



Informal Economy

What are the Policy Implications of the Informal Sector Becoming the Informal Economy?

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1. Introduction

This paper is concerned with the policy implications of drawing together the twin themes of self-employment and employment in informal enterprises with ‘informal’ employment in formal firms, comprising the ‘informal economy’. There are already large bodies of literature that address the policy implications of these two themes, mostly focusing on micro-economic interventions. A much smaller literature considers their interaction with each other, and how they are simultaneously affected by broader policy choices. Drawing the themes together should focus the minds of researchers and policy-makers on the character of precariousness of the broader workforce.

‘Informality’ is seen to entail precariousness in that the activity operates outside of bureaucratic rules or regulations. This is an important concept for poor working people, who are in the majority in developing countries. This approach forces us to focus more centrally on the contributors to uncertainty in their livelihoods.

Focusing policy on structural solutions to reduce precariousness in the assembly of household livelihoods is particularly important in a developing country context where there is less access to fiscal resources as well as limited resources to ensure regulatory compliance. Micro-economic interventions have less impact in an unsupportive structural context.

This paper is organised as follows: the first half of the paper outlines some background conceptual issues associated with emerging definitions of informality. It reviews thinking about what contributes to the proportion of informal self-employment in any economy and related policy implications. The section then goes on to consider contributors to the prevalence of precarious employment in formal firms. The second half of the paper focuses on the experience of South Africa, where it is seen that most ‘informality’ is found in formal companies and not in informal firms. The policy environment contributing to that outcome is outlined. The paper concludes by identifying the sets of policies that might be required to reduce precariousness in the emerging global economic reality.



2. Some conceptual issues

What does informality refer to? Until recently, the informal sector economic literature was mostly focused on micro-enterprise in developing economies, whether survivalist or entrepreneurial. These were seen as either a sign of underdevelopment or alternatively as offering a potential as a ladder up to improved prospects for economic participation in economies with small formal industry. As a sign of underdevelopment, the informal sector was expected to phase out with rising per capita incomes. When seen as a potential contributor to market development, formal and informal firms might expand consecutively in some fashion. Micro-enterprise has also been seen to offer a social security buffer in cyclical downturns, economic crisis or when the public sector is downsized. In this formulation, the formal and informal sectors would grow inversely. Overall, this thinking focuses uniquely on the character and needs of informal enterprises.

A completely separate literature focuses on labour standards and conditions at work, normally emphasizing that in formal companies. The link between the labour market and the informal sector bodies of work sometimes come together around home-work and outsourcing. More rarely, studies will look at formal-informal interactions.

The ILO drew together some of these strands in a wider conceptualization of the “informal economy” in 2003 (Chen, 2004; ILO, 2003). This covers any business or employment relationship that is not seen to be sufficiently covered by formal arrangements (Larsson, 2006). In other words, this definition includes both employment and self-employment in informal enterprises, and also employment outside of informal enterprises. The intention was to “extend the focus from *enterprises* that are not legally regulated to *employment relationships* that are not legally regulated or protected” (Chen, 2004:10). This approach essentially includes at least one of two main characteristics:

- An enterprise that is not registered, operates outside the tax net, and most probably also falls outside of other regulatory norms such as labour law.
- Wage workers who are in insecure and/or unprotected employment.

This conceptualization has been further developed in the past couple of years, as evidenced by the plethora of new papers (Chen 2004; Guha-Khasnobis et al, 2006, Henley et al, 2006). It seems that it took precisely 30 years for Keith Hart’s original insights to be put to good use (Hart, 2006). He is so often misinterpreted. His main insights were into the complexity of how livelihoods are shaped, the intertwining of different types of activities, and the role of the state and bureaucracy in both developed and developing economies. Informal activity was not seen as a ‘sector’ but rather the plethora of ways that people engage, sometimes simultaneously, formally and informally.

His central recommendation was for more empirical investigations to develop an understanding of these activities and how they interrelate. He did not find any particular characteristic, be it low or high productivity, large or small and so forth. His emphasis was on “reliability of income streams, the presence or absence of bureaucratic form” (Hart, 2006). This could equally refer to hawkers, home improvement, trademark piracy, offshore banking, open source software, or “corrupt

fortunes of public office-holders who often owned the taxis or the rented accommodation operated by the small fry” (Hart, 2006).

So, to be more precise for the purpose of this paper, informal activity is meant to refer to precarious low income, low productivity activities whether in employment or self-employment, whether linked to registered firms or not.

Does this new ILO formulation have relevance for policy-making that the previous approach did not have in its separate parts?

According to Hart (1973), a dominant concern of development economists at the time was for mass unemployment in poor countries arising from urban migration, without any meaningful expansion in the industrial base. His research was meant to come to grips with the intense activity he saw on the street, which was not sufficiently recognized or understood by westerners. The common currency has changed dramatically since then. Now, it is assumed that open unemployment should not exist in a developing country. Instead, the main concern is for the more invisible *under*employment. It is hard to imagine open unemployment in a poor country: each household member can only contribute in a small way to livelihoods which means that, even in the context of community-based safety nets, everyone who can needs to chip in. The informal economy is seen as infinitely expandable with low barriers to entry and few capital inputs (Fields, 2006): more entry simply has the impact of reducing profitability or wages. Open unemployment is seen to be a possible feature of higher income economies with lower employment-growth elasticities, higher earning family members, lower dependency ratios and social security.

The ‘informal economy’ does not appear to be doing its job as a social security net for the poor in developing economies. Table 1 shows that high rates of unemployment are quite common in the developing world. An unemployment rate of 4% to 6% is commonly seen as a frictional rate and a smaller policy concern. While the ‘world average’ is about 6%, almost all regions have unemployment rates above that. The lowest unemployment rates are found in highly populated regions such as North America, South Asia and East Asia, which would appear to be keeping the global average down. Unemployment rates of around 10% are found in Latin America and Sub-Saharan Africa. Unlike Latin America, the average unemployment rates in Sub-Saharan Africa have been quite stable over the 10% mark for at least a decade (ECA, 2005:6). Southern Africa has the highest regional average unemployment rate was 31.6% in 2003 (ECA, 2005: 6).¹ So, in these countries one finds both high unemployment *and* underemployment, the latter being evidenced by the high rates of ‘working poor’ defined as those whose dependents live on less than \$ 1 per day.

The second contribution is to recognize the different forms of ‘informal’ waged labour, from those linked into formal firms through either direct contracts or subcontracts to that in informal entities. Precarious employment may be a more appropriate term, since the defining characteristic is insecurity and poor access to the benefits associated with formal employment, and not really dependent on the employer being formal or informal. There is growing evidence that precariousness

¹ Southern Africa includes South Africa, Mozambique, Botswana, Namibia, Swaziland and Lesotho.

may be found where formal contracts are in place. So, other measures of insecurity are needed, and also possibly new approaches to addressing it.

Precarious employment and easy entry should theoretically, according to neoclassical economists anyway, contribute to ‘labour market clearing’. Then what explains the persistence of high unemployment globally, even in low-income economies? Is it possible that all countries have supply side problems? These might be caused by barriers to entry, insufficient access to capital or skills, or reservation wages. Or could there be insufficient demand?

Table 1 – Unemployment rates by region (%)

| Country/Region | Year | Unemployment rate (%) |
|--------------------------|-----------|-----------------------|
| World | 2003 | 6.3 |
| Industrialised economies | 2003 | 9.8 |
| Transition economies | 2003 | 9.4 |
| Latin America | 2002/2004 | 9.8 |
| East Asia | 2003 | 3.1 |
| South East Asia | 2003 | 7.1 |
| South Asia | 2003 | 4.8 |
| Middle East & Africa | 2003 | 11.9 |
| Sub-Saharan Africa | 2003 | 10.8 |
| Southern Africa | 2003 | 31.6 |
| Botswana | 2001 | 18.9 |
| Cameroon | 2001 | 11.0 |
| Egypt | 2002 | 10.2 |
| Ethiopia | 2004 | 23.4 |
| Lesotho | 1997 | 37.9 |
| Mauritius | 2004 | 8.4 |
| Namibia | 2000 | 33.8 |
| Tunisia | 2003 | 14.7 |
| South Africa | 2005 | 26.5 |

Source: Extracted from table 2, ILO (2004) and South Africa’s Labour Force Survey (September 2005). Unemployment rate for Southern Africa from ECA(2005).

Notes:

- 1. Different aggregation techniques and methodologies may lead to differences in aggregate figures. These should be used as indicative only.*
- 2. These unemployment rates are the “official” or “strict” measures, which exclude ‘discouraged’ workers. They include those that are not employed, but are actively searching for work.*

2.1 Factors contributing to the proportion of employment in ‘informal firms’

The first and most important point is that the share of employment in small informal enterprises tends to fall as income per capita rises. Here informality simply refers to firms that are not registered. Amin (2002) shows how the proportion of informal labour falls from about 60% to 70% of the labour force in low-income South Asian economies, to 30% to 50% in middle-income South East Asian countries, and to less

than 25% in high-income Taiwan, Japan and Singapore. In Sub-Saharan Africa, excluding South Africa, 78% of non-agricultural employment is found in informal firms. The informal sector is much smaller in South Africa, accounting for about 21% of total employment, including domestic workers (ECA, 2005).

Chen (2004) outlines three basic approaches to explaining the informal sector:

- **"The dualist school"** contend that with development and rising per capita incomes, the informal sector would disappear, particularly insofar as these entities were considered to be peripheral to capitalist production systems (Chen, 2004). A high prevalence of informal firms would simply be seen as a sign of underdevelopment. There is virtually no evidence that informal firms disappear completely: Pratap and Quintin (2006) show that informal output accounts for about 10 or 15% of official GDP in most developed economies.
- **"The legalist school"** argue that the informal sector is comprised of entrepreneurs who want to avoid the costs and hassle associated with formalisation, particularly in relation to business and labour regulation and company tax. In this case, informal firms resemble their formal counterparts. This phenomenon is mainly found in high-income economies and in Latin America. In some middle income Latin American economies such as Brazil, there is some evidence of this due to extremely onerous tax regimes, high interest rates and high costs of regulatory compliance. Pratap and Quintin (2006) find that the tax burden, weak rule of law, government corruption, heavy bureaucracy associated with registration, weak security of property rights and the quality of the legal system are central explanations for large variations in size of the informal sector in countries with similar levels of economic development.

This should not be confused with arguments about entrepreneurial spirits that would simply like to be independent, since this is related to choice of occupation, not whether it is formal or informal. There is global evidence to show that the returns to education and experience for those in the informal sector can be one-third to one-half that in the formal sector. While there are exceptions, it would be irrational for most people who support poor households to *choose* self-employment in the informal sector over self-employment or wage-employment in the formal.

- **"The structuralist school"** considers the informal sector as part of a continuum within the market, albeit located in a subordinate position. This approach would consider the interactions between formal and informal, whether in buyer-supplier relationships, or in employment relationships such as contracting out or casualisation. The informal sector contributes to the formal sector's risk mitigation and cost reduction strategies. In this view, the informal economy is not seen as a feature of a traditional sector, but instead a central feature of modern capitalist development.

There are also structural and other factors that will determine the precise character and scale of the informal sector that might explain large variations by income per capita (Edgren, 2005). A growing literature assesses how the informal sector is shaped by trends in the economy as a whole. This recognises that there may be inter-linkages, but also displacing qualities.



