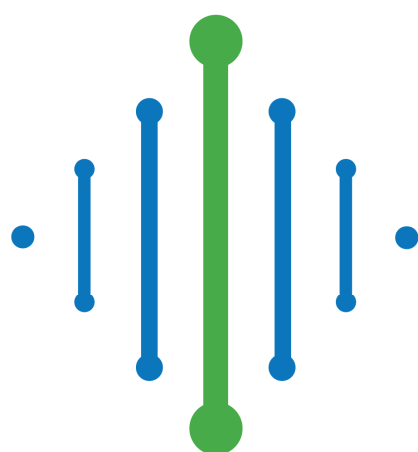


# Rethinking the Effect of Informality On Inclusive Growth: Lessons from Colombia and South Africa

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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

The relationship between informality and inclusive growth is a contested one, with views differing wildly depending on the country in question. On the one hand, increasing rates of informality may serve to decrease rates of unemployment. On the other hand, informal employment leaves workers vulnerable in terms of low pay, inadequate benefits and government intervention.

In order to shed light on this issue, this policy brief uses the case studies of South Africa and Colombia to argue that the relationship between informality and inclusive growth depends on the type of informality in question.

To this end, we suggest a typology of informality which takes into account the informal worker's preferences for informality and level of productivity as well as possible barriers to formality. We call the three types of informal workers identified “voluntary”,

“induced”, and “subsistence” informality, and suggest policy recommendations aimed at increasing inclusivity of growth for each of these groups of informal workers.

## Key Implications

1. A valid analysis of informality cannot view informal workers as a single homogenous group.
2. Whether informality is or **good** or **bad** for inclusive growth is related to the type of informality in question.
3. Policy recommendations aiming to promote inclusive growth must take the **heterogeneity** of the informal labour market into account.

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## Introduction

Ensuring that the benefits of economic growth are enjoyed by all members of society is a common challenge for governments around the world. The labour market is a key channel through which governments can promote the inclusivity of growth, however the predominance of the informal sector in job creation is a challenge in developing countries.

Therefore, the central research question of this brief is: **Do informal labour markets promote or constrain inclusive growth?** Informality may promote inclusive growth by enabling individuals to engage in the labour market, providing incomes to those who might otherwise be unemployed. Informality may constrain inclusive growth due

to lower levels of productivity, lower quality employment, erosion of the tax base, and unfair competition to formal firms.

One of the main conclusions of this brief is that **a valid analysis of informality cannot view informal workers as a single homogenous group** – informal workers range from poorly educated rural dwellers, to highly educated young adults living in productive cities. Accordingly, we argue that the impact of informality on inclusive growth is related to the type of informality that prevails in each country. Therefore policy recommendations that aim to promote inclusive growth must be coherent with the type of informality that exists.

## “Do informal labour markets *promote* or *constrain* inclusive growth? „

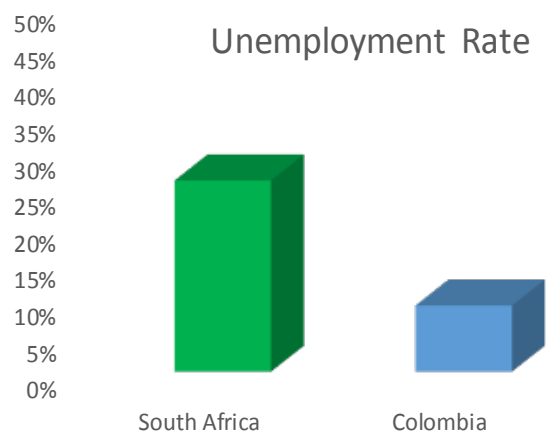
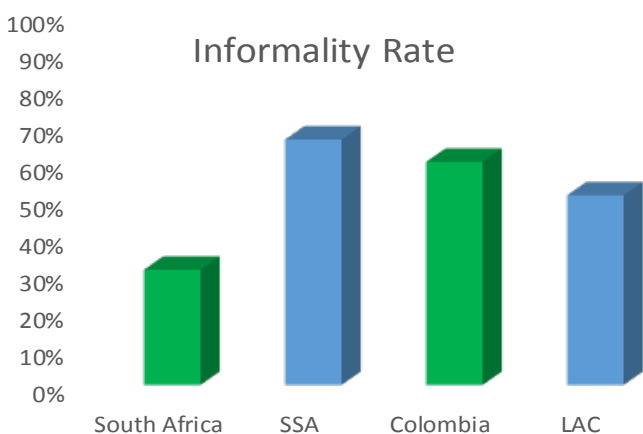
### South Africa In Context

At 31%, the informality rate in South Africa is considerably lower than that of other developing countries: less than half the sub-Saharan African average (66%) and considerably lower than the Latin American and Caribbean average (51%). This low level of informality, coupled with a high unemployment rate (26%), contributes to the view that the informal sector can be used as a way of reducing unemployment in South Africa. Consequently, South Africa aims to promote self-employment through entrepreneurship.

In contrast, Colombia has an unemployment rate nearly three times smaller (9%), while the informality rate in Colombia is nearly twice that

of South Africa (60%). Colombia therefore views the informal labour market as a constraint to the growth of the formal sector and national policy aims to control it. Colombia therefore provides a good contrast to South Africa, as prevailing views surrounding informality differ considerably in each country.

The two countries, at the outset, have two very different answers to the question of whether informality constrains or promotes inclusive growth. In order to address this puzzle, we argue that **the relationship between informality and inclusive growth depends of the *type* of informal worker in question.**



## Informality and its Relationship with Inclusive Growth

We suggest that individuals are employed in the informal labour market for three broad reasons:

**Voluntary informality** typifies workers who decide to be informal because they consider the benefits of informality greater than those of formal employment. This cost-benefit analysis takes into account income, taxes and job flexibility. Voluntary informality might be beneficial at an individual level due to free-rider benefits, but on aggregate it will have negative implications for inclusive growth because of lower earnings and productivity in the economy.

**Subsistence informality** typifies workers who are willing to work in the formal sector but are excluded due to low levels of productivity. They therefore have to “queue” for the relatively low

number of informal sector jobs available, particularly in developing countries. For these workers, informality may be the only available alternative to unemployment. Provided that they earn more being informal than from any available unemployment benefits, this type of informality promotes inclusive growth (at least in the short run).

**Induced informality** typifies workers who are willing to work formally and possess the necessary level of productivity to be employed freely in this market, but are relegated to informal jobs because of excessive labour protection or implicit rules of society, such as labour discrimination. These barriers constrain inclusive growth by preventing workers from obtaining the higher wages, benefits and work stability found in the formal labour market.

## Prevailing Types of Informality in South Africa and Colombia

Our analysis of the informal labour market in South Africa and Colombia reveals that all three types of informality coexist in both countries, but to varying degrees.

**Voluntary informality** is more prevalent in Colombia than in South Africa. In South Africa, 7-22% of informal workers are estimated to be voluntary. This increases to 21-36% in Colombia. It is more common amongst well-educated individuals in both countries.

**Subsistence informality** is the predominant type of informality in South Africa, and exists in Colombia although to a lesser extent. It is more common amongst those with low levels of education and those living in non-urban areas.

**Induced informality** is more common in Colombia than in South Africa. Barriers to formality are mainly related to payroll taxes and the inflexibility of the minimum wage in Colombia. In South Africa, induced informality is linked to race, with African individuals less likely to be formally employed than any other race group (controlling for individual characteristics). This is related to South Africa's history of race-based apartheid-era

legislation, which systematically excluded these individuals from labour market opportunities.

Therefore, we argue that in South Africa, informality has an overall positive effect on inclusive growth, while in Colombia, informality has a more negative relationship. However, informality in Colombia also plays a role in providing income to the very low educated population in low productivity cities, a perspective which is rarely taken into account in Colombia.

It is important to note that even if informality can be positive in terms of inclusive growth for some vulnerable groups, the cost of informality at society-level should not be ignored. In this sense, the Colombian experience, with its deep-rooted informality, provides an important example for South Africa, and other countries, to take into consideration.

**The only way in which facilitating the transition from unemployment to informality can offer long lasting and productive reform, is by simultaneously promoting a smooth transit from informality to formality.**

# Key Policy Recommendations for Each Type of Informality

## Voluntary informality

One of the most effective policies to combat this type of informality is labour law monitoring and control. However, this policy should not be implemented indiscriminately, since it can have negative implications for inclusive growth if applied to subsistence informal workers. Making formal work more flexible and promoting part-time jobs in particular, is also an appropriate policy action.

## Subsistence informality

Enforcing formality on this type of worker is not only likely to fail, but may imply an enormous cost in terms of inclusive growth. In the long term, the only way to reduce this type of informality is to either increase education and skills or to improve productivity, particularly in rural areas where subsistence informality is more common. In the short to medium term, facilitating geographical mobility and re-locating subsistence informal workers might be useful policies in order to increase inclusivity for these workers.

## Induced informality

The policies to address this type of informality can be divided into policies to reduce 'excessive' labour regulation, and policies to reduce discrimination in the labour market. The extent to which labour policies are excessive is debatable.

While workers should have some kind of protection to improve working conditions, 'too much' protection can make formal hiring 'too' expensive, thereby increasing unemployment and informality. Policies which help to reduce induced informality involve decreasing:

1. Labour taxes: The drawback of removing or reducing labour taxes is a substantial decrease in tax revenue.
2. Minimum wages: While existing studies tend to find a positive relationship between an increase in the minimum wage and unemployment and informality, increasing minimum wages also has a positive impact on income distribution, and therefore on inclusive growth.

Policies focused on labour market discrimination are relevant for workers who show low preferences for informality and have similar education and experience as other formal workers, but are segregated from the formal labour market by race, gender or other explicit or implicit discriminatory rules of society.

## Reference:

Oosthuizen, M., Lilenstein, K., Fernandez, C., Medellin, J.C. and Fernandez, F. (2017). "[Rethinking the effect of informality on inclusive growth: lessons from Colombia and South Africa for their regions](#)". ELLA Research Paper Series: Economic Development: Informality.

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