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## Examining The Revenue Implications of Taxing the Informal Sector

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### ABSTRACT

*The increasing interest of government to tax the informal sector is driven by pressure on government to generate more revenue for the purpose of embarking on more socio-economic development programmes. Over the years, however, this effort has not yielded meaningful results owing to operational constraints. The Nigerian government is losing out on this crucial source of revenue; yet it contributes greatly to its Gross Domestic Products (GDPs). This paper examined the revenue implications of taxing the informal sector in Nigeria. Methodology made use of in writing the work is mainly doctrinal; the bulk of the research is conducted in the library and materials from the internet were also used extensively.*

*This research revealed that the country's tax system is lopsided and dominated by oil revenue. It is also characterized by unnecessary complex and largely inequitable taxation laws that have limited application in the informal sector that dominates the economy.*

*The paper concluded that taxing the informal sector would boost revenue generation and also impact positively on the economic development of the country. For Nigeria to bring the informal sector into the tax bracket, however, there is consensus that tax authorities will have to work around the clock. Efforts by the government to widen tax base will greatly increase revenue, leading to a reduction in the reliance on donor funding and also in incidences where government is forced to increase taxes on basic commodities. But a large chunk of this sector continues to slip through the noose of tax authorities, even as government grapples with the complex problem of how to avoid this. The paper recommended that taxation of the informal sector should focus on incorporating the culture of compliance rather than short-term revenue generation.*

**Keywords:** *Revenue, Tax, Informal Sector, Economy*

## INTRODUCTION

Nigeria's economy is mono-culturally depended on oil. The implication is that large proportion of the Country's revenue is based on crude oil sales and the gap is often financed with borrowings and aids (external and internal) which makes the Country's economy totally dependent on variables beyond its control. Recent global economic downturn due to fall in the price of oil and the weak value of Nigerian currency (the Naira) in the global market of economy have raised many critical challenges and economic questions as to how the three tiers (Federal, State and Local) of government will finance their budgets in the coming years. The shortfall from oil revenue accruing to the government in recent years have negatively affected the economy with many implications as well as evoking the questions of whether taxing or not taxing the informal sector for revenue and for economic reasons should be undertaken<sup>1</sup>. Taxing the informal sector of the economy in recent times have received greater economic attention and occupies an important domain in revenue generation among developing economies.

The International Labour Organization<sup>2</sup> (ILO) was responsible for the elevation of the Informal Sector to the global spectrum in its Kenya Mission Report of 1972 when it defined informal activities as 'all economic activities that are neither monitored nor taxed by the government, and not included in the government Gross National Product (GNP) statistics.' According to ILO, the informal sector is characterized by certain drivers: (a) ease of entry; (b) reliance on indigenous resources; (c) family ownership; (d) small scale operations; (e) labour intensive and adaptive technologies; (f) unregulated and competitive markets. Initially, informal sector was

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<sup>1</sup> Three important issues have influenced this thinking. They are: (1) how to create additional sources for more revenue generation; (2) how to improve upon economic growth and (3) the quality of governance.

<sup>2</sup> ILO, *Employment, Incomes and Equality: A Strategy for Increasing Productive Employment in Kenya*, (International Labour Organization, Geneva 1972).

seen as survival strategy arising from lack of capital and requisite skills; but it has now become a permanent characteristic of the economies of developing countries because the formal sector lacks the capacity to accommodate all the new entrants, thus serving as alternative to the alarming rate of unemployment in the formal sector. Informal economy has been described in many other terms such as ‘black market’, ‘shadow economy’, ‘the underground economy’, ‘under the table’, ‘off the books’, and ‘working for cash’. It is also described as a grey market in labour.<sup>3</sup>

Informal sector is viewed as an economic unit occupying the most challenging domain in taxation<sup>4</sup>. Economic indicators are pointing to the direction of taxing the informal sector of the economy for increased revenue, which has been neglected in the past years. Taxing the informal economy in most developing countries has enlisted greater attention reflecting the increased recognition of the potential benefits to the economy.

Nigeria has come to rely on the economic activities in the informal sector. The sector is reported to constitute about 58% of the GDP in Nigeria after the rebasing in 2014<sup>5</sup>. This is up from 35% as at 2012 and it is also reported to employ over 80% of the workforce in the country. Nigeria’s informal sector came as a result of excessive regulatory system, high cost of entry into the formal sector, bureaucracy and corruption, high level of unemployment, culture of self-reliance

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<sup>3</sup> Ending the Shadow Economy Myth <<https://www.wiego.org/informal-economy#:~:text=The%20informal%20economy%20tends%20to,as%20illegal%20or%20inethical%20activity>> Accessed on 10 January, 2023.

<sup>4</sup> Hart K, *Formal Bureaucracy and the Emergent Forms of the Informal Economy*, (Oxford University Press 2006).

<sup>5</sup>National Bureau of Statistics, 2014.

or entrepreneurship, low literacy level, low income levels in the public sector and poor infrastructural facilities.<sup>6</sup>

However, despite the economic advantage of this sector, the headache with most governments for the past few decades revolves around structuring a tax administrative model that can best work in the informal sector. Taxation is believed to be the most affected and most hit by existence of informal activities. Examples of activities carried on in the informal sector of Nigerian economy are transport, rural and urban agriculture, construction, animal husbandry, entertainment, milling business, recreational hall, several small and unregistered sole proprietor businesses and in some instances joint partnership businesses which can be found both in rural and urban settlements across the country, trading, small scale manufacturing and repair industries, such as carpentry, upholstery, furniture making wood works, metal works, bakery, tailoring, bricklaying and printing. The private services providers include those in the repairing occupations like the automobile mechanics, electricians, clock and watch repairs and cobblers, among others.

Payment of taxes is considered a primary civic responsibility of every citizen and foreigner, including an informal sector operator, carrying on business in Nigeria. Taxation of the informal sector should be a veritable and sustainable source of revenue for the government, yet informal sector in Nigeria contributes little to the government revenue, and it is not easy to work out a taxation model that is suitable for activities in the sector. The sector is made up primarily of self-employed persons, small and micro-enterprises and other forms of economic activities. Incomes generated by the operators in the sector, in many cases, are not officially captured into the tax net of the States or Nation. Operators in the sector conduct their businesses using the facilities provided by government from taxes paid by other taxpayers in earning income,

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<sup>6</sup> The Informal Economy in Nigeria < <https://www.thisdaylive.com/index.php/2022/07/11/the-informal-economy-in-nigeria/>> Accessed on 10 January, 2023.

without paying taxes. Informal sector forms a greater percentage of tax defaulters, increasing cases of tax evasions leading to leakages in government revenue.

Taxation is predominantly a game of information; it is concerned with who has access to information.<sup>7</sup> Thus, when the necessary information for taxing an area of economy cannot be obtained then businesses within that area of economy cannot be subject to tax; and this can be said of the informal sector which is that area of the economy for which accurate statistical data are largely unavailable. Therefore, the sector is not fully captured into the tax bracket of the State.

In a bid to increase revenue generation, governments at the state levels are introducing several initiatives in order to bring the informal sector into the tax bracket. The state and local governments established new and several levies and set up task forces to collect them. But effort to improve taxation on this sector by undertaking several measures has not only been unsuccessful but also proved counter-productive. There are claims and counter claims about the existence of multiple taxations between the different tiers of government and the application of unethical tax collection methods sometimes involving violence and extortion and collection of illegal monies from persons in this sector by unauthorized persons, thereby creating harsh environment for owners of small scales businesses. This trend has the potentials of negatively affecting livelihoods and household income thereby contributing to poverty and inequality.

The increased thinking of taxing the informal sector by some major stakeholders in the Nigerian Tax System, bearing in mind the National Tax Policy (2012) is founded on the importance to good governance, growth and increased revenue.

## **RATIONALE FOR TAXING THE INFORMAL SECTOR**

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<sup>7</sup>Timilehin, O, Presumptive Taxation: A Solution to Taxing the Informal Sector in Nigeria. <[http://www.academia.edu/36352946/PRESUMPTIVE\\_TAXATION\\_A\\_SOLUTION\\_A\\_SOLUTION\\_TO\\_TAXING\\_INFORMAL\\_SECTOR\\_IN\\_NIGERIA](http://www.academia.edu/36352946/PRESUMPTIVE_TAXATION_A_SOLUTION_A_SOLUTION_TO_TAXING_INFORMAL_SECTOR_IN_NIGERIA)> accessed on 31 July, 2022.

The idea of taxing the informal sector was informed by three important issues, namely: how to create additional source of revenue generation; how to improve upon economic growth; and the quality of governance. The direct revenue benefits of taxing the informal sector are likely to be relatively modest, and the implications for vertical equity potentially adverse.<sup>8</sup>Therefore, argument for taxation of the informal sector is founded on potentially more indirect revenue benefits, the possibilities of rapid growth and the prospect for governance gains. Empirically, these consequences are less well established. On balance, they, however, present a convincing argument for increased efforts to enlarge the taxation of the informal sector, but there is a need to take cognizance of potential costs and greater research needs to be conducted into predicted benefits.<sup>9</sup>

Section 14(2)(b) of the Constitution<sup>10</sup> provides that the welfare of the people shall be the primary purpose of the government. Thus, if the government has responsibility to provide social services, then by necessary implication the people (operators in informal sector inclusive) also have responsibility to perform their duties to the government, one of which is payment of tax in line with the provision of section 24(f) of the Constitution<sup>11</sup> which states that it shall be the duty of every citizen to pay his tax promptly. This is because they are benefitting from the services provided by government. But this is not to say that payment of tax is a reciprocal obligation to provision of welfare because a person, although under obligation to pay tax, cannot lay claim to commensurate provision of social service by the government by reason of the tax

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<sup>8</sup> Joshi, A., Prichard, W. and Heady, C., *Taxing the Informal Economy: Challenges, Possibilities and Remaining Questions.*, (Being a Working Paper for Institute of Development Studies, 2013) p. 9.

<sup>9</sup>ibid.

<sup>10</sup> Constitution of the Federal Republic of Nigeria 1999 (as amended).

<sup>11</sup>ibid.

paid by him. Because tax has been described as ‘... any compulsory payment to government imposed by law without direct benefit or return of value or a service whether it is called tax or not.’<sup>12</sup> It is thus an established law that tax is compulsory payment, and the discretion of those to whom it applies is of no import. In other words, it is not open to an option to do or not to do. The National Tax Policy (2016) states expressly that any compulsory payment to the government, and which is imposed by law without any direct benefit or return of value, irrespective of the name by which it is called is tax.<sup>13</sup>

Informality has attracted many conceptualizations but the general agreement in the literature is that large informal sectors are detrimental to the economy.<sup>14</sup> Informal sector has the consequences of narrowing the tax base and a potential grave distortion of activity of the economy.<sup>15</sup>

The rationale for taxing the informal sector is, therefore, the efficiency and equity implications, governance implications and the revenue implications. The focus of this research work is, therefore, the revenue implications of taxing the sector.

## **EFFICIENCY AND EQUITY IMPLICATIONS OF TAXING THE INFORMAL SECTOR**

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<sup>12</sup> National Tax Policy, Federal Ministry of Finance, 2016.

<sup>13</sup> Timilehin, O, Presumptive Taxation: A Solution to Taxing the Informal Sector in Nigeria. <[http://www.academia.edu/36352946/PRESUMPTIVE\\_TAXATION\\_A\\_SOLUTION\\_A\\_SOLUTION\\_TO\\_TAXING\\_INFORMAL\\_SECTOR\\_IN\\_NIGERIA](http://www.academia.edu/36352946/PRESUMPTIVE_TAXATION_A_SOLUTION_A_SOLUTION_TO_TAXING_INFORMAL_SECTOR_IN_NIGERIA)> accessed on 31 July, 2022. p. 2.

<sup>14</sup> Kanbur, R.(2010). Avoiding Informality Traps, (Draft Paper, Cornell University, New York, 2010), in Godwin Dube, 'Informal Sector Taxation: The Case of Zimbabwe' (PhD Thesis, University of KwaZulu-Natal, Howard College Campus Durban, South Africa, 2014) p. 38.

<sup>15</sup> Keen M., VAT, Tariffs and Withholding: Border Taxes and Informality in Developing Countries. *Journal of Public Economics* 9 (2) 1892–1906.

Taxing the informal sector raises the issues of equity and efficiency. In economy, taxation has the capability to distort economic decisions. Taxation creates a loss of welfare higher than the revenues collected – the deadweight loss or excess burden of taxation<sup>16</sup>. Small businesses are absconding the distortionary effects of taxation by refusing to upgrade to the formal sector; and their growth may be hindered if they are drawn into the tax bracket. Yet, while taxation and its distortionary effects may be escaped by operators in the informal sector, inefficiencies can also be created by remaining informal. This is because by remaining informal thus becoming invisible to tax authorities, such businesses cannot afford to be too successful as this will attract the attention of tax authorities; and it is submitted that remaining informal can serve as hindrance to a business' full potential<sup>17</sup>. Thus, if being in the informal sector impedes the growths of these businesses, economic growth may be affected as well.

On the other hand, from the perspective of equity, arguments have been proffered for a nearly entire exclusion of informal sector from direct taxes. This is because informal sector taxes tend to be regressive, threatening the survival of small businesses, and bearing in mind that most of the operators in this sector are already paying levies such as trading licenses, operating permits and user fees<sup>18</sup>. In Nigeria, informality is the only viable option for unemployment. Thus, attempting, to reduce informality by taxing operators in the informal sector will destroy informal jobs and at the same time results in inequities. Although, this does not mean that

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<sup>16</sup> Rosen, H. S. (1995). *Public Finance*, Boston McGraw-Hill.

<sup>17</sup> Hillman, A. L.(2009). *Public Finance and Public Policy*. Cambridge University Press, New York.

<sup>18</sup> Parts II and III of the Taxes and Levies (Approved List for Collection) Act *CAP. T2 Laws of the Federation of Nigeria 2004* contain various taxes and levies, being collected by State and Local Governments, some of which are applicable to the operators in the informal sector.



operators in the informal sector are always poor<sup>19</sup>, because there is no nexus between informality and poverty on one hand, and formality and affluence on the other hand. Thus, not taxing these informal businesses can also give rise to clear inequities and much discontent from those with similar or lower incomes in the formal sector. Empirical evidence shows that wage earners in the formal sector in developing countries always have the feeling that they are taxed more heavily than people at equal level of income in the informal sector<sup>20</sup>.

### **GOVERNANCE IMPLICATIONS OF TAXING THE INFORMAL SECTOR**

Political and governance considerations have also been emphasized in taxing the informal sector in developing countries<sup>21</sup>. Taxing the informal sector can increase the political participation of tax-payers through reciprocity and accountability in exchange for taxes paid; in view of this, taxing the informal sector should be viewed beyond ordinary revenue considerations. Paying taxes may motivate governance in three ways. First, the state may be more responsive and accountable to tax-payers as a way encouraging quasi-voluntary compliance. Second, by paying tax tax-payers are more likely to make demands for responsiveness and accountability. Third, by taxing the informal sector operators, bargaining between State and informal sector associations may be encouraged.

If this nexus between taxation and governance actually exists, then taxing informal sector could be an important way of increasing government accountability and making sure that those in the informal sector are heard. A very good example of this is that of Ethiopia cited by Prichard<sup>22</sup>,

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<sup>19</sup> ILO, *Women and Men in the Informal Economy*. (Geneva, 2002) in Godwin Dube, 'Informal Sector Taxation: The Case of Zimbabwe', (PhD Thesis, University of KwaZulu-Natal, Howard College Campus Durban, South Africa, 2014) p. 40.

<sup>20</sup> *Informal Sector Taxation: The Case of Zimbabwe*. p. 41.

<sup>21</sup> *Ibid.*

<sup>22</sup> Prichard, W. *Taxation (2010). Responsiveness and Accountability in Sub-Saharan Africa*, (PhD Thesis, Institute of Development Studies, University of Sussex.

where it was found that expanding the taxation of small businesses just before the 2005 elections resulted in some public mobilization that prompted the government to work with the business sector in overseeing the presumptive tax regime.

Although, it is submitted that the Ethiopian evidence of connection between taxation and governance is rather far-fetched, because governance is an area that is entirely outside the scope of taxation; and as noted earlier it is an established principle of taxation that payment of tax attracts no 'direct benefit or return of value or a service' from government to the tax-payer.

### **REVENUE IMPLICATIONS OF TAXING THE INFORMAL SECTOR**

In many developing countries, informal sector forms a large and sometimes increasing part of the economy<sup>23</sup>. In order to fund the ever increasing expenditures of the government therefore, tax authorities are required to seek ways to tax the income of those carrying on business in the informal sector. In sub-Saharan Africa, the contribution of informal sector to the GDP is estimated at 24 percent<sup>24</sup>; in Asia its contribution is estimated at 22 percent while it is 23 percent in Latin America<sup>25</sup>. The National Bureau of Statistics stated in its 2015 GDP report of formal and informal sector that the informal sector's share of the Nigerian economy was about 41.1%<sup>26</sup>. By drawing attention to its size and the increasing share of its contribution to the GDP in Nigeria, the informal sector does appear to be a potentially significant source of revenue for the government. But large informal sector may have the consequence of weakening the Country's growth prospects (through the loss of revenues from tax) and broader development agenda<sup>27</sup>.

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<sup>23</sup>Godwin, D. (2014) *Informal Sector Taxation: The Case of Zimbabwe*, (PhD Thesis, University of KwaZulu-Natal, Howard College Campus Durban, South Africa. p. 38.

<sup>24</sup>ibid.

<sup>25</sup>ibid.

<sup>26</sup> 'Presumptive Taxation : A Solution To Taxing The Informal Sector In Nigeria', p. 5.

<sup>27</sup>Mbaye, M. (2014). *The Informal Sector, Employment and Structural Transformation: Some Operational Recommendations For A Productive Policy*, in Godwin Dube, 'Informal

Developing countries like Nigeria have been called by international financial institutions to fund their own developments by harnessing their local resources rather than depending on aid or foreign loans<sup>28</sup>. The inclusion of informal sector in taxation could thus be a pertinent part of taxation-development connection<sup>29</sup>. Although, taxing the informal sector is not without its problems, because the sector is made up of low income-earning businesses and it is that sector of the economy for which accurate statistical data are not readily available. Apart from these, this sector is yielding low revenue to the government, thus the costs of collecting and administering informal sector taxes in Nigeria can be high. Due to these low revenue and high costs of administration, experts on tax tends to view taxation of informal sector with skepticism. Their argument is that a reasonable allocation of resources in a developing country like Nigeria should be focused on the formal sector which has the greater revenue yield<sup>30</sup>. It is therefore not surprising that taxing the informal sector is only recently gaining prominence in the Nigerian taxation priorities.

However, taxing the informal sector is not limited to mere considerations of revenue. This is because government is losing revenue for non-payment of tax by operators in this sector and this has the effect of increasing tax rate for those who are paying taxes. Moreover, by not taxing the informal sector, not only will other operators in the formal sector may be tempted to

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Sector Taxation: The Case of Zimbabwe' (PhD Thesis, University of KwaZulu-Natal, Howard College Campus Durban, South Africa. p. 38.

<sup>28</sup> 'Informal Sector Taxation: The Case of Zimbabwe', p. 38.

<sup>29</sup> IMF, Developing the International Dialogue on Taxation: A Joint Proposal By the Staffs of OECD and World Bank', <<http://www.imf.org/external/np/fad/itd/2002/031302.htm>> accessed on 09 July 2022.

<sup>30</sup> Keen, M. (2012). Taxation and Development – Again, (IMF Working Paper WP/12/220, Washington DC) in Godwin Dube, 'Informal Sector Taxation: The Case of Zimbabwe' (PhD Thesis, University of KwaZulu-Natal, Howard College Campus Durban, South Africa, 2014) p. 39.

informalize their enterprises as well in order to avoid tax, informal sector will avoid growth (so as not to attract attention from revenue authorities)<sup>31</sup>. And not taxing the informal sector may demoralize compliance behaviour in the formal sector<sup>32</sup>. Taxation of businesses in the informal sector should be viewed as a first step towards business formalization instead of being seen from a short-term revenue perspective<sup>33</sup>. Taxation of informal sector is viewed as building a culture of tax compliance (despite the low short-term revenues) which ensures that these businesses continue to pay their taxes as they grow. Growth of business (as a result of greater access to markets, credit and finance) is viewed as providing opportunities for small businesses to move out of penury and the 'informality traps'.

## **CHALLENGES OF TAXING THE INFORMAL SECTOR**

A lot of challenges have bedeviled taxation of informal sector. These range from lack of statistical database due to non-registration of businesses in the informal sector. Also, there is lack of accounting record keeping of business transactions and incentives to official by government. Issues relating to residence of the taxpayers resulting from unstable nature of business carried out by operators in the informal sector which makes it difficult to establish a tax base. Also identified as a challenge is lack of trained and skilled personnel of relevant Tax Authority and modern operational vehicles and equipment and security of staff. Another challenge is corruption on the part of tax officials and government. a corollary of this

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<sup>31</sup> Informal Sector Taxation: The Case of Zimbabwe, p. 39.

<sup>32</sup>ibid.

<sup>33</sup>Loeprick, J.( 2014). Small Business Taxation: Reform to Encourage Formality and Firm Growth, Investment Climate in Practice, (Washington DC, World Bank,2009) in Godwin Dube, 'Informal Sector Taxation: The Case of Zimbabwe' (PhD Thesis, University of KwaZulu-Natal, Howard College Campus Durban, South Africa. p. 39.

is high level of political interference, where tax officials and politicians (government in power) jettison payment of tax but opt to spend money on electorates for their selfish interest.<sup>34</sup>

## **CONCLUSION AND RECOMMENDATION**

It is submitted that taxation of informal sector may yield huge benefits in terms of economic growth, the quality of governance and long-term revenue collection. But the evidence of this nexus remains limited generally. First, tax morale and a culture of tax compliance can be built by taxing the operators in the informal sector. Second, the growth of SMEs (Small and Medium-Size Enterprises) can be enhanced by taxing the informal sector. Yet, questions remain about how enormous these effects are, whether smaller businesses are likely to benefit, who may be disadvantaged, and which particular policies may be most significant. Finally, pertinent attention has been paid to the prospect for informal sector taxation to prompt state–society bargaining (i.e governance). But evidence is still specifically limited, with a need for research into hindrances to collective action and constructive bargaining. Cognizance should also be taken of power imbalances that always characterize the dealings between State and the informal sector, and the corresponding vulnerability of informal sector operators.

From the submissions made in this research work, the following recommendations are made:

- **Effective Customer Relations:** Maintenance of good customer relations is key; thus tax collectors should apply marketing, human resource strategies and a high sense of diplomacy to convince and encourage taxpayers to make good their respective tax liabilities. However, when the need arises the rules and regulations governing tax compliance must be applied. Again, tax net should be widened further so as to capture much more lower income earners.

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34 Adekoya, A. A. and Babatunde, A. L. Informal Sector and Tax Compliance in Nigeria- Challenges and Opportunities”<  
[https://www.researchgate.net/publication/342451989\\_Informal\\_Sector\\_and\\_Tax\\_Compliance\\_in\\_Nigeria-Challenges\\_and\\_Opportunities](https://www.researchgate.net/publication/342451989_Informal_Sector_and_Tax_Compliance_in_Nigeria-Challenges_and_Opportunities)>

Taxpayers and general public should also be involved in decision making processes as far as taxation is concerned for this will be of great help since it will ensure commitment.

- Tax laws should be made simple and to the understanding of informal sector operators; this will enhance voluntary compliance.
- Informal sector taxation should focus on incorporating the culture of compliance rather than the short-term revenue generation.
- Harmonisation of Taxes: Proliferation of taxes should be discouraged because there is no correlation between multiple taxes and increase in revenue to the government. Thus, taxes should be harmonized so as to reduce illegal charges on the people as well as boost revenue generation for the government because quite a lot of these multiple collections go into private pockets; moreover, harmonisation will also encourage small business to grow.

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