10 Tax and the informal economy

Lessons from South Africa

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The relationship between the informal economy and the tax system is an important, but under-researched, policy issue. While tax reforms often look at ways to bring the informal economy within the tax system, there are some important areas which have not received as much attention, beyond this preoccupation with bringing the informal economy into the tax net. Using illustrative cases from South Africa, which are applicable in other developing countries, we argue that there are a number of important conceptual, methodological and practical issues that should be considered. We are concerned, here, with four of these. The first is how we conceptualise and measure the informal economy from an economic policy perspective. Second, we are interested in who falls inside the tax net and who does not, and what the implications are, both for our understanding of informality, and to create an effective tax policy. Third, we look at the implications for competitiveness of businesses in the informal sector who are not registered for value added tax (VAT), increasingly the most important form of taxation in developing countries. Finally, we examine the impact of the attempt by some states, through the imposition of a presumptive tax, to draw those in the informal economy into the tax system, and the problems arising from this approach.

Tax and the informal economy

The tax system and the informal economy are closely related. Indeed, by some conceptions, the informal economy is defined precisely by the economic activity that falls outside the tax system. In many economic surveys, whether or not a respondent pays tax is often used as a proxy for informality (Gatti and Honorati 2008; Cichello and Rogan 2017). However, there are several problems with this. The first is that it does not identify workers performing precarious informal work *within* the formal sector. Indeed, for South Africa, the International Labour Organization (ILO and WIEGO 2013) finds that almost half of informal workers are employed within the formal sector itself. Research in South Africa shows that using the lack of tax registration as a proxy for informality also has the opposite problem in that it incorrectly identifies formal workers as informal (Devey, Skinner and Valodia 2006). In South Africa, and in many other countries,

employers deduct income tax from workers' incomes and pay this over to the tax authorities through Pay-As-You-Earn (PAYE) systems. In such cases, many respondents in household surveys are unaware of their own tax status and that of their employers. Indeed, when we compare the proportion of respondents who say they do not pay tax, it is far higher than the proportion of respondents who report working in occupations we would expect to be largely informal, such as livestock herding and informal selling. As we argue above, the relationship between tax and informality is not at all clear-cut, and we remain sceptical about the use of tax as a proxy for informality.

Using an enterprise's tax status to define informality for it and its workers is clearly inexact and is an inappropriate proxy for defining informality. However, it does draw our attention to our understanding of the dynamics between the tax system and the informal economy. If we assume that, as a general rule, most of those engaging in informal business fall outside the tax net, this has important implications for how we understand the role of the tax system in achieving policy outcomes.

The limits of the tax system

People work in informal employment for a number of reasons: some take up informal employment, on a paid basis, because there are either insufficient jobs in the formal sector, or their skills and education preclude them from a formal job. Others, work in self-employment in small-scale enterprises, most commonly in the retail and services sector. There is also an argument in the informal economy literature that business and individuals may choose to operate informally in order to escape the burden of the tax system. In reality, there is very little empirical evidence to support this argument, and it is important to note that there are many reasons why an individual or a business may be informal – most of these have to do with poverty, and with the structure of the economy. In South Africa, structural barriers such as high entry costs, and high levels of industrial concentration mean that there is often no real choice between operating in the formal or the informal sector, with many precarious workers and self-employed workers having no option but to work informally, though, of course, there are exceptions. Under this conception of informality, punitive policy responses which aim to drive workers into the formal sector are not appropriate.

Tax policy is also used to provide relief to both business and individuals. This can be in the form of tax incentives, tax credits, or tax relief. Those who are not part of the tax system are not eligible to receive these benefits. A good example of this is the recent rise in the rate of VAT in South Africa. The South African government raised the VAT rate by 1 percentage point, from 14 per cent to 15 per cent, in April 2018 in order to bolster government finances. VAT is an efficient way to raise revenue and its absolute burden falls largely on the rich, since they are the largest consumers of goods and services. Its relative burden, however, falls disproportionately on the poor, because the poor spend a larger proportion of their incomes on basic expenses. VAT, then, is regressive and

requires complementary policies to alleviate its regressive effects. Zero-rating can mitigate the regressive effects of VAT, but it has its limits, particularly for addressing inequality. This is because there are very few goods that are consumed disproportionately by the poor and are thus appropriate for zero-rating. Furthermore, there are some important goods, such as sanitary products, which the poor are unable to afford, regardless of whether or not they are zero-rated.

One of the best ways to address the regressive effects of VAT is through the provision of some form of tax credit to poor citizens or residents; in many ways, this is more equitable than a system of zero-rating which disproportionately benefits the rich in absolute terms (because they spend more in absolute terms, they receive a greater tax saving). However, if the poor are not in the tax system, benefitting from a tax credit is impossible. The conundrum presented by this example forces us to rethink the assumption that informality arises out of a choice to avoid regulation and taxation. Instead, because they are informal and outside the purview of the tax system, informal workers are sometimes unable to benefit from transfers and credits that are made through the tax system, usually to address poverty.

Value added tax: a problem for informal retailers

The VAT system in South Africa, and in many other developing countries, raises a particular issue for informal retailers, by far the largest proportion of workers in the informal economy, accounting for 41.7 per cent of all non-agricultural informal sector employment in 2014 (Rogan and Skinner 2018). The VAT regulations in South Africa, similar to other jurisdictions in both developing and developed countries, allow very small enterprises to operate outside the VAT system. In South Africa, an enterprise with an annual turnover less than 1 million Rand (approximately US\$70,000) is not required to register as a VAT vendor. These enterprises could opt to register, but enterprises with turnover of less than 50,000 Rand (approximately US\$3,500), are precluded from registering as a VAT vendor. Thus, in practice, most enterprises that operate in the informal economy would not be registered as VAT vendors. As VAT is charged at each stage of the production process, each supplier in a supply chain that is a registered VAT vendor acts as a tax-collection agent for the government: they collect the VAT on the sale of the goods, and can claim back the VAT expended on the inputs, thus paying over to the tax authority only that VAT related to the value added by itself. Informal businesses, which are not VAT vendors, are not able to claim back the VAT on the inputs they purchase, and thus have to absorb this cost in their final sale price. This clearly has a direct impact on their competitiveness and profitability.

Compare, for example, two enterprises, one formal and registered as a VAT vendor and the other informal and not registered as a VAT vendor, selling the same product – bread. The formal vendor is able to deduct VAT paid on all inputs and capital equipment she purchased, whereas the informal retailer cannot – thus, everything else being equal, as a result of the VAT, the informal retailer

has higher costs. Furthermore, the formal retailer is able, with the full backing of the law, to pass VAT at the final stage of production on to the final consumer. The informal retailer does not have the backing of the legal system to enable her to pass the VAT she has paid onto the final consumer through the bread price, and is therefore likely herself to have to absorb some of this cost.

Of course, not being a VAT vendor means that an informal retailer does not have to incur the costs of compliance with the VAT system, which requires adherence to formal accounting or bookkeeping practices which might be beyond the reach of many informal enterprises, and would be costly to comply with, relative to revenue for these businesses. However, the point here is that policy-makers often argue that informal retailers do not pay taxes. As the example above demonstrates, because they are deemed to be the final consumer, informal retailers do in fact pay VAT and their legal position in the VAT system often places them at a significant disadvantage relative to formal retailers against whom they compete.

Presumptive direct taxation

Most developing countries are characterised by having a large informal economy and a relatively low tax/gross domestic product (GDP) ratio. One of the challenges facing governments in all countries, but especially in developing countries, is how to collect sufficient tax revenue to meet national expenditure needs. In developing countries in particular, policy-makers are paying increasing attention to collecting taxes in the informal economy. In order to overcome compliance and information problems which face both informal sector business and the revenue service, some developing countries have elected to level a presumptive tax on informal business.¹ This is especially the case at sub-national level where, for example, local governments have been levying presumptive market taxes in markets where informal traders conduct their economic activity. Other examples include the levying of user fees to access trading sites that are controlled by local government authorities (Chen 2018).

From the perspective of informal enterprises, usually run by informal workers who are self-employed, there are several problems with a presumptive tax. The first is that, by its very nature, a presumptive tax is at best a crude estimation, and at worst an arbitrary amount. For precarious businesses in the informal sector, it may well be unaffordable. The second is that a presumptive tax often curtails the extent to which the taxpayer can engage with the tax authorities. Even if the tax dispensation provides for a rebuttable presumptive tax, informal business will often have no way of verifying their income. Third, a presumptive tax raises the issues we discussed in the first section above: while nominally drawing businesses into the tax system, a presumptive tax does not mean that the redistributive side of the tax system will be available to those paying the presumptive tax. Finally, its implementation risks being inequitable; research has shown that the more visible informal businesses (often in public space) are more likely to be targeted for a presumptive tax (Dube and Casale 2019).

Addressing the gaps

The discussion above highlights some important conceptual and theoretical challenges which we need to incorporate in our understanding of the informal economy. The first is a definitional one. Analysts and policy-makers, especially in the economics arena, continue to use the payment of tax as the primary way to identify whether an enterprise is formal or informal. Over the last decade or so, significant improvements have been made to bring conceptual clarity to the concept of the informal economy, and to the statistical collection of data on the informal economy. According to the definition adopted by the International Conference of Labour Statisticians (ICLS), informal enterprises are enterprises that are not legally incorporated or registered with a national government authority, and informal jobs are those without social protection, or paid annual and sick leave from an employer. This definition has nothing to do with whether enterprises of the self-employed and workers in informal employment pay taxes. It is therefore important that analysts and policy-makers avoid using the payment of taxes as a proxy for informality wherever possible. Not only is this conceptually incorrect but it also erroneously feeds into a discourse that those in the informal economy are not paying taxes, or are hiding from the tax regulations.

Second, it is important for policy to recognise that not being part of the tax system can be disadvantageous to informal enterprises and informal employees. As the examples of VAT demonstrate, there can be significant costs to being outside the regulatory reach of the tax system. This, of course, challenges the theoretical arguments that informality arises out of a choice to avoid regulation and taxation.

Third, the suggestions provided above point to important gaps in tax policy and practice. Overcoming these challenges will require a shift in policy thinking from one that sees the informal economy as backward and undesirable, to one which recognises the merits of the informal economy in and of itself, as a source of employment and poverty reduction (especially in the South African case of persistent unemployment), and acknowledges that the formal and informal sectors are inextricably linked (Rogan 2018a).

Finally, our discussion to some extent supposes formal and informal sectors economies that are largely static – that is, individuals operate either in the one or the other. The reality, however, is that there is a high level of churning over time as individuals move between formal and informal work (see Heintz and Valodia 2012; Valodia 2015).

Finally, the narrative that workers in the informal economy, whether self-employed or in informal wage employment, are opting to be informal in order to evade taxes is clearly incorrect and needs to be strongly challenged. As our discussion has shown, through indirect tax systems like VAT, those working in the informal economy not only pay taxes, but also being informal may well pose an additional tax on them. Moreover, through presumptive taxes in markets and other types of user fees, those working in the informal economy do pay direct taxes. More research is needed to better understand how these taxes are levied,

what the effective rates of taxation may be, and what the economic impact of these taxes are on informal enterprises.

Note

- 1 Joshi, Prichard and Heady (2014) note that presumptive taxes use a simplified tax calculation method to lower record-keeping and compliance costs for small firms. In countries such as Ethiopia, Kenya, Tanzania and Ghana, for example, a presumptive tax is levied on turnover rather than on profit (ibid.).