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# Rethinking formalization of Zimbabwe's informal sector

## **Abstract**

The notion of formalizing the informal sector in Zimbabwe is not new however; this paper asserts that although much is known on the subject, considerably little seems to be understood. This paper uses an extended literature review to characterize the identification of informality and explores the different approaches to formalizing informal activities. Furthermore, the concepts are contextualized to Zimbabwe's environment as a way of articulating the reality of available options that may be integrated into the transition process. It emerges that there is diversity of circumstances in rural and urban settings, economic sectors, occupations and national contexts. In this regard, this paper proposes a framework in which government and society play a central role in transforming Zimbabwe's informal sector to formalization and pave way for taxation thus broadening the country's revenue. Critical issues include revision, design and implementation of law and policies that dissolve informality.

## **Keywords**

formalization, informal sector; taxation, Zimbabwe

## 1. INTRODUCTION AND BACKGROUND

### 1.1 Introduction

*“As shadow economic activities are a fact of life around the world, most societies attempt to control these activities through various measures like prosecution, punishment, economic growth or education. Gathering statistics about who is engaged in shadow economy activities, the frequencies with which these activities are occurring and the magnitudes of them, is crucial for making effective and efficient decisions regarding the allocations of a country’s resources in this area. Unfortunately, it is very difficult to get accurate information about these shadow economy activities on the goods and labor market, because all individuals engaged in these activities wish not to be identified. Hence, the estimation of the shadow economy activities can be considered a scientific passion for knowing the unknown”.* Schneider (2006)

Shear-sized informal economies are an important characteristic of low income countries such as Zimbabwe. Despite informal economies being existent over the world, they are particularly prevalent in low income countries, to which Zimbabwe belongs. The informal sector is a functioning part of all economies which produces legal goods but does not comply with government regulations. In Less Developed Countries (LEDs) this sector employs up to 60 per cent of the workforce and produces nearly 40 per cent of GDP (Ihrig and Moe, 2001). The informal sector in Zimbabwe has grown from 10% of official GDP at Independence in 1980 to an all-time higher share of 70% in 2008 before subsiding to a still higher percentage share of 52% by end of 2009<sup>1</sup>. These statistics provide anecdotal evidence that the informal economy makes a sizeable contribution to national income.

Historically, the informal sector was thought to be comprised of small enterprises, street vendors, shoe-repairs and all types of relatively small and hard to tax groups. However, current trends show that professionals like accountants, engineers, lawyers, teachers and economists are operating in the hidden economy of Zimbabwe. This myriad assumption has for long impaired policy makers' attitude towards the informal sector. The informal economy in low income countries especially in Africa sums up a wide section of the whole economy. The informal sector in 2000 as a proportion of Gross Domestic Product (GDP) was 42 percent and accounted for 48 percent of the total labor force on the continent (Schneider, 2002). It was discovered that Zimbabwe, Tanzania and Nigeria had by far the largest informal economies with 59.4%, 58.3% and 57.9% accordingly.

## **1.2 Justification of the study**

The notion of formalizing the informal sector in Zimbabwe is not new however; this paper asserts that although much is known about the subject considerably little seems to be understood.

Despite the importance of a good understanding of the estimations and characteristics of the informal sector in Zimbabwe, not much has been done to try and understand drivers of informality and ways to formalize the informal sector in Zimbabwe. Literature on the nation's informal sector has focused predominantly on;

- Estimating the size and trends of second economy in Zimbabwe (Ocran, 2009; Makochekanwa, 2010).
- Nature and characteristics of the informal sector (See Dhemba, 1999).

While these and other studies have been useful in highlighting estimates and characteristics of informal sector in Zimbabwe, there still remains scant literature on drivers of informality

particularly in this nation and strategies to formalize and/or regulate this sector. Awareness on the part of policy makers on the drivers of informality and the need to revise, design and implement laws that dissolve informality are a pre-condition for the development of appropriate economic growth strategies to resuscitate the nation's economy.

### **1.3 Objectives**

#### **1.3.1 Study questions**

- i. What are the main drivers of informality in Zimbabwe?
- ii. What are the possible approaches to formalize informal activities?

#### **1.3.2 Study objectives**

The main purpose of my study is to discuss the reasons for a sheer second economy in Zimbabwe in order to come up with a framework to formalize informal activities. The specific objectives are therefore to:

- i. Examine the main causes of informality in Zimbabwe.
- ii. Propose a possible framework to formalizing the informal activities in the economy.

## **2. DEFINING INFORMAL SECTOR**

The concept 'informal sector' first featured in the work of British anthropologist Keith Hart in his famous study on informal income opportunities and urban unemployment in Ghana (Hart, 1973). A substantial and by now large volume of critical literature exists which points out the definitional problems, ambiguities and inconsistencies inherent in the concept "informal sector". The search for a homogenous definition of the informal economy has been elusive (Bhattachara, 1998).

The term ‘informal sector’ suffers from definitional confusion<sup>1</sup>, possibly due to the fact that it is characterized more by what it is ‘not’, than what it is (Kristoffersen, 2011). Numerous terms exist to describe the concept of informal sector: black market, second economy, grey economy, informal economy, System D, shadow economy, underground economy, parallel market, the agora, hidden economy, unrecorded economy, unmeasured economy, illegal economy, unofficial economy, clandestine economy, irregular economy, marginal economy, submerged economy, subterranean economy, dual economy, unregistered economy, etc.

Definition of informality tends to take two views; the *employment view* and the *enterprise view*. This study concentrates much on the informal sector from the enterprise view, though reference is made to the employment view, so as to consider possible policy frameworks to counteract the problems that prevent firms from formalizing. One commonly used definition of informal sector is all currently unregistered economic activities that contribute to the observed GNP (See Feige, 1989, 1994; Schneider, 1994a, 2004, 2005; Frey and Pommerchne, 1984; Makochekanwa, 2010). Del’Anno (2003) defines the concept as “those economic activities and the income derived from them that circumvent or otherwise government regulation, taxation or observation”.

On a broader scale, *informal sector* is considered to mean very small-scale goods and services production and distribution units which consist both employed workers and independent self-employed persons in both rural and urban areas (Bagachwa and Naho, 1995). Their informality comes from the fact that they are for the most part unregistered and unrecorded in official statistics (ILO, 1991). *Black market* refers to activities that produce and/or distribute market and non-market goods that are illegal and strictly forbidden by the government statutes (Bevan et al,

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<sup>1</sup> For example, in a study by **USAID in 2005**, there is no single widely agreed upon definition of the informal economy.

1989). *Parallel market* activities include illegal production of goods and services that are legal in their nature, and therefore have an alternative legal market. The activities usually develop in direct response to excessive government interventions and restrictions which create excess demand or supply in a particular commodity or factor market (Lindauer, 1989). It is important to note that although the terms informal sector, black market, informal economy, second economy, parallel market, unregistered economy etc. are sometimes defined differently, it is instructive to treat them as describing the same phenomena.

Schneider (2006) describes a shadow economy as one that includes all market-based legal production of goods and services that are deliberately concealed from public authorities for the following reasons;

- To avoid payment of income, value added or other taxes,
- To avoid payment of social security contributions,
- To avoid having to meet certain legal labor market standards, such as minimum wages, maximum working hours, safety standards, etc., and
- To avoid complying with certain administrative procedures, such as completing statistical questionnaires or other administrative forms.

### **3. ESTIMATING THE INFORMAL SECTOR**

As held by Tanzi (1982) and Schneider (2012), the size of the informal economy can be quantified in three different ways;

- Speculation by various interest groups can be employed to quantify the sector with the objective of increasing the awareness that phenomenon exists and that it should be taken on board in government policy making.

- Intelligent guesses can advance contribution figures, though these figures will, in a majority of cases, not be well defined and may be incomparable to other statistics.
- Well-defined, unambiguous approaches which make it easier and feasible for comparisons to be made between different time periods or between the informal sectors of diverse countries (Saunders and Loots, 2015).

Economic literature categorizes these well-defined approaches into direct and indirect approaches and model approach.

### **3.1 Direct Approach**

The approach relies on well-designed surveys and samples which will normally be based on tax audits and voluntary responses, among other sources of data (Schneider and Enste, 2003). The surveys usually provide point estimates (See Gujarati and Porter, 2008) hence are useful in approximating changes in the size of the informal sector. Nonetheless, the surveys are normally unable to cover all sections of a given population and more importantly because of the voluntary nature of the response elicitation procedure; the outcomes may only provide lower bounds of the possible size of a given informal sector (Makochekanwa, 2010).

### **3.2 Indirect Approach**

Indirect approaches are, as a rule, referred to as indicator approaches and they use secondary data sources to (in a roundabout way) guesstimate the size of the underground economy (Saunders and Loots, 2005). The approaches are mostly macroeconomic in nature and tend to employ indicators that contain information about how the informal sector evolves over time (Ocran, 2009). The main supposition underlying this approach is that the indicators have “traces” of the



development of the parallel economy that can be used in approximation. The most popular indicators that can act as indicators of the size of the hidden economy include the following;

### **3.2.1 Discrepancy method**

This uses discrepancies in national income statistics and labour in approximating the size of the informal sector. In the *national discrepancy*, the discrepancy between the estimates of GDP with respect to the expenditure approach and the income approach may be ascribed to the underground economy (Hartzenberg and Leiman, 1992). In the *labor discrepancy* method, the discrepancy between the official and actual labor force statistics may be credited to the fact that individuals work in the informal sector (Loots, 1991).

### **3.2.2 Electricity consumption method**

In this approach, electricity is believed to be the best physical indicator of overall economic activity, and as such any discrepancy between actual electricity consumption and usage patterns and official projections is caused by the informal economy (Dobozi and Pohl, 1995; Lacko, 1998 and Makochekanwa, 2010).

### **3.2.3 Monetary method**

This method consists of 2 sub-categories

#### ***3.2.3.1 The Guttman approach***

This approach hinges on 4 main assumptions;

- High taxes and the business regulatory framework are the main causes of the emergence of an informal sector.

- Only cash is used in the conduct of business transactions in the underground economy.
- The ratio of cash to demand deposits (currency ratio, CD), is solely driven by changes in taxes and the regulatory framework.
- There was a given point in time where no informal sector existed. Consistently, it is assumed that the currency ratio of that period should have remained unchanged and that any change is only due to changes in the level of tax and regulations. Thus any increases in the currency ratio can be directly attributed to the additional cash being used in the formal sector activities.

### ***3.2.3.2 The Fiege approach***

The method posits that in addition to cash holdings, players in the informal sector also use other financial instruments like cheques and bills in facilitating transactions. Employing the total volume of transactions and income in the economy Fiege suggest an equation for approximating the size of the hidden economy. Given that total transactions in the economy sum up intermediate and second hand goods among others while GDP only covers final goods and services, the proposition is that the difference between the GDP figures and the total volume of transactions can be attributed to informal sector.

### **3.2.4 Currency Demand method**

The approach makes two assumptions;

- The currency ratio is affected largely by both legal and illegal factors and
- The velocity of money in both formal and informal sectors is the same.

The model also posits that the underground economy's existence is as a result of the high tax burden and consequently, people move to the informal sector just to avoid the high tax burden that characterize the official sector. The parallel sector is generated by first approximating the currency equation with the tax variables and then estimating the same equation again but this time imposing a zero tax rate value (Makochekekanwa, 2010). The difference between the two equations resembles the currency in circulation in the informal sector (Bagachwa and Naho, 1995; and Schneider and Enste, 2003).

### **3.3 Model approach**

It is based on the proposition that the hidden economy can be seen as an “unobservable variable” which is controlled/predisposed by vast causes (tax burden, regulation and high transaction costs etc.). The model observes a multiple of exogenous and endogenous variables that lead to the emergence and growth of the informal sector over time, and in the process, infers the size of the hidden economy over time (Giles, 1999a; Frey and Schneider, 2000).

## **4. THEORIES OF INFORMALITY**

There are three broad classes of models explaining why firms and individuals remain in the informal sector (La Porta and Shleifer, 2008, 2014). Two classical theoretical traditions are exclusion model and rational exit model. A third model is that informal sector and the formal sector are different segments of a dual-economy, which are largely unrelated.

### **4.1 Exclusion model**

Informality is caused by burdensome regulations (Rothenberg et al, 2016). Government regulations **exclude**, or hold back, a large potential pool of entrepreneurs (De Soto, 1989, 2000).

Firms in the informal sector may not be able to access formal financial services from formal financial institutions, undermining their ability to secure loans to grow. In this model, informal sector firms are an ‘untapped reservoir of entrepreneurial energy’, which can be released by removing barriers to entry, cutting red tape and improving legal environments (Rothenberg et al, 2016). The exclusion model of informality tends to be consistent with “missing middle” stories (See Tybout, 2000; Hsieh and Olken, 2014). If expensive regulations hold back firms, there may be a large pool of informal firms who cluster at the threshold of formality, leading to a U-shaped firm size distribution. Reducing registration and compliance costs would increase formalization (Rothenberg et al, 2016).

#### **4.2 Rational exit model**

This model posits that informality is a rational response to high regulator costs and uncertain benefits. The theory is associated with Maloney (2004) and Levy (2008) among others and maintains that firms exit the formal sector when costs of formality are greater than its benefits. Before deciding to formalize firms and individuals weigh the benefits of formality such as increased access to formal financial services (banks), courts, government contracts, skilled labor, reduced risks of informal payments to government officials, against costs of formalizing such as registration costs, official tax payments, costs of compliance with various business regulations, like labor laws (Rothenberg et al, 2016). In this theory informal sector firms may enjoy tax advantages, cheaper wage rates, and other cost advantages from not complying with tax rules and other regulations. The appropriate response, in this model, to promote more formality is to increase the benefits of formality and to better enforce registration requirements. Reducing costs and greater enforcement may level the playing field and promote economic growth.

### **4.3 Dual economy model**

As observed by La Porta and Shleifer (2014), informal business and formal firms are fundamentally different. Informality is a by-product of poverty (Rothenberg et al, 2016). The model posits that informal firms are typically small, inefficient and run by poorly educated entrepreneurs leading to low productivity of these firms thus too low to allow for them to survive in the formal economy. As a consequence, informal sector firms are segregated from the formal economy.

## **5. LITERATURE REVIEW**

### **5.1 Causes of informality in Zimbabwe**

Literature on the subject matter of informal sector has advanced the following reasons as the main reasons for the existence and growth of a sheer-sized second economy in Zimbabwe.

#### **5.1.1 High tax burden**

A higher tax burden in the formal sector incentivizes firms and individuals to remain and join the informal sector (De Soto, 1989; Schneider, 2006; Chiumya, 2007 and Makochekanwa, 2010). Income tax in Zimbabwe has been above 30% for nearly three and half decades. This has contributed to some economic activities to continue to hide in the underground economy.

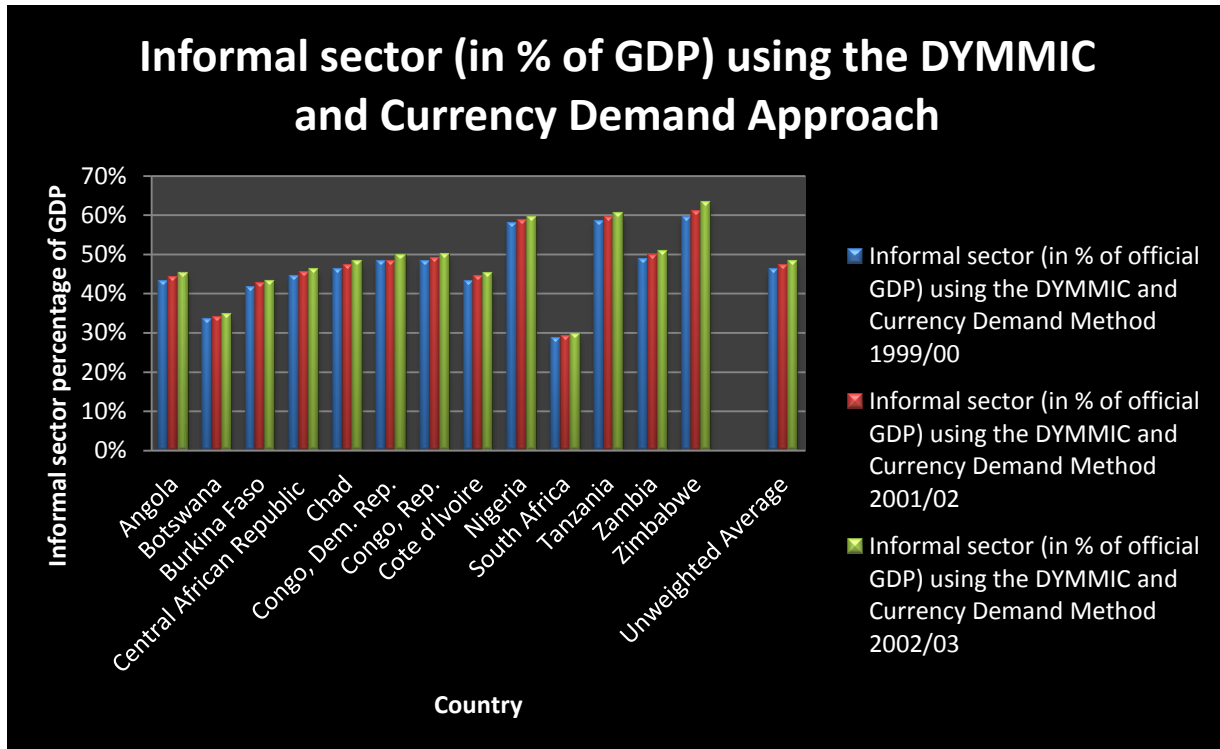
Booming informal economies in Africa (and other developing nations) are to some extent an issue of tax burdens in the formal economy than the simple fact that limited local economy means that citizens are often unable to earn a living wage in a legitimate manner. Working in the underground economy is often the only way of achieving a minimal standard of living (Schneider, 2006).

Country	Informal sector (in % of official GDP) using the DYMMIC and Currency Demand Method		
	1999/00	2001/02	2002/03
Angola	43.2	44.1	45.2
Botswana	33.4	33.9	34.6
Burkina Faso	41.4	42.6	43.3
Central African Republic	44.3	45.4	46.1
Chad	46.2	47.1	48
Congo, Dem. Rep.	48	48.8	49.7
Congo, Rep.	48.2	49.1	50.1
Cote d'Ivoire	43.2	44.3	45.2
Nigeria	57.9	58.6	59.4
South Africa	28.4	29.1	29.5
Tanzania	58.3	59.4	60.2
Zambia	48.9	49.7	50.8
Zimbabwe	59.4	61	63.2
<b>Unweighted Average</b>	46.2	47.2	48.1

SOURCE: Schneider (2006) with additional remarks

The table shows the proportion of informal sector to official GDP in selected African countries as measured by the DYMMIC and Currency Demand Method.

This data can be represented on bar graphs as shown below;



SOURCE: Schneider (2006) and author’s additional remarks.

Though the sum of informal economy contribution to GDP is substantial in Africa and the emerging world, it stands out that Zimbabwe has one of the highest figures thereby begging the question of why not considering formalization of this sector as it represents large revenue potentials.

### 5.1.2 Restrictive business regulatory environment

In principle there is a strong positive correlation between the degree of regulation and informality. Excessive degree of regulation coerce entrepreneurs to conduct business within the

realms of the informal economy (Alanon and Gomez-Antonio, 2005; Makochekanwa, 2010). According to the World Bank's Doing Business ranking the nation's rank has been sliding with the country being ranked 153 in 2015 and 155 in 2016, two points in the negative.

The table below shows the hurdles (monetary costs and time) involved in starting a business in Zimbabwe in the formal sector.

<b>Step</b>	<b>Procedure/Description</b>	<b>Time to complete</b>	<b>Associated costs (in United States dollars)</b>
1	Reserve the company name with the Chief Registrar of Companies <i>Agency: Chief Registrar of Companies.</i> The reservation is valid for 30 days and can be extended for another 30 days for an additional fee.	7 days	\$5
2	File the memorandum and articles of association with the Registrar of Companies. <i>Agency: Registrar of Companies.</i> The law provides boilerplate of incorporation. On the date of incorporation, the Registrar of Companies must be notified of the appointments of the company's directors and secretaries. This is done be	14 days	No charge



	<p>filling the particulars of the directors and secretaries and any changes therein or list of directors and principal officers (Form C R14). These documents must be accompanied by a duplicate original or printed notarized copy.</p>		
3	<p>Register with the tax authorities for income tax, VAT, and PAYE.</p> <p><i>Agency:</i> Tax authorities.</p> <p>Upon formation, a company must register at the regional Zimbabwe Revenue Authority (ZIMRA) office. A copy of the company's certificate of incorporation is required for the collector's records, along with the memorandum and articles of association and certified copy of the identification of the assigned public officer. The company will be issued a registration number, as well as the current tax tables and the PAYE, receipt books. The P8 and P6 Forms now must be generated by the applicant and are not freely available. The ITF 16 Form must be completed in consultation with the Income Tax Office. According to Zimbabwe's Finance Act (as amended), companies must now budget to pay all their company tax within the trading year. The tax</p>	14 days	No charge

	must be paid as follows: 10% by the 25 <sup>th</sup> of March, 10% by the 25 <sup>th</sup> of June, 40% by the 25 <sup>th</sup> of September, and the balance of the estimated tax for the tax year.		
*4	Register with the National Social Security Authority (NSSA) for pension and Accident Prevention and Compensation Scheme <i>Agency: NSSA</i> The employee must contribute 3% of employee the gross monthly salary.	14 days (simultaneous with procedure).	No charge
*5	Register with the Manpower Development Fund <i>Agency: Manpower Development Fund.</i> Employees must register, and contribute 1% of their wage bill, the state-run Manpower Development Fund. The fund allows employees to recover expenses when employees complete training.	1 day (simultaneous with procedure 3)	No charge
*6	Pick up the form of license application notice from the City Health Department. <i>Agency: City Health Department.</i> The entrepreneur then retrieves the license application notice form from the City Health Department.	1 day, simultaneous with procedure 3	\$20
*7	Advertise the application for a trade and business	4-6 weeks	\$30

	<p>license in a local newspaper.</p> <p><i>Agency:</i> Newspaper.</p> <p>A trade and business license applicant must publicly announce the proposed application twice in a local newspaper. The form, notice of intention to apply for the issuance of a new license, is available from the City Health Department. The first notice must be published no more than 6 weeks, but at least 4 weeks before the application will be heard by the licensing authority. The second notice must appear 7 days after the first notice. Any objections to the application must be submitted in writing to the licensing authority within 7 days of the second notice.</p>	<p>simultaneous procedure.</p>	
8	<p>Submit an application form for the issuance of new licenses for the Licensing Office in Harare Municipality.</p> <p><i>Agency:</i> Licensing Office in Harare Municipality.</p> <p>Two copies of application forms are submitted along with proof of both publications in a local newspaper of a notice of intention of business. On receipt of the application, the Licensing Office requests a police report from the applicant, as well as similar report</p>	34 days	\$530

	from the person who will be in actual and effective control of the premises to which the application relates if that person is not the same applicant. The Licensing Office also seeks a report from the Harare Town Planner to ensure that the application is consistent with the zoned use of the premises.		
*9	Receive inspection by the Licensing Officers. <i>Agency: Licensing Office in Harare Municipality.</i> Officers inspect the company site to check if the workplace premises are suitable for the intended use. The verification criteria used by the officers are specified in the relevant bylaws.	1 day	No charge

SOURCE: World Bank (2016)

\*simultaneous procedure

### 5.1.3 High rate of return in the informal sector

Informal sector operations are promoted by high rate of return in the sector (Bagachwa and Naho, 1995; Ocran, 2009 and Makochekeanwa, 2010). The absence of a tax regulatory system in the hidden economy in Zimbabwe translates to high rates of return since business owners pocket all profits.

### 5.1.4 High unemployment rates

Higher rates of unemployment are highly correlated with informality with a statistically significant figure. This is due to the fact that the greater the number of people out of employment

the more will be individuals willing to find a job in the informal sector (See Alanon and Gomez-Antonio, 2005). The Poverty Assessment Study Survey for Zimbabwe in 2006 observed that 50% of all jobs between 2003 and 2006 were in the informal sector. UN-OCHA shows that Zimbabwe's unemployment rate was 94% by end of January 2009 (Makochekanwa, 2010) with the rate believed to be more than 95% in 2016 by independent analysts' estimates.

#### 5.1.5 High poverty rates

Zimbabwe ranks in the top 20 poorest countries in the world (World Bank, 2016). In general, low disposable income means people are prepared to do various jobs with most of them being in the informal sector (Refer to Alanon and Gomez-Antonio, 2005; Ocran, 2009 and Makochekanwa, 2010). Makochekanwa (2010; 2012) and Chekenya (2016) observe that Zimbabwe's poverty rates over the recent years have been above 80%, with 25% of the country's population living in dire/abject poverty (less than a \$1 per day).

#### 5.1.6 Social security contribution burden

Higher rates of social security contribution in the country incentivize individuals and firms to remain in the informal sector (Schneider, 2003 and 2005 and Hesam, 2003). Despite the country having a statutory board in place, the National Social Security Authority (NSSA), social security contributions are a major burden to most economic activities.

#### 5.1.7 Restricted pursuit by tax collectors

There seems to be lack of understanding on the revenue potential of the informal sector in LEDCs and limited resources to tax this sector thus inducing individuals to operate in it (Bagachwa and Naho, 1995; Chipeta, 2002 and Ocran, 2009). The authority responsible for

revenue collection in Zimbabwe, ZIMRA, does not pursue the activities of the underground economy to try and tax it. This might be partly due to minimal if not negative return in which potential revenue to be collected from the informal sector activities will be lower than the costs expanded by ZIMRA to collect revenue (See Makochekanwa, 2010).

#### 5.1.8 Foreign exchange controls

According to Makochekanwa (2010) the presence of foreign exchange controls or shortages provide an avenue for illegal transfer, foreign exchange contrabandist and development of bogus statements for import-export activities which are better done in informal economy. In Zimbabwe, shortages of foreign currency coupled with illegal market for it has been a buoyant characteristic of the economy since 1980s with critical shortages of foreign currency experienced in periods 1987, 2000-2009 and 2016.

### **5.2 Formalizing the informal sector**

Formalization of the informal sector can mean different things to different interest groups. To some, it means shifting informal workers to formal wage jobs. To others, it implies registering and taxing informal businesses (Chen, 2012). To informal traders who already pay taxes (for example in Zambia) it means gaining access to legal and social protection as well as support services and being allowed to organize and to be represented in relevant rule-setting, policymaking, and collective bargaining. To informal wage workers formalization implies obtaining a formal wage job-or formalizing their current job-with secure contract, worker benefits, membership in a formal trade union (See Chen, 2006, 2012).

Chen's (2012) study observes that questions of whether and how to formalize the informal sector have been at the heart of the policy debates in development economics at least two decades. The

paper asserts that it is primarily important to ensure that formalization offers the benefits and protections/guarantees that come with being formal and does not simply impose the costs of formalizing. Formalization is not a one-step programme; rather it's an ongoing process of extending benefits of formalization incrementally to informal sector traders. In asking informal economy traders to register and pay taxes, policymakers should offer traders in this sector some benefits/rewards of formalization. Chen's study provides a comprehensive approach to formalizing the informal sector which I adopt and use in this paper as follows;

i. Formalization of the informal firms

- Registration and taxation:
  - Simplified registration procedures.
  - Progressive registration fees.
- Apposite/apt legal and regulatory frameworks, including:
  - Enforceable commercial contracts.
  - Private property rights.
  - Use of public space.
  - Occupational health and safety regulation.
- Benefits of operating formally:
  - Access (unrestricted) to financial support and information on markets.
  - Access to public infrastructure and services.
  - Enforceable commercial contracts.
  - Limited liability.
  - Lucid bankruptcy and default rules.

- Access to government subsidies/support/incentives such as procurement bids and export promotion packages.
  - Membership in formal business and industrial associations as CZI.
  - Access to a formal system of social security.
- ii. Formalization of informal sector jobs
- Legal recognition and protection as worker.
  - Rights and benefits of being formally employed:
    - Freedom from discrimination.
    - Minimum wage.
    - Occupational health and safety measures.
    - Employer contributions to health and pensions.
    - Right to organize and bargain collectively.
    - Membership in formal trade unions.

Formalization can and should take different forms, including: shifting informal workers to formal jobs, registering and taxing informal sector firms, providing business incentives and support services to informal sector firms, securing legal and social protection for the informal workforce, recognizing the organizations of informal workers, and enabling their representatives to take part in rule-setting, policymaking, and collective bargaining processes.

There is no single, one-off, overriding policy goal or prescription that can address the concerns linked to categories of informal sector firms, activities, or workers. A comprehensive policy framework will include four broad goals to address informality; create more jobs (Chen, 2006, 2012; Heintz, 2004), register informal sector firms and regulate informal jobs, broaden state



protection to the informal sector workforce, particularly, the working poor and increase the productivity of informal firms and the income of the informal workforce.

According to a study by Palmer (2012) on Ghana's informal sector, efforts to formalize the informal sector often involve the coming together of multiple forms of "best practices". The key to formalizing the underground economy is to create incentives for those operating informally to see the value of becoming formal that is to create an environment in which the benefits of formalizing outweigh the costs of remaining informal (de Medina, 2006). In doing this, informal sector firms are more likely to voluntarily opt to formalize (Nelson and de Bruijn, 2005). Efforts to formalize the informal economy often involve coming together of multiple forms of "best practices", best practice in microfinance, formalizing informal training (including best practice in skills recognition), best practice in reforming formal skills training for the underground economy, best practice in formalizing informal trade and community associations, best practice in formalizing informal social protection, in formalizing land rights.

While there are many areas of the informal economy where formalization can be promoted, Palmer's (2009) paper posits that for many policy makers in Less Developed Countries such as Zimbabwe, formalizing the informal sector-in the short run at least-simply refers to formalizing informal ventures in order for them to pay taxes and get licenses.

UNCTAD (n.d) observes that 1.8 billion people work in informal jobs compared to 1.2 million who benefit from formal contracts and social security protection. The number is projected to grow to two thirds of the workforce by 2020. In a transition from informality to formalization, the paper proposes the following measures to be implemented;

- ❖ Explain what formalization means.

❖ Make formalization easy.

- Procedures should be made as simple as possible within the framework of existing laws or by amending them.

Creating a one-stop-shop dedicated to micro entrepreneurs to cut time and moves for entrepreneurs.

- New legal schemes for self-employed e.g. France in 2009 where 300 000 new enterprises were registered.

❖ Make formalization desirable

- Communicate on benefits.
- Reinforce benefits.
- Enforce compliance.
- Partner with other empowering services.

Findings from USAID (2005) caution that formalization is not an event but a gradual process that does not involve moving from one fixed state to another. The study undertaken between January and March 2005 was meant to review literature on the informal sector, as well as donor experience in order to identify what best practice there is in reducing barriers to formalization. Results show that informal sector is as high as 56% of GDP in nations like Georgia, Zimbabwe and Bolivia.

There is mixed evidence to support the assertion that formalization is per se good for short-term growth. Nations with larger levels of per capita GDP have relatively small underground economies but it is equivocal whether formalization is a cause or an effect of these higher levels of development. Since informality is a ceiling on enterprise growth, in that it denies entrepreneurs access to key capital and government contracts, it is instructive to consider a

transition from informality to formalization. The question however is: does growth promote formalization or formalization promotes growth. An extensive and by now large body of literature finds that formalizing enterprises orients them towards upgrading operations and growing the business, thus realizing economic growth potential trapped in the informal economy.

Critics of formalization argue that it is difficult to implement the programme. SIDA's Fact Funding Study contends that formalization of informal sector firms in developing nations like Zimbabwe is cumbersome chiefly because of heavy regulations which bring longer delays and higher costs of public services.

In a study titled *Manufacturing and Informality* Gibson and Flaherty (2013) examines that economic theory does not support public intervention to formalize informal sectors but suggests that tolerating the informal economy, particularly in manufacturing, will improve overall macroeconomic performance as measured by output and employment. The paper employs various methodologies ranging from case studies to mathematical modeling of the relationship between productivity and employment in the formal and informal sectors.

In a developing country's case, Nurmsoo (2006) adopts an approach from Rona-Tas (2001) which classifies entrepreneurial activity into procyclical profit-driven entrepreneurship and countercyclical consumption-driven entrepreneurship. Building on the Schumpeterian view of creative destruction (or creative genius) the study holds that for formalization policy in Tanzania and other developing nations to be more effective it needs to focus on expansion of formal private enterprise instead of direct formalization. A change might produce more favorable results in the effort towards formalization than the previous strategy of formalization-inducing skills development.

In a study on the cause and effect of informal sector, and focusing on a case of street vendors in Addis Ababa in Ethiopia, Sibhat (2014) interviewed 91 street vendors and used descriptive and logistic regression analyses method. The main objective of the study was to investigate the importance of informal economy in Ethiopia economy. The paper finds that the main factors determining the reason of informal operators to formalize is that they are unable to fulfill the criteria of formal sector and lack of job opportunities in the formal economy. Formalization is seen to bring benefits almost the whole informal sector are: possibility to limit liability and risk, divide labour, have access to credit, have to larger markets etc.

Tokman (2007) in a paper on modernizing the informal sector explores a strategic option to regulate the underground economy, tracing the different approaches to formalizing informal activities, to facilitate their full integration into the modernization process. Formalization as seen by Tokman can come as a means of inclusion. The study proposes formalization tools which include recognition of property titles as mechanism to have access to credit (See de Soto, 1995) and recognition of labour relationships.

## **6 METHODOLOGY**

This study makes an extensive literature review and content analysis by using secondary sources to critically analyze the notion of formalizing the informal sector in Zimbabwe. Vigilance was taken in drawing lessons from country cases in the developing and emerging nations which have a booming second economy, comparable to Zimbabwe, to aid in bringing insight and revived interest in this ignored but booming and sheer-sized segment.

### **6.1 A framework for formalizing the informal sector**

This paper harmonizes with Chen (2012) and UNCTAD's studies in proposing a framework to integrate the underground economy as there is sufficient substantiation that the segment is large and thriving hence provide revenue potentials and employment prospects. Before any attempts to tax the hidden economy, it is prerequisite and instructive to first formalize this sector. The framework below can be the starting point to formalization.

**Explain what formalization is**



**Make formalization easy**

- Simplify registration procedures.  
Steps/procedures should be made as simple as possible within the framework of existing laws or by amending them.
- New legal schemes for self-employed.



**Make formalization desirable**

- Communicate on benefits.
- Reinforce benefits.
- Enforce compliance.
- Partner with other empowering services.



**Apposite legal and regulatory frameworks**

- Enforceable commercial contracts.
- Private property rights.
- Use of public space.



**Tax the informal sector**

## **7. Conclusion and Policy Implications**

After considering the Sustainable Development Goals programme and all potential sources of funding that are available, domestic resource mobilization remains the chief sustainable option. The current situation in Zimbabwe shows that the country is financially distressed and in the middle of state fragility as evidenced by inability to finance its sound economic policies such as ZIMASSET. More so, foreign aid has proved to be an unsustainable source of funding for developing the economy as it comes with strings attached. As such there is need for domestic

resource mobilization. Despite a lot of critics and suggestions to drop the issue of informal sector formalization, given the fact that at least US\$4 billion is circulating in the nation's informal sector, taxing this booming sector is a better move. However, there is need for formalization first as a precondition to taxing the hidden economy thereby widening the tax base.

The existence of a sheer-sized underground economy has several policy implications. First it means lost revenue potentials. Second, there is a possibility that the continued neglect of a booming underground economy can result in overlapping of this sector over the formal sector. All this points out that something has to be done. Taxation of this sector is a matter that deserves some considerable attention. Before this, the sector needs to be incorporated into the formal economy first. This paper suggests that.

Zimbabwe can adopt the following strategies that were used by Rwanda to formalise the informal sector:

- ✓ Engage Local Authorities and the Ministry of Small and Medium Enterprises in the formation and formalisation of informal traders' blocks for ease of tax administration. Structures are already there in some areas such as the Mbare Complex along Simon Mazorodze Road, Mupedzanhano, Mbare Musika, Avondale Flea Market and Glenview Home Industry Complex.
- ✓ Policy changes that are targeted at introducing flat tax rates or flat tax amounts for informal sector traders.
- ✓ Tailor made educational workshops for each category of current and potential taxpayers.
- ✓ Specialised training for revenue authority staff in handling different categories of taxpayers.
- A study tour to Rwanda to enable staff to have first-hand experience on how Rwanda manages its informal sector. The study tour team can comprise of representatives from the Zimbabwe Revenue Authority (ZIMRA), Ministry of Finance and Economic Development, Local Authorities and the Ministry of SMEs.

- ✓ The Minister of Finance and Economic Development indicated that he has already sent a delegation to Ethiopia to study how the country has managed to tax informal traders.<sup>2</sup>

### Strategies put in place by Rwanda

The Rwanda Revenue Authority employed several strategies to ensure the success of the taxation of the informal sector. These are as presented in the Table 1 below:

*Table 3: RRA Strategies in the taxation of the Informal Sector*

Strategy	Discussion
1. The implementation of the Block Management System (BMS).	<ul style="list-style-type: none"> <li>• The system targets small taxpayers by demarcating the areas in which they conduct businesses into sizeable and manageable areas called blocks.</li> <li>• The BMS address tax related issues that limit business growth and tax compliance.</li> <li>• Each block does all the tax function of registering, assessing, collection and accounting for revenue.</li> </ul>
2. Taxpayer Education	<ul style="list-style-type: none"> <li>• The Training Department (TD) of the RRA designed courses that address the specific needs of different categories of taxpayers such as Large, Medium and Small taxpayers.</li> <li>• Expectations from the taxpayer categories are different and hence the tailor-made courses.</li> <li>• For example, the informal taxpayers’ tax issues are managed as a block instead of individual taxpayers for ease of administration.</li> </ul>

<sup>2</sup> Financial Gazette November 10-16, 2016 ‘Chinamasa seeks informal sector tax’ Page C5



<p>3. RRA Staff Training<sup>3</sup></p>	<ul style="list-style-type: none"> <li>• Specialized training that is provided to RRA staff is determined by the needs of each category of taxpayers the staff will be dealing with, that is, Large Clients or Small and Medium Clients.</li> <li>• In the Small and Medium Tax Office (SMTO), there is a need for specialized skills that are geared towards teaching, informing, counselling and mentoring taxpayers who usually maintain very basic records.</li> <li>• On the other hand, in the Large Taxpayer Office (LTO), there is a need for specialized technical skills to deal with taxpayers who operate in a complex environment.</li> </ul>
<p>4. Formation of the Rwanda Cooperative Agency (RCA).<sup>4</sup></p>	<ul style="list-style-type: none"> <li>• The RCA was formed to spearhead formalization of informal enterprises.</li> <li>• The Agency encourages and in some instance forces every business operator who cannot get the conventional license to join a cooperative of at least 10 people.</li> <li>• The cooperative is then registered with a database of members and a certain minimum level of self-regulation and services to members.</li> <li>• Local Governments engage closely with the cooperatives, supporting capacity building, access to finance, access to land and in some cases guaranteeing loans for construction of workspace owned by the cooperatives.</li> </ul>

<sup>3</sup> <http://www.investopedia.com/terms/f/flattax.asp#ixzz4NnUw9dIY>

<sup>4</sup> [http://www.fiscalreform.net/index.php?option=com\\_wrapper&Itemid=132](http://www.fiscalreform.net/index.php?option=com_wrapper&Itemid=132)

5. Simplification of the Complex Systems and the Tax System

- Many SMEs in Rwanda are shut down due to failure to comply with tax, environmental or health regulations, even though they cannot afford to comply or do not understand the regulations themselves.
- A flat tax rate of 4% of turnover was introduced which was later reduced to 3% in 2013 for all SMEs whose income is between RWF12 million and RWF50 million (US\$14,806- US\$61,692).[3]
- The tax rate applies to every taxpayer regardless of income bracket with no deductions or exemptions allowed.
- A flat tax should maximize government tax revenue collection while keeping rates low enough to allow tax payers an acceptable return for their effort and entrepreneurship.
- Worked with other regulatory agencies to simplify and streamline regulations for SMEs.

Income RWF	Income USD	Tax RWF	Tax USD
2,000,000-4,000,000	2,468- 4,935	60,000	74.03
4,000,001- 7,000,000	4,935-8,637	120,000	148.06
7,000,001- 10,000,000	8,637-12,338	210,000	259.10
10,000,001-12,000,000	12,338-14,806	300,000	370.15

**1.1 Block Management System: Rwanda Revenue Authority vs Kabeza Market Vendors<sup>5</sup>**

The Rwanda Revenue Authority closed the Kabeza market following the non-remission of taxes by the owner of the market. The market houses over 1,000 vendors in a block management system who sells various commodities. These vendors remit their taxes to the owner of the

<sup>5</sup><http://www.newtimes.co.rw/section/article/2015-08-26/191932/>

market for remission to the Revenue Authority. The case shows the ease of administration by the Revenue Authority where more than 1,000 informal vendors can be managed through one focal person who is the owner of the market/ block for tax purposes. The full newspaper article on the issue is presented in Annexure I.

## **1.2 Zimbabwe: Starting Point**

- Informal Sector blocks are already there in some areas such as Mupedzanhamo Flea Market, Glenview Home Industry Complex, Avondale Market, Mbare Complex along Simon Mazorodze Road and Mbare Produce Market in Harare as well as home industry and produce markets in other towns and cities. These can be used as a starting point in the journey of formalizing the informal sector for ease of tax administration.
- The database of informal traders can be obtained from Local Authorities such as the Harare City Council where informal traders pay their market levies.
- The Ministry of Small and Medium Enterprises can be engaged in the training and buy-in workshops of informal traders for ease of implementation of the formalisation process.

### **Findings**

- The informal sector can best be taxed in blocks, that is, in demarcated areas where traders conduct their business.
- Taxpayer education is important with tailor-made courses for each category of taxpayers.
- Specialised training for Revenue Authority staff is also essential to equip them with skills to tax different categories of taxpayers.
- Flat rates of tax make compliance easy for the informal sector where record keeping is poor.



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