

THE NEXUS BETWEEN TAXATION OF THE INFORMAL SECTOR AND INEQUALITY IN TANZANIA

Brief 1.19

INTRODUCTION

Tax raises government revenue that is essential for funding basic public social economic services, national development goals and is at the heart of the social contract between citizens and state. The tax system can directly reduce inequality by redistributing incomes from rich to poor, by taxing the rich adequately and giving the government revenues. In Tanzania, there is a challenge of large informal sector characterized by high level of under-regulation by the government, cash transactions and improper record keeping, which has often gone untaxed hence subjecting a higher tax burden on the few within the formal sector. As a result of these problems, the informal Small and Medium Enterprises (SMEs) sector has been very complex to tax.

The informal sector tax challenges entail that little or none of the income generated in the informal sector is transferred to the government in form of tax. Therefore, a very high percentage of potential tax revenue is unaccounted for. This in a way contributes to inequality because the informal sector partly constitutes High Net Worth Individuals (HNWIs) whose incomes are not often subjected to tax. Also, those subjected to presumptive tax which may at times be taxed higher than what they actually earn and thus makes the presumptive tax regime unfair.

MAIN FINDINGS

This brief has summarised findings from a study conducted in 2018 that analysed the trends of the growth/decline of the informal sector in Tanzania and revenue collections

foregone over the years 2010/11-2016/17, the level of inequality due to taxation or non-taxation of the informal sector and provided recommendations on how to improve revenue collection from the informal sector while at the same time reducing inequality in Tanzania. The research study has come up with the following major findings;

1. The large and dynamic nature of the informal sector growth lead to the low performance of the sector

The informal sector in Tanzania is large, dynamic and unstable in the sense that the rate of entry for new entrants is high and the life span for many entrants into the sector is low (approximately less than five years) thus rate of exit is also high. Also, there is dominance of traditional businesses, mostly operated by

youth and adult characterized with basic education conducting mainly trade as the main activity in the sector.

The dynamism of the sector is also associated with the nature of the entrepreneurs whereby most of the sector operators have basic education with limited entrepreneurial education in comparison to the nature of economic situation prevailing such that low effective demand which affect the business cycle has been mentioned as among the reasons for short survival of many of informal sector operators. With presence of many small businesses which are not registered, low capital equipment and machinery usage and lack of permanent sites of business operation makes the formalization process and tax collection into the informal sector difficult. This behavior raises concerns about the potentiality of the informal sector as another main source of government revenue.

II. Unstable informal sector leads to large amount of revenue foregone

Informal sector exhibits an unstable pattern in contributing to the Government revenue and thus revenue foregone from the sector get larger overtime. Despite presence of presumptive tax and increased contributors to the tax net, still the informal sector has not contributed substantially to the total revenue. There is large dependency on few large taxpayers. This is because most of the operators in the sector have no business licenses and do not pay tax which cause large untapped potential of taxation

in informal sector and hence increases the revenue foregone. The burden of tax increases to the few payees while there are many of untaxed firms thus causing the rising of inequality in income among the operators of the sector and between the formal and informal sector.

The use of presumptive income tax has contributed to the improvement of tax revenue as it registers a positive growth of the amount collected each year. This implies that the instituted mechanisms to bring informal sector into the tax bracket are working and thus need to be enhanced and promoted. On the other hand, the increase of revenue foregone is associated with the difficulties of taxing the informal sector due to limited information about the business operators. There are some reasons for informal sector to escape paying taxes in Tanzania. These include; small capital turnover, immature business and economic hardship, Inadequate benefits of paying tax, nature of business and absence of proper business premises are the major factors for the SMEs not paying taxes. Also, inadequate knowledge and education on tax paying advantages, registration and business management practices, cumbersome procedure, bureaucracy and corruption, by the tax revenue collection units, have their contribution.

III. Inappropriate taxation of the informal sector leads to high inequality

Presumptive income tax system works better in attempting to

collect revenue from the informal sector. However, it may infringe few who are small and are not in the position to pay the taxes or tax less some who are supposed to be in higher income category. This leads to the rise of Inequality which has been viewed as the major policy issue in the country in many sectors. The existence of inequality among the informal sector in the country has been mainly contributed by taxes, size of the informal sector, and Income distribution.

The concern on the tax system particularly the Presumptive tax system is that, many presumptive regimes are deliberately designed to reduce the tax payments of smaller firms. Thus, this fuels the problem of firms not wishing to graduate onto the standard regime when they are able to, and large firms making themselves appear small, and hence leads to inequality. The increasing level of inequality in the society has direct influence in the increase level of poverty, increased level of classes, failure of other business as well as decline of the economy.

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I. Enhanced formalization and performance of graduating informal sector

The size of informal sector in the country is growing overtime and it is mostly owned by youth and adult groups. This implies that, the Government revenue collection base gets narrowed hence, increase the burden of tax to the formal sector and Government itself to cover the provision of public services. Also, this situation is fostered by high level of unemployment among youth and adult's population hence most of them engage themselves in the informal activities. Therefore, the Government should strengthen the formalization process of the graduated informal sector in the country through the following strategies:-

- (i) Establishment of informal sectors/SMEs formalization criteria
- (ii) Improvement of ICT in business SMEs operation, (E-SMEs)
- (iii) Intensify the use of EFD machines in the business operation
- (iv) Stabilize economy so as to stimulate effective demand
- (v) Ensure provision of dynamic and effective business advisory services
- (vi) Revise business registration processes so as to stimulate informal business registration

II. Widen tax base in the country

With unstable contribution of informal sector to the total revenue, which results to large revenue foregone indicates that the informal sector is still not a sector that the Government can fully depend on it for its revenue. Currently, tax revenue depends mostly to the large taxpayers as compared to the large proportion of other taxpayers. In order to widen the existing tax base, the following strategies should be considered:

- (i) Ensure continuous monitoring performances of taxable and non-taxable informal businesses,
- (ii) Raise awareness on taxation matters and business operation among SMEs
- (iii) Stabilize economy so as to stimulate effective demand
- (iv) Ensure the improvement of tax systems
- (v) Revise business registration processes so as to stimulate informal business registration

III. Optimal tax system to the informal sector

The study found that, the existence of inequality among the informal sector in the country has been mainly contributed by taxes, size of the sector, and income distribution. This indicates that, there is high level of inequality in the country which should be minimized or eliminated through the following strategies:

- (i) Enhance Research and Development on equity and equality on the informal
- (ii) Raise awareness on taxation matters, equity and equality of the informal sectors/SMEs in business operation.
- (iii) Ensure the improvement of the informal sectors/SMEs tax systems
- (iv) Strengthening financial supports and business environment (infrastructure facilities and reliable market access) to the informal sectors
- (v) Establishment of specific business operating areas for the informal sector



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