



The role of the informal sector in the early careers of less-educated workers



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ABSTRACT

Does work experience gained in the informal sector affect the career prospects of less-educated workers? This paper examines two roles that informal sector jobs play in the early stages of a worker's career: informal jobs may (i) provide the opportunity to accumulate skills, and (ii) act as a screening device that enables employers to learn a worker's ability. The paper develops a matching model of the informal and formal sectors that can accommodate both roles. Implied hazard rates from informal to formal sectors as a function of tenure are shown to differ depending on the role of informal sector jobs: human capital accumulation or screening. Using the ENOE, a longitudinal employment survey from Mexico, hazard functions are estimated for less-educated workers. The estimated hazard functions indicate that informal sector jobs play an important role by screening young less-educated workers.

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1. Introduction

Labor markets in developing countries are characterized by large proportions of workers employed in jobs that fail to comply with some or all of the labor regulations. These jobs constitute what is known as the *informal sector*. Jobs in the informal sector employ the vast majority of young unskilled workers, usually pay lower wages than jobs in the formal sector (Alcaraz et al., 2011; Arias, 2007; Arias and Khamis, 2008; Maloney, 1999), and lack the health and employment insurance that are mandated or implied by labor laws that jobs in the formal sector offer to workers.

Previous studies have found that the informal sector is the main point of entry to the labor market for young poorly educated workers (Arias and Maloney, 2007; Maloney, 1999). In this paper, I investigate whether or not informal sector jobs provide some value above and beyond make-shift low-paying employment to these workers. If informal sector jobs provide some benefits, these benefits must be considered when designing policies with the purpose of reducing the size of the informal sector.¹ That is, if the authorities implement rules designed to reduce the number of informal sector jobs, would any benefits be lost?

The center of interest of this study is the workers with low levels of education. Hence, I focus on workers with less than 12 years of

education (schooling less than the completion of high school) and refer to them as *less-educated workers*. Also, in this study, I consider a worker to be: (i) an informal sector worker if that worker is an employee (salaried) and does not have the health benefits mandated by law, and (ii) a formal sector worker if that worker is an employee (salaried) and receives the legally-mandated health benefits. Self-employed workers are treated as a separate category.

Within these parameters, Fig. 1 presents the distribution of less-educated workers among four sectors of employment in Mexico. This distribution is presented for workers of different ages, from ages 16 to 65. The picture shows that the vast majority of less-educated workers aged 16 are employed in the informal sector. It also shows that the proportion of less-educated workers employed in the informal sector is consistently lower as workers age, drawing a decreasing pattern of the proportion of less-educated workers employed in the informal sector by age. The pattern of the proportion of workers employed in the formal sector by age mirrors the one in the informal sector for workers of ages 16 to 22. That is, the proportion of less-educated workers employed in the formal sector is consistently higher as workers age, between the ages of 16 and 22. After age 22 the proportion stays at the higher level for most of the remaining age groups.

Fig. 2 presents a related picture: the worker transitions from the informal sector into other sectors of employment for workers of different ages, from ages 16 to 65. The picture presents the number of transitions for each age group as a proportion of the total number of workers employed in the informal sector for each age. It becomes clear from the picture that the formal sector is the main employment destination for informal sector workers in the age groups of 16 to 30. The pattern of the transitions by age is also remarkable, almost tripling between

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¹ The type of policies to control informality usually considered in the literature are monitoring and fines to informal firms. El Badaoui et al. (2010) and Bosch and Esteban-Prete (2012) find that implementation of these policies reduces the number of jobs in the informal sector. It is important to note that the implementation of these policies is not trivial. El Badaoui et al. (2010) highlight that in Ecuador, enforcement of minimum wage laws is weak given the small number of inspectors and that the penalties for noncompliance are low.

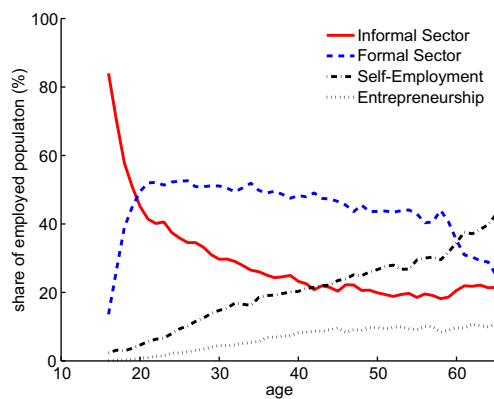


Fig. 1. Distribution of less-educated workers by employment sector in Mexico. Source: Author's calculations using ENOE I:2005–IV:2010. The four lines add up to 100%. Males not attending school. A worker is considered less-educated if his level of education is less than 12 years. And a worker is considered informal if he is an employee not enrolled in a government health care program.

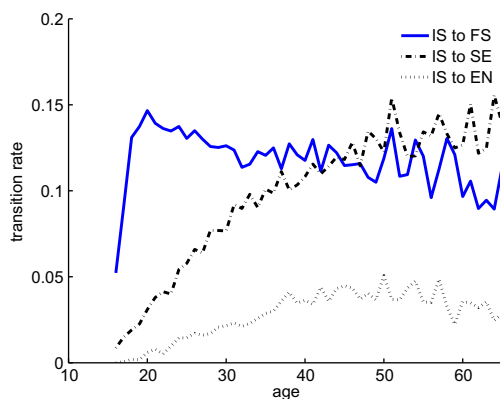


Fig. 2. Transitions of less-educated workers Out of the informal sector in Mexico. Source: Author's calculations using ENOE I:2005–IV:2010. Number of transitions from one quarter to the next relative to the size of the informal sector. IS = Informal sector, FS = Formal sector, SE = Self-employed, EN = Entrepreneur. Males not attending school. A worker is considered less-educated if his level of education is less than 12 years. And a worker is considered informal if he is an employee not enrolled in a government health care program.

the workers aged 16 and the workers aged 20, and roughly staying at the higher level for older age groups.

Figs. 1 and 2 are consistent with the idea that the informal sector is a point of entry to the labor market for young less-educated workers (Arias and Maloney, 2007; Maloney, 1999) and that the informal sector provides free-entry employment opportunities (Fields, 2009), whereas labor regulations complicate access to formal sector jobs (Arias and Maloney, 2007).² On the surface, these pictures are also consistent with a career path in which young less-educated workers enter the labor market through the informal sector and move to the formal sector when they grow older.³

Some authors believe that the formation of human capital is an important component of informal work. Hemmer and Mannel argue that “informal sector enterprises train more apprentices and workers than the formal education system and the mostly governmental job-training schemes together” (Hemmer and Mannel, 1989, page 1544).

² This study abstracts from the evolution of workers within each sector. It has been found that workers employed in the informal sector tend to have lower employment durations than workers employed in the formal sector (e.g. see Maloney, 1999). This suggests that workers in the informal sector move between informal sector employers more frequently than workers in the formal sector.

³ Although testing that this pattern exists requires following the same group of workers for many years, which is not possible given the data available.

This idea has been supported by other authors, for example Maloney (1999) and Arias and Maloney (2007).

It is easy to see why human capital accumulation is a candidate to explain the patterns observed in Figs. 1 and 2. I am particularly interested in the accumulation of skills that are equally useful at enough firms such that workers can move freely across firms and keep the returns to their training. These skills are known as *general skills* (Becker, 1993). Suppose that labor laws discourage formal sector firms from hiring less-educated workers because the lack of skills makes these workers not worth running the hazards involved in setting up a formal job.⁴ These workers would then enter the labor market through the informal sector, but if they accumulate skills while employed there, they would improve their chances of landing a formal sector job in the future, which in turn could generate the patterns in the data presented in Figs. 1 and 2.

Similarly, some authors believe that the lack of information about workers' skills may deter formal sector firms from hiring young less-educated workers. For example, Arias and Maloney argue that labor regulations and information asymmetries “impede young workers' entry into the formal sector” (Arias and Maloney, 2007, page 62). Hence, it seems that learning about workers' skills is also an important component of informal work. That is, if formal sector firms have difficulty inferring the skills of young less-educated workers due to the lack of educational credentials and the short time that they have spent in the labor market, offering an informal job may serve as a screening device to learn about these workers' skills.

It is also fairly easy to see why the role of a screening device can explain the patterns observed in Figs. 1 and 2. I am particularly interested in a screening process in which the employers learn about the worker's skills as in Farber and Gibbons (1996), and not in learning about match quality as in Jovanovic (1979). Suppose labor laws discourage formal sector firms from hiring less-educated workers because the lack of information about workers' skills makes a formal sector hiring of these workers a risky decision. Then, these workers would enter the labor market through the informal sector, but if current and potential employers can learn about the workers' skills while these workers are holding an informal job, those who are revealed as “good” workers would improve their chances of landing a formal job in the future. This hypothesis would also be consistent with the evidence in Figs. 1 and 2.

Note that in the human capital hypothesis, workers' skills can be improved, while in the screening hypothesis workers' skills are fixed, and so they are basically treated as workers' innate abilities. However, for the sake of simplicity and to make comparisons between these two hypotheses easier, I treat “skills” and “ability” interchangeably.

In regards to self-employment, both Figs. 1 and 2 indicate an increasing relevance of self-employment as workers age. The relevance of self-employment seems to manifest for older ages. At age 16, the proportion of less-educated workers who are self-employed is 2.3% whereas at age 60 the proportion of less-educated workers who are either formal or informal salaried is 97.6%. Even though these proportions change, salaried jobs remain as the main source of employment for young less-educated workers. My focus in this study is on young less-educated workers, and since self-employment has little relevance for these workers, I ignore self-employment in the theoretical framework.⁵

Hence, in this paper, I focus on salaried workers (employees) and I focus on two hypotheses about the role of the informal sector: if

⁴ Among many requirements of these labor laws, there are two noticeable ones: (i) the payment of fees to the social security administration (which provides a bundle of services to the worker including health services) and (ii) severance payment. The second one is important. Workers in Mexico are entitled to severance pay either when they are fired or when they resign. Firing a worker “with just cause,” in order to avoid severance pay, is difficult, but even in that case, the worker is still entitled to a reduced severance pay, even if the firm is closing its business (see Gordon and Williams, 2002).

⁵ However, in the empirical analysis I control for the existence of self-employment.

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