


# POLICY BRIEF

I. PETERSEN, N. MUSTAPHA AND N. VAN RHEEDE | FEBRUARY 2024



## Transitioning the Informal to the Formal Economy: A Measure to Assess Readiness and Progress

Photos: Antonio Erasmus

### Key messages

- In the informal sector, business registration is not, by itself, a guarantee of business sustainability or growth.
- A concern is that a narrow definition of formalisation, as business registration and meeting regulations, emphasises compliance rather than capability-building.
- Measures of readiness to formalise and policy progress based on a narrow definition are therefore likely to be misleading.
- This brief proposes an indicator framework for assessing capabilities to formalise, informed by an empirically derived understanding of the complex business evolution pathways of informal enterprises.
- The indicator framework is useful for assessing readiness to formalise and for designing interventions targeted to informal business evolution capabilities.

### Introduction

In the context of a weakening economy and growing unemployment, the informal sector is a persistent feature of the labour market in South Africa. Here the focus is on the informal sector as largely unregulated but legitimate economic activity carried out by mainly micro enterprises and survivalist own-account operators.

A key focus of informal sector policy is to facilitate the transition of these informal businesses to the formal economy. The International Labour Organisation (ILO) Resolution R204, to which South Africa and many other countries are committed, encourages a gradual transition by providing

incentives and creating an enabling environment through measures such as improving access to finance, infrastructure, and education and skills training opportunities. Reducing barriers to formalisation is also emphasised.

However, formalisation tends to be defined narrowly, as business registration and compliance with regulations<sup>1</sup>. Informal sector policy, therefore, tends to focus on formalisation strategies that bring the informal sector into business regulatory frameworks. Business registration is emphasised as a key condition to shift informal businesses along a trajectory towards becoming sustainable formal businesses. Business registration and compliance thus tend to be the main indicators informing the measurement of progress. As a recent Human Science Research Council (HSRC) research study shows, business registration is not, by itself, a guarantee of business sustainability or growth<sup>2</sup>. In fact, a business that is formally registered may still be largely informal in nature if a wider set of conditions for formalisation is considered.

This policy brief proposes an indicator framework for measuring formalisation capability, based on an empirically derived understanding of the complex business evolution pathways of informal businesses. The framework identifies a set of conditions that enable informal businesses to operate sustainably in the formal sector, what we call “sustainable formalisation”. It is useful for informing the measurement of progress towards sustainable formalisation and, important-

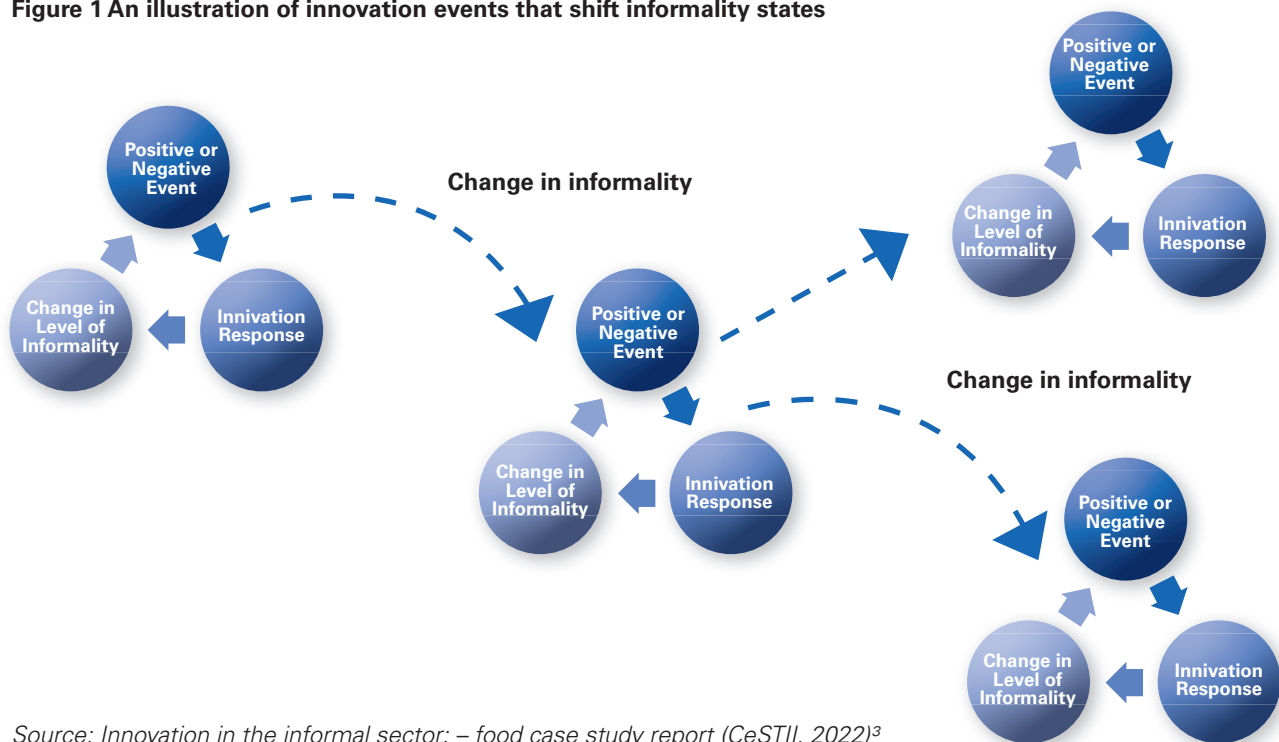
ly, for developing interventions aimed at building capabilities to formalise. In this way, the assessment of readiness to formalise may be based on an assessment of formalisation capabilities rather than picking winners.

**Informal business evolution pathways include a multiplicity of (in)formality states**

In South Africa, creating an informal business is typically

not a short-term action followed by rapid progress to formal sector opportunities. Furthermore, as a recent HSRC study shows, informal businesses report varying states of informality that they move between and rely on incremental innovation for business survival. When faced with a crisis, including financial or personal challenges, informal businesses that implement an innovative response report a change in informality (Figure 1).

**Figure 1 An illustration of innovation events that shift informality states**



Source: *Innovation in the informal sector: – food case study report (CeSTII, 2022)*<sup>3</sup>

The research points to the need for a different approach to understanding informality, one that sees it as a non-linear process involving a multitude of states. Research in other African countries show a similar trend, for example, the work of Nancy Benjamin and Ahmadou Aly Mbaye in francophone African countries<sup>4</sup>. For an informal business, an employing business or own-account operator, to evolve into a financially viable formal business, it needs to have acquired several attributes, defined by its business evolution capabilities: it must keep records, it needs management capabilities, and so on. Business registration and compliance with regulatory frameworks represent only one set of conditions as informal businesses transition to sustainable formalisation.

**A conceptualisation of formalisation based on capability rather than compliance is needed**

Therefore, a business’s state of formality or informality cannot be defined based on compliance or a single binary criterion, as this would be misleading. Furthermore, as recent news reports indicate, the emphasis on regulation and compliance has contributed to growing tension and conflict between government and informal sector stakeholders,

negatively affecting livelihoods and business growth, as informal businesses have been moved or shut down. The commonly used narrow definition of formalisation that emphasises compliance rather than capability is a concern. Informal business owners often report wanting to grow their businesses into formal businesses, when the conditions are “right”<sup>5</sup>. Interventions and the assessment of readiness to formalise need to be based on an understanding of these conditions. The current tendency to focus on small businesses leads to picking winners, with the unintended consequence of excluding the majority – i.e., survivalist enterprises<sup>6</sup> – that could benefit from policy support<sup>7</sup>.

**An indicator framework for measuring formalisation capability based on informal business evolution capabilities**

A new framework is proposed for conceptualising and measuring progress towards sustainable formalisation (Table 1). Formalisation is conceptualised as a process involving transition between a multiplicity of states of informality/formality, signalling changes in business evolution capability. Progress towards formalisation is not necessarily linear or uni-directional. Informed by this conceptualisation, the





framework proposes a set of indicators of formalisation based on a contextualised understanding of business evolution in the informal sector.

The indicator framework is based on and extends the work of Nancy Benjamin, Ahmadou Aly Mbaye and colleagues who introduced a definition of informality based on key indicators of formality: firm size, business registration, regular and accurate management of accounts, fixity of workplace, access to credit, tax compliance, and employees registered for social security benefits<sup>8</sup>. Based on this definition, they developed a set of criteria for classifying businesses according to state of informality. Their classification criteria are based on empirical data of over 1500 informal businesses across six major cities in West and Central Francophone Africa. Essentially, Mbaye and colleagues demonstrated the value of classifying businesses based on key indicators of formality. In South Africa, Derek Yu and Richard Devey and colleagues have used a similar approach, a formal-informal index, to assess worker informality<sup>9</sup>.

A team of HSRC researchers adapted and tested the classification criteria in the South African context, drawing on mixed methods research conducted over the past five years as part of the Innovation in the Informal Sector Survey project. Based on this research, the set of criteria proposed by Mbaye and colleagues was adapted to better reflect informal business evolution capabilities and pathways. This set of criteria forms the basis of the indicator framework shown in Table 1.

The resultant indicator framework includes four dimensions. The first dimension covers compliance with regulatory frameworks. Compliance with business regulatory frameworks at the local or provincial level was added, as this is important in the South African context.

The second dimension focuses on financial management.

We added the condition of use of a separate bank account. Many informal businesses, particularly survivalist enterprises, do not manage a bank account and tend to open an account when they are ready to take on business in the formal sector, for example. Access to external finance, through formal sources, is the third condition. Our research shows that informal businesses mainly access finance through informal sources such as friends and family. Fulfilling the eligibility criteria to be able to access funding through commercial banks and government funding is an important milestone. NGOs also act as intermediaries and offer funding opportunities with less stringent eligibility criteria.

Business location and premises are key indicators of informality and are covered by the third dimension, infrastructure. Here, the focus is on 'fixity of workplace'<sup>8</sup>. The main distinguishing characteristic is fixed business premises, particularly separated from the business owner's personal space, rather than a mobile structure or space in the business owner's home or a public space used as a working premises. 'Fixity' may not be relevant for some service-based businesses that do not require fixed premises to operate.

The fourth dimension covers business growth, including the size of the business based on the number of employees. The informal businesses included in our research employed an average of 2.2 employees. We further extended the existing criteria to distinguish businesses employing informally and employing full-time, considering that many informal businesses employ family members and friends, often on a part-time basis, and employees may not be paid a salary but may be paid in kind (e.g., food and sharing household expenses). To assess business expansion, the framework includes key ways in which informal businesses in South Africa show growth. Business expansion is not typically considered an indicator of formality but does reflect business evolution capabilities in the informal and formal sectors.

**Table 1 Indicator framework for measuring formalisation capability**

Dimension	Category	Indicator	Description
Compliance with regulatory frameworks	Registration status	Registered formal business	The business is registered with the relevant authority. In South Africa, this is the Companies and Intellectual Property Commission (CIPC).
		Business permit or licence	The business is registered with the local municipality and has obtained a business permit or licence to operate.
	Taxation	Registered for company tax	The business is registered for tax. In South Africa, tax registration is through the South African Revenue Service (SARS).
	Employee benefit	Provide employee benefit	All or some employees are registered for social benefits such as through the Unemployment Insurance Fund (UIF), pension fund, and medical aid.
Financial management	Maintenance of financial statements	Business bank account	The business has a bank account. It does not have to be a business account considering the relatively high monthly costs.
		Maintains regular accounts	The business maintains regular, accurate accounts and financial statements. It has certified statements, annual accounts, and/or a registry of revenue or expenditure.
	Access to external finance	Received external finance	The business has received a bank or microfinance loan within the last five years. This includes the range of finance options available to businesses: commercial banks or other private sector organisations, government and NGOs. It excludes financial support from informal sources such as friends and family.
Infrastructure	Access to business premises	Fixed premises	The business operates from fixed premises rather than the operator's home or a public space used as a working premises or being mobile.
Business growth	Firm size/employing	Firm size	The size of the business, with fewer than five employees being characteristic of informal enterprises. This can be further broken down: own-account workers, nano enterprises with two to three employees, and micro enterprises are those with four to five employees.
		Employing informally	All or some employees are unpaid and/or hired on a part-time basis.
		Employing full-time	All or some employees are hired on a full-time basis.
	Business expansion	Changed business structure	The business has sold, closed, or outsourced parts of the business.
		Employed full-time manager	The business hired someone to manage the business. The business is therefore managed by an employee other than the business owner.
New branches		The business established new branches in other geographical areas, typically within the country.	

Source: Authors, adapted from Mustapha et al. (2022), Petersen et al. (2022) and Mbaye and Gueye (2020).



## Using the indicator framework to assess readiness to formalise

The indicator framework provides a basis not only to define but to measure sustainable formalisation, as well as assess readiness to formalise. To test this, the framework was applied to data from 577 informal enterprises in our sample, from diverse industries, operating in a spatially defined area near Pietermaritzburg in KwaZulu-Natal province. Fewer indicators were used as data were available for only five of the them, but these covered the four dimensions of formalisation capability.

Table 2 includes the five indicators and describes how readiness to formalise may be assessed. For each indicator, a score of one is added if the condition is met and zero if it is not met. In other words, we are assessing to what extent a business possesses the set of attributes associated with informality. The scores are then added to provide an overall score reflecting the profile of business informality. For example, a spaza shop that is registered but does not have a bank account, has received financial support from family and friends only, operates from a fixed structure at a township business hub, and employs two people will receive a score of three. What does this score tell us? It indicates that although the spaza shop is registered with the relevant public authority, it can be described as semi-informal (Figure 2).

**Table 2. Measure of states of informality/formality**

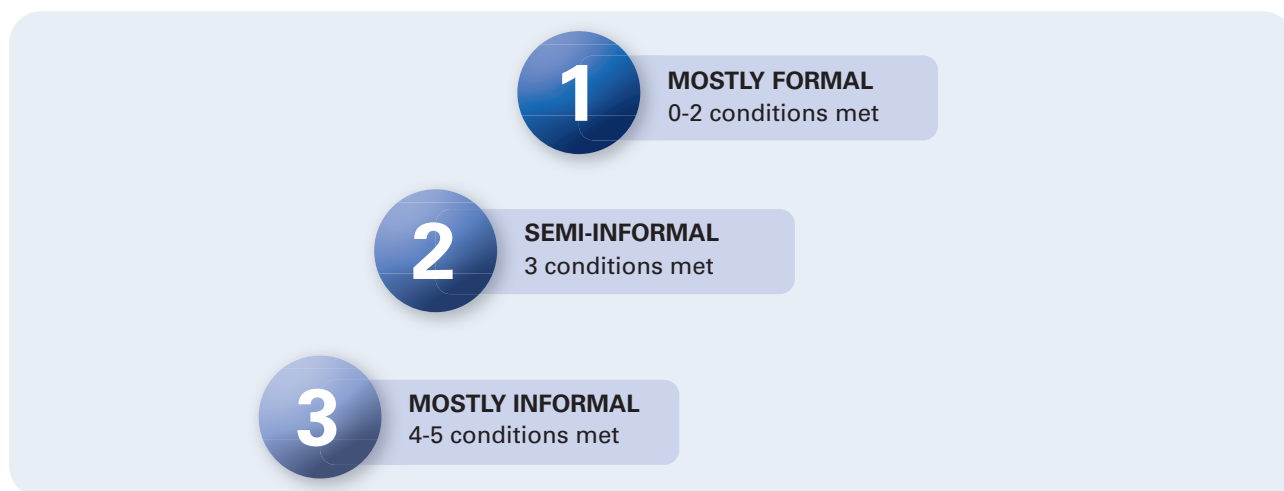
Dimension	Indicator	Description
Compliance with regulatory frameworks	Registered formal business	The condition is met if the business is not registered with the relevant authority.
Financial management	Business bank account	The condition is met if the business does not have a bank account.
	Received external finance	The condition is met if the business has not received a bank or microfinance loan from private sector organisations, or funding support from NGOs or government units/agencies. The condition is met if the business received financial support from informal sources such as friends and family.
Infrastructure	Fixed premises	The condition is met if the business does not operate from fixed premises. The business may be operating from mobile premises, business owner's or someone else's home, a make-shift structure in a public space (e.g., taxi rank, market or foot-path). The condition is not met if the business operates from fixed premises separate from the business owner's personal space including a non-residential building (e.g., an office block or factory).
Business growth	Firm size	The condition is met if the business has fewer than five employees. This can be further broken down: own-account workers, nano enterprises with two to three employees, and micro enterprises with four to five employees.

**Note:** When assessing a business's state of informality/formality, a score of one is added if the condition is met and zero if the condition is not met.

*Source: Adapted from Mustapha et al. (2022), Petersen et al. (2022) and Mbaye and Gueye (2020).*



**Figure 2. Profiles of business informality based on the analysis of the 2017-18 Innovation in the Informal Sector Survey**



Source: Authors, based on Mustapha et al. (2022), Petersen et al. (2022) and Mbaye and Gueye (2020).

This measure of formalisation capability makes it possible to classify businesses into three profiles of informality (Figure 2). For profiles one and two, informal businesses report foundational business evolution capabilities and are therefore likely to be ready to formalise. For profile 3, the businesses are mostly informal and are likely to require much more support to firstly build foundational business evolution capabilities. Once a baseline is established, this measure can be used to track change over time.

The indicator framework can be used to guide the development of targeted interventions, tailored to business evolution capability, towards facilitating gradual transition to the formal sector. When using the indicator framework to assess readiness to formalise, it is possible to identify specific areas where informal businesses require support. For example, the spaza shop described earlier would benefit from support to strengthen financial management.

The next step is to test the robustness of the framework by applying it to diverse groups of informal businesses located in other geographical settings in South Africa and other African countries. The updated version of the HSRC's Innovation in the Informal Sector Survey was designed to yield data covering all four dimensions and 14 indicators. The survey team is also conducting further research to identify suitable indicators of informal business innovation, and other informality indicators important in the South African context, such as the reliance on trust-based informal arrangements<sup>10</sup>. This survey will, therefore, be a useful resource for future research to inform informal sector policy in South Africa.

## Conclusion and policy implications

This brief is based on a growing evidence base pointing to the need to reconsider the assumptions underpinning policy aimed at promoting the graduation of informal businesses to the formal economy. What is required is the development of policy tools that enable change based on the capabilities of a business to formalise, instead of the blunter instruments based on a uni-dimensional process of formalisation through registration and compliance.

The indicator framework for measuring formalisation capabilities may be a useful resource for policymakers and informal sector support organisations wanting to design more effective interventions enabling informal businesses to gradually evolve into financially viable sustainable enterprises with greater potential to create decent jobs. The indicator framework offers:

- A broader definition of formalisation that takes into account heterogeneity and the complex business evolution path ways of informal businesses.
- A contextualised set of indicators for assessing readiness to formalise, to develop better targeted interventions.
- A contextualised indicator framework for more effective monitoring and evaluation of informal sector policy and interventions.

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## Authors

- Il-haam Petersen, PhD; Chief Research Specialist, CeSTII, Human Sciences Research Council
- Nazeem Mustapha, PhD; Chief Research Specialist, CeSTII, Human Sciences Research Council
- Nicole van Rheede; Chief Researcher, CeSTII, Human Sciences Research Council

## Enquiries

Dr Il-haam Petersen: [ipetersen@hsrc.ac.za](mailto:ipetersen@hsrc.ac.za)

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