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Journal of Comparative Economics

journal homepage: www.elsevier.com/locate/jce

Informal employment relationships and the labor market: Is there segmentation in Ukraine? [☆]

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ARTICLE INFO

JEL Classification:

J31

J40

P23

Keywords:

Informal employment

Labor market segmentation

Transition Economies

Ukraine

ABSTRACT

One of the most important factors that determine individuals' quality of life and wellbeing is their position in the labor market and the type of jobs that they hold. When workers are rationed out of the formal segment of the labor market against their will, i.e., the labor market is segmented, their quality of life is limited, and their wellbeing is reduced. When they can freely choose between a formal or informal employment relationship, i.e., the labor market is integrated, their wellbeing can reach high levels even in the presence of informal employment. We, therefore, test whether the Ukrainian labor market is segmented along the formal-informal divide, slicing the data by gender and age. The analysis that we perform consist in the analysis of short-term and medium-term transitions between five employment states, unemployment and inactivity. We also analyze wage gaps of mean hourly earnings and across the entire hourly earnings distribution, controlling for time-invariant unobserved heterogeneity. According to our results segmentation is present for dependent employees: for a large part of informal employees informal employment is used as a waiting stage to enter formal salaried employment and is not voluntarily chosen. As far as self-employment is concerned the evidence is mixed regarding segmentation in the Ukrainian labor market. This heterogeneity in outcomes implies that not all informal work is associated with a low quality of life and reduced wellbeing in post-transition economies.

1. Introduction

The quality of life of individuals depends on many factors, very prominent among them individuals' position in the labor market and the kind of jobs that they hold. For many social scientists stable employment in formal jobs is associated with life satisfaction and a high quality of life. Such a view is, however, not universal in the economics literature on formal and informal employment in developing and post-transition countries. Some authors put forth the proposition that *conditional* on workers' characteristics many workers have higher utility when they are informal wage employees or informally self-employed. Those who consider formal jobs as

[☆] The authors are grateful to Sumon Bhaumik, Gary Fields, Yuriy Gorodnichenko, Olga Kupets, Alexander Muravyev, Olena Nizalova, Hanna Onyshchenko, Anzelika Zaiceva, and participants of the conference "People matter: Quality of Life and Population Wellbeing in Post-Transition Economies" in Kyiv, Ukraine in September 2017 as well as to seminar audiences at IZA, DIW, the University of Bologna and the Warsaw School of Economics for comments and suggestions on an earlier version of the paper. The comments and suggestions of two anonymous referees have helped us to improve the paper considerably. The usual caveat applies.

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<https://doi.org/10.1016/j.jce.2018.07.011>

Accepted 2 July 2018

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superior along many dimensions perceive the labor market as segmented. In this view, formal jobs are good jobs since they provide high wages, good working conditions, employment protection and insurance against unforeseen health or employment shocks. However, because of labor market institutions and policies the access to good jobs is rationed and some workers are unlucky and must queue in informal jobs, which do not have any of the good characteristics of formal jobs, before they can enter the formal sector. A competing view sees the labor market as integrated, with individuals selecting themselves into that segment of the labor market that generates highest utility for them. Understanding the nature of jobs along the formal-informal divide is, therefore, important if one wants to assess social welfare and subjective wellbeing in developing and post-transition countries.

The empirical literature on labor market segmentation usually proposes two types of “tests”, the analysis of transition probabilities between labor market states that include informal employment, as well as the analysis of informal-formal wage gaps at the mean, and in more recent studies, across the entire earnings distribution. This paper uses a data set that is particularly conducive to testing labor market segmentation in a post-transition economy, the Ukrainian Longitudinal Monitoring Survey (ULMS).³ It allows us to make precise distinctions between different types of informal employment and it has a panel dimension that straddles the years 2003 to 2007.⁴ This latter feature enables us to estimate medium-term transitions between different types of employment and other labor market states. Most of the literature on labor market segmentation in post-transition countries uses two-year panels and is not able to distinguish between voluntary and involuntary informal employment relationships, something we are able to do with the ULMS data.

The paper contributes to the literature on labor market segmentation in post-transition economies in at least three ways. First, we explore whether labor market segmentation plays out differently for female and male workers in Ukraine. Second, we provide medium-term transition probabilities between 2003 and 2007. Such transition probabilities can better establish the search behavior of workers than with a two-year panel. Third, in spite of a relatively short panel, new methods in fixed effects quantile regressions enable us to provide consistent estimates of informal-formal wage differentials across the entire earnings distribution controlling for unobserved time-invariant characteristics. To our knowledge this kind of estimation of quantile regressions with fixed effects is novel for post-transition economies.⁵

In the next section, we, discuss the above mentioned two main paradigms in the literature on informality and informal employment plus a third paradigm in more detail, linking them to labor market segmentation. This is followed by a short presentation of the ULMS data and the definition of informal employment. The fourth section then discusses our research strategy. In section five we first show some descriptive evidence and then estimated transition probabilities between labor market states as well as estimates of wage gap regressions at the mean and across the entire wage distribution for different types of informal employment. The final section discusses our results in the light of the small empirical literature regarding labor market segmentation in post-transition economies and provides some conclusions.

2. The literature on informality and informal employment: theoretical considerations

The existence of the informal segment of the labor market alongside the formal sector and the reasons posited for its existence have given rise to several paradigms in the literature. One key question in the labor market literature for developing countries is whether informal employment or self-employment reflects voluntary choice or is involuntary due to rationing in the labor market (Guasch 1999). The traditional dualistic view, going back to Harris and Todaro (1970), sees the informal segment as the inferior sector, the option of last resort. Due to barriers to entry, minimum wages, unions or other sources of segmentation, formal jobs are rationed. Workers in the informal sector are crowded out of the formal sector involuntarily, their wage being less than that in the formal sector.⁶ For example, an increase in the statutory wage in the formal sector will reduce formal employment but lead to a lower informal wage and higher informal employment. During a recession informal employment and output expands because formal employment is reduced, while the informal labor market clears. In this view labor market segmentation between formality and informality is the defining feature of the labor market.

In contrast, in a competitive labor market one would expect workers to be able to move freely between occupations, and for wages (broadly interpreted) to equalize accordingly. In this view the formal and informal sectors of the labor market are not segmented, but integrated. Voluntary choice regarding jobs and particular attributes of these jobs, such as flexible hours, working as a self-employed and being one's own boss as a micro-entrepreneur, and not valuing social security benefits and/or future pension benefits, can be the reasons for remaining in or moving into informal employment (Maloney 1999, 2004; Cunningham and Maloney 2001). Here, contrary to the segmentation case, formal and informal employment are not necessarily negatively correlated over the business cycle.

Segmentation and integration of the formal and informal labor market segments are two polar views regarding the interaction of formality and informality. However, as suggested by Tokman (1986) and Fields (1990), it is possible that these features co-exist in the same labor market, given the heterogeneity of informal workers. Tokman and Fields envision two segments: an ‘easy-entry’ informal sector, which constitutes the involuntary segment, and an ‘upper-tier’ informal sector, where barriers of entry persist and in which

³ The ULMS is arguably the richest panel data set covering all aspects of workers’ labor market experience in a post-transition country. For a detailed description of the ULMS see Lehmann, et al. (2012).

⁴ In this paper we only use three waves of the ULMS, 2003, 2004 and 2007, when the Ukrainian economy experienced continuous strong growth. We exclude the fourth wave (2012) for reasons discussed in the section on our research strategy.

⁵ Our earlier study on labor market segmentation in Ukraine (see Lehmann and Pignatti 2007), while producing some important results, had two major shortcomings. It used only the short panel 2003 – 2004 and it did not provide any wage gap estimates across the entire distribution. Our new study is not afflicted with these drawbacks.

⁶ In this school of thought, formal sector jobs not only command higher wages but also provide employment protection and fringe benefits that are both absent with informal jobs.

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