



Taxing the Informal Economy: Challenges, Possibilities and Remaining Questions

There is growing interest in taxing the informal economy in developing countries. This paper examines the case for giving it greater priority, and suggests that policymakers and researchers should focus less on technical design issues, and more on strategies to encourage compliance, and to increase political and institutional incentives for reform.

Why tax the informal sector?

There are good reasons for the relative neglect of informal sector taxation: it offers limited potential for short-term increases in revenue; collection costs can be very high; and there are concerns that targeting small and micro businesses could have negative social and economic impacts. However, there could be indirect benefits including building a culture of tax compliance among SMEs; reducing a sense of unfairness and hence encouraging tax compliance by formal firms; and increasing economic growth of small firms through the benefits associated with formalisation, including better access to credit, markets and services. There could also potentially be broader governance gains if taxation encouraged effective collective action among informal sector operators, and more institutionalised channels for state-society bargaining. While research evidence for many of these benefits is still very preliminary, there is at the very least a good

case for improving existing practices for taxing the informal sector which are often both ineffective and prone to abuse.

Policy options

There is a good deal of research into different policy options for taxing the informal sector. They include indirect taxation through taxes imposed higher up the value chain on goods and services that informal operators buy and sell; expanding the reach of existing formal sector taxes such as income tax and VAT; and widespread imposition of presumptive taxes on small firms to get over high compliance and administrative costs. All of these have drawbacks in terms of revenue potential and /or broader development outcomes: indirect taxation has limited impact on long-term compliance, does not offer potential growth benefits of formalisation, and is unlikely to spur governance gains; direct taxation has high administrative and compliance costs for very small firms; and presumptive taxes can ➤

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impose disproportionately heavy burdens on small firms if poorly designed. Moreover most existing research is narrowly focused on the costs and benefits of compliance; to understand why progress in practice has been slow, and outcomes mixed, there is a need for more focus on a range of factors influencing the incentives and capacity of small firms to formalise and become tax compliant, and on the incentives of political leaders and tax administrators to pursue reform.

Incentives of small firms for tax compliance

Incentives for tax compliance are closely linked to incentives for formalisation. Research suggests that tax evasion is not a primary reason for remaining informal, and that the wider costs of regulation including the time and resources needed to register, get licences and follow labour laws are important disincentives. Moreover, reducing the costs of tax compliance and regulation will not alone encourage formalisation. More pro-active strategies are needed to enhance the perceived benefits including gaining access to credit, training, dispute resolution and other services; securing property rights; and reducing harassment. Policies are also needed to increase the capacity of small firms to gain access to such benefits. This could involve programmes to increase their skills but also measures to strengthen their capacity for collective action by increasing access to information about available services; addressing the issue of low government credibility; and improving co-ordination of informal sector actors, as well as their capacity to organise and bargain with government.

Strengthening political and administrative commitment to reform

Political leaders often have weak incentives to tax the informal economy: it raises little revenue, makes them unpopular, and formalisation may deprive them of influence over voters. However they have potential interests in expanding the tax base and encouraging economic growth and job creation. While research evidence is lacking, reform is likely to be more politically feasible

if there is greater compliance and support for formalisation from informal sector firms, and institutional channels are created for engaging with them. Formal sector firms may also constitute a source of support for reform as informal sector firms are often competitors. More research is needed into ways of strengthening incentives of tax administrators to implement reform, including reorganisation of rewards, creation of specialist units to deal with the informal sector, and greater use of technology to reduce opportunities for harassment and collusion, and make collection less arduous and costly.

Country cases

Examples from recent experience point to ways in which administrative and institutional reform can increase compliance by taxpayers and incentives for politicians and officials. They include specialist units for taxing the informal sector in Tanzania; delegating responsibility for tax collection to associations within the informal sector in Ghana; establishing clear links between tax payments and provision of services in Sierra Leone and Guinea; and encouraging compliance by offering a range of taxpayer services in the Gambia. Experience in Ethiopia and Cameroon illustrates the benefits and risks of delegating greater control of informal sector taxation to subnational governments.

Implications for policymakers

In seeking more effective ways to tax the informal sector, future research and policy should focus less on reducing costs of compliance and more on strengthening incentives and collective action among different stakeholders, including:

- positive incentives for small firms to comply with taxation and pursue formalisation;
- making reform more politically feasible and attractive to political leaders;
- strategic institutional reform to strengthen incentives for effective implementation;
- initiatives by states and governments to promote collective action by informal sector firms and create institutionalised channels for engaging with them.
- increasing credibility of government and trust among SMEs and state authorities

Further reading

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Credits

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