The Informal Sector in Zambia

Can it disappear? Should it disappear?

Outline

- Sources of Information
- The Private Sector Landscape
- Characteristics of MSMEs in Zambia– differences within the MSME sector
- Factors determining Growth and Formalization
- How to formalize the Informals?

Informal Sector: Should it disappear?

- Zambia's Informal Sector employs 90% of its workforce.

Key questions we pose are:

- Is there *one homogeneous* informal sector in Zambia, with low productivity and low capacity to pay taxes? Does this sector need to disappear, and be replaced by "modern industries and farms"?
- Or, does this sector contain a mix of firms, some of whom need to "disappear", with others being brought into the Government's tax net? What can be done to increase formalization? What is the role of Government provided public services in this process?

Enterprise Level Diagnostics: Two key sources of Information

World Bank Enterprise Survey	Zambia Business Survey

World Bank Enterprise Survey

- Conducted in Late 2007
- Includes 603 formal firms in Manufacturing, Retail and Services.
- Includes a separate survey of 119 urban microenterprises in Lusaka and Kitwe.
- No coverage in rural areas or in Agriculture

Zambia Business Survey

- Conducted in Late 2008
- Has two components: A Small Business Survey of 4800 mostly rural microenterprises. Includes the self employed, household firms and firms in Agriculture.
- Also includes a separate survey of 169 Large firms.

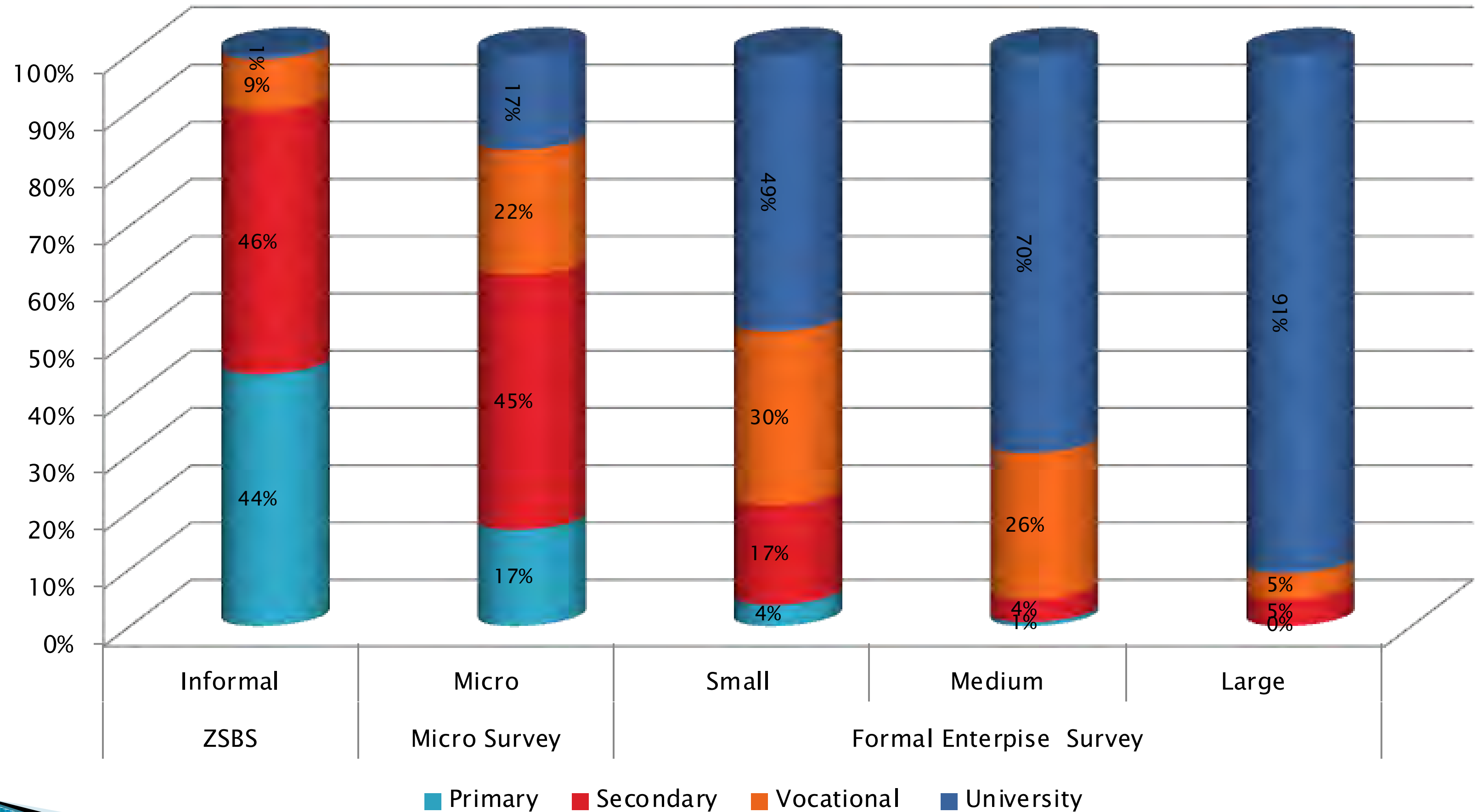
Fact: Most Large firms do not start out in the Microenterprise sector.

There is very little graduation of microenterprises into the larger size class–only 11% of Small and 1% of medium and large firms started out as Microenterprises.

Firm Mobility: Percentage of firms in Each Startup Size group					
		Current Size			
		5–9 workers	10–49 workers	50–99 workers	100+ workers
Startup Size	1–4 workers	60%	11%	1%	0%
	5–9 workers	35%	37%	9.00%	32%
	10–49 workers	4%	49%	56%	33%
	50–99 workers	1%	2%	28%	22%
	100+ workers	0%	1%	6%	43%

Source: World Bank Enterprise Survey, 2008

Fact: Larger Firms are run by more educated entrepreneurs/managers



Source: ZBS 2008, World Bank Enterprise Survey, 2008

Fact: Informality is a Microenterprise issue

- Both the large firm Zambia Business Survey and the World Bank Enterprise Surveys report all firms registered for taxes.
- Within the urban and rural microenterprise surveys, firms with higher sales are significantly more likely to register operations compared to others.

The ZBS identifies very different firms than the ICA urban microenterprise survey

	Enterprise Survey Microenterprises	**ZBS Urban Microenterprises [a]**	**ZBS All Microenterprise**
Registered with any agency	79%	20%	6%
Registered with PACRA	61%	11%	3%
Have operating license from local government	74%	18%	5%
Have TPIN from Zambia Revenue Authority	50%	6%	2%

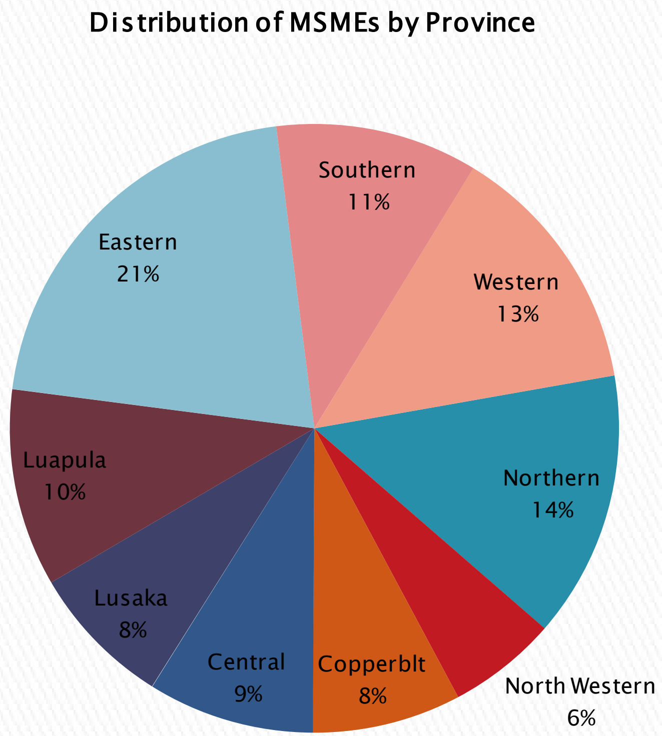
Even compared to the microenterprise survey component of the ICA Enterprise Survey, the household based sampling used in the ZBS meant that more small and informal enterprises are identified.

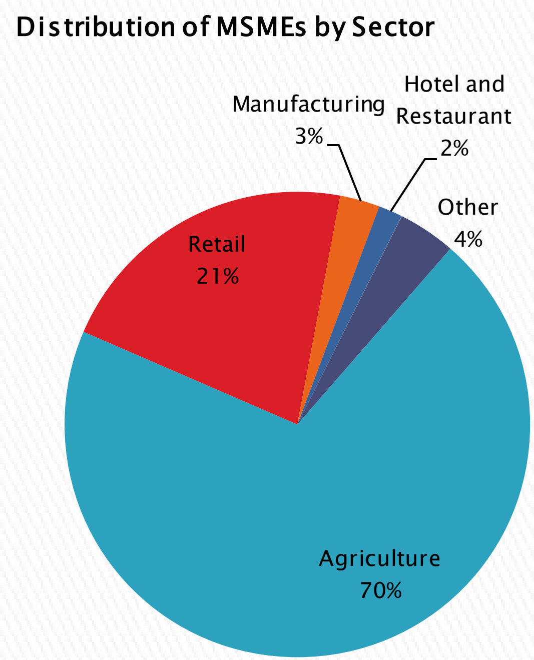
We use the ZBS database to examine the characteristics of the MSME sector.

How Big is the Informal Sector?

- The Private Sector in Zambia comprises of:
- Approximately 500 Large Enterprises with more than 50 employees, accounting for about 400,000 workers.
- Remainder are located in about 1million MSMEs, employing about 4 million workers.
- Of these1million enterprises, majority are either sole proprietors (35%) or family firms run by owner with unpaid family members (32%).

Distribution of MSMEs in Zambia



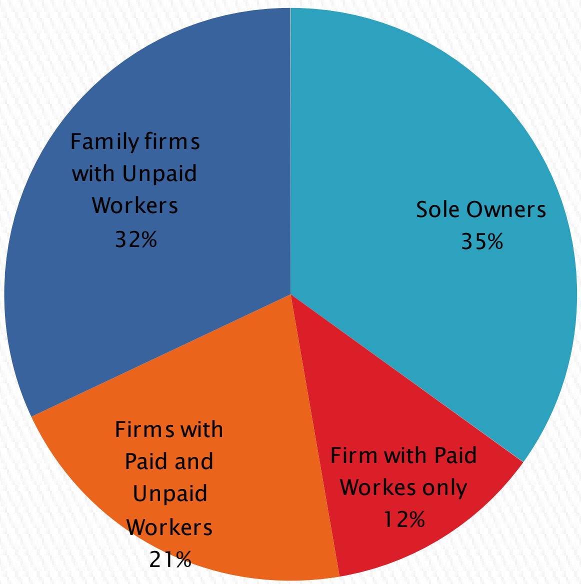


Eastern Province has the most MSME...

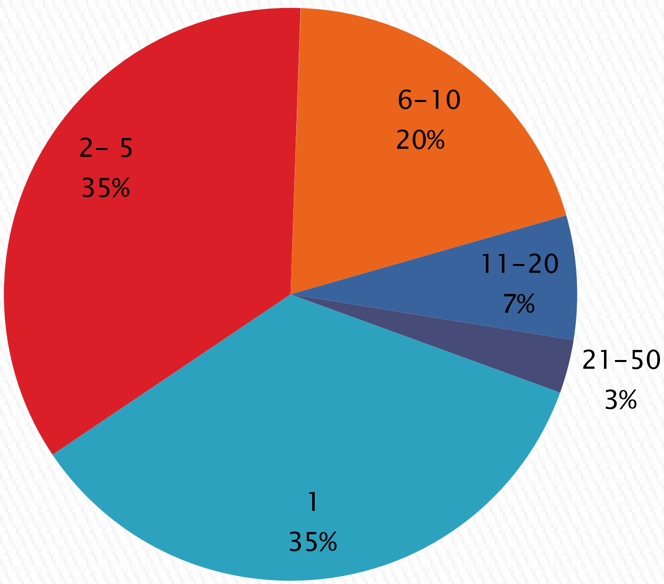
And 70% of them are in Agriculture..

Most MSMEs are very small, with a large share of the workforce in MSMEs consists of unpaid or paid-in-kind workers..

Distribution of MSMEs: By Types of Workers (paid vs. unpaid)



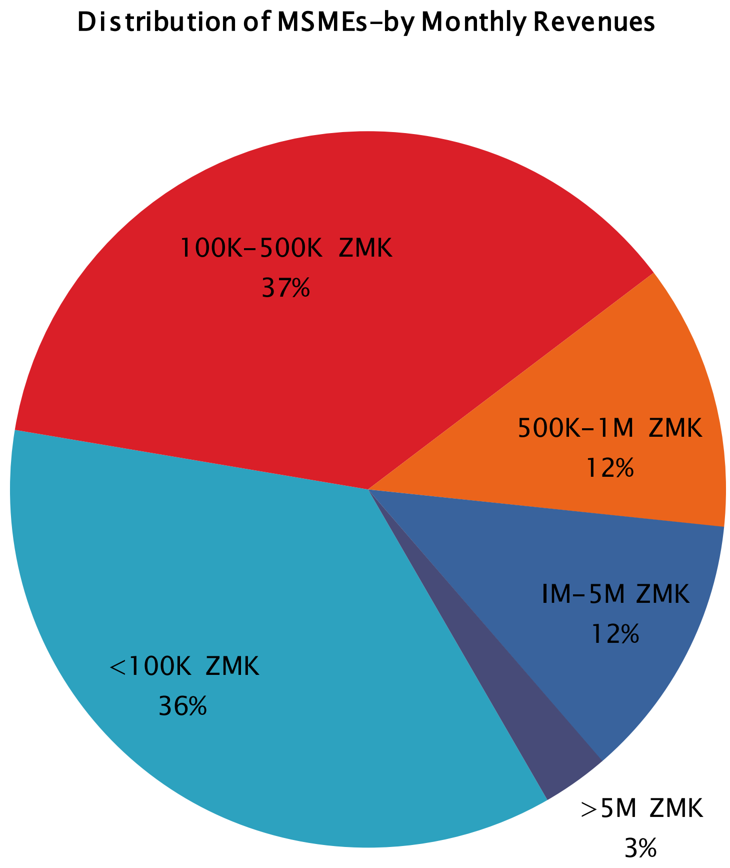
Size Distribution of MSMEs by Number of Workers (paid or unpaid)



Majority of firms are sole proprietorships or family firms..

70% of MSMEs have less than 5 workers..

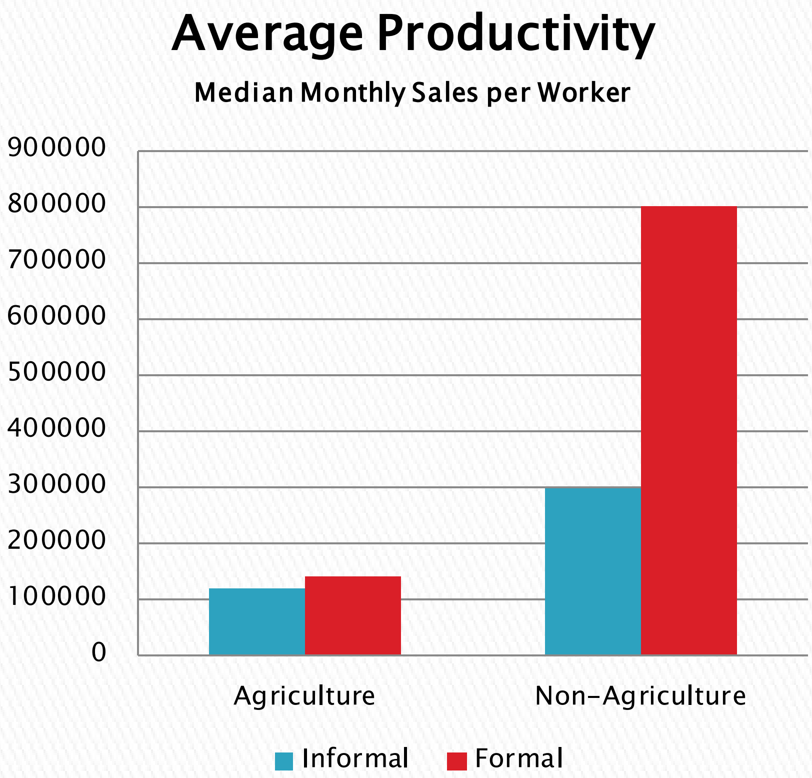
MSMEs in Zambia are also very small in terms of sales..

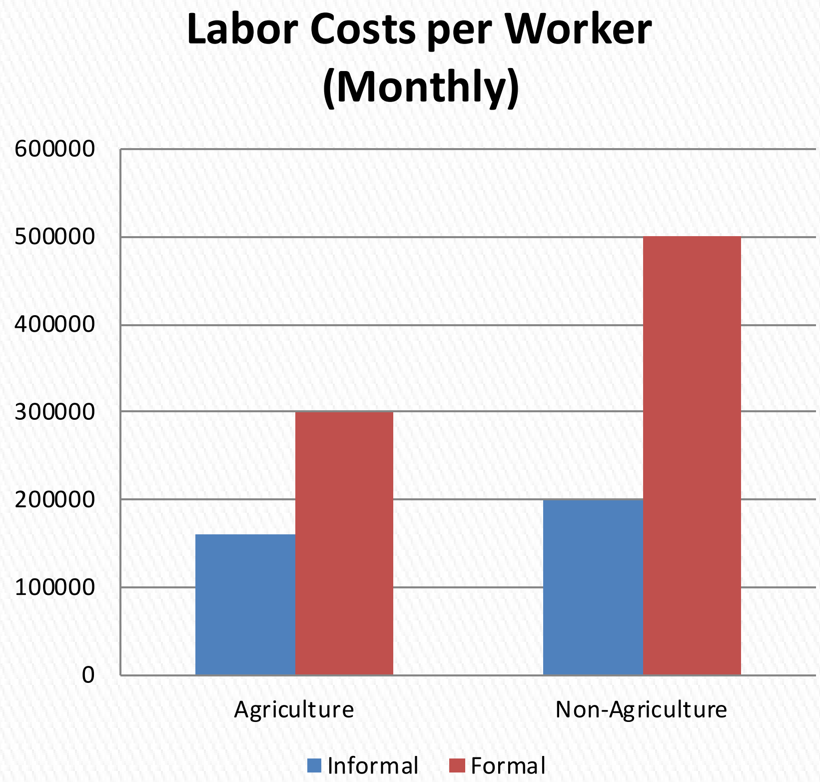


Are Formal MSMEs Different from Informals?

- We've seen that only 2% of firms in the MSME sector pay any type of income taxes. How different are these firms from those that remain informal? Why did they choose to register?

Informal Firms are less productive

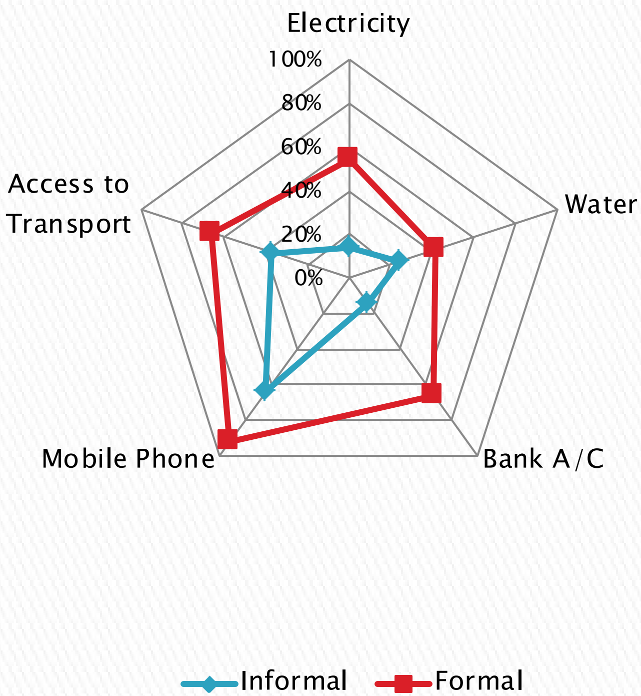


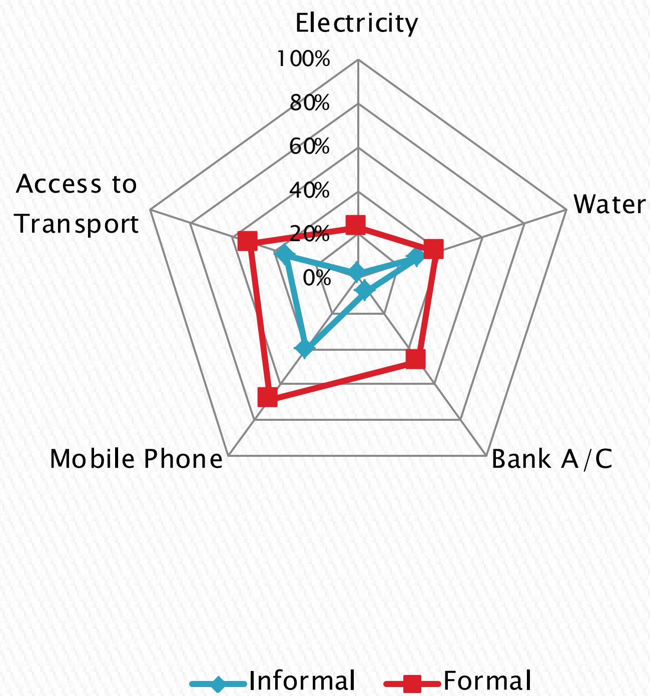


Formal Firms have higher labor productivity..

But also correspondingly higher labor costs

And have less access to infrastructure and finance..

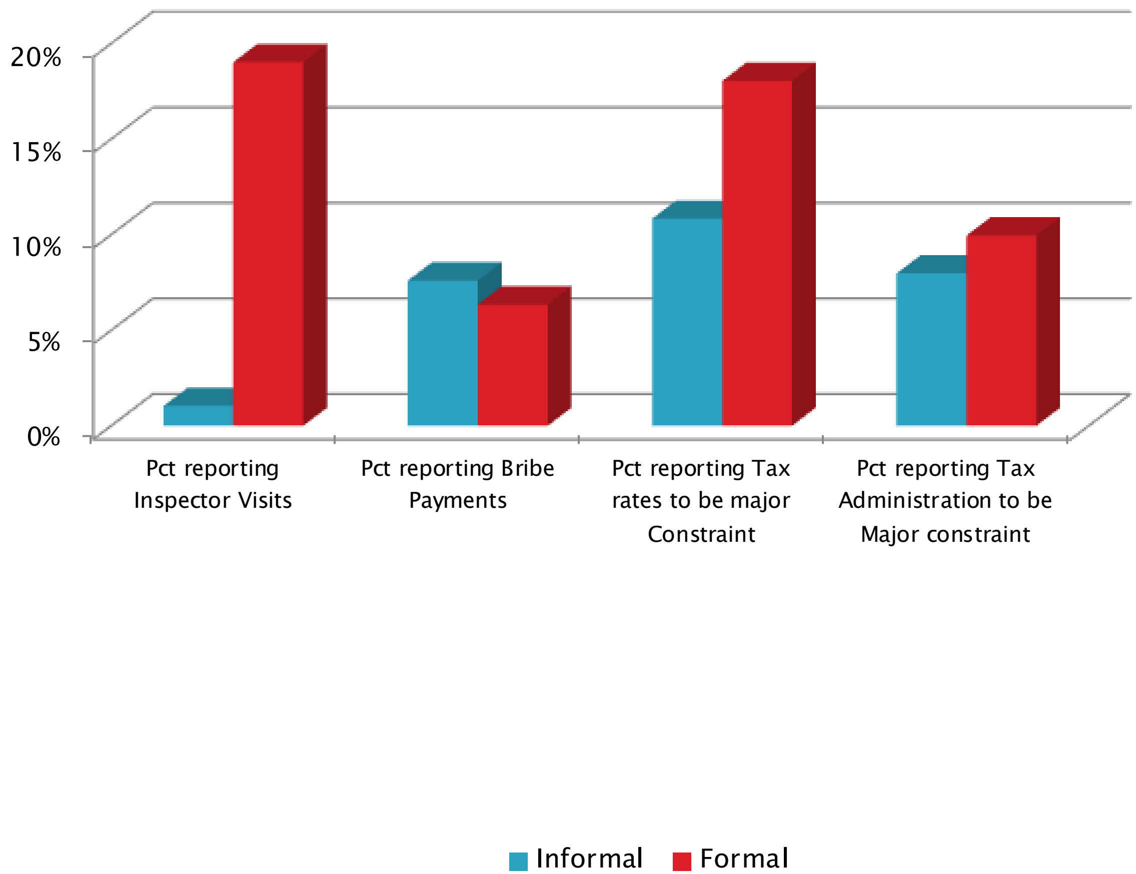




Non-Agriculture

Agriculture

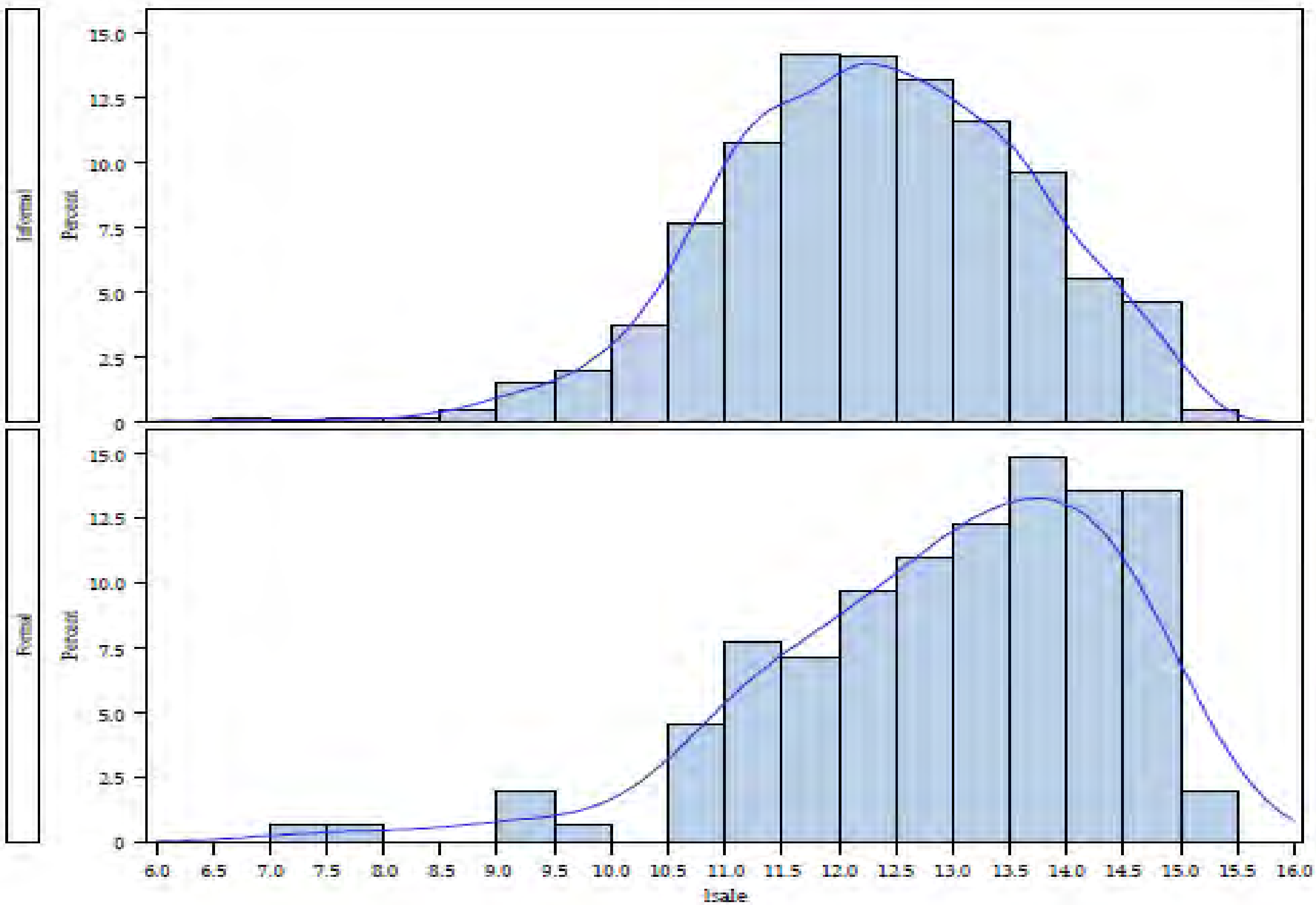
But they also have lower bureaucratic burden..



Formal versus Informal MSMEs

- Multivariate regression results indicate that on average, firms that are registered are larger than unregistered firms.
- Controlling for firm size, these firms have more educated owners, and better access to financial and infrastructure facilities.
- But these firms are also more significantly more likely to complain about tax rates, tax administration and regulatory burden.

But Averages mask the dispersions: there is large area of overlap in size between Formal and Informal MSMES



The drivers of success within the informal sector are the same as those differentiating formals from informals..

- Larger Informal Sector firms have entrepreneurs with higher education, greater access to infrastructure facilities, and greater use of mobile phones and banking services.

- The informal sector in Zambia is not a residual sector with low productivity survival enterprises only.

Which brings us to the key question: How do we formalize the Informals?

- The potential tax base is enormous.
- Currently, there are only 9,029 firms listed with the ZRA paying Turnover taxes. Of these 8,173 firms are in Lusaka.

- Assuming a threshold annual revenue of 12M ZMK (currently the level below which income tax=0%), ***we find that there are about 99,000 farmers, and 51,000 firms in other sectors–primarily retail–that are eligible to pay Turnover taxes.***

How do we bring these firms under the tax umbrella?

Taxation is about Information

- **Who has information?**
- Business owner(s) or managers
- Third parties
  - Banks and Other lenders
  - Suppliers and Customers
  - External accountants/auditors
- Government
  - •Regulatory, audit or service agency
  - •Tax agency
- Available Channels of Information about the Informal sector are through the Owner, Banks (if they use banks) and Customers or Suppliers.

Key factors to consider for formalization policies:

Compliance Capacity: Do firms have the information, education to understand and pay taxes?

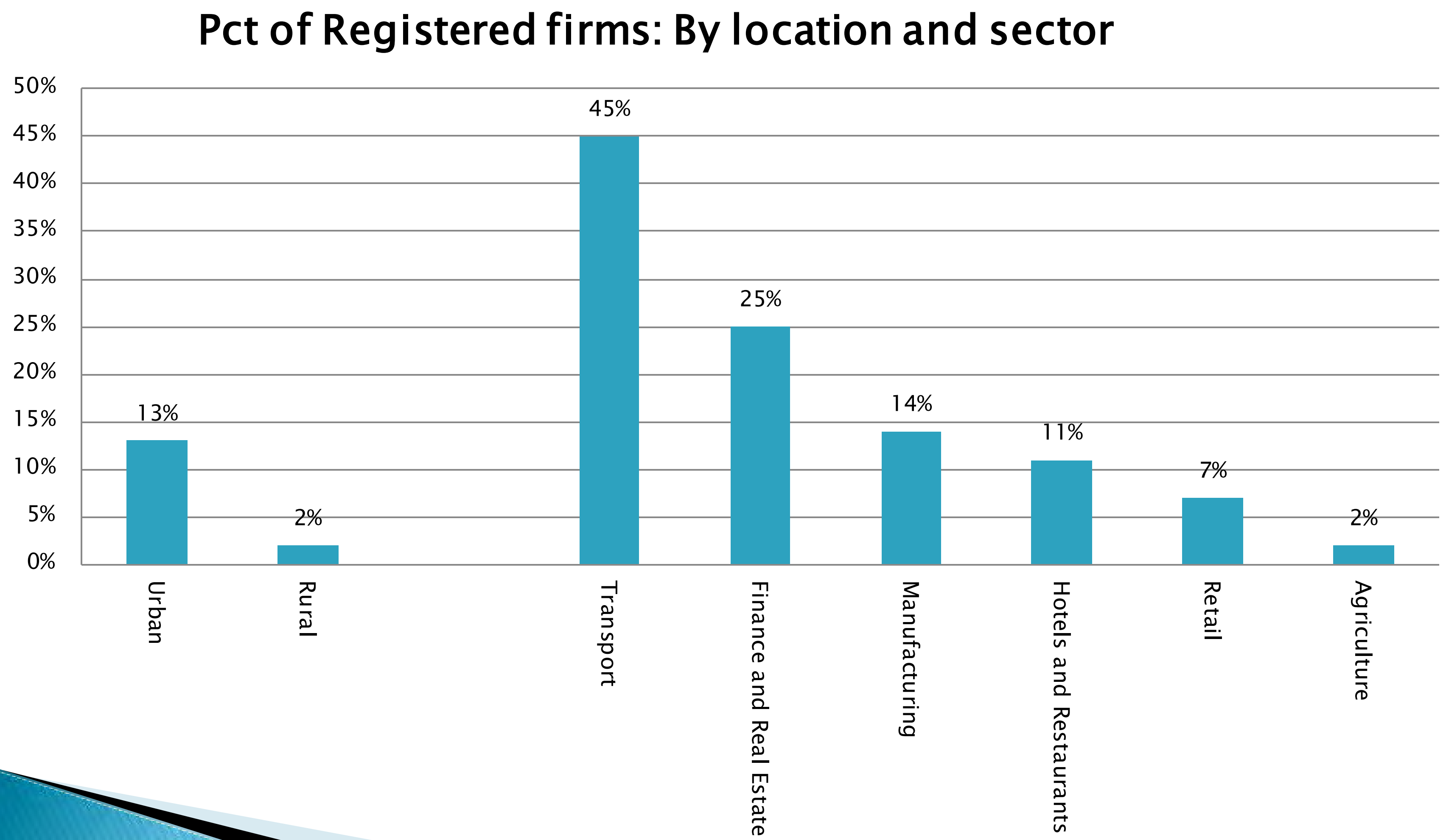
Location and Sectors of Activity: Urban versus rural, tradable or non-tradable goods, producing intermediate or final goods

Business Size: Revenues and Employment

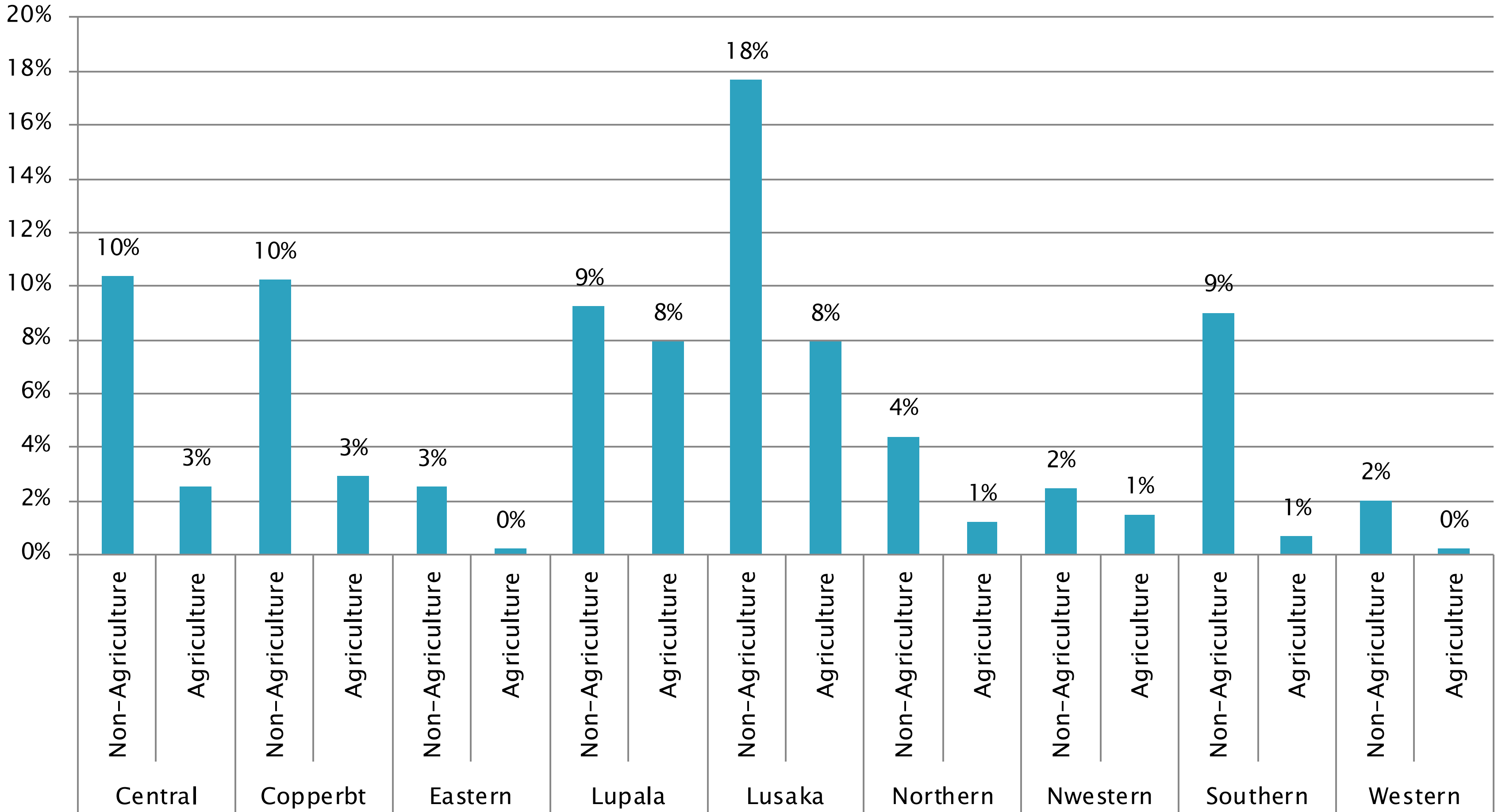
Each of these are discussed next.

Compliance Capacity: Majority of firms do not know how to register, or believe that they do not need to be registered.

The likelihood of formalization differs by sector and location..



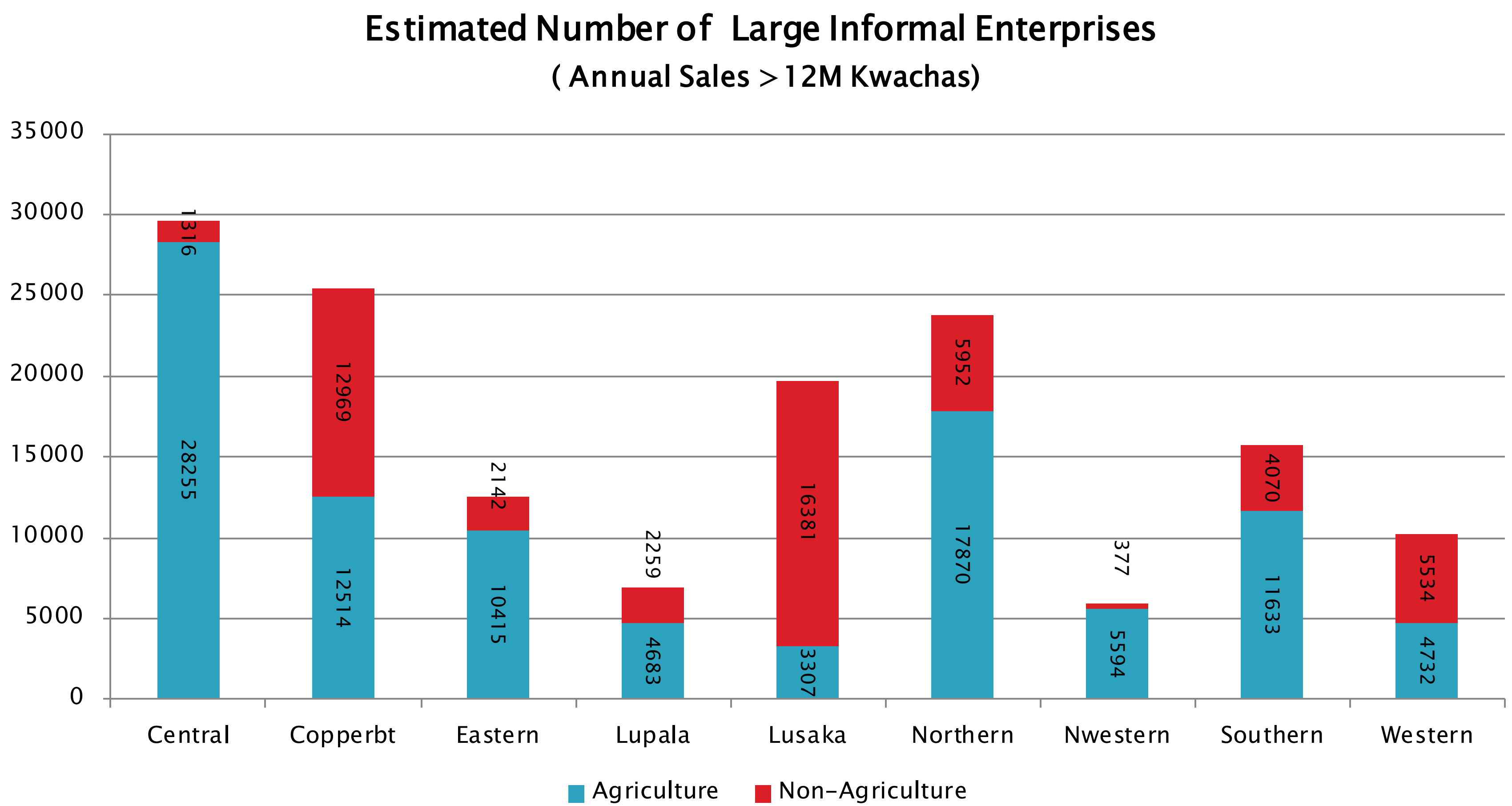
Lusaka province has the highest percentage of registered firms, North–Western and Western Provinces have the least.



Taxation potential: Size and location of larger MSMEs

- There are 15%, or about 150,000 large MSMEs (defined as those with annual sales > 12 M Kwachas).
- These firms are more likely to be located in provinces along the Line of Rail (60%, compared to 34% of MSMEs overall).
- 66%, or almost 100,000 firms are agricultural enterprises, rest are in retail (23%), hotels and restaurants (2%) and manufacturing (1%).

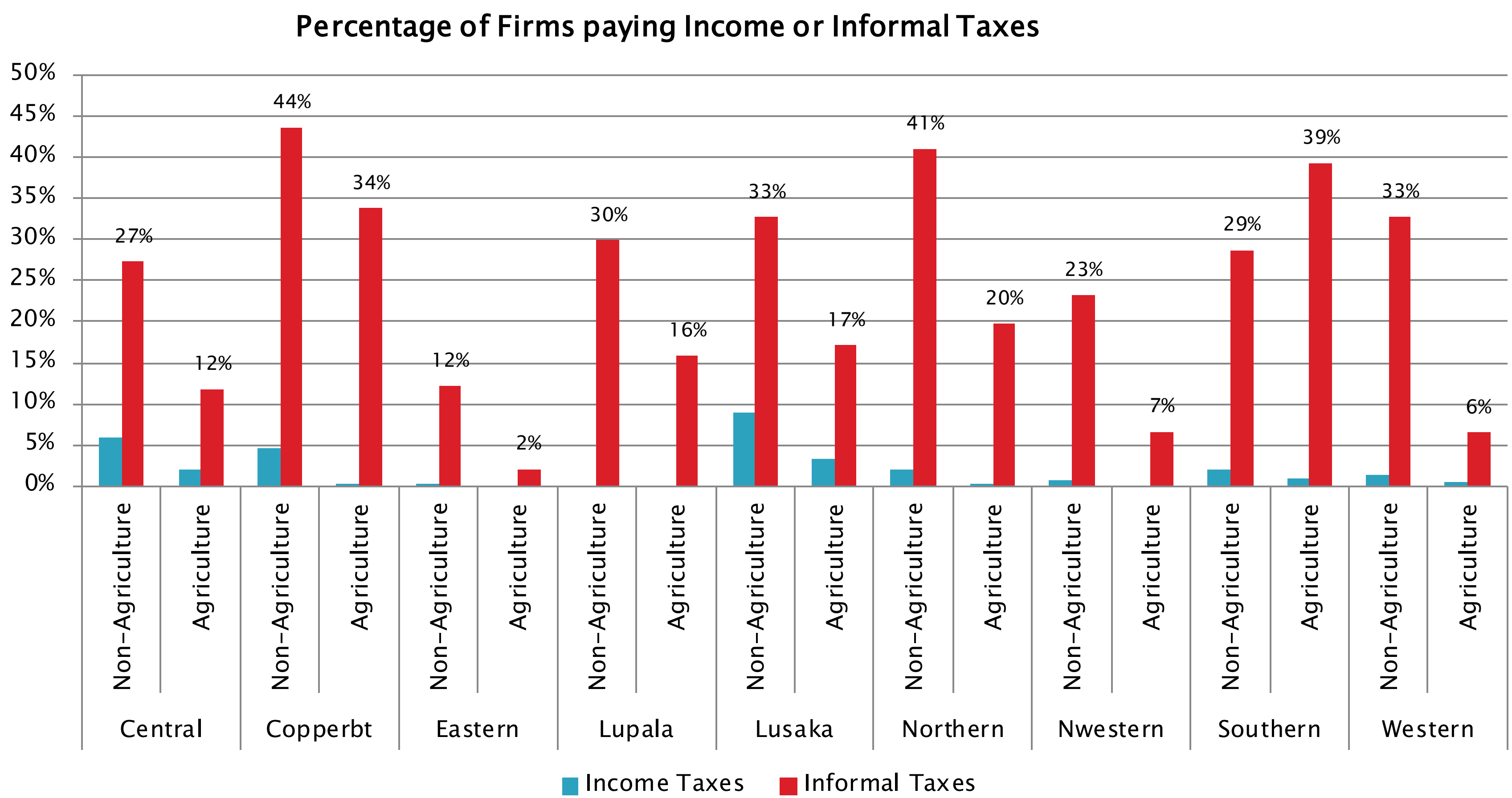
Central Province has the largest share of larger informal Enterprises, followed by Copperbelt and Northern Provinces.



Indirect Taxes: VAT payments and Potential

- Only 5% of firms, or about 50,000 enterprises, report VAT payment
- Only 2% of firms report having a cash register, indicating limited scope for VAT collection.
- But 63% of firms report buying inputs from other businesses or government, rather than individuals, indicating possible VAT payments.

While few firms are paying income taxes, many more report paying other taxes and informal payments..



Conclusions

- The Informal sector in Zambia has a mix of larger productive firms along with small survival enterprises.
- The larger firms can be brought under the tax umbrella through greater education and enforcement. Enforcement is particularly poor in provinces off the line of rail.
- Increasing education, infrastructure and banking sector access will increase microenterprise revenues and have the complementary effect of increasing formalization.