The Informal Wage Gap: New Evidence Using Panel Data

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Abstract

This paper provides new evidence on the wage gap between informal and formal sectors in countries characterized by very high inequality, namely South Africa, Brazil and Mexico. We first decompose the wage gap between price and endowment effects, both at the mean and along the wage distributions. Wages are adjusted to account for taxes paid in the formal sector. We then rely on (unbalanced) panel data to estimate fixed effects quantile regressions on the pooled sample, using recent techniques by Koenker (2004) and Canay (2008). This provides an interesting alternative strategy when instruments to explain informality are difficult to find. Results show that the raw wage penalty for informal workers throughout the wage distribution is explained by the combined effect of `better' observed characteristics (experience, education) and higher returns in the formal sector in Brazil and South Africa. A different definition of informality for Mexico, including informal independent workers, leads to contrasted results: the raw wage differential is not significant for most of the distribution (only slightly negative at the top) which is due to higher returns in the informal sector counteracted by better endowments in the formal sector. Accounting for unobserved heterogeneity decreases the informal wage penalty in Brazil and South Africa while it increases the informal wage premium in Mexico. Yet, the effect is not uniform along the whole distribution. In Brazil and South Africa, a significant penalty remains at the bottom while it disappears completely at the top (i.e., it is completely explained by differences in observed and unobserved characteristics). Our findings also corroborate that informality is not necessarily a second best for Mexican workers, although important heterogeneity exists along observable characteristics.