

MSME Tax Simplification – Can it Tackle Informality?

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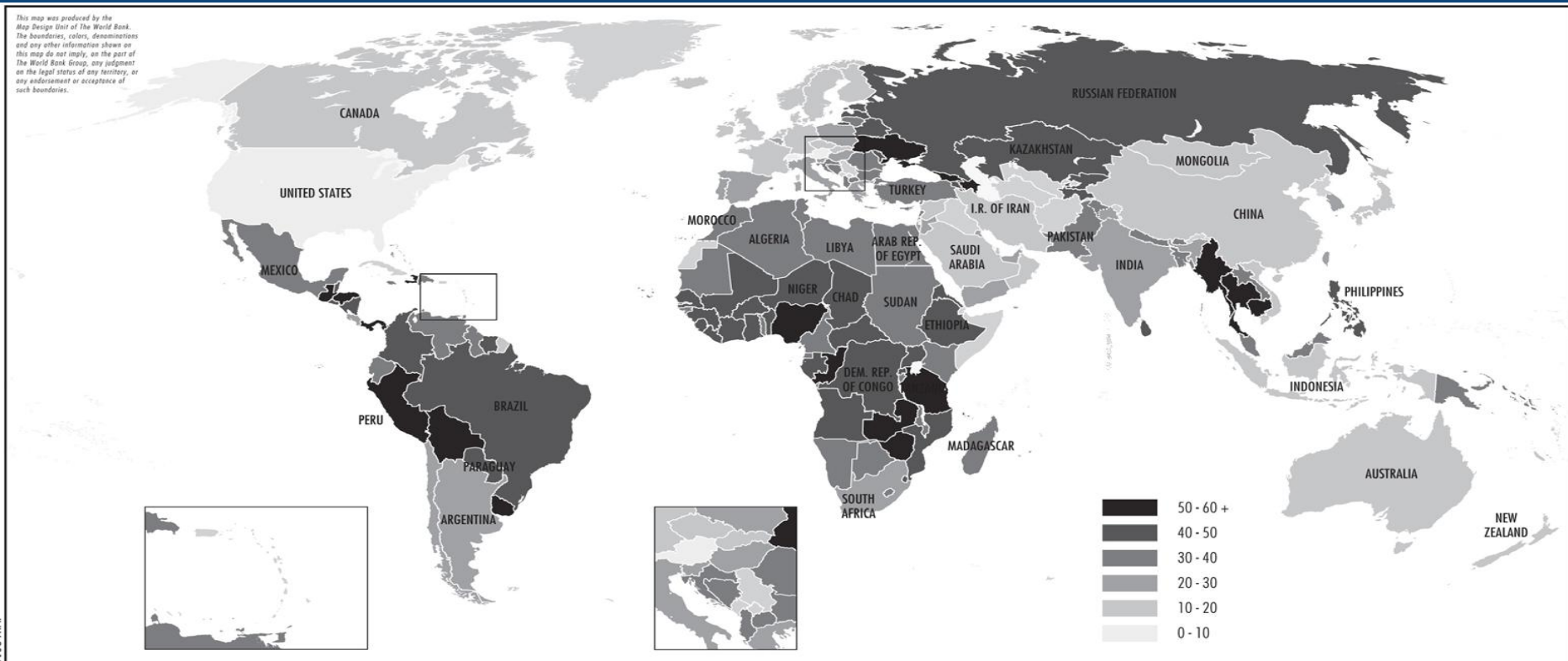
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2. Policy options and administrative solutions

Why focus on Small Business Taxation (SBT)?

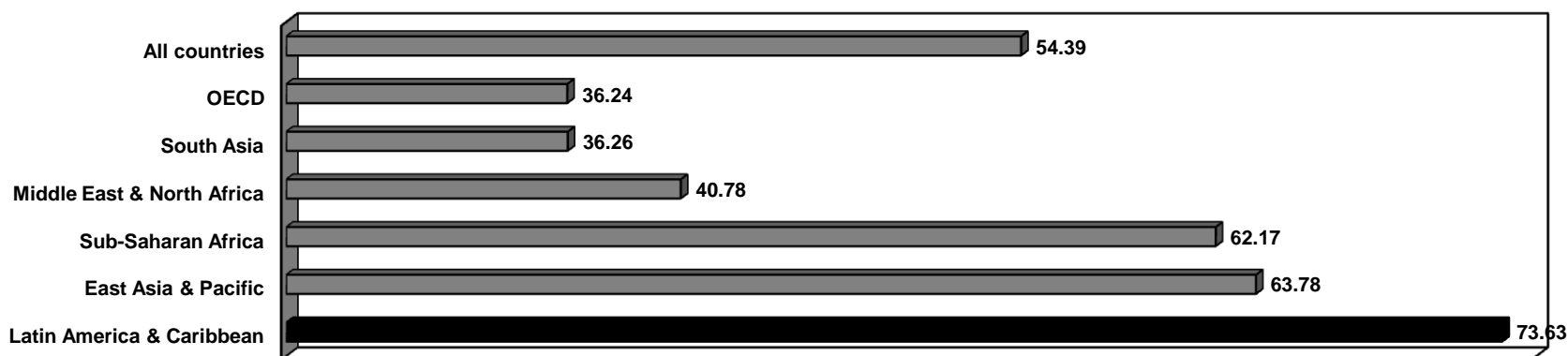
- Informality/ enterprise formalization and MSME growth
- Diagnostic studies on formalization decisions → SBT as an “entry point”

„A World View of Informality“ (Schneider/Buehn/Montenegro 2010, p. 35)

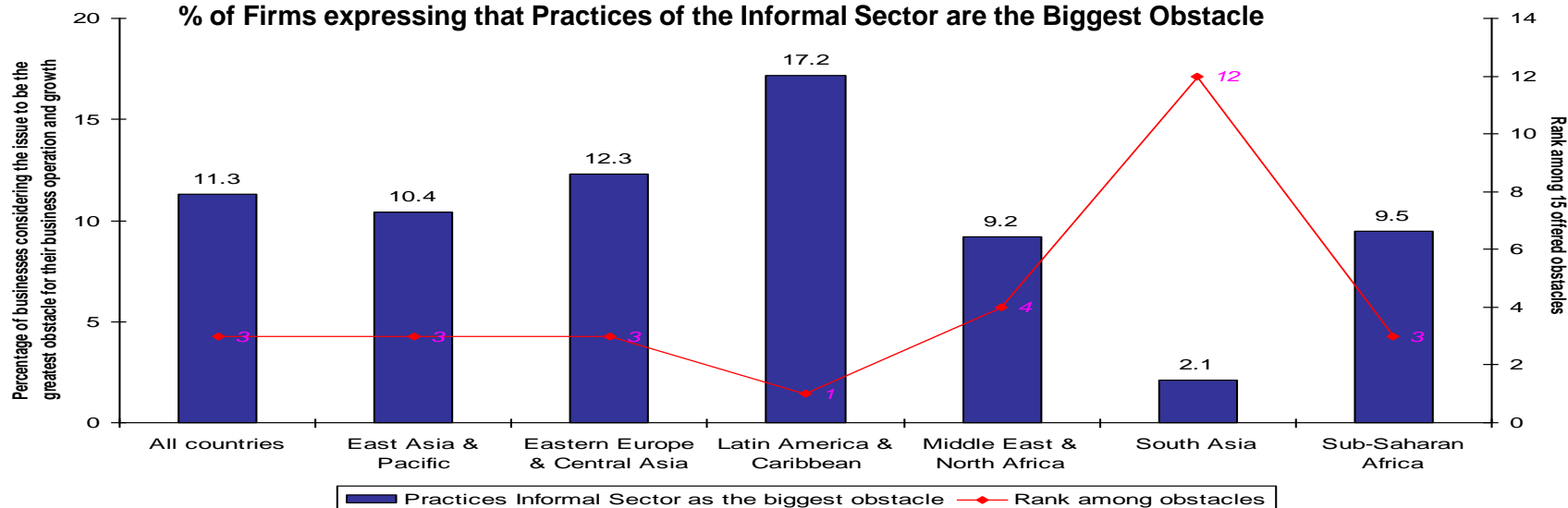


But it is not just about registering informal businesses...

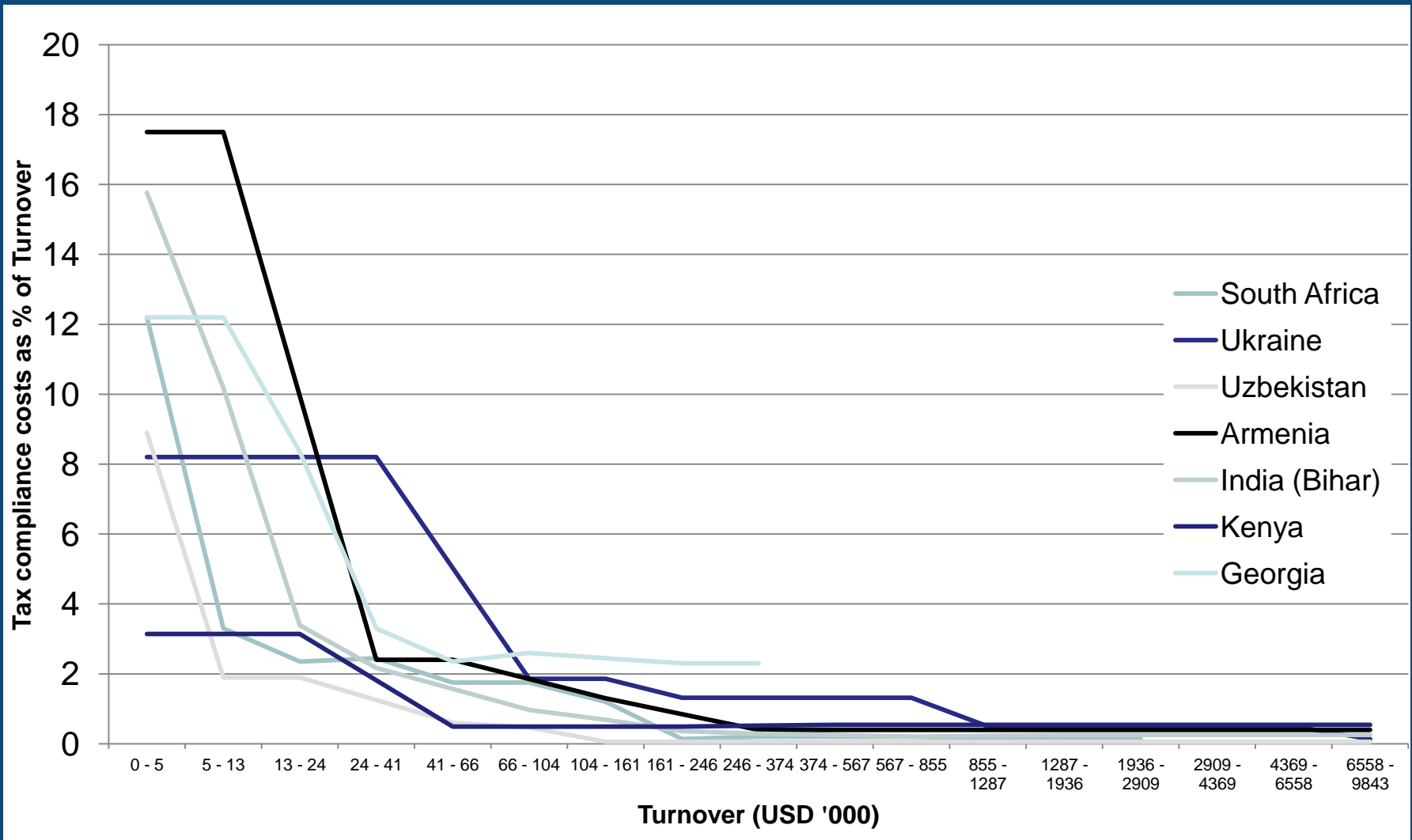
% of Firms expressing that a Typical Firm Reports less than 100% of Sales for Tax Purposes



% of Firms expressing that Practices of the Informal Sector are the Biggest Obstacle



Tax compliance costs are particularly significant for MSEs



Source: Tax Compliance Cost Surveys, WBG Investment Climate Dept, Selected Countries 2007-1011

When the “cost” of formalization is too high...



- Businesses stay out of the formal economy and can get a “free-ride”
- However: more risks, fewer opportunities (esp. access to finance)
- Serious limitations to business growth...
- Spurs vicious cycle of “squeezing” the few compliers => ticket price ↗
- Government is not reaching revenue potential

The burden of administering small business?!

- Number of businesses in the small taxpayer category continues to grow, highly dynamic segment
- With increasing importance of service sector number of high income MSEs on the rise
- How to maximize efficiency in allocation of (scarce) resources?
 - Cost of administering small taxpayers might outweigh (short term) revenues raised
- But is MSME taxation just about revenue? – The Tax and Development Agenda:
 - Creating a “culture of taxation” and regularizing of the rule of law and legitimacy of the state
 - Encourage taxpayers to hold government accountable
 - To promote MSME growth

There are actual benefits of MSME tax compliance

- The risk of tax inspections, both formal and informal, is significantly reduced: less likelihood of having to pay bribes to stay out of tax net
- Gets rid of limitations to business growth...need to split firms and business to stay below a threshold turnover, for example...
- Greater opportunities to access formal (i.e., bank) finance
- Opportunities to get government contracts – usually restricted to tax-registered entities
- In a VAT regime, small un-VAT-registered firms lose business opportunities
- MSME taxation a good instrument to strengthen local government and foster links between the local small business community and the local government
- In the medium/long run, higher tax revenues for the government

2. Policy options and administrative solutions:

- What does this mean for Small Business Taxation?

2. What does this mean for Small Business Taxation?

■ The overall objective is a SBT regime:

- With minimal compliance and administrative costs
- Closely aligned to the general tax regime
- Ideally based on taxpayer self-assessment and risk based verification by the tax-authority

■ But, it's a balancing act...

- Simplicity of a blunt turnover instrument vs. fairness of simplifying the general regime
- Simplified instruments are a second best solution and come with many trade-offs

A quick summary of pros and cons of taxing MSMEs differently

Why?

- SMEs role in fostering innovation and growth
- Compensating for Market failures/ financing constraint
- Fixed cost component of tax compliance + Cost of administering small contributors
- Simplicity can help close avenues for corruption

Why not?

- Can be a disincentive to growth
- Better to address distortions directly
- Threshold effects: Inverted U shape of effective rates
- Distortions can become a source of corruption

There are important regional differences

Region	# Countries analyzed	Countries operating presumptive regimes
European Union	21	8
ECA region	19	16
The Americas	19	16
Africa	25	23

Transition countries: presumptive systems, primarily based on turnover, in almost all countries

Latin America: primarily turnover / gross income based regimes for micro and small businesses (in some countries limited to micro businesses)

Africa: primarily turnover based presumptive systems for MSEs below the VAT threshold

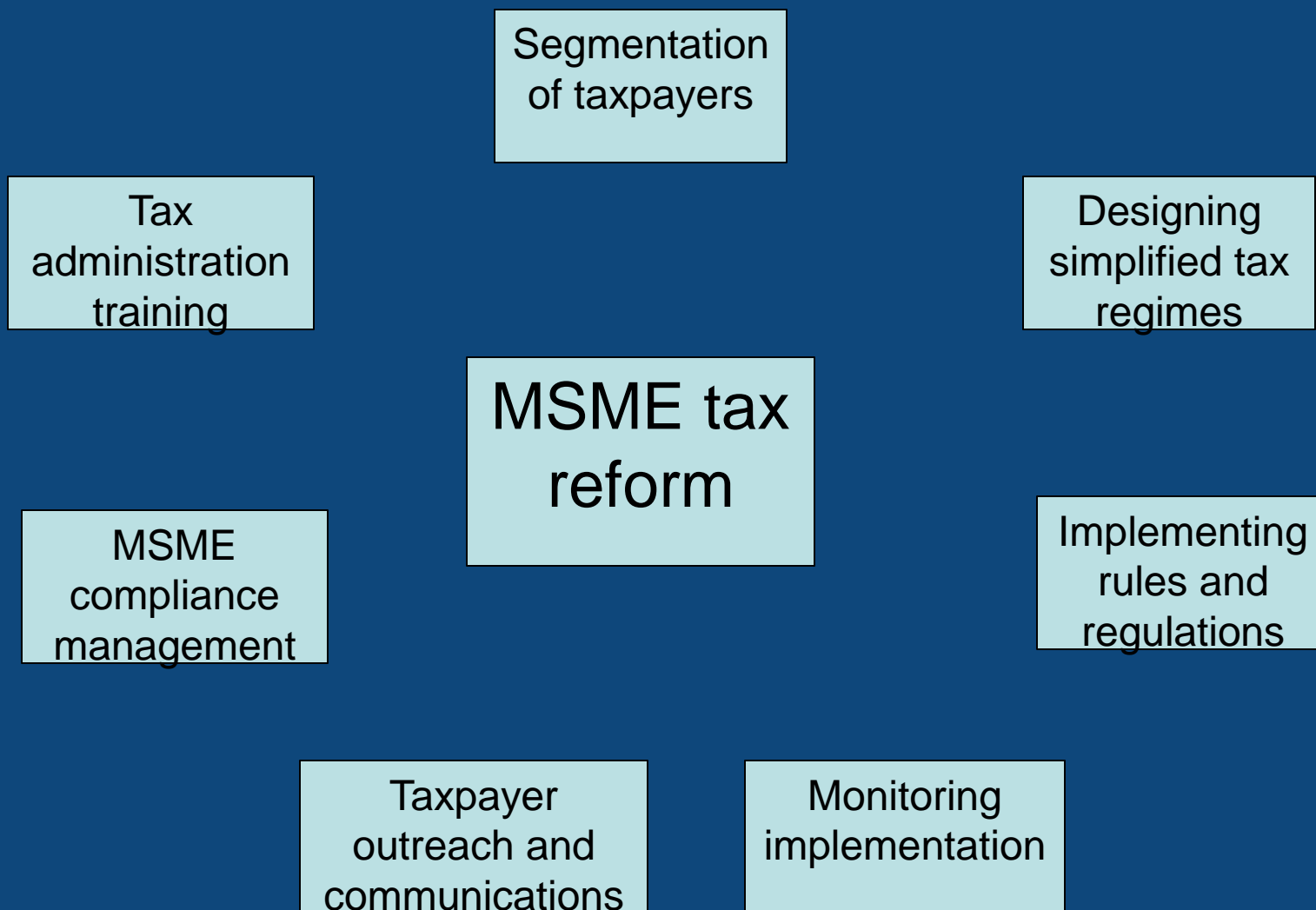
A wide range of tax treatment of MSMEs

- From very simple patent taxes to full application of standard regime
- From high VAT registration threshold to no threshold at all
- From exemption of micro businesses from taxation to uniform treatment of all MSEs.
- From substituting income taxes only to covering social security contributions (Brazil, Argentina, Uruguay)
- Inclusion (Peru, Brazil) or exclusion (Argentina, Colombia) of small legal entities from presumptive tax regimes?

But also on the administrative side:

- From practically exempting most MSEs from tax audit (Korea, Germany) to comprehensive audit coverage (some FSU countries)

The basic building blocks of MSME tax reform



The devil is in the detail: SBT regime design options and challenges

1. Simplification of gen. regime

- Simplification of tax forms, filing and payment process, alignment of payments
- Reduced direct tax rates
- VAT simplification for SMEs

2. Special regimes

a. Presumptive tax to replace income tax (+VAT)

b. Single (presumptive) tax replacing all other taxes

■ What is “small”? No universal definition

■ How should the system be designed to avoid both over- and under-taxation of MSMEs?

■ What kind of safeguards are required to avoid abuse of system by larger businesses?

■ How to align the MSME regime with the standard tax regime?

■ System must be perceived as fair and transparent

■ How to provide incentives for keeping proper books and records?

■ What assistance to MSMEs is required to facilitate voluntary compliance with the regime?

■ How to reduce the administrative burden for the tax administration?



1. Turnover based

2. Indicator based

3. Combined turnover and indicator based tax

A whole range of issues/approaches: Examples

Georgia

Bold reforms but high compliance burden and little compliance among micro and small businesses

Kyrgyz Republic, Kazakhstan:

Misaligned thresholds; downward migration, widespread abuse

Yemen

Record keeping based on taxpayer capacity. Tax payments for almost all taxpayers outside the LTO negotiated

Sierra Leone

One size fits all? ► inappropriate tax treatment + accounting requirements; Administration squeezing the wrong end

Lao PDR

No official records, skewed audit focus; win-win for admin and tp

Vietnam

A hugely complex “simplified” system

Strengthening MSME regimes: Our work to support reforms

- Evaluating/strengthening policy options - Learning from (regional) success stories and mistakes
 - Disaggregation SMEs and setting adequate thresholds between micro, small, medium, VAT
 - Determining profit margins and setting appropriate rates
 - Building-in linkages between taxation, licensing and business registration fees; Linking costs and benefits of formalization —offering carrots
 - Integrating small businesses into the reform process!
- “Smart” enforcement and outreach - Supporting the establishment of dedicated administrative approaches/structures for MSME taxation
- Specialized MSME service and information program supporting self-assessment of SME tax
- Risk based MSME audit programs (designing fallback indicators, focus on outliers)
- Technology – potential and limitations

Main Lessons Learned

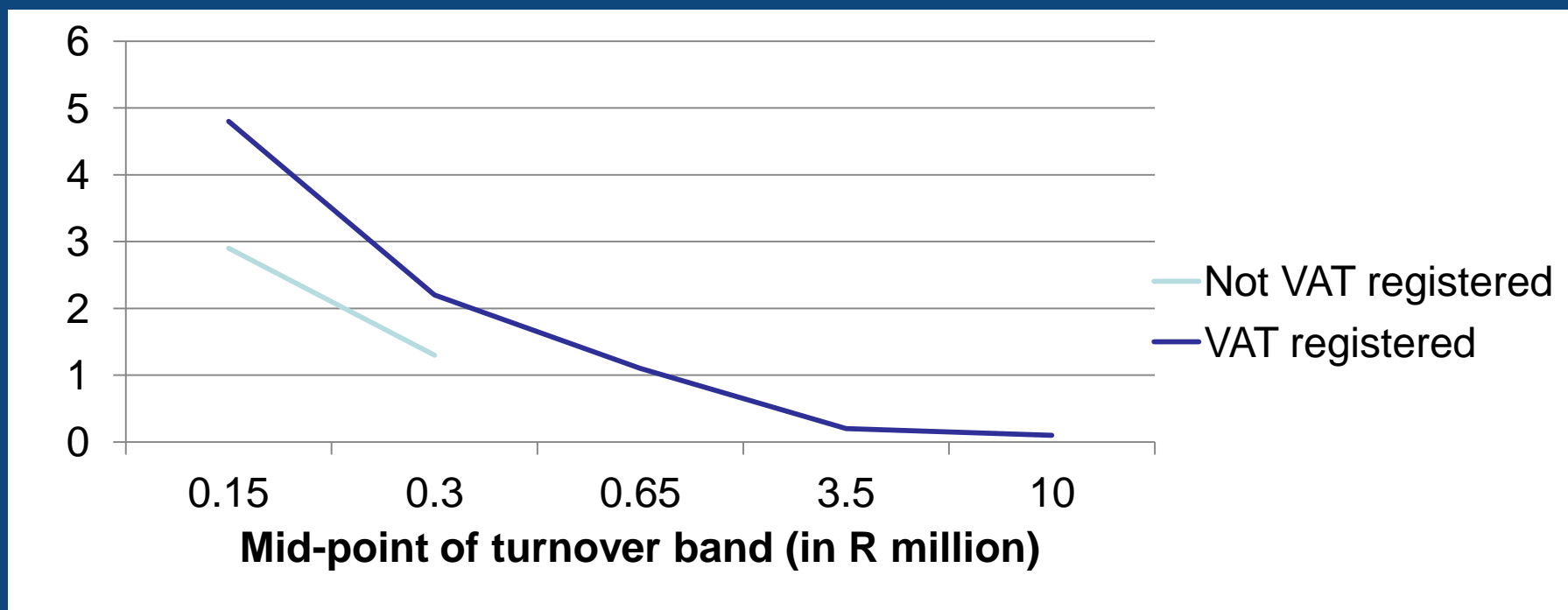
- Ministries of Finance generally are pushing MSME tax reforms much more than tax administrations. But tax administration management needs to be involved early in the reform process.
- System abuse by larger businesses is major problem in many client countries. Need policy and administrative countermeasures.
- Lack of reliable data considerably complicates fallback indicator design. More research and analysis early in the system design process necessary.
- Refining good practice examples is required: not only how have other countries done it, but also why have they done it in a particular way.
- Refining approach to estimating turnover based on indicators and profit margins based on turnover
- Developing guidelines for MSME tax accounting design

Some examples

- South Africa
- Bihar
- Georgia
- Kyrgyz Republic

VAT is a Main Element of High Compliance Costs in South Africa

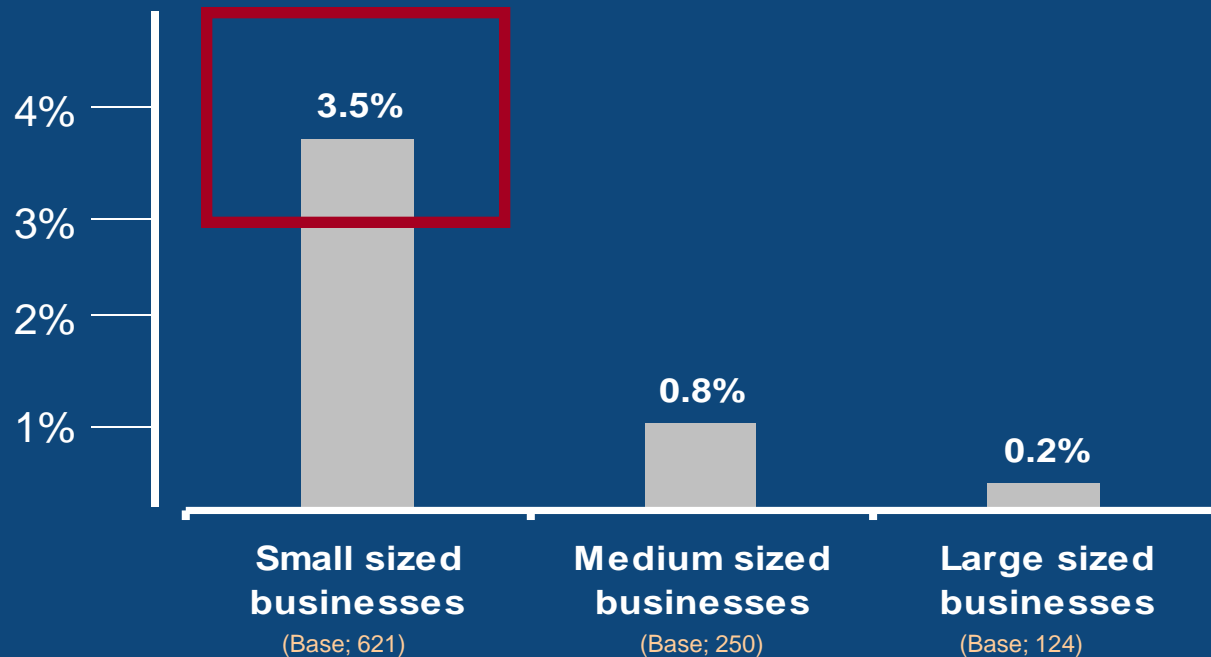
- Compliance costs as % of turnover for small businesses in South Africa



- Source: FIAS, Tax Compliance Burden for Small Businesses: A Survey of Tax Practitioners in South Africa, 2007

Bihar, India: Compliance cost burden is much higher for MSMEs

VAT cost as a percentage of turnover; Base- 1003



Cost of compliance, as a percentage of turnover significantly higher for small businesses

The small taxpayers contribute *less than 1%*

- 81% of the dealers have turnover below Rs. 50 lakh, and contribute just **0.87 per cent** of VAT collected (2007-08 data)

Turnover	No. of dealers	% of total dealers	Tax deposited (Rs.crore)	% of total tax
below 50 lakh	35058	81	30	0.87
50 lakh- 1 crore	2932	7	21	0.61
1-2 crore	2161	5	34	1.00
2-5 crore	1412	3	60	1.78
5-10 crore	555	1	59	1.73
above 10 crore	1009	2	3191	94.01
Total	43127	100	3394	100

Note that VAT payment of Rs. 62,500 implies a turnover of Rs. 50 lakh (applicable rate 12.5%, gross margin 10%)

Simplified regime for small taxpayers

- Recommended lump-sum, flat tax payment:
 - Single slab of small taxpayers, defined as those with turnovers below Rs. 4 million
 - Lump sum tax payment – Rs. 10,000 per annum
 - Payment in one or two installments at the option of the taxpayer
 - No input tax credit allowed
 - Optional scheme
 - Implemented April 2011 (start of fiscal year)
- Result: As of March 2012, 4580 new taxpayers registered *and paid the due tax*

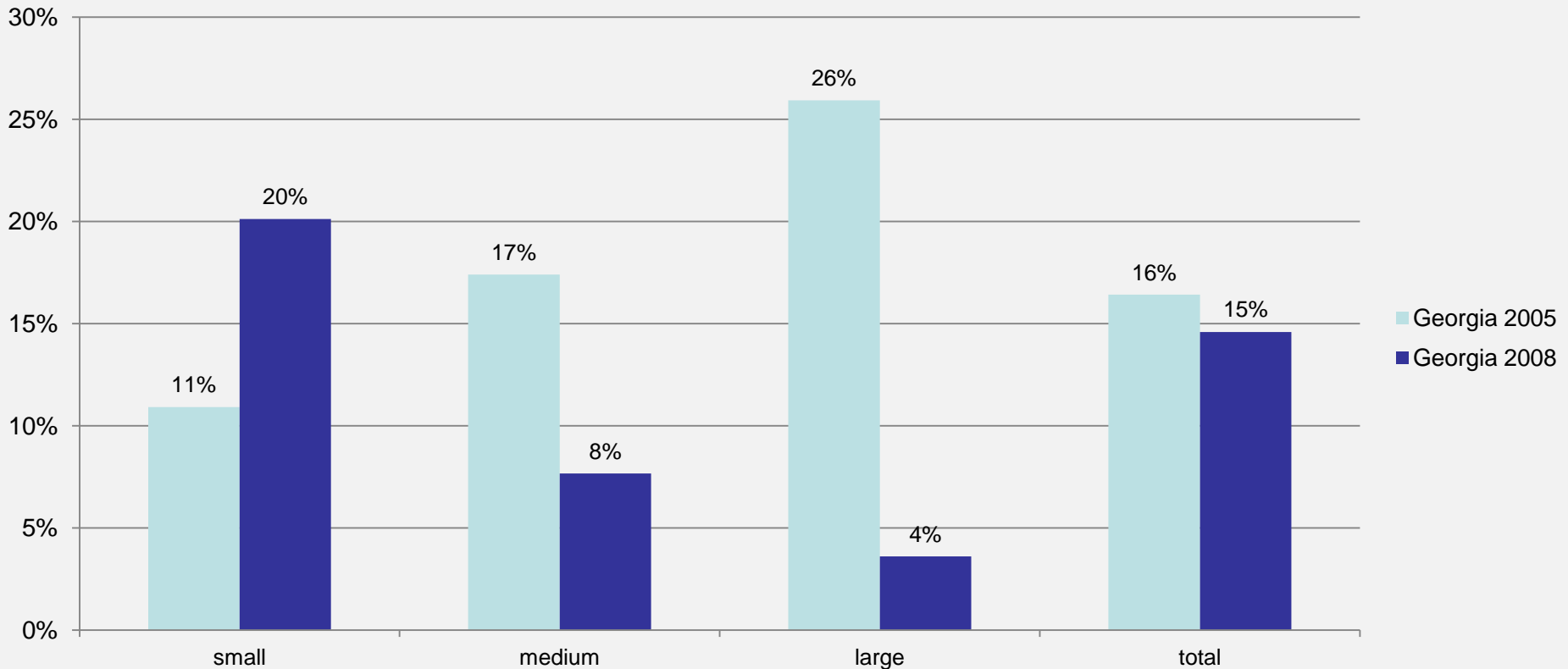
*Assumptions: Margin 8%; tax rate from 4% - 12.5%

MSMEs in Georgia: 1st Reforms missed 80% of Georgian entrepreneurs

Significant improvements in 2005, but not for small firms

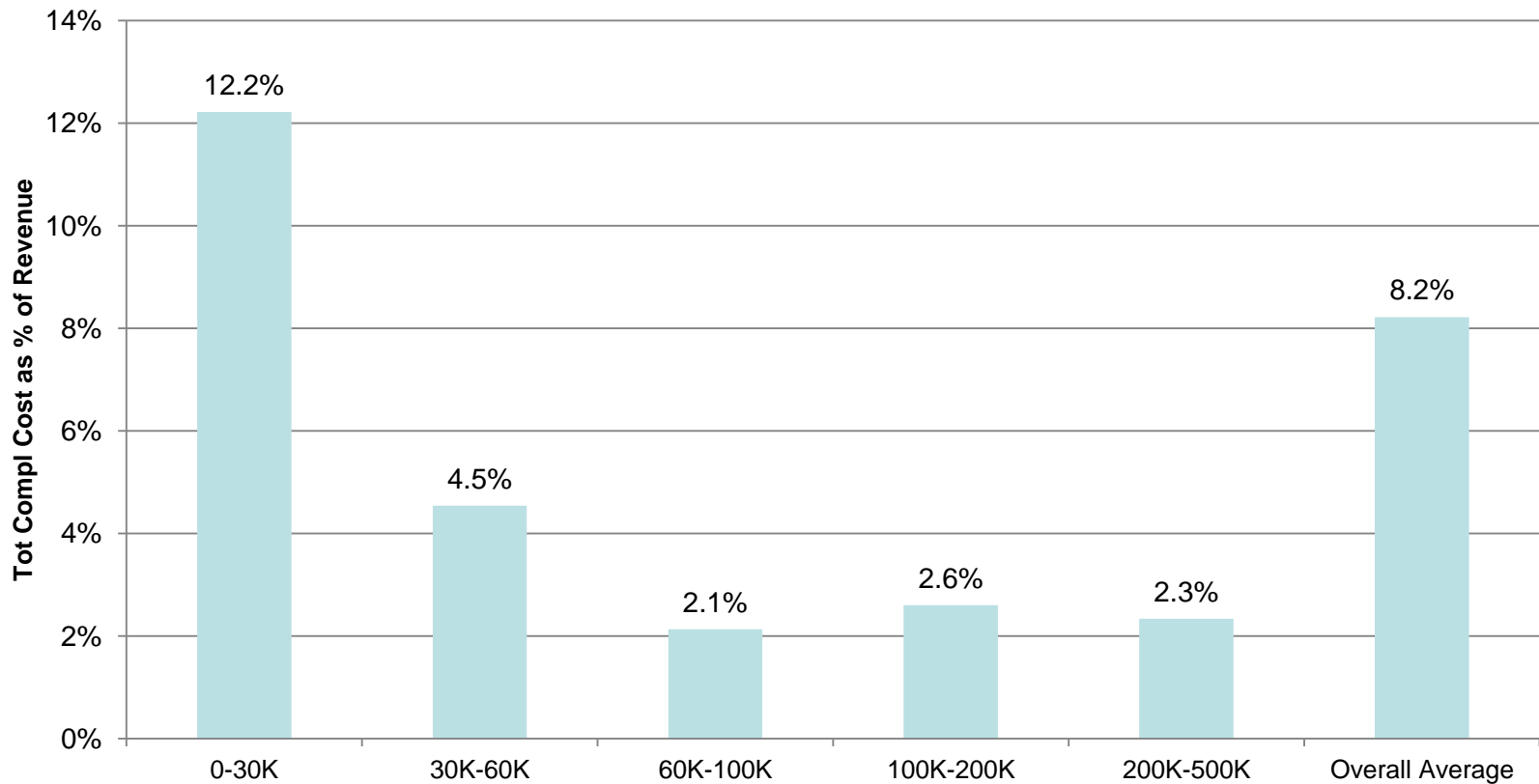
Share of Firms Who Rated Tax Administration as a Major Obstacle to Their Businesses

(Source: Enterprise Survey 2008)



Smaller Firms Pay Larger Portion of Their Revenues in Compliance Costs

Annual Tax Compliance Costs as Percent of Gross Annual Revenue, Average by Revenue Group



New taxation regimes

Micro Business	<ul style="list-style-type: none">- Turnover below 30,000 GEL- Physical persons only- No hired labor- Certain activities excluded- separate income derived from each activity	Tax exempt
Small Business	<ul style="list-style-type: none">- Turnover between 30,000 and 100,000 GEL- Physical person only- No VAT registration- Certain activities excluded	Turnover based presumptive tax 3% rate if documented expenses (excluding salaries) equal to at least 60% of gross income 5% in other cases

Challenges

- Encourage micro businesses to voluntarily register
- Ensure proper turnover reporting of small businesses
- Develop proper risk analysis system to detect major underreporting by small businesses
- Introduce fallback system for small businesses not keeping any books and records
- Develop very simple system for identification of micro businesses which should move to the small business category.

Risk based audit selection for MSMEs – Example from the Kyrgyz Republic

Audit selection in the Kyrgyz Republic:

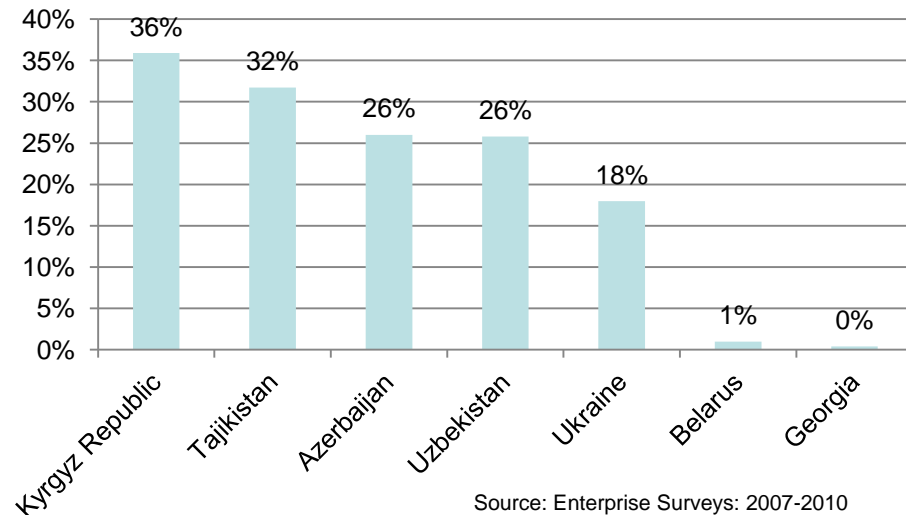
- Discretionary decision making at local offices as a source of rent-seeking
- Low capacity within Tax authority (IT and audit departments)
- Limited data available and few tax offices connected to central server

■ Project developed risk criteria (and weights/scores) based on available information and software for administration of audit process.

Reported audit coverage in the Kyrgyz Republic



% of firms reported that informal payments are requested during tax inspections



Fewer, more targeted and transparent audits



- RBA software provides web-based access to local tax offices through the STS web site
- Main functions
 - Segment and sector based analysis of taxpayer risks
 - Generation of audit plan based on risk assessment (HQ)
 - Internal administration of audits
 - Audit notice
 - Monitoring of audits
 - Depository of audit materials
 - Quality control and monitoring of staff

Thank you for your attention!