

# Informal Sector Tax Administration: Will ZIMRA Ever Win?

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## Abstract

This desktop and library study aims at reviewing the informal sector tax administration focusing on the tax effort and tax reforms in Zimbabwe. The focus on informal sector tax administration is motivated by the fact that most government revenues are lost due to inefficient and ineffective administration systems and poor or failure to implement recommended tax strategies to augment public funds. The findings from reviewed literature suggests that lack of commitment by ZIMRA staff and rampant reports of corrupt practices within ZIMRA structures destroys confidence and trust in the whole system hence informal sector will shun paying tax. The study recommends some ways that ZIMRA and Government of Zimbabwe can implement to at least *some level of trust and confidence from the informal sector*.

**Keywords:** Informal sector, Tax Administration, ZIMRA

## 1. Introduction

The debate of mobilizing revenue locally (at country level) has received great attention in recent years (Dube 2014, Masarirambi 2013, Dube & Casale 2016) and a call for the widening of tax base of a country to increase its tax revenue (FICCI 2015, Little Hoover Commission 2015, Dube & Casale 2016). Literature sources reviewed indicate that taxation has been a source of domestic revenue of ancient times and remains a key aspect of citizen's daily lives (ZIMCODD 2014, Masarirambi 2013). Taxation is regarded as the most influential fiscal instruments for any government in accomplishing its goal of strong economic growth and development as well as poverty alleviation (Dube 2014). Taxation as explained in the literature is the most reliable and predictable way of revenue generation for development unlike debts from International Monetary Fund (IMF), World Bank (WB) or other nationalities (ZIMCODD, 2014 Dube 2014).

Generally, in most developing countries tax revenue is low and the tax burden is high on a few formal sectors (Ebifuro, Mienye & Odubo 2016, Dube 2014, Brou and Collins 2001). Existing literature indicates that that the public revenue in most of developing counties is weak and the tax burden is unevenly distributed (Araujo-Bonjean 2003, Masairambi 2013, Junior 2014). This is due to the under taxation of the ever expanding informal sector (Masarirambi 2013, Junior 2014). Several scholars point out that the informal sector represents a potential source of tax revenue for a cash-strapped government (Abiola & Asiweh 2012, Jacobs 2013, Junior 2014, FICCI 2015, Little Hoover Commission 2015, Dube 2014, Oladipupo & Obazee 2016) thus taxing the informal sector is vital to sustain tax morale and tax compliance among firms in the formal sector (FICCI 2015, Korte 2013, Ministry of Finance Tax Administration 2016, Ministry of Finance Tax Administration 2013, PricewaterhouseCoopers, 2010, USAID 2005).

Extant literature shows that Zimbabwe collects many taxes from its citizens in order to finance socio-economic and political goals (Dube 2014, Masarirambi 2013). The general decline in economic activity due to land reform, sanctions poor economic policies and other factors resulted in closure of many companies and retrenchment of many workers as capacity utilisation dwindled to lowest leading to the reduction in revenue from taxation (Sikwila, Kareza and Mungadza, 2016). Period 2008 to 2016 reports suggest that more than 75% of formal companies were closed (Dube & Casale 2016, Tell Zimbabwe News 2016). In a bid to raise the much needed revenue the government of Zimbabwe spread its tax net into the informal sector (Utaumire, Mashiri & Mazhindu 2013, Dube 2014). According to Joshi *et al* (2014) informal sector is the lucrative and revenue potential and the tax authorities must devise means to tap into the sector. Presumptive tax (under presumptive tax Act Chapter 23:06) was introduced in order to collect revenue from the informal sector (Masarirambi 2013, Dube 2014, ZIMRA 2010, Sikwila *et al* 2016). Literature shows some increase in tax revenue from informal sector to the national coffers but the performance of presumptive tax head as a proportion of total tax revenue remain very low and below its revenue potential (Sikwela *et al* 2016, FICCI 2015, Dube 2014, Little Hoover Commission 2015). Reviewed literature shows that the collection of tax from the underground economy has been a problem for the revenue authorities (Masarirambi 2013, Dube 2014), Abiola & Asiweh 2012, Kwaako, Laribik & James 2012). Presumptive tax policy has not improved revenue collection from the informal urban enterprises due to many factors including weak institutions and management (Dube & Casale 2016, FICCI 2015).

## 2. Statement of the problem

Recommendations and implementation strategies to tap into the informal sector have been availed as well as efforts to effectively collect tax revenue from this giant sector have been shared among scholars and tax

authorities worldwide. In the presents of great array of strategies and recommendations many tax authorities in developing countries are failing to effectively collect revenue from the informal sector. The reasons accounting for low tax efforts (FICCI 2015) and for the relative failure of informal tax improvements (Dube 2014, Little Hoover Commission 2015) in many countries have remained under-researched. This paper aims at availing the reasons for low tax efforts and failure of tax informal sector modifications in Zimbabwe.

### 3. Informal sector, definition, characteristics, causes impacts

The term informal sector can be applied to unregistered activities aimed at yielding tangible benefits, in either natural or in monetary form, generating given consequences of value creating and/or distribution character (Schneider, Raczkowski & Mroz, 2015). Somuah (2011:21) defines informal sector as:

- (a) All currently unregistered economic activities that contribute to the officially calculated (or observed) Gross National Product,
- (b) Market – based production of goods and services, whether legal or illegal, which escapes detection in the official estimates of Gross Domestic Product and
- (c) Those economic activities and the income derived from them that circumvent or otherwise escape government regulation, taxation or observation

The following are the key characteristics of informal sector identified in the literatiure and these are: (i) small scale unincorporated businesses, (ii) legitimate or legal in nature, (iii) operate outside the formally regulated monetary economy, (iv) large and diverse businesses, (v) often mobile in operations, poor record keeping, (vi) family oriented businesses, (vii) predominantly cash-based transactions, (viii) low levels of illiteracy and unable to afford accountants, (ix) no culture of tax compliance as different rules, values and beliefs apply, and (x) challenges in compliance and monitoring. These characteristics of the informal sector have been endorsed by academic literature on informal sector ( see Dube 2014; Masarirambi 2013, FICCI 2015, Little Hoover Commission 2015, Udoh, 2015; Mpapale, 2014; Fallah 2014).

Literature shows that informality is driven by the following key divers and these are: (i) limited absorption of labour, particularly in countries with high rate of population or urbanization, (ii) excessive cost and regulatory of entry into the formal economy, often motivated by corruptions; (iii) weak institution, (iv) limiting education and training opportunities as well as (v) infrastructure development increasing demand for low-cost goods and services; and (vi) economic hardship and poverty (Udoh 2015 Fallah 2014, FICCI 2015). Research suggests that the growth of informal sector in developing countries is influenced by a wide range of factors, include: poor accounting and record keeping practices; predominance of cash transactions; peripatetic nature of the informal sector business; the overall tax and social security contribution burden; the complexity of the tax system; the cost of formalizing a business; the prevailing social welfare environment; the effectiveness of the tax administration; quality of institutions; transfer payments tax morale and attitudes to government authority and government spending (see also Russel, 2010; Ofori, 2009; Schneider & Williams 2013). Gerxhani (n.d) also highlights the primary reasons why people participate in the underground economy are: to evade taxes; to avoid losing government benefits; to circumvent regulations and licensing requirements; a reaction by both firms and individual.

Shende (n.d) argues that the presence of informal sector creates challenges in (i) resource allocation, (ii) low tax morale among formal sector, (iii) distrust toward the capability of any ruling party; (iv) unfair competition between formal and informal sector as the informal sector can get cheap labor due to lack of labour regulations and (v) the informal sector remain small because of lack of finance. According to Rahim (2015) informal sector contributes to the creation of employment, poverty eradication and also as a test bed from which willing taxpayers can graduate into mainstream (Fallah 2014, FICCI 2015). According South Africa Revenue Services, (1995) cited as by Rahim (2015:1) maintains that:

*'With millions of South Africans unemployed and underemployed, the government has no option but to give its full attention to the fundamental task of job creation, and generating sustainable and equitable growth'*

He adds that the failure by the government to tap into the informal sector will increase the tax burden on a few compliant taxpayers in a bid to raise the much needed tax revenue. The effects of informal sector are also endorsed by the academic literature on the informal sector effects (Udoh, 2015; Dube 2014, Masairambi 2013, ZIMCODD 2014; FICCI 2015; Brou & Collins, 2001; Little Hoover Commission 2015). In many developing countries informal sector has been a major reliable source of employment, new job creation, condition for sustained growth of large corporations; basis of national competitiveness and sources of innovation and entrepreneurship (Amoah, 2012). UNDP, (2016) concludes that informal sector contributes to increase in economic activities

### 4. Taxation and informal sector, definition, purposes and types of taxes

Historically governments were charging taxes to raise revenue to finance the activities of the government

(Ramabu & Ndlovu (2012) and the contemporary worlds have adopted the same philosophy as well. The Holy Bible (KJV) in Luke Chapter 2 verse 1 to 3:

*2.1 And it came to pass in those days, that there went out a decree from Caesar Augustus, that the entire world should be taxed.*

*2.2 (And this taxing was first made when Cyrenius was governor of Syria.)*

*2.3 And all went to be taxed every one into his own city*

The term taxation is often defined as involuntary amount of money paid to the government to finance its expenditure. Kwaako, *et al* (2012) indicates that tax revenue is used to finance all government expenditure and assist the state to reduce unfair advantage of wealth accumulation arising from wealth distribution. The government can however control and protect certain behaviour and consumption; local industries and other features of the economy. Boakye (2011) reports that apart from the main purpose of taxation that is (i) revenue generation, (ii) taxation fairly distribute wealth; (iii) restrict and control the use and consumption of alcohol and other drugs; (iv) protect indigenous industries and other key aspects of economy. Boakye (2011) further found evidence that ancient government has used money raised through taxation to defray expenditure on war, enforcement of law and order, wealth protection, economic and physical infrastructure and many other welfare and public services these include education system, health care system, public transportation, energy, water and waste management and elderly pensions. Presumptive tax system is the most used to collect taxes from the informal sector ( FICCI 2015, Dube 2014, Masarirambi 2013, Little Hoover Commission 2015). Other developed nations adopted Turnover tax but this is seemingly for the small registered operators (Fallah 2014)

Forum on Tax Administration: SME compliance Group (2012) assert that many revenue authorities are devising strategies to curb revenue losses arising from non-compliance with tax law. Informal sector have shown to be least compliant of all sectors of the economy due to the nature of transaction involved (cash transaction; large informal sector; poor accounting record keeping; labour intensive and time consuming; difficulty in actually collecting the amounts of tax, interest and penalties and detecting and dealing with such non-compliance does not guarantee that such actions may not be repeated into the future and those in the formal sector may also become less compliant due to unfair competition).

Levin (2004) suggests that broadening the VAT-base is the best approach for tackling the informal sector. Levin further asserts that government should come up with policies to fully incorporate growing informal sector into the tax net. He further informs that the tax authority should research more to avoid adverse impact on the poor and improve efficiency of tax system. The root causes of the informal sector should be researched on and come out with better ways of addressing the generic problems, for example, if the root cause is regulations, then government should formulate policy to address such burdensome regulations (Levin, 2004). Schneider and Enste (2000: 17) conclude that tax authorities in many developing countries endeavour to curb the informal sector activities through education and punitive procedures rather than tax reforms of the tax and social security systems which have a long term effects on the economy.

## **5. Approach to increase informal sector tax revenue**

Russel (2010:4) highlights that the choice to participate in the informal sector is due to overall tax and social security contribution burden; the complexity of the tax system; the cost of formalizing a business; the prevailing social welfare environment; the effectiveness of the tax administration; and attitudes to government authority and government spending. He further informs that informal sector can be reduced when responsible authorities embark on: simplifying tax laws; reducing taxes on informal business; reducing barriers to entry into the formal economy such as costs, time, and procedures. According to Russel (2004:4):

*...Revenue agencies should therefore develop mitigation strategies that respond to the most serious of these behaviours through a balanced set of measures aimed at engaging with the community to: (a) reduce community tolerance for the shadow economy; (b) provide targeted assistance to promote voluntary compliance; (c) encourage self-regulation; and (d) demonstrate a visible and credible detection and enforcement capability.*

The Little Hoover Commission recommends that the government can harness the informal sector in one of the following direct and indirect ways and these are tax collected at source (withholding tax), expanding the scope of presumptive taxation, cashless economy, tax on agriculture income, creating IT Infrastructure to track tax evasion, minimizing taxation on online money transfers through banking channels, standardization of Data and Reporting Formats ,electronic book keeping, cross seeding of unique Identifiers (like PAN, CIN, VAT number, etc), book keeping of public projects through a common central IT system , dematerialization of land records and property and centralize documentation generation and reporting for exports and imports including banking transactions (FICCI 2015, Fallah 2013). One best way which can be effective in improving revenue contribution from the informal sector to get everyone together, cut through the red tape, get it done. Maina (2016) reveals ways that revenue can be tapped from the informal sector and these include: (i) introduction of presumptive tax, (ii) consumption tax, (iii) tax administration reforms, and (iv) decentralization and

improvement of public service delivery. This should be coupled by the appointed by a semi-autonomous underground sector commission with clear authority to untangle the current overlap of responsibilities, bridge silos and move efficiently toward results (Little Hoover Commission 2015). Further to that the Commission recommended 15 ways to win the informal sector (for details see Little Hoover Commission 2015). Maina (2016) concludes that the recommended solutions have failed or have not be able to yield more tax revenue from the informal sector hence more research should be done to find best ways to level the playing ground.

## 6. Methodology

This paper adopted a literature review approach, in which related literature were perused and analyzed. The paper used the following sources of information journals, newspaper articles, books, ZIMRA websites and policy documents

## 7. Findings, Conclusions and recommendations

From the literature reviewed the following findings was established:

- ✦ The reasons for low tax effort by ZIMRA is due to the following
  - (i) Lack of competent human resources trained for this special unit
  - (ii) Highly politicized sector ( in which there is a political contract i.e. if you vote for me you will not pay tax)
  - (iii) Those who are connected to some high political offices are immune to tax system
  - (iv) The attitude of revenue officers to taxpayers (rude, harassment and respect of informal sector, pride etc)
  - (v) Conflict of interest in this case ZIMRA officials are engaged in the informal sector
- ✦ The current poor quality health services, or infrastructure in Zimbabwe kills the tax morale
- ✦ The institutional capacity to detect Zimbabwean informal sector and enforce tax compliance is poor
- ✦ Citizens in general s are less motivated to comply with tax laws and regulations due to deteriorating public services, a high rate of corruption, and a lack of transparency and rule of law in the whole tax Law
- ✦ There is no direct communication between the government and the greater informal sector
- ✦ Further impeding the capacity to detect tax noncompliance is the lack of information sharing across tax authorities.
- ✦ Lack of financial capacity also hampers efforts to reduce the size of the informal sector.
- ✦ There is no informal sector revenue office

It can be concluded that poor collection of revenue from the informal sector signifies poor administration process at ZIMRA. There is need for an independent commission to deal specifically with informal sector players. The results show that ZIMRA is failing to tackle tax evasion (Informal sector).

This paper strongly recommends that:

- ✦ The Government of Zimbabwe must take into account all recommendations made by scholars in Zimbabwe and by the FinMart and benchmark with other countries in the region and see how they are tackling this sector (in terms of tax revenue). Benchmark with other countries that have success stories in tackling informal.
- ✦ The Ministry of Finance Economic and Development through consultation with ZIMRA should set independent non-political Informal Sector Commission (Zimbabwe Informal Sector Tax Services(ZISTS)) which shall be responsible for the crafting of informal sector-oriented policies, recruitment of revenue officers(training them) collection and accountable for the revenue collected. Lessons from previous experiences in which the Government established Zimbabwe National Roads Authority (ZINARA) for the collection of toll fees, previous in the hands of ZIMRA. There must also be an Act which will govern ZISTS.
- ✦ The commission (ZISTS) to be established should liaise with the stakeholders including informal sector for discussion of such issues and after three or so year appraise the system/commission.
- ✦ Minimise the tax exemptions for the government officials and they must as well be subject to scrutiny by ZIMRA and by this informal sector will cooperate
- ✦ The government can win informal sector by substitution of legal coercion for moral suasion as the final means of securing unity and cooperation,
- ✦ The Government must provide tangible services to its citizens and to the poor
- ✦ Strong strategies and recommendations on enhancing local revenue mobilisation does not naturally translate into expected revenue but Implementation would yield the results that authorities can then measure outcome.
- ✦ Zimbabwe must establish a Tax Research Commission (TRC) to investigate further on the profitability (performance) of informal sector (both Rural and Urban informal sectors) and feasibility of the establishment of commission.
- ✦ ZIMRA must network with regional tax authorities, who are advocating for the taxation of informal sector, lessons from Brazil, India, South Africa, Tanzania.

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