

# **FIAS-ISSER**

## **Regional Conference on Enterprise Formalization in Africa**

Accra, Ghana, January 10-11, 2007

### **Summary of Proceedings**

#### **I. OPENING SESSION**

**Chair: Dr. Ernest Aryeetey, Director, Institute for Statistical, Social and Economic Research, University of Ghana**

**Nigel Twose, Foreign Investment Advisory Service**

The key objective of this Conference is to develop a practical framework for thinking about enterprise formalization and to gather information for a study on the process. Important for Africa because of the high degree of informality and the generally weak business environments.

Basic assumptions are (i) that there is a continuum of formality, not a simple duality; and (ii) entrepreneurs essentially make a cost-benefit assessment as to whether it is worth their while to register. In this context, there are three broad approaches to increasing degree of enterprise formalization:

- Coercion (doesn't work well; largely inappropriate)
- Regulatory simplification – reducing the hurdles to registration e
- Incentives

Note that the topic has a gender dimension, given that women are disproportionately represented in the informal economy, which is generally lacking in social protection as well as economic opportunities.

**Hon. Alan Kyerematen, Minister of Trade, Industry, Private Sector and Presidential Special Initiatives**

This conference is historic and timely. The term “informal sector” was first coined by Keith Hart in the course of his studies in Ghana of activities in low-income communities. This term was picked up, expanded and popularized by the ILO, and we are happy to welcome Keith Hart back to Ghana. Ghana is preparing for its 50<sup>th</sup> Anniversary of Independence, and continues to be a leader of Africa, with an ambitious vision of becoming a middle income country by 2012. This is an appropriate time to investigate how to better realize our economic potential and independence.

Ghana has been successful in achieving macroeconomic stability. The challenge is to proceed from stability to growth. A critical question is what role the informal sector can play in further economic transformation. Rather than reading a prepared statement [attached?], I would like to raise four basic questions for this conference:

1. How do informal enterprises emerge in the first place, and why do they remain informal?
2. Is it desirable or not to seek to promote enterprise formalization?
3. Which types of business models will best promote enterprise formalization?
4. What role can governments play in promoting enterprise formalization?

1. Most informal enterprises arise for survival, because of limited opportunities in formal sector. Once there, there is little perceived benefit to formalization, given small size and cost of registering. Also, they have little knowledge about the process of registration.

2. Desirability of formalization depends on whose interests you are trying to promote. It is often not clearly in the interests of the informal enterprises themselves. Formalization is often viewed from the perspective of regulators or getting them into the tax net. If only take the latter perspective, it will not be very effective. Need to consider how to ensure that benefits to the enterprises will accrue from formalization.

3. Need business models that promote formalization. In Ghana, have tried a number of interesting models (see formal presentation). E.g., trying to bring groups of disadvantaged individuals to participate in the economy as a corporate business entity, as a way of pooling resources together and moving beyond limitations of a cooperative.

4. Governments can:

- Facilitate access to credit and finance, including through investment in financial institutions oriented toward this market;
- Facilitate provision of business development services;
- Infrastructure support;
- Commercial and market linkages to bring them into the value chain process and to markets;
- Technology development services.

#### **Hon. Kwadwo Baah-Wiredu, Minister of Finance and Economic Planning**

Would like to share Ghana's experience in trying to ensure tax compliance in informal sector. Labor Dept. estimate that about 80% of labor force is engaged in informal enterprises (operating without direct license or permit). In this situation, it is difficult to implement tax collection, as well as to provide services. For example, whereas Registrar-General's office has registered 127,000 limited liability companies, only 16,000 appear on the books of the Internal Revenue Services.

The transition from informal to formal status with respect to taxation requires innovative measures. Some measures that have been taken to accommodate informal activities include:

- Vehicle tax system for commercial operators (quarterly collection);
- Tax stamp regime for small-scale businesses;
- Tax amnesty granted to informal enterprises that come into tax system;
- Opening regional offices and establishment of special bureaus to handle micro and small business at District level.

We are working with Ministry of Local Government to improve naming of streets and numbering of houses. Also working on freeing debt capital, in line with proposals of Hernando de Soto.

For longer-term, looking at flat tax system and working with business associations as ways to simplify the system. Trying to improve customer service orientation of tax authorities. Discussing introduction of information on taxation as part of educational curriculum, to better inform public.

## **II. PLENARY PRESENTATIONS**

### **Papa Demba Thiam, World Bank**

#### **Introductory Framework for Thinking about the Formalization Process**

The transition from informal to formal is a normal process of industrialization and development. Process is triggered through incentives and enabling environment reforms (e.g., access to credit, trade facilitation, formalization of business linkages), making costs of formalization worthwhile. Informality limits enterprise growth and access to markets. High degree of informality outside tax nets limits ability of governments to mobilize resources to provide public goods. Informality represents absence of social protection and benefits.

There is scope for small & medium enterprises (SMEs) to supply inputs into global supply chains. To participate in global market, need to: (i) access banking services and credit (requires formal accounting); (ii) comply with standards; and (iii) minimize reputational risk via corporate social responsibility.

For governments to benefit from increased formalization, need to (i) generate a level playing field for formal firms of all size; (ii) improve transparency in monitoring economic activity; (iii) clear framework for revenue collection and provision of public goods; and (iv) policy dialogue to improve business environment of all firms.

Barriers to formalization include: (i) reluctance of entrepreneurs to expose themselves (especially when revenue collection is characterized by rent-seeking); and (ii) costs that may put formal firms at a competitive disadvantage.

To support increased formalization (and reverse trends toward informalization), need to transform threats into opportunities, by: (i) limiting opportunities for rent-seeking (monitoring, incentives for transparent enforcement of regulations); (ii) building reciprocity and trust (transparent allocation of government resources; improved dialogue with informal firms); (iii) improve information flows; (iv) provide practical support (investment promotion packages; linking informal entrepreneurs to subcontracting opportunities; capacity building programs)..

### **Joseph Ayee, University of Ghana**

#### **Building Tax Compliance through Reciprocity with Government**

Reasons for interest in taxing the informal sector: (i) revenue needs; (ii) size and growth of the sector; (iii) impact on tax compliance in formal sector; (iv) state legitimacy; (v) demands from informal sector for legitimacy (avoid harassment); and (vi) tax accountability (if pay taxes, can demand services from government).

Scope of the informal sector in Ghana. Large and diverse (but no reliable data). There are some 40 associations representing diverse activities of informal sector. Mainly self-employed and family businesses. Tax evasion via (i) non-declaration of income; (ii) under-declaration; (iii) inflation of deductions from income.

Difficulties in taxing the informal sector: (i) Business transactions are done in cash; (ii) lack of proper record-keeping; (iii) inappropriate tax mechanisms; (iv) capacity constraints, poor conditions in revenue service; (v) lack of incentives to pay tax; (vi) politics (large informal is a potential source of votes).

Differences vis-à-vis other sectors. (i) nature : diversity, mobility, illiteracy, etc ; (ii) no culture of compliance ; (iii) inability of revenue agencies to gather information and establish relations with informal sector.

Incentives for people to pay tax: (i) ‘social contract’ for government to provide public goods and services in return for payment of tax; (ii) good governance, support of government; (iii) culture of compliance (lacking in Ghana; taxation regarded as colonial legacy); (iv) technical efficiency of the revenue authority. Are people more willing to pay taxes under one regime or another in Ghana?

Association taxation in Ghana: Identifiable Grouping Taxation started in 1987 with Ghana Private Road Transport Union (GPRTU). GPRTU took responsibility for collection, for a fee; collections went up. Extended to 13 other informal institutions (2.5% commission). Nevertheless, problems included: (i) evasion; (ii) poor returns; (iii) lack of internal democracy and transparency. IGT abolished 2003 and replaced with stamp tax, other mechanisms.

For effective taxing informal sector, need reciprocity with government, increasing government capacity to perform its role through better enforcement of rules and regulations, atmosphere of trust, incentives, public education.

Conclusions: Must use combination of approaches for taxing (diverse) informal sector. Cannot expect rapid advance in collection, given lack of data and effective mechanisms. Strength of the state is an important determinant of its ability to extract revenues.

### **Faycal Sharara, Senegal**

#### **Taking Advantage of Market Opportunities through Upgrading**

Will examine the fishing sector in Senegal, how the relationship between informal and formal sector enables the former to participate in global markets.

The informal sector is considered to be well developed in Senegal; only 3% of workers are in formal, registered sector. Wide variety of goods and services are available on the streets. Why is informal sector relatively extensive in Senegal? Have people *chosen* to be in informal sector, or could they move away if they wanted? Inherited laws are not well suited to the economic conditions – leads to informality. Given the very small role of formal employment, it is informal sector that holds together the social fabric.

New government in Senegal (since 1999) has succeeded in increasing revenues – more than in proportion to growth in the economy. Has taxed informal sector through various means, to bring them into tax net. But: not clear to informal sector that this is benefiting them (number of Parliamentarians increased considerably). Questions: (i) Is growth of informal sector related to lack of transparency in government? (ii) Is (lack of) competitiveness of the economy a cause of informality.

Fishing sector is a significant sector in Senegal – about 500,000 workers; primary foreign exchange earner (\$320 million). Much of it (75%) from artisanal fishing. For factory processing, norms of artisanal fishing do not meet standards. Need to upgrade artisanal fishing practices. Have wholesale fishmongers – fund them, so that they can improve

standards and provide export industry with acceptable supply. Also provide ice blocks to ensure quality of fish maintained during transport to the factory. Problem: have to undertake substantial transactions in cash, without receipts. Factories have to create invoices in order to keep track.

On basis of those invoices, tax authorities tried to collect taxes from wholesale fishmongers. Then no one wanted to sell to the factories.

In groundnut sector, state took over sale of groundnuts. But farmers were never paid; system failed. Hence cash payments are important for smooth functioning of system.

Collaboration among private sector agents is essential in order to comply with European standards. Fishing sector has grown significantly since devaluation of CFA Franc in 1994. This has been due to good collaboration of informal and formal sectors. But have to continue moving in direction of formalization for continued growth and good management of the sector.

## **Discussion**

1. Ibrahim Diouf, Director of SMEs, Senegal: Was in informal sector union of about 100,000 members. Formalization of informal sector should not be considered as a constraint, but should emanate from an approach that encourages informal workers to move toward formal to improve their market access and sustainability. Should improve the business environment with specific legislation for informal sector, recognizing that a large number represent unskilled, illiterate migrants from rural areas. Questions: What are the legal constraints to formal registration and what are the supporting measures and tools that should be developed to improve access to world markets by these enterprises? What should be the role of development partners in design, establishment and implementation of support programs for informal sector?

2. Gindeel Ibrahim Gindeel, Sudan: Need to differentiate two types of informality: (i) Agriculture and livestock (about 40% of GDP in Sudan); (ii) evaders from taxation. For agriculture, problem is how to increase returns, to reduce incentive to migrate to towns. For latter, problem is the tax system: taxes too high, stringent, inequitable; encourages informality. Tax system should recognize implications of extended family obligations. To broaden tax base, need to lower rates to make them reasonable, make it easier for evaders to come in (need amnesty to encourage compliance).

3. Mohammed Salisu, Sierra Leone: How does government combine carrot and stick approaches to

4. Ellen Bortei-Doku Aryeetey, ISSER. There are often subsidies and benefits to formal sector enterprises. Also, workers in formal sector may have informal operations. Formalization is not so clear-cut – there is a gray area of overlap.

5. Rudith King, Ghana: People in informal sector may not speak same language as we are speaker here. Need to build mutual appreciation – communications strategy, to communicate need to pay tax.

6. Paulo Fumane, Mozambique. There seems to be some confusion of “informal” and “illegal.” If activities are illegal, that is one thing; if purely informal, let’s support them. Do we really need formalization, or simplification. Make systems simple and affordable.

7. Sam Jalloh, Sierra Leone: How to extend social protection to informal workers, to secure them in old age?

8. Keith Hart, UK. Reciprocity, as stressed by some speakers, is essential. Difficult for governments to enter into equal relationships with citizens. When governments have established effective tax systems, it has historically been by offering public services and benefits. Also, originally there was the idea that revenues should come disproportionately from the rich and benefits distributed disproportionately to the poor. But nobody talks about redistribution any more.

9. Bernard Collignon, H2O Conseil: Challenge to bring the 97% of people from informal sector into formal seems impossible. But there are some feasible partial solutions. In particular, intermediate bodies, with one foot in formal sector (association) and another foot in informal (members).

10. Francis Kusi, Ghana: Strengthen business associations as a first step. Barriers of entry to informal economy are low. Perhaps try to raise the barriers to moving from formal to informal. E.g., require everyone to belong to self-regulatory association, and to receive training as a prerequisite. Use associations to deliver services, training, etc. – reduce direct role of government. If associations can provide better services, members would be more willing to pay dues needed for sustainability.

11. Olga Gomes, Mozambique: What will become of these associations? Our own governmental structures do not take these people into consideration. African social structures are not adequately prepared for these systems. Need to identify people who understand the informal sector and can improve communications.

12. Michael Ayamga, University for Development Studies: Where draw the line between different tax systems instituted by different governments? Need to find tax mechanisms that are most appealing to the people. How is this related

13. Louis Accaro, Tanzania:Private Sector Foundation: Tanzania has a program based on Hernando de Soto’s program for property formalization, so that individuals have title to property which can be used to access finance. New Business Registration Act will require all enterprises to be registered. Taxation comes in after.

14. Nigel Twose, FIAS: Should avoid the connotation that informal sector is somehow “bad” and should become more like “us.” Rather, in many cases where formal business has difficulty operating, informal enterprises have kept economies going. Rather, the problem is that informal enterprises often operate sub-optimally. Take the perspective of the individual entrepreneur and what would be in their interest, rather than that of state to control them

15. Lucie Phillips, IBI: “Reciprocity” may not be the best term, since it implies equality, whereas governments and informal entrepreneurs are not on an equal basis. Rather, the point is that there is an exchange situation. Focus should be less on punishing those who don’t pay taxes more on rewarding those who do – e.g., protection, security, reliable electricity and

water. Sometimes, those who are formal suffer more harassment due to their visibility. Credit bureaus are a good example where formality can improve access to resources, because credit status is known.

16. Raj Makoond, Mauritius: Do policymakers share understanding of the language of business – which is a common language among formal and informal? Clustering offers a vehicle for upgrading of some actors within the supply chain. Outsourcing can include informal small enterprises. Need to build on trust factor (related to family firms).

### *Responses*

**Pape Thiam:** One common issue is the need to develop appropriate business development services (BDS) suitable for informal enterprises – e.g., in Ghana MSME program being supported by the World Bank. Access to finance is also important: financial sector infrastructure in African countries is more relevant to formal sector than to less formal enterprises that need to make the transition. Need to tailor-make financial instruments to support increased outreach to MSME/informal sector. Social values and culture of informal sector are important so that people feel that they belong and have a stake in meeting standards. Also have to build reciprocity in such a way as to highlight tangible benefits associated with paying taxes (being formal). Further, need to create new financial infrastructure, to broaden access to finance.

**Joseph Ayee:** Formalizing the informal sector depends on understanding of the operations of the informal sector, its culture, values, habits. Need communication strategy based on this understanding. In South Africa, deliberately recruited people with a background in informal sector, who could understand the language. Need consultations between government and informal sector to bring them on board. If simply try to enforce (unsuitable) rules and regulations, they will go underground. Since introduction of VAT and tax stamp, more revenues have come in compared with associational approach of early 1990s.

**Faycal Sharara:** Using associations to interface between formal and informal sectors can only be intermediate, transitional solutions. Note that the system in Ghana that worked for a while in the transport sector was stopped. Cannot expect private sector to be long-term tax collectors. Migrating from informal to formal sector requires accumulation of capital. But most people in informal sector can't even pay their bills, feed their family. State can provide support in the area of finance through clear, transparent mechanisms to assist wealth accumulation.

**Ernest Aryeetey:** Have to recognize that there will be costs as well as benefits to the economy of increasing formalization of enterprises. The purpose is not to wish away the informal sector but to make it more efficient, productive, and a wide source of income.

### III. WORKING GROUPS

**Tom Kenyon:** The term “informal sector” has been used to cover a wide range of activities and behaviors. People may be coming from very different perspectives. Need to identify those for whom the process of formalization under discussion can convey the most benefits.

The intention for the Working Groups is to help provide a framework for thinking about the transition from informal to formal. The Conference is highly focused on issues of how governments and business associations can contribute to greater tax compliance and market access, in order to be able to make progress in these areas, while recognizing that there is much more to it. One question will be the extent to which the conclusions will be applicable to policymakers generally and across countries.

#### 1: What Can Governments Do? Tax

- Improve information flows:
  - How to package information about costs and benefits to firms
  - information sharing across government departments & government agencies
- Make connections between carrot and sticks explicit:
  - VAT rebate: pay less on sales than to suppliers if commit to formalize
  - Persuade banks to lend at lower rates to formalizing firms
- How to encourage sense of reciprocity?
  - Immediate demonstration effects: repairing street lights in Monrovia
  - Using business associations to lobby against ‘tips’

#### 2: What Can Government Do? Market Access

- Government not sufficient - need intermediaries to communicate information
- But should provide training to meet standards: Mauritius – tailors & dress-makers
- ICT has changed informal sector: texting market information & pricing

#### 3. What Can Business Associations Do: Tax

- BAs’ role is to provide advocacy and services to members in such a way as to encourage increased registration:
  - Indirectly broadens the tax net
  - Not to directly enforce tax regulations for gov’t (except in certain cases where they agree to act as an intermediary; but not a long-term role)
- BAs can play important role intermediating between Government & MSMEs so that policies, tax regulations, etc. are well designed and accepted
- Governments should facilitate through active dialog with BAs and making resources or challenge funds available via BAs in transparent, non-political way.

#### 4: What Can Associations do? Market Access

- What incentives for formal-informal interaction:
- For firms - profit motive, but will take least cost route: maintain competitiveness at each segment of value chain
- Business associations: varies depending on ownership, legitimacy & representativeness of assoc (donors can distort) viable if driven by problem solving & have ownership of agenda