

An alternative approach to the integration of the informal sector into the South African tax base

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ABSTRACT

TITLE: AN ALTERNATIVE APPROACH TO THE INTEGRATION OF THE INFORMAL SECTOR INTO THE SOUTH AFRICAN TAX BASE

Small businesses in the formal sector emerge from the informal sector. These small businesses play an important role in the economy. The informal sector creates job opportunities for the unemployed and for those who seek entrepreneurship opportunities with limited capital resources.

The South African Revenue Service (SARS) constantly faces a challenge of growing the tax base in order to increase tax revenues from one tax period to the next. There are a number of factors that affect the maintenance and growth of the tax base, one of which is base erosion and profit shifting.

This study discusses the unique characteristics of the informal sector small, micro and medium enterprises (SMMEs) and the nature of their operations. This provides an understanding of the SMMEs in this sector and explores some of the challenges that these informal sectors businesses face in their operations.

The study further discusses whether the current income tax relief initiatives can cater for the uniqueness of the informal sector SMMEs. The study discusses their objectives, practicality in applications and the challenges that could arise in applying them to encourage registration by informal sector SMMEs.

In order to be able to incorporate the informal sector business into the tax base, SARS would need a mechanism or program that allows for the identification of the informal sector business. As a result this study considers a Block Management System that was implemented by Tanzania in 2005 which was developed in order to cater for the unique characteristics of informal sector businesses. The Block Management System's objective is to focus on the physical identification and mapping of taxpayers.

Conclusions drawn from this study are that SARS has realised the importance of small businesses in the economy and has put several initiatives in place for small businesses but currently these provisions do not serve as an incentive for the informal economy small businesses to register and pay taxes. It was found that SARS would benefit from the implementation of a similar program to the Tanzania Block Management System as it will assist with the identification of informal sector businesses to integrate it into the South African tax base.

KEYWORDS

- Informal Sector
- Informal Economy
- Informal trading
- Tanzania Block Management System
- Tax base

TABLE 1: LIST OF ABBREVIATIONS

Abbreviation	Description
CGT	Capital Gains Tax
CIPC	Companies and Intellectual Property Commission
CIT	Corporate Income Tax
DHA	Department of Home Affairs
DTI	Department of Trade and Industry
Eighth Schedule	Eighth Schedule of the Income Tax Act No. 58 of 1962
GDP	Gross Domestic Product
Income Tax Act	Income Tax Act No.58 of 1962
OECD	Organisation for Economic Cooperation and Development
PAYE	Pay As You Earn
PIT	Personal Income Tax
SARS	South African Revenue Service
SBC	Small Business Corporation
Sixth Schedule	Sixth Schedule of the Income Tax Act No.58 of 1962
SMEs	Small and medium enterprises
SMMEs	Small, micro and medium enterprises
TAA	Tax Administration Act No.28 of 2011
TCC	Tax Clearance Certificate
TRA	Tanzania Revenue Authority
TZS	Tanzanian Shillings
VAT Act	Value-Added Tax Act No.89 of 1991
VAT	Value-added tax
VCC	Venture capital company

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CHAPTER 1

INTRODUCTION AND BACKGROUND

1.1 INTRODUCTION

The levying of taxes is imperative for a government to ensure that it achieves its economic objectives which, amongst others, include the economic development of the country and regulating the levels of employment (Croome, 2010). In terms of Sections 3 and 4 of the South African Revenue Service Act (34 of 1997), the South African Revenue Service (SARS) is empowered to administer and collect taxes in South Africa.

In South Africa, income tax is levied in terms of the Income Tax Act (58 of 1962) (Income Tax Act). The Income Tax Act does not define tax base, the Income Tax Act however does define a term referred to as taxable income.

Taxable Income is defined in the Income Tax Act as:

“the aggregate of amounts remaining after deducting from the income (gross income and deemed income) of any person:

- all the amounts allowed as valid qualifying deductions of expenditure and losses incurred in the production of income from carrying on a trade; and
- all exempt receipts and accruals in terms of Section 10 of the Income Tax Act.”

Taxable income is therefore the amount to which the applicable tax rate would be applied in determining the tax liability of a registered taxpayer. The International Labour Relations (2003) defines a taxable base as an amount or thing to which the tax rate is applied. The tax base can be defined as those activities of the taxpayer that generate revenue in the form of income and growth in assets, which after taking into account any deductions and exemptions given by SARS will be subject to taxation.

The amounts to which a rate of tax is applicable (in order to determine the tax liability of a taxpayer) will therefore be based on each of the provisions in each of the Acts SARS administers.

South Africa has a residence-based income tax system. The effect of the residence-based income tax system is that a resident's worldwide taxable income is subject to income tax in South Africa. And for non-residents, taxable income from sources within South Africa are subject to tax within South Africa (SARS, 2014).

The Income Tax Act is an example of legislation relating to income tax, turnover tax on micro businesses, capital gains tax, withholding tax on foreign entertainers and sportspersons, withholding tax on payments to non-residents on the sale of their immovable property in South Africa, donations tax and dividends tax (SARS, 2014). Each has specific rules and provisions of how to determine the taxable income or tax base to which the applicable tax rate will be applied in order to determine the tax liability.

In his 2014 Budget Speech, the Finance Minister at the time, Pravin Gordhan, declared that central to the National Development Plan (NDP) is the commitment to a social pact to reduce poverty and inequality, and to raise employment and investment (National Treasury, 2014:9).

The economic objectives of a country, such as economic development, the reduction of poverty and the creation of employment, require adequate funding to enable the government to achieve these objectives. It is therefore important for any government to have and maintain a sustainable flow of national tax revenue, as this will ensure that the services and deliverables (e.g. infrastructure investments, social spend, etc.) by the government are properly implemented (OECD, 2013; Meena, 2013).

The Organisation of Economic Co-operation and Development (OECD) defines tax revenue as revenues collected from taxes on income and profits, social security contributions, taxes levied on goods and services, payroll taxes, taxes on the ownership and transfer of property, and other taxes (OECD, 2015).

The Minister of Finance, Pravin Gordhan, stated that there is a part to be played by all South Africans (National Treasury, 2014:32). Both the formal and informal sectors of the economy contribute to revenue for national development (Oberholzer and Smulders, 2006:8).

It is important to consider the contribution of the informal sector. The informal sector firstly needs to be properly defined to understand what it entails - but according to Naidoo (2002) (cited by Ligthelm, 2004b), no single definition exists to define the informal sector.

In January 1993, the 15th International Conference of Labour Statisticians (15th ICLS) adopted an international statistical definition of the informal sector that was subsequently included in the revised International System of National Account (ILO, 1993). According to the ILO (1993), the informal sector may be defined as consisting of units engaged in the production of goods and services with the primary intention of generating employment and income. These units operate at low levels of organisation. Labour relations, where they exist, are based on casual employment, and personal and social relations, rather than contractual arrangement with formal guarantees (ILO, 1993).

The 15th ICLS (ILO, 1993) characterised informal sector enterprises as:

- Private, unincorporated enterprises that are owned by individuals or households and not constituted as separate legal entities from their owners.
- At least some of the goods or services produced are meant for sale or barter.
- The size of these enterprises, in terms of number of people employed, is below a certain threshold, and they are not registered in terms of national legislation.
- The enterprises are engaged in non-agricultural activities, including secondary non-agricultural activities of enterprises in the agricultural sector.

According to the World Bank (2014), the informal sector is diverse and includes small-scale, occasional members (such as street vendors and garbage recyclers) as well as larger, regular enterprises.

According to the ILO (1993; 2003), as discussed above, the informal sector could be characterised by a low-scale production of goods and services with the objective of creating employment and income for the persons concerned.

The need to be employed is often the motivation for starting a business (Ligthelm, 2003). Although unregulated, the informal sector is not the same as the criminal or illegal economy; non-compliance in this sector is not to purposely avoid regulations and evade taxes. The motivational factor shows that it is made up of non-standard wage workers and entrepreneurs who produce legal goods and services, even though the way they do it is not regulated (Steyn, 2008). While there might be entrepreneurs who deliberately try to evade paying taxes, some

entrepreneurs are often either not aware of the regulations or they cannot afford to comply with regulations (Steyn, 2008).

1.2 BACKGROUND TO THE RESEARCH AREA

Large multinational businesses have been believed to be the key to economic success. Since the beginning of the 1980's, new and growing small firms were the ones creating most of the jobs (Ligthelm, 2003).

Kirchhoff indicated that many research studies on job-creation statistics have concluded that small to medium sized firms (those that employ fewer than 100 people) create most jobs. (Kirchhoff, 1995:19).

Since the 1980s, when studies have been done on the informal sector, several attempts have been made in measuring the informal sector (Blaauw, 2011).

- The informal economy or sector accounted for roughly 7% of GDP in 1999 (Saunders, 2005);
- Statistics South Africa estimated non-agricultural employment in the informal sector at 18.5% of the total employment in 2007 (Stat SA, 2007).

With such statistics, the informal sector could play an important part in providing jobs and reducing unemployment. The informal sector provides support to entrepreneurial activity and helps alleviate poverty (World Bank, 2014).

In his 2006 State of the Nation Address, the former president of the Republic of South Africa, Thabo Mbeki, emphasized the need for cooperation between large entities, government and development partners, to ensure that the benefit of economic growth filters down to the lower end of the informal sector (National Treasury, 2006).

While briefing the media on 25 October 2010, current President, Jacob Zuma, justified the Economic Growth Path Strategy as part of the response to the needs of SMMEs in South Africa (Zuma, 2010). This is an indication that, although it is seen as a sector which does not have rules and regulations (Steyn, 2008), the informal sector plays a significant/important role in South Africa.

Jerven (cited by Ingle, 2013a) observes, appropriately, that the accurate reporting of GDP: “may be interpreted as an indicator of the power of a state. It expresses how much a state knows about itself, and this ability to know and to monitor is a direct measure of state power and may also be related to state legitimacy.”

1.3 MOTIVATION OF ACTUALITY OF RESEARCH TOPIC

Adcorp’s Employment Index (2014:1) indicated that the South African economy created 23,861 jobs during November and December 2013. Of this total, the informal sector alone added 12,722 jobs during this two-month period. For the period January to December 2013, the informal sector was recorded to have added 73,799 jobs, compared to the total decline of 241,536 in permanent and temporary jobs for the January to December 2013 period. These statistics reflect the growing importance of the informal sector in the South African labour market.

According to Statistics SA (2016), employment gains were realised for the formal sector for two quarters (quarter 2 and 4) of 2015, while the gains in the informal sector were realised during quarter 2 and 3 of 2015. In quarter 1 of 2016, both the formal and informal sectors experienced decreases in employment - with the formal sector showing a decrease of 217,000 and the informal sector a decrease of 111,000 jobs. This decrease, for both sectors, has been considered the largest since 2010.

Sharp (2014) stated that, with the growth experienced by the informal sector in South Africa, the informal sector is creating the much-needed jobs for the unemployed and unskilled - and alleviating poverty within many South African communities. Should the South African informal sector continue to grow and continue to play a greater and increasing part in the economy, the ideal would be for the government to become aware of this and become much more supportive of legitimate activities within the sector (Davids, 2011:3). The informal sector could play a key role in releasing the entrepreneurial spirit in South Africa (Ligthelm, 2003), and, as a result, create much-needed jobs and help to alleviate poverty in the country.

This study is pursued with the belief that knowing the dynamics of the sector may contribute towards an increased awareness of this important but unrecorded sector of the economy. This study aims to achieve an understanding into the informal sector and define the needs of this sector to comply with laws and regulations. By their nature, informal sector activities escape

regulation but that does not necessarily imply that they are unlawful or criminal (World Bank, 2015).

This study aims to identify the unique characteristic of the informal sector - and to determine how processes and procedures unique to this sector could be designed, to encourage voluntary compliance and allow government to monitor and measure the contribution of the informal sector.

Everyone needs to play a part in the development of the country (National Treasury, 2014:32), the informal sector could make a big difference in national tax revenues, and government may assist in the growth of this sector. With growth, some of these enterprises may move up into the formal economy.

Tanzania is one of the countries that faced a similar need to South Africa to expand and grow on their tax revenues. Tax administrators (the TRA) identified the importance of the formal and informal sector in the development of their country (Tanzania Revenue Authority, 2008:2,11).

The nature and structure of the Tanzanian economy is similar to that in South Africa – namely, a large informal sector, not well understood by tax authorities. Kimunyu and Kileva (2007) stated that the Tanzanian economy was characterised by small firms and very large micro enterprises. They categorised small and medium taxpayers based on their turnover. Small taxpayers earned on average between (Tanzanian Shilling) TZS0-39 million (that is, R0– R284 784) whereas medium taxpayers were those with a turnover between TZS40-9999 million (R284 784 – R71 188 938). Many of these small and medium taxpayers were noted to be operating in the informal sector (Kimunyu and Kileva, 2007).

The absence of systems and mechanisms in the Tanzania Revenue Authority (TRA) to reach a large number of taxpayers, as well as the limited knowledge about potential taxpayers in the informal economy, were identified as the challenges hindering the widening of the country's tax base in order to attain and sustain a targeted tax-to-GDP ratio of at least 20% in 2010 (ADBG, 2010).

In their need to expand and grow tax revenues in Tanzania, the TRA embarked on a drive to ensure that all reachable taxpayers (both formal and informal) were identified, registered, and forced to pay tax.

The programmes implemented included (Kimunyu and Kileva, 2007):

- Taxpayer education
- The Block Management System
- Presumptive Approach
- Assessment procedures
- Collection formalities and procedures

These programmes (as listed above) aimed to identify the potential taxpayer. Of greatest interest is the Block Management System (BMS).

The BMS was selected for this study, as it will assist in achieving the objectives of the research. In accordance with the view of Kimunyu and Kileva (2007), it addresses the integration of the informal sector, identifies possible new taxpayers, and attempts to encourage the culture of compliance across the formal and informal sectors.

The BMS is a system that was implemented by the TRA with the following aims (Kimunyu and Kileva, 2007):

- To put in place sustainable methods and strategies to monitor business activities.
- To monitor the activities of small and medium taxpayers, with a view to making them pay tax in a cost-effective way, thus reducing the compliance cost burden on these small to medium businesses.

The BMS system involved door-to-door surveys by TRA-appointed representatives. Each representative was allocated a demarcated geographical area/blocks. Each block was subjected to the full tax function of registering, assessing, collection and accounting for revenue (CMI, 2012). The representatives are responsible for updating the taxpayers' personal and business information (Kimunyu and Kileva, 2007:19).

The introduction of the BMS was communicated to communities via seminars, radio and television programmes; outreach programmes to business places or trading centres; help desks and customer service points; and billboards, to name a few (Kimunyu and Kileva, 2007).

The main objective of the BMS is to have in place a sustainable method - and strategies - to monitor the business activities of small and medium taxpayers, with a view to making them pay tax in a cost-effective way (Tanzania Revenue Authority, 2008:9).

Between the 2010/2011 and 2012/2013 tax years, the number of SMEs in Tanzania grew from 372 600 to 493,714, and the revenue collected from these entities during this period increased from US\$ 500m to US\$ 900m (TRA, 2012).

Tanzania has been selected for the purposes of this study due to the nature of their informal sector, which operates under similar conditions as those in South Africa. With their economy characterised by small firms and very large micro enterprises, many of which operate in the informal sector, the TRA was faced with the challenges of the identifying and registering of enterprises as well as the non-compliance by these enterprises (Kimunyu and Kileva, 2007).

There have been challenges faced in the process of implementation, which have led to the formulation of further improvements to the system through constant monitoring and evaluation (African Tax Administration Forum, 2014).

Based on the literature review performed, it was found that the informal sector characteristics and challenges facing businesses in this sector, that were identified in South Africa are similar to those that exist in Tanzania as noted in par 2.4, 2.7, 4.3 and 4.5 of this dissertation (Bureau of Economic Research, 2016 and African Tax Administration Forum, 2014).

These unique characteristics of the informal sector have made it a challenge for the SARS and Tanzania Revenue Authority to tax the informal sector. TRA's BMS program was implemented in Tanzania to address the challenges of identification and registration of informal SMMEs. This program/system could possibly assist South Africa in identifying and registering informal sector business and have them form part of the tax base.

1.4 PROBLEM STATEMENT

The informal sector is a growing economy that could contribute substantially to the revenue of South Africa. It is however a challenge to integrate the informal sector into the tax base, due to many constraints.

SARS has since 2001 made efforts to encourage the use of the SBC concept to encourage compliance of small business corporations by making use of certain incentives.

This study seeks to address this problem by answering the question whether the current tax relief initiatives for small businesses introduced in South Africa could be successfully applied in encouraging compliance in the informal sector to grow the South African tax base. Furthermore, the study seeks to determine if the Tanzania Revenue Authority Block Management System could be a possible alternative approach for South Africa to integrate the informal sector into the existing tax base.

1.5 RESEARCH OBJECTIVES

1.5.1. Main Objective

The main objective of the research is to consider if existing South African legislation can encourage the growing informal sector into contributing to the national tax revenue, and to consider the Tanzania Block Management System as a possible approach for South Africa to adopt, to address this problem.

1.5.2. Secondary Objectives

To address the main research objective, the following secondary research objectives must be achieved:

- i. To obtain an understanding of the nature and environment of the informal sector in South Africa, limited to only the tax implications. It is important to gain a comprehensive understanding of the informal sector and how it operates. This objective will be addressed in chapter 2.
- ii. To evaluate the applicability of the current tax legislation and tax initiatives implemented by government in integrating the informal sector into the formal sector's compliance culture. This chapter will review and evaluate the current provisions of the Income Tax Act, and assess whether the current tax legislation has been able to fully cater for the integration of the informal sector. Focus will be placed on the tax-relief initiatives implemented in the past few years for small businesses. This objective will be addressed in chapter 3.

- iii. To evaluate the Tanzania Block Management System to establish if a similar system could be adopted in South Africa that may assist South Africa in being able to integrate the informal sector into the formal sector. This objective will be addressed in chapter 4.
- iv. To summarise and conclude on the findings of the previous chapter. This objective will be addressed in chapter 5.

1.6 RESEARCH METHOD

Previous research has noted that informal sector entrepreneurs are very averse to talking to 'unknown persons' about their tax affairs, as most of the informal sector operators fail to discharge their tax obligations and they fear being discovered and made to face fines and penalties for non-compliance.

“Developing empirical research on informal sector economies offers several major challenges and difficulties. The lack of conceptual clarity and the presence of disciplinary functionalism have created considerable difficulties in formulating an appropriate methodological perspective from which to study the phenomenon (i.e. informal sector).” (Ferman, Stuart and Hoynman, 1987).

The research is primarily a literature study, which is restricted to descriptive research. As such, a hypothesis is not to be set in this research study. The reason for using this approach is that the research conducted on the informal market and its contributions to the economy is voluminous, yet it is scattered over many sources. It was felt it would be optimal to consolidate such research into one concise dissertation.

The information for the literature study has been obtained from:

- Articles published on local and international Internet websites on the subject of the informal sector and its contribution to the South African economy.
- Local and international articles on the subject published in tax and economic journals, and other business publications and newspapers.

The table below provides a description of the research methodology that will be applied to address each research objective.

Table 1: Research objective methodology

Research Objective	Research Methodology
Refer to 1.5.2 (i)	The research objective will be achieved by performing a literature review to understand the nature of the informal sector as well as the operations that are carried out in this sector.
Refer to 1.5.2(ii)	<p>This research objective will be achieved by performing a critical conceptual analysis of the current tax-relief initiatives currently in place to identify and assess whether current tax legislation could accommodate the integration of the informal sector.</p> <p>This chapter will also address any administration challenges identified and how they could be addressed.</p>
Refer to 1.5.3(iii)	<p>This objective involves the study of the Tanzania Revenue Authority programmes that were implemented, in an attempt to put in place sustainable methods to grow their tax-revenue streams. This objective will be addressed through a literature review of the Tanzania processes. As there is no single source of information, the review will include review of newspaper articles, TRA publications, journals, articles and presentations on the processes implemented by the country. The process of identifying the challenges and putting in place the decision to implement the various programmes will also be discussed. Review on whether the programmes implemented were successful and sustainable will also be studied.</p> <p>There is no single source of information, the review will include review of newspaper articles, TRA publications, journals, articles and presentations on the processes implemented by the country.</p>

1.7 CHAPTER DIVISION

The following chapter layout is proposed for the research:

1.7.1. Chapter 1: Introduction and background

The objective of this chapter will be to present the research question and the research objectives that the study would like to achieve. In addition, it will provide a background to why the study has been selected and the research methodology to be applied in achieving the objectives.

1.7.2. Chapter 2: Informal sector, historical overview and literature review

Chapter 2 will aim to provide an understanding of the informal sector and how it operates.

The chapter will start with an overview of the history of the informal sector in South Africa and, through a literature review, the historical methods previously applied to taxing the informal sector.

A literature review in this chapter will provide more insight into the origins of the sector, the informal sector will be extensively defined, and distinguishing characteristics between informal and formal sectors will be identified.

Measuring the informal sector has been identified as a challenge for this dissertation; the role of this sector in the South African economy will be investigated with the aim of providing an idea of the magnitude and size of both the formal and informal sector. Statistics SA provides statistics into job creation by both the formal and informal sectors. Such information will be used to understand the contribution and impact of the informal sector on the South African economy, if any.

The informal sector has for a long time been described as 'difficult-to-tax' because of the high levels of cash transactions, poor or no record keeping, and ignorance of laws and regulations. This chapter aims to analyse and identify these challenges.

This chapter will address the research objective as identified in par. 1.5.2(i).

1.7.3. Chapter 3: Tax relief initiatives applied in South Africa for small businesses

This chapter will consider the present tax initiatives, their objectives, and the practicality of applying this to informal sector entities in South Africa.

The study discusses the income tax-relief initiatives introduced in the South African tax law, the objectives and the practicality thereof. It considers whether these income tax-relief initiatives could be used as a tool to encourage a culture of compliance within the informal sector of the South African economy.

This chapter will address the research objective as identified in par. 1.5.2(ii).

1.7.4. Chapter 4: Tanzania Block Management System

This chapter will focus on the Tanzania Block Management System – the door-to-door survey. The TRA implemented the system with the objectives to promote and enhance voluntary compliance, and to detect taxpayers who are not paying taxes (or the correct amount of tax).

Chapter four will perform an overview of the history of the BMS in the informal sector - the working definition, its measurement and size, the characteristics of and taxation of the informal sector in Tanzania.

This chapter will further evaluate the Tanzania Block Management System to establish if a similar system could be adapted in South Africa - and to possibly suggest an approach that may assist South Africa in being able to integrate the informal sector into the formal sector to contribute to national tax revenue.

This chapter will address the research objective as identified in par. 1.5.2(iii)

1.7.5. Chapter 5: Conclusions and recommendations

This chapter will provide a summary of findings, conclusions and the recommendations of the study.

The outcome of the study will aim to assess whether the current tax legislation can accommodate the integration of the informal sector into the formal sector. This assessment will discuss the factors accounting for the hard-to-tax nature of the informal sector (or informal trading).

It will further aim to provide recommendations on how, and if, the informal sector may be integrated and brought into the pool of existing taxpayers - with possible recommendations for improvements from the Tanzania Block Management System as discussed in chapter 4.

CHAPTER 2

2. INFORMAL SECTOR: HISTORICAL OVERVIEW AND LITERATURE REVIEW

2.1. INTRODUCTION

Many developing countries are dominated by small businesses that operate in the informal sector. Informal businesses have been known to make contributions to the economies of many developing countries through employment creation, the production of affordable goods and services in an attempt to alleviate poverty (Gikenye and Ocholla, 2014).

The aim of this chapter is to provide an in depth understanding of the informal sector, its characteristics and how it operates. The literature review on the informal sector will aim to define the informal sector and where it originates from. With the growth in the sector and its dualism nature in South Africa, this chapter will focus on the economic benefits that would be subject to taxation that arise as a result of the operations undertaken and will address the secondary research objective as identified in par. 1.5.2(i).

2.2. THE ORIGINS OF THE TERM 'INFORMAL SECTOR'

Historically, the informal sector was viewed by many developing countries as a phenomenon that would disappear as modernisation spread through the economy (Marais and Ntema, 2014:127). Portes (as cited by Ingle, 2014), however, held that the sector would not disappear.

According to Ingle (2013a) there appears to be two different opinions as to the actual origin of the 'informality' concept.

The first dates back to 1942, to the scholarly identification of the sector when a Dutch anthropologist, J.H. Boeke, published *Economies and economic policy in dual societies* (Ingle, 2013a). Boeke considered a developing economy as a 'dual' economy, made up of the market economy part of the world and a part which lay outside." This dual concept was taken up and elaborated on by Arthur Lewis in the 1950s and further by development economists Harris and Todaro in a "two-sector framework of equilibrium economics" in 1970 (Guha-Khasnabis, Kanbur and Ostrom, 2006).

A second school of thought credits another British anthropologist, Keith Hart, with having originated the term'. Hart originated the term 'informal economy' in his 1973 paper "Informal income opportunities and urban employment in Ghana", and it is believed that it was through his study that the term was introduced generally to development studies (Ingle, 2013a). Ingle (2013a) contests that Hart's work led to an outpouring of research and policy focus.

Hart's main insights were into the complexity of how livelihoods are shaped, the intertwining of the different types of activities, and the role of the state and bureaucracy in both developed and developing economies (Altman, 2007). Hart (1973) highlighted uncertainty of production activities, terms of employment, and income as a distinctive feature of informality (Blaauw, 2011). His central recommendation was for more empirical investigations to develop an understanding of these activities and how they interrelate. It is for this reason that the study will be based on the concept of informal sector as introduced by Hart in 1973.

2.3. INFORMAL SECTOR DEFINED

Based on the literature available on the informal sector, it is clear that no single definition exists for the informal sector (Ligthelm, 2004b). The sector is diverse and includes small scale, occasional members (such as street vendors and garbage recyclers) as well as larger, regular enterprises (World Bank, 2014).

The informal economy provides an important but poorly understood means by which many citizens in developing countries earn a living, and South Africans are no exception (Ingle, 2014). Although relatively moderate in size, the informal sector has a major role to play in reducing the incidence of extreme poverty (Van der Berg, 1990:38).

Due to globalization, formal employment has decreased everywhere in the world (Steyn, 2008). People cannot wait for governments to create jobs; they are creating jobs for themselves. Hence, the informal economy is growing quickly. The formal sector's inability to absorb growing populations has brought about an increase in the number of individuals hoping to secure an income through entrepreneurial self-employment. The informal sector has gained importance in many developing countries, including South Africa, hence the growth of the informal economy or sector.

Ingle (2013a) is of the opinion that the informal sector is *logically prior* to the formal. The informal is the 'natural' default state of affairs out of which formality arises.

According to Antonites and Van Rooyen (2007) one approach to defining the informal sector is to define what it is not. The informal sector:

- is not the formal sector (non-formal);
- is not controlled by the government (non-plan, hidden, unofficial, unrecorded);
- is not legal (illegal, black, shadow); and
- is not taxable (unrecorded, parallel).

This definition is, flawed as it assumes that all activities of the informal sector are illegal and not taxable.

Blaauw (2011) sees the formal sector as a sector that is regulated and is affected by the direct and indirect taxation laws as well as other government regulations such as labour laws. It is located in markedly different industries from the formal economy. The informal economy is weighted towards trade-based economic activity. The formal economy is located more in service industries (Blaauw, 2011).

Chen (cited by Altman, 2007) outlined three approaches to explaining the informal sector, namely the dualist school, structuralist school and legalist school.

- **The Dualist School:** With development and rising per capita incomes, the informal sector would disappear. The entities were considered to be peripheral to capitalist production systems (Altman, 2007). A high prevalence of informal businesses was seen as a sign of underdevelopment. There has been almost no evidence that informal firms disappear. In 2016 the informal sector still exists, dominated by micro, small and medium firms (Altman, 2007).
- **The Structuralist School,** considers the informal sector as part of a continuum within the market, although located in a subordinate position. This approach would consider the interactions between the formal and informal sectors, whether in buyer-supplier relationships or in employment relationships such as contracting out or casualization. The informal sector contributes to the formal sector's risk mitigation and cost-reduction

strategies (Altman, 2007). Blaauw (2011) explained that the Structuralist School of thought is that the formal economy reduces labour and capital cost by subordinating small informal producers and traders. In this view the informal sector is not seen as a feature of a traditional sector, but instead a central feature of modern capitalist development (Altman, 2007).

- **The Legalist School** argues that the informal sector is comprised of entrepreneurs who want to avoid the costs and hassle associated with formalisation, particularly in relation to business and labour regulation and company tax (Altman, 2007).

The informal sector is often perceived as relaxed, casual, flexible and lacking in rules and regulations. For example, a business in the informal sector is considered to be an enterprise that does not follow the laws which control bigger formal businesses, such as the liability to pay taxes on income earnings.

Steyn (2008) is of the opinion that the fact that the informal sector is unregulated is not the same as the criminal or illegal economy. For many, non-compliance in this sector, is not to purposely avoid regulations and taxes. Ligthelm (2014) contends that some businesses operate partially or wholly outside the law by under-reporting (or not reporting) employment, avoiding taxes, infringing copyrights, and even failing to register as legal entities. Steyn (2008) agrees, by stating that while there might be entrepreneurs who deliberately try to avoid paying taxes, some entrepreneurs are often either not aware of the regulations or they cannot afford to comply with regulations.

Although certain activities in the informal sector derive from the desperation to secure much-needed means of household subsistence, the informal sector is not merely a set of survival positions occupied by destitute people on the margins of society (Horn, 2011). The informal economic processes cross-cut through the entire social structure (Horn, 2011). Informal economy enterprises include not only survival activities but also stable (steady) enterprises and dynamic growing businesses. All informal enterprises are affected by government economic policies (Steyn, 2008).

The World Bank (2014) found that the informal sector provides support to entrepreneurial activity and helps alleviate poverty. Ligthelm (2003) agrees that the motivational factor for starting a business is often unemployment. Steyn (2008) is of the opinion that the motivational factor shows that it is made up of non-standard wage workers and entrepreneurs who produce legal goods and services, even though the way they do it is not regulated.

It has been a widely-acknowledged notion that the informal sector includes all unregistered and unrecorded economic activities that escape detection in the official estimates of the GDP (Ligthelm, 2004). The informal economy embraces all unreported income from the production of goods and services - both legal and illegal, either from monetary or barter transactions – hence all economic activities that would have been taxable if reported to tax authorities (Ligthelm, 2008). Mtshawulana (2008:2) stated that there is no guidance in the Income Tax Act with regard to the taxation of illegal activities, except to prohibit the deduction of expenditure incurred in paying fines or in relation to corrupt activities, as defined. For the purposes of this study the fraudulent activities of the economy are excluded, but might be captured in size estimates.

Informality is not limited to one economic sector, it emphasises the links between the informal and the formal parts of the economy (proper jobs with contracts and benefits according to the law) and it highlights the fact that more and more jobs and enterprises are informal (Steyn, 2008). Steyn (2008) infers that formal jobs are being ‘informalised’, plus more new jobs are being created in the informal economy at the same time. WCPER (2007) found that informal firms source their inputs and/or stock from formal sector businesses, however, very few are able to break into the market supplying larger formal enterprises.

Ligthelm (2014) and Gikenye and Ochalla (2014) are of the opinion that another motivation for informality in the modern economy is the burden of direct and indirect taxation and the burden of government regulations.

Gikenye and Ochalla (2014) also noted that even registered business enterprises are always beyond the pale of social protection, labour legislation and protective measures at the workplace.

According to the ILO (1993), the informal sector is defined as consisting of units engaged in the production of goods and services with the primary intention of generating employment and income to persons concerned. These units operate at low levels of organisation. Labour relations, where they exist, are based on casual employment, and personal and social relations, rather than contractual arrangement with formal guarantees (ILO, 1993).

The OECD distinguishes between the three unrecorded components of an economy, namely the underground, informal and illegal economies (OECD, 2002).

- **Underground economy** is the component that consists of legal and productive activities that are deliberately concealed from public authorities in trying to avoid tax payments and having to meet government regulations such as minimum wages (OECD, 2002).
- **Informal economic** activities are those that are not conducted with the aim of avoiding any government regulations, and therefore legal. Production in this sector is normally undertaken in small households, with owner capital being used for unincorporated enterprises. According to LFS data, nine in ten informal workers reported earnings below the personal income tax threshold in 2001, therefore nullifying the argument that individuals turn to informal sector employment to escape paying tax (WCPER, 2007).
- The **illegal economy**, as defined by the OECD, embraces all forbidden activities and includes production and distribution of illegal goods (such as drugs), illegal services (such as prostitution), the production and sale of counterfeit products (such as false trademarks), smuggling (tobacco and weapons, for instance), resale of stolen goods, bribery and money laundering (OECD 2002). This part of the economy is referred to by others as the third economy.

The OECD (2002) provides a clear guideline on what the informality in the sector refers to. This study will focus on the defined informal economic activities to show that the informal sector comprises not only the illegal activities that come to mind, but legitimate operations that are undertaken in an environment where government regulations have not yet been implemented or are difficult to implement. In many cases, it may be the fact that it is not regulated that makes it attractive; however, the aim is not solely to escape compliance.

Marias and Ntema (2014) is of the opinion that the informal sector has the potential to drive economic growth and job creation in developing countries, and that it is important that this sector should be kept alive for the economic survival of developing countries in particular.

With the continued substantial growth in the informal sector, it is plausible to argue that both overregulation and non-regulation of the informal sector seem to have failed to either completely eradicate (as initially envisaged by governments in developing countries) the sector and its perceived socio-economic ills, or to provide solutions to challenges facing the sector (Marais and Ntema, 2014).

Based on the above, the linkages between the formal and informal sectors makes the two sectors co-exist and assist each other in economic development. This is mainly done through small businesses. WCPER (2007) found that small businesses are to be found in both the formal and informal sectors - and the small business sector can, therefore, not be discussed by contrasting it with the informal sector.

Government strategies are put in place in the belief that small businesses are more prevalent in the informal sector than they are in the formal (WCPER, 2007). This is the approach that will be applied to this study, as it aims to show some of the challenges faced by small businesses in the informal sector that make it difficult for them to operate competitively in the formal, regulated market. Small businesses have therefore been seen as a vehicle to create employment, promote economic growth and redistribute wealth; as such, the promotion of entrepreneurship has been identified as a critical aspect of Growth, Employment and Redistribution (GEAR) (Kambikambi, 2003).

Throughout this chapter, the reasons entrepreneurs engage in micro, small and medium business operations have been highlighted. These are: for survival purposes, where individuals simply want to be able to support themselves; or entrepreneurs seizing the opportunities created by gaps for demand of certain goods and services in the market (WCPER, 2007).

Other than the time and effort required for tax administration and the costly regulatory environment in South Africa, informal businesses face various other constraints, which are specific to the industry in which the business operates, and may vary according to business location, customer profile or product or services offered (WCPER, 2007).

A lack of access to business support services is an important constraint on the growth and development of small and informal businesses (WCPER, 2007). Therefore, there is a need for governments to prioritise intervention in and support for the informal sector through, *inter alia*, training and credit facilities and, most importantly, through the creation of an enabling regulatory environment (Marais and Ntema, 2014).

Several definitions have been considered to explain, categorise and designate the exact meaning of the informal sector (encompassing informal trade activities). This sector represents a spectrum of economic activities in commerce, agriculture, construction, manufacturing, and transportation and services, and epitomises approximately 60% of the

labour force in urban areas of developing countries and subsequently supports the critical importance of defining the focus (Antonites and Van Rooyen, 2007).

The informal sector, by its nature, is necessarily difficult to observe, study, define, and measure. Antonites and Van Rooyen (2007) contends that "there is no single source that readily defines informal economy as a unit of study."

2.4. DISTINGUISHING CHARACTERISTICS OF THE INFORMAL SECTOR

Informality is considered to be unstable in that the activity operates outside of the bureaucratic rules or regulations (Altman, 2007). Many literature studies have been performed on the sector and many agree that the informal sector is characterised by the following characteristics:

- very small scale units producing and distributing goods and services (Gikenye and Ocholla, 2014:31);
- independent, self-employed producers in urban areas of developing countries (Gikenye and Ocholla, 2014:31);
- businesses established to provide income and employment to family members, who often cannot find employment opportunities in the formal economy (Gikenye and Ocholla, 2014:31);
- operate with very little, capital, owner provided capital (Gikenye and Ocholla, 2014:31);
- operate at a low level of technology and skills (Gikenye and Ocholla, 2014:31);
- provide very low and irregular incomes and highly unstable employment to those who work in it, with little protection by labour laws (Gikenye and Ocholla, 2014:31);
- are unregistered and unrecorded in official statistics (Gikenye and Ocholla, 2014:31);
- tend to have little or no access to organized markets, to credit institutions, to formal education and training institutions, or to many public services and amenities (Gikenye and Ocholla, 2014:31);
- are not recognized, supported or regulated by the government (Gikenye and Ocholla, 2014:31);
- individuals engaged in informal sector activity tend to be less educated and have fewer marketable skills than their formal sector counterparts (WCPER, 2007);
- a large percentage of informal businesses are established in non-lucrative business environments (Ligthelm, 2004a);
- operate at a bare survival level (Ligthelm, 2004a);

- as far as legal identity is concerned, informal enterprises do not have corporate status (Ligthelm, 2004b);
- do not maintain a complete set of accounting books (Ligthelm, 2004b);
- enterprises are non-registered units in terms of taxation, labour or any other regulatory frameworks (Ligthelm, 2004b);
- marked ease of entry (Antonites and Van Rooyen, 2007);
- reliance on indigenous resources (Antonites and Van Rooyen,2007);
- labour intensive and adaptive technology (Antonites and Van Rooyen,2007);
- skills acquired outside of the formal sector (Antonites and Van Rooyen,2007); and
- unregulated and competitive markets (Antonites and Van Rooyen, 2007).

Most workers and enterprises in the informal economy produce legal goods and services, although they are sometimes not in conformity with procedural requirements, such as registration or immigration formalities. These activities should be distinguished from criminal and illegal activities, such as the production and smuggling of illegal drugs, which are covered by criminal law and are not appropriate for regulation or protection under labour or commercial law (ILO, 2014).

Despite being viewed as a type of safety net, informal sector employment is inferior relative to that in the formal sector. It is made up of non-standard wage workers such as casual day labourers (Steyn, 2008). There is lack of compliance with labour, safety and minimum-wage legislation, combined with very little bargaining power on the part of informal sector workers, which means that they often have inferior employment conditions (WCPER, 2007).

Employment of workers in the informal sector is often on a temporary, casual or seasonal basis. They are less likely to have written employment contracts or paid leave, and are less likely to have their employers pay pension or retirement contributions or UIF deductions. This leaves informal sector workers vulnerable to exploitation while they work, and in a state of poverty once they no longer are able to work (WCPER, 2007).

The sector plays an important role in transition and developing countries in facilitating successful adjustment to globalisation and structural reforms.

2.5. MEASURING THE SIZE OF THE INFORMAL SECTOR

Consensus is emerging on how to measure informality and activities within the informal sector, but only a few countries, including South Africa, produce regular statistics because market information systems are inadequate in many countries to estimate and monitor the informal economy (ILO, 2014).

The informal sector is notoriously difficult to quantify due to tax non-disclosure and the illegal nature of the activities in this economy (Muller, 2003). The informal sector is hard to tax due to the predominance of cash transactions, poor record keeping, high illiteracy rate, little or no barriers to entry, lack of laid down procedures, ignorance of tax laws (most the informal business owners are reluctant to declare income for the fear of being taxed) (Horn, 2011), and the rootless nature of some business activities and enterprises in the informal sector (Ofori, 2009).

Despite the various factors that cause the informal sector and its activities to be difficult to measure, various methods have been described in literature for measuring the size of the informal economy (Ligthelm, 2006). These methods can be broadly categorized into direct and indirect approaches. These methods are largely based on the work of Schneider (2002), conducted for the World Bank (OECD, 2002; Schneider and Klinglmaier, 2005).

2.5.1. DIRECT METHODS

Direct methods are based on surveys and samples. The surveys may focus on various aspects such as household expenditure, informal business, and unemployment surveys (Ligthelm, 2006).

The advantages of direct methods include that experience has shown that they are considered fair and simple. Respondents are more willing to participate in the questionnaires, while the opposite is found for empirical research in the formal economy (Ligthelm, 2006). This method targets the informal sector directly, for example only targeting those active in the second economy. This method would also give insight into the characteristics, composition and dynamics of the informal sector.

The disadvantages are linked to the flaws of survey research, which include among others the willingness of the respondent businesses to participate in the survey, average precision (due to this it is conceived that the survey method underestimates the size and can be regarded as providing conservative estimates) (Ligthelm, 2006) and the lack of sample frames and the micro-orientation of most the informal sector surveys.

Also, the overwhelming majority of individuals and businesses in the informal part of the first economy could not be identified, or simply refused to provide information or to provide correct information (Ligthelm, 2006). For this reason, direct measurement approaches such as surveys could not generate reliable information and indirect methods were being used more to address the gaps left by the survey methods of the direct method.

2.5.2. INDIRECT/INDICATOR METHODS

Indirect methods are macroeconomic in nature. They use various indicators that indirectly allow for the measurement of the size of the entire informal economy. Some of these methods are discussed below (Schneider, 2002; OECD, 2002; Loots and Saunders , 2005; Schneider and Klinglmair, 2002).

2.5.2.1. Discrepancy method

This method is aimed at establishing the discrepancy between GDP estimates from the expenditure and income sides (Loots and Saunders, 2005). Any residuals between these two variables are then ascribed to informal sector activities (Buehn and Schneider, 2013). In principle, the estimated size of an economy should be the same, whether calculated from the expenditure or income side. Thus, if the expenditure side exceeds the income side, the gap is indicative of the extent of the informal economy not captured on the income side. Schneider (2002:34) argues that the components of GDP are normally not measured without error, and the gap therefore reflects all omissions and errors made when compiling national account statistics. These estimates are therefore considered crude and their reliability debatable.

2.5.2.2. Labour discrepancy

The labour discrepancy method is based on a discrepancy between the so-called 'official' and 'actual' labour force - and may therefore reflect employment in the informal economy (Loots and Saunders, 2005). An officially recorded constant or declining labour force participation

amidst a situation of declining unemployment may be regarded as an indication of an increase in the informal economy (Buehn and Schneider, 2013). This method is regarded as a weak indicator of the size and development of the informal economy, because labour force statistics are not always well developed, especially in developing countries (Ligthelm, 2006).

2.5.2.3. Transactions method

The transactions method was developed by Feidge (cited by Schneider and Klinglmair, 2005; OECD, 2002). It assumes that there is a constant relationship between the volume of transactions and GDP. Any change in that ratio is regarded as being caused by the informal economy. There are several problems with Feidge's method. The method makes use of an assumption of a based year (where there is no informal activity in that year) and the assumption of the so-called 'normal' ratio of transactions over time. The model also requires precise figures of the total volume of transactions to allow a reliable estimation of the informal sector. These may not be available, especially for cash transactions (Buehn and Schneider, 2013).

2.5.2.4. Global indicator method

An example of the global indicator method is the electricity consumption approach in which it is assumed that electric-power consumption is the best single physical indicator of GDP growth. It assumes a precise and stable relationship between electricity consumption and output. A change in this ratio is assumed to be caused by informal economy activity. This method is simple and an easily applied calculation, but it does not take into account that certain informal economic activities such as street vendor and tuck shops require limited or no electricity, and that alternative energy sources (such as gas and coal) can also be used, and that technological progress and energy savings may also impact on the GDP/electricity elasticity over time (Ligthelm, 2006; Buehn and Schneider, 2013).

2.5.2.5. Currency demand method

This method states that the informal transactions are undertaken in the form of cash payments (Loots and Saunders, 2005) . It is therefore assumed that the size of the informal economy will therefore increase the demand for currency. This approach does not take into account the fact that not all the transactions in the informal economy are settled in cash (Loots and

Saunders, 2005). It makes no distinction between informal activity in the second economy and informality in the first or modern economy. It also assumes that the tax burden is the only factor contributing to the informal economy, which is not the case (Buehn and Schneider, 2013). Furthermore, this method would also measure the transactions emanating from fraudulent or illegal activities, which also give rise to cash transactions to avoid any traces of such activities (Ligthelm, 2006).

2.5.2.6. Cash to deposit ratio method

The cash to deposit ratio method is based on the ratio between cash and transferable money. It is argued that the way in which people make payments is affected only by changes in taxation and government regulations, in an attempt to conceal certain activities to avoid taxation. It is these hidden activities that are used to estimate the size of the informal economy. This method can be criticised based on its underlying assumptions. These include the fairly stable cash-to-deposit ratio of the observed economy; that the 'surplus' money held in cash is only in the hidden economy; and that one dollar held in cash is only in the hidden economy; and that one dollar held in cash in the informal economy generated as much value added as one dollar in the formal economy (Ligthelm, 2006).

2.5.2.7. Latent variable methods

The macro-modelling methods described in these previous sections assume that the informal economy can be modelled in terms of one, or a small number, of variables. The latent variable method combines a wide range of explanatory variables, including the tax burden, unemployment rate, tax morality and per capita income that may impact on the size of the informal economy. This method can also be questioned, due to its high demand for data that is often not available and/ or unreliable.

All the macro-modelling methods tend to produce high estimates (OECD, 2002:187). The discrepancies that may emanate from these various approaches should be considered when evaluating informal sector measurement studies. It is evident with the different methods above that there seems to be certainty that the informal economy can never be precisely measured (Van der Berg, 1990).

The individual transactions with the informal economy may be small; however, collectively these represent significant buying power (Beneke, Curran, Forsyth and Lamb, 2011). The actual size of the informal economy in the South African context remains a question still to be answered (Ingle, 2014).

2.6. THE ROLE OF THE INFORMAL SECTOR IN SOUTH AFRICA

Many studies performed on the informal sector concur that developing countries are dominated by informal sector enterprises that make a major contribution to creating employment, and that they exist primarily due to the inability of the formal economy to provide employment opportunities to a rapidly expanding labour force (Gikenye and Ocholla, 2014). Its emergence is largely attributed to the divergence between the growth in the urban population and employment growth in the formal economy. The shortage of productive employment opportunities in the formal sector, therefore, compels people to fend for themselves. In South Africa, that is how the informal sector constitutes an important part of the economy (Gikenye and Ocholla, 2014).

The informal sector has gained prominence in South Africa, it is seen as an alternative to the formal sector opportunities and has been portrayed as a solution to the generation of income for the many unemployed South Africans (Horn, 2011). In 2002 to 2003, the informal retail business sector was found to have contributed an estimated 28,4 per cent of South Africa's GDP.

A study by Ligthelm in 2005 indicated that the growth of the informal economy in South Africa was eight times that of the formal economy between 2001 and 2006 (Ntema and Marais, 2014). This shows the prominence of the informal sector in South Africa.

The informal sector has attracted considerable research during the past two to three decades, not only because of its sheer size but also because of its potential role in providing income-generating and employment opportunities, particularly for the unemployed in South Africa (Ligthelm, 2006).

Former president Thabo Mbeki, coined the term "second economy" during his term as president. This term has since been used to classify the elements of economic productivity which fall outside the country's official recorded Gross Domestic Product (Beneke, *et al.*, 2011). In essence, the terms, 'second economy' and 'informal sector' have become

synonymous in describing the market characterised by Prahalad (2006) in his book “The fortune at the bottom of the pyramid” (Beneke *et al.*, 2011:94).

Mbeki observed that South Africa is characterised by two parallel economies, the first and the second economy. The first economy is modern, operating with advanced technology, integrated with the global economy, and produces the bulk of the country’s wealth; however, it also contains an informal component. Informality was observed to be the result of avoiding compliance with cumbersome procedures and regulations in the first or modern economy (Ligthelm, 2006).

Mbeki defined the second economy (or marginalised economy) as characterised by underdevelopment, contributes little to GDP, contains a big percentage of the South African population, incorporates the poorest of South Africa’s rural and urban poor, is structurally disconnected from both the first and global economy, and is incapable of self-generating growth and development (Ligthelm, 2006).

The increasing growth in poverty and unemployment levels amongst the urban poor in developing countries will continue to contribute towards making the informal sector, even though irregular and unstable, a relevant alternative source of income despite the lack of official recognition of this sector in these countries (Ntema and Marais, 2014).

Mbeki’s view of the second economy may have been relevant at the time, however several studies performed after that era have indicated that although it remains unregulated and contributes little to GDP (mainly due to the inability to measure it accurately), it no longer only incorporates the poorest of the South African rural and urban poor, but also is motivated by entrepreneurship where individuals have seen opportunities and are seizing those opportunities (Ligthelm, 2003).

It is also no longer structurally disconnected from the first economy, as studies have shown that there is a link between the formal and informal sectors and they should not be viewed as being independent of each other. For example, the informal retail sector in South Africa is increasingly being acknowledged by manufacturers and wholesalers as an important delivery channel of goods to consumers (Ligthelm, 2003).

Atkinson (2012) observed that the existence of the ‘second economy’ is accepted as an unquestionable reality in South Africa, as is the fact that it is growing at a rapid rate in response to the failure of the ‘first economy’ to create enough jobs (Ingle, 2013c).

As early as the 1990s, the South African government identified the stimulation of the informal sector as an essential mechanism in its economic strategy, and has continued to embark on several initiatives to promote it (Horn, 2011; Dewar and Watson, 1991:181).

In 1994, the new South African Government embarked on the Reconstruction and Development Programme (RDP) to redress the imbalances of the past. Thereafter, the government for a time adopted the GEAR macro-economic strategy to grow the economy, create employment and redistribute wealth (Kambikambi, 2003).

Since 1995, the national Government has actively promoted the small, medium and micro enterprises (SMMEs) sector because of its potential to contribute to innovation and its ability to impact on economic growth. Institutions such as the National Small Business Council and Ntsika Enterprise Promotion Agency - and recently the Small Enterprise Development Agency - form part of the national government's ongoing initiatives (WCPER, 2007).

Government's commitment to addressing unemployment and poverty is indicated by The Accelerated and Growth Initiative of South Africa. It identifies infrastructure needs, skills shortages and unnecessary regulatory burdens as core constraints on economic growth (Horn, 2011).

Government's strategies are put in place with the view that small businesses are more prevalent in the informal sector than they are in the formal sector (WCPER, 2007). Small businesses have therefore been seen as a vehicle to create employment, promote economic growth and redistribute wealth; as such the promotion of entrepreneurship has been identified as a critical aspect of GEAR (Kambikambi, 2003). (GEAR was replaced in 2005 by the Accelerated and Shared Growth Initiative for South Africa).

South Africa faces similar challenges to any other emerging economies throughout the world (Antonites and Van Rooyen, 2007). The key issues for SMMEs operating in the informal sector are access to financial services, access to skills training, access to physical infrastructure and basic services, access to business-related infrastructure, the impact of regulations, sector-specific constraints, and poor collective action amongst the informally employed (WCPER, 2007). Firms in the informal sector require an enabling environment that will encourage growth and expansion, which in turn will hopefully benefit workers in this sector in terms of better incomes (WCPER, 2007).

In his 2006 State of the Nation Address, the former president of the Republic of South Africa, Thabo Mbeki, emphasized the need for cooperation between large entities, government and development partners to ensure that the benefit of economic growth filters down to the lower end of the informal sector (National Treasury, 2006). The individual transactions with the informal economy may be small, however collectively these represent significant buying power (Beneke, *et al.*, 2011:94).

Kirchhoff indicated that many research studies on job creation statistics have concluded that small to medium sized firms (those that employ fewer than 100 people) create the majority of the jobs (Kirchhoff, 1995:19).

Since the 1980s, when studies have been done on the informal sector, several attempts have been made in measuring the informal sector (Blaauw, 2011).

- Loots (1991) estimated the size of the informal sector or economy to be 12%, stated as a percentage of GDP, in 1989.
- The informal economy or sector accounted for roughly 7% of GDP in 1999 (Saunders, 2005).
- Statistics South Africa estimated non-agricultural employment in the informal sector at 18.5% of the total employment in 2007 (Stat SA, 2007).

It is therefore found that the informal sector in South Africa forms a prominent part of the economy and needs to be addressed in order to determine a manner in which to incorporate it into the formal economy.

2.7. CHALLENGES FACING SMALL BUSINESS IN SOUTH AFRICA

Despite the potential growth potential, historical background research has indicated that the challenges that informal small business face include access to finance and markets, poor infrastructure, labour laws, crime, skills shortages and inefficient bureaucracy (Bureau for Economic Research, 2016).

According to GEM (2014), lack of access to finance and poor profitability are among the main reasons for business closures or failures in South Africa.

Poor physical infrastructure impedes on business growth. Access to communication infrastructure, utilities and transport, land or operating space is important to a growing

business and, without those, the costs of running a business can increase significantly (Bureau for Economic Research, 2016).

The OECD (2015) found that the South African labour laws are among the most significant regulatory obstacles for SMMEs, particularly when it comes to laying off staff. Labour laws do not provide for downswings in small businesses (GEM, 2014) that would allow the laying off of staff if the business could no longer afford to keep them. South Africa's minimum wages are also a costly hindrance, as paying minimum wages can be costly for a start-up business (GEM, 2014).

The WEF 2014/2015 Global Competitiveness Report highlighted the red tape associated with starting up and managing a business. Such red tape and regulations result in high costs of compliance, regarding the time spent by small businesses allocating staff to compliance matters or seeking the services of consultants to ensure compliance (DTC, 2014).

SMMEs require a more enabling environment for these enterprises to grow and expand their operations, and to be able to hire more people. Government bureaucracy should create conditions under which 'start-ups' can grow and more entrepreneurs are encouraged to enter the different markets of opportunity-driven entrepreneurship.

The key inhibitor of small business development is noted internationally as the cost of compliance with laws and regulations (Chamberlain and Smith, 2006:1).

Oberholzer and Smulders (2006) performed a study where the nature, definition and quantification of compliance costs incurred by small businesses were reviewed. They summarised the main regulatory costs as:

- **Compliance costs** - understanding regulations with assistance from experts, proving compliance by submitting forms and more.
- **Administrative costs** - assessing submission forms, undertaking inspections and more.
- **Efficiency costs** - buying, installing and maintaining equipment required by regulations, making choices about production techniques, the number of people employed, and/or which markets to compete in, based on the regulatory impacts.
- **Non-Compliance costs** - staying small or informal as a means of avoiding regulatory oversight or remaining below regulatory threshold-incurring fines, having stock confiscated or destroyed, and/or having to pay bribes as a result of attempts to evade regulatory compliance.

Oberholzer and Smulders' (2006) summary of the compliance costs that business face in their daily operations is similar to those defined by the US AID (2008). Administration costs are incurred in the course of understanding tax laws and regulations, record keeping, preparation and submission of relevant tax returns.

As can be seen from the definitions above, compliance and administration costs are ongoing costs for a business, while efficiency costs are most likely to be incurred on initial registration by the business. Non-compliance, on the other hand, could amount to a significant amount as these are costs paid in order to avoid compliance and administration costs, even after registration (Oberholzer and Smulders, 2006).

Smaller businesses do not have the full expertise in the completion of tax returns or in other aspects of tax compliance, and are either forced to make use of expensive professional assistance or rely on the proprietor's own efforts (Ramusetheli, 2011). The proprietor's knowledge and expertise is often limited due to the skill and expertise required for tax compliance.

There are frequent changes in the tax systems and laws, making the compliance burden worse on the proprietors as they need to keep up with these changes, which sometimes can be complicated.

Most informal entrepreneurs are not aware of many of the tax laws and the benefits that they could derive from registration (Orwa, 2007). Many of the small businesses that qualify for special tax relief initiatives that are introduced by the government are not even aware of the tax allowances and incentives that have been put in place to help reduce the tax-compliance burden on them (Thersby, 2006). Although payment of taxes is compulsory, it is still the business owner's responsibility to ensure registration and compliance of the business (SARS, 2015b).

Therefore, the business/taxpayer can only enjoy the various assistance schemes, rebates and incentives that are specifically for small, micro and medium enterprises, on registration with their local SARS office. Upon registration, they will obtain an income tax reference number and only then will the offered incentives and rebates be available to them (SARS, 2015b).

It then becomes the taxpayer's responsibility to understand the duties and obligations of the business in terms of the various tax laws (SARS,2015b).

VAT, PAYE, Customs, Excise, SDL and UIF depend on factors such as turnover, payroll amounts and whether the business is involved in imports and exports (SARS, 2015b). These

factors could result in the business being liable to register for taxes, other than income tax. All obligations arising from tax compliance are up to the business operator to understand and interpret whether or not they qualify (SARS, 2015b). The compliance burden could therefore discourage the entrepreneur in the informal sector from entering the formal sector.

For the purposes of this study only the compliance burden regarding tax matters will be discussed, with no mention of other applicable laws and regulations.

Businesses, small or large, are faced with compliance through the following tax laws and regulations (SARS, 2015):

- income tax;
- capital gains tax;
- dividends tax;
- provisional tax;
- employee's tax;
- value added tax;
- skills development levies;
- unemployment insurance;
- customs and excise duties;
- transfer duty; and
- donations tax.

This amounts to eleven separate taxes categories that businesses have to comply with. This could be an administrative and financial nightmare for the business owners if they do not apply the skills of an experienced and possibly full-time expert.

2.8. CONCLUSION

The literature review performed in this chapter indicated that no single definition for the informal sector exists. The informal sector has been a topic of study since the 1940s when Boeke began to undertake his studies. Hart further expanded on these studies in the 1970s with his Kenya Informal Sector studies (Naidoo, 2002).

This chapter aimed to define and provide an understanding of the characteristics and operations of the informal sector. The chapter further provided the motivating factors for a business to operate in the informal economy rather than the formal economy. It was noted that

there are challenges faced by businesses in the informal sector, based on the nature of the business as well as the distinguishing characteristics of the sector.

The motivating factor for the informal sector appears to be employment. The formal sector's inability to absorb growing populations has brought about an increase in the number of individuals hoping to secure an income through entrepreneurial self-employment (Steyn, 2008).

The informal sector is often perceived as relaxed, casual, flexible and lacking in rules and regulations. A business in the informal sector, for example, is considered to be an enterprise that does not follow the laws which control bigger, formal businesses such as the liability to pay taxes on income earnings. Ligthelm (2014) agrees by stating that another motivation for informality in the modern economy are the burdens of direct and indirect taxation and the burden of government regulations.

Many business enterprises are often compelled by circumstances to operate outside the framework of the law. Even where they are registered and respect certain aspects of the law, they are almost invariably beyond the pale of social protection, labour legislation and protective measures at the workplace (Gikenye and Ochalla, 2014).

Despite the various factors that make the informal sector and its activities not easy to measure, various methods - direct and indirect methods - have been described in literature for measuring the size of the informal economy (Ligthelm, 2006).

Historical background research has indicated that growth and development of the informal sector is affected by the challenges that small businesses in the informal sector face which include access to finance and markets, poor infrastructure, labour laws, crime, skills shortages and inefficient bureaucracy (Bureau for Economic Research, 2016). Lack of access to finance and poor profitability, are among the main reason for business closures or failures in South Africa (GEM, 2014).

The informal sector being unregulated is not the same as the criminal or illegal economy. Non-compliance in this sector, for many, is not to purposely avoid regulations and taxes (Steyn, 2008).

This chapter addressed the research objective as identified in para 1.5.2(i) and found that the informal sector in South Africa is a force to be reckoned with. It developed to a big extent as an outcome for many poor South Africans as a source of income, where no other options are available. It forms, according to estimates, a mentionable part of South Africa's GDP and employment figures. All these findings make it important to find a way to incorporate the informal sector into the formal economy in order to widen the South African tax base.

In the following chapter, the tax relief initiatives that are available to small businesses will be considered, in order to determine if it would encourage businesses in the informal sector to integrate into the formal economy.

CHAPTER 3

TAX-RELIEF INITIATIVES APPLIED IN SOUTH AFRICA FOR SMALL BUSINESSES

3.1 INTRODUCTION

Chapter 2 dealt with the characteristics of the informal sector and the nature of the business and trading activities that are undertaken in the informal sector. The objective of this chapter is to identify the existing tax-relief initiatives that are available to small businesses in South Africa.

This chapter will furthermore consider and review the requirements for compliance with the identified tax-relief initiatives, and perform an analysis of the practical application thereof, to determine if it could be applicable to businesses in the informal sector and succeed in encouraging informal businesses to integrate into the formal sector's compliance culture by registering and complying with tax legislation. This chapter will address the research objective as identified in par 1.5.2(ii).

SARS has introduced a number of tax-relief initiatives for small businesses, which seem to encourage entrepreneurial activity, as well as empowering and reducing the compliance burden on these small businesses (Ramusetheli, 2011).

The tax-relief-initiatives reviewed and analysed in this chapter are those relating to small business corporations, manufacturing and micro businesses (SARS, 2015b).

3.2 'SMALL BUSINESS' DEFINITION FROM A SOUTH AFRICAN TAXATION PERSPECTIVE

This chapter focuses on income tax relief initiatives for small businesses. The relief initiatives that will be dealt with are incorporated into the Income Tax Act in various provisions as follows:

- Section 12E - Small Business Corporations relief provisions for income tax.
- Par 57 of the Eighth Schedule – Capital gains tax relief for small businesses.
- Sixth Schedule – Turnover tax for micro businesses.

It is important to define “small business” for each of these relief provisions as defined in the Income Tax Act to determine if these initiatives could be applicable to a business in the informal sector in order to assess if it could be successful to encourage a business in the informal sector to integrate into the formal sector and register and pay taxes.

3.2.1. Definition in relation to Income Tax

In terms of Section 12E of the Income Tax Act, tax relief is provided for small business corporations as defined. A reduced tax-rate initiative, as well as an accelerated depreciation initiative, is provided for.

Section 12E(4) of the Income Tax Act defines a small business corporation (SBC) as:

“a close corporation, co-operative or a private company whose shareholders must all be natural persons who may not hold any other equity interests in any other company other than a listed company, collective investment scheme, a share block company, body corporate or venture capital company.”

The gross income for the year of assessment may not exceed R20 million (South Africa, 1962). Any investment income earned from the rendering of a personal service may not exceed 20% of the total receipts and accruals of the small business corporation.”

The SBC definition covers businesses that are a close corporation, co-operative or a company. These are requirements of an already-registered business that operates formally. As pointed out in chapter 2, one of the characteristics of businesses in the informal sector is that they are unregistered businesses that are not recorded in any official statistics of the economy (Gikenye and Ocholla, 2014) and lack corporate status (Ligthelm, 2006).

The associated red tape and costs of operating and managing a formal registered business are reasons why many businesses in the informal sector find it difficult to formalise their business (DTC, 2014).

Individuals engaged in businesses operating informally tend to be less educated and have fewer marketable skills than their formal counterparts (WCPER, 2007). As a result, there is little motivation to formalise their businesses as they would be required to employ the skills of a qualified professional to assist with red tape-compliance in operating a business formally.

Products or services in the informal sector are on a small-scale. Laws and regulations compliance costs can become significant for small business operating on a small scale (Chamberlain and Smith, 2006).

As seen from the above, businesses in the informal sector are normally not incorporated. It will therefore have to be critically considered if the relief initiatives would be so attractive that it would encourage a business that is not incorporated to do so, in order to be compliant.

3.2.2. Definition in relation to capital gains tax

In terms of Section 26A of the Income Tax Act, a capital gain must be included in a person's taxable income. The capital gain is determined in terms of the Eighth Schedule of the Income Tax Act (Eighth Schedule).

There are two relief initiatives referred to in the Eighth Schedule. In terms of par 57 of the Eighth Schedule, relief is provided for capital gains for small businesses as defined. Small business is defined as a business where the total market value of the assets excluding liabilities, as at the date of disposal of the asset or interest, does not exceed R10 million. All business assets, despite their nature, are taken into account in determining whether the business qualifies (South Africa, 1962).

The definition in the Eighth Schedule does not state whether or not the small business referred to must be a legal registered entity or not. However, in terms of the Income Tax Act, it is required that a business, in order to be eligible for the benefits of deductions, exemptions and exclusions contained within the Income Tax Act, be a registered legal entity. That is, which is registered with SARS as a taxpayer – or, in the case of a partnership, the individual natural persons must be registered taxpayers in their personal capacities.

It is likely to be rare that informal businesses (or a person operating in an informal business) would own high-value capital assets and have capital gains. Small business as defined in the Eighth Schedule does not provide a strong motivation and incentive for businesses in the informal sector to formalise their operations and operate as formal taxpaying businesses.

3.2.3. Definition in relation to turnover tax for micro businesses

Par 2 of the Sixth Schedule of the Income Tax Act (Sixth Schedule) provides for tax relief for a micro business. A micro business is defined as such if the company or natural person (or the deceased or insolvent estate of a natural person that was registered as a micro business at the time of death or insolvency) has a qualifying turnover for the year of assessment that does not exceed R1 million. Qualifying turnover is defined in the Sixth Schedule as total receipts from carrying on the business activities, excluding receipts and accruals of a capital nature.

Businesses in the informal sector consist of independent, self-employed individuals with the aim of providing income and employment for the entrepreneur or members of their immediate family (Gikenye and Ocholla, 2014). These businesses often lack corporate status (that is, they are not registered) and are operated by natural persons (Ligthelm, 2006).

Micro business as defined can be a business operated by a natural person without having to form and register a company. This may be a motivation for an entrepreneur to register as a micro business.

Many of the businesses in the informal sector operate from owner-funded capital (Gikenye and Ocholla, 2014) and operations or services offered are on a small scale (Ligthelm, 2006). Most of these business's turnover may be below the qualifying turnover threshold of R1 million, which makes this an initiative that might be considered by businesses in the informal sector.

3.3 SMALL BUSINESS TAX-RELIEF INITIATIVES

3.3.1. INTRODUCTION

The tax relief-initiatives categories reviewed and analysed in this chapter are those relating to small business corporations, manufacturing small business corporations and micro businesses. The initiatives considered in this chapter are the reduced progressive tax rate-relief initiative (Section 12E (4) of the Income Tax Act), the accelerated depreciation (Section 12E (4) of the Income Tax Act), the capital-gains tax relief for small business (Eighth Schedule Paragraph 57 of the Income Tax Act) and turnover tax for micro businesses (Sixth Schedule of the Income Tax Act). These initiatives were introduced to the Income Tax Act (1962) over the past couple of years to assist small businesses in managing the compliance burden.

3.3.2. SMALL BUSINESS CORPORATIONS: REDUCED PROGRESSIVE TAX RELIEF INITIATIVE

3.3.2.1. Description of the reduced progressive tax-rate initiative

Section 12E of the Income Tax Act (1962) provides for special exemption applicable to SBCs. One of the initiatives is that the rate of normal tax on the taxable income of an SBC is considerably lower than the rate of normal tax (28%) for companies in general.

A company's normal tax rate on taxable income is 28%, whilst an SBC will be taxed on a progressive tax rate structure as shown in Table 2 below.

Table 2: SBC Tax Rates - 31 March 2017

Taxable Income	Rate of Tax
R0 – R75 000	0%
R75 001 – R365 000	7% of the table income above R75 000
R365001 – R550 000	R20 395 + 21% of taxable income above R365 000
R550 001 and above	R59 150 + 28% of taxable income above R550 000

Source: South Africa (2016)

3.3.2.2. Objective of the reduced tax rate-relief initiative

The SBC reduced progressive tax-rate initiative was developed with the expectation that it would contribute to the development of the labour-intensive small-business sector and generate business income (Ramusetheli, 2011). This could perhaps allow growth for small business over the short, medium and long term, as a reduced tax rate could increase after tax earnings, resulting in the ability to influence investment and financing, increase equity investment and reduce the cost of equity funds (Ramusetheli, 2011).

3.3.2.3. Challenges of the reduced progressive tax-rate relief initiative in the informal sector

The definition of 'small business corporation' focuses on the various legal entities. Section 12E(4)(a) limits the legal entities to either a close corporation registered under the Close Corporations Act (69 of 1984); or a co-operative as defined in Section 1 of the Co-operatives Act (14 of 2005); or a company registered as a private company under the Companies Act (71 of 2008). Informal sector businesses are characterized as owner-operated businesses which are unregistered (Ligthelm, 2004). It is unlikely that any informal business would ever incorporate to take advantage of this initiative.

Section 12E of the Income Tax Act is a complex section of the Act, with several exclusions relating to the shareholding restrictions and exception of personal-service providers and investment-income definition. The detail of the section is complex. Individuals running businesses in the informal sector normally have limited-to-no formal education (WCPER, 2007). It is thus unlikely that those operating in the informal sector would be able to understand and apply these provisions properly without assistance from an accountant.

Therefore, in order to apply the provisions of this section in full, a business owner might be forced to employ the services of a qualified tax professional, which increases costs for the business. Internationally, compliance costs are noted as the key inhibitor of small business development and growth (Chamberlain and Smith, 2006).

Informal sector businesses face capital restrictions (GEM, 2014), as the financing is often provided by the owner and they have no access to organized markets or financial institutions. Therefore, cash flow limits the ability to meet the requirements of operating in the formal sector and complying with all laws and regulations.

For unincorporated sole proprietors and partnerships, which is common in businesses operating in the informal sector, progressive rates appear discriminatory as they are restricted to apply to registered legal entities and not natural persons operating businesses as sole proprietors and partnerships. Individuals who are running their unincorporated businesses in the informal sector would be taxed in their personal capacity applying the personal income tax tables where the maximum income tax rate applicable to income tax is 41% versus the progressive tax rate applicable to SBC's or the normal corporate tax rate of 28% (Friedland and Rankin, 2010).

Personal service refers to a service rendered and for which the income derived is mainly a reward for the personal efforts or skills of an individual. Businesses in the informal sector are established to provide employment for the entrepreneur who often is the sole provider of services offered by the business (Gikenye and Ocholla, 2014).

The application of this relief initiative is therefore very limited and very doubtful if it would attract informal businesses to incorporate to take advantage of a lower tax rate.

3.3.3. SMALL BUSINESS CORPORATION: ACCELERATED DEPRECIATION TAX-RELIEF INITIATIVE

3.3.3.1. Description of the accelerated depreciation tax-relief initiative

Section 12E(1) of the Income Tax Act provides for the accelerated depreciation incentive and also applies to manufacturing SBCs.

The special following deductions are applicable to qualifying SBCs:

- A qualifying SBC in the manufacturing sector may deduct the full costs of the expenditure incurred in the acquisition of plant and machinery brought into use for the first time by the taxpayer in the year of assessment.

To qualify for the deduction, the asset must be owned by the SBC, or the SBC should have acquired the asset under an 'instalment credit agreement' as defined in Section 1 of the Value Added Tax Act (89 of 1991) (VAT Act).

- An SBC may elect an accelerated allowance for any machinery, plant, implement, utensil, article, aircraft or ship (other than plant or machinery used in manufacturing or

a similar process). The accelerated allowance is 50% of the cost of the asset in the year of assessment during which that asset was brought into use for the first time, 30% in the first succeeding year, and 20% in the second succeeding year.

Section 12E(1A) of the Income Tax Act allows an SBC to elect to either claim a wear and tear allowance under section 11(e) or the accelerated allowance of 50:30:20 over three years under section 12E(1A) (b) on all other non-manufacturing assets (i.e. assets which are not written off 100% in terms of S12E (1)).

3.3.3.2. Objective of the accelerated-depreciation tax-relief initiative

The accelerated-depreciation allowance is favourable to the SBC when a business undertakes capital expenditure and the economic value (that is, the ability to consume without diminishing wealth) of the asset is not reduced immediately, but only when the asset is used in production (Friedland and Rankin, 2010).

If the total or greater part of the asset's value is deducted in earlier periods, the income for tax purposes is less, thus reducing the tax liability to the business's advantage. In future periods the taxable income will be greater; however, the present value of the immediate deductions exceed that of subsequent overpayments, resulting in an overall benefit for the business (Friedland and Rankin, 2010). This improves the cash flow for the business in the earlier years that the accelerated-depreciation deductions were allowed.

3.3.3.3. Challenges of the accelerated-depreciation tax-relief initiative in the informal sector

- Section 12E(1)(a) of the Income Tax Act regarding the 100% deduction write-off initiative for plant and machinery used in the process of manufacture (as opposed to the 50:30:20 write-off over three years for other plant and machinery, which applies to other sectors) indicates that this initiative favours the manufacturing sector (Ramusetheli, 2011).

Due to the lack of access to business support services for businesses in the informal sector, such as credit facilities (Marais and Ntema, 2014), asset acquisitions are made by owner-provided capital. That can be very limited, as they are unable to access finance due to the requirements (such as security) for instalment credit agreements.

For businesses in manufacturing in the informal sector, it may be encouraging to comply and register as a taxpayer, as it results in improved cash flow in the short term. Businesses in the informal sector would normally not be in manufacturing on a big scale if it requires capital-intensive equipment or machinery.

- Section 12E, in itself, is neither short nor simple. There appears to be a trade-off between the simplicity of administration and the ability to target effectively (Friedland and Rankin, 2010). Due to limited expertise of small businesses in the informal economy, there may be a need to hire a tax specialist to assist with the structuring of the business and its tax affairs, which will result in higher compliance costs.
- To enjoy the tax relief of accelerated depreciation, the business must be registered as a taxpayer. Unless the business was registered in the last 5 years (where registration with CIPC resulted in an automatic registration with SARS), many small businesses are still not registered for tax purposes. Many even continue to operate as unregistered and unincorporated small businesses. Such businesses would not qualify for this relief.

Registration as a corporate legal entity brings about issues of compliance with laws and regulations other than those that are tax related. These laws like the tax laws are often long and complex and the services of a qualified consultant are required. This increases the number of laws the informal business would need to comply with and the lack of skills of the business owner increases the expenditure for the business in the form of consulting fees to comply.

As this initiative requires that a business be incorporated, it is highly unlikely that any business in the informal sector would give up its 'informal' status to take advantage of this initiative.

3.3.4. CAPITAL GAINS TAX: PAR 57 OF EIGHTH SCHEDULE 'DISREGARD SMALL BUSINESS CAPITAL GAINS TAX' RELIEF INITIATIVE

3.3.4.1. Description of the 'disregard small business capital gains tax' relief initiative

The tax relief initiative in terms of par 57 of the Eighth Schedule is available only to small business that meet the definition of small business, as defined. In terms of paragraph 57, as was discussed in par 3.3.2, small business is defined as a business whose total market value of assets does not exceed R10 million at the date of disposal of an asset or interest.

In terms of this paragraph, a natural person operating a small business must, when determining an aggregate capital gain or aggregate capital loss, disregard a capital gain up to R1.8 million over the person's lifetime, in respect of the disposal of assets. (South Africa, 1962):

- Any business asset in a small business owned by a natural person (South Africa, 1962);
or
- An interest in each of the active business assets of a small business, owned in a partnership, upon that natural person's withdrawal from that partnership to the extent of their interest (South Africa, 1962); or
- At least 10% direct equity interest in a company, to the extent that the interest relates to active business assets of a business which qualifies as small business of the company (South Africa, 1962).

The tax-relief initiative in terms of par 57 of the Eighth Schedule defines an asset to include property of any nature movable or immovable, corporeal or incorporeal including any right or interest of whatever nature to or in such property and any coin made mainly from gold or platinum. Currency is excluded from the asset definition of an asset in terms of par 57 of the Eighth Schedule.

In order to qualify (that is, for the capital gain to be disregarded), the following criteria need to be satisfied:

- the asset had been held for a continuous period of at least 5 years prior to the disposal;
- the natural person had used the asset in the operations of the small business during the period; and
- the person had attained the age of 55 years, or the disposal is as a consequence of ill health, other infirmity, superannuation or death.

As stated in par 57, the capital gain to be disregarded is over the natural person's lifetime, therefore cumulative and not in respect of each asset disposed of. Furthermore, the disregarded capital gain must be realised within two years of the first qualifying disposal of the asset. Subparagraph (5) of the Eighth Schedule provides that a natural person who operates more than one small business is obliged to include all qualifying disposals for each small business when determining the capital gain to be disregarded.

3.3.4.2. Objectives of the ‘disregard small business capital-gains’ tax-relief initiative

The objective of par 57 of the Eighth Schedule is to enable a small business to disregard the capital gains from active business assets owned for a period exceeding 5 years (SARS, 1962). This will improve the small businesses’ after tax earnings and ultimately improve the cash flows of the business as it would result in a reduced taxable income calculation.

3.3.4.3. Challenges of the ‘disregard small-business capital-gains’ tax-relief initiative in the informal sector

- The extension to natural persons allows for natural persons in unincorporated partnerships to enjoy the benefit as well. This may be a motivation to encourage informal sector business owners to take advantage of the benefits of the provision in their business.
- Entrepreneurs and business owners in the informal sector are individuals of all ages. The requirement restricting the availability of the provisions to natural persons who have attained 55 years of age will not encourage informal sector business owners to register the business as a process of integrating into the formal business sector.
- It is doubtful that a person in the informal sector would own high-value capital assets that would be sold for a capital gain exceeding R30 000.

The initiative does not absolve the small business from the registration requirements of Sections 22 and 25 of the Tax Administration Act no 28 of 2011 (Davis Tax Committee, 2014) which requires all businesses, regardless of size, to register with SARS within 21 days of starting to trade. This initiative and its requirements does not seem to be an initiative that would encourage informal sector businesses to register as taxpayers to take advantage of this tax relief.

3.3.5. SIXTH SCHEDULE TURNOVER TAX FOR MICRO BUSINESS TAX-RELIEF INITIATIVE

3.3.5.1. Description of the 'micro business turnover tax-relief' initiative

The provisions of the turnover tax-relief initiative are contained in the Sixth Schedule (Determination of turnover tax payable by micro businesses) and sections 48 to 48C (Turnover tax payable by micro business) of the Income Tax Act.

Part II of the Sixth Schedule provides that a natural person (or the deceased or insolvent estate of a natural person who was registered as a micro business at the time of death or insolvency), or a company, qualify as a micro business provided the qualifying turnover for the year of assessment does not exceed R1 million.

Paragraph 1 of the Sixth Schedule defines qualifying turnover as turnover that refers to total receipts, excluding any amounts of a capital nature, arising from carrying on business activities. Paragraph 3 of the Sixth Schedule excludes trusts, labour brokers, personal service providers, public benefit organisations and recreational clubs from qualifying as micro business.

Registration as a micro business is elective at the discretion of the taxpayer (natural person or company) in any particular year of assessment (Par 8 of the Sixth Schedule). Turnover tax provides for preferential progressive tax rates for micro business with a turnover not exceeding R1 million. The inclusion of natural persons in this provision allows for informal businesses being carried on by sole proprietors to possibly qualify for the progressive rates provided all other requirements are met.

Turnover tax rates for year of assessment ending 31 March 2017 are as illustrated in Table 3 below:

TABLE 3: Turnover Tax Table

Taxable Turnover	Tax Liability (2017 year of assessment)
R0 – R335 000	0%
R335 001 to R500 000	1% of the amount above R335 000
R500 001 to R750 000	R1 650 + 2% of the amount above R500 000
R750 001 and above	R6 650 + 3% of the amount above R750 000

Source: South Africa (2016)

The benefit of being registered as a micro business is that the business is taxed at low progressive rates between 0% to 6%, which is much lower than the corporate rate of 28%. The profits are not subject to the normal corporate tax rate. The marginal tax rate for natural persons is 18% of taxable income above R188 000 (for the 2017-year of assessment). That makes this initiative a possibility to consider for a person in the informal sector to become tax compliant and still not pay taxes.

Paragraph 14 of the Sixth Schedule on turnover tax for micro business, provide for the minimum records to be kept by a qualifying business. The minimum records required to be kept by a qualifying micro business are amounts received by the micro business during the year of assessment, dividends declared, acquired assets during the year of assessment whose cost price exceeds R10 000 each and any liabilities of the registered micro business as at the end of the year of assessment that exceeds R10 000. This requirement absolves the registered micro business from keeping full accounting records, which possibly could reduce the costs of administration for the micro business.

In addition to the progressive rate structure (turnover tax), the Eighth Schedule par 57A, provides that registered micro businesses to disregard any capital gain or loss which arose as a result of the disposal of immovable property and any other assets (other than immovable property) mainly used for business purposes.

3.3.5.2. Objective of the 'micro business turnover-tax' relief initiative

Turnover tax became effective on 1 March 2009 and was applied in respect of the year of assessment commencing on or after 1 March 2009.

Turnover tax is a tax introduced in a gradual process in which a small business could enter the tax net by using the relief provided by turnover tax and as the small business grows, it could become an SBC and apply for the relief provided for by Section 12E and will gradually transfer into the standard legislation process (Ramusetheli, 2011).

This is a simplified tax system for micro businesses and serves as an alternative to the current income tax, capital gains tax and dividends tax. This reduces the compliance burden on small businesses qualifying as micro businesses as they need only comply only with one tax instead of the several of normal income tax, capital gains and dividends taxation separately.

As a micro business does not have to be incorporated to take advantage of this incentive a natural person, which involve less costs, would also be able to benefit from this provision and therefore businesses in the informal sector could more likely look at an incentive such as this one.

The objective of the Paragraph 57A is similar to Paragraph 57 for SBC's which is to assist SBC's and micro business to improve the small businesses' after tax earnings and ultimately improve the cash flows of the business as it would result in a reduced taxable income calculation.

3.3.5.3. Challenges of 'micro business turnover-tax relief' initiative in the informal sector

- To register for the benefits of the turnover tax, the taxpayer must elect to register as a micro business in terms of paragraph 8 of the Sixth Schedule. This implies that the taxpayer must either be aware of the turnover tax that is applicable to small businesses whose turnover is below R 1 million or they must seek the advice of a tax specialist. This would be an additional cost for the informal business to incur affecting the cash flows of the business.
- Small businesses cannot register as micro business if their year of assessment does not end on the last day of February. This restriction eliminates those small businesses whose year-end does not coincide with the required February period, and to change year-end would lead to administration costs for the business in trying to enjoy the benefits. This would however most probably not affect businesses in the informal sector as only incorporated businesses' year-end could be something else than February.
- A micro business is not subject to the provisional tax requirements in the Fourth Schedule to the Income Tax Act, however a micro business is still required to make two interim tax payments twice a year similar to the requirements for provisional tax in the Fourth Schedule, which does not really result in reduced administration for the micro business. Compliance costs remain one of the reasons that motivate informal sector businesses to remain in the informal sector out of fear of high non-compliance costs.
- Since coming into effect there has been criticism for the fact that there are certain instances where start-ups are paying tax even though in reality they are making losses because the tax itself is applied to turnover. This in essence may affect the cash flow of

the company as turnover may be high and the resulting tax thereon is higher however the cash available to the business is lower.

- Since its effective date and because of its elective nature and the restrictive requirements, a few businesses have registered as micro businesses.

The turnover tax relief initiative could to a certain degree encourage a person in an informal business to register for tax as the tax payable could be quite low, if at all payable and it is also applicable to a natural person. This would be a solution for a person that really would like become compliant in their tax affairs.

One of the characteristics of some businesses in the informal sector is that they do not keep any formal records. Although paragraph 14 of the Sixth Schedule on turnover tax for micro business, provide for the minimum records to be kept by a qualifying business. The reality is that accurate records are required to be kept in order to substantiate the company's records to SARS.

Record keeping and registration are one of the requirements in terms of the Tax Administration Act (28 of 2011). Record keeping is an administrative matter that takes time and sometimes may need a knowledgeable person to be consulted who will ensure that the records are complete, accurate and in the correct format. This is an administration cost for the business.

3.4. CONCLUSION

It is widely acknowledged that the informal sector includes unregistered and unrecorded economic activities that escape inclusion in the official estimates of GDP (Ligthelm, 2004). One of the identified motivations for retaining informal status is the burden of government regulations and direct and indirect taxation (Ligthelm, 2006).

Ingle (2013a) and Van Rooyen and Antonites (2007) take the approach that the informal sector is logically prior to the formal, that it is the natural state of affairs out of which the formal arises. Informality therefore is not limited to one economic sector, it emphasises the links between the informal and the formal parts of the economy (Steyn, 2008). The linkages between the sectors implies that the sectors co-exist and can assist each other in economic development (WCPER, 2007).

Section 45 of the Tax Administration Act, gives a SARS official the authority to without prior notice arrive at the premises where SARS official has reasonable belief that a trade or enterprise may be carried on and conduct an inspection. If the premises are a dwelling-house or domestic premises, the SARS official must obtain the occupants consent prior to entering the premises. This section will assist SARS in establishing whether an occupant of premises is a registered taxpayer. This will assist in identifying non-compliant businesses and individuals.

This chapter reviewed and analysed small-business tax-relief initiatives currently in place to assist small businesses in alleviating the compliance burden, and to provide incentives that could result in improved cash flow through after-tax earnings savings. The review revealed the following observations regarding the current tax-relief initiatives, which could encourage businesses in the informal sector to enter the tax net through registration:

- Section 12E, the Sixth Schedule and the Eighth Schedule of the Income Tax Act, like many other sections and provisions of the Income Tax Act, are complex, with certain qualifying requirements excluding certain shareholdings and setting limits in terms of turnover. Businesses in the informal sector are often run by the owners, who provide the capital for the business. The motivation behind starting and operating the business is to create an income for the owner. These individuals tend to be less educated (WCPER, 2007). Complex compliance laws would require specialised tax-advisory services from a qualified consultant that would ensure that the provisions of the tax Act provide maximum benefit for the informal business.
- SBC refers to a small business as a company (close corporation and co-operatives included). For a business to qualify as an SBC, and qualify for the progressive tax rates on the taxable income, the business should have a corporate legal entity status. Most businesses in the informal sector operate as unincorporated sole proprietorships or partnerships. To obtain a corporate legal entity status, the business would need to register as a company, resulting in compliance obligations brought about by the legal entity status. This administration obligation may deter business owners in the informal sector, who may prefer to remain in the informal sector in order to avoid the compliance requirements.

Based on the analysis above, the current tax-relief initiatives in place for small businesses provide little or no motivation for businesses in the informal sector to give up their freedom and come aboard to the formal sector. The provisions themselves promote formality in order

to qualify for the exemptions, the preferable progressive tax rates, or deductions provided for in the Income Tax Act. It creates an administrative burden for the informal sector businesses where there is a shortage of skills and owners are confronted by the complex provisions of the tax Acts.

The research objective as identified in par 1.5.2(ii) was addressed in this chapter and it found that the current tax-relief initiatives and SARS requirements are based on voluntary compliance with the relevant tax laws and are not specifically tailored to the characteristics of the informal sector - and would not necessarily lead to integrating the informal businesses into the tax base.

CHAPTER 4

TANZANIA BLOCK MANAGEMENT SYSTEM

4.1 INTRODUCTION AND BACKGROUND

The Tanzania Block Management System (BMS), door-to-door survey is considered in this chapter. The TRA implemented the system with the objectives to promote and enhance voluntary compliance, and to detect taxpayers who were not paying taxes at all, or not paying the correct amount (Fjeldstad and Heggstad, 2011).

An overview of the history of the BMS in the informal sector of Tanzania is performed - the working definition, its measurement and size, the characteristics of – as well as an overview of taxation of the informal sector in Tanzania.

This chapter will further evaluate the Tanzania BMS, in order to establish if a similar system could be adopted in South Africa - and hopefully suggest an approach that may assist South Africa in integrating the informal sector into the formal sector, in order to contribute to national tax revenue.

This chapter addresses the research objective as identified in par 1.5.2(iii).

4.2 TANZANIA REVENUE AUTHORITY

Tanzania, officially the United Republic of Tanzania, is a country situated in East Africa in the African Great Lakes region (African Tax Administration Forum, 2014). The country has 30 administrative regions, five on the islands of Zanzibar and 25 on the mainland (African Tax Administration Forum, 2014). Agriculture accounts for nearly 25 percent of gross domestic product in the Tanzanian economy (African Tax Administration Forum, 2014).

Tanzania has vast amounts of minerals including gold, diamonds, coal, iron, uranium, nickel, chromium, tin, platinum, coltan, niobium, natural gas, and others (African Tax Administration Forum, 2014).

The TRA was established in 1996 and is a semi-autonomous revenue authority similar to SARS in South Africa (Fjeldstad and Heggstad, 2011). The objective of a semi-autonomous

revenue authority model is to limit direct political interference by the Ministry of Finance and to partly free tax administration from the constraints of the civil service (Fjeldstad and Heggstad, 2011).

The TRA has three departments which are directly involved in assessing and collecting tax revenue through the administration of various tax laws (ATAF, 2014) - the domestic revenue department (DRD) which collects taxes from small to medium taxpayers including individuals, the customs and excise department (C&E); and the large taxpayers' department (LTO).

4.3 TANZANIA SMEs AND THE INFORMAL SECTOR

The Tanzania economy is characterised by small firms and very large micro-enterprises. Many of the micro-enterprises operate in the informal sector (AfDB, 2010).

Unemployment forces the majority of the population into urban areas, and to create self-employment by establishing small businesses. The operating economic environment for both the urban and rural undertakings is often informal, predominantly untaxed and ever expanding (African Tax Administration Forum, 2014).

According to Fjeldstad and Heggstad (2011), economically active citizens in Tanzania are situated both in rural and urban areas. Tax literacy is limited, as many people are not able to understand the technical issues involved in tax administration and reform (Fjeldstad and Heggstad, 2011). Sustainable methods are required in order to broaden tax bases, and efforts may include educating taxpayers, simplifying tax registrations, and bringing non-filers and non-payers into the tax net (Fjeldstad and Heggstad, 2011; AfDb, 2010).

The Small and Medium Enterprises are important to the economy. However, in Tanzania, like many other developing countries, they face several problems. These are influenced by a number of factors, such as a persistent culture that has not recognised the value of entrepreneurial initiative in improving people's lives, coupled with a complex, bureaucratic and costly legal, regulatory and administrative environment (African Tax Administration Forum, 2014). These factors place SMEs at a greater disadvantage than their larger counterparts (African Tax Administration Forum, 2014). The high cost of complying to regulations may discourage potential entrepreneurs from formally setting up their businesses, while also driving some existing enterprises out of business (and hence those working for them into unemployment). (African Tax Administration Forum, 2014).

No single definition of SMEs exists, and definitions vary from country to country. The definition can be dependent on the level of economic and social development prevailing in each country (African Tax Administration Forum, 2014). The definition can also vary within countries, based on definitions of different institutions that reflect the objective of each of the stakeholders. Tanzania, like many other African countries including South Africa, does not have a single official definition of SMEs (African Tax Administration Forum, 2014).

The definition contained in the Tanzania SME Policy (2002), published by the Ministry for Industry and Trade, is the broadest in Tanzania and the most applied (African Tax Administration Forum, 2014). The categories of SMEs are as indicated in Table 4-1 below.

Table 4-1: Categories of SMEs in Tanzania

Category	Employees	Capital Investment in Machinery (Tshs.)
Micro enterprise	1 – 4	Up to 5million (US\$2,298)
Small enterprise	5 – 49	Above 5m to 200million (US\$2,298 to US\$91,906)
Medium enterprise	50 – 99	Above 200 million to 800 million (US\$91,906 to US\$367,642)
Large enterprise	100+	Above 800 million (US\$367,642)

Source: African Tax Administration Forum 2014

The broadest definition provided by the Ministry of Industry and Trade uses capital investment in machinery and the number of employees to define SMEs, as per Table 4-1, while the Tanzanian tax administration uses the turnover level to categorize small, medium and large taxpayers. Revenue authorities face the challenge of coming up with strategies aimed at encouraging compliance in the informal sector, due to the lack of a single and uniform definition of SMEs at national level (African Tax Administration Forum, 2014).

4.4 INFORMATION GATHERING POWERS OF TRA

The Taxpayer Identification and Exchange of Information Act (2000) of Tanzania, provides for the TRA to establish, maintain and apply a system for the identification of taxpayers for the purposes of coordinated administration of the revenue laws of the United Republic of Tanzania (Fjeldstad and Heggstad, 2011).

Taxpayer identification numbers are registered so that the public administration and management of the laws may exchange information and documents about taxpayers for the purpose of compliance with various public institution laws and regulations.

The Taxpayer Identification System (TIN) is used by a range of other public institutions, such as the Ministry of Industry and Commerce, Ministry of Energy and Minerals, and the Registrar of motor vehicles (Fjeldstad and Heggstad, 2011).

4.5 CHALLENGES OF TAXING SMEs IN THE INFORMAL SECTOR

Taxation of SMEs in the informal sector in Tanzania poses several challenges to tax administration. These challenges would need to be addressed for SMEs to become tax compliant and to contribute to government revenue (African Tax Administration Forum, 2014). Taxing the SMEs in the informal sector is a challenge due to the lack of appropriate compliance management and the general non-compliance of SMEs in the informal sector (African Tax Administration Forum, 2014).

Review of literature reveals that Tanzania faces similar problems as South Africa with regard to the taxation of SMEs operating in the informal sector. These are identification, registration, non-compliance, poor or no record keeping, and non-return filing.

According to the African Tax Administration Forum (ATAF) (2014), the vast number of SMEs and the economic nature of SMEs (narrow taxable base, undocumented, cash-based business transactions, high mobility and activity in rural areas) are reasons why tax administrations face difficulties in properly administering SME taxpayers.

Fjeldstad (2013) argues that smaller and middle-sized enterprises lack the skills required to provide minimally acceptable accounts and accurate information on total sales. African Tax Administration Forum (2014) found that there is a culture of poor record keeping within the informal sector, making it difficult to track their operations.

There are also many non-registered business activities, which makes identification difficult. Identification is a requirement for reliable and credible taxpayer registration (African Tax Administration Forum, 2014).

Another challenge is that SMEs see no incentive to comply with tax laws; the laws are complex and a wide knowledge gap exists. Tax laws, regulations and procedures provide little

assistance in compliance and filling the gap (ATAF, 2014). Many of the SMEs operating in the informal sector have never been forced in the past to pay taxes (AfDB, 2010).

Because of the issues referred to above, the system has not been without its own challenges - especially in the process of implementation and maintenance of the system - leading to the formulation of further improvements to the system through constant monitoring and evaluation (African Tax Administration Forum, 2014).

The TRA took the time to understand the challenges that would be faced in trying to tax the informal sector, and developed a programme previously known as the “Physical Survey”, which later evolved into the ‘Block Management System’. BMS was a result of improvements made to the Physical Survey.

4.6 BLOCK MANAGEMENT SYSTEM

The TRA strives to enhance the overall rate of voluntary compliance, in an attempt to broaden their tax base (African Tax Administration Forum, 2014). The TRA recognised the potential of the informal sector to contribute to the revenue base of the country but recognised that the sector has unique characteristics – and that methods used in the past had been inadequate in dealing with the uniqueness of the informal sector. Therefore, to turn the potential of the sector into tangible results, the TRA needed to come up with strategies that recognised the unique characteristics of the informal sector (African Tax Administration Forum, 2014).

“Taxation of Small and Medium Enterprises in Africa, good practices and lessons learned”, a study undertaken at the TRA, collected the information required to describe the design (and finally implement) the BMS (African Tax Administration Forum, 2014).

Nhekairo (2014) says the TRA recognised that the methods used in the past had been inadequate to deal with an ever-increasing informal sector which had unique characteristics and had potential to contribute to the revenue base. The objective of implementing the BMS was to put in place a sustainable method and strategies of monitoring business activities of small and medium taxpayers to harness the informal sector’s potential to contribute to the revenue base of the country (Nhekairo, 2014; African Policy Research Institute, 2013).

According to Fjeldstad and Heggstad (2011), the TRA introduced the BMS to expand the tax base and optimise tax-revenue collection. Broadening the revenue base, and thus increasing public income without raising tax rates, is central to creating an equitable tax regime.

The BMS was a reform undertaken by the TRA to enhance the effectiveness and efficiency of taxing the SME sector in Tanzania (ATAF, 2014). As pointed out in paragraph 4.5, a system known as the 'Physical Survey' (PS) was in place prior to the BMS implementation. According to the African Tax Administration Forum (2014), the PS was ineffective because it was not sustainable. Operating the system was not cost effective. The PS system was a periodical programme, that is, undertaken periodically as and when funds and time allowed. The system lacked consistency and sustainability in enhancing tax compliance. The BMS was therefore implemented as an improvement to the PS system. It is a continuous and permanent programme that forms an integral part of the TRA's operations (African Tax Administration Forum, 2014).

The TRA recognised that the previous methods and systems in place were not effective, and inadequate to deal with the ever-increasing informal sector which had unique characteristics and had potential to contribute to the revenue base of the country (African Tax Administration Forum, 2014).

African Tax Administration Forum (2014) argues that the purpose of the BMS is to identify and facilitate easy registration of new taxpayers and facilitate the close monitoring of taxpayers' activities and their movements. The BMS helps to meet taxpayers' requirements promptly and enhances the expansion of the tax base, both quantitatively and qualitatively (African Tax Administration Forum, 2014). It facilitates the setting of collection targets, especially with respect to small taxpayers or individual taxpayers in the Block (African Tax Administration Forum, 2014).

The African Tax Administration Forum (2014) found that the BMS helps to combat tax evasion emanating from under-declaration of business transactions, and provides a feasible way of connecting with the informal sector through field visits. It enhances tax compliance through visits to business premises, which also enables dissemination of taxpayer education and prompt delivery of services (African Tax Administration Forum, 2014).

The BMS covers corporate tax, personal income tax, withholding taxes, and value-added taxes.

4.6.1. Structure of the Block Management System

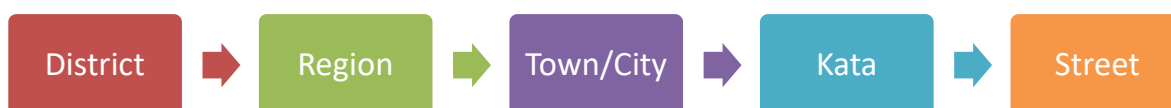
The starting point of the BMS is the physical identification and mapping of areas in which the SME taxpayers are located and operate (African Tax Administration Forum, 2014). This is done in close collaboration with stakeholders like local authorities and business associations that have jurisdiction over the specified areas for information-sharing (African Tax Administration Forum, 2014).

Block allocation is applied at both the regional level and at district level, by the creation of blocks or sub-blocks (African Tax Administration Forum, 2014). A block or sub-block can be created at regional level or at district level without any necessary coordination between them, provided the BMS policy is adhered to (African Tax Administration Forum, 2014).

A block is a specified manageable area that is mapped by sketches showing distinctive boundaries like street names (African Tax Administration Forum, 2014). Blocks can further be subdivided into sub-blocks referred to as *kata* (wards). (African Tax Administration Forum, 2014). The TRA has mostly used wards (*kata*) as the basis for defining the blocks (African Tax Administration Forum, 2014). A *kata* is a political subdivision. Each *kata* or a combination of two or more could form a block.

According to Fjeldstad and Heggstad (2011), each Block has a leader reporting to an assistant manager. The leader is assisted by a number of subordinates. Performance is measured by allocating each block revenue-collection targets (Fjeldstad and Heggstad, 2011).

Figure 4-1: Defining a Block



Source: African Tax Administration Forum, 2014

A block is defined as a type of business, particular economic or social sectorial activity, or a mapped-out geographical area such as a street or commercial estate (African Tax Administration Forum, 2014).

4.6.2. Block Administration

Each block is mandated to operate all the key tax-administration functions of registering, assessing, collecting and accounting for revenue collected (African Tax Administration Forum, 2014).

This structure makes it easier and more feasible for the staff assigned to each block to touch base with the taxpayers identified and registered in that specific block. Taxpayers also enjoy the benefits of user-friendly arrangements, making it more cost effective for them (AfDB, 2010).

The computerized block-control register (overall monitoring register), the revenue- arrears control register, and the tax assessment-position register are the three registers maintained for the purposes of the BMS (AfDB, 2010 and African Tax Administration Forum, 2014).

The allocated officers perform field surveys, which assist the officers to ensure registration of all taxpayers in sub blocks in terms of their income levels. This also serves as an information-update strategy, as officers get to update the taxpayer's personal and business information (AfDB, 2010).

Field surveys and information-update strategies have been implemented. Allocated officers ensure registration of all taxpayers in sub-blocks - and finally the block segment of the taxpayers - in terms of their income levels, and updating of the taxpayer's personal and business information in these registers. Field surveys have been implemented to ensure proper maintenance of these registers, and that information is updated accordingly (AfDB, 2010 and African Tax Administration Forum, 2014).

The officers are also responsible for tax education in their respective blocks (AfDB, 2010). The field survey is a useful tool in reaching qualifying unregistered taxpayers, hence bringing the self-employed and unregistered into the tax records (AfDB, 2010).

4.6.3. Outcomes and benefits of the project

Between the financial year 2010/2011 and 2012/2013, the number of SME taxpayers grew from 372,600 to 493,714 and the revenue collected during these two periods increased from US\$500 million to US\$900 million (Tanzania Revenue Authority, 2012; African Tax Administration Forum, 2014).

The implementation of the BMS system was an objective contained in the 2003/04 to 2005/06 corporate plan. Its aim was to focus on the physical identification and mapping of taxpayers (AfDB, 2010).

Overall BMS implementation has had a positive impact on the tax-compliance management of the SME taxpayers. This is mainly demonstrated by the increase in the revenue yield and increase in the number of registered taxpayers since its implementation (African Tax Administration Forum, 2014).

This system has simplified the registration of traders, non-filers and non-payers into the tax net through closer monitoring and collaboration with local government authorities (Fjeldstad and Heggstad, 2011).

Table 4-2: Registered Taxpayers in Tanzania (2002 – 2008)

Total #	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08	% Change (2002/03 to 2007/08)
Tax Identification Number	190 000	259 794	318 033	288 680	334 724	398 080	110%

Source: Fjeldstad and Heggstad (2011)

Table 4-2 above shows that the number of taxpayers in the TIN went up from 190 000 in 2002/03 to almost 400 000 in 2007/08 – an increase of about 110% (Fjeldstad and Heggstad, 2011). For the period between 2005/06 and 2007/08 there has been an increase of 37.8%, which is the period after the improved BMS system was implemented.

4.7 CONCLUSION

Since the TRA's establishment, the reforms centred around institution building, service delivery improvement and strengthening and integrating the authority's specialisation. These reforms are contained in successive TRA corporate plans of 1998/99 which remained in force in the 2002/03, 2003/04 to 2006/07 and the 2008/09 to 2012/2013 corporate plans (AfDB, 2010).

The Tanzania BMS has simplified the registration of traders, and has brought non-filers and non-payers into the tax net through closer monitoring and collaboration with local government authorities (Fjeldstad and Heggstad, 2011). Based on the increase in the number of taxpayers as per the TIN, it is evident that the system is achieving the objective of broadening the tax base by bringing non-filers and non-payers into the tax net. The awareness and communication process implemented during this process has also had a great impact in encouraging compliance amongst taxpayers, as they had better understanding of the tax laws and their responsibilities in complying with those laws.

The research objective identified in par 1.5.2(iii) is therefore successfully addressed, as it was found that the BMS initiative by the TRA is proactive and takes the TRA to the people, making information updates and communications faster and easier for the traders and business owners to understand. As South Africa is found to have a similar informal sector to that in Tanzania, it could be beneficial to implement a similar system in South Africa's informal sector.

CHAPTER 5

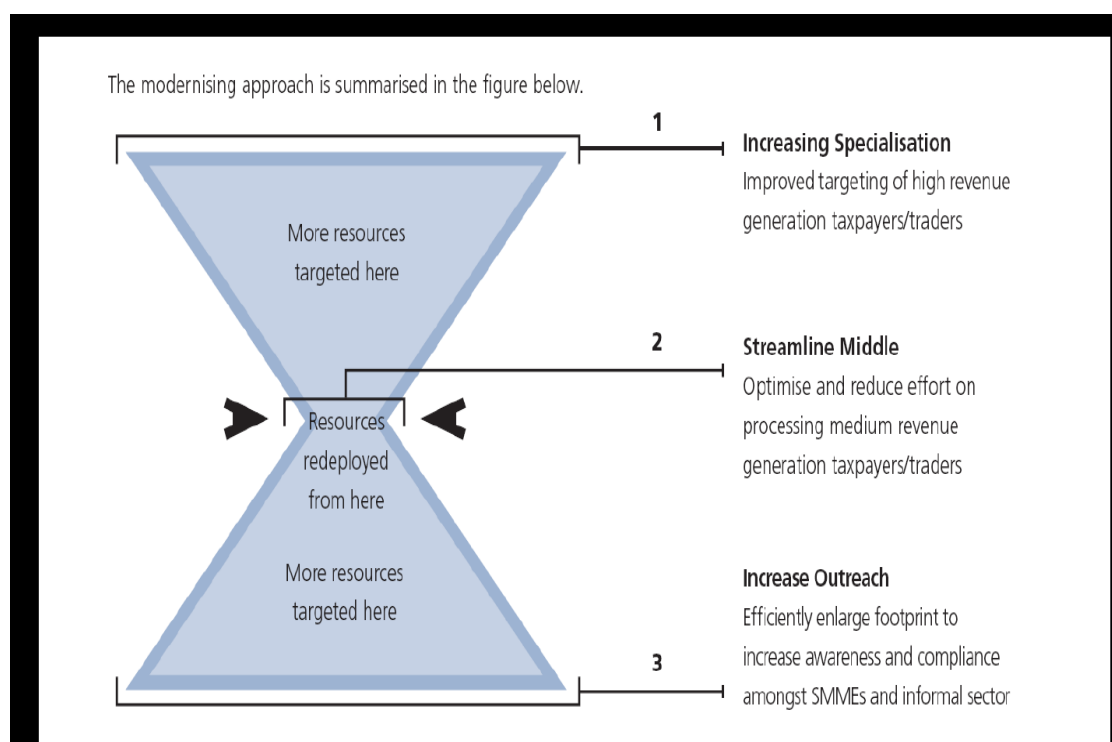
CONCLUSIONS AND RECOMMENDATIONS

5.1 CONCLUSIONS AND RECOMMENDATIONS

In 2009/10, SARS's Strategy Plan embarked on a modernisation strategy. The modernisation approach has recognised and identified that different taxpayers have different requirements, and acknowledges that interactions with taxpayers need to be tailored to meet their particular requirements (SARS, 2013).

The approach is to improve service in order to target high-revenue generating taxpayers; optimise and reduce effort on processing medium-revenue generating taxpayers; and efficiently increase awareness and compliance amongst SMMEs and the informal sector. This strategy is summarised by Figure 5-1 below:

Figure 5-1: SARS's Strategic Approach Summarised



Source: SARS 2012

Effective taxation of the informal sector is an important long-term goal (Fjeldstad, 2013:13). However, a proactive approach needs to be taken to identify all the businesses that are operating in the informal sector that should be registered, and identify liable taxpayers. The

ability to broaden the tax base through inclusion of all businesses will increase the perceived fairness of the tax system among citizens (African Tax Administration Forum, 2014).

In Tanzania, the BMS has simplified the registration of traders, and has brought non-filers and non-payers into the tax net through closer monitoring and collaboration with local government authorities (Fjeldstad and Heggstad, 2011). This outlook by the TRA is proactive and makes the TRA more approachable by making information updates and communications faster, and easier for the traders and business owners to understand. This could be beneficial to the South African environment of informal sector SMMEs.

Fjeldstad and Heggstad (2011) believe the reality is that some informal-sector entities will have income or turnover well below the tax net threshold, and therefore there can never be an expectation that large amounts of revenue could be raised by taxing informal traders.

Taxing informal urban economic activity is important, both in terms of governance concerns about the broadening the tax base, and also to explore alternative ways of building the capacity to tax the sector more effectively in the long term (Fjeldstad and Moore 2008; Fjeldstad and Heggstad, 2011).

Like any other new system, different stage rollouts are very important. The size of the country would need to be taken into account, especially in the urban areas which can be highly congested in places. On implementing the BMS, the first pilot was rolled out in the Dar-es-Salaam tax region, and other regions followed (African Tax Administration Forum, 2014). Implementation of a similar system in South Africa would require stage implementations with pre-set milestones.

A BMS-type approach implemented in South Africa would work hand in hand with the current strategy, where SARS collaborates with the Companies and Intellectual Property Commission (CIPC) to allocate an automatic tax reference number to any company that registers with the CIPC (SARS, 2015b). This proves that government departments can collaborate to achieve the objectives of the other. Through the Modernisation Strategy approach, South Africa has already put in place processes that are tailored towards the inclusion of informal sector SMMEs.

The findings of this study suggest that current tax initiatives incorporated into the Income Tax Act are not specifically tailored to the characteristics of the informal thus would not necessarily lead to the informal sector integration into the South African tax base. The

study has furthermore found that an alternative approach to integrating the informal sector into the South African tax base could be the implementation of a system similar to the BMS, successfully implemented in Tanzania - as there are marked similarities between the Tanzanian and South African informal sectors.

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