The Impact Of Widening The Tax Net; The Challenges Encountered By Developing Economies To The Informal Sector
Felix Ahima-Adonteng1,2
1Department of Accounting and Finance, Pentecost University, Pentecost University Street, Sowutoum, P. O. Box KN 1739, Kaneshie, Accra-Ghana
2Livingstone International University of Tourism Excellence & Business Management (LIUTEBM), Ibex Hill, Lusaka, Republic of Zambia

ABSTRACT
Various governments have paid close attention to the issue of broadening the country’s revenue base over the years. There has been a great deal of debate regarding it. In emerging countries, domestic tax collections are still falling far behind. When opposed to the statutory rate of 18 per cent, most commodities have a tax collecting effort of less than 5%. Epaphra, (2015). As a result, governments are increasingly reliant on overseas funding. Revenue generation, economic building and sustainability lowering market externalities, regulating trade, stimulating representation, attaining tax equity, and creating governmental responsibility and responsiveness all need the use of taxation. The informal sector has long been seen as a barrier to effective domestic revenue mobilization in developing nations, hence the renewed focus on bringing it within the tax net. This study used a critical literature review to identify the various motivations presented in the literature by various stakeholders (policymakers, scholars, and tax administrators) for the need to administer a tax on this sector and strengthen enforcement, as well as to critically evaluate the plausibility of these motives. Snowballing was used to help with the literature search, which was done using Google Scholar. Increased domestic tax collection would also imply less reliance on a few commodities for revenue, particularly gasoline, which is interconnected with many other industries and could hamper long-term growth.

Key Words: Taxable income, Tax collection, Income tax rates, Taxpayer base, Net-of-tax rates

1 Introduction
In efforts to achieve self-sufficiency, developing countries must expand their tax base by including both the formal and informal sectors to fund developmental initiatives, as highlighted by Adu-Sarkodie (2023). A persistent challenge for Ghana is its recurrent budgetary deficits, which can be partly attributed to its domestic tax revenue mobilization that stands at about 18% of its GDP, as noted by Danquah et al. (2016).

Internationally, the emphasis on widening the domestic tax base has been a recurrent theme, as evidenced by discussions within the Federation of Indian Chambers of Commerce and Industry (FICCI, 2015). In Ghana, successive tax bodies have launched myriad programs to maximize tax revenue collection, especially for developmental and social projects. Emphasizing the informal sector is essential, given the potential revenue leakages therein. This sector primarily comprises small to medium-sized enterprises, which often escape the conventional tax mechanisms due to their inherent nature (ILO, 1972).

While augmenting tax rates might seem a viable solution, it inadvertently leads to tax evasion, especially among the wealthier citizens who have the means to reallocate income for tax advantages (Fieldhouse, 2013). A more comprehensive approach would involve a mix of tax rate adjustments, broadening the tax base, and improving tax enforcement. Expanding the tax net within the informal sector could involve two strategies: refining the existing taxpayer returns and bringing more informal sector participants into the tax bracket through promoting private-sector job growth (Mpapale, 2014).

Fairness in these tax reforms is paramount to ensure minimal revenue evasion and to uphold the principle of horizontal equity, which emphasizes that individuals with comparable incomes should have analogous effective tax rates, regardless of their capability to exploit potential tax loopholes (Tax Policy Unit, Ministry of Finance and Economic Planning, 2011).

The informal sector, albeit its challenges, plays a pivotal role in the economy. It not only provides job opportunities, albeit often low-paid and precarious ones, but also promotes entrepreneurship, albeit sometimes at
the expense of regulatory compliance (Tybout, 2000). A nuanced understanding of the sector reveals its multifaceted nature, where it not only serves as a coping mechanism for many but also results from calculated decisions by entrepreneurs to bypass regulations (Grxhani, 2004; SIDA). The interplay between the formal and informal sectors, with the latter sometimes even servicing the former through subcontracting, showcases the intricate dynamics of the market (Amin, 2002).

2 Literature Review

Development policy experts are increasingly focusing on strengthening the capacity of low-income countries to augment their tax revenues. A key facet of this agenda is enhancing the effectiveness of tax administrations. In response to its fiscal challenges, Ghana has initiated numerous tax reforms. A concerted effort has been made to diversify the tax base, leading to a notable shift from foreign to domestic budget financing and a marked improvement in revenue collection.

Instrumental to this rise in tax revenue has been policy measures like overhauling the tax administration system and the inception of the Ghana Revenue Authority. However, despite these positive strides, tax revenues still don’t suffice to meet budgetary needs, with a substantial 31% of the budget sourced externally. This dependency makes the economy vulnerable to the dynamics of revenue collection and the influence of external fund providers. Historically, research has predominantly focused on the impact of taxes on households (Bahigwa et.al., 2004; Okidi et.al., 2004). There’s a consensus that certain regressive taxes have adversely affected income distribution, leading to calls for more progressive taxation models.

Expanding the tax base can be approached in two primary ways. Firstly, by targeting previously untaxed sectors, notably the informal sector, through methods like presumptive taxation. Given the informal sector’s significant employment of low-income groups, any such approach needs careful calibration to minimize regressive impacts. Secondly, by curtailing tax evasion. This entails taxing a more comprehensive gross income by minimizing tax expenditures like deductions, exclusions, and exemptions. Adherence to the principle of horizontal equity, ensuring those with comparable incomes have similar tax rates irrespective of their ability to navigate tax loopholes, is crucial.

Research shows that the actual productive economic activity is less influenced by top marginal tax rate shifts than some argue (Matthews 2010). Recent studies on the elasticity of taxable income (ETI) have shed light on how taxable income responds to tax rate variations (Giertz 2009). Saez, Slemrod, and Giertz (2012) suggest that a modest increase in the top marginal tax rate would lead to a relatively minor decline in reported taxable income, resulting in an appreciable revenue gain. The implication is that there exists significant potential to boost revenue by adjusting tax rates with only minimal repercussions on productive activities.

Interestingly, the ETI findings emphasize that wealthier households have more tax avoidance options (Gruber and Saez, 2002). This underscores the notion that a tax code minimizing such strategies can lead to higher revenue-optimal tax rates. Saez and Diamond (2011) estimate a revenue-maximizing total top tax rate for the U.S. at around 73%, indicating substantial room to raise existing tax rates.

2.1 Taxpayers Base

In India, the proportion of the population that pays income tax has traditionally been small. Data from the Ministry of Finance reveals that only 2.9% of the population, or 35 million individuals, are taxpayers. Surprisingly, a mere 0.1%, equating to 42,800 individuals, declare a taxable income above INR 1 crore. While the majority (around 90%) of India’s taxpayers report a taxable income below INR 5 lakh annually, this segment contributes to just 10% of the country’s total income tax revenue. In contrast, those with a taxable income above INR 20 lakh, though constituting less than 2% of the taxpayer population, contribute a staggering 63% of the total tax revenue. Furthermore, the number of ultra-wealthy individuals in India, those with assets above INR 60 crore, increased from 13,700 in 2013 to 14,800 in 2014. Simultaneously, the number of individuals with assets above INR 6 crore rose by 6%, increasing from 214,000 in 2013 to 226,800 in 2014. This data presents a perplexing scenario where, in a nation with 226,800 individuals boasting a net worth exceeding INR 6 crore, fewer than 50,000 report taxable income above INR 1 crore. Such statistics indicate a rampant issue of tax evasion, underscoring the government’s need to focus on expanding the tax base among the affluent.

2.2 Tax Collection
Tax revenue in the country has historically been subdued, accounting for approximately 10% of the GDP, which is significantly lower than the average of the Organization for Economic Co-operation and Development, often only a fifth of their average. The government's actual tax revenue has routinely fallen short of its budgetary projections. Despite this trend, FY14 saw a 9.4% rise in gross tax collections, reaching INR11,338 billion, up from INR10,362 billion in FY13, even though it was 6.2% less than the anticipated amount. During this period, there was a 14.4% increase in direct tax collections, while indirect taxes grew by 4.7%. However, in the span from April to July in FY15, the growth in indirect tax collections was just 3.9%, which is considerably lower than the 25% yearly growth target set in the FY15 budget (referenced from Malhotra, 2010).

2.3 Need for expansion of tax base

The nation's existing taxpayer pool is notably limited, necessitating its expansion for several critical reasons. Firstly, a broader revenue foundation is essential for the government to achieve fiscal stabilization and enhance the tax-to-GDP ratio. Secondly, given the consistent underachievement in tax collections relative to budget estimates, broadening the tax base becomes crucial to meet the ambitious goal of a 17.7% tax revenue growth in FY15. Thirdly, a larger tax base would empower the government to make strategic investments in infrastructure and other pivotal areas, driving national growth and progress. Lastly, in order to alleviate the burden on existing taxpayers, it's essential to integrate more individuals and their undisclosed earnings into the tax network.

A focused strategy is required to incorporate non-filers and unearth concealed wealth in the economy. The recently established government has taken proactive measures by initiating a Special Investigation Team (SIT) dedicated to uncovering concealed assets both domestically and internationally. The IT department has laid out plans to widen the taxpayer base, targeting non-filers, using annual information returns, and tapping into new data points like under-declared real estate transactions. Plans also include monitoring advance tax payments by affluent taxpayers, scrutinizing TDS submissions by significant deductors, and overseeing payments by entities under the purview of minimum alternate tax regulations. Moreover, the anticipated introduction of the dual Goods and Services Revenue (GST) aims not only to expand the tax base but also to streamline and unify the current complex federal and state tax structures. The 2014-15 Union Budget proposed widening the service tax bracket to encompass services like radio taxis and online ads, while also revoking certain exemptions to further enlarge the tax base.

Furthermore, the 2013 Union Budget proposed an additional 10% tax on individuals with annual earnings exceeding INR 1 crore. This move, targeting around 42,800 taxpayers, was projected to boost government revenue by approximately 1%.

3 Methodology

The importance of a comprehensive literature review in research is well-documented. Hughes et al., (2019) posit that theoretical research involves a meticulous analysis of pertinent literature. Such reviews serve several purposes: (1) assessing previously published discussions on a topic, (2) determining the clarity and trends of existing research, (3) highlighting areas requiring further examination, (4) consolidating findings towards a particular inquiry, and (5) establishing new theories or frameworks (Pare et al., 2015). Different types of reviews exist, such as narrative, systematic, scoping, semi-systematic, and critical, each with unique methodologies and goals (Grant et al., 2009; Snyder, 2019). This study followed Snyder's "integrative literature review" or critical review method (2019), aiming to critically analyze and interpret the existing literature on a subject. Such reviews seek to identify consistencies, discrepancies, and gaps (Grant et al., 2009; Mpofu, 2021).

The focal point of this investigation was the literature on expanding the tax base, with an emphasis on the rationale for targeting the informal sector and strategies for its taxation in developing nations. The research aimed to objectively present, evaluate, and synthesize existing research arguments and findings, and align them with contemporary perspectives. As stated by Akintoye (2017), literature reviews offer insights into the current state of knowledge in a specific research area. Hence, the primary objective was to discern current trends and spot research gaps concerning expanding the tax net and its enforcement strategies.

The review process was guided by clearly defined steps: determining the research question, choosing the right databases, setting selection criteria, and selecting the appropriate approach to gathering, analyzing, and synthesizing information, as suggested by Mpofu (2021) and others. Through an extensive review of literature on informal sector taxation, the research question, "How feasible and attainable are these motives?", was formulated. Google Scholar was the primary tool for retrieving peer-reviewed articles.
Snowballing, a method described by Jalali et al., (2012), which involves tracing references backward and forward, complemented the primary search. Despite being an emerging field, backward and forward snowballing techniques yielded similar outcomes, indicating the interconnectedness of the research community in this domain.

In total, 55 relevant studies were identified and examined for this review, fitting within the suggested range by Wee et al., (2016). These studies were then methodically analyzed based on the contributions they offered, leading to the identification of five main categories of motivations. To ensure the review’s coherence and standardization, the collated literature was structured around identified themes and concepts, as advocated by Padron (2018) and Snyder (2019).

Despite the systematic approach, the review’s potential biases include the possibility of focusing too heavily on certain authors due to the snowballing technique, as well as the researcher's own biases. By combining snowballing with a standard database search, efforts were made to mitigate these biases.

The underpinning framework of this study, as Adom et al. (2018) recommend, was the theme framework, which provided a coherent structure, connecting the literature review to the research objectives, problem statement, and other components. This framework guided both the literature review and the discussion of findings. The subsequent section delves into the findings and their implications.

4 Conclusion

The study reveals that developing nations consistently lag in their domestic tax collection efforts. While the official tax rate stands at 18%, the actual tax effort for many goods remains below 5%. This gap forces governments to depend excessively on external funds. Significant opportunities exist for revenue authorities to enhance their tax collection methods. The study highlights critical sectors and under-taxed products that should be the focus to boost tax revenues, ensuring fairness in the process. However, essential items like food will remain exempt. A more diversified tax base would reduce the dependence on taxing specific items, such as fuel, which can inadvertently impact other sectors and potentially hinder long-term growth.

In Ghana, the taxation landscape faces several hurdles, including intricate tax systems, widespread tax evasion, and logistical constraints, all of which diminish government revenue. One suggested remedy is the simplification of the tax structure by reducing or removing many deductions and credits. It may also be beneficial to transition to a territorial system that focuses only on taxing domestic earnings.

Reference


