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# Labor market analysis for developing countries

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ABSTRACT

This paper is about analyzing labor markets in developing countries, searching for both improved understanding and greater policy relevance. Following a five-part policy evaluation framework, the highlights of labor markets in developing countries are presented. Theoretical models with multiple sectors and segments and empirical analysis using different kinds of data are then reviewed. A brief concluding section addresses some priority research needs.



## 1. Introduction

This paper is about analyzing labor markets in developing countries. "Developing countries" include middle-income countries such as Thailand, Brazil, and South Africa as well as low-income countries such as Pakistan, Haiti, and Tanzania. "Developing" is itself something of a euphemism, in that although many of these countries are achieving economic development, many others are not.

The term "labor market" will be used in this paper to refer to the place where labor services are bought and sold. In some labor markets, people are paid employees, selling their labor services to an employer in exchange for a wage or salary and possibly other benefits. In other labor markets, people are self-employed (also called own-account workers), in which they sell their labor services to themselves. As used here, "labor market" is a comprehensive term including both paid employment and self-employment.

The focus here is on the labor markets for the poor within these countries. Three billion people — almost half of the world's population — are absolutely poor by international standards (living on less than $2.50 per person per day in purchasing power parity units), and essentially all of them live in the developing countries (Chen and Ravallion, 2010).

It is often said that the main and often the sole asset of the poor is their labor. So to understand global poverty, one must understand labor markets and labor earnings in the developing world.

Consider policy interventions such as the following: educating more people in schools, offering workers a certain type of labor market training, establishing a program to employ the unemployed and underemployed, regulating layoffs and dismissals, providing the poor with more to work with, e.g., microcredit. How might such prospective policy interventions be analyzed?

The following policy evaluation framework has proven useful in a variety of contexts and forms the basis for the analysis that follows:

**Policy instruments→Model→Outcomes→Policy evaluation criteria →Policy evaluation judgment**

The first step in the framework — logically though not necessarily chronologically — is to clarify the policy instrument or instruments under consideration: a law that might be passed, a regulation that might be imposed or removed, a tax, a public expenditure, and the like. This is the action that has been undertaken or that is under consideration.

The second part of the framework is to specify the model. Good models endeavor to capture the essential aspects of reality while leaving aside the less essential ones. Models can be theoretical or empirical; the best ones involve an interplay between the two.

Once the policy instrument(s) has/have been specified, the third step is to use the model to predict the likely outcomes. Sometimes these outcomes are theoretical ones, e.g., the policy action in question would increase outcome variable Y if parameter $\theta$ is greater than a critical value $\theta^*$ and decrease it otherwise. Other times, the outcomes are empirical ones, e.g., those countries that have achieved more rapid economic growth are those that have had greater improvements in labor market outcomes.

The policy evaluation is not yet complete. The fourth step is for the evaluator to specify the policy evaluation criteria. (I use the plural, because a full-fledged policy evaluation more often than not relies on multiple policy evaluation criteria rather than a single criterion.) The labor market criteria frequently used by labor economists and policy-makers today are increasing employment and reducing unemployment, raising the earnings of those who work so that they and their families can achieve acceptable standards of living, increasing social protection and providing security against the loss of labor market earnings, and insuring that core labor standards in the workplace are

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honored. Another objective often used in policy evaluation for developing countries is reducing poverty to the maximum extent possible.

Fifth and finally, the outcomes are then evaluated in terms of the evaluation criteria and an overall judgment is made.

Imagine that you are a researcher or a country economist formulating a labor market policy proposal which you propose to take to a client country's government. In a completely-formulated proposal, you would answer the following three questions to the best of your ability:

- What specific labor market objective or objectives are you trying to achieve and by what welfare economic criterion or criteria will you decide if your objective(s) is/are being achieved?
- What theoretical labor market model are you using to analyze the effects of a proposed policy?
- What is the empirical evidence favoring one view of labor market functioning over another?

These three questions are the ideal, defining what we want to strive for. They are not necessarily what we must have, especially in those pressing situations when time for analysis is extremely limited.

Much useful policy-relevant research has a more limited objective. One such limited objective is to get empirical information to help us formulate the right model for a particular country or market context. Are wages set according to supply and demand, by efficiency wage considerations, or by institutions? Do better-educated workers in a country earn more because of human capital created in schools, because of signaling, or because of screening? Why are people working as own-account workers in the informal sector, selling their labor to themselves? Another limited objective is to learn more about a single outcome or parameter. How elastic is the demand for labor in a country? If more jobs are created in one geographic area, how much migration into that area is induced? How important do firms judge various aspects of the investment climate to be? Policy research aimed at these limited objectives is valuable too, and in this paper I present examples of empirical research that has led to interesting policy conclusions.

The balance of this paper proceeds as follows. Labor market analysis for developing countries requires that we look at different issues from the ones typically dealt with by analysts of developed countries. This different labor market context is the subject of Section 2. Section 3 then goes on to talk about the kinds of theoretical models that have been used to analyze developing countries' labor markets and that might be developed further. Section 4 addresses the different kinds of empirical work that have been and are being done for developing countries. The paper concludes with some remarks about research priorities.

## 2. The labor market context in developing countries

As readers of this journal well know the guiding paradigm for the analysis of labor markets in the developed countries is the wage labor market. We picture the typical employee going to the same office, store, or factory day after day and earning a wage or salary that is payable each week or month.

As we move down the income scale to middle-income countries and then to low-income countries, other types of work arrangements gain in importance. In the developing countries, steady wage employment of the type found in the developed countries is the exception, not the norm.

Workers in poor countries want jobs that are steady and secure, pay well, offer benefits, meet labor standards, and offer social protections — ones that have been called “good jobs.” The problem they face is that there are not enough good jobs for all who want them and are capable of performing them.

Here are some of the salient features about labor markets in developing countries. For further details, see Fields (2011).

*The unemployment rate in developing countries is lower than it is in developed countries*

Economists and other labor market analysts use the terms “employment” and “unemployment” in accordance with specific definitions prescribed by the International Labour Organisation (ILO). The unemployment rates in the developed economies and the European Union are above average (8.4%) while those in East Asia and South Asia are below average (both 4.4%) (ILO, 2011). The fact that unemployment rates are lower in the developing countries is taken by many as a sign that the unemployment rate is a poor measure of labor market distress.

*Earnings levels are very low despite long work hours*

In much of Asia, Latin America, and Africa, daily wages are no more than one or two U.S. dollars per day. People are working — more often than not, working very long hours. The poor in the developing world are poor despite working long hours.

*Not only are incomes low but they are also uncertain*

The poor face a “triple whammy”: low incomes when they are working, irregular and unpredictable income flows, and a lack of suitable financial tools (Collins et al., 2009). They respond by managing their money carefully.

*Women are disadvantaged in developing country labor markets*

Women's earnings are lower, women's work is more likely to be informal, and women are disproportionately in casual positions.

*The composition of employment is very different in developing countries from what it is in developed countries*

As compared with the developed countries, the developing countries have a smaller percentage of people working in offices and factories and a larger percentage working in agriculture. In the developing countries, self-employment, own-account work, and unpaid family work are more important, and paid employment is less important.

*The great majority of those working in developing countries work in the private sector, not the public sector. A large majority of those who work in the private sector are not registered with the government and therefore do not receive job-related social protections*

Nine out of ten workers in the developing world are in the private sector. In a typical low-income country, some 90% of these workers are excluded from government-run economic security programs.

*Typically, the better jobs are in wage employment, not self-employment. But within wage employment, the regular wage jobs are better than casual wage jobs*

For these reasons, “everybody” in developing countries wants a regular wage job.

*The problem the poor face is that not enough regular wage employment is available for all who would like wage jobs and are capable of performing them*

Would-be wage employees could respond to the lack of wage jobs by remaining unemployed and continuing to search. However, few do, for the simple reason that they cannot afford to. They find it better to create their own self-employment opportunities. Banerjee and Duflo (2007, p. 162) write: “Nothing seems more middle class than the fact of having a steady well-paying job. While there are many