

# What are the policy implications of the informal sector becoming the informal economy?

**DRAFT – comments welcome!**

Concept paper prepared for IZA/WB Conference on Employment & Development  
Bonn, Germany, June 8 & 9, 2007

Dr. Miriam Altman, Executive Director, Employment, Growth & Development Initiative,  
Human Sciences Research Council, South Africa<sup>1</sup>

[maltman@hsrc.ac.za](mailto:maltman@hsrc.ac.za)

[www.hsrc.ac.za/egdi.phtml](http://www.hsrc.ac.za/egdi.phtml)

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## Abstract

To come

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<sup>1</sup> I would like to thank Rob Davies for his insightful comments. Usual caveats apply.

## 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 are 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.

## 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, off-shore 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 a 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 *underemployment*. 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).<sup>2</sup> 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 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

<sup>2</sup> Southern Africa includes South Africa, Mozambique, Botswana, Namibia, Swaziland and Lesotho.

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.

### ***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 60-70% of the labour force in low income South Asian economies, to 30 – 50% in middle income SE Asian countries, 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 phenomena 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. In other words, the informal and formal activities may grow in a complementary or inverse fashion depending on circumstances.

Complementary growth may be found where there are buyer-supplier relationships. In addition, the employment in the formal sector may be conducive to that in the informal, such as when intra-household transfer enables informal investments or where households with formal wage earners increase their purchases from informal enterprises.

An inverse relationship may be found where formal firms crowd out informal activity: an example might arise where large retailers crowd out informal retail if the former offers credit services or more convenient hours. Informal producers may be displaced in a context of appreciated currencies that cheapen the cost of imports that compete with their wares; or alternatively, informal retailers may benefit from these imports. On the other hand, rising open unemployment and/or a burgeoning informal economy may arise where formal firms or the public sector are not expanding fast relative to labour market supply. Some national contexts could include:

- rapid urban migration caused by push/pull factors such as diminished rural livelihood opportunities and large rural-urban wage gaps.
- economic growth and development that leads to rising capital intensity and industrial concentration that reduces the pace of formal employment growth. This is particularly found in resource-based exporting economies.
- public sector downsizing or restructuring
- an unsuccessful trade liberalisation that reduces formal employment opportunities.
- pro-cyclical fiscal policy that exacerbates the decline in formal activity during a downturn
- monetary policy that is insufficiently conducive to the sustained growth of new labour absorbing activity, for example where currencies are volatile and/or overvalued as often found in resource-based economies or those affected by portfolio flows.

Chen (2004) argues that these ‘schools of thought’ would be more useful if integrated. Alternatively, one might question whether these should be schools of thought at all and whether studying the ‘informal sector’ is a useful undertaking. A line of inquiry that analyses behaviour in specific business segments and value chains, the conditions in which they operate, and interrogates any interventions against the objectives of national industrial and development policy would be more supportive of effective policy-making.

## **Policy Implications**

The policy implications depend crucially on the aims of the intervention, the segment that is being considered, and beliefs in relation to the way they might respond to any intervention. Say the overall aim of economic policy is to promote economic growth in a way that promotes a good distribution of earnings through work. This would require as strong as possible investment in growing firms that support ‘good jobs’ (well paid, with benefits, etc) and economic growth. However, no economy generates employment for its labour force in these activities only, and so the environment needs to be enabling for the entry and expansion of other kinds of economic activities, such as lower productivity non-traded services. Informality generally refers to firms that work outside the regulatory and tax net of government. As noted, this is sometimes due to their difficulty in achieving any kind of scale or alternatively due to explicit avoidance.

- Where informal and formal firms are almost indistinguishable except for their business registration, Government may have the view that it is beneficial to close the regulatory net. This enables law and order as well as compliance with minimum standards and tax collection. It also reduces unfair competition that can further undermine the incentive to comply. Where it believed that firms are simply evading regulatory and tax rules, the solution is to ensure that the benefits from compliance outweigh the costs. Most important for these firms is having an environment where the costs are not too onerous – as found in a regime with appropriate and progressive tax systems and simple bureaucratic requirements. The incentive to avoid labour regulations may be reduced where there are basic minimum rules that apply to all employees wherever they work.
- Where informal firms are seen to be part of a spectrum, operating at different levels of sophistication and integration into value chains, policy can focus on:
  - supporting an environment that enables the accumulation of assets, skills and productivity for informal entrepreneurial firms whether or not that involves formalising. Chen (2004) notes that for many policy makers this means formalisation. She notes that many informal entrepreneurs might like to upgrade if they had the chance: but the benefits must outweigh the costs of formalisation: examples include, enforceable contracts, access to capital and insurance, tax breaks or cash incentives, membership of formal trade associations, and social protection for its workers.
  - enabling the crowding-in of linkages to higher productivity investments, whether through production or consumption linkages. This can range from more sophisticated capital equipment, to tomato growing, to the supply of personal services. For example, in resource-based developing economies with limited research and development, know-how can be developed through backward linkages into mining investments: this requires firms to actively promote local procurement. At one time, the copper industry had strong supplier networks in Zambia. This approach also explains a large part of South African industrialisation process. Some international restaurant chains and retailers such as MacDonalDs or Woolworths have been known to develop local supplier industries. However, enclave developments are more common and effort is required to incentivise and support these local linkages.
- These last two points focus on policy directly applicable to the firm. However, macroeconomic policy can have important effects on the kind of activity that is stimulated. For example, it is possible that a pro-cyclical fiscal policy may deepen economic down-turns which can have a particularly negative effect on labour intensive and small-medium sized formal firms that are more vulnerable to economic cycles. In those times, it is survivalist and lower paying activities that emerge as workers find some solution to being laid off. So, pro-cyclical policy may be conducive to survivalist activity, while counter-cyclical policy may be more conducive to the development of small and medium sized firms. Monetary policy must be sensitive to its employment implications, particularly not inducing premature capital intensity and de-industrialisation, nor introducing biases against new activities and small and medium size business. Negative real interest rates were one explanation for rapidly rising capital intensity in the 1970s and 1980s in South Africa.

### ***Factors contributing to the growth in ‘informal’ formal employment relations***

There is evidence of rising wage inequality globally. Rodrik (1997) explains this as being a result of greater global integration, where capital is mobile but labour is less so. This reduces the negotiating power of nations and of workers. It intensifies competition between firms and encourages strategies to reduce cost and mitigate risk.

This may also be caused by the changing composition of employment and industry globally. Palma (2006) shows how services employment is becoming a bigger share of employment and value added globally.

Rowthorn(1994) had shown how in high income economies, manufacturing employment rises as a proportion of total employment, but at a certain level of per capita income, begins to fall as a proportion of total employment: He found this point to be \$12,000 in 1991 dollars. Palma (2006) shows two additional characteristics to this turning point. First, for middle and high income economies, there has been a “declining level of manufacturing employment associated with each level of income per capita” between 1960 and 1998.

A number of factors may explain this. On the demand side, services tend to have a high income elasticity of demand so would grow with per capita incomes. On the supply side, the contracting out of services has in itself generated competitive markets in a range of activities that were previously handled administratively. Moreover, microelectronics and new technological capabilities have enabled new divisions of labour.

Second, Palma (2005) shows that, since 1980, there has been a large fall in the level of per capita income where this “turning point” occurs: “from \$ 20,645 in 1980, to just \$ 9,805 in 1990 (and \$8,691 in 1998; all figures in 1985 international US dollars)”. Palma refers to predictions made by Rowthorn & Wells (1987) who imagined this might happen as a result of technology diffusion, where “productivity catch-up is fastest in manufacturing”.

What is the relevance to this discussion? These sectors tend to have a higher wage inequality and a smaller mid-level wage earning class, relative to manufacturing. In particular, the top echelons tend to earn high and rising salaries, while the lower echelons experience stagnant or falling real wages. A large proportion of formal sector working poor are increasingly found in these industries.

Palma (2006) argues that a new distributional environment has emerged since 1976, which has weakened the bargaining power of labour. This has been a consequence of a growing mobility of capital relative to labour. By way of example, he reviews the experience in Mexico showing that real wages did not benefit from large improvements in productivity in its motor export industry. This has also been the case in South Africa, where real wages have trailed well behind productivity growth. The impact on wages in less traded sectors such as construction, personal or business services is more profoundly felt, where productivity growth will characteristically be slower. Real wages for Mexican workers fell dramatically in these sectors. Again there are parallels with South Africa, albeit less dramatic, due to a continuing commitment to corporatism in labour markets that is no longer found in Mexico.

## Policy Implications

Low earnings from work appear to be an emerging structural feature; underemployment and unemployment co-exist and are found globally; and the informal economy can not be seen as social security net.

The role of government in reducing poverty becomes more critical, even in low income economies with stronger traditional community support systems. This recognises that employment is a necessary but not sufficient condition for poverty reduction.

- Low waged workers in the formal economy are becoming less able in accessing rents. There is a role for minimum wages, standards and benefits. Unless labour markets become tighter, setting minimum floors, and enabling voice to more vulnerable workers, may be the only way to enable an improved distribution of between profits and wages.
- Minimum standards have to be chosen carefully to avoid possible trade-offs. Two come immediately to mind. The first is an employment-wage trade-off. The second trade-off might be possible encouragement to employers to displace regulated workers with unregulated ones. Although this question is generally handled ideologically, it is the subject of empirical investigation. In many countries, formal firms generally pay above the minimums set, and the rate simply acts as a floor to stop exploitation by some. There is also some evidence that informal rates can sometimes track formal ones: so a rise in the formal wage enables a similar rise in the informal.
- Depending on the level of development and sophistication in government systems, there may be role for the state in providing high quality socialised entitlements, in relation not only to health and education, but also industrial training, social security to mitigate risks and vulnerability such as maternity, disability, unemployment, death, retirement, etc. There are a myriad of experiments globally to locate ways of ensuring optimum social protection. For example, in SA, the government has set minimum wages for domestic workers and requires employers to register their domestic workers and jointly pay unemployment insurance: the result was a surprising degree of compliance both to the minimum rate set and to registration for unemployment insurance. The benefit of socialised entitlements over enterprise based ones, is that they are more supportive of a precarious livelihoods where workers may move from formal to informal to unemployment and back over relatively short periods of time.

## Evidence from South Africa

South Africa is unique at its level of development in having a very high rate of open unemployment, and such a small employment contribution by informal firms. Approximately 27% of the labour force was unemployed in 2005 by the strict definition. The South African economy is dominated by large sophisticated firms, and those working in informal firms accounted for about 14% of total employment or 21% if domestic workers were included. A large proportion of the workforce could be defined as 'working poor'. In 2004, about 65% of workers were working poor, where their earnings enabled each household member to live on \$2 per day or less in the context of a middle income economy.

## *Economic activity & participation*

The unemployment problem in South Africa has been expanding since the 1970s, mostly induced by historical policies. Apartheid policies were specifically aimed to separate the races. The black population were shunted away in 'homelands' and 'townships' far away from the centre of economic activity. For long periods of time, industrial policy promoted highly capital intensive investments to enable independence from international energy and chemical imports, and capital intensity in many other industries to reduce the reliance on black labour. The objective was to ultimately have separate economies with the central industrial base and urban areas relying on white higher skill labour and remote areas relying on lower skill black labour. This was complemented by a suite of complementary racial policies that controlled population movement, blocked entry to most semi-skilled and skilled occupations, maintained segregated schooling systems with the approach that the black population needed no more than some high school education to fulfil their intended economic role, strong urban controls on economic activity, lack of access to asset ownership, and very forceful legal barriers to entry for black entrepreneurs. These policies were most forcefully introduced from 1948, and their loosening began in the mid-1980s, finally being eliminated in 1994. Their effects persist. The legacy is one of weak human capital development, a thin entrepreneurial and artisan base, and long distances between where people live and centres of economic activity in the absence of adequate public transport. The weakness of networks in respect of growth opportunities for the black population is an important outcome. Weak networks and low levels of capital accumulation makes the identification of and access to business opportunities difficult. There is a high cost and uncertainty associated with job search and working, possibly raising reservation wages (see Altman, 2006 for discussion on these policies).

Over this period, a number of structural changes also occurred. Some were typical of minerals economies more generally. With few exceptions, minerals exporting economies that successfully industrialised have tended to invest directly in highly capital intensive industries, by-passing a phase of labour intensive export growth: this is made possible by the large surpluses generated from resource extraction. Developing economies without high value resources initially rely on low cost labour to for competitive advantage in export industries since they do not have other sources of foreign exchange. Minerals economies tend to have higher rates of inequality and unemployment, higher rates of capital intensity, higher rates of inflation, slower rates of GDP growth (Auty 1993, 1994, 1994a, Ostensson and Uwizeye-Mapendano, 2000) While this is sometimes called a 'resource curse' or 'dutch disease', the problem is mostly policy induced. Countries such as Indonesia or Malaysia successfully overcame these biases by making a conscious effort to promote labour absorbing export industries (see Altman, 2006, Berry, 2006, Palma, 2005).

Until the 1980s, low skill labour was absorbed in resource-based industries such as mining and agriculture. Between 1970 and 1993, agricultural employment shrank considerably – by 1.2 million jobs, as did the mining sector by about 200,000 jobs. The shift out of resources was not met by a concomitant industrial expansion. Manufacturing generated only 430,000 new jobs, or about 17,000 jobs annually. Manufacturing investment was directed towards capital intensive resource based and defence industry projects. Instead, services industries have been the main source of growth and employment – for both high and low skill jobs. These sectors mainly accommodated "Whites" and "Coloureds", explaining why their unemployment rates remained so low<sup>3</sup>.

The period from 1997 to 2005 was the first experience of positive net employment growth since the 1970s. Over that period, approximately 3 million net new jobs were created.

The private formal non-agricultural sector has been the main source of employment growth since 1997, generating about 2 million jobs (or two-thirds of the total). The majority of new formal jobs were created in finance, insurance and IT related industries, retail and wholesale, and

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<sup>3</sup> Apartheid legislation designated the main race groups as: 'White', 'Asian', 'Coloured', and 'African'.

community and social services. To a lesser extent, manufacturing employment grew, but only by about 0.9% per annum.

These industrial shifts help to explain employment growth and a fairly stable ratio of low to high skilled labour in the economy over the 1990s and 2000s. While the tradables sector (including resources, manufacturing and skill-intensive services) largely became more capital intensive, the more labour-intensive non-traded sectors expanded more rapidly. This represents a large transition, over a 20-year period, from resource-based to service industry employment.

According to the national statistics, the numbers employed in informal firms has grown quite substantially since the mid 1990s, off a very small base. Between 1997 and 2005, about 1.1 million jobs were created in the informal sector.<sup>4</sup> To some unknown extent, this growth may simply reflect the improvement of household statistics: a number of earlier area case studies show that, at least in peri-urban townships near Johannesburg and Durban, perhaps 30% to 50% of households were engaged in some informal economic activity in the 1970s and 1980s (Valodia & Devey, 2007). The dynamics underpinning the growth of the informal economy are poorly understood. It most likely grew during the 1990s as a result of a variety of liberalisations, and reduced policing – where trading by black business was actually illegal in “white” areas previously. We do not know to what extent this form of employment is part of a “virtuous circle” – feeding off growth in the rest of the economy, or alternatively part of a “vicious circle” – acting as survival strategies for the growing pool of unemployed.

There is little certainty as to why the unemployment rate is so high and persistent and the informal sector so small. Amongst the possible explanations, I will put forward three: first, there are barriers to entry and accumulation already described, associated with the Apartheid legacy as well as current day problems like high crime rates in urban townships. Second, SA has a highly capital intensive structure of production and services, that penetrate deep into all markets. Most informal activity depends somehow on it, particularly in its sourcing of inputs (Valodia et al, 2007). Within given consumer demand, consumers may prefer to buy from formal firms with known brands and credit facilities, than from less reliable and more costly informal sellers. Informal sellers tend to do well when they have a specific niche, like being able to sell small quantities that, while more expensive (per unit) can be purchased on a daily basis when money is available. This might explain the why there are so few informal firms. It may also explain unemployment, since labour productivity is higher in formal companies. These are two structural explanations. Third, it must be asked whether unemployment is completely structural or whether also demand deficient. If so, this would have additional policy implications requiring some new demand stimulant. In SA, demand deficient unemployment could have arisen as a result of extremely low incomes and assets amongst the majority of the population in the context of a middle income economy. Additionally, for many years the state pulled back its spending on infrastructure and public employment. Policies have been implemented to have some impact on demand, with recent large commitments to infrastructure spending, the expansion of social grants, or the setting of minimum wages across a large number of industries.

In addition to the Apartheid legacy, the proportion of informal employment may partly be so low due to high levels of regulatory compliance by formal firms. Comparatively speaking, South Africa has rule of law and high and rising tax compliance. Since the mid-1990s, the SA Revenue Service and tax system underwent major reform which has resulted in substantial increases in tax revenues. Some of these changes included improvement to bureaucratic processes, closing loopholes, lowering of corporate tax rates, making the tax system more progressive, offering alternative forms of business or tax registration for very small activities. Well-enforced urban regulations and a continued policy of urban orderliness make formal activity easier than informal. It will also be shown that earnings amongst informal firms tends to be less than half that in formal firms for a given level of educational attainment and experience, especially for those with more than a high school education. So, it is doubtful that the “legalistic” explanation for informal firms holds much weight in the South African context. Other countries could potentially

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<sup>4</sup> This includes the usual definition of informal sector, domestic work, and unpaid labour, but excludes subsistence agriculture.

learn from how this regulatory system was overhauled to reduce evasion by firms that could otherwise comply.

### ***Informal economy and the working poor***

In South African policy, there is a jargon currently used that refers to the ‘second economy’. The president introduced this in his 2004 state of the nation address, with the intention of mobilising more Government effort to meet the needs of the poor. The ‘second economy’ is often treated synonymously with the ‘informal sector’. Formal sector workers are seen to be relatively well off. A central guiding policy document (Accelerated and Shared Growth Initiative for South Africa or Asgisa on <http://www.info.gov.za/asgisa/>) seeks to ‘eliminate the second economy’ along the lines of the ‘dualist school’ thinking. The aim is to enlarge the ‘first economy’ and improve access to its opportunities by marginalised people. But at the same time, providing a “ladder up” is often interpreted to involve support to informal and community based activities to enable them to develop, along the lines of the ‘structuralist school’.

Instead of focusing on informal firms, the character of low paid work is the subject of analysis to understand the different ways that households assemble a livelihood<sup>5</sup>. This recognises the point made by Hart (1973) and which is still relevant, that low paid workers will often have multiple and rapidly changing sources of income. His idea of informality related more to precariousness than to any particular form of registration or specific type of activity. We have been exploring whether the traditional boundaries of formal versus informal are useful in understanding low earners in the labour force. For example, from a livelihoods perspective, is business registration the defining characteristic or is access to medical aid or pensions more important? Are the characteristics of informal earners and ‘peripheral’ formal sector workers similar? Do informal and formal workers move between these sectors? (See Altman, 2006; Valodia et al, 2005)

The ‘working poor’ refers to anyone who is ‘employed’ by the definition of the South African Labour Force Survey (using the official ILO definition), working in the formal or informal sector, earning less than R2,500 per month (approximately €382). The intention was not to say that workers earning more than that are the ‘working rich’. Rather, this was close to the threshold set by the National Treasury as the minimum level below which workers are exempt from income tax<sup>6</sup>. By chance, it also happens to be very close to the MDG poverty line of \$2 per person per day. Having chosen this ceiling, we found that 65% of all working people earned less than this amount. Workers earning less than R1,000 per month (equivalent to about \$1/per person per day) were also reviewed: they account for about 39% of working people.

Of those who earn less than R2,500 per month, 83% are African and 12% are Coloured. This accounts for three-quarters of all African workers and 60% of Coloured workers.

As noted, it is sometimes assumed that the majority of poor workers are found in informal firms. In fact, most work in formal companies. Table 2 presents the distribution of low wage earners by whether they earn less than R2,500 or R1,000. It shows that 58.7% of those who earn less than R2,500 per month work in formal companies.

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<sup>5</sup> “We” refers to a collaborative project between the Employment, Growth & Development Initiative at the Human Sciences Research Council, and the School of Development Studies at the University of KwaZulu-Natal.

<sup>6</sup> The LFS offers income bands. We chose the band that was closest to the Treasury’s threshold of R 32,000 per annum in 2004.

**Table 2 – Type of low waged employment (%)**

<b>Sector</b>	<b>≤ R1,000</b>	<b>≤ R2,500</b>
Formal	25.9	47.2
Comm agric	16.5	11.5
Subsist agric	8.5	5.2
Informal	28.9	22.0
Domestic	19.9	13.6
Unspecified	0.3	0.4
Not eco active	0.1	0.1
Total	100.0	100.0

*Source: Valodia, et al (2005), calculated from StatsSA: March LFS 2004*

**Table 3 – The distribution of formal sector earnings by sector**

<b>Sector</b>	<b>Wages earned per month</b>		
	<b>1-1000</b>	<b>1000 – 2500</b>	<b>2500 +</b>
Agriculture, hunting, forestry and fishing	85.2%	4.7%	10.1%
Community, social and personal services	20.4%	10.7%	68.9%
Construction	58.0%	22.2%	19.8%
Financial intermediation, insurance, real estate and business	30.0%	15.5%	54.5%
Manufacturing	38.0%	23.6%	38.3%
Mining and quarrying	10.1%	32.6%	57.4%
Private households	95.7%	3.4%	0.9%
Transport, storage and communication	28.3%	16.7%	55.1%
Wholesale and retail trade	56.0%	17.3%	26.7%

*Source: LFS, Sept 2004*

Table 3 shows that those earning below R 2,500 are quite evenly spread across the economy. However, there are certain sectors that tend to be particularly poorly remunerated such as construction and retail. Although manufacturing and finance are seen as high skill and well paid sectors, some would be surprised that almost one third of workers live on less than \$1 per day. Almost all participants in any form of agriculture or informal activity (subsistence agriculture, domestic work, and other unregistered activities such as trading) are working poor.

A miniscule proportion of low earners are found in the public sector despite accounting for about 13% of total employment. This is partly due to its composition, relying on a large number of professionals in the bureaucracy, health and education sectors. However, the public sector has played a particular role in underpinning equity in the labour market, as a matter of explicit Government policy. The main result is that low-skill workers earn relatively more in the public sector (Woolard 2002). The vast majority of low earners are therefore found in the private sector.

It is not surprising that the vast majority of agricultural, domestic and elementary occupations are dominated by very low earners. But Table 4 shows that the majority of machine operators and craft related occupations also earn less than R2,500 per month. Manufacturing workers would normally be seen as an elite in the working class: while they do earn relatively more than their service sector counterparts, the majority are nevertheless earning very little. It is surprising that low earners are found in almost equal proportion in service & shop work, craft & related occupations, plant and machine operation and domestic work.

**Table 4 – Distribution of low earners by occupation, formal and informal, 2004 (%)**

Occupation	% of earners ≤ R 2,500	≤ R2,500 as a % of all workers in that occupational category
Management	1.6	13.4
Professionals	0.4	5.7
Technical	3.4	20.8
Clerks	5.9	35.0
Service and shop workers	12.5	64.8
Skilled agriculture /fishery	4.4	87.7
Craft & related occupations	13.1	65.2
Plant & machine operators	11.5	69.4
Elementary occupations	33.7	89.6
Domestic workers	13.6	98.2
	100.0	

*Source: calculated from Valodia, et al(2005)., calculated from StatsSA: March LFS 2004*

*Notes: elementary workers refer to occupations such as office cleaning, serving tea, etc.*

It is well known that the SA economy is characterised by extreme unemployment amongst low-skill workers, and a shortage of skilled workers and professionals. In such a context, one would expect to find a widening gap in earnings between high- and low-skill workers. This would involve falling real wages amongst low-skill workers and rising earning for higher-skill labour. This is precisely what we have found in our study on wage inequality (Woolard & Woolard 2005). This is consistent with the path of industrial development, which has increasingly leaned to outsourcing, and the real expansion of services, and the informal sector.

Woolard and Woolard (2005) found a substantial wage gap between small and large firms, of between 10% and 40%, depending on skill level. The fall in wages of African low-skill workers was found mainly in small private sector firms, probably the result of the growing services economy and contracting out.

The different quality of work in the formal and informal sectors is made evident below. Informal sector workers earn between 1/5 to almost 1/2 of their counterparts in the formal sector. Mean monthly incomes in 2002 are presented in Table 5. Figure 1 shows us relative earnings in the formal and informal sectors for those with the same educational attainment. Formal sector workers generally earn more than informal ones. The gap becomes more pronounced, the more

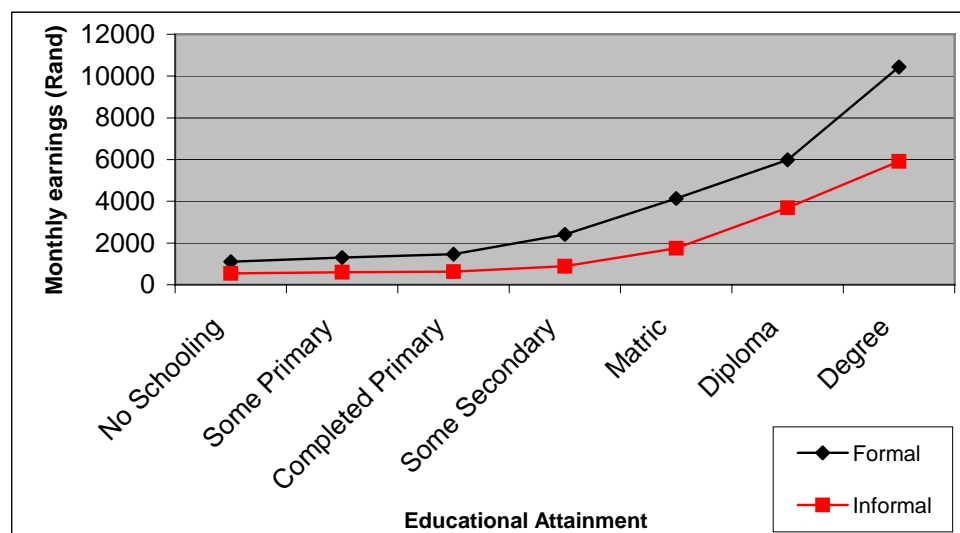
education a person has. Therefore the returns to education, for the household and society, are much lower in the informal sector.

**Table 5 – Mean monthly incomes, 2002**

	Rand		As % of formal urban African male earnings	
	Men	Women	Men	Women
White workers				
Formal (urban)	9,328	6,150	318%	210%
African workers				
Formal (urban)	2,931	3,092	100%	105%
Informal (urban)	1,055	655	36%	22%
Informal (non-urban)	723	436	25%	15%
Domestic (urban)	524	544	18%	19%
Domestic (non-urban)	410	399	14%	14%
Agricultural (formal)	698	497	24%	17%
Agricultural (informal)	480	424	16%	14%

Source: Altman 2004, calculated from Stats SA: Sept LFS 2002

**Figure 1 – Earnings in the formal and informal sector, by level of education (2002)**



Source: Altman 2004, calculated from Stats SA, Sept LFS 2002

## ***Regulation and informality***

Many observers of the South African labour market reflect on its 'inflexibility'. This is usually meant to refer to difficulty firms might have in firing labour, thereby making them more reluctant to hire. If so, falling or stagnant real wages would require explanation, since they are a strong sign of weak contracts, labour turnover and weak bargaining power of labour.

The labour regulation regime since 1996 was introduced to settle the industrial relations environment, underpin the democratic right to organize, and ensure basic minimum standards for vulnerable workers. Through a process of negotiation and dialogue, it was accepted that the Apartheid labour standards and norms needed to be overhauled to reflect the expectations in the emerging democratic dispensation. Historically, a large portion of the workforce were employed through a migrant labour system that offered substantial flexibility to the mines, in particular. Wage flexibility was further built into the labour market system, with different wage setting systems by geographic region, be they urban South Africa, outside of the urban areas of South Africa or in the 'homelands'. A hierarchy of wages could be paid depending on the distance from an urban area. This offered industrialists a 'world in a country' and so many companies developed organisational hierarchies to take advantage of these differential rates (Altman, 1997).

There are a number of essential pieces of legislation governing this environment, namely the Labour Relations Act that regulates organized bargaining, the Basic Conditions of Employment Act that underpins minimum standards for all employees. The state also sets minimum wages for vulnerable groups. The sector minimum wage determinations already covered contract cleaning, wholesale & retail, private security and clothing workers, but was then extended to domestic and agricultural workers in 2002 (Benjamin 2006). Very little is known about the actual impact of this legislation on low skill workers (see Altman 2006a).

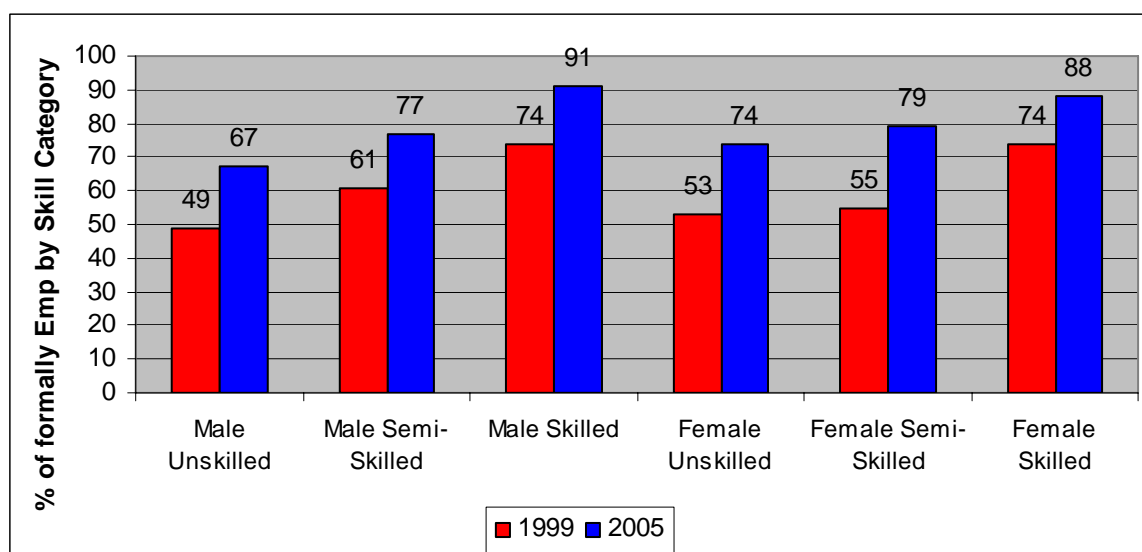
### **Written contracts**

Stagnant or falling real wages might indicate that employment contracts are weak. Evidence of growing casualisation has emerged in sector and case studies (see Valodia & Devey 2005). Figure 2 shows the proportion of workers in the formal sector who say they have a contract. Although this is a short period of time over which to measure change, it appears that an increasing proportion of workers are covered by contracts at work – with 62% of workers having written contracts in 1999 as compared to 82% in 2005. Figure 2 shows that this growth was particularly marked for the lower skill categories. This change directly coincides with amendments to the Basic Conditions of Employment Act in 1998 that required employers to have written contracts with employees<sup>7</sup>. Approximately three-quarters of formal workers say they have full-time contracts. Only 20% of the formal workforce has temporary or casual contracts.

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<sup>7</sup> More specifically, in November 1998 the BCEA was amended to require an employer to give an employee who was in employment the written particulars of employment required by Section 29 to be enforced within six months of the date on which the Act comes into effect. This was promulgated in terms of the Basic Conditions of Employment Act, No. 75 of 1997, under Government Notice No. R 1438 of 1998 in Government Gazette No. 19453 of 13 November 1998.

**Figure 2 – Formal sector workers with written contract by skill category (%)**



*Source: calculated from Stats SA, OHS 1999, LFS Sept 2005*

## Job Security

Although more people seem to be covered by contracts, the attachment to the workplace is tenuous. Valodia et al (2005) use the panel data in the Labour Force Survey to track job status over time<sup>8</sup>. They show that 53.7% of workers changed their job status at least once over the period from September 2001 to March 2004. Of all workers that started in the formal sector in September 2001, only 28% were still there by March 2004. Of those starting in the informal sector, only 15.8% remained, mostly shifting to unemployment.

There is other evidence of precarious work. Cichello, Fields and Leibbrandt (2003) revealed similar findings in their comparison of the 1993 and 1998 KwaZulu-Natal Incomes Dynamics Survey (KIDS) panel data in KwaZulu-Natal. They found that there was a general shift away from formal toward informal work. Those that managed to stay in skilled formal sector jobs experienced rising incomes. However, those that started in the formal sector in 1993 experienced a 2.6% fall in earnings.

The shift in earnings was in part influenced by movement between employment states, whether formal, informal or unemployed. Indeed Cichello et al. (2002) found that the initial employment status and the transition between employment status had a far greater impact on earnings changes

<sup>8</sup> Valodia et al (2005) managed to match 5,587 individuals over the period from September 2001 to March 2004, from a total sample of 20,000 households. Imraan Valodia has explained the following: “The LFS is run twice a year, in March and in September. The sampling design allows for 80% of the sampling in each wave to remain in the sample”.

“The panel is constructed along in the following manner: we used the unique household number to identify the households that remained in the panel. We then extracted the workers in that household. We applied two filters to determine whether we had the correct workers in the household – the worker’s sex and age. To remain in the sample the worker had to be the same sex and within 3 years of the age reported in the previous LFS (on the grounds that age may not be reported accurately).

Unfortunately the attrition rate on the panel is very high. We were getting less than half the number of workers that we should. This does raise questions about the reliability of the findings”.

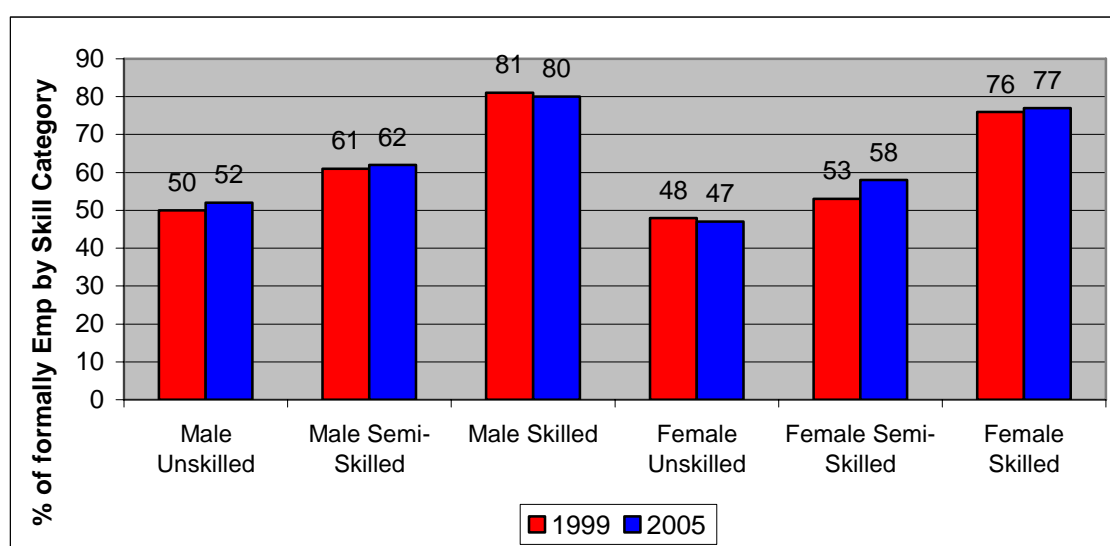
than did other demographic characteristics such as gender, education, or geographic location. Of course, initial status is impacted greatly by demographic characteristics.

## Social Protection

Figure 3 offer further representation of formal sector work conditions – essentially giving a sense of the strength of contracts and the extent to which workers are covered by private benefits.

The expansion in contracts for unskilled and semi-skilled workers did not necessarily translate into benefits – possibly indicating that while more workers have contracts (or are aware that they have contracts), they are not necessarily of a very binding or long-term nature. The number of workers covered by private pension plans hardly changed from its coverage of between 62% to 66% of the formal workforce, over the period from 1999 – 2005.<sup>9</sup> Other sorts of measures also indicate weak access to benefits that would normally be associated with formal sector jobs. For example, a large majority say they have not had any training that would help them at work.

**Figure 3 – Formal sector workers with pension plan by skill category (%)**



*Source: calculated from Stats SA, OHS 1999, LFS Sept 2005*

## Policy Implications

The concern with informality is to understand precariousness and uncertainty in the ability of households to assemble a livelihood, and accumulate sufficiently to enable them to maintain some stability. The link between work and well-being in South Africa seems tenuous. Firstly, at least a quarter of the workforce are unemployed. Second, about 2/3 of those employed are ‘working poor’, enabling household members to live on \$2 per day or less: this statistic is quite unusual for a middle income economy with attendant costs of living. Only a small proportion of employment is found in informal firms, and there earnings are half or less that found in the formal sector. However, informal firms are not the main location of low earners. More than half

<sup>9</sup> It is worth noting that the formal sector figures include both private and public sectors. In 2005, 90% of public sector workers had a contract and pension. So the figure for the private sector alone would be significantly lower.

of the working poor are found in formal companies. These jobs are also very precarious: despite a high coverage with written contracts, there is a high labour turnover, with workers shifting between formal, informal, unemployment and back on a continuous basis.

The policy implications for reducing barriers to entry and to asset accumulation for entrepreneurs is quite straightforward: any policy that improves access to public transport, business finance and insurance, public safety, training, and helps build beneficial social networks would no doubt have some impact. In addition, there is growing recognition that formal firms can play a role in making available opportunity through procurement of goods and services to small firms. A less obvious question arises in assessing whether this will be enough: is unemployment high as a result of structural barriers, or due to demand deficiency? The latter may arise simply due to high rates of poverty.

A very large proportion of households live precariously, although the South African economy is dominated a large and sophisticated formal sector. It appears that the political history plays some part in this. But so does the emerging industrial structure, where most employment is being generated in services industries with high wage inequality and relatively unstable employment opportunities. This latter feature seems to be taking place in many countries.

It is extremely difficult for poor households to accumulate assets, whether human or financial, to help them weather crises. Historically, South Africa's social security and post-school industrial training system was relatively private sector driven (Standing et al 1996). Work-linked benefits become less relevant in an economy that is increasingly dominated by precarious low wage services jobs.

The role of the state becomes more important, particularly where structural factors keep wages low. There are two central ways to improve their security:

The one is to improve earnings in some way. To this end, the South African government has introduced minimum wage setting in the most vulnerable sectors to improve the distribution between wages and profits in sectors where bargaining power is weak. This simply sets a minimum acceptable floor and is determined with affordability in mind (insofar as that is knowable by the state). It has also deepened social grants aimed at vulnerable groups, particularly young children, elderly and disabled: between 1993 and 2004, the grants directed to African households doubled.

The other approach involves reducing the reliance on money wages, and increasing the reliance on a 'social wage'. This involves any policy where the state ensures delivery of quality goods and services that lift some financial burden: the obvious examples include health and education services, including the cost of associated inputs like travel to school, school uniforms, books or medicines. Government has introduced a payroll tax that accrues to a central training fund, which is meant to re-directed to industrial training and training for the unemployed. Insurance or assistance against disaster is another: for example theft is very common in urban areas and seen to be one of the major barriers to developing a small business. Precariousness in a highly unequal society is particularly a problem in the context of the spread of HIV/AIDS and TB, especially felt in Sub-Saharan Africa. In South Africa, the average HIV infection rate is 13%, but prevalence amongst young labour market entrants is quite extraordinary, particularly amongst women. Approximately 33% of all women between the ages 25-29 have contracted HIV. One quarter of those aged 30-34 have are HIV positive (Shisana et al. 2005). This will clearly impact on the precariousness of livelihoods. Government has adopted a policy to distribute ARVs. However, only 200,000 of the eligible one million receive ARVs, partly due to slow delivery in the public sector. The private health sector is primarily accessed through medical insurance schemes, and only 15% of all South Africans and 7% of Africans are members of such schemes. Healthcare accounts for approximately 9% of GDP: but approximately 60% of this expenditure goes to the 15% on medical insurance (Marais 2006). Health care reform is a complex question, not being broached here. But it is clear that access to ARVs and HIV-related services will be essential in managing the impact of the disease on individuals, household poverty and the labour market. Funeral and life insurance for low income families can be an important contribution where funerals are common and costly, especially if it involves the loss of a breadwinner.

Workplace linked entitlements are still the most successful way of reaching people with quality services: but large parts of the workforce are no longer tied into lengthy employment relationships. Social security and insurance must be designed with two points in mind: first, it should reach workers who do not normally have access to workplace benefits. Second, it should help facilitate workplace transitions rather than hinder it. Benjamin (2006:52) argues that employment insurance should “allow persons to draw on accumulated rights at times of transition or insecurity...” While he specifically refers to unemployment insurance, such points equally refer to medical, pension and access to training. The National Treasury is considering retirement fund reform, proposing a contributory National Savings Fund that would be accessible to those that are not permanently or formally employed (Benjamin 2006)

## Conclusion

Studies on the ‘informal sector’ are sometimes criticised for being confused, in that they don’t clearly define what the informal sector is. The original conceptualisation did not see these activities as a sector at all, even though that term was used (according to Keith Hart, for reasons of appealing to economists who did not take Geertz seriously). The idea was to focus on activities that had less form and structure, that operated away from bureaucratic controls, and which were likely to be more precarious and not so stable. But the activity could refer to anything from pirated software to street-side shoe-shining to insecure work in a factory. In his early work, Hart was concerned with the ways people assemble a livelihood.

For poor people, informality really means precariousness, and many people are unable to accumulate as their lives move from one crisis to the other, without benefit of the security that can be associated with formality. This can range from stock theft, to changes in input prices, to illness, that can completely eliminate current earnings, etc. It can also be linked to present or possible episodes of unemployment.

The policy research question is so often posed to ask ‘what can be done about the informal sector’. But this isn’t a very nuanced question, because there is no sector. The purpose of any policy first needs to be identified. Is it meant to deal with lawlessness and tax evasion? Or is it concerned with improving small business stability? Or with expanding economic participation of marginalised work-seekers? Or intensifying domestic business linkages? Or with ensuring that some minimum floor is set for vulnerable workers in respect of wages, work conditions or separation norms to regularise their incomes? Or with reducing economic uncertainty in poor people’s lives?

It is to be expected that the proportion of people working in informal firms will fall with rising per capita incomes. The variations between countries with similar levels of development are mostly explained by incentives in the regulatory environment which encourage evasion. However, it is not clear that *informality* necessarily diminishes. Instead, informality for formal workers may become a more important source of precariousness.

Some policies are aimed directly at the specific issue, be it reducing barriers to entry and asset accumulation for small firms, or raising wages and work conditions for vulnerable workers. However, the overarching environment in which informal activity takes place must also be understood, or micro economic interventions will have less impact. There are structural features over which the state can play some, but perhaps only a limited role: for example, the global trend for services to become a proportionately larger share of employment (and manufacturing to have a smaller share) at ever lower levels of per capita income. Higher wage inequality and job insecurity may be natural bedfellows, particularly where capital is increasingly mobile. The state becomes more important in mediating the effects of this structural change: through industrial policy, macroeconomic policy and social protection policies. High unemployment rates cause

high levels of insecurity: the state can generate employment directly, or subsidise employment through social protection measures or incentives. There are also macro-economic interventions related to raising demand for certain types of goods and services, such as infrastructure investment, exchange rate management, etc, or to smoothing business cycles with counter-cyclical fiscal policy that is more supportive of long term accumulation by small and medium sized firms.

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