



Taxing the Informal Economy is not a Silver Bullet for Financing Development – or the Covid-19 Recovery

Max Gallien, Mick Moore and Vanessa van den Boogaard

The Covid-19 pandemic has raised twin challenges for public revenue around the world. Governments have undertaken huge expenses to finance medical responses and social protection programmes. At the same time, tax collection is decreasing as a consequence of both pandemic-related tax breaks and a dip in economic activity and trade. These challenges raise the risk of unsustainable public debt – especially for many low- and middle-income countries. As a consequence, policymakers are seeking new sources of revenue to bolster state budgets. In this context ‘taxing the informal economy’, or ‘broadening the tax net’, have become popular talking points. In the early

days of the pandemic, for example, Algeria’s President Abdelmadjid Tebboune suggested that new revenue raised from the informal sector was an alternative to international borrowing as a way of financing the crisis (Hamadi 2020). In recent months, this idea has appeared more frequently in policy conversations. Taxing the informal economy is, however, a very old idea. Tax administrations have been seemingly obsessed with registering firms and taxpayers for years (Moore 2020).

It is not difficult to see why people should find the idea of taxing the informal economy attractive. In many low- and middle-income countries, a large proportion of the national

economy is estimated to be informal. Analysts and policymakers often assume that informal enterprises are untaxed, and that there are substantial revenue gains to be achieved – a ‘missing goldmine’ in the words of one recently published article (Monye and Abang 2020). Policies around taxing the informal economy are often vague, making it possible for them to claim to be reining in tax evasion without actually disrupting political or rent-seeking networks. More genuine enthusiasm around taxing the informal economy is often underpinned by a range of misleading assumptions about the benefits of getting informal workers and enterprises onto tax registers. This includes the argument that targeting informal economic operators will increase overall tax morale and compliance, raise the productivity of informal businesses, and lead to more accountable relationships between informal firms and governments.

As practical experience and a range of recent scholarship have highlighted, however, many of these assumptions are not substantiated by evidence. The evidence shows that efforts to tax the informal economy typically:

1. Generate (considerably) less revenue than expected, in part because collection costs are high and tax payment does not necessarily follow from taxpayer registration.
2. Increase the extent of unfairness in the distribution of the tax burden – small informal sector operators already pay more in tax-like payments and fees than is generally assumed, while tax collectors often over-estimate the income potential of small firms.
3. Fail to stimulate the accountability benefits often associated with taxation, because

informal sector operators often find it particularly difficult to engage in collective political action in response to taxation.

It doesn’t raise much revenue

Taxing the informal economy is often expected to lead to substantial revenue gains – both directly from the newly-registered firms, and indirectly from positive spillover effects, as other taxpayers may perceive the system to be fairer and be more likely to comply voluntarily. Research has highlighted, however, that attempts to tax the informal economy typically result in only limited revenue, with the cost of collection often being higher than revenue raised (e.g. Benhassine et al. 2018). This is the result of at least three interrelated issues.

First, while there is substantial revenue potential in taxing large firms and high net worth individuals within the informal economy, many efforts to tax the informal economy have focused on smaller firms. The reasons for this focus are organisational and political. It is possible to identify a large number of small enterprises, even mobile ones like street vendors, by deploying relatively unskilled tax collectors, including temporary staff, to tramp the streets, observe and ask questions. By contrast, the informal economic activities of larger businesses and highly paid professionals are much more difficult to identify. They often take the form of cash transactions that have been designed to leave no bank record, or payments that are recorded but made to fake or shadow entities for goods or services not actually supplied. The identification of these kinds of informal transactions requires skilled tax auditors who are able to interrogate business accounts effectively. People with these skills are scarce and located mainly

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in the private sector, where they are used to minimise tax bills. They are not easily available to tax administrations. Further, initiatives to audit the tax affairs of larger businesses and professionals can quickly generate quiet but effective political lobbying and compelling hints to tax administration heads that they should ease off the pressure. At the same time, being able to report that a campaign to tax the informal economy has resulted in 40,000 newly-registered taxpayers has more publicity value than a more complex narrative about success in narrowing the scope for evasion by already-registered taxpayers. These organisational and political pressures can lead tax administrations to crack down on small-scale enterprises rather than focus on broader, and more profitable, informal activities.

There is also consistent miscommunication on this issue. International organisations and tax policy advisers frequently urge governments to widen the tax net. This is in large part an indirect and diplomatic way of encouraging governments to stop giving away substantial revenue to companies or wealthy people through legal tax exemptions. But the message is too subtle. It is easily read by policymakers as a justification for increasing the number of registered taxpayers,

rather than focusing on wealthier individuals or larger firms.

Second, despite policy enthusiasm around taxpayer registration drives, an increasing body of evidence shows that taxpayer registration does not necessarily lead to tax payment. Recent registration drives have primarily led to a huge increase in the number of ‘unproductive’ taxpayers and tax registers riddled with imperfect information, with tax compliance only improving where there are additional enforcement efforts. These unproductive taxpayers (also known as non-filers and nil-filers) either do not submit a tax return or report no income, and consequently do not contribute to raising tax revenue. Reviewing evidence from six countries, Moore shows that more than half of taxpayers registered with African national tax administrations do not pay taxes at all (Moore 2020).

Finally, there is little concrete evidence to support the idea that taxing the informal economy through tax registration drives actually has a positive spillover effect on the compliance level of other taxpayers, either in the short or long term. Instead, in some contexts it can fuel sentiments of unfairness, given that small businesses often face higher tax burdens than larger ones.

It’s often not fair

Proponents of taxing the informal economy often suggest that informal actors are currently under-taxed or actively evading taxes, and that they are therefore simply being asked to pay their fair share. This argument, however, often both over-estimates the income of many of the people involved, and under-estimates the taxes that they are already paying. Consequently, a push to tax the informal economy risks shifting

fiscal burdens onto some of the most vulnerable groups, thus undermining public perceptions of tax fairness.

As noted above, many of the actors typically targeted by attempts to expand the tax net are small-scale operators with relatively low incomes, who would normally fall under most tax thresholds. More critically, despite longstanding assumptions that informality is synonymous with tax evasion, a growing body of research shows that informal firms already pay a wide range of indirect taxes, nuisance taxes, user fees and informal taxes. Rather than not paying their fair share, many of these actors already pay a high and often regressive burden to finance local public goods, operate their business, or avoid harassment by state and non-state actors. At the same time, many of the advantages that are often assumed to accompany formality – including access to social safety nets, credit or safer working environments – do not simply follow from a firm’s tax registration. Focusing on taxing the informal economy without understanding the nature of the broader fiscal landscape is therefore likely to shift the burden onto already vulnerable communities.

This point is doubly important in the context of the current pandemic. Many of the groups

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generally associated with the informal economy have been particularly hard hit – not just by the health risks of the pandemic, but also by its economic fallout. Many have been disproportionately affected by lockdowns, as livelihoods reliant on face-to-face interactions or global value chains affected by the pandemic have shrunk or disappeared. Many have seen their savings depleted, assets sold, and have taken on substantial debts. As a consequence, and irrespective of their status in tax registers, policies that prioritise these groups as a target for revenue generation are likely to worsen inequality.

The links between taxation and accountability are not guaranteed

Building on theories linking taxation and accountability, it is often assumed that registering with state authorities and paying taxes or business licences will not only increase government revenue and fairness, but also increase civic and political participation and access to public services. Recent research has shown, however, that taxation only leads to improved accountability under certain conditions – including where taxpayers have the motivation, resources and power to make successful demands on their government for reciprocity (Prichard 2015). Workers in the informal economy may be particularly unlikely to meet these conditions, given that collective political action among informal operators is often limited, sometimes because governments actively oppose it. The ability to organise collectively may be particularly limited in the Covid-19 recovery period, given legal and administrative restrictions on meetings and physical interaction.

There are better ways to finance development and the Covid-19 recovery

Taxing the informal economy neither guarantees substantial new revenue nor a fairer tax system. Instead, it risks increasing the burden on some of the most vulnerable groups. In the middle of an economic crisis, this would serve to reinforce deeply embedded societal inequalities. Building new fiscal relationships with individuals and businesses not previously registered with the tax authority may nevertheless be a desirable policy under some conditions – namely, when policies to tax the informal economy are better specified and targeted. Rather than broadly targeting the informal economy, or focusing attention on small-scale, low-revenue activities, policies should focus on identifying (a) large-scale economic transactions made in cash, (b) fake transactions in business accounts, and (c) higher-income individuals that currently escape the tax net, including professionals such as lawyers and dentists. Meanwhile, closer state interaction with smaller enterprises and informal production clusters may be particularly constructive and valuable in the aftermath of the Covid-19 pandemic – but this interaction should be seen in a developmental context, with a focus on investing, addressing vulnerabilities and building relationships with citizens, rather than solely extracting revenue from them.

Meanwhile, there are other taxation strategies that are better candidates for raising revenue in the current context. Notably:

1. Taxing the wealthy – through income, property and capital gains taxes – is an underused but potentially effective revenue generation strategy in most low-income countries.
2. There is significant evidence that simply closing tax loopholes and addressing dysfunctional tax losses through corporate exemptions can lead to a substantial increase in revenue for governments.
3. Taxing digital transactions offers a promising way to target tax avoidance by big technology platforms, while recognising that these platforms have benefitted significantly from the increasing move to online interactions in the past year.
4. Increasing taxes to combat climate change may be a promising way for governments to raise revenue, while the costs to more vulnerable households or businesses can be minimised through rebates or other supports.

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Credits

Max Gallien is a Research Fellow at the International Centre for Tax and Development and the Institute of Development Studies.

Mick Moore is a Senior Fellow at the International Centre for Tax and Development and a Professorial Fellow at the Institute of Development Studies.

Vanessa van den Boogaard is a Research Fellow at the International Centre for Tax and Development and a Senior Research Associate at the University of Toronto.

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International Centre for Tax and Development
at the Institute of Development Studies
Brighton BN1 9RE, UK

T +44 (0)1273 606261 F +44 (0)1273 621202 E info@ictd.ac W www.ictd.ac