

## **Submission in response to Issues Paper No.7:**

### ***Microenterprises, Small Business, & the Informal Economy***

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#### **1.0 Introduction**

- 1.1 This submission is directed to issues surrounding the taxation treatment of persons and entities operating within the 'informal economy' of Papua New Guinea. It is written in response to Issues paper #7, though it also draws on other materials prepared in connection with the Review.
- 1.2 I lived in Papua New Guinea for eleven years, 1970 to 1981. During that time I headed the institution now known as the National Research Institute (1977-1981). More recently I contributed to writing the *National Informal Economy Policy* (see Conroy 2010). My writings on the informal economy in Papua New Guinea are available online at <http://fdc.org.au/Knowledge-centre/the-informal-economy/>
- 1.3 I am aware that the informal economy is a relatively minor consideration in relation to the broad set of issues with which the Tax Review is concerned. But the people involved in informal economic activity in PNG greatly outnumber those taxpayers engaged in the 'formal' economy, even if their monetary contribution is relatively small. This large group of people should be valued more highly than the few *kina* they earn, or the even fewer *kina* they could pay in taxes.
- 1.4 Among the purposes of the Tax Review is to consider whether, and if so how, people in the informal economy should be contributing to tax revenues. But it must be remembered that people in the informal economy are already taxpayers, because they pay the Goods and Services tax (GST) on purchases from 'formal' suppliers. And unlike registered commercial entities they cannot reclaim the money they spend on GST, even when the tax is paid on supplies necessary for their informal economic enterprises or their subsistence activities. This fact weakens any case for imposing extra tax burdens upon them, but it does not mean they should be excused all other tax responsibilities.

## 2.0 *The scope of informal economic activities*

- 2.1 PNG taxation authorities (the IRC) have a simple and functional definition of informality: people operating in the monetized economy are said to be operating 'informally' if they do not declare income which is, in principle, taxable.
- 2.2 While the reasons for this simple definition are understandable, it lumps together separate classes of people who should be treated differently for tax purposes (see sections 2.8 to 2.10, below).
- 2.3 Paper # 7 (p.19) notes that other PNG policy documents (e.g., *National Policy for the Informal Economy; Vision 2050; Development Strategic Plan 2010-2030*) give the informal economy a very important role in future development planning. Also, that they give a much broader definition of the informal economy than that used by the IRC. Paper #7 quotes the following description, from the *National Policy for the Informal Economy*, which gives a fuller understanding of the informal economy:
- 'The formal economy is where people have jobs, pay taxes and are counted in the workforce. In the informal economy, people 'get by' without formal employment, earning income however they can. The informal economy is based on the household rather than the individual worker, and households often have a number of sources of income that may be both formal and informal. Informal economy workers do not pay income tax (although they often pay GST), are not counted in the workforce, do not work regular hours and are often denied the rights and protections of workers in the formal economy'.*
- 2.4 If we compare the different viewpoints expressed in the *National Policy for the Informal Economy* and in Papers #3 and #7 it is possible to see some sources of confusion in discussions about the informal economy in PNG. There is a basic confusion between what might be called the **Survivors** and the **Submarines**.

### **Box: Submarines and Survivors in the informal economy**

**Submarines** are enterprises which *submerge* to keep out of sight. They avoid taxes and other regulations such as labour standards and minimum wages. They do so because they find the business environment oppressive, whether because of high taxes, restrictive and demanding regulation, official corruption or gangsterism. They are often capable of operating formally, or of being brought up to that level, but choose not to do so.

**Survivors** are the 'survival' enterprises of the poor who are unable to find any, or sufficiently remunerative, employment. These are 'micro' enterprises -- often a single person, perhaps with unpaid family helpers -- and are clustered in petty trading activities or simple services, conducted at low levels of productivity with a minimum of capital investment, mainly in urban areas. Such 'micro' entrepreneurs usually live in households with one or more other sources of money income. Households, urban & rural, often have multiple income sources.

- 2.5 Every informal economy has both *survivors* and *submarines*, but in different proportions from country to country, depending on local conditions. At this stage of its development PNG has more *survivors* than *submarines*, though the latter group already exists and will become more important over time. As this happens, official attempts to formalize them will become increasingly appropriate.
- 2.6 *Submarines* are more common in more developed economies such as those of Latin America and Eastern Europe where many businesses, which are capable of operating formally, instead choose for a variety of reasons to remain *submerged*. They do this to avoid being detected by taxation and labour authorities. As a result, they operate at sub-optimal scale and are unable to take advantage of a range of benefits available to formal, registered, enterprises. This is why international agencies such as World Bank, IFC and ILO campaign vigorously against informality in such countries. Such prescriptions, when applied to PNG, are often premature or inappropriate.
- 2.7 *Survivors* are the people who just 'get by', conducting low-productivity informal economic activities. Such 'survival enterprises' are common in PNG urban areas, where they often represent the last links in a chain of transactions through which the produce of the rural informal economy (e.g., foodstuffs, betel nut) is distributed to urban populations. As the World Bank has said, 'informal is normal' and at its best informality can play a 'transformational' role in economic life (Conroy 2013).
- 2.8 Paper #3 (*Case for Reform*, p49) identifies four groups in the PNG informal economy:
- (i) 'hard to tax professions' (informal in the sense they are 'not registered with IRC')
  - (ii) other small, informal businesses ('some highly profitable').
  - (iii) informal (cash) workers
  - (iv) informal (subsistence) workers, who 'should not be subject to tax'.
- 2.9 The first group ('hard to tax professions') is a relatively sophisticated collection of *submarines*, avoiding detection by tax authorities. The second ('other small informal') probably consists mainly of what I call *survival* enterprises, as well as some which are potentially viable as formal enterprises. These are the entities the IRC would like to see paying tax. The third group ('informal cash workers') are employed by informal enterprises, but also by formal enterprises which do not make full disclosure of their activities to authorities. Both the IRC and the Department of Labour would like to know more about such enterprises.
- 2.10 Concerning the fourth group, I disagree with the statement that 'subsistence' workers are in the informal economy. Subsistence is non-monetized economic activity *outside* the market economy and should not be confused with 'informal' activity, which occurs *inside* the market economy. The importance of subsistence in PNG lies in the fact that a very high proportion of rural households produces some part of its food and shelter needs, outside 'the market'. This is a source of

strength and stability in the domestic economy of many rural households, but it is not part of the national informal economy.

- 2.11 Almost all rural households have access to sources of cash income. These are most commonly informal economic activities, including informal wage labour, but they also include remittances and traditional exchanges (gifts) with *wantok*. Only a small minority of rural households will have members engaged in formal employment, or operating registered (formal) business enterprises.
- 2.12 The great majority of rural households follow a strategy of mixing subsistence (non-market) and informal (market) sources of income. Cash is earned by selling food crops in local markets, and by producing export crops (e.g., cocoa, coffee, copra); and/or by wage labour and other 'off-farm' activities in processing, transport and marketing of crops, and in other services (including trade-stores and passenger transport). Some of these are the 'highly profitable' informal businesses which the IRC would like to bring into the tax net by persuading them to 'formalize'.
- 2.13 Almost all rural households still rest on a foundation of subsistence production, and the cash earnings of most are probably below the threshold (K10,000)<sup>1</sup> at which Personal Income Tax (PIT) becomes payable. In many (most) cases such cash earnings are attributable to a number of household members, making it even less likely that any single worker's earnings would exceed the minimum tax threshold<sup>2</sup>. This circumstance increases the attractiveness for authorities of GST as an alternative source of taxation revenue.
- 2.14 Urban and peri-urban households contain much higher numbers of people in formal wage employment, as well as more proprietors of registered businesses. Some urban households engage in non-market subsistence activities, but these contribute a much smaller proportion of household income than in rural areas. Many households in which formal wage-earners reside also contain persons (whether residents or visitors) who earn incomes in informal economic activity. A significant number of urban households do not appear to have any formal wage-earner. Urban households, like those in rural areas, seem to rely on multiple sources of income, formal and informal, as well as participating in exchange (gift) activity (Sharp *et al.*, 2015).
- 2.15 Some formal workers also have 'sideline' activities to supplement their wages and these may (or may not) be registered as business enterprises (Levantis 2014; NRI 2014). If not registered, these 'sideline' activities may be regarded as informal.

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<sup>1</sup> In this submission I make no recommendations about the levels at which thresholds should be set since I do not have up-to-date knowledge of general income levels and informal economy earnings.

<sup>2</sup> None of the papers prepared for the Tax Review appears to discuss the implications of this last fact.

### 3.0 *Implications of the nature of informal activities for their taxation*

- 3.1 I accept the view of an IMF study quoted in Issues paper #7 (Keen 2012, 20). This argues that 'referring to "informality" can be unsatisfactory when applied to tax policy. Thus, 'many so-called "informal" businesses aren't necessarily an issue: ***on tax policy grounds many micro or small enterprises probably should be outside the tax system – except by indirect taxes like GST on purchases and possibly small fees***'.
- 3.2 I also agree that *some* small and potentially profitable businesses in PNG may need help to escape from the 'informality trap' and to become tax-paying entities (Paper #3, p. 48). Such advice applies to a majority of the many 'submerged' enterprises in countries such as Brazil, but in the circumstances of PNG it would be premature to chase tax revenue benefits by attempting to 'formalize the informal' on anything other than a highly selective basis. At the present stage of its development PNG needs *more* informal enterprise, not less (Conroy 2011). It would be more effective to start by increasing the 'financial inclusion' of such businesses, after which their formalization would be more easily achieved.
- 3.3 I accept the validity of the GST as a means of taxing the informal economy (3.1, above). The GST is often criticized as a 'regressive' tax -- one which affects low-income people unfairly. I agree with Paper # 3 (p.38) where it is claimed that 'the GST may not be as regressive as it appears. In particular, only medium and large businesses are required to register for the GST and so many locally produced goods (especially foods and crafts) will incur little or no GST. Since locally produced goods are likely to comprise a large share of consumption for many households in rural areas, this suggests that an increase in the GST will have a relatively smaller impact on them'<sup>3</sup>.
- 3.4 Any increase in the rate of GST would increase the attractiveness of local, informally-produced goods which are not subject to GST. This would act to enlarge domestic markets through import substitution. Also, through their capacity to provide at least part of their needs for food and shelter by working the traditional land available to them, rural people are better able to contribute to the costs of government services than their comparatively low money incomes would suggest. Certainly, some tax contribution from rural people is necessary as a matter of policy and equity, and the GST is a form of tax revenue particularly suited for this purpose.

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<sup>3</sup> It is a matter for investigation whether the GST is more regressive when applied to the spending of urban or rural people. The consumption 'baskets' of urban people are known to contain much GST-free produce from urban markets and this benefits urban low-income earners. To the extent that rural people are reliant for protein on imported tinned goods while growing most of their own vegetables, the imposition of GST would perhaps be more regressive.

- 3.5 Further contributions to tax revenue by rural people, and by 'survival' operators in the urban informal economy, might be made possible by imposing fees upon certain activities (see paragraph 3.1, above).
- 3.6 The submission by CIMC (2014) discusses an innovative pilot project conducted by NCDC and UNWOMEN, the 'Safe Cities Market Programme' (UN WOMEN 2014). Innovative 'cashless' methods of collecting market fees are being trialled, using an electronic billpay system in cooperation with Nationwide Microbank. This has benefits in relation to the safety of vendors (a large majority of whom are women and many of whom travel to markets from rural areas). It also supports their financial inclusion by associating them with the bank. Fees paid by vendors have been directed to improving the physical infrastructure of Port Moresby's urban markets. Success in this pilot program would encourage the wider rollout of such facilities.
- 3.7 Several submissions to the Review (Levantis 2014; NRI 2014) have commented on the situation of wage earners who conduct unincorporated business operations as a sideline. Particular unfairness is claimed to occur when a formal, tax-paying employee also declares income from such 'sideline' activities. Since the current practice is to 'aggregate' the income of an unincorporated business with the formal salary of its operator, the part-time entrepreneur is obliged to pay personal income tax at a high marginal rate on the business profits. Levantis (2014) suggests that 'this might well explain the high prevalence of informal businesses and the difficulty in encouraging businesses to transition to a formal status. So not only does this mechanism of taxing the small business sector curtail investment in the sector, it also shifts people into informality to avoid taxes'.
- 3.8 Some arguments in the NRI submission come close to special pleading. We are told that it is important not to 'discourage potential investment by the middle class'. At a consultation held by NRI it was argued that 'the middle class in PNG is critically important for consumption but their roles and contributions are often downplayed by the tax system. Our tax system must also be geared towards encouraging self-reliance. This means promoting PNG businesses, especially the SMEs, to grow the economy and provide the basis for supporting the middle class and their businesses — the tax base for this country' (NRI, 4.8).
- 3.9 Again, it is said (NRI, 4.6) that SMEs operated by middle-class wage-earners 'are especially created to support families of middle income earners, which is a unique insurance cover or an implicit 'wantok tax' that effectively raises the marginal tax rate for high income earners to more than 42 percent, which is regressive'.
- 3.10 Levantis sees the situation in similar terms: 'The *wantok* system means that people on high incomes are obliged to look after those in the community on low incomes. This is an excellent social system that ensures that all are looked after, but it

highlights the failure of Government to provide support and jobs to the needy, and the requirement for individuals to step up to fill the void left by Government' (Levantis, 9).

- 3.11 But *all* urban residents with access to cash are obliged by custom to support relatives. This document includes a number of references to 'traditional exchanges' and 'gifts', to explain how people in the informal economy 'get by'. In such situations it is not obvious that middle-income earners are *more* disadvantaged (in relative terms) than minimum wage earners. It may be glib for a non-Melanesian to say so, but material success in urban life appears to require a balancing act, in which personal and political skills are employed to manage traditional obligations<sup>4</sup>. It seems paradoxical to argue (as NRI and Levantis appear to do) that the failure of governments to provide for the welfare of citizens justifies modifications to a taxation regime, the effect of which modifications may be to rule out Government's *ever* meeting those obligations. It is one thing to design a modern taxation system with a sensitive understanding of traditional customs, but how far should such a system go to support traditional mores and social structures which are challenged by contemporary urban life?
- 3.12 Levantis and NRI agree that the solution is to replace the current personal income tax system with two separate and mutually exclusive forms of income tax: (a) Wage Income Tax; and (b) Investment Income Tax. These will be declared separately and tax paid on each at an appropriate rate. It would establish a 'level playing field', 'where unincorporated micro and small businesses are taxed in the same way, regardless of the owner's status in the formal workforce' (NRI, 4.4). This suggestion has some merit.
- 3.13 An alternative approach is available, if it is indeed true that 'sideline' enterprises are created for the benefit of *wantok*. Operators of 'sideline' enterprises are permitted to deduct wages paid to their *wantok*, together with associated expenses of their employment, from gross income. The net income earned by the 'sideline' is then aggregated with the operator's formal wage income, reducing his or her tax liability.
- 3.14 Some 'sideline' enterprises seem likely to be conducted by the 'hard-to-tax professions' (mentioned in 2.8, above). Since such activities seem less likely to employ other persons, under present arrangements the income is likely to be wholly taxable in the hands of the operator. This is probably the situation which concerns NRI and Levantis. I wish to draw attention to some implications of such activities.
- 3.15 Where the formal wage income of such an operator is derived from a private sector source, I presume that his or her private sector employer will monitor the

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<sup>4</sup> Once again, this is a matter for investigation. Research is likely to show a wide range of experience among urban-dwellers and varying degrees of success in handling such situations. No doubt some middle class households do suffer under the weight of *wantok* demands.

employee's activities so as to avoid suffering any loss of productivity due to the employee's 'sideline' activities. Whether or not to grant permission for an employee to conduct 'sideline' activities is a matter for the private sector employer to decide.

- 3.16 Unfortunately, experience elsewhere suggests that employees in the *public* sector who conduct 'sideline' activities are much less likely to receive appropriate levels of supervision (perhaps because 'everybody's doing it'). In this case it is more difficult to guarantee workers' full application to the demands of their public sector employment. In Indonesia, for example, many public servants are notoriously active *outside* their places of formal employment. A question arises from this: how far should the tax code facilitate behaviour by public sector employees which may prove detrimental to the conduct of their primary occupation as public servants?
- 3.17 This raises questions beyond the sphere of taxation policy, touching upon the morale and professionalism of public servants. If it is felt that such problems can be overcome by establishing conventions and procedures for public service management which would avoid the abuses experienced elsewhere, then arrangements for a permissible amount of 'sideline' activity might be facilitated by taxation arrangements such as were suggested by Levantis and NRI (see paragraph 3.12, above). Alternatively, present arrangements might be permitted to continue, but with the application of a threshold level of 'sideline' income which the employee is able to earn without tax liability, after which the top marginal rate would be applied.

#### **4.0 *Informality and illegality***

- 4.1 Informal economic activities may be respectable (or not), legal (or not), legitimate (or not)<sup>5</sup> and this has implications for the treatment of such income by tax authorities. Levantis (1997) has made the connection between urban unemployment and crime and there is no doubt that criminal activity is a thriving element in the informal economy of PNG towns. Putting aside moral judgments, one could say that some illegal activities are value-adding in an economic sense (sly-grogging, marijuana growing and distribution, prostitution) while others are merely redistributive (burglaries, highway robberies, pyramid schemes). It would be possible for the State to tax some 'illegitimate' activities which are not actually anti-social in order to raise revenue, as has been done in various legal jurisdictions around the

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<sup>5</sup> Keith Hart, originator of the idea of the 'informal sector', distinguished between 'legitimate' and 'illegitimate' activities in the Ghanaian city of Lagos, with the notion of 'legitimacy' being 'derived essentially from Ghana's laws ... coincid[ing] with the morality of "respectable" Ghanaians'. Such respectable ideas were not necessarily held by the residents of Nima, a district of Lagos 'notorious for its lack of respectability, for the dominance of a criminal element, and for the provision of those goods and services usually associated with any major city's "red-light district"' (Hart 1973, 74). No doubt residents of Port Moresby, Lae and other urban centres could change these place-names to fit their own city's circumstances.

world. This is a sensitive issue and depends on the evolution of social attitudes towards 'deviant' behaviour, such as has made the legal sale and taxation of marijuana possible in some US states, and the decriminalization of prostitution, and taxation of its proceeds, possible in some Australian states.

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