

FIAS

THE MULTI-DONOR INVESTMENT
CLIMATE ADVISORY SERVICE
OF THE WORLD BANK GROUP

Small Business Taxation

Encouraging compliance of small firms in developing countries, FIAS' experience

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Introduction: Taxing SMEs properly is vital to growth

■ Focus of taxation: raising revenue

- Cost of administering small taxpayers outweighs short term revenues raised... ► Small taxpayers neglected

■ But, taxation of small firms is critical bc of:

- Long term revenue increase from wider tax base
- Growth potential of small firms (effects of formalization: access to markets, finance)
- Political economy implications (fiscal social contract)

The economic and social costs of informality need to be included
(+ administrative costs can be reduced...)

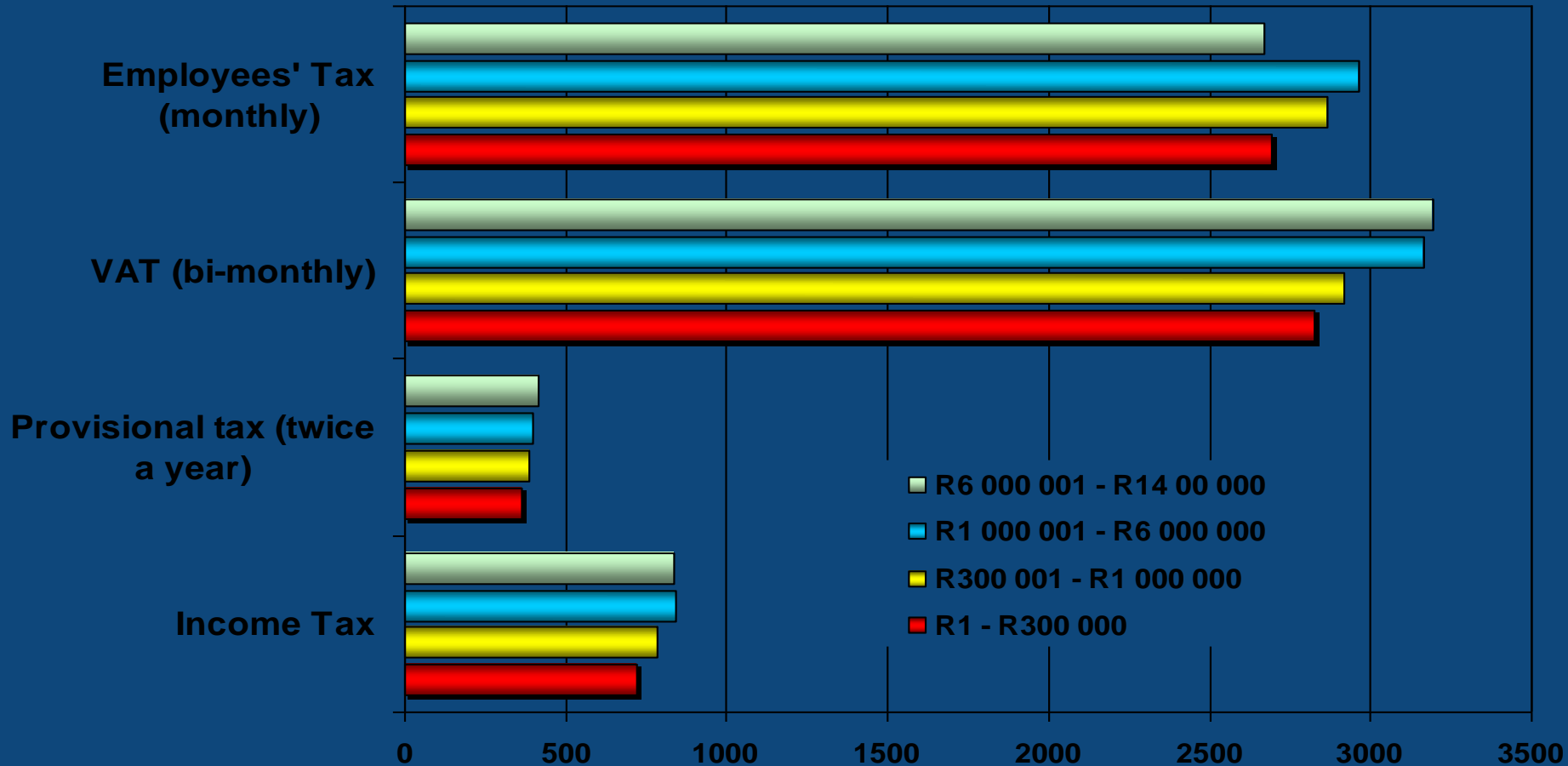
1. By asking SMEs, we learned that:

FIAS surveys on barriers to formality (for example Madagascar, Sierra Leone), on tax compliance cost (South Africa, Yemen):

- Firms are well aware of the benefits and disadvantages of operating (in-)formally
- Tax (rates and admin) are seen as a key driver of informality
- There are significant direct and indirect costs stemming from tax avoidance
- Other dimensions of formality are important and linked to tax formality decision
- Fees, licenses and other nuisance taxes are a non-negligible burden, especially for small firms
- Many firms have tried and failed to formalize: Information can go a long way...

→ There is a significant potential for voluntary formalization!

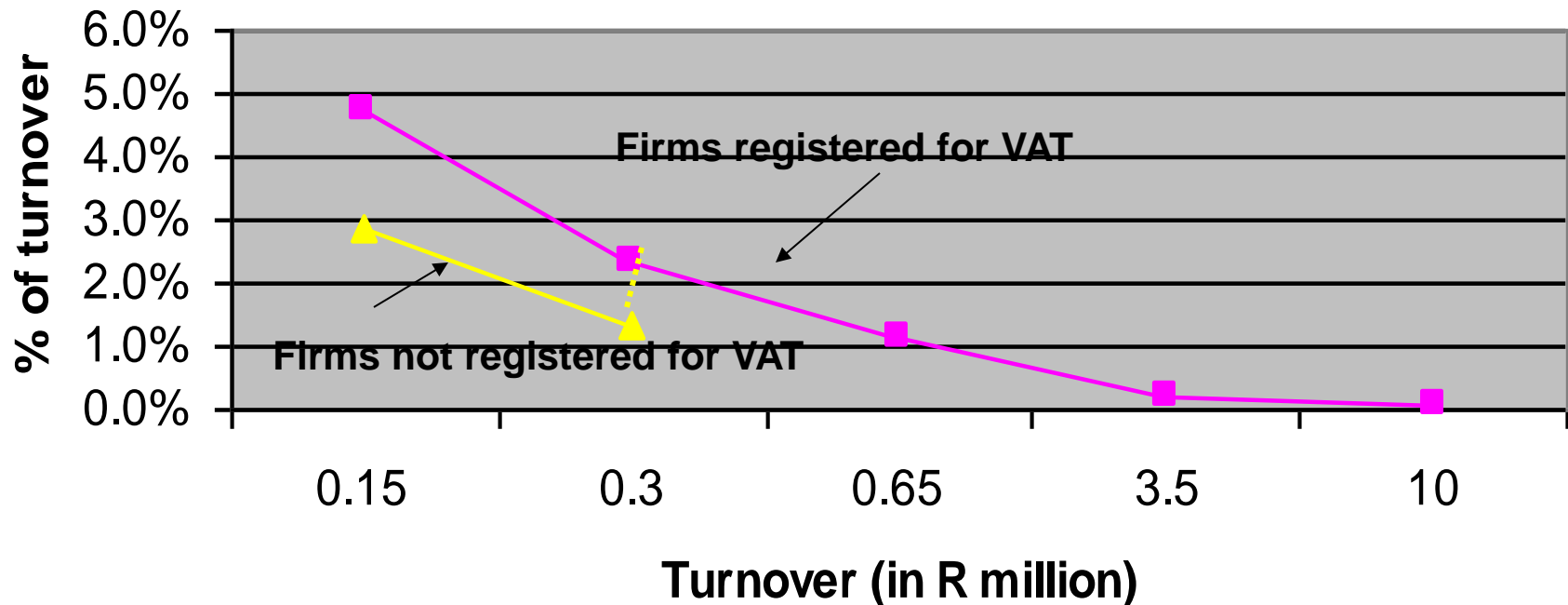
Cost to prepare tax returns in South Africa (Rand per year)



Source: FIAS Tax Compliance Cost Survey South Africa, 2007

Regressive Compliance Cost

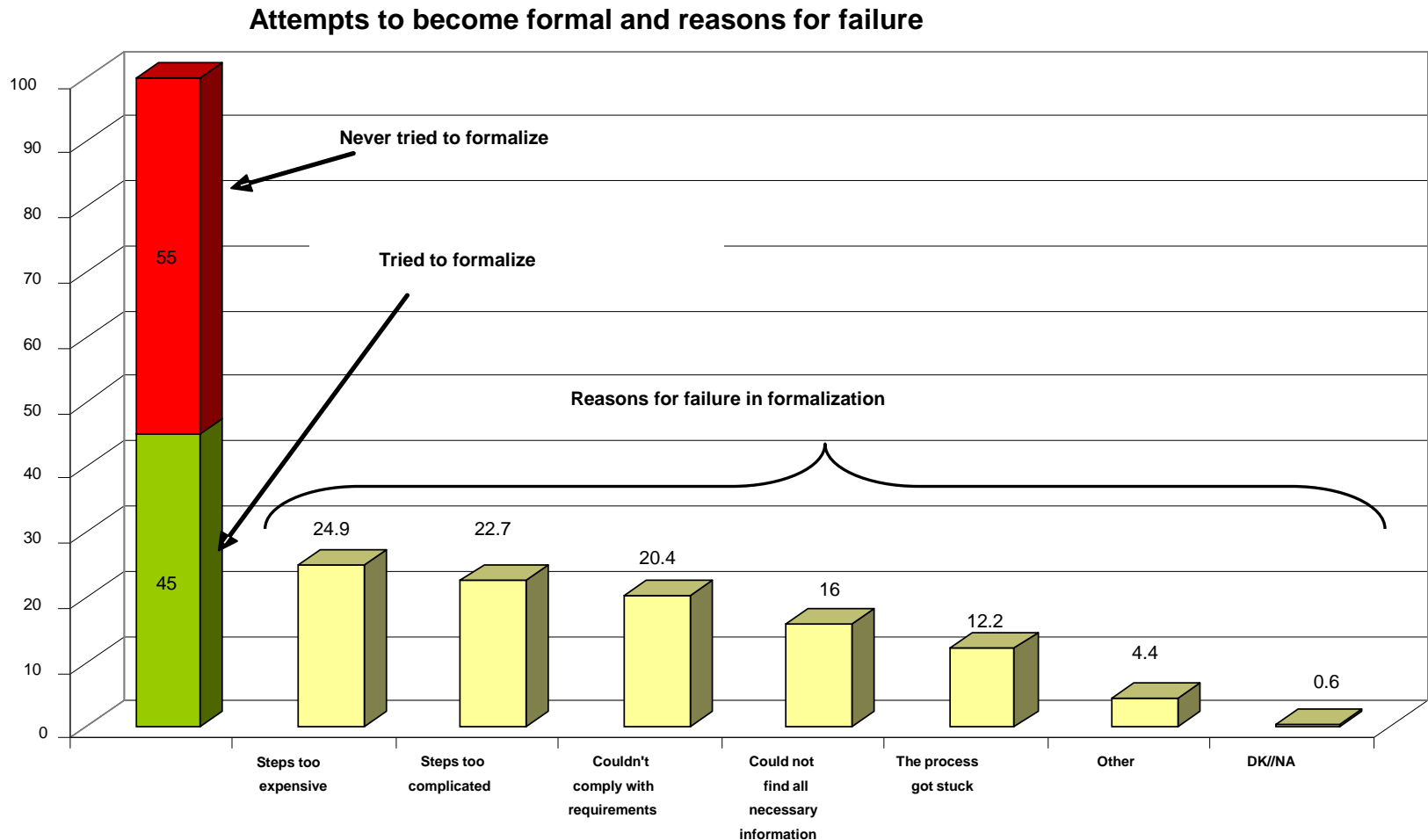
Compliance Burden for preparation of tax returns as a percent of turnover (firms registered/not registered for VAT; mandatory at R300,000)



Source: FIAS Tax Compliance Cost Survey South Africa, 2007

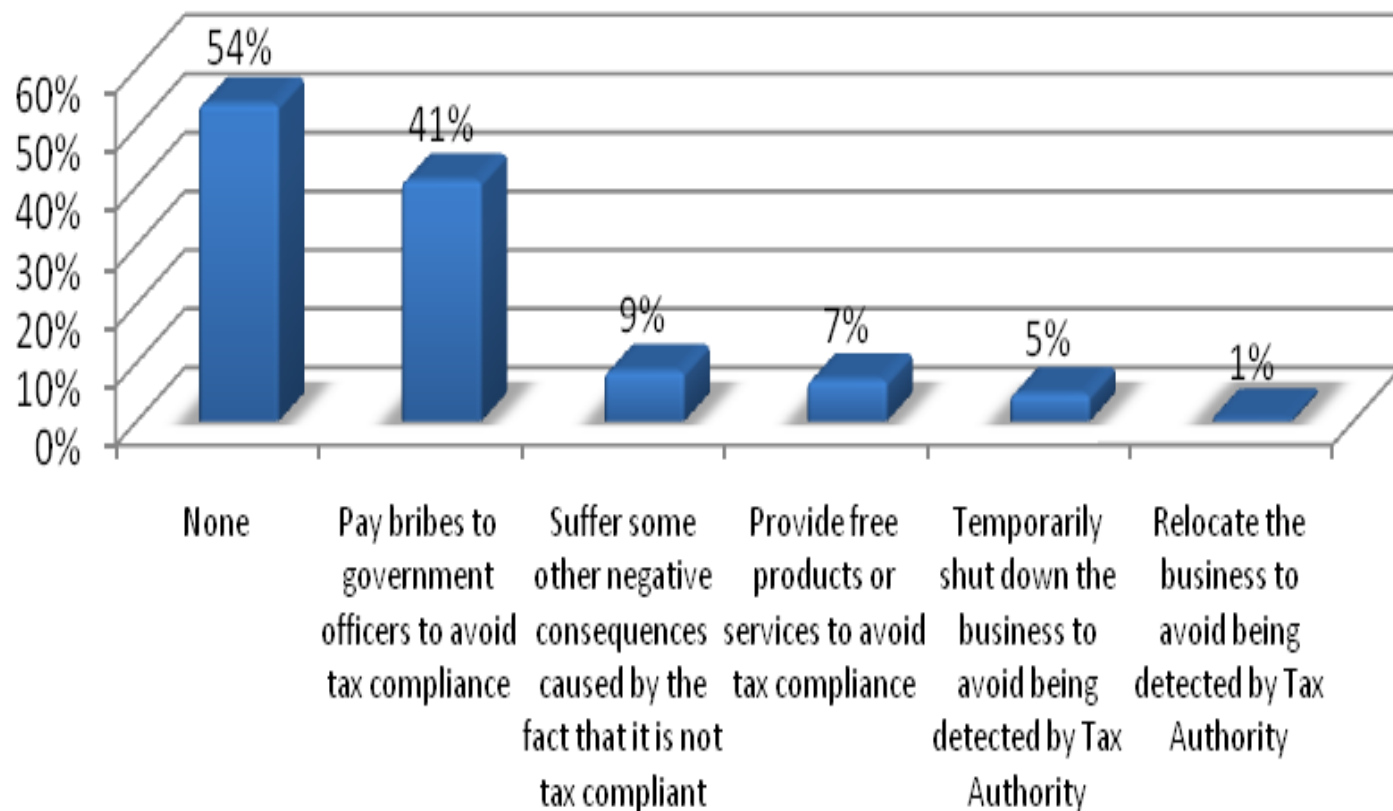
...matter for the formalization decision

Reasons for failed formalization attempts in Liberia



Informality comes with significant costs for many firms

- Percentage of informal Yemeni businesses facing costs to avoid tax payments/ remain informal



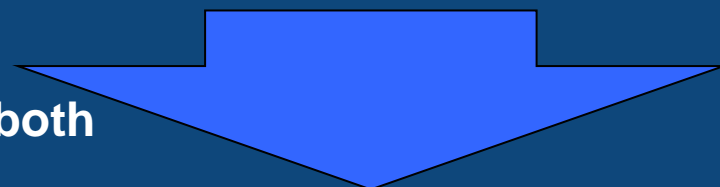
2. What does this mean for Small Business Taxation?

- The overall objective is a SBT regime:
 - With minimal compliance cost of taxpayers and minimal administrative costs, 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

SBT regime design options and key issues

1. Simplification of gen. regime	2. Special regimes	
<ul style="list-style-type: none"> - Simplification of tax forms, filing and payment process, alignment of payments - Reduced direct tax rates - VAT simplification for SMEs 	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 SMEs?**
- **What kind of safeguards are required to avoid abuse of system by larger businesses?**
- **How to align the SME 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 SMEs 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
4. Net cash flow scheme

3. Balancing in practice – the reform effort of the Yemeni Tax Authority

■ Current situation

- Extremely low compliance level, very little revenue collected, little data
- No incentives for bookkeeping or graduation, negotiation of tax burden is common practice
- Tax authority is „squeezing the wrong“ end with limited resources (less than 15% of surveyed business escaped a visit by a tax inspector)
- Widespread evasion and abuse of small business regime (lack of clear criteria, 40% of surveyed firms admitted paying bribes to „reduce the amount paid and harassment“)
- Most firms above subsistence level maintain some records of their transactions, but don't use it for tax purposes
- Corruption is more frequent as firms grow in size up to a certain threshold

Moving towards solutions: designing a new regime

- **First: Disaggregate MSMEs and setting adequate thresholds (based on turnover + nbr. of employees)**
 - Micro: 0-3 employees and turnover of < YR 720,000
 - Small: 4-9 employees or turnover of YR 0.72-20 Million
 - Medium: 10-49 employees or turnover YR 20-50 Million
- Determining profit margins and **setting appropriate rates**
- **A single turnover based tax for small firms (3 different rates), with a set of transparent indicators as a fallback option, based on self-assessed returns**
- Opt-ins allowed
- **2**Linkages between taxation, licensing and business reg. fees

Reform strategy cont'd

- Administrative reforms underway:
 - Establishment of dedicated small taxpayer administrative structure is needed
 - Change of institutional culture/approach: Self assessed/ Risk-based verification
 - Taxpayer service and information to promote and support bookkeeping among small firms
 - Data collection and matching with other sources
 - Moving towards smart enforcement
- In coordination with the Yemeni Business Council tax payer education/ communication effort on...:
 - Bookkeeping
 - Benefits of compliance
 - Information on use of tax income for the common good