# PERCEPTIONS OF INFORMAL TRADERS TOWARDS TAXATION IN BUFFALO CITY MUNICIPALITY

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## ABSTRACT

The pressure on South Africa's tax revenue (income tax in particular) has become evident in recent years. The Davis Tax Committee and National Treasury have echoed the urgency of broadening the tax base by minimizing revenue leakages and maximizing compliance to tax legislation. Compared to industrialized and developing countries, the informal sector in South Africa remains an unexplored source of tax revenue. This research investigates the tax perceptions of informal traders to understand their attitude towards tax compliance. Personal, semi-structured and in-depth interviews were conducted with ten informal traders in Buffalo City Municipality in the Eastern Cape Province. The respondents generally displayed a positive willingness to comply with tax; issues of fairness and legitimacy as they pertain to the government, tax authority and tax system were strong anchors of tax compliance. A slightly defiant attitude towards the elements of the tax system was observed. Therefore, an inclusive approach to remedy non-compliance is recommended to address such variations in compliance behaviour.

## DECLARATION

I declare that this research is my own, unaided work and that all used sources have been referenced. It is submitted in partial fulfilment of the requirements of the degree of Master of Management (in the field of Public Policy) at the University of the Witwatersrand, Johannesburg. It has not been submitted before for any degree or examination in any other university.

E.N.N. Muwanga-Zake

6 August 2018

# DEDICATION

In memory of two special people I lost during the completion of this thesis – my beloved uncle Monwabisi Philani ‘Prof’ Nguza and grandmother Nomagcisa Felicia Pearl ‘Cherry’ Bulube.

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# CHAPTER 1: INTRODUCTION

## 1.1 CONTEXT

Taxation is an important source of government revenue that fulfils a number of social, political and economic objectives. These include poverty relief, the provision of public goods and services as well as the strengthening of political accountability (Rao, 2014). In addition, tax revenue offers a sustainable foundation for development by making governments less dependent on external sources of revenue. A strong tax system provides stability and attracts foreign trade and investment.

More recently in the literature, the state building function of taxation has received attention through the promotion of government transparency to citizens. Specifically, tax systems can foster greater accountability between the government and citizens. The failure of governments around the world to provide quality goods and services to citizens is largely due to insufficient tax revenue; as such revenue mobilisation and maximisation is the crucial key to the delivery of said goods and services.

Given the importance of tax revenue, the attention evident in the literature and tax administration practice globally has increasingly focused on how to maximise and sustain high levels of tax revenue. One of the indicators used to assess the efficiency of a taxation system is the tax-GDP ratio. The tax-GDP ratio "indicates the share of a country's output that is collected by the government through taxes" (Organisation for Economic Co-operation and Development [OECD], 2016a). Higher tax-GDP ratios can be achieved by, amongst other factors, favourable tax legislation, improvements in the operational efficiency of tax administration and growth in the size of the tax base. According to the United Nations, developing countries should achieve a minimum tax-GDP ratio of 20% to realise the Millennium Development Goals (United Nations Development Programme, 2010). Notwithstanding the improvement in recent years, half of sub-Saharan African countries still record tax-GDP ratios that are less than 17% (OECD, 2015).

One of the conventional ways of increasing tax revenue, therefore, is to increase the number of taxpayers. It is in the interest of the sustainability of the tax system to have an inclusive tax base. In the light of the increasing demands on government finances, particularly since the 2008 global financial crisis, tax administration globally (mostly in advanced countries) has focused on broadening the tax base. Tax base broadening is the practice of identifying unexplored sources of tax revenue. According to Fjeldstad, Schulz-Herzenberg and Sjursen (2012), "attempts to broaden the tax base require better knowledge of how the large majority of citizens perceive the tax system" (p. 34). One of the techniques used to broaden the tax base is to ensure high levels of compliance with tax legislation. Tax compliance is the degree to which taxpayers, traders and intermediaries like tax practitioners and clearing agents meet their legal tax obligations (OECD, 2016b).

Fjeldstad et al. (2012) stated that non-tax compliance has a number of negative fiscal, economic and legal effects. Revenue losses arising from non-compliance can result in a higher fiscal deficit, borrowing costs and government debt. Economic efficiency and income distribution become distorted due to the differences in effective tax rates afforded by non-compliance. Fjeldstad et al. (2012) further noted that non-adherence to tax legislation does not only undermine the objectives of the formal tax system by perpetuating non-compliance, but it encourages a culture of disregard for the legal system in its entirety.

For this reason, interest has centred on taxpayer behaviour as a way of reducing occurrences of non-tax compliance. According to Taylor (2001), "understanding why taxpayers do or do not comply with tax regulation has been the focus of much research over the past three decades". Behavioural studies in taxation have focused on tax morale, defined as "the motivation of a country's citizens to pay taxes" (Daude, Gutierrez, & Melguizo, 2012, p. 4). Knowledge of what motivates or discourages individuals from parting with financial resources (i.e. tax) or attitudes towards taxation in general could provide insight into their actual tax compliance behaviour.

The relationship between tax morale and tax compliance has been validated empirically in both developed and developing countries (Daude et al., 2012). It has been found that tax morale gives a reliable indication of tax compliance behaviour. Therefore, in order to attend effectively to the policy issue of tax compliance, consideration must be given to the complexity of an individual's decision to pay taxes, in light of the recurring global problem of tax base erosion particularly in recent decades (OECD, 2010).

Tax administrations, globally, share a common mandate to collect all tax revenues due to the state by way of ensuring maximum tax compliance levels. However, the problem of limited knowledge regarding tax compliance behaviour in developing countries remains (D'Arcy, 2011). Knowledge of the behaviour of the tax base puts tax administration "in a stronger position to design and implement effective compliance strategies, which contributes to the sustainability of taxation systems" (OECD, 2010, p. 5). Insight into taxpayers' motivators or deterrents for paying tax therefore sufficiently enables tax administration to positively influence tax compliance, thereby minimising revenue losses. Additional spill-overs that result from understanding taxpayer behaviour are positive tax reforms such as the simplification of tax legislation and tax policy which, in turn, increase the taxpayers' awareness of the important role of tax in government finances and the economy. Further, it can increase voluntary compliance and advance the efficiency of tax administration (Walsh, 2012).

In Africa, the challenge has been to identify unexplored sources of tax revenue and to include more taxpayers in the tax base, rather than increasing tax rates (Fjeldstad & Heggstad, 2012). The distribution of the tax burden is skewed, as the majority of (formally registered) taxpayers are responsible for contributing to tax revenue while others who are able to pay taxes remain outside the tax net. The process of identifying, locating and enforcing tax obligations on new taxpayers requires, for example, financial and human resources, time, technology, intelligence systems and organisational will. For these reasons, it is not immediately appealing to tax authorities. Instead, tax authorities are more inclined to focus their efforts on existing taxpayers.

Although taxpayer non-compliance is a recurring and growing global problem, it is known that developing countries, and sub-Saharan Africa in particular, are worse off due to tax revenue leakages caused by the prevalence of the 'shadow economy'. The shadow economy is a universal term used to describe unrecorded economic activity. Schneider and Enste (2000) formally define it as "unreported income from the production of legal goods and services, either from monetary or barter transactions, hence all economic activities that would generally be taxable, were they reported to the tax authorities" (p. 78). The high incidence of the shadow economy, which is identified as one of the areas where tax compliance is especially low or non-existent in developing countries has prompted academics to mainly attribute poor tax revenue outcomes to this sector.

In South Africa, non-compliance has a direct bearing on the government's capacity to respond to pressing socio-economic development needs. Tax revenue is the most significant source of government revenue, contributing more than 90% of the government's consolidated revenue (South African Revenue Service [SARS], 2015a). Reference to South Africa's tight fiscal space was made in 2015 where Personal Income Tax (PIT) rates were increased for the first time in 20 years in the National Budget Speech (National Treasury, 2015).

The need to broaden the tax base by improving taxpayer compliance and reducing the tax gap has therefore become more critical. Among developing countries and sub-Saharan Africa, SARS has emerged as one of the success stories in matters of revenue mobilisation, technological modernisation and general operational efficiency. When compared to its peers, "South Africa is considered relatively high with strong enforcement, risk profiling, taxpayer education, and services" (Ali, Fjeldstad & Sjursen, 2012). Evidence of SARS' operational efficiency is a cost-to-revenue ratio that has been below the international benchmark of 1% for the past three fiscal years, suggesting, "SARS has contained operational costs while also increasing the amount of revenue it has collected" (SARS, 2016a, p. 7). The lowest ratio of 0.96% was recorded in 2015/16 (SARS, 2016a). The performance of South Africa's tax-GDP ratio illustrates SARS' modest success in broadening the tax base. Compared to the African Tax Administration Forum (ATAF) member countries South Africa has maintained an average tax-to-GDP ratio of 24.9% from 2010 to 2014[1], making it the second highest ratio after Zimbabwe. South Africa's tax-GDP ratio is slightly below the OECD member countries average of 25.7% recorded over the same period (African Tax Administration Forum [ATAF], 2016).

The exceptional performance of efficiency indicators shows that SARS made great strides in broadening the tax base; however, this achievement has been concentrated in the formal economy as a result of taxpayers that are currently in the tax net. Despite these achievements, at present the challenge remains extending these gains to the informal sector where SARS has been less successful in collecting tax revenue (Smith, 2003).

## 1.2 RESEARCH PROBLEM

Statistics South Africa's Census 2011 SuperCross dataset revealed a significant number of individuals in the informal sector whose declared income fell above the 2012/13 taxable income thresholds[2]. This possibly highlights cases of non-compliance and unrealised revenue from the sector to the PIT base[3]. The tax compliance behaviour of informal sector participants in South Africa generally remains unexplored, despite evidence of its revenue

[1] Analysis restricted to 2010-2014 due to data unavailability for ATAF member countries
[2] Taxable income was estimated using gross incomes declared by informal traders and by applying a micro simulation model
[3] It is unlikely that an individual would declare they operate informally yet pay income tax

generating activities. Knowledge of the tax compliance behaviour of informal traders is therefore a vital step towards reducing the levels of non-compliance of the informal sector and broadening South Africa's PIT base.

The dominant narrative is that incidences of non-compliance in the informal sector are largely deliberate. In other words, informal traders knowingly engage in tax evasion – defined as the illegal practice whereby taxpayers intentionally fail to honestly declare or pay their tax liability (OECD, 2016b). Non-compliance in the informal sector is largely attributed to tax evasion. Even if this is the case, it is not known why these traders choose to evade taxes. In analysing taxpayer behaviour then, there is a natural tendency to ask why taxpayers, well aware of their tax obligations, still make a deliberate decision to evade taxes.

## 1.3 RESEARCH QUESTIONS

This research primarily seeks to contribute to the understanding of the tax compliance behaviour of informal sector traders in South Africa, to attend to the issue of non-compliance and enable the successful collection of tax revenue from the sector. This research therefore poses three questions in an attempt to realise the research objective.

i. Primary: What are the perceptions of informal traders regarding South Africa's tax system?

The focus on the underlying perceptions is to gain an understanding of the attitudes informal traders have towards the tax system, what motivates or deters tax compliance as well as the anchors of their tax morale. Chapter 2 discusses the theoretical foundations of the primary research question in detail.

ii. Secondary: What is the understanding of informal traders regarding the taxation system and their tax obligations?
iii. Secondary: What experiences do informal traders have in using taxpayer services?

The secondary research questions consider the knowledge levels of informal traders with respect to the tax system in general as well as interactions with the tax authority. The assumption here is these aspects can influence the willingness and ability of informal traders to meet their tax obligations. For instance, where awareness levels are low and yet there is a willingness to pay, one could question the effectiveness of taxpayer education and engagement efforts by tax authorities.

## 1.4 RESEARCH RATIONALE

Empirical research on the determinants of tax compliance has been undertaken extensively by organisations such as Afrobarometer and the OECD. These have mostly been in the form of tax perception surveys of citizens globally although coverage in African countries is less robust. In addition, their sample has included the general population and not necessarily those engaged in the informal sector. In South Africa, tax perceptions studies pertaining to citizens have been conducted (Oberholzer, 2008), as well as a particular focus on previously disadvantaged South Africans (Oberholzer, 2005). Therefore, one cannot ascertain that the tax compliance drivers revealed by these studies apply to the informal sector specifically.

The methodology used in tax compliance behaviour studies has so far mostly relied on the quantitative approach. Notwithstanding its strengths and contribution to literature on tax compliance behaviour, a qualitative approach is more capable of bringing greater depth into a subject area that remains relatively unexplored. In addition, what remains ambiguous is whether, or, to what extent the theoretical framework and literature that underpin taxpayer behaviour are applicable to informal sector participants.

Tax base broadening efforts that include the informal sector have made it onto the agenda of other African countries like Mozambique, Tanzania and Zambia (Fjeldstad & Heggstad, 2012). In July 2013, South Africa's National Treasury established the Davis Tax Committee "to assess our tax policy framework and its role in supporting the objectives of inclusive growth, employment, development and fiscal sustainability" (National Treasury, 2013, p.21). Although tax broadening as it pertains to the informal sector has not been stated explicitly, one of the research interests of the Davis Tax Committee in the area of raising additional tax revenue is whether this can be achieved by improving tax compliance and broadening the tax base (Davis Tax Committee, 2014).

South Africa has one of the most unequal societies in the world, and so the progressive nature of the taxation system is a way to address these inequalities. However, existing taxpayers are significantly burdened, thus leaving limited room for the government to further raise PIT rates. Rather than raise PIT rates, an alternative is to bring more qualifying taxpayers into the net to alleviate pressure and have a more sustainable tax system. According to Fjeldstad and

Heggstad (2012), “for taxation to have a positive effect on accountability, taxes must be ‘felt’ by a majority of the citizens” (p. 1). This raises issues of fairness and the equal distribution of the tax burden based on the ability-to-pay principle. South Africa’s PIT system is modelled on the horizontal equity (ability-to-pay) principle guided by the belief that people with equal capacity or income should pay the same amount of tax.

This research hopes to make direct and indirect contributions to the issue of non-compliance in the informal sector. The direct benefit is that the compliance of informal traders that fall within the taxable income thresholds could gradually result in improved tax collections from the sector. Indirect benefits may result from traders that fall below the taxable income threshold. Although their compliance will not necessarily translate into immediate tax revenue gains, it is critically important for them to develop a culture of compliance for situations when they experience growth in operations and start earning taxable income. Moreover, existing levels of tax compliance in the formal sector may be compromised when others in the sector do not comply with tax legislation - potentially perpetuating the problem of non-compliance.

## 1.5 LIMITATIONS AND SCOPE OF THE RESEARCH

Knowledge of taxpayer behaviour may have implications for tax reform. As in any other public policy development and implementation space it has wide-ranging consequences for policy actors such as individuals, businesses and institutions. With this in mind, this research does not explore aspects of feasibility regarding the enforcement of compliance in the informal sector. Notably, the possibility of reduced participation rates by traders in the sector and the quantification thereof as a result of increased enforcement efforts by tax administration fall outside the scope of this research. The nature of the research is exploratory and is merely for the purpose of understanding the dimensions of tax morale as well as the compliance behaviour of the informal sector. For the purposes of this research, the appropriateness of South Africa’s current tax design for small, medium and micro enterprises (SMMEs) and the capacity of its tax administration to implement recommendations that may result from the research findings are not considered. No initial assumptions on the nature of non-tax compliance of the informal sector are made, that is, references to non-compliance are neutral in that it could be unintended or deliberate.

## 1.6 RESEARCH METHODOLOGY

The research approach employed was qualitative. The literature surveyed showed that research in the field of tax morale has had a quantitative bias, therefore findings have been generalised. The objective of this particular research is to give a more detailed understanding of the perceptions of informal traders towards paying tax. Studies on tax morale are relatively new in South Africa. To date, there is less evidence of the tax morale of taxpayers in the informal sector compared to taxpayers in general. Morsel, as cited in Creswell (2014), states that a qualitative approach is appropriate when the topic is relatively new within a certain sample or group under study. Data was collected by conducting personal in-depth interviews using a semi-structured discussion guide. This was motivated by the need to safeguard data validity and to establish trust. Small business owners operating informally within the Buffalo City Municipality in East London, Eastern Cape, were interviewed. On this account, the sampling method was purposive. The location was also chosen based on convenience, arising from the researcher's familiarity with the area and competence in the dominant language, isiXhosa. A total of ten respondents were interviewed. The sample size was considered adequate because at this size, the data had become saturated.

## 1.7 THESIS OUTLINE

The thesis is structured into six chapters. Chapter 1 introduces the research by providing the context, a statement of the research problem, the research questions and the research objectives. The research rationale and limitations of the research concludes the chapter. Chapter 2 discusses the theoretical framework underpinning taxpayer behaviour. The models under the theoretical framework ultimately attempt to explain what motivates or discourages individuals' payment of tax. Chapter 3 presents the literature review which is organised into four topics. The first topic introduces taxation concepts and concludes with a situation analysis of South Africa. The second topic conceptualises the informal sector and small businesses by looking at competing definitions in the literature. The third topic describes South Africa's informal sector and relevant policy frameworks. The fourth topic discusses the taxation of the informal sector. Chapter 4 further elaborates on the research methodology and the operationalisation of the research. Chapter 5 presents and analyses the research findings. Chapter 6 provides the concluding remarks.

# CHAPTER 2: THEORETICAL FRAMEWORK

## 2.1 INTRODUCTION

There is a vast body of literature regarding the theoretical foundations of the determinants of tax compliance. Researchers have classified the theoretical frameworks in different ways. This chapter conceptually divides the frameworks into two parts in line with the objectives of this research. In essence, both parts attempt to consider the factors that influence the tax compliance behavior of taxpayers or simply what prompts or discourages individuals from paying their taxes. The chapter responds to this inquiry from two vantage points – section 2.2 considers the broad determinants while section 2.3 discusses the institutional factors pertaining to tax authorities. The frameworks presented in both sections overlap slightly; the joint contribution of these frameworks has been instrumental in informing compliance programmes of tax authorities globally.

## 2.2 MODELS OF TAXPAYER BEHAVIOUR

When the motivators or deterrents of taxpayer behaviour are understood, higher levels of tax compliance can be achieved. The theoretical framework of tax compliance dates back to the 1980s when "structured research into tax evasion and non-compliance became widespread following political concerns in the United States of America of an increasing tax gap" (Devos, 2013, p. 13). Traditionally, taxpayer behaviour theory mainly falls into two schools, approaches or models of compliance[4], namely, the Economic Deterrence model, as well as the Fiscal and Sociology models. The latter were extended to include the Comparative Treatment and Political Legitimacy models.

### 2.2.1 Economic Deterrence model

The Economic Deterrence model maintains a hard stance on non-compliance by treating it as a punishable criminal activity. In most cases, references to non-compliance are illegal (tax evasion). The model assumes that the individual is a rational maximiser who considers the benefits of under-reporting income while mindful of the possibility of sanctions. Initially, it supposed that an individual's decision to pay taxes is determined by the presence of punitive measures for non-compliance. Punitive measures demand an aggressive approach where tax authorities essentially punish 'bad behaviour' by levying hefty penalties and interest on accounts for non-compliance. In this harsh enforcement environment, taxpayers are regarded

[4] Schools, approaches and models are used interchangeably

as legal offenders. The model therefore proposed that such an environment that had high audit rates, high tax rates, and legal sanctions would be sufficient to force taxpayers to honestly declare incomes. The Economic Deterrence model later evolved to incorporate persuasive measures as it proposed instead, that taxpayers respond more positively to economic incentives, supportive taxpayer engagement and the reinforcement of positive images of compliance.

Becker (1968) was one of the earliest pioneers of the Economic Deterrence approach, where criminal behavior (in general, not necessarily limited to taxpayers) was modeled within an economic framework for the first time. The decision to engage in criminal activity is made by a rational individual, who considers the costs and benefits of a crime. Criminal activity is not undertaken and is considered irrational, when the likelihood of getting caught, as well as being sanctioned, is higher. Harsh enforcement activities could therefore serve to discourage illegal activities. What is not taken into consideration in this model is that punitive measures (e.g. fines, imprisonment) are accompanied by costs. In some cases, compliance would be achieved at a loss because the enforcement costs would exceed the tax revenue to be recovered. There was therefore a need to further develop the model due to this shortcoming.

Further shortcomings of the Economic Deterrence model were introduced by Jackson and Milliron (1986) who found inconclusive evidence of the influence of the severity of sanctions on compliance behaviour. In other words, the main argument here was that penalties could prove to be counter-productive if they are severe, in that they can alienate individuals and make them rebel further against the law.

Allingham and Sandmo (1972) made one of the major contributions to the Economic Deterrence approach, with the model known as the Classical model of tax evasion. The researchers disputed any direct correlation between penalties and compliance – higher penalties do not necessarily result in a growth in honest income declarations. In particular, Allingham and Sandmo (1972) proposed that the severity of punitive consequences was less relevant, and of more importance was the certainty the taxpayer has of being audited. The model compared the net incomes arising from different scenarios based on the compliance status of the taxpayer and the probability of being audited. The researchers concluded that a taxpayer’s income is the highest when it is understated under low audit certainty and it is the lowest when tax is evaded and detected by an audit. Therefore, when tax authorities have high audit rates, taxpayers tend to declare incomes honestly because there is a higher probability of being selected as an audit case. However, by assuming away punitive measures (in form or severity) their analysis is somewhat incomplete. It is not clear how punitive measures could affect the outcome of the model.

A shift in focus from audit probabilities in the classical model of tax evasion to the tax rate occurred. Various researchers included different permutations of the effect of the tax rate and other factors in relation to tax compliance. Gordon (1989) found that although compliance decreases with increases in the tax rate, this depended on the morality levels of taxpayers. In other words, taxpayers with a low sense of morality tend to be less compliant than those with a higher morality when the tax rate increases.

The Economic Deterrence model was extended in the 1990s and incorporated persuasive approaches to encourage tax compliance. This was a departure from punishing bad behavior (through punitive measures) to encouraging good behaviour using positive motivators. Up until that point, the Economic Deterrence model had emphasised that taxpayers' compliance depended on the presence of penalties and high audit probabilities. Falkinger and Walther (1991) introduced rewards and incentives as some of the other factors that encouraged tax compliance; and, by so doing, changed the nature of compliance. Although both punitive and persuasive measures would result in higher compliance levels, this would be achieved in different ways. In the approach by Allingham and Sandmo (1972), one could say a taxpayer becomes compliant because he is forced, whereas the approach by Falkinger and Walther (1991) encourages voluntary compliance.

In addition to introducing economic incentives to encourage voluntary compliance, Falkinger and Walther (1991) further found that a combination of punitive and persuasive factors or a mixed penalty-reward system would jointly maximise tax compliance. A reward offered to the taxpayer is regarded as a guarantee against future under-declaring of income and compensates the taxpayer for the inconvenience of being selected for audit. Falkinger and Walther (1991) showed that "from an economic point of view, the introduction of such a reward is desirable in the sense that it constitutes a welfare-increasing measure" (p. 72). This input was a modification of the standard penalty models in Economic Deterrence literature, and therefore implies that an existing penalty system should still be in place because its non-existence would compromise the effectiveness of a pure reward system. The mixed penalty-reward system was therefore found to be more beneficial than a system relying solely on penalties, which is also sub-optimal.

Falkinger and Walther (1991) favoured neither approach over the other, but rather motivated for an ideal penalty-reward system that guarantees a certain amount of tax revenue for authorities while maximising the taxpayer's utility. The effectiveness of a penalty-reward system depends on the compliance status of the taxpayer. Before qualifying for such rewards, the taxpayer should be in a default or non-compliant status. The optimal solution typically entails a compromise for both parties where a taxpayer that has evaded taxes parts with financial resources to pay for the penalty while receiving compensation; while the authority potentially recovers some tax (and continues to do so) through positive reinforcements to the taxpayer. This results in reduced evaded taxes and therefore higher compliance levels.

The positive impact of persuasive incentives on tax compliance has since been validated in the literature. One of the earliest experiments by Alm, Jackson and McKee (1992a) confirmed that the use of various financial rewards - a lottery scheme or a fixed once-off payment - on compliant taxpayers resulted in more honest income declarations. The effectiveness of a lottery scheme reward system based on the earlier findings by Alm et al. (1992a) was later extended by Wan (2009), this time in a field-experiment pertaining to business taxes in Asian countries (China, Taiwan, Korea and the Philippines) and once again lent support to higher tax compliance outcomes and tax revenues.

In the evolution of the Economic Deterrence model, researchers presented differing views on the impact of a range of punitive factors (tax rate, probability of detection, audit rate, penalties) and persuasive factors (rewards, incentives) on tax compliance. There have generally been inconclusive empirical findings on the effectiveness of punitive and persuasive tools in positively influencing the compliance decisions of taxpayers. Despite the presence of punitive measures and engagement programmes that encourage compliance in many countries, there are many examples of non-compliance and overall disregard for tax legislation. Tax authorities in developed countries still have to contend with the issue of non-compliance even with sophisticated laws and tax administration systems in place. While it offers insights, the Economic Deterrence model has therefore generally proved to provide an inadequate explanation for non-compliance.

### 2.2.2 Fiscal and Social Psychology models

The Economic Deterrence model relies on the neoclassical view of the individual behaving in a rational way and in this way assumes that human behavior is predictable. The model disregards the complexity of human behaviour that is often illogical and unexplained. The

Fiscal and Social Psychology models therefore attempt to account for the additional unconsidered determinants of tax compliance behavior (Alm and Torgler, 2011).

The Fiscal and Social Psychology models consider dimensions of perceptions, attitudes, beliefs and norms and use these as a basis to describe tax compliance behaviour. These models build on from the Economic Deterrence model that views individuals as individual maximisers. Both models do not dispute that tax compliance is driven by economic factors, but rather these factors alone do not adequately capture the drivers of tax compliance. Some of the determinants of compliance in the Fiscal and Social Psychology models range from social norms and personal characteristics to judgments of fairness regarding the tax burden as well as government expenditure on public goods and services (Devos, 2013).

#### 2.2.2.1 Fiscal Exchange model

The Fiscal Exchange model states that the provision of government services has an important bearing on an individual's decision to meet their tax obligations honestly (Doerrenberg, 2015). If an individual perceives public goods and services provided by the government to be inferior compared to the amount of tax paid, it is highly likely that compliance will be low. Moreover, the perceptions of public officials by taxpayers and transparency of government finances play an important role in the willingness to comply with tax (Alm & Jackson, 1993). The fiscal contract between taxpayers and the government involves the provision of public goods in exchange for the payment of taxes. Other aspects such as positive perceptions of the tax system and collective decision making are also central to fostering high levels of tax compliance (Alm & Jackson, 1993).

Initial studies of the Fiscal Exchange model incorporated variables pertaining to the classical model of tax evasion, in acknowledgment of the prior contribution of the Economic Deterrence model to the tax compliance literature. The development of tax compliance theory became less narrowly defined and began to incorporate social as well as psychological aspects. Becker, Buchner and Sleeking (1987) hypothesised that the propensity to evade taxes was explained by expected audit probability, income, transfer payments (public expenditure variable) and the perceived tax burden. The first three variables conformed to a *priori expectations*[5] – the propensity to evade taxes rose with increasing income, declined with higher auditing probability and decreased with rising transfer payments. However, transfer

[5] The exceptional result of the fourth explanatory variable - perceived tax burden - is not discussed here. Refer to Becker, Buchner & Sleeking (1987) for a further explanation of the result

payments received by the individual showed greater explanatory support for explaining tax compliant behaviour. In addition, perceptions of a higher value of transfers received by an individual relative to others decrease the tendency to evade taxes.

In another multi-model experiment where variables of the Economic Deterrence and Fiscal Exchange were used to determine individuals' assent to pay taxes, Alm, McClelland and Schulze (1992b) provided some evidence that the Fiscal Exchange model outweighed the economic influences on compliance. Alm et al. (1992b) found that the positive correlation between the compliance rate and the consumption of public goods holds, "even when there is no chance of detection and punishment" (p. 36). This implies that Economic Deterrence factors such as probability of detection and punitive measures do not solely explain compliance with tax legislation, and that Fiscal Exchange exhibits a relatively stronger explanatory power.

Alm and Jackson (1993) made three claims regarding the impact of the use of tax revenues and the decision-making process of the use of tax revenues on compliance. Firstly, compliance behaviour is more favourable when individuals choose expenditure budget allocations than when the same allocations are imposed upon them by the government. In both cases, although the outcome is identical, it is the process used to arrive at the outcome that determines the compliance attitude. Inclusive decision making is one of the cornerstones of a democratic government, and the willingness of citizens to pay taxes cannot be divorced from broader issues of government legitimacy. Secondly, compliance is higher when the public vote receives overwhelming support, on condition that the outcome of the vote is publically communicated. The public communication of the vote is a way for citizens to confirm that others share the same preferences. Lastly, Alm and Jackson (1993) found that "compliance is lower with an imposed and unpopular public good than in the complete absence of any public good" (p. 288). Matters of inclusivity and government transparency thus have a positive bearing on tax compliance. Furthermore, the public good in question must be valued by the citizens, as well as the realization that the misuse of public funds has a negative impact on tax compliance. Not only does the analysis place the institutions and decision-making processes of fiscal policy under scrutiny, it also illustrates that consistency between government spending priorities and citizens' preferences provides an indication of compliant behaviour.

A study conducted by Doerrenberg (2015) not only confirmed the relationship between tax revenue uses and tax compliance behaviour, but also showed that differences in compliance depended on the type of expenditure. The subjects of the laboratory experiment conducted were given an option to choose between four tax revenue expenditure areas according to their preferences. Compliance levels were found to be higher in subjects where tax revenues were used for research and charity organisations, and were lower where tax revenues were spent on redistribution and transfers to the government. The study confirms earlier assertions in the Fiscal Exchange model that the decision to pay taxes is a function of the benefits received by taxpayers. It also extends the function by supposing that the payment of taxes hinges on the expenditure programme specified. This particular experiment contributed to the Fiscal Exchange framework by being one of the first studies "that explicitly tests if different recipients of tax revenue affect compliance" (Doerrenberg, 2015, p. 31).

Governments have different sources of revenue (licenses, penalties, natural resource rents). The explicit reference to taxation revenue in the Fiscal Exchange model is deliberate. Moore (2004) explained that taxation plays a unique role because it is the broadest measure of the quality of governance. Using a fiscal sociology framework, the researcher asserted that the reason that poor governance is prevalent in developing countries is that those states are less dependent on the majority of domestic individual taxpayers and more reliant on revenue from a few foreign oil companies or government owned natural resource enterprises. In these circumstances, the government is accountable to a smaller tax base which makes it comparatively easy to conceal fiscal planning from the public. Commenting on the so-called governance dividend of tax states, Moore (2004) stated that "relative to other types of taxes, tax states will tend toward accountable, representative government" (p. 299).

The evolution from Economic Deterrence to Fiscal Exchange models of tax compliance was particularly significant. For the first time in the literature, tax compliance was no longer considered from the one-dimensional view of the taxpayer, but now also implicated the government. The conceptual perspective shifted from handling non-compliance as a criminal activity to a broader governance issue. On this account, the Fiscal Exchange model appears to be a conceptually stronger approach, perhaps because within the development of the model, there appears to be a wider consensus about the variables and resulting relationships that give rise to tax compliance behaviour.

### 2.2.2.2 Social Psychology model

The Social Psychology model considers the social influences on tax compliance. Understanding the social environment therefore, in terms of the values and norms that govern it, provides the parameters and context against which individual choice is exercised. According to the Social Psychology model, individuals do not act independently, and of interest to them is whether or to what extent others meet their tax obligations.

Snavely (1990) was one of the earliest contributors to the Social Psychology model of tax compliance that advocated for the inclusion of non-economic factors such as social relationships in individual taxpayer behaviour. According to pro-social behaviour, an individual who is surrounded by compliant individuals is more likely to exhibit the same behaviour than an individual who is in close proximity with those that do not pay taxes. Here, it is important to note that references to non-compliance are purely treated as intentional. However, non-compliance can either result from a prevalence of tax evasion in a criminal sense or from a culture of ignorance brought about by misinformation. Regardless of how non-compliance comes about, the pro-social behaviour theory explains in part why one can observe common compliance behaviour in a geographic area or within a population[6].

There are various parallels between the Fiscal Exchange and Social Psychology models, which make distinguishing between the two an onerous task. The inequity theory, traditionally explored under Fiscal Exchange, implies that individuals cheat on taxes as a way to restore perceived inequity between what they pay for government services and what they receive. As much as Fiscal Exchange speaks to the contractual exchange of taxes for services between the individual and government (vertical equity), consideration should also be given to horizontal equity, i.e., what others pay to receive the same services. For example, Spicer and Becker (1980) tested the relationship between fiscal inequity and tax evasion by observing the amount of taxes participants evaded given a standard individual tax and an average tax rate paid by others that is above or below the standard tax rate. The results indicated the percentage of tax evaded increases (decreases) for those whose individual tax rate is above (below) the average tax rate. Frey and Torgler (2007) suggested that individuals use the tax system to self-correct for perceived inequity, "people will engage in certain behaviour, such as tax evasion, to restore equity" (p. 138). A lack of satisfaction between an individual's tax rate and those of others provides the justification for falsely or under-

[6] By age, race, gender, economic status, education level or income level

declaring income. Closely related to the equity theory is conditional cooperation, which supposes that an individual's payment of taxes is conditional upon the compliance of others (Frey & Torgler, 2007).

Further extensions of conditional cooperation theories are reciprocity theories. Reciprocity theories state that individuals contribute to the provision of public goods, not only when others contribute but when their contributions are matched. A study by Croson (2007) on factors that encourage voluntary contributions in social settings provided support for both conditional and reciprocal theories. The researcher found a positive association between an individual's contribution and certainty of contributions of others in his group, as well as between an individual's contribution and actual contributions of others in his group.

Herd behaviour is a phenomenon where an individual bases his decision on a decision made by another individual in formulating an appropriate course of action, "even when their private information suggests doing something quite different" (Banerjee, 1992, p. 798). This is motivated by the confidence of a previous decision maker that is said to signal vital new information that will affect the quality of the choice to be made more favourably. However, the model of herd behaviour was found by Banerjee (1992) to result in inefficiencies.

To illustrate herd behaviour within the tax environment[7]; taxpayers in a society are always faced with two decisions – to comply or not to comply. If decision making is sequential and can be observed, each individual follows the choice made by their predecessors and reject their own decisions. If the predecessor decides to evade taxes, this becomes the dominant choice for the successor even if their initial decision was to the contrary. Banerjee (1992) admits the model is oversimplified. However, at a practical level, the model suggests that a way to capture a new group of taxpayers (for example demographically or geographically) is to attempt to persuade at least one taxpayer to be compliant by making the terms of complying more attractive. In other words, although the process of herd behavior may be termed inefficient, the results can prove to be otherwise.

Some empirical studies have shown that a combination of approaches (Economic Deterrence as well as Fiscal and Social Psychology) can provide a more complete perspective on tax compliance behaviour. Legal enforcement actions such as audits may have positive spill-over effects in that they may result in positive perceptions and attitude towards the tax system and

[7] Example adapted from Banerjee (1992)

thereby increase voluntary compliance (Wetzler, 1993). The Economic Deterrence approach individualises participation in illegal activities; however, perceptions of the success rate of societal members engaged in similar activities can only really be primarily ascertained with some level of social interaction. Tax authorities have capitalised on the fear of social sanctions and the humiliation of individuals because "social stigmas can be long lasting" (Snavely, 1990, p. 63). When a taxpayer has been found to be delinquent, tax authorities typically and intentionally make this public in an effort to discourage the norm of tax evasion. To an extent, the effectiveness of punitive measures of the Economic Deterrence approach depends on some signal from the taxpayer's social environment.

Although the Fiscal and Social Psychology models succeed in providing a more holistic theory of tax compliance, their variables are difficult to measure because they are not physically observable and are subjective. In addition, it is unclear at this stage how these models account for changes in social norms and attitudes. Societal transformation is a reality and the relevance of these models lies in their ability to adapt, explain and reflect these changes.

### 2.2.3 Comparative Treatment model

The relationship between the individual and legal authorities is explored in the Comparative Treatment approach, which broadly states that compliance to legal rules is determined by how individuals perceive the functioning of the legal system. This approach also considers issues of objectivity in the application of the rule of law as well as the legitimacy of the legal authorities. According to the model, positive perceptions of the entire legal system encourage tax compliance, and vice versa.

In taxation, trust in and fairness by tax authorities have been shown to be important in fostering a culture of voluntary compliance (OECD, 2010). Fairness is a key theme of the Comparative Treatment model similar to the Fiscal Exchange and Social Psychology models. In the Comparative Treatment model, the decision to comply is not completely taken in isolation, while consideration is also given to the fairness of punitive measures applied to others. With regards to the Fiscal Exchange model, if there is a perception that others are subjected to a lower tax burden (fiscal inequity), the tax system is judged to be fundamentally weak or unfair, which then justifies non-compliance. Moreover, there is relevance in noting the compliance behaviour of societal members (a key feature of the Social Psychology model), because it gives an indication of the strength of the legal system. When others are observed to be successfully evading taxes, it encourages like behaviour because the legal system is perceived to be dysfunctional.

Wenzel (2002) established that perceptions of procedural and distributive justice have a more positive impact on tax compliance when taxpayers have a strong sense of shared national identity with the rest of society. National identity in the Comparative Treatment approach is accompanied by the belief that taxpayers will be treated respectfully, fairly and in an unbiased manner by tax authorities. In this case, it is important for tax authorities to promote and convey messages of shared national identity to taxpayers.

D'Arcy (2011) notes that despite its explanatory power, contributions to this theoretical model of tax compliance have either solely overemphasized the vertical relationship between the citizen and the state, or the horizontal relationship between the citizen and the collective. The main argument by the researcher is that the compliance behaviour modelled in the Comparative Treatment approach is a function of both vertical and horizontal dimensions. In making a compliance decision, individuals not only consider how the state treats them, but also how the state treats them compared to others. The horizontal equity consideration emerges yet again, similar to the notion of common identity which emerges as a key theme of the model.

With respect to the horizontal dimension, the issue of common identity "is seen to be important in determining the citizen's willingness to see her money spent on other people" (D'Arcy, 2011, p. 6). This willingness depends on, amongst other things, matching identities with the social group benefiting from tax expenditures. According to the Comparative Treatment model the prevalence of common civic identities or political communities affects the ability of authorities to collect taxes. This implies that citizens would be more motivated to comply were their taxes to be spent on social groups they resonate with.

Perceptions of fairness have a positive impact on the legitimacy of tax authorities, which in turn leads to higher compliance levels. The issue of legitimacy was earlier implied in the Fiscal Exchange model (although broadly with reference to the government's fiscal role). In both the Fiscal Exchange and Comparative Treatment models, citizens consent to paying taxes because authorities are considered to be legitimate. In the Fiscal Exchange model, the indicator of legitimacy is the government whereas, in the Comparative Treatment model, legitimacy manifests in the various dimensions of fairness by tax authorities.

The relevance of the Comparative Treatment model in tax compliance behaviour is that citizens are likely to be less compliant if they perceive that authorities give preferential treatment to certain individuals. For tax authorities, promoting fairness in its different forms is essential for boosting voluntary compliance. This can be problematic, however, when one considers the practical implications of the OECD's definitions of fairness. The OECD concedes issues relating to distributive fairness in particular fall outside the mandate of tax authorities as the fiscal policy function is housed in the political arena (OECD, 2010). Although the constitutional separation of the tax authority and the Finance Ministry is common practice globally, to an extent it may limit the role of tax authorities in influencing compliance behaviour. For instance, there is a restricted basis to recommend to the Finance Ministry to adapt spending priorities and tax policy according to the preferences of taxpayers. Tax authorities are thus better positioned to influence perceptions relating to retributive and procedural fairness.

### 2.2.4 Political Legitimacy model

The Political Legitimacy model is founded on the basic premise that compliance with tax legislation is determined by the taxpayer's opinion of the government and its decision making. Empirical contributions to the model have identified diminished trust in the government as a major determinant of tax evasion. Interest in the Political Legitimacy model was motivated by the failure of traditional (Economic Deterrence and Fiscal Psychology) models to provide a definitive explanation of drivers of tax compliance and their tendency of over-predicting non-compliance (Andreoni, Erard & Feinstein, 1998).

According to the Political Legitimacy approach, tax compliance in a country is encouraged to the extent that its government is deemed by its citizens to be credible or legitimate. Credibility here can be understood as the existence of trust and confidence in the functioning of government, its institutions, policies and regulatory bodies. The legitimacy of institutions breeds civic submission of a voluntary nature. Other aspects of political life that have a positive bearing on the legitimacy of a government are a low incidence of corruption, high transparency and accountability. In these circumstances, the expectation is that, generally, compliance with tax legislation is maximised.

The prevalence of political trust by citizens, defined as support for political institutions, is a desired condition for voluntary adherence to legislation. Incidences of political mistrust can make it difficult for the government to govern and at a broader level can undermine the functioning of democracy. Marien and Hooghe (2011) examined the consequences of political trust in relation to legal permissiveness in 33 European countries[8]. The authors observed that low levels of trust in political institutions are consistent with low support for obedience to the law. To take it a step further, "low trust in political institutions results in less public willingness to defer to decisions taken by those institutions" (Marien &Hooghe, 2011, p. 282). The challenge for government regarding compliance with tax legislation is the tendency for taxpayers to become more tolerant towards fiscal fraud or tax evasion.

The embeddedness of efficiency and legitimacy was explored by Fauvelle-Ayamar (1999). This has its foundations in the so-called fiscal contract explored in the Fiscal Exchange model. From this perspective, "efficiency refers to the government's capacity to provide citizens with the benefits they expect in return for their tax payment" (Fauvelle-Ayamar, 1999, p. 399). A government for instance is deemed to be inefficient if public expenditures are sub-standard or undervalued, which increases resistance to paying taxes. Efficiency is thus recognised as an important element of legitimacy and, therefore, tax compliance. However, Fauvelle-Ayamar (1999) takes it a step further by noting that even a legitimate government that lacks efficiency "will not remain legitimate if inefficiency persists" (p. 399). While not downplaying the self-enforcing relationship between legitimacy and efficiency, this suggests that efficiency exerts a greater influence on tax compliance.

Aspects of political legitimacy with regards to taxation have been empirically examined in developed and developing countries. Torgler and Schneider (2007) observed various determinants of tax attitudes in three European countries: Belgium, Switzerland and Spain. Where political institutions were concerned, the researchers found that for the three countries, higher legitimacy leads to improved tax morale. Specifically, indicators such as "trust in the legal system, government, or parliament; national pride; and pro-democratic attitudes" affirmed "that higher legitimacy for political institutions leads to higher tax morale" (Torgler & Schneider, 2007, p. 465). In developing countries[9], Fauvelle-Ayamar (1999) found that three political variables (government legitimacy, efficiency and credibility) explained taxpayer compliance (and therefore the tax capacity of government) beyond economic variables.

[8] Data covers 1999-2001 periods
[9] This consists of a sample of 86 developing countries. All data are averages for the 1980-1989 periods

Although not often directly observable, the inner workings of the government in terms of structure and governance were said to have an influence on tax compliance. A study by Picur and Riahi-Belkaoui (2006) showed that bloated bureaucracies signal high levels of corruption and deterred citizens from paying their taxes. Acts of corruption are a violation of the implicit contract between the government and citizens which creates a breakdown in trust, thus negatively impacting on tax morale. On the other hand, Darcy (2011) found that corruption has no significant impact on citizen's consent to pay taxes and government legitimacy (defined as the right to collect taxes). In other words, corruption may not always be the source of "credibility deficits afflicting particular state institutions" (Darcy, 2011, p. 18).

According to Feld and Frey (2002), "the more strongly a constitution extends participation rights to its citizens, the more likely such a psychological tax contract is to emerge" (p. 90), and this increases the motivation to pay taxes. The contractual relationship can be safeguarded by tax authorities by engaging with taxpayers in a respectful manner, preserving their rights and subjecting them to fair processes. However, when the contract is breached, parties no longer act in good faith. The terms of the contract for the taxpayer change from voluntary to forced compliance which necessarily implies lower taxpayer morale. For the tax authorities, it means higher enforcement costs are realised.

The government's decisions to change policies in accordance with the economic and political situation have a significant impact on tax compliance (Palil, 2010). Although fiscal policy can be used as a political tool, tax relief granted by government for example in periods of economic difficulties can make taxpayers more agreeable to complying. In a similar light, one could also consider the effect of an unstable government on taxpayer attitudes. It is reasonable to consider that tax compliance in a country that is relatively politically unstable, with instances where the government in power changes every other election period, will exhibit more tax resistance and thus volatile tax compliance behavior. A reason for this could be that trust in government is usually built over time and, typically, citizens would require more than a single election period to justify confidence in the government. Elsewhere, Marien and Hooghe (2011) suggest that the object of political stability matters, and that citizens value stable political institutions more than political leaders. The latter can be easily replaced after an election whereas political institutions are relatively less robust. Therefore, a country that preserves political institutions is better positioned to induce favourable tax behaviour.

Various forms of common identities are a vital component of tax compliance. The Comparative Treatment approach showed that national identity was associated with positive tax behaviour. In the Political Legitimacy approach, political affiliation with the ruling government party encourages taxpayers to comply because membership implies that they subscribe with its political ideology and, therefore, consent to fiscal policies pursued by the ruling party. On the other hand, the expectation of non-compliant behaviour among taxpayers who resonate with opposition parties is more likely (Palil, 2010). At the risk of being over-simplified, this particular aspect of the model does not readily explain the compliance behaviour of politically apathetic taxpayers. However, it does suggest that a way to discourage tax evasion is for the ruling party to capture the political support of the majority of the electorate. Moreover, those exhibiting high levels of national pride or strong national identity are more agreeable to meeting their tax obligations (Torgler & Schneider, 2007). In addition to the political affiliation aspect, changes in current government policies might also influence tax compliance patterns.

In summary, the Political Legitimacy approach noted that a legitimate government should experience lower incidences of tax evasion and therefore maintain a culture of compliance. In the main, tax compliance is a function of citizens' trust in government and its fiscal decisions as well as its efficiency of fiscal spending. These are supplemented by indications of government predictability as well as notions of national identity and political affiliation. The Political Legitimacy approach further highlighted the importance of active citizen involvement in political processes in enhancing obedience to the law and willingness to cooperate. It is therefore important for the government to ensure that it is perceived by citizens in a positive light and to guard its reputation. The political legitimacy of the government is not necessarily under the direct control of tax authorities; however, empirical studies have shown that perceptions of legitimacy have some bearing on tax authorities' ability to collect revenue. In other words, developments in the political realm have implications for the operational efficiency of tax authorities.

## 2.3 STRATEGIES EMPLOYED BY TAX AUTHORITIES

Tax authorities have various approaches at their disposal to influence tax compliance behaviour positively. This section shifts the focus to provide a more practical understanding of the determinants of compliance and specifically from the vantage point of tax administration.

### 2.3.1 Responsive Regulation approach

The basic premise of the Responsive Regulation approach is the concept of a 'regulatory pyramid' originally coined by Ayres and Braithwaite (1992). The pyramid[10] is a typology of strategic engagements or responses by regulators to clients. The strategies begin at the base of the pyramid, from persuasive and advisory types to punitive measures like penalties and suspensions. The presentation of the framework in the form of a pyramid is functional. Regulators should first endeavor to engage with clients using a range of 'soft approaches' (education, advice, prevention programs, voluntary disclosures) and escalate these to sanctions (criminal proceedings, revoking of licenses, penalties, asset seizures) at which point clients are treated as offenders (Wood, Ivec, Job & Braithwaite, 2010).

The regulatory pyramid does not prescribe a course of action but, instead, prompts regulators to consider the regulatory context. This means regulators should identify what motivates clients to adhere to regulations. The selection of an appropriate stance by regulators is therefore determined by the observed motivation. However, the effectiveness of the Responsive Regulation framework is dependent upon the presence of an enforcement programme. Ayres and Braithwaite (1992) argue "the greater the heights of tough enforcement to which the agency can escalate (at the apex of its enforcement pyramid), the more effective the agency will be at securing compliance and the less likely that it will have to resort to tough enforcement" (p. 6). The regulatory pyramid appears to confirm contributions made by Falkinger and Walther (1991) in the Economic Deterrence model, namely that it is the combination of persuasive and punitive measures that creates optimal conditions for increased compliance. In other words, exclusively persuasive or punitive measures are rather inadequate.

The regulatory approach put forward by the pyramid was later empirically extended to what is known as the four motivational postures assumed by clients in a regulatory environment.

[10] Refer to Appendix A

According to Braithwaite (2002), in a regulatory environment, individuals assume a social distance between themselves and the regulator and position themselves according to a posture throughout the engagement process with the authority. Postures are known as the beliefs and attitudes of individuals that define the terms of engagement with regulators. In the tax compliance environment, these are Commitment and Capitulation (linked to positive tax compliance) as well as Resistance, Disengagement and Game Playing (linked to non-tax compliance). Commitment is accompanied by a strong moral obligation to honestly declare and pay taxes while Capitulation is the recognition and acceptance of the tax authority's legitimacy. Taxpayers with Commitment and Capitulation postures require tax authorities to respond in a persuasive manner. On the other hand, punitive approaches are appropriate for the remaining postures. Taxpayers that assume a posture of Resistance have preconceived ideas of a tax authority that is uncooperative and, as such, they behave in a hostile manner. Disengagement is an extreme form of Resistance, where taxpayers refuse any interaction with the tax authority. Although Game Playing is not formally recognised as a posture, it denotes to a general attitude towards the law. In taxation, a Game Playing posture refers to the views held by taxpayers of whether there should be a collective adherence to tax law or whether taxpayers should be entitled to modify the law according to their own benefit.

Perceptions of tax authorities were identified in the Comparative Treatment model as significant drivers of tax compliance, in that tax authorities that exhibit a favourable disposition towards taxpayers may positively influence compliance. A tax authority that treats its taxpayers with fairness and engages with them in a constructive and consultative manner motivates taxpayers to fulfil their tax obligations honestly. Along with fairness, legitimacy and trust in the tax system as a whole can sufficiently and positively alter the motivational postures of taxpayers as per the Responsive Regulation framework. Empirical work on fairness done by Tyler (1990) - that has also been confirmed by subsequent studies - demonstrated that individuals have the propensity to accept legal judgements made against them if they believe the legal procedures were fair. Tax authorities therefore possess the potential to alter postures in the way they present and conduct themselves towards taxpayers.

Internationally, practical applications of the Responsive Regulation framework have mostly been concentrated in developed countries (with the exception of Indonesia) like Britain, Canada, New Zealand, the European Union, the Netherlands and the United States. This framework has been applied by regulatory boards across a range of sectors including health, media, environmental affairs, food, child protection and chemicals (Wood et al., 2010). A considerable amount of empirical research on Responsive Regulation within the tax environment has been conducted in Australia as it is the enforcement approach adopted by the Australian Taxation Office (ATO). The extension of the traditional and purely deterrence approach of enforcement to embrace elements of Responsive Regulation has proved to be effective for the ATO, thus validating the benefit of a balanced method for tax compliance. In addition, the approach of interrogating the individual motivational postures of taxpayers has enabled the ATO to adapt compliance programmes accordingly.

The 'case of mass marketed tax scheme investors' explored by Leviner (2008) that transpired in Australia in the late 1990s was one of the practical successes of the Responsive Regulation approach in the tax environment. The ATO identified 42 000 taxpayers that were involved in tax schemes (mostly illegal tax deductions) and their immediate response was to adopt a harsh stance in order to recover unpaid taxes. This was achieved by amending the taxpayer's returns as well as levying interest and penalties. The taxpayers responded by refusing to pay their debts, after which a formal legal process imploded between the taxpayers and the ATO. Subsequently, the ATO decided to change their approach and open a dialogue to afford taxpayers an opportunity to present themselves. The sources of conflict were made apparent; taxpayers resented how the ATO treated these schemes (sold to them as legitimate means of reducing tax liability by accountants) as illegal practices as well as profiling taxpayers as criminals. The ATO negotiated settlement offers with taxpayers which included a waiver of the original penalties and interest, a reasonable period to settle their debt, while also notifying taxpayers of sanctions for continued non-compliance. As a result of this more balanced approach which included negotiation and open communication lines, 87% of taxpayers eventually settled their debt (Leviner, 2008).

Notwithstanding its effectiveness, institutional obstacles may hinder the effective implementation of the Responsive Regulation framework. Two of these challenges identified by Job, Stout and Smith (2007) based on Australia's, New Zealand's and East Timor's tax authorities were "consistency and fairness" and "allowing staff discretion while avoiding corruption" (p. 92). Before the era of Responsive Regulation, the service narrative of the tax authorities was mostly negative. The staff was generally perceived to be aggressive and unhelpful, to be abusing their powers and of being disengaged from taxpayers. With initial engagements with taxpayers and in line with the Responsive Regulation framework, the staff was expected to cooperate and understand the plight of non-compliant taxpayers. However, the application of the Responsive Regulation framework came with potential tensions between its liberal approach and the traditional enforcement approach. The granting of concessions on the tax liabilities of taxpayers meant that tax authorities had to sacrifice lower initial tax revenue for long-term compliance. Because consideration as per the framework is given on a case by case basis, tax administrations have had to ensure that taxpayers in similar situations are treated in a similar manner to avoid taxpayer resentment. In addition, the framework provided opportunities for staff to accept bribes since the system offered discretion to potentially waive penalties and interest.

### 2.3.2 Revised Slippery Slope framework

The framework postulates that the interaction climate between taxpayers and tax authorities is determined by two factors – trust in authorities and the power of authorities – which then results in a type of compliance. Gangl, Hofmann, Pollai and Kirchler (2012) explored the intricate undercurrents of power and trust, extending the theoretical understanding of the Slippery Slope framework. In the original form of the Slippery Slope framework, trust and power independently determine the climate and the climate governs the nature of tax compliance. Trust in tax authorities creates a service climate and the ideal type of voluntary compliance, whereas the power of authorities produces an antagonistic climate and enforced compliance (Kirchler, 2007). In essence, the original Slippery Slope framework only considered the Antagonistic and Service climates (as well as Enforced and Voluntary compliance respectively).

The contradictions in the literature regarding the relationship between power and trust prompted Gangl et al. (2012) to further categorise power and trust and modify the framework[11]. The new framework distinguishes between coercive and legitimate power as well as reason-based and implicit trust which give rise to a third type of climate and compliance (Confidence climate and Committed cooperation).

Coercive power is based on the threat of punishment (legal sanctions) or the enticement of rewards (tax rebates) – individuals comply because there are either positive or negative consequences. Legitimate power in contrast refers to the power of an acknowledged authority and results from the professional practice of tax authorities; as such it includes perceptions of fairness, knowledge and skills (Gangl et al., 2012).

[11] Refer to Appendix B

Reason-based trust consists of a range of components such as respectful engagements with authorities and participation in drafting tax legislation. Implicit trust is automatically given and arises from intrinsic factors, some of which are shared national identity with the state and individual norms (Gangl et al., 2012).

According to the modified framework, coercive power gives rise to an Antagonistic climate and enforced compliance, legitimate power and reason-based trust create a Service climate and voluntary cooperation while implicit trust brings about a third type of tax climate known as a Confidence climate and a committed cooperation compliance (Gangl et al., 2012).

In addition to the contributions made in terms of categorising power and trust, the modified framework also explores the fluid relationship between the two. For instance, it has been shown that changes in power can influence trust, specifically coercive power that has a negative impact on implicit trust while legitimate power increases reason-based trust (Gangl et al., 2012).

An empirical study by Schwarzenberger, Kirchler and Muehlbacher and (2011) confirmed that trust in authorities and the powers of authorities are strong predictors of voluntary and enforced compliance, respectively. Although the study supports the Slippery Slope framework, the authors advocate for compliance initiatives that go beyond punitive measures, which they admit are more effective. Although an aggressive climate is capable of increasing compliance, this ultimately comes with negative attitudes towards paying taxes. Another reason for the non-desirability of an aggressive climate is it is regarded as a costlier form of compliance that requires more resources from tax authorities such as time for administering taxpayer accounts, additional personnel for account maintenance and establishing legal procedures.

Voluntary compliance on the other hand is considered to be more sustainable because it is associated with positive connotations like trust and a service orientated tax authority. However, this does not mean that tax authorities should be overly zealous in extending a service-friendly approach; rather, this is best limited to deserving taxpayers that display a genuine willingness to comply. Taxpayers committed to evading taxes should be subjected to punitive measures. Profiling taxpayers to have an indication of their motivational postures, as per the Responsive Regulation approach is necessary in the Slippery Slope framework (Schwarzenberger et al., 2011).

Muehlbacher and Kirchler (2010) suggest that trust and power are not mutually exclusive; instead they are critical for both types of compliance. The balance between trust and power are necessary to maximise compliance. If tax authorities are too focused on punitive measures (coercive power) such as excessive audit rates and heavy fines, this can "corrode the trust of compliance-minded taxpayers" (Muehlbacher & Kirchler, 2010, p. 608) or corrode implicit trust. It puts tax authorities in a negative light, and gives the impression that taxpayers deliberately want to break the law. The paying of taxes is no longer regarded as a civic duty backed by moral obligation. On the other extreme, few or no audits may give a perception of incompetence which can taint the image of the tax authority as a capable organ of the state. Trusting taxpayers can enhance the power of tax authorities by informing authorities of the illegal tax activities of others.

The legitimate power of tax authorities is considered to be more effective in promoting reason-based trust. The stance of tax authorities on justice can bring about positive perceptions of procedural and retributive fairness and increase the trust of taxpayers. Legitimate power, however, also proves to be superior in coercive (punitive) environments. According to Wahl, Hoelzl, and Kirchler (2008), empirical work on the tax systems of Chile and Argentina "showed that credible sanctions under legitimate power are an effective tool for achieving higher trust levels and consequently higher compliance rates" (p. 213, as cited in Bergman, 2003). The legitimacy of the tax authority was also presented in the discussions of fairness in the Comparative Treatment approach. A tax authority that has credibility with taxpayers may be better positioned to obtain trust and achieve higher levels of compliance, regardless of its use of punitive tools or being within a punitive environment.

The main submission of the revised Slippery Slope framework is the way tax authorities choose to exercise power or trust, or whichever type is dominant is an important driver of the tax climate and nature of compliance. However, Gangl et al. (2012) suggested that one of the limitations of the revised Slippery Slope framework is the strong theoretical focus relative to empirical backing. Nonetheless, it illustrates ways in which tax authorities could identify the type of compliance and modify it to whichever is considered to be more desirable.

### 2.3.3 Multifaceted approach

The Multifaceted approach consists of three compliance paradigms for tax administration. These are: the Traditional Enforcement paradigm, the Trust paradigm and the Service paradigm. Alm and Torgler (2011) suggest that all three compliance paradigms should be jointly used to reduce incidences of non-compliance and encourage compliance. The different paradigms, or at least aspects of them, explored both section 2.2 and 2.3 of this chapter. The linkages are neither misplaced nor redundant; instead they show the coherence of the entire body of theoretical frameworks. As such the paradigms discussed here can be considered as extensions of earlier frameworks.

#### 2.3.3.1 Traditional Enforcement paradigm

The Traditional paradigm focuses on increasing detection and punishment (Alm & Torgler, 2011). It views taxpayers as criminals who seek to illegally minimise their tax liability. As such, it heavily relies on classical interventions to discourage tax evasion which include high audit certainty, penalties for non-compliance, interest on debt and, in extreme cases, criminal prosecution. The Economic Deterrence approach was the earliest theoretical model used to explain the compliance behaviour of taxpayers, where punitive measures were considered as adequate deterrence measures. The main assumption in the Enforcement paradigm is that the observed non-compliance of taxpayers is intentional and that this justifies punishment. The lack of consistency in empirical studies casts doubt on the soundness of this school of thought. In addition, the approach was found to be inadequate as the compliance tools were largely ineffective, as was the assumption that taxpayers' non-compliance is deliberate. The evolution towards persuasive measures within the approach spoke to the acknowledgement of other factors impacting on compliance behavior.

Specific initiatives under this paradigm include the following: boosting the technical capacity of tax authorities, the number of internal audit staff or outsourcing audit function to professional firms, modernizing risk engines to improve detection, increasing penalties for counts of non-compliance and interest on unpaid taxes. These can be extended to include non-financial penalties like publicising the names of taxpayers that have been successfully prosecuted. Less harsh penalties, like withholding refunds due to non-compliant taxpayers, use of third party institutions like banks and employers to collect debt and increasing taxpayer registration and identification using third party data can also be applied (Alm & Torgler, 2011).

#### 2.3.3.2 Trust paradigm

The emphasis in this paradigm is on influencing taxpayer norms and ethics positively and is also concerned with creating favourable perceptions of the government and tax authority (Alm & Torgler, 2011). The government's efficiency function is assessed by taxpayers by the quality and provision of government services. The government is held accountable based on the implicit contract of taxation between taxpayers and the government. As such, support for government's fiscal expenditure programs, inclusivity in fiscal decision-making and fiscal transparency are important indicators of trust. Broader trust in government is also extended to perceptions regarding the legitimacy of its institutions. Trust in political institutions increases taxpayers' willingness to obey decisions taken by those institutions. Closely related to political legitimacy are clean governance, low corruption, and political affiliation with the ruling party which make taxpayers more agreeable to paying taxes. The definitions of fairness (distributive, procedural and retributive) pertaining to the Comparative Treatment model as exercised by tax authorities emerge as key determinants of trust. Moreover, messages of national identity by tax authorities give taxpayers the impression that they will be treated equally to others.

According to Alm and Torgler (2011), policies consistent with the Trust paradigm include the liberal use of mass media to specifically highlight the payment of taxes as a societal ideal as well as to reinforce the link between paying taxes and the provision of government services. Moreover, Alm and Torgler (2011) recognise the importance of this paradigm and assert that it is a "largely neglected strategy for improving compliance" (p. 647).

#### 2.3.3.3 Services paradigm

In the Services paradigm, Alm and Torgler (2011) suggested that taxpayers should be treated like customers and be provided with services and tools to reduce the burden of complying. The policies include a combination of technological and efficiency improvements such as targeted taxpayer educational campaigns, simplification of taxes, payment of taxes and tax return forms, developing the quality of advice given by call centre agents and providing an interactive and informative website. The Services paradigm is concerned with empowering taxpayers to fulfil their tax obligations correctly, and on time.

A study by the USA's Government Accountability Office on tax complexity found that tax complexity negatively contributed to taxpayer burden, efficiencies and the tax gap. Taxpayers used opportunities caused by complexities in reporting income to misrepresent their incomes. Reporting requirements differed in complexity depending on the circumstances of the taxpayer. Taxpayers with single sources of income like a regular salary had more simplified reporting requirements than taxpayers with additional sources. For example, with salaried taxpayers the online income tax return is normally pre-populated with their salary and allowances, enabling tax liability to be calculated immediately and automatically. Small business owners and sole proprietors, on the other hand, are more likely to take advantage of complexities to deliberately under declare income. The self-assessment system of business owners is problematic in this regard because income is declared and expenses can be claimed against income, thus providing an opportunity to minimise taxable income (Brostek, 2011).

## 2.4 SUMMARY

The Theoretical Framework was conceptually divided into two frameworks. The 'Models of Taxpayer Behaviour' (section 2.2) and 'Strategies Employed by Tax Authorities' (section 2.3) of this chapter considered the determinants of taxpayer behaviour from a micro and macro perspective respectively.

The Models of Taxpayer Behaviour framework began with discussing the models that explain the factors that influence tax compliance. The models evolved from Economic approaches to finding Fiscal, Social, Institutional (Comparative Treatment) and Political determinants of tax compliance behaviour. Although these models displayed explanatory power, others proved to be empirically superior. The main finding from this framework was that economic factors did not provide an adequate explanation for tax compliance decisions and subsequent schools of thought relied on improving contributions made by earlier models. Most of the empirical analysis of the Economic, Fiscal, Social, Institutional and Political factors was conducted separately. There was a degree of similarities between the models; in particular, aspects of legitimacy, fairness and transparency were an important anchor of the Fiscal, Political and Institutional approaches.

The Strategies Employed by Tax Authorities framework reflected on the determinants of tax compliance, unlike Models of Taxpayer Behaviour the three frameworks specifically focused on how the conduct of tax authorities can positively or negatively influence compliance and thus provided a 'micro' perspective. The framework acknowledged different compliance scenarios, how these originate and the strategies tax authorities can use to best respond to them. The Slippery Slope framework and the Multifaceted frameworks presented three similar compliance climates. The equivalent of the Antagonistic, Service and Confidence climates in the Slippery Slope framework are the Traditional, Service and Trust climates respectively in the Multifaceted framework. The Slippery Slope framework focused on the power and trust dynamics that give rise to the compliance climates, while the Multifaceted framework considered appropriate strategies tax authorities can apply in accordance to the compliance climate.

The Models of Taxpayer Behaviour provided the context and empirical backing for the compliance climates in the Strategies Employed by Tax Authorities. The Economic Deterrence model underpins the Antagonistic or Traditional Enforcement climates while the Comparative Treatment, Fiscal Exchange and Political Legitimacy models underpin the Trust and Confidence climate. Both sets of theoretical frameworks conceded that tax compliance behaviour is complex and as a result alluded to the importance of using a holistic approach to influence tax compliance. Moreover, the move from an Enforcement to a Trust and/or a Service climate came from the realisation that voluntary compliance was a more desirable objective than enforced compliance.

The main contribution of the Responsive Regulation framework was to identify and describe the various motivational postures or compliance attitude of taxpayers, which can be placed within the compliance climates. In essence the Strategies Employed by Tax Authorities provided a framework for describing the prevailing type of tax compliance (enforced, voluntary or committed), either by describing the motivational postures of taxpayers (Responsive Regulation framework) or by considering the compliance climate of tax authorities (Slippery Slope framework or Multifaceted approach).

# CHAPTER 3: LITERATURE REVIEW

## 3.1 INTRODUCTION

This literature review considers various aspects of the informal sector. The chapter begins with a universal overview of taxation concepts and an assessment of South Africa's taxation system. What follows are definitions of the informal sector and/or small businesses. Definitions of informality are divided into global contributions (which range from conceptual definitions by researchers and academics as well as international organisations) and definitions by South African institutions. The global definitions mostly pertain to the informal sector while South African definitions concentrate on small business. This is followed by a descriptive and statistical analysis of South Africa's informal sector as well as an outline of the policy framework to appreciate the context of its operating environment. The literature review concludes with arguments for informal sector taxation and considers the experience of tax administrations in developed and developing countries.

## 3.2 CONCEPTS OF TAXATION

### 3.2.1 Taxation

Taxation is conventionally defined as legislated monetary payments to the government of a country (Mohr, 2015). There is minimal dispute in the literature about what taxation is and an almost universal view on its importance. Taxation fulfils a number of social, political and economic objectives. In many countries, taxation is the single most important source of government revenue. According to the OECD (2013), tax revenue affords governments the means to advance development, alleviate poverty, provide public goods and services, and invest in physical and social infrastructure.

According to Prichard (2010), "often overlooked is the role of taxation as a catalyst for the development of responsive and accountable government" (p. 3). Taxation as a state building function is an important tool for ensuring that the state remains accountable to citizens. In this way, taxation supports democracy because a national budget process ideally contains elements of transparency and inclusive decision making.

While the theoretical basis for the role of taxation in increasing economic growth through government fiscal policy is sound, empirical evidence of the link between taxation and economic growth is inconclusive. The macroeconomic growth objective is one of the justifications for government intervention in the economy (Mohr, 2015). Government capital expenditure programmes can produce demand and employment. Empirical evidence on the relationship between taxation and economic growth diverges between developed and developing countries, and between tax types. It is therefore generally accepted that "the impact of taxation on growth is ultimately country context-specific and mediated by the implementation of tax policy" (Rao, 2014, p. 9).

Poverty alleviation and equitable income distribution are considered to be two of the most important functions of taxation, particularly in developing countries. To attend to these pressing twin challenges, developing countries normally adopt a progressive taxation system. The use of and reliance on taxation to redistribute incomes to the poor has been found to reduce inequality and increase economic growth in the long term (Rao, 2014). Issues, questions and debates on the sustainability of progressive taxation systems to attend to poverty and inequality while (over) extending the tax burden on taxpayers has been ongoing in the literature. While transfer payments (social grants) fulfil a socio-economic role, they can be used as a political bargaining tool by government. As such, the management of competing political and socio-economic objectives becomes a complex balancing act for government. Governments also seek to achieve lower inequality by using tax revenue to provide access to public goods and services (e.g. education, health, and housing) to the poor.

### 3.2.2 Tax compliance

Tax compliance is the extent to which taxpayers (firms, trusts and individuals) and intermediaries (tax practitioners and clearing agents) meet their legal tax obligation (OECD, 2016a). There are two types of compliance, namely, administrative and technical. According to the OECD (2001), administrative compliance, which is also known as procedural, reporting or regulatory compliance, is concerned with "complying with the administrative rules of lodging and paying on time" (p. 3). Technical compliance is ensuring that the tax liability is calculated according to the requirements of the law.

Both administrative simplicity and stability are pertinent principles of taxation where tax compliance is concerned. Tax legislation that is unclear can hinder and deter compliance. Often lack of clarity regarding tax obligations can lead to misinterpretation of a taxpayer's legal requirements. Tax administration has an interest in equally ensuring that administrative and technical compliance are maximised. The timely payment of taxes is important because government's fiscal expenditure plans are based on an assumed revenue target in a given fiscal year. With regards to technical compliance, an understated tax liability particularly has adverse effects on the fiscal framework. The tax revenue loss attributed to non-compliance is known as the tax gap, defined as the "difference between revenue collected and what could be collected" (Mascagni, Moore & McCluskey, 2014, p. 4).

The tax administration can use a variety of interventions to optimise compliance. These include education, enforcement, administrative, legislative and litigation types of intervention. The OECD (2001) provides a number of methods that can be used to measure compliance. These include audit based studies, assessing changes in tax returns, evaluating and benchmarking the financial indicators of firms, and the use of surveys.

The cost of complying with tax payment regulations is cited in the literature as one of the major causes of non-compliance. In the absence of technology to pay taxes, the remoteness of tax administration offices in rural areas, for example, hinders access to tax services. Other types of compliance costs identified by the International Monetary Fund (IMF) include "lengthy processes, frequent tax payments, bribes and corruption" (International Monetary Fund [IMF], 2011, p. 4).

### 3.2.3 Tax morale

Given the importance of tax compliance for maximising tax revenue, an enquiry into the causes or influences of compliance is relevant[12]. Tax morale is defined as the "motivation to pay taxes" (OECD, 2013, p. 1). Although tax morale is considered an important component of compliance, Luttmer and Singhal (2014) view enforcement as "the primary driver of compliance" (p. 151). They understand tax morale to encompass all non-pecuniary motivations for tax compliance such as monetary rewards (one of the key features of the Economic Deterrence model of tax compliance). Other factors such as personal and social values are considered to be a better indication or measure of tax morale.

The central idea behind tax morale is that it indicates the underlying attitudes and views regarding taxation. Therefore, having a sense of a taxpayer's general disposition towards taxation can indicate actual compliance behaviour. Tax morale indicates the willingness of taxpayers to comply with paying taxes. Taxpayers that exhibit positive tax morale are more likely to comply voluntarily with paying taxes. Voluntary tax compliance is more ideal than forced compliance – the latter creates a hostile climate and increases enforcement costs for

[12] This is covered extensively in chapter 2 (Theoretical Framework) of this thesis

tax administration. Insight into the compliance drivers enables tax administration to design effective compliance programmes that can successfully capture taxpayers that are non-compliant or those that fall outside the tax net.

Tax morale has been proven to play a significant role in understanding tax compliance behaviour, particularly in developed countries. Tax compliance is a joint function of morale and enforcement; however the current gap in the literature is quantifying the isolated impacts of both, due to conceptual and practical difficulties. For now, the conceptual argument - that tax morale and enforcement necessarily coexist - is sound (Luttmer & Singhal, 2014, p. 154).

From a policy perspective, efforts should not focus on the role of tax morale on compliance behaviour, but rather the significance of tax morale in the context of compliance. Luttmer and Singhal (2014) therefore recommend quantifying whether improving tax morale will have a sizable impact on compliance levels. To achieve the same increase in compliance, it may be more cost effective to increase enforcement. For tax administration, this essentially involves resource (financial and human) planning and efficient use of resources. The question is how to achieve higher compliance with lower costs. The goal of maximising compliance with tax legislation should not be pursued in isolation and without an intricate and accurate assessment of the broader goal of tax administration of lowering operational costs while maintaining operational efficiency. For under-resourced tax administrations in developing countries, adherence to the revenue maximisation mandate with such constraints remains an ongoing predicament.

### 3.2.4 Tax revenue mobilisation

Improving tax revenue growth has been at the forefront of tax administrations globally as government finances deteriorated after the 2008 global financial crisis. Developing countries have been relatively worse off and “interest in enhancing revenue mobilization in developing countries is increasing” (IMF, 2011, p. 6). Developing countries experience unique challenges where revenue mobilisation is concerned. These consist of ‘hard-to-tax’ sectors, weak governance in tax administration, low taxpayer morale, dependence on the existing tax base and high compliance costs.

Several countries in the developing world are still struggling with the challenge of extracting more revenue from their tax base, a concept known as tax base broadening. In particular, broadening revenue flows from Personal Income Tax (PIT) remains a challenge. A narrow tax base means that the existing tax burden is unevenly distributed as a result of dependence on a few taxpayers. The informal sector has been identified as one of the areas from which developing countries have struggled to successfully mobilise revenue. The immediate concern for tax administration is highly profitable traders whose taxable income exceeds the minimum threshold, in other words, traders that would normally be included in the tax base (IMF, 2011).

However, the literature recommends that the tax administration consider informal traders with a taxable income below the threshold so as to encourage a culture of compliance for peers and large corporates in the formal sector. The IMF (2011), for instance, suggests looking beyond the revenue potential of businesses in the informal sector. The inclusion of small businesses into the tax base can positively contribute to state building, participation in the political process and government accountability. Improved compliance can encourage small businesses to formalise record keeping, modernise processes by using technology, and increase productivity. Adopting aspects of formality can also improve access to financing and other business services.

### 3.2.5 Some implications of a tax gap and a way forward

The tax gap arises from a combination of factors: weak tax administrative capacity (such as inadequate enforcement, resources and governance), low tax morale and low compliance, all of which contribute to low revenue collection. The failure of tax administrations to collect all revenue due to the fiscus has far-reaching social, economic and fiscal consequences. This stems from the importance of taxation as the single most important source of government revenue.

The inability of government to meet its fiscal expenditure commitments, which increase with population growth, has a negative impact on the budget balance (Dubin, 2012). Deepening fiscal deficits (where government expenditure exceeds revenue) increases borrowing costs for the government, meaning that a greater proportion of revenue is spent on servicing debt. Successive fiscal deficits create a recurring and unsustainable debt trap that can over-burden future generations. Some commonly held principles of sustainable fiscal policy include inter-generational equity and debt sustainability. Thus excessive debt violates these principles and government's fiscal credibility. Government can institute austerity measures to mitigate the budget deficit, a move that in most instances will be met with social outrage and be politically damaging.

Reduced government revenue can have negative economic and social consequences. Government spending is financed by taxes received from taxpayers. Government expenditure in the economy comprises two major flows: expenditure to the factor market, mainly labour (employment creation), and the goods market (procurement of goods and services from private firms) (Mohr, 2015). The impact is therefore reduced demand from these markets and forgone opportunities for economic growth. The provision of public goods and services as well as transfer payments is compromised in cases where the government is fiscally constrained. The case is exacerbated in developing countries which face mounting social demands.

Because “the tax gap provides a useful tool for understanding the relative size and nature of non-compliance” (Murphy, 2017, p. 3), perhaps steps to narrow it should firstly include identifying segments of non-compliant taxpayers (tax revenue leakages) and secondly, enquiring into the causes of non-compliance. Knowledge of the causes of non-compliance can assist tax administration to modify existing compliance programmes or roll-out new ones. Furthermore, it is also important for the tax administration to determine the nature of non-compliance - whether it is intentional or unintentional. This determination will require different strategies - stricter enforcement where compliance is intentional, or tax awareness where it is unintentional (Dubin, 2012).

### 3.2.6 A situational analysis of South Africa

Tax revenue in South Africa is the single most important source of budget revenue[13] and consolidated revenue[14]. Over the past five fiscal years, the proportion of tax revenue to budget revenue has been in excess of 90% and in excess of 80% to consolidated revenue. PIT has been the largest contributor to tax revenue and, in 2015/16, the share of PIT to total tax revenue amounted to 36.4%. An analysis of the PIT register shows that since 2014 there has been a slow growth in the number of taxpayers expected to submit returns, undoubtedly PIT collections are under pressure (SARS, 2016a).

The taxpayers in the two highest taxable income bands (350 0001 – 500 000) and 500 000+ are few in number relative to those in the lowest bands, yet they make the highest contribution to total assessed tax (SARS, 2016a). Seemingly, one of the features of South Africa’s tax system (in particular PIT) is dependence on relatively few taxpayers. While this

[13] Tax revenue plus Non-tax revenue minus South African Customs Union (SACU) payments
[14] Budget revenue plus Other revenue (provinces, social security and selected public entities)

trend is not unusual and justified in highly unequal societies like South Africa, there are concerns about its sustainability. For instance, the Davis Tax Committee has alluded to the need for raising additional tax revenue by "improving compliance and broadening the tax base" (Davis Tax Committee, 2014, p. 23).

There has been a steady increase in SARS's annual revenue collections which surpassed R1 trillion for the first time in 2015/16. Over the medium term, estimates of the main budget revenue are expected to grow and reach R1 242 trillion in 2019/20. The pressure on government finances and spending obligations initially became apparent in the 2015 National Budget Speech when the Finance Minister announced an increase in the maximum marginal tax rate for PIT by 1% to 41% (National Treasury, 2015). In 2017, National Treasury introduced a new marginal rate of 45% for individuals with taxable incomes above R1.5 million. The National Budget Review estimated that 100 000 taxpayers will be affected by the new changes (National Treasury, 2017a).

Moreover, National Treasury (2017b) stated the following in chapter 4 of the National Budget Review:

> In 2016/17, for the first time since 2009/10, tax revenues have not kept pace with economic growth. There is uncertainty regarding the path of revenue collection. Risks include weaker-than-expected economic growth, and concerns about tax morality, compliance and administration. Deterioration in any of these areas can hinder tax collection. (p. 38)

The National Budget Review further echoed the importance of tax compliance on the government's service delivery mandate. To realise this mandate, National Treasury committed that SARS would build its capacity to strengthen its ability to enforce compliance and thereby reduce the incidence of tax avoidance and evasion. Public concerns over the wastage of public funds and corruption by government officials were identified as being counterproductive to raising tax morality. There is recognition that "a marked decline in the culture of tax morality would have negative effects on the public finances and be exceptionally hard to reverse" (National Treasury, 2017b, p. 38).

SARS has so far proved to be a capable tax administration and pioneer on the African continent and developing world. Some of SARS's achievements include favourable performance indicators (such as maintaining operational efficiency), improved enforcement efforts and tax base broadening which have mostly been with various taxpayer segments in the formal sector (Smith, 2003). This has contributed to the successive attainment of tax revenue targets that has enabled the government to comfortably meet fiscal expenditure plans.

Smith (2003) attributes the lack of SARS's presence in the informal sector to high revenue collections costs. However, in 2012, SARS launched a five-year Compliance Programme with the aim of increasing compliance with tax legislation to ensure fairness of the tax system. Seven priority areas were identified; one of them is the small business sector. Specific initiatives include on-site visits consisting of SARS and government agencies to facilitate business registration and tax compliance (SARS, 2012). While this is commendable in the absence of documented statistics on the growth in registration of informal businesses and compliance (since the launch of the Compliance Program), the tax morality of the sector remains unexplored. In addition, qualifying non-compliant taxpayers in the informal sector are a violation of the 'horizontal equity' principle that underpins an ideal system of taxation.

## 3.3 DEFINITIONS OF INFORMALITY AND SMALL BUSINESS

The "informal sector" or "informal economy" is a term used to describe an array of unregulated economic activities that fulfil certain criteria. Although the concept was initially framed within the context of developing countries, it is also found in developed countries. While there may be slight nuances, these activities collectively have a "mode of organization different from the unit of production most familiar in economic theory, the firm or corporation" (Swaminathan, 1991, p. 1). The informal sector thus exists in parallel to the formal or organized sector of the economy. There are divergent views in literature regarding what constitutes the informal sector. Synonyms of the informal sector or economy include the hidden, grey, illicit, shadow, unobserved, unrecorded and second economy.

For the purposes of this research the relation between the informal sector and small business is clarified. The term 'small business' describes the size of a business while the 'informal sector' refers to the economic context in which the business operates. What constitutes a small business and an informal sector is subject to various criteria. It is assumed that most businesses in the informal sector are small in nature. The assumption is plausible because there is a low likelihood of a large business operating unnoticed in the informal sector. Therefore references to small business could refer to small businesses in the informal sector.

### 3.3.1 Global definitions

The introduction of the 'informal sector' concept into academic literature dates back to the 1970s and was pioneered by social anthropologist Keith Hart. A study by Hart that described the economic conditions and activities of unskilled and illiterate urban area migrants in Southern Ghana formed the basis of what is known about the informal sector. The migrants were employed in various types of manual jobs in the urban areas (formal employment), earning low incomes due to their low levels of skill and education. The migrants sought additional employment opportunities to supplement their incomes as a means to cope with the insufficiency of wages to meet the high standards of urban living. In other words, "denied success by the formal opportunity structure, these members of the urban sub-proletariat seek informal means of increasing their incomes" (Hart, 1973, p. 67).

Based on observations of the economic activities of urban migrants, Hart (1973) proposed a typology of income opportunities to make an analytical distinction of the range of activities – formal income opportunities, legitimate informal income opportunities and illegitimate informal income opportunities. Formal income opportunities consist of public sector wages, private sector wages and transfer payments such as social grants and unemployment insurance. Legitimate informal income opportunities are activities found in all sectors of the economy (primary, secondary and tertiary) as well as private transfer payments (voluntary flows of income between individuals). Illegitimate income opportunities are primarily concerned with services (buying and selling stolen goods, bribery, and drug-pushing) as well as transfers (gambling, burglary, embezzlement, armed robbery). Hart (1973) cautions that this analytical framework refers to roles and not individuals; meaning an individual can at one time partake in more than one of the three analytical activities. In addition, the degree of participation is an important determinant of classification – "only in the case of regular involvement can we talk of 'informal employment' as distinct from casual income flows of an occasional nature" (Hart, 1973, p. 69).

In classifying the informal sector, Feige (1900) discusses informality in relation to the four institutional rules that are not adhered to, and this possibly speaks to the inherent complexities of the sector which make a single definition inadequate.

The illegal economy consists of the income generated by economic activities practised outside legal statutes defining the scope of business activity that is legally permitted. According to Feige (1990), "it's most serious consequence is to undermine the stability of political, legal and economic institutions that might otherwise serve to facilitate the developmental process" (p. 991). The unreported economy consists of those economic activities that violate established fiscal rules and tax policy. The quantification of the unreported economy is what is commonly known as the tax gap.

Economic activities that escape the reporting requirements of government statistical agencies comprise the unrecorded economy. The unrecorded economy is therefore a statistical measure of unrecorded income, or "income that should (under existing rules and conventions) be recorded in national accounting systems (e.g. national income and product accounts) but is not recorded" (Feige, 1990, p. 992). Unrecorded economic activity has the effect of distorting economic indicators such as unemployment and the Gross Domestic Product (GDP) which are used to inform and evaluate government policy. Lastly, the informal economy consists of income generated from activities that avoid the costs of administrative rules and laws such as commercial licensing and labour contracts.

Although Feige (1990) makes it clear that there are different kinds of underground economies, the researcher also seems to imply that they are mutually exclusive. In reality one can expect that illegal economic activities are unreported because entrepreneurs would be reluctant to declare income to authorities and face legal sanctions. In these and other cases, economic activities can violate more than one of the four rules.

According to Joshi, Prichard and Heady (2014), businesses in developing countries fall along a continuum, depending on prevailing circumstance, from informal to formal arrangements. The typology accommodates four types of enterprises, namely: subsistence enterprises (type A), micro enterprises and small businesses (type B), small and medium businesses (type C) and small, medium and large businesses (type D)[15]. This particular typology provides a more comprehensive description of enterprises as it explicitly reflects 'owner profile', 'degree of informality', 'market considerations' and 'finance needs'. Compared to the typologies discussed earlier, the legal status of an enterprise is not immediately obvious although it is implied under the 'degree of informality' criteria. Perhaps the most striking feature of the typology by Joshi et al. (2014) is that it incorporates aspects of taxation and, in particular, the 'tax status' as additional criteria. This is important because not all informal enterprises generate significant income for tax purposes. Of interest to this research are type B and type C enterprises that are both informal and liable for tax. The strength of the typology therefore

[15] Refer to Appendix C

is that it provides additional indicators that can be used to identify or locate the enterprise of interest.

### 3.3.2 South African institutions

There are various national laws and policy frameworks in South Africa that make provisions for small businesses; as such there is no official definition. This situation is not unique to South Africa, as globally, multiple definitions within a country are quite normal and are guided by the different mandates of government institutions. The focus of this section is specifically on the legislative definitions of small businesses by the Department of Trade and Industry and National Treasury. Concerning the informal sector, Statistics South Africa (Stats SA) uses direct and indirect approaches. The direct approach is measured by the Quarterly Labour Force Survey (QLFS). The indirect approach estimates are reflected in the national accounts and GDP publication.

#### 3.3.2.1 Department of Trade and Industry

The formalisation of businesses in South Africa can be achieved through several institutions. These include the Small Enterprise Development Agency (SEDA), Companies and Intellectual Property Commission (CIPC), Small Enterprise Finance Agency and SARS (Department of Trade and Industry, 2017). However registration with the CIPC is often identified as the main requirement because access to support services from government agencies, incentives, funding, operating a bank account, tax registration, securing of government tenders and tax clearance is dependent on CIPC registration.

The literature on small businesses in South Africa mainly refers to the National Small Business Act[16]. The Act defines a small business enterprise as follows:

> a separate and distinct business entity, together with its branches or subsidiaries, if any, including co-operative enterprises [and non-governmental organisations], managed by one owner or more [which, including its branches or subsidiaries, if any, is] predominantly carried on in any sector or subsector of the economy mentioned in column 1 of the Schedule and [which can be] classified as a micro-, a very small, a small or medium enterprise by satisfying criteria mentioned in columns 3, 4 and 5 of the Schedule.

[16] National Small Business Act 26 of 2003

Schedule 1 of the National Small Business Act (as amended) uses three quantifiable criteria to classify an enterprise as micro, very small, small or medium based which vary according to the economic sector. Therefore what constitutes a micro enterprise according to the total annual turnover criteria in the Manufacturing sector is different to the Finance and Business Services and so forth. The criteria specified by column three, column four and column five of the schedule is ‘total number of full-time paid employees’, ‘total annual turnover’ and ‘total gross asset value (excluding fixed property)’ respectively. The Act does not specify whether these criteria refer to enterprises in the formal or informal sector but provides general guidelines for identifying the size of small businesses according to the Standard Industry Classification (SIC) system.

#### 3.3.2.2 National Treasury

There are two provisions in the Income Tax Act that pertain to a micro business and a small business corporation (SBC). The Act defines a micro business is a “natural person (or the deceased or insolvent estate of a natural person that was a registered micro business at the time of death or insolvency) or a company, where the qualifying turnover of that person for the year of assessment does not exceed an amount of R1 million”[17]. The Act further defines a SBC as “natural persons in any close corporation, private company, co-operative, close corporation or personal liability company that records a maximum gross income of R20 million for the year of assessment”[18]. As with micro businesses, other additional criteria apply.

SARS’s micro and small business criteria are linked to the legislative definitions of the Income Tax Act. In recognition of the important role of small businesses in the economy, micro businesses and SBCs qualify for a number of unique tax incentives. Micro businesses may opt to register for Turnover Tax, which replaces VAT, Provisional Tax, Capital Gains Tax and Dividends Tax that would otherwise be individually payable. SBCs on the other hand are eligible for special tax benefits regarding the depreciation of machinery or assets used in the business (certain industries are excluded). Both micro businesses and SBCs are subject to their own progressive income tax rates according to specified income bands that differ from large corporates (SARS, 2015b). All SARS branches have dedicated desks for

[17] Income Tax Act 58 of 1962: Part Two of the Sixth Schedule
[18] Income Tax Act 58 of 1962: Sec 12E(4)

small business owners to ensure that they receive specialised services appropriate for their type of business.

#### 3.3.3.3 Statistics South Africa (Stats SA)

South Africa's statistical agency, Stats SA, uses direct and indirect approaches to estimate the size of the informal sector. Stats SA's survey method (direct approach) has evolved over the years but the approach has been to use growth in informal employment to measure the size of the informal sector. In 1993, Stats SA introduced the October House Survey (OHS), which was used on an annual basis until 1999. The bi-annual Labour Force Survey (LFS) replaced the OHS in February 2000. In 2008, the current QLFS replaced the bi-annual LFS.

The QLFS identifies the following components of informal employment and the informal sector:

i. Employees working in establishments that employ less than five employees, who do not deduct income tax from their salaries/wages;

ii. Employers, own-account workers and persons helping unpaid in their household business who are not registered for either income tax or value-added tax;

iii. Persons in informal employment are persons in the informal sectors who are not entitled to basic benefits such as pension or medical aid contributions from their employer, and who do not have a written contract of employment (Statistics South Africa [Stats SA], 2017).

## 3.4 SOUTH AFRICA'S INFORMAL SECTOR

Various government policy frameworks often acknowledge the informal sector in South Africa as an important vehicle for employment creation, poverty alleviation and economic growth. The economic activities of the informal sector range from "spaza shops", liquor retailers, taxis, educare centres, plumbing/mechanical repairs, hair care, take-aways and street hawkers (Sustainable Livelihoods Foundation, 2015). The sector-specific challenges experienced by the sector in South Africa are largely similar to other countries. These include a poor understanding of the factors that raise or hinder development within the sector as well as measurement constraints arising from the large number of small and informal businesses operating outside regulatory frameworks. Informal businesses are mostly located in inner cities and townships. Participation in the informal sector is exacerbated by the inappropriateness of policies that exclude traders from operating in the formal sector. The informal sector activities differ in intensity across provinces, sectors, racial groups and gender. Moreover, educational attainment and the proportion of skilled labour are generally lower relative to the formal sector.

### 3.4.1 Statistical and descriptive analysis

The Labour Market Dynamics publication[19] by Stats SA reveals notable trends regarding informal sector employment in South Africa. The informal sector provides individuals who are unable to find employment in the formal sector with a means to make a livelihood. South Africa's high unemployment rate reflects the inability of the private and public sector to fully absorb labour. As a result, self-employment arises as the only alternative to make a livelihood. Between 2009 and 2015, the proportion of informal employment to total employment increased (from 15.6% to 16.8%) while that of formal employment declined (from 70.2% to 69.5%). Between 2014 and 2015, the informal sector gained 245 000 jobs which increased its share of total employment to 16.8% from 15.8%. Over the same period, the formal sector's share of total employment declined to 69.5% from 71.5% as jobs increased by 113 000 (Stats SA, 2016).

The underlying gender and racial dynamics of the informal sector are similar to the formal sector. Employment in the informal sector is dominated by males, whose share of total employment between 2009 and 2015 rose from 15.5% to 18.4% and declined from 15.8% to 14.6% for females. Concerning race, black Africans recorded the highest proportion of informal employment in 2015 with 19.6% followed by the Coloured (12%), Indian (11.9%) and White (7.0%) population group (Stats SA, 2016).

In 2015, Limpopo at 27.8% recorded the highest provincial share in informal employment followed by the Eastern Cape (22.2%); while the Western Cape accounted for the lowest share (10.5%). Over the period 2009 to 2015, Gauteng recorded the highest increase in informal sector employment of 2.3 percentage points well above the national average (1.1 percentage point) while Mpumalanga and the Free State declined by 0.7 and 0.2 of a percentage point respectively (Stats SA, 2016).

[19] Based on Stats SA's QLFS annual data for the period 2009-2015, therefore informal employment as defined by the QLFS

The dominance of the trade sub-sector is a distinguishing factor of South Africa's informal sector compared to other African countries. The trade industry followed by construction and transport lead employment in the informal sector and registered shares in excess of 20% in 2015 (Stats SA, 2016). The manufacturing, service and finance industries each accounted for over 10% of informal employment in 2015. Employment in all industries increased between 2009 and 2015, while it remained unchanged in mining (Stats SA, 2016).

According to the Survey of Employers and the Self Employed (SESE)[20], the informal sector is dominated by black African owners in the 35-44 years age group with the lowest educational attainment (below matric). Some businesses are survivalist in nature as owners reported an absence of sanitation facilities and electricity on their premises. This suggests that these operations are not conducted in or around fixed building structures, which is typical of trade, construction and transport businesses. A sizeable proportion of traders operate from residential dwellings, followed in this trend by those without a fixed location (Stats SA, 2014).

A significant number of traders used their own capital to start their businesses, and those who used other sources mainly borrowed from friends or relatives.  The majority of traders who used their own money used previous or present wages, which supports the view that individuals participate in the informal sector either as a result of unemployment or to supplement income from existing formal employment. A substantial number of informal business owners did not have a bank account, credit facilities and asset finance or mortgage loans for their business operations (Stats SA, 2014). A number of observations can be inferred. Business is mainly conducted on a cash basis that eliminates the need for a bank account. The absence of credit facilities and asset finance may be a result of unstable business income or unaffordability. However, considering the industries where informal businesses are prevalent, it is also probable that assets are not required.

The low regulatory environment incentivises business owners to participate in the informal sector. Regulation costs (license fees, registration costs, tax policy arrangement) as well as rigid labour and goods market regulation motivate business owners to operate outside of the legal framework. Easing government regulations was identified as an area where relief is required (Stats SA, 2014). Informal businesses are highly unregulated and operate outside administrative and legal requirements. The bulk of business owners did not have a business

[20] A survey of non-VAT registered and Income Tax registered businesses in the informal sector in 2013

license or permit. The minority who had licences mostly obtained them from their municipal authority and business associations (Stats SA, 2014).

Local government plays a critical role in small business development as the primary custodians of utility services, infrastructure, land control use (rezoning) and property rights (title deeds). The small uptake in business licenses may be indicative of governance lapses. There is therefore scope to encourage formalisation by reducing registration burden and simplifying requirements. The terms of registration can be made more favourable by accessing benefits like business support services (Sustainable Livelihoods Foundation, 2016).

Financial record keeping in the informal sector is poor, as most business owners do not maintain accounts. The small size of the enterprise and the lack of required skills were given as reasons for not maintaining financial records while some business owners simply do not see the need to keep records. The low educational attainment of informal business owners can be attributed to these findings. The absence of financial records could explain the financial exclusion (credit facilities and asset finance) of informal business owners. Better access to loans was identified as the second major area of assistance (Stats SA, 2014).

### 3.4.2 Policy framework

#### 3.4.2.1 National Development Plan

The National Development Plan (NDP) was introduced by the National Planning Commission in 2011 as a long-term strategy to eliminate poverty and reduce inequality in South Africa by 2030. The NDP recognises the role of the informal sector in South Africa as an important buffer against formal sector job losses and as an additional source of income for the formally employed during economic crises. Reference is made to the precarious working conditions and vulnerability of workers in the informal sector. The absence of formal employment contracts perpetuates the vulnerability of informal workers, which prevents access to benefits by individuals outside the scope of contributory systems. In particular, these include low wage outcomes and the absence of contributory insurance systems for retirement, unemployment, occupational injury and diseases (National Planning Commission, 2011).

The NDP thus proposes that social security coverage, for example, the Unemployment Insurance Fund (UIF) and labour market reactivation measures (training and job search assistance), should be extended to informal sector workers who can prove that they were employed even if they have not contributed to the fund. The proposed funding model would include industry based funds (private sector), grants and government subsidies (National Planning Commission, 2011). Details of the progress on the policy recommendations and proposed delivery mechanism are uncertain at this stage.

#### 3.4.2.2 Licencing of Business Bill

Subsequent to the NDP, the draft Licensing of Businesses Bill was gazetted by the Department of Trade and Industry (DTI) in 2013[21] to replace the Business Act[22]. The Bill was a result of complaints received by the DTI from township business owners regarding unfair competition from businesses owned by foreigners, as well as the need to curb illegal trading (Khuzwayo, 2013). The Bill is aimed at promoting the right to trade, providing a supportive environment to conduct business and standardising norms relating to business operations. It requires businesses in the formal and informal sector to register and obtain a license from their local municipality for conducting business. In addition, it makes provision for the appointment of inspectors as well as a framework of penalties and administrative fines for non-compliance. Inspectors, for instance, are given the authority to conduct raids, confiscate goods and impose restrictions on businesses. Such provisions can disrupt the ease of doing business especially for those in the informal sector.

Among others issues, the draft Licensing of Businesses Bill has been criticised for the administrative burden it places on entrepreneurs and the potential abuse of powers given to inspectors that could create opportunities for corruption, as well as the ill-capacity of municipalities to handle the registration, monitoring and enforcement of the Bill (Duncan, 2013). The revised Bill is yet to be released following the resistance that ensued upon its initial release for public comment.

#### 3.4.2.3 National Informal Business Upliftment Strategy (NIBUS)

The Department of Small Business Development (DSBD) launched the NIBUS in 2014. The strategy "seeks to uplift informal businesses and render support to local chambers/business associations and Municipal Local Economic Development offices to deliver and facilitate access to upliftment programmes" (Department of Small Business Development [DSBD], 2017). The targeted groups include women, youth and people with disabilities residing in the

[21] Gazette No. 36265. Notice 231 of 2013
[22] Business Act 71 of 1991

townships and rural areas. At a national level, five economic sectors are prioritised – retail, manufacturing, agriculture, services and construction. Lower levels of government may identify additional sectors relevant to their regions. The NIBUS comprises two main instruments. The first one, the Shared Economic Infrastructure Facility, offers a 50:50 cost-sharing grant for the funding of infrastructure such as township industrial parks shared by informal businesses. The Informal and Micro Enterprise Support Programme, the second instrument, is a skills development programme to upskill business owners in the areas of marketing, product improvements, technology support and basic compliance including business registration at municipalities or CIPC, tax, accreditation and licensing) (DSBD, 2017).

## 3.5 TAXING THE INFORMAL SECTOR

The presence of informal sector activity has been accompanied by an interest in its tax revenue potential. In appreciating this revenue potential, discussions have equally centred on the challenges of successfully extracting revenue from the sector. Tax administrations face similar challenges in maximising compliance from the informal sector as it does from various taxpayer segments in the formal sector. These common challenges range from technical issues of revenue maximisation, the appropriateness of tax policy design to the wider political and governance limitations. Taxation of the informal sector is considered to be difficult and normally given a low priority (McKerchar & Evans, 2009). Some of the challenges unique to the informal sector are the limited revenue potential, high administration costs, inappropriate enforcement strategies, and the possible negative impact on economic growth. Improving compliance in the informal sector therefore requires an understanding of administrative, technical and institutional barriers that tax administration faces.

### 3.5.1 Benefits arising from informal sector taxation

Joshi et al. (2014) argue that while important, the direct revenue benefit of the informal sector has been overemphasised in the literature, and the indirect benefits are relatively less explored. The compliance of small business can have a positive influence on the compliance of large corporates and further encourage compliance. The recognition of a joint civic responsibility across all taxpayers fosters cooperation regarding the paying of taxes. Such positive attitudes to compliance indirectly translate to higher tax revenue collections.

The governance benefit of informal sector taxation speaks to the envisioned higher fiscal accountability (provision of quality public services) that will be demanded by informal traders as taxpayers. The theoretical basis of this argument is anchored in the Fiscal Exchange[23] model of tax compliance that views taxation as a fiscal contract between taxpayers and the government. In addition, political accountability is said to increase with growth in the tax base. The informal sector is often viewed as a politically vulnerable and marginalised group, whereas as taxpayers they can solidify their influence to ensure their interests are represented in the policy making space (Mascagni et al., 2014).

Once informal businesses have been formalised (registered for tax purposes), they become more accessible and visible to tax administration. For instance, the OECD (2013) notes that "efforts to better understand the profile and perceptions of small traders, for example, could help to engage them and establish a dialogue on tax issues thereby contributing to a culture of compliance" (p. 8). This bodes well for institutional reform because engagements with small business owners can further improve compliance by identifying gaps in tax policy and tax administration's service offering. It further encourages small businesses to continue to conduct themselves in a formal manner such as maintaining formal bookkeeping practices and ensure good standing with compliance requirements of other government and regulatory authorities.

### 3.5.2 Strategies to tackle the informal sector

#### 3.5.2.1 Industrialised countries

Best practice regarding informal sector taxation has been formerly documented in tax administrations of industrialised countries like Australia, Canada and the United Kingdom (UK). However, the principles are largely modelled on the conventional compliance and enforcement strategies used by tax administration. The principles include protecting the tax base, encouraging voluntary compliance and maintaining fairness in the tax system, and confidence in the tax authority. According to RAND Europe (2008), strategies used by tax administrations in developed countries to address the tax gap caused by the hidden economy are risk identification, organisational structure, public-private collaborations and policy initiatives (information campaigns, voluntary disclosure programmes and surveys tracking tax attitudes).

[23] For more detail refer to the Theoretical Framework (chapter 2) of this thesis

Section 3.3.1 of the Literature Review provided various definitions of the informal economy which can include legal and illegal activities. The tax authorities of Australia, Canada and the UK refer to informal economic activities as the black, underground and hidden economy respectively. These activities include legal trade that is either not reported or underreported for tax purposes. In other words, these terms are interchangeable.

### Australia

The most recent estimates by Australia's Bureau of Statistics placed the size of the black economy at about 1.5% of GDP in 2012, up from 1.3% in 2001. The Black Economy Taskforce is a partnership between the public and private sector headed by an independent chair established in 2016. The Taskforce includes representatives from the Reserve Bank of Australia, ATO, government departments (Treasury, Human Services and Immigration), chartered accountants and industry associations. It was established in 2016 "to develop an innovative, forward-looking whole-of-government black economy strategy" (Australian Treasury, 2017, p. 2). In its Interim Report the Taskforce noted that the ATO's current programmes were inadequate as indicated by the perceived growth in size of the black economy since 2012. In particular, the current approach relied on traditional policy tools like audits; and with business registration and verification systems being so weak, thus open to abuse by taxpayers with policies that were fragmented, which resulted in duplication of effort. Nevertheless, one of the ATO's achievements has been in industry collaborations "in some high-risk sectors to better target its audit and enforcement activities" (Australian Treasury, 2017, p. 25).

From a risk identification perspective, the Australian Taxation Office (ATO) mainly uses two methods to detect the black economy, which are the data matching method and small business benchmarks (Australian Taxation Office [ATO], 2017). The data matching tool electronically consolidates third-party information (government agencies and industry) and identifies taxpayers conducting operations outside the tax system, those under-reporting their income and the registered taxpayers who do not file returns. An example of third party information is purchases of high value assets which is compared with the taxpayers reported income and expenditure. The data is used by the ATO to indicate possible problematic areas that require education and compliance activities. The following areas are currently being targeted: motor vehicle registries, online selling, specialised payment systems and ride-sourcing. Small business benchmarks "are key financial ratios designed to help businesses compare their performance against similar businesses in their industry” (ATO, 2017). Businesses that significantly deviate from the benchmark possibly point to the under payment of taxes due to the under-declaration of income. The under-declaration can be achieved by only recording electronic sales and by concealing predominately cash payments. The benchmark can be used to approximate the actual income which is used to re-calculate the tax liability. Other risk identification measures used for the black economy include behaviour monitoring of previously audited taxpayers and the anonymous reporting of suspected tax evasion from the community (ATO, 2017).

## Canada

Underground economic activity in Canada was estimated at 2.4% of GDP in 2013 and this been stable since 2002 (Statistics Canada, 2016). The Canadian Revenue Agency (CRA) uses a combination of outreach, communication and compliance interventions to address the underground economy. In 2014 the CRA launched a three-year strategic framework to inspire compliance in sectors with high volume cash transactions. The Underground Economy (UE) Governance structure consists of the UE Advisory Committee that reports to the Minister of National Revenue. The UE Advisory Committee consists of groups and individuals from government, industry and academia. The Advisory Committee is guided by three main strategy elements. These are “understanding of the underground economy; seek to reduce the social acceptability of participation in the underground economy and deploy a range of initiatives to encourage compliance and reduce participation” (Canadian Revenue Agency [CRA], 2014).

The CRA employs a number of methods to expand its knowledge of the underground economy. The use of third party information and data mining models to detect sectors with a high risk of unreported income and automated systems to identify non-filers are some of the core risk identification methods. Information leads from the public and legislation compelling institutions to disclose information on non-compliant individuals further assists in detecting income from the underground economy (CRA, 2014).

Awareness and education campaigns are conducted to influence behaviour by increasing the CRA’s visibility in high risk sectors as a means of encouraging voluntary compliance. An integral part of the strategy entails changing perceptions of the underground economy by making participation socially unacceptable. This is achieved by the public awareness of the costs and burden of the underground economy, and publishing the punitive consequences for non-compliance (CRA, 2014).

In addition to the first two strategies, the CRA uses specialised underground economy teams to identify unreported and under-reported income, and underground economy centres of expertise are placed in tax offices across the country (CRA, 2014).

### United Kingdom (UK)

In 2014/15, the Her Majesty Revenue and Customs (HMRC) attributed 17% (£6.2bn) of the total tax gap to the hidden economy (Her Majesty Revenue and Customs [HMRC], 2017a). In most respects, the underlying elements of HMRC's hidden economy strategy are similar to those employed in Australia and Canada (HMRC, 2013). Most recently, between 2016 and 2017, the HMRC held three parallel consultations between government and stakeholders on various aspects of the hidden economy, "demonstrating that the government is exploring a full range of options to promote compliance, prevent non-compliance and respond to hidden economy activity when it occurs" (HMRC, 2017a, p. 4). The outcomes of the three consultations are summarised below.

### Tackling the hidden economy: Sanctions

The consultation was intended to obtain policy proposals to address the repeated non-compliance prevalent in the hidden economy. The consultation considered increasing the severity of penalties and the monitoring (non-financial sanctions) of hidden economy participants. The HMRC's current Managing Serious Defaulters (MSD) monitoring programme was not tailored to the circumstances of underground economy taxpayers as sanctions were harsh and levied on the assumption that taxpayers sought to evade taxes. The concern is the negative effect of alienating taxpayers or first time offenders that would otherwise comply voluntarily. There was an appreciation that current financial sanctions were inadequate in discouraging repeated non-compliance, and that levying escalated penalties would positively change the compliance behaviour of individuals in the hidden economy. It was recommended that the revised penalty model should therefore distinguish between deliberate and non-deliberate non-compliance, be proportionate to the severity of the non-compliance, and be accompanied by educational interventions to assist the taxpayers with their tax obligations. The existing penalties model is currently under review (HMRC, 2017a).

**Tackling the hidden economy: Extension of data-gathering powers to Money Service Businesses (MSBs)**

The consultation sought views on extending the HMRC's data-gathering powers to include MSBs, which are "entities that provide money transmission, cheque cashing or currency exchange services" (HMRC, 2016). MSBs were identified as having data that could assist the HMRC to detect non-compliant individuals in the hidden economy. The HMRC's operational experience shows that taxpayers exploit MSB services to dispose of cash income which can escape tax declarations. As a way forward, the government is drafting legislation to include MSBs as a data holder under Schedule 23 of Finance Act 2011 and draft secondary legislation stating the type of data that can be requested by HMRC from MSBs (HMRC, 2016).

**Tackling the hidden economy: Conditionality**

Essentially all businesses rely on services from other businesses or the government in order to trade. The principle of conditionality would require businesses to obtain tax clearance or good tax standing status from the HMRC before conducting trade. The aim of conditionality is "to tackle the hidden economy by building tax compliance into the process of doing business" (HMRC, 2017b, p. 4) and make it difficult for participants to operate in the hidden economy. The effectiveness of conditionality across sectors was raised in recognition of the disproportionate effect of conditionality on various sectors. Some sectors are already burdened by high administration and regulation costs and further compliance requirements could discourage the use of important services like finance and insurance. Going forward, the government intends to conduct pilots on conditionality toward designing an appropriate policy that simultaneously reduces burden and increases compliance (HMRC, 2017b).

#### 3.5.2.2 Developing countries

The informal sector in Africa contributes an average of 40% of GDP. The average is significantly above advanced economies, which indicates that there are ample opportunities for African countries to expand their tax base and increase revenue collection (ATAF, 2014a). However, successfully exploiting the revenue potential of the informal sector has been hindered by the capacity, resource and organisational constraints faced in particular by tax administrations in Africa. In addition, certain characteristics of the informal sector such as the temporary nature and large prevalence make it difficult to monitor or enforce tax compliance. Nonetheless, tax reforms for informal Small and Medium Enterprises (SMEs) have been implemented by tax administration in Africa and in different contexts (ATAF, 2014a). As with industrialised countries, the informal economic activities referred to below constitute legal economic activities that were not tax compliant.

### Ghana

In 2005, Ghana Revenue Authority (GRA) introduced the Tax Stamp project targeted at micro and self-employed enterprises in the informal sector. Informal traders are segmented into categories according to activity, location and size, with a standard amount levied for each category. There are 3 categories as at 2013 (A,B,C) which are further divided into 4 sub-categories (Table Top, Small, Medium and Large) in recognition of scale differences within categories. Different colour stamps are used to distinguish the categories of informal taxpayers with embedded security features to prevent imitations. The stamp details taxpayer name, amount paid and payment date (ATAF, 2014b).

The Tax Stamp project is managed by a hybrid of GRA staff as an anti-corruption measure. The Small Taxpayer Office (STO) head office is mainly responsible for enforcing and monitoring the project while on-the-spot verification is conducted by senior officials from the Domestic Taxes Department. A regional revenue office is responsible for a tax jurisdiction and reports to the STO head office. In addition, there is a separation of functions between the classification of an informal enterprise and the collection of tax stamps among staff members. In essence, the Tax Stamp project provides a means of identifying, monitoring and increasing compliance in the informal sector and to ensure that taxes are paid in an equitable manner (ATAF, 2014b).

From a tax revenue growth perspective, in 2008 revenue growth from the Tax Stamp was negative (3.6%) despite a strong growth in domestic economic activity. The project was relaunched in 2009 and saw a significant growth in revenue of 8.4%; however in 2010 and 2011 growth recorded 7.0% and 0.2% respectively. Between 2009 and 2011, growth in revenue was positive although it declined on an annual basis. The poor monitoring of the regime and high printing cost of the stickers are some of the challenges attributed to performance that is below expectations (ATAF, 2014b).

## Tanzania

Tanzania's Block Management System (BMS) was formulated in 1995 in line with Tanzania Revenue Authority (TRA's) objectives of creating a practical and sustainable system of managing the compliance of SMEs. The BMS establishes geographic areas of business activity into sizable, manageable blocks and sub-blocks. The BMS offers a comprehensive solution and facilitates the registration, payment and monitoring of all taxes administered by the Domestic Revenue Department for which SMEs have to qualify. The TRA relies on third party information sharing by local municipalities and business associations for demarcating blocks. Blocks are identified either on the basis of common business activity or geographical area, with the overriding principle being manageability (ATAF, 2014c).

Each of the TRA's tax regions are serviced by one or more Tax Service Centre (TSCs) which in turn services one or more blocks. TRA staff is assigned to service a sub-block of taxpayers on a 3 year rotation cycle and report to a supervisor that manages the entire block. The block staff mainly comprises experienced tax officials, and training interventions are conducted to address skills gaps. Staff levels have been cited as one of the major challenges with the BMS project. The TRA enforced the use of Electronic Fiscal Devices (EFD) to store electronic transactions (through government legislation) in 2010 to assist VAT vendors with the issuing of invoices and receipts to improve tax compliance and formalise record keeping (ATAF, 2014c).

Tanzania's BMS has had a notably positive impact on the tax compliance of SMEs. An analysis of key performance indicators reveal an annual growth in the number of SME taxpayers from 372 600 in 2010 to 493 714 in 2012. Consequently, the revenue from this segment increased from US$500m to US$900m in the same period. The success of the BMS project is attributed to the risk management system that limited the frequency (and costs) of field verification visits. Moreover, the BMS has improved the data integrity of the informal sector register, and the quality of tax assessments. It also provided accurate statistics on the economic activities of the informal sector (ATAF, 2014c).

## Rwanda

Rwanda Revenue Authority (RRA) identified gaps in the skills set of its staff and the low tax literacy of SMEs as major challenges contributing to the low compliance levels in the informal sector. As a result, a concurrent strategy entails training staff through the Training

Department (TD) as well as providing taxpayer education and services through the Taxpayer Services Department. Specialised training is offered according to the taxpayer segment that the staff services. The RRA acknowledges for instance that staff from the Small Medium Taxpayer Office (SMTO) requires "specialised skills that are geared towards teaching, informing, counselling and mentoring taxpayers, who usually maintain very basic records" (ATAF, 2014d, p. 8).

The Training Department puts certain measures in place to ensure that the strategy remains effective. The RRA's training policy requires the staff to commit to a minimum of 7 hours of personal development training annually. Furthermore, an assessment of the training intervention is performed through the annual performance appraisal system. Staff members are subjected to continuous assessments after training by supervisors. New staff recruits are specifically deployed to tax jurisdictions with a high concentration of SME taxpayers and get trained accordingly. Some skills competencies include basic accounting, public relations, information dissemination and basic ICT skills (introduction to computers, word processors and spreadsheets). The RRA relies on information from external stakeholders associated with the SME tax base to understand the challenges and needs caused by their operating environment. Such insights are used as inputs into the training programmes (ATAF, 2014d).

The Staff Training Programme has generally yielded positive results. Between 2009/10 and 2011/12, the small taxpayers grew from 40 495 to 88 351, and filing compliance increased from 54.4% to 58.2%. The growth in the RRA's total tax revenues from US$636m to US$1.1bn can be attributed to the success of the programme (ATAF, 2014d).

Despite the achievements in taxing the informal sector, Tanzania, Ghana and Rwanda still experience challenges. The fast growing informal sector poses a major risk to revenue collection efforts as it implies the allocation of more financial and human resources and possibly higher collection costs. The efficiency of the tax administration operational environment is unsupportive of effective revenue mobilisation owing to its manual processes and procedures. The lack of automation has a negative impact on the compliance costs of small taxpayers who pay their tax liability in cash, which may be accompanied by corruption and collusion between taxpayers and tax officials (ATAF, 2014a).

### South Africa

Relative to other tax administrations in Africa that have made in-roads in informal sector taxation[24], SARS's strategy is less established or at least still developing. In the 2015/16 Annual Report, the revenue service indicated participation in study tours to Ghana and Tanzania "in order to learn and understand how they are managing the compliance of the cash and informal sector of their respective economies" (SARS, 2016b, p. 52). In 2015/16, SARS embarked on two separate informal economy initiatives where 1000 SMEs were registered and thirteen audit assessments with a value of R8.2 million were conducted. Through these initiatives, the need for taxpayer education was identified (SARS, 2016b).

SARS currently undertakes compliance initiatives in the informal sector through its Branch Operations Engagement (BOE) unit. The core functions of BOE entail conducting tax education campaigns and services to targeted taxpayer segments (SARS, 2016c) which naturally includes 'walkabouts' to identify economic activities that are outside the tax net (Fjeldstad & Heggstad, 2012). To increase the visibility and accessibility of SARS, BOE uses Mobile Tax Units in three rural provinces in South Africa - KwaZulu Natal, Eastern Cape, Limpopo – and collaborates with state agencies and provincial government departments. Moreover, other interventions include identifying and equipping small businesses with the means to comply, as well as establishing Points of Service at malls and strategic locations (SARS, 2016c).

## 3.6 SUMMARY

Literature on taxation has alluded to the importance of taxation, tax compliance, the socio-economic implications of the tax gap and what constitutes an ideal taxation system. In recent years South Africa's tax revenue collection and PIT, the most important revenue stream has been under strain. The Medium Term Expenditure estimates require a steady growth in tax revenue to enable the government to meet its fiscal obligations. Moreover, the Davis Tax Committee and National Treasury have echoed the urgency of broadening the tax base. Tax base broadening can be achieved by minimising revenue leakages and maximising compliance with tax legislation. SARS's attainment of the tax revenue target has thus far been attributed to operational and technical efficiency within the formal sector tax base. The organisation is yet to fully extend these gains to the informal sector. Globally, the informal

[24] This specifically refers to (informal) SMEs not registered for tax purposes. SARS does administer Small Business taxation, as discussed in the Literature Review

sector has been identified as having some revenue potential and exacerbating the tax gap. Knowledge of the perceptions of informal traders regarding taxation in South Africa is an area that requires exploration as it can further provide insights into the nature of their tax morality and compliance behaviour. This can be instrumental in informing appropriate compliance strategies that can be used by SARS to extract tax revenue successfully from the sector.

Having identified the informal sector as a potential source of tax revenue, discussions in literature have considered in detail what the term entails. The complexity of defining the informal sector and/or small businesses arises from the selection of criteria used for identification and segmentation. The lack of a standard definition is a direct result of this complexity; however this has also opened up debate about what is really understood and misunderstood about the informal sector. In defining the informal sector for taxation purposes, cognisance must be given to the income generating capacity. Some small businesses in the informal sector are survivalist in nature while others generate income that is significant for tax purposes. In South Africa, Stats SA's definition of the informal sector is qualitative and categorical whereas definitions of Small Businesses by various legislations of the Department of Trade and Industry as well as National Treasury are quantitative. Under the current definitions, there is no quantitative definition of small businesses in the informal sector and this effectively excludes them from tax legislation. Therefore, before taxing informal activity, SARS would need to develop a separate and specialised tax regime for informal businesses (similar to reforms in Ghana and Tanzania) particularly those not meeting the turnover requirements of micro enterprises and SBC's as defined by the Income Tax Act[25].

There are notable trends regarding South Africa's informal sector. A considerable proportion of informal sector activity is conducted from residential premises followed by those who are mobile (without fixed operating premises). This implies that some informal activity takes place away from the mainstream economic activities found in city centers. The location bias may present a challenge for SARS in terms of locating informal traders. A majority of business owners do not have a bank account, which suggests that transactions are mainly conducted on a cash basis and this charaterises the informal sector. The lack of financial record keeping is mainly attributed to the lack of required skills, and some business owners

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[25] Income Tax Act 58 of 1962

merely do not recognise the purpose of keeping records. From an audit perspective, the absence of a bank account and business financial records presents challenges which prompt the use of alternative and innovative ways to estimate tax liability by using presumptive methods. The majority of business owners did not have a business license or permit, which confirms the highly unregulated nature of the informal sector. High costs of formalisation (taxes, license fees, registration costs) encourage business owners to operate in the informal sector.

The main argument for the taxation of small businesses in the informal sector was initially framed in terms of the tax revenue potential. However, the argument has since evolved to considering the non-revenue benefits. These may include strengthening the tax morale of taxpayers in the formal sector which would make them more agreeable to paying taxes. Political accountability and fiscal responsibility is said to strengthen when the government becomes accountable to more taxpayers. As taxpayers, informal traders can legitimately exert influence on policy formulation. Moreover, positive tax reform can result, particularly in cases where current tax legislation is unresponsive or unsuited to the needs of the informal sector. Despite these benefits, a range of technical, operational, political and governance considerations accompany informal sector taxation. The tax administrations in developed and developing countries have in recent years undertaken some strategies where informal taxation is concerned. However, divergences are noted; developing countries have a significantly higher proportion of informal activity and tax administration is less capacitated to effectively mobilise tax revenue from the informal sector.

# CHAPTER 4: RESEARCH METHODOLOGY

## 4.1 INTRODUCTION

The chapter discusses the methodology used in the research. These include the research paradigm, sampling and target population, data collection, analysis and validity, ethical considerations applied and experiences from the fieldwork.

## 4.2 RESEARCH PARADIGM AND PHILOSOPHICAL UNDERPINNING

The specification of a research paradigm is necessary to provide alignment and consistency in all aspects of the research design as well as to state the underlying assumptions. The constructivist or interpretivist paradigm used involves “understanding the world as others experience it” (Wagner, Kawulich & Garner, 2012, p. 55). The main objective of the research was to uncover the tax perceptions of informal traders. Their perceptions, realities and lived experiences are therefore considered to be true and cannot be disputed.

## 4.3 SAMPLING AND TARGET POPULATION

### 4.3.1 Sampling

The target population included small business owners in the informal sector operating in Buffalo City Municipality in the Eastern Cape province. The location was chosen on the basis of convenience, due to the researcher’s familiarity with the area and proficiency in the dominant language of isiXhosa, which facilitated communication with the interviewees.

Purposive sampling was identified as the most ideal for the research because participants were required to fulfil a set of pre-determined criteria, i.e., non-tax paying small business owners operating in the informal sector. According to Richie, Lewis, Nicholls and Ormston (2014), the principal aim of purposive sampling is “to ensure that all the key constituencies of relevance to the subject matter are covered” (p. 113). Participants were initially identified from various trading locations in and around the city of East London.

Snowballing sampling was used as an additional sampling method where interviewees were asked to recommend others with the same criteria (Bryman, 2016). This was done to broaden the diversity of business owners and industries. Moreover, snowballing was particularly useful as it was difficult to locate informal business owners, since they were reluctant to be identified because of their operating circumstances. Some interviews were obtained on a referral basis and this increased the willingness of the informal traders to participate in the interview.

The literature provides guidelines regarding sample size in qualitative research. Despite the lack of consensus about minimum and maximum sample sizes, the guiding principle is to obtain in-depth information rather than to aim for a pre-determined target (Creswell, 2013). This principle was evaluated against the time constraints encountered in the field to arrive at the final sample size.

### 4.3.2 Target population

The participants were identified using two criteria. The Literature Review (chapter 3) discussed various definitions of informality and business size. The first selection criterion was guided by the National Small Business Act[26] (as amended). The schedule to the Act classifies small businesses as 'micro', 'very small', 'small' and 'medium', according to three indicators - the 'number of full-time employees', 'total annual turnover' and 'total gross asset value'. Different indicator thresholds are applied to each industry to determine the classification (size) of the enterprise. The 'number of full-time employees' indicator was used to identify 'micro' businesses. The sample therefore included business owners employing less than five employees. The choice of indicator was informed by the non-intrusiveness of the indicator compared to 'total annual turnover' and 'total gross asset value'. The chosen indicator thus provided an indirect estimate of the corresponding maximum turnover of R200 000 for micro enterprises as specified by the Act.

The 'micro' size businesses were selected as the point where businesses are small enough to operate without detection from authorities, yet are profitable enough to generate taxable income. Although 'micro' businesses have the lowest estimated turnover per industry, business owners in this category qualify for some of SARS's graduated tax rates for small businesses discussed in the Literature Review (chapter 3).

The second criterion, which served as a possible indicator of 'informality', was the non-registration status of the micro business with the Company and Intellectual Property Commission (CIPC), formerly called Companies and Intellectual Property Registration Office (CIPRO). Registration with the CIPC is a pre-requisite for small businesses to register

[26] National Small Business Act 26 of 2003

for tax purposes and thus become taxpayers. The selected participants were engaged in legal economic activities.

Participants included traders not registered with SARS as well as those registered with SARS who, by their own admission, are not paying tax on profits. There was no pre-determined requirement for the type of industries and gender of participants; however, an attempt was made to be as representative as possible. The industry and gender characteristics were mainly influenced by the availability of participants.

## 4.4 DATA COLLECTION

### 4.4.1 The rationale for the data collection instrument and research approach

Country-level research into tax morale and compliance behaviour has used a quantitative survey instrument. Daude et al. (2012) acknowledge the usefulness of survey data for cross country comparisons of tax morale; however, they also point out that "for a better understanding of the issues to guide policy reform a more in-depth country analysis is needed" (p. 34). Another shortcoming of the survey instrument is it places the burden of interpretation on the respondents. Additionally respondents are provided with a limited opportunity to seek clarification of the terms as well as the intended meanings of the questions. Where the level of understanding of respondents on the subject matter is unknown, the validity of the results is compromised. Likewise, researchers may not be able to ascertain with confidence that respondents fully understand the issues of interest.

Wagner et al. (2012) note that "one of the greatest strengths of qualitative research is the richness and depth of explorations" (p. 126). The open-ended nature of the discussion guide instrument enables the researcher to seek clarity by probing, and it gives participants the opportunity to address aspects of the subject matter that are misunderstood. Research into tax perceptions is relatively new in South Africa (see paragraph 4.4.2); moreover, there is less evidence to date of the perceptions of taxpayers in the informal sector. Morsel, as cited in Creswell (2014), advises that a qualitative approach is appropriate when the topic is relatively new within a certain sample or group under study.

### 4.4.2 Similar studies conducted in South Africa

Oberholzer (2005) investigated the tax perceptions of previously disadvantaged South Africans using personal face-to-face interviews (structured and semi-structured questionnaires) in Wonderboom and Soshanguve Township in Pretoria. Abrie and Dousy (2006) studied the tax compliance obstacles faced by small and medium manufacturing enterprises in Gauteng Province using a combination of self-administered questionnaires and personal face-to-face interviews. In a pilot study, Oberholzer (2008) examined the attitudes of South African taxpayers (White, Coloured, Indian and African) in the Tshwane metropolitan area. Personal face-to-face interviews using structured and semi-structured questionnaires constituted the method of inquiry.

### 4.4.3 The interview and discussion guide

Interviews are ideal to collect data about “ideas, experiences, beliefs, views, opinions and behaviours of the participant” (Wagner et al., 2012, p. 133). The choice of the interview was motivated by the sensitive, moral, controversial and personal nature of taxation. Cognisance was taken of the social stigma attached to non-compliance. It was therefore important to ensure a method of data collection that creates trust between the researcher and interviewees. Focus groups were considered as an alternative method; however, in addition to the sensitivities of the topic, participants could have easily influenced one another and thus compromised data validity.

The structure of the discussion guide was aligned to the three research questions (refer to Appendix E) in line with the focus of this research. The primary research question intended to probe informal traders about their tax perceptions, using contributions from the Theoretical Framework (chapter 2). The secondary research questions sought to ascertain the knowledge levels of taxation and experiences with using taxpayer services. The research questions were jointly aimed at drawing conclusions about the compliance attitudes or nature of compliance behaviour of informal traders. The literature stipulates that tax perceptions, tax knowledge and service offering of the tax authority (among other factors) have a bearing on the taxpayer’s decision to comply with tax.

The interviews were semi-structured for two main reasons. Firstly, empirical studies on taxpayer behaviour provide some level of predictability regarding the determinants of compliance decisions. Secondly, the open-ended and unstructured element of the instrument provided flexibility to accommodate emerging issues. It further gave interviewees the opportunity to make additional comments and seek further clarification - this is believed to have solidified the validity of data collected.

## 4.5 DATA ANALYSIS

Data preparation entailed transcribing the audio interviews to enable data analysis. The data was analysed by using a process of reducing the transcripts into codes; with the codes further reduced into themes (Creswell & Poth, 2017). The first stage of analysis entailed the coding technique where meaningful concepts were identified that best captured each interviewee's responses to the interview question. Subjective judgement was applied in the choice of codes. Direct quotations from the transcripts were used alongside the codes to justify the accuracy of the code and to provide the context. In the second stage of analysis, the codes were classified into themes to identify patterns in the data and to facilitate interpretation of the data. The themes formed the basis of discussion. A number of software programmes can be used for coding; but due to budgetary constraints, the coding was done manually. The code book was compiled in Microsoft Excel and the data analysis for each interview was recorded in its own individual sheet. Each sheet had a column for codes, themes and verbatim responses. The main aim of the data analysis was to identify patterns and associations within the data, with the aim of responding to the research questions.

## 4.6 DATA VALIDITY

Validity in qualitative research is defined as to whether the data is plausible, credible, reliable and can be defended when challenged (Maxwell, 1992). The sampling method was purposeful, being that the interviewees were selected based on their participation in the informal sector. The use of the 'number of full-time employees' indicator was deliberate in that it is less intrusive than asking interviewees to state their 'total annual turnover' or 'total gross value of assets'. Therefore it is assumed that the chosen criteria offered an additional measure of trust and truthfulness that would otherwise not have been achieved with the other two indicators. During the interviews, a technique of member checking was used, wherein interviewees' responses were repeated to confirm meaning (Merriam, 2009). The researcher's proficiency in both English and isiXhosa further guaranteed data validity. The chosen research paradigm assumes that because the experiences and perceptions of the interviewees are subjective, they are necessarily legitimate. Other measures of validity that were used are addressed in the 'Ethical Considerations' section below.

## 4.7 ETHICAL CONSIDERATIONS

The issues of tax morale and compliance behaviour are sensitive in nature. As such, the basic ethical considerations suggested by Merriam (2009) were adhered to and communicated prior to each interview. Among these were assurance of anonymity and confidentiality, freedom to end the interview at any time, explaining the purpose for using an audio recorder and requesting permission. The interviewees were requested to sign consent forms to this effect with the objective of creating rapport and improving the richness and reliability of the data.

## 4.8 THE FIELDWORK

Preparation for the fieldwork entailed two pilot interviews, in English and isiXhosa, conducted on 16 and 17 November 2017 respectively. The consent form and discussion guide were translated into isiXhosa and the interviewees were asked their preferred language prior to the interview. The pilot interviews were useful as they indicated ambiguity with ‘government’ where interviewees questioned whether it is local or national government being referred to. A decision was taken to specify that references to the government include local, provincial and national because traders benefit from the spending functions of the different government levels. The second point of clarity was on the tax type referred to; upon which the decision was taken to state income tax as the tax type of interest. Overall, the pilot interviews proved that the discussion guide is a comprehensive data collection instrument as interviewees alluded to the probes in their response to the main questions. As a result, there were no major revisions to the discussion guide. Responses from the pilot interviews were excluded from the analysis and sample size as the main purpose was to test the discussion guide.

A total of ten informal traders were interviewed during 18-23 November 2017. The interviews were mostly held at the trader’s place of businesses during work hours. Some of the difficulties encountered were the adverse weather conditions (for traders without sheltered business premises) that resulted in the rescheduling of interviews. At times there were pauses during the interviews when traders had to attend to customers. As a result, some interviews had to be conducted after business hours. These factors resulted in logistical challenges which further compounded the issue of the limited time allocated for conducting fieldwork.

## 4.9 SUMMARY

The chapter provided an overview of the research methodology. All aspects of the research design were reinforced by the literature and thus considered to be adequate for the purpose of the study.

# CHAPTER 5: ANALYSIS OF FINDINGS

## 5.1 INTRODUCTION

The chapter presents data collected from the fieldwork. The discussion guide[27] used for the interviews was divided into three main sections, in-line with the research questions.

As mentioned in section 1.3 in chapter 1 (Introduction) the research questions are as follows:

i. What are the perceptions of informal traders regarding South Africa's tax system?
ii. What is the understanding of informal traders regarding the taxation system and their tax obligations?
iii. What experiences do informal traders have in using taxpayer services?

The data analysis techniques employed were discussed in chapter 4 (Research Methodology). This chapter begins with a demographic profile of the respondents followed by an analysis of the findings. The findings are then discussed in more detail mainly with relevance to the research questions and chapter 2 (Theoretical Framework).

## 5.2 DEMOGRAPHIC PROFILE OF RESPONDENTS[28]

### 5.2.1 Gender

A total of ten respondents were interviewed, with a gender composition of 50% male and 50% female.

### 5.2.2 Age of respondents

Apart from one outlier in the 21-30 age group (10%) and the 60-69 age group (10%), 30% of respondents were in the 30-39 and 50-59 age group respectively and the remaining 20% in the 40-49 age group.

### 5.2.3 Business age

An equal proportion (40%) of respondents has a reported business age of between 1-9 years and 10-19 years, moreover an equal proportion (10%) has a reported business age of between 20-29 years and 30-39 years respectively.

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[27] Refer to Appendix E
[28] Refer to Appendix D for tables

### 5.2.4 Business location

The majority (50%) of businesses are operated from the Township followed by the Suburb (20%) and the Rural Area (20%). The business activity of one respondent (10%) is conducted on the Beach Front.

### 5.2.5 Economic activity

The respondents were engaged in a number of different economic activities. The most dominant were Retail (20%), Catering (20%) as well as Art and Craft (20%). The remaining activities were in Farming (10%), Floristry (10%), Sewing (10%) and Plumbing (10%).

### 5.2.6 Education level

Half of the respondents (50%) have Secondary education, one has Primary education and one has no formal education (10%). One of the respondents (10%) has a Tertiary education qualification (Diploma) and two respondents (20%) did not specify their level of education.

### 5.2.7 Employment status

The majority of respondents are self-employed in the informal sector (90%) while one respondent (10%) is a full time employee in the formal sector with an informal business.

## 5.3 ANALYSIS OF FINDINGS

The main themes associated with the research questions are discussed below (section 5.3.1 to 5.3.3) and these should be read with the discussion guide. An additional theme emerged from the interviews and is discussed in section 5.3.4.

### 5.3.1 Perceptions about tax and the tax authority

All the respondents were able to articulate the importance of tax and the role it plays in society. Among the issues identified were the provision of social grants, government services and poverty alleviation. Moreover, there was an appreciation that tax is one of government's most important sources of income.

> *"Tax is helpful because the very same money that gets collected helps people, for example, we receive social grants and this is made possible by taxpayers"*
> *(Respondent A)*

*"I see the government is doing something. These things that taxes are used for, like problems with electricity, toilets etc." (Respondent I)*

*"I understand taxes need to be paid because all governments depend on tax" (Respondent C)*

Issues of fairness regarding taxes were evident. Most of the respondents appear to support the progressive nature of tax, with some stating affordability as one of the major reasons for not paying tax.

*"Those earning higher incomes obviously cannot pay equal tax to those earning lower income at all" (Respondent B)*

*"If I am earning something below a threshold where I am even unable to buy myself food then it will be a big problem. If I am not having that much of which if they deduct something or I have to spend a lot of money for tax, then I will end up suffering" (Respondent I)*

*"It is obvious that those who can afford should pay according to the money they have" (Respondent E)*

The respondents recognised the negative impact of non-compliance with punitive consequences or fear from prosecution being widely cited.

*"You are putting yourself at a disadvantage by not paying tax because when they eventually discover your actions; you will have to pay it back with interest and penalties" (Respondent D)*

*"I wouldn't give SARS a hard time because I will get arrested if I don't pay my taxes…and get locked up in jail" (Respondent C)*

*"It is only to protect my business (against court action) and not to be found on the wrong side of the law" (Respondent F)*

The respondents generally exhibited positive tax morale. Their willingness to pay tax appears to be supported by a moral obligation to society and the expectation of a positive direct benefit for paying tax.

*"I would definitely pay tax…the tax I pay is the same that helps those in need. That would encourage me to pay tax once I start making money" (Respondent J)*

*"Because really sometimes, if one does pay tax they get something in return" (Respondent H)*

> *"In the township we don't pay attention to a lot of things…paying taxes is something I have never thought about but if someone says I should do it then I will. If someone says to me 'go to SARS to pay a certain amount' I will get into a taxi and do just that if I am able to pay it" (Respondent D)*

SARS was regarded as an important institution. Its importance was expressed in two ways. On a broad level, respondents identified the role played by SARS in collecting tax revenue and indirectly assisting the government with the means to provide social services. The technical function of SARS in administering individual taxes was highlighted.

> *"SARS has to be there because the money it collects is recycled and used for old age grants (for example) so tax is necessary. The government relies on this tax, everything depends on tax, public servants get paid from tax collections" (Respondent I)*
>
> *"It is the institution that collects money and sends it to the government. That's what I know about SARS. There has to be an institution that performs this function in South Africa" (Respondent A)*
>
> *"Sometimes you can go to SARS and find that you are over-taxed so it is very important that SARS is there to check what is happening with your taxes because you cannot calculate that by yourself and you find there is some money due to you" (Respondent J)*

SARS was regarded as an institution that is generally accommodative towards taxpayers.

> "*If for example they notice you are failing to pay your debt they can lower your instalments to an amount you can afford" (Respondent F)*
>
> "*SARS is reasonable towards taxpayers…they notify you before the deadline if you need to submit documents or make a payment*" *(Respondent G)*
>
> *"It is accommodative, in the sense that it's like you can pay tax according to how much you earn"(Respondent B)*

#### 5.3.1.1 Economic factors

The Economic Deterrence model considers the impact of a range of punitive factors (tax rate, probability of detection, sanctions) on tax compliance. The severity of these factors and an aggressive approach by tax authorities is said to positively influence compliance. The vast majority of respondents who have had limited or no interactions with SARS were questioned on what they had heard about the experiences of others.

Respondents generally considered the use of penalties for non-compliance to be effective. There is a sense of fear or anxiety associated with receiving written communication from SARS, for instance about the non-submission of tax returns. There is a belief that such communication creates a strong sense of obligation to respond positively by complying. Moreover, it would serve as an effective deterrent that would prevent future incidents of non-compliance. There appears to be confidence in SARS's institutional ability to trace tax evaders. Reference was made to the highly publicised case of a prominent politician who was taken to court by SARS for tax arrears. Some respondents could not comprehend how taxpayers could successfully evade taxes. Positive perceptions of SARS's operational and technical efficiency were evident. This could be closely related to the perceptions of SARS's legitimacy, which is discussed later in this chapter.

The respondents were not able to ascertain whether they considered the current tax rates as reasonable or high. This was expected because the sampling did seek out traders whose businesses are not registered for tax purposes; others admitted to not paying taxes on their business income. Some respondents admitted that taxpayers within a close proximity to them complained about tax rates being too high. Although the respondents do not pay tax in their business capacity, they appeared to be sympathetic to the tax burden (caused by the perceived severity of tax rates) of those who can afford to pay tax. A further possible indication that supports the perception that tax rates are high is the respondent's assertions that others (like themselves) live below the subsistence level and cannot afford to pay tax. At the other end of the spectrum (and perhaps more noteworthy), tax is considered too much of a burden even to those who can afford to pay.

The progressive nature of tax rates was a major point of discussion. Respondents generally agreed that a progressive tax system is fair because it is based on the 'ability to pay' principle. It is tempting to attribute this to the fact that they are beneficiaries of such a system as low income earners. However, this would not be fully correct. For the most part, the respondents exhibited a strong willingness to pay tax. By their own admission they are beneficiaries of tax as recipients of social grants and government services. Furthermore, the respondents were able to articulate the positive impact that government expenditure has had on their communities and expressed a wish to play their part in contributing to social assistance. Many respondents cited affordability (low profits) as the main reason for not paying; therefore it does not appear that high tax rates are a major deterrent to paying tax.

One respondent had an alternative view about the fairness of tax rates. The respondent stated that there is no certainty regarding taxes and his understanding of fairness is uniformity. According to this respondent, progressive tax rates are uncertain because the tax liability varies with taxable income, and the tax paid varies from one period to another. The perception of high tax rates held by the respondent is based on information obtained from third parties. The respondent made an example to illustrate his point more clearly. To demonstrate the point of vertical equity, a 'spaza shop' in the township and an established retail shop in the suburb cannot be expected to pay the same amount of tax even though they are in the same sector. Retail shops in the suburb should pay more tax than 'spaza shops'. With regards to horizontal equity, businesses in the same sector should pay equal tax.

However, it is important to note the response was given without knowledge of the current graduated tax rates for small businesses. The question is whether the respondent would share the same sentiments if he was aware that the tax system inherently ensures vertical equity wherein larger corporates and small businesses have separate tax arrangements. It is therefore highly unlikely that the profits of a 'spaza shop' and a major retailer would be taxed in the same manner. The observation that businesses in the same sector should pay uniform tax is based on the assumption of standard profits. This case further reveals the importance of tax education where tax rates are concerned because its absence can lead to misplaced knowledge.

#### 5.3.1.2 Fiscal factors

According to the Fiscal Exchange model, aspects that have an important bearing on tax compliance include perceptions of government services, transparency in government finances and citizen participation in government spending. The respondents commented on national, provincial and local government.

The dissatisfaction with government services was expressed with respondents attributing this to the perceived wastage and misuse of taxes. Government corruption is a major cause of deficiencies in the quality and quantity of government services. Government officials who use public funds for private gain are not held to account – reference was made here to national and local government office bearers. In spite of this, corruption does not appear to be a significant deterrence for non-compliance, because of society's dependency on government assistance (including the respondents). Respondents acknowledged the positive impact of government services and social grants and gave examples of how the quality of their life had improved. For instance school feeding schemes, electrification of rural areas and improved facilities in schools were cited.

Respondents mainly mentioned local government services when asked to comment on the quality and quantity of services. This is understandable because of the close proximity that citizens have with local government as the service delivery tier of government. Poor service delivery has resulted in dirty townships, poor road maintenance as well as inadequate water supply and housing. There is mistrust towards government because of unfulfilled promises to roll-out services. One respondent mentioned that the municipality is unable to provide free basic services but they are still expected to pay rates despite applying for exemptions based on unaffordability.

There is a belief that service delivery is uneven between townships and low density suburbs. Services are often adequate and of a better quality in low density suburbs. Moreover, the migration of rural residents to urban areas (townships) has resulted in competition for services. The shortage of services is aggravated by the existence of foreigners in these areas; as such, the government is accused of not being able to balance its efforts. The respondents exhibited a sense of entitlement, where citizens should receive priority use or allocation of services over foreigners. The shortage of services is made worse by governance lapses and poor resource planning by local government, perhaps more to the point, perceptions of corruption mentioned by the respondents.

One of the main features of the Fiscal Exchange model is the concept of tax being a contract whereby citizens pay tax in exchange for government services. Using the traditional concept of a contract in the legal sense, the respondents were asked whether they believed taxpayers are justified in withholding of taxes if the government does not honour its responsibilities. There was a general concern that if the majority of taxpayers behaved in this manner, government resources would be significantly lowered to the dismay of the poor who rely heavily on taxes. A respondent believed evading taxes is a self-defeating exercise that puts one at a disadvantage when detected because of the penalties that will accumulate and result in a higher liability. Because tax is the lifeline of any government, one respondent felt strongly about eligible citizens honouring their tax obligation; and suggested that an alternative and more appropriate method of signalling dissatisfaction is by voting the government out of power.

There was a wide-held perception by respondents that other taxpayers are not content with services they receive from the government. The discontentment stems from unmet expectations with government services, given the high tax burden. For example, some taxpayers opt for private services (Health, Education) and use government services (Home Affairs) when there is no private alternative. The discontentment is therefore attributed to the perceived 'quality gap' between government and private services. In addition to the lack of quality, those genuinely paying for services are frustrated by not having access. To illustrate this point, reference was made to power outages in the townships (that affect taxpayers) caused by illegal electricity connections from shack dwellers.

Citizen participation (consistent with democratic ideals) in the spending decisions of government is an important anchor of tax compliance. There was a difference in opinion; some respondents think participation is necessary and for others it is unwarranted. Those in support felt citizens should have a (greater) input so that there is more clarity on what taxes are used for. This view seems to be motivated by a perceived lack of transparency with budgets as well as a need to hold the government accountable. Others felt that citizens should not be involved in spending decisions because of differing views that would lead to a lack of consensus. Interestingly, respondents who held this view also appeared to have a strong sense of trust in the government which was absent in those advocating for citizen participation.

#### 5.3.1.3 Political factors

Confidence in the government's decision-making ability as well as a government that acts in the best interests of its citizens tend to make citizens more agreeable to comply with tax legislation. Other related political factors are accountability, civic participation, credible government institutions and efficiency in government spending.

Political legitimacy is compromised by a perception held by respondents of an inefficient and unproductive local government. The low confidence in local government was attributed to its failure to provide services. The negative perception in the way the government conducts its fiscal duties was used by the respondents as subjective measure to assess the government's legitimacy. This is consistent with the Political Legitimacy model which finds that a government is deemed to be inefficient if public expenditures are sub-standard or undervalued. Without downplaying the self-enforcing relationship between legitimacy and efficiency, this suggests that efficiency has a more superior influence on tax compliance. The efficiency of government spending is an equally important factor in the Fiscal Exchange and Political Legitimacy models.

The extent of civic participation that is guaranteed by democratic institutions has an important bearing on tax compliance. There was much discontent with the perceived lack of inclusive decision making. Upon observation, the absence of visible citizen involvement in decision-making was a major source of government mistrust. To drive the point further, a respondent made reference to Legislation considered to be illogical. The same respondent was considerably frustrated having exhausted publically available platforms to contact the office of the President. The expressed wish for increased accessibility to government officials was on the basis that ordinary citizens could better advise on policies and governance. This implies that the strengthening of dialogue between the government and citizens could circumvent the perceived gap in inclusive decision-making. Active involvement in decision-making can therefore reduce government mistrust and make the government more accountable.

The Political Legitimacy model advocates that government predictability has a positive impact on taxpayer behaviour and the data supported this view. The constant changes in government leadership were a cause of discomfort; and the source of instability rendered government leadership unsupportive to the needs of South Africans. In particular, a change in the Executive responsible for fiscal decisions would inspire greater confidence. The remark could have been incited by the several changes to the Minister of Finance leadership portfolio over a short period of time.

#### 5.3.1.4 Social Psychology factors

The premise of Social Psychology model is that individuals exist in a social environment, individual compliance decisions are to an extent shaped by their interaction with others. The model considers the role of non-economic factors - social norms, values and social relationships – in shaping tax perceptions and ultimately compliance behaviour.

One of the major concerns of individuals is the extent to which others meet their tax obligation; which according to the model has a positive influence on the personal decision to comply. The respondents were asked whether they would voluntarily pay taxes regardless of evasion by others and reactions were both positive and negative. The majority displayed independence and were adamant they would comply nonetheless. For others, compliance was conditional and depended on whether others too met their tax obligations.

What could explain these differences? The former had a strong sense of moral obligation and genuine willingness to contribute to the government purse; this was likely attributed to their positive perceptions regarding the government. They had a greater appreciation for government efforts and gave personal examples of the positive impact government spending had on the community. Another contributing factor was the perception that SARS is an institution that is capable of detecting and punishing tax offenders. The latter appeared to advocate for sanctions against tax evaders and were more sensitive to issues of fairness. They held a belief that taxpayers should be accountable and not overburden others who would ultimately have to absorb their portion. It is important to note because these different views are held by respondents who are currently not paying tax on their business income; this gives a possible indication of their compliance behaviour as future taxpayers.

The second major point of enquiry was whether the respondents believed that those in close proximity to them were compliant. This is significant because the compliance behaviour of an individual's peers or those closest to him in the social environment had an important bearing on their decision to comply. Within the respondents' networks, a large portion of people are employed and as a result compliance is indirectly enforced by the employer (PAYE deductions) rather than being voluntary. This is probably because respondents indicated that taxpayers in their communities are discontent with high tax rates due to a widely held perception that the tax rates are disproportionate to the quality of services received from the government.

#### 5.3.1.5 Comparative factors

The 'Comparative Treatment' approach stipulates that common identity and fairness are favourable for tax compliance. The respondents resonate with being South African. Despite disappointment with government leadership, the majority of respondents exhibited a positive national identity. There is hope that current political ills are temporary and will dissipate with the inevitable change in leadership. Other sources of national pride include the political stability of South Africa compared to other (African) countries, beautiful landscapes, diverse ethnicities as well as government assistance to the poor through the provision of free basic services and social grants. In essence the Comparative Treatment approach suggests that the concept of national identity is a precondition for voluntary tax compliance because it is a subconscious measure used by taxpayers to infer equal treatment by the tax authority. The respondents generally viewed SARS as a legitimate and fair institution. This implies that respondents are naturally inclined to accept the procedures, outcomes and sanctions imposed by the tax authority. Furthermore, according to the Comparative Treatment approach, the extent of social proximity (or common identity) between taxpayers and the beneficiaries of tax has a positive impact on the willingness to pay tax. Indeed, respondents echoed these sentiments by asserting their willingness to comply is motivated by the observed positive impact free basic services and social grants have had on their communities.

#### 5.3.1.6 Views about the tax authority (SARS): Motivational postures and the compliance climate

The motivational postures of the Responsive Regulation framework introduced in chapter 2 are discussed. For the purpose of the discussion and due to an overlap between the postures, Commitment and Capitulation are combined because they “reflect an overall positive orientation to authority” (Braithwaite, 2002, p. 18). Similarly the “Resistance” and “Disengagement” postures reflect defiance (Braithwaite, 2002).

**Commitment and Capitulation**

The respondents appeared to exhibit a strong sense of willingness towards paying taxes, with part of this willingness being driven by a moral obligation and the positive impact tax (via government spending) has had in their lives as well as people in their communities. These aspects of commitment were mentioned at length under the Fiscal Exchange model.

The legitimacy of SARS was expressed in terms of its important role. The respondents made reference to SARS’s technical role as well as its broader role (collecting tax revenue) in enabling the government to provide goods and service. SARS’s technical role is in administering the payment of taxes and issuing of Tax Clearance certificates. Furthermore, SARS acts as the mediator between employees (taxpayers) and employers by ensuring employees have been taxed correctly. In some instances employees are over-taxed and do not have the skill to calculate whether a refund is due to them. SARS was depicted as an institution that sides with taxpayers against employers who take advantage.

SARS was generally portrayed as an institution that accommodates taxpayers. The institution takes a proactive approach towards taxpayers by sending written notices (of required documents and payments) ahead of deadline. SARS is reasonable because it affords taxpayers the opportunity to rectify their tax affairs. Respondents gave practical examples of how SARS staff in the branch is tolerant with incomplete forms and that they endeavour in showing people how to correct their mistakes.

One respondent perceived SARS as an accommodative institution on the assumption it would lower debt instalments to an affordable amount if one fails to pay their debt. The respondent would welcome arrangements that suit individuals who cannot afford to part with a significant portion of their income and settle debt with one payment. On the other hand, a respondent disagreed with the notion that SARS could consider the individual circumstances that would prevent a taxpayer from honouring their obligations. This view was consistent with the said respondent's perception of SARS as an antagonistic institution.

SARS was also assessed positively regarding fairness. Fairness was understood in two ways. Firstly, the perception that SARS treats taxpayers equally and its primary concern are collecting tax revenue. To drive the point, respondents made reference to high profile politicians that SARS had previously taken to court. The second aspect of fairness pertained to the idea that one pays tax according to income (i.e. taxes are progressive).

### Resistance and Disengagement

Most respondents stated they would cooperate with SARS even if this is not reciprocated. These respondents displayed a reverence for SARS based on its perceived authority (and legal power) that cannot be challenged. According to these respondents, the onus is on the taxpayer to take the initiative and engage SARS on what is required of them. It is the taxpayer's responsibility to do whatever is required until an understanding is reached with SARS. This view appears to be motivated by the negative consequences that result from defying SARS. One respondent stated that if his business is not in good standing with SARS, it can jeopardise endorsements with various industry associations which would ultimately affect the success of his business. Ultimately, taxpayers are under SARS's authority and therefore cannot argue with SARS; it is in the interest of every taxpayer to avoid disputes with SARS at all costs.

However, in one unique case a respondent displayed a defiant attitude towards SARS which suggested her cooperation is conditional upon cooperation by SARS. The expectation here is that SARS must be an institution that accommodates taxpayers and any form of resistance from SARS is an indication of intolerance. Other circumstances that justify defiance are being expected to pay debt with no consideration or sympathy for personal mitigating circumstances. Cooperation is therefore conditional on fairness.

Despite being a legitimate institution, respondents felt they have the right to challenge SARS if their rights as a taxpayer are infringed upon. The reason for challenging SARS in this case is to be given the opportunity to rectify tax affairs. They are of the view that taxpayers need to be aware of their rights. If for example, SARS informs a taxpayer of tax owed, the taxpayer needs to ask how it came about and insist that SARS provides evidence. One respondent stated that challenging SARS would depend on the severity of the alleged offence, for example when SARS claims large amounts are owed. One of the main interests respondents have (where challenging SARS in tax disputes is concerned) is preservation of their reputation.

Many respondents were of the view that SARS has the ability to force taxpayers to comply. The respondents gave examples of negative consequences that result from evading tax. In addition to the legal consequence of arrest, there is the perception that the businesses of people who do not pay their tax, are shut down, making it difficult or impossible for the business to recover. Moreover, SARS can freeze the bank accounts of defaulters until tax obligations are honoured. One of the other reasons SARS can enforce compliance is it can easily locate taxpayers. Therefore the negative potential consequences (that result from SARS's capacity to enforce compliance) appear to contribute to the respondent's willingness to comply.

### 5.3.2 Tax knowledge

When asked to explain what they understand about tax compliance, some respondents were able to explain correctly while others had no understanding. The negative impact of non-compliance was also identified.

> *"According to my knowledge, in order to be compliant you must pay your taxes in the manner and time you are supposed to" (Respondent E)*
>
> *"I have never been employed and exposed to tax I would not have tax knowledge" (Respondent I)*
>
> *"I have been collecting my receipts and everything so that eventually when I register it then I can go back to SARS and see am I in a loss or am I in a gain" (Respondent J)*

*"Not paying taxes excludes you from many opportunities business-wise, because your bad conduct will be revealed when checks are done against your name and ID number and you will be denied opportunities" (Respondent A)*

The respondents appeared to be motivated to register their businesses for tax purposes because of the perceived benefits of registration. An explicit link between registration and business growth was recognized.

*"If I register will that not enable me to submit tender applications as a service provider? It is said that if you register you are able to put in applications to get work" (Respondent F)*

*"It is to get the funding I was talking about because it is given to registered business owners" (Respondent H)*

*"I guess it would be good (if it is not too expensive), it's just that I am not educated and therefore cannot articulate what these benefits are" (Respondent C)*

The knowledge respondents have on taxation included the concept of tax thresholds and filing season. There were mixed views about the ease of understanding taxes as some respondents felt taxes are difficult to understand.

*"At this time of the year its peak season where taxpayers and SARS staff are pre-occupied with filing annual returns" (Respondent G)*

*"It is difficult, as I just said because you do not know when you will get money. Unlike those that are employed…they are better off (with understanding tax) because they complete the forms and get something in return" (Respondent B*

*"According to SARS rules…when you make a certain amount of money you get taxed" (Respondent J)*

Specific knowledge pertaining to SARS's various small business tax arrangements or concessions was mostly poor. All the respondents had difficulty in articulating the graduated tax rates or thresholds for small and micro enterprises. In some instances, the role of SARS concerning small business was grossly misunderstood.

*"I have never heard of such otherwise I would have long gone to enquire" (Respondent C)*

*"I know that as a taxpayer who paid taxes you could ask SARS to assist with funding" (Respondent E)*

While having no knowledge of the applicable tax thresholds for small businesses, one respondent thought small businesses pay reduced tax rates. It should be similar to PAYE (salaried workers) and based on the ability-to-pay.

> *"If that's how it (PAYE) works with individuals then surely it (small business tax) must be the same" (Respondent H)*

Respondents obtain tax information from various sources. Although some of this information is gathered from primary sources there is also a dependence on secondary sources. Sources of tax information include TV, radio, internet, print media, physical visits to the SARS branch and word of mouth. Some respondents indicated preference of one medium over another.

> *"I think it would be better if I get tax information from a person so that I am able to ask questions. With the radio I am listening passively and cannot ask questions" (Respondent G)*
>
> *"I asked one of my colleagues and also saw something on TV about a filing deadline of the end of November; this prompted me to also try to get my tax affairs in order (Respondent A)*
>
> *"From TV, newspapers and obviously, people help because they talk about it. But honestly what is most helpful are talk shows for example the 'Daily Thetha', 'Lazi Ilungelo Lakho' etc." (Respondent I)*

Some respondents expressed an intention to register their businesses with SARS for tax purposes and compliance.

> *"Pretty soon too, because I feel I don't want leave it too long…let's say in two years' time" (Respondent D)*
>
> *"Last year I thought there wasn't a need yet (to register my business with SARS) because I wasn't making enough money yet" (Respondent F)*

#### 5.3.2.1 Compliance

The respondents generally had a basic understanding of what compliance which involves understanding requirements in order to fulfil tax obligations. This entails registration, filing returns, paying taxes in the manner and time to avoid arrears. Worryingly, only two respondents were further able to articulate on compliance. A respondent highlighted a negative impact of non-compliance is that it excludes one from business opportunities.

Another respondent mentioned that she has been collecting business receipts to present to SARS (after registration) to assess whether the business is in a “loss” or “profit” status.

#### 5.3.2.2 Registration

The benefits given for registration were well articulated by all except two respondents. Registration was perceived as something that could improve the growth prospects of their businesses. For instance, respondents would be able to obtain contracts (tenders) because registration with SARS is a pre-requisite. Specific mention here was made to the Tax Clearance Certificate that is required for each tax year and only issued to registered businesses. Having a registered business would place respondents in good standing with suppliers, obtain discounts for materials and buy materials on credit. Access to business loans from commercial banks and funding from other sources was also cited as a benefit of having a business registered for tax purposes. Because the majority of respondents could explain the benefits of registration, the follow up question was why they remain unregistered. A number of respondents stated they are not making enough profit. This naturally led to a further line of enquiry into what they perceive as the income threshold that will qualify them to register and pay tax on their profits (mentioned in the section below).

#### 5.3.2.3 Tax in general

At a basic level, respondents understood that tax is a compulsory payment to the government. The other two major knowledge areas are the progressive nature of tax (paid according to income) and the filing of tax returns. Even with the knowledge that tax is paid according to income, one respondent seemed to think that it is negotiable; this is possibly explained by misinformation from third parties. The filing of tax returns was understood in terms of PAYE. The respondent explained that PAYE is deducted from a salary and the employee is required to file every year to ensure either the employer deducted the correct amount, which results in a refund due to the employee or the employee owes SARS. Another respondent was aware that SARS’s ‘peak period’ (filing season deadline) is the end of November. It is important to note that the respondents obtained this information from their social circles (third parties) and from their prior experience as PAYE taxpayers in previous employment.

### 5.3.2.4 Small business tax

None of the respondents had knowledge of SARS's graduated tax arrangements for Small Business Corporations (SBCs) and Micro Enterprises. Although they were not able to indicate the exact thresholds applicable to small businesses, many respondents relied on their general knowledge of income tax being progressive and stated the same would apply for small business tax. However, by their observation, survivalist businesses like theirs are not eligible due to profits that are below the threshold. When questioned on what they considered to be 'significant' profit that would make them eligible to pay tax, the responses ranged between R6 000 and R10 000 a month. It is not clear what judgement was used; however, respondents are in different economic sectors. Some respondents did not seem interested in knowing about small business tax and stated knowledge would be solicited once they register. A concern was the lack of knowledge regarding the tax concessions for small businesses and that as a registered taxpayer; one can approach SARS to assist with funding.

### 5.3.2.5 Sources of tax knowledge

The respondents obtain tax knowledge from a range of sources, in addition to the third parties mentioned above. These include radio, TV programmes, internet, newspapers and the SARS branch. Respondents visited the SARS branch for their own queries or accompanied relatives, friends and colleagues. TV talk shows by the public broadcaster and physical visits to the SARS branch were highlighted as preferred mediums. One of the two respondents who preferred making enquiries at the branch found tax difficult to understand (and had the least knowledge on tax) and indicated it would be better to obtain information directly from a person to enable a dialogue. With radio for instance, one listens passively and is unable to ask questions.

Two of the respondents who have their own businesses also belong to a Co-Operative that is registered with SARS. The only time they get exposed to tax issues is through their periodic meetings with the Co-Operative. Within the Co-Operative they rely on certain members that interact with SARS for the tax matters of the group and have no knowledge beyond the information that gets communicated to them. They demonstrated some theoretical knowledge on the significance of income tax thresholds and preparation of annual financial statements to determine profit. However, operational knowledge is lacking because they are not directly involved in the tax matters of the Co-Operative and as a result are not able to apply the same knowledge to their individual businesses.

### 5.3.3 Experiences with using taxpayer services

It was found that some of the respondents had no experience with using taxpayer services.

> *"I haven't gone to SARS in my individual capacity as a business owner as such I have no dealings with SARS" (Respondent A)*
>
> *"I have not been there for my own affairs" (Respondent G)*

As a result, the experiences referred to include both first-hand experience of respondents and experiences of colleagues and relatives that were relayed to them. There was a mixture of positive and negative experiences with using taxpayer services.

> *"I enjoyed their attentiveness the most and the help they gave me…I was able to understand" (Respondent C)*
>
> *"Processes and requirements change often with each time you visit the branch there is something new…the offices are far and you get told you need a certain document to get a tax clearance" (Respondent F)*
>
> *"Another aspect I did not like is it gets overcrowded because people come from areas that are far away" (Respondent J)*
>
> *"It would be nice if you would know before you go to SARS that you won't spend more than 30 minutes waiting" (Respondent A)*

#### 5.3.3.1 Positive aspects

The staff at SARS was commended on their service approach, describing them as welcoming and friendly. The respondents found instructions given by staff members on how to meet requirements simple to follow. There is also assurance that one will never leave the SARS branch without knowing what is required. One of the respondents (a Zimbabwe national) particularly valued the accommodative stance of SARS staff and their patience. The cleanliness of the premises was also appreciated. A few respondents commented on the quick service; however, one attributed this to the 'off-peak' period during which he visited the branch.

#### 5.3.3.2 Negative aspects

The respondents complained about processes and requirements that change with almost every visit to the SARS branch. Delays result because they are often told to return with a certain document which is required to resolve a query. The branch is far from their places of residence and multiple trips waste time. One respondent mentioned that she was told that an affidavit stating that she is unemployed was required. This meant that she had to leave the branch and go to the police station which resulted in additional transport costs.

Long queues and overcrowding were aspects other respondents complained about. The perception is that the reason for overcrowding in the East London branch is that there are no offices in neighbouring towns like Queenstown and Butterworth. The long queues are also attributed to staff shortages. A respondent explained that a SARS employee that works at the East London branch is stationed at other towns in the Eastern Cape Province for weeks on end due to staff shortages in those areas. There are either no SARS offices there, or even if there are offices the services are lacking in quality.

#### 5.3.3.3 Service improvements

According to one respondent, the numbering system of the queues is not explained. This creates frustration and confusion because sometimes a taxpayer that arrives after you gets attended to before you. Another respondent would appreciate photocopying machines in the branch to make copies of documents required for queries and self-service computers to facilitate compliance. To alleviate the service pressure in the East London branch, respondents suggested more SARS branches could be established in neighbouring towns such as Butterworth and Queenstown.

### 5.3.4 Business challenges

The perceived survivalist nature of their businesses was singled out as the main reason respondents were unable to pay tax on their business income, despite demonstrating a willingness to do so. This theme was not a formal part of the discussion guide; however it became a recurring theme in the interviews. The challenges mentioned below have an indirect impact on the growth (and profitability) of the businesses and therefore the respondents' ability to contribute to the fiscus.

The respondents face a number of challenges in their businesses. Some are common whilst others are specific to the nature of the business and economic sector.

> *"I just missed out on a catering job for the prison; I submitted the documents and didn't get a call. There is someone who got that job by paying a bribe. Another lady told me 'so and so' got the tender and had to buy furniture and cars in exchange for the tender" (Respondent G)*

*"My business has been shrinking instead of growing because foreigners have started selling in our community" (Respondent J)*

*"Yes, they sell all their stock at low prices. We even stopped selling cool drink because…and it seems our people have a preference for foreigners" (Respondent D)*

*"There are some shops if I go there and they don't have the material it means I have to get the material from Joburg. Some of the shops are not reliable – I go there and they say "we don't have this bead colour" you see now it means I have to look around" (Respondent B)*

The respondents also identified required interventions to assist with the growth of their businesses.

*"I do not recall in the past years having a sum of money/funding that has ever enabled me to start a business" (Respondent H)*

*"Assistance with social media advertising would help us because we are not educated, so potential customers would at all times know where I am located…because we live in a fast paced world (so we must adjust the way we do business) (Respondent I)*

*"A convenient place where customers can reach, where it is safe for them to pay cash. Here it is a little bit better but there is no shelter" (Respondent E)*

#### 5.3.4.1 Tenders

The businesses are small-scale and do not have a solid customer base. As such their survival is highly dependent on government tenders or short-term contracts. The respondents have been unable to get tenders because, in their experience, tenders are not awarded on merit. One respondent explained that she submitted documents for a government tender (catering) and was told the tender was awarded to another service provider on the basis of a bribe. The tender process is not competitive and monopolised by a few service providers. It is common practice that tenders are awarded to the same service providers. One respondent relayed an incident where she was approached by a service provider who requested to submit a tender using her business details. The service providers had been getting numerous tenders and wanted to escape scrutiny and apply for another tender. The arrangement resulted in the respondent receiving a portion of the pay-out. Females have the additional pressure of being expected to engage in inappropriate relations to obtain tenders that are awarded by males.

#### 5.3.4.2 Foreign-owned businesses

The growth in foreign-owned businesses in the communities has significantly reduced market shares. Foreign business owners have scale advantages that enable them to sell products at lower prices. Foreign business owners come together, buy in bulk and divide the goods amongst themselves for re-selling. Respondents lack the capital to buy in large quantities and therefore cannot afford to sell products at lower prices. As a result, they have discontinued certain product lines and experienced a significant reduction in sales.

#### 5.3.4.3 Suppliers

Suppliers of raw materials are often unreliable. Consequently, respondents have to source the materials from bigger cities like Johannesburg, which is more expensive and time-consuming. These results in higher production costs (which have to be passed onto the customer) and losing potential business because of the delays in obtaining raw materials.

#### 5.3.4.4 Financial support

The respondents mentioned the lack of financial support (funding) as one of the major hindrances to the growth of their businesses. Funding is required for purchasing raw materials, land (e.g. Floristry) and vehicles (e.g. Plumbing). Respondents who have had their businesses for many years have failed to receive funding. They were discouraged to continue with funding applications in certain instances where unethical expectations become clear.

#### 5.3.4.5 Other challenges

Assistance with marketing (social media advertising) would enable respondents to interact with potential as well as existing customers and create brand awareness. Respondents operating from outside expressed the need for fixed and affordable business premises where cash-paying customers can transact safely. Weather conditions are sometimes unfavourable and as a result they experience low customer turnout.

The Zimbabwean respondent experienced uncertainty regarding the future of his business because of intermittent issues with his permit. He is therefore unable to formalise his business without a confirmation of his legal status. The required documents had been submitted and he is awaiting a response from the authorities. Without a permit he is unable to register with SARS and will have to cease operations and return to Zimbabwe.

## 5.4 SUMMARY

This chapter discussed the tax perceptions of the respondents using data from the fieldwork and chapter 2 (Theoretical Framework). The respondents generally exhibited a positive willingness to comply with taxes. The theoretical foundations of the models of taxpayer behaviour were particularly useful in highlighting the possible drivers of compliance at a broader level. Fairness was one of the significant drivers; this extended to the tax authority (Comparative Treatment) and the tax burden (Economic Deterrence). The legitimacy of the government (Political Legitimacy), efficiency of government spending, and clean governance (Fiscal Exchange) were important elements of the decision to comply with tax.

Concerning the tax authority, legitimacy and fairness were yet again a noteworthy feature. Using the motivational postures of the Responsive Regulation approach, it was found that most of the respondents exhibited a positive orientation towards the tax authority. As a result, the modified Slippery Slope framework suggested that the respondents had the potential to comply voluntarily with taxes and in exceptional cases; compliance would have to be enforced. The Multifaceted approach therefore provides a workable approach to address both types of compliance.

Tax knowledge and awareness of the tax authority's Small and Micro business tax arrangements were non-existent. However, the respondents have had some exposure to taxpayer services (either personally or secondary sources) and therefore had a basic understanding of the progressivity of income tax and tax compliance. The respondents cited various challenges in their businesses that have an effect on their growth (profitability) and an indirect impact on their ability to pay income tax.

# CHAPTER 6: CONCLUSION

## 6.1 AIMS OF THE STUDY

The study sought to provide insights into the tax perceptions of South Africa's informal sector (Buffalo City Municipality in the Eastern Cape was sampled). These perceptions were used to postulate the prevailing compliance attitudes of informal traders or the nature of their compliance behaviour. In addition to perceptions, awareness of the tax system and experiences with the tax authority were investigated. The study was motivated by low tax compliance levels of the informal sector (despite its tax revenue potential), as well as the need for identifying prospective sources of tax revenue (or tax base broadening) in light of the pressure on South Africa's fiscus in recent years. South Africa is yet to make successful in-roads into informal sector taxation compared to its African peer countries, and this is in part due to limited knowledge about the compliance dynamics of sector. This chapter discusses the main empirical findings of the study, provides recommendations and concludes by suggesting areas for future research.

## 6.2 MAIN FINDINGS

### 6.2.1 The nature of compliance of informal traders

Two theoretical models (Responsive Regulation framework and the Slippery Slope framework) considered the micro influences (concerned with the tax authority) on tax compliance and were used to propose the dominant type of compliance behaviour exhibited by the respondents.

Using the Responsive Regulation framework to describe the relationship or social distance between the respondents and the tax authority, it was found that only a minority of respondents displayed a slightly defiant posture (Resistance and Disengagement) while the majority showed positive postures (Commitment and Capitulation). The implication for the majority of these respondents is that they are more likely to comply voluntarily with paying taxes and do not require positive persuasion or to be threatened by sanctions. The assumption is that respondents intend or are willing to comply and require assistance in the form of tax education interventions to be fully compliant. The minority of respondents displayed a slightly defiant posture which possibly means they would seek to avoid paying their fair share of taxes if given the opportunity and punitive sanctions would be warranted.

The main submission of the Slippery Slope framework is the manner in which the tax authority is perceived to exercise power or trust drives the tax climate and nature of compliance. The framework was used to elaborate on the possible driving factors of the observed postures by considering the power and trust dynamics of the tax authority.

It appears that respondents react to the coercive and legitimate power of the tax authority. The coercive power was evident as the willingness to comply of some respondents appeared to be motivated by the fear of punitive measures. On the other hand, legitimate power was also evident as respondents emphasized that they considered SARS as a fair institution.

Although evidence of the dominant trust was more difficult to ascertain, there was some indication of both types of trust. The mostly positive interactions with SARS suggest that reason-based trust is present. The respondents also had a strong sense of national identity, which according to the modified Slippery Slope framework positively contributes to implicit trust. Based on the observed combination of power and trust, the Service climate is more dominate and therefore the type of compliance attitude that was inferred by the respondents is Voluntary.

The influences external to the tax authority that shape perceptions were of an Economic, Fiscal, Social, Political and Comparative nature. Other than the political factors that present a potential risk to tax compliance, the respondents generally appear to be agreeable to comply with tax.

The dominant themes in the Economic Deterrence model were the fairness of the tax rates and the effectiveness of penalties for non-compliance. The respondents were not able to comment on the fairness of small business tax rates presumably because they do not pay tax on their business income. There was support for the progressive nature of tax rates because it is based on the ability-to-pay principle. The majority of respondents believed the use of penalties is an important deterrent for non-compliance.

The respondents are appreciative of government services but indicated dissatisfaction with the quality and quantity thereof. Corruption by government officials, wastage of government resources and lack of clean governance appeared to contribute to the erosion of trust in the government**.** Despite this, the discontentment with the fiscal function of government (and other factors relevant in the Fiscal Exchange model) did not seem to justify the evasion of taxes. In fact, tax evasion was seen as a self-defeating exercise.

Government predictability was a dominant factor to the Political Legitimacy model. The respondents were concerned about the many changes to government leadership, particularly in the Minister of Finance portfolio between 2015 and 2017. This instability created uneasiness about the decision-making ability of the government and the quality of decisions. According to the model, perceptions of political mistrust could potentially damage tax morale and the willingness to comply with tax.

The Social Psychology model revealed tax compliance of respondents appears to be conditional on the compliance of individuals in their social circles whilst others' compliance decision was independently determined. The latter were generally satisfied with the government's conduct and services and viewed SARS as a powerful institution that is capable of punishing tax evaders. This perception reinforces the view that SARS provides limited opportunity for taxpayers to evade tax. The model's explanatory power, that compliance is influenced by social environment, thus proved to be relatively inferior.

The empirical findings also found support for the Comparative Treatment model. The respondents have a strong sense of national pride and common identity with their community members. The Comparative Treatment model suggests these are important anchors used by taxpayers to infer that the tax authority will treat them equally to other taxpayers. As a result, the respondents generally viewed SARS as a fair institution that is impartial in the execution of its duties to taxpayers. This finding is noteworthy because it implies that the respondents are likely to be agreeable to the procedures, decisions and sanctions imposed by the tax authority, which can positively safeguard tax compliance.

### 6.2.2 Knowledge, awareness and experiences with the tax system

Knowledge areas included compliance, registration, tax in general and small business tax. The respondents were generally able to articulate what compliance entails – registration, filing returns and fulfilling tax obligations in the required manner. The respondents further displayed a solid understanding of the benefits of registration. An explicit link between registration and business growth was made. One of the major benefits of registration is obtaining a tax clearance certificate which is vital for business opportunities (tenders), funding and credit facilities. The majority of respondents admitted their businesses are not registered for tax purposes because their profits are below the tax threshold, however none of the respondents knew what the threshold is. At a basic level, respondents understood that income tax is progressive. Specific detail on SARS's tax arrangements for small businesses and micro enterprises was non-existent; however, some respondents assumed it should progressive like income tax.

Tax knowledge is obtained from a variety of sources (third parties, radio, TV, newspapers and the SARS branch in East London). TV talk shows by the public broadcaster and physical visits to the SARS branch were noted as preferred mediums. One respondent that preferred branch visits found taxes difficult to understand and had the least tax knowledge. Respondents who have made use of taxpayer services at SARS have mainly gone for tax clearance enquiries as well as PAYE registration and filing of returns (for those previously employed) while others accompanied relatives. As expected, the respondents had limited interaction with SARS; as such, the empirical findings included a combination of primary and secondary experiences with the tax authority. Reflecting on their experiences, respondents were impressed by the service approach and disposition of SARS staff and cleanliness of the premises. On the other hand, long queues, changing compliance requirements and an inefficient queuing system were cited as negative aspects.

## 6.3 RECOMMENDATIONS

### 6.3.1 Proposed compliance strategies

The findings from the fieldwork reveal that the informal sector traders generally have a tendency to voluntarily comply with paying taxes except for a minor case of a slightly defiant attitude towards compliance was observed. The question is then - how the tax authority can best safeguard compliance in the sector? The literature recognises the fact that individuals are either prone to comply voluntary or in some cases compliance has to be forced. Compliance strategies should therefore be tailored by the tax authority according to the observed compliance behaviour.

The Multifaceted approach introduced in the Theoretical Framework (chapter 2) thus provides a relevant starting point. The approach recommends three paradigms (traditional enforcement, trust and services) that should be used holistically to address non-compliance. The results of the empirical work indicated that indeed, there is a need for all three paradigms to strengthen tax compliance in the informal sector. Intervention efforts however should rely less on enforcement and concentrate on trust. The challenge for the tax authority is to safeguard and encourage voluntary compliance while deterring non-compliance.

### 6.3.2 Traditional Enforcement paradigm

A less extreme form of defiance was observed towards the tax authority in the respondents. It is worth noting that one of the major indicators of a defiant posture towards the tax authority could mainly be attributed to the perception that tax authority is not a fair institution and does not engage with taxpayers in a reasonable manner. There is therefore an opportunity for the tax authority to correct this perception through educational campaigns, engagements and other progressive interventions with informal traders.

The paradigm puts forward a number of interventions that can be used to enforce compliance, depending on the severity of defiance. It is therefore advisable, based on the findings, for the tax authority to make use of less harsh interventions within the Traditional Enforcement paradigm. These may consist of boosting the technical capacity of the tax authority to detect non-compliance (audit functions and modernizing risk engines) as well as maintaining high monetary penalties and interest for non-compliance. Non-financial penalties like publicising the names of taxpayers that have been successfully prosecuted could be effective as respondents attached a stigma against violating the tax authority. Other appropriate interventions can include the use of third party institutions like banks to collect debt and increase taxpayer registration and identification using third party data can also be applied.

Harsher enforcement efforts like legal prosecution should be used sparingly, for two key reasons. Firstly, the majority of respondents already perceive the tax authority possess the coercive power to enforce compliance; as such there would be no apparent need to follow-through with enforcement interventions. Secondly, according to literature enforced compliance is undesirable because it generally expensive.

### 6.3.3 Trust paradigm

The majority of respondents expressed trust in the tax authority and this was due to perceptions of the authority's professional practice, fairness, knowledge and skills (legitimate power). The tax authority was generally viewed as an accommodative institution. The challenge therefore is to maintain mutual trust between the tax authority and informal traders as potential taxpayers. The tax authority can achieve this by increasing its visibility by making use of mass media to communicate campaigns aimed at educating informal traders as new taxpayers. Tax amnesty, debt compromises and voluntary disclosure programmes should be used sparingly, as they can instead provide opportunities for non-compliance. The tax authority should also publicize appeal processes that informal traders can use to address unfair practices. Inclusivity and transparency need to be fostered; such as the drafting of future legislation pertaining to informal traders as a way of increasing trust.

### 6.3.4 Services paradigm

In contrast to the Traditional paradigm, the assumption of the Services paradigm is that taxpayers are willing to comply but do not have the means. The culture of non-compliance can be circumvented to an extent by appropriate and targeted education outreach campaigns. The lack of tax literacy was potentially identified as one of the major reasons for non-compliance. Taxpayer education would make information easily accessible; education gaps can only be ascertained through interactions with the informal traders. All forms of tax communication need to be simplified because the respondents had difficulty in understanding the technical aspects of taxation. Furthermore, the tax authority can potentially find innovative ways of increasing the tax literacy of informal traders. The Services paradigm is particularly useful in this case because the respondents had no knowledge of Small Business tax arrangements offered by the tax authority. The mostly positive service experience experienced by the respondents thus far also indicates their receptiveness to future interactions with the tax authority. It is also worth addressing the stated service challenges and suggested areas of improvements.

## 6.4 SUGGESTIONS FOR FUTURE RESEARCH

It is suggested that this research can be extended to the business challenges faced by informal traders, implementation of the best practices of informal sector taxation by tax authorities in Africa and quantitative research enquiry into the tax perceptions of informal traders.

The business challenges experienced by the respondents were an incidental theme and did not form part of the official discussion guide. It arose when respondents were questioned on their non-compliance despite displaying a positive tax morale and willingness to pay tax. The respondents stated their profits were too low due to a number of challenges. These ranged from corruption with the awarding of government (municipal) tenders, unfair competition from foreign-owned businesses, lack of suppliers, lack of financial support, marketing skills and high rental costs of business premises. These challenges therefore have an indirect impact on the ability to pay tax. Although the stated challenges fall outside the locus of control of the tax authority, the findings of this research suggest that alleviating the barriers to business growth could improve the profitability of informal businesses. It is therefore advisable to investigate the extent to which these challenges contribute to low profitability (and ability to pay tax), as well as the suitability of the current policy frameworks for informal businesses to unlock their growth potential.

The Literature Review (chapter 3) indicated South Africa's tax authority lacks a targeted approach or strategy where taxing the informal sector is concerned. When compared to peer tax administrations on the continent, there appears to be an opportunity for the development of a stronger policy focus for informal sector taxation in order to realise similar gains. The tax authorities of some African countries (Ghana, Tanzania, Rwanda and Zambia) have made impressive progress in this area. Their achievement has been attributed to a well-informed strategy encompassing a combination of the identification and segmentation of informal traders; decentralisation of SME operations; taxpayer education, skilled staff and external stakeholder collaboration. It may be worthwhile to investigate the implications and practicalities of implementing these and other meaningful policy interventions.

This research used a qualitative method of enquiry, which was motivated in the Research Methodology (chapter 4). It is believed that the findings of this research provide an important starting point for disseminating knowledge regarding the tax perceptions, knowledge and experiences of informal traders. It is advised that quantitative enquiry be used to broaden the scope of the study in terms of sample size as well as the geographic and industry dynamics in more detail.

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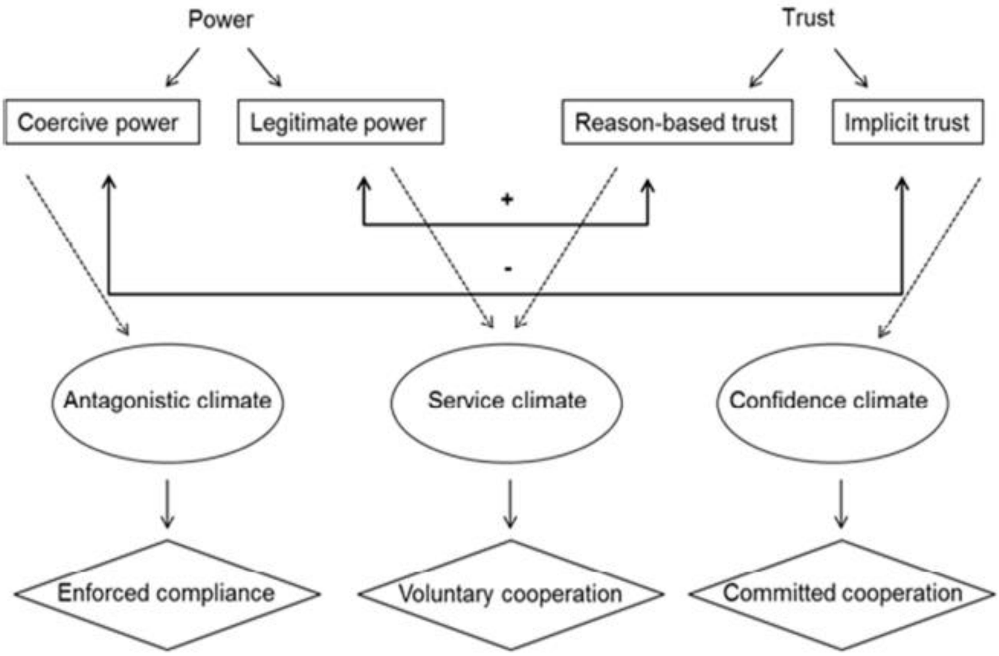
# LIST OF APPENDICES

## Appendix A: The Responsive Regulation framework


Braithwaite, V. (2007)

## Appendix B: The modified Slippery Slope framework




Gangle, K., Hofmann, E., Pollai, M., & Kirchler, E. (2012)

# Appendix C: A typology of enterprise formality

| Features | Informal Economy | | | Formal Economy |
|---|---|---|---|---|
| | A<br>**Subsistence Enterprises** | B<br>**Microenterprises and Small Businesses** | C<br>**Small and Medium Businesses** | D<br>**Small, Medium and Large Businesses** |
| Degree of informality | Totally informal for the most part | High proportion of sales undeclared and workers not registered | Some proportion of sales undeclared and workers unregistered | Labour and firms registered and regulated |
| Type of activity | Street traders, cottage/microenterprises, subsistence farmers | Small manufacturers, service providers, distributors, contractors | Small and medium manufacturers, service providers | Range of manufacturing and services |
| Technology | Labour intensive | Mostly labour intensive | Mixed labour and capital intensive | Knowledge and capital intensive |
| Owner profile | Poor, low education, low level of skills | Poor and non-poor, well educated, high level of skills | Non-poor, likely educated, skilled | Non-poor, highly educated, sophisticated level of skills |
| Markets | Low barriers to entry, highly competitive, high product homogeneity | Low barriers to entry, highly competitive, some product differentiation | Some barriers to entry, established markets | Significant barriers to entry, established market/ product niche |
| Finance needs | Working capital | Working capital, some investment capital, supplier credit | Investment capital and working capital, letters of credit, supplier credit | Investment capital and working capital, letters of credit, supplier credit |
| Other needs | Personal insurance, social protection, security | Personal and perhaps business insurance and business support services, security | Personal and business insurance, business development services | Personal and business insurance, business development services |
| Tax implications | Earnings can be below minimum tax threshold No recordkeeping, cash transactions | Liable for tax, difficult to identify and assess, poor or no recordkeeping, cash transactions | Liable for tax, under-report earnings, use loopholes, escape formal tax assessments | Taxed under formal tax assessment |
| Tax design desired features | No tax liabilities | Low rates to encourage registration, minimal compliance costs, low administration costs | High rates to encourage graduation into formal regime | |

Joshi, A., Prichard, W., & Heady, C. (2014)

# Appendix D: Demographic profile of respondents

**Table 1: Gender**

| Gender | Frequency (n) | Percentage (%) |
|---|---|---|
| Female | 5 | 50 |
| Male | 5 | 50 |
| Total | 10 | 100 |

**Table 2: Average age of respondents**

| Age | Frequency (n) | Percentage (%) |
|---|---|---|
| 21-29 | 1 | 10 |
| 30-39 | 3 | 30 |
| 40-49 | 2 | 20 |
| 50-59 | 3 | 30 |
| 60-69 | 1 | 10 |
| Total | 10 | 100 |

**Table 3: Average business age**

| Age | Frequency (n) | Percentage (%) |
|---|---|---|
| 1-9 | 4 | 40 |
| 10-19 | 4 | 40 |
| 20-29 | 1 | 10 |
| 30-39 | 1 | 10 |
| Total | 10 | 100 |

**Table 4: Business location**

| Location | Frequency (n) | Percentage (%) |
|---|---|---|
| Township | 5 | 50 |
| Suburb | 2 | 20 |
| Beach Front | 1 | 10 |
| Rural | 2 | 20 |
| Total | 10 | 100 |

**Table 5: Economic activity**

| Activity | Frequency (n) | Percentage (%) |
|---|---|---|
| Retail | 2 | 20 |
| Catering | 2 | 20 |
| Art and Craft | 2 | 20 |
| Farming | 1 | 10 |
| Floristry | 1 | 10 |
| Sewing | 1 | 10 |
| Plumbing | 1 | 10 |
| Total | 10 | 100 |

**Table 6: Education level**

| Education | Frequency (n) | Percentage (%) |
|---|---|---|
| None | 1 | 10 |
| Primary (Grade 1 - Grade 7) | 1 | 10 |
| Secondary (Grade 8 - Grade 12) | 5 | 50 |
| Tertiary | 1 | 10 |
| Unspecified | 2 | 20 |
| Total | 10 | 100 |

**Table 7: Employment status**

| Employment | Frequency (n) | Percentage (%) |
|---|---|---|
| Informal Sector (Full Time) | 9 | 90 |
| Informal Sector (Part Time) | 1 | 10 |
| Total | 10 | 100 |

## Appendix E: Discussion guide

1. Perceptions on tax

    a. What are your opinions about paying taxes in South Africa?

Probe if required:

- *Social influences* - Do you think the people closest to you (family, friends) generally pay their taxes? Why do you think they pay (or don't pay) their taxes? Would you pay taxes if others didn't pay their share?
- *Fiscal exchange* - What are taxes used for and what should they be used for? What do you think about the quality and quantity of government services? Is the tax system fair - should people with high income pay a larger share, same share or smaller share than those with low income? Does the government make proper use of taxes? Should citizens have a say in how taxes are spent? Do you think those who pay taxes are satisfied with the government services they receive?
- *Political legitimacy* - Do you trust the government to make the right decisions? Should citizens pay taxes if they agree/disagree with the government? Do you believe the government acts in the best interests of its citizens? Are you generally proud of being a South African citizen?
- *Comparative treatment or legitimacy of tax authority* - Do you think SARS gives individuals the same treatment? Does SARS act independently or do you think government institutions or officials have an influence? Do you identify SARS as an important institution? What is the role/importance of SARS in South Africa?
- *Economic deterrence* - What do you think is the likelihood of tax evaders being caught by SARS? Are tax rates high or fair? Do you believe (harsh) penalties can make citizens comply with taxes?

    b. Can you tell me your views about SARS?

Probe if required:

- *Commitment* - Do you feel a moral obligation towards paying taxes? What impact do you think the payment of your taxes has on the lives of ordinary South Africans?
- *Capitulation* - Do you identify SARS as a legitimate institution? Is SARS generally accommodative and understanding towards taxpayers? Would you cooperate with SARS regardless of whether it cooperates with you?
- *Resistance* - Would you challenge SARS when you feel your rights as a taxpayer are being infringed upon?

- *Disengagement* - Would you take active steps to rectify mistakes in your tax affairs if requested by SARS? Do you think SARS has the ability to force you to comply?

2. Awareness and knowledge of tax

    a. What is your understanding about your tax obligations and procedures?

Probe if required:

- What do you think is meant by being a compliant taxpayer / What steps does one take to comply
- Are you aware of any special tax arrangements for small businesses?
- What do you think are the benefits of registering with SARS for your business / How would paying taxes negatively impact your business?
- Do you generally find taxes difficult or easy to understand?

    b. How / from where do you receive information about taxes?

3. Experience with using tax services

    a. Tell me about your interactions (if any) with SARS?

Probe if required:

- How would you describe the approach of SARS staff when addressing your queries or concerns?
- What are some of the obstacles you have encountered in accessing services or complying with taxes?
- What kind of service (improvements) would you like to see?
- What do you appreciate about SARS service currently?

    b. What have you heard about the experience of those that have used SARS services?

Probe if required:

- Based on the above, do you look forward to interacting with SARS?

Ends