



Munich Personal RePEc Archive

Informal Economy in SSA: Characteristics, size and tax potential

Makochekanwa, Albert

Department of Economics, University of Zimbabwe

1 February 2020

Online at <https://mpra.ub.uni-muenchen.de/98644/>
MPRA Paper No. 98644, posted 18 Feb 2020 21:27 UTC

Informal Economy in SSA: Characteristics, size and tax potential

By

Professor Albert Makochekanwa (Ph.D)

Department of Economics

University of Zimbabwe

Email: almac772002@yahoo.co.uk

Mobile: +263 77 4444 390

February 2019

Table of Contents

| | | |
|-----|--|----------|
| 1 | Introduction | 3 |
| 1.1 | Defining the informal economy..... | 3 |
| | <i>1.1.1 Views on the informal economy</i> | <i>4</i> |
| | <i>1.1.2 Various definitions of informal economy.....</i> | <i>6</i> |
| 2 | Causes of the informality in SSA | 8 |
| 3 | Characteristics of informal economy in SSA | 11 |
| 4 | Size of informal economy in Africa | 13 |
| 4.1 | Approaches to measure the size of the informal economy | 13 |
| 4.2 | Informal economy contribution to GDP as a measure of size | 15 |
| 4.3 | Informal economy contribution to employment as a measure of size | 18 |
| 5 | Tax and revenue potential of the informal economy | 18 |
| 6 | Policy options for taxing the informal economy | 20 |
| 6.1 | Indirect taxation of the informal economy | 20 |
| 6.2 | Reliance on existing taxes on formal sector firms..... | 21 |
| 6.3 | Presumptive taxes..... | 21 |
| 7 | Conclusions and policy recommendations | 22 |
| | References..... | 23 |
| | Annex 1: Old and new view with regards to informal economy | 25 |
| | Table A2: Criteria used to define the informal economy..... | 26 |

1 Introduction

Since the “discovery” of the informal economy (IE) in the beginning of the seventies, many stakeholders used to argue that the informal economy was marginal and peripheral and that the sector was temporary and that it would disappear once a given country achieved sufficient levels of economic growth and modern industrial development (Becker 2004). However, this notion that the informal economy will disappear was, over the years approved to be wrong, as this sector has, in most developing countries grown over time. At the same time other scholars and observers contended that the informal economy was not linked to the formal sector or to modern capitalist development, a notion that again, has been proved wrong by the existing linkages between these two (informal and formal) economies.

Evidence from the African continent show that the informal economy is a permanent feature in countries where incomes and assets are not equitably distributed. Experience shows that in countries where there is jobless growth compounded and lopsided income distribution, the informal economy does not shrink. Observations currently show that the informal economy is continuously increasing in most developing countries, even in rural areas. Estimates show that the non-agricultural employment share of the informal workforce is 78% in Africa in general, 57% in Latin America and the Caribbean, and 45–85% in Asia. With most developing countries struggling with formal employment opportunities, self-employment has been the second best alternative, and it comprises a greater share of informal employment than wage employment. For instance, self-employment represents 70% of informal employment in Sub-Saharan Africa (if South Africa is excluded, the share is 81% 1), 62% in North Africa, 60% in Latin America and 59% in Asia. As a result, informal wage employment in the developing world constitutes 30 to 40% of the informal employment outside of agriculture (Becker 2004).

The main objective of this research study is to provide insights into the meaning of the informal economy in Sub-Saharan Africa (SSA) by demystifying the concept of IE versus the hidden or shadow economy as well as the cash economy. Specifically, and in the context of SSA, the research study will: (i) define the IE, (ii) provide an overview of the major causes of IE, (iii) provide estimates of the size of the IE; and (iv) analyse the tax and revenue potentials of the IE.

1.1 Defining the informal economy

Although the International Labour Organization (ILO), which is one of the authoritative international organizations which has done work on informal economy (IE) defines it broadly as referring to “all economic activities by workers and economic units that are – in law or in practice –not covered or insufficiently covered by formal arrangements” (ILO, 2009: iii), the 2003 definition by the same organization provides an elaborated definition. The 17th International Conference of Labour Statisticians (ICLS) ICLS (ILO, 2003) has adopted guidelines for defining informal employment as comprising all jobs carried out in informal enterprises as well as in formal enterprises by workers, and especially employees,

whose employment relationship is, in law or in practice, not subject to national labour legislation, income taxation, social protection or entitlement to certain employment benefits (advance notice of dismissal, severance pay, paid annual or sick leave...) because of non declaration of the jobs or the employees, casual or short

duration jobs, jobs with hours or wages below a specified threshold...place of work outside premises of employer's enterprise (outworkers), jobs for which labour regulations are not applied, not enforced, or not complied with for any other reason. (ILO, 2003) Informal employment is, therefore, usually defined by the absence of social protection (mainly health coverage) or the absence of written contract (but this criterion can only be applied to paid employees and is consequently narrower than social protection). (ILO, 2003).

From the above definitions, a number of issues are considered in defining the informal economy. First, there are conceptual problems associated with studying this sector because of the absence of a single definition of informality (Phiri and Nakamba-Kabaso, 2012). As such, many terms have been used to refer to the IE and these include: shadow economy, black economy or lack economy, grey economy, hidden economy, underground economy, parallel sector, second sector, subterranean sector or cash economy (Medina and Schneider, 2018; and Phiri and Nakamba-Kabaso, 2012). Second, the concept has shifted from informal sector (IS) to informal economy (IE). According to Becker (2004), the informal sector is increasingly being referred to as the informal economy to remove the notion in policy makers, scholars and all stakeholders that informality is confined to a specific sector of economic activity given that it rather cuts across many sectors. Furthermore, “informal economy” also emphasises the existence of a continuum from the informal to the formal ends of the economy and thus the interdependence between the two sides. The broadened term – informal economy as opposed to informal sector – took on board considerable diversity of workers and economic units, in different sectors of the economy including in informal settlements, in townships, in slum dwelling societies, in streets and across rural and urban contexts that are particularly vulnerable and insecure. Thus this study adopts informal economy as opposed to the narrow informal sector. Third, the various schools of thought with regards to the informal economy also shape the way the sector is viewed. Lastly, the heterogeneity character of the informal economy has resulted in various definitions elaborated as Phiri and Nakamba-Kabaso succinctly said “Any study’s definition of the informal sector will depend on its focus” (2012:9). Harding and Jenkins (1989) indicated that the literature on the informal sector is fraught with terminological confusion.

1.1.1 Views on the informal economy

Since ILO’s pioneering work on informality began in Africa with the Kenyan multidisciplinary mission in 1972, a number of views have been proffered with regards to how the sector is seen. Whilst Chen et al (2002) articulated three main schools of thought regarding the relationship between the formal and informal economies, a fourth school of thought in the name of underground economy approach has been added. First are the *dualists* who claim that the informal economy is a separate marginal economy not directly linked to the formal economy, providing income or a safety net for the poor (ILO 1972). Second are the *structuralists* who argue that the informal economy is subordinated to the formal economy. According to this school, in order to reduce costs, privileged capitalists seek to subordinate petty producers and traders (Castells and Portes 1989). Third are the *legalists* who posit that the informal work arrangements are a rational response by micro-entrepreneurs to over-regulation by government bureaucracies (de Soto, 2000). Lastly, are the “*Portes or underground economy*” scholars who emphasis ‘downgraded labour’. For them, they argue that downgraded labour receive lower wages, fewer benefits and normally experience inferior working conditions compared to individuals employed in the formal economy,

The above views clearly show existence of diverse interdependencies between the informal and the formal economies. According to Amin (2002), market links exist through the trade of raw materials, goods, tools and equipment as well as in the acquisitions of skills and know-how. Participants in the informal economy provide services to formal economy on a sub-contracting basis. Furthermore, economic actors can participate both in the formal and the informal economies. Table A1 in Annex provides two broad views categorized into ‘old’ and ‘new’ with regards to the informal economy. According to Table 1, and using example of enterprises, the border between informality and informality is not strict and is blurred.

Table 1: A typology of enterprise informality

| ← Informal economy → | | | | Formal economy |
|-----------------------------|--|---|---|--|
| Features | A | B | C | D |
| | Subsistence enterprises | Micro enterprises and small businesses | Small and medium businesses | Small, medium, and large businesses |
| Degree of informality | Totally informal | High proportion of sales undeclared and workers not registered | Some proportion of sales undeclared and workers unregistered | Labour and firms registered and regulated |
| Type of activity | Street traders, cottage/micro enterprises, subsistence farmers | Small manufacturers, service providers, distributors, contractors | Small and medium manufacturers, service providers | Range of manufacturing and services |
| <i>Technology</i> | <i>Labour intensive</i> | <i>Mostly labour intensive</i> | <i>Mixed labour and capital intensive</i> | <i>Knowledge and capital intensive</i> |
| Owner profile | Poor, low education, low level of skills | Poor and non-poor, likely educated, skilled | Non-poor, well educated, high levels of skills | Non-poor, highly educated, sophisticated level of skills |
| <i>Markets</i> | <i>Low barriers to entry, highly competitive, high product homogeneity</i> | <i>Low barriers to entry, highly competitive, some product differentiation</i> | <i>Some barriers to entry, established markets</i> | <i>Significant barriers to entry, established market/ product niche</i> |
| Finance needs | Working capital | Working capital, some investment capital, supplier credit | Investment capital and working capital, letters of credit, supplier credit | Investment capital and working capital, letters of credit, supplier credit |
| Other needs | Personal insurance, social protection, security | Personal and business insurance and business support services, security | Personal and business insurance, business development services | Personal and business insurance, business development services |
| Tax status | Earnings can be below minimum tax threshold, no recordkeeping, cash transactions | Liable for tax, difficult to identify and assess, poor or no recordkeeping, cash transactions | Liable for tax, under-report earnings, use loopholes, escape formal tax assessments | Taxed under formal tax assessment |
| Tax design desired features | No tax liabilities | Low rates to encourage registration, minimal compliance costs, low administration costs | Higher rates to encourage graduation into formal regime | |

Source: Joshi et al (2014: 1328)

Notes: Greyscale or italicized text comprises features less relevant to taxation

1.1.2 Various definitions of informal economy

As already alluded to, the heterogeneous character of the informal economy has resulted in numerous definitions, which among others, shows the perspectives from which the informal economy can be viewed. Box 1 shows examples of classification of the informal economy and this nomenclature influences the various definitions of the informal economy. For examples of criteria used to define the informal economy (see Table A2 in Annex). These various definitions have a bearing when it comes to measuring informal economy activities in any country as well as the tax and revenue potential of the IE.

Box 1: Examples of classification of the informal economy:

- From a **labour categories/employment** status perspective.
- From an **industrial classification** perspective (trade, services, manufacturing, construction and transportation).
- From a **rural/urban divide** (rural informal sector and urban informal sector).
- From the standpoint of **urban spatial structure**: those in the Central Business District (CBD) and those in suburban areas.
- From a **location perspective**: those who are location-specific and those who are not.
- From a **zoning perspective**: those located in proper business locations and those in home-based enterprises.
- According to **size classification**: 1 persons unit (own-account workers), 2–4 persons units (micro enterprises), 5–9 persons units (small scale enterprises).
- From a **migratory status** (native, recent migrants and long-term migrants).
- From the viewpoint of **employment quality**: normal jobs and misemployment (begging, prostitution and scavenging).
- From the viewpoint of **income/employment enhancing potential**, which is crucial for advancement or upward mobility: enterprises/work with growing market demand that reflects high-income elasticity of demand and those with low-income elasticity of demand (rickshaw services). Alternatively denoted dynamic/modern informal sector and marginal/survivalist groups.

Source: Amin (2002)

i. Definition by activities (economic units/enterprises)

The most traditional definition of the informal economy is definition by activities (economic units/ enterprises). According to this definition, informal activities are characterized as such because they rarely comply with all the regulations that apply to their trade, for example concerning registration, tax payment, conditions of employment and operating licenses. Furthermore, these activities and or their owners have limited capital resources, they normally raise necessary finance at their own risk, they don't have accounting systems in place and they rarely engage in transactions, enter into contracts or incur liabilities.

The International Conference of Labour Statisticians (ICLS) of 1993 elaborated a definition based on production units rather than on employment relations:

“Units engaged in the production of goods and services with the primary objective of generating employment and incomes to the persons involved. These units typically operate at a low level of organisation, with little or no division between labour and

capital as factors of production and on a small scale. Labour relations – where they exist – are based mostly on casual employment, kinship or personal and social relations rather than contractual arrangements with formal guarantees.”

One of the main weakness of the ICLS definition is that it concentrates on enterprises, thus leaving out on a plethora of informal wage work arrangements and does not capture all dimensions of informal employment.

ii. Definition by employment categories

This definition considers informal employment as all remunerative work, both self-employment and wage employment that is not recognised, regulated, or protected by existing legal or regulatory frameworks as well as non-remunerative work undertaken in an income-producing enterprise. The following are some of the major employment categories used to describe the informal economy according to this definition.

- a) *Self-employed*, i.e. own-account workers, heads of family businesses and unpaid family workers;
- b) *Wage workers*, i.e. employees of informal enterprises, casual workers without a fixed employer, home workers, paid domestic workers, temporary and part-time workers and unregistered workers.
- c) *Employers*, i.e. owners and owner operators of informal enterprises.

iii. Definition based on the location of informal economy actors

This definition is based on a description of the location within which these actors operate. The major location categories as presented by Becker (2004) include:

1. Home-based workers:
 - a) Dependent home-based workers which:
 - Work at home outside the establishment that buys their product;
 - Agree by prior arrangements to supply goods or services to a particular enterprise;
 - Get remunerated through what is paid for their products;
 - Do not employ workers on a regular basis.
 - b) Independent home-based workers are those who work in their home and deliver their products or services to prospective buyers. Their characteristics are those of the self-employed and are classified as part of the “account workers”.
2. Street traders and street vendors.
3. Itinerant, seasonal or temporary job workers on building sites or road works.
4. Those in between the streets and home, e.g. waste collectors.

iv. *Definition by income and employment enhancing potential*

The fact that the informal economy is heterogeneous with regards to technology in use, capital invested, types of management practices, productivity levels and net earnings, implies that players are also composed of a heterogeneous group with different reasons for joining the informal economy. On one end of the continuum of the informal economy are small-scale modern manufacturing and service enterprises, while street vendors, shoe shiners, junk collectors and domestic servants, among others constitute those at the other end of the spectrum, with a range of service providers in between. The main segments include:

1. Enterprises with the potential of becoming a significant contributor to the national economy and that take up informal economic activities because of their potential for generating growth or wealth. What attracts some is the fact that informal activities are thought to be unregulated and untaxed and, therefore, to have the potential for autonomy and profits (ILO, 2002).
2. Individuals or households who take up informal activities for survival purposes. The factors that may attract them are the relative ease of entry, reliance on local resources and a minimum of capital investments. Informal activities also allow disadvantaged individuals or households to maximise their only asset: labour. This group operates informally either because the costs of formalising the activities are too high or because the procedures for registration are too complicated and time-consuming.
3. Individuals that devote part-time to informal activities while working elsewhere. For instance, some government employees in both Asia and Africa, because of low and irregular salaries, have alternative incomes to secure their living.

2 Causes of the informality in SSA

The fact that there is still no consensus on the definition of second economy has resulted in corresponding multitude of possible factors advanced as causes of this economy (Makochekanwa, 2012b). Medina and Schneider (2018) contends that the size of the informal economy depends on various elements. Thus, literature on the subject matter has advanced multiple reasons as the major causes behind the existence and growth of the second economy. Table 2 provides some of the reasons which caused the growth of the second economy in the case of Zimbabwe over the years.

Table 2: The main causes/indicators determining existence and growth informal economy

| | Causal/indicator variable | Theoretical reasoning or intuition | References |
|---|--|---|--|
| 1 | Tax and social security contribution burdens | The distortion of the overall tax burden affects labour-leisure choices and may stimulate labour supply in the informal economy. The bigger the difference between the total labour cost in the official economy and after-tax earnings (from work), the greater the incentive to reduce the tax wedge and work in the shadow economy. This tax wedge depends on social security burden/payments and the overall tax burden, making them key determinants in the existence of the shadow economy. | Thomas (1992), Johnson, Kaufmann, and Zoido-Lobaton (1998a,b), Giles (1999a), Tanzi (1999), Schneider (2003, 2005), Dell'Anno (2007), Dell'Anno, Gomez-Antonio and Alanon Pardo (2007) |
| | | The greater the number of unemployed, the more will be | Ahn and De la Rica |

| | | | |
|---|--|--|--|
| 2 | High Unemployment | individuals willing to find a job in the informal economy | (1977); Alanon and Gomez-Antonio (2005); Schneider and Williams (2013), Williams and Schneider (2016) |
| 3 | Restrictive regulatory environment | Excessive degree of regulations forces individuals to undertake certain activities within the scope of informal economy. Regulations, for example labour market regulations or trade barriers, are another important factor that reduces freedom (of choice) for individuals in the official economy. They lead to a substantial increase in labour costs in the official economy and thus provide another incentive to work in the shadow economy: countries that are more heavily regulated tend to have a higher share of the shadow economy in total GDP. Especially the enforcement and not the overall extent of regulation – mostly not enforced – is the key factor for the burden levied on firms and individuals, inducing them to operate in the shadow economy. | Alanon and Gomez-Antonio (2005). Johnson, Kaufmann, and Shleifer (1997), Johnson, Kaufmann, and Zoido-Lobatón (1998b), Friedman, Johnson, Kaufmann, and Zoido-Lobatón (2000), Kucera and Roncolato (2008), Schneider (2011), Hassan and Schneider (2016) |
| 4 | Quality of institutions or corruption | The quality of public institutions is another key factor in the development of the informal sector. In particular, the efficient and discretionary application of the tax code and regulations by the government plays a crucial role in the decision to work off the books, even more important than the actual burden of taxes and regulations. A bureaucracy with highly corrupt government officials tends to be associated with larger unofficial activity, while good rule of law through securing property rights and contract enforceability increases the benefits of being formal. A certain level of taxation, mostly spent in productive public services, characterizes efficient policies. In fact, production in the formal sector benefits from higher provision of productive public services and is negatively affected by taxation, while the shadow economy reacts in the opposite way. An informal sector developing as a consequence of the failure of political institutions to promote an efficient market economy, and entrepreneurs going underground due to inefficient public goods provision, may reduce if institutions can be strengthened and fiscal policy moves closer to the median voter's preferences. | Johnson et al. (1998a,b), Friedman, Johnson, Kaufmann, and Zoido-Lobatón (2000), Dreher and Schneider (2009), Dreher, Kotsogiannis and McCorriston (2009), Schneider (2010), Teobaldelli (2011), Teobaldelli and Schneider (2012), Amendola and Dell'Anno (2010), Losby et al. (2002), Schneider and Williams (2013), Hassan and Schneider (2016), Williams and Schneider (2016) |
| 5 | Public sector services | An increase in the shadow economy may lead to fewer state revenues, which in turn reduces the quality and quantity of publicly provided goods and services. Ultimately, this may lead to increasing tax rates for firms and individuals, although deterioration in the quality of public goods (such as public infrastructure) and of the administration continues. The consequence is an even stronger incentive to participate in the shadow economy. Countries with higher tax revenues achieved by lower tax rates, fewer laws and regulations, a better rule of law and lower corruption levels should thus have smaller shadow economies. | Johnson, Kaufmann, and Zoido-Lobatón (1998a,b), Feld and Schneider (2010) |
| | | The efficiency of the public sector also has an indirect effect on the size of the shadow economy because it affects tax morale. Tax compliance is driven by a psychological tax contract that entails rights and obligations from taxpayers and citizens on the one hand, but also from the state and its tax authorities on the other | Feld and Frey (2007), Kirchler (2007), Torgler and Schneider (2009), Feld and Larsen (2005, 2009), Feld and Schneider (2010) |

| | | | |
|----|--|---|--|
| 6 | Tax morale | hand. Taxpayers are more inclined to pay their taxes honestly if they get valuable public services in exchange. However, taxpayers are honest even in cases when the benefit principle of taxation does not hold, i.e. for redistributive policies, if such political decisions follow fair procedures. The treatment of taxpayers by the tax authority also plays a role. If taxpayers are treated like partners in a (tax) contract instead of subordinates in a hierarchical relationship, taxpayers will stick to the obligations of the psychological tax contract more easily. Hence, (better) tax morale and (stronger) social norms may reduce the probability of individuals working in the shadow economy. | |
| 7 | Deterrence | Despite the strong focus on deterrence in policies fighting the shadow economy and the unambiguous insights of the traditional economic theory of tax non-compliance, surprisingly little is known from empirical studies about the effects of deterrence. This is because data on the legal background and the frequency of audits are not available on an international basis; such data are difficult to collect even for OECD countries. Either the legal background is quite complicated, differentiating fines and punishment according to the severity of the offense and the true income of the non-complier, or tax authorities do not reveal how intensively auditing is taking place. The little empirical survey evidence available demonstrates that fines and punishment do not exert a negative influence on the shadow economy, while the subjectively perceived risk of detection does. However, results are often weak and Granger causality tests show that the size of the shadow economy can affect deterrence, instead of deterrence reducing the shadow economy. | Andreoni, Erard and Feinstein (1998), Pedersen (2003), Feld and Larsen (2005, 2009), Feld and Schneider (2010) |
| 8 | High level of poverty | If individuals have low disposable income, that is poor, they are mostly likely to be willing to do various jobs, some of them in the second economy | Alanon and Gomez-Antonio (2005); Ocran (2009) |
| 9 | Limited pursuit by tax collectors | The fact that revenue agencies do not understand fully the immense revenue potential of the sector or have limited resources cause them not to vigorously pursue tax collection in this sector, thus acting as an incentive to operate in second economy | Bagachwa and Naho (1995); Chipeta (2002); Ocran (2009) |
| 10 | High rate of return | With zero direct taxation, high rate of return on second economy operations provides an incentive for individuals to enter this type of economy | Bagachwa and Naho (1995); Ocran (2009) |
| 11 | High inflation | High inflation implies increased seigniorage or inflation tax and this accentuates the effect of taxes upon individuals, thus increasing the effective tax burden on tax payers. This forces some individuals to go into second economy | Alanon and Gomez-Antonio (2005); Ocran (2007) |
| 12 | Foreign exchange controls And shortages | Presence of foreign exchange controls or shortages (e.g., foreign currency black market) provides an avenue for illegal transfer, foreign exchange contrabandist and development of fake statements for import-export activities and these are all better done in second economy. | Dabla-Noris et al (2008) ; Hesam (2003) |
| 13 | Development of the official economy | The development of the official economy is another key factor in the shadow economy. The higher (lower) the unemployment quota (GDP growth), the higher the incentive to work in the shadow economy, ceteris paribus. | Schneider and Williams (2013), Feld and Schneider (2010) |
| 14 | Self-employment | The higher the rate of self-employment, the more activities can be performed in the shadow economy, ceteris paribus. | Schneider and Williams (2013), Feld and |

| | | | |
|----|---|--|---|
| | | | Schneider (2010) |
| 15 | Size of the agricultural sector | The larger the agricultural sector, the more possibilities to work in the shadow economy, <i>ceteris paribus</i> . | Hassan and Schneider (2016) |
| 16 | Use of cash | The larger the shadow economy, the more cash will be used, <i>ceteris paribus</i> . Mostly measured as M0/M1, or M1/M2, or cash per capita outside the banking sector. | Hassan and Schneider (2016) Williams and Schneider (2016) |
| 17 | Share of labour force | The higher the shadow economy, the lower the official labour force participation rate, <i>ceteris paribus</i> . | Schneider and Williams (2013), Feld and Schneider (2010) |
| 18 | GDP per capita (economic growth) | A larger shadow economy is associated with more economic activities moving out of the formal economy, hence, it shows a decrease in economic growth, <i>ceteris paribus</i> . | |
| 19 | Redundancies | Structural adjustment programmes during the eighties and nineties have fuelled the growth of the informal economy in developing countries. The disappearance of public sector jobs and the closure of uncompetitive businesses have forced many laid-off workers to find other ways to survive. | Becker (2004) |
| | Capital is favoured over labour | Global integration privileges companies who can move easily and quickly across borders to the disadvantage of workers. The globalisation of the world economy as well as global trade and investment patterns thus tends to privilege capital and disadvantage labour, especially lower-skilled workers that cannot migrate easily or at all. | Rodrik (1997) |
| | Demand for low-cost goods and services | The informal economy has been boosted by rural to urban migration in conjunction with the demand for low-cost goods and services from those employed in the formal and informal economies. | Becker (2004) |
| | Uncommitted or unaware governments | Many governments are unaware of the economic contributions of the informal economy and the problems found in it and have therefore found it unnecessary to intervene because of the belief that the informal economy would die out. The informal economy has often been left unattended and has thus had few obstacles for its growth. Economic hardship and poverty | |

Sources: Makochekanwa (2012b:33-34) and Medina and Schneider (2018:34-35)

3 Characteristics of informal economy in SSA

The informal economy is generally considered as the unregulated non-formal portion of the market economy that produces goods and services for sale or for other forms of remuneration. The term “informal economy” thus refers to all economic activities by workers and economic agents that are – in law or in practice – not covered or insufficiently covered by formal arrangements. The informal economy is largely characterised by:

i. Low entry requirements

This sector is normally characterised by low entry requirements in terms of capital and professional qualifications. Thus, any person or entity can easily enter and start conducting activities, and should there be any challenges, exit is also easy. The low barriers to entry are actually an incentive for entry into the informal economy.

ii. Private un-incorporated entities

Most entities are private and are not incorporated in terms of being formally registered with national registration bodies like registrar of companies etc. In other words, entities are not registered under any specific form of national legislation.

iii. Poor accounting and recordkeeping

Given the thin line between personal finances of the owner, and finances of the operating entities, most entities in the informal economy tend to either not keep proper books of accounts or when they have them, the standard of recordkeeping and bookkeeping will be poor. This also makes it difficult for the taxing authorities to measure the level of taxation applicable to these entities.

iv. Small scale operations

Another important feature characterising informal economy activities in SSA is that their production and economic activities are normally of small scale in nature. There are no economies of scale to talk about, and in most instances the production and/or product or service supplies are not reliable.

v. Employment size below certain threshold

Whilst there is no generally agreed average employment level for informal economy entities in Africa, what is however clear is that most entities have employment size below certain threshold.

vi. Skills often acquired outside of formal education

Majority of skills that are normally employed by economic agents in this sector are acquired outside of formal education system. Some of the skills are acquired either through learning by doing or they are inherited from those who started the operations.

vii. Labour intensive methods

The level of production and/or service provision vary across the various economic agents, but in general the activities are generally labour-intensive. Most methods of production are labour intensive, though some participants adapt technology relevant to their line of business.

viii. Lower product/service quality

The quality of products or services from this sector, is considered as subordinate to similar products or services offered by entities in formal economy. Given that most economic agents in the informal economy do not subscribe to any quality control mechanisms or organizations, their products/services tend to be of lower quality.

ix. Part of the goods or services are for sale or barter

For some entities, some part of the goods or services are normally sold, while others are exchanged in barter trade (especially with other informal economy entities).

x. Informal employment

The employment relationship, in law or in practice is not subjected to:

- Labour legislation (or law)
- Income taxation
- Social protection, or
- Entitlement to certain employment benefits

Informal employment also exists even outside the informal economy. In other words, the informal economy consists of both the informal economy and informal employment outside the informal economy!

4 Size of informal economy in Africa

Estimating the size of the informal economy is problematic, although there are internationally defined measurement methods to define the size and contribution of the informal economy to national accounts (Becker, 2004). Practically, mapping the informal economy so as to comprehend its size, composition and evolution is a difficult and inevitably imprecise exercise (ILO, 2002b). It is also difficult to make international comparisons as different definitions are used. Furthermore, within different countries, the informal economy is highly segmented by location of work, sector of the economy and status of employment and, across these segments, by social group and gender (ILO, 2002c).

Another dimension of challenges relates to the fact that data on the informal sector (excluding agriculture) is often compared to data on the total workforce (including agriculture), resulting in an under-estimation of the significance of the informal sector. The informal economy is therefore not necessarily adequately reflected in the national accounts. Consequently, the use of for instance the gross domestic product (GDP) as a measurement for economic development does not always reflect the actual situation in a country. Despite these facts, some generalisations can be made on a regional basis.

4.1 Approaches to measure the size of the informal economy

There are various methodologies that are used to measure the size of the informal economy. These approaches can be divided into direct, indirect or model approaches (Mdeina and Schneider, 2018; Becker, 2004 and Makochekanwa, 2012b). According to Tanzi (1982), the size of the informal economy can be quantified in three different ways. Firstly, speculation by various interest groups and institutions can be used to quantify this sector with the aim of increasing the awareness that the phenomenon exists and that it should be taken on board in government decision making. Secondly, educated guesses can advance contribution figures, though these figures will in most cases not be well defined and maybe incomparable to other

statistics. Lastly, there are well-defined, unambiguous approaches which make it easier for comparisons to be made between different time periods or between the second economies of different countries (Saunders and Loots, 2005). According to literature, and as already presented, these well-defined approaches can be categorized into direct approach, indirect approach and the model approach.

a) Direct approaches

The direct 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 hence they are useful in estimating changes in the size of the second economy. Nevertheless, the surveys are normally unable to cover all sections of a given population and as such the outcomes may only provide lower bounds of the possible size of a given informal economy. In summary there are generally four direct methods that are used to measure the size of informal economy in any country and these are:

- i. Measurement by the System of National Accounts Statistics – Discrepancy method;
- ii. Representative survey technique approach;
- iii. The use of surveys of company managers; and
- iv. The estimation of the consumption-income-gap of households

b) Indirect approaches to measuring the size of the informal economy

The indirect approaches are normally referred to as indicator approaches and they use secondary data sources to (indirectly) estimate the size of the informal economy (Saunders and Loots, 2005). These approaches are mostly macroeconomic in character and tend to use indicators that contain information about how the unrecorded economy evolves over time (Ocran, 2009). The main assumption underpinning this approach is that the indicators have traces of the development of the informal economy that can be used in estimation. The most popular indicators that can act as indicators of the size of the informal economy include the following:

- i. Discrepancy between national expenditure and income statistics approach
- ii. Discrepancy between official and actual labour force approach
- iii. Electricity consumption approach
- iv. Transaction approach
- v. Monetary approach (which has two sub-components namely the (a) The Guttman method and (b) The Fiege method
- vi. Currency demand approach (CDA)
- vii. Multiple Indicators, Multiple Causes (MIMIC) approach

c) Model approach

The model approach is based on the assumption that the informal economy can be seen as an

unobservable variable which is influenced by a variety of causes (tax burden, regulation and high transaction costs etc.). This model thus examines a number of exogenous and endogenous variables that lead to the existence and growth of the second economy over time, and in the process, infers the size of the second economy over time (Giles 1999a, and Frey and Schneider, 2000).

4.2 Informal economy contribution to GDP as a measure of size

A number of studies and estimates have been done over the years using the above methodologies. Whilst the size of informal economy can be measured in a variety of ways, literature has mostly concentrated on its measurement with relation to GDP given the easily availability of objective data. Other studies also measure size of IE by inferring from employment levels. This study will present the estimated size of SSA countries using its contribution to GDP. Table 3, which has been extracted from Medina and Schneider (2018), shows size of informal economy for 49 African countries for which figures were available and this covers the period from 1991 through to 2015.

Tabulated figures show that the size of the informal economy in Africa in terms of its contribution to GDP has declined from an average of 42% of total GDP in 1991 to 35% of total GDP by end of 2015. Looking at individual countries, Zimbabwe is the country with highest level of informality with informal economy contributing on average 61% towards the country's GDP. Informal economy activities for Zimbabwe have actually grown from contribution 57% towards annual GDP in 1991 to 67% of GDP in 2015. Nigeria is the second ranked country with high informality averaging 57% of the country's GDP though growth in this sector has declined from contributing 57% of the country's GDP in 1991 down to 52% of the national GDP in 2015. On the other extreme, Mauritius is the country with least informal economy activities which averages 23% towards national GDP. Informal economy activities for Mauritius have actually been decreasing from contributing 26% towards the country's GDP in 1991 to 19% of its GDP in 2015.

Table 3: Size and development of the informal economy of 158 countries over the period 1991 to 2015

| No. | Country | 1991 | 92 | 93 | 94 | 95 | 96 | 97 | 98 | 99 | 2000 | 01 | 02 | 03 | 04 | 05 | 06 | 07 | 08 | 09 | 2010 | 11 | 12 | 13 | 14 | 2015 | Ave |
|-----|-------------------|------|----|----|----|----|----|----|----|----|------|----|----|----|----|----|----|----|----|----|------|----|----|----|----|------|-----|
| 1 | Algeria | 35 | 36 | 38 | 38 | 37 | 38 | 37 | 38 | 36 | 34 | 34 | 32 | 30 | 28 | 25 | 24 | 24 | 24 | 26 | 26 | 27 | 27 | 26 | 26 | 24 | 31 |
| 2 | Angola | 50 | 48 | 55 | 50 | 52 | 46 | 50 | 49 | 49 | 49 | 46 | 48 | 49 | 47 | 44 | 41 | 37 | 35 | 36 | 37 | 36 | 37 | 36 | 35 | 35 | 44 |
| 3 | Benin | 59 | 61 | 59 | 57 | 55 | 53 | 53 | 51 | 51 | 50 | 50 | 50 | 53 | 55 | 56 | 56 | 53 | 54 | 57 | 54 | 55 | 54 | 51 | 46 | 48 | 54 |
| 4 | Botswana | 34 | 35 | 36 | 36 | 36 | 35 | 33 | 34 | 33 | 33 | 33 | 32 | 31 | 31 | 30 | 28 | 27 | 27 | 28 | 26 | 25 | 24 | 23 | 22 | 24 | 30 |
| 5 | Burkina Faso | 43 | 44 | 45 | 45 | 44 | 44 | 42 | 41 | 39 | 41 | 41 | 41 | 39 | 39 | 37 | 36 | 38 | 36 | 36 | 33 | 32 | 31 | 31 | 31 | 30 | 38 |
| 6 | Burundi | 27 | 29 | 32 | 32 | 35 | 40 | 39 | 38 | 39 | 40 | 39 | 39 | 40 | 40 | 38 | 36 | 39 | 38 | 38 | 39 | 38 | 37 | 37 | 36 | 36 | 37 |
| 7 | Cape Verde | 44 | 45 | 47 | 44 | 44 | 40 | 41 | 38 | 38 | 36 | 35 | 36 | 37 | 36 | 35 | 30 | 30 | 29 | 31 | 31 | 30 | 30 | 29 | 29 | 30 | 36 |
| 8 | Cameroon | 35 | 35 | 38 | 35 | 33 | 36 | 34 | 33 | 34 | 33 | 33 | 33 | 32 | 32 | 31 | 30 | 30 | 30 | 33 | 32 | 31 | 31 | 30 | 28 | 29 | 32 |
| 9 | CAR | 40 | 43 | 44 | 42 | 40 | 42 | 39 | 39 | 41 | 43 | 42 | 40 | 43 | 42 | 42 | 39 | 38 | 39 | 38 | 38 | 37 | 38 | 53 | 56 | 51 | 42 |
| 10 | Chad | 46 | 46 | 49 | 46 | 46 | 46 | 46 | 44 | 47 | 46 | 45 | 40 | 42 | 35 | 34 | 35 | 36 | 37 | 37 | 34 | 35 | 34 | 34 | 31 | 29 | 40 |
| 11 | Comoros | 40 | 36 | 36 | 40 | 40 | 42 | 41 | 43 | 43 | 40 | 39 | 39 | 38 | 39 | 38 | 37 | 38 | 39 | 40 | 39 | 39 | 39 | 37 | 36 | 41 | 39 |
| 12 | Congo Republic | 50 | 51 | 53 | 52 | 49 | 48 | 51 | 53 | 52 | 48 | 48 | 48 | 47 | 46 | 45 | 42 | 46 | 43 | 41 | 36 | 36 | 37 | 36 | 33 | 35 | 45 |
| 13 | Cote d'Ivoire | 46 | 48 | 48 | 45 | 41 | 39 | 43 | 40 | 42 | 43 | 44 | 44 | 46 | 46 | 45 | 44 | 44 | 44 | 43 | 42 | 44 | 43 | 41 | 39 | 42 | 43 |
| 14 | DRC | 48 | 49 | 49 | 46 | 46 | 46 | 48 | 48 | 47 | 48 | 48 | 48 | 46 | 47 | 47 | 47 | 45 | 44 | 46 | 44 | 45 | 46 | 46 | 41 | 47 | 46 |
| 15 | Egypt | 36 | 36 | 37 | 37 | 37 | 35 | 36 | 35 | 36 | 35 | 35 | 36 | 35 | 34 | 33 | 33 | 31 | 29 | 30 | 31 | 33 | 34 | 34 | 35 | 33 | 34 |
| 16 | Equatorial Guinea | 38 | 38 | 38 | 37 | 36 | 33 | 33 | 33 | 33 | 33 | 31 | 32 | 31 | 30 | 30 | 29 | 28 | 27 | 28 | 29 | 28 | 29 | 30 | 32 | 31 | 32 |
| 17 | Eritrea | 38 | 49 | 44 | 37 | 39 | 34 | 31 | 34 | 38 | 40 | 36 | 36 | 40 | 39 | 40 | 41 | 42 | 46 | 44 | 45 | 41 | 37 | 38 | 36 | 37 | 39 |
| 18 | Ethiopia | 38 | 38 | 37 | 38 | 38 | 36 | 36 | 38 | 40 | 40 | 38 | 39 | 39 | 37 | 36 | 34 | 32 | 32 | 31 | 30 | 28 | 27 | 26 | 24 | 25 | 34 |
| 19 | Gabon | 49 | 51 | 48 | 44 | 44 | 44 | 42 | 43 | 49 | 48 | 56 | 56 | 57 | 58 | 55 | 60 | 59 | 60 | 63 | 58 | 55 | 54 | 53 | 53 | 52 | 52 |
| 20 | Gambia | 51 | 49 | 49 | 54 | 57 | 55 | 54 | 52 | 48 | 45 | 42 | 52 | 43 | 39 | 46 | 48 | 48 | 45 | 40 | 35 | 49 | 43 | 41 | 44 | 44 | 47 |
| 21 | Ghana | 46 | 46 | 48 | 46 | 45 | 47 | 45 | 46 | 45 | 42 | 43 | 43 | 43 | 43 | 43 | 42 | 42 | 41 | 41 | 40 | 41 | 41 | 39 | 39 | 39 | 43 |
| 22 | Guinea | 41 | 41 | 41 | 42 | 42 | 42 | 41 | 40 | 40 | 40 | 39 | 38 | 39 | 39 | 38 | 37 | 38 | 39 | 42 | 44 | 40 | 38 | 38 | 38 | 42 | 40 |
| 23 | Guinea Bissau | 31 | 31 | 32 | 31 | 31 | 28 | 22 | 43 | 38 | 40 | 40 | 42 | 42 | 42 | 40 | 40 | 39 | 39 | 39 | 38 | 34 | 39 | 39 | 39 | 35 | 36 |
| 24 | Kenya | 35 | 35 | 32 | 32 | 32 | 34 | 35 | 36 | 35 | 34 | 34 | 35 | 36 | 35 | 33 | 32 | 33 | 33 | 34 | 32 | 30 | 30 | 30 | 29 | 33 | 33 |
| 25 | Lesotho | 35 | 35 | 36 | 34 | 35 | 33 | 35 | 32 | 33 | 31 | 32 | 30 | 31 | 31 | 32 | 31 | 30 | 29 | 30 | 29 | 28 | 28 | 27 | 25 | 32 | 31 |
| 26 | Liberia | 42 | 44 | 45 | 45 | 46 | 47 | 45 | 46 | 45 | 43 | 42 | 42 | 43 | 41 | 42 | 40 | 43 | 43 | 43 | 42 | 42 | 42 | 42 | 42 | 44 | 43 |
| 27 | Libya | 34 | 36 | 36 | 35 | 35 | 36 | 36 | 38 | 36 | 35 | 36 | 35 | 32 | 31 | 30 | 28 | 27 | 26 | 28 | 27 | 39 | 33 | 35 | 38 | 38 | 34 |
| 28 | Madagascar | 40 | 41 | 41 | 41 | 41 | 44 | 42 | 42 | 40 | 40 | 41 | 47 | 45 | 40 | 41 | 41 | 43 | 39 | 43 | 45 | 45 | 44 | 46 | 45 | 45 | 43 |
| 29 | Malawi | 39 | 40 | 40 | 44 | 39 | 40 | 40 | 39 | 38 | 40 | 40 | 42 | 39 | 39 | 39 | 39 | 37 | 37 | 38 | 36 | 37 | 36 | 35 | 34 | 34 | 39 |

| | | | | | | | | | | | | | | | | | | | | | | | | | | | |
|-----------|------------------|-----------|-----------|-----------|-----------|-----------|-----------|-----------|-----------|-----------|-----------|-----------|-----------|-----------|-----------|-----------|-----------|-----------|-----------|-----------|-----------|-----------|-----------|-----------|-----------|-----------|-----------|
| 30 | Mali | 44 | 45 | 45 | 43 | 43 | 43 | 41 | 45 | 42 | 42 | 40 | 40 | 38 | 41 | 39 | 36 | 37 | 35 | 37 | 33 | 34 | 31 | 31 | 31 | 29 | 39 |
| 31 | Mauritania | 36 | 37 | 35 | 36 | 33 | 32 | 36 | 36 | 36 | 36 | 37 | 39 | 38 | 37 | 33 | 28 | 28 | 29 | 30 | 28 | 27 | 25 | 24 | 24 | 26 | 32 |
| 32 | Mauritius | 26 | 26 | 26 | 26 | 26 | 25 | 24 | 23 | 24 | 23 | 22 | 22 | 23 | 23 | 23 | 22 | 21 | 19 | 21 | 21 | 20 | 19 | 20 | 20 | 19 | 23 |
| 33 | Morocco | 37 | 38 | 40 | 39 | 40 | 36 | 39 | 36 | 37 | 36 | 36 | 35 | 35 | 34 | 34 | 32 | 31 | 29 | 31 | 29 | 29 | 30 | 30 | 29 | 27 | 34 |
| 34 | Mozambique | 43 | 45 | 45 | 47 | 42 | 41 | 41 | 41 | 40 | 40 | 39 | 37 | 37 | 36 | 35 | 34 | 34 | 33 | 33 | 32 | 31 | 30 | 31 | 32 | 31 | 37 |
| 35 | Namibia | 32 | 32 | 32 | 32 | 32 | 32 | 32 | 31 | 32 | 31 | 31 | 29 | 29 | 29 | 28 | 26 | 25 | 24 | 25 | 25 | 23 | 23 | 23 | 22 | 22 | 28 |
| 36 | Niger | 39 | 43 | 43 | 42 | 41 | 40 | 41 | 39 | 42 | 42 | 40 | 40 | 42 | 43 | 42 | 41 | 41 | 39 | 39 | 36 | 37 | 36 | 35 | 36 | 34 | 40 |
| 37 | Nigeria | 57 | 58 | 59 | 67 | 62 | 61 | 61 | 62 | 60 | 58 | 58 | 60 | 57 | 57 | 56 | 52 | 55 | 53 | 54 | 53 | 52 | 52 | 52 | 51 | 52 | 57 |
| 38 | Papua New Guinea | 42 | 39 | 34 | 32 | 34 | 31 | 35 | 34 | 35 | 36 | 36 | 37 | 37 | 36 | 38 | 37 | 35 | 35 | 34 | 32 | 28 | 27 | 26 | 23 | 35 | 34 |
| 39 | Rwanda | 40 | 40 | 40 | 40 | 41 | 42 | 39 | 40 | 41 | 40 | 41 | 39 | 39 | 36 | 39 | 38 | 35 | 33 | 32 | 32 | 30 | 28 | 28 | 27 | 28 | 36 |
| 40 | Senegal | 53 | 52 | 53 | 52 | 50 | 53 | 52 | 47 | 46 | 45 | 44 | 41 | 42 | 40 | 38 | 40 | 37 | 36 | 39 | 38 | 40 | 38 | 37 | 36 | 34 | 43 |
| 41 | Sierra Leone | 38 | 42 | 43 | 44 | 45 | 46 | 47 | 46 | 48 | 49 | 50 | 48 | 45 | 44 | 43 | 43 | 41 | 41 | 41 | 39 | 36 | 32 | 26 | 26 | 34 | 41 |
| 42 | South Africa | 30 | 31 | 31 | 30 | 28 | 29 | 29 | 29 | 29 | 28 | 28 | 28 | 28 | 27 | 25 | 21 | 22 | 20 | 23 | 23 | 22 | 22 | 21 | 21 | 22 | 26 |
| 43 | Swaziland | 44 | 43 | 44 | 44 | 41 | 41 | 44 | 43 | 43 | 41 | 40 | 38 | 38 | 39 | 39 | 38 | 38 | 38 | 38 | 39 | 40 | 36 | 36 | 35 | 41 | 40 |
| 44 | Tanzania | 60 | 60 | 58 | 57 | 55 | 55 | 56 | 58 | 58 | 58 | 57 | 55 | 54 | 53 | 51 | 54 | 49 | 47 | 49 | 47 | 44 | 44 | 44 | 40 | 39 | 52 |
| 45 | Togo | 38 | 41 | 51 | 43 | 40 | 37 | 32 | 35 | 35 | 35 | 38 | 38 | 37 | 38 | 39 | 38 | 37 | 38 | 38 | 36 | 35 | 35 | 34 | 34 | 31 | 37 |
| 46 | Tunisia | 42 | 40 | 40 | 39 | 39 | 39 | 39 | 40 | 38 | 38 | 36 | 38 | 37 | 34 | 34 | 31 | 29 | 27 | 29 | 28 | 34 | 32 | 33 | 33 | 31 | 35 |
| 47 | Uganda | 42 | 42 | 43 | 43 | 41 | 41 | 42 | 42 | 41 | 43 | 42 | 43 | 42 | 40 | 39 | 38 | 36 | 34 | 35 | 35 | 35 | 32 | 32 | 33 | 32 | 39 |
| 48 | Zambia | 54 | 51 | 51 | 51 | 51 | 52 | 52 | 52 | 50 | 49 | 49 | 48 | 48 | 48 | 49 | 49 | 46 | 43 | 42 | 34 | 37 | 33 | 31 | 31 | 33 | 45 |
| 49 | Zimbabwe | 57 | 62 | 59 | 56 | 57 | 54 | 56 | 52 | 56 | 59 | 56 | 58 | 62 | 64 | 63 | 61 | 60 | 62 | 69 | 66 | 64 | 64 | 65 | 66 | 67 | 61 |
| | Average | 42 | 42 | 43 | 42 | 42 | 41 | 41 | 41 | 41 | 41 | 40 | 41 | 40 | 40 | 40 | 39 | 38 | 37 | 37 | 38 | 36 | 36 | 35 | 35 | 35 | |

Source: Medina and Schneider (2018:61-76)

Key: CAR = Central African Republic; DRC = Democratic Republic of Congo

4.3 *Informal economy contribution to employment as a measure of size*

Informal work as a source of employment in Africa is estimated to have accounted for almost 80% of non-agricultural jobs, over 60% of urban employment and over 90% of new jobs (WIEGO, 2002). With regards to women, the informal economy represents 92% of the total job opportunities outside of agriculture (against 71% for men). Almost 95% of these jobs are performed by women as self-employed or own-account workers, and only 5% as paid employees. According to ILO (2002b), in Sub-Saharan Africa in particular, street vending predominates in much of the informal economy.

5 **Tax and revenue potential of the informal economy**

The formalization of informal economy activities, which is hinged among others on taxation, has received widespread attention from scholars, tax practitioners, development partners and governments (Joshi et al., 2014). The renewed attention to the taxation of the informal economy is grounded in its potential importance to revenue, growth, and governance. When considering revenue potential, existence of a large informal economy in any country renders it very laborious and difficult, especially for developing countries' governments to finance sustainable development from broad-based taxation. Formalization of informal economy activities has the potential of bringing more taxpayers into the tax net because firms that wish to benefit from the formal economy (for example, through better access to finance) eventually become more visible to the tax authorities (Besley and Persson, 2014). Bringing informal activities into the tax net is also linked to the overall notion of improved domestic revenue mobilisation, which is a core topic of the Addis Ababa Action Agenda (AAAA) (UN, 2015) and also speaks well to UN's Sustainable Development Goal (SDG) 17.1¹. With regards to growth, formalization has capability of enhancing improved productivity of small informal firms, which are frequently thought to be less efficient than formal ones (La Porta and Shleifer, 2014). Taxation of the informal economy is also integrally linked to good governance, given that quasi-voluntary compliance and tax morale are driven by governmental accountability and responsiveness (Joshi et al., 2014).

i. Revenue and equity implications

Combination of a large number of potential taxpayers in the informal economy, and the difficulties of monitoring "hidden" entrepreneurs and small-scale firms, results in serious revenue collection costs for tax authorities in developing countries. Simultaneously, the revenue potential of taxpayers in the informal economy is fairly modest, as their taxable incomes are usually quite low (Joshi et al., 2014) given that some informal economy activities are often located in remote rural areas where basic infrastructure like roads etc are near non-existence let alone tax collection infrastructure, or come from self-employed sellers living near the subsistence level (La Porta & Shleifer, 2014). In this setup, individual incomes within the informal sector are low, and tax rates correspondingly low, while the costs of collection are very high, owing to the large number of individual firms and the difficulty of monitoring them. Resultantly, given the low "value for money" in revenue terms, tax

¹ "Strengthen domestic resource mobilisation, including through international support to developing countries, to improve domestic capacity for tax and other revenue collection."

<https://sustainabledevelopment.un.org/sdg17>

administrations have often given little priority to the taxation of the informal economy firms (Fjeldstad, 2014), which can also be related to equity consideration, namely that taxation falls more strongly on the shoulders of low income informal firms (Joshi et al., 2014).

Taxing economic activities of the informal economy also raises equity concerns, given that most economic agents in this sector are frequently low income and taxation of such entities is potentially regressive (for example, Pimhidzai & Fox, 2012). If efforts to tax the informal economy also increase the risk of relatively coercive or corrupt behaviour by tax officials (as is often the case), these concerns are exacerbated. For these reasons, many tax experts have been skeptical of focusing scarce resources in developing countries on taxing small informal sector firms (Keen, 2012, pp. 19–21, 30–32).

The revenue and equity arguments for expanding informal economy taxation is premised on a number of reasons. First, is the argument that taxation of small firms in the informal economy, though yielding little revenue in the short term, helps to bring firms into the tax net, thus ensuring higher tax compliance if they expand over time. In other words, it is a matter of building a culture of tax compliance. Second, and a related argument explains the standard equity argument in reverse, suggesting that the failure of informal firms to pay taxes can be viewed by formal firms as being ‘unfair’. This can lower general tax morale and discourage tax compliance among larger firms (Alm et al., 2003; Terkper, 2003; Torgler, 2003, 2005). Lastly, arguments are advanced to the effect that that formalization may increase equity by offering small firms a measure of predictability and protection from arbitrary state and related racketeering action.

ii. Growth implications

The concern for tax experts and practitioners is that increased taxation of small firms may ultimately hinder growth, and that this cost may far outweigh the purported expected long-term revenue benefit. The reasoning is that small firms opt into informality precisely because they believe that informality will benefit them, given the burdens of formality. However, other scholars contend that formalization – of which entry into the tax net is a central component – may, in fact, have significant benefits for growth, or, at the very least, may not hinder growth (Kenyon & Kapaz, 2005). While informality helps firms avoid certain costs, it may also preclude access to certain opportunities available to formal firms, including greater access to credit, increased opportunities to engage with large firms and government contracts, reduced harassment by police and municipal officials, and access to broader training and support programmes. Much of the early evidence that formalization may lead to more rapid growth came from evidence that formal firms tend to grow faster than informal sector firms. However, such studies leave open the question of causality: do firms grow faster because they are formal, or do firms with greater growth prospects formalize. The debate about formalization is further complicated by the fact that some small businesses asserts that the benefits of formalization, though real, are not high enough or exclusive enough to be an incentive to formalize. The fact that business owners in informal economy activities have different underlying when compared to larger firms provides another complication. For instance, some small businesses are operated by individuals who are not entrepreneurs at heart, but are waiting for an opportunity to enter salaried jobs or are running microbusinesses in parallel with other employment to supplement income (Maloney, 2004).

iii. Governance implications

One of the major motivating factor for taxing the informal economy is the possibility that payment of taxes by firms in the informal economy may promote good governance and political accountability through three related channels (Joshi et al, 2014). Kundt (2017) point out that the line of reasoning is related to an implicit “fiscal contract” between taxpayers and the state, which is based on the principles of accountability, legitimacy and mutual trust, and encompasses a social norm of paying taxes. First, in order to encourage quasi-voluntary tax compliance, the state may be more responsive and accountable to groups that pay taxes (Bates & Lien, 1985; Levi, 1988). Second, individuals are more likely to make demands for responsiveness and accountability if they are paying taxes, due to a sense of ownership over government activities (Bird and Vaillancourt, 1998, pp. 10–11; Prichard, 2009, 2010a). Third, efforts to tax informal sector operators could catalyze collective action and political engagement by informal sector associations, providing a foundation for expanded bargaining (Joshi and Ayee, 2008; Prichard, 2009).

These possible connections point to the fact that, if pursued in a relatively ‘contractual’ manner (Moore, 2008), taxation of the informal economy can enhance political voice among relatively marginalized groups. However, while plausible, there are also possible reasons skepticism: informal economy entities are generally poorly organized, face collective action problems, generally lack political power, and may fear reprisals by the state in response to expanded demands. Given these challenges, Meagher and Lindell (2013, p. 67) ask: ‘Does taxing informal traders strengthen public accountability, or just create new avenues of predation?’

6 Policy options for taxing the informal economy

There are basically three broad, and not mutually exclusive, categories that can be used to tax informal economy activities: (i) taxing indirectly through trade taxes, (ii) expanding the reach of major formal sector taxes, and (iii) developing specialized presumptive tax regimes.

6.1 Indirect taxation of the informal economy

The simplest approach of collecting tax from the informal economy is indirectly, that is, by taxing the goods and services that it buys and sells. As pointed by Keen (2007), this is mostly done through Value Added Tax (VAT), which is not refunded to enterprises that are not registered for VAT, and import and export duties. In this context, ‘indirect’ implies that entities operating in the informal economy are not themselves registered as taxpayers, but are nonetheless taxed by virtue of taxes paid on goods and services higher up and lower down the value chain (Joshi et al, 2014). This form of taxation dominates other approaches to taxing the informal economy by virtue of the fact that it does not require any active informal economy participation in the tax system (such as filing tax returns), and so does not come up against the difficulties of high compliance costs or limited capacity in the informal sector. The most important source of indirect tax revenue in most SSA countries is VAT, as most countries have drifted away from import tariffs to VAT, on the bases that VAT is less economically distorting. Alongside being able to tax a wide range of economic activity, an important benefit of VAT is that it can create positive incentives for informal sector firms

with actual or prospective dealings with formal sector firms to enter the formal tax system in order to claim tax credits. Evidence from some African countries shows that despite the shift toward VAT, import taxes have remained an important component of developing country tax revenue, particularly in low-income countries, even as tax rates have declined in recent decades.

6.2 *Reliance on existing taxes on formal sector firms*

The other option available for taxing informal economy activities is to extend the reach of common formal sector taxes through enhanced enforcement and compliance (Bird and Casanegra, 1992; Bird and Wallace, 2003; and Terkper, 2003). In this case, additional incentives for compliance, for instance, reduced rates or rewards to small firms that maintain effective records, can help, though both types of measures can increase the overall complexity of the tax system and create incentives for small firms to remain, or appear to remain, small (International Tax Dialogue, 2007; Loeprick, 2009). Although, enhancing the enforcement of formal sector taxes may be suitable for larger entities operating in the informal economy, for very small firms the administrative costs for the government are likely to be extremely high and present the risk of harassment and abuse. To this end, a number of developing countries have established relatively high thresholds for both VAT and income taxes with the aim of excluding smallest and micro businesses, which are instead captured by presumptive tax regimes (discussed below).

In some cases, some countries have used withholding taxes which have helped them to collect taxes from small firms without raising compliance issues (Keen, 2007). These taxes are extremely prevalent in SSA, and make up an appreciable share of total revenue collection in some cases, with governments or larger firms withholding taxes on transactions with small businesses that may not be tax compliant. Evidence and experience from some African countries however suggests that withholding taxes can become administratively burdensome in that they result in a high degree of incoherence to the overall system, while requiring cooperation from withholding firms, and, most importantly, an effective system for crediting those firms from which tax is withheld (IMF, 2011; and James, 2009). Given inconsistent evidence on both benefits and costs, making conclusive judgements about the merits of withholding taxes is difficult.

6.3 *Presumptive taxes*

Presumptive taxes have been the darling tax method for taxing informal economy entities for most African governments. In general taxing small informal economy entities is hindered by two factors: high compliance costs for small taxpayers and high costs of collection for tax administrations (Loeprick, 2009). Presumptive taxes resolve these problems by using a simplified indicator of the tax base to simplify recordkeeping for firms and estimation of tax liabilities by tax collectors. Within this basic structure, their particular design is highly variable across countries (Bird & Wallace, 2003). The main variations are the following:

- Permitting a simplification of the generally applicable tax base, such as the use of cash rather than accrual accounting. IMF (2011) advocates for this approach,

perceiving that ‘the difficulty is not that small traders cannot keep simple accounts – it is persuading them to share them’.

- Employing some other financial measure as the tax base rather than net profit or net value-added. Loeprick (2009) highlights turnover as a widely-used measure, while Sadka and Tanzi (1993) argue for the use of a tax on gross assets.
- Using a non-financial indicator of tax liability, such as floor area or number of employees. This is the simplest approach, and allows the estimation of tax liabilities by tax collectors even in the absence of accounts, but also has the most obvious drawbacks. In their simplest form such taxes may approach a simple business fee.

7 Conclusions and policy recommendations

The study analyzed informal economy (IE) in SSA. The research provided insights into various possible definitions of IE, elaborated on the major causes and characteristics of this sector in Africa. The size of informal economy activities in terms of contribution to GDP and employment was also analyzed. Tax and revenue potential from the informal economy activities was also investigated.

With regards to size, the informal economy in Africa in terms of its contribution to GDP has declined from an average of 42% of total GDP in 1991 to 35% of total GDP by end of 2015. At country level, the study found that Zimbabwe was the country with highest level of informality with informal economy contributing on average 61% towards the country’s GDP. Informal economy activities for Zimbabwe have actually grown from contribution 57% towards annual GDP in 1991 to 67% of GDP in 2015. On the other extreme, Mauritius was the country with least informal economy activities which averaged 23% towards national GDP. Informal economy activities for Mauritius actually decreased from contributing 26% towards the country’s GDP in 1991 to 19% of its GDP in 2015. The contribution of informal economy work towards employment in Africa was found to be around 80% in terms of non-agricultural jobs, over 60% of urban employment and over 90% of new jobs.

Given existence of a large informal economy in Africa, the study found evidence of renewed attention to the taxation of the informal economy, and that revived interest is grounded in its potential importance to revenue, growth, and governance. Formalization of informal economy activities has the potential of bringing more taxpayers into the tax net because firms that wish to benefit from the formal economy (for example, through better access to finance) eventually become more visible to the tax authorities. Bringing informal activities into the tax net is also linked to the overall notion of improved domestic revenue mobilization, which is a core topic of the Addis Ababa Action Agenda (AAAA) and also speaks well to UN’s Sustainable Development Goal (SDG) 17.1 with regards to growth, formalization has capability of enhancing improved productivity of small informal firms, which are frequently thought to be less efficient than formal ones (La Porta and Shleifer, 2014). Taxation of the informal economy is also integrally linked to good governance, given that quasi-voluntary compliance and tax morale are driven by governmental accountability and responsiveness (Joshi et al., 2014).

Going into the future and after taking on board cost and benefit analysis, the paper analyzed three possible strategies that can be employed in taxing activities in the informal economy in Africa. These three options are (i) taxing indirectly through trade taxes, (ii) expanding the reach of major formal sector taxes, and (iii) developing specialized presumptive tax regimes.

References

Amin, N. (2002). *The Informal Sector in Asia from Decent Work Perspective*, Asian Institute of Technology, Bangkok, ILO, 2002

Becker, Kristina Flodman (2004). *The Informal Economy: Fact finding study*. Swedish International Development Cooperation Agency (SIDA). Publication can be downloaded/ordered from www.sida.se/publications.

Castells, M., and Portes A. (1989). *World Underneath: The Origins, Dynamics, and Effects of the Informal Economy*. In Portes, A., Castells, M., and Benton, L.A. (Eds.), *The Informal Economy: Studies in Advanced and Less Developed Countries*, 11-41. Baltimore and London, The Johns Hopkins University Press.

De Soto H., *Mystery of Capital: Why Capitalism Triumphs in the West & Fails Everywhere Else*, 2000

De Soto, H. (1989). *The Other Path. The Invisible Revolution in the Third World*. New York, Harper and Row.

Gër Khan, K (1999). *The Informal Sector in Developed and Less Developed Countries: A Literature Survey*. Tinbergen Institute Discussion Paper, TI 1999-083/2

Harding, P. and Jenkins, R. (1989). *The Myth of the Hidden Economy: Towards a New Understanding of Informal Economic Activity*. Philadelphia: Open University Press, Milton Keynes.

International Labour Organization (ILO) (2009). *The informal economy in Africa: Promoting transition to formality: Challenges and strategies*. ILO, Geneva, Switzerland.

International Labour Organization (ILO). (2003). *Report 1, General Report*. 17th International Conference of Labour Statisticians, Geneva, Switzerland. 24 November–3 December.

International Labour Organization (ILO). (2002). *Supporting workers in the IE: A Policy Framework*. Geneva, Switzerland.

International Labour Organization (ILO). (2002b). *Decent work and the informal economy*, International Labour Conference 90th session.

International Labour Organization (ILO). (2002c). *Women and Men in the Informal Economy, A Statistical Picture*.

International Labour Office (1972). *Employment, Income and Equality: A Strategy for Increasing Productivity in Kenya*. Geneva, Switzerland.

Joshi, A., Prichard, W and Heady, C. (2014). Taxing the Informal Economy: The Current State of Knowledge and Agendas for Future Research. *The Journal of Development Studies*, Vol. 50, No. 10, 1325 – 1347.

Kundt, T.C. (2017). Opportunities and challenges for taxing the informal economy and subnational taxation. K4D Emerging Issues Report. Brighton, UK: Institute of Development Studies.

Makochekanwa, A. (2012b). Measuring the second economy in Zimbabwe. *Botswana Journal of Economics*, Volume 10, and Issue 14, pages: 27-58.

Martha. A., Jhabvala, R and F. Lund. (2002). Supporting Workers in the Informal Economy: a Policy Framework, International Labour Office Geneva, Switzerland.

Medina, L and Schneider, F. (2018). Shadow Economies Around the World: What Did We Learn Over the Last 20 Years? IMF Working Paper, WP/18/17. Washington DC, USA.

Phiri, S. C and P. Nakamba-Kabaso (2012). Taxation of the informal sector in Zambia. Zambia Institute for Policy Analysis and Research. Working Paper No. 5.

Women in Informal Employment: Globalizing and Organizing (WIEGO) (2002). Second Annual Meeting, Cambridge, Massachusetts, 22–24 May 2002

Annex 1: Old and new view with regards to informal economy

| The Old View | The New View |
|---|---|
| The informal sector is the traditional economy that will wither away and die with modern, industrial growth. | The informal economy is increasing with modern, industrial growth – accounting for more than half of the new jobs in Latin America and 80 percent of new jobs in Africa. In India, more than 90 percent of the labour force is in it. It is a feature of economic transition as well as capitalist industrialization. |
| It is only marginally productive. | Virtually everywhere the informal economy is efficient and resilient, creating jobs. It is a major provider of employment, goods and services for lower-income groups. It contributes significantly to GDP. |
| It exists separately from the formal economy. | It is linked to the formal economy – it produces for, trades with, distributes for, and provides services to the formal economy. |
| It represents a reserve pool of surplus labour | Much of the recent rise in informality reflects the decline in formal employment associated with structural adjustment and global competition. It reflects not only the incapacity of formal firms to absorb labour, but also their unwillingness to do so. |
| Most of those in the sector are entrepreneurs of illegal and unregistered enterprises seeking to avoid regulation and taxation. | It should not be equated with the criminal or illegal economy. It is made up of non-standard waged workers as well as entrepreneurs and self-employed persons producing legal goods and services, albeit through irregular or unregulated means. Most entrepreneurs and the self-employed are amenable to, and would welcome, efforts to reduce barriers to registration and related transaction costs and to increase benefits from regulation. Most non-standard workers would also welcome more stable jobs and workers' rights. |
| Work in the informal economy is comprised mostly of survival activities and thus is not a subject for economic policy. | Informal enterprises include not only survival activities but also stable enterprises and dynamic growing businesses. All informal enterprises are affected by economic policies. |
| It is comprised mainly of unregistered business | It is comprised not only of informal enterprises but also of informal jobs, including employees of informal firms, casual day labourers, and domestic workers as well as industrial outworkers and other non-standard workers in both informal and formal firms |
| It is comprised mostly of street traders and very small-scale producers. | It is made up of a wide range of informal arrangements- both "resilient old forms" and "emerging new ones" (temporary and part-time jobs plus home-based work for high tech industries). Its two basic segments are informal enterprises and informal jobs. |
| It is unregulated. | Some informal enterprises-such as street vendors-are highly regulated, so much so that regulations are impossible to enforce or comply with and are often not clear either to local authorities or to vendors. Regulations become a tool of harassment and control, not a way to encourage economic contributions of street vendors. On the other hand, the employers of most informal workers often seek to avoid complying with labour legislation. |
| Because it is unregulated and untaxed, many working in the informal sector are wealthy. | Average incomes are lower in the informal economy than in the formal economy. A higher percentage of people working in the informal economy are micro entrepreneurs who hire others. The poorest are, typically, informal waged workers, especially industrial outworkers. |
| To regulate the informal economy is unnecessary interference with its workings. | In today's globalized economy, the active role of government is needed in the regulation of economic activities, including the informal economy. Clear rules and appropriate legislation are needed to regulate the relationship between governments, foreign investors, local enterprises, and the workforce. |
| Street traders are to blame for crime in the inner sites. | Criminals are a threat to business interests of both formal and informal enterprises. |
| It does not contribute to economic growth. | It contributes substantially to the economy and needs to be encouraged and facilitated. |

Source: Becker (2004: 52)

Table A2: Criteria used to define the informal economy

| Criteria | Political (Legal Aspects) | | | Economic | | | | | | Social | | |
|--------------------------------------|---------------------------|--------------------|---------------------------|--|-----------------------------------|--|---|---------------------------------------|---------------------------|----------|------------------------|----------|
| | Government. regulation | illegal activities | national statistics (GNP) | labor market or status of labor (unregul., no soc. benef., work condit., etc.) | tax evasion or unreported. income | activity's size (small scale of operat.) | professional status (self-empl or family based) | activity's regulation or registration | national statistics (GNP) | networks | autonomy & flexibility | survival |
| Authors | | | | | | | | | | | | |
| Hart (1971, 1973) | | | | + | | | + | + | | | | |
| Intern. Lab. Of.' (ILO) – (1972 on.) | + | | | + | | + | + | + | | + | | |
| Feige (1979, 1980) | + | + | + | | + | + | | | + | | | |
| Breman (1980) | – | | | + | | + | + | | | + | | |
| Grossman (1982) | + | + | | | | + | | + | | + | | |
| Banerjee (1982) | | | | + | + | | | | | + | + | + |
| Tanzi (1982, 1989) | | | + | | + | | | | + | | | |
| Gershuny (1983) | + | + | | | + | | | + | | | + | |
| Beneria (1989) | + | | | + | + | + | | + | | + | + | + |
| Castells and Portes (1989) | + | + | | + | + | + | + | + | | + | + | – |
| Harding and Jenkins (1989) | + | + | + | + | + | | | + | | + | + | |
| Renooy (1990) | + | + | + | + | + | + | | + | + | + | + | + |
| Swaminathan (1991) | + | | | + | + | + | + | + | | | + | + |
| Kaufmann and Kaliberda (1996) | + | + | + | + | + | + | | + | | | | + |
| Commander and Tolstopiatenko (1997) | + | + | | + | + | + | | + | | | | |
| Anderson (1998) | + | + | + | + | + | + | + | + | + | + | + | + |

Source: Gërxfan (1999: ix-x)

Key: (+) refers to the inclusion of the criterion in defining the informal sector.

(-) refers to the explicit exclusion of the criterion in defining the informal sector;