Small Business Taxation: Is this the Key to Formalization?

Evidence from Africa and Possible Solutions

This paper argues that SME taxation regimes in Africa have been key contributors to firms’ decision to operate informally. This conclusion is based on the results of both modeling the “weight” of the tax burden on SMEs and on surveys of policy-related sources of informality in Africa. The information from these empirical investigations suggests guidelines for redesigning SME tax regimes and adjusting related policies to reduce the disincentive to enter the culture of compliance. This paper will present the results of these studies and highlights key challenges to encourage formalization using a reformed tax program.

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I. Background

Tax is a central parameter defining the business climate and to political accountability mechanisms. Yet most technical assistance has been aimed at implementing revenue generating mechanisms (short-run) with little attention on the effects of the system on investment and economic growth (long-run), or on deepening political stability on which the culture of compliance, investment climate and growth depend. At the same time, tax practitioners agree that a central long term goal of tax policy is to broaden the base to produce more sources of revenue and ultimately to reduce the burden for individual taxpayers, and to strengthen political accountability processes. In developing countries, the OECD estimates that only 5% of taxable base complies with fiscal obligations. Thus, governments rely on this narrow base to provide the revenues needed; as a result, financial and time burdens to comply with these obligations are heavy and provide a strong disincentive to investment and formal operation. Therefore, by streamlining tax systems, governments can lower the barriers for firms to participate, encourage foreign and domestic formal investment, widen the tax base, and set the conditions necessary to lower the per-business burden.

FIAS-DFID’s diagnostic studies in 13 countries over the past 2 years confirm results found in DB and ICA: a business-enabling tax environment still eludes most developing countries. Even the countries which have in place appropriate instruments calibrated at appropriate rates, the administration of these regimes becomes an onerous financial and time barrier for businesses. Our studies show that the technical assistance provided in the past has focused on revenue generation, a short-run goal, and not revenue growth over time which happens through investment and PSD.

In addition, one missing piece in the development of an effective tax system which promotes investment—not discourages investment—is the effective treatment of SMEs; few countries have an effective SME tax system which is integrated fully into the general tax system and which encourages graduation. Although any tax reform should help businesses of all sizes, the largest un-tapped source of taxpayers in all developing countries is SMEs; most tax practitioners both international experts and country authorities agree that this particular issue is both pressing and yet unresolved. Thus, broadening the tax base is a key component for improving the investment climate in developing countries and may not generate more revenues in the short run, but will in the long run as firms grow. Broadening the tax base therefore is a key intermediary stage of
improving governance and political development essential for improving the investment climate in developing countries.\textsuperscript{1} Addressing the “tax base gap” explicitly links political economy to the investment climate: a fiscal policy for economic growth requires political leadership and electoral support. Although this approach is appropriate for all developing countries, frontier economies in particular will gain the most returns from the proposed interventions.

Fixing the SME tax issue is critical to fixing the business climate in general. First, especially in frontier economies, SMEs both formal and informal constitute 80-90 percent of the workforce and over 50 percent of GDP on average. Thus, the key source of economic growth from within is the SME sector, as is the source of tax net widening. Second, one foundation of SME tax design is that it is a subset of the general tax system. Therefore, if the SME tax system involves streamlining both policy and administration, it will require streamlining the general tax system as well; otherwise, there is a risk of large firms breaking up into SMEs.

II. Pieces of Evidence: what we know about SME tax regimes

This investigation relied on two different analytical tools: marginal effective tax rate analysis and surveys of informal economic activity and behavior in Africa.

Measuring the weight of the tax system on SMEs: a snapshot of the METR tool. Over the past 2 years, FIAS and DFID conducted qualitative measurement of the relative weight of the tax burden by sector in 10 African countries. The measurement relied on Marginal Effective Tax Rate (METR) analysis to determine the relative tax burden between sectors, and the relative tax burden compared to comparator countries. The concept of a marginal effective tax rate (METR) was created to analyze in a single measure how investment decisions are affected by the large number of provisions of the business and individual income tax systems, as well as by features of any property and wealth taxes, sales taxes including VAT, customs duties, and special incentive regimes such as tax holidays, that affect the incentives to invest. The primary goal of an METR analysis is thus to describe this net effect of a tax system on investment incentives in a straightforward and intuitively appealing form.

In all 11 country analyses in African countries, the measured weight of the tax system faced by SMEs (outside of the VAT net) was higher than every sector of the economy subject to the general tax regime (see table 1). This result suggests that the design of SME tax systems, i.e., SME tax systems as they stand on the books is biased against SMEs relative to the general tax system.

\textsuperscript{1} DAC GOVNET workstream on taxation and National Accountability 2007; Mick Moore et al 2007;
Table 1. A sample of METR results comparing SME tax burden to that of large enterprises in selected African countries, 2006
(in percent)

<table>
<thead>
<tr>
<th>Country/Sector</th>
<th>Manufacturing</th>
<th>Tourism</th>
<th>Agriculture</th>
<th>Finance</th>
<th>Mining</th>
<th>SME (no VAT)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Zambia</td>
<td>5</td>
<td>5</td>
<td>10</td>
<td>30</td>
<td>0</td>
<td>25</td>
</tr>
<tr>
<td>Rwanda</td>
<td>29</td>
<td>14</td>
<td>7</td>
<td>38</td>
<td>15</td>
<td>34-51</td>
</tr>
<tr>
<td>Madagascar</td>
<td>24</td>
<td>14</td>
<td>15</td>
<td>29</td>
<td>11</td>
<td>60</td>
</tr>
<tr>
<td>Tanzania</td>
<td>15</td>
<td>15</td>
<td>20</td>
<td>29</td>
<td>23</td>
<td>30-32</td>
</tr>
<tr>
<td>South Africa</td>
<td>27</td>
<td>28</td>
<td>23</td>
<td>31</td>
<td>10</td>
<td>22-32</td>
</tr>
</tbody>
</table>

Source: FIAS tax reports, 2006

Additionally, surveys of compliance costs for SMEs reveal that to time and financial burden of complying with tax reporting (again, as it is proscribed by law) is higher for small firms and decreases dramatically as firm size grow.

Figure 1: Compliance Burden for preparation of tax returns affect small enterprises disproportionately in South Africa

Given that current tax regimes are neither designed nor executed to minimize the cost to SMEs to comply, it is not surprising that tax is a key contributor to firms’ decisions to operate informally.

III. Tax and Informality

To analyze this link further, FIAS conducted a series of surveys of informal and partially formal entrepreneurs in Rwanda, Sierra Leone, Liberia and Madagascar to study the causes of informality and to identify possible approaches to encourage greater formalization. Some of the relevant results are summarized below:

**Firm perceptions on advantages/disadvantages of formalizing their operations**

Interviewed firms are well aware of the benefits and disadvantages of operating in the informal or formal economy. Not surprisingly, avoidance of income tax, compliance costs, and social contributions are identified as the main advantages of being informal. Yet, firms are also cognizant of the cost stemming from tax avoidance. In Madagascar, more than 50% of informal respondents highlighted limited market access as the second most important disadvantage of operating informally (seconded only by fear of government repression) and informal Rwandan firms see limited access to finance as the key constraint of their status\(^2\). Moreover, entrepreneurs pointed to important direct costs of staying informal. In Liberia, over 60% of respondents who have begun to formalize were driven by the desire to avoid high unofficial ‘payments’ needed to maintain their informal status. Overall, informal firms and partially formal firms in the surveyed countries agree that formal firms are in a better situation.

\(^2\) However, access to finance was not a major factor when partially formal enterprises were asked explain reasons for their decision to formalize. Just over 30% of partially formal enterprises have applied for loans in the last 2 years, compared to fewer than 10% of informal enterprises. Becoming more formal is likely to have a positive impact but does not resolve financing problems.
Information alone can go a long way to encourage enterprise formalization.
The survey results from all four countries show that the majority of completely informal businesses are not well informed about formalization steps. About 36% of completely informal Sierra Leonean businesses know nothing about the formalization procedures in their area of business, and another 40% only know a few details. Similarly, less than 1 out of 3 firms are well informed about necessary formalization steps in Madagascar. Only 6.2% of surveyed Liberian businesses know exactly what to do to formalize.
Figure 3: Almost half of the respondents in Madagascar have little or no knowledge about steps and procedures necessary to become formal.


In Sierra Leone, most of the businesses in the sample which moved to the formal economy in the past did so because information on the required procedures became available. Moreover, in Rwanda most interviewed enterprises which recently formalized their operations say they realized that taxes are not too high and tax administration is fair. These findings strongly suggest that providing better information alone can go a long way to encourage enterprise formalization.

**Burdensome procedures deter SME formalization**

The survey findings confirm that formalization is deterred by expensive and administratively burdensome procedures. In Sierra Leone one-quarter of completely informal businesses have attempted to become formal by at least actively collecting necessary information about the required procedures. The businesses attribute this failure to formalize to expensive (27%) and complicated (26%) procedures and lack of information (22%). Similarly, almost every other completely informal Liberian business has tried and failed to formalize because of too expensive (24.9%) and complicated (22.7%) procedures. In Madagascar the potential for voluntary formalization is highest with more than half of the informal respondents claiming that they have tried to become more formal. Again, the largest share of these firms stopped their formalization attempts because of high costs of these procedures (40%).

Figure 4: Reasons for failed formalization attempts in Liberia
The importance of tax reform to encourage enterprise formalization

Participation in the tax net is the most critical step in the formalization process. The surveys results in all four countries show that the tax regime is one of the key drivers of informality. Most surveyed businesses claim to operate informally because of the tax system and those who stated few chances of considering formalization would re-consider their stance if taxes were reduced and tax incentives provided.

Businesses in Sierra Leone say that they decide to operate informally mostly due to licensing and tax issues, and lack of information on how to formalize. 75% of interviewed businesses see the tax burden and administration or lack of information as a main driver of informality. Even though some of Sierra Leone’s tax policies, such as imputed taxes based on revenues and profits imposed on unregistered businesses, were designed to broaden the tax base and bring informal enterprises into the formal economy, the arbitrary way in which these taxes are assessed may have the opposite effect, and prevent small businesses from moving to the formal economy.

Similarly, and despite the set-up of a simplified tax regime for small and medium enterprises (SMEs)\(^3\), high taxes are the principal reason for tax avoidance in Liberia, where 68.3% of respondents identified high tax rates as the main reason for their not paying taxes. Lack of information (38.7%), weak enforcement (38.2%), and the number of inspections (21.9%) follow as other barriers to compliance with the tax regime. In both countries roughly four out of five respondents who are skeptical about their chances of

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\(^3\) An annual flat fee system of three categories is available for petty traders depending on the nature of their business operation. Enterprises with annual revenue between LD200,000 and 5,000,000 (about USD 3,200 - 80,000) pay a 4% revenue tax.
formalizing would consider formalization if taxes were lower, followed in importance by a general reduction of the administrative burden (51.1% in Liberia). When asked what additional government actions would increase their chances of formalizing, the majority of Sierra Leonean businesses (56%) stated that they would seriously consider becoming formal if information on the procedures required became more freely available. About 37% of businesses would formalize if tax rates/administration was improved, and 34% if administrative barriers were reduced. A reduced fiscal burden were more prominent in Liberia, with 42.9% saying it is the single most important formalization incentive, and in Madagascar where 67% would consider formalizing with a reduced tax burden.

**Figure 5.** Four out of five informal Liberian businesses who are skeptical about their chances of formalizing would consider formalization if taxes were lower.

IV. What the data imply for re-design of an effective SME tax regime which does not discourage formalization

Because small businesses will not be a major source of revenue for the government, the traditional cost-recovery requirement for a tax system will never be achieved by even the most efficient SME tax system, which is why most developing county governments pay little attention to such SME tax systems as they are seen as resource drains. One conclusion drawn from the empirical work is that perhaps the goal of SME tax system should be broadened beyond simple cost-recovery to include the benefits of having more formalized firms in the economy. Many studies have been carried out demonstrating the benefits of formalization and shown that activities in the informal sector are less productive than formal ones. Firms in the informal sector are extremely sensitive to the business climate, grow more slowly, and generate fewer jobs. They are market-constrained (they cannot take government contracts), potentially resource-constrained (they can only access finance in the informal market and cannot participate in donor-funded projects), and are likely unable to participate in capacity building programs. Yet, formalization may not always be appropriate. For those involved in subsistence activities the benefits of being regulated may be comparatively small. A small business taxation reform therefore targets enterprises that are likely to benefit significantly from obtaining formal status, through accessing new markets and financial services, and security of tenure and investments.

The following section presents key challenges and some design options for SME tax system reform.

A. General design elements and challenges

1. Administrative capacity determines “best practice” for SME design. It is standard development jargon that there are no silver bullets. Of course, this holds especially true for the design of SME tax regimes. First, country specifics and legal tradition require individual solutions. Secondly, and more importantly, successful tax regimes are less dependent on the design of the right instruments than on the quality of tax administration. A badly designed, but well administered SME tax is preferable to a well designed but poorly run regime. To a large extend the design of the regime therefore needs to be guided by the quality of institutions in place. “Best international practice” may often be incompatible with institutional capacities and second or third best options have to be pursued.

2. Eliminating SME systems as “stand-alones” and creating a wholly integrated SME regime? Reform measures for SMEs in more developed economies are usually integrated into the general tax regime offering simplified options for SMEs complying with the general system. In

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4 Studies show that, on average in a given industry, informal companies are three times less productive than formal ones (McKinsey Global Institute). See: Palmade (2005)
developing countries with high levels of informality a more drastic departure from the general system to encourage SME formalization may be justified. Instead of making income or sales tax compliance less burdensome the introduction of a single tax not only for micro-enterprises could be pursued. Such an approach may seem particularly useful in countries with numerous small nuisance taxes. Having said that, there might be a special case made for SMEs with capacity to join the VAT regime. For those eligible SMEs, it is worth considering the implementation of a special (subset) VAT regime. A relatively high VAT threshold is preferable to reduce compliance and administrative costs. SMEs below the threshold should be allowed to opt into the VAT system, if they desire, to avoid inordinately high METRs on capital. A transitional regime based on turnover, with a notional recognition of VAT paid on inputs, between tax exempt status and full participation, is desirable.

3. The right balance between fairness and simplicity An ideal SME taxation scheme can be monitored with minimal effort, is easily measurable, and reduces reporting and bookkeeping requirements. The most drastic reform of the SME taxation is the introduction of a single presumptive tax. Such systems are usually based on turnover or on specific indicators (i.e. floor space, number of employees, electricity consumption). Presumptive regimes trade fairness for simplicity. Indicators are usually very crude proxies for business profitability and turnover based systems are burdensome for firms with low profit margins and generous for those with high margins. (Engelschalk 2007) Accordingly, constructing appropriate indicators or setting an appropriate tax rate for turnover based presumptive systems is challenging, requires extensive analysis of profit margins, and will usually be disputed by parts of the business community.

4. Avoid skewed incentives and align SME and standard tax system A lower tax burden under a presumptive system can provide a disincentive for SMEs to grow out of the regime and an incentive for larger firms to reorganize operations in order to participate in the simplified scheme. Furthermore, many employees in Eastern Europe became self-employed under the presumptive system to avoid income tax and social security contributions. (Engelschalk 2005). Accordingly, it is crucial for any SME tax regime to include safeguards against abuses and to ensure that it is favourable for firms at the threshold of the SME regime to join the general tax system (for example by using progressive rates).

5. Linking costs and benefits of formalization—offering a carrot in addition to the tax stick Even though resources and capacities are often overstretched, it is important to emphasize that sometimes small carrots might be sufficient to convince entrepreneurs of the benefits of being formal—perhaps underwritten initially by the donor community. In this context, it is essential to understand that benefits of formalization are specific to sectors of activity. For many small and medium traders access to credit can be the primary reason for
entering the formal sector. For small scale miners, on the other hand, a means to store money (access to savings accounts) and a reliable claim to their mining parcel might be reason enough to get a mining license and comply with tax requirements. For small and medium agricultural producers, training to meet product standards for export markets alone might justify paying registration fees and taxes. A small business forum can provide a chance for informal entrepreneurs to engage in a dialogue and might help building trust between entrepreneurs and state officials.

6. **Associated with the above, the provision of information and training must be a part of the SME regime** In order to create the desired effect, SME tax reforms need to be accompanied by the provision of information and basic business services such as bookkeeping and marketing. The facilitation of tax compliance should therefore be combined with the delivery of services to firms. These services can include information on access to (micro-) finance and to markets, support accessing government programs, entrepreneurship training on accounting/financial management, facilitation of business associations, quality control, networking and, most importantly, education and information to small scale entrepreneurs.

7. **Linkages between SME taxation and licensing and business registration and even licensing and fees** The central goal of small business taxation reform is to facilitate SME participation in the formal economy and build a culture of compliance. Yet, minimizing compliance cost to maximize compliance goes beyond taxation issues. Other start-up and operations procedures (business licensing, labor regulations) similarly affect a firm’s compliance burden and thus drive the decision to operate formally. Accordingly, reforms in other areas are necessary to complement improvements in SME taxation. A related issue is whether SME tax simplification can also encompass licensing and fees to lower compliance cost for fiscal and regulatory burden. This important topic is an area for further research.

**B. Administration**

Given the significant resource constraints facing most revenue authorities in African countries, it is clear that priority must be given to larger taxpayers because they are the major source of tax revenue. In this regard, the creation of large taxpayer units within the revenue authority is common, and has been quite effective. However, after large taxpayer units are up and running, revenue authorities should turn their attention to SMEs, perhaps by creating a small business tax unit to focus on small business tax compliance issues, especially to the extent that they cause informality. This unit should concentrate on outreach and education on tax issues as well as improving functional administration. In particular, Terkper (2003) suggests that a tax accounting unit should be separated from the audit and enforcement units to make internal control procedures effective. Moreover, the headquarters should include small business activities in its planning, control, and
feedback processes to ensure optimum utilization of scarce resources. In addition to coordinating and supervising operations for a cluster of small offices, regional offices can be used as processing centers and to organize special teams to implement more advanced enforcement programs (e.g., special audits and investigations).

V. Conclusion

The empirical results tell us that SME tax systems need to be designed in such a way as to minimize compliance cost and maximize accessibility. Reform of SME tax systems designed would then need to require compliance commensurate to capacity. It is clear that such a system is unlikely to be cost-effective from an administration standpoint, but perhaps, if the aim of the tax system were broadened to reduce informality (i.e.; widen the culture of compliance by widening the tax net), the net cost to the economy be offset by the well-known benefits of formalization.
References


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