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CONTENTS

CONTENTS CONTINUED

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The implementation of informal sector taxation: Evidence from selected African countries

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Abstract

This paper adds to a growing literature on informal sector taxation in developing countries by describing and analysing the experiences of four African countries (Ghana, Tanzania, Zambia and Zimbabwe) that have implemented informal sector taxes in recent decades. These taxes are analysed in terms of their revenue, technical (that is, administrative effectiveness, equity and efficiency) and governance implications. The evidence suggests that the revenue potential from informal sector taxation is low, in part because of the difficulty in designing and administering effective informal sector tax regimes. Based on the experiences in these countries, negotiating with informal sector associations might be a useful strategy to improve administrative effectiveness and state-citizen relations.

Keywords: informal sector taxation, presumptive taxes, Africa

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introduced (see Bruhn & Loeprick, 2014).[4] This paper aims to contribute to this area by describing and analysing the experiences of four African countries that have implemented informal sector taxes in recent decades, namely Ghana, Tanzania, Zambia and Zimbabwe.

as formalisation', where informal sector tax policy is indeed mainly concerned with registering eligible firms and/or bringing them into the standard tax net. At the other end, informal sector taxation refers to simplified taxes specifically designed to raise revenue from informal businesses without the intention of necessarily formalising these enterprises.

In some countries the implementation of simplified taxes specifically meant for those in the informal sector is viewed as a kind of formalisation by governments and researchers, placing them somewhere along the spectrum (Bruhn & Loeprick, 2014; De Mel et al., 2012; Fajnzylber et al., 2011). For example, in Brazil, the Simples Nacional (for firms with gross revenues between US$120 000 and US$1.2 million) and Microempreendedor Individual, taxes covering even the smallest enterprises (and workers in those enterprises) with gross revenues below US$20,000, are viewed as a process of formalisation. Similarly, in Uruguay, the simplified monotributo, a tax which is supposed to be paid by all microenterprises in the informal economy, has as its principal goal formalisation (ILO, 2014: 6–8; OECD, 2015b).

In this paper, we focus on countries in which informal sector tax policy has involved the levying of administratively simple taxes, where unregistered businesses are allowed to remain in the informal sector as long as they pay the taxes designed specifically for their sector. The distinction between this form of informal sector taxation on the one hand and 'taxation as formalisation' on the other is important, as these two approaches are likely to have different policy goals and implications. For example, the taxation as formalisation literature (De Mel et al., 2012; McKenzie and Sakho, 2010) emphasises the benefits of formalisation on firm growth (for example, greater access to markets, credit and finance) and looks at the possible ways in which incentives for this growth can be implemented. However, growth may not be important to informal sector firms that have a small optimal size (Kanbur, 2014). Therefore, these firms will require different (that is, non-growth related) incentives for tax compliance, such as the provision of services specific to this sector or the opportunity to engage policy-makers on matters of concern to their operations (such as crime or harassment by officials) (Joshi et al., 2014).

Collecting taxes from small unregistered operators clearly comes with its own set of

insubstantial in countries where the informal sector accounts for a large share of GDP or employment (Joshi & Ayee, 2002).

4. TAXING THE INFORMAL SECTOR IN PRACTICE

According to the IMF (2007: 27), more than 25 countries in sub-Saharan Africa and 14 countries in Latin America have a special tax regime for small enterprises (which includes the informal sector). The literature on informal sector taxation described above has focused mainly on conceptual issues, however, with little empirical evidence available on how these taxes have been implemented, and with what effect. In this section, we describe the various practices and experiences of four countries that have implemented presumptive taxes in recent decades—Ghana, Tanzania, Zambia and Zimbabwe. These countries were selected as there was relatively more evidence available in the literature and in government records on the presumptive tax policies implemented in these countries, including changes in coverage over time and revenue collected. It goes without saying however, that the experiences of these countries may

As a way of strengthening the implementation of presumptive taxes, the TRA in 2005 introduced the block management system (BMS). The main objective of this system was to ensure tax compliance by identifying, registering and collecting tax information from all eligible small and medium-sized businesses in a particular sector or geographic location (ATAF, 2014b). Where there are many informal traders, city blocks were mapped and divided into small segments consisting of a few streets or a specific geographical area.

This focus on small unregistered enterprises necessitated a reorganisation of how the TRA operates and efforts were made to develop the human resources required for this new approach to informal sector taxation. Each block, under a team leader, was tasked with managing all the tax functions (that is,

8.57

In terms of equity, a TRA report opined that the BMS system is regressive as it penalises those who do not record their business transactions. These are the informal entrepreneurs who are more likely 'to lack the capacity to keep proper accounts' (TRA, 2011: 84). However, record-keeping (for tax purposes) is not only important in the implementation of fairer taxes but could also result in business performance improvements. Despite these various concerns, the BMS is still being used to collect taxes from Tanzania's informal sector (ATAF, 2014b)

4.3 Informal sector taxes in Zambia

The Zambia Revenue Authority (ZRA) started implementing informal sector taxes in 2004 to raise revenues (Phiri, 2013). There are four main types of informal sector taxes in Zambia. First, there is the Turnover Tax (TOT), which is levied at 3 per cent on individuals and small firms with an annual turnover of up to ZMK200 million (US$50 000)[15]. Second, there is the presumptive tax on minibus taxis, with annual taxes ranging from ZMK600 000 (US$150) for a seating capacity below 12 to ZMK7.2 million (US$1800) for a seating capacity of 64 or above in 2009 (Mwila et al.eaw c aw9.2 ( )04 .7 (w c [(4.6 (, 24.-7.7 ()10.w9.2 (os10.9 ( )].w9.2 002 T)4))-)-11.)6.3

per cent of total income tax revenue with many in the informal sector going untaxed in Zambia. In contrast, the medium taxpayers' office has 10 per cent of the ZRA's employees and collects 18 to 23 per cent of the income tax revenue. The LTO has a staff complement of 3.8 per cent of total employees but collects 75 to 80 per cent of the income tax revenues. Clearly, given the difficulty of implementing and enforcing presumptive taxes among informal businesses, the cost-benefit ratio related to collecting taxes from small taxpayers in Zambia is much higher compared to that related to collecting taxes from larger taxpayers, as is the case in many countries (see Benjamin & Mbaye, 2012; TRA, 2011). Mwila et al. (2011: xi) suggest the ZRA engage informal sector associations as the STO on its own is unlikely to collect significant revenues from this sector.

Mwila et al. (2011) argue that three main factors contributed to the limited success in collecting revenues from the informal sector in Zambia. First, poor record-keeping among those in the informal sector, many of whom are poorly educated, resulted in low revenues from the TOT. Second, the labour-intensive nature of informal sector tax administration in a sector where many people are not aware of these taxes, resulted in low revenues relative to collection costs. In the case of the base tax for example, the high collection costs operated as a disincentive to agents required to collect this tax from numerous marketeers in geographically dispersed areas. T(a)-1.7 (l)14(g)12.3 (u)10.9a(t)4.6

Municipality of Kariba), Utaumire et al. (2013) found that a large number of traders were not even aware of informal sector taxes, and many expressed concern that they were not consulted in the setting of these taxes. In qualitative work by Dube (2014b), where around 50 informal operators in Harare were interviewed at length, there were also reports of coercive tax collection methods and frequent payments that had to be made by informal entrepreneurs to non-state actors such as touts and ruling party-aligned militias and 'committees' (Dube, 2014b).[18] These actions are likely to undermine the potential, discussed in the literature (Meagher, 2013; Prichard, 2015), for informal sector taxation to promote better state-citizen relations.

In the study by Dube (2014b) the equity implications were also assessed, with respect to equity both within the informal sector and between informal sector operators and those in the formal sector. The study found that informal entrepreneurs generally bore a higher tax burden than those with similar incomes in the formal sector, given high presumptive tax rates and the lack of minimum income thresholds. However, there were income levels at which the CIT and PIT were inequitable vis-à-vis presumptive taxes in some informal activity classes (for example, taxi-cab and minibus taxi operators), with informal traders paying less in taxes than those paying CIT/PIT with comparable incomes. In addition, within the informal sector, operators in certain activity classes were eligible for much higher taxes than operators in other activity classes at the same income level (hairdressing salons bore a particularly high tax burden for example). The selective enforcement of presumptive tax collection (sometimes politically motivated) was another major source of inequity within the informal sector, and acted as a disincentive to continue paying taxes for those who were compliant.

Using the reported and observed behavioural changes resulting from the implementation of presumptive taxes, Dube (2014b) found that economic efficiency was potentially being undermined. Public passenger operators reported using long circuitous routes and parking their vehicles to avoid the police checkpoints, which would also result in man-hours being wasted if workers are not transported to their workplaces on time. An observation made by ZIMRA officials concerning hairdressing salon operators was that some of them were moving from areas of high visibility, such as the central business district, to residential areas. This could result in a reduction in output if clients can no longer get to the new site or the new site is not visible to potential customers.

5. DISCUSSION

In all four of the country case studies, the quest for revenues appeared to be the main motivation for introducing presumptive taxes. While the evidence indicates that the introduction of these taxes did result in increased revenues for the fiscus, presumptive tax revenue as a proportion of total revenue is nonetheless reported to be very low. It is possible that the sector's revenue potential has not been fully tapped, with many informal enterprises escaping the tax net, however, the challenges experienced at the administrative level suggest that th0 Tc 0 Tw 2 (r)-1.9 (e85 Tw T*12.8 (est)2 (u)2 (e 12.8 (est the informal sector makes it hard to tax. It is difficult to identify potential taxpayers, particularly when informal operators do not always have a fixed location, and many informal businesses have highly variable incomes and weak accounting systems.

Discussion on how to improve informal sector tax administration in the tax literature has included the setting up of STOs, tax farming (using agents to collect taxes) and fiscal decentralisation (using local authorities to collect tax revenues) (Kiser & Baker, 1994; Loeprick, 2009; Terkper, 2003). According to this literature, an STO can improve enforcement and offer targeted taxpayer services (for example, education, feedback, and a channel for handling complaints and appeals). However, an STO on its own is unlikely to have a significant impact on administrative effectiveness. Tax authorities in most developing countries do not have the resources and manpower to effectively monitor and enforce compliance in the large informal sectors on their own (Araujo-Bonjean & Chambas, 2004; Mwila et al., 2011). As the case studies show, staff shortages were cited by tax authorities as a major constraint even in a country like Zambia with an STO.

Tax farming and fiscal decentralisation are the other approaches that have been suggested to improve the administration of presumptive taxes. The main objective of these approaches is to free the tax authority to focus on monitoring and selective audits.[19] However, the Zambian and Ghanaian examples show that the effectiveness of tax farming depends on the capacity of the agents tasked with this collection and the ability to eliminate corruption.[20] Although there is growing literature on the importance of empowering local governments to collect taxes as they are closer to the informal sector (Bodin &

from presumptive taxes in Ghana) but also reduce administrative costs and improve state-citizen relations.

However, more research is needed on what Bräutigam et al. (2008: 3) refer to as the 'governance dividend' from informal sector taxation and, from the review of the literature, two main threads are suggested. First, while the few examples in the literature suggest that informal sector associations are important (Joshi & Ayee, 2002; Meagher, 2013; Prichard, 2015), very little has been written on the contextual factors that would result in fruitful negotiations and improved state-citizen relations. The specific ways in which these associations can be used (for example, involvement in tax design, tax collection or education campaigns) are likely to vary depending on the informal activity and various country-specific factors. Secondly, there are many informal sector operators who cannot be expected to pay presumptive taxes to central government on equity grounds (and who may not belong to associations). However, these operators are likely to pay various user and license fees to local authorities. There is therefore a need to investigate the type of (probably non-associational) bargaining that could occur at the local level, possibly through street committees (Mkhize et al., 2013) so as to allow operators who are not organised into associations to have a legitimate voice in negotiations.

Another way in which quasi-voluntary compliance might be encouraged is through the provision of amenities and work related infrastructure (a function that should be performed by local government but rarely is), business support and training, and the development of trade specific tax negotiation forums (which are consulted regularly as is often the case in formal sector/tax authority consultations) (Meagher, 2013; Prichard & Bentum, 2009). Quasi-voluntary tax payment is likely to be higher if taxpayers feel that they will get 'value for money' for the taxes that they are paying (Coolidge & Ilic, 2009; Therkildsen, 2006).

Understandably, there are many concerns around whether it is equitable to tax the informal sector, especially given perceptions that informal sector operators are mostly survivalist in nature. Presumptive taxes can result in inequities between informal and formal sector firms at comparable incomes, but also within the informal sector itself because of uneven coverage and differential rates by activity. In addition, because of their simple structure (often lump sum taxes, with no minimum thresholds), presumptive taxes tena( )-10.3 (a)11. ( )11parinct.

those in the informal sector who are compliant (or who cannot avoid the tax net). Outreach programmes, possibly using informal sector associations, may be an important way of increasing taxpayer awareness of the equity implications of these taxes.

The public finance literature shows that there is a direct relationship between tax rates and the economic inefficiency or excess burden created by taxation (Slemrod & Yitzhaki, 1996). Presumptive taxes at low rates therefore potentially can minimise the economic inefficiency associated with taxation. Basing the tax rate on average ratios (profits to sales) and average income may even be able to incentivise these enterprises to be more efficient in their business operations, as the marginal tax rate on the additional income above the average would be zero (Pashev, 2006).[31] However, the evidence suggests that in some countries (for example, Zimbabwe), poorly researched presumptive tax design and high effective rates (which are sometimes so high that no enterprise can reasonably be expected to pay them), have been counter-productive. Indeed, there are reports of operators reducing operations or moving to less visible areas in order to avoid the attention of the tax authorities (Dube, 2014b). Few studies mention economic efficiency in informal sector taxation (Dube, 2014b; Memon, 2013; Taube & Tadesse, 1996), pointing to the need for more work in this area.

In summary, presumptive taxes, which are designed to reduce both collection and compliance costs in informal sector taxation, will inevitably result in trade-offs

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