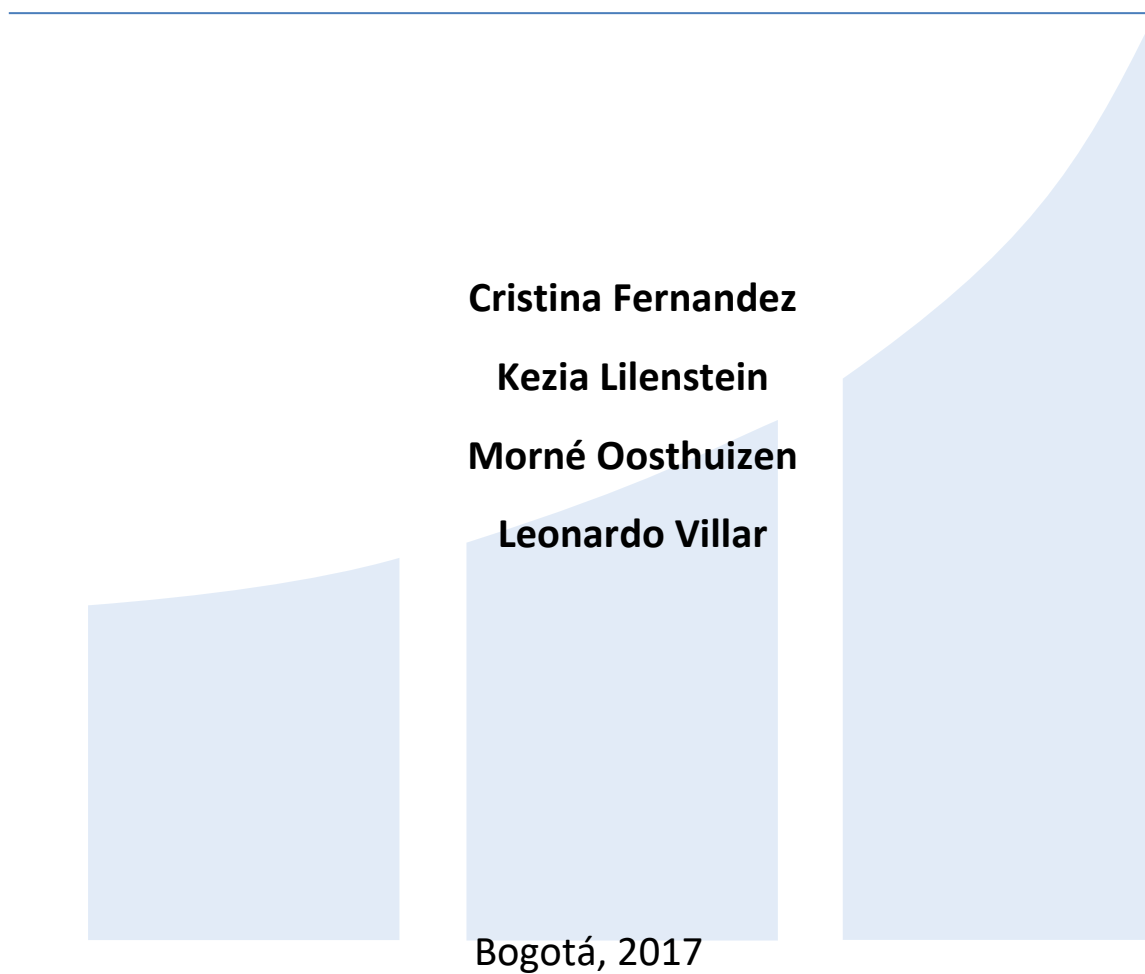


**RECONCILING OPPOSING VIEWS TOWARDS LABOUR
INFORMALITY.
THE CASE OF COLOMBIA AND SOUTH AFRICA**



RECONCILING OPPOSING VIEWS TOWARDS LABOUR INFORMALITY. THE CASE OF COLOMBIA AND SOUTH AFRICA.

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1. INTRODUCTION

The analysis of labour markets in Colombia and South Africa provides a framework of informality broad enough to understand the complex phenomenon of informality. Both South Africa and Colombia are upper-middle income countries struggling to break out of the middle-income trap. While both countries have similar levels of per capita income and inequality, South Africa stands out for having relatively high levels of unemployment and low levels of informal employment, whereas Colombia has a lower rate of unemployment but persistently high levels of informality. As a result, current debates surrounding informality in the two countries are very different. In South Africa, the informal sector is viewed as a way of reducing unemployment and, consequently, national policy aims to promote self-employment through entrepreneurship. In Colombia, on the other hand, informality tends to be viewed as a constraint on the growth of the formal sector and consequently the national policy aims to control it. Similarly, the nature of unemployment tends to be different in both countries. In Colombia, where there are neither unemployment benefits nor barriers to informality, unemployment is almost a luxury that can only be afforded by those individuals whose families or savings can provide them a means to survive while looking for a job. In South Africa, individuals are driven into unemployment because of barriers to both formal and informal employment², even if there is insufficient income at the household level to cover their basic needs. We therefore have two similar countries with different approaches towards informality and unemployment. In other words, while Colombia struggles to reduce informality, South Africa struggles to reduce barriers to informality in order to reduce unemployment.

We realized that the different approaches to informality were not due to differences in the definition or measurements of informality but in the type of informality in which each country is focused. To identify the types of informality, we developed a taxonomy based on the reasons

¹ We would like to thank Juan Camilo Medellin and Francisco Fernandez for their excellent research assistance in this paper. We will also want to thank Mark Lewis from PAC and Don Leonard and Shandana Mohamed from IDS, as well as the comments received from Guillermo Perry, Angel Melguizo and other participants of the Informality Summit hosted in South Africa.

² **Some of the informal sector barriers in South Africa have historical roots.** Historical legislation enforced spatial segregation and resulted in large informal settlements being built outside of cities and distant from formal economic activity. The current geographical distribution of the population is a legacy of this apartheid-era legislation, making the transport costs associated with setting up and running an informal enterprise high. At the same time, enforcement of labour laws in South Africa hampers growth in informal activities (Ceni 2014; Almeida and Carneiro 2005). Labour law enforcement - measured as the number of labour inspectors per 10,000 employed persons - reveal relatively high levels of enforcement in South Africa (0.82), compared with 0.30 in Colombia and 0.76 in OECD members countries. Similarly, the number of inspector visits per year in South Africa (101,792) is ten times the number of visits in Colombia (10,438) (ILO 2013). This inspection rates go very much in line with the differences in governance and institutions indicators.

behind informal employment, from the point of view of the individual. We also developed a methodology to identify the composition of informality in both countries. At the outset, our expectation was that Colombia and South Africa's informality would be classified into two different types of informality. However, one of the main conclusions of this paper is that all types of informality coexist in both countries. Nonetheless, the main reason to be informally employed in South Africa is that individuals find themselves segmented from the formal labour market given their low levels of productivity – what we called subsistence informality - therefore authorities are willing to tolerate and even promote informality in order to reduce unemployment; whereas in the case of Colombia, although subsistence informality is important, informality tends to be more heterogeneous and to interact more with formal employment than with unemployment, and therefore informality is viewed as a growth constraint.

Consistent with this framework, we also argue that policy recommendations related to informality must be coherent with the type of informality in question. For example, providing economic incentives to formalise and controlling informal activities might be effective when formality is voluntary, whereas the same policies applied to subsistence informality might have a negative impact by driving these individuals into unemployment.

The paper is structured as follows: Chapter 2 discusses the reasons to develop a taxonomy of informality; Chapter 3 proposes a taxonomy for informality; Chapter 4 develops and implements a methodology to identify the composition of informality in both countries Chapter 5 provides policy recommendations to face each type of informality and Chapter 6 concludes.

2. WHY DEVELOP A TAXONOMY OF INFORMALITY?

Our first hypothesis was that the differences in the approaches towards informality were due to broad differences in the countries we were comparing, since Colombia and South Africa are geographically distant. However, as shown in Table 1, Colombia and South Africa are very similar in a number of aspects which are commonly used to explain differences in informality, including size, dependence on natural resources, population and its distribution, income and its distribution and even conflict and violence.

Insert Table 1

Our second hypothesis was to explain differences in the approaches towards informality through differences in the labour market structure. Although, as shown in Table 1, the working age, the economically active and even the formally employed population are similar in both countries, there is a big difference in the distribution of individuals between informality and unemployment. The unemployment rate in South Africa (26%) is nearly three times that of

Colombia (9%), while the informality rate in Colombia (60%) is nearly twice that of South Africa (31%)³.

These differences in informality and unemployment outcomes cannot be explained by differences in concepts or measurements. The understanding of informality and unemployment is similar in both countries⁴; and while both countries have different methodologies to measure this concepts⁵, the gap between the two countries grows when we measure informality using the other country's methodology. Applying the South African definitions to Colombia, informality increases to 64.5% and unemployment lowers to 8.3%, whereas applying Colombia's definitions to the case of South Africa, informality lowers to 26% and unemployment increases to 30%.

While the size of the two outputs might explain the different approaches towards informality, we claim that the structure of the informal labour market might have a role in this issue. In fact, the informal sector is not a homogeneous mass of individuals. The informality of a senior executive avoiding taxes or that of a street vendor are significantly different. Therefore, we argue that there are different types of informality and that the policy approach to deal with each type of informality differ.

3. OUR TYPOLOGY OF INFORMALITY

We used the reasons behind informality from the point of view of the individual as a criteria to formulate our taxonomy that considers three types of informal workers⁶:

³ Unless otherwise stated, the Colombian data used the ensuing analysis is from the third quarter 2015 whole survey data – including rural households- of the *Gran Encuesta Integrada de Hogares* (Widescale Integrated Household Survey, GEIH) provided by the Department of Statistics (Dane). For South Africa, we primarily use data from the third quarter 2015 of the Quarterly Labour Force Survey, conducted by Statistics South Africa. All panel data analysis uses Waves 1 and 3 of the National Income Dynamics Study (NIDS), implemented by the Southern Africa Labour and Development Research Unit (SALDRU).

⁴ Both countries understand informality as jobs or firms that are not regulated and/or do not contribute to public funds – the definition used in this paper. Both firms and individuals are included in the definition, which means that informal workers can work either in the formal or the informal sector. Correspondingly, informal work can be measured by the informal sector definition - or those individuals who work in the informal sector - and the informal worker definition - or those individuals who are not covered by social security. We make use of both approaches in our analysis since both have been extensively used in the literature and together they inform a more nuanced understanding of informality by capturing different dynamics of the phenomenon. Similarly, both countries understand unemployment as working age individuals that do not have a work, are searching for a job and are available.

⁵ Whereas in Colombia both the informal sector and the informal worker definitions are used alternatively, South Africa uses a hybrid definition of informality, in which if either the informal sector or individual-level criteria are met, the employee is deemed to be working informally. Moreover, there are differences in how Colombia and South Africa delineate both the informal worker and the informal sector definitions within their countries (Fernandez et al, 2017). However, we argue that there is relatively high correlation between the measures used to define informality, which gives us confidence in proceeding with the official definition of informality in South Africa and the firm definition in Colombia, as due to data restrictions we cannot fully apply the other country's definition to our own country statistics. In the case of Colombia, we also included the legal definition statistics, when possible. Similarly, Colombian unemployment statistics includes open unemployment whereas South Africa excludes it.

⁶ We are only considering the worker's point of view towards informality, ignoring the firm's point of view towards informality, while in practice, it is the interaction of both which fully characterises the informal employee market which makes up 39% of the informal market in Colombia and 69% in South Africa. Given that the quality of data on informality at a firm level is weak and hard to cross-reference with household data, we continued with our typology for informality from the point of view of the individual but taking into account the firm's perspective when possible.

Voluntary informal workers are those who decide to be informal because they consider the benefits of informality greater than those of formal employment. This cost-benefit analysis includes monetary variables such as income and taxes, but it can also include other ‘amenities’ such as labour flexibility, being one’s own boss and independence, which are all weighed up against the benefits of being formally employed. This explains why voluntary informality is popular among workers with relatively high incomes who can afford the non-monetary ‘amenities’ and in countries with low monitoring and control. In this respect, a recent survey showed that younger generations prefer higher labour flexibility (Ernst and Young 2015) and this undoubtedly represents a challenge for formalisation policy in the future. On the other hand, we found, particularly in Colombia, that a number of low income workers choose informality, probably because otherwise they could lose their social benefits. Although voluntary informality might be beneficial at an individual level due to free-rider benefits - provided that individuals perform a long-term and accurate cost-benefit analysis, it can be negative at an aggregate level because informal individuals and firms operate in a less productive environment.

Subsistence informal workers are those willing to work in the formal sector (or who do not have a particular preference for informality) but are segmented from the labour market given their low levels of productivity, which is understood as a combination of skills and experience as well as being allowed, able and willing to produce in sectors/places where human resources are relatively more scarce and are more enhanced by infrastructure and institutions⁷. While these individuals may suffer from entry barriers to the formal labour market, a significant reduction in these barriers is not likely to increase their formal employment rates, since the main drivers of subsistence informality are low production - both of the worker and of the economy - coupled with a lack of demand for low productivity jobs in the labour market. For subsistence informal workers, informality may be the only available alternative to unemployment. Therefore, provided that they earn more being informal than any benefits they may receive if unemployed, it would be very difficult to argue against some benefits from informality at least in the short run.

Induced informality workers are those 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 discrimination⁸. Here, the line is unclear because whether a policy is ‘excessive’ is debatable. It seems clear that workers should have some kind of protection and that this protection should improve income distribution and the likelihood of obtaining a decent work; however, ‘too much’ protection relative to average productivity can make formal hiring ‘too’ expensive, thereby

⁷ What segments workers from the formal labour market is not their level of skills but their level of productivity, which takes into account geography and sector of production. Low skilled workers can be very productive in a developed country, not only because of the infrastructure and institutions but also because they offer a relatively scarce resource. This explains why subsistence informality might not exist in developed countries, while making up the majority of informality in developing countries, particularly in rural areas.

⁸ We do not include here other types of discrimination, such as discrimination in education, which might be the cause of subsistence but not induced informality.

increasing unemployment and informality⁹. These ‘excessive’ entry barriers, such as labour discrimination, high payroll taxes or complex legislative requirements to formalisation, are preventing workers from obtaining the higher wages, benefits and work stability found in the formal labour market, and therefore, constraining growth and personal welfare.

In sum, the cost and benefits of informality at an individual level are very much determined by the type of informality in question, and whether the alternative is unemployment or formal labour market employment. However, the macroeconomic cost that applies to each of the three types of informality described above should not be ignored. Informality is associated with decreased tax revenue, increased corruption through the use of bribes, lower productivity (due to factors such as firm size, access to finance, few incentives for training and technology adoption in big firms), lower probability of exporting and restricted consumption of public goods such as justice. Informality may also impact aggregate productivity by weakening the process of creative destruction.

4. IDENTIFYING THE PREVAILING TYPE OF INFORMALITY

WITHIN COLOMBIA AND SOUTH AFRICA

Although the three types of informality are not perfectly identifiable in any given country, it is possible to estimate an approximate configuration for each country based on the typologies provided in the previous section. The three dimensions we consider key for this purpose are the preference for informality, the level of productivity and the existence of formal market barriers¹⁰. The specific indicators used to measure this three dimensions and their measures for the cases of Colombia and South Africa are detailed as follows:

4.1 INDICATORS TO IDENTIFY VOLUNTARY INFORMALITY

The extent to which informal employment is due to preferences is a key component of identifying voluntary informality. We measure this dimension by analysing data on surveys, observable transitions from informality to formality, and the counter- or pro-cyclicalities of informality.

⁹ There might be some overlap with voluntary informality, since the ‘excessive’ cost of informality might play an important role in the cost-benefit analysis that lies behind the decision to work informally. However, it should be noted that most voluntary informal workers choose to be informal even if this means earning a lower wage, as we will see in the next section.

¹⁰ We consider the main characteristic that identifies voluntary informal workers to be their high preference for informality, regardless of their level of productivity, and we also assume that the main characteristic that differentiates subsistence and induced informal workers - is the low level of productivity of subsistence informal workers. In most cases, the impact of market barriers can only be estimated at an aggregate level and therefore we have adopted formal market barriers as a validation variable. This is only a practical issue and we do not intend to give the impression that regulatory and discriminatory barriers are less important in explaining informality.

4.1.1 SURVEYS

The best way to understand whether informality is a preference or a default option is simply to ask the informally employed the reason why they are informal rather than formal workers¹¹. The 2007 Colombian Household Survey (GEIH) includes two useful questions to identify whether independent workers (self-employed and employers) are informal out of choice or necessity.¹² One question asks informal workers if they would accept a job in the formal market with the same wage plus benefits or at a higher wage. The other question asks respondents the reason why they are informally employed. If the worker answers negatively to the first question or does not state the impossibility of finding formal work as the reason for being informal, then the worker is considered a voluntary informal worker.

According to the survey data, 36% of informal independent workers in Colombia declare a preference for informal jobs. This percentage is low when compared to Brazil or Mexico as shown in Perry (2007). Fernandez and Villar (2016a) examine the determinants of preferences for informality among informal workers, using a logit model. The results suggest that workers with tertiary education, women who are not household heads, 45 years old and older and those living in big and border cities are more likely to prefer informality. Unfortunately, we don't have similar information on preferences for informal employees in Colombia - 39% of the informally employed. Two alternative assumptions can be made at this point. First, that employees show the same preferences for formal jobs as independent workers and second, that informal salaried employees who tend to earn low levels of income do not tend to choose voluntarily to be informal. These two assumptions gives us a range for voluntary informality in Colombia of between 21% and 36% of the informally employed population.

In the case of South Africa - according to our own calculations of the 2013 household survey of non-VAT registered businesses, most of which operated in the informal sector - 62% of respondents started their business because of unemployment (Stats SA, 2013b). Other reasons indicating that informality was involuntary include retrenchment (4%) and inadequate alternative income sources (12%). Together, these figures imply that 78% of informal business owners could be classified as involuntarily informal, although it should be noted that these answers serve as a proxy rather than directly revealing involuntary entry into the informal labour market. Given that only 31% of the informally employed are self-employed, the range for voluntary informality can be estimated between 7% and 22% of the population. In South Africa, tertiary educated individuals also have relatively higher preferences for informality: The indicator of involuntary informality was 83% for informal business owners with primary school education or less, 79% for those with secondary education and 49% for those with tertiary education or higher.

¹¹The best way does not necessarily mean the most optimal way since workers might interiorize their probabilities of finding a formal job or do not have complete information of what it means to be formal when answering the survey.

¹²These questions were not included in the 2015 GEIH survey

4.1.2 TRANSITIONS FROM INFORMALITY TO FORMALITY

Another method which allows us to assess the relative importance of voluntary informality is the worker's transition from informality to formality, since infrequent transitions between informality and formality tend to signal that movement in the labour market is obstructed either by low productivity or by formal market barriers. Fernandez et al. (2016a) find that transitions from informality to formality in Colombia are infrequent, with only 14% of informal workers transiting to formality between 2010 and 2013. In the case of South Africa, they find that 26% of informal workers transitioned to formality between 2008 and 2012. According to the authors, transitions from informality to formality were more frequent among workers with tertiary education (26%) than those with primary or less (10%) or those with high school studies (12%). In South Africa, as shown by Oosthuizen et al. (2016), transitions from informality to formality were also most frequent amongst those individuals with higher levels of education. While 51% of those with tertiary education transitioned from informality to formality between 2008 and 2012, only 17% of those with a primary school education or less made this transition.

4.1.3 COUNTER AND PRO-CYCLICALITY

Counter-cyclical is another indicator of involuntary informality. In the presence of barriers to formality or high segmentation due to productivity, when the economy is growing, workers are able to transition into the formal sector of the labour market at higher rates. Conversely, during hard times some workers are forced into the informal sector as jobs are lost in the formal labour market. In presence of neither barriers to formality nor segmentation because of productivity, informal and formal workers tend to move in the same direction in response to economic activity.

In the case of Colombia, as shown in Fernandez and Villar (2016a) there is a positive relationship between the formality rate and the business cycle - the correlation was -0.42, between 2002 and 2015¹³. In South Africa, it is not possible to implement a rigorous analysis of the cyclical of informality due to the lack of time series data. However, there does not appear to be strong evidence of pro or counter-cyclical: the correlation coefficient between informality and GDP growth for quarterly data between 2008 and 2015 was 0.63; the coefficient of correlation with the lagged GDP is -0.38, and the annual coefficient of correlation between self-employment and the output gap¹⁴ between 1996 and 2013 is -0.26, and not significant (Oosthuizen et al. 2016). Therefore, in South Africa the informal sector may not be acting as a buffer against unemployment during hard economic times. This contrasts with our previous indicators of voluntary informality for the country, but can be explained by high barriers to informality, that limit the informal sector's capacity to absorb retrenched formal sector workers during downturns. As explained by Perry (2007), another possible cause of the pro-cyclical behavior of informality, in the presence of voluntary informality, is the introduction of a very restrictive monetary policy in response to a commodity boom because it incentivizes the service sector which is intensive in informal business.

Based on these indicators, it can be stated that voluntary informality is not the dominant type of informality in either South Africa or Colombia, but appears to be higher in Colombia than in South Africa, according to the results of survey data.

4.2 DIFFERENCES IN PRODUCTIVITY

The previous section focused on identifying workers who were voluntarily informal. In this section, we shift our attention to involuntary informality and the distinction between subsistence and induced informality. We use two indicators to approximate this concept: the incidence of informality in lower productivity groups and the percentage of workers earning a wage significantly lower than the minimum hiring cost.

¹³This correlation coefficient was 0.74 between 2002 and 2013, showing that informality in Colombia has been less counter-cyclical in the last two years, probably because of the recent reduction in payroll taxes.

¹⁴ Calculated as a Hodrick Prescott filter residual.

4.2.1 HIGH INCIDENCE OF INFORMALITY IN GROUPS WITH LOW PRODUCTIVITY

According to Table 2, in both Colombia and South Africa, informality is higher among those socio-economic groups that tend to show lower rates of productivity: the low educated, the young¹⁵ and those working in low productivity cities¹⁶. Consistent with these findings, Table 3 presents the results of a multinomial logit regression¹⁷ on the probability of being informal, unemployed or inactive relative to formal, controlling by other observable variables. The coefficients of the regression represent the Relative Risk Ratios (RRRs), that can be interpreted as follows: The 2.58 RRR on “Primary or less” for the case of South Africa implies that, those with elementary school education or less face a 2.58 times greater relative risk of being informal (compared with being formal) than those with a secondary school education, the base group. Similarly, being young and working in rural areas or less productive cities are significant positive determinants of an individual’s probability of being informal, relative to be formal, in both countries.

Insert Table 2

Insert Table 3

In sum, in both countries informality tend to be higher among low productivity groups - lower education, lower experience, low productivity cities and the rural areas. We argue that what explains the higher incidence of informality among these groups is their low productivity and not preferences since, as shown in section 4.1.1, workers with lower education- and in the case of Colombia young workers and workers in low productivity areas - do not show preferences for informality. Other groups that also show high incidence and predicted levels of informality are: women (whose high rates of informality can be explained by both preferences and discrimination as will be shown in the next section), older workers in Colombia (who also show high preferences for informality)¹⁸, and those living in border cities in Colombia (which are impacted by smuggling).

¹⁵ Age is commonly used as a proxy for experience, that is a component of productivity. In fact, controlling by education that tends to be higher in younger generations, young workers tend to have less experience and to imply an additional risk associated with hiring individuals who are relatively ‘untested’ in the job market.

¹⁶ Sector of activity is also a variable which is very closely related to productivity. However, this factor was not included in the exercise in order to avoid endogeneity problems.

¹⁷ We used the multinomial logit specification because we believe it describes the labour market of developing countries more accurately than other models, as the traditional logit for formality correcting by selection bias. In fact, in developing countries informality is more a default option than inactivity. The assumptions of the multinomial logit also hold for our estimation, namely: (i) each independent variable has a single value for each case; (ii) the dependent variable cannot be perfectly predicted from the independent variables for any case and (iii) eliminating some of the unchosen alternatives should not affect the selection of the best option for the individual (independence of irrelevant alternatives). Nevertheless, we estimated the determinants of informality using other specifications and the results are very similar. Similar results were obtained using the informal worker definition of informality for the case of Colombia. RRR is the ratio of the relative risk of being informal, compared with being formal, for those with an education of primary or less education, compared to the same relative risk for the base group - those with a secondary school education.

¹⁸ These preferences can be explained by regulatory pension issues since workers that have already completed the minimum weeks needed to have a pension tend to move to the informal sector.

4.2.2 PERCENTAGE OF WORKERS WITH PRODUCTIVITY LEVELS BELOW THE MINIMUM COST OF HIRING THEM

In Colombia, the cost of hiring a formal worker is approximately 1.5 times the minimum wage¹⁹. We assume that there is evidence of subsistence informality if an informal worker earns less than half this amount, or if their marginal productivity is less than half this amount. By considering this measure, we are trying to approximate the subsistence informal workers by excluding those involuntary informal workers for whom the regulatory barriers are binding because their productivity is close to the minimum hiring cost – the induced informal workers²⁰. In Colombia, approximately 48% of informal workers earn less than half of the total hourly cost of hiring i.e. less than 75% of the minimum wage²¹. In South Africa, there is currently no national minimum wage, but numerous minimum wages which apply at the sectoral level, sometimes varying according to the location of employment (urban or rural area) and hours worked (full or part time). Violations of these sectoral minimum wages range from 37% in the hospitality sector to 75% in forestry (Stats SA 2013a, own calculations).

In sum, according to the two indicators the we used, there is evidence of a considerable number of informal subsistence informal workers in both South Africa and Colombia, to whom informality might be a way to escape from unemployment.

4.3 EVIDENCE OF BARRIERS TO FORMALITY

The existence of barriers to formality is also a tool which enables us to determine whether the involuntary informal are subsistence or induced informal workers, and therefore to corroborate the results in the previous section. These barriers can be implicit, as in the case of race or gender discrimination, or explicit, as in the case of labour taxes.

4.3.1 IMPLICIT BARRIERS TO FORMALITY OR DISCRIMINATION

Gender discrimination: We classify as induced informal workers, those women that face some discrimination in their hiring, but are willing to take a job in the formal market and are productive enough to be in the formal market; in other words, excluding voluntary and subsistence informal workers²². As show in Table 4, there are not big differences in the overall informality rates of women and men, probably because these rates do not control for preferences and productivity. The logit model in Table 5 controls for productivity, by adding the relevant

¹⁹ Including holidays, transport subsidy, severance and associated interest levels, yearly bonus, pension contributions, risk insurance and the *Caja de Compensación Familiar* - Colombian institutions that provide family benefits in return for mandatory payroll taxes.

²⁰ However, this specific measure might only make sense for cases as the Colombian where half the hiring cost is an amount similar to the median and mean for work earnings amongst informal involuntary workers in 2015.

²¹ In those cases when it was not reported as it is the case of about 10% of the informal workers in Colombia, we imputed a salary.

²² Subsistence informal workers might have suffer for other types of discrimination not included here, as discrimination in education.

variables in the regression; and controls by preferences, by dividing women into those who are heads of household with similar preferences for formality as men, and those who are not heads of the household – such as spouses and daughters – who that tend to prefer informality. These groups are evaluated relative to the base group, which is all males.

In both countries, the coefficient for women who are household heads indicates that they face a higher relative risk of informality (compared with formality) than men, revealing some signs of discrimination as explained before. However, when looking at the coefficient for women who are not household heads, results diverge between the two countries. In the case of Colombia, the coefficient is significant and of a similar size to that for women who are household heads, revealing preferences for informality, as expected. In South Africa, the coefficient for women who are not household heads is non-significant, which may be explained by the fact that females who are not household heads typically reside with a household member who is responsible for the financial well-being of the family. They are therefore more likely to be unemployed or inactive (compared with being formal), as Table 5 indicates. These women can also be pickier about the form of employment they participate in, resulting in no significant differences in the relative risk of informality (compared with formality) between females who are not household heads and males.

Race discrimination: In the case of race, there is no need to control for preferences, since specific groups do not have an explicit reason to prefer informality. On the contrary, Bernal (2009) found that in the case of Colombia, ethnic minorities are 8% more likely to prefer a formal job than the rest of the self-employed population.

Unfortunately, in the case of Colombia we couldn't include race in the previous exercise because of lack of data. However, Bernal (2009) found that the probability of working in the informal sector is 5.4 percentage points higher for indigenous people and 2.2 percentage points higher for Afro-Colombians, controlling for other observable characteristics. Similarly, the ELCA survey indicates that estimated informality rates vary significantly, by more than 15 percentage points, depending on the colour of the worker's skin (Fernandez and Villar, 2016a). In South Africa, it is clear from Table 4 that rates of informality differ substantially across race groups. White individuals are most likely to be in the formal labour market and only 9% of white workers are informally employed. Conversely, African individuals are least likely to be in formal employment, with 36% percent informally employed. This indicates that not only do white South Africans face the lowest unemployment rate (see Annex B1), they are also more likely to be engaged in formal employment which is typically characterised by higher wages, increased job security and better quality working conditions. This is confirmed by the multinomial logit in Table 5 which indicates that African individuals have a higher relative risk of being informal (compared with being formal) than any other race group, significant at the 1% level.

4.3.2 EXPLICIT BARRIERS TO FORMALITY

The existence of explicit formal market barriers is an unambiguous symptom of induced informality. In analysing these barriers, we look not only at payroll taxes, hiring and firing costs and high minimum wages, but also at the unionisation process that often plays a key role in determining the strength of these barriers to formality.

Payroll taxes: Despite a recent tax reform in Colombia that reduced payroll taxes by 13.5 percentage points, Colombia continues to be in the upper half of the country distribution, when looking at labour taxes as percentage of commercial profits, and much higher than in South Africa (Fernandez and Villar, 2016a). The relatively high impact of the reduction in payroll taxes is another symptom of the high incidence of induced informality in Colombia: the informality rate of those affected by the reform lowered by between 4.7 and 6.3 percentage points (Fernandez and Villar, 2016b). This result is similar to previous estimates on the matter.

Minimum wage: As mentioned earlier, there is currently no national minimum wage in South Africa. Instead, there exists a range of minimum wages by sector, region and occupation. According to the OECD (2015), in the wholesale and retail sector, the largest covered sector, the minimum wage is only 17% of average wages compared with 39% in the OECD. This is compared with 66% in Colombia²³. This result signals that the minimum wage is an important driver of informality in Colombia, whereas is not a particularly strong barrier to formality in South Africa.

A further substantial difference between the two countries is the way the minimum wage is set, which has important implications for the level of informality, as will be explained in section 5. The minimum wage in Colombia is established at a national level and is increased annually based on past inflation plus increases in productivity. In South Africa, wage minima are set in a complicated array of bargaining processes at the sectoral and regional levels, and are augmented by sectoral determinations that regulate wages in sectors without formal collective bargaining arrangements (such as agriculture or domestic work).

Unions and other barriers to formality: Another important difference between Colombia and South Africa is the role of unions in the labour market. The percentage of employees that are union members as proportion of total employment is 4.5% in Colombia compared with 27% in South Africa (Stats SA QLFS 2015Q3; ILO 2016). Superficially, it may appear that powerless unions should result in low barriers to formality, and vice versa. However, the unionisation process in Colombia is weak, forcing workers to concentrate their power on minimum wage negotiations and leave aside other aspects of worker protection (OECD, 2015). As a result, the minimum wage has increased above the productivity level of the economy, increasing informality despite the feeble power of the unions. In South Africa, unions are stronger and, since 1994, politically well-connected and have achieved significant successes related to wages

²³ More than 40 hours of work per week.

and worker protection. At the same time, unions strongly resist moves towards greater informality in the South African labour market, as well as the creation of jobs that are not deemed a decent work. Consistent with the above, Colombia ranks very low, whereas South Africa ranks medium high, in the Rigidity of Labour Index (Heritage Foundation 2015) which includes other aspects of labour legislation, such as working hours and hiring, firing and severance costs.

Overall, both countries show some degree of induced informality, but this type of informality is more prevalent in Colombia than in South Africa. In South Africa, most of the discrimination problems are related to race, and most of the regulatory barriers take the form of labour legislation not related to labour cost. Colombia suffers from both implicit and explicit barriers to informality, and particularly, high hiring costs.

4.4 THE PREVAILING TYPE OF INFORMALITY IN COLOMBIA AND SOUTH AFRICA

Table 4 summarises the main findings of the previous section, including a similar exercise we performed over the 13 metropolitan areas survey in Colombia. According to this table, both countries show the existence of some voluntary informal workers, but this prevalence is relatively low when compared to other countries such as Mexico and Brazil. In South Africa between 7% and 22% of informal workers show some (weak) indication of voluntariness. In Colombia, this figure is higher, ranging from 21% to 36%. These results are consistent with the low levels of transition between informality and formality in both countries, and with the evidence in favour of counter-cyclicalities of informality in Colombia; but contrast with evidence in favour of pro-cyclicalities in South Africa. This might be explained by the existence of high barriers to informality, probably a repercussion of apartheid-era legislation in South Africa. However, there is evidence of a relatively small, but still important, group of voluntary informal workers in both countries for whom informality might be positive at an individual, but not at an aggregate level.

On the other hand, we found substantial evidence in both countries of subsistence informality. According to our findings, about 48% of the workers in Colombia earn less than 50% of the cost of hiring them in the formal sector. Even if barriers to formality were reduced substantially, these workers would have a very low chance of being hired by the formal sector. Our findings on the incidence of informality among groups with low levels of education and experience, and in non-urban and non-productive areas confirms the relevance of subsistence informality in both countries, for whom informality might be positive at least in the short run.

Regarding induced informality, we find good evidence for the relevance of this type of informality in both countries, although the incidence of induced informality is higher in Colombia than in South Africa. Whereas in Colombia the problem is mainly related to explicit

barriers to formality, such as payroll taxes and inflexibility of minimum wage, in South Africa induced informality is linked to some race discrimination in the formal labour market.

As a result, we argue that although the three types of informality are observable in both countries, in South Africa subsistence informality is most prevalent. This is consistent with Lund (1998) who finds that the informal sector in Durban offered employment to unskilled women who would not easily find a job elsewhere; and Ranchhod and Dinkelman (2007) who further support the hypothesis that informality is the only employment option for vulnerable groups in South Africa. In Colombia, we find a more heterogeneous distribution of informality, consistent with Perry (2007). This suggests the need for a package of policies rather than a single policy to face informality. We also found that in Colombia a significant percentage of voluntary informal workers had productivity levels comparable to the subsistence informal. We suspect that this is the result of errors in the design of social benefits which resulted in unintentional increases in the incentives to be informal, as explained in Levy (2008).

Therefore, we argue that in South Africa informality has overall positive benefits for unemployment, which might be even higher in its absence. In Colombia, informality has more negative implications. 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. In analysing this issue, the cost of informality at a society level should not be ignored.

Insert Table 4

5. POLICY IMPLICATIONS

Despite the fact that the proposed taxonomy of informality is not perfect, it provides a useful way to organize the discussion about informality as well as the relevant policy implications for each type. Similarly, the classification of policy recommendations is not perfect, and very often the same policy helps to fight different types of informality, but nevertheless this is a useful framework to target policies and to structure this discussion. In the following, we present some policy recommendations by type of informality.

Induced informality. The policies to face this type of informality can be divided into policies to reduce ‘excessive’ labour regulation and policies to reduce discrimination in the labour market. The first group of policies relates to the excessive regulation on labour markets that restricts the incentives of firms to hire workers formally. Here the line is unclear because whether a policy is ‘excessive’ or not is debatable, as previously explained.

Policies aiming at reducing labour taxes may serve to reduce both informality and unemployment, although removing these taxes requires substituting the source of tax in order to prevent a substantial decrease in tax revenue. While minimum wages are a clear example of a worker's protection, it is debatable where the 'excessive' level of such a wage is. While the literature usually finds a positive relationship between an increase in the minimum wage and an increase in unemployment and informality; there is also an extensive literature on the impact of increasing minimum wages over income distribution. Similarly, the way in which the minimum wage is set might impact informality. According to Hazans (2011), European countries that set the minimum wage at a national level tend to have higher rates of informality. However, the convenience of a national or federal minimum wage is not settled due to the impact on income distribution²⁴. The same may be true for minimum wages set at a sectoral versus country level. In addition, high bureaucracy, paperwork and legal requirements may promote induced informality. If some flexibility is not allowed by the authorities regarding formalisation of businesses, this will promote complete informalisation, including a lack of any labour protection. One of the examples of effective policies to reduce bureaucracy is the single-tax policy, recently adopted in Colombia.

The second group of policies which may combat induced informality is focused on labour market discrimination. This is 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 the society. In this case, it is also important to note that some protection might reduce labour discrimination but too much protection may increase it. For example, enforcing maternity leave which is "too long" discourages the formal hiring of women. Similarly, a retirement age which is "too low" may inhibit pensioners from effectively accessing pension benefits, unless those benefits are highly subsidized.

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 if applied over workers that suffer from subsistence informality. Further, making formal work more flexible and particularly promoting part-time jobs would also be an appropriate policy for dealing with voluntary informality. Lowering transportation costs, facilitating the creation of formal jobs in low productivity areas and promoting child-care facilities in marginal neighbourhoods may also be effective to reduce this type of informality. Regarding the voluntary informal who have productivity levels similar to the subsistence informal, it is important to be careful about the perverse incentives that may be

²⁴ The impact of the minimum wage as a reference not only for formal workers but also for informal workers, or the lighthouse impact, implies that the minimum wage has an important role in ensuring decent work, even over those not affected by it. Therefore, it is also true that the simplicity of the federal minimum wage has important attributes including the reduction of inequality.

created by some types of social policies, mainly via direct transfers, non-contributory pension systems and subsidized health care schemes.

Subsistence informality. One of the main takeaways of this research is that informality might be positive for these workers if their only alternative to informality is unemployment. To enforce formality on this type of worker is not only likely to fail, but may imply an enormous social cost. Alternatives such as facilitating geographical mobility and re-localization of subsistence informal workers might be useful policies for this type of informality. In the long term, the only way to reduce this type of informality is to either increase education and skills or to increase productivity, particularly in rural areas where is more common to find this type of informality.

Overall, the optimal protection of workers is a delicate question. The answer seems to be related to alternative schemes of protection. As an example, in Colombia where pensions lower than a minimum wage are not allowed, the government created a savings scheme with government benefits that allow for pensions of a lower value (BEPS). The line between appropriate levels of protection and protection that promotes informality is very fine, as the relatively high number of voluntary informal with the productivity levels of the subsistence informal in Colombia testifies. In addition, although forbiddance of informality is an option it is also highly correlated with violence, availability of public spaces, the capability of the government to provide public services, affecting the welfare of individuals and even the appearance the so-called ‘mafia’ to operate as street vendors.

In sum, given that Colombia shows a very heterogeneous mix of informality types, a package combination of several of these policies might be the only possibility to impact informality as a whole. In the case of South Africa, policies to increase subsistence informality (as an alternative to unemployment) should be the most important to review, taking good care that these policies do not promote the other two types of informality.

6. CONCLUSION

While in Colombia, informality is considered a major economic problem with policy focused on reducing rates of informality, in South Africa it is seen as at least a partial solution to the country’s exceptionally high unemployment rate. With these contradictions in mind, our approach was to design a conceptual framework broad enough to include both countries and perspectives. With this approach, it became clear that there are certain characteristics and conclusions from the South African perspective that can easily be applied to some groups in Colombia and vice-versa.

One of the main conclusions of this paper is that the analysis of informality cannot be performed by assuming that informal workers are a single homogenous group. Informal workers range from poorly educated individuals, who may be classified as the subsistence informal; to highly educated young adults living in productive cities, who can be classified as voluntarily informal. The policy measures to deal with informality varied according to the type of informality in focus.

This analysis brings about important policy implications. Although a significant proportion of the informal population is affected by formal employment barriers, there is also a component of informality that is structural in nature and that needs to be tackled with other kinds of policies, such as education. In the case of voluntary informality, imposing constraints on remaining informal and providing economic incentives to formalise might be effective, whereas the same policies applied to subsistence informality are likely to increase unemployment.

It is important to note that even if informality can be positive for some vulnerable groups, the cost of informality at a society level should not be ignored. In this sense, the Colombian experience, with its deep-rooted informality, provides an important example for South Africa to take into consideration. The only way in which facilitating the transition from unemployment to informality can be a long lasting and productive reform is by simultaneously promoting a smooth transit from informality to formality.

Finally, we identified that the institutional setting in South Africa may have contributed to reductions in informality and this provides valuable lessons for institutional reform in Colombia. As an example, Colombia could consider establishing a more flexible arrangement for setting minimum wages, general pension schemes and unemployment benefits. Other institutional arrangements in South Africa, such as inspection and control practices, should be taken with care in Colombia where the same policy might have negative social outcomes for subsistence informal workers.

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TABLE 1. SELECTED COUNTRY STATISTICS: COLOMBIA AND SOUTH AFRICA

| Indicators | Colombia | South Africa |
|---|----------|--------------|
| Area (km ² , millions) | 1.1 | 1.2 |
| Population | 48 | 54 |
| GDP (US\$ billions) | 378 | 350 |
| Per capita GDP (PPP) | 13,357 | 13,046 |
| Total natural resources rents (% GDP) | 10.3 | 9.2 |
| Population in the largest city (millions) | 9.6 | 9.2 |
| Population in urban areas of more than 1 million (millions) | 20.3 | 20 |
| Population ages 15-64 (% of total) | 68.5 | 65.4 |
| Working age population (thousands) | 34.6 | 36.1 |
| Inactive population (thousands) | 13.3 | 14.9 |
| Formal employment (thousands) | 8.8 | 11.0 |
| Gini | 54.2 | 63.4 |
| Homicides per 100,000 people | 31.8 | 31.9 |

Source: 2015 World Development Indicators, World Bank.

TABLE 2. SOUTH AFRICAN AND COLOMBIAN INFORMALITY RATES BY WORKER CHARACTERISTICS

| | South Africa Total | Colombia Total[^] |
|------------------------------|---------------------------|-----------------------------------|
| | % | % |
| Total | 30.4 | 59.9 |
| Gender | | |
| Male | 30.3 | 59.3 |
| Female | 30.5 | 60.6 |
| Education Level | | |
| None | 56.5 | 92.0 |
| Pre-School | - | 100.0 |
| Primary | 55.5 | 83.7 |
| Middle School | - | 75.9 |
| Incomplete Secondary School | 41.8 | - |
| Completed Secondary School | 20.6 | 56.4 |
| Certificate/Diploma | 9.7 | - |
| Tertiary | 4.8 | 26.5 |
| Age | | |
| 15-24 years | 37.3 | 59.0 |
| 25-34 years | 31.3 | 46.5 |
| 35-44 years | 28.8 | 57.7 |
| 45-54 years | 29.9 | 56.2 |
| 55+ years [^] | 27.1 | 80.0 |
| Location^{^^} | | |
| Urban Area | 27.4 | 53.5 |
| Non-Urban Area | 39.4 | 83.9 |
| Productive Cities | - | 44.5 |
| Non Productive Cities | - | 59.8 |
| Race²⁵ | | |
| African | 35.9 | - |
| Coloured | 22.2 | - |
| Asian/Indian | 15.5 | - |
| White | 8.6 | - |

[^] For South Africa, data is available for 55-64 years.

^{^^} For the case of Colombia. Productive cities are: Bogotá, Medellín, Tunja and Bucaramanga. Non-productive cities Quibdo, Cucuta, Sincelejo and Barranquilla.

Sources: Stats SA QLFS Q3 (2015) and GEIH Q3 2015, for Colombia.

²⁵ Race groups in South Africa and divided into, amongst others, the distinct ethnic groups “African”, “Coloured” and “White”.

TABLE 3. MULTINOMIAL LOGIT: PROBABILITY OF BEING INFORMAL, UNEMPLOYED OR INACTIVE RATHER THAN FORMALLY EMPLOYED.

| | South Africa | | | Colombia | | |
|----------------------------------|---------------------|---------------------|----------------------|---------------------|---------------------|---------------------|
| | Informal | Unemployed | Inactive | Informal | Unemployed | Inactive |
| Primary or less | 2.584*** [0.124] | 1.322*** [0.071] | 2.402*** [0.103] | 2.797*** [0.093] | 1.851*** [0.100] | 6.047*** [0.216] |
| Tertiary or more | 0.228*** [0.016] | 0.316*** [0.018] | 0.195*** [0.011] | 0.294*** [0.009] | 0.571*** [0.027] | 0.426*** [0.015] |
| 10 or 12 - 14 years | - | - | - | 1.493*** [0.062] | 4.010*** [0.255] | 2.831*** [0.112] |
| 15-24 years | 1.412*** [0.094] | 4.050*** [0.230] | 18.161*** [0.920] | 0.901** [0.033] | 1.341*** [0.084] | 0.338*** [0.014] |
| 25-34 years | 1.167*** [0.053] | 1.752*** [0.077] | 1.549*** [0.067] | 1.283*** [0.051] | 0.966 [0.070] | 0.406*** [0.018] |
| 45-54 years | 0.999 [0.052] | 0.778*** [0.045] | 1.439*** [0.070] | 2.568*** [0.113] | 1.732*** [0.141] | 3.668*** [0.160] |
| 55+ years | 0.900 [0.065] | 0.612*** [0.056] | 4.749*** [0.270] | 0.601*** [0.018] | 0.724*** [0.033] | 0.624*** [0.019] |
| Productive city [^] | - | - | - | 1.149*** [0.035] | 1.207*** [0.056] | 1.122*** [0.036] |
| Non-productive city [^] | - | - | - | 0.477*** [0.022] | 0.743*** [0.054] | 0.683*** [0.033] |
| Urban | 0.890** [0.036] | 1.182*** [0.047] | 0.420*** [0.014] | 1.378*** [0.053] | 1.678*** [0.114] | 2.207*** [0.091] |
| Women (head of HH) | 1.215*** [0.057] | 0.891** [0.048] | 1.621*** [0.070] | 1.414*** [0.040] | 2.506*** [0.109] | 5.178*** [0.152] |
| Women (not head of HH) | 1.015 [0.044] | 1.681*** [0.063] | 2.763*** [0.094] | | | |
| Ethnicity: Coloured | 0.515*** [0.035] | 0.555*** [0.033] | 0.670*** [0.037] | | | |
| Ethnicity: Asian/Indian | 0.554*** [0.074] | 0.361*** [0.050] | 1.308** [0.122] | | | |
| Ethnicity: White | 0.367*** [0.036] | 0.182*** [0.021] | 0.737*** [0.047] | 2.095*** [0.113] | 0.152*** [0.014] | 0.520*** [0.029] |
| Constant | 0.535*** [0.026] | 0.380*** [0.019] | 0.600*** [0.026] | 2.797*** [0.093] | 1.851*** [0.100] | 6.047*** [0.216] |
| Number of Obs. | 43 961 | | | 159573 | | - |
| F | 292.51 | | | 530.50 | | - |

Linearized standard errors in brackets

*** p<0.01, ** p<0.05, * p<0.1.

[^] Productive cities are: Bogotá, Medellín, Tunja and Bucaramanga. Non-productive cities Quibdo, Cucuta, Sincelejo and Barranquilla.

Source: Authors' calculations based on GEIH 3rd Quarter 2015 (Colombia) and QLFS 3rd Quarter 2015 (South Africa).

Notes:

1. Base groups: ethnicity is African; gender is male; education is secondary school; age is 35-44; average productive cities were also used as base groups.
2. Workers with less than 15 years old were excluded to make both countries comparable

TABLE 4. COLOMBIAN AND SOUTH AFRICA. INDICATORS OF THE TYPE OF INFORMALITY

| Dimension | Indicator | South Africa | Colombia Total | Colombia 13-areas |
|-----------------------|---|--|---|---|
| Choice | Preferences for informality-surveys | Very low (22%) | Low (35.9%) | Low (41.5%) |
| | Transition between informality and formality | Medium (26%) | | Low (14%) |
| | Cyclical | Pro-cyclical | | Counter-cyclical |
| Productivity | % of workers earning wages below minimum hiring cost | N/A | High (48%) | High (44%) |
| | Relative probability of being informal, low productivity groups: Primary or less, workers younger than 24, less productive areas. | High probability | High probability. | High probability |
| Barriers to Formality | Indicators of segregation. Relative probability of being informal versus formal | High evidence of race discrimination and some evidence of labour gender discrimination | Medium Some evidence of race and gender discrimination. | Medium Some evidence of race and gender discrimination. |
| | Minimum wage / average wage ²⁶ | Low (17%) ²⁷ | High (66%) | High (55%) |
| | Labour tax / commercial profits ²⁸ | Low (4%) | Medium high (18.6%) | |

Source: Survey of Employers and Self-Employed (Stats SA), 2013, QLFS 3rd Quarter 2015 (South Africa), GEIH (2007) and GEIH (2015). Fernandez et al (2016) and Oosthuizen et al (2017), OECD (2015), World Development Indicators (World Bank, 2015). Own calculations, already showed in previous sections.

²⁶ Only for workers that work more than 40 hours a week.

²⁷ Wholesale and retail sector (the largest of all covered sectors).

²⁸ World Development Indicators (World Bank, 2015)