

## **Exploring Determinants of Low Tax Collection in Informal Businesses: Evidence From Mbeya City, Tanzania**

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### ***Abstract***

*This study explored the determinants of low tax collection among informal businesses in Mbeya City, Tanzania. Informal businesses, which make up a significant portion of Tanzania's economy, face challenges in complying with tax regulations, despite the government's efforts to create tax awareness and improve collection systems. The study is anchored in the Informal Economy Tax Compliance Theory, which suggests that tax compliance is influenced by economic survival, regulatory complexity, and trust in government institutions. The research employs both qualitative and quantitative methods to assess the efficiency of tax collection processes, the clarity of regulations, and the willingness of informal businesses to comply. Findings indicated mixed perceptions of tax collection efficiency, significant dissatisfaction with the clarity of tax regulations, and varying levels of tax awareness among informal business owners. The study concludes that simplifying tax processes, providing education programs, and enhancing the perceived fairness of the tax system could improve compliance and boost revenue collection. This research contributes valuable insights for policymakers and stakeholders aiming to strengthen tax collection strategies in Tanzania's informal sector.*

**Keywords:** *Informal Businesses, Tax Collection, Compliance, Mbeya City*

### **INTRODUCTION**

Two billion people work in informal jobs around the world, which come with risks and vulnerabilities. This equates to 90% of all small and medium-sized businesses and 60% of the world's labour force (Odusanya et al., 2018; Benjamin & Mbaye, 2012). Governments in the Global South suggest that most people either directly or indirectly rely on the informal sector for survival (Singh & Ehlers, 2020; Mtengeti, 2013; Etim & Daramola, 2020). Many wealthy nations have focused on the development of SMEs, particularly informal businesses, recognizing their potential for driving economic growth. Countries like the USA and the UK have provided considerable financial and non-financial resources to support the growth of

SMEs. One such initiative is the creation of advantageous tax structures for these businesses, which has stimulated their development (McCluskey & Huang, 2019; Mwila et al 2011; IMF, 2007). Furthermore, tax revenue from previously unregistered businesses has contributed significantly to socioeconomic advancement.

In a similar vein, nations such as; South Africa, Nigeria, Kenya, and Rwanda are implementing tax policies designed to foster the growth and profitability of small and medium-sized enterprises, particularly those in the informal sector (Dom & Miller, 2018). Tanzania shares this perspective on the importance of SMEs, especially informal ones, due to their substantial contribution to the nation's economic growth and development strategy. According to data from the Tanzania Chamber of Commerce, Industry, and Agriculture, over 95% of businesses in Tanzania are small and medium-sized enterprises. These businesses contribute 35% to the country's GDP and provide employment to roughly 40% of the workforce (Kashalaba, 2017). Additionally, Tanzania relies heavily on tax revenue collection to support its socioeconomic development, making the role of SMEs even more crucial in sustaining national growth (Masanja, 2019).

To collect the essential taxes and fund the country's development, the government has worked hard to construct an effective tax administration system. Small- and medium-sized taxpayers are one group that has a lot of potential to boost domestic revenue mobilization and so help close enormous budget deficits. The industry provides a sizeable quantity of taxable income and employs a sizable portion of the nation's active labor force (Mlay et al., 2013; Dube, 2014). Nevertheless, small, and medium-sized firms in Tanzania contributes to the expansion of the economy, these companies face significant taxation issues that jeopardize their long-term viability and expansion (Masanja, 2019). One of the biggest problems affecting small and medium-sized businesses is tax compliance, specifically with multiple and costly taxes (Eragbhe & Modugu, 2014). Due to this intricacy, fewer taxes are being collected from taxpayers, including unregistered enterprises. Despite of the government efforts of providing awareness and other efforts still low tax collection among informal businesses remain questionable in Tanzania. Furthermore, different studies (McCluskey & Huang, 2019; Dube & Casale, 2016) have been conducted but little is known on low tax collection among informal businesses. Therefore, this study intended to fill the gap through investigating factors leading to low tax collection among informal businesses Mbeya City Council.

The willingness of informal sector businesses to pay taxes is influenced by factors such as tax morale, transaction costs, the effectiveness of tax administration, and the capacity for auditing and monitoring tax payments (Sebele-Mpofu, 2021; Loeprick, 2009). Despite government efforts, a significant number of businesspeople in informal firms, managed by both men and women, are reported to evade taxes, negatively impacting overall tax collection. Notably, initiatives like providing identity cards for an annual fee of 20,000 Tsh have been introduced to facilitate business operations for entrepreneurs in the informal sector (Masanja, 2019). However, the sustainability of tax payments among informal businesses remains uncertain, prompting the need for a closer examination (Kashalaba, 2017; ILO, 2018). Given the intricate tax and fiscal environment influencing tax collection in Tanzania, there is a critical research gap in understanding the specific factors contributing to low tax collection among informal businesses in the Mbeya City Council.

### **Guiding Theory of the Study**

This study is guided by the theory named Informal Economy Tax Compliance. The theory was firstly proposed by David P. Weber (2006). It stated that low tax collection in informal businesses is influenced by a complex interplay of economic, structural, and behavioral factors. The theory stated further that informal businesses often operate outside formal regulatory frameworks due to perceived high costs of compliance, lack of formal record-keeping, and a general mistrust of government institutions. The assumption of this theory is that informal businesses prioritize immediate their economic survival over tax compliance, they perceive the tax system as unfair or ineffective, and weak enforcement and complex regulations impair non-compliance (Loeprick, 2009). The theory fits in this study by straightly addressing the sole challenges and factors affecting tax collection in the informal businesses (OECD, 2019). Furthermore, the theory is applied in order to improve tax collection strategies employed to informal businesses. Researchers such as (Ordonez, 2014; Zogli et al, 2021; Phiri & Nakamba-Kabaso, 2012; Benjamin & Mbaye, 2012) have used this theory in their studies to explore tax compliance behaviors in various informal businesses and proposed the targeted policy interventions.

To address the study, gap this study investigates the factors leading to low tax collection among informal businesses in the Mbeya City specifically assessing the current tax collection processes among informal businesses in the area and identifying the key factors that contribute to the observed low tax collection. Additionally, the following questions will be answered to

fulfill the objectives of the study, how are taxes currently collected among informal businesses in the Mbeya City? What are the specific factors that lead to low tax collection among informal businesses in the Mbeya City? Addressing these questions is essential for developing targeted interventions that enhance tax compliance within the unique context of informal businesses in Mbeya City. Also, this study contributes to adding knowledge to the existing literatures, policy makers and various stakeholders on enhancing tax collection and compliance.

## **METHODOLOGY**

This study employs a quantitative and qualitative research approaches to explore factors influencing low tax collection from informal businesses in Mbeya City (Creswell & Clark, 2011; Mlay et al, 2013). The chosen approach aims to provide an in-depth understanding of perceptions and experiences, also a convergent parallel design is utilized for the concurrent collection and analysis of qualitative data (Klassen et al., 2012; Ary et al, 2010). The study focuses on Mbeya City which is selected for its significant informal business presence. Participants include tax collectors, business administrators, and informal business owners, chosen purposively for their insights into the research problem. Data is gathered through semi-structured interviews and questioners. Semi-structured interviews were conducted with tax collectors and business administrators to explore their perspectives on low tax collection (Creswell, 2009; Mugenda & Mugenda. 1999). Open-ended questions allowed participants to express nuanced views beyond predefined categories. In data analysis, the study used the descriptive analysis to analyze the findings.

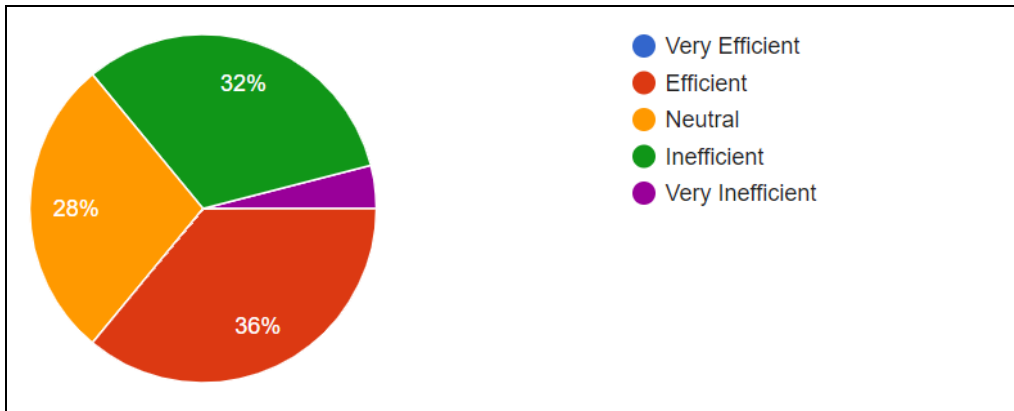
## **RESULTS AND DISCUSSION**

### **Descriptive Results**

The study findings were analyzed by the descriptive analysis and compared with references from various researchers and came up with different observations; -

### **Efficiency of tax collection**

From the survey questionnaires used, the respondents were asked on the efficiency of tax collection on informal business practices in Mbeya City and the results were as follows; -



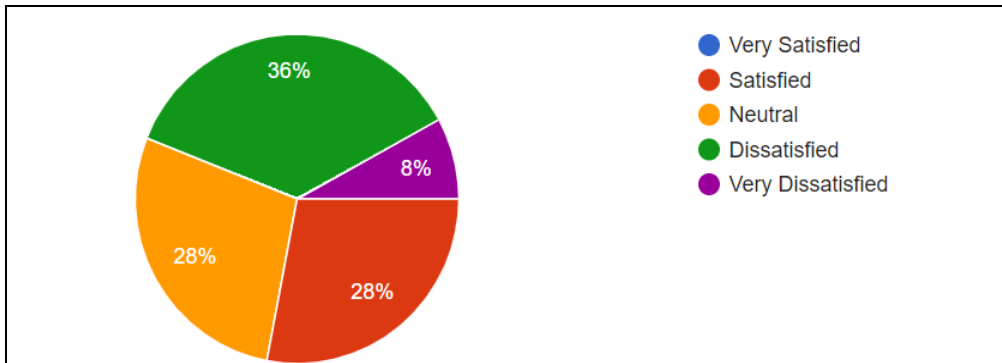
**Figure 1:** Tax collection efficiency for informal businesses.

Figure 1 shows the efficiency of tax collection mechanisms employed by Mbeya City Council for informal businesses reveals a diverse range of opinions among participants. While 36% perceive the current methods as efficient, 32% find them inefficient, and 2% label them as very inefficient. Additionally, 28% provided a neutral rating. These results are in line with Assfaw & Sebhat, (2019) and OECD (2019). Also, the results are in line with the study theory in that there is a minor deviation in respondent's percentage as between efficient and inefficient of tax collection efficiency for informal businesses. To address these findings, a policy brief may recommend a comprehensive review of the existing tax collection processes, incorporating feedback from both satisfied and dissatisfied stakeholders. This could involve soliciting input from informal business owners to identify specific challenges and areas for improvement.

On the other hand, through interview, respondents elaborated that *“Tax collection efficiency in informal businesses is a serious concern, as compliance behavior and attitudes towards the tax system are often influenced by an individual, relatives, neighbours, and friends. If a taxpayer is aware that many people in their important social areas are evading taxes, their own commitment to comply is likely to be weak, and further its impairing challenges in effectively collecting taxes from the informal sector.”* (Business Administrator, February, 2024)

### **Clarity of tax regulations and procedures applicable to informal businesses**

Respondents were asked on clarity of tax regulations and procedures applicable to informal businesses in Mbeya City and the findings were as follows: -



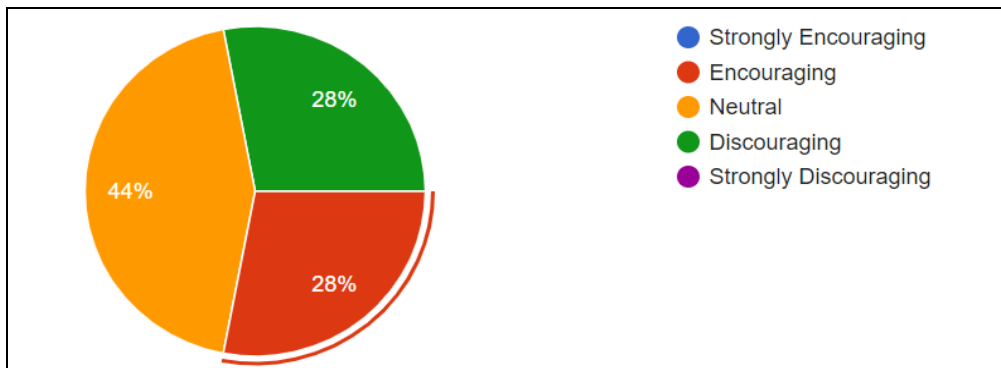
**Figure 2:** Clarity of tax regulations and procedures applicable to informal businesses

Figure 2 depicts the analysis of satisfaction with the clarity of tax regulations and procedures for informal businesses which shows a substantial level of dissatisfaction with 36% expressing discontent and an additional 8% being very dissatisfied. Meanwhile, 28% of respondents reported being satisfied, and the same percentage indicated a neutral stance. This indicates a significant gap in understanding and acceptance of tax regulations among respondent. These findings are in line with Dube & Casale (2016) which recommended that there should be conducted a comprehensive review and simplification of tax regulations applicable to informal businesses.

On explaining clarity of tax regulations and procedures through interview, respondents were recorded and saying that *“Clarity of tax regulations and procedures applicable to informal businesses is important. How well taxes are collected from informal businesses is a big issue because people’s attitudes towards taxes can be shaped by their family, friends, and neighbors. If a taxpayer sees that many people around them are avoiding taxes, they may not be very committed to paying their own taxes. This makes it harder to collect taxes from the informal sector.”* (Business Administrator, February, 2024).

### **Compliance on the willingness of informal businesses to pay taxes**

Regarding compliance on the willingness of informal businesses to pay tax in Mbeya City, the respondents revealed as follows: -



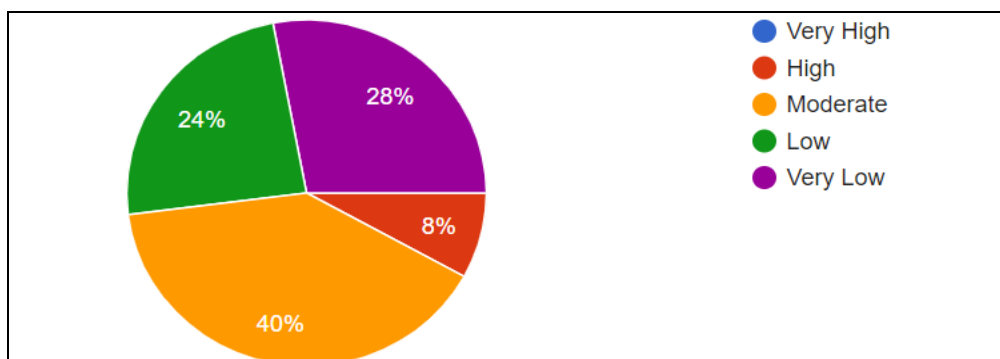
**Figure 3:** Compliance on paying tax.

Figure 3 shows the analysis of the study on the influence of compliance on the willingness of the informal businesses to pay taxes and reveals a balanced result, with 28% of responses categorized as encouraging and an equal 28% as discouraging. This divided sentiment suggests the need for further investigation into the specific factors driving these perspectives. These results resemble with the study theory in that informal businesses are mostly relying on their own economic survival over tax compliance also the results are in line with the findings of Sebele-Mpofu (2021) who recommended that the policymakers could tailor interventions to address the concerns and motivations of informal businesses to pay tax effectively.

On an interview, the respondents said that *“the willingness of informal businesses to pay taxes often depends on whether they feel it’s fair and if they see any benefits from paying. Many are unsure because the tax rules can be complicated, they don’t see what they get in return, or they worry about being closely watched. To get more informal businesses to pay taxes, we need to make the process easier to understand, clearly explain how tax money helps improve things like roads and services, and build trust”*. (The informal businessman, February, 2024)

### **Awareness among informal businesses owners regarding their tax obligations**

The results on awareness among informal business owners regarding their tax obligation on informal businesses in Mbeya City were as follows: -



**Figure 4:** Awareness to pay tax.

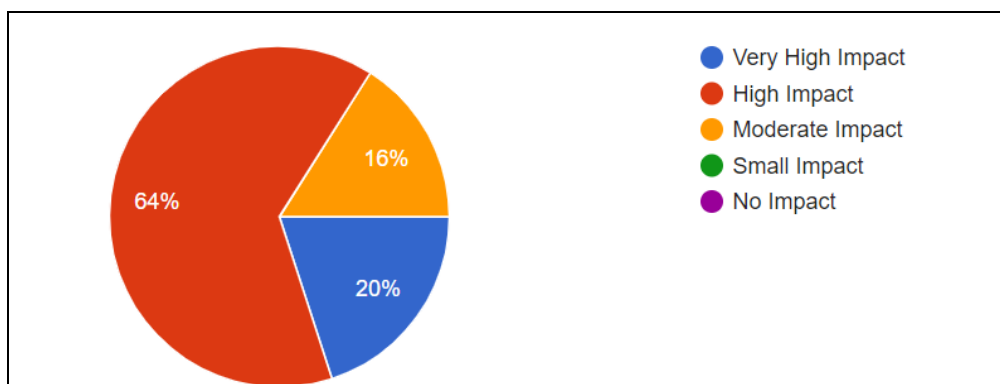
The analysis of the awareness level among informal business owners regarding their tax obligations reveals a range of perceptions. Notably, 40% of respondents rated the awareness as moderate, indicating a substantial portion with a satisfactory understanding of their tax responsibilities. In contrast, 28% perceived the awareness level to be very high, suggesting a significant group well-informed about tax obligations. On the other hand, 24% considered the awareness to be low, indicating a notable portion with insufficient knowledge. Lastly, 8% rated it as high, signifying a smaller yet considerable group acknowledging a commendable level of awareness. These results are in line with Tegegn & Kebede (2016), who propounded that awareness is one of the strategies that the regulator may use to improve tax compliance.

On an interview, pertaining with awareness to pay tax, the respondents said that many *informal business owners don't know much about their tax obligations. They often aren't aware of what taxes they need to pay or how to handle them. This lack of knowledge means they might miss important deadlines or even face fines. Educating these business owners about their tax responsibilities could help them stay compliant and avoid problems.*" (*The informal businessman, February, 2024*)

### **Tax Education Programs for Improving Tax Collection in Informal Businesses**

The results on tax education programmes for improving tax collection in informal businesses in Mbeya City were as follows: -





**Figure 5:** Tax Education Programs for Informal Businesses.

The analysis of the results for the impact of providing tax education for improving tax collection in informal businesses indicates a significant positive perception among respondents. A majority of 64% believe that such education programs would have a high impact, while 20% anticipate a very high impact. Additionally, 16% perceive a moderate impact. These results are in line with Fjeldstad (2014) and Gaspar et al (2016), who recommended that the overall positive sentiment towards the potential effectiveness of tax education programs suggests a strong endorsement for implementing initiatives aimed at enhancing tax awareness and understanding among informal businesses, with an emphasis on the expected high and very high impacts as highlighted by the respondents.

In an interview question on tax education programmes, the respondents presented that “the presence of tax education programs will help informal businesses understand and manage their taxes better. These programs teach business owners about tax regulations, how to keep proper records, and the benefits of paying taxes, such as access to government services and avoiding penalties. By improving their knowledge and skills, informal businesses can comply with tax laws more easily, leading to better tax collection and a more organized financial system overall.” (The informal businessman, February, 2024).

## CONCLUSION

The study on exploring determinants of low tax collection in informal businesses in Mbeya City revealed the key areas for improvement in informal business tax compliance. The mixed perceptions of tax collection efficiency indicated 36% found as effective and 32% ineffective. This indicates a need for a thorough review and stakeholder feedback to refine processes. Dissatisfaction with tax regulation clarity, affecting 44% of respondents,

underscores the need for simplification to enhance understanding and compliance. The balanced views on tax payment willingness 28% encouraging and 28% discouraging suggest the necessity for targeted interventions to address specific concerns and improve perceptions of fairness. Awareness levels among business owners vary, with a significant portion needing better education to avoid penalties. The high regard for tax education programs 84% anticipating a positive impact point to their potential in boosting compliance. Addressing these gaps through clearer regulations, educational efforts, and stakeholder engagement will help create a more efficient tax system, benefiting both the economy and the community.

## **RECOMMENDATIONS**

To improve tax collection efficiency and compliance among informal businesses in Mbeya City, it is recommended to conduct a comprehensive review of current tax collection processes and gather stakeholder feedback to refine strategies. Simplifying tax regulations and procedures will enhance clarity and understanding. Tailored interventions should address specific compliance concerns and ensure tax policies are perceived as fair. Increasing educational efforts to raise awareness about tax obligations is crucial, along with implementing and promoting tax education programs to improve understanding and compliance. These measures will contribute to a more effective and equitable tax system.

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