

THE EFFECTIVE TAXATION OF THE INFORMAL SECTOR - The Real Challenge to Tax Administration

Being a paper Presented by:

Prof. M.T. Abdulrazaq

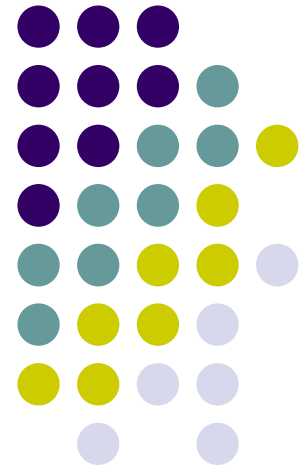
LL.B., Ph.D.(ABU)., LL.M.(Lond)., B.L., FCTI., FCIB.

Partner, Tax Services

Ernst & Young Nigeria

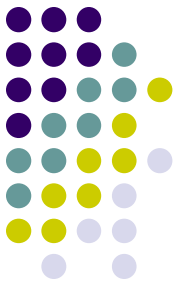
At the

**1st AKWA IBOM STATE
REVENUE SUMMIT**
APRIL 6 & 7, 2009



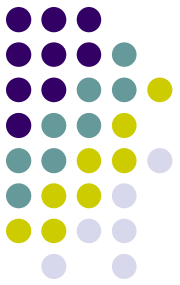
Outline

- Informal sector
- Options for informal sector taxation

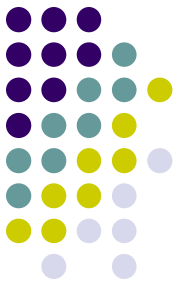


Informal sector (1)

- What is informal sector?
- What are useful perspectives on informal sector from a tax administration perspective
- How does informal sector differ across countries?
- What are the real challenges to tax administration?



Informal sector: Composition (2)



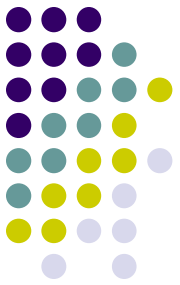
- Informal sector?
 - Sector of economy that is weakly documented by authorities.
 - Lack of official documents. Who has information?
- Taxation is essentially an information game – who has information on business activities?
 - Business owner(s) or shareholders
 - Business manager(s)
 - Third parties
 - * Financiers and bankers
 - * Buyers of outputs/suppliers of inputs
 - * External accounts/auditors
- Government
 - * Regulatory, audit or service agency
 - * Tax agency
- Information in informal sector concentrated in owner-manager

Informal sector: Composition (3)



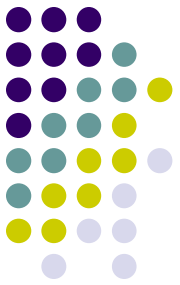
- Two basic types of officially undocumented sectors: below and above ground informal sectors
- **Underground untaxed activities**
 - Criminal activity, black market or grey activity and tax evasion, which may involve organized groups or gangs
 - Moonlighting, more typically independent individuals with collusion by employer or purchaser of individual services
- **Above ground or parallel market sector**
 - Micro/small scale unincorporated business activity that may also be outside monetary economy

Informal sector: Constituents (4)



- Major characteristics of informal or officially undocumented sector in a country
 - **Compliance capacity** of businesses?
 - * General skills? Numeracy, literacy
 - * Specific skills? Transaction records and accounting.
 - * Understanding of how to comply with tax provisions.
- **Legal or illegal activity** (tax and other laws)? **Willingness of informal business to comply with tax?**
- **Sector** containing informal activity: tradable or non-tradable goods/service; intermediate or final stage; urban or rural; monetary or non-monetary (subsistence)
- **Size** of the sector in terms of employment and value added in economy.

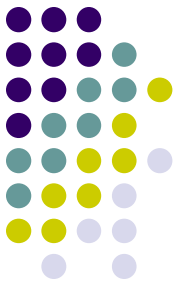
Informal sector: Constituents (5)



Two extremes: High-income OECD versus low-income country

High-income OECD country	Low-income country
<ul style="list-style-type: none">➤ About 10% to 20% of employment and GDP in informal sector➤ Mainly due to unwillingness to comply with formal sector legal requirements (criminal activity, tax and regulation evasion)➤ Non-compliance with tax concentrated in self-employed service sector and moonlighting, cash or undocumented employment➤ Income levels at or above formal sector➤ Income taxes (IT) and social security payroll taxes provided major incentive for untaxed informal employment	<ul style="list-style-type: none">➤ Up to 50% of GDP, but higher share of employment (up to 90%)➤ Mainly due to lack of capacity to comply; illiteracy & innumeracy and weak specific accounting and tax compliance capacities➤ Significant share (5% to 30%) in non-monetary subsistence sector➤ Rural (agriculture and trading) and growing urban sectors (trading, personal services, food and beverage services, petty manufacturing)➤ Low average income levels➤ Social security payroll taxes threshold (some minimum income)

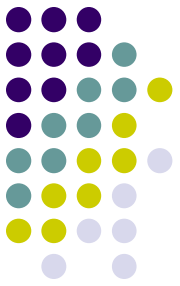
Challenges to tax administration (6)



High-income countries

- If lack of tax compliance capacity is not an issue, then a range of tax policy and administrative reforms within major domestic taxes may assist in minimizing induced underground business activity and employment
- Measures could include changes in
 - **Tax structure**
 - * Lower tax rates on SME sensitive activities
 - * Indirect taxation (input taxes or withholding taxes)
 - * Simple tax structures and procedures
 - **Tax administration**
 - * Use of third party information
 - * Improved external audits and investigations
 - * Appropriate penalties and certain application of penalties
 - * Improved education and service of taxpayer to lower compliance costs, including accounting and tax compliance training.
 - **Governance**
 - * Improved public service delivery and political integration

Challenges to tax administration (7)



Adjustments to traditional taxes

➤ **Thresholds**

- Income tax: some monthly or annual minimum level of income exempt for individual taxpayer – informal business tend to be unincorporated and low income
- VAT/GST: More complex

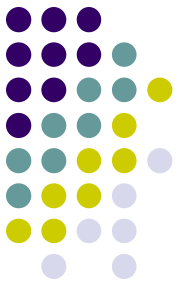
➤ **Accounts**

- Modified cash flow accounts for small or unincorporated businesses

➤ **Administrative support**

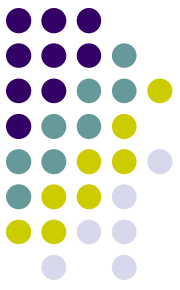
- Specific tax-skill training
- Modification of documents or procedures to simplify compliance

Challenges to tax administration (8)



VAT Threshold

- VAT is highly taxpayer compliance intensive.
- Taxpayer may **lack both accounting skills and tax compliance knowledge** – potentially significant up-front one-time fixed costs of registration and compliance
- Typically threshold for registration is defined by **annual business sales or turnover** – compliance and verification requires **invoices and accounts which may not exist**
- **Basic economic criteria for setting threshold:** Balancing economic costs and benefits of raising threshold:
 - Benefits = costs of administration and compliance saved
 - Costs = economic cost of change in tax revenues
- **Net economic benefit from excluding small businesses from VAT registration: At what threshold does net benefit fall to zero?**

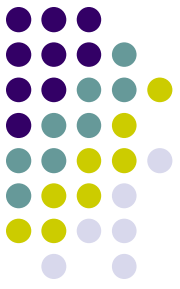


Challenges to tax administration (9)

VAT Threshold and taxpayer education

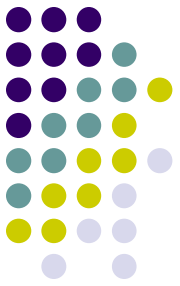
- **Raise VAT threshold or lower compliance costs through VAT compliance skill training?**
- High VAT thresholds (plus voluntary registration) are economically justified.
- Where problem of compliance capacity, threshold should be in range where issuing invoices and keeping basic books is feasible.
- Specific tax skill training to improve compliance capacity could be cost-effective in range of businesses at or below threshold turnover range.
- Target of training?
 - Selected sectors: such as informal taxi and bus services
 - Self-selection: Offer tax compliance training to new registrants in exchange for amnesty from retroactive taxation.
- General strengthening of accounting education and profession to support tax compliance should have positive tax externalities.

Challenges tax administration (10)



- **Direct presumptive taxes:** two types:
 - withholding
 - direct tax on all or below threshold businesses
- **Presumptive withholding taxes**
 - Requires **formal sector tax collector** such as customs (import or exports), marketing agency (agricultural, forestry, etc products), government or private corporation (goods and services purchases), corporation (dividends), financial institution (interest income, pension, etc)
- Withholding tax offset against income tax for registered taxpayer, but final tax for others, including informal sector
- Base often limited by sector, market channel, extent of **informal-informal trade**, etc limiting revenues, creating opportunities for avoidance and causing distortions between businesses.

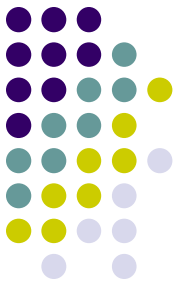
Challenges to tax administration (11)



- Focus on **low-income countries** where lack of tax compliance capacity dominates and compliance with VAT/GST rather than IT is important issue.

- **Options**
 - Indirect taxation
 - Adjustments to traditional taxes
 - * Thresholds and tax accounts
 - * Administrative strategies
 - Direct presumptive taxes

Challenges tax administration (12)



➤ Indirect taxation of informal sector

- VAT on inputs

* Informal business buying VAT paid inputs from domestic supplier or importing bears burden of input tax to extent tax cannot be passed forward.

- Import duty on inputs and/or outputs

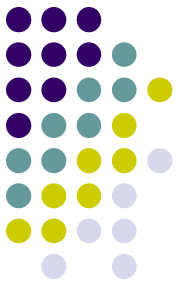
* Import duty on intermediate and capital goods

* If informal business is competing with imports, then gets same protection as formal business

- **Withholding taxes** on imports, exports or purchases by formal sector (corporations and government) from unregistered businesses

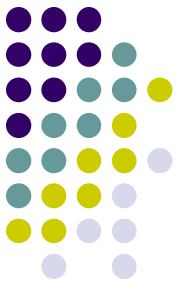
* Withholding taxes creditable against income tax; otherwise final taxes

Challenges to tax administration (13)



- **Types of direct presumptive taxes on informal sectors depending upon information about taxpayers**
 - Head tax (registered individuals)
 - Annual business permit/license/lump sum tax (registered businesses)
 - Unit or ad valorem sales tax or turnover tax (quantity or value of sales of registered businesses)
- **Regular taxes**
 - Invoice or credit method VAT (Sales and purchase values of registered businesses)
 - Income tax and subtraction or addition method VATs (full accounts of registered businesses)
- **Annual lump sum or turnover tax** are main competitors for direct taxation of informal businesses

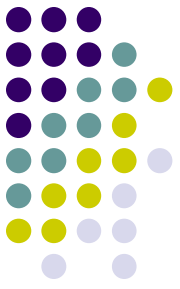
Challenges tax administration (14)



Limitations of turn over tax

- Require **turnover information**: compliance problem where capacity does not exist in micro-informal businesses
- Possible as a **sub-layer tax below VAT**: register for turnover tax if turnover above **first threshold** and for VAT if turnover above **second higher threshold** such as Mozambique), but need to raise VAT threshold to have a feasible “entry level” or “learning-by-doing” layer of capable small businesses subject to turnover tax below VAT businesses
- Need turnover tax to be creditable under VAT to allow sales to larger VAT businesses
- Leaves large number of smallest businesses outside of tax net and weakens political responsibility relationships

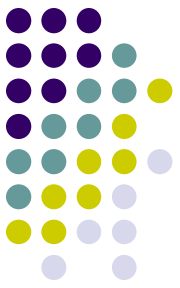
Challenges to tax administration (15)



Design features of **annual lump sum tax on businesses** (for example, Kenyan **Single Business permit** from 1998)

- Can apply to **all** businesses (not just businesses below VAT threshold) which allows:
 - * separate administration of tax for a client-oriented organization
 - * revenue contribution for public services by all businesses
 - * promotion of political responsibility relationship
- Effective tax rate of lump sum tax declines with business size: hence, set rates for below threshold businesses so that effective rate is low for businesses also paying VAT & IT.
- Scale tax to market size, sector and business size (S/M/L) using simple size criteria such as floor, space, number of hotel rooms/beds, restaurant capacity, etc.
- Tax simplification by replacing all business license fees with one annual lump sum tax.

Challenges to tax administration (16)

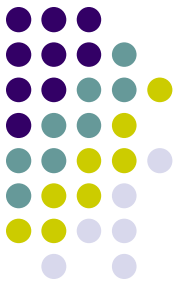


Need for **cost-effective client-oriented administration of annual lump sum tax. Local government administration** has favourable features:

- Need **agency-assessed tax** where no third party information from formal sector businesses (Central revenue authorities that administer self-assessed taxes not organizationally suitable.)
- Need **low labour cost for tax official** as small tax yield per business (High-paid professionals of central revenue authority not suitable)
- **Complementary functions** by local government lower costs and increase effectiveness of identifying and assessing businesses in tax base.
 - Business registration in jurisdiction
 - Land use regulation, including street vendors
 - Property taxation
 - Utility, waste disposal and other services to business properties
 - Management of public markets, taxi ranks, bus stations, etc.

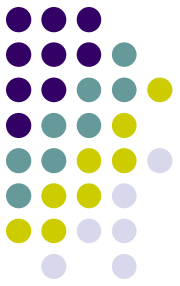
Recommendations (17)

- Information on small business characteristics
 - Labour market survey
 - Tax data – analyze characteristics of businesses just above compulsory threshold in VAT/GST or just above minimum tax free income in IT.
 - * Turnover per year
 - * Sectors or outputs – non-trade or traded
 - * Share of value added in turnover share of taxed inputs in turnover
 - * Time since registration and number of active months since registration
 - * Quality of return and accounts from audit reports
 - * Characteristics of deregistered businesses
- Estimates of entry and recurring compliance and administrative costs for small businesses
- Raise threshold as appropriate (with voluntary registration provisions)
- Training in minimum records and booking for sector, location or self-selected individuals.
- Tax Aid Units



Bibliography (18)

- International Tax Dialogue Global Conference on Taxation of SMEs (Oct 16-19, 2007)
- Special Regimes & Thresholds for Taxation of SMEs
- Graham Glenday – Duke Centre for International Development and International Taxation Program



Thank you for listening (19)

