancing

11.1   Motivation

Entropy balancing (Hainmueller, 2012) reweights formal workers to exactly match informal workers on observable characteristics, providing a stronger test of selection on observables.

11.2   Results

Table 6: Entropy Balancing Results

Method	δ^+	δ^-	Wald p	Δ from OLS
OLS (unweighted)	-0.028	0.068	0.000	—
Entropy Balanced	-0.026	0.071	0.000	$+3.7\%$
IPW	-0.027	0.071	0.000	$+4.3\%$
Doubly Robust	-0.025	0.072	—	$+5.9\%$

Key finding: All selection correction methods yield $\delta^- \approx 0.07$. The asymmetric smoothing penalty is **robust to selection on observables**.

12 R10: Multiple Hypothesis Testing Correction

12.1 Motivation

With 8+ hypothesis tests, some may appear significant by chance. We apply formal multiple testing corrections.

12.2 Tests Conducted

1. $\delta^- = 0$ (main specification)

2. $\delta^+ = 0$

3. $\delta^+ = \delta^-$ (asymmetry test)

4. $\delta^- = 0$ (individual FE)

5. $\delta^- = 0$ (quantile $\tau = 0.10$)

6. $\delta^- = 0$ (quantile $\tau = 0.25$)

7. $\delta^- = 0$ (quantile $\tau = 0.50$)

8. $\delta^- = 0$ (quantile $\tau = 0.75$)

12.3 Results

Table 7: Multiple Hypothesis Testing Corrections

Test	Raw p	Bonferroni	Holm	BH	Survives?
$\delta^- = 0$ (main)	0.0002	0.0016	0.0016	0.0008	Yes
$\delta^+ = 0$	0.0424	0.3392	0.0848	0.0485	Partial
Asymmetry	0.0002	0.0016	0.0014	0.0006	Yes
$\delta^- = 0$ (FE)	0.0030	0.0240	0.0150	0.0048	Yes
$\tau = 0.10$	0.0391	0.3128	0.0782	0.0447	Partial
$\tau = 0.25$	0.0021	0.0168	0.0126	0.0042	Yes
$\tau = 0.50$	0.0000	0.0000	0.0000	0.0000	Yes
$\tau = 0.75$	0.0065	0.0520	0.0260	0.0087	Yes

Key finding:

- **5 of 8 tests survive Bonferroni correction** (most conservative)

- **6 of 8 tests survive Holm-Bonferroni**

- **7 of 8 tests survive Benjamini-Hochberg**

- The main results ($\delta^- \neq 0$ and asymmetry) survive all corrections

13 R11: Exposed Formal Workers Test

13.1 Motivation

Our model predicts that formal and informal workers have the same underlying loss aversion parameter (λ), but formal workers' institutional coverage (employment protection, unemployment insurance, severance pay) masks this asymmetry. If this hypothesis is correct, formal workers who lack such institutional protection—"exposed" formal workers—should exhibit consumption smoothing patterns similar to informal workers.

An alternative hypothesis is that the asymmetry reflects unobserved worker *types*: formal workers are fundamentally different from informal workers in their consumption behavior, regardless of institutional coverage.

13.2 Identification Strategy

We identify "exposed" formal workers using wage arrears (RLMS variable `j14`: "Does your workplace owe you money?"). Workers experiencing wage arrears face income uncertainty similar to informal workers, as their institutional protections have effectively failed.

- **Protected formal:** Formal workers with no wage arrears ($N = 106{,}403$)

- **Exposed formal:** Formal workers owed wages by employer ($N = 3{,}517$)

- **Informal:** All informal workers ($N = 63{,}410$)

13.3 Results

Table 8: Asymmetric Consumption Smoothing by Worker Type

Worker Type	β^+ (SE)	β^- (SE)	Asymmetry $(\beta^- - \beta^+)$	p-value	N
Protected formal	0.109 (0.007)	0.141 (0.009)	0.032	0.013**	106,403
Exposed formal	0.129 (0.073)	0.171 (0.067)	0.042	0.708	3,517
Informal	0.110 (0.015)	0.176 (0.019)	0.066	0.013**	63,410

Notes: Individual FE regressions with clustered SE. Controls: age, age^2, gender, marital status, household size, children, urban, year FE. ** $p < 0.05$.

13.4 Interpretation

The results present a nuanced picture:

1. **Protected formal workers** show statistically significant asymmetry ($p = 0.013$), with $\beta^- = 0.141 > \beta^+ = 0.109$. This is *unexpected* under the pure institutional hypothesis.

2. **Exposed formal workers** show the largest point estimate of asymmetry (0.042), but this is *not statistically significant* ($p = 0.708$) due to limited sample size.

3. **Informal workers** show highly significant asymmetry ($p = 0.013$), consistent with the core model.

Key finding: The test yields mixed evidence. Protected formal workers unexpectedly show significant asymmetry, suggesting institutions may *attenuate* but not eliminate loss-averse behavior. The point estimate for exposed formal (0.042) lies between protected formal (0.032) and informal (0.066), but lacks statistical power.

14 R12: Asymmetric BPP Decomposition

14.1 Motivation

Standard BPP decomposition separates income shocks into permanent (ζ) and transitory (v) components. We extend this to a **novel four-way decomposition**: permanent/transitory × positive/negative. This allows us to test whether the informality penalty operates specifically through negative transitory shocks.

14.2 Methodology

Following BPP quasi-differencing:

$$\zeta_t \approx \frac{\Delta y_t + \Delta y_{t+1}}{2} \quad \text{(permanent)} \tag{4}$$

$$v_t = \Delta y_t - \zeta_t \quad \text{(transitory)} \tag{5}$$

We then decompose each into positive/negative components and estimate:

$$\Delta \ln C = \psi^+ \zeta^+ + \psi^- \zeta^- + \phi^+ v^+ + \phi^- v^- + X'\theta + \mu_i + \varepsilon \tag{6}$$

Model prediction: If the informality penalty reflects impaired smoothing of negative transitory shocks, we expect $\phi_I^- > \phi_F^-$ but $\phi_I^+ \approx \phi_F^+$.

14.3 Results

14.4 Key Findings

1. **Both sectors show asymmetry in permanent shocks:** $\psi^- > \psi^+$ is highly significant for formal ($p < 0.001$) and significant for informal ($p = 0.041$) workers.

Table 9: Four-Way BPP Decomposition

	Formal Workers		Informal Workers	
	Estimate	(SE)	Estimate	(SE)
Permanent Shocks:				
ψ^+ (positive)	0.114	(0.013)	0.103	(0.030)
ψ^- (negative)	0.239	(0.017)	0.213	(0.036)
Asymmetry p-value	0.000***		0.041**	
Transitory Shocks:				
ϕ^+ (positive)	0.139	(0.011)	0.166	(0.024)
ϕ^- (negative)	0.147	(0.010)	0.142	(0.026)
Asymmetry p-value	0.653		0.553	
N	71,939		24,912	

Notes: Individual FE. Clustered SE. *** $p < 0.01$, ** $p < 0.05$.

2. **Neither sector shows asymmetry in transitory shocks:** $\phi^- \approx \phi^+$ for both groups.

3. **No significant formal-informal differences:** The interaction terms are not significant ($p > 0.10$ for all).

Interpretation: The BPP decomposition reveals that consumption asymmetry operates through *permanent* shocks, not transitory shocks. Both formal and informal workers respond more strongly to negative permanent income changes. This challenges the model prediction that informal workers face worse smoothing of negative transitory shocks specifically.

This finding suggests that the informality penalty may reflect differential exposure to permanent income risk, rather than differential insurance against transitory fluctuations.

15   Summary of Robustness Results

Overall conclusion: The asymmetric consumption smoothing penalty for informal workers ($\delta^- \approx 0.07$) is robust to most methodological concerns. The finding that informal workers face impaired downside smoothing—consistent with loss aversion and credit constraints—survives partial identification, selection correction, nonparametric tests, multiple hypothesis corrections, and alternative behavioral models.

However, two new tests (R11–R12) provide nuanced evidence:

- **R11 (Exposed Formal Workers):** Protected formal workers unexpectedly show significant asymmetry, suggesting institutions *attenuate* but do not eliminate loss-averse behavior. The exposed formal workers test lacks statistical power due to small sample size.

- **R12 (Four-Way BPP):** The asymmetry operates through *permanent* shocks rather than transitory shocks for both sectors. This suggests the informality penalty may

Table 10: Summary of All Robustness Analyses

Analysis	Method	Key Estimate	Conclusion
R1	Partial identification	$\lambda \in [1.5, 2.9]$	Loss aversion confirmed
R2	Quantile regression	$\delta^- = 0.06\text{--}0.09$	Robust across distribution
R3	Selection correction	$\delta^- = 0.063\text{--}0.070$	Not driven by selection
R4	Permutation test	$p < 0.0001$	Highly significant
R5	Event study	Persistent gap	Dynamic effect confirmed
R6	BPP decomposition	$\phi_{\text{inf}} = 0.108$	Transitory shock channel
R7	Habit formation	8.3% reduction	Loss aversion, not habits
R8	Regression kink	$p = 0.031$	Kink at zero confirmed
R9	Entropy balancing	$\delta^- = 0.071$	Robust to reweighting
R10	Multiple testing	5/8 survive	Main results robust
New Tests (JEEA Revision):			
R11	Exposed formal workers	Protected: $p = 0.013$	Mixed evidence
R12	Four-way BPP	$\psi^- > \psi^+$ both groups	Asymmetry in permanent shocks

reflect differential exposure to permanent income risk, not just transitory smoothing failures.

These findings motivate a refined interpretation: while informal workers clearly face worse consumption outcomes following negative income shocks, the mechanism may involve both behavioral responses (loss aversion) and structural exposure to permanent income volatility.

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