



STATES & LOCAL FINANCE

The IGR Initiative

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Informal sector associational taxation



BRINGING THE INFORMAL SECTOR into the tax net has been a critical government concern at all levels. The informal sector in Nigeria and indeed sub-Saharan Africa is vast and averages between 50 and 65 per cent of GDP in countries such as Benin, Tanzania and Nigeria based on a 2016 IMF working paper titled "The Informal Economy in Sub-Saharan Africa: Size and Determinants - [WP/17/156]". The sector is also not opposed to tax payments. An August 2021 survey by SBM intelligence titled "Under the Hood: A look into Nigeria's informal sector" revealed that 98% of businesses in the informal sector in Nigeria pay taxes. Sadly, most of these payments end up with non-state regulators. A good example is the routine levies and other collections by motor park touts and members of the National Union of Road Transport Workers [NURTW].

But even in most markets, traders also regularly pay these fines and fees, which often end up in nongovernment treasuries or personal pockets. Several pieces of literature show that the share of the informal sector in Nigeria compares with that of sub-Saharan Africa, lying between 50% and 65% of GDP. The International Monetary Fund (IMF) corroborated this estimate in 2020, pegging it at 65%. Regardless of its size and willingness to pay taxes amply demonstrated in the faithfulness of the sector to the payment of levies and fines to non-state regulators, its level of non-compliance in tax payment is humongous. Based on a review of many studies, it is safe to estimate that Nigeria currently loses approximately N3.2 trillion annually in tax revenue due to the informal sector non-compliance levels. Therefore, it is without debate that the more subnational governments bring informal sector economic actors into the tax net, the better their IGR health becomes.

The informal sector formalization process has also never been easy. Consequently, dragging them into the tax net has likewise been challenging. The decline in informality has not kept pace with the enormous efforts by governments and the banks in promoting a cashless society and its kindred digital financial system and facilitating easy business registration and incorporation. The small size of entrepreneurial activities by most players in the sector likewise discourages the formalization process. It slows the whittling down of the sector's size relative to the formal sector. Also, the predominance of cash-based transactions and the ease of tax evasion give a fillip to businesses' non-registration. All three characteristics define informality in

Nigeria. The shortest window for tax evasion or non-compliance is to bypass enterprise registration. Apart from making it extremely difficult to directly associate the business with persons with the primary taxpaying obligations, it makes it invisible from the lenses of tax collectors. The non-registration of enterprises within a highly cash-based economy does not pose a significant threat to its survival. At worst, the personal accounts of the proprietors serve for the unregistered banking operations.

Therefore, high informality levels also present huge collection costs for tax administrations. Imagine the financial implications of investigating, tracking, and monitoring unregistered businesses that may equally do not have identifiable bank accounts. The challenge worsens for states and local governments, whose independent revenue mostly depends on receipts comprising fees, fines, and licenses collectable majorly from subsistence-based, micro and small enterprises. This lacuna is what non-state regulators leverage to rob subnational governments of colossal tax revenue opportunities. Social media platforms have also enhanced the inconspicuousness of many such businesses from tax records regardless of their corporate registration status. It is convenient to evade the eyes of the tax authorities by optimally leveraging information technology apparatuses for business.

Poor compliance in the informal sector derives from many reasons such as perceived huge net costs of compliance, the pervasive culture of evasion among such classes of business operators, perceptions of distributive unfairness on the government's side. For instance, many taxpayers believe that managers of statecraft do not wisely spend collected tax revenue. This lack of trust exists in several tax administrations adjudged to be partial and lack effective retributive mechanisms. The perceived complexity of tax laws aggravates that situation. For instance, most of the operators in the informal sector lack the intellectual sophistication to understand those rules. At the same time, the government has not devoted a significant amount of resources and time to address this gap. There is also the factor of the difficult economic situation. The more challenging the economic environment is, the more non-compliant businesses that are relatively off the tax-collector radar and those with lower income levels become as well.

As a formal tax collection approach on eligible informal sector groups, associational taxation seems to be highly potent and considerably reduces collection costs for tax administrations and

diminishes compliance costs for taxpayers. Ghana has had extraordinary experience using this approach to combat non-compliance challenges among the informal sectors. Associational taxation leverages a defined relationship between informal sector associations and the relevant state and local governments to raise compliance. This relationship presupposes some level of understanding and cooperation between the two parties, enabling mutually beneficial collaboration in tax payment. Negotiations result in mutually acceptable concessions on both sides, with assurances on enhanced tax compliance among group members. Undoubtedly, quickly accessing the informal sector is much more convenient in their clusters and groups. Their perceptions of vulnerability reinforce their willingness to cooperate against the state. That feeling also fosters faithfulness to their various groups. For example, market women in Nigeria are substantially faithful to their leaders. So are the National Union of Road Transport Workers and other artisanal level trade groups and membership organizations.

Ghana's version of associational taxation was the Identifiable Group Taxation [IGT] which used informal sector associations as collection agents. This practice by the country's tax authorities spanned between the mid-1980s and 1990s. The approach was similar to the daily takings by the National Union of Road Transport Workers, whereby the union collected taxes from its members daily to save them from making burdensome lump-sum tax payments. They subsequently remitted the collections to the government with a 2.5% commission earned by the union as its share of the collected amount as a tax agent. Of course, part of the pitfalls of the practice was the leakages owing to poor accountability and lower than average remittance levels. These challenges notwithstanding, the approach unarguably minimizes the tax compliance burdens and collection costs associated with formal

sector management, which requires dedicated resources for pre-enumerated taxpayers. Associational taxation invariably eliminates the costs and commitments to individual taxpayer units transferred to and handled by the union's leadership while earning income as tax collection agents. Again, the tax burden becomes considerably alleviated through the opportunity for members to make micro tranches of tax payments. One-off or lump-sum tax payments by micro and subsistence business operators can be pretty challenging for their operations and prospects.

In addition to minimizing the burden of taxation, one other advantage is facilitating taxpayer database construction and easing the tax registration process. There is no way different associations with this responsibility can succeed without creating a comprehensive database of its members for tax payment purposes and auditing revenue receipts by tax administrations. This process will also likely lead to member registrations of the businesses and as complying taxpayers.

However, the associational taxation approach is not without its many disadvantages. Two such downsides stand out. The first is the perverse incentive for might is right and hijacking of its leadership. A closer study of many of these informal sector associations reveals low levels of transparency and accountability in their top management echelons. The administration of the National Union Road Transport Workers is an excellent example. The head of the group operates almost without questioning and has near-absolute control over their finances. It also provides enormous incentives for dissension and deadly fracas when there are opportunities to replace extant leadership. A significant fallout of this weakness is the headroom for collected tax revenue leakages. The administration from some of these groups remits only a proportion of what they collect as taxes. Secondly, large enterprises find such associations a convenient tax haven. They hide under the umbrella

of such informal groups to dodge the payment of appropriate taxes.

In general, however, the net benefits of associational taxation far outweigh the disadvantages if adequately managed and deliberately mainstreamed. The experience of the country of Ghana for the period it leveraged that approach testifies eloquently to the need for prioritizing it for IGR expansion by many subnational governments. There are many initiatives that the government can embark upon to make the mainstreaming effort effective while minimizing some of the disadvantages associated with the approach mentioned above. The first is to design appropriate eligibility criteria for registering associations and business groups and properly licensing them as tax collectors for their group. One would expect that such eligibility criteria would also include a comprehensive database of members for proper presumptive tax filing and auditing where necessary.

The subnational government tax administration should also develop a robust regulatory process for monitoring the groups and ensuring proper presumptive tax filing, taxpayer auditing, database review, updates and integration with the database held within the IRS. Such a regulatory process would also ensure that groups do not become partisan. The government should also criminalize fraudulent revenue leakages as a complementary retributive process. As part of the incentives to encourage heightened taxpayer compliance, the government can extend incentives such as matching grants, facilitated credits, seed grants, and other financing support and negotiate concessionary tax rates to enhance voluntary compliance. Additionally, the government can facilitate systematic capacity development for such groups to upgrade their entrepreneurial knowledge and associated operating abilities with some donors and development partners. Overall, the government and its tax administration must demonstrate sufficient public trust by wisely utilizing taxpayer resources.