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**Taxing the Informal Economy:  
Challenges, Possibilities and  
Remaining Questions**

Anuradha Joshi, Wilson Prichard and Christopher Heady  
August 2013



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# Taxing the Informal Economy: Challenges, Possibilities and Remaining Questions\*

Anuradha Joshi, Wilson Prichard and Christopher Heady

## Summary

Recent years have witnessed significantly increased attention to the challenge of taxing small businesses in the informal sector. However, much of this recent attention has remained focused on comparatively technical issues of revenue maximisation and policy design. This paper argues that this debate should focus increasingly on the wider development implications of informal sector taxation, as well as the political and institutional barriers to improved performance.

When considering the merits of committing scarce resources to taxing small informal sector firms, debate has frequently focused on limited revenue potential, high costs of collection and potentially perverse impacts on small firms. By contrast, recent arguments have increasingly emphasised more indirect benefits of informal taxation in relation to economic growth, tax compliance and governance. These potentially broader benefits are increasingly finding support in recent research, but they are contingent on government support and consequently demand further attention.

When we turn our attention away from whether tax authorities should tax small informal businesses towards the challenge of how to do so more effectively, we again argue that a broader frame of analysis is needed. Most existing research has focused on developing less distortionary tax regimes and on tax simplification in order to reduce the costs of compliance. However, while important, these strategies remain too narrow. Encouraging tax compliance demands not only lowering costs but also strengthening the potential benefits of formalisation, from increased security to new economic opportunities. As importantly, successful reform needs political support from political leaders, tax administrators and taxpayers alike. This demands greater attention to strengthening political incentives for reform, through strategic policy, administrative and institutional reform. With this in mind, the paper highlights a number of recent experiences that have sought to address these challenges, but which need further study.

**Keywords:** taxation; informal sector; developing countries; politics; hard-to-tax.

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# Introduction

The question of taxing the informal economy<sup>1</sup> in developing and transition countries has received increasing attention in recent years.<sup>2</sup> This reflects a growing recognition of 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 (Schneider and Klinglmaier 2004, Schneider et al. 2010). Taxing the informal sector may also be essential to sustain tax morale and tax compliance among larger firms (Torgler 2003, Terkper 2003, Alm et al. 2003). With respect to *growth*, the formalisation of informal sector firms may accelerate growth and may have broader benefits for existing formal sector firms (Loeprick 2009, Perry et al 2007, Fajnzylber et al 2009a, 2009b, McCulloch et al. 2010, de Mel et al. 2012). Finally, with respect to *governance*, the payment of taxes by firms in the informal economy may be a way of engaging firms with the state, and thus promoting good governance and political accountability (Joshi and Ayee 2008, Prichard 2009).

However, while the topic has received more attention, this has not been without controversy or challenges. Controversy has surrounded the question of whether taxing the informal sector should, in fact, be a major priority for developing country governments. In the view of critics, the potential revenue yields are low, administrative costs are high, tax incidence is likely to be regressive, and the broader growth and governance gains remain insufficiently proven (Keen 2012: 19-21, 30-32). This disagreement aside, major questions remain about how, in practice, to achieve meaningful improvements in informal sector taxation, as progress in implementation has been slow. *Policymakers* have shown comparatively little interest in this area, owing to the relatively small amount of revenue that can be raised compared to large businesses, and the potentially high political cost of trying to expand informal sector taxation. Meanwhile, *tax administrators* face major operational difficulties – including the lack of bookkeeping, transience of operations and the large number of unregistered businesses. They may also have few incentives to prioritise informal sector taxation.

This paper seeks to take stock of the existing debate, to draw attention to new thinking about how to strengthen informal sector taxation, and to highlight recent innovations and efforts. While there are many definitions of the informal sector, this review focuses on small and medium sized informal enterprises, rather than workers in the informal sector. The central goal is to move beyond the majority of the recent literature, which addresses the problem of taxing the informal sector largely in terms of the technical demands of policy design, in order to frame the issue equally as a problem of incentives, politics and institutions. That is, what incentives can be created to 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 reform generally, and recent innovations specifically, in terms of their ability to address these challenges.

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<sup>1</sup> 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 et al. 2002). We follow the trend in the literature reviewed here, which tends to use both terms.

<sup>2</sup> Recent conferences looking at the theme of informal sector taxation in Africa and Asia that were organised by the International Tax Dialogue (ITD) reflect this concern. These were held in Rwanda ([www.itdweb.org/rwandaconference/documents/program.pdf](http://www.itdweb.org/rwandaconference/documents/program.pdf)), Georgia ([www.itdweb.org/GeorgiaConference/documents/Program.pdf](http://www.itdweb.org/GeorgiaConference/documents/Program.pdf)), and the Philippines ([www.itdweb.org/ManilaConference/documents/program.pdf](http://www.itdweb.org/ManilaConference/documents/program.pdf)). Simultaneously, scholars working on the business environment, private sector development and economic growth are also increasingly aware of issues related to the informal economy (including taxation) as evident from the recent Donor Committee for Enterprise Development's conference on 'Business Environment Reform and the Informal Economy' in Cape Town, South Africa, April 2010 ([www.enterprise-development.org/page/informal-economy-conference-2010](http://www.enterprise-development.org/page/informal-economy-conference-2010)). Most importantly, a growing number of tax authorities are looking seriously at ways of tackling this issue, and a number of experiments have been carried out in several countries, particularly in Africa, many of which are explored in this paper.

The remainder of the paper proceeds as follows. Section one explores competing definitions of the informal economy, highlighting our focus on micro and small enterprises large enough to pay taxes, but small enough to warrant unique policy and administrative arrangements. Section two turns to the question of whether informal sector taxation should, in fact, be given some priority in low-income countries, and suggests that there are persuasive arguments for doing so. Section three presents a review of the major policy options for taxing informal sector firms, highlighting our focus on specialised presumptive tax regimes that target small enterprises. Section four considers the broad barriers to more effective taxation of the informal sector, and possible approaches to identifying solutions. It highlights both the need to create individual and collective incentives for small firms to more readily accept taxation, and the challenge of generating commitment to more effective taxation among political elites and tax administrators. Section five draws on this analysis in exploring a series of recent administrative innovations aimed at strengthening informal sector taxation. While many are very recent, we consider their impact so far, as well as the extent to which they address the major barriers to success identified earlier. The final section highlights a series of key questions that need to be addressed in future thinking about research and policy.

# 1 Defining the informal sector

The term informal sector is much debated and contested. As Peattie (1987) noted several decades ago, the concept is a fuzzy one, popular because it encompasses the interests of a wide variety of interest groups. The term, originally proposed by Keith Hart (1973), was initially used to refer 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' (Hart 2005). In the seventies, the International Labour Organisation took up the concept, and mainly used it for small and microenterprises that were outside the purview of government regulation and taxation (ILO 1972). These were mainly viewed as businesses in the subsistence economy. The term was reinterpreted in 1989, when De Soto identified the informal sector as a source of dynamism and growth, held back only by inappropriate government regulation. The conception of the informal sector thus moved to a focus on the legal status of the business: whether or not it was registered and followed appropriate legislation. It is this legal definition that has widespread use today (Gerxhani 2004, Kenyon 2007). 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 used to describe a duality: an opposition to the formal sector. In this conception firms can be classified into one category or the other. In practice, however, the duality description is misleading. As 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). It is clear that, 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. Focusing solely on the question of tax compliance, while informal sector operators may escape national taxation, they are often burdened by several types of fees, charges and licensing costs paid to local governments

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<sup>3</sup> Some have argued that the size of the informal sector is related to deliberate government policies and regulations that create barriers to entry and related rents that can be easily appropriated through taxation at low administrative costs (Auriol and Warlters 2005). Others suggest that regulation is related to the size of the informal economy only in countries with effective law enforcement (Kus 2010).

(de Mel et al. 2010). More broadly, the literature on private sector development has long highlighted that the formal and informal economies are inexorably linked.<sup>4</sup> 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 material (Mitchell 1993). At the same time, many street vendors and small traders operate on behalf of larger and medium size businesses, with, for example, retailers in Africa often engaging informal sector operators to sell their goods on the street.

Following much of the existing literature, we make several boundary choices for this research. 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. The more important distinction is between three groups: subsistence enterprises which would normally not be liable for taxes; informal small and microenterprises who could be the subject of specific informal sector targeting regimes; and small and medium firms, who are clearly large enough to be in the standard tax net but are not.<sup>5</sup> These three groups are described in Table 1 below.

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

| Features                    | Informal Economy   |   |   | Formal Economy   |
|-----------------------------|--|---|---|--|
|                             | A<br>Subsistence Enterprises   | B<br>Microenterprises and Small Businesses  | C<br>Small and Medium Businesses  | D<br>Small, Medium and Large Businesses                                    |
| Degree of informality       | Totally informal for the most part   | High proportion of sales undeclared and workers not registered                                | Some proportion of sales undeclared and workers unregistered                        | Labour and firms registered and regulated                                  |
| Type of activity            | Street traders, cottage/microenterprises, subsistence farmers                      | Small manufacturers, service providers, distributors, contractors                             | Small and medium manufacturers, service providers                                   | 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, well educated, high level of skills  | Non-poor, likely educated, skilled  | 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 perhaps business insurance and business support services, security               | Personal and business insurance, business development services                      | Personal and business insurance, business development services             |
| Tax implications            | Earnings can be below minimum tax threshold<br>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       | High rates to encourage graduation into formal regime                               |  |

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

<sup>4</sup> 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 microentrepreneurs 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 microbusinesses (Portes and Castells 1989).<sup>4</sup> These views underpin the quite different conceptions of what policy approaches to take vis-a-vis formalisation.

<sup>5</sup> Standard tax policy literature distinguishes between Large Taxpayers, Medium Taxpayers and Small Taxpayers. Some make a distinction between small and medium-sized enterprises (SMEs) and microenterprises, which include subsistence businesses (Bodin and Koukpaizan 2008).

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 liability for tax 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 bringing these firms into the tax net, 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 motivation of such firms and the merits of taxing them.

## 2 Should taxing the informal sector be a priority?

As noted in the introduction, increasing attention to the taxation of the informal economy is grounded in its potential importance to revenue, growth and governance. However, it is important to interrogate the basis for this enthusiasm carefully. Most notably, the direct revenue benefits of taxing the informal sector are likely to be relatively modest, and the implications for vertical equity potentially adverse. As such, much of the argument for taxation of the informal sector is grounded in potentially more indirect revenue benefits, the prospects of accelerated growth and the potential for governance gains. These effects are less well established empirically. On balance, they nonetheless present a convincing argument for increased efforts to expand taxation of the informal economy, though there is a need for sensitivity to potential costs and greater research into predicted benefits.

### 2.1 Revenue and equity implications

Much of the debate over the costs and benefits of taxing the informal sector has focused on the direct revenue and equity implications of the taxes themselves. On the surface, taxation of the informal economy appears to be a potentially important source of government revenue, as the informal sector comprises a large, and in many countries growing, share of GDP (Schneider and Klingmair 2004, Schneider et al. 2010).<sup>7</sup> However, in practice the revenue gains from expanded taxation of the informal economy are likely to be comparatively modest over the short to medium term. Apart from the difficulty of bringing such firms into the tax net, individual incomes within the sector are low, and tax rates correspondingly modest, while the costs of collection and overall administrative burden are very high, owing to the large number of individual firms and the difficulty of monitoring. Further opposition to the taxation of the informal economy is sometimes raised on equity grounds, as the operators of informal sector firms are frequently low-income, thus making taxation of such firms potentially regressive (e.g. Pimhidzai and Fox 2012). If efforts to tax the informal sector also increase the risk of relatively coercive or corrupt behaviour by tax officials, these concerns are exacerbated. Consequently, many tax experts have been somewhat sceptical of the value of focusing significant scarce resources in developing countries on taxing small informal sector firms, given low revenue yields, high administrative costs and the questionable value of taxing low-income individuals (Keen 2012: 19-21, 30-32).

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<sup>6</sup> 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, as it tends to include agricultural production minimally, while other hard-to-tax groups, like the high-income self-employed, may also be included (Alm et al. 2004, Bird and Wallace 2003)

<sup>7</sup> Schneider et al. (2010) examined the shadow economy (which is a broader category than just the informal sector) and find that the shadow economy on average modestly shrank between 1999 and 2007, but is still quite large (38.4% of official GDP) in Africa.

Viewed through a purely revenue and equity lens, justification for expanding informal sector taxation rests instead to a significant degree on more indirect connections. One possibility is that the taxation of small informal sector firms, while yielding little revenue in the short-term, serves to bring these 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 among SMEs.<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 as a source of unfairness by formal firms. This may lower general tax morale and discourage tax compliance among larger firms, leading to reduced government revenue (Torgler 2003, Terkper 2003, Alm et al. 2003). The latter argument finds some support in evidence that tax morale is lower in countries with a larger informal sector (Torgler and Schneider 2007), but overall these connections remain only weakly documented empirically.

## 2.2 Implications for growth

At least as important as the immediate revenue implications of informal sector taxation, are the implications of expanded taxation for the growth of small firms. This is central to supporting job creation and poverty reduction among lower-income groups, long-term economic development and the development of a larger tax base over time. The immediate 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. This logic is intuitively compelling, and rests on the notion that small firms opt into informality precisely because they believe that informality will benefit them, given the burdens of formality. However, despite this fear that taxation may hinder growth, 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. At the core of those findings is the fact that informality carries a variety of costs to firms, and it also precludes access to certain opportunities available to formal firms. The benefits of formality may include greater access to credit, increased opportunities to engage with large firms and the government, reduced harassment by police and municipal officials, and access to broader training and support programmes. Of course, the fact that many firms continue to opt into informality, despite these apparent benefits, suggests that there remain important barriers to formality, that the potential benefits to bringing firms into the tax net is likely to be dependent on the particular features of how this goal is achieved, and that any costs and benefits are likely to vary across firms.

Much of the early evidence that formalisation may lead to more rapid growth comes 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? More recently, a handful of studies have begun to provide more robust evidence. In a paper examining the impacts of formalisation based on panel data on microfirms in Mexico, Fajnzylber et al (2009a) find that formalisation in the form of access to credit, training, tax payments and participation in business associations has positive effects on firm profits, growth and survival. Formalisation appears to have the effect of bringing microfirms closer to their optimal size. In a controlled study in Sri Lanka, de Mel et al. (2012) find evidence that formalisation had significant benefits for a small group of firms, while for most firms incomes were relatively unaffected, though firm owners felt that they came to enjoy greater legitimacy.

In a study of Indonesian microenterprises, McCulloch et al. (2010) find that microenterprises employing a greater number of workers (highest employment quartile) increase their profits the most from formalisation. McKenzie and Sakho (2010) examine microfirms in Bolivia using

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<sup>8</sup> Interview by Joshi with senior officer responsible for domestic taxes in Tanzania, November 2011.

distance from the tax office as an instrumental proxy 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. Others using slightly different methods and approaches come to similar conclusions with slightly different emphases and nuances (Fajnzylber et al 2009b). While these studies point towards the existence of growth benefits from formalisation, they do suggest that the benefits may be reduced for the smallest microbusinesses. A survey of informal microfirms in Mexico conducted by McKenzie and Woodruff (2006) provides a possible explanation, as they find that many microbusinesses explain that the benefits of formalisation, though real, are not high enough, or exclusive enough, for them to be an incentive to formalise. Given that microbusiness may be able, for example, to rely on informal credit mechanisms, the added value of formalisation may be comparatively limited.

Another reason why the benefits of formalisation may be smaller for microbusinesses is that these businesses may have different interests than larger firms. There is a stream of literature that argues that many microbusinesses are operated by individuals who are not entrepreneurs, but who are doing something while waiting for an opportunity to enter salaried jobs, or who are running microbusinesses in parallel with other employment in order to supplement income (Maloney 2004). In such circumstances, expanding the business may not be a central motivation, and formalisation is more likely to be irrelevant and potentially costly. More broadly, there may be differences between firms who choose to enter the tax net in order to access new opportunities and those that are simply ‘caught’ by the tax authorities. The only study to explicitly adopt this distinction is Fajnzylber et al. (2009a: 1042), and they find that paying taxes constituted a benefit for all firms, leading to at least a 20 per cent increase in profits, whether they were unfortunately caught or willingly compliant.

### **2.3 Governance implications**

An important additional factor motivating recent interest in taxing the informal economy is the possibility that the payment of taxes by firms in the informal economy may be a way of promoting good governance and political accountability of the state. This argument builds on a broader body of research suggesting that tax payment may contribute to broader governance gains 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 and Lien 1985, Levi 1988). Second, individuals may be more likely to make demands for responsiveness and accountability if they are paying taxes, as it may foster a sense of ownership over government activities (Bird and Vaillancourt 1998: 10-11, Prichard 2009, 2010b). Third, efforts to tax informal sector operators may encourage collective action and collective political engagement by informal sector associations, providing a longer term foundation for expanded bargaining (Joshi and Aye 2008, Prichard 2009).

These potential connections suggest that the expanded taxation of the informal economy, if pursued in a comparatively contractual manner (Moore 2008), could become an important basis for expanding political voice among relatively marginalised groups. However, evidence for these propositions remains very preliminary. Joshi and Aye (2008) show that government efforts in Ghana to tax informal sector firms resulted in at least some degree of 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 prior to elections in 2005 triggered some public mobilisation 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, though they do not explore any broader governance implications. As such, these issues remain a potentially powerful argument for taxing informal sector operators, though much more research is needed.

## 3 Policy options for taxing the informal sector

The various costs and benefits of taxing the informal sector lead to disagreement about how much priority it should be given. There is, however, broad agreement on the value of improving existing practices, which are frequently both ineffective and prone to abuse. The bulk of existing research on this topic has focused on the technical design of appropriate policies for taxing the informal economy, with a smaller literature addressing the question of strengthening administration. We correspondingly consider alternative policy strategies here, while we return to the less studied question of administration in the following section. We focus exclusively on taxes, but it is worth again bearing in mind that informal sector firms also frequently pay a variety of fees, charges and licensing costs, particularly to local governments. We propose that 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, while it is specialised presumptive taxes that are our primary focus.

### 3.1 Taxing the informal sector indirectly

The simplest way to tax the informal sector is indirectly, by taxing the goods and services that it buys and sells, most obviously through VAT and import and export duties. 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 the value chain. In this sense many informal sector firms effectively do pay some taxes, though less than would be the case if they were registered. More important than the revenue foregone, as this strategy does not require active informal sector participation in the tax system, it is likely to have a limited impact on long-term compliance, does not carry the potential growth benefits of formalisation, and is unlikely to spur governance gains.

In practice, this is a predominant form of taxation of informal sector firms. While export taxes were once a common form of taxation of agricultural production of cash crops (e.g. cocoa, coffee and tea) in developing countries, the role of such taxes has significantly diminished over the past few decades. In contrast, import taxes have remained a major component of developing country tax revenue, and are still significant despite sharp reductions in rates since the 1980s. Gordon and Li (2009) report that the poorest countries on average still raise more than 16 per cent of government revenue from border taxes, a number that declines to 5.4 per cent for the richer developing countries and 0.7 per cent for developed countries. They also develop a model that explicitly explains this pattern as a strategy for dealing with tax evasion by potential taxpayers that are outside of the banking system and difficult to tax.

The traditional economic argument against import and export taxes is that they prevent countries from fully exploiting their comparative advantage, and may thus discourage growth more than domestic taxes. This argument is weakened by the difficulties in taxing the informal sector: Dasgupta and Stiglitz (1974) showed that limitations in the imposition of domestic taxes could justify trade taxes (tariffs), and Heady and Mitra (1987) showed how an untaxable agricultural sector could justify taxation of imported fertilizer. More recently, Emran and Stiglitz (2005) have argued that a non-taxable informal sector makes tariffs desirable. In addition, it is a form of taxation that 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 education and capacity in some parts of the informal sector.

### 3.2 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, including income taxes and VAT, to reach small informal firms. This is a question of strengthening enforcement by identifying small informal sector firms and ensuring compliance (e.g. Terkper 2003, Bird and Casanegra 1992, Bird and Wallace 2003: 7-8). It may be buttressed by the use of additional incentives for compliance, such as reduced rates or rewards to small firms that maintain effective records, 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 (ITD 2007, Loerick 2009). However, while strengthening 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 relative to potential revenue, while also imposing high compliance costs on small firms and presenting the risk of harassment and abuse.

As a result, developing countries have overwhelmingly opted to establish 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). The one exception is the widespread use in some countries of withholding taxes. 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. This means that it is only the non-compliant firms that ultimately bear the taxes, thus providing an incentive for non-compliant firms to become tax compliant.

These withholding taxes can be levied on imports or on domestic transactions, for example, where large tax-compliant firms collect withholding taxes on transactions that they make with small businesses that may not be tax compliant. For example, large construction companies may be required to withhold taxes on the payments that they make to small sub-contractors. The use of withholding tax on domestic transactions is widespread, including, for example, Sierra Leone (which requires tenants to withhold tax on rent payments to landlords), Burkino Faso (where all businesses have to withhold taxes on transactions with traders who are not tax-registered), and Bangladesh (which has very extensive withholding requirements).<sup>9</sup>

Keen (2007) provides evidence that an appreciable number of countries similarly apply withholding taxes on imports that can be credited against income tax, including Benin, Burkino Faso, Central African Republic, Egypt, Ethiopia, Gabon, Guinea, Mali, Mauritania, Niger, Pakistan, Rwanda, Sudan, Togo and Uganda. Of these, Burkino Faso, Mali, Niger and Togo apply higher withholding rates on importers without a tax identification number, thus bringing extra pressure to bear on those who are not tax compliant. Keen (2007) also provides a theoretical argument against the claim of Emran and Stiglitz (2005, see previous section), and shows that there is no place for tariffs if both VAT and withholding taxes are optimally set. Keen's argument against tariffs is that a withholding tax on imports acts like a tariff on non-compliant firms (thus raising revenue from them) but is credited back to compliant firms. This means that there is no distortion of international trade for tax-compliant firms, and so the country is better able to take advantage of its comparative advantage.

However, while withholding taxes have obvious merits, they can become administratively burdensome, introduce a high degree of incoherence to the overall system and discourage more fundamental reform (IMF 2011: 40). Administratively, effective withholding tax regimes require cooperation from withholding firms and, most importantly, an effective system for

<sup>9</sup> See presentation by Nasiruddin Ahmed and Aminur Rahman, National Board of Revenue, Bangladesh, at the ITD conference 'Effective Micro and Small Business Compliance Management – Tax Policy and Tax Administration Solutions', 2-5 March 2010, City of Makati, Philippines.

crediting those firms from whom tax is withheld. Both Sierra Leone and Burkino Faso, for example, have difficulty in identifying and managing the large number of withholding agents.<sup>10</sup> In contrast, Bangladesh has had considerable success with withholding taxes and collects more than half of its income tax revenue this way, though at the cost of significant administrative complexity.<sup>11</sup>

### 3.3 Presumptive taxes

At a very basic level, 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). In response, many countries apply presumptive taxes to small firms. These taxes use a simplified indicator of the tax base (profits and/or value added), in order to simplify record keeping for firms and the estimation of tax liabilities by tax collectors.

While presumptive taxes share this basic commonality, their particular design is highly variable across countries. Loeprick (2009) outlines the available options for presumptive taxation, while Bird and Wallace (2003) provide a number of country examples, paying particular attention to transition countries. The options can be classified as:

1. Allowing a simplification of the generally applicable tax base, such as the use of cash rather than accrual accounting. IMF (2011: 41) supports this approach, noting that 'the difficulty is not that small traders cannot keep simple accounts – it is persuading them to share them'.
2. 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.
3. 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 the simplest form such taxes may approach a simple business fee, with microbusinesses periodically paying a lump sum tax at a fixed rate.

Such presumptive tax regimes are extremely widespread, though they 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 (based on turnover) as well as a 2 per cent tax on turnover instead of VAT. 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 microbusinesses are covered by a tax stamp regime, in which a fixed tax is paid on a quarterly basis (Prichard 2009, 2010b).

There is an important trade-off in the choice of these systems. The use of a tax base that is closer to the generally applicable tax base improves horizontal equity, and reduces any incentive for the firm to stay in the presumptive tax regime once they have developed the necessary skills to comply with the standard tax regime. As some measure of size is the normal criterion for inclusion in the presumptive regime, this can reduce firms' incentives to grow. On the other hand, using a tax base that is much simpler to measure – such as

<sup>10</sup> See presentation by Sebastian James, FIAS, World Bank Group, at the ITD conference 'Taxing Micro and Small Business - From Confrontation to Cooperation', 22- 24 April 2009, Kigali, Rwanda.

<sup>11</sup> See presentation by Nasiruddin Ahmed and Aminur Rahman, National Board of Revenue, Bangladesh, at the ITD conference 'Effective Micro and Small Business Compliance Management –Tax Policy and Tax Administration Solutions', 2-5 March 2010, City of Makati, Philippines.

number of workers – reduces the compliance burden on the firm and makes the liability easier to check for the tax administration.

In addition, the use of a tax base that is further from the generally applicable tax base makes it more likely that at least some firms will pay substantially lower taxes in the presumptive regime than they would in the standard regime. Many presumptive regimes are deliberately designed to reduce the tax payments of smaller firms, increasing the problem of firms not wishing to graduate onto the standard regime when they are able to, and large firms making themselves appear small. This makes it necessary to have rules to prevent this from happening, for example a maximum level of turnover coupled with rules to prevent artificial splitting of businesses in order to get below the threshold.

On the other hand, it is also possible, though seemingly less common, that some firms may bear a disproportionately heavy tax burden under poorly designed presumptive regimes. Most notably, turnover taxes, generally set at 2 or 3 per cent of turnover, make implicit assumptions about average rates of value added and profitability, but may consequently impose an unintentionally heavy burden on small firms with very narrow profit margins. This raises the question of whether presumptive regimes should be rebuttable (Bird and Wallace, 2003, p. 21) – allowing such firms to opt for the standard regime. But for the smallest firms, opting into the standard regime is unlikely to be a plausible alternative. While attention to the risk of presumptive regimes that allow for reduced tax burden is crucial, it is also important to be aware of the risk of overtaxing small firms, particularly where profit margins are small and turnover-based taxes may overestimate profitability.

## 4 Improving outcomes: incentives, politics and institutions

While there is thus growing interest in taxing the informal economy, and well-established thinking about appropriate policy measures for taxing the informal sector, progress in practice has been comparatively slow. In part, this reflects the administrative complexity of locating and taxing very large numbers of small firms that are eager to evade being captured in the tax net. Though less researched, it also appears to reflect lack of commitment on the part of both political leaders and tax administrators, both of whom may face weak incentives to focus resources on taxing the informal economy. Collectively, this suggests the need to better understand incentives, politics and institutions in relation to informal sector taxation, in order to devise strategies for encouraging tax compliance among informal sector firms, strengthening political leadership and creating positive incentives for administrators. What follows first considers the question of tax payment from the perspective of firms, and then turns to an analysis of the interests of political leaders and administrators.

### 4.1 Strengthening firm incentives, capacity and collective action

Given their small size, mobility and potential political influence, more effective taxation of informal sector firms is likely to depend not only on more effective enforcement, but also on encouraging greater quasi-voluntary compliance among such firms. The incentives for informal sector firms to enter the tax net are closely connected to the broader question of formalisation, as firms are likely to enter the tax net in large part in order to access the potential economic benefits of formalisation (Perry et al 2007).<sup>12</sup> It is consequently a small

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<sup>12</sup> There is also a minority view in the literature that allowing informality is one way of governments dealing with the fact that they are unable to collect taxes, consequently unable to provide adequate public services such as the rule of law, or adequate employment opportunities in the formal sector (Garcia Bolivar 2006).

but growing literature on formalisation that offers the greatest insights into potential strategies for encouraging informal sector firms to enter the tax net. This literature can be usefully broken into three parts: (a) a cost-benefit approach, underpinned by a legalistic view which views informality as a choice; (b) 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 (c) an approach that emphasises the importance of collective action and state-society bargaining (Zinnes 2009, Kenyon 2007).

#### **4.1.1 Shifting incentives: a cost-benefit approach to tax compliance**

The dominant strand of existing research views formalisation as a rational choice for firms: firms will formalise if the benefits of formalisation outweigh the costs.<sup>13</sup> Costs of formalisation include the time and resources taken in registration or getting licences, the cost of tax compliance, and the cost of following labour laws and other regulations. Benefits commonly take the form of access to credit and capital markets, government procurement contracts, other external markets, state-provided services and facilities. Benefits equally include avoiding the frequent costs of informality, including paying bribes and the need to provide free services, relocate or shut down business to avoid taxes (FIAS 2008). Significantly, much of the research in this area shows 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 (Ngoi 1997; De Soto 1989). Encouraging firms to enter the tax net may often depend on addressing these broader costs and benefits of formalisation.

Several empirical surveys have contributed to understanding the cost-benefit calculations of firms, though these studies focus disproportionately on the costs of formality and informality. 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 US\$180,000 in income and fees, over the 50-year life of a business (ILD 2005 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 costs of doing so (Everest-Phillips 2008). A less conventional cost lies in the complexity of tax legislation, and Bonjean and Chambas (2004) argue that non-compliance often results from ignorance of tax legislation rather than deliberate evasion. Interestingly, cross-regional comparative evidence in Brazil shows that informal employment (and by extension informality) is lower in regions with better education, higher manufacturing and better governance, suggesting that the costs of formalisation may be higher where governance is weak (Jonasson 2011).

The policy implication of such an approach is a focus on business environment reforms that reduce the costs of formalisation or increase the benefits. Reducing the costs of registration, which can be significant in many countries, has been the dominant approach (see *Doing Business* reports from the World Bank: <<http://www.doingbusiness.org/>>). Efforts have similarly been made to use tax compliance cost surveys, and tax evasion surveys, to help identify potential policy entry points that support formalisation and tax compliance (Coolidge 2010, Gerxhani 2007). This has led, for example, to the creation of a new turnover tax for small businesses in South Africa; and to exempting microbusinesses from central taxes, and the creation of a simplified turnover tax regime for small businesses in Yemen (Coolidge 2010, Everest-Phillips 2008). The assumption of these approaches is that if the costs of formalisation, including the costs of tax compliance, are reduced, businesses will formalise in order to gain the benefits of access to credit, security of property, government support for growth and access to markets. That said, some scholars have argued that the benefits likely need to be substantially higher than the costs in order to motivate firms to formalise (Zinnes 2009).

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<sup>13</sup> See Zinnes (2009) for a fuller exposition of the approach and critiques.

Several countries have undertaken such simplification and cost reducing reforms, but their impact on formalisation has been mixed. In Bolivia, while simplification of registration procedures did lead to an increased number of firm registrations, the size of the informal sector remained high (Garcia Bolivar 2006). In Vietnam, similar reforms led to an increase in registration, yet only 40 per cent of the newly registered firms had operated previously in the informal economy (Garcia Bolivar 2006). In Kenya, significant attention has similarly been given to the simplification of the tax system and business registration for small firms through the creation of a single business permit. Positively, and consistent with expectations, Devas and Kelly (2001) report that these efforts encouraged some degree of formalisation and improved conditions overall for small firms. On the other hand, it has become clear over time that the benefits are likely to remain partial, with firms particularly emphasising that formalisation does not necessarily imply freedom from harassment by local officials, and may in some cases lead to increased harassment.<sup>14</sup>

An experiment in Lima, Peru shows the complexities of such formalisation policies (Jaramillo 2010). Surveys showed that small businesses reported huge disadvantages to being informal, yet when licences were offered free (along with help in complying with regulations) only one in four firms were willing to take them. The author argues that the reasons are that there are recurrent costs of being formal (in addition to the one-time cost of registration), and these, along with low perceived benefits of formalisation, limited growth ambitions, and low trust in government, lead firms to avoid formalising even if it has no initial cost. A comparable experiment in Sri Lanka reported similar findings (de Mel et al. 2010). The lesson is that while reducing compliance costs is very important, it is not sufficient on its own to encourage widespread formalisation.<sup>15</sup>

#### **4.1.2 Empowering small firms**

While such cost-benefit analysis has been dominant in the literature, some scholars perceive informality primarily as a problem of empowerment, rather than as a choice (Abor and Quartey 2010, Kanbur 2011, Zinnes 2009). In this view, firms may be unable to register formally due to: problems of capacity – such as illiteracy, limited skills, transience of their business, uncertainty and the prevalence of cash transactions; and problems of the enabling environment – including a general lack of trust in government, and the lack of easy access to a range of services including information, accountancy, security, justice and insurance.<sup>16</sup> Thus, even if aware of the potential benefits of formalisation, such businesses would remain in the informal economy. Of course, lack of capacity and power can be seen as another facet of the costs of formalisation, but this approach stresses the involuntary nature of the informal economy, as opposed to the rational choice calculations of the cost-benefit approach.

The policy advice that follows focuses on what the Commission on Legal Empowerment of the Poor (CLEP) (2008 quoted in Zinnes 2009) call the four pillars of legal empowerment: (i) strengthening access to justice; (ii) assuring property rights; (iii) ensuring safe working conditions, including for women and children; and (iv) increasing economic opportunities such as credit, markets and investment. However, no one policy mix is likely to fit all contexts (Kanbur 2011). This approach seems most appropriate to the subsistence end of the informal

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<sup>14</sup> This draws on unpublished research conducted by Joshi, as well as Kamunyor (2007). This emphasis on the importance of bribes and harassment, alongside taxation and regulation, is likewise emphasised in survey evidence from Tanzania (Fjeldstad et al. 2006).

<sup>15</sup> Some cross-country analysis finds that the degree of state regulation seems to have a significant association with the size of the informal economy only in nations with effective law enforcement. Where this is not the case, deregulatory policies are unlikely to achieve the goals of formalisation (Kus 2010).

<sup>16</sup> There is some interesting evidence to suggest that business associations can help overcome some of these empowerment barriers and can reduce transaction costs in disputes, help protect property rights and provide information about markets. Thus membership of business associations can be a viable substitute for remaining informal. Research finds that in transition countries they constitute a transparent, formal and efficient alternative to staying informal by helping reduce unofficial payments and bribes and underreporting for tax purposes (Nugent and Sukiassyan 2009).

economy spectrum in which illiteracy, lack of accounting skills, poor information and a mistrust of government prevails. An interesting approach to the issue of empowerment comes from China, where liberalisation of the economy has led to a considerable growth of the informal economy. In Shanghai the municipal authorities took a novel approach by 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, to encourage growth and eventual formalisation (Howell, 2002).

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 with other policies. Thus the policy canvass is broader than reducing costs of registration or increasing economic benefits, and includes important elements 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. These can lead microbusinesses to view taxation as one step towards empowerment and legalisation, thus escaping arbitrary harassment and injustice. 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.

#### **4.1.3 Collective action and state-society interactions**

An extension of these two approaches seeks to focus additional attention on the nature of interactions between the state and informal sector operators, and on the importance of collective action within the informal economy (Tendler 2002, Kenyon 2007, Daly and Spence 2010). 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 is related to the need for empowerment, and arises from the fact that many intended beneficiaries in the informal economy simply are not aware of the programmes targeted at them. While this problem varies from one context to another, it is surprising how prevalent it is, and how large is the consequent need for states to adopt strategies that focus greater attention on outreach and taxpayer services.

The importance of credibility reflects the fact that firms need assurances that the government will uphold their part of any bargain (of reduced tax rates, or provision of benefits) if firms formalise, as a fear of predation is a significant deterrent to successful formalisation policies (Jaramillo 2010). Given a pervasive lack of trust in government among many small firms, establishing this credibility can be challenging. In Bangladesh, the government encouraged the registration of businesses through tax fairs which reduced the costs involved, yet a major fear among firms was that while the registration process was relatively smooth, it might open the door to subsequent harassment.<sup>17</sup> This issue of credibility is a recurrent theme in tax policy implementation, and has also been pointed out as a key element of success in the formation of autonomous revenue agencies (Taliervo 2004).

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. However, there are significant barriers to effective collective action in many sectors of the informal economy. This issue is taken up in Joshi and Ayee's (2008) analysis of the conditions under which governments are likely to tax the informal economy successfully. Drawing on empirical evidence from Ghana, Peru and Senegal, they argue that the

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<sup>17</sup> Unpublished research conducted by Prichard.

organisation of the informal economy matters, as the existence of collective actors who can bargain with policy makers around taxes is essential to arrive at policy solutions that both sides will buy into. In Senegal, although the informal sector was well organised with viable channels to bargain around taxes, informal sector associations were powerful and were able to resist the imposition of either VAT or direct taxes. In Peru, the government attempted to impose higher taxes on an informal sector that was fragmented and unorganised. This resulted in harassment of businesses in the absence of a real capacity to monitor and collect, and ultimately a dysfunctional system for all involved. In Ghana, the association of private transport operators was able to strike a deal with the government, and collected income taxes from its members in exchange for tangible services, in an arrangement which is detailed in section five. These findings thus point to the importance of collective actors and of credible institutional channels for negotiation between the state and associations, without which such bargaining cannot stick.

As important as the need for collective actors within the informal sector, is the question of whether national revenue authorities are likely to have the capacity and interest to engage in negotiating with these collective actors. Particularly when the informal sector is loosely organised, often with several rival associations, negotiation implies understanding and interacting with several small collective actors with diverse interests. As is discussed in more detail below, relatively weak incentives for the tax administration to engage with taxing the informal sector may make negotiations unlikely. Bodin and Koukpaizan (2008) propose that local authorities are the more appropriate locus for such negotiations because they: (a) have incentives to invest in collecting taxes from this sector (due to their need for own source of revenue); (b) can provide tangible benefits to businesses thus increasing compliance; and (c) have more detailed knowledge about this sector than national tax agencies. Of course, such assignment requires capacity on the part of the local government to collect, and streamlining the graduation of growing firms into the national tax system. More generally, though, this discussion draws attention to the importance of collective action and state-society interactions to the success of efforts to tax the informal economy.

## **4.2 Strengthening political and administrative commitment**

While the preceding discussion highlights growing attention to the factors that may shape incentives for firms to enter into the tax net and formalise, it is equally important to consider incentives for governments and the state to make taxing the informal sector a priority. Without reform champions who wield sufficient political influence to overcome entrenched resistance, successful reform is unlikely (e.g. Boesen 2004, Heredia and Schneider 2003). Unfortunately, there are a variety of reasons to believe that, in practice, government and state actors may face comparatively weak incentives to pursue more effective taxation of the informal economy aggressively. Progress will depend in part on strategies to build greater support for reform.

This area has begun to receive some attention within the relevant literature (e.g. Tendler 2002, Kenyon 2007, Daly and Spence 2010), but on balance has remained peripheral to most debates. What follows does not seek to delve into the little explored detail of why particular tax policies are adopted, but rather to consider the broader question of what incentives political and administrative leaders face with respect to informal sector taxation. That is, what can we say generally about the incentives that they face, and how might those incentives potentially shift? This section is divided into two parts. The first considers the incentives political leaders face, while the second considers the incentives facing administrators, from senior officials to frontline tax collectors.

#### **4.2.1 Strengthening political incentives to pursue reform**

Though there are only a few studies of the issue, there are powerful reasons to expect that political leaders may have weak incentives to tax the informal economy. The simple version goes thus: informal taxpayers are too numerous and taxing them will raise very little revenue and make politicians unpopular, so it is not in the interest of politicians to tax them; better to leave them alone. For example, as Kloeden (2011: 26) points out, in Africa small and micro enterprises generate only up to 10 per cent of revenue, even though they comprise up to 90 per cent of taxpayers. It would not be politically sensible for politicians to alienate a majority of their constituents by trying to impose taxes that raise little revenue. The fact that informal sector taxation may promote public engagement and broader governance gains, while attractive from the social perspective, is not likely to be a particularly strong inducement to governments. In most cases they would rather avoid such public mobilisation.<sup>18</sup>

The more complex version of the 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: 99). This dynamic has long been observed in the literature on informal settlements and land markets, and, in fact, some argue 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 this 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.

Despite this basic structure of incentives, instances of successful reform suggest that the challenge of changing these incentives is not insurmountable.<sup>19</sup> However, none of the studies reviewed for this paper actually presented politicians' perspectives, either through interviews, or through public statements. The interesting question for prospective reformers is under what circumstances may governments give greater priority to taxing the informal sector, and there is clearly much more research required in this area.

Intuitively, the most obvious answer is that reform will be more politically feasible if it enjoys greater buy-in from informal sector firms themselves. As has been discussed at length, there is evidence suggesting that informal sector businesses are willing to pay taxes when: (a) the benefits outweigh the costs; (b) when they are sufficiently empowered; and (c) when there are effective institutional channels for facilitating collective action and bargaining (Roever 2005). As such, adopting such strategies may not only be good for informal sector firms, but may shift the political balance for politicians seeking to build support for taxing the informal sector, and thus securing greater revenue, increased growth and, potentially, more productive state-society interactions.

The earlier example of informal sector taxation in Ghana is indicative of the potential for such a mutually beneficial outcome. Negotiations between the government and informal sector

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<sup>18</sup> There is anecdotal evidence of select governments claiming to be pursuing informal sector taxation specifically in order to spur public engagement among informal sector operators, by giving them a great stake in the state. Whether or not such government statements are genuine, or mere public relations, is an important research question. Even if genuine, these seem more likely to be isolated examples than a replicable basis for reform across countries.

<sup>19</sup> As Haggard and Webb (1993: 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'.

associations produced modest revenue gains, improved conditions for informal sector actors and, most interestingly, strong alliances between political parties and associations of informal sector workers that helped realign political incentives. 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 and Aye 2008, Prichard 2009). However, while this example is indicative of the potential for building political incentives for informal sector taxation, it also highlights the need to move beyond an existing policy discourse that is focused overwhelmingly on reducing costs of tax compliance, and the broader cost of formalisation. First, it suggests that while cost-reducing measures are very important, there is a need for equal attention to be paid to establishing clear benefits to formalisation (Jaramillo 2010), not least of which is providing credible assurances of protection from harassment from public officials (Kamunyor 2007). Second, it draws attention to the essential role of informal sector collective action, and the existence of institutional channels for bargaining with government, in facilitating the emergence of such agreements. There is thus a seemingly strong argument for seeking to support both elements.

Of course, while getting buy-in from the informal sector is likely to be integral to generating political support for reform, it is also possible that broader constituencies for taxing the informal sector may emerge, or may be fostered by reform leaders. Broadly, reform leaders may seek to frame the drive to tax the informal economy in terms of the need to foster growth and the opportunity to foster a stronger fiscal social contract. However, framing of the debate is likely to be of limited value on its own. More pointedly, the one constituency with potentially strong incentives to support the taxation of the informal economy is formal sector firms. Of course, some such firms clearly benefit from informality, and may intentionally work with informal sector partners in order to avoid government regulation. However, informal sector firms are also frequently direct competitors for formal sector firms, while the formalisation of informal firms may facilitate transactions with the formal sector. Consistent with this logic, 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 trying to facilitate a broader dialogue between government, formal sector associations and informal sector associations may hold promise, though the potential for disagreement is obvious.

#### **4.2.2 Strengthening administrative incentives to pursue reform**

Irrespective of policy choices, the success of any tax will depend on the effectiveness of administration. This is reflected in the oft-quoted maxim that ‘tax administration *is* tax policy’ (Casanegra de Jantscher 1990), and in the observation, more than two decades ago, that tax policy reform is sometimes surprisingly easily achieved precisely because opponents realise that weak administration means it will rarely be well implemented (Ascher 1989). This is all the more true of informal sector taxation, which relies heavily on regular interactions between tax collectors and taxpayers, and involves enormous scope for non-enforcement and/or corruption by so-called street level bureaucrats (Lipsky 1980). While powerful political leadership in the push for reform can certainly encourage more committed administrative effort, tax administrations can also be powerful actors in their own right. A resistant administration may be able to block reform, either through political influence or simply weak implementation, while a proactive administration may be able to advance meaningful reform.

As with political elites, there is evidence that tax administrators may generally have weak incentives to prioritise taxation of the informal economy, for at least two reasons. First, the likely revenue gains are relatively modest. For a tax administrator 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 collecting taxes and enforcing compliance among small operators tends to

represent a particularly demanding task. It is poorly rewarded, offers few opportunities for informal payments and appears to be widely viewed as, at best, lacking prestige, or, at worst, degrading. While there is a need for more research on the perceptions of administrators, the implication of this is that there may be strong resistance to focusing on informal sector taxation from among the rank and file within tax administrations.

At a broad level, the obvious policy implication of these issues is that any reform strategy must pay attention not only to broad political incentives, but also to incentives for administrators to buy into reform. This could take a huge range of forms, and research has the potential to yield important new insights into such strategies.

One relatively straightforward possibility is the simple reorganisation of rewards and incentives for tax administrators, so that involvement with taxing the informal sector is better rewarded and more conducive to future advancement. This may, among other things, rely on the development of performance benchmarks that are more diverse and nuanced than current heavy reliance on the simple meeting of revenue collection targets (Bird and Vazquez-Caro 2011).<sup>20</sup> A more ambitious approach to the same challenge may lie in institutional reform to reward informal sector taxation better. 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: 20).

Another possible option is greater use of technology to facilitate informal sector taxation, with a particularly interesting possibility being 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. However, it may also have several broader benefits. It may increase taxpayer support for reform, as it could help to make the banking system accessible to very small firms while reducing fears among firms that registration will result in expanded harassment. It may similarly increase support among tax administrators, by not only reducing the costs of collection for tax administration, but perhaps also making the work of collection less unattractive and painstaking for front line tax collectors.

A more radical option, noted earlier, is to decentralise elements of informal sector taxation to sub-national governments. This possibility is discussed in more detail below, but the overarching message here is that taxation of informal sector firms is likely to be of much greater fiscal importance to local governments. This may give political leaders and tax administrators alike stronger incentives to make it a priority. This possibility remains speculative, but reflects the type of reform strategies that may expand the political feasibility of taxing the informal economy.

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<sup>20</sup> Though beyond the scope of this paper, there are good reasons to believe that over-reliance on revenue targets, by governments and donors alike, remains an important part of the problem, both in relation to informal sector taxation, and more broadly. In isolation, revenue targets, which can be an important part of broader benchmarking efforts, have the potential to prioritise short-term and often coercive collection at the expense of investments in building rules-based, transparent and client-oriented administration (Bird and Vazquez-Caro 2011, Prichard et al. (forthcoming), Fjeldstad 2001).

## 5 Making informal sector taxation work: lessons from recent experience

Improving taxation of the informal economy will demand not only technically appropriate policy choices, about which much is known, but also broader administrative and institutional reform strategies that can generate both greater acceptance among taxpayers and leadership among political and administrative actors. The discussion so far has highlighted potential elements of such strategies in abstract. This final section examines some recent administrative reform efforts in light of the broad messages explored so far. These reform efforts have generally been poorly studied, and as such the discussion here is very preliminary. It seeks to highlight potential alternative trajectories of reform, and the extent to which these different strategies seem to address major barriers to more effective taxation. This discussion thus aims to buttress the analysis presented so far, but also to point towards possible future directions for both policy and research.

### 5.1 Reorganising tax administration: segmental organisation and the Block Management System (BMS), Tanzania<sup>21</sup>

The most straightforward administrative strategy for improving informal sector taxation is simply to reorganise tax administration, so as to strengthen monitoring and provide more focused incentives for administrators to target small firms. At a broad level, a recent push among many tax reform experts for the introduction of segmental organisation of tax administration, with separate departments to deal with small, medium and large firms, respectively, is consistent with this goal. Such reform is intended to allow for services more specifically tailored to the needs and realities of small firms, and to ensure that tax administrators will have incentives to focus on these firms despite potentially low revenue yields (IMF 2011: 20).

The logic of such segmental organisation can, in principle, be extended further, in creating ever more specialised units for taxing informal sector firms. For example, as part of a broader set of reforms targeted at micro and small firms since 2002, Tanzania has introduced a Block Management System (BMS) aimed at promoting compliance and registering all eligible traders within particular sectoral or geographic areas. The BMS is set up so that trading areas are mapped and divided into blocks on the basis of geography, administrative boundaries or a few streets. Each block is mandated to operate all tax functions of identification, registration, assessing and accounting for revenue collected, with the BMS team allocated a team of staff with relevant skills to perform these functions. The BMS team locate themselves in identified blocks by rotation and intensify their efforts to identify, register, educate and interact with taxpayers, particularly in the informal economy. Door-to-door visits are made to ensure all eligible taxpayers are registered. Each block is set a target for revenue collection, with presumptive taxes used for assessment purposes.

Existing evidence suggests that the BMS has resulted in increasing the number of businesses registering with the tax administration. In 2006-2007, 16 per cent of new registrants were through the BMS. In 2007-2008, the number had grown to 43 per cent, and this was sustained in 2008-2009 at 41 per cent. While the system has thus shown some apparent success, research has yet to explore taxpayer perceptions of this system or the political economy factors that have underpinned this innovative effort, and there is significant scope for future research. That said, it is interesting to note that at least part of the push for

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<sup>21</sup> This section draws heavily on a presentation by Christine Shekidele, Deputy Commissioner TRA made at the ITD conference on 'Taxing Small and Micro-Business: From Confrontation to Cooperation', 22-24 April 2009, Kigali, Rwanda.

this system came from formal firms, who were upset about paying taxes while facing competition from informal businesses. Broadening the tax base was thus a strategic objective for the tax administration to improve compliance among all taxpayers.

## 5.2 Associational taxation: Identifiable Grouping Taxation (IGT), Ghana

While one approach is to focus primarily on enforcement, an alternative approach is to seek actively to address the importance of collective action and credibility for the success of efforts to tax the informal sector. Such a strategy implies proactive efforts to foster effective collective action within the informal sector, coupled with the creation of institutional channels to facilitate bargaining and cooperation between informal sector associations and the state.

This has been the focus of research undertaken by Joshi and Ayee (2008), who focus particularly on the development of associational taxation in Ghana. From 1987 to 2003 the Ghanaian Internal Revenue Service delegated responsibility for collecting income tax from the informal sector to the associations of the informal sector – 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 and Ayee 2002, Joshi and Ayee 2008). Following success in the early years, the arrangement was extended to associations in thirty-two other informal sector activities. IGT has been credited with increasing revenues generated from the informal sector (Joshi and Ayee 2008).

The arrangement overcomes some of the problems associated with tax collection from microbusinesses. 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. The associations bore the burden of identifying members and ensuring that they complied. 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 system allowed for micropayments (initially the system collected taxes daily from transport workers, then shifted to weekly payments). This suited the uncertainty of earnings in the sector and did not become a visible burden. In addition, complying with the tax payments did not make operators individually visible to the state, thus protecting them from the imposition of other, perhaps more burdensome, regulations. The downside was that often informal associations were not internally democratic, and extracted revenues from members without necessarily handing over the collections to the revenue authority. Another problem was that the associations and linked taxation were seen as tax havens for larger enterprises, which could avoid paying full liabilities by claiming to be within the IGT and its presumptive taxes.

These drawbacks became increasingly apparent over time. Despite this, one of the big achievements of the system was inculcating a culture of taxpaying within businesses in the informal economy. This proved important when, recognising growing problems with the IGT system, the government decided to shift to a more common presumptive tax regime, known as the Tax Stamp and Vehicle Income Tax. These new regimes called for informal sector and private transport operators to purchase tax compliance stickers from the tax authorities on a quarterly basis. These were to be visibly displayed at all times. This provided a relatively simple method of tax compliance, but, perhaps most notably, was introduced without any significant resistance. Small tax payments had become a regular expectation for these firms, many of which actually welcomed a shift from the once popular, but increasingly problematic, IGT system (Prichard 2009, 2010b).<sup>22</sup>

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<sup>22</sup> Observers have noted the potential for such arrangements to work in other countries. For example, see McKerchar and Evans (2009) for Nigeria.

The Ghanaian experiment with IGT and the later move to standard presumptive taxes is useful in highlighting several issues. First, that the outlook for taxing the informal sector is not as bleak as it appears, and governments fearing a backlash from attempting taxation may find that the informal sector is not as averse to taxation as one might be led to believe. Second, a close examination of the political context in specific countries might offer clues to potential entry points for taxation that work with the grain of existing state-society relations. Finally, while the IGT is not an ideal tax given some of the drawbacks discussed earlier, if one looks at taxation from a broader, long-term perspective, it does offer a possible route to taxation of the informal economy, with a view towards building more accountable and inclusive states.

### **5.3 Emphasising transparency, services and engagement**

Complementing strategies that focus on enforcement and quite explicit negotiation and cooperation, are more general efforts to focus attention on fostering voluntary compliance by emphasising transparency, taxpayer services and engagement. Such a strategy grows out of the need to foster quasi-voluntary compliance among small firms if informal sector taxation is to be either technically or politically feasible. While there is, again, little systematic research on this topic, select cases suggest ways to move forward.

A first possibility is to focus on transparency, and particularly on establishing clearer links between tax payments and the provision of public services. Such approaches may exist on a spectrum running from transparency about overall revenue collection and public expenditure, to more explicit forms of tax earmarking, where specific taxes are allocated to particular purposes. More explicit earmarking has the advantage of potentially building stronger trust among taxpayers by delivering well defined benefits, but has the disadvantage of reducing budget flexibility and creating a perverse expectation that taxes should function on a fee-for-service basis, rather than on the basis of a broader conception of the public good. A recent example comes from Sierra Leone, where local governments have been attempting to expand local government tax capacity, including through taxes on markets and small businesses. Research by Jibao and Prichard (2012) finds that the most successful efforts have been in Bo City Council, where the government has gone to great lengths to communicate revenue and expenditure data to the public, including informally highlighting connections between specific taxes and public expenditure. In a similar vein, Korsun and Meagher (2004) report findings from a donor-funded project in Guinea, where the collection of market taxes doubled after they were linked explicitly to the construction of new market facilities. While such explicit forms of earmarking cannot be applied universally, they indicate the potential to encourage compliance through transparency.

A slightly different strategy for encouraging tax compliance lies in strengthening taxpayer services. Such an approach appears to be in its infancy in Gambia, where the creation of a semi-autonomous revenue authority in 2004 enabled the Gambian tax administration to begin a systematic approach to informal sector taxation.<sup>23</sup> Besides the introduction of standard reforms such as the Taxpayer Identification Number (TIN), this has involved a variety of measures apparently aimed at improving the customer interface: decentralised tax offices with modern facilities throughout the country; tax tribunals that offer taxpayers a cost-effective way of seeking redress; tax clinics to help with filing of taxes; a taxpayer education programme that allows direct exchanges between the Gambian Revenue Authority (GRA) and taxpayers; and the publication of *Revnews*, a magazine to disseminate information about taxation to the general population. Although the impact of these measures is not yet known, the GRA appears to be starting from the perspective of taxation as a reciprocal relationship in which services are rendered to consumers who have rights. Research into how this

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<sup>23</sup> Based on the presentation of Bakary K. Sanyang, Commissioner for Domestic Taxes, Gambia at the ITD conference on 'Taxing Small and Micro-Business: From Confrontation to Cooperation', 22-24 April 2009, Kigali, Rwanda.

approach is perceived by tax officials, as well as informal sector operators, will be important in assessing its impact on revenue-raising as well as strengthening accountability.

A final strategy is for revenue authorities to seek proactively to foster the development of informal sector associations, and more proactive negotiation and dialogue between the state and informal sector operators. This recognises the centrality of collective action and bargaining to successful outcomes. This has been part of the strategy adopted by the Rwanda Revenue Authority (RRA), which has sought to cooperate with the Private Sector Federation (PSF), an umbrella organisation for all kinds of business, and local government.<sup>24</sup> The RRA, in dialogue with the PSF, established the Tax Issues Forum (TIF) as a platform where issues related to tax policy, compliance and tax rates could be discussed among stakeholders. Under the TIF, PSF conducts a business census that is then used by RRA to identify unregistered taxpayers. Technical committee meetings are held to help RRA better understand industry issues, including profitability, constraints to growth and service needs. The PSF uses the forum to understand taxpayer rights and obligations and filter them to its members. While such approaches are still at an early stage, further research into the creation of durable and inclusive institutions such as the TIF, that simultaneously deal with problems of information, collective action and credibility which pose barriers to formalisation (and subsequent taxation) of informal sector enterprises, can offer greater insights into the politics of business state interactions around taxation.

#### **5.4 Ceding control to local government: experience in Cameroon<sup>25</sup> and Ethiopia**

A more radical option for the re-organisation of tax administration in relation to informal sector firms is to decentralise responsibility for this to sub-national government. Local governments already levy significant taxes (see Corthay 2009, Loeprick 2009), and extending their responsibility may encourage voluntary compliance and strengthen political and administrative commitment to taxing small firms.

Boudin and Koukpaizan (2008) argue four possible benefits to such a strategy: (a) local governments have greater need of resources, and may thus have stronger incentives to pursue taxation of informal firms; (b) taxes are expected to be closer to, and thus responsive to, local conditions; (c) local governments may be better placed to negotiate productively with informal sector actors, and respond by supplying relevant services to informal sector operators; and (d) it may encourage greater coherence, as there is, at present, frequently large and harmful overlap between taxes levied by different levels of government. 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 (Fjeldstad and Therkildsen 2008, Moore 2008); and disconnecting local taxation from the national level may, in fact, lead to more double taxation and complicate the transition of firms into the formal tax system.

In Cameroon, there has been recent discussion of ceding responsibility for collection of taxes from microbusinesses to local government. The national revenue authority has neither the capacity nor interest to engage substantially with this sector, which is relatively unorganised and offers limited revenue potential. Several local mayors are, in fact, asking for such responsibilities. Unlike national tax authorities, local governments need the revenue sources for the provision of services and have the possibility of using such revenue to improve services for the informal firms, thus increasing the likelihood of compliance. Moreover, local

<sup>24</sup> Based on presentations made by Uzarama Vincent, Deputy Commissioner Rwanda Revenue Authority, and Emmanuel Hategeka, CEO Private Sector Federation, at the ITD conference on 'Taxing Small and Micro-Business: From Confrontation to Cooperation', 22-24 April 2009, Kigali, Rwanda.

<sup>25</sup> Personal interview, Gerard Chambas, 25 May 2011, as well as information presented by the Cameroonian tax authorities at the Ministerial Meeting of the IMF Fiscal Affairs Department, 17-19 April, Washington DC.

authorities have better information about the scale, location and profitability of informal firms, and greater capacity to monitor and enforce tax payments.<sup>26</sup>

Resistance to adopting this policy has focused particularly on the risk that local government lacks the capacity to collect these taxes effectively and fairly. Consideration has been given to the possibility of support from the local office of the budget administration (an offshoot of the treasury that helps control accounts). There is currently little coordination between tax administration and budget administration at the local level, and, from some accounts, the budget administration office would be well placed and willing to help establish informal microenterprise taxation in local government. What this would require, however, is the coordination of tax policy between local and national governments in order to avoid both tax evasion and double taxation, as well as to encourage firms to graduate out of the informal taxation regime as they grow (Loeprick 2009).

Experience in Ethiopia has followed a somewhat similar path, and offers some tentative support to the viability of decentralised taxation of small firms. Ethiopia is a federal state, and regional governments control small business taxation. Under Ethiopian law, from 2008 firms are divided into three categories based on turnover, with firms with turnover above \$50,000 subject to the standard tax regime. The two smallest categories of firms are not expected to maintain detailed financial accounts. Instead of being subject to income tax and VAT, these firms are required to pay a presumptive tax on income<sup>27</sup> and a 2 per cent tax on turnover (Prichard 2010b).

While bearing in mind that capacity constraints are likely to be less severe at the regional level than at the local government level, the Ethiopian experience nonetheless points to some of the perceived benefits of sub-national collection. Most obviously, while tax revenue from these firms represents only a relatively small share of national tax revenue, it is a very important component of revenue for regional governments. It has thus given greater effective meaning to decentralisation efforts. Though central control remains substantial, the importance of this revenue means that effective administration has been given greater attention. Equally interesting, the proximity of the regional tax authorities to the affected firms appears to have contributed to greater discussion around the design of the tax. Following unhappiness with the tax, authorities brought representatives from business associations and businesses at large on to the committees responsible for estimating the turnover of small firms, thus increasing the perceived legitimacy and fairness of the system. Finally, there is some evidence that taxation of small businesses has contributed to encouraging public engagement by firms, with small business taxation emerging as an important issue in the wake of 2005 elections (Prichard 2010b).

## 5.5 Auctioning tax collection rights

Finally, perhaps the oldest strategy for strengthening taxation of informal sector firms is privatisation of the tax administration, with individual firms bidding for tax collection rights, and then retaining any additional taxes collected. In principle, privatisation provides clear incentives for the maximisation of enforcement and collection, but in practice it has been prone to corruption, while doing little to encourage negotiation, voluntary compliance or more productive interactions between state and society. It is thus a relatively narrow strategy, though it may prove useful in specific circumstances.

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<sup>26</sup> 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 microbusinesses levied by local governments, rather than as central taxes on income.

<sup>27</sup> Tax liability is assessed by estimating turnover, applying a predetermined industry-specific profit rate and then taxing the resultant profits at the standard income tax rate (Prichard 2010b, Warner 2005a, 2005b).

History is full of examples of tax farming, in which the rights to collect taxes have been auctioned to the highest bidder. Stella (1992) reviews the history of tax farming since its introduction in Mesopotamia in about 1750 BC. He shows that, historically, while the system delivered revenue, it usually resulted in overzealous tax collection – as a result of the excessive incentive for the tax collector – leading to resentment and even rioting amongst the population. This is not what is wanted in the context of improving government accountability and good governance.

In more contemporary settings, experience with the privatisation of informal sector taxation is very poorly documented, though not uncommon, particularly at the local (sub-national) government level. The most extensive studies are those of Iversen et al. (2006) in Uganda and Fjeldstad et al. (2009) in Tanzania, both of which document relatively prominent examples of privatised tax collection at the local government level. Both studies conclude that in some cases privatisation has led to greater and more predictable revenue collection. However, they also highlight significant problems. While the historical literature focuses on the risk of overzealous and arbitrary tax collection, these studies suggest that the largest problems have occurred at the contracting stage, 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. While this might, in principle, reflect problems of asymmetric information, Iversen et al. (2006) in particular argue that such information problems are quite limited, and that contracting problems generally reflect politicisation and corruption. The overarching conclusion is that privatisation can yield some revenue gains when well managed, but in practice corruption has often outweighed these potential gains.

Similarly, in India some urban authorities have for some time been auctioning off the rights to collect local taxes from street vendors in local markets.<sup>28</sup> In the city of Patna, street vendors are liable to pay local taxes in order to operate, and city authorities have auctioned off rights to collection for a number of years. Although there is significant revenue generated for the municipal authorities, there are two problems. First, auctions of the licences to collect taxes are not free and fair. Collusion among contractors (to reduce the highest bid amount), and between municipal officials and contractors (in the awarding of the contracts), has led to reduced revenue generation compared to potential. Second, contractors who won licences to collect exploit their position and often over-tax street vendors, who are often illiterate and not aware of the rates or their rights.

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<sup>28</sup> Interviews by Joshi with staff of Streetnet International, Patna, India, July 2004.

## 6 Conclusion: key remaining questions

The starting point for any discussion of informal sector taxation remains a question of assessing whether this should, in fact, be a public policy priority. This paper has suggested that it should be given greater priority than has historically been the case. This reflects a judgment about the potential benefits of such taxation as against the costs, but this is an area that continues to warrant additional research not only into the magnitude of these costs and benefits, but into their distribution across population groups. In some parts of the world particular population groups – e.g. women, ethnic minorities, or religious groupings – are overrepresented in the informal sector generally, or in particular occupations. However, we continue to know remarkably little about whether and how particular groups, like women (e.g. Carroll 2011), may be disproportionately impacted by policy in this area. In broad terms, informal sector taxation has somewhat limited potential to produce immediate revenue gains, is subject to high administrative costs, and, because it primarily targets already low-income individuals, risks having significant negative social and economic costs. Given these limitations, the case in favour of expanding informal sector taxation depends largely on three more indirect claims.

First, there is some evidence that taxing informal sector operators is important to build tax morale and a culture of compliance, both among small firms and within the economy more broadly, though there is need for more detailed evidence to support this highly intuitive claim. Second, there is growing evidence that taxing the informal sector can be important for economic growth, by encouraging the growth of small firms, and creating a better overall business environment for formal sector firms. However, there remains scope for more research to understand how large these effects are, which firms are most likely to benefit and, perhaps most interestingly, what specific policies for encouraging formalisation may be most important to promote longer term gains in growth. The growth gains associated with formalisation are contingent on the claim that formal firms are able to access important benefits, from credit to improved security, but it is not yet clear which of these benefits are most important for micro and small firms. Finally, significant recent discussion has focused on the potential for informal sector taxation to prompt state-society bargaining and broader governance gains, but evidence remains relatively limited. There is significant scope for research looking at the potential for informal sector taxation to spur collective action and bargaining. There is equally a need for research into the potential for informal sector taxation to spur broader investments in building related state capacity, be it in the realm of policing, providing basic services or developing institutions to settle disputes.

Moving from the question of whether the informal sector should be taxed to the question of how to do so, a great deal is known and widely accepted about the various policy options for effective informal sector taxation. This covers not only the distinction between taxing indirectly, directly or through specialised presumptive regimes, but also the variations of presumptive taxation, and their costs and benefits. There has similarly been more attention to the costs and benefits to firms of tax compliance and broader formalisation. Increasing numbers of surveys have shed light on the costs of tax compliance and formalisation for small firms, and yielded policy strategies to minimise these costs and thus seek to encourage firms to enter the formal system.

This paper has sought to review some of what is known about these questions, and, more importantly, to draw attention to a set of issues about which less is known, and about which there is scope for significant research and policy experimentation. These issues broadly relate to the question of how to translate growing interest in taxing the informal economy into better outcomes in practice. Conceptually, we have suggested that at a broad level we can focus, in turn, on the interconnected challenges of expanding quasi-voluntary tax compliance

and of building government and state commitment to reform. However, in both areas significant questions remain.

With respect to encouraging compliance among informal sector firms, recent work has shed significant light on reducing costs of compliance and formalisation, but has said much less about how to provide positive incentives to formalisation. This is particularly important given recent evidence that lower costs can help, but are not, in themselves, enough to transform outcomes. There appears to be a need for attention to two big questions. First, what type of positive inducements to tax compliance – such as access to credit and training, greater security of property or protection from harassment by police and local officials – are most important to micro and small firms? Second, how can states and governments more effectively promote collective action among informal sector operators, and provide institutional channels for bargaining with them, in order to build trust and encourage tax compliance and formalisation? Together, these questions represent important directions for extending existing research and policy practice.

Less is currently known about generating support from political leaders and tax administrators for more effective taxation of the informal economy, and specific questions are less clearly defined. 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. At a more specific level, this paper has suggested several possibilities that warrant further exploration. The first is that the adoption of policies aimed at increasing the benefits of voluntary tax compliance may, by addressing the needs of informal sector operators, make reform more politically feasible and attractive. A second is that efforts to foster effective collective action among informal sector associations, and open up institutional channels of negotiation, may help expand the tax base. The inclusion of formal sector businesses in some such processes may further build a constituency for reform.

The final section of this paper explored the possibility that administrative and institutional reform related to the collection of informal sector taxes may be able not only to address narrow administrative shortcomings, but also generate positive incentives among taxpayers, political leaders and administrators alike. The experience of associational taxation presents one potentially compelling route to develop more institutionalised links between the state and informal sector associations, and thus lead to more effective taxation and, potentially, broader governance gains. Similarly, the prospect of decentralising a greater part of the taxation of micro and small firms to local government holds significant risks, but also promises both to strengthen commitment to reform and encourage engagement between taxpayers and governments. However, these and other possibilities remain insufficiently studied, and thus largely remain exciting but as yet uncertain possibilities.

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