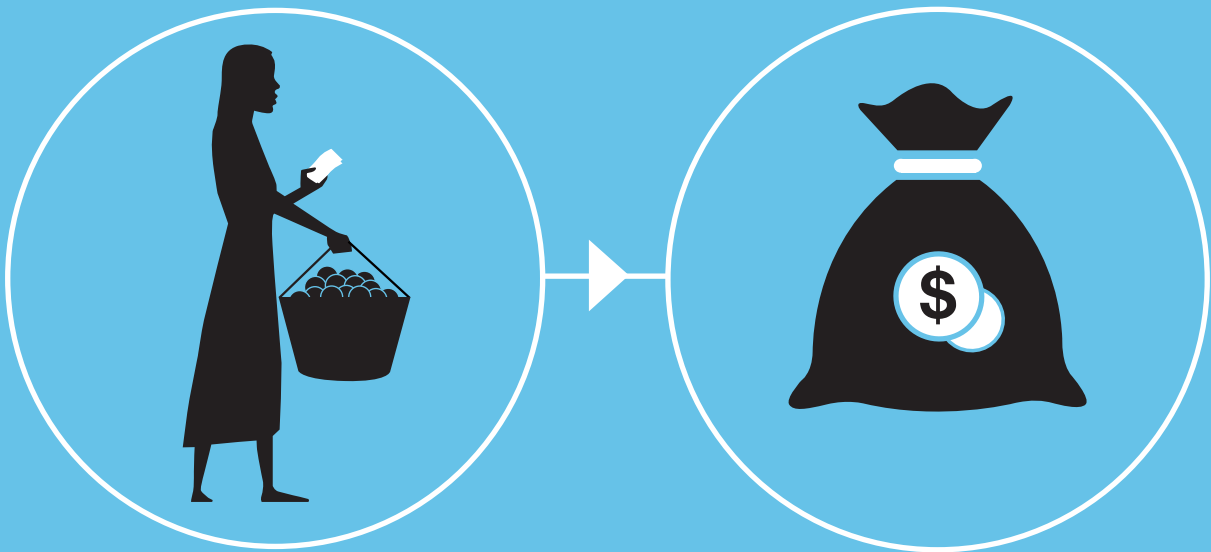


Taxation of the informal sector

Progressive Taxation Briefing



What is taxation of the informal sector?

► What is the informal sector?

The informal sector comprises workers and businesses which are not registered by the state, and which do not necessarily comply with legal obligations. Informal businesses are often not visible to government and the work is typically poorly paid and precarious. In most developing countries, a majority of people work in the informal sector. Many smallholder farmers who live just above subsistence levels are also informal traders, selling surplus produce, and other informal workers run small businesses such as

market stalls, hairdressers or minibuses. Waged labour such as construction jobs and services such as house-help are often informal.

While most informal businesses are small, and workers in the informal sector poor, better-off urban professionals (such as doctors, lawyers and architects) and owners of larger businesses also often operate informally. For example, less than a third of Uganda's top 60 lawyers paid personal income tax between 2011 and 2014.¹ Thus, the informal sector partly consists of thriving enterprises intentionally dodging taxes.

However, many more informal workers and businesses are from the most marginalised groups, ending up in the informal economy in the absence of viable alternatives, rather than as a deliberate choice.² For these people, tax evasion is not

a primary reason for remaining informal – since many of the businesses would in any case fall below the threshold for income tax. It is much more about the time and resources needed to register, get licences and follow labour laws.³

In most countries for which data is available, there are more women in informal employment in non-agricultural activities than men.⁴ In sub-Saharan Africa, 74% of women's (non-agricultural) employment is informal, compared with 61% for men.⁵ In South Asia, “informality also has a gender bias. Women are somewhat more likely to be engaged in the informal economy, and significantly more likely than men to be working as informal workers in the formal sector.”⁶

How is the informal sector taxed?

Clearly, informal workers and businesses do not pay income tax in the same way as formal ones – and most would in any case fall below the thresholds their countries set for paying personal income tax. Informal businesses also do not pay VAT to the government because they are unregistered. But they do pay VAT on inputs they purchase, without any chance of a refund which are available only to VAT-registered companies.

Nevertheless, informal workers and businesses are often taxed. This is done through numerous types of fees, charges and licensing costs, which may be levied locally, nationally or both. Often these taxes and fees fail to take account of one another, and overlap, resulting in the payer being taxed multiple times. They tend to be based on very general estimates and are commonly flat-rated, which usually produces regressive results.

A common type of local taxation of the informal sector that affects poor people is the market taxes and fees levied on market stallholders. Many examples of taxation of the informal sector are ‘presumptive’ taxes. These are *estimates* of tax payable, based on simple indicators of business performance (such as turnover) or on visible characteristics such as the number of seats in a bus, and often paid as lump-sums.⁷

The ‘other’ informal sector

Thriving businesses making a good income, rather than people on very low incomes, should be taxed by increasing incentives to formalise and charging penalties for failure to do so. This is really a matter of ensuring formalisation, rather than taxing the informal sector. It should be a priority for any government concerned with progressive taxation as well as labour standards and workers’ rights.

The Fiscal Affairs Department of the IMF says, “micro traders may be informal, but are also likely to have income and sales well below any reasonable tax threshold - much of the most egregious evasion is by qualified professionals.”⁸

► How does taxation of the informal sector affect women and men differently?⁹

Because a higher proportion of women than men work in the informal sector, taxes on the informal sector fall on women more than men. For example, taxes on market traders affect women disproportionately in places where the majority of these traders are women, such as sub-Saharan Africa. In Ghana in 2011, 80% of women and only 50% of men worked in the informal sector. A 2011 study found that 95% of informal women traders paid some kind of tax, whether national presumptive tax or local taxes including market fees. Half of these women paid both national and local taxes, and a higher proportion of taxes was paid by those earning relatively less.¹⁰

How taxation of the informal sector can affect women's incomes

In Nakonde, Zambia, ActionAid conducted a focus group discussion with market traders, 90% of whom are women. There is no running water in the market. They have to pay US\$0.2 to use the toilet facility (prices for men are the same but men need to make less use of it), and US\$0.1 for a ten-litre container of water, as well as market fees. This often means they go home for water and the toilet, which reduces their incomes as they have to close their stalls.¹¹

How can taxation of the informal sector be made more progressive?

► Why tax the informal sector?

The key question is whether to try to tax informal sector at all. One of the main arguments against it is that it is usually **not possible to raise a lot of revenue in the informal sector** as taxable incomes are usually low or non-existent.¹² Higher-earning workers and businesses should not be working in the formal sector at all but should instead be formalised, registering for personal and corporate income tax. Because so many informal workers are poor and many are women, taxation of the informal sector risks being **highly income and gender regressive**.¹³ These types of taxes also tend to fall more heavily on lower-income informal firms.¹⁴ **Collection costs tend to be very high**, as informal sector taxation means collecting small amounts of tax from a very large number of people. There are often few records of accounts and many people effectively work invisibly

(e.g. from home). Finally, the sheer number of fees and lack of clarity about who collects them creates frustration and **opportunities for corruption**.

There are, however, reasons why taxing the informal sector might be beneficial. There *is* a good reason to broaden the tax base, as taxation of more people creates **accountability of government to more of its people**, particularly the poor.¹⁵ There might also be further governance gains if taxation encourages collective action among informal sector operators.¹⁶ Taxing the informal sector may not raise much revenue, but in low-income areas of low-income countries it is not possible to raise much local revenue from anywhere: market taxes are often the most **important source of local government revenue**.¹⁷ The emergence of a **taxpaying culture** may also be a positive outcome, building a culture of tax compliance among small businesses and a reduced sense of unfairness that might also increase compliance amongst formal firms.

► Making informal sector taxation more progressive

When governments decide to tax the informal sector, it is crucial to ensure that taxes and other levies are designed and applied in a way that does not perpetuate economic and gender inequalities. From an income perspective, there are two ways of increasing progressivity: having a threshold below which taxation does not occur and having a progressive scale of rates. As the examples below show, it is possible to apply this to presumptive taxation, with the threshold being an estimate. The estimate might be based on estimated business size or might be a proxy such as the number of seats in a bus.

From a gender perspective, there needs to be a local gender analysis as a basis for the tax policy. This should comprise an estimate of the gender ownership and worker composition of different kinds of businesses in the local area, and application of this analysis to decide what kinds of taxes to levy.

From both perspectives, the estimates must be selected carefully. For example, in Ghana in 2011 one assessment was based on the kind of building housing the business. This could mean that a garment worker in a shack with

twenty customers a week (and therefore a steady income) paid less than a worker in a concrete structure that had only two customers a week.¹⁸ No proxy will ever be perfect, but the more the particular features of a business are taken into account, the better it is likely to be.

Greater transparency would in many contexts be a path to accountability. Prominently displaying the rates that, say, market stall operators or mini-bus owners are expected to pay can guard against arbitrary charges and multiple taxation. Standardized receipts for taxes and fees paid can be used to prove payments have been made and to hold officials accountable for the productive use of the revenue raised.

Examples of good and bad uses of informal sector taxation

► Multiple taxation of informal traders in Ghana¹⁹

In 2017, ActionAid Ghana carried out a study in Ga West Municipal Authority (GWMA), a rural area of Ghana close to Accra. Most women there were engaged in informal business activities such as market trading, hairdressing, soap-making or dressmaking.

The women paid a national 'tax stamp' (displayed in shops by those who have paid), a flat fee aimed at informal sector businesses, which were grouped according to business size and type. The tax stamp raised 1% of national-level revenues collected from the area. The local taxes included licence fees and market tolls, which were levied on informal as well as formal businesses. The threshold for paying personal income tax in Ghana was c2,592 (US\$541). Some of the informal traders made more than this and some less; for many, it was impossible to say as they did not keep records. Nevertheless, they all had to pay the tax stamp and local market tolls.

A focus group in the GWMA area discussed issues of taxation of the informal sector. The group had 17

participants, of which 13 were women and 4 men. Their observations included:

- They questioned why the revenue authority and the Municipal Assembly do not determine their incomes in a participatory way before imposing taxes on their businesses, and they said that some businesses that made little profit were taxed heavily. Such objections to the perceived arbitrary nature of presumptive taxes are common. (They are supposed to register for the tax stamp, which could mean less arbitrary assessment, but they were unaware of this.)
- They did not feel they were seeing much in terms of development and service delivery in return for their taxes.
- They have no advance notice of the tax collectors' visits, meaning they sometimes have to borrow to pay.

In a wider survey (where the large majority of the participants were also women), most felt it was right to pay tax but that they had to pay too much, again because they felt they did not see development or service improvement.

► Zambia – a range of presumptive and local taxes

In 2004, Zambia introduced a national turnover tax of 3% on firms with an annual turnover of less than ZK800,00 (c. US\$80,000).²⁰ In addition, a schedule of graduated monthly advance income tax was charged, ranging from ZK225 (on earnings between ZK4200 and ZK8300) to ZK1025 (on earnings over ZK 20,800).

Zambia also had a national annual presumptive minibus tax based on seating:²¹

Type of vehicle (seating capacity)	Amount of tax per vehicle per annum effective 1st June 2018
64 and above	ZK 10,800
50-63	ZK 9,000
36-49	ZK 7,200
22-35	ZK 5,400
18-21	ZK 3,600
12-17	ZK 1,800
Below 12 (including taxis)	ZK 900

These national taxes led to an increase in revenue collection attributed to the informal sector: 1.8% of total income tax in 2009 compared to 0.3% in 2003. The vast majority of these revenues came from the advance income tax (71%) and the turnover tax (27%). However, overall success was limited, as administrative costs were very high due to labour costs in collection and low awareness of the taxes.

There were also local-level taxes on the informal sector. ActionAid carried out a study in Sesheke and Nakonde, which are Zambian border towns.²² Local taxes in Sesheke on the informal sector included a wide range of levies and fees; annual levies on retail businesses, automotive parts shops, and hotels and lodges, in addition to the national presumptive taxes mentioned above. In 2017, a little over 10% of Sesheke's local revenue comprised levies. The 100 or so traders in Nakonde market pay a range of levies: ZK2 a day for an inside stall, ZK1 a day for an outside pitch (the majority).

► Tanzania – a progressive turnover tax

Tanzania also has a turnover tax. Unlike the Zambian one, it is progressive, and its upper threshold is much lower than in Zambia.

► Citizens' views on informal taxation in Nigeria²³

ActionAid's local partner in Ondo, Nigeria, the Justice Development and Peace Centre (JDPC) says that problems with taxation of informal market traders include a lack of tax statistics and transparency, a poor tax administration and a multiplicity of tax payments. In turn, the traders note the lack of benefits or public services that should result from the taxes they pay. Traders also note sudden and steep tax increases and flat tax rates that ended up being disproportionate for some payers. Complaints were also made about harassment of traders.

Traders in Nigeria have taken various types of action in protest against the informal taxes they have to pay. A trader in Kuje demanded to see her tax receipt; the amount written was one eighth of what she had paid. A local yam association went to government to complain about a new tax. In Akure there was a collective agreement to close down shops and refuse to pay when the tax collectors arrived.

Annual turnover	Tax payable when records are incomplete	Tax payable when records are complete
Less than Tsh 4m	NIL	NIL
Tsh 4m to Tsh 7,500,000	Tsh 150,000 (2.6%)	3% of the turnover in excess of Tsh 4m
Tsh 7,500,000 to Tsh11,500,000	Tsh 318,000 (3.3%)	Tsh 135,000 + 3.8% of the turnover in excess of Tsh 7.5m
Tsh 11.5m to Tsh 16m	Tsh 546,000 (4%)	Tsh 285,000 + 4.5% of the turnover in excess of Tsh11.5m
Tsh 16m to Tsh 20m (US\$8,767)	Tsh 862,500 (4.8%)	Tsh 487,000 + 5.3% of the turnover in excess of Tsh 6m

Recommendations

▶▶ Governments should:

- *Ensure that taxation of the informal sector distinguishes clearly between those who are earning too little to meet VAT or income tax thresholds and those 'hiding' in the informal economy to evade taxes. The latter should be brought into the formal economy and then pay income taxes and VAT.*
- *Ensure that informal sector taxes are fair and progressive by:*
 - *Carrying out impact assessments, with a focus on women and poor people, to ensure those groups are not disproportionately affected.*
 - *Applying presumptive taxes progressively, for example by levying proportionately higher charges on, say, larger businesses, or buses with more seats, choosing proxies according to the impact assessments.*
 - *Having estimated thresholds, below which informal workers and businesses are not taxed.*
 - *Maintaining an overview of taxation of the informal sector and trying to reduce multiple taxation.*
- *Ensure that any reform of informal sector taxation aims to improve compliance. There are several dimensions to this, all of which need attention, capacity and investment:*
 - *Clear information and communication with people expected to pay, about the purpose and structure of informal taxes, and who will collect.*
 - *Budget transparency and actual spending of tax revenue on local development.*
 - *Increased awareness of the fact that if informal businesses register for VAT, they would be able to claim back the VAT they pay on inputs.*
- *Improve transparency, with public postings of rates payable and standardized receipts. Those paying tax should always demand and save receipts, which can be useful in holding local officials accountable for use of the revenue raised.*
- *Ensure that there is sufficient skilled revenue authority capacity to implement the taxation.*

This is one of a series of briefings on Progressive Taxation published by ActionAid International in October 2018. You can find them at www.actionaid.org/taxpower

▶ Endnotes

1. Kangrave, J. et al. 2018. *Taxing high net worth individuals: lessons from the Uganda Revenue Authority's experience*. ICTD Summary Brief 14.
2. ActionAid. 2015. *What a Way to Make a Living*.
3. Joshi, A. et al. 2013. *Taxing the informal economy: challenges, possibilities and remaining questions*. ICTD Research in Brief 3.
4. <http://www.oecd.org/gender/data/womenandinformality.htm>
5. http://www.ilo.org/addisababa/whats-new/WCMS_377286/lang--en/index.htm
6. <https://www.ilo.org/newdelhi/areasofwork/informal-economy/lang--en/index.htm>
7. Dube, G. and Casale, D. 2016. *The implementation of informal sector taxation: Evidence from selected African countries*. Journal of Tax Research, 14(3), pp. 601-623.
8. IMF Fiscal Affairs Department. 2011. *Revenue Mobilisation and Developing Countries*.
9. Joshi A. 2017. Gender and taxation in developing countries – what are the issues? ICTD Summary Brief 6.
10. Carroll, E. 2011. *Taxing Ghana's informal sector: the experience of women*. Christian Aid Occasional Paper Number 7.
11. ActionAid Zambia. Forthcoming. *Tax and local rights programme research report: Sesheke and Nakonde*.
12. Ibid.
13. Pimhidzai, O. and Fox, L. 2012. *Taking from the poor or local economic development: the dilemma of taxation of small informal enterprises in Uganda*. World Bank discussion paper.
14. Joshi et al. 2013. Op cit.
15. <http://www.ictd.ac/theme/tax-and-governance/>
16. ICTD Research in Brief – Issue 3, October 2013.
17. Joshi. 2017. Op cit.
18. Carroll. Op. cit.
19. ActionAid Ghana. Forthcoming. *Making taxes work for women – a case study of the GWMA region of Greater Accra*.
20. Dube and Casale. Op cit.
21. <https://www.zra.org.zm/commonHomePage.htm?viewName=TurnoverTax>
22. ActionAid Zambia. Forthcoming. *Tax and local rights programme report – Sesheke and Nakonde*.
23. Sempere, K. 2018. Tax unrest among market traders: the local side of ActionAid's international tax justice campaign in Nigeria, ICTD Working Paper 80.



ActionAid is a global movement of people working together to achieve greater human rights for all and defeat poverty. We believe people in poverty have the power within them to create change for themselves, their families and communities. ActionAid is a catalyst for that change.

<http://actionforglobaljustice.actionaid.org>

International Registration number: 27264198

Website: **www.actionaid.org**

Telephone: **+27 11 731 4500**

Fax: **+27 11 880 8082**

Email: **mailjhb@actionaid.org**

ActionAid International Secretariat,
Postnet Suite 248, Private Bag X31, Saxonwold 2132,
Johannesburg, South Africa.

October 2018