

# **‘TRANSITION FROM INFORMALITY TO FORMALITY’ PERCEPTIONS OF INFORMAL TRADERS IN THE HARARE METROPOLITAN AREA**

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## **Abstract**

*The size of the informal business and the proportion of working people in this sector continue to grow in Zimbabwe. In order to expand its revenue collection base, the government intends to devise mechanisms to formalise the activities of this sector. However, little is known about the perceptions of informal traders on formalising business activities. To address the identified research gap, the current study sought to explore the perceptions of informal business owners about formalising their business activities. A qualitative paradigm was adopted using in depth interviews to collect data from a sample of 30 participants who were selected purposively selected. The interview transcripts produced four major themes namely: barriers to formality, informality benefits, informality disadvantages, and formality enablers. It became evident that informal traders are aware of disadvantages of operating informally and the benefits of formalising business activities. The results also indicate that entry barriers namely high taxes, tedious and costly registration procedures, corruption government and municipality officials, high rentals of business premises, lack of requisite skills and lack of access to finance inhibit the demand for formality. Recommendations arising from the results of the study and avenues for future research are made.*

*Keywords: informal sector, formalisation, formality barriers, formality enablers, formality benefits*

## INTRODUCTION

The prevalence and persistence of informal businesses in developed, emerging and developing economies continues to attract the attention of academics and policy makers. A substantial share of the global labour force is in the formal sector because the sector continues to grow (Chen, 2012). According to Schneider (2007), the average size of the informal in developing and emerging countries is around 40% of Gross Domestic Product (GDP) and in the Organisation for Economic Cooperation and Development (OECD) countries, it stands at 16.3% of GDP. With regards to employment, Williams and Nadin (2012) state that a considerable proportion of working people is found in the informal sector. To substantiate the claim, Williams and Nadin (2012) provided statistics indicating that 70% of working in sub-Saharan Africa is found in the informal sector, 62% in North Africa, 60% in Latin America, 59% in Asia and 77% in the European Union.

A country with a huge informal business sector lacks development and is less able to finance public service because of low tax revenue collection (Levy, 2008). Informality is associated with complexity and non-transparent trading systems and this discourages foreign direct investment, undermines trade policy and negatively the impact on the international competitiveness of developing countries like Zimbabwe (Benjamin, Beegle, Recamatini and Santini, 2014). Furthermore, formal and informal businesses which operate in the same sector or industry experience different labour costs and taxes which lead to inefficient allocation of resources (Del Mel, Mckenzie and Woodruff, 2012). While on the one hand, informal traders perceive that formal firms have better opportunities, on the other hand, formal traders feel that informal counterparts pose an unfair competition (Benjamin *et al.*, 2014). In that regard, global policy makers are seeking ways to formalize the informal traders. Their decision is based on the notion that formality gives productivity advantage to a country. Scholars such as Benjamin *et al.* (2014) believe that high levels of formalization are associated with high performance levels. Similarly, Fajnzylber, Maloney and Montes-Rojas's (2011) study found that formalization in Brazil increased employment by between 40-50% as well as an increase in revenue and profits. In Vietnam, Rand and Torm (2012) found that informal traders who formalized themselves between 2007 and 2009 managed to increase profits and investments. In the same vein, in Bolivia, the firms that formalized and began to pay tax realized greater sales (McKenzie and Sakho, 2010). This justifies the need to formalize the informal sector. However, a firm's decision to formalize depends on its perception of benefits and costs of formalization (Del Mel *et al.*, 2012). Policy makers should therefore craft strategies to motivate formalization of the informal sector. To develop these strategies, there is need for the government officials to understand the perceptions of informal traders with regard to formalization so that they can devise appropriate

strategies to address their concerns. Without this knowledge, it is difficult to come up with measures to enforce formalization of these firms. Few studies have examined informal traders' motives for operating informally. More work is still needed to help in the development of policy recommendations in the informal sector (Benjamin *et al.*, 2014). It is against this background that this study sought to:

- investigate the informal traders' motives to operate informally
- evaluate the barriers to formalization
- assess the perceived benefits of trading formally
- establish circumstances under which informal traders would consider to trade formally

The study will provide some invaluable insights on how formalization of informal firms can be done. The study will also contribute to the existing body of knowledge on informal and formal business literature. The rest of the paper is arranged as follows: the literature review on formalization and informalisation will be presented. This will be followed by the methodology used in the study. Thereafter the results of the study will be discussed and the recommendations for policy making will conclude the paper.

## LITERATURE REVIEW

Different descriptions such as “cash in economy”, shadow economy” and underground economy” have been used to define the informal sector. Dzhekova and Williams (2014) view the informal sector as the “hidden economy”. The authors further state that in an informal economy, the business activities are legal yet they are unreported. The sector uses home-made produced inputs as well as domestic labour and there is no requirement to declare the activities. According to Williams and Nadin (2012), informal traders are those involved in legitimate production and sales of products but are not registered for tax and labour law purposes.

The reasons for trading informally are varied. Literature indicates that informal traders face entry barriers in their attempt to join the formal sector. For example Loayza, Owedo and Serven (2005) argue that regulation costs and long procedures positively correlate with the levels of informality. Klapper, Laeven and Rajan (2006) also confirm this with evidence from European countries that shows that costly regulations on registration are a major stumbling block to the creation of new enterprises. Jaramillo's (2009) study of Peru's informal traders found that the major constraining factors include not having time to register, perceived costs involved, perceived costs and administrative burden of the registration process. Over-regulation, deregulation and lack of regulation are serious barriers that have a punitive effect on formalization efforts (Chen, 2012). In the context of Bulgaria, Dzhekova and Williams (2014)

identified barriers to formalization namely lack of access to finance, difficulties in getting business licensing and permits, electricity shortages, lack of education and high tax rates. Loayza (1994) also found weak institutions, high levels of taxation, burdensome regulations in registration and inability to enforce property rights. Similarly, Dzhekova and Williams (2014) are of the view that unfavourable economic and business environment, distrust in institutions, bleak business prospects, corruption, lack of liquidity and expensive technology are also challenges do deal with in the formalization process. Williams *et al.* (2012) therefore advise that policy makers should simplify regulatory compliance, provide business support and advice and the need to use targeted and indirect tax incentives for customers buying from the formal sector. The World Bank (2008) in its *Doing Business* Project argued that advocated for easing registration barriers to encourage formalization and to stimulate growth. For Chen (2012), formalization benefits include enforceable commercial contracts, legal business ownership and means of production, trade and labour associations and workers' benefits and minimum wages. Jaramillo (2009) found that informal traders would consider registering if registration fees go down, if procedures are simplifies, if municipal authorities disseminate adequate information, if taxes are reduced and if there is more enforcement of the law. Van Stel, Storey and Thurik (2007) who used a database of 39 countries from five different continents present findings showig that e removal of entry barriers will significantly reduce informality.

## **METHODOLOGY**

An extensive literature review relating to the informal business sector was carried out. Furthermore the cross sectional study adopted a qualitative paradigm to collect data from 30 owners of the informal business firms. As advised by Saunders, Lewis and Thornhill (2009), a qualitative method namely in-depth interviews was used to collect data because they helped to understand the meaning behind the behavior of informal traders.

### **Sampling**

The sample in the study consisted of owners of informal businesses who traded for at least two years and are currently still operating as informal traders. A total of 30 owners of informal businesses were purposively selected from three major informal trading business centres namely Avondale, MbareSiyaso and Glen View informal traders market. To ensure a fair distribution, 10 participants from each market were selected. The researchers moved from one table to the other inviting respondents to participate in the interview. The interview would go ahead after the respondents expressed willingness to participate. The exercise was done at each informal market until the required number was reached.

## **Interview schedule**

Semi-structured in-depth interviews with open-ended questions were used to gather data from 30 participants. According to Saunders *et al.* (2009), the use of in-depth interview helps to collect a rich and detailed set of data about a phenomenon. Reviewed literature on informal trading, an interview guide was developed in order to explore the perceptions of informal traders about transforming to formality. In order to ensure content validity, two researchers with experience in the field were requested to check the questions on the interview guide. Furthermore, the interview guide was pre-tested with 5 informal traders to establish if the questions were clearly formulated. The feedback given by the two researchers and pilot testing participants resulted in minor modifications on the interview guide.

Before the interview was carried, the researchers clearly explained the purpose of the study and assured the respondents about confidentiality, anonymity, voluntary participation and the fact that anybody was at liberty to terminate the interview at any stage of the interview. After a respondent had agreed, the interview would start whilst also tape recording the interview. The tape recording of the interview enabled the researchers to get the actual information that participants were providing. The other advantage of tape recording was that the interview proceeded without distraction as what normally happens when the interviewer is transcribing the responses during the interview (Surujlal and Maseko, 2011). As advised by Surujlal and Maseko (2011), the interviewer used the non-evaluative stance to avoid any influence on the responses provided by the participants. The idea of having interviews at their business premises was advantageous because the participants felt comfortable and this helped as the participants could openly express their perceptions and were also free to raise issues to do with informal trading. The interview proceedings were transcribed verbatim by the researcher.

## **Data Analysis**

Content analysis was used to analyse the data. The process involved breaking down, examining, comparing, conceptualizing and categorizing the data. This process was necessary as it helped to identify the crucial issues and themes that developed from the transcripts. The development of a theme was informed by recurring words, phrases and comments which the researchers grouped to form particular themes. The researchers compared the notes to compare similarities and differences in the themes that were developed. An agreement was then reached by reconciling the notes compiled by the two researchers and as a result four themes were formed.

## ANALYSIS & RESULTS

Demographic analysis was conducted to establish the distribution of the sampled participants. The results are depicted in Table 1 below

Table 1: Demographic distribution of participants

Variable	Categories	N	n	%
Gender	Males	30	19	60.5
	Females	30	11	39.5
Age	20-25	30	5	16.7
	26-35	30	11	36.7
	36-40	30	10	33.3
	41-40	30	1	3.3
	46-50	30	3	10
Position held in business	Owner	30	21	70
	Employee	30	9	30
Highest education level	Certificate	30	27	90
	Diploma	30	3	10

The transcripts were subjected to a thematic analysis and the four themes that were determined predominantly by the interview questions are as follows: *barriers to formality, informality benefits, informality disadvantages, and formality enablers.*

### Barriers to formality

Barriers to formality are the factors that make it difficult for informal traders to enter the formal sector. Fifteen participants said that they do not have financial resources to operate formally because they argued that it is too expensive to operate formally. Thirteen participants attributed their failure to operate formally to high taxes that informal traders pay. After the researcher probed further, the participants mentioned several varied factors such as tedious registration process, lack of stock, high rentals, unconducive business environment, and liquidity challenges. The following extracts represent the participants' perceived barriers to formalization.

*"The government charges too high taxes and I do not have that kind of money because we earn little from our businesses"*

*"It takes too long to apply for a permit"*

*"The business environment is not conducive"*

*"There is no financial assistance from banks and the government"*

What can be deduced from the probes is that the informal traders there are several barriers to formality. A similar finding is also reported in a study by Van Stel *et al* (2007) which used evidence from five continents showing that informal traders fail to formalize due to several entry barriers. Chen (2012) pointed out that some of the serious barriers having a punitive effect on efforts to formalize include eviction, harassment, demand for bribes by police and municipal officials. All these barriers do frustrate the efforts by informal traders to register in order to trade formally. Most of these informal traders are aware of the benefits of formal business but they always compare the costs and benefits of formalizing. If the cost of capital is too high, then it becomes a stumping block to formalisation (Paula and Scheinkmen, 2006). The argument is consistent with the findings in Dzhekova and Williams' (2014) study of Bulgarian informal sector revealed that access to finance, permits, and electricity, lack of education and high tax rates, are also serious inhibiting factors to formalisation. This demonstrates that informal traders fail to formalize their business activities due to several entry barriers.

### **Informality benefits**

Informality benefits are the advantages that informal traders have for operating informally. When asked about the benefits that informal traders think they are enjoying, a majority of the participants (n=19) indicated that they are operating freely without paying taxes. Five informal traders pointed out that they also enjoy free rentals for business premises they are operating. The following extracts encapsulate the perceived benefits of operating informally.

*“Rather than wasting money paying high taxes charged by the government I am using that money for my personal needs”*

*“We get more money than some businesses in the formal sector”*

*“We are not affected by government legislations like labour laws and paying minimum wages”*

*“We use all the profits we get for our own benefit, all you collect belongs to you”*

The responses of the participants seem to demonstrate a general feeling that informal traders are comfortable with the sector in which they are operating due to the benefits they mentioned and hence they are not prepared to formalize their operations. A majority of participants see more benefits than costs of being informal. The finding is consistent with a study by Jaramillo (2009) which found that the informal traders who participated in the study indicated that by operating informally, they would not be obliged to pay taxes and municipal licenses.

### **Informality disadvantages**

Informality disadvantages refer to the perceived benefits that informal feel they are losing for not operating formally. The responses of the participants demonstrate the general awareness among the informal traders about benefits they would enjoy if they were to trade formally. The most mentioned disadvantage (n=21) was the reluctance by banks to advance loans to informal traders. Fifteen participants showed that they always have the problem of raids by municipal police who usually demand for a bribe. The other disadvantages that were mentioned by the participants are indicated in the following excerpts:

*“Our products are at risk of being stolen since we are operating at open space”*

*“In the event of fire or theft, you can’t have any compensation because our products are not insured”*

*“If I get an order from big organisations, I can’t manage it because I have limited resources”*

*“I serious disadvantage is that we can’t advertise our products “*

*“We can’t participate in exhibitions because we are not registered”*

According to Chen (2012) formalized traders enjoy enforceable commercial contracts, legal business ownership and means of production, trade union associations and minimum wage earnings. Therefore being informality puts informal traders at a disadvantage as they lose out all these benefits. The World Bank (2008) advocate for the promotion of informal traders because they are marginalized in many government support services and because of that they remain in poverty. Jaramilla (2009) alluded to the fact that being informal is associated with difficulties in doing business with larger firms, risk of paying bribes and fines, buying expensive and low quality inputs and not participating in public bidding and programmes. Participating in the informal sector is associated with high poverty levels because it reinforces the marginalization of these traders (Williams and Windebank, 2001).

### **Formality enablers**

Formality enablers are factors that facilitate the formalization of informal traders. The responses of the participants suggest that if suitable intervention mechanisms are provided, informal traders are prepared to formalize their business activities. In that regard, a majority of the participants (n=21) pointed out that they would consider to register if the government reduces the amount of tax. Similarly, sixteen participants indicated that if they are assisted with capital to start and support their businesses, they would consider registering. Various other factors that may motivate formalization were mentioned and they are captured in the following excerpts:

*“If registration procedures and requirements are flexible and fast, I will definitely register”*



“If government gives us enough space for us to operate”

“If we are provided with enough information about formalization”

“Shop licenses must be reduced”

“If the economy is stable we are willing to be formal”

According to Van Stel *et al.* (2007), if barriers to enter the formal sector are reduced, the size of the informal sector will significantly be reduced. This assertion is consistent with the World Bank's (2008) study that found that lowering regulatory registration fees and easing the registration procedures positively influence formality among the informal sector. Similarly, Benjamin *et al.* (2014) advocated for the provision of appropriate training programmes that specifically designed for the informal traders. Other scholars such as Schneider and Enste (2000) confirm the negative effects of institutional factors such as high tax regimes and restrictive regulations on the willingness to formalize. The foregoing discussion demonstrates that there is need to develop deliberate measures to create favourable conditions for formalization.

## **CONCLUSIONS**

The study investigated the perceptions of informal traders with regards to formalisation of their businesses. The results indicate that informal traders are aware of the benefits of trading formally. However due to several entry barriers, they are unable to formalize their business activities. It is evident that if policy makers provide an enabling and favourable environment, the demand for formality will increase.

## **Recommendations**

It is recommended that the government understand the specific needs of informal traders in order to craft policies that promote formalization. There is need to simplify the new business registration process and the regulatory compliance (Williams *et al.*, 2012). The government needs to provide training and advice services to informal traders because most of them need to be empowered through training programmes to acquire the skills that are needed to operate in the informal sector. The use of tax incentives for informal traders joining the formal sector could also motivate them to formalize business operations.

## **Limitation and avenues for future research**

Data were collected from a small sample and this limits the generalizability of the findings of this study. Nevertheless, the current study made a contribution by adding to the existing body of

knowledge on formalization of the informal business sector. The phenomenon of the informal business activities continues to be a challenge generally across the globe and specifically in developing countries like Zimbabwe, and therefore it warrants further investigation. Future research could further investigate the phenomenon using a large sample size in order to generalize the findings. Comparative studies could also be carried out to assess the phenomenon in different developing countries to find out similarities and differences in the way the phenomenon occurs.

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