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# **SME Taxation: SMEs – Specific Problems and Opportunities**

## **On-going Reforms and Challenges**

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June 20th, 2007

# **SMEs – Specific Problems and Opportunities**

**Where does taxation fit in?**

# Motivation

- **SMEs represent 80-90 percent of the work force, most are informal.**
- **Main source of broadening the taxable base**
- **Government sees inclusion of these operators as essential to state-building (culture of compliance). Externality ?**
- **No coherent policy for SME taxation**
  - **no system tried yet for which compliance cost for the administrator justifies the application of the tax code.**

# Motivation

- **Administration of SME taxes is erratic and does not produce substantial revenue individually, but collectively they can.**
- **SMEs chose to operate outside of the tax net because**
  - 1) they can and
  - 2) because there is no incentive (measured in time and financial cost) to comply and not enough disincentive to formalize as well
- **As a result, there's a chicken and egg problem: tax practitioners know that SME should be taxed, and want to do so, but don't know how; SMEs (from our informality work) would prefer to be in the tax net but see it as being too costly.**

# Compliance Costs hurt SMEs the most: e.g. New Zealand

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Size of firm (Turnover \$)	Overall average compliance costs as percent of turnover
<b>&lt; 30,000</b>	<b>13.4</b>
30,000 – 100,000	6.5
100,000 – 250,000	4.2
250,000 – 500,000	2.4
500,000 – 1 million	1.5
1 million – 2 million	1.2
2 million – 10 million	0.4
10 million – 50 million	0.09
more than 50 million	0.03

- **In the US too it is a big problem. Compliance Cost (Time + Money) for businesses with total receipts of less than \$10,000 is of the same magnitude as the total receipts.**
- **In developing countries this is one of the causes for SMEs not becoming formal i.e. avoid the extra expenses of compliance.**
- **All the more reason to make the system simple for them.**
- **Should Small Business be treated the same way as Big Business**
  - **small business face much higher cost of finance**

# Why is it so hard to develop a good system to appropriately tax SMEs?

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- **Low levels of capacity and infrastructure to create and administer, and strengthen a tax regime**
- **Weak information base to administer taxes**
- **Shifting Tax base: movement of firms in and out of the informal sector**
- **and revenue authorities have neither the resources nor the motivation to concentrate on SMEs for revenue generation**

# Informality: the key SME issue

- In developed economies, most SMEs are formalized; specific reform measures include simplification and reduction in compliance burden.
- In developing economies the task is more difficult in that SMEs are not generally compliant (through ignorance as well as intent) nor are they easily located by the tax administration. Most operate within the informal sector

# Obstacles to Taxing SMEs in the Informal Sector

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- **Inconspicuous to tax administration.**
- **Largely cash businesses – inadequate accounting records and audit trail.**
- **Complicated tax systems and numerous processes (licensing etc.) make it difficult and expensive for start-up firms to act in good faith.**
- **In developing countries, SMEs are rarely excluded from the tax base but are rarely properly attended to by the RAs.**
- **Presumptive taxes proliferate – their incentive effects are not well thought out.**

## **and, weak tax administration for SMEs compound the problem**

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- **Revenue authorities have neither the resources nor the incentive to focus on SMEs**
- **As a result, firms tell us the application of the tax laws are variable and inconsistent at best**
- **Firms complain refunds (eg: for overpayment of presumptive taxes) rarely come and usually not without an audit.**

# What is being done so far?

# Quick Wins for SME Taxation

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- **Simplification of tax forms**
- **Simplification of filing and payment process**
- **Simplification of tax registration**
- **Alignment of tax payments**
- **Clarification of tax regulations**
  
- **Thats the easy part ...**

- **Simplify and streamline our normal tax regime**
- **Any regime to be implemented should not become a “refuge” where small business stagnates – there must be sufficient incentive for small business to want to “outgrow”**
- **Instead of presumptive taxation, maybe a single tax along the lines of a “business license”**

## **Next Steps – More Diagnostics, Research & Implementation**

# Plans in the works

- 1. Work to filter out best practice for countries by region**
- 2. Pilot program together with consortium of donors to design and implement tax systems for SMEs with a transition mechanism to standard tax regime (Africa, MENA ?)**
- 3. Implementation program to be rolled out in concert with other programs (SME business registration? Customs?)**

# Who can do Implementation?

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## Possible Solutions, all requiring inter-donor coordination

- Together with the IMF and the IFC/WBG, implement SME taxation schemes based on country experience
- Design information dissemination and sensitization programs for SME tax policy
- A radical idea: implement a Small Business Tax Unit (like the LTUs) to focus on SME issues
- SME taxation as a possible sub-national tax ?

# Responses: Q&A