TRADE GUIDE

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FIXING INFORMALITY:

ISSUES FOR TAX HARMONISATION AND CROSS-BORDER TRADE REFORMS TO CONSIDER TO FOSTER INVESTMENT, TRADE AND SME DEVELOPMENT IN EAC

A major motivation for countries to integrate their economies is to expand investment areas and markets and opportunities thereof to improve living standards of their people. Ordinarily, the integrating parties would prioritise and cooperate in all areas to bring about the opportunities. This motivation has seen the East African Community (EAC) Partner States comprising of Burundi, Kenya, Rwanda, Tanzania and Uganda move to prioritise harmonisation of their taxation regimes. If left to be, the existing differences in taxation systems of EAC Partner States could confer unfair tax competition and unequal treatment on tax payers and the goods and services they trade across the Community; this can considerably distort the implementation of EAC Common Market arrangement and, ultimately, the essence of regional integration. As they seek to expand investments and trade regionally, they also wish to do so as formally as possible and, therefore, reduce informal cross-border trade (ICBT). It is the case that ICBT, as it evades taxation and custom duties, compete unfairly with formal firms –most of which have paid often punitive taxes and custom duties –thus discouraging investments in the region.

Small and medium enterprises (SMEs), predominantly located within the informal economy, have been singled out as the major culprits in ICBT practices, tax evasion and tax avoidance within EAC. Incidentally, these SMEs are the major growth drivers within the Community; they create more jobs compared to the big private sector and usually provide a landing pad for those laid off from public and formal private sector employment. Many SMEs have different reasons why they select to operate in the informal sector, but they seem to converge on the existence of high tax rates and compliance costs as well as excessive and bureaucratic custom requirements and regulations as their main reasons for resorting to operate in the informal economy.

Can EAC achieve a policy balance that supports the growth of SMEs to continue playing their productive roles as well as increase investments and formal trading within the region? Harmonisation of EAC tax regimes is one way to encourage foreign investments and trade and if well tailored to the circumstance of SMEs could attract many informal SMEs into formalisation and increase the growth of local entrepreneurship. Similarly, policy measures must be taken to encourage increased cross-border trade in goods produced by SMEs and reduce informal cross-border trade as far as possible. It takes a developmental state to spearhead these twin processes.

This Trade Guide illuminates some proposals and policy measures that EAC could adopt to reduce the size of its informal economy. But, are EAC Partner States up to the challenge?

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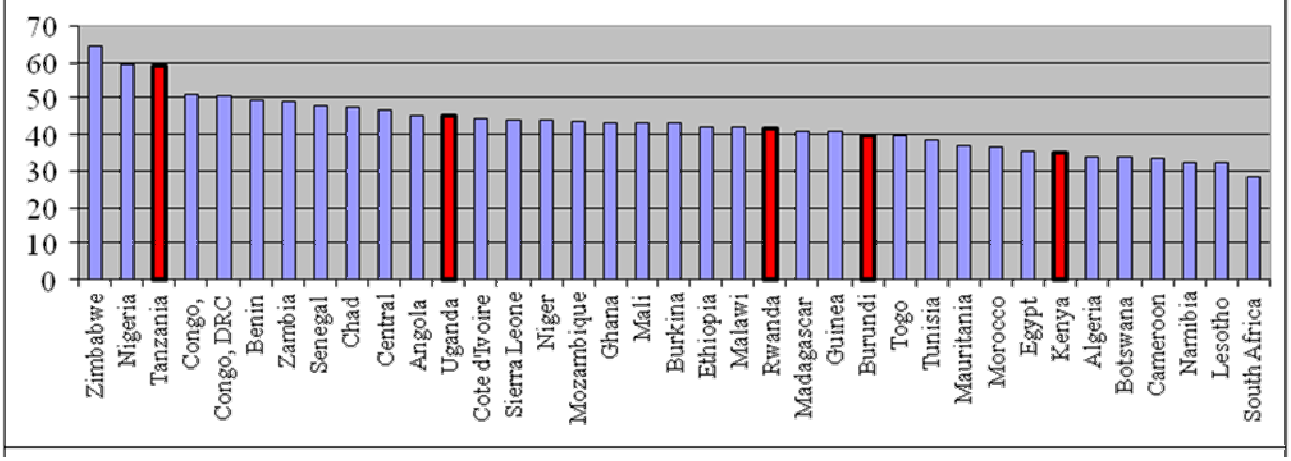
Understanding the Magnitude and Characteristics of Informal Economy in EAC

It is estimated that over 30% of the gross domestic products of 37 African economies come from the informal economy apart from South Africa where it constitutes about 28% of GDP (Schneider, 2007). There is no universally accepted definition of the informal economy; it could take any of these terminologies: unofficial, underground, hidden, invisible, shadow, parallel, second, unregulated, unrecorded, black, moonlighting, unmeasured and unobserved economy. In all EAC countries, this economy constitutes nearly 60% of Tanzania's GDP, 45% in Uganda, 41% in Rwanda, 39% in Burundi and 36% in Kenya (see table 1). In all African countries, the informal economy corresponds largely with the micro, small and medium enterprise (MSMEs) that are seen as semi-organized and un-regulated. Some native names ascribed to this economy include *'Jua Kali'*, and *'Nguvu Kazi'* enterprises. Today, these small enterprises constitute the bigger majority of enterprises in all EAC countries. In Rwanda over 90% of businesses are MSME's (Hategeka, 2009).

Table 1: Informal Economy as Percentage of GDP



Players in the informal economy are not necessarily the small informal businesses. Actually, the informal economy in EAC is composed of both small and big players who could both come from formal firms and informal firms. They range from professional consultants (such as lawyers, doctors, accountants and engineers), to fruit and vegetable vendors, public transport operators, food kiosks, hair-dressers/barbers, jua-kali manufacturers of all sorts of goods including artisans like tinsmiths, ironmongers and blacksmiths; shoe shiners, miraa dealers, open air photographers, hawkers of all sorts of wares, painters, engravers, graphics and designers, carpenters, massage parlours, saloons, sand harvesters, etc. Thus, informal sector participation has not only been linked with junior public and private sector employees –seeking for additional income to their salaries, but also with corporate executives hence it has developed as a means of extension of formal businesses.

Table 2: Categories of firms in the Informal Economy

Informal Micro, Small, and Medium enterprise (SMEs)	Informal Big Businesses	Formal Businesses engaging in informal practices

In addition to the above features, the informal economy may also be characterised by simple labour intensive technology; may or may not have licenses from authorities and are not registered with the registrar of companies; ease of entry and exit; small-scale nature of the activities; self-employment with a high proportion of family workers and apprentices; little capital and equipment; labour intensive technology; low skills; low level of organisation with little access to organized markets; unregulated and competitive markets; less formal credit; low education and training; cheap provision of goods and services; low productivity and low incomes; and lastly, most of the transactions are conducted on cash basis, with very little or none conducted through banks.

When targeting policy intervention at this sector, it is important to know who the policy is meant for so that the non-targeted do not end up being the beneficiaries. This will require a survey of the sector including all its characteristics. For example, the survey should split the informal economy based on players

such as informal SMEs (differentiating them into micro, small and medium); the 'big informal players'[i]; and, the formal firms engaging in this economy as in table 2. Secondly, the survey must capture their magnitude and the goods they trade.

In the 1970's, EAC countries perceive SMEs as marginal to the mainstream economic activities; they typically cast them as habitual tax avoiders and evaders and so neglected them. However, since 1980's, as most of these economies began to embrace liberalisation, the service sector took off and represented a higher and growing proportion of gross domestic product (GDP) of these economies. Much of this growth has been spurred by the growth of SMEs. With the growth of SME sector, however, has come the challenge of a growing informal economy and the difficulty to administer it in many requirements such as taxation. Yet, these small enterprises, arguably, are said to create many job opportunities even in the face of hard economic times when ordinarily the big private sector businesses would downsize their human resource base and even close shops at some point.

<u>Knowing why firms decide to operate informally</u>

Each of the three categories of firms identified in table 2 has varied reasons why they select to operate informally. Excessively burdensome requirements in registering businesses and complying with labour and tax regulations as well as overly burdensome or inefficient regulation can significantly increase the cost of both joining the formal economy and operating within it. These are the leading reasons pushing firms to operate informally. However, the informal economy is not full of benefits; it has also several disadvantages. Some of the perceived advantages and disadvantages in both domestic trade and cross-border trade are listed in table 3. Most traders would weigh these advantages and disadvantages before they decide to operate in the informal economy; others would find themselves there quite ignorant of any costs or benefits.

Table 3: SME Perceptions of advantages and disadvantages of operating informally

Advantages	Disadvantages
Domestic and Cross-Border Trading	
▪ will not pay income or profit taxes ▪ will not pay social security contributions to workers ▪ able to avoid labour regulations ▪ no problems with licenses ▪ not subjected to products standards ▪ not subjected to health and safety inspections ▪ not subjected to price controls ▪ will avoid overly cumbersome, rigid, time-consuming and inefficient bureaucratic export/import procedures and regulations ▪ will avoid payment of border agency fees and charges (e.g., administrative and inspection fees, license fees, consular fees, terminal handling charges, etc.) ▪ will avoid compliance with other formalities which bear additional expenses such as conformity assessments with technical regulations, insurance, pre-shipment inspections, customs brokers, etc.	▪ lack of access to finance; ▪ lack of access to raw materials; ▪ lack of access to broader market; ▪ cannot access government tenders ▪ fear of government retribution; ▪ need to pay bribes to avoid taxes and sometimes bribes exceed amount of taxes; ▪ provide free products or services to avoid tax compliance; ▪ temporarily shut down the business to avoid being detected by tax authority; and ▪ relocate the business to avoid being detected by tax authority ***Source: OTF Group, Rwanda Informal Sector Survey Report, (FIAS) December 2006***

As firms weigh both costs and benefits of informality, there are those who will resist attempts to formalise; those who will formalise only when tracked; those who try to formalise but are discouraged along the way; and, those who want to do the right thing but have no full information how to. In this case, no one-fits-all policy measure can turn these players to formalise their operations; different strategies must be pursued for the **resisters**, the **disengaged**, the **triers** and the **supporters**.

Factors that encourage firms to operate informally are not the same for all informal firms as they are different for formal firms that exist in the informal economy. Similarly, these reasons differ from sector to sector but there are those that cut across all firms and across different sectors. Policy makers would need to understand what cross-sector as well as sector specific regulations or factors encourage firms to operate informally. This will help them understand the sector-specific and cross-sector regulations and policy measures to encourage formalisation. Similarly, in instances where both informal and formal firms exist in the informal economy, it is important to understand why some firms choose to operate informally and others choose to operate formally.

As there may be many reasons why firms operate informally in both the domestic economy and across the borders, many SMEs mention tax issues as key advantages and lack of access to finance, raw materials and a broader market as the key disadvantages to remaining informal. The informal economy literature indicates that access to credit, government training programmes, and strong regulatory enforcement encourage firms to operate in the formal economy. Complicated tax systems, tax rates and numerous processes (licensing etc.) make it difficult and expensive for start-up firms to act in good faith. In Kenya and Rwanda, high tax rates features at the top of the top ten constraints to investors who may consider investing in both (see table 4 for all EAC countries).

Table 4: Perception of the top ten constraints to investment in each EAC country (% of firms identifying the problem as their greatest obstacle)

Constraint/Deterrent	Burundi	Kenya	Rwanda	Tanzania	Uganda
Electricity	41.25	11.94	32.81	73.56	63.90
Access to finance	16.25	13.47	14.86	9.47	6.80
Tax rates	3.77	21.74	27.69	3.94	11.10
Tax administration			3.78	0.73	0.90
Political instability	14.48	4.41			
Practices of informal sector	5.46	11.98	1.62	1.23	8.25
Customs and trade regulations	3.88		1.08		0.80
Licenses and permits		3.16	1.39	0.55	1.15
Corruption	2.28	9.59			2.47
Inadequately educated workforce			2.84	1.46	
Access to land	3.12	1.73	6.32	2.61	0.84
Crime, theft and disorder	2.94	11.47		1.93	
Transportation	3.22	7.73	6.66	3.23	2.82

Source: http://www.enterprisesurveys.org

The factors that push traders into informality go beyond the incentives inherent in the informal economy or the high costs of operating within the formal economy. To some traders it is the socio-economic constraints that hinder their beneficial engagement in formal trading. Other important factors that lead to growth of the informal economy are based on the weak economies of EAC; as formal employment shrink, more people seek income-generating opportunities in the informal sector. At the same time, the rising rural-urban migration in search of often non-existent employment also leads people to the informal sector employment. Together, the low wages and underemployment in the formal sector push people to look for alternative ways to supplement their incomes in the informal sector. Yet, in spite of all these, some firms operate in the informal sector because they lack knowledge of the benefits of trading within the formal sector.

How and who engages in informal cross-border trade?

As shown in the previous section, participants in the informal sector, including ICBT, are both from informal and formal firms. Those from the informal firms operate entirely outside the formal economy, and those from formal firms are fully evading trade-related regulations and duties by avoiding official border crossing posts and passing their commodities through "unofficial routes". In other instances, they may partially evade trade-related regulations and duties even as they pass their goods through official routes that have border crossing points and customs offices yet involve illegal practices such as ***under-invoicing*** (i.e., reporting a lower quantity, weight or value of goods so as to pay lower import tariffs), ***misclassification*** (i.e., falsifying the description of products so that they are misclassified as products subject to lower tariffs), ***mis-declaration*** of country of origin, and/or ***bribery of customs officials*** (see table 5).

Table 5. Types of informal cross-border trade

Category A	Category B	Category C
Informal (unregistered) traders or firms operating entirely outside the formal economy.	Formal (registered) firms fully evading trade-related regulations and duties (e.g., avoiding official border crossing posts).	Formal (registered) firms partially evading trade-related regulations and duties by resorting to illegal practices (e.g., under-invoicing).

Source: OECD, 2009

In most cases, the flows of ICBT goods appear to be in small quantities. Where formal firms are involved, goods come in big consignments but these are usually divided into smaller quantities to avoid attention when passing across borders. Since the small quantities are passed repeatedly, they end up being significant. The small quantities passed across the border are not necessarily sold immediately; they are piled in jointly-owned stores until a reasonable volume is reached and the players jointly hire means of transport to haul them to their final destinations.

Do informal and formal firms compete?

These traders deal in nearly all types of goods – *all staple food commodities* and *final consumer goods* (mostly of low quality such as shoes, clothes, textile and vehicle and bicycle parts and even fake drugs). What is important to note is that some of the goods here reflect the same ones that benefit from government export promotion schemes, such as textiles; the latter ones are sneaked into the domestic market duty free.

We indicated at the beginning that since informal traders provide unfair competition to formal firms that have often paid punitive taxes and tariffs, now is time to explain the extent of such competition. As to whether informal firms engage in anticompetitive practices (ACP) and therefore could affect EAC competition law enforcement in the formal sector depends partly on whether informal firms compete (or could quickly enter the market and compete) with formal firms. Given their characteristics, some of their operations provide unfair competition to formal firms but others don't. On the one hand, many operations of informal firms are in small scale and labour-intensive industries such as construction, retailing and personal transport –industries that are often cash-based. They are rarely found in industries where scale and scope economies are important, such as in the steel, telecommunication and banking industries.

Some markets may be comprised only of informal firms and others may be comprised almost entirely of formal firms. In some sectors, small informal firms may be able to compete with large formal firms due to the costs that they can avoid. In other situations, economies of scale and scope will enable formal firms to price lower than informal firms. In some markets, informal firms may find they can compete with formal firms because they can position their products geographically closer to the customer than formal firms. For example, produce vendors may be able to drive to the customer and thus take away the productivity advantages of large scale, stationary formal firms or supermarkets.

It is important to know the extent to which formal and informal firms coexist in the same market and compete for the same customer base across sectors and markets. Policy makers would need to determine the sectors in which informal firms serve the same customers as formal firms and determine whether the small informal firms compete with the large formal firms, the factors driving this competition, where they operate in the same sector and serve same customer base.

Is competition from informal firms beneficial or harmful?

After determining the nature of the competition between the informal and formal firms, it may be important also for policy makers to determine whether that competition is beneficial or harmful.

One school of thought posits that, in the short-run, informal trade brings the benefit of lower prices to the consumers. The low prices they charge can also increase competitive pressure on formal firms and promote price efficiency, especially, where the formal firm was initially raking in supernormal profits. Incidentally, also, it is the informal contacts that do strengthen regional integration networks and relationships more than formal links. There are also other benefits associated with the informal sector. As both public and formal private sectors of EAC economies have been laying off their employees over the last three decades, it is the informal sector that has been providing a soft landing pad as an alternative source of employment.

Another school of thought posit that as informal firms evade taxes and custom duties, they can limit possibilities of economic growth and development of economies. It can create unhealthy competition with the formal enterprises and limit their growth which can result into an overall decline in economic growth through lost employment and further loss in tax revenues to the government. In addition, incentive to innovate and invest could also be significantly reduced in an informal trading environment. Furthermore, mere existence of ICBT breeds a culture of corruption among the rent-seeking public administration and customs border officials.

When assessing the benefits or harm of informal firms, it is important to differentiate whether these are short-run and long-run concerns. A further factor to consider is the circumstances under which the size of the informal economy will improve or hinder competitive pressures in the formal sector. Does the competitive pressure from informal firms ignite some market efficiency reforms from the formal sector, e.g. price efficiency and improved supply? It will also be important to know the sectors where informal firms are more (or less) productive than formal firms. Do informal firms reduce or increase economic growth? Do informal firms harm the development of intellectual property by formal firms?

What tax harmonisation measures can support SME growth and reduce informality?

Small business enterprises in EAC countries often face difficulties when dealing with the government in general and the tax administration in particular. Many of the difficulties with the tax authorities are the consequence of poorly conceived tax policies and a lack of certainty regarding future policy changes. It would be rare indeed not to hear complaints about the complexity and/or ambiguity of the tax laws, high tax rates, and the lack of an integrated fiscal strategy that takes social taxes, local taxes and fees into account when determining the overall tax burden placed on the business community. In carrying out their responsibilities, Tax Administrations can also create problems for the business community when they impose burdensome reporting and record keeping requirements; conduct excessive inspections and audits; fail to deal with corrupt Tax Administration employees; and, fail to provide transparency in Tax Administration operations. This type of environment harms individual businesses and the overall economy. As a result, many in the business community react by taking steps which adversely affect the tax base. This typically includes under reporting profits and turnover; over reporting employee wages; and, by creating "phantom" employees. A significant number of businesses also fail to register or file tax declarations. This only increases the burden on those taxpayers who try to comply with the tax law, and discourages their future compliance. The result is a vicious cycle which tends to preserve the status quo. Only meaningful reforms to the tax system can break the cycle and result in an improved business climate which will stimulate economic growth.

A number of initiatives can be taken by government in the tax field to foster the growth of small and medium enterprises and/or reduce the paperwork burden that SMEs face. Measures which have the greatest impact are those which are established by tax legislations. Though tax policy is not the major thrust of this guide, a brief mention of some of these measures follows, along with measures that the tax administration can employ. There are several tax policy and tax administration measures that EAC countries could employ to support small business growth and reduce informality. It is not the purpose of this paper to enlist those measures; however, a guide is given on the **small business tax design (SBT).**

Since small businesses will not be the major source of revenue for the government, the goals of a taxation regime for small businesses must be different than those standard tax regime participants; the difference in focus necessitates a difference in design of the SBT. The design of the SBT therefore should be such that it encourages firms to join the regime; i.e., it should be clear to the small firms that they will receive benefits for joining the culture of compliance which at least neutralise the fiscal and time cost of paying taxes. For example, firms receive training on how to set up simple accounting systems which facilitate compliance requirements, as well as build capacity. This training is also an investment for the tax authority because as the firm grows, it is likely that it will pay more taxes.

The following is a list of suggested best-practice design features of an SBT designed to foster small business growth:

- **SBTs and Revenue authorities should focus on capacity building especially in the monitoring system.**
- **An optimal SBT would include a graduated system of taxation and introduction into culture of compliance supported by education on basic business operations, accounting, and monitoring (simple turnover, low rate). Emphasis for new taxpayers should be on learning and monitoring.**
- **As capacity and output grow, offer a more sophisticated tax system which may be more advantageous (adding VAT, or some reclaim ability) as a reward for better compliance. Emphasis should be on widening instruments and movement toward the standard tax regime.**
- **Simplified alternative tax regimes should be non-presumptive. Presumptive tax systems can cause significant cash flow problems especially for new small businesses and for SMEs in sectors with variable output (for example, agricultural producers).**
- **To bring into the Tax net, efforts should be made to identify taxpayers that are not ready to comply voluntarily at the points of convergence for service delivery and made to register for tax as a condition for enjoying the service and given unique Taxpayers Identification Numbers.**

Conclusion

In conclusion, the focus of taxation should not be merely to raise revenue. It is only rational that the cost of raising that revenue falls far below the revenue collected; however, the taxation of the informal sector accounting for such a significant percentage of GDP (table 1) cannot be ignored because of the cost of administering it. Taxation need not only focus on short-term revenue collection. Bringing the informal sector within tax is critical because of the long term revenue increase from wider tax base and growth potential of small firms when they operate within a formal framework. Different strategies will be needed for the different compliance attitudes. In all economies it is possible to distinguish four main taxpayers' attitudes towards compliance: the resisters; the disengaged; the triers; and, lastly, the supporters. Each of these attitudes is built on a different reason and all EAC countries have all them in varying degrees. So the question is what strategy do they need to employ on each? One would imagine that for supporters and triers, the strategic objective should be on facilitation and for the disengaged and resisters, a broader set of measures is required comprising; *strengthening of tax enforcement capacity,* and *developing programs to change their overall attitude towards government.*

In order to solve the problem of informality, whether in cross-border trade of domestic trade, the measures must go beyond tax harmonisation to encourage formalisation. Certainly, governments should approach the problem of informality by dealing with the factors that drive its growth and not fighting the traders who are merely eking a living out of the business. The fact that informal economy is still a reality in developed countries (that have existed for close to 300-400 years) should be a point of reflection to the EAC region whether it can succeed in eradicating the practice altogether. In that case, what would be important is to establish for the sector an enabling environment with measures that will reduce its negative impact on the economy. By creating a supportive environment for the informal traders, both the EAC countries and informal traders stand to benefit more. To the EAC countries, it could be the start of a successful process of formalisation of the informal traders. Consequently, this will enable the countries to collect better information of the goods, values and quantities traded amongst them. Better information collected will improve the planning and decision-making of the EAC countries. Similarly, to the ICBT players, creating conducive environment for their trade may mean better knowledge of the trader about their rights as they trade across the region, hence cases of paying bribes to border officials and smuggling goods across borders will be reduced. The trader will also benefit from payment of the correct amount of taxes (where taxes still apply) as opposed to the current case where they are sometimes charged duties on goods that are not supposed to attract any duties. Lastly, the cost and time of clearing the goods will be reduced resulting in lower prices of goods and higher earnings for the trader.

END NOTE

[i] Because of the advantages inherent in the informal economy, a big company that ordinarily can afford to maintain the requirements of formality can still chose to split its businesses into smaller constituents and operate as so permanently but continue enjoying scale economies just as other big compliant players in the formal sector.

This Trade Guide has been prepared by Victor Ogalo, Programme Officer at CUTS Africa Resource Centre, Nairobi. It is adapted from debates and reflections on two Research Papers: *"Informal Cross-Border Trade in EAC: Implications for Regional Integration and Development"* by Victor Ogalo; and "*Harmonisation of East African Community Tax Policies and Laws:Proposals for Taxation Regime for Fostering Small Business Development and Regional Economic Growth"* by Clyde Mutsotso. Both Research Papers and this Trade Guide are CUTS publications as part of the 'Building an Inclusive East African Community' project supported by the Duetsche Gesellschaft für Technische Zusammenarbeit (GTZ).

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