



Opportunities and challenges for taxing the informal economy and subnational taxation

Dr. Thorben C. Kundt
Independent Consultant
October 2017

About this report

The K4D Emerging Issues report series highlights research and emerging evidence to policy-makers to help inform policies that are more resilient to the future. K4D staff researchers work with thematic experts and DFID to identify where new or emerging research can inform and influence policy.

This report is based on ten days of desk-based research.

K4D services are provided by a consortium of leading organisations working in international development, led by the Institute of Development Studies (IDS), with Education Development Trust, Itad, University of Leeds Nuffield Centre for International Health and Development, Liverpool School of Tropical Medicine (LSTM), University of Birmingham International Development Department (IDD) and the University of Manchester Humanitarian and Conflict Response Institute (HCRI).

For any enquiries, please contact helpdesk@k4d.info.

Suggested citation

Kundt, T.C. (2017). Opportunities and challenges for taxing the informal economy and subnational taxation. K4D Emerging Issues Report. Brighton, UK: Institute of Development Studies.

Copyright

This report was prepared for the UK Government's Department for International Development (DFID) and its partners in support of pro-poor programmes. It is licensed for non-commercial purposes only. K4D cannot be held responsible for errors or any consequences arising from the use of information contained in this report. Any views and opinions expressed do not necessarily reflect those of DFID, K4D or any other contributing organisation.
© DFID - Crown copyright 2017.



Contents

1. Overview	1
2. Taxation of the informal sector	3
Revenue implications	5
Growth implications	6
Governance implications	8
Policy implications and experiences.....	9
3. Subnational taxation	9
Revenue implications	11
Growth implications	12
Governance implications	13
Policy options and experiences.....	13
4. References.....	14
Appendix A: Measurement of the informal sector	18
Appendix B: Presumptive taxes in Sub-Saharan Africa.....	19

1. Overview

The mobilisation of domestic resources in developing countries, particularly through transparent, fair and efficient tax systems, is regarded as a central means of implementation for the Sustainable Development Goals (SDGs). Recognising the crucial role that domestic revenue mobilisation plays in financing sustainable development, international donors seek to intensify their support in this area over the next years. Many of the international development partners (including the UK as one of its founding members) have joined the Addis Tax Initiative (ATI) and made the commitment to collectively double their support until 2020 as part of their membership in ATI.

To date, international support to taxation and domestic revenue mobilisation has been rather strongly focused on the national level. For instance, DFID's centrally managed programmes, and HMRC's capacity work, have considered national taxation collected by a central revenue authority. However, there might be some compelling arguments to extent support to levels others than the national level. This report considers two distinct areas: (1) the informal sector (which is, by definition, outside of the national economy), and (2) the subnational level. In particular, the report focuses on the revenue, growth and governance implications of taxation in these areas and provides some recent experience from developing countries.

A large informal sector is found to be a persistent phenomenon in low-income and emerging economies. Taxation, in turn, is often seen as a key ingredient of formalisation, and developing countries might benefit from increases in revenues, growth effects from improved productivity, and a more vital relationship between taxpayers and the state authorities. A key result of the report is that these effects, while convincing in theory, are often hard to assess empirically. They are also rather complex, which makes it difficult to draw some general conclusions whether informal sector taxation can lead to improvements in some or all of the above areas.

Regarding the subnational level, a common observation is that subnational governments (SNGs)¹ seriously suffer from appropriate financial resources, particularly from own-source taxation. This might be a serious impediment for delivering local quality institutions, which in turn has some negative impacts on SNG governance. Subnational taxation might not only be a source of self-financing for SNGs, but also serve some broader growth and governance goals. Again, the implications of taxation for these areas are complex. Growth, for instance, strongly depends on the incentive structures of central and local governments, which can differ substantially. Regarding the governance implications, for which there is only very limited evidence in the literature, local level taxation is for instance driven by the varying interests and power of local elites.

The key observations of the report and potential research gaps can be summarised as follows:

Taxation of the informal sector

¹ As defined by the OECD a subnational government (SNG) is a decentralised entity whose governance bodies are elected through universal suffrage and which has general responsibilities and some autonomy with respect to budget, staff and assets (OECD & UCLG, 2016)

- There is broad consensus that informal sector activities are widespread in developing countries, and that informality relates to some key business sectors, such as retail and construction
- The exact size of the informal sector is however hard to assess, and commonly used figures from the literature have become subject to some serious criticism
- The revenue potential from the informal sector can be substantial, but broad-based taxation might come at the expense of significant administrative costs due to a large number of informal firms and entrepreneurs, and the difficulties of monitoring them
- The literature focuses more on the indirect revenue effects of informal sector taxation, such as long-term effects on growth and governance effects, but there is no strong empirical support in the literature (*research gap*)
- Regarding growth, informal firms are often found to be less productive than formal ones and formalisation might help to improve productivity through various channels
- The benefits of formalisation, including through taxation, might however strongly depend on firm size and other factors, which are not yet studied to a sufficient extent in the literature (*research gap*)
- Governance is affected by the interplay between informal sector taxation, accountability and quasi-voluntary tax compliance
- Taxation of the informal sector can help to strengthen political participation and collective actions, but empirical evidence on the effects are limited (*research gap*)

Subnational taxes

- Self-financing abilities of subnational government are crucial to ensure strong local institutions, and to provide good local governance
- Recent data suggests that subnational governments in low-income countries frequently lack financial resources, particularly from shared or own-source taxes and predominantly rely on central government subsidies and transfers
- Central governments can be a limiting factor for subnational taxation, given that they do not want to compromise own revenue positions or do not wish to assign taxing rights to local governments when the latter lack the necessary capacities
- Local governments can be, in some instances, more effective in taxing parts of the revenue base that are out of the reach of central governments (e.g. the informal sector), or that are less attractive for the latter due to high administrative costs (e.g. small businesses)
- Recent evidence suggests that subnational governments with sufficient own-source tax revenues are less generous in offering local tax incentives in relation to governments that depend on central government transfers
- National and local governments might differ in their growth and development objectives and spending patterns, and an increase in local taxation might lead to reduced pro-growth spending on the central level
- Incentives for local pro-growth policies are shaped by the dependence on different sources of subnational financing (own-source tax revenues vs. central government transfers and subsidies)

- In general, there is lack of systematic evidence on the growth and development effects of local level taxation (*research gap*)
- Subnational taxation can contribute to good governance through “bargaining” over tax payments and the benefits received in return
- From a governance perspective, subnational taxation can also give rise to collective action, which also carries the risk of tax resistance from local elites
- There is lack of literature focusing on the relationship between governance, taxation and state-building on the subnational level (*research gap*)
- Property taxation is the predominant form of subnational taxation in developing countries and is argued to be closest to a “benefit tax”
- Recent country evidence from Africa suggests that the success of property taxes and/or property taxes crucially depend on a variety of factors, including political resistance, administrative capacity building, and good local governance

2. Taxation of the informal sector²

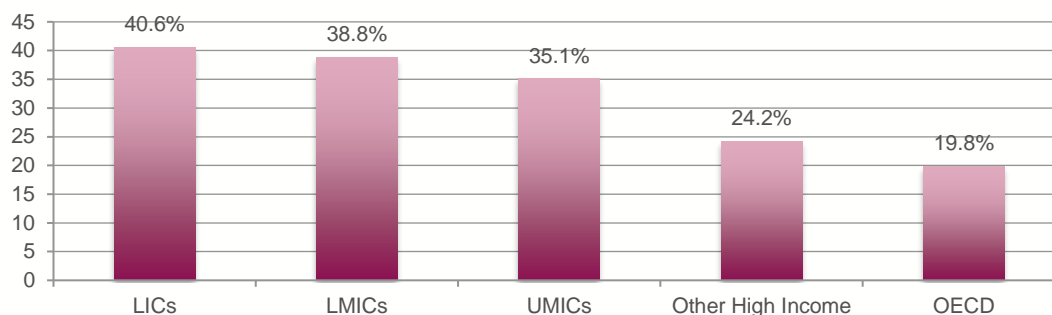
The formalisation of informal sector activities has received some particular attention in the international development agenda, and taxation is often regarded as a key ingredient (Joshi et al., 2014). In particular, the Addis Ababa Action Agenda outlines that the international community will need to invest “(...) continuing efforts to integrate the informal sector into the formal economy in line with country circumstances” (UN, 2015, p. 11). In the same vein, Target 8.3 of the Sustainable Development Goals (SDGs) stresses the need to “(...) encourage the formalisation and growth of micro-, small- and medium-sized enterprises (...)”³ in order to promote sustainable and inclusive economic growth.

Widespread informal activities are usually regarded to be a persistent phenomenon in developing countries (Besley & Persson, 2014; La Porta & Shleifer, 2014). It has been suggested, for example, that some of the largest and fastest growing business sectors in African countries, such as the retail and construction sector, are dominated by informal firms and entrepreneurs (Benjamin et al., 2014). Recent data from Schneider & Buehn (2018) displayed in Figures 1 and 2 provide an overview of the size of the informal economy for different country income groups and world regions:

² This report relies on the legal definition of informality, which is most commonly used throughout literature (Joshi et al., 2014). According to this definition, informality depends on the legal status of a firm, that is whether it is registered or not, and whether it complies with legal rules and obligations or not. As Joshi et al. (2014, pp. 1326-1327) state: “(...) firms in the informal sector are there because they contravene – or are not subject to – some of a variety of rules and regulations, including labour laws, environmental laws, registration, and taxation”. A second important element is the lack of visibility of informal actors, which usually seek to hide their non-compliant behaviours from governmental institutions (Feige, 2016a).

³ Source: <https://sustainabledevelopment.un.org/sdg8>.

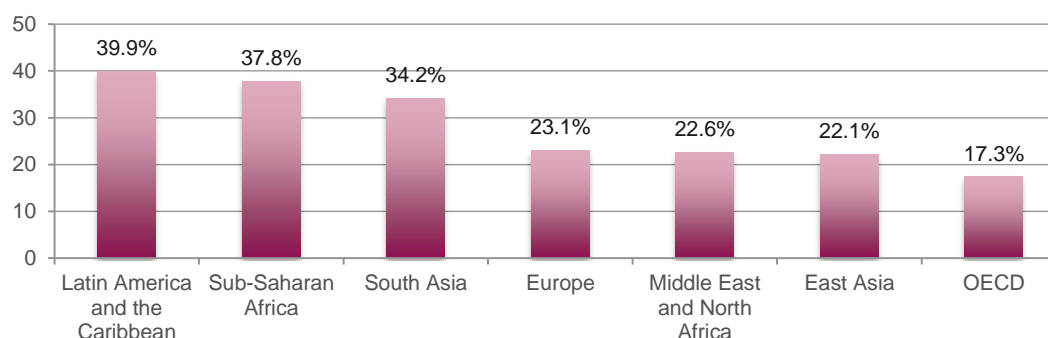
Figure 1: Average size of the informal economy by country income groups (1996-2014, % of official GDP)



Source: Schneider & Buehn (2018).

Figure 1 shows that the informal sector in low-income countries (LICs) is on average twice as large as in OECD countries, and that the size of the informal sector diminishes with country income size. As Medina et al. (2017) argue, the latter observation is likely to reflect increases in government capacities, and stronger incentives for formalisation in high-income countries.

Figure 2: Average size of the informal economy by region (2010-2014, % of official GDP)



Source: Schneider & Buehn (2018).

A similar pattern is shown in Figure 2. The informal sector is largest in the Latin America and the Caribbean region (39.9%), followed by developing countries in Sub-Saharan Africa (37.8%). The lowest figures can be found for East Asia (22.1%) and, again, the OECD countries (17.3%). The figures, however, should be treated with caution because the measurement of the informal sector, in general, is challenging; also, the particular estimation technique used to derive the data cited above has become subject to some serious criticism (see Appendix A for details).

From a revenue perspective, a large informal sector renders it highly difficult for low-income countries' governments to finance sustainable development from broad-based taxation. Improved formalisation can help to bring more taxpayers into the tax net because firms that wish to benefit from the formal economy (e.g. through better access to finance) eventually become more visible to the tax authorities (Besley & Persson, 2014). This is again linked to the overall notion of improved domestic revenue mobilisation, which is a core topic of the Addis Ababa Action Agenda

(UN, 2015) and also covered by SDG Target 17.1⁴. In terms of growth, formalisation might give rise to improved productivity of small informal firms, which are frequently thought to be less efficient than formal ones (La Porta & Shleifer, 2014). Although taxation leads to additional business costs, that could otherwise be avoided, formalisation can bring some important benefits for informal firms and employees (Joshi et al., 2014). Informal sector taxation is also inherently linked to good governance, given that quasi-voluntary compliance and tax morale are driven by governmental accountability and responsiveness (Joshi et al., 2014).

Drawing on these initial observations, the following section of the Helpdesk Report studies the effects of informal sector taxation on revenue, growth and governance in more detail. It is partly based on a recent contribution by Joshi et al. (2014), who provide a comprehensive literature overview on the topic. It also draws on some recent evidence from four Sub-Saharan African countries based on a study by Dube & Casale (2016).

Revenue implications

As outlined in the start of this report, the informal sector can have some serious negative impacts on developing countries' tax revenue potential and, consequently, their ability to raise domestic revenues for financing sustainable development. However, as outlined in Joshi et al. (2014), efforts to improve informal sector taxation must not necessarily lead to substantial increases in governmental revenues in case that the associated costs of tax collection are high. In this sense, taxation of the informal sector as a means of revenue mobilisation is inherently a matter of costs and benefits.

The large number of potential taxpayers in the informal sector, and the difficulties of monitoring "hidden" entrepreneurs and small-scale firms, can give rise to serious revenue collection costs for tax authorities in developing countries. At the same time, the revenue potential of taxpayers in the informal sector is fairly modest, as their taxable incomes are usually quite low (Joshi et al., 2014). Informal sector activities are often located in rural areas or come from self-employed sellers living near the subsistence level (La Porta & Shleifer, 2014).

Consequently, given the low "value for money" in revenue terms, tax administrations have often given little priority to the taxation of the informal sector firms (Fjeldstad, 2014), which can also be related to equity consideration, namely that taxation falls more strongly on the shoulders of low-income informal firms (Joshi et al., 2014). From a conceptual perspective, the direct revenue impacts of informal sector taxation and the associated costs might also be highly difficult to assess as data availability and quality is poor for many developing countries.

Having this in mind, Joshi et al. (2014) point out that arguments in favour of an expanded informal sector taxation often rely more strongly on the *indirect* benefits of the latter. From a long-term perspective, formalisation might contribute to the overall productivity of informal firms and, thus, ultimately lead to grow and a higher revenue potential (Gasper et al., 2016; Joshi et al., 2014)⁵. This argument is also linked to broader governance implications, namely that informal sector taxation will contribute to building a social norm of voluntary tax compliance as firms

⁴ "Strengthen domestic resource mobilisation, including through international support to developing countries, to improve domestic capacity for tax and other revenue collection." (<https://sustainabledevelopment.un.org/sdg17>)

⁵ It is argued that informal firms, in general, are much less productive than formal firms.

expand over time (Joshi et al., 2014). This line of reasoning can also be related to overall economic growth and development, as recently noted by Gaspar et al. (2016). The emergence of a “taxpaying culture” is likely to come hand-in-hand with good governance and strong governmental institutions, which eventually gives rise to economic growth and development through various channels. These effects can be even mutually reinforcing, causing a “virtuous circle” of good governance, voluntary compliance, and growth.

Leaving the informal sector out of the tax net can be justified from a purely economic perspective (cost-benefit-analysis), but might have some important implications in terms of perceived horizontal equity. Larger formal firms might consider it as unfair that small informal firms remain untaxed, which in turn potentially affects their own willingness to pay taxes (Joshi et al., 2014). As shown in Figure 3, formal firms in developing countries indeed see informal sector competition as an important obstacle for their business operations, and this might also impact their overall perception of fairness. Finally, again from an equity perspective, informal firms might benefit from taxation by improved predictability and less exposure to arbitrary state actions, harassment, and corruption (Joshi et al., 2014).

Empirical evidence on the indirect effects of informal sector taxation is scarce, however. As noted by Joshi et al. (2014), there is no evidence on the long-term effects of informal sector taxation channelled through an emerging social norm of voluntary compliance. Regarding the relationship between informality and tax morale, some studies suggest that there is a negative impact of tax morale on the informal economy. In a cross-country study, Torgler & Schneider (2007) find a positive and significant correlation between the size of the shadow economy (as measured through the MIMIC⁶ approach) and tax morale. Gërxfhani & van de Werfhorst (2011) report a similar result for Albania. The authors find that individuals with a low level of (self-reported) tax morale are more likely to participate in the informal economy. However, as noted by Joshi et al. (2014), these studies are only able to demonstrate a correlation between the two variables rather than causal effects, which might be more interesting from a policy perspective. In this sense, it is not possible to judge whether low tax morale causes informality, or whether informality leads to low tax morale (or if there might be even a circular relationship).

Finally, the few studies available do not allow to draw any general conclusions regarding the positive or negative effects in terms of predictability and equal treatment of informal firms by the state authorities (Joshi et al., 2014).

Growth implications

Broad-based taxation is a central element in the process of formalisation, and can have some strong implications for economic growth (Joshi et al., 2014). A particularly important channel through which growth could be triggered is the increase in firm productivity, which is usually low for informal sector firms in developing countries.

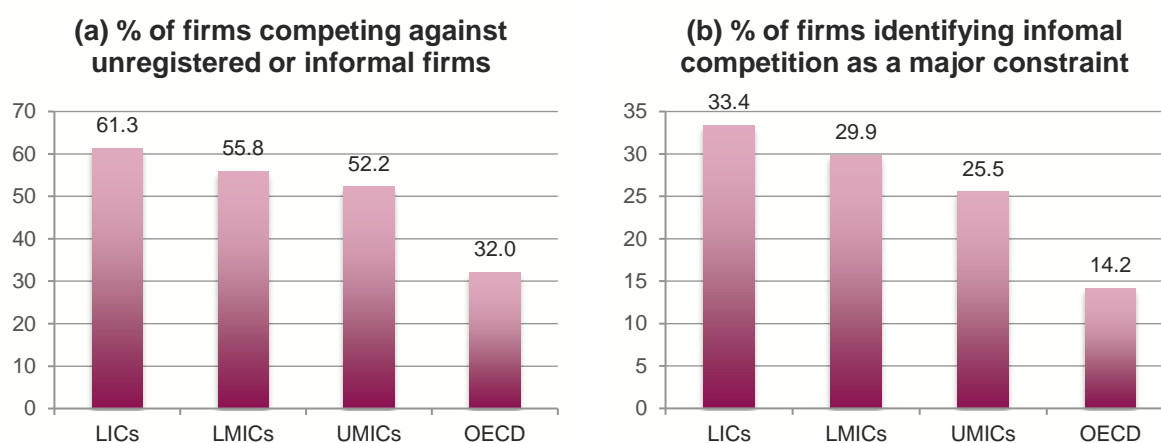
Empirical findings suggest that the “productivity gap” between formal and informal firms can be substantial. La Porta & Shleifer (2008), for instance, show for a sample of developing countries that the value-added of informal firms is only 15% when compared to the value-added of formal firms. For some countries, it this ratio can even become as small as 1%-10%. As outlined by La Porta & Shleifer (2014), this lack of productivity is driven by some “generic” elements of informal

⁶ “Multi Indicators, Multiple Causes”

sector firms, which include their relatively small size, inefficiency, as well as the observation that they are often run by poorly educated entrepreneurs. In addition, small informal firms also have fewer opportunities to benefit from economies of scale and exporting opportunities, given that they operate outside of the legal system (Besley & Persson, 2014).

For formal firms, competition with the informal sector might have some serious consequences for their business operations. This might be particularly true for larger or less poor informal firms competing with formal firms with a similar or lower income (Dube & Casale, 2016). Figure 3 shows that informal practices might be a serious obstacle for business activities of formally registered firms in developing countries. Evidence from the World Bank Enterprise Surveys Data suggests that, on average, 61.3% of formal firms in low-income have to compete with unregistered or informal companies, compared to only 32.0% in OECD countries. Likewise, 33.4% of firms in low-income countries identify informal sector competition as a major obstacle for doing business (compared to 14.2% in OECD countries).

Figure 3: Informal sector competition



Source: World Bank Enterprise Surveys Data (2010-2017).

In addition, as argued by Singh (2014), the informal sector may limit overall state capacities, which are necessary for the expansion of a more productive formal sector. Other studies have argued that smaller informal firms especially are too inefficient and too different from formal ones to pose a threat on the latter (La Porta & Shleifer, 2014). In addition, while informal firms might be able to reap the benefits of non-taxation, they are at the same time excluded from some other positive effects of formalisation.

Opting into the formal economy, which also requires compliance with tax laws and obligations, might bring some important benefits for informal sector firms, which can ultimately trigger growth and productivity. These include the access to capital markets, new market opportunities, less exposure to police and municipal officers, and access to training and capacity building (Joshi et al., 2014). Furthermore, informal employees might benefit from formalisation through the access to social protection, more adequate contracts, higher wages, and reduced vulnerability in case of unemployment or retirement (Brys et al., 2016). According to Joshi et al. (2014), there is a growing body of literature supporting this view. The empirical findings in these studies suggest that formalisation can in fact lead to improved profitability, higher incomes, more investments,

and better labour contracts. These effects, however, depend on firm characteristics and are more often related to mid-sized firms rather than to small or micro ones.

However, as argued by La Porta & Shleifer (2014), other studies draw a quite different picture and suggest that informal firms rarely become formal even when barriers for entry are reduced, and that they are too inefficient to survive in formal markets. In addition, they claim that informal firms are too different from formal ones (e.g. in terms of the products offered) to pose a threat on the latter. According to La Porta & Shleifer (2014), these observations are supportive of a “dual view” of informality, namely that informal and formal firms are largely segregated.

In summary, the effects of informal sector taxation on growth are complex, and the results of the studies cited above are somehow inconclusive. However, as Joshi et al. (2014) note, there is a growing body of literature that empirically supports the assumption that formalisation (including through taxation) can have significant positive impacts in terms of profitability, investments, and growth. Yet, there remains uncertainty whether these effects also apply to small or micro informal firms, and which channels are the most important ones.

Governance implications

A number of governance implications of informal sector taxation have already been mentioned in the previous sections. The line of reasoning is related to an implicit “fiscal contract” between taxpayers and the state, which is based on the principles of accountability, legitimacy and mutual trust, and encompasses a social norm of paying taxes.

Taxation of the informal sector allows informal firms to hold the state accountable for the use their payments, and can thus contribute to an emerging sense of democratic participation and ownership over governmental actions⁷. The state, in turn, has an incentive to demonstrate accountability and responsiveness to taxpayers in order to foster voluntary tax compliance based on a social norm of paying taxes (Joshi et al., 2014). As outlined earlier, the informal sector is inherently hard to tax, and improved voluntary compliance might be a cost-efficient way of raising additional taxes when compared to pure enforcement through tax authorities. State legitimacy also depends on the existence of strong governmental institutions and state capacities, of which the capacity to tax is a particular important one (Gaspar et al., 2016). In addition, the contractual relationship between taxpayers and the state implies that informal sector taxation might help to strengthen collective action and political participation among business associations in the informal sector (Joshi et al., 2014).

As noted by Joshi et al. (2014), some studies find a positive relationship between informal sector taxation, accountability and collective action, but evidence is limited. The effects described in the literature relate to different channels of good governance and include bargaining between the state and informal business associations, stronger public engagement, as well as higher levels of trust resulting from formalisation. At the same time, Joshi et al. (2014) point out that the success of bargaining between informal associations and the state authorities can be crucially affected by the organisational structure and political power of the former. Informal sector taxation might even emphasise the weaknesses of informal sector associations and lead to a marginalisation of certain groups, as well as to a stronger fragmentation of political voice.

⁷ In this sense, the famous motto of the Boston Tea Party (1773) has often been turned around in the developing country context: “No representation without taxation”.

Policy implications and experiences

The specific characteristics of the informal sector render it challenging to directly apply formal sector tax policies. In some instances, the informal sector is instead covered indirectly through standard tax regimes, as in the case of the Value Added Tax (VAT). Unregistered informal sector firms have an incentive to enter the tax system in order to claim VAT refunds in case that they are dealing with formal firms. Another indirect approach is the reliance of withholding taxes on transactions with informal firms, which are collected by formal firms or the government. Again, withholding taxes provides an incentive to become formal because withheld payments can be credited against formal tax liabilities (Joshi et al., 2014).

In addition, developing countries increasingly rely on simplified taxes for assessing the informal sector that often take the form of so-called presumptive taxes. Under a presumptive tax regime, tax liabilities are estimated on the basis of simple indicators of business performance (such as turnover) or certain “visible” firm characteristics (such as transport capacities), and taxes are often paid on a lump-sum basis. The rationale behind presumptive taxes is to collect some additional tax revenues with a reasonable amount of administrative and tax compliance costs (Dube & Casale, 2016), which somehow mirrors the economic “cost-benefit-analysis” described earlier.

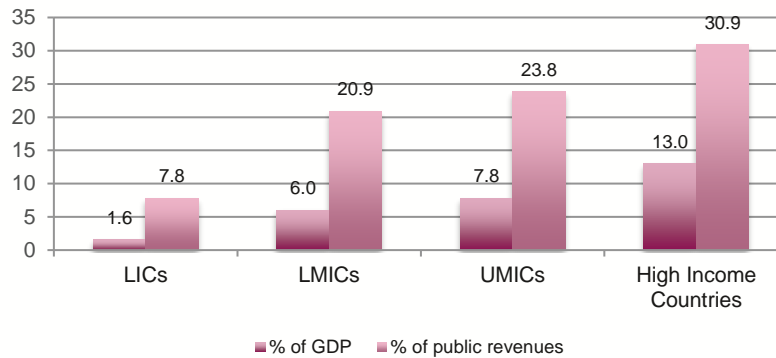
In a recent publication, Dube & Casale (2016) provide some evidence on presumptive taxation in four countries in Sub-Saharan Africa (Ghana, Tanzania, Zambia and Zimbabwe). Although the presumptive taxes vary greatly with respect to their design, coverage and implementation, there are some common observations regarding their effectiveness and efficiency, which turns out to be generally limited. Some tax administrations found it difficult to implement the presumptive taxes due to severe capacity limitations, in particular with respect to adequate manpower. Administrative constraints also sometimes lead to a lack of monitoring and enforcement, so that taxpayers failed to pay. The lack of compliance was also stressed by the fact that taxpayers were not informed about the taxes, and that they questioned the legitimacy of tax collectors. More details on country experiences can be found in the Appendix B.

3. Subnational taxation

It is a core assumption of decentralisation that local and regional governments are more accountable and responsive to citizens’ needs and preferences regarding central governments. However, for decentralisation to be effective, subnational government (SNGs) need to rely on adequate financial resources, including through their own mobilisation (Martinez-Vasquez, 2013; Smoke, 2013). The critical role of subnational governments and their financing has also been recently recognised on the international level among others in the course of the third UN Financing for Development Conference (UN, 2015). The Addis Ababa Action Agenda includes the global commitment “(...) to scaling up international cooperation to strengthen capacities of municipalities and other local authorities” and to “(...) strive to support local governments in their efforts to mobilise revenues as appropriate” (UN, 2015, p. 16).

Despite this fact, empirical evidence suggests that subnational revenue mobilisation in developing countries is rather weak (Smoke, 2013). Figure 4 shows that SNG revenues in low-income countries made up only 1.6% of GDP and 7.8% of public revenues in 2013. The share of SNG revenues rises with country income and is largest for the group high-income countries (13.0% and 30.9%):

Figure 4: SNG revenues (2013, by country income groups)

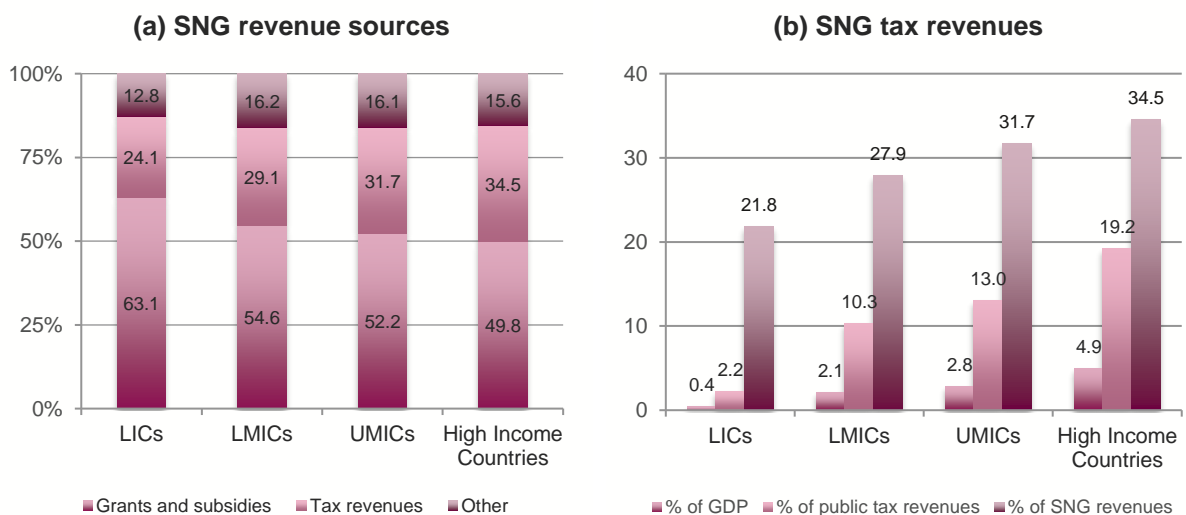


Source: OECD & UCLG (2016).

Figure 5 (a) also suggests that SNG revenues primarily come from central governmental grants and subsidies (63.1% of revenues), followed by tax revenues (24.1%) and other revenue sources (12.8%) in low-income countries. While tax revenues rise with country income, the difference between low-income and high-income countries is rather modest and accounts to 10.4 percentage points. It has to be noted that tax revenues do not necessarily reflect only own-source SNG revenues (which could be indicative of the level of decentralisation), but also tax revenues that are shared between SNGs and the central government (OECD & UCLG, 2016).

Figure 5 (b) reveals that SNG tax revenues of low-income countries only account to 0.4% of GDP on average, whereas the shares in low-middle, upper-middle and higher income countries are significantly larger in relative terms (2.1%, 2.8%, and 4.9%, respectively). In addition, SNG tax revenues make up only 2.2% of total public tax revenues, compared to 19.2% in high-income countries. This lack of relevance is likely to show that SNGs in low-income countries do not benefit from the sharing of taxes (OECD & UCLG, 2016).

Figure 5: SNG revenue sources and tax revenues (2013, by country income groups)



Source: OECD & UCLG (2016).

The figures above might be indicative for the lack of international support to strengthening subnational taxation, with the former being mostly focused on the national level (Fjeldstad, 2014). In addition to that, revenue autonomy of SNGs is often limited by the central government due to concerns over national fiscal policy management and capacity concerns, as well as a reluctance to possibly give up own revenue positions (Bird, 2011; Smoke, 2013). Local authorities might be unable to reap the benefits of autonomy because they lack the necessary capacities and knowledge, or they face serious political and fiscal constraints that render local autonomy less attractive (Smoke, 2013).

This section focuses on the role that subnational taxation can play in supporting revenue generation, growth, and good governance in developing countries. A particular focus lies on the use of property taxation, which is often seen as the most promising tax policy instrument on the subnational level (Kelly, 2013), and which represents the largest single source of own revenues for SNGs worldwide (Moore, 2013).

Revenue implications

Taxation, be it on the national or subnational level, has the primary objective of raising revenues for financing public goods and services and for providing quality state institutions. Depending on their degree of tax autonomy and other factors, SNGs in developing countries are sometimes more and sometimes less successful in raising own source taxes. A general impression, though, is that SNGs in low-income countries significantly suffer from financial resources in general and own-source or shared tax revenues in particular (see Figures 4 and 5).

In general, from a political economy perspective, central and local government can be thought to compete over the same taxable incomes. The central government might thus be reluctant to give up own revenue sources by assigning some collection rights to SNGs (Bird, 2010; UN-HABITAT, 2015). Transfers and subsidies from the central government, which on average represent more than 60% of SNGs revenues in low-income countries, might also crowd out efforts for improved own local taxation. However, SNGs might be in some instances able to reach out to some parts of the revenue base that would be otherwise left untaxed by the central government, either because the latter is not willing due to high administrative costs (e.g. taxation of small businesses) or not able due to a lack of monitoring and control (e.g. informal activities). In this sense, SNG revenue authorities might have a comparative advantage in identifying local businesses for the purpose of taxation, as they oversee licensing and regulatory activities, among others. From the perspective of the central government, the successful implementation of local taxes might even lead to a better revenue position in case that own-source taxation reduces the need for central government transfers (Bird, 2010).

It has been for instance proposed to shift taxation of the informal sector to local authorities. SNGs are thought to be, among others, better able to negotiate with informal actors and to be more responsive to them, given the small local distances. These benefits can be compromised when SNGs lack the necessary capacities, when there is harmful competition between SNGs (see below), or when taxation is arbitrary and coercive (Joshi et al., 2014).

Another important revenue aspect is related to the tax competition between SNGs, which is commonly seen as a direct consequence of fiscal decentralisation. SNGs that have the authority to tax might compete over local mobile capital, having in mind that businesses might move to regions with lower tax rates. It is a common argument that local tax competition can give rise to less extractive taxation, more efficient spending and better public services (Li, 2015). On the

contrary, excessive and unproductive tax competition might result in a 'race-to-the bottom', which ultimately compromises the self-financing abilities of local governments (Bird, 2010).

On the national level, developing countries frequently use various types of tax incentives to attract foreign direct investments, but these policies are often inefficient and lead to (unnecessary) revenue losses (Kundt, 2017). For the subnational level, recent empirical evidence provide by Li (2016) suggests that the use of local tax incentives depends on the degree of fiscal autonomy of SNGs, that is whether they have the authority to tax to some degree. Li (2016) finds that the use of tax incentives is more pronounced when SNGs can expect to receive central government transfers. SNGs that rely more heavily on own-source taxation, by contrast, are found to be less generous in offering tax incentives and to show more fiscal discipline.

Growth implications

National growth and development objectives might significantly differ from the objectives of subnational governments. While central governments put strong emphasis on capital spending, SNGs focus more heavily on consumption goods and services. In case that taxation rights are given to the latter, resources are shifted away from the central government that might have otherwise been used for pro-growth spending for example on infrastructure (Bird, 2010).

Another important argument is related to the different incentive structures of SNGs and their primary sources of financing (i.e. central government transfers or other non-tax sources regarding own-source tax revenues). Self-financing SNGs have stronger incentives to secure future tax revenue prospects than those who depend external financing. The former may therefore in the long run seek to facilitate growth by improving their local productivity and by implementing market-oriented economic policies (Bird, 2010; Pöschel & Weingast, 2013; Prichard, 2016). In the same vein, SNGs with a high degree of self-financing abilities have an incentive to spend their own tax revenues more efficiently than SNGs that rely more heavily on "third-party" revenues⁸ (Pöschel & Weingast, 2013).

Regarding the ease of doing business and the formalisation of informal sector activities, it is important to ensure a high degree of cooperation between central and local governments. A lack can results in a large number of non-transparent taxes, charges and fees levied at the local level, and duplications with central government taxes. These can give rise to significant administrative and tax compliance costs, discourage formalisation and lead to opportunities for corruption (Loeprick, 2009; Everest-Phillips, 2010). The problems can be further accelerated when local governments excessively rely on the use of parafiscal charges, as it is the case for Serbia. A survey conducted by the Serbian Association of Employers for instance revealed that there is a total of 499 different parafiscal charges in place, which are in turn based on 150 individual tax laws. These charges are a significant obstacle for the business operations of particularly small and medium enterprises and have been linked to corruption and informality (Serbian Associations of Employers, 2015). In addition, the burdens imposed by the large number of individual charges may give rise to tax evasion, which is found to be substantial in Serbia (Kundt et al., 2017).

⁸ This is comparable to the famous "House Money Effect" described in the behavioural economics literature (i.e. individuals spend money more recklessly when it comes from a third party rather than out of their own pockets) (Thaler & Johnson, 1990).

In general, the relationship between taxation, growth and development is found to be rather complex⁹. This renders it likewise difficult to draw any meaningful conclusion on the growth-effects of taxation on the subnational level, as argued by Bird (2010), which might be a potential area of future research.

Governance implications

A central governance argument for increased decentralisation rests on the assumption that SNGs have a better knowledge of the needs and preferences of local citizens, and thus provide a higher level of responsiveness and accountability to them (Martinez-Vasquez, 2013; Smoke, 2013). In terms of taxation, this line of reasoning can again be related to the “bargaining” over tax payments and the goods and services delivered in return, which is a core element of the fiscal contract between citizens and state authorities.

At the subnational level, the role of accountability is likely to be even more important and direct than on the national level. Local taxpayers have a better sense of what is done with “their” tax money, given that the benefits of local taxation are visible to them and that the tax burden is large enough to be noticed. Thus, they are also more likely to hold the local authorities accountable (Bird, 2010) and to develop a stronger sense of the social benefits of paying taxes, which can ultimately lead to higher levels of quasi-voluntary tax compliance (Jibao & Prichard, 2015). For accountability to be effective, taxpayers thereby need to be able to exert control over SNGs to some degree (Bird, 2010), which may trigger democratic participation and collective action. Collective action and the control over SNGs must however not always lead to favourable outcomes in terms of broader taxation and better governance. These are strongly depending on the level of cohesion and economic interest of elites, with the latter being key for collective decision-making on the sub-national level. Some elites might be in favour of improved taxation from a broader state-building perspective, while others might share the same interest to resist taxation (Jibao & Prichard, 2015).

On a more general level, good subnational governance depends on the existence of strong local institutions, which are in turn crucially affected by the self-financing abilities of SNGs and their level of control over tax revenues (Bird, 2010). Regarding this, Figures 4 and 5 suggest that there is a serious lack of SNG financing in developing countries, which is likely to impact their overall abilities to provide quality institutions and strong subnational capacities. It would be out of the scope to study all the potential causes for this observation, but in general, it has been argued that there is a lack of international support to subnational taxation (Fjeldstad, 2014). Having this in mind, international donors might reconsider the role of subnational taxation as part of their efforts to significantly increase support to domestic revenue mobilisation (for instance with respect to the Addis Tax Initiative). In addition, despite the potentially strong implications for governance, there is lack of literature focusing on the relationship between governance, taxation and state-building on the subnational level (Prichard, 2016). This may again call for intensified research in the field.

Policy options and experiences

The political decision to assign taxing rights to local governments is in principle driven by a variety of factors. As noted above, there might be some compelling reasons for central

⁹ See, for instance, the recent K4D Helpdesk Report on taxation and growth (Kundt, forthcoming).

governments to restrict local taxation (e.g. concerns about the own revenue position for administrative deficiencies of SNGs.). It would be out of the scope of this rapid desk research report to address all aspects in detail, but in general, recent contributions to literature suggest that SNGs should be assigned only those taxes that are as closely related to beneficial spending as possible (Bird, 2010; Martinez-Vasquez, 2013).

A widespread form of taxation at the subnational level is the taxation of property. Property taxes might be closest to be a “benefit tax” at the local level and bring some particular advantages that render them important for subnational taxation. These include a high degree of visibility, their revenue potential and stability of property taxes, comparably low compliance costs, and a close match between those who pay the tax and those who receive the benefits (i.e. local residents). Finally, from an equity perspective, property taxes can be progressive and thus serve distributional objectives. Some drawbacks of property taxes are their lack popularity (due to their high visibility), liquidity problems of low-income households, administrative costs due to revaluation and enforcement, as well as a lack of revenue growth potential (UN-HABITAT, 2015).

Recent evidence from the African continent suggests that the success of property taxation and/or the reform of property taxes depends on a variety of factors. Jibao & Prichard (2015), drawing on experience from Sierra Leone for instance show that elite cohesion can be an important factor for the success of property tax reforms. Strong resistance of local elites sharing the same interests might be a significant impediment for local property taxation. By contrast, ethnic diversification can lead to a fragmentation of local elites can thus have an opposite effect. A third factor is the extent of local political opposition, since local oppositions might wish to secure financial independence from the central government by securing own tax revenues. Finally, competitive elections may incentivise tax collections and give rise to transparency, inclusiveness, and equity. Monkam & Moore (2015) stress that effective local property taxation requires a mixture of legislative reform, technical know-how and political will. On the administrative level, capacity building is regarded as a key factor for successful property taxation, with some minor reforms having strong impacts (e.g. cadastral survey or information sharing and alignment). Good governance and a visible link to the benefits of property taxation in terms of spending can contribute to the acceptance of property taxes, while elite resistance can be again a limiting factor.

4. References

- Benjamin, N., Beegle, K., Recanatini, F., & Santini, M. (2014). *Informal economy and the World Bank* (World Bank Policy Research Working Paper No. 6888).
<http://documents.worldbank.org/curated/en/416741468332060156/Informal-economy-and-the-World-Bank>
- Besley, T., & Persson, T. (2014). Why do developing countries tax so little?. *The Journal of Economic Perspectives*, 28(4), 99-120. <http://piketty.pse.ens.fr/files/BesleyPersson2014JEP.pdf>
- Bird, R. M. (2010). *Subnational Taxation in Developing Countries - A Review of the Literature* (World Bank Policy Research Working Paper No. 5450).
<http://documents.worldbank.org/curated/en/942791468155366645/pdf/WPS5450.pdf>
- Brys, B., Perret, S., Thomas, A., & O'Reilly, P. (2016). *Tax design for inclusive economic growth* (OECD Taxation Working Papers No. 26). http://www.oecd-ilibrary.org/taxation/tax-design-for-inclusive-economic-growth_5jlv74ggk0g7-en

- Dube, G., & Casale, D. (2016). The implementation of informal sector taxation: Evidence from selected African countries. *eJournal of Tax Research*, 14(3), 601-623. https://www.business.unsw.edu.au/research-site/publications-site/ejournaloftaxresearch-site/Documents/Dube_Casale_The_implementation_of_informal_sector_taxation_tracked_changes.pdf
- Everest-Phillips, M. (2010). State-Building Taxation for Developing Countries: Principles for Reform. *Development Policy Review*, 28(1), 75-96. <http://onlinelibrary.wiley.com/doi/10.1111/j.1467-7679.2010.00475.x/full>
- Feige, E. L. (2016a). Reflections on the Meaning and Measurement of Unobserved Economies: What do we really know about the “Shadow Economy”? *Journal of Tax Administration*, 2(1), 5-41. <http://jota.website/article/view/69>
- Feige, E. L. (2016b). Professor Schneider’s Shadow Economy (SSE): What Do We Really Know? A Rejoinder. *Journal of Tax Administration*, 2(2), 93-107. <http://jota.website/article/view/109>
- Fjeldstad, O. H. (2014). Tax and development: Donor support to strengthen tax systems in developing countries. *Public Administration and Development*, 34(3), 182-193. <http://onlinelibrary.wiley.com/doi/10.1002/pad.1676/full>
- Gaspar, V., Jaramillo, L., & Wingender, P. (2016). *Tax Capacity and Growth: Is there a Tipping Point?* (IMF Working Papers No.16/234). <https://www.imf.org/external/pubs/ft/wp/2016/wp16234.pdf>
- Gërzhani, K., & Van de Werfhorst, H. G. (2011). The effect of education on informal sector participation in a post-communist country. *European Sociological Review*, 29(3), 464-476. <https://academic.oup.com/esr/article-abstract/29/3/464/461775>
- Gyomai, G., & van de Ven, P. (2014). *The non-observed economy in the system of national accounts* (OECD Statistics Brief No. 18). <https://www.oecd.org/std/na/Statistics%20Brief%2018.pdf>
- Jibao, S. & Prichard, W. (2015). The political economy of property tax reform in Africa: Elites, political competition and tax bargaining in post-conflict Sierra Leone. *African Affairs* 114(456), 404–431. http://r4d.dfid.gov.uk/pdf/outputs/taxation/60813_The-political-economy-of-property-tax-in-Africa.pdf
- Joshi, A., Prichard, W., & Heady, C. (2014). Taxing the informal economy: The current state of knowledge and agendas for future research. *The Journal of Development Studies*, 50(10), 1325-1347. <http://www.tandfonline.com/doi/abs/10.1080/00220388.2014.940910>
- Kelly, R. (2013). Implementing sustainable property tax reform in developing countries. In R.M. Bird & J. Martinez-Vasquez (Eds.), *Taxation and Development: The Weakest Link? - Essays in Honor of Roy Bahl* (pp. 326-363). Cheltenham, UK: Edward Elgar.
- Kirchgässner, G. (2017). On estimating the size of the shadow economy. *German Economic Review*, 18(1), 99-111. <http://onlinelibrary.wiley.com/doi/10.1111/geer.12094/full>
- Kundt, T.C. (forthcoming). *Private Sector Development and Growth in Developing Countries – The Role of Tax Policy and Administration*. K4D Helpdesk Report.

- Kundt, T. C., Misch, F., & Nerré, B. (2017). Re-assessing the merits of measuring tax evasion through business surveys: an application of the crosswise model. *International Tax and Public Finance*, 24(1), 112-133. <https://link.springer.com/article/10.1007/s10797-015-9373-0>
- La Porta, R., & Shleifer, A. (2008). *The unofficial economy and economic development* (NBER Working Paper No. 14520). <http://www.nber.org/papers/w14520>
- La Porta, R., & Shleifer, A. (2014). Informality and development. *The Journal of Economic Perspectives*, 28(3), 109-126. <http://pubs.aeaweb.org/doi/pdfplus/10.1257/jep.28.3.109>
- Li, Q. (2016). Fiscal decentralization and tax incentives in the developing world. *Review of International Political Economy*, 23(2), 232-260. <http://www.tandfonline.com/doi/full/10.1080/09692290.2015.1086401>
- Loeprick, J. (2009). *Small business taxation: Reform to encourage formality and firm growth* (World Bank Investment Climate in Practice: Business Taxation No. 1). <https://openknowledge.worldbank.org/handle/10986/10571>
- Martinez-Vasquez, J. (2013). Tax Assignments at Regional and Local Levels. In E. Ahmad & G. Brosio (Eds.), *Handbook of Multilevel Finance* (pp. 358-388). Cheltenham, UK: Edward Elgar.
- Medina, L., Jonelis, A. W., & Cangul, M. (2017). *The Informal Economy in Sub-Saharan Africa: Size and Determinants* (IMF Working Paper No. 17/156). <https://www.imf.org/en/Publications/WP/Issues/2017/07/10/The-Informal-Economy-in-Sub-Saharan-Africa-Size-and-Determinants-45017>
- Monkam, N. & Moore, M., 2015. *How Property Tax Would Benefit Africa*. Africa Research Institute. <https://www.africaresearchinstitute.org/newsite/publications/property-tax-benefit-africa/>
- Moore, M. (2013). *Obstacles to increasing tax revenues in low-income countries* (ICTD Working Paper No. 15). <http://www.ictd.ac/publication/2-working-papers/84-obstacles-to-increasing-tax-revenues-in-low-income-countries>
- OECD & UCLG (2016). *Subnational Governments around the world: Structure and finance*. <https://www.oecd.org/regional/regional-policy/Subnational-Governments-Around-the-World-%20Part-I.pdf>
- Pöschl, C., & Weingast, B. R. (2013). *The fiscal interest approach: The design of tax and transfer systems*. <https://web.stanford.edu/group/mcnollgast/cgi-bin/wordpress/wp-content/uploads/2013/10/Weingast-Poschl-BRW.13.1007..pdf>
- Prichard, W. (2016). *Taxation, Governance and Growth* (GSDRC Professional Development Reading Pack No. 43). http://www.gsdrc.org/wp-content/uploads/2016/06/Taxation-governance-and-growth_RP.pdf
- Schneider, F., & Enste, D. H. (2000). Shadow Economies: Size, Causes, and Consequences. *Journal of Economic Literature*, 38, 77-114. <http://www.econ.jku.at/members/Schneider/files/publications/JEL.pdf>
- Schneider, F., & Buehn, A. (2018). Shadow Economy: Estimation Methods, Problems, Results and Open Questions. *Open Economics*, 1(1), 1-29.

<https://www.degruyter.com/downloadpdf/j/openec.2017.1.issue-1/openec-2017-0001/openec-2017-0001.pdf>

Serbian Association of Employers (2015). *Fiscal and parafiscal burdens of entrepreneurs and SMEs in the Republic of Serbia – Position Paper*. https://www.poslodavci.rs/wp-content/uploads/2015/11/fiscal_and_parafiscal_burdens_position_paper.pdf

Singh, A. (2014). Inclusive growth, institutions, and the underground economy. In M. P. Lagon & A. C. Arend (Eds.), *Human dignity and the future of global institutions* (pp. 103-122). Washington, D.C.: Georgetown University Press.

Smoke, P. (2013). Why theory and practice are different: The gap between principles and reality in subnational revenue systems. In R.M. Bird & J. Martinez-Vasquez (Eds.), *Taxation and Development: The Weakest Link? - Essays in Honor of Roy Bahl* (pp. 287-325). Cheltenham, UK: Edward Elgar.

Thaler, R. H., & Johnson, E. J. (1990). Gambling with the House Money and Trying to Break Even: The Effects of Prior Outcomes on Risky Choice. *Management Science*, 36(6), 643-660. <http://pubsonline.informs.org/doi/abs/10.1287/mnsc.36.6.643>

Torgler, B., & Schneider, F. (2007). *Shadow Economy, Tax Morale, Governance and Institutional Quality: A Panel Analysis* (IZA Discussion Paper No. 2563). <https://pdfs.semanticscholar.org/c749/7fcea37ef43552a0e848ce930120728384d6.pdf>

UN (2015). *Addis Ababa Action Agenda of the Third International Conference on Financing for Development (Addis Ababa Action Agenda)*. http://www.un.org/esa/ffd/wp-content/uploads/2015/08/AAAA_Outcome.pdf

UN-HABITAT (2015). *The Challenge of Local Government Financing in Developing Countries*. https://sustainabledevelopment.un.org/content/documents/1732The%20Challenge%20of%20Local%20Government%20Financing%20in%20Developing%20Countries%20_3.pdf

World Bank (2010-2017). *Enterprise Surveys Data*. <http://www.enterprisesurveys.org/data>

Appendix A: Measurement of the informal sector

Given the hidden nature of informal activities, it is challenging to determine the exact size of the informal sector. There exist various indirect and indirect approaches to measure the informal economy, all of which bringing their own limitations (for a recent overview, see Feige, 2016a, and Schneider & Buehn, 2018).

Most of the data cited in the literature comes from the so-called “Multi Indicators, Multiple Causes” or MIMIC approach used for example in Schneider & Enste (2000). The MIMIC model relies on a “latent” variable that links multiple causes of the informal economy (e.g. taxation) to multiple indicators of the informal economy (e.g. labour force participation or cash demand). The latent variable is used to determine the size of the informal economy, but cannot be interpreted in isolation, that is as percentage of official GDP. For this, it needs to be further calibrated to a benchmarking value, which is usually derived by another estimation technique (Schneider & Enste, 2000; Gyomai & van de Ven, 2014).

Despite its prevalence in the literature, which also includes some recent work of the IMF (Medina et al., 2017) and the World Bank (Benjamin et al., 2014), the validity of the MIMIC model has become subject to some serious criticism. In two recent publications, Feige (2016a, 2016b) among others addresses the lack of documentation and non-transparent use of the complex MIMIC procedure, which makes it impossible to replicate the estimates. The latter are also sensitive to the choice of indicators and causes, and the omission of some might cause biased results. In addition, some variables might also be related to the official rather than the informal sector (Gyomai & van de Ven, 2014). In addition, as argued by Kirchgässner (2017), the benchmarking values, which are used to calibrate the MIMIC models, can lead to an overestimation of the size of the shadow economy.

Appendix B: Presumptive taxes in Sub-Saharan Africa¹⁰

Ghana. Starting in 1987, the Ghana Internal Revenue Service (IRS) relied on a simplified “Identifiable Grouping Taxation (IGT)” system for the purpose of presumptive taxation. Under this system, which has also been termed “associational taxation”, collection of presumptive taxes was outsourced to a total of 32 informal sector business associations. Notwithstanding an initial increase in revenue collections and an emerging taxpaying culture that resulted in high compliance rates, the IGT system had some serious inherent problems. The tax authorities, due to capacity constraints, were not able to monitor the associations effectively, with the latter often failing to pass the tax revenues collected. The IGT was eventually replaced by a presumptive Vehicle Income Tax in 2003, mainly due to the continuing decrease in revenues collected, which declined by about 1.4 percentage points between 1991 and 2003. However, the government now regularly engages with informal sector association when setting quarterly presumptive taxes.

Tanzania. The Tanzania Revenue Authority (TRA) introduced a presumptive tax regime for small individual traders in 2001. The tax applies to traders with an annual turnover of less than USD 9359 and is based on a progressive scheme. Since 2005, revenues from this presumptive tax are collected using a “Block Management System (BMS)”. Under the BMS, teams of tax collectors are assigned to geographical and/or sectoral blocks in which they identify small and medium businesses and levy presumptive taxes based on turnover. Where records are not available, the tax collectors estimate the turnover. The team is given specific revenue targets in order to measure performance. Although the BMS led to an increase in business registrations and a broader coverage of informal taxpayers, revenues collected by BMS teams are low. This is mainly due to serious capacity constraints in manpower. In addition, serious problems may arise from the concentration of all administrative functions under one tax office, namely identification, registration and administration. In particular, this might lead to corruption, poor internal controls, and arbitrary use of power. Finally, from an equity perspective, TRA found regressivity in cases where businesses did not keep records.

Zambia. The Zambia Revenue Authority (ZRA) introduced four types of informal sector taxes in 2004 with the general objective to make compliance easier for informal firms: 1) a Turnover Tax (TOT) of 3% on individuals and small firms with an annual turnover of USD 50,000; 2) an annual presumptive tax on minibuses based on seating capacity (USD 150 for below 12, to USD 1,800 for 64 and above); 3) an Advance Income Tax (AIT), which is a withholding tax from cross-border traders at 6% of value of imports exceeding USD 500; and 4) a base tax of USD 0.13 per day collected from market traders. These simplified taxes led to some increase in revenues collection attributed to the informal sector (0.3% of total income tax collected in 2003 compared to 1.8% in 2009), with the majority of revenues coming from the AIT (71%) and the TOT (27%). In total, however, the success of the presumptive taxes was limited. Poor record keeping due to a lack of education contributed to relatively low revenue collections from TOT. In addition, administrative costs turned out to be still very high relative to the additional revenues collected, which was due to high labour intensity and a low awareness of the presumptive taxes. Finally, enforcement often failed because collectors were seen as not legitimate to collect taxes.

Zimbabwe. The presumptive tax regime introduced in 2005 by the Zimbabwe Revenue Authority (ZIMRA) was initially restricted to the transport sector (particular informal urban transport

¹⁰ Source: Dube & Casale (2016).

operators) and later extended to a larger number of low-value business activities, such as hairdressing saloons, driving schools or informal traders. Revenue from presumptive taxes accounted to USD 1.39 million in 2009 and was nearly ten-times larger in 2011 (USD 13.3 million). This, however, represents only 0.14% and 0.45% percent of revenues, respectively, which suggests that the presumptive tax regimes were not able to reap the full tax potential located in the informal sector. The limited success of the informal sector taxes has been related to a variety of factors, which included capacity constraints and corruption in the ZIMRA, selective enforcement, and cases of coercive tax collection. These limiting factors lead to significant difficulties in administrating the taxes, which were further accelerated through low levels of tax morale and a relatively high tax burden in some sectors. Furthermore, informal sector entrepreneurs frequently had to pay parafiscal charges to non-state actors and were often not properly informed about the taxes. Finally, from an equity perspective, the effects of the presumptive taxes were mixed, both with respect to the unequal treatment of formal and informal firms with similar income levels, as well as the equity effects on informal sector firms in different business setors, but with a comparable income.