

Labor Market Frictions, Informality and Schooling Investments*

Matteo Bobba[†] Luca Flabbi[‡] Santiago Levy[§]

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Abstract

Many labor markets, typically in medium- and low-income countries, are characterized by high levels of informality. While informality may constitute an important margin to increase labor market flexibility, it may also dampen firms' productivity. This paper explores one long-term effect of informality: the possible under-investment in individuals' education *prior* to labor market entry. To do so, we formalize the presence of informal job opportunities in a search-matching-bargaining model of the labor market with endogenous schooling decisions. We estimate the model on individual-level data from the Mexican labor force survey. Estimation results show reasonable values of the estimated parameters, including those harder to identify like the firms' costs of evading the labor regulations and the workers' valuation of the extra-wage benefits for both legal and illegal contracts. Counterfactual experiments varying key policy parameters allow us to quantify the channels through which labor market frictions inhibit schooling investments.

Keywords: Labor market frictions, Search and matching, Nash bargaining, Informality, Returns to schooling.

JEL Codes: J24, J3, J64, O17

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[†]Toulouse School of Economics, University of Toulouse 1, Manufacture des Tabacs, 21 Allée de Brienne 31015 Toulouse France. E-mail: matteo.bobba@tse-fr.eu.

[‡]Department of Economics, University of North Carolina – Chapel Hill, 107 Gardner Hall, CB 3305 Chapel Hill, NC 27599-3305. E-mail: luca.flabbi@unc.edu.

[§]Vice-Presidency for Sectors and Knowledge, Inter-American Development Bank, 1300 New York Avenue 20577 Washington DC. E-mail: slevy@iadb.org.