

UNEMPLOYMENT DYNAMICS WITH INFORMALITY: AN EMPIRICAL ANALYSIS FOR A DEVELOPING COUNTRY

Carlos Henrique Corseuil

Researcher at the Institute for Applied Economic Research (Ipea).

E-mail: <carlos.corseuil@ipea.gov.br>.

Miguel N. Foguel

Researcher at Ipea. E-mail: <miguel.foguel@ipea.gov.br>.

Ajax Moreira

Researcher at Ipea. E-mail: <ajax.moreira@ipea.gov.br>.

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In this paper, we have conducted several decompositions of cyclical unemployment departing from the usual three states representation of the labor market (employment, unemployment, and inactivity) by partitioning the employment state into formal and informal states. This new setup is particularly relevant for developing countries where informality is an important feature of labor markets and therefore has potential implications for the dynamics of unemployment. Our data are for Brazil, a large developing country for which one can construct labor market flows for an extensive period. Methodologically we implement the standard steady-state decomposition used in the literature as well as a decomposition for the variance of the actual unemployment rate. For robustness, we also conduct decompositions for projections of the unemployment rate over a large range of time horizons.

The first contribution of the paper was to show that the relative contribution of the flows between employment and unemployment depends on whether one is considering formal or informal forms of employment. While informal employment drives the contribution of job separations to unemployment variance, formal employment dominates the contribution of job

finding to unemployment variance. This distinction was completely hidden in the three states representation and confirms the importance of a finer treatment of the employment state to unveil the dynamics of unemployment in a richer way.

The second contribution of the paper was to provide evidence that the four states representation performs better than the three states one to model unemployment dynamics. This was evinced through easily implemented indicators of model performance and was also shown to be robust to projections of the unemployment rate over various time horizons (including the steady-state one). Thus, the gain in information with a finer treatment of the employment state does not come at the cost of any loss in model performance.

One should have in mind that a four states representation can be used to accomplish any partition of employment in two groups, including alternatives suitable labor markets of developed countries. For instance, one may think in jobs with lower and higher adjustment costs such as temporary or part-time jobs, which are forms of employment that have gained in importance in developed countries in the last years.