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Anuradha Joshi, Wilson Prichard & Christopher Heady

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# Taxing the Informal Economy: The Current State of Knowledge and Agendas for Future Research

ANURADHA JOSHI\*, WILSON PRICHARD\*\* & CHRISTOPHER HEADY†

\*Institute of Development Studies, University of Sussex, Brighton, UK, \*\*Department of Political Science, University of Toronto, Toronto, Canada, †School of Economics, University of Kent, Canterbury, UK

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**ABSTRACT** *This paper reviews the literature on taxation of the informal economy, taking stock of key debates and drawing attention to recent innovations. Conventionally, the debate on whether to tax has frequently focused on the limited revenue potential, high cost of collection, and potentially adverse impact on small firms. Recent arguments have increasingly emphasised the more indirect benefits of informal taxation in relation to economic growth, broader tax compliance, and governance. More research is needed, we argue, into the relevant costs and benefits for all, including quasi-voluntary compliance, political and administrative incentives for reform, and citizen-state bargaining over taxation.*

## 1. Introduction

The issue of taxation of the ‘informal economy’<sup>1</sup> in developing and transition countries has received increasing attention in recent years. This paper seeks to review existing debates, draw attention to new thinking about whether and how to strengthen informal sector taxation, and highlight recent innovations and efforts from a state-oriented perspective. The issue of whether taxation of the informal economy is justified has been a subject of longstanding controversy. In the view of critics, the potential revenue yields are low, administrative costs are high, tax incidence is likely to be regressive, and tax enforcement risks exposing vulnerable firms to harassment (Keen, 2012, pp. 19–21, 30–32). Yet, recent interest has been catalysed by growing attention to the potential benefits of informal sector taxation in terms of revenue, growth, and governance. With respect to revenue, the informal sector forms a large and, in many countries, growing share of GDP, and thus represents a potentially significant source of tax revenue for cash-strapped governments (Schneider, Buehn, & Montenegro, 2010; Schneider & Klinglmaier, 2004). Taxing the informal sector may also be essential to sustain ‘tax morale’ and tax compliance among larger firms (Alm, Martinez-Vazquez, & Schneider, 2003; Terkper, 2003; Torgler, 2003). With respect to growth, there is some evidence now that formalisation may accelerate growth for some informal sector firms, and may have broader benefits for existing formal sector firms (de Mel, McKenzie, & Woodruff, 2012; Fajnzylber, Maloney, & Montes Rojas, 2009a, 2009b; Loepnick, 2009; McCulloch, Schulze, & Voss, 2010; Perry et al., 2007). Finally, with respect to governance, new arguments have been made that the payment of taxes by firms in the informal

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*Correspondence Address:* Anuradha Joshi, Institute of Development Studies, Governance, at University of Sussex, Brighton, BN1 9RE, UK. Email: [a.joshi@ids.ac.uk](mailto:a.joshi@ids.ac.uk)

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economy may be a method of engaging firms with the state, and thus promoting legitimacy, good governance, and political accountability (Joshi & Aye, 2008; Prichard, 2009).

Against this background, this paper aims to review and assess research about the potential revenue, growth, and governance benefits of informal sector taxation, to consider alternative strategies for taxing informal sector firms, and to explore the technical and political economy barriers to relevant reform. Our ultimate interest is not primarily in advocating for or against expanded taxation of the informal economy, but in considering how these systems can be made more effective and equitable; that is, how efforts to tax informal sector operators can yield new benefits, rather than resulting in 'adverse incorporation' into formal systems (Hickey & du Toit, 2007; Meagher & Lindell, 2013). Our review of the literature suggests that the growth and governance benefits of improved informal sector taxation are potentially large under specific contexts, but are uncertain. By contrast, the costs to small producers are evident and potentially significant in the contexts of widespread corruption and abuse. This suggests the need for research into the conditions under which potential benefits are most likely to be realised.

Throughout, we seek to move beyond the technical demands of policy design, and frame the issue equally as a problem of incentives, politics, and institutions. In thinking about potential reform, the key questions are: what are the costs and benefits of expanded taxation; what incentives can improve compliance among currently informal sector firms; how can the political barriers to greater informal sector taxation be overcome; and what institutional arrangements might contribute to this goal? This framing allows us to think about reforms in terms of their ability to address two issues: the revenue needs of governments and the growth and governance needs of informal sector firms. In addressing these questions we maintain an intentionally narrow focus on small and medium-sized informal enterprises, rather than informal sector workers or subsistence-level economic activities. Likewise, we are focused on specific questions about whether and how to tax the informal sector, while paying only selective attention to a significantly broader literature exploring the social and political features of the informal economy and its relationship to the state and formal economy.<sup>2</sup>

The paper proceeds as follows. [Section 2](#) explores competing definitions of the informal economy, highlighting our focus on micro and small enterprises that are large enough to pay taxes but small enough to warrant unique policy and administrative arrangements. [Section 3](#) turns to the question of whether informal sector taxation should, in fact, be given some priority in low-income countries, assessing still nascent evidence about potential growth and governance benefits. [Section 4](#) presents a review of the major policy options for taxing informal sector firms, focusing on specialised presumptive tax regimes that target small enterprises. [Section 5](#) considers the broad barriers to more effective taxation of the informal sector, and possible approaches to identifying solutions. [Section 6](#) draws on this analysis in exploring a series of recent, but poorly studied, administrative innovations aimed at strengthening informal sector taxation. The final section highlights key issues for future research.

## **2. Defining the Informal Sector: Conceptual Clarifications**

The term 'informal sector' is contested. As Peattie (1987) noted several decades ago, the concept is fuzzy but popular because it encompasses the interests of a wide variety of groups. Originally proposed by Keith Hart (1973), it initially referred to employment outside of formal labour markets. The idea was to distinguish businesses on their 'degree of rationalisation, or embodiment of impersonal principles of social organisation' (Kenyon, 2007:2). In the 1970s the International Labour Organisation (ILO) took up the concept, and mainly used it for small and micro enterprises that were outside the purview of government regulation and taxation (ILO, 1972). These were businesses in the subsistence economy. The term was reinterpreted when de Soto (1989) identified the informal sector as a source of dynamism and growth, held back only by inappropriate government regulation. The concept of the informal sector thus moved to a focus on the legal status of the business: whether registered and complying with relevant legislation. It is this legal definition that has widespread use today (Gerxhani, 2004; Kenyon, 2007). In this usage, firms in the informal sector are there because

they contravene – or are not subject to – some of a variety of rules and regulations, including labour laws, environmental laws, registration, and taxation.<sup>3</sup>

This brief history of the origins of the concept highlights several issues that are pertinent to our concern with taxation. First, although the term initially described labour conditions, its current use encompasses informal wage labour, the self-employed, and informal sector firms. Second, the term ‘informal sector’ is often currently used to describe a duality: an opposition to the formal sector.<sup>4</sup> In practice, however, the duality description is misleading. As is evident from the most cursory survey of businesses in the developing world, there is a continuum of firm types from the most informal (subsistence-type activities) to the most formal (formal, tax-paying, law-abiding businesses). Depending upon the context, businesses often move along this continuum, some seeking formalisation, others falling into informality, as the cost-benefit calculations of being in one category or another change. In fact, while some firms may escape national taxation, they are often burdened by several types of fees, charges, and licensing costs paid to local governments (de Mel, McKenzie, & Woodruff, 2010). More broadly, the literature on private sector development has long highlighted that the formal and informal economies are intricately linked. Formal businesses often use inputs produced by the informal economy and are frequently involved in complex subcontracting arrangements with them, for example advancing credit in the form of materials (Hays-Mitchell, 1993). At the same time, many street vendors and small traders operate on behalf of larger and medium-sized businesses with, for example, retailers in Africa, often engaging informal sector operators to sell their goods on the street.

Given this complexity, we make several boundary choices for this literature review, while acknowledging that the borders between our categories are somewhat blurred. First, we do not focus on workers in the informal economy, but on businesses and their owners (including the self-employed), because they are more likely to have an income that is sufficiently high to have a tax liability. Second, we make an important distinction among three groups (see Table 1): subsistence enterprises which would normally not be liable for taxes (Column A); informal small and micro enterprises which could be the subject of specific informal sector tax regimes (Column B); and small and medium-sized firms, which are clearly large enough to be in the standard tax net but are not (Column C).<sup>5</sup>

This paper is concerned with small and micro businesses that generate enough income to warrant taxation but find it easy to escape the attention of the tax administration, or to conceal a substantial part of their tax liability, because of their location, size, and/or nature of their business.<sup>6</sup> These fall within Columns B and C of Table 1. While our focus is on the issue of taxation, this is invariably linked to the broader question of formalisation. Table 1 makes it clear that registering with the tax authorities is only one of many features associated with informality. It is important to bear in mind both the narrow question of taxation and the broader implications of formalisation in order to understand both the motivations of such firms and the merits of taxing them.

### **3. Costs and Benefits of Taxing the Informal Economy**

As noted earlier, increasing attention to the taxation of the informal economy is grounded in its potential importance to revenue, growth, and governance. Yet the direct revenue benefits of taxing the informal sector are likely to be relatively modest, and the implications for vertical equity potentially adverse. The weight of the argument for taxation is then based on indirect benefits, notably the prospect of accelerated growth and the potential for governance gains. The research reviewed in this section provides preliminary indications of potential benefits to taxing the informal economy. However, equally it highlights the need for substantially greater research and attention to the challenges posed by the overall vulnerability of many informal sector firms due to unequal power dynamics, particularly in contexts of endemic corruption.

#### *Revenue and Equity Implications*

Much of the debate over the costs and benefits of taxing the informal sector has focused on direct revenue and equity implications. On the surface, taxation of the informal economy appears to be a

**Table 1.** A typology of enterprise informality

Features	Informal economy			Formal economy
	A	B	C	
Degree of informality	Subsistence enterprises	Micro enterprises and small businesses	Small and medium businesses	Small, medium, and large businesses
Type of activity	Totally informal enterprises, cottage/micro enterprises, subsistence farmers	High proportion of sales undeclared and workers not registered Small manufacturers, service providers, distributors, contractors	Some proportion of sales undeclared and workers unregistered Small and medium manufacturers, service providers	Labour and firms registered and regulated Range of manufacturing and services
Technology	Labour intensive	Mostly labour intensive	Mixed labour and capital intensive	Knowledge and capital intensive
Owner profile	Poor, low education, low level of skills	Poor and non-poor, likely educated, skilled	Non-poor, well educated, high levels of skills	Non-poor, highly educated, sophisticated level of skills
Markets	Low barriers to entry, highly competitive, high product homogeneity	Low barriers to entry, highly competitive, some product differentiation	Some barriers to entry, established markets	Significant barriers to entry, established market/ product niche
Finance needs	Working capital	Working capital, some investment capital, supplier credit	Investment capital and working capital, letters of credit, supplier credit	Investment capital and working capital, letters of credit, supplier credit
Other needs	Personal insurance, social protection, security	Personal and business insurance and business support services, security	Personal and business insurance, business development services	Personal and business insurance, business development services
Tax status	Earnings can be below minimum tax threshold, no recordkeeping, cash transactions	Liable for tax, difficult to identify and assess, poor or no recordkeeping, cash transactions	Liable for tax, under-report earnings, use loopholes, escape formal tax assessments	Taxed under formal tax assessment
Tax design desired features	No tax liabilities	Low rates to encourage registration, minimal compliance costs, low administration costs	Higher rates to encourage graduation into formal regime	

*Notes:* Greyscale text comprises features less relevant to taxation.

*Source:* Adapted from Zinnes' (2009, p. 8) adaptation of Djankov et al. (2002).

potentially important source of government revenue, as the informal sector comprises a large and, in many countries, growing share of GDP (Schneider et al., 2010; Schneider & Klinglmair, 2004).<sup>7</sup> However, in practice, revenue is likely to be comparatively modest. Individual incomes within the sector are low, and tax rates correspondingly low, while the costs of collection are very high, owing to the large number of individual firms and the difficulty of monitoring them. Taxation of the informal economy also raises equity concerns, as the operators of informal sector firms are frequently low-income and taxation of such firms is potentially regressive (for example, Pimhidzai & Fox, 2012). If efforts to tax the informal sector also increase the risk of relatively coercive or corrupt behaviour by tax officials (as is often the case), these concerns are exacerbated. For these reasons, many tax experts have been sceptical of focusing scarce resources in developing countries on taxing small informal sector firms (Keen, 2012, pp. 19–21, 30–32).

The revenue and equity arguments for expanding informal sector taxation thus rest instead on more indirect benefits. One argument is that taxation of small informal sector firms, while yielding little revenue in the short term, serves to bring firms into the tax net, thus ensuring higher tax compliance if they expand over time. More simply, it is a matter of building a culture of tax compliance.<sup>8</sup> A related argument turns the standard equity argument on its head, suggesting that the failure of informal firms to pay taxes can be viewed by formal firms as being ‘unfair’. This can lower general tax morale and discourage tax compliance among larger firms (Alm et al., 2003; Terkper, 2003; Torgler, 2003, 2005). Finally, arguments are advanced that formalisation may increase equity by offering small firms a measure of predictability and protection from arbitrary state and related racketeering action.

However, while both claims are intuitive, evidence remains highly imperfect. While it is widely believed that taxing small firms can build a culture of tax compliance, there is no systematic evidence on the long-term impact of small business taxation on attitudes toward taxation among those firms. Meanwhile, evidence that informality can lead to reduced tax morale is limited to cross-country correlations, with corresponding difficulties in asserting causation (Torgler & Schneider, 2007). Finally, power inequities between the state and small enterprises imply that while formalisation may offer protection and predictability to some firms, it may equally make firms vulnerable to unequal treatment and harassment by making them more visible to state authorities. These risks have been highlighted by recent research into informal sector traders in border areas in fragile and conflict-affected states (Schomerus & Titeca, 2012; Titeca, 2009). This research has noted the potential equity benefits of formalisation, or at least recognition, but also the potential pitfalls of formalisation if it disrupts precarious livelihoods or exposes traders to new forms of vulnerability (Tegera & Johnson, 2007; Titeca & Kimanuka, 2012).

### *Implications for Growth*

The implications of expanded taxation for the growth of small firms are as important as immediate revenue implications. The concern for many tax experts is that increased taxation of small firms may ultimately hinder growth, and that this cost may far outweigh the revenue benefit. The thinking is that small firms opt into informality precisely because they believe that informality will benefit them, given the burdens of formality. However, a growing body of research suggests that formalisation – of which entry into the tax net is a central component – may, in fact, have significant benefits for growth, or, at the very least, may not hinder growth (Kenyon & Kapaz, 2005). While informality helps firms avoid certain costs, it may also preclude access to certain opportunities available to formal firms, including greater access to credit, increased opportunities to engage with large firms and government contracts, reduced harassment by police and municipal officials, and access to broader training and support programmes. Much of the early evidence that formalisation may lead to more rapid growth came from evidence that formal firms tend to grow faster than informal sector firms. However, such studies leave open the question of causality: do firms grow faster because they are formal, or do firms with greater growth prospects formalise?

A handful of more recent studies have begun to provide more robust and nuanced evidence on the causal impact of formalisation by controlling for unobservable features of firms or by

employing experimental methods. Drawing on panel data on micro firms in Mexico and controlling for a wide range of firm characteristics that proxy for the economic potential of firms, Fajnzylber et al. (2009a) find that formalisation, through access to credit, training, tax payments, and participation in business associations, has positive effects on firm profits and survival by allowing firms to reach their optimal size. Rand and Torm (2012) explore the impact of formalisation on small and medium enterprises (SMEs) in Vietnam by employing a matched double difference approach and find a positive impact on profits, investments, and the formality of labour contracts. McKenzie and Sakho (2010) examine micro firms in Bolivia, using distance from the tax office as an instrument for informality, in an effort to establish the causal role of formalisation. They find that formalisation, in the form of registration with the tax authorities, increases firm profitability, but only for mid-sized firms. McCulloch et al. (2010) similarly employ instrumental variables in looking at small firms in Indonesia, and find that the impact of formalisation on sales is heterogeneous across firms, with the primary benefits for mid-sized firms with higher levels of employment. Interestingly, they attribute an important part of these gains to *reduced* tax payments and exposure to corruption after formalisation, thus highlighting the risk of harassment faced by informal firms. Moving beyond panel data techniques, Fajnzylber et al. (2009b) use a regression discontinuity design in order to exploit a natural experiment offered by reforms introduced in Brazil in 1996 that made it easier for small firms to formalise. They, again, find a positive impact of formalisation on revenues and profits and attribute these gains to the adoption of more permanent production techniques and staffing. Finally, de Mel et al. (2012) employ a controlled experiment in Sri Lanka, in which they randomised the availability of incentives for small firms to formalise. They find that a small group of these firms experience significant income benefits, but that most firms experience no significant changes in income.

While this literature thus highlights the benefits of formalisation, it equally stresses that these impacts are heterogeneous across firm types. The smallest firms frequently are least able to reap the benefits of formalisation, with mid-sized firms experiencing the largest improvements. A survey of informal micro-firms in Mexico conducted by McKenzie and Woodruff (2006) provides a possible explanation, which is echoed in the literature. Many micro-businesses asserted that the benefits of formalisation, though real, are not high enough or exclusive enough to be an incentive to formalise. For example, when micro-business can rely on informal credit mechanisms, the added value of formalisation is perceived as limited. Another reason is that micro-businesses have different underlying interests than larger firms. Many micro-businesses are operated by individuals who are not entrepreneurs at heart, but are waiting for an opportunity to enter salaried jobs or are running micro-businesses in parallel with other employment to supplement income (Maloney, 2004). In such circumstances, business expansion may not be a central motivation, and formalisation is likely to be irrelevant and potentially costly. Further, there may be differences between firms who choose to pay taxes in order to access new opportunities and those that are simply caught by the tax authorities. The only study to explore this issue is Fajnzylber et al. (2009a, p. 1042), who find that paying taxes resulted in a benefit for all firms, leading to at least a 20 per cent increase in profits, regardless of whether they were caught or willingly compliant. Finally, power dynamics in the relationship between firms and the state may again be decisive in shaping outcomes. Formalisation may in some cases protect informal firms from harassment and arbitrary state behaviour, and open new business opportunities, but in other contexts engagement with the state may actually exacerbate risks, while producing few opportunities. As importantly, these relationships may vary across firms, reflecting divergent 'dynamics of inclusion and exclusion' that privilege some firms and disadvantage others (Schomerus & Titeca, 2012, p. 6).

On balance, there is now a convincing body of evidence that formalisation can drive broader economic gains, though there remains significant uncertainty about whether the smallest micro firms are likely to be beneficiaries. There is equally continuing uncertainty about which channels are most important in driving economic gains from formalisation. Finally, there is a need to recognise that actual outcomes for firms – reduction in harassment, predictability, and new opportunities – are likely



to vary, and to be shaped by power relations and political networks linking the state and individual firms in particular contexts.

### *Governance Implications*

An important factor motivating recent interest in taxing the informal economy is the possibility that payment of taxes by firms in the informal economy may promote good governance and political accountability through three related channels. First, in order to encourage quasi-voluntary tax compliance, the state may be more responsive and accountable to groups that pay taxes (Bates & Lien, 1985; Levi, 1988). Second, individuals are more likely to make demands for responsiveness and accountability if they are paying taxes, due to a sense of ownership over government activities (Bird & Vaillancourt, 1998, pp. 10–11; Prichard, 2009, 2010a). Third, efforts to tax informal sector operators could catalyse collective action and political engagement by informal sector associations, providing a foundation for expanded bargaining (Joshi & Ayee, 2008; Prichard, 2009).

These potential connections suggest that, if pursued in a comparatively ‘contractual’ manner (Moore, 2008), taxation of the informal economy could become an important stimulus for expanding political voice among relatively marginalised groups. However, while plausible, there are also grounds for scepticism: informal sector firms are frequently poorly organised, face collective action problems, generally lack political power, and may fear reprisals by the state in response to expanded demands.<sup>9</sup> Given these challenges, Meagher and Lindell (2013, p. 67) ask: ‘Does taxing informal traders strengthen public accountability, or just create new avenues of predation?’

There is some, albeit limited, evidence that taxation of the informal sector can lead to improved mobilisation and accountability. Joshi and Ayee (2008) show that government efforts in Ghana to tax informal sector firms resulted in at least some bargaining between informal sector associations and the government (see also Prichard, 2009). In a similar vein, Prichard (2010b) finds that expanded taxation of small firms in Ethiopia triggered public engagement and prompted the government to include greater business involvement in overseeing the presumptive tax regime. Finally, de Mel et al. (2012) find that in Sri Lanka the formalisation of firms, including entrance into the tax net, fostered expanded trust in the state, even where the firms did not increase their profitability.

However, the potential for further marginalisation is also high. A variety of studies in contexts of conflict and fragility *emphasise* the weakness of informal sector organisations and the fundamental power imbalance characterising their relationship to the state (Titeca 2009; Titeca & Kimanuka, 2012). Indeed, the broader literature looking at the political organisation of the informal sector highlights the complexity of potential outcomes. Lindell’s (2010) review of the disparate forms of political agency exercised by informal operators highlights highly divergent outcomes, ranging from cooperative bargaining with the state to fragmentation of political voice. Similarly, Meagher and Lindell (2013, p. 68) note that political action by informal associations frequently creates both winners and losers, potentially fostering the fragmentation of interests and the marginalisation of certain groups. What is critical is the ‘situated analyses of the who, the where, and the when of formal–informal engagement [as these] are central to understanding the selective character of incorporation and the interests served’. In sum, while the evidence suggests that governance gains *could* be a potentially powerful argument for expanding taxation of the informal economy, more research is required, specifying the conditions under which these benefits are likely to be realised.

## **4. Policy Options for Taxing the Informal Sector**

Although the value of prioritising taxation of the informal sector remains debated, there is agreement about the need to improve existing policy and practice. Here, the bulk of existing research (reviewed in this section) has focused on the technical design of appropriate policies, while a smaller literature

(reviewed in the next section) addresses the question of strengthening administration. Most of the research is based on theoretical models or the accumulated experience of people who have advised countries on their tax reforms. Formal statistical analyses are relatively rare, mainly because of a lack of appropriate data.

The main policy strategies can be thought of in three broad, and not mutually exclusive, categories: taxing indirectly through trade taxes, expanding the reach of major formal sector taxes, and developing specialised presumptive tax regimes. We review each in turn.

### *Indirect Taxation of the Informal Sector*

The simplest way to tax the informal sector is indirectly: by taxing the goods and services that it buys and sells, most obviously through Value Added Tax (VAT), which is not refunded to enterprises that are not registered for VAT, and import and export duties (Keen, 2007). Here ‘indirect’ implies that informal sector firms are not themselves registered as taxpayers, but are nonetheless taxed by virtue of taxes paid on goods and services higher up and lower down the value chain. In practice, this is a predominant form of taxation of informal sector firms, as it does not require any active informal sector participation in the tax system (such as filing tax returns), and so does not come up against the difficulties of high compliance costs or limited capacity in the informal sector.

The most important source of indirect tax revenue in most developing countries is VAT, with recent decades witnessing a broad shift from import tariffs to VAT, based largely on the premise that VAT is less economically distorting. Alongside being able to tax a wide range of economic activity, an important benefit of VAT is that it can create positive incentives for informal sector firms with actual or prospective dealings with formal sector firms to enter the formal tax system in order to claim tax credits. A recent, particularly convincing, study (as it pairs a standard cross-sectional probit analysis with a difference-in-difference approach) of small firms in Brazil shows that an individual firm is more likely to register for VAT if its suppliers and/or customers are registered (de Paula & Scheinkman, 2010).

Despite the shift toward VAT, import taxes have remained an important component of developing country tax revenue, particularly in low-income countries, even as tax rates have declined in recent decades. Gordon and Li (2009) develop a theoretical model that shows how this behaviour could be a good strategy for dealing with tax evasion by potential taxpayers that are outside the banking system. The traditional economic argument against import taxes is that they prevent countries from fully exploiting their comparative advantage, and may thus discourage growth more than domestic taxes. This theoretical argument is weakened by the difficulties in taxing the informal sector: Dasgupta and Stiglitz (1974) show that limitations in the imposition of domestic taxes could justify trade taxes (tariffs); Heady and Mitra (1987) show how an untaxable agricultural sector could justify taxation of imported fertiliser; Emran and Stiglitz (2005) have developed a theoretical model that shows how a non-taxable informal sector makes tariffs potentially welfare-enhancing, relative to a shift toward VAT.

### *Reliance on Existing Taxes on Formal Sector Firms*

The most obvious alternative to relying on taxing firms indirectly is to extend the reach of common formal sector taxes through enhanced enforcement and compliance (for example, Bird & Casanegra, 1992; Bird & Wallace, 2003, pp. 7–8; Terkper, 2003). Additional incentives for compliance, such as reduced rates or rewards to small firms that maintain effective records, can help, though both types of measures can increase the overall complexity of the tax system and create incentives for small firms to remain, or appear to remain, small (International Tax Dialogue, 2007; Loepnick, 2009). While strengthening the enforcement of formal sector taxes may be appropriate for larger firms within the informal sector, for very small firms the administrative costs for the government are likely to be extremely high and present the risk of harassment and abuse.

As a result, many developing countries have established relatively high thresholds for both VAT and income taxes so as to exclude most small and micro businesses, which are instead captured by presumptive tax regimes (discussed below). In contrast, the use in some countries of withholding

taxes enables taxes to be levied on small firms without raising compliance issues (Keen, 2007). These taxes are extremely widespread, and make up an appreciable share of total revenue collection in some cases, with governments or larger firms withholding taxes on transactions with small businesses that may not be tax compliant. Withholding taxes are similar to taxing indirectly, but with the important difference that these taxes can be credited against the tax liability of tax compliant firms, thus providing an incentive for non-compliant firms to become tax compliant. Keen (2007) argues that such taxes can be highly efficient: a withholding tax on imports acts like a tariff on non-compliant firms, while it is credited back to compliant firms, thus increasing revenue from the informal sector without distorting trade. That said, experience suggests that withholding taxes can become administratively burdensome: they can introduce a high degree of incoherence to the overall system, while requiring cooperation from withholding firms, and, most importantly, an effective system for crediting those firms from which tax is withheld (IMF, 2011, p. 40; James, 2009). Given patchy evidence on both benefits and costs, making definitive judgements about the merits of withholding taxes is difficult.

### *Presumptive Taxes*

The most common method of taxing small informal firms is through presumptive taxes. Taxing small informal sector firms is hindered by two factors: high compliance costs for small taxpayers and high costs of collection for tax administrations (Loeprick, 2009). Presumptive taxes resolve these problems by using a simplified indicator of the tax base to simplify recordkeeping for firms and estimation of tax liabilities by tax collectors.

Within this basic structure, their particular design is highly variable across countries (Bird & Wallace, 2003). The main variations are the following:

- Allowing a simplification of the generally applicable tax base, such as the use of cash rather than accrual accounting. IMF (2011, p. 41) supports this approach, noting that ‘the difficulty is not that small traders cannot keep simple accounts – it is persuading them to share them’.
- Using some other financial measure as the tax base rather than net profit or net value-added. Loeprick (2009) highlights turnover as a widely-used measure, while Sadka and Tanzi (1993) argue for the use of a tax on gross assets.
- Using a non-financial indicator of tax liability, such as floor area or number of employees. This is the simplest approach, and allows the estimation of tax liabilities by tax collectors even in the absence of accounts, but also has the most obvious drawbacks. In their simplest form such taxes may approach a simple business fee.

Such presumptive tax regimes differ across countries in their specific features. In Ethiopia, instead of being subject to income tax and VAT, mid-sized firms are required to pay a presumptive tax on income as well as a 2 per cent tax on turnover. Kenya levies a 3 per cent flat rate on turnover to replace both income tax and VAT. Tanzania operates a scheme in which tax is a progressively increasing proportion of turnover, and those without adequate records pay a larger amount. In Ghana, the government operates a flat rate turnover tax of 3 per cent for small firms to replace standard VAT, while micro businesses are covered by a tax stamp regime, of a fixed tax per quarter (Prichard, 2009, 2010b).

There is an important trade-off between simplicity and equity in the choice of presumptive systems. The motivation for adopting a presumptive regime lies in adopting a tax base that is much simpler to measure and monitor, thus reducing the compliance burden on the firm. However, the further the presumptive tax base is from the generally applicable tax base, the greater the risks of horizontal inequity and of creating incentives for firms to stay in the presumptive tax regime rather than graduate (Bird & Wallace, 2003, p. 21).

## 5. Improving Outcomes: Incentives, Politics, and Institutions

Despite the well-developed thinking on technical policy options outlined above, attention to the politics of such reform has been relatively limited. In part this reflects the continuing uncertainty about the merits of expanding taxation of the informal sector. However, there is little doubt about the importance of reforming and strengthening existing practices to make them more equitable and efficient, and politics is critical to the potential for such reform. A common theme in much recent discussion has been the lack of reform leadership. Consequently, there is a need to better understand politics, institutions, and incentives facing political leaders and administrators, in order to devise strategies for making taxation fair and accountable. These issues are taken up in the following sections.

### *Strengthening Firm Incentives, Capacity, and Collective Action*

Given their small size, mobility, and potential political influence, effective taxation of informal sector firms is likely to depend on encouraging greater quasi-voluntary compliance. The likelihood of such quasi-voluntary compliance is linked to the broader questions of the benefits of formalisation described earlier (Perry et al., 2007). Consequently, it is the small but growing literature on formalisation that offers the greatest insights into strategies for quasi-voluntary compliance. This literature can be usefully broken into three parts: a cost-benefit approach, underpinned by a legalistic view that views informality as a choice; an empowerment approach, underpinned by the dualist view that sees subsistence businesses forced into informality due to lack of capacity or access to services; and an approach that emphasises the importance of collective action and state–society bargaining (Kenyon, 2007; Zinnes, 2009).

*Shifting incentives: a cost-benefit approach to tax compliance.* The dominant strand of existing research views formalisation as a rational choice: firms will formalise if the benefits of formalisation outweigh the costs.<sup>10</sup> Costs of formalisation include the cost of registration or getting licences, the cost of tax compliance, and the cost of following labour laws and other regulations. Benefits are usually access to credit and capital markets, government procurement contracts, other external markets, and state-provided services and facilities. Benefits also potentially include a reduced need to pay bribes, provide free services, or relocate/shut down in order to avoid taxes (Foreign Investment Advisory Service, 2008, McCulloch et al., 2010). Significantly, research in this area finds that tax evasion is generally not the primary reason for being informal (Friedman et al., 2000); avoiding costly regulation is often a more powerful motivation (de Soto, 1989; Ngoi, 1997). Encouraging firms to enter the tax net may depend on addressing these broader costs and benefits of formalisation.

Among the earliest relevant studies is the work of Djankov, La Porta, Lopez-de-Silanes, and Shleifer (2002), who reported cross-country econometric evidence that higher costs of formalisation were associated with larger informal sectors across a sample of 85 countries. This result has more recently been echoed by Kus (2010) over a larger range of countries, though he argues that this relationship does not hold where law enforcement is weak – as in most low-income countries – thus suggesting that other factors are also important in those contexts. While these cross-country studies provide a starting point, they face inevitable limitations in their ability to capture the nuance of these processes.

Several empirical surveys have contributed to understanding such cost-benefit calculations, though studies focus disproportionately on costs. For example, a survey in Tanzania found that a poor Tanzanian entrepreneur would spend 32,216 days waiting for approval for various permits, and pay over USD180,000 in income and fees over the 50-year life of a business (Institute for Liberty and Democracy, 2005, as cited in Garcia-Bolivar, 2006). Surveys in Sierra Leone, Liberia, and Madagascar show that a significant proportion of informal firms have at some point attempted to become formal, but were deterred by the cost of doing so (Everest-Phillips, 2008). A less conventional cost lies in the complexity of tax legislation. Bonjean and Chambas (2004) summarise survey evidence that non-compliance often results from ignorance of tax legislation rather than deliberate evasion. Finally, the costs of formalisation may be higher, and the benefits less accessible, where governance is weak.

Jonasson (2011) employs cross-sectional econometric analysis demonstrating that informality in Brazil is negatively associated with the quality of local governance, though he cannot confidently establish causation. Qualitative evidence from conflict areas likewise highlights the significant barriers and limited benefits of formalisation where states are weak (Titeca & Kimanuka, 2012). Ultimately, policy makers have sought to use these varied tax surveys to help identify potential policy entry points to support formalisation and tax compliance (Coolidge, 2010; Everest-Phillips, 2008; Gerxhani, 2007).

The primary policy implication of such an approach has been an attempt to encourage formalisation by reducing costs, for example simplified registration, through business environment reforms (World Bank, n.d.). The most important recent studies have correspondingly focused on assessing the impact of simplification and cost reducing reform programmes on formalisation. Early studies focused on the retrospective evaluation of such reform programmes, thus offering suggestive, but imperfect, evidence. In Kenya, significant attention has been given to the creation of a simplified 'single business permit' for small firms. Consistent with expectations, Devas and Kelly (2001) report that these efforts encouraged some degree of formalisation and improved conditions overall for small firms. Sander (2003) reports the results of a very similar pilot project in Entebbe, Uganda, where reforms that reduced the costs of formalisation were followed by a 43 per cent increase in compliance with the requirement to register. However, in both the Kenyan and Ugandan cases the absence of follow-up research results in an incomplete picture of the long-term impact of reform, while in Kenya subsequent research has noted that newly-registered firms have in some cases continued to be subject to corruption and harassment by public officials.<sup>11</sup> Similarly, Garcia-Bolivar (2006) reports the results of reducing the costs of formalisation in Bolivia, which resulted in a 20 per cent increase in the number of firm registrations, and he reports similar increases in Vietnam. However, while noting these increases he also stresses their limitations, as the informal sectors remained large in both countries following reform.

In recent years two significantly more robust studies, based on experimental evidence, have provided a clearer picture of the complex impacts of reduced registration costs on formalisation. Jaramillo (2009) reports the results of a field experiment in Lima, Peru, in which a randomly-selected group of firms were offered free business licences and support with the registration process. He reports that only one in four firms was willing to formalise even with registration costs largely eliminated. He attributes this to the recurrent costs of being formal along with the low perceived benefits of formalisation, limited growth ambitions, and low trust in government. De Mel et al. (2012) report the results of a similar experiment, in which randomly-selected firms were offered positive financial inducements to formalise. They find that a financial offer equivalent to one-half to one month's median profits induced registration of about 20 per cent of firms, while a financial offer equivalent to two months' profits led to 50 per cent of firms registering.

The messages from these studies appear to be twofold. On one hand, there is little doubt that reduced costs of registration have led to expanded formalisation among at least a significant minority of firms. On the other hand, even extreme reductions in costs fail to encourage compliance among the majority of informal firms, owing to low benefits, limited ambitions, mistrust of governments, and the possibility of high recurrent costs of formalisation (Zinnes, 2009). This is consistent with arguments that the focus on registration costs emphasised historically by many donors is inadequate, as it neglects the need for proactive support for small firms (Altenburg & von Drachenfels, 2006; Arruñada, 2007).

*Empowering small firms.* In contrast to the dominant cost-benefit approach, some scholars perceive informality primarily as a problem of power and capacity, rather than of choice (Abor & Quartey, 2010; Kanbur, 2011; Zinnes, 2009). In this view, despite willingness, firms may be unable to register formally due to problems of capacity (illiteracy, limited skills), the transience of their business, the prevalence of cash transactions, or general uncertainty. The broader environment is often not enabling and is characterised by a lack of trust in government and the lack of easy access to a range of services including information, accountancy, security, justice, and insurance.<sup>12</sup> Thus, even if aware of the potential benefits of formalisation, businesses tend to remain in the informal economy. This approach

thus stresses the involuntary nature of informality, as opposed to the rational calculations of the cost-benefit approach.

The policy advice that follows focuses on what the Commission on Legal Empowerment of the Poor (CLEP) (2008, as cited in Zinnes, 2009) calls the four pillars of legal empowerment: strengthening access to justice; assuring property rights; ensuring safe working conditions, including for women and children; and increasing economic opportunities such as credit, markets, and investment. However, no single policy mix is likely to fit all contexts (Kanbur, 2011). This analysis seems most appropriate to the subsistence end of the informal economy spectrum, in which illiteracy, lack of accounting skills, poor information, and a mistrust of government prevail.

The implications of this approach for taxation purposes are twofold: a need to adapt tax regimes to the characteristics of informal firms (such as illiteracy, lack of trust, and information); and a need to supplement business environment reform policies (such as reducing the costs of registration) with other supplementary policies such as securing property rights (which are often the cause of transience), improving security (safety from theft or harassment), establishing dispute resolution mechanisms, and affordable accountancy services.<sup>13</sup> These can help micro-businesses to view taxation as one step toward empowerment and eventual formalisation. Unfortunately, however, we are not aware of any research that has systematically assessed the effectiveness of these types of policies in encouraging formalisation and tax compliance.

*Collective action and state–society interaction.* Complementing the approaches outlined above, a third approach seeks to focus additional attention on politics and the nature of the relationship between the state and informal sector operators (Daly & Spence, 2010; Kenyon, 2007; Tandler, 2002). To this end, Kenyon (2007) argues that, beyond simple cost-benefit analysis, formalisation policies need to acknowledge and address three key strategic problems: information, credibility, and coordination.

The importance of information arises from the fact that many intended beneficiaries in the informal economy simply are not aware of programmes targeted at them, or do not understand the requirements of formalisation. While this problem varies from one context to another, it is surprisingly prevalent, with a significant consequent need for states to adopt strategies that focus on outreach and taxpayer services (for example, Jaramillo, 2009).

The importance of credibility reflects the fact that firms need assurances that the government will uphold their part of any bargain (reduced tax rates, provision of benefits, legal protection) if firms formalise. Surveys indicate that a fear of predation is a significant deterrent to successful formalisation policies (Jaramillo, 2009), driven by a pervasive lack of trust in government. In Bangladesh, for example, the government encouraged the registration of businesses through tax fairs that reduced costs, but found that many firms feared that registration might expose them to subsequent harassment by the state.<sup>14</sup>

Finally, the importance of coordination lies in the fact that it is only in the interest of firms to formalise if they can be relatively certain that a critical mass of competitors will also do so. Joshi and Aye (2008) find that the existence of collective actors who can bargain with policymakers around taxes is essential to arriving at policy solutions that are acceptable to both sides, exemplified by the experience of associational taxation in Ghana. However, they equally note that such outcomes are uncertain: collective action by informal sector operators can facilitate bargaining and agreement, but can also lead to informal sector actors being able to block effective taxation entirely. As such, the challenge lies in being able to promote constructive bargaining between state and society. An interesting, though very preliminary, experience comes from Shanghai, where the municipal authorities contributed to creating informal labour associations, within which informal business and labour could organise. While, technically, these associations remained outside of the formal economy, they received government assistance in the form of training, preferential tax treatment, and subsidised credit in order to encourage growth and eventual formalisation (Howell, 2002). Additional research into how to support constructive bargaining between informal associations and governments is much needed.

### *Strengthening Political and Administrative Commitment*

While the preceding discussion highlights the factors that may shape incentives for firms to formalise, it is equally important to consider incentives for governments and the state to make taxing the informal sector a priority. Constructive negotiation between the state and informal operators depends on not only collective action among firms, but also a willingness and ability within the state to bargain with multiple small collective actors with diverse interests. More broadly, without reform champions who wield sufficient political influence to overcome entrenched resistance, successful reform is unlikely (Boesen, 2004; Heredia & Schneider, 2003). Although these issues have begun to receive some attention within the relevant literature (for example, Daly & Spence, 2010; Kenyon, 2007; Tendler, 2002), on balance they have remained peripheral to most debates. Here we consider the incentives faced by politicians and administrators (both senior officials and frontline tax collectors), respectively, in deciding whether and how to prioritise taxation of the informal economy.

*Political incentives.* Although research has been limited, there are powerful reasons to expect that political leaders may have weak incentives to tax the informal economy. The simple version is thus: taxing the informal economy will raise limited revenue, is administratively challenging, and potentially politically unpopular; better to leave them alone. For example, as Kloeden (2011, p. 26) points out, in Africa small and micro enterprises generate at most 10 per cent of revenue, even though they comprise up to 90 per cent of taxpayers. Simple political logic prevents politicians with short time horizons from alienating large constituencies by trying to impose taxes that raise little revenue.<sup>15</sup>

The more complex version of this argument suggests that it is actually in the interest of politicians to keep the informal economy informal as a captive source of votes. In what Tendler (2002) calls a 'devil's deal', politicians make an unspoken agreement with informal sector operators: 'if you vote for me [...] I won't collect taxes from you, I won't make you comply with other tax, environmental or labour regulations and I will keep the police and inspectors from harassing you' (Tendler, 2002, p. 99). This dynamic has long been observed in the literature on informal settlements and land markets and, in fact, some argue that it is the reason why such settlements are provided services only incrementally (Baross, 1990; Cross, 1998). Once formalised or provided with full benefits, politicians lose their hold over these groups, who are then free to vote as they want. Once the deal is made, it is difficult to break, as it serves the interests of all involved: firms like the universalist, burden-reducing, support that it implies with respect to regulations and taxes; state officials like it as it does not disturb their rent-seeking activities; and politicians are unwilling to take risks associated with other strategies of gaining electoral support.

Experience with reform in other arenas suggests that these challenges are not insurmountable.<sup>16</sup> Intuitively, reform will be politically feasible if it enjoys greater buy-in from informal sector firms themselves. As has been discussed earlier, informal sector businesses appear willing to pay taxes when: the benefits outweigh the costs; they are sufficiently empowered; and there are effective institutional channels for facilitating collective action and bargaining (Roever, 2005). As such, adopting such reforms would not only be welcomed by many informal sector firms, but may shift the political calculus for reformers.

However, there is surprisingly little literature on the subject of political incentives; none of the studies reviewed for this paper actually present politicians' perspectives, either through interviews or through public statements. With a few exceptions (for example, Joshi & Aye, 2008), neither do we have good analysis of cases in which politicians undertook reforms aimed at taxing the informal economy. The Ghanaian case presented earlier suggests that mutually beneficial outcomes are possible: negotiations between the government in power and informal sector associations produced modest revenue gains, improved conditions for informal sector actors, and created strong alliances between political parties and informal sector associations. The result was an arrangement that, while imperfect, helped to generate a tax-paying culture that could contribute to state-building in the long run (Joshi & Aye, 2008; Prichard, 2009).

Of course, while getting buy-in from the informal sector is critical, it is also possible that other reform constituencies may emerge, or may be fostered by reform leaders. There is some evidence that formal sector firms facing competition from the informal sector could mobilise in support of reform. In Kenya, formal sector businesses became a key interest group supporting government efforts to expand taxation and formalisation, going so far as to support the strengthening of informal sector associations directly in order to facilitate bargaining (Prichard, 2010b). This suggests the possibility that the sources of shifting political incentives may be diverse, and alternative sources of reform pressure may yield different types of outcomes: coercive and divisive or collaborative and constructive.<sup>17</sup>

*Administrative incentives.* Irrespective of policy choices, the success of any tax depends on the effectiveness of implementation: ‘tax administration is tax policy’ (Casanegra de Jantscher, 1990). This is likely to be particularly true of informal sector taxation, as regular, unmonitored interaction between tax collectors and tax payers expands scope for non-enforcement and/or corruption by tax collectors, who are effectively street level bureaucrats (Lipsky, 1980). Meanwhile, tax administrations themselves can be powerful collective actors able to block reform, or sabotage its implementation.

There are at least two reasons why tax administrations face weak incentives to tax the informal economy. First, revenue gains are relatively modest. For tax administrations under pressure to meet revenue targets, it is much easier to focus attention on large taxpayers than to invest in painstaking collection from a large number of small taxpayers. Second, for individual tax administrators, enforcing compliance among small operators is an unfulfilling task. It is poorly rewarded, offers few opportunities for large rent seeking, and is widely viewed as, at best, lacking prestige, or, at worst, degrading. In Ghana, educated tax collectors resented having to interact with illiterate, poor, and sometimes violent operators in the informal economy, a task they viewed as not being ‘professional’ (Joshi & Ayee, 2008, p. 190).

One relatively straightforward possibility for shifting incentives is the development of performance benchmarks that are more diverse and nuanced than the current reliance on the simple meeting of revenue collection targets (Bird & Vazquez-Caro, 2011).<sup>18</sup> A more ambitious approach is institutional reform to better reward informal sector tax collection. Recent attention to the potential advantages of the segmental organisation of tax administration, with specialised units for small, medium, and large taxpayers, is potentially consistent with this goal (IMF, 2011, p. 20; McCarten, 2005).

Another option is greater use of technology to facilitate informal sector taxation. Of particular interest is the use of mobile banking to make tax payments (Loeprick, 2009). Such an approach has the immediate benefit of reducing interaction between tax officials and taxpayers, and the consequent risks of harassment, collusion, and corruption. Moreover, it could help to make the banking system accessible to very small firms, while reducing fears that registration will result in expanded harassment. Finally, it may similarly increase support among tax administrators, by not only reducing the cost of collection but also perhaps making the work of collection less unattractive and painstaking.

A final, more radical option is to decentralise responsibility for informal sector taxation from national to sub-national governments. At present, local governments usually grant business licences and collect fees, while other taxes on small firms are under central control. Whereas national authorities may view informal sector taxation as unrewarding, administratively difficult, and politically costly, local authorities may have stronger incentives to collect taxes and bargain with local associations, as discussed in greater detail below. In sum, while administrative buy-in is increasingly recognised as essential to successful reform, we still know little about how to achieve it.

## 6. Making Informal Sector Taxation Work: Lessons from Recent Experience

The discussion so far has drawn on the existing literature to highlight alternative perspectives on, and approaches to, the taxation of the informal economy. This final section examines a series of recent experimental reform efforts – still relatively unstudied – which are illustrative of the potential range of strategies available to reformers, and potential directions for future research.



### *Reorganising Tax Administration: Segmentation*

The most straightforward strategy for improving informal sector taxation is to reorganise tax administration, so as to strengthen monitoring, services, and incentives for administrators. A recent push towards segmental organisation of tax administration, with separate departments to deal with small, medium, and large firms, respectively, is one such strategy. It would allow services to be specifically tailored to the needs and realities of specific types of firms (including the informal economy), and ensure adequate incentives for tax administrators to focus on these firms despite potentially low revenue yields (IMF, 2011, p. 20).

Tanzania took this approach, as part of a broader set of reforms targeted at micro and small firms since 2002, and introduced a Block Management System (BMS) aimed at promoting compliance and registering all eligible traders within particular geographic areas.<sup>19</sup> The BMS is set up so that main market areas are mapped and divided into small and manageable blocks on the basis of logical geographic boundaries. A BMS team with the mandate to perform all relevant tax functions (identification, registration, assessment, and accounting) move block by block in order to identify, register, educate, and interact with taxpayers, particularly those within the informal economy. Each block is set a target for registration and revenue collection, with presumptive taxes being used for assessment purposes. The BMS system attempts to use scarce administrative resources in a targeted fashion by rotation.

Existing evidence suggests that the BMS has resulted in increasing the number of businesses registering with the tax administration.<sup>20</sup> While the initiative came as part of the tax authority's efforts to broaden the tax base, part of the push was from formal firms who were being undercut by informal sector businesses. Whether increased revenue collection was accompanied by greater bargaining for services or became largely coercive remains to be assessed.

### *Associational Taxation*

An alternative is to directly address the issue of collective action, negotiation, and dialogue between the state and the informal sector. Research undertaken by Joshi and Ayee (2008) focused on one such example: the development of 'associational' taxation in Ghana from 1987 to 2003. Under this system, the Ghanaian Internal Revenue Service delegated responsibility for collecting income tax to informal sector associations, a strategy called Identifiable Grouping Taxation (IGT). The arrangement originated in the politics of the corporatist relationship between the largest passenger transport union, the Ghana Private Road Transport Union, and the Rawlings regime (1981-2000), and continued after the electoral victory of the opposition (Joshi & Ayee, 2002, 2008). Following success in the early years, the arrangement was extended to associations in 32 other informal sector activities, and IGT was credited with increasing revenue generated from the informal sector (Joshi & Ayee, 2009).

The arrangement overcame some of the problems associated with tax collection from micro businesses. From the perspective of the tax administration, IGT reduced collection costs to a fixed 2.5 per cent, which was paid to the associations for their work in collection. From the perspective of the associations, becoming tax compliant granted them legitimacy, and helped to protect them from more arbitrary harassment by public officials and police. The downside was that informal associations were often not internally democratic, and extracted revenues from members without handing over full collection to the revenue authority. From the perspective of government, the associations came to be viewed as tax havens for larger enterprises, which could avoid paying full liabilities by claiming to fall under IGT.

Despite these drawbacks, one of the primary achievements of IGT was to inculcate a culture of taxpaying among informal sector businesses. This proved important when the government decided to shift to a more common presumptive tax regime, which was introduced without any significant resistance from firms, many of which actually welcomed a shift from the once popular, but increasingly problematic, IGT system (Prichard, 2009, 2010b).<sup>21</sup> This example highlights the benefits of

strengthening collective negotiation between the state and informal sector associations, while also pointing out the importance of local political context in identifying potential entry points that work with the grain of existing state–society relations.

### *Emphasising Transparency, Services, and Engagement*

Another strategy has been to emphasise transparency, taxpayer services, and engagement in an effort to foster quasi-voluntary compliance among small firms. While there is little systematic research on this topic, some recent cases offer preliminary insights.

Explicit earmarking (as compared to overall transparency of public expenditure) is one strategy, and has the advantage of building stronger trust among taxpayers by delivering well-defined benefits. A recent example comes from Sierra Leone, where Jibao and Prichard (2013) found that the Bo City Council built support for local tax collection in part by communicating revenue and expenditure information to the public, including informally linking revenue increases to specific public expenditures.<sup>22</sup> In a similar vein, Korsun and Meagher (2004) found in Guinea that the collection of market taxes doubled after they were linked explicitly to the construction of new market facilities. Earmarking, however, has the disadvantage of reducing budget flexibility and creating expectations that taxes should function on a fee-for-service basis.

A slightly different strategy lies in strengthening taxpayer services, and tax authorities around the world appear to be making this shift. The Gambia Revenue Authority (GRA) has put in place a variety of measures aimed at improving the customer interface: decentralised tax offices, cost-effective tax tribunals, tax clinics to help with the filing of taxes, and a taxpayer education programme that allows direct exchanges between the GRA and taxpayers. The impact of this type of measure has yet to be carefully studied, and implementation remains an important challenge.

A final strategy in this vein is for revenue authorities to proactively foster the development of informal sector associations and more effective negotiation and dialogue between them and the state. As noted earlier, municipal authorities in Shanghai have pursued such a strategy in an effort to improve tax compliance (Howell, 2002). The Rwanda Revenue Authority (RRA) has similarly cooperated with the Private Sector Federation (PSF)—an umbrella organisation for all kinds of business—and local governments in an effort to improve dialogue with smaller firms.<sup>23</sup> The RRA established the Tax Issues Forum (TIF) in dialogue with the PSF, as an open platform for discussion of tax issues, while the PSF conducts a business census that is then used by the RRA to identify unregistered taxpayers. Technical committee meetings are held to help the RRA better understand industry issues, including profitability, constraints to growth, and service needs; while the PSF uses the forum to understand taxpayer rights and obligations and filter them to its members. Research into the creation of such durable and inclusive institutions can offer greater insights into the politics of business–state interactions around taxation.

### *Ceding Control to Local Government*

A more radical option for reforming taxation of the informal sector is to decentralise responsibility to sub-national government. Bodin and Koukpaizan (2008) suggest four possible benefits to such a strategy: local governments have a greater need of resources, and will have stronger incentives to pursue taxation in the informal economy; tax collection will be closer to, and thus responsive to, local conditions; local governments are better placed to negotiate productively with informal sector actors, and respond by supplying relevant services; and it may encourage greater coherence, as there are, at present, frequently large and harmful overlaps between taxes levied by different levels of government.<sup>24</sup> On the other hand, there are important risks: local governments may lack necessary capacity; there is a risk of wasteful tax competition between localities; local government may in some cases be particularly arbitrary and coercive in their tax practices (Fjeldstad & Therkildsen, 2008; Moore, 2008); and disconnecting local taxation from the national level may complicate the transition of firms into the formal tax system (Loeprick, 2009).

In Cameroon, there has been recent discussion of ceding responsibility for the collection of such taxes to local governments.<sup>25</sup> The national revenue authority has limited interest in this sector, with low levels of organisation and revenue potential. By contrast, several local mayors have actively demanded such responsibilities. To overcome capacity concerns and improve coordination, the local office of the budget administration has been asked to support the process. Experience in Ethiopia has followed a similar path, with small business taxation controlled by regional governments rather than the federal state, small firms being subject to a presumptive tax on income<sup>26</sup> and a 2 per cent tax on turnover. Interestingly, following unhappiness with the tax, regional authorities included business representatives on the tax assessment committees, thus increasing the perceived legitimacy and fairness of the system. Subsequently, public engagement by firms subject to small business taxation emerged as an important issue in the wake of the contested 2005 elections, highlighting the potential benefits of bringing small business taxation closer to taxpayers (Prichard, 2010b).

### *Auctioning Tax Collection Rights*

Finally, perhaps the oldest strategy is the privatisation of tax administration, with individual firms bidding for tax collection rights, and retaining any additional revenue collected. In principle, privatisation provides clear incentives for the maximisation of collection, but in practice it has been prone to corruption, while doing little to encourage negotiation, voluntary compliance, or more productive interaction between state and society (Stella, 1992).

Experience with the privatisation of informal sector taxation is poorly documented, though not uncommon, particularly in relation to sub-national market taxes. Iversen, Fjeldstad, Bahiigwa, Ellis, and James (2006) in Uganda, and Fjeldstad, Katera, and Ngalewa (2009) in Tanzania document relatively prominent examples of privatised tax collection at the local government level, and both conclude that privatisation has sometimes led to greater and more predictable revenue collection. However, they also show problems with contracting, as the price paid for tax collection rights by private collectors is often far below actual revenue potential, leading to limited government revenue and high profits for tax collectors.

Similarly, in the city of Patna, India, city authorities have long auctioned off rights to tax collection from street vendors.<sup>27</sup> Successful contractors exploit their position and often over-tax street vendors, who are largely illiterate and not aware of the rates or their rights. Moreover, collusion among contractors, and between municipal officials and contractors, has led to reduced revenues compared to potential. Iversen et al. (2006) argue that such contracting problems are not a result of asymmetric information but generally reflect politicisation and corruption. Thus, while privatisation may solve some incentive problems, it also creates others.

## **7. Conclusions: Towards a Research Agenda**

Recent literature proposes that taxation of the informal sector may produce significant benefits in terms of long-term revenue collection, economic growth, and the quality of governance. However, evidence of these connections generally remains limited. First, there is some cross-sectional evidence that taxing informal sector operators can build tax morale and a culture of tax compliance. However, there is a need for evidence that more precisely captures the impact of tax reform and formalisation on attitudes toward compliance and overall tax morale. Second, there is growing evidence that taxing the informal sector can enhance the growth of SMEs. Yet, questions remain about how large these effects are, whether smaller firms are likely to benefit, who may be disadvantaged, and which specific policies may be most important. Finally, significant recent attention has been paid to the potential for informal sector taxation to prompt state–society bargaining. However, evidence remains particularly limited, with a need for research into barriers to collective action and constructive bargaining. Underlying all of these issues is a need for sensitivity to the power imbalances that frequently characterise relations

between states and the informal sector, and the corresponding vulnerability of informal sector operators.

There is, meanwhile, clear scope for reform aimed at improving the effectiveness and equity of existing practices, which has been the focus of the second half of this paper. This discussion has focused particularly on two interconnected challenges: expanding quasi-voluntary tax compliance and building government and state commitment to reform.

With respect to compliance, recent work has shed light on the potential for reducing costs of compliance and formalisation, but has said much less about how to provide positive incentives for formalisation. Here, three big questions need attention. First, what type of positive inducements to compliance matter to micro and small firms? Second, how can states and governments effectively promote collective action among informal sector operators and create legitimate institutional channels for engagement? Third, what is the magnitude of costs and benefits of informal sector taxation across population groups, especially for women or ethnic minorities, and how do current practices, and potential reform, affect them (for example, Caroll, 2011)?

With respect to building government and state commitment to reform, we know very little. At a broad level, there is a need to study episodes of successful reform and innovation in order to better understand the conditions under which governments and administrators have embraced and implemented reform. The final section of the paper highlighted a range of recent innovations that warrant greater attention. More specifically, we suggest that the adoption of policies aimed at increasing voluntary tax compliance and facilitating collective action by informal sector associations may be useful in improving prospects for reform. These strategies are attractive because they hold the potential to simultaneously strengthen political incentives for reform, expand prospective benefits for firms, and improve long-term governance of the informal sector. The goal is to fundamentally shift prevailing disincentives to reform by generating improved outcomes for both state revenues and informal sector firms.

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## Notes

1. In this paper we use the terms 'informal sector' and 'informal economy' interchangeably. Some have argued for dropping the term 'sector' in favour of 'economy' (Chen, Jhabvala, & Lund, 2002). We follow the trend in the literature reviewed here, which tends to use both terms.
2. This includes, for example, literature focusing on the historical origins and definition of the informal sector (Meagher, 1990), the social and institutional structures that characterise the organisation of informal sector firms (Meagher, 2010, 2011), and broader literature that explores the nature of connections between the formal and informal sectors (Meagher & Lindell, 2013; Lindell, 2010) and the very definitions and conceptualisations of 'informality' and 'informalisation' (Meagher, 1995; Portes & Castells, 1989).
3. Some have argued that the size of the informal sector is related to deliberate government policies and regulations that create barriers to entry to the formal sector, and thus generate rents that can be easily appropriated through taxation at low administrative cost (Auriol & Warlters, 2005). Others suggest that regulation is related to the size of the informal economy only in countries with effective law enforcement (Kus, 2010).
4. In understanding the links between the formal and informal economies, the literature can be divided into three main views: the dualist, the legalist, and the structuralist (Chen et al., 2002). In the dualist view, the informal economy is marginal and subsistence oriented, provides a safety net for the poor, and is not directly linked to the formal economy (ILO, 1972). The

- legalist view sees micro entrepreneurs opting out of the over-regulation of business by government by going informal (de Soto, 1989). Finally, the structuralist view focuses on the informal economy as a product of privileged capitalists attempting to reduce the costs of production by hiring informal labour and subordinating small and micro businesses (Portes & Castells, 1989). These views underpin the quite different conceptions of what policy approaches to take vis-à-vis formalisation.
5. Standard tax policy literature distinguishes between large taxpayers, medium taxpayers, and small taxpayers. Here our categories are an attempt to disaggregate the small taxpayer category. Some scholars also make a distinction between SMEs and micro enterprises, which include subsistence businesses (which would be Columns A and B of Table 1; Bodin & Koukpaizan, 2008. In a recent paper, Kanbur and Keen (2014:3) similarly seek to consider the 'quite distinct varieties of informality with potentially very different policy implications'.
  6. Owing to the potential ambiguity of the term 'informal sector', some authors have preferred the term 'hard-to-tax'. However, this term has the disadvantage of being broader than our focus here, frequently including other hard-to-tax groups like agricultural producers or the high-income self-employed (Alm, Martinez-Vazquez, & Wallace, 2004; Bird & Wallace, 2003).
  7. Schneider et al. (2010) report that the shadow economy (a broader category than the informal sector) on average shrank modestly between 1999 and 2007, but is still quite large (38.4% of official GDP), in Africa.
  8. Interview by Joshi with senior official responsible for domestic taxes in Tanzania, November 2011.
  9. Jibao, Prichard, and van den Boogaard (2014) present evidence, for example, that members of border management committees in Sierra Leone tend to face higher levels of extraction by customs authorities, and find suggestive evidence that this is a direct consequence of their efforts to organise trader interests.
  10. See Zinnes (2009) for a fuller exposition of the approach and critiques.
  11. This draws on unpublished research conducted by Prichard, as well as Kamunyor (2007). The importance of bribes and harassment, alongside taxation and regulation, is similarly emphasised in survey evidence from Tanzania (Fjeldstad, Kolstad, & Nygaard, 2006).
  12. Business associations can help overcome some of these empowerment barriers by reducing transaction costs in disputes, protecting property rights, and providing information about markets, making membership in business associations a potentially viable alternative strategy for getting the benefits of formalising (Nugent & Sukiassyan, 2009).
  13. As de Soto (1989) pointed out many years ago, informal street vendors in Peru were keen to pay taxes to gain quasi-legal status, as insecure property rights can otherwise constrain investment and make expansion risky.
  14. Interviews conducted by Prichard in May 2011 with public officials involved in implementing the reform programme.
  15. There is anecdotal evidence of governments claiming to be pursuing informal sector taxation specifically in order to spur public engagement among informal sector operators, by giving them a greater stake in the state. Whether or not such government statements are genuine, or mere public relations, is an important research question, as such a rationale could potentially overcome traditional resistance to reform.
  16. As Haggard and Webb (1993, p. 144) have written of reform more broadly, reform experiences 'show that interest group pressures need not block reform even in democracies. Under the right institutional conditions, astute political leaders can build new coalitions of winners that crowd out those with an interest in maintaining the status quo'.
  17. This notion mirrors a distinction within the broader literature on informality between 'top-down' and 'bottom-up' pathways toward the formal incorporation of the informal sector (Meagher & Lindell, 2013).
  18. For example, over-reliance on revenue targets, by governments and donors alike, likely generates disincentives for taxing the informal sector effectively and equitably (Bird & Vazquez-Caro, 2011; Fjeldstad, 2001; Prichard, Brun, & Morrissey, 2012).
  19. This section draws heavily on a presentation by Christine Shekidele (2009).
  20. In 2006-2007, 16 per cent of new registrants were through the BMS. In 2007-2008, that number had grown to 43 per cent, and this was sustained in 2008-2009 at 41 per cent.
  21. Observers have noted the potential for such arrangements to work in other countries. For example, see McKerchar and Evans (2009) for Nigeria.
  22. While their research focuses primarily on property taxation, Bo City Council has equally enjoyed significant success in strengthening market and business taxation, both of which have been linked to specific improvements in service delivery.
  23. Based on presentations made by Uzarama Vincent (2009) and Emmanuel Hategeka (2009).
  24. In a similar vein, Pashev (2006), examining presumptive taxes in Bulgaria, argues that such taxes should not be loaded with equity objectives but assigned to enhance collection efficiency. He suggests their best use is as licence taxes on micro businesses levied by local governments, rather than as central taxes on income.
  25. Personal interview, Gerard Chambas, 25 May 2011, as well as information presented by the Cameroonian Tax Authorities (Assobo 2011).
  26. Tax liability is assessed by estimating turnover, applying a predetermined industry-specific profit rate, and taxing the resultant profits at the standard income tax rate (Prichard, 2010b; Warner, Beyede, Asaminew, & Sibhatu, 2005; Warner, Ergano, Bekele, & Moges, 2005).
  27. Interviews by Joshi with staff of Streetnet International, Patna, India, July 2004.

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