

Informality and Inclusive Growth

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ELLA

Evidence and lessons
from Latin America

PRACTICAL ACTION



For more information, see ella.practicalaction.org and click on “Informality”

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- **BACKGROUND**

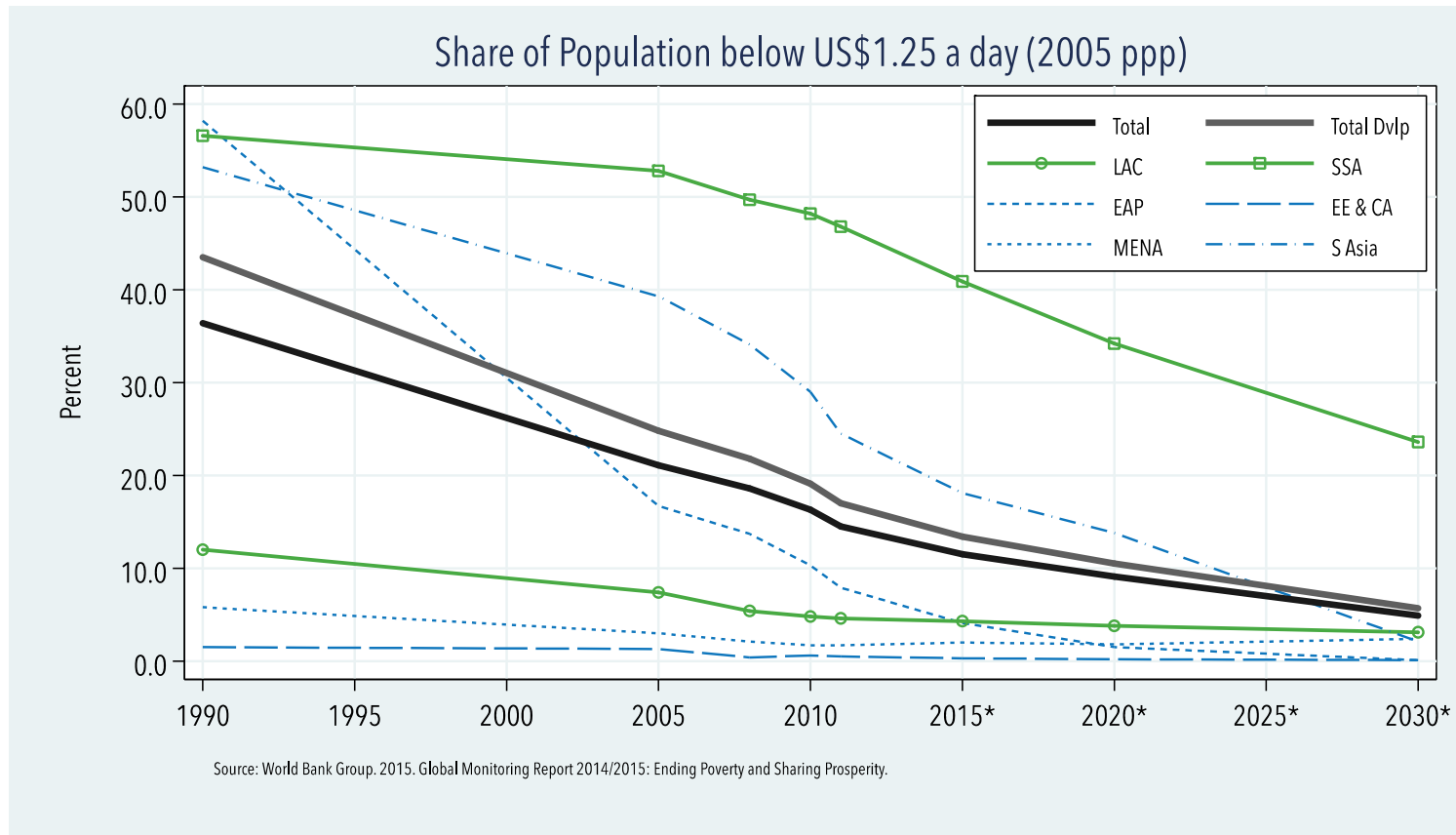
The ELLA Research
Justification
Why Colombia and South Africa?

The ELLA Research

- ELLA Phase II
 - Six research pairs
 - Economic development, governance and environmental management
- South-South learning
 - Focus on Africa and Latin America
 - ‘Multi-way’ learning
 - Emphasis on research uptake
- Various activities
 - Research
 - Online learning
 - Offline learning

Justification

- Globally, pressure on governments to engender inclusive patterns of economic growth



Justification

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 - Poverty rates have been slow to decline in SSA countries relative to global trend
- **Demographic trends demand rapid job creation in SSA**

Justification

- **Globally, pressure on governments to engender inclusive patterns of economic growth**
 - Poverty rates have been slow to decline in SSA countries relative to global trend
- **Demographic trends demand rapid job creation in SSA**
 - SSA economies have been unable to create enough jobs for their growing populations over the past 30 years
 - Next 40 years will see SSA working age population grow by average 21.5 million annually
 - Demographic dividend is only potential

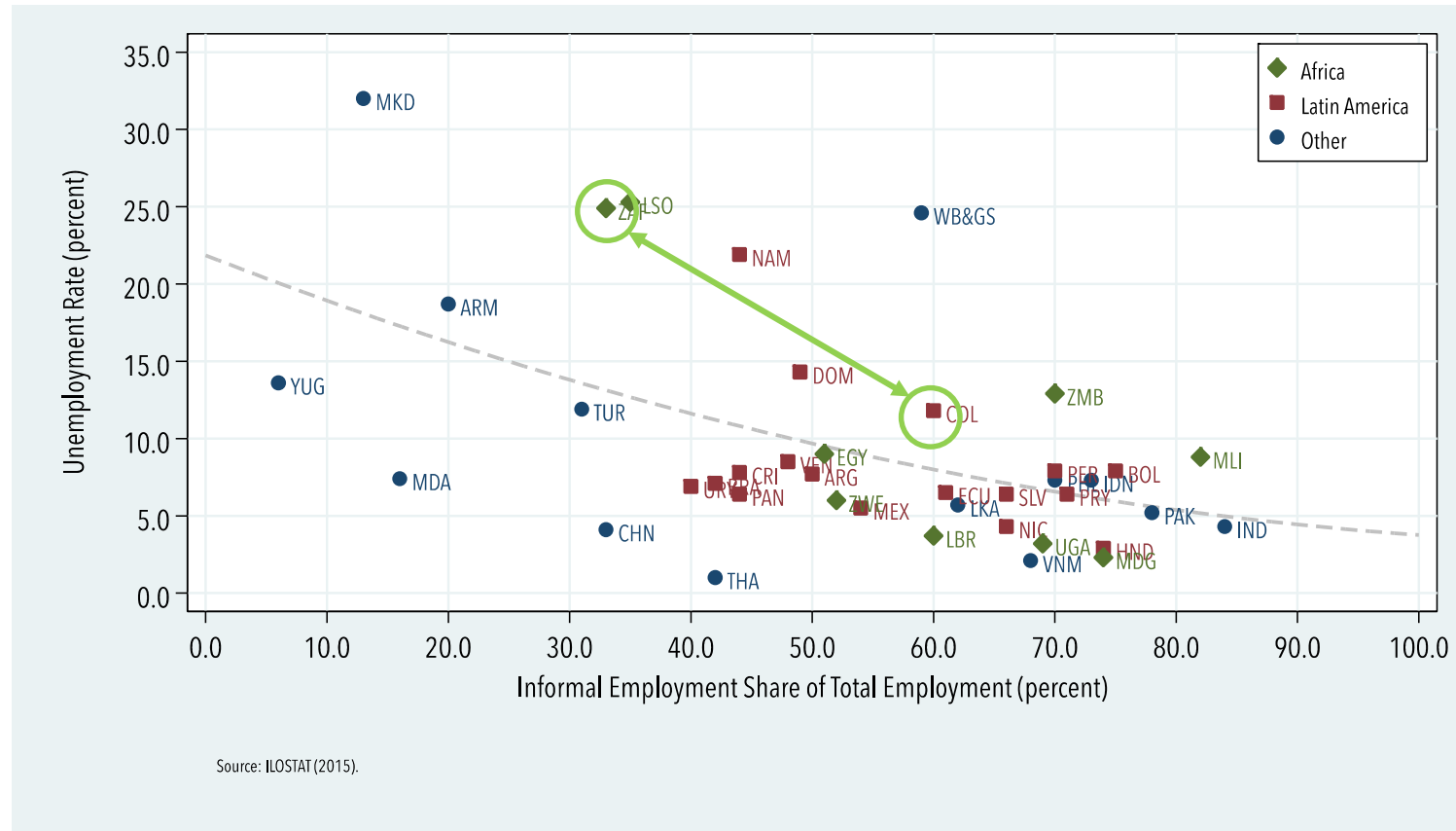
Why Colombia and South Africa?

- Actually quite similar in many respects

| | Colombia | South Africa | Year |
|---------------------------|-----------------------------|-----------------------------|------|
| Area | 1.0 million km ² | 1.2 million km ² | |
| Population | 48 million | 54 million | 2014 |
| Share in working ages | 68.5% | 65.4% | 2015 |
| GDP | US\$ 378 billion | US\$ 350 billion | 2014 |
| GDP per capita (PPP) | \$ 13 357 | \$ 13 046 | 2014 |
| Inequality (Gini) | 54.2 | 63.4 | 2011 |
| Urbanisation rate | 73.2% | 64.3% | 2014 |
| Pop in largest city | 9.6 million | 9.2 million | 2014 |
| Pop in 1 mil+ urban areas | 20.3% | 20.0% | 2014 |
| Natural resource rents | 10.3% of GDP | 9.2% of GDP | 2013 |
| Intentional homicides | 31.8 per 100 000 | 31.9 per 100 000 | 2013 |

Why Colombia and South Africa?

- But, a key difference...



Why Colombia and South Africa?

- **But, a key difference...**

| | Colombia | South Africa |
|-------------------|----------|--------------|
| Unemployment rate | 9% | 26% |
| Informality rate | 60% | 31% |

Why Colombia and South Africa?

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... leads (?) to differing views on informality

- In South Africa, informality viewed as an option to reduce unemployment
- In Colombia, informality viewed as a constraint on the growth of the formal sector



● THE CHALLENGE OF DEFINITIONS

Inclusive Growth
Informality

Defining Inclusive Growth

- Definitions used vary
- **Broadly understood** as economic growth with poverty reductions and equitable opportunities for all segments of the population
 - Lanchovichina & Lundstrom, 2009: Inclusive growth should “[raise] the pace of **growth** and [enlarge] the size of the economy, while **levelling the playing field** for investment and increasing **productive employment opportunities**”
 - AfDB, 2013: Inclusive growth is “economic growth that results in a **wider access to sustainable socio-economic opportunities** for a broader number of people, regions or countries, while **protecting the vulnerable**, all being done in an environment of **fairness, equal justice, and political plurality**”

Defining Inclusive Growth

- Definitions used vary
- **Broadly understood** as economic growth with poverty reductions and equitable opportunities for all segments of the population
- We look at:
 - GDP per capita
 - Income inequality
 - Unemployment levels
 - Quality of employment (incl. monetary and non-monetary benefits)

Defining Informality

- ‘Informal sector’, ‘informal employment’ and ‘informal economy’ are used in inconsistent ways
- Countries have a specific definition of these terms: lack of consensus limits comparability of cross-country data
- Broadly, informality can be measured by the informal sector or informal worker definition. Using ILO definitions:

| | Informal worker definition | Informal sector definition |
|--------------|----------------------------|----------------------------|
| Colombia | 60% | 53% |
| South Africa | 28% | 14% |

Defining Informality

- In Colombia, **both** the informal sector and the informal worker definitions are used alternatively

Informal sector includes: (1) individual employees and the workers who work in businesses or companies that employ at most five persons in all its branches; (2) unpaid family workers; (3) unpaid workers business or enterprises owned by other households; (4) domestic workers; (5) daily farmhand labour; (6) the self-employed working in establishments up to five people, excluding freelancers and other independent workers; and (7) employers or employees in businesses with five employees or less; however, government employees are excluded.

Informal employment includes all workers not contributing to pension and/or health benefits.

Defining Informality

- In Colombia, **both** the informal sector and the informal worker definitions are used alternatively
- South Africa uses a **hybrid definition** of informality

Informal sector includes employees working in establishments that employ fewer than five employees and do not deduct income tax from their wage/salary; and employers, own account workers and persons helping unpaid in their household business who are not registered for either income tax or VAT

Informal employment includes all persons in the informal sector; employees in the formal sector and persons employed in private households who are not entitled to basic benefits such as pensions or medical aid and who do not have a written contract of employment

Defining Informality

| Type of worker | South Africa | Colombia (sector) | Colombia (worker) |
|---|--|--|--|
| Employees | <ul style="list-style-type: none"> Firm size <5 AND Firm doesn't deduct income tax OR Not entitled to pension or medical aid AND no written contract | <ul style="list-style-type: none"> Firm size < 6 Government employees excl. Includes owner and/or partners | Not contributing to pension and/or health benefits |
| Self-employed | <ul style="list-style-type: none"> Not registered for VAT | <ul style="list-style-type: none"> Freelancers and other independent workers excl. | |
| Unpaid family workers | <ul style="list-style-type: none"> Automatically classified as informally employed | <ul style="list-style-type: none"> Automatically classified as informally employed | |
| Unpaid workers where business/enterprise is owned by other households | <ul style="list-style-type: none"> Unable to discern in the surveys | <ul style="list-style-type: none"> Automatically classified as informally employed | |
| Domestic workers | <ul style="list-style-type: none"> Only those who meet the employee definition | <ul style="list-style-type: none"> Automatically classified as informally employed | |
| Public workers/servants | <ul style="list-style-type: none"> Only those who meet the employee definition | <ul style="list-style-type: none"> Automatically excluded | |
| Daily farmhand labour | <ul style="list-style-type: none"> Only those who meet the employee definition | <ul style="list-style-type: none"> Automatically classified as informally employed | |

Defining Informality

- To see the impact differences in the definition of informality has on the size of informality, we applied each country definition to the other country's data

Defining Informality

| | South Africa (Total) % | South Africa (Urban only) % | Colombia (13 Urban Areas Only) % | Colombia (Urban Only) % | Colombia (Total) % |
|---|------------------------------|-----------------------------------|---|-------------------------------|--------------------------|
| 1. South Africa national definition (informal sector + social benefits definition) | 30.6 | 27.6 | 53.6 | 58.9 | 64.5 |
| 1.2. South African social benefits definition | 20.0 | 18.0 | 33.1 | 38.1 | 42.9 |
| 1.3. South African informal sector definition | 18.1 | 15.8 | 47 | 52.6 | 58.7 |
| 2. Colombia national definition (informal sector definition) | 26.7 | 24.4 | 48.0 | 53.5 | 59.9 |
| 2.1. Colombia health contribution definition | 70.0 | 67.6 | 43.4 | 50.9 | 58.1 |
| 2.2. Colombia pension contributions definition | 53.6 | 49.4 | 49.1 | 55.6 | 61.8 |
| 2.3. Colombia health and pension definition | 71.5 | 69.4 | 50.3 | 56.9 | 63.3 |

Source: Data for South Africa is from the Stats SA (2015), QLFS Q3 2015. Data for Colombia is from the Department of Statistics Gran Encuesta Integrada de Hogares, Q3 2015.

Defining Informality

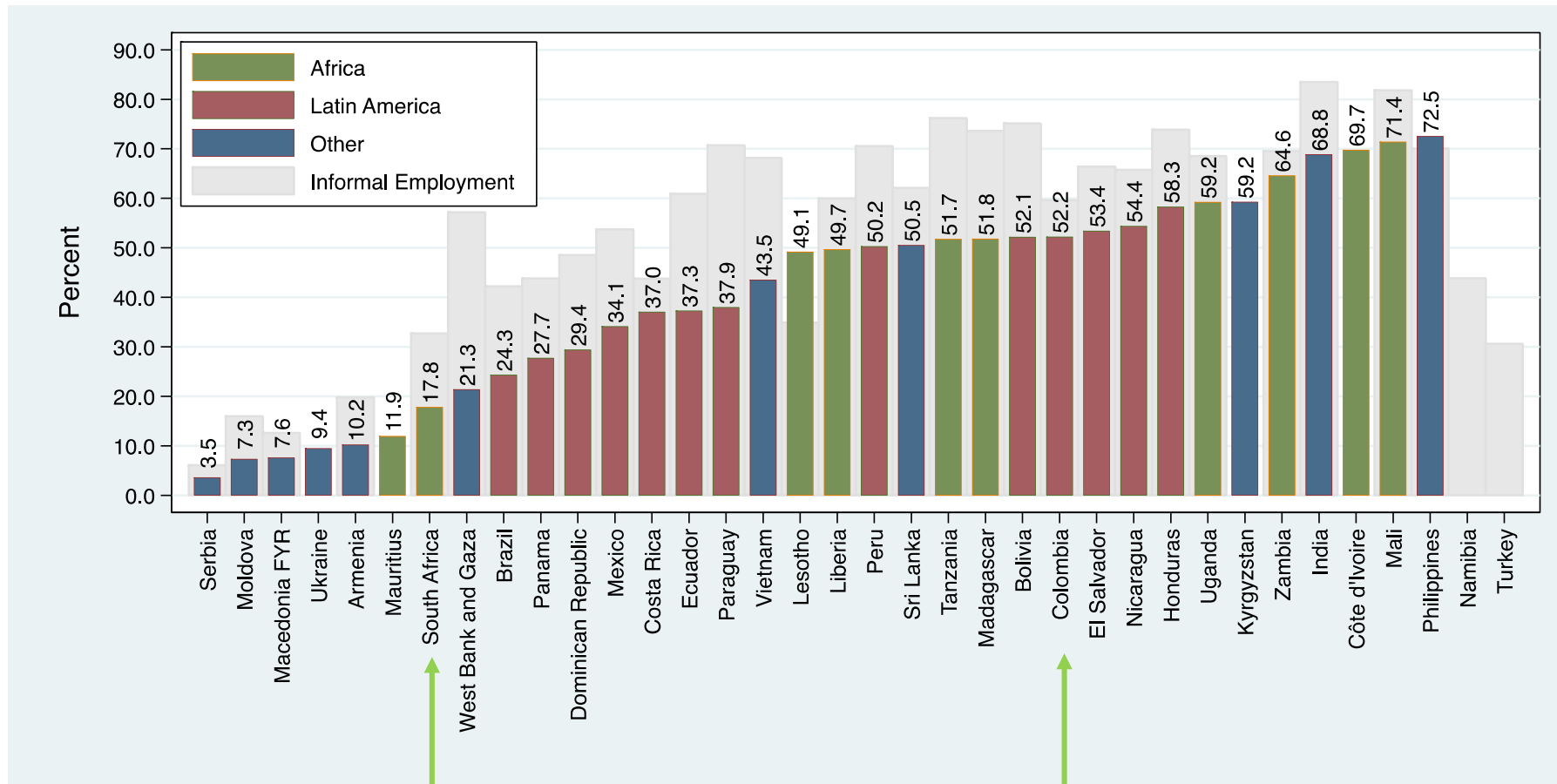
- Colombian definition **tends to lower the informality rate** compared to the SA definition
- Differences in informality between Colombia and SA are **larger** than they appear at first glance
- Overall, relatively high correlation between measures used to define informality

Defining Informality in Sub-Saharan Africa

| | Botswana | Lesotho | Namibia | Nigeria | Malawi | Rwanda | South Africa | Tanzania | Uganda | Zambia | Zimbabwe |
|----------------------------|----------|---------|---------|---------|--------|--------|--------------|----------|--------|--------|----------|
| Informal Sector | | | | | | | | | | | |
| Legal status | x | x | | | | | | x | | | |
| Registration | x | | x | x | x | x | x | | x | x | x |
| Accounts | x | x | | | | | | x | | | |
| Size | x | | x | | | | x | | | | |
| Perception | | | x | | | | | | | | |
| Household | | x | | | | | | x | x | | |
| Informal Employment | | | | | | | | | | | |
| Social security | | | x | | x | | | | x | x | |
| Paid leave | | | | | x | x | | | x | x | x |
| Sick leave | | | | | x | | | | x | | x |
| Pension | | | x | | x | x | x | | | | x |
| Medical aid | | | x | | x | x | x | | | | |
| Contract | | | | | | | x | | | | x |
| Maternity leave | | | | | | | | | | | x |
| Tax | | | | | x | | | | | | |

Defining Informality

Informal sector employment as share of non-agricultural employment (ILO 2015)





- **INFORMALITY AND INCLUSIVE GROWTH**

Hypotheses

Informality and Inclusive Growth

- So, what is the relationship between informality and inclusive growth?
- We consider two hypotheses:
 - Informality promotes inclusive growth by providing incomes to those who might otherwise be unemployed
 - Informality constrains inclusive growth by providing lower quality employment, eroding the tax base, increasing corruption and congesting public services without contributing to their funding.

Typology of Informality

- We theorized individuals are informally employed for three broad reasons:
 1. **Voluntary:** have a preferences for working in the informal labour market due to benefits of informality.
 2. **Subsistence:** don't have a preference for informality but they don't have the skills to produce in the formal labour market.
 3. **Induced:** don't have a preference for informality and productivity is comparable to formal workers but are prevented from entering due to barriers to formality.

Impact on Inclusive Growth

- 1. Voluntary:** Free-rider benefits make this beneficial at an individual level. Negative implications for IG at an aggregate level.
- 2. Subsistence:** Promotes IG provided benefits of informality outweigh benefits of unemployment (at least in SR).
- 3. Induced:** Constrains IG by preventing workers from obtaining the higher wages, benefits and work stability found in the formal labour market.

Impact on Inclusive Growth

- **Macroeconomic cost** of informality for all 3 types:
 - Lower productivity due to: size, financial market access, less training and technology adoption and lower probability of exporting.
 - Lower tax revenues
 - Corruption: informal entrepreneurs lose 10-15% of gross income to corruption, compared to 1% for formal entrepreneurs. (De Soto, 2000).
 - Unfair competition: firms report practices of informal firms as a major constraint on their functioning.

Identifying Types of Informality

- To reduce the problem of overlapping types of informality, we assume:
 1. Main characteristic identifying voluntary informality is **high preference for informality**, regardless of level of productivity.
 2. Main characteristic differentiating subsistence and induced informality is **level of productivity**.

Identifying Types of Informality

Preference for informality

Informality as the default option (surveys)

Transition between informality and formality

Counter-cyclical

Level of Productivity

High % informality in low-productivity groups

% workers earning wages < minimum hiring cost

Barriers to Formality

Implicit: Indicators of segregation

Explicit: High formal market barriers (international comparison)

Thank you

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