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Informal Sector Taxation: Is There Anything Worth Research

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Abstract
This paper sought to establish the usefulness of a great array of recommendations aimed at taxing the informal sector. In terms of the methods and data collection, this paper predominantly reviewed literature (desk research). From the reviewed articles, this paper recognised that there are many practical policy strategies that developing countries can implement to combat informal sector but this paper has not establish whether each strategy would result in tax revenue in the short run or not. The paper further recommends that researchers must consolidate all the recommendations made and develop a framework/ model that incorporate key policy matters aimed at creating responsible informal sector world over.

1. Introduction

Contemporary researchers divulge that there is potential tax revenue in the growing informal sector in developing countries (Aranjo-Bonjean & Chambas: 2003; Masarirambi: 2013; Kedir: 2014), and thus taxing this sector will increase the national tax revenue and enhance the economic development of a country (Pfister: 2009; John: 2010; Ohaka & Zukbee: 2015). These assertions suggest that ignoring the collection of tax revenue from this sector will trigger serious operational problems for the government and increase the tax burden on a few compliant taxpayers in a bid to raise the much needed tax revenue (CAGE:2013; Dalu, Maposa, Dalu, & Pabwaungana: 2014).

Developing countries face extensive political, economic and administrative challenges in closing tax gaps. Tax reform is often difficult due to “interest groups” who profit from the current tax system (European Parliament 2014) what is termed as devil deal in the literature (Munjeyi 2017). Informal taxation is a true phenomenon especially in weaker jurisdictions (Van den Boogaard & Prichard 2016), there is no doubt that informal sector impacts on poverty and development greatly. Therefore need for researchers and policymakers to widen scope to understand the sophistication of its activities so as to curb revenue losses (Munjeyi *et al* 2017). Research had it that informal institutions require critical thinking about appropriate reform of the formal to address to budget deficits, and an understanding of the shrinking of tax revenue from the formal sector at national level to inform policy measures.

Gurtoo (n.d) concludes that the wide disparity between developed and developing country is about how they perceive informal sector players in the economy. In developed countries informal sector is professed as a “resource” and policies have been advanced to harness their work and support them as they gradually shift into the formal sector (lessons from UK, Italy, Belgium, France and Netherlands). This can be best explained by cultural capital ideology- business philosophy (Bandura 1999). In short developed countries approached informal sector through a business venturing philosophy while in developing nations, pieces of legislation have been designed to extinguish it (Gurtoo n.d).

In developing countries, economy is anchored by the informal sector this is depicted by over 60% of its contribution to the Gross Domestic Product (GDP) and National Domestic Product (NDP) (Kalyani, Hod and Reader 2016). Literature discloses that the Indian economy is dominated by informal sector and constitutes about 90% of the workforce (OECD 2017). Other similar research reveals that nearly half of India’s Gross Domestic Product is attributed to informal sector (Mishra & Shankar 2013, Gutoo n.d). In India, only 53 million individuals paid personal income tax in 2014/15 out of a population of around 946 428 571 people, and this shows that millions and millions in tax revenue is lost annually (OECD 2017). In Uzbekistan, informal sector accounted for 48.2% of GDP and 76% of the total employment (Tadjibaeva & Komilova (2009).

Bhorat, Naidoo and Ewinyu (2017) postulate that informal sector contributes between 50 to 80 percent of GDP, 60 to 80 percent of employment and about 90 percent of new jobs. They also presented country specific statistics as follows: C’ote d’voire, Lesotho, Liberia, Madagascar, Mali, Mauritius, South Africa, Tanzania, Uganda, Zambia and Zimbabwe, 69.7%, 49.1%, 49.7%, 71.4%, 11.9%, 17.8%, 51.7%, 59.8%, 64.6% and 39.7% respectively.

2. Statement of the problem

Following the prophesised contributions of informal sector in both developing and developed countries economy, literature is rich with practical policy strategies aimed at combating the ballooning sector (Munjeyi *et al* 2017, Little Hoover Commission 2015). Researcher are continuously proposing even more but surprising few of these recommendations were implemented (Little Hoover Commission 2015). However, these numerous recommendations in the whole universe do not yet testify to the creation of a taxpaying informal sector or a perfect tax system to address this phenomenon. This remains as one of the most pressing in the informal sector fraternity world over. The question that remains unanswered is that: Is it worth research further or rather research has failed to provide solution?

3. Overview of Informal Sector; Causes, Activities, Problems, Impacts

Many scholars have tried to characterise the informal sector by using various descriptions. William and Round (2007: 31) describe the informal sector as "non-structured, unpaid, non-official, non-organised, abnormal, hidden, an illegal, black, submerged, non-visible, shadow, a-typical or irregular, and Cash-on-Hand". Brou and Collins (2001:1541) define informal as "comprising all activities and transactions that would normally be taxed but that are not reported." This definition of the informal sector encompasses all activities which are not registered and regulated by the formal economic framework of a specific country (Losby, John, Kingslow, Elaine & Matin: 2002; Marcias: 2008).

Informal sectors include the parallel market in currency trading, commercial sex workers, illegal backyard canteens and illegal gold panning. Also, falling within this sector is illegal street salons or barber shops, vendors (air time and other wares), second-hand clothes vendors (commonly referred to as *"pedgars"/ "Bhero"* or '*Kotamai'* Market in vernacular), landlords, emerging pirates and indigenized farmers among others. Under-the –table payments by employers, barter system transactions, rent collected but unrecorded and underreported tips received at hotels are also types of business activities or transactions in the informal sector (Collins & Brou : 2001).

The most important contributory factors to informality are summarized as excessive taxes , inflation, poor enforcement of tax laws, low salaries, excessive government regulations to formalize the informal sector and the high unemployment rate among others (Marcias: 2008; John: 2010; Zhou & Madhikeni: 2013). Politicians are capitalizing on this sector of the economy by avoiding the imposition of tax on this sector and relaxing certain important laws, so as to ensure that they are voted into power (Bairagya: 2011: 2). Such actions cause informality to become more appealing and formalization less attractive (Bairagya: 2011, Karki & Xheneti 2016).

Mpapale (2014) asserts that the informal sector came into existence due to the following attributes: ease of entry, low level of education, scarcity of formal employment and the inability of people to raise sufficient initial capital to establish formal business ventures. Some studies also find that the impact of taxes on informality varies with the quality of governance, as proxied by corruption (Litina & Palivos 2015). Palil (2011) finds that at low levels of corruption, higher taxes tend to be associated with lower rates of informality, as proxied by the share of self-employment. Russel (2010) summarises the main drivers that influence a firm to operate informally and these include: the overall tax and social security contribution burden; the complexity of the tax system (Dalton & Gangi 2007); the cost of formalizing a business; the prevailing social welfare environment; the effectiveness of the tax administration; and attitudes to government authority and government spending.

World Bank (2011) acknowledges the importance of informal sector in both developing and developed countries in that it absorbs dozens of the unemployed workers and is a sometimes referred to as social safety for the poor. Munjeyi, Mutasa, Maponga and Muchuchuti (2017) stress that informality is a "talent show" and can gradually graduate into formality (World Bank 2011). Klyani *et al* (2016) maintain that informal sector is regarded as a key resource in most developing economies as it contributes immensely to reduction of unemployment challenges (Ibid) and it is presumed that about one third of developing countries comes from the informal sector (Klyani *et al* 2016). The informal sector plays a significant role in the economy in terms of employment opportunities and poverty alleviation. This sector generates income-earning opportunities for a large number of people. In India, a large section of the total workforce is still in the informal sector, which contributes a sizeable portion of the country's net domestic product (Klyani 2016). Statistics available about the informal sector in developing countries suggest that 80% to 90% of total employment is in this sector (Benjamin: n.d) and the informal sector increased by 20% from less than 10% by 1986/7, 27% by 1991 and an estimated 40% by 2004 (Tibaijuka: 2005)

However, these perceived benefits are supressed by tax revenues forgone (World Bank 2011, Russel 2010), lower productivity and lack of social security coverage. There are various reasons why governments may be concerned about large informal sectors. These include potentially negative consequences for competitiveness and growth, incomplete coverage of formal social programs, undermining social cohesion and law and order, and fiscal losses due to undeclared economic activity. For most governments, these concerns outweigh any advantages that the informal sector offers as a source of job creation and as a safety net for the poor.

Many researchers reveal that a high level of informal sector presences the following challenges: undermine the rule of law and governance (this may weaken the respect citizens have on their nations); leads to a loss of regulatory control over work conditions and service provision in the economy ; reduces state's ability to achieve social cohesion and law and order; fiscal losses due to clandestine economic activity; results in an unfair competitive advantage for informal over formal entrepreneurs; cost developing countries a significant percentage in annual GDP growth(result in a low-productivity equilibrium); results in de-regulatory cultures enticing law-abiding entrepreneurs into a 'race to the bottom' away from regulatory compliance and results in 'hyper-casualization' as more legitimate entrepreneurs are forced into the informal economy to compete(see World bank 2011, Williams 2010, Andrews, Sanchez and Johansson 2011, OECD 2017, Munjeyi *et al* 2017). Also informal firms may fail to comply with intellectual property rights, undermining incentives for formal sector firms to engage in innovation, develop new products, and invest in branded products, a larger informal sector means that higher tax burden to few formal sector players, stifle economic growth. This can limit a society's ability to address collective needs and undermine social norms, increasing the cost of law enforcement. The resulting loss of social capital/trust may also reduce the ease and certainty of doing business and adversely affect growth.

4. APPROCHES TO CURB IN FORMAL SECTOR

It is widely accepted that local resource mobilisation can serve as an important source of revenue for financing basic local initiatives, and engaging citizens with local governments. At present a large number of citizens are irresponsible and governments are failing to achieve national goal due to budgets deficit (Van den Boogaard and Prichard 2016). It is important to pool in informal sector to the tax net.

The proliferation of the informal sector embraces the potential for employment, greater local manufacturing, quality service delivery and ultimately more tax revenue collection leading to increased national tax revenue (Tanzania Revenue Authority (TRA): 2011). Thus taxing the ballooning informal sector presents the opportunity of revenue generation to fill the gap in the tax revenue and reduce tax gap. This will also increase the visibility of the informal sector in national programmes and in the economy (Africa Tax Spotlight: 2012; CAGE: 2013). Taxing the informal sector will improve revenue collection (Palil 2010), growth and governance, enhance productivity, the provision of infrastructure, public education and health care, tax morale, redistribution of income and wealth and (political) representation as well as provide an interface between the government and the stakeholders (Aranjo-Bonjean et al: 2003; Gobham: 2005; Myles: 2007; Africa Tax Spotlight: 2012; Dalu et al: 2013, Joshi, Prichard & Heady 2012).

Pfister (2009: 4) summarises the use of tax collected by the government as to finance their social and physical infrastructure needs; provide a stable and predictable fiscal environment to promote economic growth and investment; promote good governance and accountability by strengthening the relationship between government and citizens; and ensure that the costs and benefits of development are fairly shared. Bairagya (2011) argues that the government should tax the informal sector to increase the tax yield of government, hence improved service delivery and governance. In his remarks, Bairagya (2011) asserts that the over-protection of this sector as a special category and in particular, the so-called inability to pay taxes and conform to other regulations, has an adverse effect on the economy at large. In this regard, policy makers must view the informal sector as the hub of development that will stimulate economic development and improve the gross domestic product of a country.

Although there are challenges in taxing this informal sector, ranging from underreporting of taxable income, the lack of authority and mechanisms to monitor the activities of the informal sector, the informal sector not being registered and taxation ethics, which lead to the budget deficit (Dalu et al: 2014; Alabede, Zaimoh & Kamil 2010; Zimra: 2010) the exercise has to be carried out. The fact that informal sector players are unregistered and unrecognized and are engaged in illicit activities makes it difficult to tax them (Martinez-Vazquez, Parupong & Timofeer: 2009). This will increase the government tax revenue and achieve broader governance goals (Joshi & Heady: 2012).

Joshi *et al* (2012) propose policy strategies to combat informal sector and these are taxing directly through trade taxes, expanding the reach of major formal sector taxes, and developing specialised presumptive tax regimes. Williams (n.d) hypothetically proposes policies to curb the informal economy and these include: do nothing; de-regulate formal sector; eradicate informal sector, or formalise informal sector. He further on provides a great array of strategies to tackle informal sector and these include direct controls (incentivise) and indirect controls (deterrents: Administrative penalties & tax surcharges and sanctions as well as advertising penalties) - commonly referred to as "carrots" and "stick" measures (Zhu 2007, World Bank 2011). Researchers point out that the use of Repressive State Apparatus (RSA) adversely impact on informal sector culture and growth (Wold Bank 2011, Chuenjit (2014, Munjeyi *et al* 2017). RSA stifles growth potentials of the informal sector.

Other measures include recognise the existence of informal sector in tax system and policy issues (this entails the provision of advice and support on how to formalise, combating corruption practices; formalisation, open help-lines on tax compliance and education; income tax relief to informal sector; simplifying business registration procedures (Tadjibaeva & Komilova 2009); tax education) and changing the informal institutions (through procedural fairness and justice, redistributive justice wider economic and social development) among others (Williams n.d). Such policies have been widely adopted in European community and part of Africa (World Bank 2011, OECD 2017).

In addition to these policies to reduce informality World Bank (2011) recommends that community sensitisation and consciousness campaigns as regards the consequences of clandestine activities re-orient those in the informal sector to comply with tax laws. International Tax Compliance Compact (2013) recommends that that in order to harness tax revenue from informal sector tax authorities should: improving management and steering of reform processes; improving taxpayer relations (through implement effective anti-corruption measures, strengthen tax appeals system, reduce compliance costs, improve access to information, invest in taxpayer education and community engagement); strengthening audit functions; strengthening of human resources and capacities and further development of IT-support.

Tadjibaeva & Komilova (2009) advocate that informal sector may be brought into tax net through one of the following measures: financial inclusion (i.e. access to formal credit, banking facilities, promote digital cashless economy and impart financial knowledge); introduce distance control (cameral inspections or distance audits)land and tax reforms (offers incentives for growth); increase connectivity; improve quality of human capital (education and skill levels will provide ground for formalisation of the economy) and better access to markets and price discovery. They also suggested that digitalisation of financial transactions, promotion of buying and selling digitally with zero transaction fees, demonetisation in a gradual manner and incentivising digital transaction restrict the proliferation of informal sector activities in any economy.

4.1. Practical Lessons from Euro-Centric and other non-African Countries

Existing literature reveals that developed countries devised policy that encourages graduation of firms from the informal sector into formal sector (Gurtoo n.d). Reviewed literature indicates that a number of developed countries have implemented tax reforms aimed at reducing tax burden to formal sector by broadening their tax bases(World Bank 2011). Slovakia and Estonia introduced flat rate personal income tax (Ibid). From the literature review conducted, Belgium, Netherlands and France have introduced special payroll tax reductions for low-wage earners (World Bank 2011), the move was to disincentive informal sector activities (World Bank 2011). Czech Republic, Latvia and Lithuania have reduced their corporate income taxes (World Bank 2011). It is worth to note that various tax concessions have been introduced for examples Austria, Canada, France, Germany, Greece, Ireland, the Netherlands, Spain and Turkey set up a ceiling on social security contributions (a regressive personal tax system). Several European governments, such as France, Belgium, the Netherlands, have introduced tax concessions in sectors where the incidence of undeclared work is high (Little Hoover Commission 2015).

Another strategy to tackle informal sector is to engage informal sector in policy matters and set a maximum taxable income, this will lead to an increase registration (lessons from Bulgaria Republic)(World Bank 2011). With the advent of electronic filling informal sector complied especially in the developed countries (Dalton & Gangi 2007). Stack of literature demonstrates that the existing tax system in most of developing nations is marred with corruption and complications (Devos & Zackrisson 2015). Thus simplifications of tax administration through e-filling and lower compliance costs encourage a renewal of informal sector's mind-set and ultimately comply. Approaches to informal sector tax show that *naming and shaming* economic offenders may reduce the occurrences of evasion (Lesson from Spain) (World Bank 2011, Devos & Zackrisson 2015). Some attempts to formalise informal sector was through offering some incentive, Denmark for instance reimbursed 40% of their (informal sector) costs upon informal sector registration (Gurtoo n.d).

Literature show that developed countries adopted stringent measures in harnessing informal sector such as improving the flexibility of occupation security and reduction in minimum salary thresholds the net effects was a reduction in hiring costs and thus attracting informal sector players into the mainstream (OECD 2017). Japan made it a law that each employee whether in formal or formal sector has a right to unemployment benefits claim (World Bank 2011), thus when the employer(informal sector operator) has not contributed to social security will risk detection and severe penalties, it sound impracticable. Such a move was to supress informality activities. Hungary offered numerous incentives to encourage formalisation such as START; START PLUSZ and START EXTRA to support somewhat formal set up of deprived persons, however its sustainability is still questionable. Evidence from reviewed literature suggests that strong cooperation can help to condemn informal sector activities for example Belgium, Switzerland collective agreements have been extended to employers and trade unions in various sector, the aim being to discourage informal sector activities and inform the citizens on the quality products and services offered by registered entities (World Bank 2011).

Confirmation from literature shows that creating conducive business environment is central for the promotion of formalisation as well as provision of information to "graduates" from the informal sector can enhance formalisation. This will result in reduction in administrative, time and financial burdens on firms, (lessons from Italy, Ukraine and some European countries (World Bank 2011). Reviewed literature showed that Europe and also Canada embarked on the simplification of registration process and reduction of capital requirement encouraged existing and potential informal sector players to register (World Bank 2011, Little Hoover Commission 2015).

Provision of public utilities, health facilities and public information as well as education contribute to a reduction of informal activities to an extent where informal sector activities becomes a deviant (world Bank 2011) and irregular proposition (uncalled for) (Devos & Zackrisson 2015, Little Hoover Commission 2015). There is evidence in the literature that education creates a compliance culture (Russel 2010) as it denounces certain practices, similar strategies have been adopted by Hungary, United Kingdom and Sweden. Tadjibaeva and Komilova (2009) conclude that the use of tax exemptions can encourage business in the informal sector to shift to formal sector.

4.2. Lessons from an African-Centric Approaches

Approaches or policies measures adopted by some African countries include: presumptive tax system (ZIMCODD, 2014; TRA, 2010); simplified tax model for the informal sector (Heggstad *et al,* 2011), corporation tax for the informal sector (Mpapale, 2014), turnover tax system (Mpapale, 2014), Value Added Tax, Block Management System (TRA, 2010), Unified revenue tax for the informal sector (Heggstad *et al,* 2011), Tax stamp system (Amoah, 2012), Identified groupings (Ofori, 2009) and PAYE (Mpapale, 2014). Extant literature reveals that policies to combat informal sector have been anchored on between preventative measures and sanctions (World Bank 2011). The practical application of tax policy to address informal sector focuses on eliminating incentives for evading taxes (through reducing social security contributions, and other taxes for firms) and imposition of presumptive tax system: Tanzania implemented Block Management System; Benin has implemented a "Taxe Professionnelle Unique" (TPU); Kenya adopted PAYE, Cameroon adopted Unified Tax System; Zimbabwe use presumptive tax system; Ghana introduce Tax Discs for public vehicles; South Africa use Turnover Tax; Mozambique use Simplified tax model and to name but a few.

Presumptive taxation is the indirect means of ascertaining an individual's tax liability and it differs from general rules based on the taxpayer's account records (Deloitte: 2011, Tax Bulletin Zimbabwe: 2014, Masarirambi: 2014) and is usually used when the desired income cannot be reasonably determined (World Bank 2011, Zivanai, Manyani, Hove, Chiriseri, & Mudzura: 2014). The term presumptive implies that there is a legal assumption that the taxpayer's income is no less than the amount resulting from application of indirect methods (Masarirambi: 2014; Samuel: 2011). The objective of imposing presumptive tax is to simplify administration process, collect some revenue from the hard-to-tax sector, improves tax assessment, reduces tax evasion and avoidance and educating the informal sector players on tax issues with the aim of integrating them into a formal tax system (Samuel :2011).

Fjedstad and Haggstad (2012) show that Mozambique Tax Authority is negotiating with the ministry of education so that tax education will be a core subjects from primary to the institution of higher and tertiary education. Similar strides have been adopted by Tanzania Revenue Authority and on a monthly basis the revenue officers will visit informal sector trading areas and educate them on the goodness of paying tax (Ibid). Evidence from literature shows that Mozambique, Tanzania and Zambia managed to collect significant tax revenue from this(informal sector) vibrant sector through simplification of taxing procedures (including mobile collection points); education/ awareness campaign and collaboration with informal sector players (Fjedstad & Haggstad 2012).

In similar studies, Russel (2010) proposes a number of measures aimed at supressing informal sector activities and include: community engagement(raise community appreciation of the role: this must be substantiated by essential services and infrastructure) of tax to reduce community tolerance (build community attitude to informal sector) for informal sector, offer targeted support to encourage voluntary compliance(educate, engage the community shaming and naming informal sector activities, provide enquiry service-hotlines, free seminars among others); encourage self-regulation (through online self-help tools)and demonstrate a visible(develop a registrations risk engine of matching data and trustworthy, elimination of cash in the economy (Munjeyi *et* al *2017)* and implementation capability

Research study indicates that both deterrence and incentives measures are widely adopted in many countries to elicit a psychological and social commitment to legitimate behaviour and self-regulation. Despite the many strategies devised and adopted to tax the informal sector in developing, the outcomes were not impressive at all (Fjedstad & Haggstad 2012, Sikwela *et al* 2016, FICCI 2015, Dube 2014, Little Hoover Commission 2015).

5. Methodology

This research was predominantly desk research and library research, where several journals, articles, government minutes, debates and thesis were perused. A comparison of international approaches and regional occur in a number of ways.

6. Findings, conclusion and recommendations

This paper established that:

i. A lot of research work on informal sector have been conducted
ii. There is indeed great array of recommendations made in the literature that informs policy.

iii. Some of the recommendations have been overtaken by events and need a re-examination.
iv. Education looks to be key element that enhances compliance and transforms behaviour and attitude towards tax.
v. Claims of success stories on the practical implementation of informal sector tax strategies has been evidenced in developed countries, with some uncorroborated and dismissible claims in Tanzania (developing country in Africa) though its success was later on marred with political interference and perceived corruption
vi. It is true that there are many reforms initiated by government of both developing and developed countries aimed at bringing informal sector into tax net.
vii. Informal sector taxation is a world phenomenon, which gives policymakers and researchers hard times.
viii. Effectiveness towards creating formal economy lies in implementation and political will and cooperation among others.
ix. There is no one convincing informal sector tax framework that fix-all in the entire universe this is due to cultural differences.

This paper concludes that there are practical solutions or policy measures that can be adopted by governments in developing countries and Africa in particular to harness informal sector.

This paper recommends that:

i. Researchers world over should not research for the sake of research but for a change, they must pride in seeing the workability of their recommendations.
ii. Researchers must take their evidence-based-recommendations to those charged with revenue collections (Tax Authorities or Revenue Services).
iii. Wold Bank must fund researches aimed at evaluating strategies adopted by governments when tackling informal sector.
iv. Keeping in mind the revenue potential in the thriving informal in many countries world over, it is necessary to design a framework to harness informal sector, such a framework must focus on finding lasting solution to this challenge- by creating a responsible informal sector.
v. Given volumes of published papers on the taxation of informal sector, researchers must consolidate all these recommendations and come up with a framework/model that incorporates key policy matters aimed at creating responsible informal sector.
vi. Politicians, Churches, Education Institutions, NGOs, Village Heads, Chiefs and all citizens **MUST BE UP IN ARMS** in building taxpaying culture.

The Holy Bible (2006) also asserts that: *"5Therefore it is necessary to be in subjection, not only because of wrath, but also for conscience' sake. 6 For because of this you also pay taxes, for rulers are servants of God, devoting themselves to this very thing.7 Render to all what is due them: tax to whom tax is due; custom to whom custom; fear to whom fear; honour to whom honour." (*Romans 13:5-7)

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