August 2018

Creating jobs, reducing poverty III: Barriers to entry and growth in the informal sector – and business cycle vulnerabilities

Frederick Fourie, *Convenor: Employment/unemployment,REDI3x3, based at SALDRU, UCT*

In this extract from a new REDI3x3 book, the focus is on the constraints faced by informal enterprises in trying to enter, survive, grow, or increase employment. A lower tier of 'survivalist' enterprises and an upper tier of 'growth-oriented' enterprises is apparent, with barriers limiting entry into the upper tier. Selling into higher-value or formal-sector markets and value chains encounter significant structural barriers. And the sector is particularly vulnerable to severe cyclical downturns.

Preamble

This is the third in a short series of edited extracts from a new REDI3x3 book: The South African Informal Sector: Creating Jobs, Reducing Poverty. The research findings reported in the book address a significant knowledge gap in economic research and policy analysis.

The book flags the importance of explicitly addressing the informal sector in policy initiatives to boost employment and inclusive growth and reduce poverty. Its last chapter – from which the extracts are drawn – generates a synthesis of key findings on the informal sector and develops the outlines of a proposed policy approach.

Previous extracts presented a compact picture of the informal sector and analysed job creation. Forthcoming articles will discuss policy to strengthen the informal sector and boost its role in job creation, poverty reduction and the provision of livelihoods; and a constructive way to approach the possible 'formalisation'[1] of the informal sector.

**** More information on the book is provided at the end of this article***

[1] The idea of formalising the informal economy has received prominence due to the International Labour Organisation's International Labour Conference 2014 and 2015 deliberations, resulting in Recommendation 204 concerning 'the transition from the informal to the formal economy' (ILO 2015).

The book is the collective output of twenty authors from ten universities as well as NGOs and government institutes. Since the chapter from which these extracts are drawn partly is a synthesis chapter, it draws on inputs from all the chapters as well as contributions at several workshops. I wish to acknowledge all these contributions. I wish to thank Caroline Skinner in particular for fruitful interactions on framing the chapter, for adding ideas and acting as a critical reader. I also wish to thank Mike Rogan, Paul Cichello, Philippe Burger and David Neves for useful comments and inputs on an earlier draft of the chapter.

Introduction

The previous article discussed the performance and potential of the South African informal sector with regard to employment generation. In 2013 more than 1.4 million informal enterprises provided employment to about 2.3 million workers as owner-operators and employees. In 2018 it reached 2.9 million. An increase in the *employment orientation* and *employment intensity* of the informal sector was observed. More than half a million (approximately 530 000 jobs) were created in a one-year period via employment expansion as well as the entry of new enterprises (2013 data).

On the down-side, enterprises that wish to grow or expand employment face many constraints and the viability of many are continually under threat. New entrants are very vulnerable and up to 40% may close down within six months.

Barriers to entry and to 'stepping up'; tiers and segmentation

As shown in the previous article, if one distinguishes between non-employing and employing enterprises it provides important insights into the texture and dynamics of the informal sector. Enterprises also differ in several other respects. Some of these are interpreted as indications of segmentation and barriers within the informal sector.[2]

Survivalist and growth oriented tiers?

Makaluza and Burger (Chapter 7 in the book) distinguish between two informal-sector tiers which they denote as 'survivalist' and 'growth-oriented' informal enterprises (a distinction often used in the literature). Using national labour-force data, they identify a lower and an upper tier of informal-sector jobs. The lower tier contains jobs in enterprises characterised by low wages and variable work hours, a high proportion of self-employment with no or few

[2] In earlier work, Heintz and Posel (2008) considered the possibility of labour market segmentation using LFS (Labour Force Survey) data on informal employment (i.e. not the informal sector as such, and which includes domestic workers). They find substantive earnings differentials between subsectors, after controlling for observable characteristics. They interpret this as supporting the hypothesis of barriers to entry and barriers to mobility not only between formal and informal labour markets, but also between subsectors within the informal sector. The six informal-sector subsectors considered, as dictated by the available statistics, are: non-agricultural wage employment, self-employment (employers) and self-employment (own-account); also agricultural wage employment and self-employment; the last subsector is public-sector wage employment.

employees, low job satisfaction, etc. The upper tier comprises jobs in enterprises that have better earnings, are more likely to have employees and have better job characteristics. Nationally, about 73% of those in informal-sector jobs were in 'survivalist' enterprises and about 27% in 'growth-oriented' enterprises

Their main inquiry relates to entry barriers, that is, why most informal-sector workers are in the lower tier rather than the upper tier, which clearly has better jobs.[3] They find a much lower probability of persons entering the upper tier than the lower tier of the informal sector. For example, jobless persons are almost three times as likely to enter the 'survivalist' tier than the tier of 'growth-oriented' enterprises. This suggests that the barriers to entering the tier of growth-oriented enterprises are greater than for the survivalist tier. Even a step-up transition from the lower tier to the upper tier is constrained – and unlikely for most.

Moreover, for transitions out of the informal sector, the upper tier acts as a springboard into formal-sector jobs, but the lower tier does not. Those in the lower tier are much more likely to remain (trapped) there, or become jobless, compared to those in the upper tier.

Traditional and modernising enterprises?

Similar to these tiers, in a township case study Rakabe (Chapter 11 in the book; also see his Econ3x3 article) investigated the applicability of differentiating between 'traditional' and 'modernising' informal enterprises.[4] He applied a number of indicators that could distinguish whether an informal enterprise is mostly traditional or mostly modernising along a 'modernisation path'. The indicators include: the motive for starting the business; whether the product is for consumers or for intermediate/production purposes; the extent of supply linkages to informal or formal producers; skills and technology levels involved; the number of non-family employees; and whether the enterprise is based in residential or non-residential premises. (Several of these variables are indicated as significant for business viability elsewhere in the book.)

Applying this framework to non-retail enterprises – a group which is more likely to contain a modernising component – his results indicate that 60% of the surveyed non-retail enterprises in these two townships can be classified as traditional, with a noteworthy 40% 'modernising' enterprises. While service and manufacturing activities are present in both groups, the upper end of the modernising enterprises is 100% manufacturing.

---

[3] In contrast to the entry of enterprises and owners discussed earlier, these authors consider all workers together (owner-operators *and* employees).

[4] In this framework, 'traditional informal enterprises' are those that are static, less productive and incapable of facilitating capital accumulation; 'modernising informal enterprises' are those that are more dynamic and productive with better market linkages and higher earnings (see Rakabe, Chapter 11 in the book).

Structural handicaps hold back those who want to step up

Whatever modernisation disposition is present in the operators of township informal enterprises appears to be capped by structural features that prevent a modernising component from growing. Most township enterprises cater for a spatially localised demand pattern with largely low-income consumers. This constrains informal manufacturing and service enterprises. Philip (Chapter 12 in the book; also see her Econ3x3 article) highlights how, given the concentrated nature of the South African economy, the 'product space' of regular consumption goods – which should be within the scope of informal manufacturing as in other developing countries – is dominated by branded products that are mass produced by large, vertically integrated corporations. These products are widely sold in small retail shops such as spaza shops, as well as supermarkets in townships, at very competitive prices (due to economies of scale). While benefiting low-income consumers, it disastrously constrains informal manufacturing as well as retail. It also means that local spending does not benefit small-scale entrepreneurs but flows to formal-sector companies in the core economy – thus undermining local multiplier effects within township areas.

A second structural element relates to the ability of informal enterprises to grow (or enter an upper tier of the informal sector) by transcending local markets and gaining access to formal markets and supply chains. This can be seen as a form of 'transitioning' to markets outside the informal sector (or to more sophisticated submarkets in the informal sector). In Rakabe's survey a large majority of respondents indicated that neither government, nor formal manufacturers, nor retail chains form part of their customer base. Despite the proximity of factories in an industrial park, the non-retail informal businesses are not involved in the production of inputs for these producers, not even maintenance or repair services. Even modernising informal-sector enterprises are worlds apart from large, vertically integrated corporate enterprises. (A similar divide is found in the rural economy, as noted earlier; see Neves and Du Toit, Chapter 13 in the book).

This divide is most likely due to the inability of informal enterprises to provide goods and services at the scale and standards required by the formal-sector firms or government. Philip (Chapter 12) highlights how engaging with formal-sector firms requires a huge step-change in both business sophistication and formalisation for an informal enterprise. Apart from something as simple as a bank account, it requires elements such as capacity in financial administration (e.g. invoices, receipts, regular payments), permanent physical premises, an email address or an internet or social media presence. In addition, it requires compliance with business practices and conventions – the formal and informal rules of the business game – which together signal to formal-sector participants that contracts could be entered into with confidence and minimal risk. Lastly, the products or services also need to be more sophisticated. Together, these elements constitute a formidable constraint to accessing external markets.[5] Most informal enterprises remain locked into low-value income streams with little scope to grow.

It seems that policy-makers should consider measures to enable and capacitate owner-operators with the necessary skills and know-how to gain access beyond local markets. It is a complex issue, though. The solution is not as simple as reducing red tape, or formalisation or skills development. There also is a potentially important role for intermediaries, acting as an interface between informal and formal enterprises; the potential role of franchising deserves attention as well.

Of course, strategies for those enterprises that remain locked into local markets matter as well, being critical for livelihoods. Philip points out that formalisation will not help them – it will only add costs and obstacles without any benefits. Thus careful differentiation is necessary (whilst also distinguishing industries/sectors such as services, trade, manufacturing, etc.).

On a broader scale, to really address constraints to growth in the informal sector (and small business) attention needs to be paid to the nature and structure of the South African *formal sector*. In any case, policy for small enterprises and the informal sector should be regarded as integral to wider economic policies, particularly industry-specific industrial policy and competition policy. The services sector seems to be less affected by concentration or large companies and offers scope for expansion and innovation. This includes home-building and maintenance services in townships and informal-settlement areas, as noted earlier.

Rakabe’s survey results (Chapter 11) suggest that informal enterprise owners do not really recognise these structural constraints. Questioned on constraints, they indicate typical elements such as water or electricity connections, business stands, finance and credit, or a lack of government support.[6] But a large majority are not aware of available business support programmes. Access to markets and the threat of competition are not mentioned as major obstacles, even though most would like to expand their businesses. This may indicate an inadequate managerial awareness of how market access and competitive structure can impact their businesses.

Business-cycle vulnerabilities

A last level of challenges relates to the informal sector’s vulnerability to cyclical downswings in the business cycle. Two contributions in this book help us to understand this dimension.

[5] Philip rightly argues that such step-up challenges do not apply to informal enterprises only, but also to formal-sector small enterprises. Von Broembsen (2016) provides important case study material with regard to the obstacles faced by small enterprises trying to supply large retail chains.

[6] Perhaps surprisingly, crime, often mentioned in similar surveys in other locations such as Diepsloot (Mahajan 2014) or in the Khayelitsha township study (Cichello et al. 2011), was not prominent as an obstacle in these particular townships.

Citing ‘popular wisdom’ that the informal sector plays a positive role during recessions by absorbing labour released (retrenched) from the formal sector, Rogan and Skinner (Chapter 4) show that in the 2008–2009 recession, the opposite happened: employment in the informal sector declined more than in the formal sector.

From the macroeconomic analysis of Burger and Fourie (Chapter 8 in the book), which stretches over a longer period, we learn that the cyclical impact on the informal sector may be quite complex. In the entire period 2002–2015, which had three different cyclical phases, no consistent or single relationship was found between informal-sector employment and output.

The research confirms that the sector appears to be particularly vulnerable during severe downturns, as in the period from the third quarter of 2007 to the third quarter of 2009. During milder slowdowns in the economy it may happen that the informal sector absorbs some additional workers, but haphazard patterns can also occur, possibly because entry barriers limit the extent of such absorption.

In policy terms, this suggests that in severe downturns the informal sector should receive policy attention, particularly since informal enterprises typically have few resources (capital, savings or credit) to carry them through a recessionary period. Policy measures that enable them to ‘bridge’ major downturn periods, for example, could make informal enterprises cyclically more robust and contain closures.

On the positive side, the period up to November 2007 demonstrates that, during high or accelerating economic growth episodes, the informal sector has the ability (and inclination) to respond and create employment, thereby contributing to a reduction in the number of unemployed people. As such, the informal sector is part of the solution to reduce unemployment once economic growth starts to pick up.

Next extract: What policy approach for enabling the informal sector? How to support the forgotten sector?

References

The edited extracts are from:

Fourie FCvN (2018) Enabling the forgotten sector: Informal-sector realities, policy approaches and formalisation in South Africa. Chapter 17 in Fourie FCvN (ed) *The South African Informal Sector: Creating Jobs, Reducing Poverty.* HSRC Press, Cape Town.

Referenced chapters, by number:

4. The size and structure of the South African informal sector 2008–2014: A labour-force analysis – *Mike Rogan & Caroline Skinner*
7. Job-seeker entry into the two-tiered informal sector in South Africa – *Nwabisa Makaluza & Rulof Burger*
8. The informal sector, economic growth and the business cycle in South Africa: Integrating the sector into macroeconomic analysis – *Philippe Burger & Frederick Fourie*
11. Prospects for stimulating township economies: A case study of enterprises in two Midrand townships – *Eddie Rakabe*
12. Limiting opportunities in the informal sector: The impact of the structure of the South African economy – *Kate Philip*
13. Informal-sector employment in the rural non-farm economy in South Africa – *David Neves & Andries du Toit*

Other references:

Cichello P, Almeleh C, Mncube L & Oosthuizen M (2011) *Perceived barriers to entry into self-employment in Khayelitsha, South Africa: Crime, risk, and start-up capital.* CSSR Working Paper No. 300, University of Cape Town

Heintz J & Posel D (2008) Revisiting informal unemployment and segmentation in the South African labour market. *South African Journal of Economics* 76(1): 26–44

Mahajan S (ed.) (2014) *Economics of South African townships: Special focus on Diepsloot*. World Bank Studies. Washington, DC: World Bank

Von Broembsen M (2016) *You can't bite the hand that feeds you: The commercial and contractual relations between the four large South African food retailers and their SME suppliers*. REDI3x3 Working Paper No. 22