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# **Taxing the urban unrecorded economy in sub-Saharan Africa**

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## Summary

The global public revenue level of numerous African countries is low and the tax burden is highly concentrated on modern sector firms. One of the most current explanations for the low level of public revenue is the under-taxation of the urban unrecorded activities. The aim of this paper is to define an appropriate strategy in order to collect additional public resources from unrecorded activities in Sub-Saharan African Countries.

In order to define an adapted taxation strategy for the unrecorded sector, informal micro-activities are distinguished from tax evasion activities (TEA). In Africa, the expansion of informal micro-activities is not fundamentally determined by their ability to evade taxes. On the contrary, the expansion of TEA, which are composed of large and small scale firms, is strongly linked to tax fraud (internal taxes, customs duties, etc.). The fundamental justifications of taxing the unrecorded activities differ according to the components of the unrecorded sector. Tax enforcement for TEA should produce substantial additional tax revenues and safeguards the durability of the tax collection system. With regard to informal micro-activities, taxation could be a significant tax revenue objective for local governments only and not for the central government.

We examine the results of the measures aimed at taxing the unrecorded sector in some sub-Saharan African countries (Benin, Burkina Faso). Then, specific strategies are proposed in order to tax the informal micro-activities and TEA respectively. These strategies imply some specific tax measures widely implemented in Sub-Saharan African countries, such as a withholding tax profit. Some new measures, in particular a drastically simplified business tax for informal micro-activities, could be useful. With respect to tax collection, some innovative choices are suggested.

## Résumé

Les ressources publiques de nombreux pays d'Afrique subsaharienne sont insuffisantes pour financer l'offre de biens publics nécessaires au développement de ces pays. De plus, la pression fiscale est excessivement concentrée sur le secteur moderne. Une des explications couramment avancées à ces deux phénomènes est la sous-fiscalisation des activités non enregistrées urbaines. L'objectif poursuivi ici est d'évaluer les stratégies mises en œuvre pour mobiliser des ressources fiscales à partir des activités non enregistrées.

A cette fin, on distingue parmi les activités non enregistrées, d'une part les micro-activités informelles dont l'objectif essentiel est d'obtenir un emploi et, d'autre part, les activités frauduleuses dont le développement dépend étroitement de la fraude fiscale. Cette distinction justifie des stratégies fiscales spécifiques à chacune de ces catégories d'activités.

Seules les activités frauduleuses qui peuvent être de taille variable présentent un potentiel de recettes importants. Compte tenu de l'influence des groupes de pression, des stratégies fiscales de second rang ont été utilisées notamment à travers des acomptes au titre de l'impôt sur les bénéfices perçus sur les importations ou les ventes locales des entreprises enregistrées. Des résultats substantiels ont été obtenus. Les micro-activités informelles, en dépit de leur importante contribution à la production et à l'emploi, présentent un faible potentiel de recettes fiscales inexploitées : elles permettent d'obtenir des revenus individuels souvent très faibles et elles supportent déjà à travers leur leurs achats de consommation intermédiaire l'incidence d'impôts indirects. Cependant, une patente synthétique indiciaire pourrait permettre de mobiliser une ressource pour financer les collectivités locales. Des modalités originales de recouvrement sont proposées.

## 1. Introduction

Many countries in sub-Saharan Africa experience considerable difficulties in mobilizing public revenues. During the nineties, in order to alleviate these difficulties, the tax systems were simplified, modernized and adapted to the specific context of these countries. At the same time, particular importance was attached to improving tax administration. The results obtained are substantial as, despite the difficulties encountered in African countries, average public revenues in relation to the GDP remain similar to those of other groups of developing countries (Brun, Chambas, Combes, 2003). Like the other regions, African countries are currently implementing a tax transition process, characterized by the substitution of internal tax revenue for customs revenue.

However, public revenues remain weak in numerous sub-Saharan African countries and the tax burden appears to be unevenly distributed. Two sectors are often considered as being under-taxed: the agricultural and the unrecorded urban sectors. Because of the characteristics of these two sectors, a specific analysis is needed for each one. The present analysis focuses on the unrecorded urban sector. Its under-taxation results in considerable losses in tax revenue. On a 57 developing countries sample, Alm and Martinez (2003) estimate these revenue losses up to 40 % of the potential public revenue. What is worse, the development of unrecorded activities is threatening the official sector, which plays a crucial role in collecting government resources (Bagahwa and Naho, 1995).

After identifying the different components of the unrecorded sector<sup>1</sup>, the aim of this paper is to evaluate their respective tax potential and then to define a tax collection strategy.

## 2. The importance of unrecorded activities

Since the beginning of the 80s, extensive literature has shown the significant role played by the unrecorded economy in numerous countries and particularly in developing countries (Schneider, 2003). The unrecorded economy, also referred to as the “underground economy, hidden economy, shadow economy, black economy, ...” (Dixon, 1999) remains difficult to appraise due to the diversity of the activities it covers as well as the unobservable nature of these activities. Nevertheless, it would seem that, in many countries, the size of the unrecorded sector has grown substantially since the end of the 70s with increasing taxation and regulation (Tanzi, 1999).

### 2.1. Informal activities vs. tax evasion activities: an important distinction

In order to define a taxation strategy for the unrecorded sector, we differentiate unrecorded firms by segments. Two categories of unrecorded activities should be distinguished in addition to illegal activities<sup>2</sup>: informal activities and tax evasion activities (TEA).

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<sup>1</sup> The urban unrecorded sector is henceforth designated as the “unrecorded sector”.

<sup>2</sup> Productive or commercial activities which violate the law (drug trafficking, etc.) which are not dealt with here.

*Informal activities*

In Africa, the informal sector is composed of small firms which “are not ... recorded in official statistics (and which) ... operate on a very small scale and with a low level of organization. It covers commercial or non-commercial activities (trade of goods and services, self-consumption, etc.). Most of these small firms use a very low level of capital with low productivity and low income” (Husmanns, 1997) and most of them do not even keep any simple accounts (Terkper, 2003). This definition of the informal sector excludes modern small business (more precisely modern services) because modern small business uses sophisticated techniques and because in Africa, the size of this kind of activities is usually larger than the one of the micro-informal activities. In concrete terms, this sector is composed of small craftsmen (joiners, mechanics, builders, etc.), small service providers (water carriers, street peddlers, street sellers, pavement food stalls, washer-people, etc.) who operate, at least in part, on the fringe of regulations (labor and tax legislation) and who often satisfy the needs of the most disadvantaged part of the population.

Various surveys demonstrate that in the case of African informal activities, tax non-compliance often results not from an intentional act but from ignorance of the legislation or from the complexity of the tax system (Gautier, 2001, Ngoi, 1997, Roubaud, 1992). In Tanzania, the 1995 survey shows that the central aim of informal activities is to procure a job (Ngoi, 1997). Certainly, the willingness to evade taxes and their associated constraints (red tape, corruption) is not to be excluded, but tax evasion is not a decisive factor in the expansion of the informal activities<sup>3</sup>.

The informal sector micro-firms are supplied both by the recorded and unrecorded sector. They supply mainly the final consumer or the TEA. For instance in Benin, large-scale tax evaders use the services of small-scale informal firms to transport cars from Benin to Nigeria. Informal sector micro-firms rarely supply firms in the official sector as they are hampered<sup>4</sup> by the VAT mechanism and by a generally lower product quality. We will show later that, despite their importance, such informal activities are unlikely to compromise either the durability of the tax collection system or the level of government revenues.

*Tax evasion activities (TEA)*

TEA is the second component of the unrecorded sector. Unlike informal activities, tax evasion or the willingness to avoid restrictive regulations are decisive factors in the expansion of these activities. Most of these activities can only survive by means of tax evasion. For instance, retailing petroleum products in the street (as in Benin for instance) results from evasion of tax and would not survive if the taxation laws were enforced. TEA seek to avoid regulations and taxes (notably tariffs, VAT and direct taxes) in order to generate additional profits and/or increase their competitiveness relative to firms in the official sector. The

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<sup>3</sup> Some small-scale activities can prove to be particularly difficult to disentangle: for example, street mechanics possess all the characteristics of informal sector firms but they purchase their inputs from TEA.

<sup>4</sup> Informal firms are not subject to VAT. Hence, they cannot deduct VAT paid on inputs purchased from registered firms.

decision to evade tax depends on the expected gain, taking into account the probability of detection and the cost of penalties.

Two categories of TEA should be distinguished: on the one hand, unrecorded micro-firms most often undertake small-scale fraudulent import-export activities<sup>5</sup>, and on the other hand large-scale firms sometimes operating as registered firms, part of whose activities are fraudulent.

In a large number of countries, the distortions generated by trade policies (tariffs, regulations, etc.)<sup>6</sup>, the porosity of borders and the existence of traditional trade networks on both sides of the borders, favor the development of small-scale smuggling activities. Because of their large number and their small size, the smugglers prove difficult to monitor for the customs services whose material and human resources are insufficient. This is the case, for instance, of the *charcharis* in Djibouti. It is also the case of the micro-firms engaged in smuggling petroleum products between Benin and Nigeria. These smugglers buy cans of gasoline in Nigeria, transport them by dugout, then by motorbike and sell them in the streets of Benin. Despite the low unit value of the transactions, the volume of activity performed by these numerous small smugglers is considerable and, in the case of Benin<sup>7</sup>, the parallel distribution networks for gasoline tend to supplant the official ones.

Smuggling activities are not restricted to micro-firms: large firms are also involved. In some cases, large-scale firms are not recorded and their whole activity belongs to the underground economy. In other cases, firms are identified and recorded by the tax administration although a significant part of their activities is not recorded. The expansion of these large-scale activities more often than not results from collusion between the public authorities and the TEA. In Africa, tax non-compliance is generally to be encountered in the sectors of construction, spare parts, petroleum products, cigarettes or alcohols, import-export of vehicles. Because of their size, these activities cannot be unnoticed, but they succeed in evading taxes and customs duties by means of sometimes very sophisticated strategies, solidarity networks, political and social influence. They also take advantage of the administrative weakness and resort to corruption. In countries such as Benin, Niger and Togo, these TEA are a fundamental component of economic activity.

## 2.2. Estimating the size of the unrecorded sector in Africa

The unrecorded sector is evaluated using several methods<sup>8</sup>, the results of which can vary greatly. In the case of African countries, it is often measured using National Accounting data; it can also be appraised by means of intermediate consumptions, such as electricity, or money demand. Within the framework of these global approaches, it is not easy to measure the respective size of informal activities and TEA. Specific surveys concerning informal firms are sometimes available, but these surveys generally use different concepts and methodologies, which do not provide homogenous and directly comparable data.

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<sup>5</sup> The small-scale fraudulent sector is also likely to sell products purchased illegally from domestic companies.

<sup>6</sup> For example, between Nigeria and neighboring countries.

<sup>7</sup> Smuggling between Niger and Nigeria has been analyzed in Barlow and Snyder (1993).

<sup>8</sup> For a survey of the different methods used to evaluate the importance of underground activities, see Schneider and Enste, (2000).

According to various analyses (Chickering and Salahdine, 1991; Schneider and Enst, 2000; Schneider, 2003), unrecorded activities are particularly important in developing economies where they represent between 40 and 80 % of domestic value added. These figures are confirmed for African countries. For instance, at the beginning of the nineties the non-agricultural unrecorded sector in Senegal represented more than 50 % of the GDP (Fall, 1997). In Guinea, it represented<sup>9</sup> 54 % of the GDP and 82 % of non-agricultural employment in 1994. In Tanzania in 1991, the unrecorded urban economy represented 33 % of the global GDP, this rate being estimated at approximately 50 % for Dar es Salaam (Ngoi, 1997). In Madagascar, the informal micro-firm sector represented 18 % of the GDP in 1998 (Paillaud et alii, 1998). These punctual observations are corroborated by Schneider (2003): on a sample of 24 African countries, he estimates the contribution of the shadow economy between 28 % and 60 % of GDP, the mean being 41 %.

The importance of unrecorded activities can also be captured using observations relative to specific sectors. For instance in Benin, fraudulent car importations represent a considerable volume since, for a national market estimated at 10,000 vehicles, 250,000 vehicles are imported and declared meant for the domestic market; in fact, most of them are re-exported illegally to Nigeria. Large-scale import-export smuggling activities also deal in the trade of second-hand tires and spare parts. Similarly, and in part in competition with Benin, large-scale TEA are also widespread in Togo. Obviously, these large-scale TEA benefit from powerful support within the countries.

Consequently, in sub-Saharan Africa, the unrecorded urban sector provides a substantial contribution to economic activity.

### **3. The justifications for taxing the unrecorded sector**

Attempts to tax the unrecorded sector generally pursue three main objectives: the collection of tax revenue, the preservation of the incentives system and the promotion of equity.

#### **3.1. Tax revenue objective**

Activities, not recorded by the tax and customs administrations, succeed in evading, in part, the tax burden which they should otherwise bear or collect; this results in a loss of tax revenue. This direct loss of tax revenue is compounded by an indirect loss stemming from the unfair competition exerted by the unrecorded sector on the official sector. Indeed, in the unrecorded sector, firms who evade regulations and tax burden, face lower production and transaction costs than the official firms.

This phenomenon is likely to cause the decline<sup>10</sup> of honest firms which not only contribute directly to the tax revenue, but also collect taxes on the wages of their employees as well as indirect taxes (VAT and excise duties). In other words, there is an important risk of bankruptcy of the firms, which in sub-Saharan Africa, as in many other regions, collect the

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<sup>9</sup> Source: Guinean national authorities.

<sup>10</sup> Loayza (1996) shows that, for a sample of Latin American countries, the growth of the underground sector has a negative effect on the recorded sector.



major part of internal tax revenue on behalf of the tax administrations. For instance, in Niger, the unfair competition stemming from large tax evaders severely affects the durability of the tax collection system.

Hence, with regard to the tax revenue objective, taxing the unrecorded sector aims at both collecting tax revenue and preserving the durability of the tax collection system.

### **3.2. Incentive objective**

Submitting both recorded and unrecorded activities to similar tax obligations would not only be favorable to the public revenue objective, but would also reduce the distortions in the incentives system defined by the national authorities via tax and trade policies (Auriol, Walters, 2002; Feige, 1990).

Indeed, by modifying the relative prices and incomes structure, taxes and more specifically tariffs, determine an incentives system. Insofar as the unrecorded sector avoids, at least in part, taxation, each firm faces a particular incentives system whose characteristics depend on its capacity to evade taxes. In other words, unrecorded firms face a price system for outputs and inputs different from that of honest firms. Therefore, resources allocation is affected by price distortions stemming from tax evasion. For instance, tariff evasion on rice imports in countries such as Guinea and Madagascar significantly reduces the protection of local rice.

### **3.3. Equity objective**

The impact of the under-taxation of the unrecorded sector on the progressiveness of the tax system is ambiguous.

On the one hand, tax evasion may introduce a certain degree of progressiveness into the system of indirect taxes (tariffs, VAT, excise duties). Indeed, if we consider that the poorest categories of the population are mainly supplied by the unrecorded sector, these categories therefore avoid, in part, indirect taxes on the products: unrecorded activities allow the reduction of the tax burden on the products consumed by the poorest. On the other hand, it is generally recognized that tax evasion relative to direct taxation has a regressive distribution effect. According to various analyses, the impact of tax evasion increases with the level of the taxpayer's income (Andreoni, Erard and Feinstein, 1998). In sub-Saharan African countries, tax evasion allows the tax burden of high-income earners belonging to TEA to be reduced.

In summary, one of the consequences of a large unrecorded sector is to make the tax system more opaque and its redistribution effects more uncertain. In order to make up for these drawbacks, taxation of the unrecorded sector should aim at filling the gap between the actual tax system and the legal tax system, thus bringing it into line with the incentives and equity objectives of the national authorities. In particular, one of the most fundamental objectives is to redistribute the tax burden over all the economic units according to their taxable capacity.

## 4. Tax potential of the unrecorded sector: an evaluation

The respective characteristics of informal activities and of TEA determine differentiated tax potential.

### 4.1. Tax potential of informal activities

Contrary to widespread opinion, the tax potential of informal micro-activities is already partially exploited through both direct and indirect taxation (Oudin, 1991; Morrisson et al. 1994; Maldonado, 1995). According to several country studies conducted by OECD (Morrisson et al., 1994), informal firms often bear a non-negligible direct tax burden (54 % of informal firms in Swaziland, 85 % in Tunisia). In this respect, the easiest tax to collect is the business tax (“patente” in francophone countries). Market place fees are also generally well accepted insofar as they finance some local public services.

Moreover, the informal micro-firms bear the incidence of indirect taxes. Indeed, informal micro-firms consume a large amount of intermediate goods and services subject to indirect taxes (VAT, excises taxes). For instance, in Senegal, intermediate consumption of most informal firms ranges from 40 % to 59 % of turnover (table 1). Insofar as their suppliers do not evade indirect taxes (tariffs, VAT and excise duties), the informal activities bear the incidence of taxes levied on their intermediate consumption<sup>11</sup>.

**Table 1: Intermediate consumption of informal firms in Senegal**

Unit: %

|                                 | <b>Joinery</b> | <b>General mechanics</b> | <b>Food industry</b> | <b>Construction materials</b> | <b>Transports</b> |
|---------------------------------|----------------|--------------------------|----------------------|-------------------------------|-------------------|
| <b>Production</b>               | 100            | 100                      | 100                  | 100                           | 100               |
| <b>Intermediate consumption</b> | 39.7           | 58.9                     | 56.1                 | 48.8                          | 54                |
| <b>Value added</b>              | 60.3           | 41.1                     | 43.9                 | 51.2                          | 46                |

Source: Fall B (1997)

Despite their large contribution to production, most informal micro-firms have a low direct tax revenue potential (profit tax, business tax). Most informal micro-firms generate small profits which are divided into a large number of people participating in the activity of each informal firm. Moreover, the poor economic performance of numerous informal micro-firms, their large number, their geographical dispersion and their inability to keep accounts or submit tax returns imply prohibitive administrative collection costs for direct taxes. Therefore, direct taxes from informal activities would be very difficult to collect at a reasonable cost even by means of a simplified direct tax system (cf. *infra* the case of the “Contribution du Secteur Informel” in Burkina Faso).

<sup>11</sup> In the case of Peru, De Soto (1994) measured the considerable contribution in indirect taxes for the Peruvian informal sector. Through purchases of supplies from the modern sector, this author estimated this contribution to be 5.7 % of the GDP in 1985.

With regard to indirect taxes, and more specifically VAT, the amount of tax which would correspond to the value-added of each micro-firms is not collected. In this case also, it would not be efficient to try to collect these uncollected taxes because of the high administrative cost of collection: according to the tax code, the informal micro-activities are below the taxation threshold and moreover, these firms can in no way constitute reliable collectors of indirect taxes (VAT, etc.). On the one hand, the informal micro-firms are often managed by illiterate people unable to file tax returns and unreliable in satisfying their tax liabilities. On the other hand, the tax administration does not have the capacities to manage a very high number of taxpayers<sup>12</sup>.

#### **4.2. Tax potential of the tax evasion activities**

Tax evasion activities, whatever their scale, often compete with the activities of official firms. The tax evasion of TEA results in substantial losses in tax revenue and threatens the durability of the tax collection system. Thus, in various sub-Saharan African countries, the official trade networks for products such as second-hand cars, spare parts for cars, textiles, cigarettes or alcohol suffer unfair competition from TEA and, in some countries such as Niger (Barlow, Snyder, 1993), the official firms tend to become marginal.

In African countries, as in other regions, the tax potential is highly concentrated at the level of the largest firms. Hence, tax enforcement of large-scale unrecorded firms should<sup>13</sup> allow collection of indirect tax revenues, especially at the border. Moreover, as for indirect taxes, the large TEA exhibit a significant direct tax potential (profit tax, business tax, etc.) and they have to comply with their tax obligations.

However, reducing tax evasion would likely result in a significant decrease of some commercial transactions. For instance, in Benin some trade flows, such as the re-exportation of cars, would disappear to the benefit of direct imports by Nigeria. In this case, Benin would suffer a dramatic decrease in its tax revenues. In other case, the official sector would take over market shares. For instance, this would probably occur for the textile trade in the Gulf of Guinea controlled by the informal businesswomen, called "Mama Benz". Even if we allow a certain price elasticity of demand, which could involve a decrease in global consumption, a positive effect on tax revenue would be expected.

### **5. Taxation strategies for unrecorded activities**

Before defining any taxation strategy, we must underline once again the socio-political dimension of tax compliance. In most countries, TEA are closely linked to the political authorities. Indeed, most attempts to enforce tax legislation have failed because of the political influence and impunity of special interest groups. We first examine a tax compliance

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<sup>12</sup> The risk would be the poor monitoring by the tax administration of the largest taxpayers who constitute the major part of the VAT potential. As in other countries (developed and developing countries) whatever the region, we may observe a very high concentration of the tax potential to the benefit of the largest firms.

<sup>13</sup> Unrecorded firms, which achieve a turnover above the legal taxation threshold, are legally obliged to collect the indirect taxes (VAT, excise duties, tariffs).

strategy for the TEA, characterized by a large unexploited tax potential. We then turn to the informal sector.

### 5.1. Taxing “tax evasion activities”

In order to tax the TEA, two types of measures could be undertaken: reducing tax non-compliance and implementing a withholding profit tax.

#### *Tax enforcement vis-à-vis “tax evasion activities”*

The enforcement of tax laws vis-à-vis the large-scale TEA should be a crucial objective. The importance of the unexploited tax potential should lead to the enforcement of the current tax legislation, particularly at the border<sup>14</sup>, and the implementation of standard administrative techniques (cross-checking of the firm’s data with their foreign trade transactions, checking through registered taxpayers<sup>15</sup>, through public contracts, etc.). Implementing standard techniques to reduce tax evasion by large-scale firms seems feasible, even for weak tax and custom administrations<sup>16</sup>. However, these standard techniques are rarely implemented in Africa due to the effective opposition of pressure groups mentioned above.

Due to their large number, tax compliance of the small scale TEA is a difficult target. However, to some extent, tax evasion by the TEA could also be reduced by using standard procedures<sup>17</sup>. For instance, when tax evasion takes place under cover of “occasional imports”<sup>18</sup>, imposing the systematic identification of all professional importers by means of a Tax Identification Number (TIN) common to the customs and tax administrations would be a means of taxing their importations and, therefore, of reducing tax fraud. The main difficulty raised by this strategy, in most African countries, is the generally unsatisfactory implementation of the TIN. At the present time, it is still possible for smugglers to “occasionally” import in numerous countries and data crosschecking between the customs and tax administrations is still non-operational.

Confronted with difficulties in enforcing tax legislation, in particular with regard to direct taxation, a withholding tax strategy has been implemented in numerous sub-Saharan countries. This strategy, which should represent a step towards a more comprehensive taxation of the TEA, would also allow an additional taxation of the informal activities.

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<sup>14</sup> Internal taxes (direct and indirect) are more difficult to collect than customs taxes.

<sup>15</sup> For example, cf. Silvani (1992)

<sup>16</sup> On the other hand, visits from tax administration agents in the field do not seem appropriate in light of the lack administrative resources and the risks of corruption.

<sup>17</sup> It is nevertheless necessary to underline that the lack of human and material resources of the tax and customs administrations constitutes an obstacle as soon as a large number of taxpayers is to be monitored.

<sup>18</sup> In numerous African countries, “occasional imports” allow the anonymity of the importers vis-à-vis the customs and tax administrations. Moreover, these imports often benefit from a low level of taxation.

*Withholding profit tax*

As a result of the poor management capacities of African administrations, the withholding tax strategy has been restricted to direct taxes (profit tax)<sup>19</sup>. In this strategy, advance payment of profit tax allows taxation *a minima* of all unrecorded activities (TEA and informal activities).

The advance profit tax payment is withheld either on imports, or on domestic sales at a rate generally ranging from 1 to 3 %. The tax is withheld either by the customs administration or by the registered firms. The registered importers and local producers subject to the profit tax can deduct the advance payment from the profit tax due. If the advance payment exceeds the actual profit tax due, the taxpayer may be refunded. For the unrecorded firms, the advance payment becomes a definitive tax<sup>20</sup>. The main advantage of this mechanism, when correctly applied, is the collection of substantial tax revenues from the unrecorded sector.

In Benin, (table 2), the withholding profit tax generated in 2001 a tax revenue of about 20.7 billion CFA francs, i.e. almost 32 % of direct tax revenues<sup>21</sup>. However, this strategy is not effective for identifying taxpayers. The amount of non-deducted advance payment highlights that the most of taxpayers prefer to remain anonymous. Anonymity facilitates evasion of other legal obligations and administrative red-tape. It should be noticed that, in order to tax some activities, a specific withholding tax can be implemented. Thus, in Benin, an advance payment of 50,000 CFA francs is withheld on each imported car and deductible from profit tax; this withholding tax allows a minimum profit tax to be collected from unregistered firms marketing second-hand cars. In 2001, the net revenue of this tax was 11.5 billion CFA francs (cf. table 2), i.e. 22 % of direct tax revenue.

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<sup>19</sup> In certain countries, an advance tax payment was deductible for various taxes, notably indirect taxes (VAT, etc.). The disastrous experience of the ASDI (“*acompte sur divers impôts*”) in Côte d’Ivoire shows that this mechanism was unmanageable due to its complexity.

<sup>20</sup> To avoid an excess tax burden, the firms can register with the tax administration and request to be subject to the real tax profit regime. This is an anticipated effect of the withholding tax system.

<sup>21</sup> Similarly, for beer distribution firms in Burkina Faso, an advance profit tax (“*Contribution sur les boissons*”) is levied at brewery level, allowing 1.04 billion CFA francs to be collected whereas drink distribution firms are traditionally hard to tax.

**Table 2: Withholding profit tax collection***Unit: billion CFA francs*

|  | 2000        | 2001        | 30 June 2002 |
|--|-------------|-------------|--------------|
| <b>1 Withholding profit tax: gross revenue</b>                                 | 8.3         | 9.2         | 4.8          |
| <b>2 Deducted advance payment</b>  | 2.9         | 2.7         | 4.0          |
| <b>3 Proportion of deducted advance payment %<br/>(1/2)</b>                    | 34.9<br>(%) | 29.3<br>(%) | 83.3<br>(%)  |
| <b>4 Withholding profit tax: net revenue (1-2)</b>                             | 5.4         | 6.5         | 0.8          |
| <b>5 Special withholding profit tax for vehicles</b>                           | 7.4         | 12.4        | 5.7          |
| <b>6 Deducted special withholding profit tax for vehicles</b>                  | 0           | 0.9         | 1.4          |
| <b>7 Proportion of deducted withholding profit tax for vehicles %</b>          | 0<br>(%)    | 7.3<br>(%)  | 24.6<br>(%)  |
| <b>8 Special advance payment on profit tax for vehicles: net revenue (5-6)</b> | 7.4         | 11.5        | 4.3          |
| <b>9 Net withholding tax on services purchases</b>                             | 2.8         | 2.7         | Na           |
| <b>10 Net global revenue of the withholding taxes (4+8+9)</b>                  | 15.6        | 20.7        | Na           |
| <b>11 Net global revenue / Direct taxes</b>                                    | 26.6<br>(%) | 31.9<br>(%) | Na           |

Source: Ministry of Finances, Benin

This system of withholding profit tax raises significant tax revenue in a very difficult environment, but it makes the tax system more complex. An efficient and fair implementation of this system rests on an effective reimbursement of the excess tax paid. It also requires that the advance payment should not be excessive compared to the profits generated by unrecorded activities (risk of over-taxation). The advance payment should, however, be sufficiently high to avoid an under-taxation. Moreover, the advance payments collected at the border increase the rate of customs taxation and therefore reinforce the incentive for tax evasion. Finally, the management and collection of this tax profit advance payment generates an additional compliance cost for registered firms.

## **5.2. Taxation of informal activities: a unified business tax**

### *Foundations of a unified business tax*

Informal activities bear indirect taxes on their intermediate consumption as a definitive tax burden. Furthermore, most African countries have implemented a withholding profit tax (cf. above) which generates an additional definitive tax burden for informal activities. In light of the characteristics of these activities, their unexploited tax potential is weak.

However, subjecting informal activities to a direct tax appears important for two main reasons. First, taxpayers are far more aware of direct taxes than of indirect taxes. As a result, direct taxes can give the taxpayer the feeling of belonging to a community and therefore might encourage him to demand more efficient public expenditures. Second, a direct tax on informal activities can constitute a significant resource for local public finance.

### *Experiences of simplified taxation of informal activities*

In the past, small firms in francophone Africa were subject to a complex tax system (the “forfait” system). The amount of different presumptive taxes<sup>22</sup> included in the “forfait” system (profit tax, VAT or turnover tax and business tax) were mainly calculated in relation to an estimated turnover, whereas small firms carried out no book-keeping. As a result of its complexity, this mechanism was rarely implemented and when it was, it favored corruption. Only the old business tax, traditionally considered as being an authorization to exercise a professional activity, was relatively well collected.

Currently, a unified business tax is encountered in various African countries. For instance, since 1994 Benin has implemented a “Taxe Professionnelle Unique” (TPU). This option for a unified business tax substituted to all other taxes previously levied on small firms is a factor of simplification and efficiency. However, due to the lack of reliable book keeping, the reference to turnover in order to determine the tax base of this unified business tax still remains a source of uncertainty and complications. This often leads to untimely discussions between the taxpayers and the agents of the tax administration, or even to discretionary decisions. This is all the more detrimental as the tax revenue potential of this type of tax is low.

The revenue from unified business taxes is generally low while its collection costs are high. Thus, in 2001 in Benin, the TPU on small activities generated a revenue of 2.4 billions CFA francs which can, for instance, be compared to the 11.5 billion CFA francs collected through the advance payments on vehicles (cf. table 2). Similarly, Burkina Faso implemented a “Contribution sur le Secteur Informel” which, in 2000, necessitated huge administrative resources for a total revenue of 820 millions CFA francs levied on 70,126 taxpayers, representing an average of approximately 15 US dollars per taxpayer<sup>23</sup>.

### *Implementing a unified business tax on informal activities*

The taxation system for small informal activities could therefore be greatly improved by adopting a simplified unified business tax. The scale of this tax would be determined according to objective indicators<sup>24</sup> of taxable capacity, with no reference to turnover. Hence, book-keeping and return filing would be eliminated. The tax base would be calculated from a tax scale determined according to objective and simple indicators which are easily

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<sup>22</sup> On the different presumptive tax systems, cf. Bulotoglu (1995), Thuronyi (2003).

<sup>23</sup> All statistical data were supplied by the tax administrations.

<sup>24</sup> These can be the nature of the activity, its geographical situation, the equipment used, etc. For restaurants, it could be the number of tables, seats, employees, etc.

recognizable<sup>25</sup>. Such a tax, “*impôt libérateur*”, will shortly be implemented in Cameroon. The scale of the unified tax should naturally take into account any advance payment on profit tax, as well as the VAT incidence on intermediate consumptions (cf. *supra*).

The extreme simplicity of this unified business tax would facilitate its understanding and acceptance by the taxpayers. It would also allow a reduction in monitoring costs by avoiding an excessive number of complex taxes with regard to these small taxpayers. For an efficient collection of the unified tax, it would be necessary to favor a spontaneous payment procedure based on periodic payments (most often a quarterly periodicity would be adequate). Collection visits in the field would aim at registering the informal taxpayers, checking the effective tax payments and collecting the tax from defaulters. The simplification introduced by a calculation of the unified business tax based on specific indicators would also allow the collection of this tax to be entrusted to the decentralized authorities<sup>26</sup>: the unified business tax has a clear local application.

## Conclusion

Unrecorded activities significantly contribute to the creation of wealth in countries throughout sub-Saharan Africa. Among these unrecorded activities, the tax evasion activities (TEA) should be distinguished. These activities exhibit a substantial unexploited tax potential which, if collected, could make easier the reduction of public deficits and/or provide additional public goods. Informal micro-activities, the second component of the unrecorded sector and for which tax fraud is not a decisive factor of expansion, already contribute to public revenues by bearing the incidence of indirect taxes (VAT, excise duties, tariffs) as well as paying advance payments on tax profits. Informal micro-activities thus represent a reduced unexploited tax potential.

A more efficient taxation of the unrecorded sector, and especially of the TEA, would be favored by a harmonization of tax and customs legislations in bordering countries. Such a harmonization is currently in progress in some regional integration zones such as the West African Economic and Monetary Union (WAEMU). However, despite significant improvement, severe distortions remain, notably vis-à-vis countries outside the zone (especially Nigeria). Distortions still exist even within the WAEMU due to the unequal implementation of tax and customs measures.

The strategies for taxing unrecorded activities, and more particularly TEA, are confronted with considerable obstacles. Improvements are nevertheless possible, more precisely through a more strict implementation of import tax. With regard to direct taxation, the challenge which is proving difficult to overcome is to succeed in subjecting the largest tax evasion activities to a real tax regime and to monitor these taxpayers efficiently. Confronted with the difficulties caused by interest groups, a well enforced withholding profit tax constitutes the beginning of a solution.

Informal activities are to be subject to a unified business tax, based on objective indicators, whose characteristics mark it out as a local tax. This tax should be sufficiently

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<sup>25</sup> This allows the taxpayer to know the criteria used to determine the amount of tax to be paid.

<sup>26</sup> In general, African tax administrations do not possess sufficient human and material resources to manage a large number of taxpayers.



simple to be understood by the taxpayers and to be collected, if necessary, by the local authorities. The tax administrations of African countries do not have the human and material resources to manage large number of taxpayers, which means that local tax collection will more and more resort to other networks.

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