

CATA 42ND TECHNICAL CONFERENCE

Session 1: Digitalization and the informal economy

November 28, 2022

First an apology for not being able to join you at this CATA event. I still have fond memories of my last visit to Abuja in 2018.

Duncan and his team, working with our Nigerian colleagues, have put together an agenda which touches upon all of the main issues which are currently preoccupying Commissioners in CATA countries under the overarching theme of digitalisation. In my view, it will be the main driver of reform on our tax systems, at least if we are not afraid of embracing the way that these technologies can disrupt existing systems.

I have been asked to address the issue of digitalisation and the informal economy

My presentation will be in four parts:

1. What do we mean by the informal economy?
2. What are the economic consequences of this economy?
3. What are the implications for governments?
4. What can governments do to shift people from the informal to the formal economy?

It will take about 20 minutes and happy to answer questions at the end.

1. Defining the informal economy

Many terms are used to describe this phenomenon: the underground economy, the black economy (liked by our Indian colleagues), and the cash economy. But the main characteristics are:

- Informal activities which take place outside the control of the government (e.g. micro enterprises which have no formal records or fixed place of business)
- Illegal activities where two or more parties collude to break the law (e.g. sale of drugs)

So, these activities can embrace unreported activities in both the regulated and unregulated sectors.

2. What is the size of the informal economy?

In most African and Latin American countries, the informal economy is **THE ECONOMY**, accounting for 60-70% of economic activity and the biggest source of employment (Some estimate in Nigeria suggest it could be even as big as 85% of the economy). In Asian developing economies, the figures are more between 35-50% (Malaysia for example is around 40 %). In Europe, the figures are substantially lower, but in some of the emerging European economies, informality can still account for a significant part of economic activity (e.g. Albania about 28 %).

Looking at the overall figures does not help governments to take action to move people into the formal economy. The macro figures need to be broken down by sector.

Analysis by the WB and IMF suggest that in developing countries the highest rates of informality are found in:

- the retail sector, especially micro enterprises
- home services
- construction
- transportation
- Hotels and restaurants

Most of these activities are purely domestic, but increasingly we see digital starts going global and failing to comply with VAT and other cross-border taxes. Also for large MNEs, there remains the problem of illegal misinvoicing.

The Bottom line is we know that the informal economy is big and still growing.

3. Implications for government

Much of the focus has been on revenues lost – which can be large – but there are other implications:

- A large informal sector may undermine the credibility of government and reduce tax morale which in turn can reduce voluntary compliance
- These activities can also distort competition and lead to an unlevel playing field

- Informality may also discourage the growth on SMEs which prefer to remain below the thresholds beyond which they would be subject to tax
- They can also lead to a break up of supply chains to maximise non-payment of tax
- Overall economists have concluded that widespread informality lowers the long run productivity of the economy

So there are good reasons why governments should try to get people from the informal to the formal sector but governments need to be cautious. We do not want to close off the employment creation potential of MSME. Also, governments need to be cautious about not blocking access to the data that SME hold.

4. What Actions can government undertake?

There is no silver bullet. Governments need to adopt a package approach combining the following eight elements:

1. Get the MSME to see the tax administrations as a partner which can help them to:

- get access to government programs (e.g. social benefits)
- assist in getting access to finance (especially important for micro-entrepreneurs which do not have access to traditional sources of funds)
- Putting in accounting programs and improving the management of their business.

So before saying “we want you to pay tax“, you have a conversation about how we can help you grow. But at the end of the conversation, you mention that they will need to register to get these benefits! Yes, this does require a different mindset but as can be seen from countries as diverse as Chile and Singapore it can work.

2. Reviewing the tax policy framework that applies to MSME

Can it be simplified? Can we substitute annual fees/licences for VAT and other transaction taxes? Should we raise thresholds to exclude these MSME taxpayers from the tax base (always carries the risk that the habit of being outside of the tax net becomes ingrained and the other entities. May restructure to get under the threshold)

More generally, it’s good to follow some of the advice from the OECD FTA to put in programs that facilitate compliance by design.

3. Put in educational programs which explain why taxes are needed and how the money is spent
4. Whistle-blower programs can also help
5. As can incentive programs in the form of lotteries based upon VAT invoice numbers (Turkey very successful)
6. Tougher penalties and interest rate regimes
7. Undertake surveys of how the current regimes are influencing taxpayer behaviour
8. Apart from these actions, digital technologies offer a way that could transform the informal economy by:
 - Promoting the move towards a cashless economy using mobile money and electronic payments (e.g. Kenya). Encourage or require business to install point-of-sale operating registers or QR codes on mobile phones. Promote contactless payment systems. Put a ceiling above which cash payments are not allowed. All moves that have been facilitated by the pandemic.
 - Requiring SMEs to make all wage payment's to employees by electronic means.
 - Moving social benefit from cash to electronic money (been very successful in India).
 - Developing more sophisticated data-based approaches to risk management based upon a broader cross-section of information.

So technology can help but it must be accompanied by a change in the way that tax administrations and taxpayers interact in a way where trust becomes the norm rather than the exception.

I look forward to our discussion.