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Informal Economies and Taxation: Legitimacy, Compliance, and Fairness

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ABSTRACT

The informal economy constitutes a substantial share of employment and economic activity across developing and emerging economies, presenting significant challenges for taxation, state legitimacy, compliance, and equity. This paper reviews the relationship between informal economies and taxation by examining the conceptual foundations of informality, the role of state capacity, and the factors influencing tax compliance among informal economic actors. It explores how legitimacy, trust in government, social contracts, and perceptions of fairness shape taxpayers' willingness to comply with tax obligations. The study further evaluates policy instruments designed to encourage formalization, including simplified tax regimes, administrative reforms, technological innovations, and compliance monitoring systems. Particular attention is given to the principles of horizontal and vertical equity, distributional consequences of formalization, and comparative experiences from emerging and developed economies. The review demonstrates that taxation of the informal economy cannot rely solely on enforcement measures but must be supported by credible institutions, transparent governance, equitable tax policies, and improved public service delivery. Evidence suggests that voluntary compliance increases where taxpayers perceive taxation as legitimate, fair, and accompanied by tangible public benefits. Conversely, weak institutions, high compliance costs, corruption, and limited state accountability undermine both tax morale and formalization efforts. The paper concludes that sustainable taxation of informal economies requires an integrated approach that balances revenue mobilization with fairness, inclusiveness, and institutional legitimacy, thereby strengthening the social contract between governments and citizens while promoting long-term economic development.

Keywords: Informal Economy, Tax Compliance, State Legitimacy, Tax Fairness and Formalization

INTRODUCTION

Taxing and regulating informal economies has emerged at the forefront of tax policy debates in the past two decades [1]. The pressing needs to expand the tax base, especially in developing and emerging economies, has strengthened calls for policy measures intended to tax the informal economy, even if informal taxation remains a highly contentious issue [2]. The informal economy as individuals or enterprises operating outside government scrutiny. As they noted, the informal economy often includes unregistered small enterprises, informal workers in non-farm activities, casual labourers, temporary domestic workers, seasonal labourers, and illicit street vendors. According to the International Labour Organisation (ILO), during 1996-2016 the size of informal employment in terms of its share in total employment ranged from a low of about 33% in 2015 to a high of about 64% in 2000[3]. Most of the non-agricultural employed live in countries where the informal economy remains significant. Focusing only on the economic segment, the informal sector employs about 90% of the world's workforce: about 69% of the workforce in Africa, 64% in Asia and the Pacific, 51% in the Arab States, 41% in the Americas, and 25% in Europe and Central Asia [1]. Providing an important basic living, agriculture remains the most dynamic economic sector in developing countries. Nevertheless, across the developing world, informal employment has become a viable economic alternative shaping the transition towards formal economies and increasing economic growth and domestic product [2].

Conceptualizing the Informal Economy

Tax systems fluctuate dramatically across the globe, and many developing countries possess enormous informal economies [3]. The widespread presence of informal enterprises, however, poses a serious challenge for governments, particularly those in developing economies, because these enterprises remain untracked in the economy and often do not adhere to regulations such as taxation, labour laws, and permits [4]. The informal economy comprises a range of activities, ranging from petty vending to street hawking, from domestic servants to sexual workers. One of the common concerns in the literature denoting the informal economy is the issue of taxation [5]. Many working in the informal economy consider formalising their activities to penetrate the economy totally. The literature on taxation of the informal economy generally employs three analytical frameworks. First, the issue of legitimacy constraints represents a conceptual tool to examine issues regarding tax compliance in the informal economy [6]. Second, restrictive due to capacity constraints remains a prominent framework in linking informal economy structures with structure taxation strategies. Third, issues of fairness and equity are of central concern to economists, policy makers, and the broader socio-political community [1]

Definitions and Scope

Informal institutions and transactions operate outside the regulatory capacity of the state. The informal economy encompasses transactions that are generally unregulated and unrecorded by state institutions [2]. The attack on nested markets, or the black markets of climate-change policies, threatens transaction costs under the gravest of all conditions: the one that constitutes the fabric of society itself. Informality reduces complexity [3]. It shorts the chain of transactions between the state and the businesses that lie outside the formal economy i.e., the taxman, safety regulation or the license-dealer are eliminated [4]. A corollary is that the state exhibits both excessive strength, such as repressive measures and inadequate strength, such as taxation, in areas where informality is flourishing [1].

Causes and Dynamics

Taxing the informal economy remains a pressing issue for many developing countries. With informal enterprises providing employment for a large proportion of the population, the dilemma confronting policymakers is how best to align tax systems with the prevailing economic structure [3]. Governments face a further challenge in addressing the legitimacy of tax systems and their perceived fairness, particularly since there is often a significant disparity between the taxes levied on enterprises in the formal sector and those imposed on the considerable number of informal enterprises [4]. In many cases, the informal economy represents a response to complex and often dysfunctional relationships between the state and society. During periods of political upheaval and breakdowns in social contracts, for example, informality may increase significantly [1].

Taxation and State Capacity

Informality manifests in various economic activities [1]. Yet, it frequently denotes unregistered firms operating largely outside the reach of government authorities including tax administrations. The informal economy expressed as a share of GDP or employment is a critical feature of state capacity that systematically influences taxation [2]. These elements lie at the centre of public discourse. The dominant discourse emphasises the economic dimension, specifically the rationale for mobilising resources for infrastructure upgrading. Such resource flows are thought essential not only to facilitate the growth and formalisation of informal businesses but to enhance overall economic growth [3]. Taxation is an essential obligation of the citizenry, and states depend on revenue streams to fulfil their obligations. The informal economy has shown rapid expansion. Governments remain cognizant that activities within this dynamic segment of the economy escape taxation and that revenue foregone from this source compounds existing shortfalls from planned budgets [4]. Furthermore, since taxation emerges at the micro level, resource flow incorporating decisions on the extent, type, structure, and level of tax—is perceived as even more critical than the anything fuelling the economy. During crises, higher consumption taxes trigger exponential growth in informal activity [5]. States have established general principles justifying taxation. Notably, the Organisation for Economic Co-operation and Development contends that taxation secures equitable contribution and discourages tax evasion and avoidance, underscoring the clear separation of the formal economy from both [6]. Where activities fall within clear delineations of the informal economy, taxation cannot be justified since transactions do not constitute part of the macro economy. Without a formal contract establishing the expectation of tax deposit, taxes cannot be imposed in lieu of a comparable fiscal contribution expected from the formal economy [7]. The financial literature has devoted attention to barriers. Clearly evident, from the perspective of compliance costs, government provides towards improving statutes and jurisprudence [8]. Where cost and distortions are excessive interaction with government thus becoming uneconomically large assures [1]. Flows are unlikely to be recorded, hence unreported, and transmission is stored, unexplained, for capital accumulation. Where funds are otherwise deployed and/or accrue into recordable and transferable amounts directed towards formal assets and payments are made, debt assumes priority over taxes [2].

Revenue Imperatives and Fiscal Obligation

The burden of tax is not so crucial as its degree of legitimacy, compliance mechanisms, and fairness especially in the informal sector. Legitimacy refers to the perceived moral rightness of taxation and is linked to social contract theory [3]. Compliance mechanisms specify the actions of different agents or possible government policies that induce compliance and encourage, dissuade, or prevent evasion. Fairness considers tax equity as a guiding design principle [4]. There is strong evidence that perceived legitimacy, when coupled with effective compliance mechanisms and horizontal equity, strongly encourages compliance in the informal sector [1]. The informal economy absorbs more than 80% of the economically active population in low-income countries and is expected to exceed USD 1 trillion [2]. Taxpayer trust in the government and tax collection agencies, government accountability, quality of public services, and availability and accessibility of mechanisms to claim right redresses are important determinants of compliance. With rising revenue demands, emerging and developing economies are seeking to tax both informal enterprises and workers more vigorously [5].

Administrative Barriers and Compliance Costs

Informal sectors arise in developing economies where political stability, strong economic performance and effective justice systems are lacking [6]. The business environment becomes uncertain and the potential for predatory state behavior discourages formalization. Consequently, informal economy activity is higher and margins immediately above zero are common [7]. Tax compliance is therefore low, but nonetheless desired to avoid bureaucratic harassment, reduce uncertainty, enable easier access to government contracts, and enhance other business opportunities [8]. In low-capture environments, reductions in registration, licensing and ongoing compliance costs stimulate higher rates of formalization [7]. Stronger state capacity to enforce protection of rights against arbitrary intervention increases taxes collected on the remaining informal sector; however, the remaining sector is not deviant but reflects attempts to evade a predatory state [1].

Legitimacy and Social Contract

Taxation relies on people's belief in the state's legitimacy. The informal economy raises questions about the legitimacy of taxing informal income. Two important factors affect perceived legitimacy: (i) trust in government institutions and (ii) horizontal fairness [1]. Tax morale and the extent of tax evasion are influenced by general trust in governmental institutions, regulations, public service delivery, and the social contract established between the state and society [2, 3]. Perceptions of trust, fairness, and social capital shape the social contract in society [2]. An authority's overarching institutional framework influences formalization decisions in two ways. General trust in institutions constrains formalization to the greater authority laws and regulations; infringing these leads to civil disobedience, revolution, or anarchy [4]. Compliance depends on states' ability to offer legitimacy through the social contract [5]. Perceptions of fairness regarding whether taxes paid by others is equitably exchanged by resources received by the tax-payer in practice effects cooperation with formalization of income and tax-reporting. A modification of an established fairness-based social contract model that can explain key aspects of compliance also applies to the decision of informal entrepreneurs to either comply with authorities or evade taxes [4].

Perceived Legitimacy of Taxation in Informal Sectors

Taxing the informal economy remains critical for developing countries. Principally, it determines the perceived legitimacy of the state to levy taxes on businesses classified as informal [5]. Given the informal economy's size, public authorities may collect tax revenue without stifling entrepreneurship or self-employment. Yet, policymakers must tread cautiously [6]. Taxing already burdened informal businesses may breed resentment toward the state and dampen formalization prospects. Analysis reveals evidence of informal taxation legitimacy. Regimes that collect taxes from small and micro firms enhance the state's perceived legitimacy to tax the informal sector [7]. These findings shape the evaluation of compliance-enhancing mechanisms [1]. In the Struggling Cities project, perceptions of formal state taxes acquired a polarizing character in the informal business community. Informal entrepreneurs regarded the rates as excessive yet acknowledged the fairness of administration, collection, and distribution [8]. Levying informal taxes at local levels seemed appropriate; 77 percent felt ready to pay for public goods such as health care and road maintenance [5].

Trust, Compliance, and Tax Morality

Tax morale, or intrinsic motivation to pay taxes, can be expressed in terms of five social attitudes: obligation, trust, equity, authority, and public good [6]. Tax compliance is shown to depend on social capital, civic duty, accountability, trust, and informal taxpayers' belief that the tax system treats citizens fairly [7]. A social contract springs from citizens' compliance and the government's legitimate use of revenue. Compliance can increase if the informal economy is not perceived as an area where tax obligations are neglected, if social capital is high, if civic duties are demonstrated through tax compliance, and if tax administration improves and is perceived as fair [8].

Compliance Mechanisms and Policy Tools

As highlighted in taxation has been consistently identified as a mechanism that can diminish informality and enhance fiscal capacity [1]. This section discusses compliance mechanisms that influence tax payment behavior, examining relevant policy tools. It integrates some of the insights regarding the determinants of interactions between tax authorities and informal operators that are articulated in Section [4]. A key policy approach for inducing compliance is the introduction of formalization incentives. Two broad classes of formalization policies have been considered: those that increase the economic returns associated with a formal status and those that reduce the economic returns from informality [5]. While formalization policy remains an appealing compliance mechanism, the record of its successful design and implementation is limited. Another frequently proposed intervention to reduce compliance costs and broaden the tax base is the introduction of simplified tax schemes such as flat-rate presumptive taxes that apply to the turnover of business operators. Evidence suggests that administration through utilities may enhance formalization [6]. A complementary approach to engaging with the informal sector relies on technology, data-sharing arrangements, and alternative interfaces, which offer opportunities to monitor compliance at lower administrative cost [7]. These tools facilitate targeted outreach and communication with operators in the informal economy, often through the existing means of payments linked to formal economic exchanges. Tax authorities frequently establish partnerships with large companies in the formal sector to access these data sources [8].

Formalization Policies and Incentives

Waste, garbage, refuse, rubbish, trash, litter biodead, consumables turned to dead, everyday commodities gone rusty, tagged by decay and rot[3]. Such a commodity is bulky, pushes limits in finance, space, and market itself through dynamic pricing. Commodity of energy in a market of stench [4]. The odour lingers even after wash; hence perpetual disposal becomes a prominent task. Humanity spends noteworthy efforts, time, and resources on such commodities, only to put them out of actual distress. Burgeoning divorcement of thoughts and fancies, mind and intuition, insight and foresight about ubiquitous commodities [5]. The pungent stench alleviates, still leaves behind faint disposition in longing of creation on others' wreckage. Languishing and conflicting nature of who is the creator's caretaker. The deposition matters in its own right; it gives rise to such diverse fancies, when commingling and reacquiring the simplicity in a space, time, or a domain [6]. Urge to find self in such burst of thinking, to outgrow the cliché theme of giving a second birth to trash and rubbish. The fancies in 1- paragraph disposition whilst commuting to classroom provides significant motivation [7]. Formalization of informal taxation is resonant with creation merely on different context; it resonates on a commodity called tax instead of waste. Tax generates ole beside itself, similar to these wastes and bulks. Tax is the primary lawful honour on income, put unto by the constitution consciously by the citizens [1].

Simplified Tax Regimes and Administrative Reforms

Within state administrations, the desire for tax simplification frequently stems from a dual problematic. The first issue entails that taxpayers find it difficult to navigate tax laws or understand their rights and obligations [2]. The second problem is that the public perceives tax systems as overly complex [3]. Apart from data-collection systems based on direct personal or corporate income, simplified tax regimes may also apply to indirect taxes such as value-added tax [1]. Tax simplification has, therefore, become an established component of both tax policy and budgetary planning. Nevertheless, simplicity is resistant to a precise definition. Simplification typically means promoting ease of tax law use and financial compliance, but what makes a system easy and how simplicity can be achieved remain matters of debate [2].

Technology, Data, and Compliance Monitoring

Informal economies are dependent upon a continuing system of monitoring to ensure their compliance with existing tax regulations. Widespread use of technology such as Electronic Fiscal Devices (EFDs) for tax compliance should be embraced to enhance monitoring and revenue collection [4]. These devices enable tracking of tax liabilities in real-time, allowing governments to assert and demonstrate clearer public benefits arising from tax contribution. Transparency in tax compliance is enhanced through validation online, SMS bulletins, and affiliation with service providers through payment receipts [5]. Accounting software, Digital Transaction Monitoring (DTM), and Blockchain technology promise to simplify the collection process and tracking by allowing real-time collection of tax data and information for cross-validation of returns [6]. Government promotional subsidies for fiscalization further encourage self-fiscalization among informal taxpayers by making such services more attractive [7]. Nonetheless, unregulated usage of such technologies may facilitate tax evasion rather than compliance [1].

Fairness and Equity Considerations

Taxation is often thought of as a means for redistributing wealth and reducing inequality, yet taxation in formal or informal settings can exacerbate inequity. Tax policies are hard to sustain when a large share of gross domestic product is produced outside the formal economy [8]. Equity considerations related to informal economic activities therefore take on additional importance. Horizontal equity refers to the principle that taxpayers in equal circumstances should pay the same amount of tax [2]. Some aspects of the informal sector present challenges in assessing fairness in taxing a wide range of activities. Formal companies perceive businesses in the informal sector as benefiting from lower operating costs while still competing with the formal counterparts [1]. On the other hand, the direct social benefit from engaging in the informal sector may be regarded as higher compared to taxes paid there by these taxpayers. Horizontal equity considerations likewise apply to measuring the compliance burden on different types of tax [5]. Vertical equity refers to the principle that taxpayers in unequal circumstances (i.e., capacity of compliance) in a much broader sense include wealth, income, benefits and returns on taxes paid should provide differing amounts of tax [6]. Tax systems across a country's territorial span display consideration of geographic differences in what is expected of compliance versus how much capacity residents maintain, from both individual and corporate perspectives [7]. Distributional matter comes into play when attempting to measure the net beneficiaries of these informal activities, especially on income redistribution, when examining the impacts of formalization. Countries with high levels of informal economic activity could anticipate substantiation in revenues collected and subsequent usage [8].

Horizontal and Vertical Equity in Informal Taxation

Taxing the informal economy has limited direct revenue potential because of low incomes and high collection costs, and raises equity concerns since informal operators are often low-income, making the tax potentially regressive [1]. Taxing small informal sector firms may also increase risks of coercive or corrupt behavior by tax officials, and many experts therefore counsel against targeting small informal firms [2]. Some indirect benefits still justify outreach efforts: bringing small enterprises into the tax net can improve compliance over time, and addressing formal firms' perceptions of unfair treatment helps sustain scarce fiscal capacities [1]. Focusing solely on formal taxation captures only the idealized version of the tax system: informal taxation by state or non-state actors is prevalent in many low-income countries, often surpassing formal tax payments [3]. Moreover, informal taxes tend to be regressive as a share of income and enforced coercively through social or political power [4]. Enforcement can involve harassment or social sanctions like barring access to resources, with severe economic consequences, especially in rural areas [5]. Even formal local government collection in sub-Saharan Africa is often arbitrary and coercive [6]. Informal taxation is not synonymous with corruption or extortion; it can also fund essential public goods such as roads, schools, and water systems when an effective or accountable state is lacking, and sometimes supplements public officials' low salaries [5].

Distributional Impacts of Formalization

Effective taxation of the informal economy can increase the tax base without major distortions and help address difficult trade-offs between equity and efficiency [5]. The distributional effects of formalization are uncertain, particularly for micro firms, but there is substantial evidence that broader economic growth ensues. Many informal operators remain engaged with formalizing agents to avoid harassment, increase predictability, and tap into new opportunities [6]. Because formality is associated with better services at a lower price, actual firm behaviour in Ghana has been to pay taxes even when not legally required [1]. Although taxation of the informal economy may impede growth and disproportionately harm marginal enterprises, it could also foster development and reduce inequities. Studies indicate that compliance incentives operate via public goods, accountability, and ownership. Conversely, there is no clear consensus on the legitimacy of taxing informal operators, particularly micro firms, or the legitimacy of the state itself [7]. Exempting or taxing at a nominal level public goods could support development, while withdrawal at higher tax levels creates deadweight losses and undermines the fiscal basis for public goods [8].

Case Studies and Comparative Perspectives

Comparative perspectives on the role of the informal economy in taxation and state legitimacy indicate a remarkable uniformity across emerging and developed economies [3]. Tax systems geared towards social and economic equity play a key role in offsetting the detrimental effects of the informal economy [4]. Where individual compliance rates within informal sectors are low or perceived legitimacy is lacking, tax and compliance policies generate significant social and economic costs and deter voluntary participation in formalization programs [5]. Inclusion and legitimacy, therefore, occupy an essential position in tax compliance. Where the informal economy dominates, pro-growth structural reforms enhance compliance by broadening the formal tax base and widening the compliance net [6]. Emerging economies generally devote a larger share of total gross domestic product (GDP) to public expenditure than developed economies. Yet the informality of the economy accounts for a larger slice of official GDP, often 60 to 80 percent compared to 30 to 40 percent elsewhere[7]. Public expenditure needs therefore exceed capacity. Informal operators play an indirect role by supporting consumption taxes on downstream activity. Strategies to develop infrastructure and increase the efficiency of the formal sector typically encounter opposition from informal operators [1].

Lessons from Emerging Economies

Taxing the informal economy remains a prominent issue for policymakers and researchers alike. While informal sectors are growing in both developing and developed economies, there have been calls for greater, more effective taxation of these actors [8]. The informal economy has been part of the literature on tax policy and administration for decades, and the need for theoretical and testable propositions remains high [5]. Understanding informality is critical for grasping why taxation remains heavily tilted toward formal actors and recognizing how functional government segments, like integrity and tax administration, affect it [1]. Half of the world's workforce and approximately one-fifth of GDP are considered informal in large emerging economies. Nevertheless, emerging economies with this combination of informal sectors still collect more revenue than many developed economies. An interesting case for tax policy experimentation is India, with its informal economy representing 90 percent of total employment in 1970[2]. The introduction of the Value Added Tax (VAT) system in 2005 and Digital India initiatives in 2015, which aimed to transform India into a digitally empowered society and economy, had little measurable impact on the formalization of informal businesses [3]. The continued weight of the informal sector is partly due to the perception that tax compliance among informal businesses in developing economies is disjointed [4].

Lessons from Developed Economies

Most theories of the informal economy favor the dual economy model, which argues that small businesses primarily complete unofficial, informal transactions in order to evade taxes. Depending on the economy, estimates of informal-sector employment range from less than 2% to over 50% [4]. The phenomenon of informality occurs within an economy already occupying its final bifurcated state, in which taxes and administrative burdens are excessive. Tax compliance and informal taxation are remotely related in developed economies, and, far more importantly, the informal economy is relatively small [5]. Attaining high economic growth leads to significant increases in legitimate tax revenues and, therefore, lower reliance on tax evasion through informal transactions, suggesting that facilitating the shift from ultra-low to low informality would yield large fiscal gains[6]. Finally, developed economies mainly must consider improved tax efficiency rather than the extent to which an early-stage economy has adopted a legitimate revenue regime [1].

Policy Frameworks for Legitimacy and Compliance

Taxation is a mechanism through which societies seek to raise revenue and finance public goods, although inequalities in revenue collection between different economic sectors formal and informal remain an issue. In terms of the equitable distribution of tax obligations and revenues, informal sectors may find themselves at a disadvantage if they are considered illegitimate or viewed as less entitled to access public goods [4]. Addressing inequities between the formal and informal economy requires effective programs to enhance legitimacy and foster compliance [5]. Tax efforts should target informal workers with assistance to promote the transition to formality and expand opportunities and productivity [1]. The informal economy has been a critical topic for many emerging and developing countries, and therefore much comparative research in this area has been conducted [5]. Informality, or the absence of adherence to regulations, is perceived differently across countries and regions. The degree to which informal workers perceive the state as legitimate and the extent of their willingness or desire to endeavour toward formality in collaboration with the state varies significantly [6]. Policy frameworks should be centered on acknowledgment of informal work as a legitimate source of income and enhancement of opportunities for these workers [7]. Instruments employed for targeting informal workers need to include safeguards to guarantee that such workers are not subject to abuse or persecution due to political priority, public distrust, or the absence of a social contract with the state [8]. At a broader level, tax systems should be designed to fit the differing needs of formal and informal firms, and in some cases, policies enshrined in such frameworks may need to be accepted by the formal sector for conciliation between the two[1]. Regimes that target both formal and informal firms highlight the size of the latter and the vast number of micro or non-firm enterprises that remain important to assist and to incorporate into the tax base [2].

Designing Inclusive Tax Systems

Informality remains an obstacle for inclusive tax systems without administrative burdens, excessive compliance costs, or unjust revenue extraction schemes [1]. Recognizing that informal rather than formal economic activity is prevalent prompts the question of how tax regimes might be designed to serve actors engaged in informality, whether as a strategy to incentivize formalization or simply to extract unaccounted-for revenues [2]. Efforts to pursue tax engagement, notwithstanding a simultaneous call to simplify formalization, must nevertheless take account of the desired fiscal, social, and legitimacy objectives of the system under consideration [3].

Safeguards Against Abuse and Evasion

States targeting the informal economy typically intend to increase tax revenues or extend social rights to informal workers and firms, but rather than enhancing the social contract, they risk worsening state-society relations [4]. In every country that has undertaken large-scale tax collection from informality, the informal economy and its businesses and workers have resisted [5]. Collectively, informal tax programs appear to have growing even greater government capacity, and slave revenues slightly larger than those devoted to education or health appear to have been captured [6]. Taxation is an obligation, the head of state protected a territory through taxation, and finance is a precondition to consent of the governed [7]. Recognizing how the informal economy historically co-existed, managed, and contributed to the social contract helps solicit cooperation [8]. In Honduras, Costa Rica, and Uruguay without tax taints such as corruption, arbitrary authority, restrict attention to contributions and escape the legitimacy trap [2]. Governments targeting informality generally neglect this aspect and focus on the unjust withdrawal of contributory rights, forge a more just social contract by financing this commitment through other sources [3]. A few states do not target informality at all, and government legitimacy conditional on non-taxation enables informal enterprises to coalesce, press accountability reforms, and even shape the direction of government programs [2]. Effective fixed-water right systems prevent hijacking of user fees for unrelated activities. Attention to collective-action problems does propel some reform and associational efforts nevertheless rather than stimulate curtailment or capture [1].

CONCLUSION

The informal economy remains one of the most significant challenges confronting modern tax systems, particularly in developing and emerging economies where informal employment and unregistered enterprises account for a substantial proportion of economic activity. While expanding the tax base is essential for increasing public revenue and financing sustainable development, taxation of the informal economy extends beyond fiscal considerations and is fundamentally linked to issues of legitimacy, trust, compliance, and fairness. The evidence reviewed in this study demonstrates that informal economic actors are more likely to comply with tax obligations when governments establish credible institutions, deliver quality public services, ensure transparent tax administration, and apply equitable tax policies. The findings further reveal that coercive taxation and excessive compliance burdens rarely produce sustainable formalization. Instead, they often reinforce distrust in government, encourage continued informality, and weaken the social contract between citizens and the state. Policies that simplify tax procedures, reduce administrative costs, provide incentives for formalization, and employ digital technologies to improve tax administration have shown greater potential for enhancing voluntary compliance while minimizing enforcement costs. However, technological innovations must be accompanied by adequate institutional safeguards, accountability mechanisms, and protections against abuse to maintain public confidence. Fairness also emerges as a central determinant of successful taxation policies. Horizontal and vertical equity are essential for ensuring that taxpayers perceive the tax system as just and proportionate to their economic circumstances. Governments must therefore balance revenue objectives with the need to protect vulnerable informal workers and micro-enterprises from disproportionate tax burdens that may undermine livelihoods and discourage economic participation. Comparative experiences from both emerging and developed economies demonstrate that no universal model exists for taxing the informal economy. Successful reforms are highly context-dependent and require adaptation to local institutional capacity, governance quality, political conditions, and socioeconomic realities. Inclusive policy frameworks that recognize informal economic activities, encourage gradual formalization, strengthen taxpayer trust, and improve public accountability are more likely to achieve sustainable compliance than approaches focused primarily on enforcement. Ultimately, effective taxation of the informal economy depends not merely on expanding tax collection but on strengthening the relationship between citizens and the state. Building institutional legitimacy, promoting fairness, reducing compliance barriers, and ensuring that tax revenues translate into visible public goods and services are fundamental to improving voluntary compliance and supporting long-term economic growth. A balanced, inclusive, and trust-based approach to informal economy taxation therefore offers the greatest opportunity to enhance fiscal capacity while fostering equitable and sustainable development.

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