

OpenSpace Report on

Title/Topic of the Session:

Tax reforms to encourage formalization and growth

2) Person suggesting Topic & Group Participants

(Name of the convener: Jackie Coolidge)

Other participants: Mikkel Klim, Peter Silenga, Mario Berrias, Chisanga Kashoki, Ernest Chirwa, Aly Mbaye, Nancy Benjamin, Chupa Mwere, Aminur Rahman, Ezamo Maponde

3) Summary of Discussion

There was a view that tax policy and administration are major factors influencing the decisions of businesses regarding formalization. Businesses are often afraid of paying taxes (both in terms of the amounts of tax and in terms of complex compliance requirements), and hide from tax officials, which often requires that they remain informal. Some governments are trying to introduce reforms, especially simplified business tax regimes, that will encourage formalization. This is usually a challenge, as governments' goals in relation to business taxes pull in different directions. They want revenue, they want a broad tax base and high levels of compliance; the business community wants low tax burdens (both tax payments and tax compliance burdens), simpler ways to file and pay taxes and a level playing field. But micro-enterprises are notoriously "hard to tax" because they are sometimes hard to find and usually rely on cash transactions and do not keep or provide good records of their transactions. Some sectors and /or geographic locations are left out entirely; others are "preyed upon" by tax officials who may be trying to fulfil a specific revenue target. There are several different "small business tax regimes" but they all have problems of one sort or another. There is not yet a clear sense of "best practice" although there are many experiments that we all hope will be well researched, analyzed and documented for "lessons learned". What works in one setting might not work well in another setting – there is no "one size fits all."

4) Conclusions

One person suggested this group should stay in communication and share experiences and information (including reports about actual reforms that have been enacted and tested).

It is probably good practice to avoid trying to subject "survivalist" businesses (those below the poverty level or below the threshold for personal income tax) to national level taxes. They are already usually paying VAT when they buy inputs. For those somewhat larger, there is often merit in trying to offer simplified taxes that are not too onerous to encourage them to participate in the formal economy. Those who aspire to sell to larger, established businesses are often motivated to formalize (i.e., register for tax and often even VAT) in order to take advantage of more business opportunities.

Examples of simplified business tax regimes include a turnover tax (instead of profit tax, e.g., as in South Africa) or flat fees based on a particular sector (e.g., daily small flat tax for mini-buses in Zambia). There are significant trade-offs of benefits and drawbacks to all different schemes, and some will be more appropriate than others depending on the circumstances (e.g., capacity of entrepreneurs, capacity of tax administrations). Both examples cited seemed to be suffering from a lack of awareness on the part of the intended beneficiaries, which points to the need for more outreach and education. Both could probably also benefit from more input from the intended beneficiaries to fine-tune their attributes.

We all agreed it would be very beneficial to undertake more empirical research, especially to assess different simplified regimes in regard to the goals they were designed to achieve, and to share information across countries. This should include estimates of the marginal effective tax rate on businesses (the combined effect of most tax instruments, deductions, incentives, etc.), tax compliance costs (the cost to businesses of preparing and paying their taxes, etc.) and the revenues received by governments (as well as related measures of business growth in terms of numbers of businesses registered for tax and their performance). It would also be helpful to understand the perceptions of informal businesses about tax compliance – is it reasonable? Is it fair? Do they see tax revenues put to good use to

provide public services?

Existing literature can be found (inter alia) on the web-site of the International Tax Dialog (www.itd.org) and the World Bank Group Investment Climate Department: www.fias.net [publications] ["by topic"] ["business taxation"]. We should try to ensure we get more "case studies" to share in order to help identify what approaches (e.g., types of small business tax regimes) seem to be "good practice" to encourage formalization and business growth.

Cape Town, 15 April 2010