POLICY BRIEF

SEPARC
Swaziland Economic Policy
Analysis and Research Centre

QUANTIFYING THE SIZE AND DEVELOPMENT OF THE SHADOW ECONOMY IN SWAZILAND

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Key Message

The size of the shadow economy has been declining at a slow rate over the past 16 years in Swaziland. The size of the shadow economy was found to be 37.4 % in 2016. This was equivalent to E20.5 billion of the Gross Domestic Product (GDP) in 2016. The key drives of the shadow economy in Swaziland were found to be the tax burden (direct and indirect taxation), self-employment, the importance of the agricultural sector and the institutional quality of governance institutions. For the country to fast tract its developmental agenda (Vision 2022), it is important for the country to enact policies that will harness and transition the shadow economy into the mainstream economy by targeting the drivers of the shadow economy locally.

What is the issue?

The issue is that in Swaziland we do not know about the size and the drivers of the shadow economy even though evidence (high unemployment rate, increase economic activities and high money supply) suggests that a bigger share of the population depends on it to support their livelihoods.

The shadow economy has received a lot of attention all over the world, because of its developmental implication on a countries tax base and its role to foster employment creation for the unemployed. However, there is still lack of empirical studies about the shadow economy in Swaziland using local macroeconomic data. Schneider (1994) defined the shadow economy as all unregistered economic activities that would add to the overall gross domestic product (GDP), if observed. Enthusiasm in comprehending the shadow economy comes from the consequences and policy implications such as misallocation of public goods and services associated with the shadow economy. Moreover, it is intensified by the inability of the government to keep track of all the economic activities occurring in the economy, often due to lack of time and resources (Hassan and Schneider, 2015).

It has been found that the key drivers of the shadow economy are the tax burden, importance of the agricultural sector on the economy, institutional quality of governance institutions, the rate of unemployment in the economy and the rate of self-employment within the economy. However, the drivers of the shadow economy are country specific varying from one country to the next. Therefore, having knowledge about the drivers of the shadow economy is critical to influence the magnitude of the shadow economy. Mainly because only through influencing the driver, the size of the shadow economy can be managed.

Understanding the shadow economy is vital because if all these unregistered economic activities were registered they would be liable to taxation and government regulations (Hassan and Schneider, 2015). Thus the shadow economy accounts for a large share of the economy that goes unnoticed in government's books. Globally, the contribution of the shadow economy is estimated to be 13.7 percent of the world's gross domestic product (GDP). Moreover, the Organisation of Economic Cooperation and Development (OECD) (2009) found that 1.8 billion of the population around the world were working in shadow economy.

In Swaziland, there tends to be mixed views on the contribution of the shadow economy in Swaziland. Sceptic's view that shadow economy as a hindrance to the mainstream economy. Their argument is that shadow economic activities encourage defiance of the tax obligation by people and lead to a reductive effect on the country's tax base. Increasing shadow economic activities tend to have serious penalties on the government's ability to generate income to drive development. Hence, the shadow economy has an effect on the country's budget deficits and slowing economic growth.

On the other hand, advocates of the shadow economy argue that the shadow economy is the cornerstone of the small, micro, medium enterprises (SMME) sector as it promotes entrepreneurship and income generation. Indeed, they see the shadow economy as an enabling engine for employment creation for unemployed people within the economy. This view of the shadow economy argues the need to have alternative economic instruments that can support basic livelihoods, especially among the poor and marginalised in a country.

While those that are neutral believe that shadow economy can only be beneficiary only if it can be harnessed and transitioned into the mainstream economy (Williams and Round, 2011). They believe if such enterprises are formalised, it would contribute to the development of enterprises and encourage fuller employment. Therefore, it is important for Swaziland to graduate and transition people in the shadow in order to promote employment creation and income generation while also increasing the tax base.

Why does it matter?

It matters because if the country wants to allocate resources efficiently in terms of public services and goods in order to accelerate its development agenda (Vision 2022) the government must know the size and drivers of the shadow economy locally. Thus, if the country cannot measure it, therefore we cannot measure it.

In that sentiment Swaziland adopted the 2030 agenda for Sustainable Development Goals (SDGs) in 2015, which committed the country to creating decent work and economic growth in SDG 8 and also reduced inequalities in SDG 10. Nurturing and graduating shadow economic activities into formal economic activities has become a priority for the country to stimulate economic growth and to reduce income inequalities. Additionally, the fulfilment of decent work for all is pivotal for the achievement of all 17 SDG Goals.

Over the past years the economy of Swaziland has been resilient during times of recurrent drought and economic turmoil. This has led to an inquest by regulatory authorities about the size and the development of the shadow economy in Swaziland. Jutting and de Laiglesia (2009) established that shadow economic activities tend to grow during times of economic

hardship because they act as a shock-absorber for people to sustain their livelihoods. The shadow economy has become a viable option for livelihood for those that are unable to find work. Swaziland is not immune from economic shocks. Recently, the country was hit by the worst drought since the 1950 coming at a time the country was still trying to recover from stagnation dating back to the economic recession of 2010/11.

A study quantifying the size and development of the shadow economy using local data was needed to identify the drivers of the shadow economy in Swaziland, to be able to make sense of the vulnerability of the economy to external shocks. It is expected that acquiring a benchmark for the magnitude of the shadow economy in the country will assist policy makers determine an acceptable level of the local shadow economy. This will be achieved by developing policies that influence the drivers of the shadow economy in order to reduce the number of people that depend on it as their main livelihood source.

How was the study conducted?

The study used secondary data analysis by collecting Swaziland macroeconomic data for a period of 16 year beginning from the year 2000 to 2016. Annual time series data was collected from different government institutions and other institutions such as the International Monetary Fund (IMF) as well as the Mo Abraham Foundation. Tax revenue data was obtained from the Swaziland Revenue Authorities (SRA), whereas population data, gross domestic data, employment statistics, and inflation data was obtained from the Central Statistics Office (CSO). Self-employment data, specifically sole-proprietorship business data was obtained from the Ministry of Commerce and Trade, the Business Registration Unit and Business Licensing Unit. Money supply data was obtained from the Central Bank of Swaziland and Regulation data (institutional quality) was obtained from the Ibrahim Index for African Governance (IIAG) database.

The secondary data was fitted into a structural equation model called the Multiple Indicator Multiple Cause (MIMIC) model for statistical inference in order to derive the drivers of the shadow economy in Swaziland and also quantify the size of the shadow economy in Swaziland over a period of 16 years.

Figure 1: The general structure of the MIMIC model and the hypothesized relationship between variables
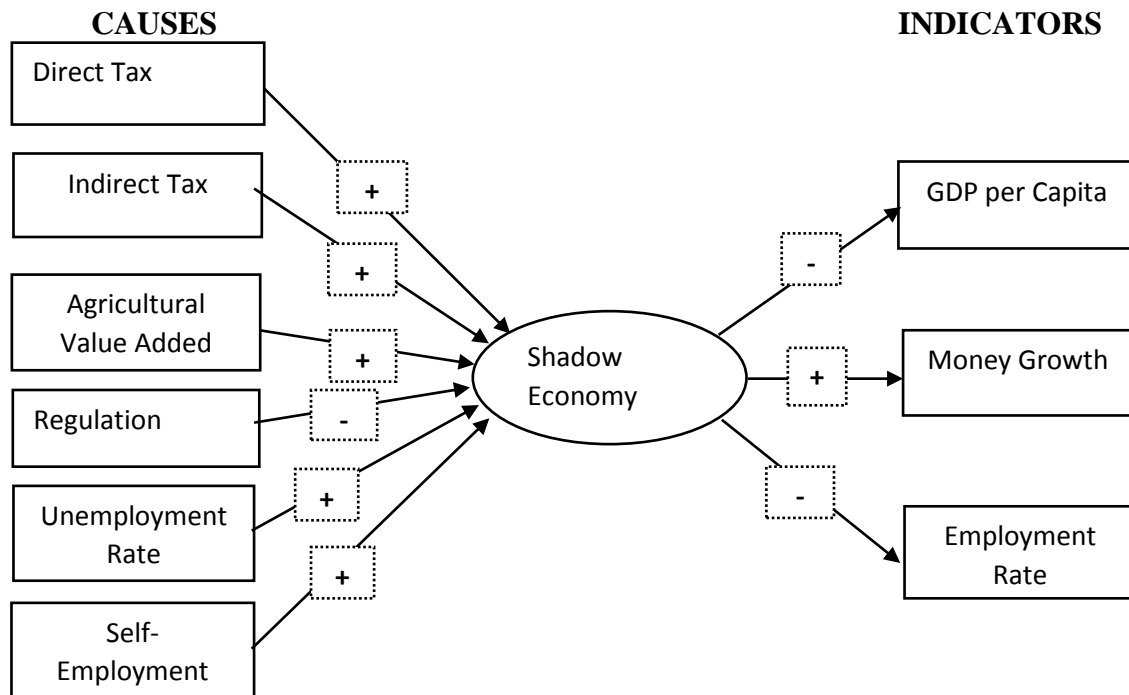
What did the study find?

In terms of the drivers of the shadow economy, the study made five (5) key finding:
First, the tax burden was a key driver of the shadow economy in Swaziland. The tax burden had a positive correlation with the shadow economy, meaning the higher the tax obligation the bigger the size of the shadow economy.

Second, the agricultural sector was an important driver of the shadow economy in Swaziland. The significance of the agricultural sector in the Swazi economy had a positive correlation to the shadow economy. The relationship between the agriculture sector and Swaziland's economy was that when the share of the agriculture sector contribution to GDP increases, the size of the shadow economy also increases.

Third, institutional quality of governance institutions was a driver of the shadow economy in Swaziland. The results showed that there was a negative relationship between the institutional quality of governance institutions and the shadow economy, meaning the better the quality of regulatory institutions, the small the size of the shadow economy.

Forth, self-employment was another driver of the shadow economy in Swaziland. The results reveal that there was a negative relationship between the shadow economy and self-employment. This generally means that as more people start their own businesses, the size of the shadow economy shrinks.

Fifth, unemployment was not amongst the drivers of the shadow economy in Swaziland. This was contrary to economic theory, as unemployment is viewed as one of the main drivers of the shadow economy. However, this was not an anomaly as the same result was found in Egypt (Hassan and Schneider, 2015). This may be directly linked to the fact that Swazis'

mind-sets towards employment have shifted as they prefer to start their own businesses as opposed to waiting for someone to employ them. In short, the drivers of the shadow economy in Swaziland are direct tax, indirect tax, the importance of the agricultural sector, quality of institutions and self-employment.

Finally, the size of the shadow economy in Swaziland has been declining slowly over time. The size of the shadow economy in Swaziland for 2016 was found to be 37.4%. However, this figure may be understated, inconsideration of the fact that the shadow economy is very board. It can be inclusive of both household economic activities and illicit activities. This means that if all shadow economic activities were registered in Swaziland they would contribute 37.4% towards the current GDP value. In monetary terms the shadow economy would add E20.5 billion towards the GDP value of Swaziland.

This provides valid case for the transitioning and harnessing of shadow economic activities into the mainstream economy due to its economic potential. The implications of the study are that, the size of the shadow economy in Swaziland accounts for a large share of the official economy, although, its share has been decreasing slowly over time. The slow decline of the shadow economy shows the inability of policy makers to develop policies that are aimed at reducing the shadow economy and stimulate economic growth in the formal sectors of the economy. Such policies are a necessity to create an enabling environment for shadow economy agent to transition from the shadows in to the formal economy.

Recommendations

Having a comprehensive understanding of the factors that drive the magnitude of the shadow economy in the country is important to enact policies that are developed to nurture and transition people from the shadow economy in to the mainstream economy. By graduating and transitioning people from the shadows into the mainstream economy, the country would have reached its target in SDG 8 and 10, which advocate for decent work and economic growth as well as reducing inequalities respectively. Thus it is recommended that:
- Build transparent and democratic institutions that are less keen on regulatory bottle-neck, corruption and bureaucracy to improve the institutional quality of governance institutions (Regulations).
- Create an enabling environment for sole-proprietors in order assist in ensuring self-employment does not have a negative influence on the shadow economy.
- Focus on reducing the overall tax burden especially indirect taxation to decrease the effect of the tax burden on the shadow economy.
- Improve the incentive mechanisms for National Marketing Boards to motivate farmers to sell their produce to them and also reduce the significance of the agricultural sector on the shadow economy.

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