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## POLICY BRIEF

# INFORMALITY AND INCLUSIVE GROWTH: WHAT SOUTH AFRICA CAN TELL US ABOUT THE BENEFITS AND COSTS OF INFORMAL EMPLOYMENT



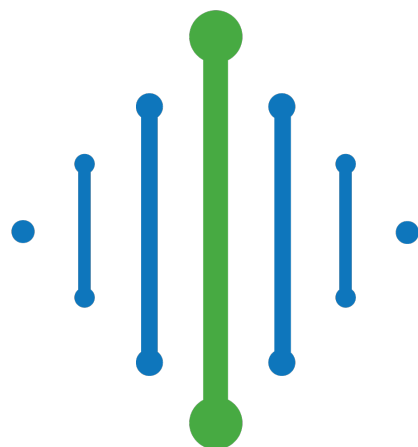
SOUTH AFRICA

This brief was developed by the authors as part of the ELLA Programme. It was developed based on a Regional Evidence Paper [Informality and Inclusive Growth in Sub-Saharan Africa](#) by the same authors, which contains an overview of regional evidence, as well as original data collection and analysis, on a particular research topic. All publications can be found in the [ELLA programme website](#).

# Informality and Inclusive Growth: What South Africa can tell us about the benefits and costs of informal employment

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The Development Policy Research Unit (DPRU) specialises in socio-economic research with a core focus on the areas of labour markets, poverty and inequality. The DPRU is located in the School of Economics at the University of Cape Town.



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## Summary

Informality in the labour market is often seen as both a hindrance and a help to inclusive growth. On the one hand, low pay and less benefits – which characterise informal markets – may exacerbate poverty and inequality concerns. On the other hand, it is far better than the alternative: unemployment.

This brief explores the relationship between informal employment and inclusive growth in sub-Saharan Africa, with a specific focus on South Africa. We find clear benefits of informality for inclusive growth, including absorption of vulnerable groups into employment and the flexibility of the informal sector during and after economic downturns. Informal employment is not a magic bullet though; with issues such as lower pay, less benefits and job insecurity among the most problematic.

We find policy measures aimed at reducing informality work best when they relax the external and internal constraints facing informal firms. Policy measures that aim to reduce informality by making it costly to be informal can unintentionally in-

crease unemployment by pushing firms out of the market, which constrains inclusive growth. For this reason it is recommended that policy makers aim to support rather than to penalise informal enterprises.

## Key Implications

1. Informal employment can be **good** for inclusive growth if the alternative is unemployment.
2. Informal employment can be **bad** for inclusive growth if the alternative is formal employment.
3. Informal employment can also be **good** for inclusive growth in the period following an economic downturn if, after a recession, it creates jobs before the formal sector does.

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## Introduction

Despite high growth rates in developing countries in recent years, poverty and inequality persist, meaning that this growth has failed to be inclusive. Inclusive growth is growth that produces employment and income benefits for vulnerable population groups, thus reducing poverty and inequality. Growth may fail to be inclusive when participation in the formal economy is low and when informality and unemployment are high.

This policy brief will explore the relationship between informality and inclusive growth in Sub-Saharan Africa, with a particular focus on South Africa.

South Africa is unique in that it has high levels of unemployment and also low levels of informal employment. As a result, South Africans typically hold one of two opposing views on informality. The first is that the informal sector is an underutilised source of new employment that should be promoted since 'any employment is better than unemployment'.

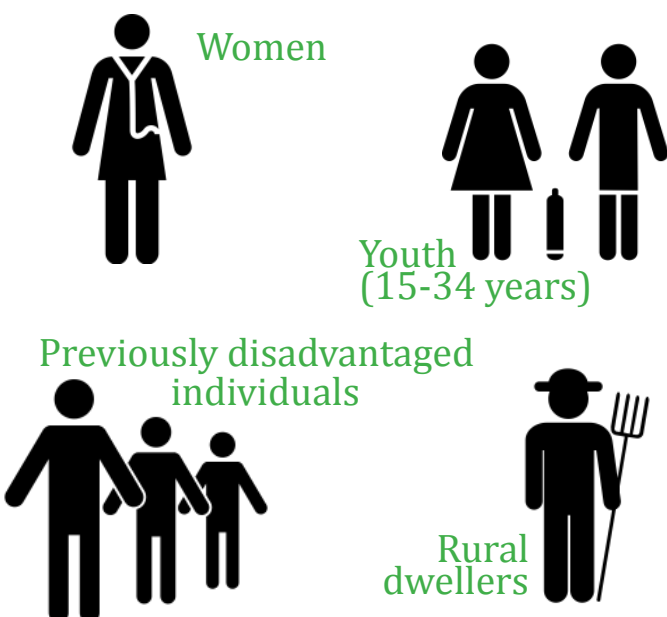
The second is that informality should be discouraged given the inferior quality of informal employment, and that the focus should be on creating decent jobs in the formal sector.

## Characteristics of the informal sector

**The informal sector is an important source of job creation, especially for vulnerable groups**

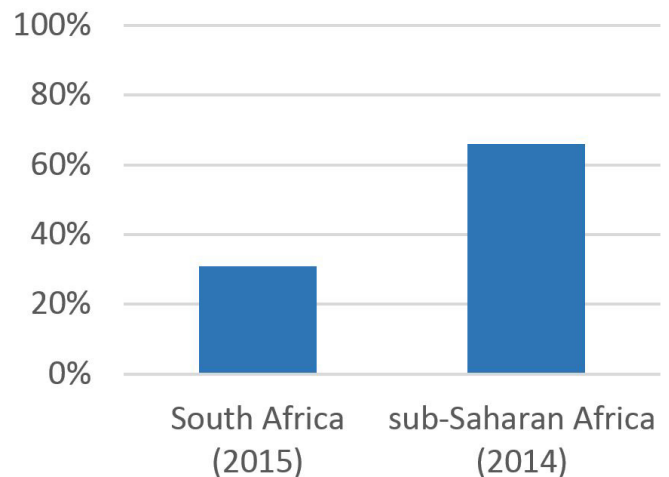
All of these groups are also the most likely to be unemployed, indicating that the informal sector provides employment for the most vulnerable population groups.

**In South Africa, informality is most common amongst:**



This policy brief discusses how both views hold truth, given that informality is both good and bad for inclusive growth, depending on whether the alternative to informality is formality or unemployment.

## Informal Employment as % of Total Employment



Source: Own calculations QLFS 2015 Q4 and Vanek et al., 2014.

**The informal sector is flexible and responds quickly to changes in output**

After the 2009 recession, informal sector employment contracted earliest yet also recovered quickest. Initial job losses during the first quarter of the recession were almost exclusively within the informal sector. But informal sector employment growth recovered quickly and was positive by the second quarter of 2010, while the formal sector was still shedding jobs.

This is because informal sector employment reacts swiftly to changing economic circumstances in a way that the formal sector cannot. In the aftermath of economic downturns, it is this flexibility that may help promote more inclusive growth by getting unemployed individuals (back) into the workforce during economic recoveries more quickly.

**The informal sector is less productive than the formal sector**

In Africa, there are stark productivity differential between the formal and informal sector and even small registered firms are more productive than unregistered firms (La Porta & Shleifer, 2008).

Unsurprisingly then, countries with high levels of informality typically have lower income levels.

## The informal sector offers lower income, fewer benefits and less security

Benefits of being employed in the formal sector include higher wages, access to welfare and health services (if they are not universal), work stability and access to credit.

The average wage of informal sector workers in Africa is just one-fifth of that of their formal sector counterparts (ILO, 2009). Although this makes formality costlier for employers, formality also benefits employers by helping to insulate firms from corruption, improving their access to credit, and improving their access to other business services provided by the state, such as contract and law enforcement.

Individuals in formal employment are less likely to be in poverty than individuals in informal employment.

## Informality's impact on growth and jobs in the formal sector

Formal firms have higher wage costs and are less flexible, therefore formal sector firms may face significant competition in the form of informal firms with their lower cost structures.

However, there are often linkages between the formal and informal labour markets, with formal sector busi-

## Moving between formal and informal employment

### Informal employment is more transient and less secure than formal employment:

In South Africa, individuals who have secured formal employment are unlikely to transition into informal employment or unemployment. In contrast, informal employment is more vulnerable, with individuals likely to become unemployed, leave the labour market or move into formal employment.

|                                  | 2008:<br>Formally employed | 2008:<br>Informally employed |
|----------------------------------|----------------------------|------------------------------|
| 2012:<br>Formally employed       | 74%                        | 26%                          |
| 2012:<br>Informally employed     | 9%                         | 27%                          |
| 2012:<br>Unemployed              | 6%                         | 12%                          |
| 2012:<br>Not Economically active | 11%                        | 35%                          |
| Total                            | 100%                       | 100%                         |

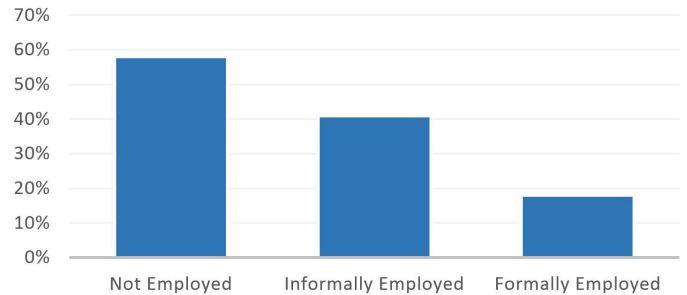
Source: Own calculations, NIDS Wave 1 and Wave 3

### Informal employment can be a safeguard for the vulnerable:

Individuals who struggle to find formal employment may seek informal employment as a buffer to unemployment. Women and those with low levels of educa-

However, those in informal employment experience lower poverty rates than those who are not employed.

## Percentage of Individuals Living Below the Poverty Line: South Africa



Source: Own calculations, NIDS Wave 3.

ness recognising the informal sector as a key connection to consumers.

This means that goods made in the formal labour market often reach consumers through informal distribution channels.

tion are most likely to be informally employed. They are also least likely to move from informal employment into formal employment.

### Movement from the informal to the formal sector can occur naturally:

Firms can move organically into the formal sector as they grow. This is most common for firms suffering from external rather than internal constraints, which can be dealt with through various short-term interventions. External constraints are linked to the external environment and include access to finance, to a fixed business location and to basic infrastructure while internal constraints have to do with skills of those within the enterprise.

### Staying informal can be a rational choice

Stringent regulations create barriers to formalisation which increase the costs of transitioning from informality to formality. In addition, the costs to informality are lower when enforcing formalisation is difficult. This is likely to be the case when the informal sector is pervasive and institutions are weak. Making regulations easy and cost-effective to comply with, as well as upholding existing laws, can contribute to an environment where firms naturally choose formality over informality.

# Key Policy Recommendations

## 1. Make formality more attractive than informality:

- a. Increase the benefits of formality by providing incentives to firms who formalise.
- b. Decrease the costs of formality by making legal requirements a simple, cost-effective, and efficient process.

## 2. Don't penalise informal firms, support them by eliminating constraints:

- a. Eliminate external constraints: provide a space to work in, electricity and other necessary services, and the required infrastructure.
- b. Eliminate internal constraints: provide educational and upskilling programmes.

Policies aimed at *supporting* informal microenterprises can lead to:

- Natural movement from informality to formality
- Increased profits for informal firms
- Increased employment by informal firms
- Increased incomes for the informally employed

Policies aimed at *penalising* informal microenterprises can lead to:

- Exit from the market
- Increased costs for informal firms
- Unemployment for previous informal employees
- Lowered incomes for the informally employed

## Conclusion

In summary, informality has both positive and negative implications for inclusive growth, depending on a variety of factors. Perhaps one of the key considerations for policymakers in this area is the extent and importance of heterogeneity of firms and individuals active within the informal sector. Without due consideration of this fact, policies aimed at promoting formality may reinforce existing inequalities within the economy by excluding those who would stand to benefit most from a more inclusive growth path.

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This brief was developed as part of the [ELLA Programme](#). ELLA, which stands for Evidence and Lessons from Latin America) is a south-south knowledge and exchange programme that mixes research, exchange and learning to inspire development policies and practices that are grounded in evidence about what works in varied country contexts. The programme has been designed and is coordinated by [Practical Action Consulting \(PAC\) Latin America](#), in line with the objectives agreed with the funder, the [UK Department for International Development \(DFID\)](#). [UK Aid](#). The [Institute for Development Studies \(IDS\)](#), [Sussex University UK](#), supports on research design, methods and outputs. For other ELLA publications and knowledge products go to [ella.practicalaction.org/](http://ella.practicalaction.org/)

