

Presumptive Taxation and Equity: Evidence from the Ethiopian Informal Sector

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Summary of African Tax Administration Paper 32

Introduction

Presumptive tax has become a popular way of taxing businesses operating in the informal sector in middle- and low-income countries. The introduction of the presumptive tax system in Ethiopia in 2002 was intended to widen the tax base by bringing more informal sector operators into the tax net. However, the unintended consequences of its introduction were not adequately scrutinised, and it has been a source of criticism and complaints due to its alleged unfairness and lack of clarity in its implementation.

A simple imposition of the presumptive tax upon the informal sector, without considering its complexity and the diversity of its actors, might have various negative consequences. In particular, it would likely compromise both horizontal and vertical equity. This study examines the issue empirically, exploring the equity implications of the presumptive tax system to tax the informal sector in Addis Ababa. The informal sector receives limited attention from either policymakers or researchers, and, prior to this research, we had no evidence on the characteristics of informal micro enterprises and the equity implications of Ethiopia's presumptive tax system.

This research presents the characteristics of informal enterprises and addresses the following two questions.

- What is the status of income distribution in the informal sector based on gender?
- What are the equity implications of applying the presumptive tax system to tax the informal section in Addis Ababa?

Data and method

We use informal micro-enterprise (IME) survey data collected in Addis Ababa in 2021 by Stichting Nederlandse Vrijwilligers (SNV) Ethiopia in collaboration with BAN-Development Research Centre for Excellence (BAN-DRCE). Following a mixed-method approach, the data was collected from 1,063 IMEs operating in Addis Ababa City Administration.

We used the definition of informal businesses from Ethiopia's Central Statistical Agency: as 'household type establishments/activities, that are mainly engaged

in marketed production (of goods and services), not registered companies or cooperatives, have no full written book of accounts, have less than ten persons engaged in the activity, and have no license'.

Key findings

- **Participants in the informal sector are predominantly young, married women with limited vocational training.**

Nearly 60 per cent of informal sector operators in our sample were women while 83 per cent had no vocational training. In a broad category of activities, most of these firms engage in retail trade types of business activities (68 per cent). They choose the sector as a last resort, and not because of its attractive benefits in terms of economic returns or tax evasion. The two top reasons given for participation are to fulfil the basic needs of their family and to become self-employed in the absence of other employment opportunities.

- **Informal sector taxation using the turnover-based presumptive tax system is both horizontally and vertically inequitable compared to the standard Business Income Tax (BIT).**

Using the representative taxpayer approach, we find that presumptive tax places a heavier financial burden on small businesses than BIT does. Compared to the presumptive tax system, a business owner would pay a lower tax in the BIT schedule. Taxing the informal sector through the presumptive tax rate is not horizontally equitable. If we further consider (a) the various benefits and incentives provided by the government for formal firms (like tax holidays and tax-free imports) and (b) the fact that firms in the informal sector also have to pay informal taxes, the tax burden gap between the two groups becomes substantial.

There is also vertical inequity. Because it is based on turnover, and because the ratio of profit to turnover varies between sectors, presumptive tax is levied at a higher rate relative to income in some sectors than in others. For instance, low-turnover restaurant businesses pay an average of 6.3 per cent of income whereas other businesses pay 3–3.3 per cent. There are similar sectoral disparities within the average and the higher income groups.

Furthermore, mapping annual income against BIT schedules, our analysis shows that about 44 per cent of informal sector businesses in the survey earn below the minimum formal sector business income tax threshold, and most of these businesses are owned by women.

Key messages for policymakers

- A wider and forward-looking consideration of the existing stylised facts about the complex informal actors is crucial in policymaking. Most of these actors are among the more vulnerable sections of the community, but could be potential future taxpayers. Policy efforts such as formalisation should not focus principally on revenue generation. That would end up regressively taxing informal sector firms. Since female-owned businesses are the most hard-hit by the earning gap, gender-based policy interventions would help to make informal sector operating firms sustainable and able to serve as potential future taxpayers.
- Informal sector taxation using the presumptive tax system compromises welfare by exacerbating vertical and horizontal inequity. One plausible reason for this is the complex and unclear nature of determining

the tax burden through the presumptive tax rate. As the determination of the presumptive tax rate is not easily understandable by the lower-level tax officials who are responsible for tax collection, the tax burden is not distributed equitably among different informal sector operating firms. This suggests the need for a reconsideration of the existing presumptive tax rates, considering other countries' experience and the current status of the sector.

- The informal sector in Ethiopia gets the least attention, and is not well understood by policymakers, researchers, and other relevant stakeholders. Further studies and public dialogues about the sector would increase stakeholders' awareness of the issues and facilitate more effective public policymaking.

“Informal sector taxation using the turnover-based presumptive tax system compromises welfare by exacerbating both horizontal and vertical inequity. The presumptive tax system in Ethiopia requires a serious discussion that extends up to revision.”

Further reading

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Credits

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