



DEVELOPMENT POLICY  
RESEARCH UNIT

A DPRU Policy Brief\*: **PB 15/44**  
Commissioned for the



**WORLD BANK GROUP**  
Jobs

## INFORMALITY AND INCLUSIVE GROWTH IN SUB-SAHARAN AFRICA

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**December 2015**

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## INTRODUCTION

In the last decade a number of emerging markets have recorded relatively high growth rates, yet many struggle to convert this growth into improvements in poverty and inequality, suggesting that this economic growth is not inclusive. Inclusive growth refers to growth that produces employment and income benefits for vulnerable population groups, thus reducing poverty and inequality. Growth may fail to be inclusive when a large number of individuals do not participate in the formal economy and are either informally employed or unemployed. This research seeks to better understand the relationship between informality and inclusive growth in Africa, with a particular focus on South Africa. South Africa stands out in the region for having relatively high levels of unemployment and low levels of informal employment. As a result, South Africans typically hold one of two opposing views on informality. The first is that the informal sector is an underutilised source of new employment that should be promoted, since ‘any employment is better than unemployment’. The second is that informality should be discouraged given the inferior quality of informal employment, and that the focus should be on creating decent jobs in the formal sector. The central research question is therefore: “Do informal labour markets promote or constrain inclusive growth?”

## 1 UNDERSTANDING INFORMALITY

### 1.1 Characteristics of the informal sector

#### *The informal sector is generally an important source of job creation, especially for vulnerable groups*

Overall, informal employment is estimated at about 66 percent of total employment in the SSA region, the bulk of which are in informal enterprises or self-employment (53 percent; Vanek et al., 2014). Informal employment outside of the informal sector – that is, being informally employed in a formal enterprise – is just 14 percent of informal employment. Roughly one-third of informal employment is wage employment, with two-thirds self-employment (Vanek et al., 2014). Employed women are more likely to be find themselves in the informal sector than employed men (74 percent of employed women find themselves in informal employment relative to 61 percent of men) and overall the informal sector also employs more women than men (Vanek et al., 2014). Taken together, these statistics illustrate the importance of the informal sector in job creation as well as in absorbing into employment some of the most vulnerable groups within the population.

#### *The informal sector offers lower income, fewer benefits and less security*

Benefits of being employed in the formal sector include higher wages, access to welfare and health services (if they are not universal) (ILO, 2009), work stability and access to credit. According to the ILO (2009), the average wage of informal sector workers in Africa is just one-fifth of that of their public sector counterparts. Kingdon and Knight (2007) find that formal sector wages and benefits in South Africa are far greater than in the informal sector. Also in South Africa, Bargain and Kwenda (2010) estimate that informal sector employees suffer a 62 percent wage penalty compared to formal sector workers, while there is a 30 percent penalty for the self-employed. Although this makes formality more costly for employers, formality also benefits employers by helping to insulate firms from corruption, improving their access to credit (Caro et al., 2010), and improving their access to other business services provided by the state, such as contract and law enforcement.

#### *The informal sector is less productive than the formal sector*

The productivity differential between the formal and informal sector can be profound. For African countries, La Porta and Shleifer (2014) find that the ratio of value added by informal firms to that by formal firms ranged from one percent in the Democratic Republic of Congo and three percent in Rwanda, to 10 percent in Kenya, 14 percent in Botswana (the median for the region) and 70 percent in Cape Verde. In an earlier study, the authors also found

that registered firms are typically more productive than unregistered firms; even small registered firms are more productive than unregistered firms; and large firms are significantly more productive than small firms (La Porta & Shleifer, 2008). These productivity differentials at the micro-level are often evident at the macro-level: countries with high levels of informality typically have lower income levels. It is for this reason that the OECD (2006) argues that, “While informal enterprises may provide a short-term solution to a household’s livelihood needs, creating an economy with a higher proportion of formal enterprises and jobs is important to long-term welfare creation, stability and poverty reduction”.

### ***Staying informal can be a rational choice***

The regulatory and institutional environment can contribute to the decision to remain in the informal sector as opposed to the formal sector. Firstly, stringent regulations create barriers to formalization, which increase the costs of transitioning from informality to formality. Secondly, in a number of African countries, certain institutions, including those that uphold property rights and facilitate access to credit, are not necessarily upheld (Benjamin & Mbaye, 2014), which decreases the benefits of transitioning to the formal sector. Thirdly, where the informal sector is pervasive, enforcing formality becomes difficult, particularly when institutions are weak, which decreases the costs of remaining informal. Overall, this means that there is less benefit and a greater cost to entering the formal sector. To some extent, this explains why the informal sector is as large as it is in SSA.

## **1.2 Informality’s impact on growth and jobs in the formal sector**

The various advantages inherent in formality from the perspective of workers can often represent disadvantages from the perspective of firms, when compared to informal sector firms. Formal firms have higher wage costs and are less flexible (Almeida & Carneiro, 2005). Thus, formal sector firms may face significant competition in the form of informal firms with their lower cost structures (OECD, 2009). As La Porta and Shleifer (2014) note, this view of “informal firms as parasites competing unfairly with law-abiding formal firms” implies that “informality should be suppressed, not unleashed”.

Despite competition between the formal and informal sector, it is important to acknowledge the linkages between the two. Ligthelm (2004; 2005), for example, finds evidence of increasing linkages between the sectors in South Africa, evidenced by supplier relationships from formal suppliers to township retailers. This, it is argued, is the result of the recognition by formal wholesalers of the informal sector as a key channel to the township consumer (Ligthelm, 2004). Similarly, Böhme and Thiele (2012) investigate formal-informal linkages in the economic capitals of six West African countries, namely Benin, Burkina Faso, Mali, Niger, Senegal and Togo. They find that while informal goods are almost exclusively sold through informal distribution channels, the majority of household expenditure on formal goods in each of the countries occurs through informal distribution channels (with spending on formal goods through informal distribution channels typically outweighing spending on formal goods through formal distribution channels by a factor of roughly two to one; Böhme & Thiele, 2012). Paralleling the South African experience, Böhme and Thiele (2012) point to the potentially negative impact of (formal) supermarkets on the livelihoods of informal households, as they limit the available options.

## **1.3 Facilitating transitions from unemployment to informal employment and from informality to formality**

### ***Transitions can occur naturally***

There are examples of firms that move organically into the formal sector as they grow. Sonobe et al. (2011), in a case study on metalworkers in Kenya, find that businesses organically move into the formal sector when they outgrow the informal sector. In this case, government did not provide any support for the informal businesses besides a space in which to operate. Grimm et al. (2012), based on a study of seven West African countries, suggest

that firms suffering from external constraints as opposed to internal constraints are far more likely to grow and even formalise. External constraints are linked to the external environment and include access to finance, to a fixed business location, and to basic infrastructure. Internal constraints on the other hand, have to do with skills of those within the enterprise. External constraints are supposedly not binding and can be dealt with through various interventions in the short term.

***Facilitating transition with policies aimed at supporting microenterprises***

One way of encouraging firms to move naturally into the formal sector is to support microenterprises; relaxing external constraints to formalization, so that they begin to outgrow the informal sector. In East Africa, innovations such as M-Pesa (mobile money transfer), and access to online platforms and e-services have had a positive impact on microenterprises. This is an example of a policy intervention targeting firms' external constraints. Frederick (2014) examined the relationship between mobile money transfer and profits of microenterprises in Zambia, and found evidence of substantial positive net marginal benefits for microenterprises using mobile money. Mbogo (2010) undertook an analysis of the usage of M-Pesa by microenterprises in Kenya, the majority of which were argued to be informal. It was found that the convenience of the money transfer technology, its accessibility, lower cost relative to other structures, security and usage services, enhance the success and growth of microenterprises. While services such as these may result in a business growing and becoming more profitable, it does not necessarily mean that the business will enter into the formal sector. However, the positive impact on income suggests that businesses become more sustainable and likely to survive, thereby promoting inclusive growth.

***Facilitating transition with policies aimed at increasing formalisation by decreasing informalisation***

The legislative environment often constrains microenterprises. When policies which aim to increase formalisation do so by targeting informalisation, they can have unintended consequences. Policies which increase the costs of informalisation could lead to firms exiting the market altogether, thereby increasing unemployment. Alternatively, they could result in firms simply incorporating the higher costs of informalisation into their business models, having no effect on the size of the sector at all. Finally, they could lead to firms moving into the formal sector as the relative costs of formalising decrease – as is the aim of such policies. A combination of these results is also possible and likely, given that firms in the informal sector represent a heterogeneous group.

The costs of enforcing formality may outweigh the benefits depending on the context in which the firm operates. A recent set of studies by Charman et al. (2013) and Charman et al. (2014), provides an example of public policy directed at enforcing formality within a sub-sector of South African retail firms (namely liquor retailers), and the impact of these policy efforts. Illegal liquor retailers, or 'shebeens', are plentiful, largely heterogeneous, and have strong linkages to the formal sector as well as to the communities in which they operate. As a result, formalisation policies have largely been unsuccessful, with only a few shebeens formalising (11 percent), and most developing new strategies to evade law enforcement instead. Enforcing informality can also lead to negative consequences when the impetus for such policies comes from the promotion of political interests of government officials, rather than market efficiency. In a study of Zimbabwe's small-scale mining sector, Spiegel (2012) discusses how the promotion of government interests lead to the suppression of the industry: by making informal mining activities illegal and sentencing transgressors harshly. This is one example in which formalisation policies have been used to justify heavy-handed law enforcement campaigns that have resulted in insecure livelihoods for a number of small-scale producers (Spiegel, 2012).

What is clear is that there is a lack of information regarding the heterogeneity of the informal sector, and policy interventions do not always account for this. Firms facing mainly internal constraints require different interventions to those facing mainly external constraints; firms with internal constraints require interventions that target skills and basic managerial practices, while microenterprises with only external constraints require policy interventions

that facilitate doing business in the firm's environment. Further, formalisation policies seem to favour small businesses that are more successful and in a better position to exploit such interventions, since formalisation requires that firms incur a number of costs that are often more affordable for firms that are better off. Thus, policy-makers should recognise that firms at different stages of development will formalise at different rates. Enforcing formalisation may have more detrimental effects on welfare if it forces firms out of the market. Finally, policies need not always target formalisation through regulation, as certain firms will outgrow the informal sector organically. In order to facilitate this, skills training, access to credit, a space in which to do business, and a reliable energy source, may allow businesses to flourish and expand into formal markets.

## 2 INFORMALITY AND INCLUSIVE GROWTH IN SOUTH AFRICA

In this section, we turn our focus towards South Africa, aiming to provide evidence relating to some of the issues raised in the previous section. In particular, we investigate the following questions in the case of South Africa. First, to what extent do formal and informal sector workers differ from each other in their observable characteristics? Second, how does informal sector employment react to changing economic conditions? Is it pro- or countercyclical, and what are the implications for the inclusiveness of economic growth? Third, how common are individual-level transitions into informal and formal sector employment, and is there any evidence of obstacles to certain types of labour market transitions?

### 2.1 Who is Informally Employed in SA?

Formal employment is considerably more common than informal employment in South Africa, with only 34.6 percent of the employed in informal employment. Workers are most likely to be formal employees, followed by informal employees, with 27.3 and 11.5 percent of working-age individuals engaged in these activities respectively. Self-employment (whether formal or informal) is not common, although individuals of working-age are more likely to be informally than formally self-employed.

Informal employment is most common in African and Coloured South Africans, women, those who have not completed secondary or tertiary education, youth aged 15 to 34, and those living in traditional rural areas. Mean and median monthly wages are also substantially lower in informal employment, compared to formal employment wage levels. The mean monthly wage for formal employees is R6 260 per month, compared with only R1 845 per month for informal employees. Similarly, the formally self-employed earn on average R20 237 per month, compared with only R1 684 for the informally self-employed (NIDS Wave 3, own calculations).

These large wage differentials are echoed in differences in poverty measures by labour market status<sup>1</sup>. Irrespective of the poverty line or poverty measure used, there is greater poverty amongst those that are not employed (i.e. unemployed or not economically active) compared with those that are employed, and greater poverty amongst those who are informally employed compared with those that are formally employed. Thus, there are higher levels of deprivation amongst those with weaker connections to the labour market: using the lower-bound poverty line, between 56 and 60 percent of working age adults who are not employed are poor, compared to between 37 and 45 percent of the informally employed, 17.5 percent of formal employees, and just 4.9 percent of the formal self-employed (NIDS Wave 3, own calculations).

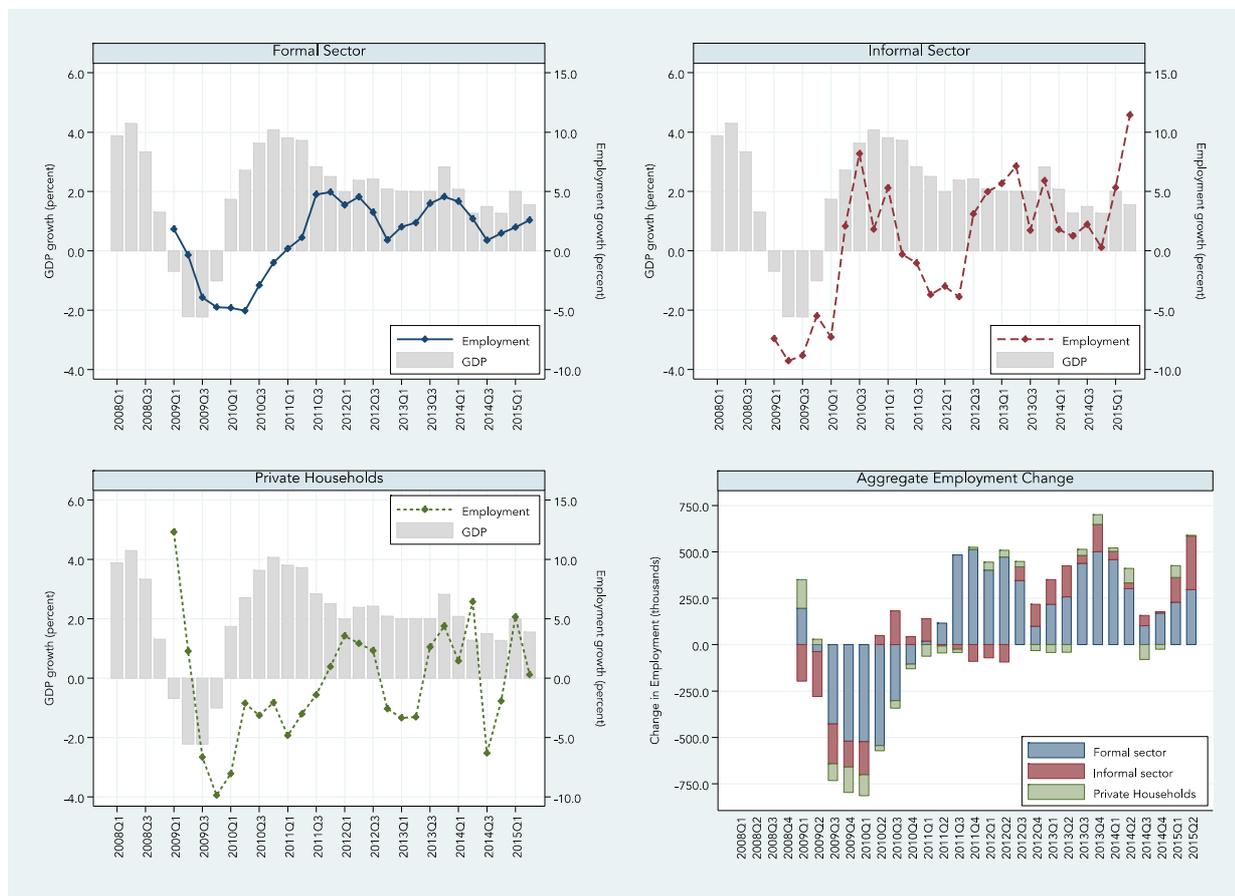
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<sup>1</sup> The poverty lines used are from Budlender et al. (2015).

## 2.2 Employment and the business cycle

One of the key mechanisms through which informality may promote inclusive growth is through the ability of the informal sector to absorb the unemployed into employment. This is particularly important in the context of cyclicality in the labour market as employment responds to changing economic conditions.

**Figure 1: Economic growth and formal and informal employment in South Africa, 2008Q1-2015Q2**



Source: Quarterly Labour Force Surveys, 2008Q1-2015Q2 (Statistics South Africa); South African Reserve Bank (2015).

Notes: GDP growth rates calculated as quarterly year-on-year growth rates of seasonally adjusted real GDP at constant 2010 prices. Employment growth rates are quarterly year-on-year growth rates. QLFS data only begins in 2008Q1; therefore, year-on-year changes are only available from 2009Q1 onwards.

Figure 1 presents economic growth rates alongside changes in formal and informal employment in South Africa for the period since 2008. The first three panels plot employment growth for each sector—formal, informal, private households—and real GDP growth over time. The fourth panel (bottom right) plots actual employment changes in each of the three sectors for the same period. The labour market impact of the 2009 recession in the real economy is clearly evident. Year-on-year, employment declined in each of the three sectors in the quarters during or immediately after the economic contraction. However, the data suggests that it was informal sector employment that contracted earliest: while informal sector employment was already strongly contracting in 2009Q1, it was still only marginally negative in the formal sector in the following quarter. The bottom right panel confirms this, indicating that initial job losses during the recession were almost exclusively within the informal sector. In contrast, employment change in private households mimicked quite closely that in the formal sector. This is not particularly surprising given that these are primarily domestic workers and, given the wage differentials between the three sectors, are most likely to be employed by households with formal sector jobs. However, informal sector

employment growth recovered quickly and was positive by the second quarter of 2010. In contrast, formal sector employment only began growing again in the first quarter of 2011, while private household employment growth turned positive three quarters later.

Although this data covers a relatively short period of time and includes only one period of negative economic growth, it suggests a degree of procyclicality in informal sector employment in South Africa since 2008. Informal sector employment reacts swiftly to changing economic circumstances in a way that the formal sector cannot. In the aftermath of economic downturns, it is this flexibility that may help promote more inclusive growth by getting unemployed individuals (back) into the workforce during economic recoveries, more quickly.

### **2.3 Extent of labour market transitions into and out of (in)formality**

The National Income Dynamics Study (NIDS) panel enables the analysis of the extent of transitions into and out of formal and informal employment between 2008 (Wave 1) and 2012 (Wave 3).<sup>2</sup> The transition matrix presented in Table 1 presents transitions between labour market statuses, and is augmented to include the overall percentage of working-age individuals in each state in 2008 and 2012 on the inside border of the matrix, with 2008 levels reported on the left and 2012 levels reported above the interior matrix. We include individuals who were between the ages of 15 and 64 years in 2008, with no restriction on age in 2012.

Overall, the proportion of the working-age population in formal employment rose between 2008 and 2012, from 23.0 percent to 29.9 percent. This is accompanied by a decrease in the proportion of the working-age population in informal employment, rather than an increase in the overall level of employment in South Africa. As 2008 and 2012 can be viewed as pre- and post-recession, this indicates that the recession years may have facilitated a shift from informal to formal employment in South Africa. This is consistent with the data presented earlier in Figure 1 and is supported by Verick (2010) who found that, over a one-year period between 2008 and 2009, the informal sector accounted for 64 percent of total job losses.

Each row in the interior matrix of Table 1 shows the proportion of individuals in each state in 2008 that found themselves in any given state in 2012. For example, the first row of the interior matrix indicates that, of all those individuals who were formal employees in 2008, 74.0 percent were still formal employees in 2012 while 10.2 percent were not economically active. This indicates the relative 'stickiness' of the formal employee state compared with the other states, as nearly three-quarters of those who were formal employees in 2008 were still formal employees in 2012.

Overall, both types of informal employment were more transient than formal employment between 2008 and 2012. Only 23.3 percent and 20.1 percent of those who were informal employees and informally self-employed in 2008 were still in these states in 2012. Of those individuals who were informal employees in 2008, 32.7 percent had found formal employment in 2012. In addition, individuals in informal employment in 2008 were more likely than those in formal employment to be searching unemployed, discouraged (non-searching unemployed) or not economically active in 2012. The transition from informal to formal self-employment was almost unheard of at just 1.8 percent. Instead, the informal self-employed in 2008 were more likely to transition to inactivity in 2012 than to any other status. While 26.6 percent of the searching unemployed in 2008 continued to actively seek work in 2012, 21.2 percent transitioned to formal employment. In terms of transitions to the informal sector between 2008 and 2012, 14.8 percent of the unemployed transitioned to informal employment while just 5.2 percent of individuals

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<sup>2</sup> Ideally, labour market transitions would be analysed between 2008 and 2010 (Waves 1 and 2) and between 2010 and 2012 (Waves 2 and 3). However, due to problems related to the labour market status variable in Wave 2, a decision was taken to analyse only the 2008-2012 transitions. For more detail on this issue, see Cichello et al. (2012).

transitioned to informal self-employment. A large proportion of the searching unemployed in 2008, however, were part of the not economically active population in 2012.

These aggregate transitions hide important variations between different groups within the population. Further analysis of the NIDS data reveals that men are in general more likely to transition into the formal employee status than women. Further evidence of men being more likely to transition 'upwards' includes higher rates of transition from non-searching unemployment and economic inactivity to searching unemployment, and lower rates of transition into economic inactivity from all other statuses except formal self-employment. Lower levels of education appear to be related to poorer 'quality' transitions over the period. Those who have completed a secondary education are more likely to remain in formal employment than those with fewer than 12 years of education. This suggests that higher levels of educational attainment are a *sine qua non* for success in formal self-employment over time, a finding with important implications for policies that aim to formalise informal sector enterprises. Those with fewer than twelve years of education are also less likely to transition from informal employment, unemployment or inactivity to formal employment than those with more education; they are also more likely to transition into economic inactivity from every state in 2008 than are those with more education.

**Table 1: Labour market transition matrix, 2008 to 2012**

		Year Total	Status in 2012						
			Formal Employee	Formal Self-employed	Informal Employee	Informal Self-employed	Searching Unemployed	Non-Searching Unemployed	Not Economically Active
			<b>29.9</b>	<b>1.2</b>	<b>12.0</b>	<b>5.1</b>	<b>15.8</b>	<b>2.6</b>	<b>33.4</b>
Status in 2008	Formal Employee	<b>23.0</b>	74.0	1.2	7.0	1.3	5.5	0.8	10.2
	Formal Self-employed	<b>1.4</b>	16.9	41.5	1.6	18.0	9.9	0.9	11.0
	Informal Employee	<b>13.3</b>	32.7	0.5	23.3	3.0	12.0	2.5	26.1
	Informal Self-employed	<b>7.7</b>	10.6	1.8	9.3	20.1	13.2	1.6	43.4
	Searching unemployed	<b>15.7</b>	21.1	0.6	14.8	5.2	26.6	2.7	29.1
	Non-search. unemployed	<b>5.6</b>	12.7	0.1	13.3	4.9	26.4	7.9	34.6
	Not Economically Active	<b>33.3</b>	8.7	0.3	9.5	4.2	19.1	2.9	55.2

Source: Own calculations, NIDS Wave 1 and Wave 3.

Notes: All statistics weighted using Wave 1 to Wave 3 panel weights. Rows in the interior matrix sum to 100.0 percent.

## CONCLUSION AND POLICY RECOMMENDATIONS

The relationship between informality and the inclusiveness of economic growth is complex and varies in different contexts. Firstly, we find that the informal sector promotes inclusive growth through providing an alternative to unemployment when there are no alternative employment opportunities available; particularly for those with low skills, as well as women and young people. This is true for sub-Saharan Africa broadly, as well as for South Africa. In terms of our measures of inclusive growth, the unemployment-informality transition reduces poverty, but is unlikely to have much effect on inequality in a high-unemployment society such as South Africa.

In South Africa, we find that transitions from searching or non-searching unemployment to informal sector employment or self-employment are relatively rare, and, that there are two specific challenges that policymakers

should address: the overarching skills gap, specifically in entrepreneurship and practical business management; and the failure of female-run micro-enterprises to progress. Skills constraints are often an outcome of poor quality schooling, which is prevalent for the majority of households at the lower end of the income distribution. Therefore, there is a larger issue at stake for policymakers to deal with regarding the infrastructure and quality of teaching in schools. Schooling should also be used as a tool to empower young women who may want to become entrepreneurs instead of transitioning from school to a traditional formal sector type job. In addition, specifically targeted incentives and business incubators should be used to support female-run micro-enterprises.

Secondly, we find that formal sector workers are better off, and therefore the informal sector may inhibit inclusive growth when workers find themselves in precarious positions where earning benefits are outweighed by job insecurity and other potential negative impacts associated with informal employment. In South Africa, we find only one-third of informal employees transitioning into formal employment or self-employment over the four-year period examined. In addition, there is virtually no evidence of formalisation amongst the informal self-employed over the period. Nevertheless, informality does seem to serve as a stepping stone to formal employment, as these 'upward' transition rates are larger than the 'downward' transition rates from formality to informality.

For those informal sector enterprises that are larger and more profitable, policymakers should aim to promote growth of enterprises such that they join the formal sector more organically. The evidence suggests that policies that are supportive of informal sector firms and that encourage their growth are more likely to lead to transitions to formality. This typically requires providing access to basic services such as electricity and water, as well as suitable space for their activities. In addition, ICT technology should be made accessible for broader communities including those in rural areas, although this requires prices to be more competitive. As has been found in West Africa, if businesses are given a space in which they can operate and grow, some transition into the formal sector and begin to compete in higher value products. This is preferable to enforcing legislation that penalises microenterprises, with those unable to afford to comply being forced out of the market. While such policies may in the short run reduce informality, they certainly have a negative impact on welfare and isolate individuals from the potential benefits of economic growth. In addition, firms that are better off are more likely to contribute to the economy, either through moving into the formal sector and contributing taxes, or by providing a service at a fair price that promotes the welfare of consumers.

Finally, the flexibility that characterises the informal sector may have a positive role in promoting inclusive growth in the aftermath of economic contractions.

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