Business Taxation: Is this the Key to Formalization?

Evidence from Africa and Possible Solutions

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I. Why do we bother trying to tax SMEs?

II. Empirical evidence on the shortcomings of SME taxation in Africa:
   - “Weight” of the tax burden + compliance costs
   - Firms’ perceptions of barriers to formalization

III. Guidelines for redesigning SME tax regimes
But are we doing the right balance sheet calculation?

The facts:

• Given experience in even middle income countries, the financial cost of administering an SME tax regime outweighs the short term revenues raised

• SMEs don’t see benefits of formality beyond reducing sidepayments to tax officials

...so maybe it’s time to think about reframing the goals of SME taxation through a political economy lens and adding in the benefits of formalization from a long-term growth perspective
Back to First Principles: Shifting lenses to deal with SME tax

Traditional Revenue Goal
• Raise Revenue for government expenditure

Development/Growth Goals
• Create a “culture of taxation”
• Regularization of the rule of law
• To increase the size of the formal sector
• To promote growth
Broad tax base critical for:

- **Fiscal social contract** – a responsive and accountable government strengthens legitimacy and encourages tax compliance. This in turn generates the tax revenue necessary to deliver services.

- **State legitimacy** - essential for sustainable growth

- **Accountability** – only when governments need to raise revenue, requiring bargaining with citizenry/private sector (“no taxation without representation”)}
# METRs in Selected AFR Countries

(Data from DFID-FIAS Studies 2006, category avgs)

<table>
<thead>
<tr>
<th>Country Sector</th>
<th>Manuf</th>
<th>Tourism</th>
<th>AG</th>
<th>Fin</th>
<th>Min</th>
<th>Small Business (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
Compliance Burden for preparation of tax returns as a percent of turnover (firms registered/not registered for VAT; mandatory at R300,000)
Estimated percentage of South African businesses deciding to stay informal

- R1 - R300 000: 60.3%
- R300 001 - R1 000 000: 33.2%
- R1 000 001 - R6 000 000: 18.0%
- R6 000 001 - R14 000 000: 11.8%
- R14 000 001 and above: 8.4%
High potential for voluntary formalization:

- Madagascar: > 50% of informal respondents highlighted “limited market access” as a disadvantage
- In Liberia: formalization driven by the desire to avoid high unofficial ‘payments’ to stay informal.
- Overall, informal firms agree that formal firms are in a better situation
Information alone can go a long way to encourage enterprise formalization...

Almost half of the respondents in Madagascar have little or no knowledge about steps and procedures necessary to become formalized.

**Sierra Leone:**
- 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.

**Liberia:**
- Only 6.2% of surveyed Liberian businesses know exactly what to do to formalize.
The importance of tax reform to encourage enterprise formalization

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

Stimulations for a decision to formalize

Respondents not likely to formalize

<table>
<thead>
<tr>
<th>Stimulus</th>
<th>Most important stimulant</th>
<th>Top 3 stimulants</th>
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<tbody>
<tr>
<td>Reduced taxes</td>
<td>81.2</td>
<td>81.2</td>
</tr>
<tr>
<td>Reduced administrative burdens</td>
<td>51.1</td>
<td>51.1</td>
</tr>
<tr>
<td>Reduced cost of formal labor less restrictive labor regulat.</td>
<td>32.1</td>
<td>32.1</td>
</tr>
<tr>
<td>Increased transparency of all procedures/start up requirem.</td>
<td>35.3</td>
<td>35.3</td>
</tr>
<tr>
<td>More transparent administrative requirements</td>
<td>35.3</td>
<td>35.3</td>
</tr>
<tr>
<td>Tax incentives (at least for some period)</td>
<td>30.1</td>
<td></td>
</tr>
<tr>
<td>Increased gov't pressure</td>
<td>15.8</td>
<td>15.8</td>
</tr>
<tr>
<td>Increased costs of informality (penalties)</td>
<td>8.3</td>
<td>8.3</td>
</tr>
<tr>
<td>Other (please specify)</td>
<td>1.5</td>
<td>1.5</td>
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Respondents may consider formalization if certain incentives are provided, such as reduced taxes and administrative burdens.
A complete balance sheet

Revenue Authority Balance Sheet

Cost of administration $\leq$ Revenues + Benefits of Formalization (State building)

SME Balance Sheet

Cost of compliance $\leq$ benefits of Formalization
Emerging consensus on importance of SME taxation and useful tools

• ITD Conference on the Taxation of Small and Medium Enterprises (Oct 2007): Reduce the SME compliance burden, provide effective services, and reform administrative structures for SMEs.

Reform tools:
• Simple instruments: (turnover tax, cash flow accounting)
• Self-assessment (SMEs) and risk-based assessment (Revenue authorities)
• Rewards for more sophisticated accounting (lower rates?)
• Training, training, training,
• Information, information, information
General design elements for implementation and new solutions

Implementation on both sides of the street

- **For the SME**, the system has to be simple, easy to comply with, and accompanied by capacity building (includes training and information on benefits of formalization)
- System has to encourage growth of business (need advantages to graduation)

- **For the authorities**, the system must not require disproportionate administration
- A small taxpayer unit, donor funded, to focus on SME issues?
How could a system look like?

**Design Options:**

1. Simplification of general regime for SMEs
   - Reduced direct tax rates
   - VAT simplification for SMEs
   - Simplified tax returns

2. Special regimes for SMEs
   - a. Presumptive tax replacing CIT (+VAT)
   - b. Single (presumptive) tax replacing all other taxes

**Turnover system**

<table>
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<th>Indicator based system</th>
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<tbody>
<tr>
<td>a. Uniform tax rate</td>
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<tr>
<td>b. Progressive turnover-based tax</td>
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<tr>
<td>c. Different tax for different sectors</td>
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**Combined turnover/indicator based tax**

<table>
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<th>Turnover system</th>
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<tr>
<td>a. Turnover system with added indicators to counter tax evasion.</td>
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- For small firms: A single presumptive tax based on turnover, replacing all other fiscal levies.
- Micro-enterprises would only be required to pay a one-time fee per year and medium sized firms to comply with the general system.
- Administrative solutions (central vs. local) to anchor the small business tax depend on the quality of local administration.

Source: Engelschalk 2007
But we’re still facing many complex implementation challenges

• **The right balance between fairness and simplicity**

• **Avoid skewed incentives and align SME and standard tax system**

• **Linking costs and benefits of formalization—offering a carrot in addition to the tax stick**

• **Linkages between SME taxation and licensing and business registration and even licensing and fees**

• **Administrative burden of payroll taxes and social contributions…**