



LEGAL CHALLENGES RELATING TO TAXATION OF THE INFORMAL SECTOR IN TANZANIA.

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Abstract

This article looks at some underlying legal challenges of taxing the informal sector in Tanzania. In many African countries SMEs have been in existence since 18thc and their recognition is unvoidable situation. In Tanzania Micro and Small Enterprises (MSMEMs) are recognized in the Income Tax Act. A presumptive Taxation system is used as a means of taxing the sector. However, one of the challenges of using this system is on how to bring all the MSMEMs into tax base. Despite all what has been done by MKURABITA (Financing and

Financing Plan), the small informal sector still cannot pay tax as provided in the tax law as the sector does not meet legal requirements for taxpaying sectors. Devising strategies that will bring the sector into tax net seems to be one of the solutions the government should think about. It is against the above context that the article exposes legal challenges in taxing the sector and highlights on how the government can structure and implement some legal strategies to bind the informal sector to pay tax.

Key Words: Legal challenges, taxation, informal sector

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1.0 Introduction

In Tanzania the Informal Sector occupies much of the population in the economy. The sector consists of many small scale businesses carried out by different individuals. Some of the businesses are not identified, and hence not registered. They tend to hide and evade tax payment.³ Informal sector in Tanzania needs to be formalized since it includes people of low classes,⁴ such as shoe shiner, *mama ntilie*, local clothes tailor, *machingas* and sales men of local medicines.⁵ In 20th century the ILO first defined a socio-economic structure that is now commonly known as the informal sector, to mean.

All activities that operate largely outside the system of government benefit and regulation.

Informal sector is characterized by the following; ease of entry, reliance on indigenous resources, family ownership of enterprise, small scale operation, labour-intensive methods of production and adapted technology, skills acquired outside the formal school system, unregulated and competitive markets.

In Tanzania, it is very difficult to make a clear determination of the informal sector as it is composed by those with no realistic enterprises and those who have fleeting behavior or appear seasonally and those who migrate from one area to another. Hence, there is no clear determination of all business records, properties and account.⁶

The MSMEM is now on the face of reformation in order to bring any business activity into tax net for the aim of ensuring that they all pay all necessary tax as is in a formal sector. This involves formalizing its small enterprises.⁷ The main objective is to formalize the informal sector so that it pays tax and expands the tax base.⁸ The taxation of informal sectors has proved to have many challenges which hinder effective tax collection by the government. This article aims at revealing and explaining the major legal challenges which hinder effective tax collection from the informal sector by the government.⁹

1.1 Identifications (Id) of the Informal Sector in Tax Law

Identification of the informal sector in tax law in a developing country like Tanzania is a major problem. This is because the National Identification (ID) does not

3 The Tanzania Investor Road Map, Final Assessment Report, USAID/Tanzania, 1999 provided that; "While the current regulatory environment is difficult for medium and large scale formal sector firms, it is largely inappropriate and irrelevant to micro and small scale informal businesses. ... It is virtually impossible for small businesses to operate legally. ... Consequently, the current environment encourages businesses to remain small, informal, and operating outside many of the constraints faced by large more visible operations. Although informal sector entrepreneurs, by being informal, may operate outside some of the constraints faced by larger enterprises, they face multiple obstacles of similar and different nature. Besides the fact that informal sector entrepreneurs often cannot operate without permits and do face regulatory constraints, they also have to deal with insecure and inappropriate working places, harassment by authorities and limited access to utilities and other inputs and services."

4 Mkuki, M.J., *Corruption in Africa: Cases, Consequences and Clean Up*, the Roman and Littlefield Publishing-U.K, USA, 2005.

5 www.taknet.or.tz/viewclosedtopics.asp?topic_id=19&topic_status=1..... Accessed(03/01/2018) The informal sector in Tanzania consists of mainly the unregistered and hard-to tax groups such as small scale traders, farmers, small manufacturers, craftsmen, individual professionals and many small scale businesses

6 The informal sector is regarded as a group of production units which form part of the household sector. Household enterprises are units engaged in the production of goods and services, which are not constituted as separate legal entities independently of the household or household members that own them. They do not have a complete set of accounts which would permit a clear distinction between the production activities of the enterprises and the other activities of their owners, or the identification of any flows of income and capital between the enterprises and owners. The informal sector comprises: • Informal own-account enterprises ('self-employed') • Enterprise of informal employers (employing one or more employees).

7 Shahe, M. E., and Stiglitz, J.E., *On selective indirect tax reform in developing countries*, 89, Journal of Public Economics, 2005, pp. 599-623.

8 Kimungu, H., and Kileva E. L., International Tax Dialogue Conference on SMEs Taxation: Challenges of Administering Small and Medium Taxpayers Tanzania Experience, Buenosaires, Argentina, 2007.

9 "The first phase of the program (diagnostic study) has been accomplished. It is now in the second phase of Reform design be 'I fore entering the third and fourth phases which are creation of the resource and implementation respectively. The formalization process in Tanzania is following a model by Peru's Professor Hernando De sotto. His company, Institute of liberty and Democracy (ILD) has been contracted by the government of Tanzania – with financial assistance from the Royal Norwegian Government – onto advice on the property and business formation process"

cater for all income earners. As a result, many businesses in the informal sector are left unregistered. It is thus difficult to access the tax payers' information. Yet, TRA has always been blamed for the lack of well organised strategies in collecting tax and in particular from the informal sector.

Recent development has seen petty traders across the country being given special identity. The exercise started on 10th November 2018. The special identity cards will make it easy for TRA to recognize them. This is a new strategy by President Magufuli to protect the group.¹⁰ The IDs issued by the President Office are like 'stickers' that one buy and stick for identification and it carries no further information in terms of for instance which ID belongs to which *Machinga*. It seems that, the security features and serial numbers will only help to know if the ID is legal or fake, but it will not help to detect its holder and the trade he/she is engaged in, for example, whether its holder is a shoe shiner or *mama lische*. The obvious danger is that these IDs might be sold to others when they become scant and precious. By using this model, the government is denying itself the right to have stout information or data of those engaged in the informal sector as the only information they will have now is the number of the *Machinga* based on the number of IDs sold out and this will make the Informal sector to remain untaxed.

Nevertheless, identification of individuals engaged in the informal sector such as the *Machinga* is an

important stage and the country should be commended for that as it recognizes and support small traders to unleash their potential. To make the most out of the President's will and order, the Government should not only 'sell' these IDs, but they should properly identify and capture key information and profiles of all those engaged in the sector who turn out to buy and collect the IDs. As such, the exercise should result into a strategic investment in the 'informal' sector and have them paying tax.

1.2 Registration of the Informal Sector

Registering petty traders in the informal sector such as *mama ntilie*, shoe shiner and *machingas* in Tanzania seems is a serious problem. The problem mainly hinges on the fact that most of the petty traders in the informal sector do not meet requirements which enable them to be registered. Nevertheless, the law requires any business of any size to obtain a business license prior to commencing operation. This is a process which is meant to ensure that the proposed business takes place in authorized areas in premises which the authorities can reach the entrepreneur for inspection and at which legal standards of safety, hygiene, employment and production are respected.¹¹

On the other hand, there is a complex business registration and licensing systems. This is due to the fact that, there are many and different ways of registering and licensing a business entity. So, each business operating in Mainland Tanzania is required to obtain a certificate of registration from the Business Registration Centre within the local authority where the business is

¹⁰ During the meeting of his excellence with the Regional Commissioners the President pointed out that, the identification cards titled 'Small entrepreneur identification card' will be carried by these people wherever they will be doing their activities. In the first phase, each region will have 25,000 ID cards and the exercise will be continuous.

¹¹ Section 17 of the Tanzania Investment Act of 1997

located depending on type of activities example of authorities includes local government, BRELA and TRA.¹² In most cases these processes of registration are cumbersome to Small and Medium Enterprises Sectors.¹³

This is again due to the fact that, there is no proper personal contract between tax officials and tax payers and poor provision of knowledge on regulation regarding taxation process which results into illegal and dishonest in tax collection as a result there is resistance in tax registration for purpose of tax payment.¹⁴

Another observed problem from the SMEs is that there is lack of a well-designed strategy to secure property right, example permanent piece of land for running the business.¹⁵ Therefore, to avoid this people find it easy to opt to engage themselves into informal sector (SMEs) activity which seem to be easy to conduct.¹⁶

For SMEs to be registered for paying tax, the knowledge of tax laws should be given. This is because education is a key element of the human capital needed for business achievement. It is through education and training that one gets the foundation for intellectual development needed by entrepreneurs for a successful business.¹⁷ Furthermore,

it gives confidence to the entrepreneurs when dealing with clients.

On this, the government should be commended for its efforts on educating the SMEs on different issues of tax. However, the knowledge of tax law which is needed always depends on; expectations about the tax, the type of tax and the quality of the tax which is not sufficiently provided to the SMEs. Individuals should also be given knowledge about ways to conduct their businesses. For instance, they can be trained on how to dispose of hazardous waste, to negotiate, and manage contracts, essential elements of a binding contract, a basic knowledge of their rights and duties and how they can escape from making crimes.

Hence, the policy maker should keep in mind that the knowledge of tax law is a key factor for government revenue. There should therefore be guidelines to tax advisers so that a proper knowledge can be given and implemented in peoples mind and individuals should not be scared from asking for advice he or she needs on taxation matters before they register.¹⁸

1.3 Lack of Record Keeping and Uncertainty of Income

An accounting system is one of the most effective decision making tools of management. It provides ordinary methods of gathering and organizing information about the various business transactions in order to aid management in making informed decisions.¹⁹

In developing countries like Tanzania,

12 Review of Informal Sector for Taxation Purposes – DPG Tanzania www.tzdp.gov.tz/.../TRA_Informal_Sector_Presumptive_Income_Tax_Report_draft_J... (accessed on 13 May, 2019)

13 www.ilo.org/wcmsp5/groups/public/@ed_emp/.../documents/.../wcms_asist_8365.pdf (accessed on 13 May, 2019)

14 <https://journals.openedition.org/articulo/3376> (accessed on 13 May, 2019)

15 Basically, an entity will be regarded to acquire legal status if it is formed (incorporated), registered and or licensed according to the laws of the country. In Tanzania an entity acquires legal status if it is registered and formed according to the law. When an entity acquires a legal status as a limited liability company, it separates itself from its owners. It becomes liable on its own. For a business entity to acquire legalization in Tanzania, it should be registered in accordance with the requirement of laws.

16 University of Dar es salaam Entrepreneurship centre (UDEC), “Jobs, Gender and small Enterprises in www. Yef Africa.org/ (accessed on 12th January 2019)

17 Nkonoki, E., *What are the factors limiting the success and/or growth of small businesses in Tanzania? – An empirical study on small business growth* Arcada University of Applied Sciences, Helsinki, 2010, p.43-44

18 *Ibid*

19 Amoako. G.K., (2013) *Accounting Practices of SMEs: A case study of Kumasi Metropolis in Ghana: International Journal of Business Management Vol.8 No.24, pp.73- 83.*

most of those engaged in the informal sector experience challenges relating to income generation activities.²⁰ They lack transparency in accounting records and financial statement. This is mainly because of improper business records keeping.²¹ The challenges of improper record keeping make it difficult for the financial institutions and government agencies to deal with the SMEs.²²

As a result of lack of proper record keeping and record filing system in Africa and Tanzania in particular, the SMEs are traditionally experiencing difficulties in obtaining financial credits or equity. Consequently, most of them finance their activities using own funds, loans from friends and family, money lenders, relatives, rotating servings and credit groups.²³

For instance for a person to purchase a loan he/ she should have a record of his or her business income of which the informal sector is lacking. SMEs also lack business plan and in most cases, their businesses are not permanent. Therefore, it is difficult for them to access loans. Morland and Dobie provide that SMEs are considered not to have any assistance in controlling up their activities.²⁴ Because of all these challenges of poor record keeping and uncertainty of income, it is hard for the tax collectors to have definite tax estimation. This leads to tax avoidance in order to expand their profit margin.

1.4 Fleeting or Seasonal Nature of Informal Sectors

Normally informal sectors are involved in businesses which are very difficult to measure and capture. Their businesses are done seasonally and they are transitory in nature. It is common place for these people to engage in a particular activity which is possible in specific period of the year.²⁵ Therefore the businesses depend on seasons. Selling of fruits during their season and when the season ends, the seller may engage in another activity like selling of second hand clothes is an example of the nature of businesses in this sector. One feature that needs to be noted is that change of business in relation to change of seasons also goes hand in hand with transferring from one place to another.²⁶ In this regard, it is difficult for the government to manage them. As a result, the government receives very little income tax from this sector. In most cases the sector operate from underground. This makes it difficult to capture the group for the government income.²⁷

1.5 Migratory Nature of Informal Work

This is another challenge of informal sector. It is characterised by a habit of having no permanent place of business. This presents many challenges. They include difficulties in accessing market, unfaithful and unreliable customers, and

20 Kolstad I et al, (2006) *Bribes, Taxes and Regulations.. Business Constraints for Micro-Enterprises in Tanzania*. CHR Mchelsen Institute Norway. "the informal sector are subjected to high rate of business failure, high administrative cost, low productivity, under capitalization, shortage of skills, poor attitudes of the borrowers, collateral, legally registration as a limited liability company; and submission of feasibility studies.."

21 Masuke E(2010) Recent African Experience in SMEs Financing – A Case Study of CRDB Bank LTD (Tanzania). A presentation Paper.

22 Kengere,O., et al (2011). An Assessment of the effect of proper book keeping on the financial performance perspective from small and medium Scale Business Enterprises Kisiji Municipality

23 Olomi. D., et al (2018) Constraints to Access to Capital by Tanzania SMEs, Dar es Salaam: REPOA

24 M.P Morland And C Dobie, "Africa Ethics and Sustainability Within SMEs In Sub Sahara Africa Enabling Contradicting and Contaminating Relationship" In L. J. Spence And M.P. Moorland, (Eds) The International Society Of Business, Economics And Ethics Book Series, Heidelberg London , New York, 2010, p. 22

25 <https://books.google.co.tz/books?isbn=019872845X> (Edwin G. Nelson and Erik J. De Bruijn (2005). The informal sector of the Tanzanian economy is a changing, heterogeneous mixture of enterprises operating wholly or partially outside of the government system of regulation. It flourishes partly because informality offers opportunities of economic necessity to the poor, most of who will never be able to assimilate the costs of formalization, and partly because it offers others a low cost arena for experimentation that can lead to business growth. Some enterprises do formalize voluntarily, the stimulus for which can be represented as an economic function determined by the values that operators assign to institutional incentives, opportunity costs and formalization costs, and the process can be represented as an exchange transaction with government.

26 F . Schneider," The Size and Development of The Shadow Economy Around The World And Its Relation. The hard to tax aysps.gsu.edu/isp/2636. Html- America (accessed on 6th September, 2018),

27 T.A. Backu,(et al) "SMEs, growth, and poverty: cross- country evidence" 10,3, *Journal of economic Growth*, 2005 p. 220

poor growth of a business.²⁸The other challenge is in relation to the difficulties of capturing these individuals for tax purposes. As they make different places to be their selling places for their product, this makes the assessment of tax collect.²⁹

1.6 Tax Evasion and Tax Avoidance

Tax avoidance is the practice and technique whereby one arranges his business affairs such that he pays little or no tax at all without contravention of the tax laws. Section 35 of Income Tax Act of 2008 defines tax avoidance³⁰ and also empowers the commissioner to make adjustment to any arrangement where he is of the opinion that the arrangement is tax avoidance.³¹

Tax avoidance is not punishable by the law. Thus where the tax authorities detect the practice of tax avoidance, the only solution is to amend the law in order to cork the loophole and weakness of the law which allows the possibilities of tax avoidance.³²

Tax evasion on the other hand involves tax payers deliberate contraventions of the laws in order to minimize or eliminate tax liabilities altogether by paying no or little tax through violation of the law. Tax evasion is the application of fraudulent practices in order to minimize or eliminate tax liabilities. Unlike tax avoidance, tax evasion is punishable by the law. Examples of tax evasion includes making a false return of income by omitting or understating income or overstating expenses or making false statement in a return affecting tax liabilities.³³

It is common ground that about 60 to 80 percent of the Small and Medium Enterprises sector do not pay tax because of small sizes of their capital, turnover and profit generated from their operations. Not paying or negative taxes is a means of increasing business net

28 Robinson, D.O., "Tanzania: Growth Acceleration and Increased Public Spending with Macro Economic Stability." In Chuhan-Pole, P. and Angwafo, M., (Edts), *Yes African Can success: Stories from a Dynamic Continent*, The World Bank Washington DC-Street NW, USA, 2011, pp. 1-20.

29 *Ibid*.

30 Section 35 (3) of the Income Tax Act of 2008 state that, "For the purposes of this section, "tax avoidance arrangement" means any arrangement - (a) one of the main purposes of which is the avoidance or reduction of liability to tax of any person for any year of income; (b) one of the main purposes of which is prevention or obstruction in collecting tax; or (c) where the main benefit that might be expected to accrue from the arrangement in the three years following completion of the arrangement is - (i) an avoidance or reduction of liability to tax of any person for any year of income; or (ii) prevention or obstruction in collecting tax, but excludes an arrangement where it may reasonably be considered that the arrangement would not result directly or indirectly in a misuse of the provisions of this Act or an abuse having regard to the provisions of this Act, other than this section, read as a whole."

31 Section 35(1) of the Income Tax Act of 2008 state that, "Notwithstanding anything in this Act, where the Commissioner is of the opinion that an arrangement is a tax avoidance arrangement, he may by notice in writing make such adjustments as regards a person's or persons' liability to tax (or lack thereof) as the Commissioner thinks appropriate to counteract any avoidance or reduction of liability to tax that might result if the adjustments were not made."

32 (PDF) Avoidance and Evasion Tanzania By Godlove MMari | Godlove https://www.academia.edu/.../Avoidance_and_Evasion_Tanzania_By_Godlove_MMari. (Accessed on 13 June 2019)

33 Sections 98, 99 and 100 of the Income Tax Act of 2008, As follows; Section 98(1)A person who fails to - (a) maintain proper documents for a year of income as required by section 80(1); (b) file an estimate for a year of income as required by section 89(1); or (c) file a return of income for a year of income as required by section 91(1), shall be liable for a penalty for each month and part of a month during which the failure continues calculated as the higher of - (d) 2.5 percent of the difference between the income tax payable by the person for the year of income under section 4(1)(a) and (b) and the amount of that income tax that has been paid by the start of the start of the month; or (e) Tshs. 10,000 in the case of an individual or Tshs. 100,000 in the case of a corporation. (2) A withholding agent who fails to file a statement as required by section 84(2) is liable for a penalty for each month or part of a month during which the failure continues calculated as the higher of - (a) the statutory rate applied to the amount of income tax required to be withheld under Subdivision A of Division II of Part VII from payments made by the agent during the month to which the failure relates; or 89 (b) Tshs. 100,000; Section 99(1) This section applies where - (a) an installment payer's estimate or revised estimate of income tax payable for a year of income under section 89, which shall be used to calculate an installment of income tax for the year of income payable under section 88; shall be less than (b) 80 percent of the income tax payable by the payer for the year of income under section 4(1)(a) and (b) (the "correct amount"). (2) Where this section applies, the installment payer shall liable for interest for each month or part of a month (the "period") from the date the first installment for the year of income is payable until the due date by which the person must file a return of income for the year of income under section 91(1). (3) The amount of interest that an installment payer must pay for each period under subsection (2) shall be calculated as the statutory rate, compounded monthly, applied to the excess of- (a) the total amount that would have been paid by way of installments during the year of income to the start of the period had the person's estimate or revised estimate equaled the correct amount; over (b) the amount of income tax paid by installments during the year of income to the start of the period and Section 100.-(1) A person who fails to pay tax on or before the date on which the tax is payable shall be liable for interest for each month or part of a month (the "period") for which any of the tax is outstanding calculated as the statutory rate, compounded monthly, applied to the amount outstanding at the start of the period. (2) For the purposes of calculating interest payable under subsection (1), any extension granted under section 79(2) or 93 shall not be applied. (3) A withholding agent may not recover from a withholder interest payable by the agent in respect of a failure to comply with section 84(1) or (3),

worth and keeping more of the wealth for the purpose of further investments. Negative taxes help micro and small businesses to survive and grow and get ahead in life significantly.³⁴ Thus the government fails to obtain tax from the SMEs.

To solve this the Government rationalized the presumptive scheme by introducing a new simplified taxation schedule for small business taxpayers as part of a drive to make it easier for informal sector operators (including start-up businesses) to register, formalize and start paying taxes. The First Schedule of the Income Tax Act of 2008 defines and provides content and structure of Presumptive Income Tax in Tanzania. However, the scheme could not accommodate all informal sectors due its requirements which seem to be difficult to be adhered by the SMEs.

In order to address the problem of taxation of informal sector in 2016 TRA conducted a policy research study aiming to pull small and medium enterprises into the tax net and introduced presumptive taxation scheme. Whereas the scheme has managed to simplify the taxation for operators in the informal sector to enter in the tax net, significant number of the operators in the informal sector still operate outside the net. However to date, the only success so far is identification of SMES which is a crucial stage for taxation process.

Therefore, this article proposes that, there is still a need to put in place a more simplified presumptive income tax structure in Tanzania that will promote an enabling and supportive environment to the development and taxation of the informal sector. This is because SMES are in huge numbers and if they could be taxed, the government revenue would have increased and this could have improve social services provisions to the citizens. Therefore Tanzania should find a better way to place the informal sector in the tax base for improvement of taxation.³⁵

1.7. Conclusion

This article looked at the legal challenges that contribute to the rapid growth of informal sector in Tanzania, as not all persons in the informal sector are in tax base. The informal sector as a part of SMEs is categorized by two groups; the formal SMEs and Informal SMEs. To that effect, the formal SMEs consist of those businesses which can be taxed by the use of Presumptive Tax System. On other hand, the informal SMEs are not taxed. This shows that there is inadequate strategy in place for placing them in tax base.³⁶ With all these, taxation system of the informal sector in Tanzania seems to be a current issue which poses serious dilemma in tax. Tax law does not comprehensively provide for informal sector (micro informal sectors –MSMEMs) as it does to the formal sector.

34 Muhanga, M. I., et al (2014), How informal is the Informal Sector? An analysis of the Setting and Characteristics of the Informal Sector in Morogoro, Tanzania. A paper presented at Mwenge Catholic University 1st Annual Conference, October 29th – 30th, 2014, At Moshi, Kilimanjaro, Tanzania.p.166-167

35 D. Romav., "Costs And Benefits Of Marginal Reallocation Of Tax Agency Reallocation Of Tax Agency Resource In Pursuit Of Hard –To-Tax Groups " aysps.gsu.edu/isp/2636.html-North America, (accessed on June 6, 2018),

36 E.G. Nelson and E.J. De Bruijn, " *The Voluntary Formalization of Enterprises in a Developing Economy: the Case of Tanzania*" Journal of International Development, 2005.

Despite the call for registration of informal sector, there is little improvement made thus far. The government is thus alerted to re-think of new methods of taxing small businesses.³⁷ Consideration may be made on the merits and demerits of adopting ways applicable to other sectors in Part III Division I: Subdivision A and B in the Income Tax Cap 332 RE 2008 which include employers, businesses and investments. On the other hand the government should promote voluntary compliance to the rules of taxation and have a self-assessment approach. This can be made by using information technology to facilitate communication with all tax payers and putting in place special officers for taxing these informal sectors in order to bring them to tax base.

37 As also provided under Paragraph 2.-(1) of the 1st Schedule of The Tanzania Income Tax Act of 2008 which provides that, Where a resident individual meets the following requirements for a year of income the individual's "income tax payable with respect to section 4(1)(a) for the year of income shall be equal to the amount of presumptive income tax provided in subparagraph (3): (a) the individual's income for a year of income consists exclusively of income from a business having a source in the United Republic; (b) the turnover of the business does not exceed the threshold in subparagraph (2); and (c) the individual does not elect to misapply this provision for the year of income. (2) The threshold referred to in subparagraph (1)(b) is Shillings. 20,000,000".