The Informality Trade-Off: Wages and Rural-Urban Migration in South Africa*

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January 21, 2025

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Abstract

In rapidly urbanizing countries, many urban inhabitants work in the informal sector. Should policy makers try to shrink it? To answer this question, I develop a general-equilibrium model of rural-urban migration based on frictional job search and matching. A key novelty of this approach is to combine migration choice of workers with occupational choice across formal and informal labour markets. I first estimate my model with a South African panel of workers. I find that the urban informal sector serves as a stepping-stone to urban formal jobs. This makes it a valuable outside option for urban formal workers. Then, I simulate formalization policies by tripling the expected cost of being inspected for urban informal firms. I find a decline in informal employment and wages that is not associated with job destruction, but with wage cuts in the formal sector. This is because urban formal firms now have more labour market power. As a result, cities become less attractive. This is exacerbated by the response of rural firms that offer higher wages and retain potential migrants: the urban population share falls by 4%. Overall, the decline in urban informality improves the allocation of labour, both across sectors in urban areas and towards more productive firms in rural areas, at the cost of lower workers' welfare.

JEL Classification: J31, J46, O15, O18, R23

Keywords: Rural-urban migration, job search, informal sector, spatial misallocation

*I am grateful to Benoît Schmutz-Bloch for supervising this project ; to Geoffrey Barrows, Roland Rathelot, and Pauline Rossi for following it as part of my PhD committee ; and to all CREST people that I cannot cite here. For helpful comments and suggestions, I thank Damiano Argan, Toshi Arimura, Kentaro Asai, Jean-Pascal Bassino, Pierre-Philippe Combes, Sylvie Démurger, Klaus Desmet, Xiaofang Dong, François Gerard, David Gomtsyan, Nicolas Gravel, Nina Guyon, Tomohiro Hara, Oliver Harman, Jonas Hjort, Clément Imbert, Leonard le Roux, Kwok-Hao Lee, Romaine Loubes, David Margolis, Samuel Marshall, Angelica Martinez Leyva, Aline Mortha, Hiro Okoshi, Pinchuan Ong, Fabien Postel-Vinay, Imran Rasul, Alex Rothenberg, Christian Schluter, Harris Selod, Yuta Suzuki, Kohei Takeda, Gabriel Ulyssea, Nicola Viegi, Ao Wang, Yun Xiao, and Huaiping Yuan ; participants at the UCL PhD Seminar, the Paris PhD Seminar on Urban Economics, the 13th European Meeting of the Urban Economics Association, and the 2nd HEC Economics PhD Conference ; the Policy and Strategy team at the City of Cape Town, and faculty members at the University of Cape Town. The views expressed in this paper are those of the author and do not reflect the position of CREST, Ecole Polytechnique, or IP Paris. This research is funded by LabEx ECODEC - Investissements d'Avenir, Institut Louis Bachelier - Just Transition Hub, and EUR DATA EFM.

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1 Introduction

According to the World Bank (2023), the global urban population is set to double by 2050, with Sub-Saharan Africa (SSA) and East Asia and Pacific (EAP) experiencing the most rapid urban growth. There, rural-urban migration plays a significant role in driving urbanization rates, especially in low- and middle-income countries (Wahba Tadros *et al.*, 2021). In this paper, I focus on an important aspect of this phenomenon: the share of job-related moves that depend directly or indirectly on informal job opportunities in cities. Are such jobs associated with spatial labour misallocation? This paper shows that it is not necessarily so, as I find that reducing urban informality can lead to higher total output but also lower workers' welfare. In my results, migration choice acts as a substantial adaptation mechanism: a decline in urban population mitigates both the fall in welfare and the rise in output.

Informal jobs designate unregistered positions where firms and workers do not comply with, or are not covered by, laws and regulations. To quantify the effect of urban formalization policies and assess how the urban informal sector affects the spatial allocation of labour, I develop a general-equilibrium model of rural-urban migration with frictional job search and matching. Indeed, formal and informal labour markets appear to be interconnected: firms with similar productivity levels and operating in the same industries can be found in both sectors. Besides, some informal firms do change status in response to labour supply and demand shocks, and (mostly low-educated) workers do transition between sectors and perform similar tasks (Ulyssea, 2020). This generates spillover effects that make it difficult to study equilibrium outcomes in reduced form, all the more so when accounting for space.

I therefore build upon the wage-posting model of Burdett & Mortensen (1998). As in Schmutz & Sidibé (2019), homogeneous workers randomly search for jobs locally and remotely, on- and off-the-job. They move from rural to urban areas upon finding a job and incurring a fixed mobility cost. As in Meghir *et al.* (2015), the urban labour market is further divided into a formal and an informal sector: formal workers benefit from unemployment insurance and severance payment when being fired. Workers search across both sectors, subject to amenity differentials and frictions that vary across origin and destination states. Indeed, informal jobs may be seen as an alternative to formal jobs since they are subject to different frictions. For workers, these frictions include monetary and psychological search costs, as well as limited networks. For firms, they essentially cover advertising and recruiting costs (Caria & Orkin, 2024). In the model, firms are pinned to a location and are heterogeneous in productivity. They choose whether to enter the market and in which sector to operate based on their expected profits. Then, they post unique wages given existing matching conditions. Whereas formal firms have to pay taxes, informal firms incur a relative cost that is increasing and convex in firm size: this cost can be narrowly interpreted as the expected cost of being inspected and/or fined, or more broadly as the opportunity cost of being excluded from formal land, capital, and financial markets. A key novelty of this paper is to combine migration choice of workers with formality choice of workers and firms, two elements that I show to be complementary.

The allocation of workers across sectors and locations is obtained by assuming that wage offers are consistent with local reservation welfare values, and mobility-compatible indifference welfare values. The latter formalize the dynamic utility trade-off between locations faced by workers. I further assume standard steady-state conditions on local employment shares at each wage level. Importantly, I do not assume that relative urban and rural population shares are at the steady state: this is because I deal with countries that are still urbanizing. To solve for workers' allocation, I therefore target a stationary urban growth rate that reflects structural change factors that are not fully micro-founded in the model. This is similar in spirit to search-and-matching models with population growth, such as Head & Lloyd-Ellis (2012), except that I do not assume a constant growth rate in each state. My results should therefore be interpreted as a snapshot of labour market outcomes at a given stage of a (slow) structural change process, rather than as a stable equilibrium outcome over the very long term. On the firms' side, I recover wage-posting policies by inverting the workers' program and assuming that local shares of employees at each individual firm are at the steady state. To solve for the allocation of firms across sectors, I further assume free entry in cities, and that urban firms of equal productivity make equal profits in the formal and informal sectors over the productivity range where the two overlap.

I estimate my model with a nationally representative South African panel survey covering individuals' migration choices and labour market outcomes more or less every two years over the 2008-2017 period. I first show that South Africa is comparable to other low- and middle-income countries in SSA or EAP in terms of urbanization and formalization trends, but that it is closer to emerging economies elsewhere (e.g., Turkey) in levels. Second, I process the data to be consistent with my modelling assumptions. To do so, I reduce my benchmark sample to low-educated working-age adult males to abstract from the spatial sorting of workers with respect to skills suggested by Young (2013), Alvarez (2020), and Hicks *et al.* (2021). Besides, the low-skilled segment of the population is the most affected by informal employment. I observe that this segment of the workforce is very substitutable across industries and occupations, hence relatively unspecialized (Belot *et al.*, 2019), which conforms with the assumption of homogeneous workers. It also features relatively low returns to experience (Bobba *et al.*, 2021), which makes it possible to keep a stationary model structure. Focusing on adults allows me to abstract from schooling decisions (Bobba *et al.*, 2022) and differential returns to schooling across the informal and formal sectors (Joubert, 2015; García, 2015). Moreover, since males typically do not value the flexibility in working hours provided by informal jobs as much as females do (Berniell *et al.*, 2021; Bernatzky *et al.*, 2024), I abstract from the intensive margin of labour supply too.

Then, I check how informal job characteristics in my sample align with existing evidence (Ulyssea, 2020) to motivate my modelling approach. I find that rural migrants have a higher propensity to work informally in cities than urban stayers, but that they are not more likely to work in the informal than the formal sector conditional on migrating. Therefore, if search frictions stay constant across counterfactuals and informal jobs are replaced by formal jobs one-to-one, only a change in the value of job offers will affect the spatial allocation of workers in equilibrium. As in Donovan *et al.* (2023), I also find that formal workers tend to have higher wages and more stable jobs than informal ones. Contrary to them, I find a non-negligible probability to transition from informal to formal jobs locally. This has important consequences in equilibrium, as the value of the informal sector as an outside option for formal workers limits the local labour market power of formal firms in the presence of matching frictions (Donovan & Schoellman, 2023): a local change in the share of informality will therefore affect job offers in counterfactuals, hence the spatial allocation of workers. Urban informal jobs may also serve as a stepping-stone for rural migrants in search of higher urban incomes and/or higher urban amenities (Selod & Shilpi, 2021). This is all the more relevant in contexts marked by high information frictions holding back rural-urban migration overall (Lagakos, 2020). In fact, I find that rural migrants who move to urban informality experience a wage cut when doing so: under common preferences, this can only be justified by higher urban amenities or future incomes. I see these different elements as further motivating evidence for my modelling approach which incorporates them all.

At baseline, offer distributions and transition rates that capture underlying search-and-matching frictions are jointly identified by observed wages and transition probabilities across geo-employment states. The estimated model has a good fit on targeted quantities, and a satisfying one on untargeted quantities (worker and firm shares). I find higher average welfare values for urban informal workers than for rural workers, in spite of higher relative rural amenities. The choice of moving into urban informality is therefore rationalized by improved career prospects. Indeed, I find that the option value of future urban formal jobs accounts for 20% of urban informal welfare. The informal sector can therefore be seen as a stepping-stone to formal jobs in my context. Incidentally, I find that urban areas are more productive than rural ones. Rural firms also appear to have more market power than urban ones. Within cities, the lower average productivity of informal firms comes from a composition effect: given existing matching conditions, it is never profitable to operate in the informal sector passed some productivity threshold. Still, for a given productivity level, formal and informal firms offer similar values as they partly compete for the same workers: informal firms need to pay higher wages that compensate them for the loss of welfare benefits in order to be attractive. These factors explain the resulting welfare values in equilibrium.

In counterfactuals, offer distributions and firms' behaviour are endogenized by targeting the underlying productivity distribution in which urban firms draw. It is estimated at baseline and assumed to stay constant across counterfactuals. Correspondingly, the rural-urban productivity gap is fixed, and so is the structural urban growth rate that is supposed to reflect it. The main policy scenario I estimate consists in tripling the monitoring costs that weigh on urban informal firms. This simulates a wide range of formalization policies adopted in low- and middle-income countries (Ohnsorge & Yu, 2022), often with varying success (Gallien & Van den Boogaard, 2021), to address the negative externalities associated with informal jobs (notably smaller government revenues). In response to the policy shock, informal firms of various productivity levels formalize depending on their relative profit opportunities in the formal sector. In my context, they are productive enough not to exit the market: informality mostly appears as a tax/competition avoidance strategy for firms. Therefore, the urban share of informal firms decreases by 8% and the urban share of informal workers by 10%.

This generates more competition for workers in the formal sector, destroying the least productive firms there: the share of inactive firms and the local unemploymen rate rise by 2%. Still, over most of the productivity distribution, this effect is dominated by relaxed matching conditions for firms which are now competing for a wider pool of workers with fewer outside options. Consequently, formal firms post lower wages. In the informal sector, firms reduce their posted wages to mitigate their increase in size-related costs. Formal and informal firms also compete between each other and match with their respective workers conditionally on their productivity level, but this is second-order since search frictions are larger across than within sectors. As urban wages fall, it becomes profitable for some rural firms to outbid urban firms and retain workers. Such competition pushes the lowest-productivity rural firms out of the market and reallocates workers towards the most productive ones. The urban population share hence decreases by 4%, until congestion forces adjust to reflect the new transitory spatial equilibrium.

The rise in urban output generated by the reallocation of informal workers towards the formal sector comes at the cost of lower welfare due to firms' wage-setting power. In rural areas, increased wages and the reallocation of workers towards more productive jobs improve both welfare and output. However, more workers are now staying in rural areas where they are also less productive. This limits the rise in total output (+2%). Moreover, as the rural-urban welfare gap remains high, the increase in rural population does not fully offset the fall in workers' welfare caused by lower urban wages (-1%). Like urban informal jobs, rural jobs limit the monopsony power of urban firms, which is also a source of local labour misallocation. Indeed, when removing rural-urban migration from the model, the negative welfare effect of the policy is 6 times stronger for urban workers than in my main specification. This points to the role of rural jobs as an important alternative outside option for potential migrants when urban informal employment becomes more constrained. The positive output effect is 5 times weaker, as the most productive urban firms are also those which cut wages the most, reallocating workers towards the least productive ones.

Related literature. I contribute to the existing literature in four ways. First, I contribute to the labour economic literature dealing with the role of workers' informality in low- and middle-income countries. When simulating negative demand shocks on informal firms, researchers generally find positive effects on output, but negative (Ulyssea, 2010; Charlot *et al.*, 2015), neutral (Dix-Carneiro *et al.*, 2021; Haanwinckel & Soares, 2021), or even positive (Meghir *et al.*, 2015) effects on welfare. For comparison, the corresponding reduced-form literature (Almeida & Carneiro, 2009, 2012; De Andrade *et al.*, 2016; Ponczek & Ulyssea, 2022; Samaniego & Fernandez, 2024) typically finds negative effects on both welfare and output. This is because it mostly deals with law enforcement on formal firms hiring workers informally (Ulyssea, 2018), a possibility that I exclude in the absence of firm data. Compared to the symmetric policy that consists in decreasing the costs of formality for firms through taxes or entry costs (Ulyssea, 2010; Charlot *et al.*, 2015; Narita, 2020; Haanwinckel & Soares, 2021), increasing the costs of informality for firms empirically leads to higher formalization of workers (Ulyssea, 2020). This also holds in comparison with the policy that consists in reducing the costs of formality for workers through wage subsidies (Abel *et al.*, 2022). Note that informal workers are rarely targeted directly. I therefore focus on increasing the costs of informality as my main policy scenario in this paper.

Although my approach is closer to the one adopted by Meghir *et al.* (2015) for Brazil, my results more closely align with Ulyssea (2010) and Charlot *et al.* (2015), as I show that the formalization shock generates a trade-off between lower welfare and higher output. I argue that this is due to different underlying frictions in our empirical settings. As urban informality comes with non-negligible dynamic gains in mine, it is also a more valuable outside option for formal workers. This explains why its reduction increases the monopsony power of formal firms in the labour market. I also show that the local effects found in these studies are likely an underestimate of the global effects, as I find that endogenous rural-urban migration choice is associated with stronger positive effects on output and weaker negative effects on welfare. This is because rural employment acts as an alternative outside option limiting urban firms' labour market power in the absence of urban informal employment. Incidentally, I complement the recent reduced-form literature on the role of informality as a stepping-stone for workers (Samaniego, 2024). I also align with existing evidence on firms' local labour market power in low- and middle-income countries (Brooks *et al.*, 2021; Felix, 2022; Amodio & De Roux, 2023; Armangué-Jubert *et al.*, 2023; Bassier, 2023), especially across formal and formal jobs (Amodio *et al.*, 2023), as well as rural and urban jobs (Marshall, 2024).

Second, I bridge the previously cited informality literature with the economic literature dealing with migration models, primarily in low- and middle-income countries with a strong rural-urban divide (Bryan *et al.*, 2014; Munshi & Rosenzweig, 2016; Morten, 2019; Meghir *et al.*, 2022; Lagakos *et al.*, 2023). Compared to most of these papers, I focus on permanent, rather than seasonal migration. My approach is therefore closer to the one adopted by Bryan & Morten (2019) or Tombe & Zhu (2019), who find substantial welfare and productivity gains when removing spatial frictions. Likewise, I motivate my model by documenting the rural-urban income gap (Lagakos *et al.*, 2020) and rural-urban productivity gap (Pulido & Święcki, 2019; Gai *et al.*, 2021; Cenci *et al.*, 2023) when adding heterogeneity across the urban formal and informal sectors. None of these papers endogenize the job search process inherent in many migration decisions, and therefore cannot deal adequately with potential spatial spillovers of local labour market policies. A notable exception is Marshall (2024), who considers local labour markets featuring both self-employment and regular firms with market power. Apart from the fact that I focus on informal jobs generally and not on self-employment, our settings differ in that I incorporate dynamic search-and-matching frictions along with unemployment risk. I see these two elements as key for studying spatial labour misallocation.

My methodology therefore aligns more closely with migration models featuring job search-and-matching, that are set rather in high-income country contexts (Kennan & Walker, 2011; Baum-Snow & Pavan, 2012; Schmutz & Sidibé, 2019; Balgova, 2022; Maguain & Koubi, 2022; Martellini, 2022; Porcher, 2022; Bilal, 2023). I adapt them to a middle-income country context with two sectors, a formal and an informal one, and ongoing urbanization. Most related to my work, Heise & Porzio (2022) find that removing spatial frictions increases both welfare and output, due to an improved worker allocation within rather than across locations. Indeed, removing spatial frictions increases the local competition for workers and diminishes firms' local monopsony power. The simulation I run without rural-urban migration can be seen as an extreme case with infinite spatial frictions. I find effects that are symmetric with Heise & Porzio (2022), as welfare and output decrease compared to my baseline results. The allocation of employed urban workers across the formal and informal sectors does not vary much across the two specifications, unlike in Marshall (2024). This may be due to the dominance of frictional informal wage employment over self-employment, deemed to be frictionless in his approach, in my empirical context.

Third, I see my work as complementary to the structural informality literature focusing on firm dynamics (D'Erasmo & Boedo, 2012; Ordóñez, 2014; Allen *et al.*, 2018; Lopez-Martin, 2019; Erosa *et al.*, 2023; Alvarez & Ruane, 2024), as opposed to worker dynamics. Compared to Ulyssea (2018), I find a higher proportion of informal firms that do not need to operate informally in order to survive. More related to my work, Imbert & Ulyssea (2023) simulate the impact of an exogenous migration shock in rural areas on urban labour markets with informal employment. In the long-run, as formal wages become flexible, it becomes profitable for informal firms to formalize and urban informal employment decreases. This translates into higher urban output but lower welfare, which is consistent with my results. I place myself in a similar long-term perspective, as I consider fully flexible wages in equilibrium, and I add rural production in the model. Although my policy scenario focuses on the impact of an exogenous urban informality shock on rural-urban population shares, a question that is symmetric to the one asked by Imbert & Ulyssea (2023), my findings suggest a feedback-loop effect that is absent from their model: with frictions and endogenous migration choice, rural-urban migration flows should decrease as urban informality and wages fall, mitigating the initial reduction in welfare. The effect on output is ambiguous. Indeed, the rural outside option should improve the productive allocation of labour within the urban formal sector by limiting firms' monopsony power. However, it should also limit the formalization rate of urban informal firms that is motivated by lower wages in the formal sector (and not primarily by a rise in monitoring costs).

Finally, I contribute to the literature studying the role of labour market frictions - and factor misallocation - in structural transformation (Restuccia & Rogerson, 2017; Poschke, 2019; Hao *et al.*, 2020; Martellini & Menzio, 2021; Guner & Ruggieri, 2022; Buera *et al.*, 2023; Gollin & Kaboski, 2023; Lagakos & Shu, 2023; Feng *et al.*, 2024). For instance, Schwartzman (2024) proposes a (non-spatial) model of structural transformation through endogenous formalization of low-skilled services. In my model, I do not account for industry changes or agglomeration economies across space, notably because I do not observe overlapping generations of workers (Hobijn *et al.*, 2018; Porzio *et al.*, 2022). In fact, the relation between rural-urban migration and sectoral change is not clear in my sample: as the economy urbanizes, urban employment appears to switch from manufacturing to more labour-intensive consumer services (Imbert *et al.*, 2022; Fan *et al.*, 2023), but so does rural employment. As in Budí-Ors (2023), the share of agriculture in rural employment decreases, but it also increases in urban employment. There is no clear relation between industry composition and formality status either. I therefore abstract from sectoral change: in the model, this translates into a fixed rural-urban productivity gap and urban growth rate across counterfactuals. Rather, I show how a given local labour market policy impacts aggregate urbanization, output, and welfare at a given stage of the sectoral change process.

The rest of this paper is structured as follows. Section 2 presents the data and some motivating facts. Section 3 presents the model and Section 4 how it is estimated. Section 5 presents the estimation results and Section 6 the policy counterfactuals. Section 7 concludes.

2 Data and Motivating Facts

2.1 Context

Compared to countries surveyed by Ulyssea (2020), South Africa features a relatively high rate of unemployment (26% of working-age males in 2023, ILO) and a relatively low (but still substantial) rate of informal employment (41%), which makes it an interesting case study per se. Rodrik (2008) and Banerjee *et al.* (2008) point to the legacy of apartheid in explaining low levels of social networks and entrepreneurship needed to support informal activity, whereas Shah (2022) points to substantial spatial frictions within cities (regressive transport costs, zoning, and permits) and competition from the formal sector in a few key industries (hospitality, retail, commercial agriculture). Abel (2019) adds that generous old-age pensions may increase reservation wages of working-age household members sharing expenses with the beneficiaries.

Then, South Africa is likely a good setting for studying rural-urban migration. The fact that cities grew while rural areas stagnated during the apartheid era translates into a strong rural-urban welfare gap that persists to this day (Lochmann, 2022). Moreover, the end of apartheid indeed led to massive out-migration flows for Black people living in rural areas (Dominguez-Iino & Le Roux, 2022). This is an important phenomenon that is still feeding current urban growth (Bakker *et al.*, 2019), with an urban population share of 69% in 2023 (World Bank). The informal employment rate has remained relatively stable over the period, with unemployment rising at the expense of formal employment (Elgin *et al.*, 2021). South Africa is therefore comparable with other low- and middle-income countries in the SSA and EAP regions in terms of urbanization (+0.8% per year over my study period) and informality (-0.2%) trends. However, its relatively high level of urban population and low level of informality align more closely with emerging economies elsewhere (e.g., Turkey).

2.2 Data

The National Income Dynamics Study[1] (NIDS) is a nationally representative panel survey of South African workers. It samples 28,226 individuals from 7,305 households, starting in 2008, and interviews them again on average every 27 months (2.25 years) until 2017 (i.e., over five waves). It features a relatively low rate of attrition over a large number of periods, and a large number of variables compared to similar studies set in low- and middle-income countries (Lagakos *et al.*, 2020). Below, I define my benchmark sample as well as my main variables of interest.

Sample selection. I reduce my benchmark sample to males since labour market frictions and preferences vary by gender, especially in low- and middle-income countries. More specifically, female workers tend to favour jobs with fewer (Mahmud *et al.*, 2021) and more flexible (Ho *et al.*, 2024) working hours, two distinctive features of the informal sector from which I abstract. These are often associated with high search-and-matching frictions as women face difficulties finding regular, part-time work (Fletcher *et al.*, 2017; Caria *et al.*, 2021). They also may face discrimination from recruiters (Kuhn & Shen, 2013; Chowdhury *et al.*, 2018; Chaturvedi *et al.*, 2021; Gentile *et al.*, 2023), and search differently from men due to the time demands of unpaid domestic work, mobility constraints, limited social networks (Field *et al.*, 2010; Kandpal & Baylis, 2019; Anukriti *et al.*, 2020), or heterogeneous risk-aversion profiles (Archibong *et al.*, 2022). Focusing on men, who are declared as household heads in the vast majority of cases, also allows me to abstract from the joint location decision problem in a couple. I further restrict my sample to individuals who stay within the 18-64 year-old range over the study period as I focus on job-related mobility of independent agents.[2] I also restrict it to individuals who never obtain a high-school certification (or equivalent diploma) since the low-skilled are the most affected by informal employment. This is also a way to ensure that migration choices are not motivated by university or other adult education choices. Finally, I aggregate all sources of individual labour market income to obtain monthly wages net of taxes. I multiply them to cover full time periods between waves, deflate them to Dec. 2012 levels (using indices included in the data), and de-trend them by residualizing for wave fixed effects, so as to make them comparable across time periods. Then, I drop individuals found in the first and last percentiles of the wage distribution to reduce heterogeneity in the sample. I am left with 3,453 individuals followed over five waves.

Geography. One specificity of this data set is that it allows me to identify informal employment while following individuals when they change locations. Although I do not have access to a finer geographic scale than the 52 districts of South Africa, I know whether the enumeration area (census block group) where individuals live was classified as urban or rural in the National Census of 2011 (based on the continuity of built-up areas).[3] The vast majority of individuals declare to reside permanently (i.e., stay more than four nights a week) in the area where they were interviewed and there is no apparent seasonality in interview dates, ruling out potential temporary migration patterns.[4] Note that attrition is not an absorbing state in my sample: half of the individuals that are lost at some point are recovered at some later point over the study period. For the sake of simplicity, I therefore pool

[1] Department of Planning, Monitoring, and Evaluation ; Southern Africa Labour and Development Research Unit ; DataFirst

[2] It suffices to spend 15 nights a year under the same roof and sharing food and resources when staying together to be part of the same household. As a consequence, an individual can be part of many households, and I consider household members as independent agents. For a model of migration choice with or without one's family, see Imbert *et al.* (2023).

[3] Three-quarters of my rural population live in communally-owned land (traditional), as opposed to commercial farm land (farms): it is 4.5 times more likely to move from rural to urban areas than to move across traditional and farm areas.

[4] The cases where several migrant workers share the same permanent residence are marginal in my sample.

all observations together to study attrition. Out of the 25% of non-responses I obtain when doing so, two-thirds are due to a refusal or non-availability, and one-third are due to a geographic move that was not well followed. Contrary to individuals, households are not identifiable across waves. Hence, I cannot compare the number of untracked moves with an accurate number of geographic moves that are well followed. Still, I can say that it is roughly equal to the number of non-missing observations following a change in districts or geography types, which understates the actual number of moves in my sample. With that in mind, I decide to impute missing values for geography type and employment status based on past or future states when available to obtain a balanced panel.[5] I further assume that respondents work in the same area type as where they live, and more specifically that rural workers do not commute to urban areas. They therefore have to migrate to benefit from local job opportunities there: based on estimates of commuting costs from Pfeiffer *et al.* (2024), I find that 90% of the rural subsample for which I have information on transport expenses travel less than 5km to go to work (with 70% not travelling at all). As a consequence, I consider that workers also change local labour markets when changing geography types. Furthermore, I abstract from sequential migration as the vast majority of migrants only move once in my sample. Finally, I focus on rural-urban migration since it is three times more likely than urban-rural migration and I want to study the impact of an urban policy on rural migrants.[6]

Informality. Since workers do not directly declare themselves as being informal, I follow the definition of informal work used by Bassier *et al.* (2021) with the same data: self-employed workers not registered to VAT or income tax ; wage workers who do not have a written contract and who do not contribute to medical aid, unemployment insurance, or pension funds ; and workers declaring to work on a "casual" basis. Note that most job characteristics are only available for wage workers in the data, and that most self-employed workers are found in the informal sector. Along all the dimensions studied below, there is less heterogeneity between formal and informal jobs in rural than in urban areas. I therefore collapse rural formal and informal jobs into one rural employment category, as my focus is on urban formalization policies. Interestingly, urban informal wage jobs are one-third more likely than formal ones to be obtained through personal networks, which points to heterogeneity in search frictions. Personal connections can also be seen as an alternative to formal contract enforcement. There is no strong heterogeneity in industries (or occupations) across the formal and informal sectors for wage employment, with construction being slightly over-represented in the informal sector compared to manufacturing. Actually, there is more heterogeneity, independently of formality status, across urban and rural areas given the role played by agriculture. Besides, my low-skilled workforce appears to be highly substitutable across industries, since almost half of on-the-job transitions for wage workers imply a change in industries. Finally, given that aggregate informality figures are aligned with the National Census of 2011, I consider the risk of self-reporting bias to be relatively low. Also note that respondents are informed that the survey is anonymous. Furthermore, informal job monitoring targets mostly large firms (typically in cities): this will be reflected in the modelling of the informality cost function for firms, which is growing and convex in the number of employees. Hence, workers (especially the self-employed) should have few incentives to systematically misreport their status.

[5] I therefore do not make use of survey weights to correct for attrition. I make this choice as the characteristics used to compute weights in the data do not specifically reflect migration decisions, and weighted estimates may lack consistency for transitions with few observations (Davezies & D'Haultfoeuille, 2009).

[6] I observe very few changes in districts within rural or urban areas, but two-thirds of rural-urban moves are associated with a change in districts.

Employment. When employed, it is as likely to become inactive as it is to become unemployed. When inactive, it is as likely to become active as it is to stay inactive. I therefore merge the non-economically active and the unemployed into a non-employed category. Note that this category may include workers engaging in home production. This allows me to abstract from labour force participation choice, which may drive part of migration choice: in my sample, it is 40% more likely to transition from inactivity to activity for rural-urban movers than for rural stayers. I further abstract from the intensive margin of labour supply, which may drive part of the (in)formality choice. In fact, informal workers in cities work 3.7 hours more per week than formal workers on average, which is both smaller in magnitude and contrary to the tendency observed in middle-income countries: Bick *et al.* (2022) find that, in this group, workers in the traditional sector work on average 5.8 hours less per week than in the modern sector. The difference disappears when keeping wage workers only: I comment on this issue in the next sub-section. I identify on-the-job transitions within the formal or informal sectors via employment spells lasting less than the time interval between two interview dates. When this information is missing (for non-wage workers), I identify on-the-job transitions through changes in industry, occupation, employment type (wage or self-employment), or district. Finally, I make use of a retrospective variable yielding employment states in between periods. This allows me to correct for non-employment spells in between employment periods and employment spells in between non-employment periods (assuming other job characteristics do not change), and to consider close-to-yearly (13.5 months) time periods. Wages are correspondingly divided by 2. It is worth noting that median wage growth for employed workers who keep the same job is less than 0.5% a year, which I interpret as evidence of low returns to experience for low-skilled workers.

2.3 Summary Statistics

Tables 1 and 2 summarize key descriptive statistics pooled over the study period, by mover status and geo-employment state, along with the corresponding worker allocations. As could be expected from the literature, rural migrants are younger than their peers. They are more educated and richer than rural stayers, but less so than urban stayers. In terms of race and employment characteristics, they are similar to rural stayers, with a relatively high propensity to be non-employed. Cities are less ethnically homogeneous and more educated than rural areas. They also feature lower non-employment rates. Age and education are positively correlated with formal employment. Finally, rural and non-employed individuals tend to be part of larger households. These socio-demographic characteristics could bias my parameter estimates for a setting with homogeneous workers if they indeed generate a lot a self-selection across origin-destination pairs of states in my model.

Moreover, whereas the vast majority of formal jobs are wage jobs, less than half of informal jobs are. As a first approach, I assimilate self-employed jobs to wage jobs at one-employee firms. This can be understood a self-employment not being a frictionless outside option for workers who still need to search for clients, suppliers, etc. If those frictions are very different from the ones faced by wage workers (Breza *et al.*, 2021), this could be a source of unobserved heterogeneity. More precisely, if heterogeneous job characteristics such as differences in hours worked indeed drive part of the (in)formality choice of workers, it should be reflected in heterogeneous wage profiles and/or transition probabilities, which I use to estimate frictions in my model. I discuss selection issues in the next sub-sections.[7]

[7] For a model of (in)formality choice with self-employment and a life-cycle approach, see Narita (2020).

Table 1: Mean summary statistics by mover status over the study period

	Black dummy	Age	Educ. yrs	HH size	Log(wage)	Non-empl.	Inform. vs. formal
Rur. stayer (42%)	0.92	39.36	6.35	5.14	10.00	0.51	0.52
Urb. stayer (45%)	0.69	39.54	7.95	4.31	10.35	0.38	0.39
Rur. mover (10%)	0.86	32.81	7.75	5.09	10.12	0.47	0.49
N	17,265	17,265	17,265	17,625	6,290	17,265	9,693

Notes: National Income Dynamics Study 2008-2017, low-skilled males aged 18-64. Percentages of observations in parentheses. The left panel corresponds to exogenous individual characteristics from which I abstract in the model. The right panel corresponds to endogenous job characteristics accounted for by the model.

Table 2: Mean summary statistics by geo-employment state over the study period

	Black dummy	Age	Educ. yrs	HH size	Wage empl.
Rur. nonempl. (25%)	0.98	37.89	6.66	6.03	n.a.
Urb. nonempl. (19%)	0.71	38.63	7.69	4.78	n.a.
Rural empl. (24%)	0.85	39.09	6.42	4.22	0.69
Urban formal (19%)	0.72	40.54	8.42	3.77	0.98
Urban inform. (13%)	0.69	37.52	7.80	3.88	0.40
N	17,265	17,265	17,265	17,625	6,491

Notes: National Income Dynamics Study 2008-2017, low-skilled males aged 18-64. Percentages of observations in parentheses. The left panel corresponds to exogenous individual characteristics from which I abstract in the model. The right panel corresponds to endogenous job characteristics from which I also abstract in the model.

2.4 Stylized Fact 1: Transition Probabilities

By pooling all the observed transitions and tabulating destination states conditional on origin states, I obtain the transition probability matrix in Table 3. This yields the first set of moments targeted by the model. The key underlying assumptions are that transitions follow a Markov process of order 1 and that workers are homogeneous, so that repeated observations can be treated independently. The first assumption is standard in the search-and-matching literature but is difficult to support with few observed transitions across states per workers: when re-deriving my probability transition matrix conditional on each state at $t-1$, some cells feature very few observations and are therefore not significant. I support the second assumption by dealing with potential unobserved heterogeneity in several ways. First, I recover the corresponding predicted probabilities from a multinomial logit model with added (quadratic) individual controls including race, age, years of education, and household size. I find results that are close to my main specification. Second, I re-derive my pooled transition matrix by splitting my sample below and above mean values for age, education, and household size: results are more heterogeneous but still relatively in line with my main specification. The same comment holds when splitting the sample for wage and non-wage employment in the informal sector.

Let us first remark that, at every period, the most likely outcome is to stay in the same state with no on-the-job transitions. Then, there is some probability for employed workers to succeed in on-the-job search (either within the same sector or across formality status) or to lose their job, and for

Table 3: Transition probabilities towards model states at $t+1$ conditional on state at t

	RN_{t+1}	RE_{t+1}	UN_{t+1}	UF_{t+1}	UI_{t+1}	$OTJS_{t+1}$	N
RN_t	0.86	0.12	0.01	0.01	0.01	n.a.	7,021
RE_t	0.12	0.79	0.01	0.01	0.01	0.06	6,639
UN_t	0.01	0.00	0.83	0.07	0.09	n.a.	5,515
UF_t	0.00	0.01	0.07	0.86	0.02	0.03	5,170
UI_t	0.00	0.01	0.13	0.07	0.75	0.03	3,279
N	6,910	6,145	5,498	5,202	3,211	658	27,624

Notes: National Income Dynamics Study 2008-2017, low-skilled males aged 18-64. "RN" stands for rural non-employed, "RE" for rural employed, "UN" for urban non-employed, "UF" for urban formal, "UI" for urban informal, and "OTJS" for on-the-job search (distinct from keeping the same job in the same sector). Row probabilities sum up to one.

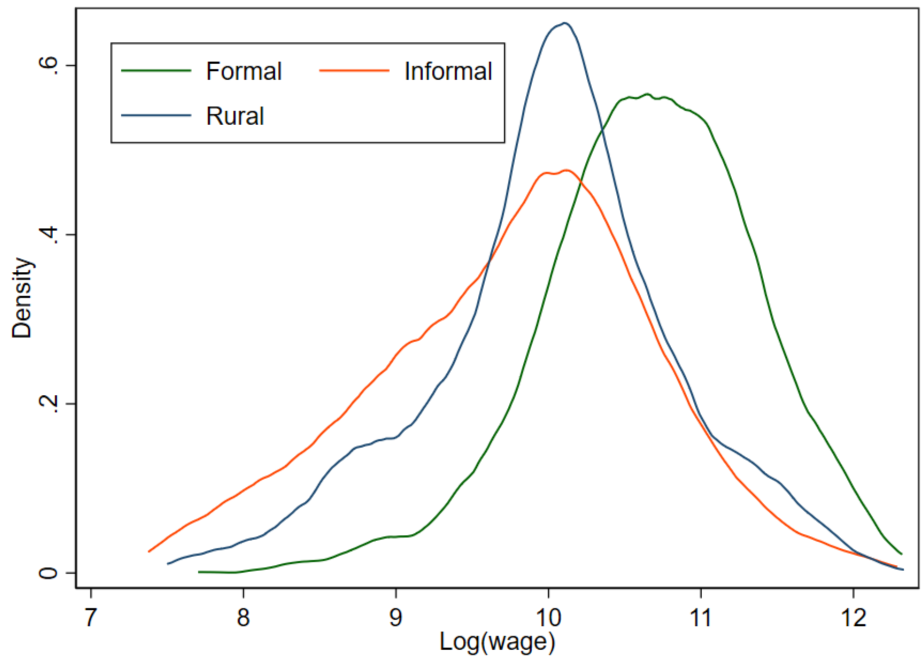
non-employed workers to find a job locally. Those probabilities are of the same order of magnitude. If anything, job-finding probabilities are higher and job-losing probabilities are lower in cities than in rural areas. It is worth noting that urban formal jobs are typically more stable than urban informal ones, with lower job destruction. Still, the urban non-employed appear to find informal jobs more easily than formal ones, and transition probabilities from informal to formal employment are actually higher than on-the-job transition probabilities within the informal sector. Finally, probabilities to migrate are typically smaller. They are also higher from rural to urban than from urban to rural areas. One has to keep in mind that this is still one order of magnitude above what is found in high-income countries: whereas the aggregate urban population share in South Africa has grown by 8% over my study period, it has only done so by 2% in the United States (World Bank). Also note that, although probabilities to migrate into urban informality are not substantially different from probabilities to migrate into urban formality, rural-urban migrants are 28% more likely to be informally employed than urban stayers, which conforms to the empirical regularity observed in other contexts.

The relatively high transition probabilities across states further support the use of a dynamic job search-and-matching model with interconnected labour markets. Note that I will not account for migration flows into non-employment in the model, as such moves violate spatial equilibrium conditions: this is a theoretical constraint (see Section 3.1 for a discussion). I will not allow for urban-rural moves either, as they prevent me from solving analytically for worker shares across states: this is a numerical limitation. I justify these simplifications by considering such transitions as second-order in the data.

2.5 Stylized Fact 2: Cross-Sectional Wage Distributions

Figure 1 plots pooled cross-sectional log wage distributions for the three employment states of interest. This is the second set of moments targeted by the model. As with transition probabilities, I test for unobserved heterogeneity by residualizing the distributions for individual controls and plotting them over splitted samples: my baseline specification appears to be relatively robust. The three distributions share roughly the same support, but urban formal wages dominate the others, and rural wages slightly dominate urban informal wages. The variance is also higher for urban informal than urban formal wages, and lower for rural wages. However, as I will assume risk-neutral agents, volatility in earnings will not affect workers' welfare directly in the model.[8] These distributions reflect the accepted offers from workers, conditional on their current employment state. Yet, they may not necessarily reflect the actual wage gains or losses they experience when transitioning from one state to the other. Hence, I now turn to the observational returns to migration.

Figure 1: Pooled cross-sectional log wage distributions by model employment state



Notes: South African National Income Dynamics Study 2008-2017, low-skilled males aged 18-64. Wages are deflated for interview date, de-trended for wave fixed effects, and multiplied to cover one full period in the model (approximately one year), so as to be comparable across individuals and time periods. They include all sources of labour income.

2.6 Stylized Fact 3: Observational Returns to Migration

Table 4 shows the average monetary returns for rural-urban migrants, separately for urban formal and informal jobs. This is not a set of moments targeted by the model, but it can be used to quantify the importance of residual self-selection. Each panel shows the estimated coefficients for three distinct linear regressions of log wages over an urban dummy. Columns (1) and (4) show the raw regression coefficients and reflect the cross-sectional wage gaps. Columns (2) and (5) include individual fixed effects and time-varying controls for the subset of movers. Columns (3) and (6) show the coefficients estimated on the sub-sample of rural-urban movers. This is essentially the same set of regressions estimated in Lagakos *et al.* (2020) but with a selected sample, individual income instead of household income per person, and an heterogeneity analysis based on urban formality status.

Several remarks are in order. First, rural movers incur a wage cut when accepting an informal job in cities, no matter the specification. Under common preferences, this can only be rationalized through higher urban amenities or better urban job opportunities in the future. My model incorporates these elements and its estimation identifies the dominant effect. Second, the coefficient for urban informal jobs does not change much across specifications. I interpret this as evidence of little self-selection of rural migrants into urban informality: no matter their differences, they are as likely to draw from the

[8]One way to deal with insurance motives would be to calibrate the insurance value of formal vs. informal jobs and urban vs. rural jobs as lump-sum transfers, using results from Finamor (2023) and Lagakos *et al.* (2023).

Table 4: Linear regression of log wages over an urban dummy

	Formal jobs			Informal jobs		
	(1)	(2)	(3)	(4)	(5)	(6)
Urban	0.639***	0.193***	0.291***	-0.249***	-0.220***	-0.173
	(0.040)	(0.060)	(0.104)	(0.044)	(0.082)	(0.165)
Obs.	4,978	629	392	3,990	471	297
Adj. R^2	0.150	0.566	0.433	0.019	0.455	0.439
Controls	No	Yes	Yes	No	Yes	Yes
Ind. FE	No	Yes	Yes	No	Yes	Yes
Sample	All	Movers	Rural movers	All	Movers	Rural movers

Clustered standard errors in parentheses

* $p < 0.10$, ** $p < 0.05$, *** $p < 0.01$

Notes: South African National Income Dynamics Study 2008-2017, low-skilled males aged 18-64. The left panel accounts for urban formal jobs, the right panel for urban informal jobs. Controls are quadratic and include age, education, and household size.

same wage distributions as stayers in origin and destination states. This is not the case for urban formal jobs, given the reduction observed between columns (1) and (2). Fixed effects are driving most of the difference. At least, the formal urban wage gap remains significantly positive, and its value is robust to restricting the sample to rural-urban migrants. Nonetheless, since model parameters are jointly identified by observed transition probabilities and wage distributions, a bias on the actual wage draws may be compensated by targeting the true transition probabilities (see Section 4.2.1). In this case, overestimated wage gains for rural migrants into urban formality will be partially offset by underestimated job arrival rates from rural to urban formal jobs. In other words, transition rates will capture unobserved heterogeneity between origin-destination pairs of states, assuming no heterogeneity within pairs.[9] This exercise therefore yields a higher bound on the upward bias of the urban formal option value for rural workers (see Section 5.3).[10] I now turn to the formulation of the model to define more explicitly the meaning of these terms.

3 Model

3.1 Workers' Program

Environment. Let us consider two local labour markets: a rural and an urban one. Workers are infinitely lived, homogeneous, and risk-neutral. They inelastically supply one unit of labour. They randomly search for jobs in a memory-less fashion, on- and off-the-job, locally and remotely. They do so across both the formal and informal sectors. I only distinguish between formal and informal jobs in urban areas. Formal jobs provide workers with unemployment benefits and severance payment paid as a lump-sum transfer when they get destroyed. This assumption allows me to keep the model independent of time and is without loss of generality under risk neutrality. The contribution of pensions and medical aid to welfare is lost as there is no corresponding standardized plan to incorporate in the homogeneous model.

[9] For a spatial search-and-matching model with heterogeneity within origin-destination pairs, see Heise & Porzio (2022).

[10] A similar exercise can be run to account for self-selection across formality status within urban areas.

Problem. Workers accept job offers so as to maximize their expected lifetime utility stream W_i^k in area $i \in \{Rural, Urban\}$ and sector $k \in \{Nonemployed, Employed\}$ for rural areas or $k \in \{Nonemployed, Formal, Informal\}$ in urban areas, discounted at calibrated rate r. They take as given their current wage w when employed or utility of leisure b when non-employed, plus a relative amenity term γ (that can be positive or negative) in rural areas.[11] These terms sum up to workers' flow utility value. They receive job offers with values W_j^l distributed according to exogenous cumulative distributions F_j^l (and complementary functions $\overline{F_j^l}$) with supports $[\underline{W_j^l}, \overline{W_j^l}]$, that arrive at exogenous rates λ_{ij}^{kl} (from state ik to state jl) according to a Poisson process. They accept job offers whose value is higher than their current one, plus a compensating differential for calibrated monetary mobility cost c when mobing from rural to urban areas.[12] When employed, their job gets destroyed at exogenous Poisson rate δ_i^k. When losing a formal job, workers benefit from unemployment insurance at calibrated rate UIF and severance payment at calibrated rate s, that are paid upfront as a fixed fraction of their current wage. These terms sum up to workers' option utility value.

Workers only move from one area to the other with a job in hands: this pins down relative amenities in equilibrium as the constraint $W_R^N \geq W_U^N - c$ is saturated (spatial equilibrium condition). Besides, non-employed workers accept all the offers they are made within their current local labour market: this pins down utility of leisure in equilibrium as the reservation value is set to $W_R^N = \underline{W_R^E}$ in rural areas and $W_U^N = \underline{W_U^I}$ in urban areas, assuming $\underline{W_U^I} \leq \underline{W_U^F}$ (reservation value condition). After integrating by parts, the Bellman equations associated with the workers' problem are:

$$rW_R^N = \gamma + b + \lambda_{RR}^{NE}\left(\int_{\underline{W_R^E}}^{\overline{W_R^E}} x dF_R^E(x) - W_R^N\right) + \lambda_{RU}^{NF}\int_{W_R^N+c}^{\overline{W_U^F}} \overline{F_U^F}(x)dx + \lambda_{RU}^{NI}\int_{W_R^N+c}^{\overline{W_U^I}} \overline{F_U^I}(x)dx \tag{1}$$

$$\begin{aligned} rW_R^E(w) =& \gamma + w + \delta_R^E\left[W_R^N - W_R^E(w)\right] \\ &+ \lambda_{RR}^{EE}\int_{W_R^E(w)}^{\overline{W_R^E}} \overline{F_R^E}(x)dx + \lambda_{RU}^{EF}\int_{W_R^E(w)+c}^{\overline{W_U^F}} \overline{F_U^F}(x)dx + \lambda_{RU}^{EI}\int_{W_R^E(w)+c}^{\overline{W_U^I}} \overline{F_U^I}(x)dx \end{aligned} \tag{2}$$

$$rW_U^N = b + \lambda_{UU}^{NF}\left(\int_{\underline{W_U^F}}^{\overline{W_U^F}} x dF_U^F(x) - W_U^N\right) + \lambda_{UU}^{NI}\left(\int_{\underline{W_U^I}}^{\overline{W_U^I}} x dF_U^I(x) - W_U^N\right) \tag{3}$$

$$\begin{aligned} rW_U^F(w) =& w \\ &+ \delta_U^F\left[W_U^N + (UIF + s)w - W_U^F(w)\right] + \lambda_{UU}^{FF}\int_{W_U^F(w)}^{\overline{W_U^F}} \overline{F_U^F}(x)dx + \lambda_{UU}^{FI}\int_{W_U^F(w)}^{\overline{W_U^I}} \overline{F_U^I}(x)dx \end{aligned} \tag{4}$$

$$rW_U^I(w) = w + \delta_U^I\left[W_U^N - W_U^I(w)\right] + \lambda_{UU}^{IF}\int_{W_U^I(w)}^{\overline{W_U^F}} \overline{F_U^F}(x)dx + \lambda_{UU}^{II}\int_{W_U^I(w)}^{\overline{W_U^I}} \overline{F_U^I}(x)dx \tag{5}$$

[11] This captures differential factors such as housing prices, public services and infrastructure, local networks, or education opportunities for children.

[12] The largest share of migration costs is likely to be non-monetary (Imbert & Papp, 2020a; Bryan *et al.*, 2021; Lagakos *et al.*, 2023), but Schmutz & Sidibé (2019) show that migration costs are not separately identified from spatial frictions without additional structure. The non-monetary component is therefore captured by job arrival rates in my model.

Equilibrium conditions. Let us comment on the underlying assumptions. When employed, workers can lose their job and become non-employed, but never accept an offer with a lower value than their current one.[13] I do not see this as a critical assumption given that median wage growth for employed workers who change jobs is 2.8%, which is not only positive but also substantially higher than wage growth for workers who keep the same job. There is no wage renegotiation or firms' response to outside offers, and the only way for workers to increase their wage is through on-the-job transitions. When non-employed, workers accept any local offer they are made. This corresponds to the reservation value condition stating that, in equilibrium, the value of local non-employment is equal to the lower bound of local employment values: for values above the threshold, firms have a profitable incentive to downgrade their offers ; for values below the threshold, firms naturally upgrade their offers as they are unable to recruit local workers at such low values.[14] Finally, I do not allow for migration into non-employment. This corresponds to the spatial equilibrium condition stating that, in equilibrium, no non-employed worker can be worse off than what they would be if they moved into non-employment in the other location. Indeed, if it were the case, all non-employed workers in one area would move to the other, which is counterfactual.[15] In my context, this means that rural non-employed workers' welfare is greater or equal to urban non-employed workers' welfare minus migration costs. In practice, this constraint is saturated to be consistent with the assumption of no urban-rural moves.

3.2 Stationary Worker Flows

Geography. I do not allow for urban-rural moves, as adding them prevents me from solving analytically for worker shares in the equations below: this is a numerical limitation. However, both rural-rural and urban-urban moves are implicitly captured by on-the-job transitions within a given geography type. Importantly, my sample is not at a geographic steady state to the extent that rural-urban migration flows dominate urban-rural ones: at the end of my study period, the urban population share has grown linearly by 13%. I therefore have to target this observed urban growth to close the model. This accounts for structural urban growth factors, assumed to be constant over the study period, that are implicitly captured in model parameters but not fully micro-founded since they do not only depend on search-and-matching in the labour market. Even with urban-rural moves, assuming a geographic steady state to close the model would therefore be a rough approximation of labour market conditions in urbanizing countries. Given that I consider infinitely-lived agents and a fixed urban growth rate, solving the model out of steady state would lead to empty rural areas over the very long run. In fact, the urban growth rate decreases slowly in macro data (World Bank). My stationary results should therefore be interpreted as transitory outcomes at a given stage of a slow structural change process, rather than as stable equilibrium outcomes over the very long term.[16]

Employment. To solve the model, I additionally assume that the shares of employed workers with welfare W are at the steady state for all values of W. The shares of non-employed workers therefore adjust in the stationary equilibrium to reflect both the steady-state and the urban growth conditions. The empirical deviations from steady state will be captured in the quality of the model fit, which will allow to quantify the strength of the model assumptions more generally.

[13]For a job-search model allowing for value cuts in on-the-job transitions, see Jolivet *et al.* (2006).

[14]I assume that firms do hire at least some workers locally.

[15]Balgova (2022) rationalizes such moves through idiosyncratic location preference shocks that only satisfy the spatial equilibrium condition on average.

[16]A way to impose a geographic steady state in the model would be to have overlapping generations of workers with a higher rate of natural increase in rural than in urban areas, but this is counterfactual (Jedwab *et al.*, 2017).

Problem. The stationary equilibrium hence features a fixed worker allocation across employment $\{m_R^E, m_U^F, m_U^I\}$ and non-employment $\{u_R, u_U\}$ states in urban and rural areas, such that $m_R^E + u_R + m_U^F + m_U^I + u_U = 1$. To recover these quantities analytically, and to express (unobserved) offered value distributions F_i^k as a function of (observed) accepted value distributions G_i^k, I assume that worker inflows equate outflows in any employment state for any point of the welfare distribution, and that rural worker outflows equate targeted urban population growth. This translates into three steady-state equations for employment states in the model and one structural urban growth equation for urban and rural shares. After integrating by parts, this yields:

$$m_R^E G_R^E(W) d_R^E(W) + m_R^E \left(\lambda_{RU}^{EF} \int_{\underline{W_R^E}+c}^{W+c} G_R^E(x-c) dF_U^F(x) + \lambda_{RU}^{EI} \int_{\underline{W_R^E}+c}^{W+c} G_R^E(x-c) dF_U^I(x) \right) \\ = u_R \lambda_{RR}^{NE} F_R^E(W) \tag{6}$$

$$m_U^F G_U^F(W) d_U^F(W) + m_U^F \lambda_{UU}^{FI} \int_{\underline{W_U^F}}^{W} G_U^F(x) dF_U^I(x) = u_U \lambda_{UU}^{NF} F_U^F(W) + u_R \lambda_{RU}^{NF} \left[F_U^F(W) - F_U^F(\underline{W_R^E}+c) \right]^+ \\ + m_U^I \lambda_{UU}^{IF} \int_{\underline{W_U^I}}^{W} G_U^I(x) dF_U^F(x) + \mathbb{1}_{[W > \underline{W_R^E}+c]} m_R^E \lambda_{RU}^{EF} \int_{\underline{W_R^E}+c}^{W} G_R^E(x-c) dF_U^F(x) \tag{7}$$

$$m_U^I G_U^I(W) d_U^I(W) + m_U^I \lambda_{UU}^{IF} \int_{\underline{W_U^I}}^{W} G_U^I(x) dF_U^F(x) = u_U \lambda_{UU}^{NI} F_U^I(W) + u_R \lambda_{RU}^{NI} \left[F_U^I(W) - F_U^I(\underline{W_R^E}+c) \right]^+ \\ + m_U^F \lambda_{UU}^{FI} \int_{\underline{W_U^F}}^{W} G_U^F(x) dF_U^I(x) + \mathbb{1}_{[W > \underline{W_R^E}+c]} m_R^E \lambda_{RU}^{EI} \int_{\underline{W_R^E}+c}^{W} G_R^E(x-c) dF_U^I(x) \tag{8}$$

$$u_R \left(\lambda_{RU}^{NF} \overline{F_U^F}(\underline{W_R^E}+c) + \lambda_{RU}^{NI} \overline{F_U^I}(\underline{W_R^E}+c) \right) \\ + m_R^E \left(\lambda_{RU}^{EF} \int_{\underline{W_R^E}+c}^{\overline{W_U^F}} G_R^E(x-c) dF_U^F(x) + \lambda_{RU}^{EI} \int_{\underline{W_R^E}+c}^{\overline{W_U^I}} G_R^E(x-c) dF_U^I(x) \right) = \nu \left(u_U + m_U^F + m_U^I \right) \tag{9}$$

where $[...]^+ = max\{..., 0\}$, $d_i^k(W)$ is the total job destruction rate for jobs in area i and sector k with values W, and ν is the calibrated urban growth rate.

Equations (6)-(8) state that the share of workers in state ik whose value is below some threshold W and who either lose their job, receive an offer higher than W in any state, or an offer lower than W but higher than their current value (including compensating differentials c) in state $jl \neq ik$ (left-hand side) is equal to the share of all non-employed workers plus the share of employed workers in state $jl \neq ik$ who accept an offer below W in state ik (right-hand side). Equation (9) states that the share of rural workers who receive an urban offer higher than their current value plus mobility costs (left-hand side) is equal to the share of urban newcomers at any period (right-hand side). Pulling equations (6)-(8) together and solving for G_i^k yields analytical relations between G_i^k and F_i^k. Together with equation (9), they form a new system that can be solved for worker shares independently of G_i^k, by setting W to its higher bound. Plugging the results back into the initial system pins down the functions G_i^k. This is where the model substantially differs from Meghir *et al.* (2015) or Schmutz & Sidibé (2019).

3.3 Firms' Program

Environment. Firms are pinned to a location and draw from an (ex-ante) local productivity distribution that I only explicitly model in urban areas. Conditional on their (ex-post) productivity draws, they choose whether to enter the market and to operate either in the formal or the informal sector so as to maximize (static) profits. Note that firms' optimality conditions yield a one-to-one mapping between worker values and ex-post productivity distributions, which allows me to recover them even in the absence of data on firms.

Production. They produce with constant returns to scale and labour as the only factor of production, and post unique offer values. Even though I focus on the labour market, my model is consistent with perfect competition in an homogeneous market for goods, with productivity capturing technology differences across firms times a constant price level, both of which are assumed to be constant over time.[17] I consider constant returns to scale to remain agnostic about the impact of population growth on structural change: increasing returns would reflect agglomeration economies and decreasing returns would reflect a decline in labour productivity under sticky capital allocation within firms. It is not clear which effect dominates the other in existing studies. Besides, I do not observe a clear relation between sectoral change and urbanization or formalization over my study period. Posted wages directly depend on posted offer values through inversion of workers' value functions. Following Cahuc *et al.* (2006), I consider that low-skilled workers have zero bargaining power, which justifies the wage-posting assumption. All the heterogeneity in wages therefore depends on firms facing heterogeneous matching conditions along the productivity distribution.

Informality. Formal firms have to pay corporate and payroll taxes, as well as severance payment when firing workers. There is no minimum wage in my model as the National Minimum Wage Law was only voted in 2018 (after my study period).[18] Informal firms only incur a cost that is growing and convex in firm size: this stands for monitoring costs or opportunity costs of operating in the informal sector. I do not distinguish between formal and informal firms in rural areas. Also note that formal firms cannot hire workers informally in my model, contrary to Ulyssea (2018). In the absence of complementarities between workers and under constant returns to scale, this should be of second-order for welfare and output.

Equilibrium conditions. I make of couple more innocuous assumptions on firms' behaviour in equilibrium. First, formal and informal firms operating at the same productivity level should have equal profits to rationalize the coexistence of such firms: this is a sector indifference condition. Then, profits at the lower bound of active firms' productivity distribution should be equal to zero, as potential entrants enter the market until it is not profitable to do so: this is a free entry condition. Both conditions pin down firm shares and informality cost function parameters. Finally, I assume that firm sizes are in steady state at any point of the productivity distribution: inflows of workers equate outflows for any such firm.

Problem. Active firms are heterogeneous in productivity p and choose in which sector to operate based on their expected profits π_i^k when in urban areas. They produce using labour l_i^k with constant returns to scale. In the formal sector, they are subject to calibrated corporate taxes t and

[17] For a model with differentiated formal and informal goods, see Belavadi (2021).

[18] In fact, as of 2018, 40% of formal workers in South Africa are covered by collective bargaining agreements setting minimum wages by sector of activity (Bassier, 2022). As I do not have precise enough information to make firms heterogeneous by sector, such wage floors are lost in my model.

payroll taxes τ, and must pay a calibrated fraction s of wage w_i^F when firing a worker at the exogenous job destruction rate δ_i^F. In the informal sector, firms incur a relative cost function C (with exogenous parameters) that is increasing and convex in firm size l_i^I. They post unique values W, which in turn determine wages w_i^k and firm sizes l_i^k, so as to maximize profits π_i^k. This yields the following problem:

$$\pi_R^E(p) = \underset{W}{max} \left\{ \left(p - w_R^E(W)\right) l_R^E(W) \right\} \tag{10}$$

$$\pi_U^F(p) = \underset{W}{max} \left\{ (1-t) \left[p - (1 + \tau + \delta_U^F s) w_U^F(W)\right] l_U^F(W) \right\} \tag{11}$$

$$\pi_U^I(p) = \underset{W}{max} \left\{ \left[p - w_U^I(W)\right] l_U^I(W) - C\left(l_U^I(W)\right) \right\} \tag{12}$$

Wage functions can be recovered by inverting equations (2), (4), and (5) for w. At the steady state, the flow of workers leaving any given firm should be equal to the flow of workers entering that firm, which yields the following expression for firm size:

$$l_i^k(W) = \frac{M}{N_i n_i^k} \frac{h_i^k(W)}{d_i^k(W)} \tag{13}$$

with M the total number of workers, N_i the total number of either urban or rural firms (including inactive firms), n_i^k the share of potential entrants in location i operating in sector k, and h_i^k the share of contacts between firms and workers willing to accept a job of value W. The ratios $\frac{M}{N_i}$ are calibrated and firm shares n_i^k are determined in equilibrium (see next sub-section).

This relation between firm size and offer values underlines the non-linearity of firms' behaviour in equilibrium. Indeed, firm size grows non-linearly in offer values. This is because the number of firms and the number of workers they are actually competing for under search frictions do not grow monotonously with productivity. As productivity increases, firms therefore offer higher values and grow in size, but their profit rate evolves non-monotonously, as do wage markdowns. This reflects local labour market power under heterogeneous matching conditions.

3.4 Equilibrium Productivity Distributions

Problem. The first-order optimality conditions associated with equations (10)-(12) yield the productivity support of active firms in each area and sector:

$$(K_R^E)^{-1}(W) = w_R^E(W) + (w_R^E)'(W) \frac{l_R^E(W)}{(l_R^E)'(W)} \tag{14}$$

$$(K_U^F)^{-1}(W) = (1 + \tau + \delta_U^F s) \left[w_U^F(W) + (w_U^F)'(W) \frac{l_U^F(W)}{(l_U^F)'(W)} \right] \tag{15}$$

$$(K_U^I)^{-1}(W) = w_U^I(W) + (w_U^I)'(W) \frac{l_U^I(W)}{(l_U^I)'(W)} + C'(l_U^I(W)) \tag{16}$$

where $K_i^k(p) = W^*$ or $(K_i^k)^{-1}(W^*) = p$, and "$*$" superscript denotes optimal quantities.

The firms' sector indifference condition ($\forall p \in \left[max\{\underline{p_U^F}, \underline{p_U^I}\}, min\{\overline{p_U^F}, \overline{p_U^I}\}\right]$, $\pi_U^F(p) = \pi_U^I(p)$) and firms' free entry condition ($\pi\left(min\{\underline{p_U^F}, \underline{p_U^I}\}\right) = 0$) in urban areas pin down firm shares and the partial productivity distributions in each sector (see Section 4.2.2):

$$\Xi_U^k(p) = n_U^k F_U^k(W^*) \tag{17}$$

with support $p \in [\underline{p_U^k}, \overline{p_U^k}]$.

Then, the aggregate productivity distribution (for all potential entrants) in urban areas can be expressed as:

$$\forall p \in [\underline{p_U}, \overline{p_U}],\ \Xi_U(p) = n_U^N + \Xi_U^F(p) + \Xi_U^I(p) \tag{18}$$

with n_U^N the local share of inactive firms.

Considering that $n_U^N = \Xi_U(\underline{p})$, the truncation of unobserved function Ξ_U over the active firms' productivity range can be expressed as the observed productivity distribution of urban firms. Under some parametric assumptions, this pins down the form of Ξ_U and the value of n_U^N (see Section 4.2.2). The function Ξ_U corresponds to the ex-ante local distribution in which firms draw their productivities before deciding on their behaviour. It is an equilibrium outcome at baseline that will be used to endogenize firm distributions in counterfactuals. As I do not explicitly model firm entry in rural areas, I take $n_R^N = 0$ and $n_R^E = 1$ at baseline. In counterfactuals, changes in the composition of rural firms will be captured by the evolution of rural firm productivities, in accordance with urban recruiting of rural migrants (see Section 6.1).

3.5 Equilibrium

Let us define $\Omega = \{RE, RN, UF, UI, UN\}$, $\mathbb{E} = \{RE, UF, UI\}$, and $\mathbb{G} = \{R, U\}$. A stationary equilibrium in the labour market consists of a set of welfare distributions $\{G_i^k(W)\}_{ik\in\mathbb{E}}$, value of leisure b, relative rural amenities γ, employed worker shares $\{m_i^k\}_{ik\in\mathbb{E}}$, non-employed worker shares $\{u_i\}_{i\in\mathbb{G}}$, value-posting policies $\{K_i^k(p)\}_{ik\in\mathbb{E}}$, firm sizes $\{l_i^k(W)\}_{ik\in\mathbb{E}}$, and firm shares $\{n_i^k(p)\}_{ik\in\Omega}$ such that:

- Workers accept offers to maximize their expected present discounted values (equations (1)-(5)) taking as given offered value distributions $\{F_i^k(W)\}_{ik\in\mathbb{E}}$, job arrival rates $\{\lambda_{ij}^{kl}\}_{ik\in\Omega, jl\in\mathbb{E}}$, job destruction rates $\{\delta_i^k\}_{ik\in\mathbb{E}}$, utility of leisure b, and relative rural amenities γ.
- Utility of leisure satisfies the reservation value condition and relative rural amenities satisfy the spatial equilibrium condition.
- Active firms set values $\{K_i^k(p)\}_{ik\in\mathbb{E}}$ to maximize overall profits (equations (14)-(16)), taking as given the functions mapping offer values to wages $\{w_i^k(W)\}_{ik\in\mathbb{E}}$, firm sizes $\{l_i^k(W)\}_{ik\in\mathbb{E}}$, and informality costs $C(l_U^I(W))$.
- Offer distributions are consistent with firms' optimal decisions (equations (10)-(12)).
- Worker distributions $\{m_i^k\}_{ik\in\mathbb{E}}$ and $\{u_i\}_{i\in\mathbb{G}}$ and welfare distributions $\{G_i^k(W)\}_{ik\in\mathbb{E}}$ satisfy the stationary equations (6)-(9), and firm sizes satisfy the stationary equation (13). Model stationarity

yields a transitory equilibrium assuming infinitely-lived agents and a fixed urban growth rate.

- Offer distributions, informality costs, and firm shares $\{n_i^k(p)\}_{ik\in\Omega}$ are consistent with firms' partial and aggregate productivity distributions (equations (17)-(18)), hence firms' sector indifference and free entry conditions.

The model does not admit analytical solutions for offer distributions, transition rates, firm shares, informality costs, and urban firms' aggregate productivity distribution, which need to be estimated.

4 Estimation

4.1 Externally Calibrated Parameters

Before describing the estimation procedure, I explain how the model parameters in Table 5 are calibrated. The discount rate r is the average of annual discount rates for South Africa over the study period taken from the Federal Reserve Economic Data (FRED) and adjusted to period lengths in the model. Section 41 of the Basic Conditions of Employment Act (BCEA) sets the minimum legal severance pay rate to one week's remuneration for each completed year of continuous service. Considering that employment spells are uninterrupted between model periods, I set the value of parameter s accordingly. Bhorat *et al.* (2013) show that the average income replacement rate (IRR) for first-instance (89% of cases) unemployment insurance male claimants is 48%. Given that the number of credit days is set to one for every six days of employment and cannot be larger than 238, I set the value of parameter UIF accordingly. Lagakos *et al.* (2023) set the permanent migration monetary cost to twice the seasonal migration monetary cost, which is equal to 10% of rural expenditures over six months. Again, I set the value of mobility cost c accordingly. The corporate income tax rate t is directly set by the South African Revenue Service (SARS) from where I take its value. There are no unified payroll taxes in South Africa but the private platform *Horizons* estimates that average social contribution rates from firms are 1% for unemployment insurance, 1% for the Skills Development Levy (SDL), and 0.65% for the Compensation for Occupational Injuries and Diseases Act (COIDA): I sum up those values to obtain parameter τ. The structural urban growth rate ν is set to fit the observed worker shares in my sample: to do so, I invert equation (9) and solve for ν. Finally, the average number of workers per urban firm $\frac{M}{N_U}$ is obtained by targeting the average formal firm size taken from Tsebe *et al.* (2018): to do so, I take the expected value of equation (13) and solve for $\frac{M}{N_U}$. The average number of workers per rural firm $\frac{M}{N_R}$ is set to make rural firms half the size of urban formal firms on average, as the World Bank Enterprise Survey for South Africa (2020) suggests that firms in majoritarily rural provinces are roughly half the size of firms in majoritarily urban provinces.[19]

4.2 Estimated Parameters

4.2.1 Offer Distributions and Transition Rates

Method. To simplify the estimation procedure, let us assume that values W_i^k follow a beta distribution with parameters $\alpha_i^k \geq 1$ and $\beta_i^k > 1$, and support $[\underline{W_i^k}, \overline{W_i^k}]$. These distributions offer the advantage of bounded support, guarantee the smoothness of density functions, and are flexible enough while only depending on a limited number of parameters. The estimation procedure can be further

[19]The fact that I consider all rural firms as being active pushes the calibrated value of $\frac{M}{N_R}$ up. In any case, the impact of this parameter should be negligible under constant returns to scale.

Table 5: Calibrated parameters

Parameter	Meaning	Source	Value
r	Discount rate	Federal Reserve Economic Data (FRED)	0.10
s	Severance pay rate	Basic Conditions of Employment Act (BCEA)	0.02
UIF	Unemp. insurance rate	Bhorat *et al.* (2013)	0.08
c	Mobility cost	Lagakos *et al.* (2023)	861.43
t	Corporate tax rate	South African Revenue Service (SARS)	0.28
τ	Payroll tax rate	Horizons	0.03
ν	Urban growth rate	Internal fit with observed worker shares	0.02
$\frac{M}{N_U}$	Workers per urban firm	Tsebe *et al.* (2018)	117.24
$\frac{M}{N_R}$	Workers per rural firm	World Bank Enterprise Survey (2020)	117.09

simplified by expressing $\underline{W_R^E}$, $\overline{W_R^E}$, $\underline{W_U^I}$ and $\overline{W_U^F}$ as functions of other model parameters. Therefore, let us define $\theta = \{\alpha_i^k, \beta_i^k, \underline{W_U^F}, \overline{W_U^I}\}_{ik\in\mathbb{E}}$ and $\vartheta = \{\lambda_{ij}^{kl}, \delta_j^l\}_{ik\in\Omega, jl\in\mathbb{E}}$. I follow Meghir *et al.* (2015) and estimate these two sets of parameters jointly with an iterative two-step method of moments that I describe below.

Step 1: Transition rates. Let us start with an initial guess on θ and ϑ. The estimate of ϑ is updated by matching the transition probabilities presented in Section 2.4. Indeed, there is an analytical relation between their theoretical value and the model parameters: the probability to accept a given job directly depends on the job arrival rate from origin to destination state and the offer distribution at destination. I therefore define the quadratic distance:

$$Q_1(\vartheta|\theta) = \sum_{ik,jl\in\Omega} \left(\widehat{D_{ij}^{kl}} - D_{ij}^{kl}\right)^2 \tag{19}$$

where $\widehat{D_{ij}^{kl}}$ are the transition probabilities observed in the data and D_{ij}^{kl} their theoretical counterparts.

After computing Q_1, the value of ϑ is updated by solving for ϑ with $\widehat{D_{ij}^{kl}}$ substituted for D_{ij}^{kl} its theoretical expression. The value of G_i^k is updated accordingly using equations (6)-(8), and so is the value of Q_1. The process is iterated until the value of Q_1 falls below a precision threshold that I set at 0.001 for each of the sum components.

Step 2: Offer distributions. The above procedure is repeated for several discrete values of θ. Considering that wages w_i^k follow the same distribution as values W_i^k due to the one-to-one mapping from equations (2), (4) and (5), I define for each iteration the quadratic distance:

$$Q_2(\theta|\vartheta) = \sum_{ik\in\mathbb{E}} \sum_{q=1}^{M} \left(\widehat{G_i^k}(w_q) - G_i^k(W_q)\right)^2 \tag{20}$$

where $\widehat{G_i^k}$ are the wage distributions observed in Section 2.5, and q denotes M main quantiles taken over observed wages such that $w_{i,q}^k = w(W_{i,q}^k)$. The iteration ends by selecting the set of parameters $\{\theta, \vartheta\}$ that minimize the function Q_2.

4.2.2 Firm Shares and Informality Cost

Method. For the sake of simplicity, I assume that informality cost C has a standard span-of-control form: $C\left(l_U^I(W)\right) = c_f l_U^I(W)^{\gamma_f}$, where $c_f > 0$ and $\gamma_f \geq 1$. I still follow Meghir *et al.* (2015) by first estimating $\widetilde{n}_U^I = \frac{n_U^I}{n_U^F + n_U^I}$, $\widetilde{c_f} = c_f \left(\frac{M}{(n_U^F + n_U^I)N_U}\right)^{\gamma_f - 1}$ and γ_f, then separately estimate n_U^N and finally recover values for n_U^F, n_U^I, and c_f.

Step 1: Active firms only. Substituting $\widetilde{n}_U^F = 1 - \widetilde{n}_U^I$, $\widetilde{n}_U^I$, and $\widetilde{c_f}$ for n_U^F, n_U^I and c_f in equations (13) and (15)-(16), and plugging the results back into equations (11)-(12), I define the quadratic distance:

$$Q_3\left(\widetilde{n}_U^I, \widetilde{c_f}, \gamma_f | \theta, \vartheta\right) = \widetilde{\pi}\left(min\{\underline{p_U^F}, \underline{p_U^I}\}\right)^2 + \sum_{q=1}^{M} \omega_q \left[\widetilde{\pi}_U^F(p_q) - \widetilde{\pi}_U^I(p_q)\right]^2 \tag{21}$$

where q denotes M equally spaced points taken over the overlapping productivity range of formal and informal firms, and ω_q are weights accounting for the mass of firms around productivity quantile p_q.

The first term of the sum captures the free entry condition in urban areas, the second term of the sum captures the sector indifference condition for firms of equal productivity. By minimizing quadratic distance Q_3, I therefore select the set of parameters that best fit these two equilibrium conditions. I do so by scanning discrete values of the parameter set.

Step 2: All potential entrants. Then, I define partial productivity distributions $\widetilde{\Xi}_U^k$ by substituting $\widetilde{n}_U^k$ for n_U^k in equation (17). A transformation of equation (18) yields:

$$\forall p \in [\underline{p_U}, \overline{p_U}],\ \Xi_U(p) = n_U^N + (1 - n_U^N)\left[\widetilde{\Xi}_U^F(p) + \widetilde{\Xi}_U^I(p)\right] \tag{22}$$

Fitting a log-normal distribution with parameters μ and σ on function Ξ_U over $[0, \overline{p_U}]$ by fitting a truncated log-normal distribution with same parameters on $\widetilde{\Xi}_U^F + \widetilde{\Xi}_U^I$ over $[\underline{p_U}, \overline{p_U}]$ (using the fact that $\Xi(\underline{p_U}) = n_U^N$ and $\Xi(\overline{p_U}) = 1$), I recover the equilibrium value of n_U^N. Since $n_U^F + n_U^I = 1 - n_U^N$, the expressions for n_U^F, n_U^I, and c_f directly follow.

5 Estimation Results

5.1 Parameters

Transition rates. Table 6 shows the estimated transition rates for the moves allowed in the model. They capture how frictional each sub-market is independently of origin and destination offer values. The resulting pattern is approximately the same as with transition probabilities featured in Section 2.4. Interestingly, local on-the-job arrival rates are typically higher than job destruction rates, be it within or across sectors: this is because workers receive more offers than they accept. The stepping-stone potential of the urban informal sector is confirmed as the urban non-employed indeed receive more informal job offers than formal ones, and the urban informal receive more formal job offers than the non-employed do. However, the urban informal sector does not appear to be less frictional than the urban formal sector for rural-urban migrants. It also features a higher job destruction rate. If informal jobs are replaced one-to-one by formal jobs in counterfactuals, the change in rural-urban worker allocation will be mostly driven by changes in offer values for fixed transition rates.

Table 6: Estimated transition rates ϑ_{ij}^{kl} between states ik and states jl over one period

ik \jl	RN	RE	UN	UF	UI
RN	.	0.128	.	0.008	0.008
RE	0.140	0.192	.	0.038	0.031
UN	.	.	.	0.074	0.101
UF	.	.	0.079	0.118	0.123
UI	.	.	0.147	0.209	0.128

Notes: "RN" stands for rural non-employed, "RE" for rural employed, "UN" for urban non-employed, "UF" for urban formal, "UI" for urban informal, and "OTJS" for on-the-job search (distinct from keeping same job in same sector). Parameters of Poisson distributions corresponding to yearly arrival rates.

Offer distributions. Table 7 presents the parameters governing the offer value distributions (not to be confused with offered wages) for the three employment states of interest. Offers from rural firms and from urban informal firms appear to be very similar, whereas offers from urban formal firms are more skewed towards higher values. However, since accepted offers depend on both offered values and transition rates (see Section 3.2), similar offers do not directly translate into similar welfare values for workers, as will become clear in Section 5.3.[20]

Table 7: Estimated offer distribution parameters θ_i^k for employment states ik

ik	α_i^k	β_i^k	$\underline{W_i^k}$	$\overline{W_i^k}$
RE	1.00	5.55	$1.578{\cdot}10^5$	$4.776{\cdot}10^5$
UF	1.00	17.61	$1.579{\cdot}10^5$	$1.353{\cdot}10^6$
UI	1.00	5.52	$1.579{\cdot}10^5$	$4.776{\cdot}10^5$

Notes: "RE" stands for rural employed, "UF" for urban formal, and "UI" for urban informal. Parameters of non-standard beta distributions fir yearly welfare values.

Other parameters. Table 8 presents remaining model parameters. As such, relative rural amenities and utility of leisure are endogenous outcomes of the model and are not estimated. They are both positive and substantial as a share of welfare (see Section 5.3). Importantly, I do not take any stance on the sign of those parameters beforehand. Positive relative rural amenities therefore suggest that, at baseline, rural characteristics such as lower housing prices or stronger social networks are more valuable for workers than urban characteristics such as better-quality infrastructure or local public goods. A high positive value of leisure points to high reservation wages, which is consistent with the relatively high rates of non-employment and low rates of informal employment found in South Africa. The parameters governing the distribution of informality costs are such that they form a substantial share of mean revenues (see Section 6.2) and grow linearly with firm size.[21] Finally, the parameter values of the aggregate productivity distribution for all potential entrants in urban areas are of no intrinsic interest. They will be kept fixed in counterfactuals to pin down the endogenous response of firms, assuming the underlying productivity distribution does not change (see Section 6.1).

[20] Note that I do not enforce shape parameters to be equal to one, which is an outcome of the estimation procedure.
[21] Again, I do not impose lineaerity beforehand.

Table 8: Other worker and firm parameters

γ	b	c_f	γ_f	μ	σ
2,483	5,612	2,256	1.00	10.27	0.63

Notes: Left panel stands for relative rural amenities and utility of leisure, middle panel for informality cost function parameters, and right panel for aggregate productivity distribution parameters.

5.2 Model fit

Targeted quantities. Table 9 shows the model fit on observed wages from Section 2.5. It features for each distribution the five quantiles that are targeted in the estimation. I do not include the model fit on transition probabilities from Section 2.4 as it is perfect by construction: the analytical relation between theoretical probabilities and model parameters ensures the efficiency of the estimation procedure. The fit on wages is good overall, especially in the middle of the distributions. Apart from that, the predicted distributions appear to be slightly skewed to the left, but the relative ordering across states is preserved.

Table 9: Model fit on log wage percentiles

	Rural employed		Urban formal		Urban informal	
	Actual	Model	Actual	Model	Actual	Model
$P10$	8.90	8.69	9.80	9.64	8.49	7.96
$P25$	9.60	9.54	10.23	10.22	9.18	9.27
$P50$	10.06	10.12	10.68	10.70	9.88	9.98
$P75$	10.49	10.49	11.14	11.13	10.40	10.40
$P90$	11.02	10.72	11.52	11.46	10.87	10.65

Notes: South African National Income Dynamics Study 2008-2017, low-skilled males aged 18-64.

Untargeted quantities. Table 10 shows the model fit on workers' and firms' allocation across geo-employment states. Contrary to Table 9, those are not directly targeted moments (even though the total urban population share is targeted indirectly through the urban growth parameter). Taking this into account, the fit on worker shares appears to be satisfying, compared to Meghir *et al.* (2015) for instance. The major discrepancies from observed data are an underestimated urban non-employment share and an overestimated urban formal employment share. This may come from the fact that those are the two states which are the furthest away from stationarity in the data, as discussed in Section 3.2.[22] As explained in Section 4.1, the average urban firm size is directly targeted in the model. However, I have no data to validate average urban informal firm size. Still, taking these at face value, I impute what the actual urban firm shares (unobserved) would be given the actual worker shares (observed). The fit on urban firm shares appears to be more precise than for urban worker shares. If anything, the relative overestimation of informal firm share may be due to the impossibility to hire workers informally for formal firms.

[22]To improve the model fit, a deviation from steady state can be calibrated and added to the equations, in a similar fashion as for urban growth. However, the evolution of employment shares is not linear in the data, and it is harder to interpret it as the manifestation of fixed structural factors. It may therefore lead to overfitting in counterfactuals.

Table 10: Model fit on workers' and firms' allocation

	Actual	Model
Worker shares		
u_R	0.246	0.260
m_R^E	0.242	0.200
u_U	0.193	0.105
m_U^F	0.194	0.303
m_U^I	0.126	0.133
Firm shares		
n_U^N	0.093	0.082
n_U^F	0.487	0.422
n_U^I	0.420	0.496

Notes: Actual firm shares imputed from actual worker shares and model firm sizes. Worker shares and local firm shares sum up to one.

5.3 Welfare analysis

Table 11 shows the average discounted welfare values for each state in the model and presents the respective shares of their individual components. First, let us remark that the urban non-employed feature similar option values across the formal and the informal sectors: this is because lower wages in the informal sector are compensated for by lower frictions. They also feature a substantial value of leisure, as the rural non-employed do, equal to more than one-third of their overall welfare. Relative rural amenities are also important, as they account for between 10% and 20% of rural welfare values.

Table 11: Average discounted welfare decomposition

	Value	Amenities	Exp. wage / leisure	Rur. empl. opt.	Urb. form. opt.	Urb. inform. opt.
rW_R^N	15,220	0.16	0.37	0.41	0.03	0.03
$rE(W_R^E)$	22,120	0.11	0.70	0.13	0.04	0.02
rW_U^N	15,300	.	0.37	.	0.31	0.32
$rE(W_U^F)$	26,620	.	0.89	.	0.07	0.04
$rE(W_U^I)$	23,030	.	0.73	.	0.20	0.07

Notes: Amenities are relative to urban baseline and are therefore only accounted for in rural areas. Expected wage/leisure includes both the flow value of current wage and option value of unemployment risk when employed, or utility of leisure when non-employed. Other columns cover option values of future job opportunities: as I do not allow for urban-rural moves, there is no rural option value in urban areas. Row proportions sum up to one.

Profitable transitions. Importantly, average values for employment states are ranked as expected: $E(W_R^E) < E(W_U^I) < E(W_U^F)$. It means that urban formal jobs are indeed more valuable than urban informal jobs on average, essentially due to higher wages and lower job destruction rates. It also means that it is profitable for rural migrants to move to urban informality on average, even when they experience a wage cut. This is in spite of relative rural amenities being positive. Moreover, as transition rates from rural to urban informal are not higher than to urban formal (Section 5.1), such moves should not be driven by lower frictions (or overoptimism) either. Under common preferences, I therefore justify them by higher dynamic gains in urban compared to rural labour markets.

Stepping-stone mechanism. Indeed, it appears that the option value from future formal jobs when informally employed in cities accounts for 20% of the average discounted welfare value: this quantifies how much workers value the stepping-stone potential of informal jobs. Likewise, the option values of urban jobs for rural workers show that they similarly value formal and informal job opportunities in cities, since they account for between 2% and 4% of their welfare values. The upward bias on urban formal option values discussed in Section 2.6 therefore seems to be limited, as it is unlikely that formal jobs are actually valued less than informal jobs on average.

Finally, the value of informal jobs says nothing of the share of such jobs that would be destroyed or formalized following an exogenous shock. It is not informative either on the impact of such shock on movers and stayers through wages in equilibrium. I therefore turn to policy simulations in Section 6.2 to see how the stepping-stone mechanism plays out in counterfactuals.

5.4 Productivity analysis

Before that, Tables 12 and 13 show respectively firm-specific distributions and characteristics by joint productivity level. They help explain the differences between the estimated welfare distributions. First of all, wages, offer values, and firm sizes grow monotonously with productivity, which is the most important factor driving these values. Then, let us remark that urban workers are more represented on the right end of the firms' productivity distribution compared to rural workers, especially in the formal sector. This is due to either a higher share of firms in those quantiles, or a higher capacity of these firms to absorb workers: in any case, urban areas are more productive than rural ones.

Table 12: Comparative worker and firm distributions by productivity level

		Rural	Urban			Wage (log)			Value (log)		
	p (log)	Cumul. worker share	Cumul. worker share	Fract. formal work	Fract. formal firms	*RE*	*UF*	*UI*	*RE*	*UF*	*UI*
P10	9.88	0.00	0.06	0.62	0.42	.	8.99	8.12	11.96	12.06	12.05
P25	10.35	0.00	0.20	0.60	0.43	.	9.76	9.75	11.96	12.22	12.21
P50	10.66	0.15	0.34	0.62	0.43	9.10	10.13	10.20	12.09	12.35	12.34
P75	10.89	0.47	0.45	0.64	0.45	10.06	10.34	10.45	12.29	12.46	12.43
P90	11.23	0.75	0.57	0.70	0.50	10.49	10.56	10.73	12.47	12.60	12.57
P99	13.06	0.99	0.81	1.00	0.99	11.03	11.07	11.32	12.81	13.00	12.98
$\overline{p}$	14.70	1.00	0.89	1.00	1.00	11.21	11.32	.	12.93	13.20	.

Notes: Cumulative worker share = fraction of all workers employed at firms with productivity less than p ; Fraction of formal firms = probability of drawing a formal job conditional on drawing a job of productivity p ; Fraction of formal workers = share of formal workers among employees at jobs of productivity p ; Wage is wage offer of firms of productivity p ; Value is corresponding welfare value ; $\overline{p}$ corresponds to the 0.999 quantile of the total aggregate productivity distribution (effectively the max).

Wages and productivity. For a given productivity level, firm size grows with the size of the worker pool available locally (through ratio $\frac{M}{N_i}$), but also with the ease of recruiting conditions (through matching rate $\frac{h_i^k(W)}{d_i^k(W)}$). Interestingly, informal firms tend to offer higher wages than formal firms as productivity grows. This is because, as informality costs fall as a share of revenues, informal firms face relatively fewer costs than formal firms subject to taxes. They are therefore able to offer workers compensating differentials for the absence of unemployment insurance or lower dynamic gains. Actually, the corresponding offer values are almost the same. Note that such compensating differentials

Table 13: Comparative firm characteristics by productivity level

		Profit rate			Firm size		
	p (log)	*RE*	*UF*	*UI*	*RE*	*UF*	*UI*
P10	9.88	.	0.42	0.71	.	14.61	12.91
P25	10.35	.	0.31	0.38	.	30.36	30.43
P50	10.66	0.79	0.28	0.31	14.25	51.40	48.90
P75	10.89	0.56	0.29	0.31	26.67	71.79	65.58
P90	11.23	0.52	0.34	0.36	41.87	101.48	88.46
P99	13.06	0.87	0.62	0.82	58.86	182.50	116.56
$\overline{p}$	14.70	0.97	0.69	.	59.70	223.00	.

Notes: Profit rate = profit flow divided by output ; $\overline{p}$ corresponds to the 0.999 quantile of the total aggregate productivity distribution (effectively the max).

are compatible with higher wages on average for urban formal firms since they are also more productive: this is a composition effect. Indeed, passed some threshold, it is never profitable for urban firms to operate informally and they all choose the formal sector.

Labour market power. Relatively lower wages (and welfare values) for rural firms have to do with higher local labour market power, as rural workers have fewer outside options than urban workers and rural firms are able to capitalize on this. This is reflected in higher profit rates overall, and is aligned with existing evidence of higher local labour market power in rural areas (Marshall, 2024). They also tend to be larger in the informal compared to the formal sector. Interestingly, profit rates are not monotonous with respect to productivity level: this is because they depend on the mass of competitors and the mass of workers, which are not uniformly distributed across the productivity support. This will create non-monotonicities in firm behaviour in counterfactuals. Besides, they are quite large. This will also matter in counterfactuals as informal firms will be able to absorb a substantial share of the shock before the formal sector becomes a profitable alternative. This will depend on the net effect between added competition from incoming firms and more relaxed matching conditions from incoming workers in the formal sector, and will also generate non-monotonous responses of firms. Because the direction of this net effect is not clear a priori, I now turn to policy simulations to assess it quantitatively.

6 Policy Simulations

6.1 Estimation procedure

To compute counterfactuals, I replicate the estimation procedure described at baseline with a few key modifications. First, I do not re-estimate transition rates which stay constant across simulations. This boils down to considering that they are mostly driven by information frictions, assumed to be fixed in counterfactuals.[23] I also keep the values for informality cost parameters and utility of leisure as exogenous, but allow relative amenities to adapt to reflect congestion forces on the workers' side. Then, I re-estimate offer distributions by targeting the urban aggregate productivity distribution obtained at the end of Section 4.2.2, in a similar fashion as what I do with observed wage distributions in Section 4.2.1, but with added weights to account for the mass of firms associated with equally spaced

[23] Meghir *et al.* (2015) suggest a way to endogenize job arrival rates based on changes in labour market tightness. In their case, this does not change the direction of the effects but makes them stronger, as this accelerates the worker reallocation that already takes place through stationary worker flow conditions (Section 3.2).

productivity points. This consists in minimizing the following quadratic distance:

$$Q_4\left(\theta|\vartheta, c_f, \gamma_f, \{n_U^k\}_{k\in\{N,F,I\}}\right) = \sum_{q=1}^{M} \omega_q \left(\Xi_U^*(p_q) - \Xi_U(p_q)\right)^2 \tag{23}$$

where Ξ_U^* is the target productivity distribution and Ξ_U the predicted one.

The rationale is that firms' underlying productivity distribution should remain unchanged in counterfactuals as I abstract from any structural change effect. Likewise, the structural urban growth rate is fixed: all the reallocation effects will be captured by new worker shares across geo-employment states, and not through changes in migration (or other transition) rates. Given that urban firms hire rural migrants, targeting the productivity distribution of urban potential entrants suffices to identify model parameters in both urban and rural areas.

Also remark that the error measure depends on predicted firm shares $\{n_U^k\}_{k\in\{N,F,I\}}$. This is because the algorithm now embeds the firms' side estimation from Section 4.2.2 within the workers' side estimation of Section 4.2.1, instead of dealing with it sequentially. Indeed, the local firm shares have an impact on the simulated aggregate productivity distribution which is now used to select the appropriate solution. Note that I need to go through this non-standard procedure because the policy shock I am considering will affect firms' entry and sector decisions, as well as their wage-posting strategy. It is therefore not possible anymore to identify offer distributions through accepted offers, since they will change as an equilibrium outcome in counterfactuals.

6.2 Increasing the cost of informality

Scenario. My main scenario consists in increasing the informality cost elasticity parameter γ_f incrementally by steps of 0.1 from its initial value of 1 towards 1.3. This can be understood as increasing monitoring costs on urban informal firms. Before any behavioural changes from firms, this consists in a non-linear rise of mean cost per revenues from 13% to 36%. I stop there not to extrapolate results too far out of sample. Note that this could be mapped to the creation by the Department of Employment and Labour's Inspection and Enforcement Services of a National Labour Inspection Task Team in 2022 (after my study period) to target the informal sector.

The informality trade-off. The main results are given in Tables 14 and 15, and can be explained with the help of Tables 16, 17, and 18. The bottom line is that the policy generates a rise in urban output due to a reallocation of workers from the informal to the formal sector. However, this benefits firms more than workers, as workers' welfare actually decreases in the face of wage cuts. This trade-off between welfare and output is mitigated by rural firms which increase wages to retain potential migrants: both local welfare and output rise in rural areas, as workers are reallocated towards the most productive firms. The rural-urban welfare gap goes from 29.2% to 25.5%. Still, this is not sufficient to offset the fall in urban welfare as rural workers are still paid less than urban workers on average: global welfare falls by 0.9%. Because they are also less productive, the rise in global output (+2.4%) is limited by such spatial reallocation: the urban population share falls by 4.1%. This corresponds to 2.2% of the total population, or 2.7 years of reversed urban growth at current rates.[24]

[24]Considering total output relative to workers' welfare matters for potential redistribution policies. However, since I implicitly consider sticky capital allocation in the model, the impact on output could change with capital reallocation on the very long term.

Table 14: Welfare effects of increasing the costs of informality

	Baseline	Change from baseline		
	$\gamma_f = 1$	$\gamma_f = 1.1$	$\gamma_f = 1.2$	$\gamma_f = 1.3$
rW_R^N	15,220	-0.80%	-1.35%	-2.36%
$r\mathbb{E}(W_R^E)$	22,123	+1.94%	+4.18%	+4.14%
Rural	18,219	+0.76%	+1.81%	+1.35%
W_U^N	15,303	-0.80%	-1.34%	-2.34%
$r\mathbb{E}(W_U^F)$	26,624	-0.63%	-0.69%	-0.60%
$r\mathbb{E}(W_U^I)$	23,027	-0.98%	-2.36%	-4.91%
Urban	23,541	-0.73%	-1.07%	-1.53%
Total	21,096	-0.37%	-0.37%	-0.88%
WF gap	*0.29*	*-6.51%*	*-12.51%*	*-12.57%*

Notes: Average discounted welfare per worker is aggregated within rural and urban areas and for the total population, based on estimated worker shares in each state.

Table 15: Output effects of increasing the costs of informality

	Baseline	Change from baseline		
	$\gamma_f = 1$	$\gamma_f = 1.1$	$\gamma_f = 1.2$	$\gamma_f = 1.3$
$\mathbb{E}(p_R^E l_R^E) \cdot \frac{N_R^E}{M_R^E}$	76,068	+6.85%	+13.47%	+15.08%
Rural	33,044	+7.54%	+14.89%	+16.71%
$\mathbb{E}(p_U^F l_U^F) \cdot \frac{N_U^F}{M_U^F}$	174,868	+0.35%	-0.20%	-1.64%
$\mathbb{E}(p_U^I l_U^I) \cdot \frac{N_U^I}{M_U^I}$	57,587	+1.59%	+4.10%	+8.31%
Urban	112,024	+0.62%	+1.13%	+1.57%
Total	75,747	+1.01%	+1.96	+2.39%
Output gap	*2.39*	*-9.12%*	*-16.99%*	*-18.40%*

Notes: Average output per worker is aggregated within rural and urban areas and for the total population, based on estimated worker shares in each state.

Wages and rural-urban migration. In fact, the informal sector maintains urban employment levels by acting as an outside option for workers (which I have shown to be valuable), thereby limiting the local labour market of formal firms, hence their propensity to cut wages in counterfactuals.[25] This is the first main contribution of this paper. In this context, rural jobs play the role of an alternative outside option: simulating an isolated city without rural-urban migration yields stronger negative welfare effects (by a factor of 5.5) and weaker positive output effects (by a factor of 4.5) following the policy shock, as the most productive urban firms are also the ones which cut wages the most. This is the second main contribution of this paper. I will now give more details on the model mechanisms.

Firms' formalization. Following the policy shock, urban informal firms of relatively low productivity do formalize as it is too costly for them to absorb the shock, which pushes the urban informal productivity distribution up (Table 18). None of these firms are destroyed given that the lower bound of informal productivity that I estimate is still higher than the lower bound for urban

[25] Note that I consider atomistic firms and therefore do not consider strategic competition for workers as an added source of labour market power.

Table 16: Changes in worker and firm allocation as costs of informality increase

	Baseline	Change from baseline		
	$\gamma_f = 1$	$\gamma_f = 1.1$	$\gamma_f = 1.2$	$\gamma_f = 1.3$
Worker shares				
Rural	0.46	+2.13%	+4.21%	+4.84%
Non-empl. rate	*0.57*	*-0.49%*	*-0.96%*	*-1.09%*
Urban	0.54	-1.81%	-3.58%	-4.11%
Non-empl. rate	*0.19*	*+0.16%*	*+0.62%*	*+1.62%*
Informal rate	*0.25*	*-0.64%*	*-3.84%*	*-10.07%*
Informal vs. empl.	*0.31*	*-0.61%*	*-3.69%*	*-9.72%*
Urban firm shares				
Active	0.92	-0.01%	-0.91%	-2.24%
Informal rate	*0.54*	*-2.02%*	*-5.02%*	*-8.08%*
Mean firm sizes				
Rural employed	23.35	+2.79%	+5.51%	+6.34%
Urban formal	46.66	-3.55%	-5.92%	-4.95%
Urban informal	35.19	-0.22%	+0.19%	+0.63%

Notes: Figures in italics are defined within the geography type stated above.

formal firms: they are therefore productive enough to survive taxes and competition in the formal sector. This stands in contrast with other contexts where jobs are directly destroyed in the wake of such policies. If anything, this should strengthen my findings as an increase in non-employment should reduce workers' welfare and increase firms' labour market power. As the shock becomes stronger and more productive firms formalize, urban formal productivities actually increase with the newcomers after an initial drop (Table 18). This added competition pushes the lowest-productivity formal firms out of business. These moves are reflected in the evolution of relative active firm shares (Table 16): 2.2% of urban firms are destroyed.

All else equal, this should push observed wages up. On the contrary, they fall in the urban informal sector, especially in the lower quantiles (Table 17): this is because remaining firms still need to absorb the increase in cost, especially in the most affected quantiles, and they do so by lowering their offers independently of matching conditions. The net effect between reduced competition among firms and a depleted pool of available workers on wage-posting in the informal sector is unclear. The picture is different for urban formal firms. As observed wages first increase, then decrease along the distribution (Table 17), it would seem that added competition in the quantiles most affected by firms' formalization pushes wages up (although the increase in productivity levels could also play a role), but that easier matching conditions push wages down in the higher parts of the distribution.[26]

Workers' formalization. This effect on wages translates into lower welfare values for urban formal and informal workers, although the effect is mostly marked for informal workers. The value of urban non-employment also falls to reflect this new situation (Table 14). Still, the reduction in urban welfare (-1.5%) is mitigated by the reallocation of urban workers from the informal to the formal sector, which pays better overall. Mean firm sizes adapt accordingly (Table 16): the share of informal

[26]It is difficult to directly show the evolution of wage markdowns as the productivity grid on which the model is estimated also varies across counterfactuals.

Table 17: Changes in accepted wage distributions as costs of informality increase

	Baseline	Change from baseline		
	$\gamma_f = 1$	$\gamma_f = 1.1$	$\gamma_f = 1.2$	$\gamma_f = 1.3$
Rural wages				
P10	8.69	+7.18%	+15.03%	+17.33%
P25	9.54	+8.09%	+16.81%	+19.09%
P50	10.12	+7.63%	+15.73%	+17.69%
P75	10.49	+6.97%	+14.24%	+15.98%
P90	10.72	+6.32%	+12.86%	+14.46%
P99	11.01	+5.12%	+10.27%	+11.61%
Urban formal wages				
P10	9.65	-0.53%	+0.87%	+3.45%
P25	10.22	-0.64%	-0.55%	-0.49%
P50	10.70	-0.98%	-1.97%	-3.69%
P75	11.13	-1.43%	-3.59%	-7.32%
P90	11.46	-1.49%	-4.15%	-8.88%
P99	11.85	-1.26%	-3.59%	-7.92%
Urban informal wages				
P10	7.96	-4.04%	-17.54%	-44.49%
P25	9.27	-2.42%	-8.89%	-21.00%
P50	9.98	-1.94%	-6.90%	-16.22%
P75	10.40	-1.61%	-5.80%	-13.97%
P90	10.65	-1.44%	-5.16%	-12.58%
P99	10.90	-1.21%	-4.69%	-11.63%

Notes: Baseline columns contain log wages as predicted by the model. Remaining columns are changes from respective baselines.

workers in cities fall by 10.1%, whereas the share of non-employed workers rise by 1.6% only. At the same time, average urban output per worker increases by 1.6% (Table 15). Again, the reallocation of workers from the informal towards the more productive formal sector plays the main role. However, it is worth noting that average formal output per worker decreases slightly, which limits the potential gains. This is in spite of the rise in productivity levels, as larger firms with more market power cut wages the most, reallocating workers towards the least productive ones. Output per worker rises in the informal sector as the increase in monitoring costs counts as added government revenues (as for taxes).

Spatial reallocation. At the new welfare levels, it becomes profitable for some potential rural migrants to stay in rural areas. Actually, it also becomes profitable for some rural firms to outbid urban firms offering lower wages, thereby retaining even more workers. As firms raise wages, they also increase the local competition for workers, which crowds out the least productive ones: this is reflected in fewer active, but larger (Table 16) and more productive (Table 18) rural firms. This translates into higher observed wages in Table 17, and a slight decrease in local non-employment (Table 16), hence an increase in average rural welfare. Note however that the rise in welfare is mitigated by a fall in relative rural amenities that is reflected in the lower value of rural non-employment (Table 14). This is a direct consequence of the spatial equilibrium condition and corresponds to increased congestion as population grows in rural areas. The positive effect on rural output is even more sizable (Table 15).

Table 18: Changes in productivity distributions as costs of informality increase

	Baseline	Change from baseline		
	$\gamma_f = 1$	$\gamma_f = 1.1$	$\gamma_f = 1.2$	$\gamma_f = 1.3$
Rural productivities				
P10	10.60	+8.47%	+17.66%	+19.72%
P25	10.64	+7.40%	+15.19%	+16.69%
P50	10.74	+6.18%	+12.55%	+13.67%
P75	10.96	+5.69%	+11.69%	+13.00%
P90	11.28	+5.70%	+11.85%	+13.56%
P99	12.37	+6.96%	+13.12%	+14.98%
Urban formal productivities				
P10	9.66	-0.16%	+2.24%	+5.88%
P25	9.97	-0.34%	+1.28%	+4.02%
P50	10.37	-0.52%	+0.45%	+2.51%
P75	10.81	-0.70%	+0.05%	+2.28%
P90	11.31	-1.01%	-0.23%	+2.81%
P99	12.97	-1.23%	-3.00%	-5.62%
Urban informal productivities				
P10	9.77	+4.77%	+9.91%	+15.04%
P25	9.93	+4.16%	+8.85%	+13.90%
P50	10.27	+3.02%	+6.53%	+10.51%
P75	10.67	+1.97%	+4.19%	+6.99%
P90	11.03	+1.05%	+2.10%	+3.51%
P99	11.74	-0.41%	-2.80%	-6.45%

Notes: Baseline columns contain log productivities as predicted by the model. Remaining columns are changes from respective baselines.

On aggregate, the effect is weaker for global output as there are now more workers in less productive areas (Table 16). Global welfare also decreases since rural workers are still paid less than urban workers, even though the reallocation of workers across space alleviates the even stronger fall in urban welfare: this is confirmed by alternative simulations without rural-urban migration where increased monopsony power of urban firms leads to even more negative outcomes.

7 Conclusion

In this paper, I undertook to study the role played by informal employment for spatial labour misallocation in low- and middle-income country contexts. By focusing on rural-urban migration and by taking South Africa as my case study, I found the role of urban informality more specifically to be ambiguous. Indeed, imposing more stringent regulations on urban informal firms locally improves output through worker reallocation towards more productive jobs, but it also reduces welfare as firms then offer lower wages. This is because the informal sector limits the local labour market power of formal firms by offering a valuable outside option to workers. Importantly, when this option becomes unavailable, reduced rural-urban migration may act as an alternative strategy to cope with the negative welfare effects. However, the effect on aggregate welfare and output is muted as more workers then stay in areas where they are less productive and less paid overall.

I therefore draw two main conclusions from this study. First, the urban informal sector indirectly provides jobs to potential rural migrants by maintaining local wage levels in the formal sector. This effect holds independently of potential job destruction in the wake of a formalization shock, in contexts where informal jobs indeed provide workers with substantial dynamic gains. This argues for formalization policies that better take matching frictions in consideration. For instance, it has been shown that public employment can act as a substitute for informal employment (Yassin & Langot, 2018). By offering guaranteed wages, local public work programs can therefore provide workers with a valuable alternative. These have been shown to generate positive spillovers on wages in the private sector, be it in urban (Franklin *et al.*, 2024) or rural (Imbert & Papp, 2015, 2020b) areas. I consider such policies as a more promising avenue than national minimum wages in this regard, since most of the wage cuts I simulate happen above floor levels. Second, local labour market policies can generate sizable spatial spillovers that can drastically change policy recommendations. Indeed, when simulating a closed urban economy, the trade-off between aggregate welfare and output appears to be substantially larger than it actually is with rural-urban migration. This suggests substantial gains from reducing spatial frictions, and argues for more detailed spatial analyses of place-based policies more generally (Neumark & Simpson, 2015; Juhász *et al.*, 2023).

As with any policy study, I would need more information on implementation costs to draw a proper cost-benefit analysis from this paper. I also think it would be especially relevant to consider the specificity of housing markets in low- and middle-income countries (notably informal housing), as job-related mobility partly depends on housing choice. Finally, biased beliefs (Baseler, 2023) and job-specific preferences (Blattman & Dercon, 2018; Feld *et al.*, 2022) may also play a role. I leave these extensions for future work.

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