



# Informal employment and its effect on the income distribution in urban China



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## ABSTRACT

This paper discusses the issue of informal employment and its effect on the income distribution in China using datasets from the China Urban Labour Surveys of 2005 and 2010. Based on a new definition of informal employment, we estimated the proportion of informal employment relative to total non-agricultural employment in urban China and found it to be 49.7% in 2005 and 40.3% in 2010. Meanwhile, our study illustrated that informal employees' earnings were 67% that of formal employees, and this large earnings gap raised the Gini coefficient to 0.42 in 2005. The Blinder–Oaxaca decomposition result shows that the earnings gap explains more than half of the overall personal income inequality in urban China. These results indicate that informal employment has a significant effect on the income distribution in urban China. Consequently, regulating the labour market, eliminating job discriminations and legislating the informal employment should be considered as alternative means of reducing inequality in China.

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## 1. Introduction

China has been experiencing rapid urbanisation associated with its market-oriented economic reforms since 1978. The urbanisation rate in China increased from 17.9% in 1978 to 51.3% in 2011 (NBSC, 2012). Meanwhile, during the process of urbanisation, especially since the mid-1990s, income inequality has been exacerbated in urban China, attracting significant attention (Khan & Riskin, 1998; Knight & Song, 2008). For instance, resident income inequality as measured by the Gini coefficient increased from 0.235 in 1988 to 0.302 in 1995 and then to 0.47 in 2007 (Deng & Li, 2009; Li, Zhao, & Lu, 2007). In exploring what has led to the high income inequality in urban China, the main explanatory factors are thought to be the privatisation of state-owned enterprises (SOEs), the expansion of private enterprises and of the self-employment sector, and the reform of wage systems (Deng & Li, 2009; Gustafsson & Li, 2001; Khan & Riskin, 2005). However, if we consider the issue of China's urbanisation, which is mainly driven by internal rural-to-urban migration (with rural migrants now accounting for more than one third of the total urban population, Cai & Wang,

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2010), we may discover new explanations for the current income disparity. More specifically, informal employment, which mainly results from rural-to-urban migration, plays a very important role in wage determination and income inequality in urban China.

The most striking feature of China's economic development is its large-scale labour migration. Before the economic reforms in 1978, labour migration in general and rural-to-urban migration in particular were subject to strict restrictions that detained nearly 200 million surplus labourers in rural areas (Cai, 2001). During this reform process, the deregulation of labour migration and the increasing demand for labour in urban areas stemmed from the development of the urban non-state-owned economy. As a result of this demand, increasing numbers of rural labourers migrated to cities. The quantity of these rural migrant workers increased from 62 million in 1993 to 75.5 million in 2000 and then to 159 million in 2011 (Cai & Wang, 2010; NBSC, 2012). However, due to the lack of human capital and social networks, most rural-to-urban migrants can only find informal employment as vendors, domestic workers and small-business employees (ILO, 2002), as can be observed in most developing countries. In 2005, 68.7% of rural-to-urban migrant workers undertook informal jobs (Wu, 2009), and furthermore, rural-to-urban migrant workers accounted for 66.2% of the total urban informal employment in China in 2002 (Yao, 2006).

Many studies have demonstrated that informal employment is generally associated with lower wages than formal employment (Angel-Urdinola & Tanabe, 2012; Bargain & Kwenda, 2011; Bosch & Maloney, 2006; Chen, Vanek, & Carr, 2004). In urban China, the earnings ratio between formal and informal workers in 2005 was more than 1.5, as formal workers earned 6.47 Yuan per hour, but informal workers only earned 4.15 Yuan per hour that year (Cai & Wu, 2006). Inevitably, this large wage disparity will impact the overall income inequality. According to an empirical study based on the case of Serbia, informal employees earn significantly less than employees in the formal sector (by approximately 35%); thus, informal employment has become an increasingly important factor in income inequality when various other variables are controlled for (Krstic & Sanfey, 2011). Furthermore, due to the lack of minimum-wage regulation, the avoidance of payroll taxes, and the evasion of social insurance payments by individuals who have informal employment (ILO, 2002), it can be deduced that the income distribution among informal workers must be higher than it is among formal workers; naturally, such a disparity will contribute considerably to the overall income inequality. Based on a dataset from 16 transition economies in two different years, an empirical study found that income inequality is positively correlated with the share of output produced in the informal economy (Rosser, Rosser, & Ahmed, 2000). Furthermore, research on Bosnia and Herzegovina has shown that income inequality is more pronounced in the informal economy than it is in the formal economy (Krstic & Sanfey, 2007).

Although there is a substantial amount of literature on informal employment and income inequality, only a few studies have examined the links between these phenomena (Krstic & Sanfey, 2011). In the limited literature that focuses on the impact of informal employment on income inequality, only Brazil, Mexico, South Africa, Serbia, and a few other developing countries have been studied (Bargain & Kwenda, 2011; Bennett & Rablen, 2012; Krstic & Sanfey, 2011); China is not among them. Some scholars have mentioned the potential link between informal employment and income inequality in urban China, but they have only described the wage gap between informal and formal workers; they have not studied to what degree this wage gap contributes to overall income inequality, and they have not sought to determine the factors contributing to the income gap (Cai & Wu, 2006; Du, Cai, & Meiyang, 2006).

To make a contribution to this particular field, this paper will study the impact of informal employment on income inequality in urban China by using survey data from five large Chinese cities in 2005 and 2010. In doing so, first, we measure the proportions of informal employment and the amount of inequality with respect to personal earnings in those cities. Second, we determine whether the earnings ratio of informal workers has declined during this period, as important labour regulations such as the *Labour Contract Law* have been introduced in China. Using the Blinder–Oaxaca decomposition method, we then estimate the degree to which informal employment contributes to the overall urban income inequality in China. Finally, we investigate the determinants of the earnings gap between informal and formal workers.

Our results contain a number of interesting findings. The most striking finding is that the earnings disparity among informal workers is much higher than that found among formal workers. In fact, this finding and the large earnings gap between informal and formal workers explain more than half of the overall personal income inequality in both survey years. The second finding of interest is that the personal earnings inequality in urban China declined considerably when the proportion of informal employment significantly decreased in this period. However, informal workers still earn much less than formal workers, and this remained true even when we controlled for a range of other characteristics. These results all indicate that informal employment is one of the most important factors causing and exacerbating income inequality in urban China, highlighting the importance of reforming the labour market and legislating the informal employment throughout the labour market as an alternative policy for China's authorities to reduce income inequality.

This paper is organised as follows. Section 2 defines informal employment and describes the survey data, Section 3 measures the informal employment in urban China, and Section 4 calculates the contribution of informal employment to the overall urban earnings inequality. In addition, Section 5 studies the determinants of the earnings gap between formal and informal workers. Finally, Section 6 concludes the paper by presenting some of the policy implications of our results.

## 2. Definition and data description

Informal employment originally referred to employment in the informal sector. The concept of the 'informal sector' was first proposed by the International Labour Organization (ILO) in its report on Kenya in 1972. This report indicated that in the urban areas of Kenya, most people were not employed in the formal modern sector but instead were 'working poor' who worked in the informal sector as vendors, carpenters, repairmen, or cooks, for example. At that time, the informal sector usually included small-scale enterprises and labourers who are not covered by labour laws or national regulations (ILO, 1972). Later, the scope of the category of informal employment was extended; all of the employment in informal enterprises and households and all of the informal jobs in the formal sector were considered informal employment. The difference between the informal sector and informal employment is

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