

## Evidence-based Employment Scenarios

### Formal / Informal Linkages in South Africa: Some Considerations

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## 1 Introduction

A feature of the development of the South African labour market in the recent period has been growth in informal employment. Although there are serious problems with attempting to provide any consistent trend data (see Devey et al, 2006)<sup>1</sup>, Figure 1 below shows (for indicative purposes only) the pattern of informal employment within broader labour market performance. As is evident from Table 1, over the period, informal employment, excluding subsistence agriculture and domestic work, 'grew' from 965,000 to just over 2.3-million workers<sup>2</sup> between 1997 and 2005, rising from about 10% to 18% of the employed workforce. Notwithstanding the difficulties and debates about data issues, it is widely accepted that informal employment grew rapidly in the late 1990s, and stabilised in the 2000s.

To know how the economy might meet the target of halving unemployment by 2014, the Employment Scenarios project needs to ask how the informal sector might grow. There is an important set of questions that would need to be explored. How much of the employment target is likely to be made by growth in the informal economy? Is the informal sector likely to continue growing in the period leading up to 2014? Most important for the ES project is to untangle the relationship between the formal sector and the informal sector in South Africa, and to assess whether the relationship is likely to continue as is or likely to change in the period leading up to 2014. Now that the informal sector has reached a significant scale, would it be expected to grow in alignment with the formal sector? Or might it shrink if there is success in expanding the formal sector?

In order to make some informed assessment of these issues we begin by discussing some definitional and measurement issues, examine the international literature on formal-informal linkages, assess some known trends in South Africa and, finally, suggest a few plausible hypotheses for further exploration.

## 2 The definitional issues

Before exploring the set of issues identified above it is important to clarify what the informal economy, or the informal sector, is composed of. Despite Peattie's (1987) critique of the term 'informal sector' as an 'utterly fuzzy' concept and her suggestion that those interested in policy and analysis of this phenomenon should start by abandoning the concept, the concept continues to be used. Since Keith Hart (1973) first coined the phrase 'informal sector' in the early 1970s to describe the range of subsistence activities of the urban poor, there has been considerable debate about what exactly the term refers to. The most quoted definition is that contained in the International Labour Organisation's Kenya Report (1972:6) in which informal activities are defined as 'a way of doing things', characterised by:

- a) ease of entry;
- b) reliance on indigenous resources;

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<sup>1</sup> In particular, it should be noted that we are using two different surveys – the OHS for 1997-99 and the LFS for 2000-05. Further, it is difficult to isolate two factors that may explain the growth in informal employment – actual growth in informal employment and better capture of informal employment by StatsSA.

<sup>2</sup> The estimate for 2005, based on the September LFS, does seem to be unusually high. The estimate for March 2005 was 1.9-million informal workers.

- c) family ownership of enterprises;
- d) small scale of operation;
- e) labour-intensive and adapted technology;
- f) skill acquired outside of the formal school system; and
- g) unregulated and competitive markets.

Most commonly though, the informal sector is often simply thought of as containing firms that are not registered and are therefore unregulated.

For our purposes, two important points are worth noting. First the term informal sector disguises a significant degree of heterogeneity. Informal activities encompass different types of economic activity (trading, collecting, providing a service and manufacturing), different employment relations (the self-employed, paid and unpaid workers and disguised wage workers) and activities with different economic potential (survivalist activities and successful small enterprises). Second, the distinction between the formal and informal 'sectors' suggests that there is a clear line dividing the two. As we will come to see, the two 'sectors' are often integrally linked. With the exception of illegal activities, there are few examples of informal operators who are not linked (either through supply or customer networks) into the formal economy. As Peattie (1987:858) points out, 'if we think about the world in terms of a formal and informal sector we will be glossing over the linkages which are critical for a working policy and which constitute the most difficult elements politically in policy development'.

The official definition used to determine informal employment in South Africa is based on a self-classification question in the LFS. Having determined whether or not the respondent is employed (in the last seven days), the respondent is then asked whether the organisation that s/he works in is in the formal or informal sector, where formal sector employment is defined as employment in a registered institution and informal sector employment as that in an institution that is not registered. The respondent is then asked about the industry that s/he is employed in. Devey et al (2006) highlight two important points about informal employment statistics in South Africa. First, the self-classification question used to distinguish between formal and informal employment leads to inconsistencies in the data. Second, notwithstanding this, the informal employment trend derived from the LFS seems to be plausible. Importantly, Valodia et al (2006) highlight the extent of low-waged work in the South African economy in both the formal and the informal economy and demonstrate that a large proportion of employment currently classified as formal has all of the characteristics of insecure, low-paid, informal employment.

### **3 Some lessons from the international literature**

Although there is a large literature examining the informal economy in developing countries, there is, unfortunately, very little specifically on the linkages between the formal and the informal economy.

The debate about the links between formal and informal sectors is informed largely by the theoretical positions that different 'schools' on the informal economy subscribe to. There are three main theoretical views that emerge in the literature. First, the dualist school, informed largely by the early work of the ILO sees the informal economy as a set of marginal activities that provide incomes for the poor who are unable to access employment in the formal economy. Second, structuralists such as Caroline Moser

and Alejandro Portes see the informal economy as a set of subordinated economic units that serve to reduce the input and labour costs of the large, formal enterprises. In this view, growth, or at least growth in profitability in the formal economy is, at least in part, dependent on growth in informal enterprises. Third, the legalist school most prominently represented by Hernando de Soto views the informal economy as being made up of a set of entrepreneurs who *choose* to operate in the informal economy, thereby reducing their costs of conforming to regulations (that stifle entrepreneurs).

A large portion of the international literature, pioneered by French statistician Jacques Charmes, has sought to examine and improve statistics on informal work in developing countries. The evidence from this is that non-agricultural informal employment is a significant and growing phenomenon in developing countries, especially for women. In many cases, informal employment is the major form of employment (see [www.wiego.org](http://www.wiego.org)). This suggests that, irrespective of formal sector growth, there is an international trend toward more insecure and informal forms of employment. Guy Standing and others have written insightfully about these developments.

The little empirical evidence that exists is useful, but is often contradictory. Based largely on the Latin American experience, and informed by the 'De Soto view' of the informal economy, Maloney shows that the earnings of workers that moved from formal sector employment to the informal economy were not consistent with the view that the informal economy was made up of survivalists. If this finding holds, we would expect the informal economy to behave in similar fashion to the formal economy – with employment expanding during growth phases and contracting when the economy moves into recession. The evidence in other settings, primarily Asia and Africa, however, suggests that segmentation is a feature of labour markets in developing countries. Notwithstanding these contradictory positions, Chen (2004) highlights three important issues that emerge from the empirical literature.

- First, the statistical data and the analysis thereof suggests that, contrary to earlier notions which saw employment in the informal economy as a short-term transitory phenomenon, informalisation is a feature of contemporary economic growth patterns.
- Second, workers currently classified in informal employment operate in a wide range of economic units and their employment relations falls somewhere between what is considered formal (i.e. regulated and secure) and informal (unregulated and insecure).
- Finally, the term 'informal sector' hides a significant degree of heterogeneity in informal enterprises. These include, among others, entrepreneurs operating small micro-enterprises, workers in these enterprises, own-account workers, unpaid family workers, industrial outworkers and homeworkers. There is thus a wide range of employment relations and linkages to the rest of the economy (see Chen, 2004).

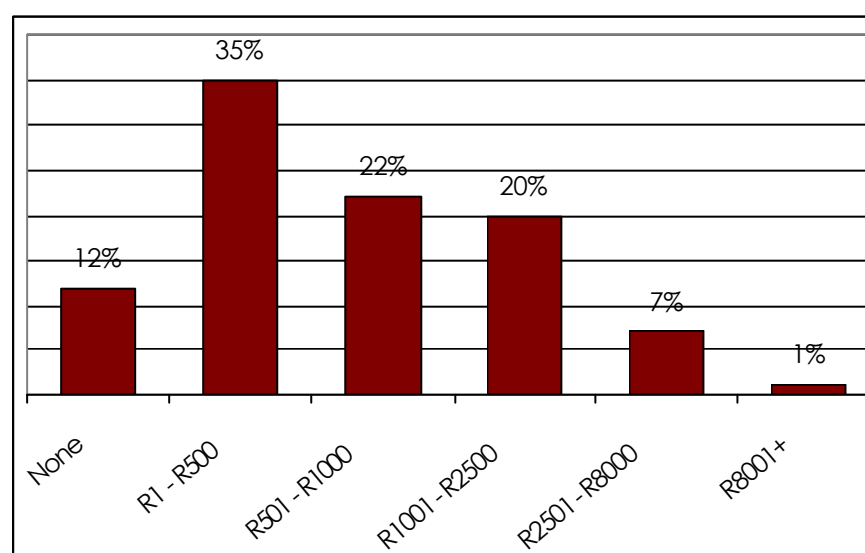
The lesson that seems to emerge most forcefully from the international literature is that the specific relationship between formal and informal sectors depends considerably on context. For example, the informal sector is so large in Brazil partly because many firms seek to avoid extremely onerous regulations and a heavy tax burden. The informal sector in Zimbabwe may have expanded from the implosion of the formal sector. Low-income countries have large informal sectors because their formal sectors are relatively undeveloped. South Africa's informal sector grew partly due to urbanisation, the easing of policing behaviour and regulations which historically

treated black informal operators as illegal (rather than ‘extra-legal’ as in most other countries), and the lack of employment opportunities in the formal sector.

## 4 The evidence in South Africa

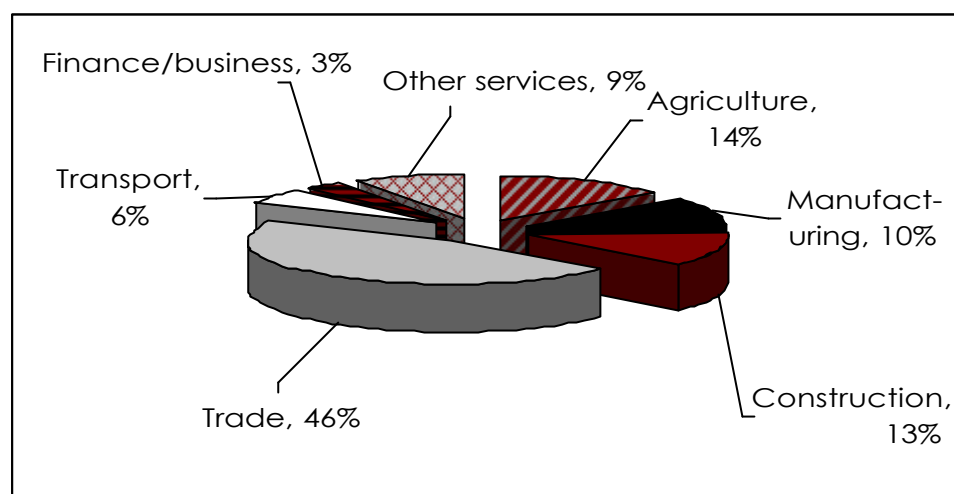
The informal sector is incorporated in South Africa’s national accounts and is estimated to contribute some 7% of GDP. Other estimates (see, for example, Budlender et al) suggest that this may be as high as 12%. The statistical work that has been done suggests that, unlike some other developing countries, informal employment is largely of a survivalist nature. Figure 1 shows monthly incomes of those working in informal enterprises. Sixty nine percent of respondents reported earning R1,000 or less, suggesting that there is a close correlation between being poor and working informally, as is the case internationally.

**Figure 1 - Monthly income for individuals in informal enterprises, September 2005**



Source: Skinner and Valodia, 2006



**Figure 2 - Informal enterprises by industry, September 2005**

Source: Skinner and Valodia, 2006

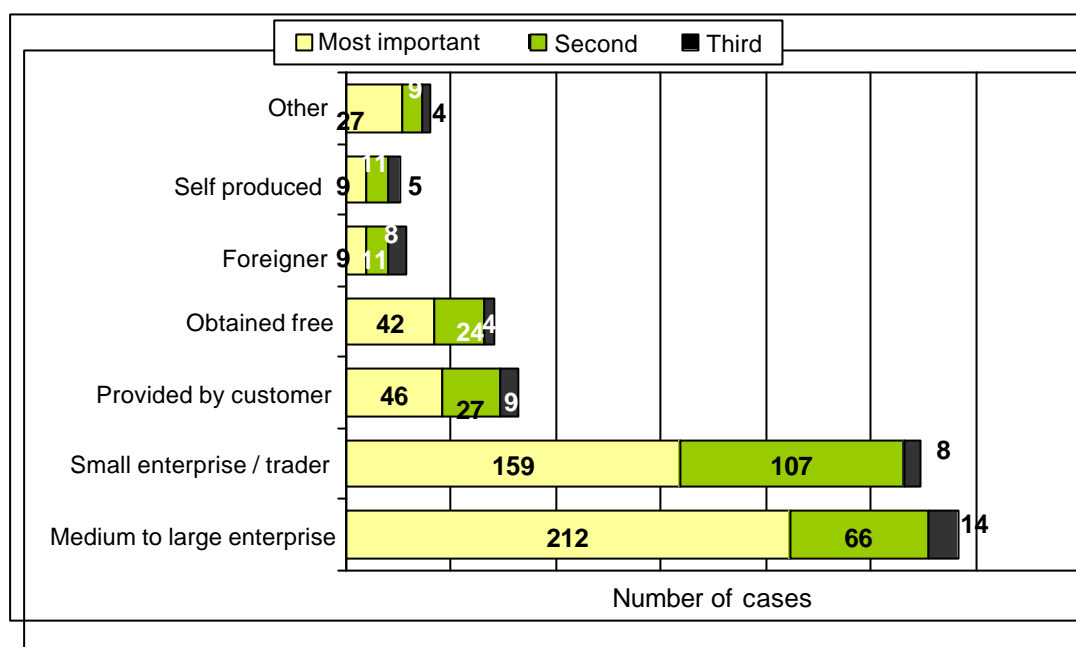
Figure 2 shows the informal enterprises are mainly engaged in service-related activities. Trade, primarily retailing, makes up 46% of informal activity.

There is only very limited and sketchy empirical evidence of linkages between the formal and informal economy. Perhaps the most comprehensive survey of informal enterprises is that reported by Skinner (2005), of informal enterprises in the greater Durban area, where some 507 detailed surveys were conducted with informal workers. Skinner's study provides some useful indicators of forward and backward linkages in the informal economy. Figure 3 shows sourcing of raw material for informal enterprises in the Durban area. The most frequently cited source of supply is medium to large enterprises, with six in every 10 enterprise owners identifying this as a source. This suggests quite strong forward linkages into the formal economy. The second most cited source was a small enterprise or trader, with over five in every 10 respondents identifying this as a source. A portion of these are also likely to be in the formal economy. It is interesting to note the role of foreign-linked supply networks in the informal economy. One in 20 respondents stated they sourced their goods from a foreigner.

As is to be expected there are sectoral differences in these linkages. Table 1 shows that certain informal activities are more strongly linked into the formal economy than others. Apparel, spaza shops, shebeens and crèches tended to source their goods in medium and large shops. The responses from those working in traditional medicine indicate that a number of formal shops and foreigners were involved in supply. There are also more formal shops involved in supply of crafts than would be expected from a segment of the economy that is often considered to be entirely informal. With respect to apparel, a group of those interviewed are likely to be dressmakers as their supplies were provided by their customers.

Valodia et al (2006) have used the panel component of the LFS to explore labour market churning in South Africa. Although their sample sizes are small, their results suggest that there is a surprising degree of movement between formal and informal employment in South Africa.

Figure 3 - Source of supply, n=503



Source: Skinner, 2005

Table 1 - Source of supply by % in sector, n=503

	Medium/large shop	Small shop/trader	Provided by the customer	Foreigner	Obtained free	Self-produced	Other
Apparel	61%	70%	40%	4%	1%	2%	4%
Craft	43%	73%	1%	9%	13%	5%	5%
Traditional medicine	19%	54%	0%	18%	69%	15%	25%
Spaza shops	79%	48%	0%	0%	0%	2%	2%
Construction	56%	41%	51%	0%	5%	0%	3%
Metal work	79%	37%	30%	2%	0%	0%	5%
Shebeens	85%	46%	0%	0%	0%	2%	0%
Crèches	67%	36%	15%	3%	5%	13%	15%
Hairdressing	66%	51%	22%	5%	0%	0%	7%
	292	274	82	28	70	25	40

Source: Skinner, 2005

## 5 Some research issues in South Africa

The international literature and the limited empirical evidence in South Africa suggest a few plausible hypotheses or research questions that may be explored.

First, processes of global integration and economic restructuring have, as we have seen, led to a growth in informal employment internationally. Thus the growth in informal employment in South Africa is, at least in part, linked to processes of global economic integration. There is ample evidence that global integration has led both to increased demand for skilled labour and increased informalisation of work. A key consideration is therefore whether or not South Africa's continued integration into the global economy will continue to generate these labour market outcomes.

Second, unlike the evidence in Latin America, informal employment in South Africa tends not to be voluntary and is characterised by low incomes in (generally overtraded) retail enterprises. Thus, growth in the formal sector will lead to higher levels of labour migration from the informal sector to the formal sector. How large is this migration likely to be, and how many of the current unemployed are likely to enter the informal economy?

Third, the statistical issues are important. The current classifications used in South Africa hide a significant degree of informality in the formal economy. Several research issues arise. How accurate are the estimates of informal employment, and might the new definitions recommended by the ILO Conference in 2005 (see [www.wiego.org](http://www.wiego.org)) be more appropriate for South Africa? What portion of low-waged work currently defined as formal employment is likely to become more informal, and thus be classified as informal work?

Fourth, with retailing being the dominant activity in this sector, its future development is important for the overall trajectory of informal work. We can identify two possible trends – informal retailing may grow as the economy grows and demand grows, or it may contract as formal retailing increasingly penetrates (a now more attractive) 'township' market.

It would probably be correct to say that all of the above (and other trends) are likely to operate at the same time. The net effect on the trajectory of informal employment will depend on the relative strength of each of these effects. Understanding these will require a concerted research effort. The ES project intends to explore three issues. First, some sector research, particularly in retail and construction, to deepen our understanding of formal-informal linkages in the retail trade. Second, the LFS panel data might reveal some important findings, especially with respect to the factors that might account for movements between the informal sector and the formal sector (and vice versa). Third, the LFS panel can be explored at the household level to deepen our understanding of how employment relations may be linked inside the household.

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