

Tax compliance and representation in Zambia's informal economy



In brief

- Despite conventional wisdom that informality is defined by being outside the tax net, informal workers in developing countries often encounter a range of taxes to community, municipal, and national authorities. They also can be coerced to make payments to non-state entities, such as party youth leagues and vigilantes, in exchange for security.
- This study examines when and why some informal workers pay these taxes and, in turn, how tax compliance affects political representation.
- To do so, a survey was conducted with more than 800 informal traders and service workers located in or near 11 different markets in Lusaka, Zambia, complemented by semi-structured interviews with local and government stakeholders.
- The findings show that where informal workers have access to services within the markets, such as toilets, clean water, drainage, and garbage collection, they are more likely to pay taxes and fees to the relevant authorities.
- Furthermore, results from a vote choice experiment suggests that paying taxes increases demands for a government representative to respond to the specific service delivery needs of informal workers rather than those of the broader urban populace.
- Overall, the paper provides support for the fiscal exchange hypothesis and shows that improvements in how tax money is used can enhance revenue mobilisation, even among a relatively poor segment of the population.

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Overview of the research

As a rapidly urbanising country that has struggled to generate sufficient structural transformation to create formal jobs, the informal sector remains the main source of employment in Zambia. Within the capital of Lusaka, 72 percent of the labour force works in the informal sector, and this rate has barely shifted over the last decade. Many of those within the sector labour as traders, tailors, hairdressers, or food sellers within the city's more than 60 open air markets, or they hawk their goods along the capital's streets.

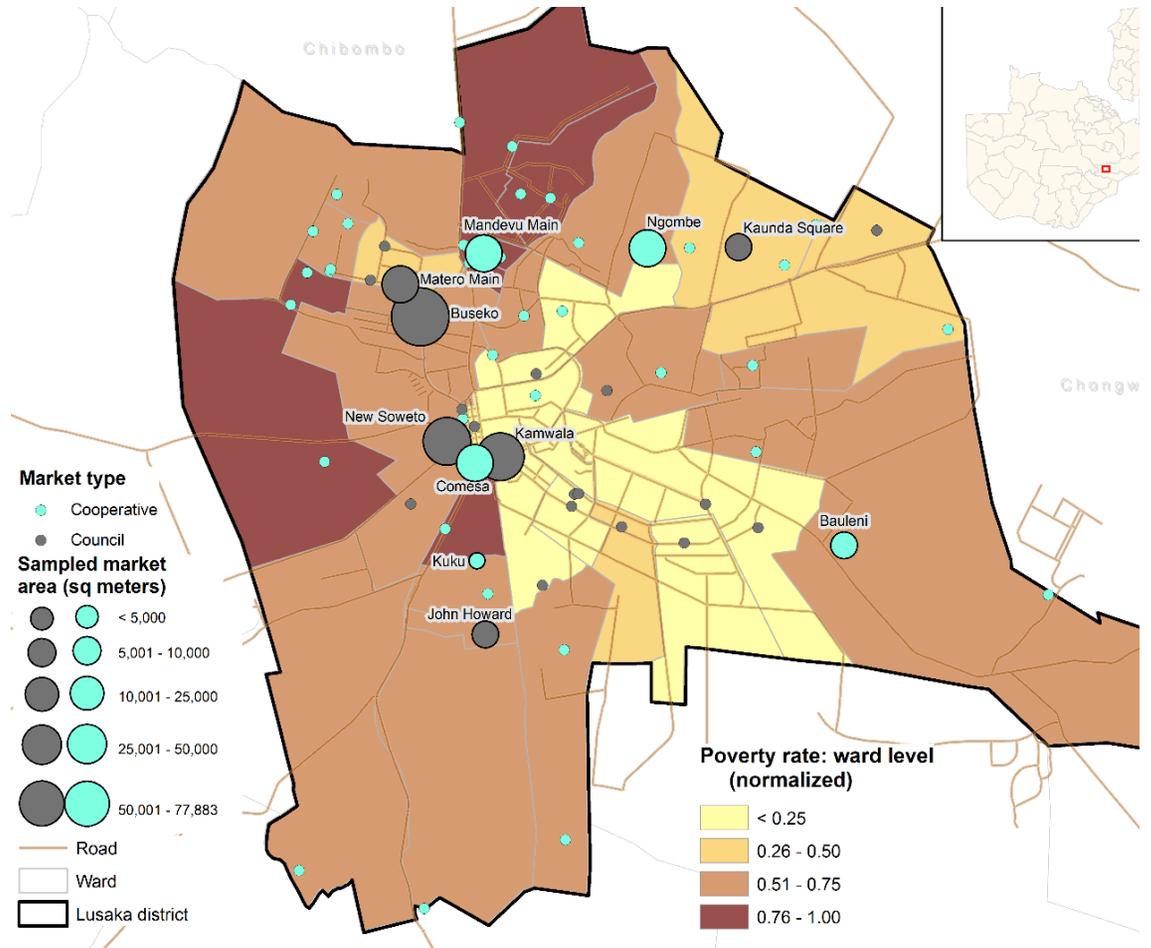
Since 2004, the Zambian Revenue Authority (ZRA) has applied, with differing levels of enforcement, a range of informal sector taxes, including a base tax on marketeers, a turnover tax on businesses with turnover that falls below a certain threshold, a tax on minibuses and taxi drivers, and an advance income tax on imports by cross-border traders who are not registered with the ZRA. In addition, there are a range of taxes collected by the Lusaka City Council (LCC) and the market cooperatives that allow individuals to trade or run a business in the markets. Party cadres, who are typically youth who operate as vigilantes on behalf of a political party, also attempt to tax traders in exchange for security and protection. However, the payment of any of these taxes by informal workers is erratic, depriving official authorities, such as the LCC and the ZRA, of necessary resources for sustainable development.

As such, this research addressed two main questions:

1. What drives tax compliance among informal workers?
2. Does paying taxes affect demands for political representation among informal workers in the same way that political economy scholarship has found for the broader citizenry?

To address these questions, semi-structured interviews were conducted with a range of government and civil society stakeholders about challenges to tax compliance. This was complemented by primary data collection with 823 informal workers in Lusaka during November 2017 under the "Lusaka Market Study on Taxation and Service Delivery." A cluster sampling approach was used that targeted 11 markets across the city, spanning both those that are in the central business district (CBD) and those in the city's high-density shanty compounds. In doing so, six council markets and five cooperative markets were included in the sample (Figure 1).

Figure 1: Survey locations for the Lusaka market study on taxation and service delivery



Along with a variety of demographic and socioeconomic questions, respondents were asked about the frequency and amounts of payments they made to a variety of actors that operate in the markets, including market cooperatives, the LCC, ZRA, and party cadres, as well as the benefits they received in exchange for such payments. Approximately 82 percent of the sample claimed to pay taxes to one or more of these entities.

They were also exposed to a vote choice experiment where they were presented with three hypothetical mayoral candidates that were similar in terms of gender, education, job, and origin. Only their policy platforms varied. Candidate A is portrayed as a “law and order” mayor who would clean up the streets and remove hawkers. Candidate B is concerned with improving market services and stall fees, as well as making base taxes more affordable. Candidate C campaigns on a platform of improving access and quality to schools and health clinics in Lusaka. While 57 percent selected Candidate B, 14 percent liked the “law and order” candidate and 29 percent preferred Candidate C.

This analysis of tax compliance and representation offers two main contributions:

1. It advances research on the political economy of taxation in developing countries, which necessarily requires focusing on the informal sector where a majority of citizens work.
2. Moreover, determining whether taxation affects demands for representation among informal workers thus far has relied on case studies where associations of informal workers lobbied for greater concessions by governments. The use of a vote choice experiment uncovers whether the inclination to have more responsive government manifests at the individual-level even in the absence of such mediating associations.

Policy motivation for research and key findings

Taxation is fundamental for national and local governments to be able to provide services in a sustainable way. In fact, Zambia's 2017 Economic Growth and Stabilization Program aims to "strengthen tax compliance and modernize tax administration." Since they generate a relatively high level of turnover, market places in Lusaka, as in other African cities, are an attractive target for taxation, albeit one fraught with logistical difficulties.

The survey findings reveal that a number of factors are associated with compliance:

- Most notably, those who had engaged in some type of political participation in the prior 12 months or who own (rather than rent) their store or stall are more likely to pay taxes.
- In addition, those who are located in or near markets with better services, including toilets, water, drainage, and garbage collection, are more likely to comply.

This latter finding is in line with the fiscal exchange hypothesis, which assumes that compliance is greater when citizens perceive benefits in exchange for their payments.

Informal sector taxation often is justified based on its implications for growth and for assisting with the formalisation of micro and small enterprises. However, there are also important governance externalities of taxation. Indeed, based on a statistical analysis of the results of the vote choice experiment, there is a substantive and significant correlation between those who pay taxes and a preference for the informal sector-friendly Candidate B over the social goods Candidate C. For those who do not pay taxes but work in a market where they believe services have improved, the probability of voting for Candidate C actually exceeds that of supporting Candidate B (Figure 2).

Figure 2: Predicted probabilities of supporting hypothetical mayoral candidates



Policy recommendations

- Improve quasi-voluntary compliance by reinvesting monies collected into the markets**
 In mid-2018, Zambia issued Statutory Instrument No.48, which announced that the base tax on marketeers would henceforth be collected through mobile phone providers. Technology is believed to increase compliance. However, this analysis suggests that tax payments also can be improved if citizens believe that their money results in services from

which they can directly benefit. As such, one of the most feasible ways of increasing compliance is to work with local government and market cooperatives to more effectively manage these resources and prioritise investments in those market services that are most needed.

- **Earmark and publicise investments in service delivery to enhance social accountability**

Relatedly, earmarking, or explicitly allocating in a budget that certain tax payments are for particular services, is one way to ensure that informal workers can identify how exactly their money is used. To be effective for purposes of oversight and accountability, especially among those with minimal education or access to news outlets, earmarking should be publicised in an easily accessible format, such as citizen scorecards, and be available in multiple media venues.

- **Eliminate taxation with no social or administrative benefit**

Taxation extorted by party *cadres*, was experienced by approximately 14 percent of the sample, especially those who work in the city's central business district. Most respondents noted that they either received "no benefit" in exchange for these payments or that the main benefit was security from theft and fires. Interviewees noted that payments to cadres undermine revenue to the LCC as well as create a sense of intimidation in the marketplaces. Efforts to reduce such extortion are needed to improve informal traders' trust that the government is indeed interested in their welfare.

In many developing countries where a majority of citizens work in the informal economy, there is a notable trade-off between needing tax revenue but not wanting to excessively burden the poor. Informal sector workers are one promising source of enhancing domestic revenue mobilisation. Yet, in Zambia, as elsewhere, eliciting their compliance requires fairness and accountability in the way in which such revenues are utilised.