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Employment in Low-Income Countries: Beyond Labor Market Segmentation?

Abstract
[Excerpt] Throughout the world, there are fundamentally two, and only two, ways that people can escape from poverty. One is by earning their way out of poverty. The other is by receiving socially-provided goods and services that lift them out of poverty. Even with multilateral and bilateral assistance, low-income countries are too poor to be able to make a significant dent in poverty by the social services route alone. This means that creating more and better earning opportunities for the poor is the only other option available.

In policy discussions, two mistakes are often made. One is to assume that policy interventions need to be made in the sectors of the economy where the poor *are*. Such interventions would raise the earnings of the poor in the low-earning sectors. The other mistake is to assume that the most appropriate interventions are in the parts of the economy where the poor *are not*, so that more of them can be drawn into the higher-earning parts of the economy. Neither is correct. What is required is a careful comparison of the benefits and costs associated with each approach to policy.

Keywords
employment, poverty, income, economic growth

Comments
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Employment in Low-Income Countries: Beyond Labor Market Segmentation?

Gary S. Fields
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June, 2006

Introduction

Throughout the world, there are fundamentally two, and only two, ways that people can escape from poverty. One is by earning their way out of poverty. The other is by receiving socially-provided goods and services that lift them out of poverty. Even with multilateral and bilateral assistance, low-income countries are too poor to be able to make a significant dent in poverty by the social services route alone. This means that creating more and better earning opportunities for the poor is the only other option available.

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In what I just said, I have implicitly adopted a labor market segmentation approach to the analysis of employment and labor market policy in low-income countries. Before proceeding, I would like to try to establish agreement on the meaning of these terms. *Employment,* as I shall use the term here, is of two types: wage-employment (in which the worker is hired by an employer and paid a wage or salary) and self-employment. "Employment" is to be contrasted with "unemployment" which, according to standard ILO definitions, consists of people who a) did not work even one hour of work for pay in the preceding week or fifteen hours of unpaid work in a family business or on a family farm, and b) were actively looking for work. *Labor market segmentation*

is the idea that the labor market consists of various segments with qualitatively different types of employment. When there are just two segments, we have *labor market dualism.* Because the segments differ qualitatively, access to the good job segments is restricted in the sense that not all who want to work in those segments are able to be employed there. Such rationing is an essential part of the idea of labor market segmentation.

My current thinking is influenced heavily by two well-developed strands of work in economics: the dual economy models of development economics and the dual labor market models of labor economics. At the same time, I will argue that we need a third duality: the duality that arises *within* the informal sector. Bringing together these three types of duality into a coherent analytical framework is a task that remains to be completed; it constitutes the frontier of future work on employment in low-income countries.

I shall begin this note by talking about these three types of duality. I will then go on to put forward a number of propositions about labor markets, after which I will consider the implications of these propositions for analytical and policy purposes. Finally, I will answer the specific questions posed to me by the conference convener.

Drawing on the Past: A Brief Intellectual History of Dualism and Segmentation

A half-century ago, two Nobel Prize-winning economists published two of the most influential papers in the history of development economics. The first was W. Arthur Lewis's pathbreaking paper "Economic Development with Unlimited Supplies of Labor" (Lewis, 1954). Lewis wrote (p. 150): "Earnings in the subsistence sector set a floor to wages in the capitalist sector, but in practice wages have to be higher than this, and there is usually a gap of 30 per cent or more between capitalist wages and subsistence earnings." Lewis explained that although part of the gap is "illusory" because of the higher cost of living in the capitalist sector, there remained a real wage gap due to a) the "psychological cost of transferring from the easy going way of life of the subsistence

sector to the more regimented and urbanized environment of the capitalist sector," b) the payoff to experience in the capitalist sector, and c) "workers in the capitalist sector acquiring tastes and a social prestige which have conventionally to be recognized by higher real wages." Lewis went on to analyze the dynamics of economic growth as profits earned in the high-income sector were reinvested, leading to capital formation, an increased demand for labor, and continued intersectoral shifts.

Also in 1954, Simon Kuznets delivered his famous presidential address to the American Economic Association entitled "Economic Growth and Income Inequality," published a few months later as Kuznets (1955). Kuznets explored how various measures of income inequality would change as the high-income sector comes to employ an increasing share of the population. All of the inequality measures used by Kuznets exhibited an inverted-U pattern, which later came to be known as the "Kuznets Curve."

Some of the subsequent writings on labor market dualism were grounded in the then-emergent theory of human capital, which also earned its developers the Nobel Prize (Schultz, 1961; Becker, 1964). The later literature on labor market dualism stressed that for dualism to exist, different wages must be paid in different sectors to *comparable* workers (e.g., Wachter, 1974; Cain, 1976). Many researchers reported empirical evidence showing such dualism or segmentation for observationally equivalent workers; see Fields (1980) for a survey.

At the same time, dual labor market theory received a boost through the work of Doeringer and Piore (1970). As summarized by Wachter (1974), the dual labor market model advances four hypotheses:

> First, it is useful to dichotomize the economy into a primary and a secondary sector. Second, the wage and employment mechanisms in the secondary sector are distinct from those in the primary sector. Third, economic mobility between these two sectors is sharply limited, and hence workers in the secondary sector are essentially trapped there. Finally, the secondary sector is marked by pervasive underemployment because

> workers who could be trained for skilled jobs at no more than the usual cost are confined to unskilled jobs.

These features are ones that I continue to find useful today, a point to which I shall return later.

For some purposes, it is useful to think of just two labor market segments. These have alternatively been called capitalist and subsistence, formal and informal, modern and traditional, industry and agriculture, urban and rural, primary and secondary, and good and bad jobs.

While many researchers continued with the dualistic framework (e.g., Harris and Todaro, 1970; Stiglitz, 1976), other researchers felt that another sector was needed. It seemed clear that there was a duality *within* the urban economy: some jobs were highly desirable and others were not. This in turn led to models with three types of employment - an urban formal sector, an urban informal sector, and a rural agricultural sector – plus unemployment (e.g., Fields, 1975). In these models, the best jobs were assumed to be located in the urban formal sector. Job-seekers would therefore have an incentive to locate in the urban areas to improve their chances of being hired for the better jobs. However, in low-income countries, in which family resources were limited and unemployment benefits non-existent, few job-seekers could afford to remain unemployed and earn nothing for very long. The urban informal sector played the important role of offering earning opportunities to such people. Accordingly, the urban informal sector was characterized as a free-entry or fallback sector, one that enabled those who worked there to eke out a meager existence, not because they were happy about what they could earn there but because working and earning in the informal sector was better for most of them than being openly unemployed. Once this was recognized, the view of the employment challenge in developing countries changed from a concern with employing the unemployed to the additional concern of raising the earnings of those employed

(Turnham, 1971; Squire, 1981). The ILO now reckons that there are seven times as many working poor in the world as there are unemployed (ILO, 2006).

More recently, one more need has become apparent. This is to give due recognition to the fundamental duality to be found *within* the informal sector. On the one hand, the informal sector has free-entry activities of the sort just described. On the other hand, it also has restricted entry activities that people who could be working formally *choose* to work in instead (e.g, Hart et al., 1972). In Fields (1990), I highlighted this distinction and labeled these two sectors the "free entry" part of the informal sector and the "upper tier" of the informal sector. Recently, in a series of papers, William Maloney has maintained that, in Mexico at least, self-employment in the informal sector provides a package of wages, non-wage benefits, and working conditions that is at least as attractive for many people as what they could receive as wage employees in the formal sector; (e.g., Maloney, 2003). Still, though, there is "no consensus" (Maloney's term) on how many enterprises and individuals are to be found in each tier.

In sum, any analyst looking at the labor markets of low-income countries today would have to recognize at minimum five labor market states. Workers might be employed (be it in wage employment or self-employment) in one of four sectors: the formal sector, the free entry part of the urban informal sector, the upper tier of the urban informal sector, and rural agriculture. They might also be unemployed.

For labor market segmentation to exist, it is not enough that there be different types of employment. It must also be that the number of jobs in the better sectors is insufficient to employ all who would like to work there. The available jobs must be rationed among the job-seekers, either in a random way as in the Harris-Todaro model or in a systematic way using such characteristics as education, gender, race, and tribe to include some individuals while excluding others.

Moving beyond recognition of the existence of labor market segmentation, two questions need to be asked. The first is, how are wages and employment determined

within each segment? And second, what mechanisms connect the segments? I have written a guide to multisector labor market models (Fields, 2005), but much more remains to be done. In what follows, I outline some of the highlights of future modeling efforts.

Ten Uncontroversial Labor Market Propositions

I would like to put forward ten ideas that I think would command such widespread support that I shall label them "uncontroversial labor market propositions." Let me now record my positions and alternative positions that might be held:

1. My position: Labor markets are important to study because labor incomes are the most important component of total incomes.

An alternative position: Total incomes vary largely because of variation in capital incomes and other non-labor income sources.

2. My position: Employment is important primarily as a means of raising incomes and thereby reducing poverty.

An alternative position: The goal of policy is employment maximization or unemployment minimization.

3. My position: There are multiple labor markets.

An alternative position: There is one single labor market.

4. My position: Workers differ in terms of skills.

An alternative position: Labor is homogeneous.

5. My position: For workers of any given skill type, there are better jobs and worse jobs.

An alternative position: The law of one price holds in the labor market.

6. My position: The various labor markets are linked to one another.

An alternative position: Changing conditions in one labor market have no effect on other labor markets.

7. My position: Workers maximize utility. In low-income countries, utility can usefully be thought of as a function of income alone, although sometimes utility is a function of working conditions as well as income.

An alternative position: No single unified purpose guides workers' behavior.

8. My position: Firms maximize profits and make labor market decisions accordingly.

An alternative position: Firms exist to serve the interests of multiple stakeholders, of whom workers are one.

9. My position: The number of good jobs is limited. Workers who take up bad jobs do so in preference to unemployment.

An alternative position: The number of good jobs is not limited. Each worker is doing the type of job that maximizes his/her utility.

10. My position: Open unemployment is less important a problem than is working poverty.

An alternative position: Unemployment is the main labor market problem.

Please look these propositions over carefully and let me know of any disagreements you may have.

Implications of These Propositions for Analytical and Policy Purposes

A systematic framework is needed for analytical purposes as well as for policy purposes. Here is what I see the needs being at present:

1. My position: A clear maximand or minimand is needed for policy analysis. I would suggest that for the World Bank, the focus for labor market policy should be poverty reduction, now and in the future.

An alternative position: Labor market policy should be designed to minimize unemployment.

2. My position: Theoretical models are needed for analytical and policy purposes.

An alternative position: Policy implications follow from empirical findings alone.

3. My position: Demand, supply, and wage-setting mechanisms should be at the core of labor market modeling.

An alternative position: Productivity should be at the core of labor market modeling.

4. My position: For any given sector, marginal productivity is a good theory of hiring but often a bad theory of wage-determination.

An alternative position: For any given sector, marginal productivity is as good a theory of wage-determination as it is a theory of hiring.

5. My position: The informal sector has a fundamental duality: i) a free entry segment, in which all who want jobs can find them, and ii) an upper tier, which is preferred to formal sector employment.

An alternative position: The informal sector consists only of i) or ii).

6. My position: The sectors may be linked in a variety of ways, depending on the country in question.

An alternative position: One type of intersectoral linkage applies everywhere.

7. My position: Different theoretical models predict different outcomes for a given policy action.

An alternative position: Policy-makers need more of the same kind of micro data analysis, using newer data and applying established methods to more countries.

8. My position: Standard labor market data and empirical estimation equations are consistent with multiple theoretical models.

An alternative position: The data speak for themselves.

9. My position: A different empirical approach is needed, one that focuses on changes in labor markets.

An alternative position: Policy-makers need more of the same kind of micro data analysis, using newer data and applying established methods to more countries.

10. My position: Two kinds of change data would be most informative: (1) Comparable cross sections of individuals and firms. (2) Panel data on individuals and firms.

An alternative position: Data on current labor market conditions is good enough.

Here too, I would like to know where you agree and where you disagree.

Answers to Specific Questions Posed

To conclude, let me state my views on a number of questions posed by the conference convener:

1. How important is segmentation of labor markets in low income countries?

Answer: Virtually ubiquitous. We cannot do without it.

2. Are labor markets dualistic or is segmentation of a higher order?

Answer: Higher order.

3. What dimensions of employment are important to understand the structure of employment?

Answer: Wages and employment within each labor market, plus connections between labor markets.

4. Is there a theoretical foundation?

Answer: Yes: Supply and demand, market-clearing and non-market-clearing equilibria, intermarket connections.

5. What does the empirical evidence tell us?

Answer: A single-market framework will not do.

6. How important is informality to understand employment in low-income countries?

Answer: Essential.

7. Is informality the right concept?

Answer: Yes, if precisely defined and suitably qualified. However, because "informal sector" means different things to different people, it may be better to abandon the term and use alternatives such as "free-entry sector," "unregistered sector," or "microenterprises" instead.

Finally, it seems apparent to me that in low-income countries, not everybody who would like a formal sector job can get one. Hence, the dual challenge for policy is to find ways of creating more good jobs while also raising the labor market earnings of those who are rationed out of the good jobs sector and only have the opportunity to work in the bad jobs sector. These are very large challenges indeed.

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