The International Tax Dialogue (ITD) is a joint initiative of the European Commission (EC), Inter-American Development Bank (IDB), International Monetary Fund (IMF), Organisation for Economic Co-operation and Development (OECD), World Bank Group and Inter-American Center of Tax Administrations (CIAT). The ITD aims to encourage and facilitate discussion of tax matters among national tax officials, regional tax organisations, international organisations and other key stakeholders.
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CHAPTER 1

Introduction by Alan Carter, Head of the ITD Secretariat

Collecting taxes is a very ancient profession. Tradition and custom have long been influential in shaping the way in which national revenue authorities go about this task at the national level. However, the nature of collecting and administrating taxes has undergone many changes over the last few decades. The growing use of consumption taxes in the form of value added taxes, the increasing importance of globalised companies whose tax affairs transcend national boundaries, and more recently the global financial crisis that began in 2007 have also created many new and difficult challenges. The importance of strengthening domestic resource mobilisation to support development has become an increasing focus of attention, a trend that current pressures on development spending by the advanced economies is reinforcing. Reacting to these changes, and preparing for the future, has required tax policy makers and administrators to become familiar with an ever widening range of tax issues. These new challenges sometimes obligate the creation of new institutions and institutional mechanisms. Those that already exist must also evolve to meet the latest challenges.

In 2002 the International Tax Dialogue (ITD) was set up by the International Monetary Fund (IMF), the Organisation for Economic Cooperation and Development (OECD) and the World Bank to bring together the main international organisations active in the tax sphere in a more formal way. Since 2002 the ITD has involved a growing number of global and regional tax organisations, with the Inter-American Development Bank (IDB), and the United Nations (UN) all having played a role in taking forward the ITD initiative. The European Commission (EC) has been both an active participant and a regular contributor to the costs of the ITD initiative since 2007. The UK’s Department for International Development (DFID) has also provided some financial support in recent years. Regional tax organisations are playing an increasingly important role on the international tax stage, and the ITD partners warmly welcomed CIAT as an active participant in the ITD in late 2010. The ITD also cooperates with the work of the UN, the Economic Commission for Latin America and the Caribbean (ECLAC) and the African Tax Administration Forum (ATAF) amongst other supra-national organisations.

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1 In 2006 China abolished the agricultural tax on farmers which had been collected for more than 2600 years as part of its tax modernization and reform program. A special stamp was issued to mark this occasion.
The central objective of the ITD from the very start was to encourage the sharing of tax knowledge at a global level between countries. A key mechanism to achieve this objective has been the biennial ITD global tax conferences to which nearly all countries are invited. The themes of these conferences have been chosen so as to maximize their relevance and timeliness to the very many revenue authorities and international and regional organisations that have taken part. As part of the process of organising these conferences, the ITD partner organisations prepared background papers that addressed the theme of each conference. Many of these have become a standard reference document used by those working in those tax areas.

This publication brings together and updates the background documents from the first three global ITD conferences, so that they retain their place as invaluable reference documents for those with a professional interest in taxation. Each provides an overview of the main issues that all who work on these tax topics should be aware of, and a primer for those who are coming new to these topics, having worked on other tax issues beforehand. They provide an aide memoire of questions and possible solutions that can be adapted and related to the specific situation of different countries. The original conference background papers and the updated versions which appear in this book are the result of the combined efforts of many staff in the international organisations who work on these issues, and of the ITD secretariat. The views expressed in this publication, however, should not be taken to represent the policy positions of the institutions which contribute to the ITD initiative.

I. THE GROWING IMPORTANCE OF VAT

The first ITD global conference held in Rome in 2005 addressed the many issues that countries should deal with in relation to the Value Added Tax (VAT). By comparison with personal and corporate income taxes, and excises, VAT is a young tax. The UK introduced an income tax in something like its modern common forms in 1799, whilst the first value added tax was introduced over 150 years later in France. The many advantages of VAT in terms of administrative and economic efficiency and revenue buoyancy, championed by the EU and the IMF in particular, have resulted in its take up in over 120 countries.

Despite a common underlying design principle, its actual implementation continues to vary very much between countries, even within the EU which has led the way in terms of trying to align the practice of VAT with the principles of a single European market unimpeded by tax distortions.

Politics and the nature of pre-existing sales taxes can still be very much seen in the exemptions and zero rating of certain products in many countries. Concerns over the distributional impact of VAT continue to shape its implementation and design, despite growing empirical evidence that narrowing the VAT tax base is a relatively ineffective way of achieving distributional goals compared even to the relatively blunt spending tools available in many developing countries.
The politics of base broadening reform are a hard sell electorally, even if the consensus amongst policy advisers is in general very supportive of such change.

In federal countries, the need to administrate VAT at a national level can create political logjams that can only be resolved with major constitutional reform and an acceptable deal on future revenue sharing among different government levels. However, such movement is possible as was demonstrated by Australia’s movement from a system of state level goods and services sales taxes to a federal GST/VAT system, and the implementation of the federal GST in Canada. In some other larger federal countries the VAT has not yet been fully, or at all, yet adopted. In India, it is still slowed by constitutional and political obstacles, despite considerable progress in recent years; in the United States, historical reliance of the states on the consumption tax base, combined with a perception by some that the VAT is a “money machine” for government, has created strong opposition to its adoption, despite its attractiveness in terms of economic efficiency.

VAT requires relatively sophisticated administration capabilities at the level of the firm, something that very small businesses often struggle with. The levels of informality that exist in many developing countries raise the problems of effective implementation and administration further. The nature of VAT, which involves large repayments of tax in addition to revenue inflows to government, creates issues around fraud that even the most sophisticated of tax authorities have had trouble addressing effectively. In the case of developing countries, these concerns about fraud have often led to very detailed checks before repayments are made, with sometimes added budgetary pressures from the centre not be too quick in VAT refunds due. This can lead to serious delays such that the cash flow impact on businesses deters compliance and investment, unintentionally making the VAT a tax on production as well as consumption. In 2011 the OECD, in cooperation with the IMF, organised a Global Forum on VAT which followed in the footsteps of the 2005 ITD VAT conference. The chapter on VAT was then updated to address the issues that had grown in significance and emerged during the intervening years since the 2005 conference. The most important change has been a recognition that the vastly increased trade in cross border services necessitates much greater coordination, exchange of information between source and destination countries, and more consistency across jurisdictions in the way tax laws are applied to such services. Work on these issues is currently on-going between countries under the auspices of the OECD, involving both countries and also the IMF and EC who participate in the steering group of the Global Forum on VAT.

II. THE CHALLENGES OF TAXING MICROENTERPRISES AND SMEs

The 2007 ITD conference in Buenos Aires looked at a broad range of tax issues that impact microenterprises and SMEs. The way in which the tax system affects SMEs and the compliance issues they create have long been of central importance to both economic policy makers and revenue authorities. Fundamental challenges for taxing smaller enterprises often arise from the need to involve them in withholding payroll taxes and social contributions from their employees.
Simplification in this area is far from easy and may not be advisable, given the (increasing) importance of social insurance schemes for which some record of individual-level contributions is necessary.

Economic policy in many countries places an emphasis on SMEs as an important source of employment, innovation and economic growth. Market failures such as adverse selection in lending and information costs (since due diligence costs for potential investors and lenders may be relatively fixed which means investors are often reluctant to do many small deals in preference to one larger one) provide a rationale for policy intervention, which may occur via the tax system. However, it is hard to distinguish genuine market failure from the market working and weeding out bad deals. Not infrequently, ideas pitched to investors and banks by small businesses and start-ups may have little ultimate commercial potential. However, distinguishing between these ex ante given the uncertainties involved can be very difficult. This places a premium on the creation of multiple financing channels, such as the promotion of business angel investors for SMEs, which can provide a heterogeneous pool of investors and lenders with different views and knowledge levels about the risks and market prospects in different SME sectors. A SME investment unacceptable to one investor may be seen as a good commercial opportunity by another.

Innovative SMEs can face particular problems accessing finance as they are by definition inherently more risky, and it is harder to secure lending against hard to value and trade intangible assets which may make up most of their asset base, and underpin their enterprise valuation. Capital or equity gaps are difficult to define and measure because we cannot get at the counterfactual of what state of the world would otherwise have emerged. Structural features such as steeply stepped administrative burdens, e.g. first employee; complexity, resulting in a need to incur professional fees; and the cliff edges of some targeted SME tax incentives, are a mixture of the unavoidable and the inevitable.

Governments that target assistance at SMEs should aim for burdens and complexity to be minimised and proportionate. Experience in some OECD countries such as the UK suggests that even where SME tax reliefs exist, many do not make use of the reliefs available. This is mainly because targeted reliefs may not be relevant but there is also a strong perception that they are difficult to claim with detailed and complex criteria, with the latter generally existing to deal with potential avoidance issues. Uncertainty as to whether tax claims would succeed is another issue for SMEs. Finally, lots of SMEs are unaware of the existence of tax and non-tax mechanisms for assisting SMEs which raises questions over the effectiveness of the communication strategies toward SMEs used by revenue authorities and ministries, and other bodies responsible for economic development.

Lowering the tax burden on SMEs, both in terms of revenue levied and the compliance costs, is thus often seen as important if this enterprise segment is to thrive. Recognising the diversity of microenterprises and small and medium sized enterprises (MSMEs) is critical to sensible tax design. A feature of MSMEs is their heterogeneity. Within any country, the MSME sector may
include street sellers barely at subsistence level, highly paid professionals, and substantial manufacturing as well as innovative service enterprises; and what one country would see as a small enterprise might in another find itself in the large taxpayer unit. It is also an important fact in most countries, however, that MSMEs generally contribute far more to output and employment than they do to tax revenue. This fact may be overstated by the widespread use of larger enterprises (and imports) as withholding points—illustrating too that MSMEs may be powerfully affected by taxes formally borne by others—and reflects choices made in designing and enforcing the tax system. This suggests, nevertheless, some degree of untapped revenue potential—and an uneven playing field—in many countries.

From a tax authority’s perspective, the often complex linkages between the different taxes collected and paid by SMEs and the frequent scope for evasion and avoidance need very careful handling. At its worst, poorly designed SME tax policy and tax administration can lead to major leakages in labour and social security tax revenues, via tax motivated incorporation, without much offsetting benefits in terms of enhanced economic growth, employment and productivity amongst the population of SMEs. This implies that the best response to market failures that may adversely affect MSMEs is often unlikely to be through size related tax measures. Arguments are sometimes made for preferential treatment of smaller enterprises on pure policy grounds: if they have difficulty raising external finance, for example, a reduced tax rate on retained earnings, freeing more internal finance, may seem useful. The importance of this and other possible market imperfections in impeding realisation of the full potential of MSMEs remains unclear. The crucial points, however, are that size itself may not be closely associated with the relevant market failure (some smaller enterprises may face no financial constraints, for example), and tax interventions will often be dominated by targeted spending measures (such as development loans). Inadvertent damage to smaller enterprises from flawed tax design should be avoided, but the case for preferential treatment is far from clear.

Discussion of SME tax issues has often been linked to the issue of informality. In many developing countries most SMES and, in particular microenterprises, operate to a greater or lesser extent informally. However, understanding the true nature of informality is a critical first step in undertaking analysis that will lead to workable solutions that help alleviate the SME tax issues that it gives rise to. There are many differing degrees of informality. It is not a binary issue and cannot be equated directly with missing tax revenue. Some informality is linked to illegality, whilst in other case it is the result of economic and social exclusion, e.g. the potential role of women in MENA region is significant as estimates suggest only a quarter of women participate in the formal labour market, the lowest proportion in the world.

Measurement is difficult as the concept of informality is multi-dimensional and elastic, and by definition its degree is a hidden, unobserved variable to revenue authorities and others. Some revenue authorities have attempted to estimate the extent of informality and link it to potential lost tax revenue via tax audit methods, requiring both random audit programmes and tax inspectors who are very good at investigative work. In other cases revenue authorities have
relied on direct estimates from surveys such as the World Bank Enterprise survey or some labour force surveys. Whilst academic economists have explored measurements of informality using macroeconomic approaches based on monetary, physical inputs, and other modelling, the macro approaches provide little or no information about where a revenue authority might best target its compliance resources, and may lead to very inflated estimates of the potential revenue to be collected compared with what feasible practical measures to tackle the problem could actually produce.

The consensus emerging from estimates of the scale of the problem is that informality is much less significant in most OECD countries than in developing countries, but there are a few exceptions. Informality is significant in many middle income countries and, as mentioned above, can often constitute a large part of the economy of very low income developing countries. Conversely the tax revenue foregone aspect may be more important in most OECD and middle income countries. In poorer developing countries, it may be better to impose a low direct tax burden on low income microenterprises for reasons of policy and administrative costs. The IMF has explored the consequence of links between formal and informal sectors and in particular the impact of consumption taxes (VAT) on the tax burden borne by those operating under conditions of informality, and for some developing countries at least the distributional consequence of VAT appear more pro-poor than the trade and excise taxes they replaced.

More generally, when addressing the issue of informality from the perspective of a tax authority, it may be better to frame it in terms of the debate about how best to categorise and define appropriate cost effective compliance solutions for the hard to tax who are often in the formal SME sector, but who under declare revenue and/or profit. The role of presumptive taxes in SME taxation has been explored in a number of publications by the OECD and the World Bank. Whilst not an ideal solution, it does provide revenue authorities with a pragmatic solution to some of the problems that place SMES in the hard to tax (accurately) category while allowing them to benefit from being part of the formal network of enterprises.

The extent to which workers and firms seek to hide their economic activity from tax administrations varies significantly across countries, although differences in opportunity (to evade) seem more important than intrinsic differences in motivation, at least for OECD countries. Differing experiences of revenue authorities in creating systems to gather information and intelligence about SMEs, and in constructing risk engines or algorithms that can guide efficient use of compliance resources were apparent at the 2007 conference. Revenue authorities need to balance the cost of collection with potential revenue yield and distributive

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implications when designing tax systems, with very different implications for the structure of taxation faced by SMEs in OECD countries with those based in poorer developing countries.

In administrative terms, it is small, rather than medium-sized enterprises, that pose the main challenges. Fostering voluntary compliance and self-assessment are key to strengthening the taxation of smaller enterprises as it is for all others, with a number of countries developing innovative approaches to the distinct challenges they pose, including by fostering the use of information technology.

Tax administration organisational responses may also be appropriate, including in the form of special offices for smaller taxpayers. The structure of tax offices in terms of geographical location can impact on the ability of tax administrations to tackle many SME issues. Contact mechanisms between SMEs and tax administration may affect the levels of informality and non-compliance. Views about these mechanisms often differ between tax officials, even within countries and depending on their own personal experience. Each country needs to balance administrative economies of scale with operational needs, given different levels and types of SME activity. The nature of taxpayer demands, capabilities and behavioural characteristics will partly determine the extent to which different types of contact mechanisms from personal visits, telephone contact, and via online processes in the presence of tax intermediaries, such as accountants and bookkeepers, predominates in each country. These types of detailed issues were at the heart of the debate about SME taxation in the 2007 conference, and are explored further in the chapters that follow.

Planning for the future in terms of the appropriate office networks and the allocation of staff geographically is very challenging when IT and technology are changing so fast. The increasing uptake of cloud based computing has led to innovative ideas, such as some tax authorities exploring the idea of whether to offer SMEs free accounting software that would calculate their tax liabilities at the same time as providing the management and accounting information to run their own businesses. At the other end of the spectrum, some developing countries are struggling with the issue of taxation of SMEs in a context where official contacts with taxpayers on the ground may often be more accurately be perceived and characterised as harassment and bribe seeking behaviour, rather than productive and professional tax administration contacts. In both cases the implications of IT developments accessible to SMEs will have a significant impact on the future shape of their taxation.

In recent years there has been significant interest in the issue of whether state-building aspects of tax systems, which may be important to wider development needs, should be given more weight in efforts to widen the proportion of people paying taxes in developing countries. There are strong arguments for tax design and enforcement that facilitates widespread inclusion of MSMEs in the tax net. Size does matter as a proxy for the likely magnitude of compliance and administration costs, even though its relevance for choosing the optimal tax policy in the absence of such costs is debatable. There is no doubt that these costs are proportionately high for smaller enterprises, reflecting substantial fixed components. Account also needs to be taken,
however, of benefits that compliance may bring the taxpayer (with formalisation perhaps easing access to finance, for example), of further benefits that may also arise from incorporating an additional taxpayer into the tax system (strengthening the incentives for other firms doing business with it to comply, and fostering norms of compliance), and, not least, of the scope that exists for reductions in implementation costs associated with simplification of tax design. The key point is that variations in relative implementation costs and potential revenue may call for some size-tailoring of tax design and administration in order to achieve the goal of inclusion in the tax system, recognizing the danger of overburdening tax administrations with a very large number of small taxpayers contributing a relatively small amount of revenue. In this context, the VAT threshold—which varies widely across countries—may have an important role to play. Of a similar importance from an administrative point of view is the distinction between small and micro businesses and the design of a very simple presumptive approach to the taxation of micro businesses.

Overall trends in SME tax policy and administration internationally appear to have been relatively positive. There is more reliance on cooperation and assistance, and less on untargeted, unfocused and unnecessary coercion, with the latter being increasingly reserved for only the most recalcitrant SMEs. Effort had been put into regulatory simplification and more careful attention paid to policy design to ensure that incentives to formalise and comply exist in relation to SME taxation, and more generally in relation to the factors that can otherwise trap enterprises into continued informality or otherwise deter increases in size.

III. RESPONSE TO CRISIS AND TAXATION OF THE FINANCIAL SECTOR

The final section of this book deals with the important topic of taxing the financial sector. The primary responsibility for rebuilding the financial sector out of the recent global crisis lies with the sector itself, and its regulators. However, tax policy makers and administrators have a responsibility too, in helping to identify how the global tax system can better support and promote a healthy financial environment. The global reach, scale and complexity of financial sector business, as well as the role of the financial sector in third party tax payments and information reporting, all add a special dimension to tax administration in this sector. This has always been a specialised area of taxation that required the development of particular laws and regulation that took account of some of its unique features, including the longstanding difficulty of applying VAT systems to many financial services.

The 2009 ITD conference on taxing the financial sector provided tax policy makers and administrators with a timely opportunity to get together to discuss how far the tax system may have contributed to the global economic crisis via its impact on the overall size of the sector and the incentives it provided in regard to the way it operated. One particular concern that has emerged is ‘debt bias’: the incentive created by the deductibility of interest payments but not the normal return to equity against corporate level taxation for companies, including in the financial sector, to take on excess leverage.
Financial innovation has arguably blurred some of the borderlines on which tax systems traditionally rely such as the distinction between debt and equity, making them more vulnerable to arbitrage where rules rely on this distinction between them. Non-neutrality in the cross-border taxation of financial instruments and their exploitation through aggressive tax planning continues to raise further challenges for tax policy and administration. Though these are not obviously a source of financial instability, the increased revenue needs of many countries, and public sentiment in times of hardship, have focused policymakers’ attention on such activities and the imperfections in the international tax architecture that permit them. This implies a need to re-appraise those distinctions in certain areas, or perhaps more widely, as these issues have long been a concern in many countries, and a focus of much technical assistance by the IMF and others. Work is underway on these issues at the international level, led by the OECD and at the request of the G8 and G20, under the umbrella of a larger programme of actions whose aim is to address base erosion and profit shifting (BEPS). Importantly, these issues are no less significant for many developing countries, which tend to be especially reliant on corporate tax revenues. At the request of the G20 Finance Ministers, in July 2013 the OECD launched an Action Plan on Base Erosion and Profit Shifting (BEPS), identifying fifteen specific actions needed in order to equip governments with the domestic and international instruments to address this challenge. The actions outlined in the plan will be delivered within the coming nine to twenty-four months in the framework of the “G20/OECD BEPS Project” with participation of all OECD members and G20 economies, as well mechanisms for developing countries to add valuable input.

Collective investment vehicles raise questions of neutrality between different forms of financial sector activity, and how greater neutrality between investments made through funds and those made directly could be achieved. Similar issues are raised by the taxation of private equity and hedge funds, which also exemplify the challenge of a policing the borderline between taxation of income from labour and income from capital, and the true income nature of the “carried equity” that has been used to remunerate many of those working in the former sector.

The global crisis has triggered greater interest in putting in place a simpler and more transparent, less distortionary, and more secure basis on which financial sector commercial profits can be translated into financial sector tax revenues. A policy desire to raise further taxes from the sector, so that banks and bankers contributed to some of the costs of public bailouts, is also very apparent in many countries. Finally, taxation of those working in the financial sector, given the prevalence of very high pay and bonuses that were common, was and remains an issue, although it is somewhat distinct from the issue of how financial entities and products themselves should be taxed.

One of the most important issues addressed in the chapter on financial sector taxation is whether new tax approaches are needed that would offset the incentives towards a larger than otherwise financial sector created by it being exempted or zero rated for VAT purposes. Thus

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1 See for instance IMF (2013).
one strand of thinking in the current debate about the financial sector relates to the role different taxes may have in scaling back distortions to the structure and possibly size of the financial sector. This could be achieved in a number of ways; through taxes designed to increase the relative price of financial services; through forms of financial activities tax intended to go some way to addressing distortions form the VAT-exemption of many financial services; through financial transaction taxes which would deter use and trading in particular types of financial instruments; through fundamental reform of corporate tax systems to reduce the tax bias towards the use of greater levels of debt in the capital structure of all enterprises as a result of interest deductibility; higher corporate taxes on bank profits to reflect that fact that government implicit guarantees of the banking sector create economic rents which boost the profitability of the sector; or by taxes designed to make banks and some other financial enterprises pay a price for the wider systemic social and economic risks that they create and would otherwise be borne by government without being compensated for bearing this residual risk, in addition to existing and longstanding charges related to deposit insurance schemes.

Perhaps the most striking development has indeed been in the latter of these areas, with the introduction by several countries of new bank levies on balance sheet elements along the lines of the Financial Stability Contribution recommended by the IMF. These aim to both secure finance for resolution mechanisms in future crises and reduce reliance on volatile wholesale finance (the precise purpose of course varying between them).

A fundamental issue in the taxation of parts of the financial sector raised by these new instruments is the extent to which regulation should have primacy over taxation in determining the incentives and behaviour of the financial sector, and in the difficulty of understanding the ways in which the two might interact both positively and negatively. The debate over the introduction of a wide ranging financial transactions tax in Europe has put this issue in stark contrast, with supporters of such a tax saying it will increase stability in Europe whilst Mervyn King, Governor of the Bank of England on the regulators side expressed the view “that he had found no-one in the central banking community who thought it was a good idea”. In particular, bank regulators have concerns about how changed tax arrangements may impact on important parts of the financial systems “plumbing” in markets like interbank repo operations, making monetary policy operations more difficult, and more generally in reducing credit provision to parts of the rest of the economy.

IV. THEMATIC APPROACHES TOWARDS A BROADER TAX PERSPECTIVE

In recent years the focus of the ITD global and regional conferences has shifted from more specific taxes and taxpayer segments toward a broader and more thematic approach. The Delhi conference in 2011 addressed the way in which the tax system had interacted with more general global economic factors which were causing increased inequality at the national level, with a very significant increase in the share of wealth and income being earned by those at the very top of the income distribution. Debate about the impact of VAT, SMEs and the financial sector were
very much part of the thematic discussion as to how new policy on these tax issues should be shaped by concerns about distribution in the context of widening inequalities. One important principle to emerge was that whilst equity issues are important, they need to be seen against the context of the whole tax system and not assessed on a tax by tax basis. The complexity and sheer size of many countries tax codes, and resultant necessity for increasing narrow specialisation within revenue authorities, mean that it is easy for tax officials and policy makers to lose track of this key insight in their own day to day work. For this reason readers are encouraged to read all the chapters, in addition to the use of this book as a work of reference on the individual tax topics it covers.

An ITD MENA regional conference in Tunis in 2012 broadened the discussion further and linked the issue of inequality to that of governance and fair taxation. Participants from all sectors of MENA society and government discussed the role of citizens and social organisations and the processes that would create greater engagement by them in tax policy decisions. The importance of the fair taxation of SMEs in order to create the conditions for more confident businesses that spurs investment, employment and economic growth was at the heart of many of the loud demands for reform that were seen in the region. Minimising the administrative burden of VAT and increasing the effectiveness of the financial sector in supplying services to SMEs, insofar as this can be achieved via the tax system, are very much part of this important agenda.

Open, transparent and accountable governments, with equitable and fair tax systems, provide the strong base for political processes and constitutional arrangements that are sustainable over the long term. The 2013 ITD conference in Marrakech will focus on the issue of tax and intergovernmental relations. Again we see a need for tax policymakers and administrators to think about the issues involved in administrating specific taxes in relation to broader debates about the scope and impact of devolving tax powers and administration on a range of social, economic and political objectives including growth, equity, and accountability.

When the ITD started in 2002, discussions about the technicalities of tax took place mostly or almost entirely amongst tax professionals in the public and private sector. Over a decade later, tax has risen to near the top of the political agenda and has become a major focus of discussion amongst national leaders and finance ministers at gatherings such as G8 and G20 meetings. This higher political profile is partly the result of many civil society organisations that have become involved in discussions and campaigns around technical tax issues that they argue have a significant impact on development. This external interest in what would previously be regarded as very technical (even within the tax community itself) issues, such as automatic exchange of information, could not have been foreseen in 2002.

The wider interest in many detailed tax issues is yet another challenge all those who participate in the activities of the ITD must address. In order to make such debates productive, and ensure they do not lead to mutual misunderstanding between those who now campaign on tax issues and those who actually work on them in the public and private sectors, tax dialogue increasingly
requires officials to communicate more clearly what they do and why they do it to a non-specialist public audience. The organisations that constitute the ITD, and the revenue authorities and finance ministries from many countries that participate in the conferences, therefore hope that the knowledge contained in this volume will also be more generally useful in informing the positions adopted by those civil society organisations and citizens who wish to participate more deeply in discussions of tax. Two messages that have emerged again and again from ITD conferences is that all those involved in the tax world have very much to learn from each other about tax administration and policy, and also that there are many wider economic and social issues that further reform of tax administration and policy could help address. This volume touches on some of the most important.
CHAPTER 2

The Value Added Tax: Experience and Issues

I. INTRODUCTION

The aim of this chapter is to provide an overview of the main current issues and challenges in designing and implementing the value added tax (VAT). What follows begins by describing the main features of the VAT and its continuing spread worldwide. As in all areas of taxation, the distinction between policy and administration is not entirely clear-cut, but for convenience Section II focuses on issues that are primarily ones of policy, and Section III on issues of administration. The discussion concludes by looking at likely challenges for the VAT in the years ahead.

A. DEFINITION AND SPREAD OF THE VAT

The essence of a VAT is that it is charged on a wide range of transactions, with a mechanism for offsetting tax paid on inputs against tax paid on outputs (see Box 1). Beyond this, the VATs observed in practice exhibit considerable diversity as regards, inter alia, the base of the tax and the range of economic activity to which the tax applies. As a result, there can be room for disagreement as to whether a given tax is properly called a VAT or not. This paper takes a VAT to be: a broad-based tax levied on sales with systematic offsetting of tax charged on inputs against that due on outputs.

While there are many variations on the structure of the VAT and how it is implemented, there is wide agreement on some core issues. First, the consensus favours ensuring that the final base of the tax is consumption. Such a VAT, which requires that tax on capital goods be credited, does not distort the prices that producers face in buying and selling from one another, and, accordingly, has the desirable feature of preserving production efficiency (so that the tax does not move the economy off its production possibility frontier). Given that it is levied at each stage of production, ensuring that the VAT bears only on consumption also requires both full crediting of the tax paid on inputs and the absence of breaks in the VAT chain. The exemption of inputs causes such breaks (see Box 1).

4 Moreover, many countries choose to call what is a VAT by some other name, such as a general sales tax or a goods and services tax. The label is of no economic importance.
The invoice credit method\(^5\) is widely used. This is for several reasons, notably that by explicitly linking the tax credit on the purchaser’s inputs to the tax remitted (reportedly, at least) by the supplier of those inputs it discourages fraudulent undervaluation of intermediate sales.

**BOX 1- A PRIMER ON THE VAT**

The key features of the VAT are that it is a *broad-based* tax levied at *multiple stages* of production of goods and services, with—crucially—taxes on inputs *credited* against taxes on output (and if need be, refunded when the former exceeds the latter). That is, while sellers are required to charge the tax on all their sales, they can also claim a credit for taxes that they have been charged on their inputs. The advantages of this is that revenue is secured by being collected throughout the process of production (unlike a retail sales tax) but without distorting production decisions (as a turnover tax does).

Suppose, for example, that firm A sells its output (produced using no commodity inputs) for a price of US$100 (excluding tax) to firm B, which in turn sells its output for US$400 (again excluding tax) to final consumers. Assume now that there is a VAT at a 10 percent rate. Firm A will then charge Firm B US$110, remitting US$10 to the government in tax. Firm B will charge final consumers US$440, remitting tax of US$30: output tax of US$40 less a credit for the US$10 of tax charged on its inputs. The government thus collects a total of US$40 in revenue. In its economic effects, the tax is thus equivalent to a 10 percent tax on final sales (there is no tax incentive, in particular, for B to change its production methods or for the two firms to merge), but the method of its collection secures the revenue more effectively than would relying on full collection at the final stage.

**Zero rating** refers to a situation in which the rate of tax applied to sales is zero, though credit is still given for taxes paid on inputs. In this case, the firm will be due a full refund of taxes paid on inputs. In a VAT designed to tax domestic consumption only, exports are zero rated, meaning that exports leave the country free of any domestic VAT. This is called the *destination principle* and is the international norm in indirect taxation, with total tax paid on a good being determined by the rate levied in the jurisdiction of its final sale and revenue accruing to that jurisdiction. The alternative to destination-based taxation is origin-based taxation, under which the tax is paid at the rate of, and to, the country or countries in which the item is produced.

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\(^5\) Under this method, each trader charges output tax at the specified rate on each sale and gives the purchaser an invoice showing the amount of tax thus charged. Traders can then credit such payment of input tax on their own purchases against the output tax charged on their sales, remitting the balance to the authorities (or, if the net balance is negative, claiming a refund).
Exemption is quite different from zero rating in that, while tax is also not charged on outputs, tax paid on inputs cannot be reclaimed. Thus, no refunds are payable. In this case, because tax on intermediate transactions remains unrecovered, production decisions may be affected by the VAT.

The VAT was initially developed to meet rising revenue requirements that could not easily be satisfied by existing turnover taxes, the cascading nature of which could seriously distort economic decisions. Adoption of the VAT, which came first in France (in several steps from 1948) began slowly. As can be seen from Figure 1, however, the pace of adoption subsequently accelerated. The adoption of VAT as a requirement for entry to the European Union—where a primary attraction of the tax was the ability to transparently eliminate indirect taxation (or subsidization) of trade between member states—prompted its expansion in the developed countries in that region (including non-member countries such as Norway and Switzerland, and the last accession countries). All OECD countries other than the U.S. have now adopted a VAT. Current research shows that countries with a VAT tend to raise more revenue, all else equal, than those without one—though this is less clear in sub-Saharan Africa than elsewhere. Moreover, the introduction of a VAT is associated with a long run increase in the overall revenue to GDP ratio of 4.5%.

The 1990s witnessed a particularly spectacular increase in the take-up of the VAT (see Figure 1), with its adoption by almost all of the transition economies (reflecting the need to replace their traditional sources of revenues), by a large number of developing countries, notably in Sub-Saharan Africa, but also in Asia and the Pacific, and by the small island economies. Analysis however shows that a country is less likely to adopt a VAT the larger is its agricultural sector and the more open its economy. VAT introduction and reform continue to be prominent policy concerns around the world. Iran, for example, introduced its VAT system in 2008. In 2009,

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6 Since a turnover tax is levied on turnover irrespective of value added, the tax collected on a given commodity will reflect the number of taxable stages in the chain of its production, resulting in a “cascading” tax burden. This gives producers an incentive to substitute away from taxed inputs, resulting in production methods that are privately profitable but inefficient from a wider social perspective. As a result, and as a further distortion, there is an incentive for industries to integrate vertically solely to reduce tax liabilities.

7 The idea of the tax itself originates in the writings of a German businessman, von Siemens, in the 1920s. See C.F. von Siemens, “Improving the Sales Tax” (1921).


10 See Keen and Lockwood in 8 above.

China converted from a production-based VAT to a consumption-based VAT. The GCC extensively discussed the introduction of a VAT system but eventually deferred it. Moreover, India is currently undertaking a GST reform with the aim of creating a sustainable long-term system of GST. The Democratic Republic of Congo introduced a VAT on January 1, 2012. There is considerable diversity in the structure of the VATs currently in place. For example, the standard VAT rate tends to be higher in Western Europe and in the former transition economies than elsewhere, being lowest in the Asia and Pacific region. Moreover, Western Europe, North Africa, and the Middle East have the most complex VATs in terms of the number of rates.


VAT often plays an important role in fiscal consolidation. Many countries have taken the approach of trying to consolidate public budgets over the medium term, in part, by raising the

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standard rate of VAT. Among these countries, many have chosen to seek additional revenues from VAT, rather than other taxes, as evidence suggests that consumption taxes, VAT in particular, would distort saving, investment and work incentives to a lesser degree than income taxes and should therefore be less adverse to growth. While raising the standard rate often appears to be the easiest way to increase revenue in the short term, reductions in the standard VAT rate (perhaps temporarily) have appeal in supporting aggregate demand in times of crises and broadening the tax base in the medium term. An alternative way of raising VAT revenue would be to gradually increase the zero or reduced rates applied to goods and services to the standard rate. However, the obstacles for implementing such a reform (including not least the perceived distributional impact) may be considerable. Among the exceptions is Portugal that decided to limit the application of reduced rates and exemptions.

It is suggestive of the perceived success that an existing VAT has only ever been removed in six cases — Vietnam (in the 1970s), Grenada (introduced 1986, dismantled shortly thereafter), Ghana (introduced March 1995, removed two months later), Malta (introduced 1995, removed 1997), Belize (introduced 1996, removed 1999) and British Columbia (introduced 2010, removed 2011). However, in all cases, except for British Colombia, the tax has since been reintroduced: Ghana in 1998, Malta and Vietnam in 1999, Belize in 2006 and Grenada in 2010.

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18 See Arnold et al 16 above.

19 See Henriques R.G. and L. Castro, 2011, “The importance of VAT in the Portuguese economic turmoil”, International Tax Review, Vol. 22(10), pp. 57-59. In The Netherlands, the “Van Dijkhuizen Committee” recently advised the government to further increase the standard VAT rate (from 21 to 23%; it was increased to 21% from 19% on October 1, 2012) as well as the reduced VAT rate (from 6 to 8%). In the medium term the Committee advocates moving to a single rate; see Commissie Inkomstenbelasting en toeslagen, Naar een activerender belastingstelsel—Interimrapport (October 2012), p. 62; available (in Dutch) at: http://www.rijksoverheid.nl/bestanden/documenten-en-publicaties/rapporten/2012/10/16/interimrapport-commissie-inkomstenbelasting-en-toeslagen/interimrapport-commissie-inkomstenbelasting-en-toeslagen-2.pdf [Accessed 1 November 2012].

20 Apart from not being a country, the case of British Columbia is special as it has to be understood in the context of the dual structure of the Canadian GST. From July 2010 British Columbia repealed its 7% provincial sales tax (PST)—a retail sales tax—and “tagged” a provincial 7% onto the federal 5% GST to form a combined 12% Harmonized Sales Tax (HST). After British Columbia voters rejected the move to HST in a referendum in August 2011, the province decided to pull out of the HST. This means that, from April 1, 2013, it will reinstate its “old” 7% PST. The federal 5% GST remains in place throughout Canada, including in British Columbia; see, on the Canadian GST system: R. Bird, “The GST/HST: Creating an integrated sales tax in a federal country”, University of Calgary School of Public Policy Research Paper, vol 5, issue 12 (March 2012), available at http://www.policyschool.ucalgary.ca/sites/default/files/research/bird-gst-hst.pdf [accessed 2 November 2012].
B. PERFORMANCE OF THE VAT

A central claim made by advocates of the VAT is that it is a particularly efficient form of taxation. Has that actually proved to be the case? One way of testing for this is to ask whether, all else equal, countries with a VAT raise more revenue, overall, than do those without. Econometric analysis of this issue suggests that the answer, broadly, is yes, but less clearly in sub-Saharan Africa than elsewhere.

Looking closer, the gain in revenue and efficiency associated with the presence of the VAT tends to be greater the higher is GDP per capita and the lower is the share of agriculture in GDP—the latter may simply reflect the typical exemption of agricultural output from VAT. The positive revenue effect associated with the presence of a VAT is smaller, however, where the ratio of imports to GDP is higher, possibly reflecting the fact that in such economies other types of taxes—most obviously tariffs—are no less effective at raising revenue than the VAT. Empirical evidence suggests that VAT revenue tends to be greater in high income and more open economies.

These general results conceal considerable variation across countries in the performance of the VAT (as measured, for example, by the ratio of revenue from the tax to the product of the standard VAT rate and aggregate consumption). What explains this variability? Or, put differently, what are the factors—both in terms of tax design (e.g., the precise definition of the tax base) and the wider economic environment (e.g., the share of imports in GDP)—that are conducive to revenue productivity of the VAT? This issue can again be addressed by

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22 See Keen and Lockwood in 8 above.

23 It has sometimes been suggested that the adoption of a VAT should be good for export performance, as a consequence of the exclusion of exports from the tax. The theoretical issues here are more complex than they may seem, since the exchange rate and/or internal prices can adjust to offset to some degree the effects of taxes bearing on production costs. For these reasons, improved export performance is rarely used as an argument for adoption of the VAT. Recent empirical work suggests, however, that in developing countries the presence of a VAT is associated with, if anything, lower trade flows (there being no significant effect in high income countries): Desai, M. A. and J. R. Hines Jr., 2002, “Value Added Taxes and International trade: The Evidence”, [pdf] Available at: http://www.people.hbs.edu/mdesai/vats.pdf [Accessed 29 October 2012].


25 The idea is that a benchmark VAT levied at a uniform rate on all consumption would have “C-Efficiency,” thus measured, of 100 percent. The use of this measure is subject to a range of caveats, as discussed in Ebrill L., Keen M., Bodin J.P. and V. Summers, 2001, “The Modern VAT”, (International Monetary Fund: Washington D.C.).

econometric analysis, relating VAT yields to characteristics of both the VAT itself and the economy at large. Subject once more to caveats, the principal results include:

- The standard VAT tax rate has (unsurprisingly) a significant impact on revenues: each 1 percentage point increase in the standard rate raises the ratio of VAT revenues to private consumption by about 0.6 percentage points on average.

- The importance of trade to an economy also has a significant positive association with the yield of the VAT. This is a different question from how much additional overall government revenue is raised by adopting a VAT in economies where trade is particularly significant, addressed above—the interpretation here is that, all else equal, the more important is trade, the more revenue can be collected from an existing VAT. The obvious interpretation is that border formalities (and, perhaps, an established customs service) make the collection of VAT on imports relatively easy.

- The age of the VAT has a significantly positive effect. One interpretation is that administration of the VAT, and compliance with it, improves with experience; another one is that unobserved attributes of VAT design improve over time.

- Literacy also has a powerful positive association with VAT yield.

- Albeit fragile empirically, and surely not a basis for policy recommendations, there is evidence that the range between the highest and the lowest positive VAT tax rate in countries with multiple-rate VATs also has a positive bearing on VAT revenues for a given standard rate. (Among potential explanations of this counterintuitive result is that it is picking up the positive revenue effect from taxing favoured items of final consumption at a positive rate rather than simply granting exemptions.)

It is sometimes argued that the VAT is a particularly complex and costly tax to comply with and administer, and is consequently ill-suited to developing countries. Indeed, the econometric analysis referred to above indicates that VAT revenues are higher—all else equal—in countries with higher literacy rates and hence presumably with better administrative capacities.

However, the real issue is whether, at lower levels of development, the VAT fares worse than other taxes for similar amounts of revenue. This will depend on the costs involved in its operation. These resource costs can be decomposed into the administrative costs incurred by the tax authorities and the compliance costs incurred by taxpayers. Given the potential role of the VAT as a catalyst for change both within the tax collection agencies and among taxpayers (e.g., by stimulating a culture of record keeping), a VAT may involve substantial collection costs, especially at the outset, but still be very successful in terms of generating tax revenues.
It is widely agreed that collection costs are significantly lower where the VAT is simple, with a single rate, and that high threshold are conducive to relatively lower collection costs. Since compliance costs are largely independent of the amount of tax payable, however, they fall more heavily on smaller traders. Especially the question of the frequency of filing returns can be important for the compliance costs of smaller taxpayers. In a recent communication, the European Commission argues that compliance costs are high, ranging from 2% to as much as 8% of VAT collection, and regressive (in the sense that small businesses are more than proportionally burdened by compliance requirements). The report also indicates that compliance costs will not fall over time in the absence of policy action.

The evidence for developed countries suggests that the VAT is less costly than the income tax, but the more relevant question is whether it is more or less costly than alternative forms of sales tax, and, in particular, than the taxes that it replaced. Making such a comparison for six Francophone and six Anglophone African countries, Ebrill et al (2001) find that the predecessors to the VAT were far from simple to collect. In West Africa, the VAT generally replaced turnover taxes of the kind prevalent in France before the adoption of the VAT there. In East Africa, it generally replaced a manufacturer level sales tax on the old Commonwealth model. There were many similarities among the earlier regimes: numerous and sometimes narrowly differentiated rates (including luxury excises); many specific exemptions, an exemption for retail trade, and, in some cases, differential treatment of domestic sales and imports.

Especially notable is that all of these VAT predecessors included complicated methods for avoiding the cascading inherent in turnover taxes. In the Eastern and Southern African systems, for example, this role was played by a combination of a “ring” system exempting sales of certain items between registered traders only and general exemption of some categories of products normally viewed as being intermediate goods. In many countries, both Francophone and Anglophone, “fixed investments” or “capital equipment” and “raw materials” were exempt.

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27 Some guidance can be found in the various studies of VAT collection costs for OECD countries. It has been estimated that administrative costs to the government for a broadly “best-practice” VAT are about US$100 per registrant per annum. Estimates of taxpayer compliance costs for such a VAT are around US$500 per registrant per annum. These dollar figures will overestimate the corresponding costs in developing countries, since they largely reflect labor costs.


29 See [5.1] Communication from the Commission to the European Parliament, the Council and the European Economic and Social Committee on the future of VAT – Towards a simpler, more robust and efficient VAT system tailored to the single market, COM 2011(851) final.
raising complicated identification issues. Indeed, the complexity of some of the predecessors to the VAT is quite stunning. For example, in Mauritania, which now has a VAT, the predecessor system involved three distinct turnover taxes each levied at multiple rates, with relief against cascading being provided by deducting the cost of certain inputs from sales receipts.

Although differing in a number of respects, the VATs that have replaced these taxes during the 1990s have crucial common features including: the use of the credit/invoice method; broader bases than the predecessor taxes (even where there are still wide exemptions); a single, or few, positive rates; zero rating of exports; inclusion of all levels of production while excluding much retail trade and other small businesses by means of a threshold; and identical treatment of domestic production and imports.\(^\text{30}\) It is thus hard to argue, for these countries at least, that the VAT currently in place is inherently more complex or more costly to collect than the taxes it has replaced. Indeed, with the precursor taxes commonly already embodying, as just noted, some measures to credit or suspend tax paid on inputs, introducing a VAT, has in many cases meant the consolidation and simplification of previous crediting devices.

II. **TAX POLICY ISSUES**

This section raises and addresses some of the most common and troublesome questions of VAT design.

A. **HOW MANY RATES OF VAT?**

Standard advice has been for a single-rate VAT (other than a zero rate for exports only).\(^\text{31}\) This has not always been followed. Table 1 shows the number of positive rates adopted in the full set of countries currently having a VAT as a proportion of all countries having a VAT. Closer analysis indicates that the older the VAT, the more rates there are and, conditional on age, that the number of rates is significantly higher in Europe and North Africa and the Middle East than in the other regions. Strikingly, most new VATs adopted in recent years have a single rate: not only in Australia and New Zealand, but also in developing countries. Experience also shows, that moving towards a uniform VAT rate structure is not easy once differentiation has been admitted (though there are some success stories: the Slovak Republic, for instance, unified its two distinct VAT rates in 2004; but, it must be admitted, also reintroduced a reduced rate in 2007).\(^\text{32}\)

\(^{30}\) Alternatives such as VATs at either the manufacturing and import stages or the wholesale and import stages were tried until the end of the 1980s. However, these attempts were not viewed as successes, with the extension of the VAT to the retail level seen as an improvement in all cases.


TABLE 1- DISTRIBUTION OF THE NUMBER OF VAT RATES

<table>
<thead>
<tr>
<th>One Rate</th>
<th>Two Rates</th>
<th>Three Rates</th>
<th>Four Rates</th>
<th>Five Rates</th>
<th>Six Rates</th>
<th>More than Six Rates</th>
</tr>
</thead>
<tbody>
<tr>
<td>45</td>
<td>25</td>
<td>22</td>
<td>5</td>
<td>2</td>
<td>0</td>
<td>1</td>
</tr>
</tbody>
</table>

Source: Annex 1

1/ Figure is percentage of all countries currently with a VAT with numbers of VAT rates shown.

Since the VAT is designed to tax consumption, the question is why one might wish to tax different components of consumption at different rates. Differentiated rates can be supported on efficiency grounds, with the “inverse elasticity” rule (applicable, strictly, only as a somewhat special case) implying that inelastically demanded goods should be subject to particularly high tax rates. However, such a case for differentiation in rates of VAT is greatly weakened by the need to take account of administrative considerations and by the fact that separate excise taxes can be levied on some of the more inelastically demanded commodities (e.g., alcohol, gasoline, and tobacco products), which are largely final products (so that cascading is either insignificant or, where the tax also in part corrects for environmental damage, appropriate).

The more important issue, therefore, is the potential for rate differentiation to accommodate equity considerations. It will be desirable, all else equal, to tax most heavily those goods that account for a greater share of the expenditure of the better-off members of society. The strength of the equity case depends on the range of policy instruments available. In contrast to the situation in developed countries, many developing countries do not have well-functioning income taxes and/or targeted expenditure programs to facilitate attainment of equity objectives. The redistribution that can be achieved through indirect taxes alone, however, is intrinsically limited. The key point here is that even if the poor spend a larger proportion of their income on some particular item (food, for example), the rich will typically spend a larger absolute amount; so a reduction in the tax rate on that item actually transfers more money to the rich that it does to the poor.33 The real question for policy in many developing countries is

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(Oxford University Press: Oxford), pp. 275-363 at p. 301. See also the Van Dijkhuizen Committee referred to in footnote 17, which advocates for The Netherlands to adopt a single VAT rate post 2017, recognizing at the same time that the evolution—and divergence—of VAT rates in the neighbouring Member States should be taken into account.

33 In one IMF technical assistance mission, staff estimated that for every US$100 (say) in VAT revenue forgone as a result of zero-rating food, less than US$15 accrued to the poorest 30 percent of the population, while about US$45 benefited the richest 30 percent Ebrill, L., Keen, M., Bodin, J.-P. and Summers, V. (2001), “The Modern VAT”, International Monetary Fund, Washington DC p.76. Similarly Australian research revealed that the expenditure in that country on zero rated food was ‘...almost six times greater for the highest than the lowest income groups’. Thus ‘...more than one-third of the $5 billion exemption for GST-free food’ was of benefit to those households that were ‘...in the highest 20 per cent of the income distribution.’ See Australia’s Future Tax System Report (2010) p 286
whether the better policy is not to maintain a single rate and use the enhanced revenue this yields to finance well targeted pro-poor spending.34

A related issue is whether the VAT is intrinsically a regressive tax. It is true that the share of current income consumed tends to decline with increases in current income. 35 The issue becomes less clear, however, when one considers consumption over a lifetime, where consumption and income tend to be proportional with respect to each other. Moreover, one needs to compare the distributional implications of the VAT with those of the taxes replaced, and indeed to assess the distributional consequences of the whole tax-spending system, of which the VAT is just one part. There are also important incidence questions concerning, for instance, the competitive advantage that may be enjoyed—depending on what other taxes they are subject to—by small traders below the VAT threshold. Notwithstanding these caveats, it is interesting that empirical evidence (albeit limited) for a few developing countries finds that the distribution of VAT payments is not especially regressive and, in particular, can be more progressive than that of trade taxes. Very recent empirical evidence from Bangladesh using household income expenditure survey data concludes that indeed VAT has some progressive elements. 36 On the other hand, data from New Zealand show that taxing certain goods, such as food, is regressive.37 It is noted, however, that the incidence of this regressivity is very country specific and generalizations can be misleading.

To this must be added the increase in administration and compliance costs associated with multiple VAT rates, including the increased likelihood that refunds will have to be paid (to sellers of lightly taxed commodities embodying heavily taxed inputs), the possibility of definitional disputes and evasion, and the possibility that increased differentiation will make it harder to resist the political pressures for yet more differentiation. There is considerable experience suggesting that multiple rates increase compliance and administrative costs and perhaps facilitate evasion.38

36 See Faridy, N. and T.K. Sarker, 2011, “Progressivity of Value Added Tax in Developing Countries: Empirical Evidence from Bangladesh”, Asia-Pacific Tax Bulletin, Vol. 17(3), pp. 185-191. The progressive elements were discerned in consumption by rural populations and progressivity was relative to regressivity discernible in urban consumption.
B. WHAT EXEMPTIONS?

Standard advice is also for a short list of exemptions, limited to basic health, education, and financial services. Systematically documenting worldwide practice in this area is difficult, but the proliferation of exemptions in VATs in practice is an increasingly common concern (as is also true with other taxes, such as the corporate income tax).

Exemptions are often justified on the grounds that the output is hard to tax (such as financial services) and/or that they are a practically convenient substitute for a reduced rate. There can also be specific reasons offered for selected exemptions; the commonly encountered agricultural exemptions seem to reflect distributional concerns, while that for donor-funded projects often reflect conditions imposed by donors.

However, the consequences of exemptions are complex and generally adverse. Exemptions violate the basic logic of the VAT, being part way between levying a positive VAT rate in the usual way (by taxing output and crediting input tax) and applying a zero rate (removing all VAT embodied in the price of a product by crediting input tax, while not taxing output). As a result, exemptions: (1) reintroduce cascading, with associated production distortions—when an exempted commodity is an input into another commodity, the VAT embodied in the first commodity cannot be claimed as a credit against output due on the sale of the second commodity; (2) compromise the destination principle for internationally traded commodities—if an exporter uses exempted inputs, that exporter’s zero-rated exports will embody VAT from earlier in the production chain; (3) can create a competitive advantage for imports over domestically-produced exempt commodities (since zero-rating in the country of export means that input tax is recovered on the former, but not the latter); (4) in the case of exempt traders, create incentives for the avoidance of tax liability by vertical integration and, in some cases, more aggressive tax planning; and (5) initiate a dynamic whereby exemptions feed on each other resulting in “exemption creep”—once a sector receives an exemption, it has an incentive to lobby for exemptions to be granted to those from whom it buys its inputs (so as to “recover” the VAT paid in earlier stages of production). On the administration side too, exemptions can be problematic: allocation rules for taxed inputs are needed for traders selling both taxed and exempt output, and further problems arise from voucher and other schemes used to exempt foreign-financed assistance projects. However, there is little firm evidence on the quantitative extent to which exemptions increase administration and compliance costs.

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39 The OECD publishes a biannually updated list of exemptions existing in its member countries in *Consumption Tax Trends*.


Reflecting these difficulties, the rolling back of exemptions is likely to be a recurrent theme in VAT reform over the coming years. On the intellectual front too, much has been learned about practicable alternatives to exemption in relation to the public sector and financial services. On the latter, for example, the possibility of a cash-flow form of VAT has attracted attention in recent years, and New Zealand has adopted a zero rate for supplies by financial service providers where the customer is a taxable person with at least 75 percent of their output taxable while Australia uses a reduced input tax credit system to only partially input tax financial supplies by large scale providers of certain financial supplies. This does not eliminate the cascading problem, but is an interesting development. Within the EU, a gradual approach of phasing out existing exemptions such as education or health will be carefully considered. Generally, the plan envisages some reduction in the scope of VAT exemptions and reduced rates. However, eventually, the use of exemptions and reduced rates is mainly within the sovereignty of the member states.

**C. The Threshold**

The level of the threshold at which registration for the VAT becomes compulsory is a critical choice in the design and implementation of the VAT. Experience suggests that many countries have tended to set the threshold too low, putting themselves in considerable difficulty when their tax administration is found to be insufficiently developed to administer a large VAT population, especially the small tax payers for which compliance costs may be higher. Indeed, in both Ghana and Malta an initially low threshold was one of the primary reasons for the failure of their first VAT.

There is considerable variation across countries in the level of the VAT threshold, ranging from a few thousand dollars to over US$200,000. Even within the European Union, where there is a common legal framework governing the VATs of member states, the threshold levels vary from zero to exceeding US$100,000. There is also significant variation in the form that thresholds take and in the extent and nature of related measures. In addition to the most common case of a single threshold, variations include: different thresholds for different activities; sliding adjustments to the tax liability of entities below the threshold to smooth the discontinuity around the threshold. Ethiopia and Kenya, for instance, apply sector-selected registration...

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44 The Australian partial input taxing method apparently under-taxes final consumers and over-taxes banks as well as losing revenue overall. See 2010 Australia’s Future Tax System Report p 304 and Overview Chapter 7 (cited above).

45 See Communication from the Commission to the European Parliament, the Council and the European Economic and Social Committee on the future of VAT – Towards a simpler, more robust and efficient VAT system tailored to the single market, COM 2011(851) final. However, potential significant impact in terms of cost of public goods or on social security needs to be taken into account.
requirements in which traders engaged in specific sectors are required to register for VAT regardless of the level of their turnover.\textsuperscript{46} Another common feature in particular of western African VATs is to apply a lower threshold to suppliers of services than to suppliers of goods.\textsuperscript{47}

The appeal of a high threshold stems from the empirical regularity that a relatively small proportion of firms typically account for a very large proportion of potential VAT revenue. A high threshold thus economizes on scarce administrative resources at little cost in revenue. The authorities can afford to exempt small traders without adverse revenue consequences since the value added among that group can be expected to be modest. This is in marked contrast to single stage taxes, such as the retail sales tax, where a threshold implies that the full amount of tax—not just that on their value-added—is lost on the exempt sales made by those under the threshold. A high threshold can also alleviate the compliance burden on firms, which can be sizable: research from New Zealand concludes that VAT compliance costs of SMEs amount up to 21\% of their turnover.\textsuperscript{48}

Nevertheless, many countries—including, ironically, many with relatively weak administrative capacity—have evidently not been persuaded by the arguments for a high threshold. In addition to the revenue implications, national authorities are also often concerned that a high threshold unfairly favours small traders (by exempting them from the tax). By way of example, the EU’s first proposal for a directive to tax “imported” electronic services\textsuperscript{49} advocated a threshold of €100,000 for non-EU based suppliers making supplies to consumers in the EU. However, in the ensuing negotiations the member states removed the references to thresholds. This has led to a situation where a non-EU business has, in theory at least, to account for EU VAT on all sales into the EU, irrespective of the amount of sales involved. This contrasts with thresholds available in most, but not all, EU Member States, thereby introducing an element of distortion.

The trade-off between tax revenue generated and collection costs is key, with the appropriate threshold being higher the more costly are administration and compliance, the less urgent is the government’s need for funds, and the lower is the ratio of value added to sales.\textsuperscript{50} This last is


\textsuperscript{48} See Colmar Brunton, 2005, “Measuring the tax compliance costs of small and medium-sized businesses”. However, compliance costs as a ratio of turnover drop dramatically the higher the turnover.


\textsuperscript{50} For example, suppose administrative and compliance costs of US$100 and US$500 per taxpayer, a marginal value of a dollar of tax revenue of US$1.20, a tax rate of 15 percent, and ratio of value added to sales of 40 percent. Then a simple formula capturing the key elements of this trade-off, developed in Ebrill and others, 2001, implies an optimal threshold of about US$52,000. The issue of the optimal VAT threshold is pursued further in Keen, M. and J. Mintz, 2004, “The Optimal Threshold for a Value-Added Tax,” Journal of Public Economics, Vol. 88, pp. 559–76.
important since, all else being equal, it makes a case for setting a reduced threshold for more profitable and/or labour intensive activities. However, this raises the practical difficulties of distinguishing between different activities and of dealing with traders conducting multiple activities. The literature has developed an explicit expression for the optimal threshold that permits illustrative calculations.51

The differential treatment of those above and below the threshold also raises issues. For example, firms selling to other firms would wish to register for VAT in order to reclaim tax paid on inputs. Hence, it is normal practice to allow firms below the threshold voluntarily to register for VAT. However, this is not always the case.52 In contrast, firms characterized by a high ratio of value added to sales and selling to unregistered purchasers—notably, small traders providing services directly to final consumers—are likely to find it advantageous to be exempt from VAT. The favouring of small over large traders implicit in the use of a threshold has equity and efficiency implications. Specifically, it will benefit higher-cost small traders at the expense of more efficient larger traders, implying, all else equal, an optimally lower threshold. Related to this concern, and also tending to favour a lower threshold, is the potential scope that the threshold creates traders to organize production in a series of sufficiently small enterprises to avoid VAT and associated accounting and reporting requirements.

The extent and nature of the distortion between those above and below the threshold will, however, depend on how those below the threshold are taxed.53 Presumptive taxes (such as a simple turnover tax) are relatively common, which implies that the calculation of the optimal threshold needs to be recast in terms of the differential revenues and collection costs associated with the two taxes around the threshold. As a general result, the cheaper the alternative tax is to collect, and the higher the rate at which it is levied, the higher is the optimal threshold for the VAT.

Other considerations also arise in the choice of the threshold and any taxes applying below it. It may be, for instance, that payment of tax by small traders, even if not warranted in terms of the calculations above (because revenue is so low relative to the cost of implementation) plays an important role in encouraging citizens’ interest and participation in the tax system and, hence, wider governance issues. It may also convey an element of education in basic book keeping and similar functions that yield the taxpayer and society wider benefits. These and other issues related to VAT threshold and the tax treatment of smaller enterprises more generally need much further research and experience-sharing.

51 See Keen et al. A retrospective evaluation of elements of the EU VAT system (Institute of Fiscal Studies), 2010. The formula that captures the benefits and costs of amendment of the registration threshold is explained at p 81.
D. SMALL COUNTRIES

Are there countries so small that a VAT would be inappropriate? The question is important to the future spread of the VAT, since it is still the case that many of the remaining countries without a VAT are small. As noted above, empirical analysis indicates that VAT revenues are higher the greater the significance of international trade for an economy, all else equal. Since smaller economies tend to rely more on trade, there is a sense in which VATs actually perform better in small countries than in larger. Moreover, a consumption tax will in general distort the economy less than a tariff regime levying an equivalent amount of revenue. However, whether or not a VAT is especially appropriate for small economies will also depend on the difference in collection costs between a VAT and the alternative revenue source.

Nevertheless, there is a strong trend of smaller economies introducing a VAT regime. The VAT has spread in the Caribbean, and the Seychelles, for example, is among the latest smaller economies to introduce a VAT in 2013. Likewise, The Gambia, the smallest country on mainland Africa, replaced its current sales tax by a VAT from 1 January 2013.

A VAT will be less advantageous for countries that import most of their consumption and for which the share of intermediates in imports is low, since the difference between an import tariff and a consumption tax is then evidently slight. For the smallest economies, the bulk of consumption would likely be imported. The share of intermediates in total imports, however, is not a matter of size alone: it will also depend on the degree of development of domestic activity. In addition, a country using a broad-based tariff may also deploy excises on selected domestic goods, which will further diminish the efficiency gain from moving to VAT.

Much, therefore, may hinge on the potential differential administrative and compliance costs in the comparison between VAT and alternative strategies. First, the fixed costs of collection associated with a VAT administration may be relatively burdensome for the smallest economies with either small and/or just a few firms. Second, an economy with only a few sizable retail firms might find an advantage in implementing a retail sales tax.

E. INTER-JURISDICTIONAL ISSUES

The VAT faces challenges too in the context of trade relations between countries, and in defining its role in the tax systems of federal countries.
1. **INTERNATIONAL ISSUES**

With respect to international trade, the standard\(^{54}\) and recommended approach is to levy the VAT on domestic consumption through the destination principle. That principle has always been implemented by zero-rating exports and taxing imports, with the result that total tax paid in relation to a commodity is determined by the rate levied in, and revenue accruing to, the jurisdiction of its final sale. The alternative to destination based taxation is “origin” based taxation in which the tax is paid at the rate of, and to, the country or countries in which the item is produced.\(^{55}\)

Implementing the destination principle by zero-rating exports requires some mechanism for identifying the movements of goods and services across borders. Trends toward regional integration and the development of the Internet have complicated this. The elimination of borders within the EU has resulted in a long-running debate on how best to deal with VAT on intra-EU trade.\(^{56}\)

Particular problems arise in the VAT treatment of international services. In this case, border controls cannot be used to monitor international flows, and it can be far from clear in which country consumption is properly deemed to occur. As trade in services has continued to grow, these problems have become increasingly important.

The problems are compounded for countries where administration is weakest. Specifically, zero rating of exports implies the need to ensure appropriate refunding of excess VAT input credits to exporters, which, as discussed below, has raised serious administrative difficulties. Methods to address this situation, while still producing the appropriate economic outcome to avoid distortions, will be increasingly critical. This is an area for close monitoring of developments to ensure that future implementation and updating of the VATs are both current with the latest thinking and consistent with the new and evolving realities of the global trading system.

The need for international co-ordination first became apparent following the emergence and strong growth of e-commerce. OECD-ministers agreed in 1998 on an international common approach for taxing e-commerce, the so-called “Ottawa Taxation Framework Conditions”, and

\(^{54}\) The main historical exception was the use of the origin principle for much intra-CIS trade until mid-2001.

\(^{55}\) A destination-based VAT preserves production efficiency across countries since foreign and domestic producers face the same VAT tax treatment within each country. This is widely recognized as an especially desirable feature in tax design. An origin-based VAT does not have this property.

\(^{56}\) The initial proposal was to tax exports to other member states at the rate of the exporting country, with full crediting of those taxes for (nonexempt) VAT-registered importers. Revenues would subsequently be reassigned across member states to achieve the zero-rating assignment—receipts in the exporting country would be transferred to the importing country. In the context of the review of the EU VAT system launched by the so-called Green Paper in 2010, the EU Commission concluded that this initial proposal is politically unachievable. Hence, the EU Commission has now proposed to abandon it in favour of a EU VAT system based on the destination principle. See COM (2011) 851/3, Communication from the Commission to the European Parliament and the European Economic and Social Committee on the Future of VAT.
the OECD published Guidelines on cross-border taxation of e-commerce in 2001. Destination based taxation of cross-border e-business was the governing principle of this framework. These Guidelines have since then notably served as a basis for the European VAT-rules on e-business and telecommunication and broadcasting services, adopted in 2008 (see below).

The EU amended its rules for taxation of electronic services in 2008, in line with the OECD Guidelines on e-commerce. Among the most notable changes are the new rules for the VAT-treatment of intra-community supplies of telecommunication services, broadcasting and electronic services to final consumers. Until end 2014, these services to final consumers remain taxed where the supplier is established. This will change on 1 January 2015. From then on, suppliers will have to charge VAT to EU consumers on the basis of the rate applicable in the consumer's member state and the revenue collected will accrue to that member state. These suppliers will be permitted to discharge their VAT obligations using a “one stop” scheme which will enable them to fulfil their VAT obligations to the member state where they are established including for services provided in another one where they are not established. The VAT revenue from these services will be transferred from the country where the supplier is located to that where the customer is situated.

Evidence grew that VAT could distort international trade in services and intangibles more generally and the OECD launched a project in 2006 to develop OECD International VAT/GST Guidelines. These are developed as a set of principles for the VAT treatment of the most common types of international transactions, to serve as a basis for countries to frame their own laws and administrative practice. This is still work in progress, although a number draft Guidelines have been published for public consultation and finalisation of this work is planned for end 2014.

2. **FEDERALISM**

The widely-perceived success of the VAT has raised the question of whether it might be used as a subnational tax in federal countries, with lower levels of government having some autonomy in the design of the tax. Only a few examples of such systems now exist—in particular in Brazil, which has long had a subnational origin-based VAT, and in Canada.

Inter-jurisdictional trade at the subnational level in federal countries, where there are seldom true customs borders, poses significant challenges to the implementation of subnational VATs.

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59 See for more information Consumption Tax Trends (OECD), 2012.

60 Arranging some sharing with and across subnational governments of a centrally-designed VAT raises a distinct set of (generally easier) issues, not addressed here.
Traditional advice has been that a VAT should not be implemented at a subnational level because of a lack of internal borders and problems with cross-jurisdictional crediting. Another view, however, points to alternative forms of VAT that may mitigate many problems, though these would work best with an overarching good federal level administration. This too is an issue likely to receive continuing attention in the coming years.

III. TAX ADMINISTRATION ISSUES

The specifics of VAT administration clearly have to take into account the policy design decisions that have been made about questions such as thresholds, rates and exemptions and individual country circumstances. However, there are some general principles of good administration (including the principle of voluntary compliance referred to below) and best practices that can be taken into account in developing good administrative practice.

The compliance framework that the Forum on Tax Administration (FTA) has developed is based on the principles of responsive regulation and their application to practical tax compliance issues. One clear lesson from experience is that changes in legislation should be supported by enhanced tax administration. Otherwise, changes would not achieve their intended objectives and may even have adverse impacts.

A. ORGANISATION OF THE VAT ADMINISTRATION

The introduction of a VAT can facilitate a substantial improvement in overall tax administration, and indeed adoption of the VAT is often seen as an opportunity for overall tax administration modernization. The introduction of the tax, however, has occasionally disrupted the functioning of an existing administration because of inadequate preparations and/or ill-advised implementation decisions.

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61 Brazil has often been advised to replace the subnational VAT with a national VAT supplemented by regional retail sales taxes.


64 http://www.oecd.org/site/ctpfta/abouttheforum.htm

One important decision concerns where to place the VAT within the overall tax administration. Virtually all countries make the collection of all taxes on imports, including VAT, the responsibility of the customs department. Moreover, irrespective of the type of organization recommended, there needs to be close coordination of the VAT preparations between the income tax administration and the customs department, though this coordination has been rather poor in some countries. An important and less settled issue in a few (happily, increasingly few) countries is the question of who should administer the domestic VAT and account for the tax collections on imports reported by customs. There are three possibilities: (1) administration of the VAT by the department responsible for domestic tax operations (including personal and corporate income taxes, and, in several countries, social contributions); (2) administration by a separate VAT department; or (3) administration by the customs department.66

Several factors bear on this choice. First, although the experience with physical controls acquired by customs officers is sometimes useful, the VAT is essentially a self-assessed, accounts-based tax, which calls on the skills typically found in domestic tax administrations rather than in customs. Second, establishing a specific VAT department results in fragmentation of the tax administration and recruitment difficulties, and thus in increased administration and compliance costs. On balance, while administering the VAT in the domestic tax administration may initially raise some potential difficulties—notably, that there may be insufficient focus on the specifics of the VAT—almost all experts now favour such a choice. In particular, it is consistent with establishing a function-based organisation that supports modern tax administration systems based on self-assessment and risk-management principles.

Against this background, how have countries structured their VAT administration? The answer is that in the vast majority of countries (around 90 percent) the domestic VAT is administered by the domestic tax administration. In these cases, discussions when the VAT was implemented focused on the respective merits of establishing separate VAT offices or administering the VAT, along with the income tax, in a function-based tax administration. Although most countries opted for a function-based organization, some initially introduced the VAT in a separate division (e.g., Albania, Australia67, Bulgaria, and Sri Lanka), an approach that was generally supported to facilitate the administration of the VAT during the first years of its implementation.

Discussions on where to locate the VAT administration have been more extensive in those (relatively few) countries with no tradition of administering indirect taxes in the domestic tax administration. These are mainly former U.K. colonies with a tradition of administering indirect taxes and excises in the customs department. It is worth noting here that the U.K. itself has

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66 This last approach was adopted by the United Kingdom until recently, as noted later. Only one other country currently has this organizational structure: Israel (where integration of VAT and income tax administration is under consideration).

67 Although with no more extreme organisational division than as a discrete ‘business line’ within the federal tax agency.
merged its direct and indirect tax departments into one administration (including, at least initially, customs) and that a number of countries in the Middle East and Africa (e.g., Botswana, Jordan, Kenya, Malawi, Nigeria, Rwanda, Tanzania and Uganda\(^{68}\)) have also recently introduced major organizational reforms to integrate their VAT and income tax administrations.

Since the end of the 1990s, significant work has been undertaken in those countries with fragmented domestic tax administrations—particularly in Anglophone countries with VAT and income tax administered in separate departments—to implement integrated, function-based organisations, which are seen as much more effective and efficient in administering a modern tax system, using self-assessment and risk-management principles.\(^{69}\)

B. SELF-ASSESSMENT PROCEDURES

Modern tax systems and their administration are built on the principle of “voluntary compliance,” meaning that taxpayers are expected to comply with their basic tax obligations with only limited intervention by revenue officials. In practice, voluntary compliance is achieved through a system of “self-assessment,” under which taxpayers, with reasonable access to advice from the tax administration, calculate their own tax liabilities; complete their tax returns; submit returns and payments to the tax administration; and are then subject to risk of audit particularly of large credits and refunds. In most countries, the development of self-assessment is closely linked to the rise of the VAT. Indeed, the real question is not how to administer a VAT in a country without the capacity to conduct self-assessment, but how to implement the basic principles of self-assessment in a country willing to introduce a VAT.

Self-assessment is critical since without the need to calculate every taxpayer’s liability and notify them of it, tax officials can instead concentrate on the minority of “at risk” taxpayers who do not comply with their tax obligations. At the same time, taxpayers’ compliance costs are reduced because the need for constant interaction with the tax administration is greatly reduced. Conversely, absent self-assessment, filing and payment procedures become burdensome, with taxpayers carrying out several time-consuming steps in the tax office and at the bank.\(^{70}\) Not only do such procedures reduce the tax administration’s efficiency and effectiveness, but the resulting regular contact between taxpayers and officials can encourage corrupt practices.

The arguments against self-assessment sometimes encountered are unpersuasive. One such argument is that “small traders are too illiterate to complete their returns.” With, a sufficiently


\(^{69}\) Most other countries, including Francophone as well as the vast majority of countries in Latin America and Central and Eastern Europe, have generally had a tradition of integrated domestic revenue administrations.

\(^{70}\) VAT filing, unlike that associated with the income tax, could take place 12 times a year, although such frequency is not recommended for smaller taxpayers.
high threshold, however, small traders are kept out of the VAT. A second is that “taxpayers cannot be trusted.” The answer to this lies in developing effective taxpayer service and enforcement programs, and good understanding by tax officials of basic risk management principles. It is certainly true that if the tax department must assess each taxpayer, there will be few resources left for necessary compliance and control. Third, “the preconditions for self-assessment have not been met.” This is the most challenging argument, notably in some former transition economies and Middle-Eastern countries where historically there was a complete absence of a taxing culture and where proper accounting standards and basic tax administration systems were lacking.71

A review of experience in 31 developing countries prepared by the IMF a decade or so ago found that VAT administration is based on the concept of self-assessment in 26 of them. But further analysis of the data indicated less progress than this headline figure would suggest. First, only about 40 percent of the surveyed countries had implemented modern collection procedures (using simple filing and payment forms and a self-assessment system). Second, another 40 percent, although using self-assessment procedures, still had a weak understanding of risk-management and so place excessive data requirements on taxpayers— forms often comprise several pages, and sometimes taxpayers are requested to attach additional documentation (such as invoices). Third, a number of countries, notably transition economies where there was still less than complete appreciation of the administrative requirements of an accounts-based tax, did not use self-assessment at all. While maters have certainly improved since then, implementation of full self-assessment remains a challenge in many countries.

Another approach that has been implemented in some countries, particularly in Latin America and some parts of West Africa is the implementation of VAT withholding schemes. These oblige certain business and government entities to withhold VAT from payments to their suppliers. The rationale is that this ensures that unregistered traders, particularly in hard-to-tax sectors, are forced to pay at least some VAT. Proponents of these schemes maintain that they provide a manageable way of increasing VAT collections where administration is weak and attitudes to taxation are poor, particularly among smaller traders. Opponents argue that the better way to deal with VAT compliance problems in the small business sector is to regulate the number of registered taxpayers by adopting a high VAT threshold,72 and point to the increase in refund claims if withholding rates are set too high. It is noted that Kenya abandoned its VAT withholding arrangements that inflated collections and severely strained the refund mechanisms. But while


72 A recent survey of the countries where a VAT withholding system has been implemented shows that almost all have very low VAT registration thresholds.
opinions on withholding differ somewhat, there appears to be consensus that the proliferation of such schemes can seriously undermine the integrity and long-term health of the VAT.

Even more resources may need to be allocated to VAT preparation needs in countries with little or no prior experience of self-assessment. In that regard, a longer timetable has been suggested for VAT implementation, including such measures as the establishment of pilot Large Taxpayer Units, the development of a function-based administrative organization, taxpayer education programs, and modern collection forms and procedures.

C. AUDIT

In many countries, especially developing and in transition, audit performance is reported to be a particularly poor aspect of VAT administration. The evidence is that several of the developing countries which adopted the VAT in the last 10–15 years do not yet have effective audit programs. And, for those that do have some elements of such a program, it is often dominated by pre-refund verification. There is also a tendency for these countries to try to offset weak audit by adopting complex procedures, such as increased filing requirements and massive cross-checking of audit. These compound administrative difficulties and add to compliance costs. Without effective audits, VAT compliance deteriorates and the credibility of tax administration suffers. Strengthening audit is thus a key challenge, particularly in developing countries.73

Countries with well-designed VATs that have been properly implemented are likely to face fewer compliance problems in the longer-term. Experience shows that it takes 18–24 months to implement a VAT effectively. Key to success is a sound policy design (a single rate, few exemptions and high threshold), simple laws and procedures, an appropriately structured and resourced administration, and compliance strategies based on a balanced mix of education and assistance programs, and risk-based audit programs. Well-managed implementation of these critical components has been shown to lead to quicker establishment of the registration base, better understanding by taxpayers of their obligations, lower levels of non-compliance, lower administration costs, and greater revenue mobilization. Some countries have found that a program of advisory visits by auditors during the early months of the new tax has promoted taxpayer goodwill towards the VAT, as well as towards the tax administration. It has also helped auditors better understand their wider role of promoting voluntary compliance. In contrast, countries whose preparation has been less complete often face greater compliance issues, and are more inclined to look to ad hoc measures to overcome them.

The most common types of VAT evasion parallel those associated with traditional sales taxes—non-registration of businesses, underreporting of gross receipts, abuse of multiple rates, and non-remittance of tax collected to the tax authorities—but there are additional types of evasions

73 See the discussion of this and desirable audit practices in Bird, R.M., above n 71.
arising from the nature of the VAT. These include the use of fake invoices and the claiming of VAT credits for non-creditable purchases.74

Advanced administrations have found that a well-designed audit program is critical to reducing the extent of VAT fraud and evasion, simply because potential fraudsters are deterred by the belief that they stand a reasonable chance of detection and punishment. The most successful audit programs, within an overall risk management strategy, are marked by the following design features and principles:

- A broad coverage of taxpayer groups, by size and by sector, and of compliance issues.
- Audit resources spread across all elements of the audit program, ensuring that a disproportionate share is not absorbed in verifying refund claims prior to payment; pre-refund audits are limited to high-risk cases only, while lower-risk claims are subjected to selective post-refund audits.
- Audits that are mainly short, issue-oriented (checking, for instance, for credits claimed for taxable supplies to exempt activities, or on private purchases), and limited to one or two tax periods.
- Audits of accounting systems rather than individual transaction checking, especially with larger taxpayers.
- Close coordination between the VAT audit program and the audit programs of other taxes, especially the income tax.
- Investigation of cases involving serious fraud, with a view to criminal prosecution.

In many less advanced countries, reasons for the failures to implement effective audit programs include: (1) insufficient numbers of the required highly skilled and appropriately remunerated audit practitioners; (2) lack of an institutional history of sound audit practice; (3) the authorities’ concerns about collusion between taxpayers and auditors; (4) inadequate preparations at the time of VAT implementation, possibly because the consequences of a weak audit program are not immediately perceptible; (5) the lack of clear political support for the tax administration; and (6) the lack of an appropriate legal and judicial environment. The defensive resort to overly complicated procedures compounds such problems.

74 Keen M. and B. Lockwood note “The VAT has also proved vulnerable to high profile criminal attack: ‘carousel fraud,’ for example, which exploits arrangements for the taxation of intra-community trade within the European Union, has amounted to around 1.5–2.5% of net revenue, or more, in the United Kingdom” 2010, “The value added tax: its causes and consequences”, Journal of Development Economics, Vol. 92(2), pp. 138–151 at p. 139.
However, it is clear that VAT losses arise in advanced economies too. Evidence points to substantial abuses in developed economies, particularly the EU. A study was carried out for the EU Commission in 2006 to quantify and analyse the VAT gap in each EU member state over the period 2000–2006, comparing the accrued VAT receipts with a theoretical net VAT liability. The report, that has to be read against a long list of assumptions and caveats, puts the revenue loss of non-compliance for different EU countries in a (wide) range of some 2 to 30 percent of potential revenues, with an overall average for the EU of about 12 percent.\textsuperscript{75}

Losses of VAT revenue can be due to a number of factors, including criminal attacks on the VAT system (typically the “carousel” fraud, which involves intra-community supplies and traders going missing after reclaiming input tax), general non-compliance, failure to register, and aggressive tax avoidance.\textsuperscript{76} Some EU member states have proposed reverse charging as a solution for carousel fraud. In business-to-business transactions this places the VAT liability on the buyer rather than the seller. This would deal effectively with the carousel fraud as the opportunity to make fraudulent gains by claiming refunds of tax that have not in fact been paid would thereby be eliminated. However, it also undermines the fractional nature of the VAT, which is an important part of its attraction as it secures the revenue more effectively than does relying on full collection at the final stage. Nevertheless, reverse charge would appear to be used increasingly by EU member states as a measure to address specific carousel fraud schemes. The vast majority of EU member states have made use of the option under the EU VAT Directive to apply a reverse charge to the trade in CO\textsuperscript{2} emissions, which had proved to be particularly vulnerable to carousel fraud.\textsuperscript{77} Some member states (incl. Austria, Germany, Italy and UK) have also implemented reverse charging for mobile phones, computer chips, and some other easily


\textsuperscript{77} Under Article 199a of Council Directive 2006/112/EC on the common system of value added tax (“the VAT Directive”) EU member states are allowed, until 30 June 2015 and for a minimum period of 2 years, to apply the reverse charge mechanism to transfers of allowances to emit greenhouse gases.
transported and high value goods which have been prone to carousel fraud.\textsuperscript{78} The EU Commission is reviewing the way VAT is collected and monitored as one of the possible strategies to reduce the VAT gap. It is notably analysing the feasibility of a so-called “split payment model”, in which the purchaser would pay the VAT to a blocked VAT bank account with the tax authorities’ bank which could only be used by the supplier for paying VAT to his suppliers’ blocked VAT account.\textsuperscript{79} Policy responses noted above intended to implement the destination basis without zero rating, may also reduce the vulnerability of the VAT system to carousel–type frauds, though it should also be noted that some believe the problem to have been overstated.\textsuperscript{80}

There are a number of ways in which the effectiveness of practice and advice in this area can be improved. Attention has too often concentrated on the administrative preparations for and functioning of the VAT during the first few months following its introduction at the expense of ensuring that the tax performs satisfactorily over the long term. This longer-term performance will depend critically on implementing effective audit programs. There also needs to be more forceful convincing of authorities that massive checking of refunds and invoices can be self-defeating. The benefits of such a program are very unlikely to offset the considerable administrative and compliance costs they involve.

A strategic approach, incorporating all aspects of VAT losses and countermeasures, would provide governments, especially in developed and transition countries, with significant tools for measuring tax administration performance. The U.K. is a leading example, having not only measured the VAT gap and its components, but developed a strategy to counter the losses. It seems improbable that the VAT gap can be closed completely although the same can be said of income tax. The better question may be whether the VAT is worse than other taxes in this regard and there is some evidence that it is in fact better.\textsuperscript{81}

\textsuperscript{78} Member states can be authorized to apply the reverse charge mechanism to specific transactions in the form of a special measure “to prevent certain forms of tax evasion or avoidance” under Article 395 of the VAT Directive. See also Mirrlees, J., Adam S., Besley T., Blundell R., Bond S., Chote R., Gammie M., Johnson P., Myles G. and J. Poterba, (2011), Tax by Design - The Mirrlees Review, p. 188 [pdf]. Available at \url{http://www.ifs.org.uk/mirrleesreview/design/taxbydesign.pdf} [Accessed 4 November 2012] and Institute for Fiscal Studies (Project Leader), 2011, A retrospective evaluation of elements of the EU VAT system; p.141 [pdf]. Available at \url{http://ec.europa.eu/taxation_customs/resources/documents/common/publications/studies/report_evaluation_vat.pdf} [Accessed 4 November 2012].

\textsuperscript{79} See Communication from the Commission to the European Parliament, the Council and the European Economic and Social Committee on the future of VAT – Towards a simpler, more robust and efficient VAT system tailored to the single market, COM 2011(851) final, at p. 14.


D. Refunds

A key feature of the invoice-credit form of VAT is that some businesses—notably exporters (since their sales are zero rated), and those businesses with large investment purchases—will pay more tax on their inputs than is due on their output, and therefore should be entitled to reclaim the difference from the government.\(^82\) It follows that an effective refund mechanism is essential to preserve the VAT as a tax on consumption and to avoid distorting the allocation of resources.\(^83\) While refunding excess credits is straightforward in principle, formidable problems arise in practice, making the refund process arguably the Achilles heel of the VAT. First, the payment of refunds can create lucrative opportunities for fraud (e.g., exporters making false claims by overstating input taxes paid). Second, the power of tax officials to make refunds may invite corruption. Third, governments may be tempted to delay refunds when their budgets are under pressure, thereby creating serious cash flow problems for businesses. This is particularly so in those countries that pay refunds out of consolidated VAT collections rather than from specific expenditure appropriations.

Failure to fully refund excess credits undermines the integrity of the VAT and the credibility of the tax administration. When tax authorities deny payment of legitimate refund claims, the VAT ceases to be a tax only on domestic consumption—it becomes, in part, a tax on production. Intermediate goods transactions are distorted; the competitiveness of the export sector is harmed; and the competitive edge is tilted against new firms with large start-up costs. In addition, compliance is seriously jeopardized if businesses lose faith in the VAT system and are motivated to operate outside the law and engage in tax fraud and evasion.

The risk of fraudulent claims is often cited by tax authorities as the main reason for auditing all claims and delaying payment of refunds. In several countries, particularly those with a weak tax administration and inadequate experience with modern risk management practices, the authorities pursue time-consuming and labour intensive processes to verify claims before approving refunds, resulting in backlogs of refund requests and considerable disquiet among businesses that have been deprived of their working capital. In contrast, the most advanced tax administrations tackle refund-related fraud as part of a broader VAT compliance strategy based on risk management principles, and generally limit pre-refund verification checks to high-risk claims.

In theory, VAT refunds should be paid promptly following receipt by the tax authority of a VAT return giving rise to an excess credit. While most, but not all, developed countries make timely refunds of excess credits, the situation is different in many less advanced countries where it

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\(^82\) Refunds can be substantial. In some economies (Slovak Republic, Canada), refund levels exceed 50% of gross VAT collections, while in others (e.g., Sweden, the Netherlands, Russia, United Kingdom, Hungary, and South Africa) they reach at least 40%. See Harrison/Krelove, VAT Refunds: A Review of Country Experience (2005).

\(^83\) For a discussion of this topic and an initiative to improve performance see OECD International VAT/GST Guidelines, Guidelines on Neutrality (OECD), 2011, Available at: www.oecd.org/ctp/ct.
often takes several months, and sometimes more than a year, to process refund claims. Such practices can seriously undermine the competitiveness of the export sector.\textsuperscript{84} Though partly due to a reluctance of cash-poor governments to return taxes received, it is also clear that weak tax administration and associated compliance issues are a major contributing factor, and that increasing awareness of the risks of fraud has led to departures from the theoretically ideal practice of immediate refunding. A measure adopted by many countries is to impose a mandatory carry forward period for excess credits. This means that a refund is paid only if an amount of excess credit remains to be recovered by the taxpayer at the end of the carry forward period (generally three to six months). The rationale of the carry forward scheme is that, for a non-exporting business, an excess VAT credit in one tax period should normally be followed by periods where net VAT liabilities are sufficient to absorb the credit brought forward.\textsuperscript{85} Businesses tend to see this as rough justice—a credit delayed is to some degree a credit denied. Another measure adopted by some tax administrations is to require security or bank guarantees from traders who seek refunds. A strong case can be made that the same tight statutory timetables imposed on persons paying VAT should also apply to tax authorities in refunding VAT.\textsuperscript{86}

Approaches have emerged in an attempt to reduce the number of VAT refund claims and address business cash flow concerns. For example, some EU countries such as France and Ireland, as well as some countries in North Africa and Asia, have implemented schemes which apply a zero rate on supplies to exporters. While the perceived benefits of these arrangements may be tempting, they add complexity to administration and open up new revenue risks, especially in developing countries and transition economies where administrative capacity needs significant strengthening. These factors should be carefully considered if introduction of these measures is contemplated.

With the aim of further shielding the VAT system from refund abuse and controlling taxpayer behaviour, a small number of countries have attempted, with mixed results, to introduce more intrusive systems. One such system involves collecting and cross-checking of purchases and sales transaction data from all VAT-registered businesses. With similar objectives in mind, a small number of countries have considered requiring business enterprises to deposit the VAT due on their supplies into special bank accounts,\textsuperscript{87} thereby locking away a portion of the enterprises’ working capital. A distinguishing feature of such schemes is that they subject businesses to extra


\textsuperscript{85} As a general rule, carryforward measures are not applied to regular exporters.


\textsuperscript{87} This would also be the case under the so-called “split payment model” that is considered by the EU Commission as a possible measure to reduce the VAT gap. See Communication from the Commission n 85 above.
workloads and higher compliance costs,\textsuperscript{88} and thus raise important questions about the extent to which they should be expected to bear the costs of tax administration. Because of their intrusive nature on all traders, good and poor compliers alike, these schemes deviate significantly from the principles of a modern tax system based on voluntary compliance (with tax administrations focusing their efforts on high risk cases, leaving the vast majority of traders to go about their business, free of unnecessary workloads and compliance costs).

In response to increasing demands by the business community for improved services from tax administrations, there has been a growing trend among countries to introduce fast-track refund processing for exporters with proven records of good compliance.\textsuperscript{89} This might involve a “gold card” scheme, for instance, under which exporters with good payment records obtain repayment within some specified period; silver card, and those in any lower groups, receive somewhat less prompt treatment. To the same end, a number of transition economies exempt from VAT the import of foreign capital equipment, at least by foreign investors and particularly in the development phase, in order to reduce the generation of excess credits. Of course, these schemes create their own difficulties and distortions: for example beneficial treatment of firms with established reputations creates a bias against new firms. The European Union introduced an electronic procedure for intra-community refund procedures as of 1 January 2010, with tighter deadlines and possible penalties for Member States.\textsuperscript{90}

A survey by the OECD in 2010 provided some evidence of the difficulties for businesses to recover VAT incurred in countries where they are not established and do not carry out a taxable activity.\textsuperscript{91} The report indicated that, although most OECD countries have implemented VAT relief procedures, these are frequently considered complex. 72% of the businesses surveyed said that they found these procedures “difficult” and more than 20% reported to be unable to recover any foreign VAT. Many businesses said that they recover less than 25% of the VAT incurred in foreign countries and one third said that these difficulties influence decisions on investment. The replies indicated that businesses would like to see improved communication with tax administrations

\textsuperscript{88} In particular, they remove a cash-flow benefit that sometimes offsets a business’s tax compliance costs by allowing it use of the government’s money for a period before it is remitted. This reduces interest charges that might be incurred to borrow working capital (see for example Evans, C., Ritchie, K., Tran-Nam, B. and M. Walpole, 1997, “A Report into Taxpayer Costs of Compliance”, (Commonwealth of Australia: Canberra),

\textsuperscript{89} The FTA published a report entitled “Tax Repayments: Maintaining the Balance Between Refund Service Delivery, Compliance and Integrity” in May 2011, which includes a discussion of Vat refunds and practical recommendations concerning repayment systems.


\textsuperscript{91} VAT/GST Relief for Foreign Businesses: the State of Play (OECD), 2010, Available at: www.oecd.org/ctp/ct.
and a greater harmonisation and standardisation of the procedures, which would speed up and improve refund systems. In response, the OECD developed Guidelines on VAT neutrality.\(^{92}\)

### IV. WORK IN PROGRESS

In 2005, discussion at the ITD conference on VAT in Rome clearly indicated that the VAT was very much a work in progress and it concluded that the range of challenges ahead—improving the structure and implementation of the tax, dealing with the new challenges posed by international services, electronic commerce, regional integration and trade liberalisation—would mean that the VAT would remain on the reform agenda for many years to come. Eight years later, this prediction has proven correct. More than 150 countries operate a VAT today, twice as many as in 1992, and this number continues to grow. The importance of VAT as a source of government revenue will likely continue to grow as countries deal with fiscal consolidation pressures in the wake of the economic crisis while seeking to restore growth. VAT is widely seen as a relatively growth-friendly tax and, as a result, many countries are seeking to raise additional revenues from VAT, rather than other taxes, as part of their fiscal consolidation strategies. Many countries may consider broadening the VAT base, by using fewer exemptions and reduced rates, as research suggests that this could increase output and economic welfare. But the political obstacles to such reform are often formidable.

In an international context, the uncoordinated interaction of national VATs creates considerable risk of double taxation and double non-taxation, hindering economic growth and distorting competition. This is especially problematic with respect to international trade in services, which has doubled between 2000 and 2008. Services cannot be subject to border controls in the same way as goods, so administrative procedures for ensuring that the right amount of tax is paid in the right place are more complex. From a government’s viewpoint there is a risk of under-taxation and loss of revenue, or distorting trade through double taxation. From a business viewpoint, there are large revenue risks and high compliance costs.

In short, VAT is a major revenue raiser and the design of regimes can thus potentially have a significant impact on a country’s economic performance. Most world trade is subject to VAT at its origin or destination and the interaction of regimes can potentially have a major impact in either facilitating or distorting trade. There is thus a strong prima facie case for internationally agreed principles that contribute toward ensuring that VATs interact consistently so that they facilitate rather than distort international trade. Similarly the design and operation of VAT is an area where countries can potentially learn from each other and develop best practices. With many countries, developed and developing alike, facing similar challenges, the scope and potential benefits from continued experience sharing are immense.

CHAPTER 3

Taxation of Micro-, Small - and Mediums Sized Enterprises

I. INTRODUCTION

The purpose of this section of this publication is to set out key issues in the tax treatment of micro, small- and medium-sized enterprises (MSMEs). It draws to a large extent on presentations and discussions at a global and a number of regional conferences organized by the ITD as well as on country surveys conducted by the IMF and OECD. The paper focuses on issues rather than description: the survey responses themselves can be found in the conference area of the ITD website, at www.itdweb.org.

The taxation of MSMEs has come to attract increasing attention in recent years, in developed and developing countries alike. This reflects a range of considerations.

Firstly, from a revenue authority perspective, it is the natural next step after a strong focus in the last fifteen years or so, across industrialised, emerging and developing countries, on ‘large taxpayers’ as a separate group (Baer et al, 2003). This focus had a clear rationale in concentrating effort (of the taxpayer as well as the tax administration) where the revenue yield is greatest: moreover, in lower income countries in particular, the large taxpayer segment has frequently served as a focus for beginning overall revenue administration modernisation. While this calculus remains valid, awareness of the dangers of inadequate attention to the taxation of MSMEs has grown. It can lead, for example, to distortions of competition as a result of uneven tax enforcement, with incentives created to limit growth and to avoid tax through artificial splitting of enterprises. Not least, voluntary compliance by larger enterprises themselves, and by wage earners, may be undermined by the (correct) perception that their smaller counterparts, or better-off neighbours, are getting away with poorer compliance.

Secondly, finance, economy and industry ministries have had longstanding concerns about a variety of market failures, such as adverse selection in credit markets, which can result in credit rationing behavior, and information costs, which particularly affect MSMEs and provide a rationale for policy intervention. A vibrant MSME sector is often seen as a source of future economic growth, despite the fact that genuinely technologically innovative SMEs are a very small part of the total SME population in every country. The extent to which such market failures are best addressed through the tax system is however a very different issue. The economic arguments for providing tax preferences for SMEs to deal with such market failures are much weaker. However, a political desire to provide visible and tangible support to SMEs often results
in the use of tax measures, even if alternative more targeted spending instruments are potentially available.

Privatization and deregulation have spurred the development of the SME sector, most spectacularly in countries transitioning towards market economies: the number of small businesses in Russia nearly tripled between 1991 and 1994 (Engelschalk, 2004), for example, while the number of private SMEs recorded in China\(^9\) rose from zero in the early 1980s to over 40 million now, with the government expecting the number to grow by 8 per cent a year till 2015. Their potential economic significance and vitality lends an importance to the tax treatment of SMEs that is potentially far greater than their contribution to revenue alone could warrant. A vibrant MSME sector is often seen as a source of future economic growth and the focus on MSMEs in policy circles therefore reflects a view, rightly or wrongly, of their role in fostering innovation, employment and growth, despite the fact that genuinely technologically innovative SMEs are a very small part of the total SME population in every country.

Not least, especially—though by no means only—in developing countries, the close link between informality (or the ‘grey’ or ‘hidden’ economy) and enterprise size, together with increasing concern with the distortions and inequities associated with a large (and generally perhaps growing\(^5\)) informal sector, has led to greater focus on the tax treatment of MSMEs as a key element in countering, or at least not aggravating, informality.

While there is considerable similarity in the broad concerns that countries bring to the taxation of MSMEs, there are also very considerable differences both within the MSME sector in any country—ranging from a single individual engaged in a part-time profit-making activity, to quite major corporations with several hundred employees—and across countries. The latter is perhaps especially marked: a ‘medium’ sized enterprise in an industrialized country might well be one of the largest businesses in a small, developing country; and while even the smallest enterprise in a developed economy can be presumed to have basic skills of numeracy and literacy, this may not be the case in low income countries.

Given such a wide variation in country circumstances, there can clearly be no single ‘best’ approach to the taxation of MSMEs, applicable in all circumstances, and indeed practice in this area varies widely even across countries at roughly similar stages of development. The same point applies to many aspects of MSME analysis: “It has...become something of a truism that the SME sector is so heterogeneous that little of universal value can be said of it” (Dannreuther, 2010).

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93 The Chinese State Statistical Bureau defines SMEs somewhat differently than the WB/IFC but these definitional differences are not material to the discussion contained in this chapter.

94 Schneider, Buehn, and Montenegro (2010) argue that informality has been growing modestly worldwide in the period 1999 – 2007, and Schneider and Buehn (2012) estimate a modest decrease in the size of the shadow economy in OECD countries in the period 1999 – 2010. However, the OECD has argued that the methodology used in these studies is fundamentally flawed, and in any case macro level estimates of the size of the shadow economy provide little practical help in decisions about allocating compliance resources within revenue authorities.
Greater segmentation is thus required in both analysis and practice. In much of this paper, the focus is on small, and micro, enterprises, which typically pose the greatest challenges to tax compliance and administration—rather than on medium-sized businesses, which, while smaller than the largest enterprises, should nonetheless be expected to comply with the regular tax regime even in developing countries (albeit some simplifications for medium-sized businesses might be warranted to reduce compliance costs and facilitate migration from the small into the medium taxpayer segment).

The task of constructing tax regimes for MSMEs is an inherently difficult one, mixing policy and administration considerations more intimately than perhaps any other aspects of tax design. There is as yet relatively little cross-country experience with generalized approaches to SME taxation, including on the part of multilateral agencies such as the ITD partner organizations. At a more academic level too, while there is a sizable literature on the challenges faced in designing tax regimes for MSMEs, these have received far less analytical attention than many other aspects of tax design.

All this—the topicality, diversity, difficulty, and analytical novelties of the issue—make the taxation of MSMEs an area with evident scope for fresh thinking and experience sharing. This paper, in setting out some of the key economic and practical concerns, and central features of current practice, is intended to set the scene for such discussion. It starts by considering what is meant by an MSME, and sets out some stylized facts on this sector to guide the later discussion. Section III then focuses on pure policy issues, by considering how SMEs should be taxed if implementation were costless. The real difficulties are raised, however, precisely by costs of compliance (incurred by taxpayers) and of administration (incurred by the authorities); the design issues that these raise are taken up in Section IV, which suggests for consideration a possible generalized scheme based upon this analysis. Administrative issues are the focus of Section V. Section VI concludes, and provides some issues for further consideration.

II. BACKGROUND

This section aims to provide some basic stylized facts to inform the subsequent discussion, on the nature of MSMEs and their significance in both the wider economy (a more complete account being in Berry (2007)) and the tax system.

A. THE DEFINITION AND IMPORTANCE OF MSMEs

There are various criteria of size that might be used to define an MSME (turnover, number of employees, capital base, profits, extent of imports and exports...), and various definitions have indeed been developed for application in a range of countries.95

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95 The World Bank and the European Commission, for instance, define:
For the purposes of this paper, however, no single definition is appropriate.\textsuperscript{96} For whether a particular enterprise appears for tax purposes to be large, medium or small differs very widely across countries, depending on their degree of development and the general scale of economic activity.\textsuperscript{97} A firm with turnover of less than EUR 10 million is categorized as ‘small’ in the European Union, for example, but in many developing countries would be included in the large taxpayer unit. There is thus some degree of relativism in the relevant notion of size for purposes of tax design: as noted by OECD (2004), “the characteristics of a SME reflect not only the economic, but also the cultural and social dimensions of a country. Not surprisingly, very different patterns are used across countries and over time.” There is also, however, an inescapable absolute component to the notion of firm size: the very largest enterprises are large by the standards of any country, and the smallest—the street traders in developing countries, with income approximating some level of absolute poverty are also small everywhere. Indeed it will be helpful to refer to this latter group as a distinct category of micro enterprise.\textsuperscript{98}

While there is thus no single definition of MSMEs suitable for all countries and for all tax-related purposes, there is nevertheless some commonality of meaning that underlies much of the discussion in this area. In this spirit, Table 2 provides a sense of how these size classifications are used in this paper.

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Micro</strong></td>
<td>10 or fewer employees, assets no more than USD100,000</td>
<td>10 or fewer employees and balance sheet total of no more than EUR 2m</td>
</tr>
<tr>
<td><strong>Small</strong></td>
<td>10 to 50 employees, turnover and assets between US$100,000 and US$3 million</td>
<td>10 to 50 employees, and annual turnover and/or balance sheet total of less than EUR 10m</td>
</tr>
<tr>
<td><strong>Medium</strong></td>
<td>50 to 300 employees; turnover and assets between US$3 to 15 million.</td>
<td>20-250 employees and turnover and/or annual balance sheet of EUR 10-50m</td>
</tr>
</tbody>
</table>

\textsuperscript{96} In Section IV.C, an implicit, practical, definition emerges, in which ‘small’ businesses are those with turnover below the VAT threshold, and ‘medium’ businesses are those above it but not eligible for inclusion among the largest taxpayers (those administered by an LTU).

\textsuperscript{97} Even within countries, differing definitions may be adopted for tax and other purposes (such as lending by development banks). Analysis of trends is also complicated by a tendency for definitions to change over time: that of the European Union has changed three times in the last fifteen years, and that in China four times since the 1950s.

\textsuperscript{98} Usage of the term in this paper thus differs from that in the World Bank and European Commission schemes in the earlier footnote.
TABLE 2 - CHARACTERISTICS OF MICRO, SMALL, AND MEDIUM ENTERPRISES

<table>
<thead>
<tr>
<th>CHARACTERISTICS</th>
<th>MICRO</th>
<th>SMALL</th>
<th>MEDIUM</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Number of taxpayers</strong></td>
<td>Very numerous</td>
<td>Many</td>
<td>Moderate</td>
</tr>
<tr>
<td><strong>Type of taxpayers</strong></td>
<td>Individuals (small traders or non-</td>
<td>Family-owned business with some employees;</td>
<td>Legal entities with several employees;</td>
</tr>
<tr>
<td></td>
<td>specialized service providers); family-</td>
<td>highly specialized self-employers</td>
<td>partnerships</td>
</tr>
<tr>
<td></td>
<td>owned businesses.</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Ownership Structure</strong></td>
<td>Owner, employee(s) and manager are one</td>
<td>Owner(s) are generally the manager</td>
<td>Owner is usually different from managers</td>
</tr>
<tr>
<td></td>
<td>and the same</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Type of transactions</strong></td>
<td>Mainly cash; high informality</td>
<td>Cash/bank; some informality</td>
<td>Bank; much more formal</td>
</tr>
<tr>
<td><strong>Place of business</strong></td>
<td>Frequently non-fixed</td>
<td>Fixed (but may be volatile)</td>
<td>Fixed</td>
</tr>
<tr>
<td><strong>Business administration</strong></td>
<td>Non-professional (family-run)</td>
<td>Some professional assistance</td>
<td>Regular professional advice</td>
</tr>
<tr>
<td><strong>Accounting Standards</strong></td>
<td>No or few records; very limited</td>
<td>Some records, limited to partial</td>
<td>Partial to good compliance and record-</td>
</tr>
<tr>
<td></td>
<td>understanding</td>
<td>compliance; limited understanding</td>
<td>keeping</td>
</tr>
<tr>
<td><strong>Market reach</strong></td>
<td>Local</td>
<td>Local/Regional</td>
<td>National/International</td>
</tr>
<tr>
<td><strong>Life-span of business</strong></td>
<td>Very dynamic; rapid creation and</td>
<td>Dynamic; may disappear or change</td>
<td>More stable (consolidated) business</td>
</tr>
<tr>
<td></td>
<td>dissolution</td>
<td>business approach,</td>
<td>activities</td>
</tr>
<tr>
<td><strong>Growth potential</strong></td>
<td>Very limited.</td>
<td>Limited, Many stay small, but growth</td>
<td>Generally remains at medium-size level</td>
</tr>
<tr>
<td></td>
<td>Usually remains at micro level</td>
<td>not infrequent</td>
<td></td>
</tr>
</tbody>
</table>

Source: IMF staff

Perhaps even more important is the substantial heterogeneity of MSMEs within any country. They are likely to vary substantially in size itself, of course, from the small retail outlet to the substantial manufacturing enterprise. They are also likely to vary widely in their organizational form, which will typically include, for instance, sole proprietorships (with or without employees),
small corporations (public or private), professionals, and partnerships. These latter differences may in turn carry differing obligations for record-keeping that affect the costs to the enterprises of complying with (and to the revenue authorities of administering) alternative possible tax obligations. Public corporations, for example, commonly have stronger accounting requirements than do sole proprietorships, and enterprises with employees may be subject to the full panoply of requirements associated with withholding labour income taxes and social contributions.

Internationally comparable data on the extent of economic activity conducted through MSMEs are scarce. What is clear is that a large majority of enterprises, in both developed and developing countries are MSMEs. Over 95 percent of businesses in the OECD fall into this category, and they account for about two-thirds of total private employment (OECD, 2005a). In Latin America and the Caribbean MSMEs account for 99 percent of businesses and employ 67 percent of workers (OECD 2012). Beyond this, Figures 2 and 3 provide a, now somewhat dated, indication of their relative importance in countries at different income levels. These figures conceal significant variation in the importance of MSMEs across countries at broadly similar income levels.\(^9\) Nevertheless, it emerges clearly that both the output and employment shares of formal sector MSMEs increase with the general level of development (though Berry (2007) argues that this regularity may be weakening, in part because of the decline of large scale manufacturing enterprises in higher income countries).

A variety of data supports the important and well-known regularity that informality decreases as per capita income increases. Importantly, Figure 3 suggests that in terms of GDP these two effects are largely offsetting, in that the combined share of the formal SME sector and the informal sector is broadly the same at all income levels, at around 60-70 percent of GDP. This is consistent with (though not in itself proof of) the presumption that in developing countries, informality is largely associated with smaller enterprises.\(^{10}\)

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\(^9\)As defined, respectively, by the World Bank and the EU (see footnote 3 above), MSMEs account for around 70 (40) percent of employment in the EU-19, for example, compared to 50 (22) percent in the U.S. (Dannreuther, 2007).

\(^{10}\) See however the discussion of partial informality of larger firms in Fajnzylber et al (2007)
FIGURE 2- FIRM SIZE AND EMPLOYMENT


FIGURE 3- FIRM SIZE AND GDP SHARE


This aggregates across a range of prior studies, augmented by estimates of informality.
B. Collection and Incidence: MSMEs in the Wider Tax System

1. Firm Size and Patterns of Tax Payment

An especially important aspect of the MSME sector is that they account for a much smaller share of all tax revenues than they do of GDP or employment, and this is so in both developed and developing economies. This is the converse of the well-known empirical regularity that potential tax payments are typically very heavily concentrated in a relatively small number of enterprises. For example, typical distributions of revenue by firm size for African and Mid-Eastern countries would be: (1) for the largest—less than 1 percent of taxpayers and over 70 percent of revenues; (2) for the medium-sized—10-20 percent of taxpayers and 20-25 percent of revenues; and (3) for the small and micro enterprises—80-90 percent of taxpayers and 5-10 percent of revenues. Table 3 provides some examples from countries in various regions and development levels.

<table>
<thead>
<tr>
<th>Country</th>
<th>Percent of taxpayers</th>
<th>Percent of tax revenues</th>
</tr>
</thead>
<tbody>
<tr>
<td>Brazil</td>
<td>0.35</td>
<td>80.0</td>
</tr>
<tr>
<td>Argentina</td>
<td>0.1</td>
<td>49.0</td>
</tr>
<tr>
<td>Benin</td>
<td>1.0</td>
<td>90.0</td>
</tr>
<tr>
<td>Bulgaria</td>
<td>0.1</td>
<td>51.4</td>
</tr>
<tr>
<td>Kenya</td>
<td>0.4</td>
<td>61.0</td>
</tr>
<tr>
<td>Spain</td>
<td>0.1</td>
<td>40.2</td>
</tr>
</tbody>
</table>

Source: IMF staff compilation 2007 for then recent years

This stylized fact—heavy concentration of revenues in relatively few firms—needs, however, to be interpreted with caution:

One reason for this is that larger enterprises are to some degree used as withholding agents, so that part of the tax recorded as paid by them is intended as prepayment by smaller enterprises. As stressed by Slemrod (2007), it is, after all, a long-established principle of effective tax administration to collect tax at a few key nodes in the wider system—which often, and especially in developing countries, means larger enterprises and border points. For example, many lower

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101 There is some evidence that the distribution of firm size is even more unequal in lower income countries than in higher—reflecting a ‘missing middle’ in the former—with a greater concentration of potential tax payments among larger enterprises and smaller enterprises accounting for a larger share of output and employment (see for example Tybout, 2000).
income countries, especially in Francophone Africa and South America, but also in a number of Asian countries, require large enterprises to withhold VAT and/or income tax in respect of their purchases from smaller firms (this tax then being creditable against those smaller firms’ own liability). In one Francophone country for which data are available, taxes withheld in this way have been in the order of 8 percent of all profit tax revenue. Many lower income countries also make extensive use of withholding (against income tax) on imports.  

A second reason for caution is that the real economic burden of taxes remitted by larger enterprises may not be borne by them but rather passed on to (or through) MSMEs. More generally, MSMEs may well be powerfully affected by taxes that are the formal responsibility of, and remitted by, others: in this area of tax analysis as in others, what matters is the real incidence of the tax system—a point returned to below.

Despite the previous qualifications, that MSMEs account for a far smaller share of tax payments than they do of GDP is certainly suggestive of relatively low effective tax rates on MSMEs (at least for the sector as whole, though not necessarily for individual enterprises). However, such assessment is only true when looking exclusively at taxes collected at the national level. Taking into consideration also taxes and quasi-taxes collected by subnational governments the overall tax burden on the smallest enterprises can substantially exceed the tax burden on larger businesses.  At the national level, low effective tax rates may of course reflect policy choices, since the distribution of tax payments itself reflects decisions made in designing and enforcing the tax system (both directly on tax remittances and indirectly, as discussed below, though effects on the underlying size distribution of firms).

Importantly, however, there is some evidence (at least for developing countries) that effective tax rates do not necessarily increase with firm size. Instead, studies for both Cameroon and Uganda—based on surveys that provide an unusual (if no doubt imperfect) ability to identify those evading tax—find an inverse-U shaped relationship (on average) between firm size and effective tax rates (Gauthier and Gersovitz, 1997; Gauthier and Reinikka, 2006). Smaller firms, it seems, reduce their tax payments by evasion and informality. Large firms, on the other hand, reduce them by securing legal exemptions (with corporate income tax (CIT) holidays or reduced rates, for example, on investments above some absolute amount); they may also have more access to tax-planning devices. The striking implication is that it is thus firms in the middle of the size distribution that pay the highest average tax rate.

102 See for example Table 1 of Keen (2007).
103 See e.g. Pimhidzai and Fox (2011), Backiny-Yetna (2009).
104 Sri Lanka, for example, offered tax holiday schemes that increased in generosity with the size of the investment.
105 Implicit tax payments in the form of bribes may also follow this hump-shaped pattern: those with relatively low incomes have relatively little tax to evade and relatively little to be extorted from them, while those with relatively high incomes are less vulnerable to extortion from tax collectors in that they can more easily afford access to such appeals process as is available (Hindriks, Keen and Muthoo, 1999).
2. **TAX INCIDENCE AND MSMEs**

As stressed above, assessing the impact of the tax system on MSMEs is not simply a matter of looking at statutory tax provisions. Allowance must be made for the impact of (and on) informality, and—still more fundamentally—difficult questions faced concerning the effective incidence of taxes formally imposed on other enterprises. For example:

- A small enterprise not required to register for the VAT may still be powerfully affected by the tax—and may even benefit from it. Even in the absence of VAT withholding of the kind described above, such a firm will bear unrecovered VAT on inputs that it purchases from VAT-registered firms or imports. If it cannot pass this unrecovered tax along to the buyer in the price at which it sells its product (perhaps because the demand for its product is highly elastic), the real burden of the tax must be borne by the owners or employees of the enterprise.106 If, however, a VAT exempt firm is able to sell its product at the same price to final consumers as do enterprises liable to the VAT, then it is able to keep for itself as profit what VAT-registered companies must pay as tax on their value added. In this case, the VAT acts as subsidy to exempt firms.

- Calculated marginal effective tax rates (METRs)—indicating how the tax system affects incentives to invest—are built on some assumption as to the required after-tax rate of return to the final investor. For large enterprises, the conventional assumption is that finance is obtained on a world capital market, so that, for a small country, the required return can be taken as independent of its own tax policy: the burden of the tax cannot then be borne by capital, but rather the distortion of investment it implies will be felt in reduced payments to other less mobile factors. Moreover, since the marginal shareholder can then be taken to be non-resident, the METR is independent of personal tax rates in the country in which the investment is located. For MSMEs, however, a more plausible assumption may be of domestic financing: in which case some of the real burden may be passed on in the form of a reduced after-tax return to investors, with a consequently negative impact on investment; and, moreover, an important role may be played by personal tax parameters.

- For larger enterprises, attention often focuses as much on average effective tax rates (AETRs) as on METRs: to the extent that their earnings are independent of their location, they will tend to locate wherever the AETR is lowest. Smaller companies may have fewer such options, making the AETR less relevant. By the same token, simple changes in the statutory CIT rate may have less impact on the behaviour of MSMEs than on larger enterprises, with the latter more able to respond by using transfer pricing and financial devices to shift taxable profit to lower-taxed jurisdictions.

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106 Or if the firm sells mainly to VAT registered firms then it has an incentive (compliance costs aside) to register voluntarily for the VAT.
One important dimension of incidence is the impact of the tax system on the size of the MSME sector, and on the extent of informality. A heavy enforcement focus on larger enterprises, for example, may induce some enterprises to limit their size so as to remain below the threshold test for inclusion in any large taxpayer unit (LTU). Other discontinuities in tax treatment at particular size levels may have similar effects. For example, enterprises may choose to restrict their growth—or to artificially split their operations—in order to avoid a jump in their tax liability when they cross the VAT threshold.\textsuperscript{107} Even in the absence of such threshold effects, tax structures may themselves systematically (even if unintentionally) affect the distribution of firm size. Perhaps most important, the choice between operating as an employee within a larger enterprise or as a self-employed entrepreneur—perhaps even performing the same tasks as contractor rather than employee—may be sensitive to a range of tax considerations (not only statutory tax provisions regarding the treatment of labour and capital income—including any tax privileges for forms of saving other than investment in one’s own enterprise—but also opportunities for avoidance and relative compliance costs).\textsuperscript{108} Commodity taxation may also affect the distribution of firm size: ad valorem excises may tend to reduce the number of active firms, for instance (one of its effects being akin to an increase in the fixed costs that firms must cover in order to break even); specific taxation, in contrast, may tend to reduce industrial concentration (by in effect narrowing cost differentials across heterogeneous firms).\textsuperscript{109}

Policy thus needs to be set bearing in mind the endogeneity of the size distribution of enterprises. In some cases, it should be noted, this may point to less favourable policy towards MSMEs. The ease of collecting taxes from a relatively small number of large firms, for example, may give the authorities an incentive to facilitate such concentration by making it harder for smaller enterprises to do business (including perhaps by non-tax measures), a point developed by Auriol and Warlters (2005).

\section*{III. Tax design for MSMEs—when implementation is costless}

It is useful to begin thinking about tax design for MSMEs by imagining first that there are no costs to enterprises of complying with tax rules and none to the tax authorities in administering them. In the absence of such costs of compliance and administration—the two together being

\textsuperscript{107} Some countries adopt devices to avoid jumps in VAT liability.

\textsuperscript{108} Taxation may also powerfully affect the incorporation decision (as recently argued for the EU by de Mooij and Nicodème, 2006). This dimensions of effects is not considered here, however, since the decision made does not in itself affect the size of the enterprise. It remains true, of course, that a disproportionate number of small and micro enterprises tend to be unincorporated, so that tax measures that benefit the corporate form (such as a reduction in the effective rate of tax on dividends) tend to raise the tax payments of SMEs relative to those of other enterprises. For brevity, however, attention is confined throughout the paper, so far as possible, to measures that themselves are directly contingent on (not simply correlated with) some notion of size.

\textsuperscript{109} On this aspect of ad valorem taxation, see for instance, Delipalla and Keen (1992). The claim on specific taxation, more precisely, is that a uniform specific tax reduces the Herfindahl index of concentration in homogeneous product Cournot oligopoly when firms are characterized by exogenous differences in marginal cost (and fixed costs are zero).
referred to in this paper as implementation costs—would there be any reason to tax MSMEs any differently from larger enterprises?\textsuperscript{110}

A. TAX POLICY ARGUMENTS FOR DIFFERENTIAL TREATMENT OF MSMEs

A first step in answering this is to understand the distribution of firm size itself: why is it so invariably the case that this is characterized by a relatively large number of small firms? This remains less than fully understood.\textsuperscript{111} Textbook explanations begin with Gibrat’s law, which shows a skewed distribution of this kind to be the long-run outcome if the rate of firm growth is a random variable independent of initial size:\textsuperscript{112} this does not, however, appear to be the case (Sutton, 1997). More compelling approaches to the question draw attention to other possible characteristics of small firms that some may feel to warrant special tax treatment.

1. FINANCING CONSTRAINTS

Some recent models of the size distribution stress the possibility that imperfections in capital markets may make it especially difficult for small firms to access debt or equity finance (Cabral and Mata (2003), Gill (2005)). This would then make them more reliant on retained earnings as a source of finance—which, for start-ups in particular, may well be limited.

It is possible, it should be noted, that such imperfections could lead to the opposite outcome—that is, the theory also points to possibilities of over- rather than under-investment.\textsuperscript{113} Moreover, such as evidence as—such as that for Africa reviewed in Bigsten and Söderbom (2006)—does not always suggest that access to finance is a primary obstacle for the growth of small firms. And to the extent that these credit market constraints take the form of interest charges higher than are socially optimal, the deductibility of interest payments means that the tax system directly subsidizes part of these costs. Nevertheless, the perception of market failure in this area underlies, if only implicitly, a range of tax measures intended to ease any such financing constraint:

- A reduced rate of CIT might be charged on smaller companies (defined for example by turnover or capital level) or on lower levels of taxable profit, so increasing the internal finance available to them. Such measures are fairly common—a sample being in Table 4, with more detail for OECD countries also provided in Annex 2—though by no means universal, and many countries do not vary the corporate tax rate by size.

\textsuperscript{110} For further discussion of the issues addressed in this section, see, for instance, Holtz-Eakin (1995), Jousten (2007) and Slemrod (2007).

\textsuperscript{111} Some suggested answers to this question are non-economic in nature: there may simply be many people who prefer to work for themselves rather than within a larger organization.

\textsuperscript{112} More precisely, the proposition is that if the distribution of firms’ growth rates is normal and independent of initial size, then the limiting distribution of firm size is lognormal.

\textsuperscript{113} Though underinvestment results have attracted particular interest, simple models of asymmetric information in financial markets can quite easily generate over-investment: see for example Boadway and Keen (2006).
• Additional or specific investment allowances may be provided for MSMEs (as is done, for example, in Canada, Japan, Poland, the United Kingdom, and the United States).

• Tax preferences for investment in MSMEs may be given not at the level of the enterprise but at that of the investor, for example by providing favourable capital gains treatment for venture capitalists (exempted from capital gains tax on eligible venture investments in Australia, for example, and given a 50 percent deduction in the U.S.).

### TABLE 4- REDUCED RATES OF CORPORATION TAX FOR SMALL COMPANIES, SELECTED COUNTRIES

<table>
<thead>
<tr>
<th>Country</th>
<th>CIT Rates</th>
</tr>
</thead>
<tbody>
<tr>
<td>Belgium</td>
<td>Standard rate: 33.99 percent, below a threshold: progressive 24.98 and 31.93 percent</td>
</tr>
<tr>
<td>Costa Rica</td>
<td>Standard rate: 30 percent; below a turnover threshold: progressive 10, 20, and 30 percent.</td>
</tr>
<tr>
<td>Indonesia</td>
<td>Standard rate 25 percent. Reduced rate for small corporations 12.5 percent</td>
</tr>
<tr>
<td>Japan</td>
<td>Standard rate: 39.54 percent; below a certain capital threshold, progressive: 29.34 and 30.85 percent</td>
</tr>
<tr>
<td>Korea</td>
<td>Progressive rates: 14.3 and 24.2 percent</td>
</tr>
<tr>
<td>Netherlands</td>
<td>Progressive rates: 20, 23.5 and 25.5 percent</td>
</tr>
<tr>
<td>South Africa</td>
<td>Standard rate: 28 percent; below a turnover threshold: progressive 0,7 and 28 percent</td>
</tr>
<tr>
<td>Spain</td>
<td>Standard rate: 30 percent; reduced rate of 25 percent for small corporations (turnover under 8 million Euros) for taxable profit up to 102,202 Euros</td>
</tr>
<tr>
<td>United States</td>
<td>Progressive rates. Small business tax rate of 20.2 percent for profits up to US$ 50,000. Basic CIT rate 39.1 percent.</td>
</tr>
</tbody>
</table>

*Source: OECD (2013) and the World Bank.*
Chapter 3 | Tax design for MSMEs—when implementation is costless

The difficulties with the first of these measure—a reduced rate of corporation tax for smaller enterprises—illustrate some of the potential difficulties that all are liable to face. First, it is poorly targeted: many MSMEs may simply be unconstrained in their financing, so that a tax reduction for smaller firms foregoes revenue with little beneficial effect. Measures to reduce investment costs (such as the first year allowances for MSME investment in plant and machinery provided in the U.K.) may be more closely targeted on enterprises with genuine growth prospects—but again much of the benefit may go to companies not facing significant financing constraints and, moreover, enterprises (not least in the service sector) using little physical capital will receive correspondingly little advantage. Second, either the reduced rate or special investment incentives for MSMEs can actually create disincentives to growth: attempting to focus the benefit of a reduced CIT rate more sharply on smaller enterprises by clawing it back from larger, for instance, requires over some range a marginal rate that is above the higher ‘standard’ corporate tax rate. The METR is then likely to have the same inverse-U shaped as noted earlier has been observed for average effective rates in some developing countries. Third, since start-ups are likely to be loss making in their early years of operation, a reduced tax liability provides them only limited benefit: although the losses can be carried forward, they generally do not attract interest and are unlikely to be acceptable as collateral for loans. (The same objection applies a fortiori, of course, to the tax holidays that some countries have offered to start-ups). Providing the incentive at the level of the final investor can be a way to avoid this difficulty, but runs into yet a fourth difficulty: such schemes can become vehicles for tax avoidance, by companies artificially splitting\(^{115}\) (or engaging in arbitrage activities) to exploit the progressivity of the tax system, or shifting taxable income towards enterprises subject to the lower marginal rate.

All these difficulties reflect a more general problem with the use of tax measures to overcome perceived market failures in relation to MSMEs. As a general principle, the best response to a distortion is to act directly on the distortion itself.\(^ {116}\) If capital market imperfections are a genuine concern, the wisest policy response is generally to act on that imperfection directly—perhaps, for example, by offering subsidized loans, grants and guarantees to such firms (and many countries do indeed operate such schemes, such as Canada, Japan, New Zealand, Spain, and United States; several developing and emerging countries also offer similar schemes, as shown in the IMF survey, including Algeria, Argentina, Brazil, Peru, and Trinidad and Tobago). The availability of alternative spending measures may vary across countries, however, and would be expected to be systematically greater in more developed countries—so that the case for special tax measures there is likely to be especially weak.

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\(^{114}\) The difficulties discussed here are domestic ones; measures targeted at MSMEs may also raise issues of international tax competition and coordination.

\(^{115}\) Goolsbee (2004) shows that companies do separate, to exploit the progressivity of the U.S. income tax.

\(^{116}\) Second best considerations mean that this principle is not a formal proposition, but a useful guide for policy given the difficulties and risks in identifying more finely-tuned corrective policies.
While the argument for active tax measures to mitigate capital market imperfections may be weak, measures that tend to create or amplify such distortions need to be avoided. In particular, incomplete integration between corporate and personal taxation may exacerbate any difficulty in obtaining external equity finance by in itself tending raising the cost of new equity finance. In this case action—reducing the additional tax on dividends—may be warranted not as a form of preferential treatment for start-ups but rather as eliminating a distortion that happens to be especially damaging for them.

2. EMPLOYMENT, INNOVATION AND RISK-TAKING

It is sometimes argued that small businesses play a particularly important role in employment generation, and in developing new ideas. To the extent that these generate significant positive externalities, the implication is that relatively favourable tax treatment is appropriate.

Simple correlations between net employment growth and firm size do often show an apparently strong employment effect of small companies. But regressions of this kind on starting size are biased by the tendency of small firms to be temporarily small, and hence to grow, and of large firms to be temporarily large and hence to contract. Controlling for this, Davis, Haltiwanger and Schuh (1993) report no statistically significant effect of firm size on employment growth. Similarly, Biggs and Shah (1998) find that in Sub-Saharan Africa, large firms were the dominant job creators in the manufacturing sector. As argued by de Rugy (2005), the common focus in popular discussion on the share of net job creation by smaller enterprises in economy-wide net job creation can also be misleading: this share can be more than 100 percent, for example (and this can be so even if gross job creation is much larger in larger enterprises).

On the other hand, the World Bank has highlighted that in rural areas of some developing countries, small enterprises provide the only realistic employment opportunities. Similarly, the OECD (2005b) concludes that encouraging entrepreneurship is an effective means of job creation and poverty alleviation.

The suggestion that MSMEs are particularly innovative, thus leading to higher individual firm and aggregate economic growth, is also not fully supported by econometric evidence. Though it is

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117 The (no longer so) ‘new view’ of dividend taxation stresses that taxing dividends at an unchanging rate does not affect the cost of retention finance—equity already in the firm is ‘trapped,’ in that the dividend tax must be paid either today (if profits are not retained) or in the future (if they are), and so do not affect value-maximizing decisions. Subscribing to new equity, however, means putting money into this trap, and so is discouraged by the taxation of dividends.

118 De Rugy gives an example in which a small firms increase their net employment by 50 while of two larger companies one hires 2000 people and the other sheds 2000: the small firm accounts for 100 percent of net job creation, but only 2.4 percent of gross job creation. The point here is largely one of presentation: it is perfectly correct to say that ‘without’ the increased employment in small firms there would have been no increase in aggregate employment; but is also true that smaller enterprises made only a negligible contribution to the (over) replacement of jobs lost. The point, in any event, is not merely theoretical: on the net measure, for example, physician offices accounted for 174 percent of non-farm job creation in the U.S. between 2000 and 2001.
tempting to think of spectacular success stories—the big company that started as a small garage operation somewhere in the unspectacular suburbs of some city—not all companies follow the same growth patterns. There are many firms that start small and stay small for generations; and there are others that are necessarily large-scale operations on pure economies of scale grounds. Empirical evidence seems to support this. Pagano and Schivardi (2003) show that for a sample of European firms, larger firm size is associated with faster innovation. Beck, Demircu-Kunt and Levine (2005) do not find empirical support for a causal impact of the prevalence of MSMEs on growth, using data from 45 countries. Some studies do though find that small firms may play a key role in diffusing new ideas and technology (Aps, Morck and Yeung (1999); Tether (1999)).

In any case, neither argument—employment creation or innovation—is persuasive as a basis for special tax treatment of MSMEs. In each case, the same general principles as discussed above apply: better targeted instruments may well be available—public support for R&D, for example, and earned income tax credits to encourage employment, especially of the low paid. Even if there is no purposive role for tax policy in correcting market failures, however, care needs to be taken in setting tax policy to avoid unintended harm (by ensuring, for example, that risk-taking is not unduly discouraged by inadequate provision for loss carry forward).

3. DISTRIBUTIONAL CONSIDERATIONS

Equity arguments arise in both developed and developing countries. Since businesses are not people, however, their impact on welfare comes only insofar as their owners or employees benefit from their activities. It is thus not clear from first principles, for example, whether large businesses employing unskilled labour at reasonable wages have any greater or lesser welfare impact than do small family-owned enterprises or subsistence self-employment. In the case of developing countries, the opportunity to create micro-businesses is often seen as an important route out of poverty, particularly for women. It is also important to remember, however, that the ‘self-employed’ often includes such people as high-earning attorneys and doctors, not obviously more deserving of support than are low wage employees. Whether MSMEs help alleviate poverty or decrease income inequality appears to remain an open question: Berry (2007) argues that experience shows that a strong MSME sector can be associated with relatively low inequality, for example, whereas Beck, Demircu-Kunt and Levine (2005) find no evidence to that effect.

It may be that in some contexts small firms are created by those with few if any alternative employment prospects, and so might be seen as a form of active labour market program (to develop job skills and prevent the erosion of labour market attachment) and so warranting support comparable to that provided to such schemes. It might also be argued that small businesses form part of the foundation of local communities, contributing to social cohesion, as well as allowing the development of skills for the disadvantaged. This function may be better provided, nonetheless, through training and other services rather than by favourable tax treatment.
4. **INEFFICIENCY**

One of the simplest ways to explain the co-existence in a single market of firms differing in size—and certainly one of the easiest ways for economists to model it—is by supposing the smaller of them to be less efficient, but able to survive because imperfections of competition sustain an equilibrium price in excess of their average production costs.\(^{119}\) This does not mean that MSMEs serve no socially useful purpose: depending upon the structure of the particular market, their continued existence may discipline abusive pricing by larger ones. It raises the possibility, nevertheless, that it may be optimal to impose systematically heavier taxes\(^{120}\) on small firms than on large in order to shift production to more efficient firms (Lahiri and Ono, 1988). In a standard model of Cournot competition, Gersovitz (2005) shows that this will indeed be the case if the marginal cost of public funds (MCPF)—loosely speaking, the marginal social value of tax revenue—is not too high (specifically, is less than 2). At higher levels of the MCPF, however, it is optimal to tax larger firms more heavily than small: intuitively, the concern to use the tax system to raise revenue by soaking up rents is then greater, and these rents are concentrated in the larger (more efficient) firms. Again, then, the optimal tax policy toward MSMEs from an efficiency standpoint is ambiguous.

5. **COMPENSATING FOR OTHER DISADVANTAGES**

It may seem tempting to offer special treatment to smaller enterprises to offset other cost disadvantages they may face. Apart from disadvantages related to size itself, which are sources of inefficiency of the type just described, these can be of broadly two types. There are those associated with complying with the tax system itself: the implications of these are the focus of the next section. The second is other policy-induced costs of doing business (and, often a particular concern, entering export markets) with a substantial fixed cost component: costs of registering a business, for example, or of meeting product standards.\(^{121}\) If these are set inappropriately, however, the proper policy response is to change them, not to distort the tax system and in the process implicitly validate other policy errors.

6. **INTERNATIONAL MOBILITY**

MSMEs are likely to be less internationally mobile in their activities and financing than larger enterprises, being more likely to produce services that are hard to trade internationally (lawyers trained in one country, for example, may face restrictions on working in another), or to produce

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\(^{119}\) In this spirit, for example, the popular model of Melitz (2003) predicts that the most efficient companies in any given sector become multinationals, the moderately efficient ones become exporters from their home base, and the least efficient operators are limited to domestic production.

\(^{120}\) The analyses referred to in this paragraph focus on production taxes, but broadly similar conclusions can be expected to apply for consumption or income taxes.

\(^{121}\) As Berry (2007) notes, however, smaller enterprises may actually be in some respects less policy-hampered than large, for instance in relation to labor regulations.
for local markets and preferences.\textsuperscript{122} These firms may also simply not be able to realize sufficient economies of scale to operate in world markets.

This point should not be overstated—increased international trade in services, and facilitating MSME exports, are often an important part of trade liberalization—and may be more true in developing than in developed countries. But any such difference in relative mobility has potentially important implications for tax design. Greater international mobility implies a greater sensitivity of the tax base to domestic tax conditions; and a higher elasticity of the tax base points towards setting a lower tax rate. Crudely, larger enterprises may choose to relocate abroad if tax conditions become less favourable than elsewhere, while immobile companies have no such choice. Optimal tax design requires recognizing this, with more mobile firms taxed at lower rates (Hagen, Osmundsen, and Schjelderup, 1998). And this means that, to the extent that they are less mobile, MSMEs should on this account face relatively high tax rates. The decline in effective tax rates at the upper-end of the inverse-U relation noted earlier might, in principle, be a feature of good tax design.\textsuperscript{123}

If, on the other hand, larger firms are also more likely to be foreign-owned, this effect may be counteracted by the particular attraction of taxing foreigners rather than domestic residents. But this too has a counter-argument: many countries seem to attach particular value to foreign-owned investments, in the belief that these are especially likely to bring spill-over benefits to the wider economy.

\textbf{B. Lessons}

Arguments clearly can be made, on pure tax policy grounds, for differential treatment of MSMEs—and indeed they are made, often with some success. Whether they are compelling from an economic standpoint, however, is debatable.\textsuperscript{124}

First, it is not even clear in which direction, on balance, they point. Perhaps, for example, MSMEs do face capital market constraints that would be eased by tax measures increasing their potential retained earnings; but perhaps they are also less mobile, in which case efficiency requires that they be more heavily taxed than larger and more mobile firms.

\textsuperscript{122} Hall (2007) reports, for example, that SMEs in the EU derive about 13 percent of their turnover from exports.

\textsuperscript{123} From a national perspective, at least: from a collective perspective, the incentive for each country to set low rates on more mobile enterprises may leave all ultimately worse off. This raises wider issues concerning the costs and benefits of international tax competition that are not addressed here.

\textsuperscript{124} Political economy considerations will of course also shape the treatment of MSMEs in practice, though these may be complex. On one hand, the large number of individuals directly affected by the taxation of smaller enterprises suggests that they are likely to receive relatively favorable treatment, and indeed this group has clearly been powerful in many countries: Engelschalk (2004) gives the example of a tax-motivated strike of taxi drivers that achieved is led to the resignation of a Deputy Minister of Finance, On the other, the very heterogeneity of smaller enterprises may make it harder for their associations to represent more than their broadest common interests—Danreuther (2007) stresses that “It is very hard to find out what SMEs want”—and the smaller number and perhaps deeper pockets of larger enterprises has clearly in some cases made them relatively well-positioned to lobby for favourable treatment.
Second, few of the underlying rationales for differential treatment relate to size as such. They relate rather to characteristics that may be correlated with size, but are not synonymous with it: access to capital markets, for example, or innovativeness or efficiency. These may be better proxied by some feature of an enterprise other than size, such as its age. While it would then be better to condition tax policy on these closer proxies—focusing support on start-ups, for example—effective implementation may prove difficult: reorganizations can make it all too easy, for example, to obscure an enterprise’s true ‘age,’ and differential treatment of enterprises inescapably creates scope for tax avoidance.

Third, and of critical importance to the analysis of this paper, the tax system is generally not the most effective way of influencing the aspect of behaviour that might be of concern. Spending programs—subject to careful oversight, more closely targeted, and less subject to abuse and/or unintended side effects—will often be a better approach. Micro-credit schemes for the self-employed in developing countries, and job-training or similar schemes in developed countries, are good examples. There may be some cases, most likely perhaps in developing countries, in which such devices are unavailable, or subject to even more significant governance problems than tax measures. Even then, however, the difficulties associated with tax interventions noted above, combined with the generic weakness of the case for special treatment, are likely to create a presumption against tax differentiation on pure policy grounds.

While the case for active tax interventions to promote MSMEs may thus be weak, it remains important that the tax system not create biases that distort the extent or operations of such enterprises. In this context, tax-induced preferences for operating as a self-employed contractor rather than an employee can cause particular difficulties, and distortions against equity finance and inadequate loss carry forward provisions, while also damaging to larger enterprises, may be felt especially keenly by MSMEs.

IV. TAX DESIGN FOR MSMEs—WHEN COMPLIANCE AND ADMINISTRATION ARE COSTLY

While policy considerations thus create no significant case for differential treatment of MSMEs, practical concerns make it effectively inescapable for small and micro enterprises, particularly in developing and emerging countries. Size is often the best proxy for differences in compliance cost and revenue potential that are key elements in effective and efficient revenue rising - a very imperfect proxy, but often the best there is.

A. COMPLIANCE, ADMINISTRATION AND TAX STRATEGIES FOR MSMEs

1. COMPLIANCE AND ADMINISTRATION COSTS: EVIDENCE AND SIGNIFICANCE

There is considerable evidence that the costs of compliance, relative to firm size, are greater for smaller firms. This has been widely documented for higher income countries: European Commission (2004), for example, reports survey results indicating that compliance costs for the
VAT and corporate tax are around 0.02 percent of turnover for larger enterprises, but 2.6 percent for small businesses.\(^{125}\) Emerging evidence for lower income countries points to similar conclusions: World Bank Tax Compliance Cost Surveys conducted in a number of developing and transition countries\(^{126}\) consistently show a striking degree of regressivity in compliance costs; while medium and large businesses may spend less than 0.1 percent of their turnover in compliance costs, small businesses often face tax compliance costs of 5 percent or more of turnover.\(^{127}\) VAT is a main contributor to high compliance costs; survey results from South Africa, e.g., reveal compliance costs of about 5 percent for businesses with turnover below the VAT registration threshold, but voluntarily registered for VAT, compared to compliance costs of less than 3 percent for similar businesses not voluntarily registered. Such results underline the importance of setting a sufficiently high threshold for compulsory VAT registration. They also provide an argument for the introduction of simplifications in VAT calculation, filing and payment procedures for medium-sized businesses to avoid a spike in compliance costs at the level of the VAT threshold and thus an impediment to business growth.\(^{128}\) These findings are no surprise, of course, since compliance is likely to involve significant fixed costs: the costs of registering for the VAT, for example, are likely to be largely independent of firm size. On the side of the tax authorities too, fixed costs in some aspects of administration—the time required for collection enforcement is largely independent of the amount due, for instance—mean that taxing smaller enterprises is relatively more costly.\(^{129}\) The complexity of the tax system and in particular overly complicated record-keeping and tax filing rules are a key determinant for compliance costs (Coolidge, 2010). European Commission (2007) lists as main reasons for high compliance costs of small businesses: (i) frequent changes of tax laws; (ii) complexity of tax systems, which are more geared to large enterprises; (iii) existence of different tax administrations; (iv) incomprehensible language of tax laws and tax forms; (v) short and inflexible deadlines for tax payments resulting in cash flow problems; (vi) costs of tax consultants; and (vii) registration procedures.

Smaller enterprises may thus find paying taxes especially burdensome, while the tax authorities are likely to find it especially unrewarding to collect it from them. All this points to relatively low

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\(^{125}\) Other studies reach similar conclusions. Pope and Rametse (2001), for instance, estimate the cost of complying with the Australian GST to be only about 0.04 percent of turnover for large businesses (turnover of around A$2 million) but around 2 percent for smaller (at turnover of around A$100,000). Pope (2001) reports similar figures for U.K. VAT compliance costs, ranging from 0.22 percent for large firms (turnover over 10 million Pounds) to 2.17 percent of turnover for smaller business (turnover between UKL 20,500 and 50,000). Crain (2005) presents estimates for the US based on the number of employees, which go in the same direction: the tax compliance costs for firms with less than 20 employees were estimated at US$ 1,304 per employee, but US$ 780 per employee for large firms (more than 500 employees).

\(^{126}\) South Africa, Vietnam, Ukraine, Yemen, Peru, Uzbekistan, Armenia, Georgia, Lao PDR, Kenya, Burundi, and some Indian States

\(^{127}\) For details see Coolidge (2012).

\(^{128}\) For examples of VAT simplification provisions see OECD (2009).

\(^{129}\) Slemrod (2007)
levels of both compliance and enforcement for smaller enterprises—consistent indeed with the focus on larger taxpayers that, as noted above, has been so marked in recent years. Viewed more positively, it points to potential mutual gains, to taxpayer and tax authorities, from the development of simple schemes for taxing small businesses.  

It is important, however, not to take too narrow a view of compliance and administration costs. For enterprises, there may be benefits of compliance to offset against the costs on which most studies naturally focus: a firm that produces accounts on which its tax liability is based may also find it easier, for example, to access finance or insurance. And for the administration too there may be benefits from including an additional taxpayer in the tax system beyond the additional revenue raised. These can include not only reduced economic distortions and increased future revenue, but external effects arising both from extending the social norm of compliance and by increasing the advantage to other firms of complying: if a firm chooses to register for the VAT, for example, then its suppliers also face an increased incentive to register.

Compliance and administration costs—net of associated benefits—may thus be lower than they may seem. And of course implementation costs also depend on the complexity of the tax being implemented: there is evidence, for instance, that VATs with a single rate are cheaper to implement than those with multiple rates. Nevertheless, there is an inherent regressivity in compliance costs that is likely to make informality—by which we shall simply mean substantial failure to comply with all tax and other regulatory obligations—especially attractive for smaller enterprises, resulting in an erosion of revenues and a distortion of resource allocation, perhaps with an adverse impact on long-term growth (to the extent, for instance, that the decision to remain informal also impedes access to finance and access to markets).

Coping with non-compliance and informality is thus a central part of tax design towards smaller enterprises, perhaps especially so in lower income countries. Importantly, it may shape the treatment of larger enterprises too—as with the use of withholding taxes by larger enterprises mentioned above—and motivate the use of other tax instruments, such as the withholding taxes levied on imports in many developing countries. Indeed the VAT itself can be seen as in part an attempt to ensure that informal operators bear at least some tax (on their inputs, so far as these are imported or purchased from VAT-compliant enterprises), and tariffs too may have value as a means of reaching those otherwise hard to tax.  

The focus here, however, is on the tax treatment of MSMEs themselves.

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130 It is crucial, however, that such schemes do not themselves create unnecessary complexity or distortions, either through their inherent structure or, importantly, through sheer multiplicity. One suggested response is provided in subpart C below.

131 On the relative merits of the VAT, tariffs and withholding taxes in the presence of a large informal sector, see Emran and Stiglitz (2005), Keen (2007) and Munk (2007).
2. CHALLENGES

The nature of the challenges posed by non-compliance—and the search for simple tax regimes suitable for small enterprises—differs substantially across countries. At risk of caricature, a broad distinction can be drawn between two types of situation:

- That in which literacy and numeracy are nearly universal, there is good access to technology, the financial sector and good quality professional advice and assistance, taxation rules are clear and tax administration discretion is limited, and there is a broad social norm that stigmatizes substantial tax evasion. In such circumstances, even relatively small taxpayers can be expected to maintain fairly complete and accurate books. Compliance costs (for any given set of tax rules) are likely to be relatively low, with most non-compliance likely to take the form of misreporting rather than wholesale concealment of economic activity.

- Those with the opposite features, and hence relatively high compliance costs. In particular, smaller taxpayers may have difficulty keeping books of any sophistication: or, at least, concealment of such books is widespread.\(^{132}\) Informality is extensive, and many enterprises may simply be ‘ghosts’ operating without any effort at tax compliance (even though they may in some cases be compliant with basic registration requirements).

This dichotomy is overly sharp: in the early stages of transition, for example, many economies lay somewhere between the two, being characterized by high levels of literacy but also limited access to professional tax advice. And while many of the relevant features are of correlated with income levels, the link is far from perfect: wider governance and educational features, and established social norms, clearly have an important role to play.

Interpreted in a very broad fashion, the distinction nevertheless captures some important features of international experience. And it is tempting to draw from it a similar dichotomy between the appropriate strategies towards taxing MSMEs. In the first set of circumstances it might seem, dealing with small enterprises is merely a matter of finding simpler ways to impose on them taxes that in their essential design features are the same for all taxpayers: paying VAT on the same basis, for example, but simply less frequently. For those in the latter, on the other hand, simplification may mean applying taxes on a significantly different base. This dichotomy does indeed seem to apply in relation to the taxation of business income under the personal income tax: in most OECD countries and many emerging countries, the income tax treatment of small businesses tends to be more broadly similar to the general system; in developing

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\(^{132}\) Gauthier and Gersovitz (1997) report evidence for Cameroon that nearly half of the enterprises evading tax actually kept books of account.
countries, on the other hand, taxation of smaller enterprises on a substantially different base is commonplace (as discussed further below).

In all circumstances, however, the generic problem in taxing MSMEs is the same: to partition taxpayers into distinct categories defined by some notion of size and determine in what form—and indeed whether—to impose on them each of the taxes levied on larger taxpayers. It is to the practice and principle in these matters that we turn in the next two subsections.

Before that, however, the stylized comparison between the two types of countries above raises one other general issue of some significance: To what extent should, and can, a country in the latter group seek to shape its tax system not only in recognition of that fact but, more purposively, to move itself to the former? There are two related but distinct aspects to this. One is the question of encouraging enterprises to move into the formal sector. The other is that of developing enterprises’ business practices and capacities (even for those fully formalized). There are here potentially important trade-offs to be faced, in that the compliance costs which largely drive the decision as to whether or not to become fully tax compliant (and enter the formal sector), and/or on the business practices to adopt, can be reduced by the tax authorities incurring increased costs of administration (perhaps in education campaigns, or providing technical support). How much such public expenditure should be undertaken depends in large part on the externalities that are perceived to be associated with improved compliance or formality. Some such externalities relate to the operation of the tax system itself, as noted above. But there can of course be wider benefits: encouraging firms to keep proper records may provide a form of business training that enhances their productivity and growth prospects. As with the other policy objectives discussed above, a key question is whether there may be other instruments better suited to these non-tax ends. Research in Australia demonstrates that for small business operators mandatory tax compliance activities also lead to better record keeping and to an improved knowledge of the financial affairs of their business. However there is reluctance to accept the idea that benefits could be derived as a result of complying with tax obligations (Lignier, 2009). The view one takes of this potentially wider role of the tax system in promoting business development can have powerful implications for both tax design and tax administration (Toro, 2007).

B. PARTITIONING: THRESHOLDS AND PRESUMPTION

There are two sets of decisions to be made in designing any tax regime for MSMEs:

- A partitioning of the set of taxpayers into groups for distinct treatment, generally by the use of thresholds specified in terms of some notion of size; and

- Determining what form of special tax regime—if any—should be applied to each of size categories of taxpayer thus identified.

These decisions need to be made, it should be stressed, in respect of each of the taxes levied under the ‘normal’ regime on larger taxpayers, most notably the VAT, income tax (corporate and
personal) on owners of the enterprise and the withholding from employees’ wages of income tax and social contributions. Distinct considerations arise from the quite different purposes each is intended to serve.\textsuperscript{133}

It is also important to recognize that these two sets of decisions are (or should be) closely related, both vertically (within tax types) and horizontally (across them). With a high VAT threshold, for example, there is likely to be a stronger case for some kind of simple surrogate tax on those below the threshold. And simplification calls for some horizontal consistency in the reporting requirements and thresholds associated with the replacement regimes for, in particular, the VAT and real income tax regimes.

All this creates a highly complex problem—one that has received little attention from theorists, and which practitioners have addressed (if only implicitly) in very different ways.

1. **Thresholds**

Considering first the vertical dimension of the generic design problem, distinct considerations arise in setting thresholds under the main taxes.

2. **VAT**

The practical case for differentiating enterprises’ tax treatment by size is clearest, and has been most fully analysed,\textsuperscript{134} in relation to indirect taxes on final consumption, the VAT of course being of particular practical importance.\textsuperscript{135} If there were no implementation costs and efficiency were the sole concern, the optimal threshold for the VAT would be zero: excluding some enterprises from tax would simply distort competition to no social gain. All that changes, however, when implementation is costly. Balancing the government’s need for revenue\textsuperscript{136} (taking account of the costs they incur in collecting the tax) against the compliance costs that taxation imposes on taxpayers suggests—given the broadly regressive pattern of implementation costs—that it will generally be optimal to levy the tax only on taxpayers above some critical size, and entirely exclude from the tax all those below it.

Importantly, these considerations argue against the view that lower tax rates should be set on smaller enterprises on the grounds that compliance costs are more burdensome for them: intuitively appealing though that may sound, setting a lower tax rate in itself does nothing to

\textsuperscript{133} In some countries questions arise in relation to other taxes too, including for example local property taxes or in relation to the allocation of taxes across levels of government. These are generally fairly straightforward, in principle at least, and are not addressed here.

\textsuperscript{134} See Keen and Mintz (2004), Zee (2005), and Dharmapala, Slemrod and Wilson (2006).

\textsuperscript{135} The main excises are commonly collected from large enterprises, favoured by economies of scale that can be especially closely monitored, though there are exceptions, such as the Indian bidi.

\textsuperscript{136} Contribution of MSMEs to total VAT collection is generally not significant, however. In the EU, e.g., 80% of VAT revenues are paid by 5% of registered taxpayers.
reduce the real resource costs involved in complying, but merely reduces the social value—tax revenue—that it creates. What these considerations do leave open is the possibility that some simpler tax, with lower compliance costs for taxpayers and cheaper for the tax authorities to administer, should be imposed below the VAT threshold (which in turn affects where that threshold should be).

Quite where the optimal VAT threshold lies depends on the urgency of the government’s need for revenue, the tax rate, and the level of compliance and administration costs. But this simple account ignores, of course, other considerations that affect the calculation of the appropriate VAT threshold. The simpler the VAT, in terms of the extent of rate differentiation and product-based exemption, the lower are implementation costs likely to be and hence the lower the optimal VAT threshold. Concerns to limit the scope for VAT fraud—which when especially widespread can be viewed as imposing particularly high administration costs—on the other hand, may argue towards restricting the set of VAT payers by leading to a relatively high threshold. Other important considerations include the impact that firms below the threshold will feel through VAT on their inputs, the consequent need to allow for voluntary registration (and revenue dilution that implies), and the potential distortions (and associated equity effects) that any such threshold creates (being, as noted above, likely to confer a competitive edge to enterprises exempted in this way from the VAT). While the balance of considerations is clearly complex, it may be that the threshold should fall over time as income levels rise and, more particularly, implementation becomes easier. This has indeed been the strategy in many countries (though it is notable too that many high income countries, such as the U.K. have continued to retain quite high thresholds). The important point remains, however, that practical issues mean that the optimal VAT threshold is almost certainly not zero and could be quite substantial, especially in developing countries.

3. Corporate income tax

Similar arguments might be made for the corporate tax. Compliance costs may in this case be relatively low, to the extent that books are required to be and—quite a different matter in many countries—actually are kept for other reporting purposes. Administration costs, however, may not be low (relative to the revenue at stake), and indeed some countries do impose special

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137 Keen and Mintz (2004) derive a simple closed form for optimal VAT thresholds, specified in terms of turnover and denoted by \( Z^* \), by supposing compliance and administration costs to be fixed and writing the ratio of value added to turnover as \( \nu \equiv B / Z \), in which case (1) becomes

\[
Z^* = \frac{\delta A + C}{(\delta - 1)\nu}.
\]

138 These same considerations also suggest that it may be appropriate to set lower VAT thresholds for groups likely to be subject to lower administration and compliance costs, or to high mark-ups on material input costs (the latter likely to be the case in many services, for instance). Any such benefits would need to be weighed against the further complexities differential thresholds would introduce, for example in the treatment of enterprises with multiple activities.
corporate income tax regimes for smaller enterprises. For example, incorporated business with
total assets below one million Euros and net turnover below two million Euros are allowed to
use simplified accounting in Spain. Other countries allowing simplified accounting for business
below a certain threshold, including Denmark, Germany, Italy, United Kingdom, and United
States. There are also examples of presumptive systems substituting for the income tax for
smaller corporations, as in the case of Brazil and Portugal, where profit is estimated as a
percentage (which differs across certain economic sectors) to turnover and then taxed at the
standard CIT rates.

4. PERSONAL INCOME TAX AND SOCIAL CONTRIBUTIONS

Quite different considerations apply for the personal taxation of unincorporated business
income. Almost all personal income tax systems exclude some basic amount of income from tax,
as a practically convenient way of lending some progressivity to the tax schedule. Excluding from
tax personal business incomes above this basic amount, however attractive it might be on
implementation grounds, runs afoul of norms of horizontal equity. The choice of some simplified
regime to be imposed on small business income above this basic amount is then effectively
inescapable. The key question in this case is that of determining some level of size below which
such a simplified form of business income taxation should be applied, rather than requiring the
full panoply of the ‘regular’ income tax regime to be applied.

There is an important link to be made here with the VAT threshold. The ability to comply at
reasonable cost with the VAT implies a basic capacity in record-keeping which in turn means that
the taxpayer should be able to comply with a reasonably sophisticated accounts-based form of
income taxation. Hence any fundamentally simplified form of income tax should apply, if at all,
only to taxpayers below the VAT threshold, where such a threshold is set along the lines
described above, based upon administrative and compliance costs.

5. SOCIAL CONTRIBUTIONS AND WITHHOLDING OF INCOME TAX ON WAGES OF EMPLOYEES

Broadly similar considerations to the personal income tax may apply to the levying of any social
contributions on the business owner’s income; while social contributions may also be subject to
a (separate) exempt amount drawn largely in response to distributional concerns, any income
estimated or presumed to be above that amount should be subject to social contributions. More
complex problems arise in the case of small businesses with one or more employees. If wages
paid exceed the personal income tax (and social contribution) threshold, there are few good
alternatives to requiring the business owner/manager to comply with regular withholding
requirements for such wages.

6. SPECIAL REGIMES: SIMPLIFIED AND PRESUMPTIVE TAXES

With some small businesses excluded, by virtue of relatively high implementation costs, from
operation of the ‘standard’ system for some taxes, the issue becomes that of designing the
regimes to replace them.
At this point, questions of terminology need to be confronted: the taxation of MSMEs is an area in which terms are often used loosely, with consequent risk of confusion. For clarity, we refer to any tax intended to replace some levy under the standard regime applied to larger enterprises as a ‘special regime,’ with a further and looser distinction made within this category between ‘simplified’ and ‘presumptive’ taxes, with the former referring to ones that differ from the standard regime only in relatively minor matters of procedure or definition (such as frequency of payment or the use of cash rather than accrual accounting) and the latter indicating some quite different base. This distinction between simplified and presumptive taxes is largely a matter of judgment, of course, but captures a potentially significant distinction.

7. PRESUMPTIVE TAXES IN PRACTICE

Comparative information on presumptive regimes around the world is hard to come by, though the surveys conducted by the OECD and IMF for the ITD 2007 conference on taxation of small and medium enterprises go some way towards filling this gap. Three key features of international experience stand out.

The first is that special regimes are pervasive. More striking still is how common are regimes that, in the sense set out above, are clearly presumptive rather than essentially procedural simplifications. This can be seen from Table 5, which provides an overview of practice in Latin America and sub-Saharan Africa. Importantly, however, several OECD countries also have presumptive regimes, or some elements of them. Italy, for example, utilizes a system heavily based on sector studies, which required in its elaboration data gathering through questionnaires and cluster analysis in order to fix its various presumptive coefficients. The system’s sophistication includes different coefficients not only by sector but also by geographical area. The system applies to taxpayers, regardless of their legal nature or accounting system, who declared profits below 7.5 million Euros.

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139 This usage differs, it should be noted, from an alternative and natural interpretation of presumptive taxes as those proxy for the ideal object of taxation. In this wider sense, as Slemrod and Yitzhaki (1994) stress, “[a]ll taxes are presumptive, to some degree.” The depreciation allowance claimed by the most sophisticated IFRS-compliant multinational for instance, is unlikely to be an exact measure of its true economic depreciation, and transfer-pricing adjustments in complex international transactions are in effect taxing by constructing a presumption on income streams. Indeed the minimum corporate or personal taxes found in many countries, at all income levels, are forms of presumptive taxes. More generally, most tax systems also provide for ‘best judgment’ tax assessments of liability when the taxpayer provides insufficient information for a normal assessment, or when that information appears inconsistent with external indicators of lifestyle. While presumptive taxes in this wide sense serve a number of roles (Thuronyi (1996) provides a review), the focus here is on their use as a routine form of final assessment for smaller enterprises.

140 The detailed responses are available at www.itdweb.org.

141 See also Engelschalk (2004) for an overview of special regimes during the transition period.

142 Portugal, to give another example, applied a simple regime based on a percentage of the turnover in order to estimate the tax base (20 percent for sales of goods and hotel/restaurant services; and 65 percent for other services under PIT – or 45 percent for other services under CIT). The qualification criterion is total turnover (less than 150 thousand Euros). Spain has a more complex system based on objective parameters, which take into account variables
TABLE 5- EXAMPLES OF PAST AND CURRENT SPECIAL REGIMES IN LATIN AMERICA AND SUB-SAHARAN AFRICA

<table>
<thead>
<tr>
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<th>Latin America</th>
<th>Sub-Saharan Africa</th>
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<tbody>
<tr>
<td><strong>Extent of presumptive regimes in the region</strong></td>
<td>Latin American countries have adopted a wide range of simplified regimes for MSMEs. Of 17 countries, 14 adopted some type of simplified taxation (Argentina, Bolivia, Brazil, Colombia, Costa Rica, Chile, Dominican Republic, Ecuador, Mexico, Nicaragua, Honduras, Paraguay, Peru, and Uruguay). Exceptions are El Salvador, Panama and Venezuela.</td>
<td>Pervasive: 25 out of 44 countries in the region for which data are available have special regimes for smaller enterprises (Benin, Burkina Faso, Burundi, Cameroon, Central African Republic, Chad, Comoros, Republic of Congo, Côte d’Ivoire, Gabon, Guinea, Kenya, Liberia, Mali, Mauritania, Niger, Rwanda, Senegal, Sierra Leone, Tanzania, Togo, Uganda, and Zambia). Almost half apply (usually creditable) withholding income tax on imports.</td>
</tr>
<tr>
<td><strong>Criteria for qualification</strong></td>
<td>Some countries use turnover as the principal criterion for qualification (Brazil, Chile, Dominican Republic); others use objective parameters as the primary criteria, such as physical area, electricity bill, number of employees, or number of vehicles as the main qualification, or use these as additional criteria (Argentina, Bolivia, Colombia, Costa Rica, Chile, El Salvador, Honduras, Mexico, Nicaragua, Paraguay, Peru and Uruguay); some countries prohibit certain economic sectors from presumptive taxation (e.g., Brazil).</td>
<td>Turnover is almost universally used as a qualification criteria, with the special regime generally linked explicitly to the VAT threshold.</td>
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<tr>
<td><strong>Existence of multiple regimes</strong></td>
<td>Some countries have two or more presumptive regimes (Argentina, Bolivia, Brazil, Chile, Mexico, Peru and Uruguay). These multiple regimes are used to tailor solutions for businesses of different sizes or specific economic sectors, such as agriculture, handicrafts, and transport.</td>
<td>Generally a single regime, though in some cases (Liberia and Uganda) with structurally different treatment of the smallest taxpayers.</td>
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<tr>
<td><strong>Universe of</strong></td>
<td>Some countries provide presumptive qualification.</td>
<td>Typically for unincorporated businesses, such as number of employees, physical area, electric power, number of tables in a restaurant, etc. This system covered nine different economic activities and utilizes several coefficients for fine adjustments (e.g., special activities such as taxis and transport, start-ups, temporary activities). Turnover (450 thousand Euros as a general case) and sector activity are used as parameters for qualification. Other OECD countries with existing, or past, elements of presumptive taxation include Austria, Belgium, France, Greece, Japan, and Spain.</td>
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such as number of employees, physical area, electric power, number of tables in a restaurant, etc. This system covered nine different economic activities and utilizes several coefficients for fine adjustments (e.g., special activities such as taxis and transport, start-ups, temporary activities). Turnover (450 thousand Euros as a general case) and sector activity are used as parameters for qualification. Other OECD countries with existing, or past, elements of presumptive taxation include Austria, Belgium, France, Greece, Japan, and Spain.
<table>
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<tr>
<th>taxpayers covered</th>
<th>regimes for individuals, usually self-employed or unincorporated businesses (Argentina, Bolivia, Colombia, Chile, Dominican Rep., Ecuador, Mexico, Nicaragua, Honduras, Paraguay, Peru and Uruguay), while others also provide this for legal entities or incorporated businesses (Brazil, Costa Rica, Chile, Mexico, Peru and Uruguay).</th>
<th>enterprises only, though in a few cases (such as Zambia) applies to corporations too.</th>
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<tbody>
<tr>
<td>Tax calculation</td>
<td>The main tax calculation methods are percentage of the turnover level (Brazil, Chile, Dominican Rep., Peru) and/or a patent or fixed quota (Argentina, Bolivia, Chile, Mexico, Nicaragua, Peru and Uruguay).</td>
<td>Most common methods are: fixed amounts varying across turnover bands (examples being mainly in Francophone countries such as Burkina Faso and Togo); percentage of turnover, either uniform or at multiple rates (such as in Rwanda and Tanzania respectively); fixed amounts varying across turnover bands (examples being Burkina Faso and Togo); and forfait/standard assessment methods (in Burundi and Gabon, for instance).</td>
</tr>
<tr>
<td>Type of revenue covered (applied in lieu of taxes and/or social security contributions)</td>
<td>Many regimes substitute for only one tax (Brazil, Colombia, Chile, Dominican Rep., Ecuador, Honduras, Paraguay, Peru) but others—even in the same countries—include more than one tax, usually the income tax and the VAT (Argentina, Brazil, Bolivia, Costa Rica, Mexico, Nicaragua, Paraguay, Peru and Uruguay). In the case of Brazil, sub-national taxes are also included. Some presumptive regimes also substitute for social security contributions (Argentina, Brazil and Uruguay).</td>
<td>The presumptive schemes generally replace all other taxes.</td>
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<tr>
<td>Turnover threshold</td>
<td>A wide range: some countries define it at a low level to cover mainly micro and very small (usually unincorporated) businesses (below US$ 50,000); Brazil is an exception with a threshold at US$ 1,000,000 (in lieu of all taxes and social contribution) and US$ 20,000,000 (in lieu of income tax only).</td>
<td>Commonly linked to the VAT threshold, which varies from around 12,000 USD to around 100,000 USD, but is commonly in the range 40-80,000 in Francophone countries and 30-40,000 USD in Anglophone countries.</td>
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Source: Inter-American Development Bank (2007) and IMF staff.
A second key feature of international practice—hard to document, and somewhat elusive—is a wide diversity in the normal tax that special regimes are intended to replace. Some countries, for instance, impose distinct special taxes specifically to replace distinct normal taxes; others seek to replace only some; and others have tried to use a single tax to replace all taxes. The concept of replacement here is somewhat elusive, it should be noted, in so far as it relates to the intention of policy makers. A single tax, for instance, could be rationalized either as replacing several or as replacing only one, with the others simply not being applied in any form to smaller taxpayers. Nevertheless, the notion of replacement is central to the coherent formulation of special regimes; it will be revisited below.

But the most striking aspect of experience is the sheer diversity in the form of the special regimes applied. Even within the OECD, a wide range of methods and qualification criteria are used (turnover, objective parameters, sector coefficients, estimation based on net worth, etc.); some (such as those in Austria and Spain) apply only to unincorporated businesses, while others (in Italy, Japan and Portugal for example) reach incorporated businesses too; some countries allow opting-out (such as in Austria, Belgium, Portugal, and Spain), while others do not (as in Greece, Italy, and Japan).

Among the most common bases for presumptive taxes are:

- **Turnover (or ‘gross receipts’).** The appeal of this is that almost every business operator, no matter how small, will have a basic idea of their cash receipts, even if they cannot produce an accurate record of expenditures. The view that turnover is relatively easy to monitor presumably underlies, for example, it’s almost universal use as a threshold for the VAT, and indeed this link can be key in designing regimes for the treatment of smaller taxpayers, as discussed below. Cash receipts can also form a suitable bridge to the VAT and business income tax; for those small businesses that do grow, a properly designed presumptive regime based on cash receipts therefore eliminates some of the problems and disincentives associated with transition from the presumptive to the real regimes. Against this, of course, turnover taxation creates potential distortions through cascading (with consequent incentives to vertical integration, and loss of transparency in effective tax rates) the severity of which has been a primary reason for adoption of the VAT.

Even within the class of turnover-based taxes, a variety of methods can be found and/or conceived of. In some countries, for instance, tax is not levied directly on turnover but rather as a fixed amount within bands defined by turnover (creating discontinuities in tax liability, and to no very obvious benefit given that turnover has to be calculated in order to verify the applicable band). Or, as a replacement for the income tax, turnover can be taxed at progressive rates or, more systematically, used not as the tax base itself but rather as a means to proxy income, to which the normal tax schedule itself is then applied. And countries vary in the number of distinct turnover rates they apply.
Cash flow. An alternative as a replacement for the income tax—much less common, though it has been used in Mexico and Madagascar\(^{143}\), for instance (and the U.S. allows immediate expensing for smaller enterprises)—is to tax income on a cash flow basis: that is, using cash rather than accrual accounting and, still more important in economic terms, allowing immediate expensing of all investment spending (but no deductibility of financial costs). This has the appeal of providing a closer proxy to income (as normally defined) than does simple turnover, and of requiring only moderate sophistication in record keeping. And as a matter of economic principle, cash flow taxation has considerable attraction even for larger enterprises, and there is much to be said for taxing all enterprises on this basis. Even leaving that wider issue aside, taxing smaller enterprises on this basis has potential merit, as set out clearly by Conrad (2006), for example. If larger enterprises remained on the more standard form of income tax, issues would arise in relation to the transition from one regime to another (it being necessary, or instance, to deny depreciation deductions on assets acquired with immediate expensing, and to claw back appropriately on any subsequent asset sales). But such problems seem intrinsically no greater than those associated with the transition under other regimes.

Indicator-based schemes use of range of characteristics of an enterprise and its activities as a basis for determining tax liability. These can take a number of forms, including:

- Under the classic French forfait system (which had been in use for many decades before being abolished in 1998) liability was based on a range of indicators—purchases, sales, number of employees, number of cars owned by the taxpayer, and so on—with the sum due agreed between tax authorities and individual taxpayers, this amount then applying for two years.

- Standard assessment systems use mechanical rules (unlike the taxpayer-level negotiation under the classic forfait, although perhaps drawing on industry-level negotiation) to assess tax on the basis of a range of indicators of activity (floor space, location...), often specified in great detail. The Israeli tackshivim system, officially in place until 1975, is the classic example. This covered the assessment of income in 130 economic branches, specifying within each the parameters to be used. Restaurants, for example, were divided between exclusive, fish, vegetarian..., with a further classification by location; revenue was then estimated per waiter (with rules not only on hours but on whether owners are to be treated as waiters) and income calculated by allowing proportionate reductions to allow for various costs (Yitzhaki, 2006; Engelschalk (2004) provides examples of similarly complex schemes from the transition experience). Evidently not all presumptive taxes are simple.

\(^{143}\) For a description of the system applied in Madagascar see Bodin and Koukpaizan (2009).
A *patente* (or ‘fixed tax’) system simply charges a fixed fee—often varying with location and type of activity—and so is in a sense just a highly simplified form of standard assessment.

*Asset based methods* impute income as a return on some measure of an enterprise’s assets. This is most appealing for small businesses that are dependent upon commercial assets with respect to which the government has good information and control. For example, in urban areas with good real estate cadastres, small businesses that operate from fixed premises could be taxed based upon imputed rents (a system that has been used with some success in Benin, for example). This approach is particularly appealing in a number of developing countries to overcome difficulties in assessing income of transportation businesses, which are taxed based upon the number, type and capacity of vehicles operated.

8. **General considerations in designing presumptive regimes**

The relative merits of alternative presumptive bases will depend on the purpose they are intended to serve—in particular, the normal tax they are intended to mimic, a point discussed in more detail in the next subsection. Simplicity and transparency are evidently key concerns. Beyond this, there a range of considerations of which should guide the choice between them.

Clearly the presumptive base must be compatible with the compliance and book-keeping capacity of the target group, and with the implementation capacity of the tax administration (a point discussed in detail by Terkper (2007)). Full record keeping, commensurate with that necessary for full accrual accounting of large businesses, is beyond the reach of many, if not most, small and micro business operators in developing countries.\(^{144}\) However, all but the very smallest (micro level) operators in all countries should more or less know what their basic cash receipts are. A cash receipts journal is sufficient as a foundation for a simple presumptive regime suitable for most small businesses. Costs of administration also need to be borne in mind in choosing between presumptive regimes: developing (and keeping up to date) standard assessment tables, for example, can be a substantial undertaking.

Relatedly, the base should ideally be some rudimentary variant of that in the standard regime, with broadly equivalent economic effect. This can help ease the transition between regimes as firms grow, in particular minimizing discrete ‘jumps’ in tax liability as the taxpayer moves to the standard regime. It also helps preserve the economic coherence of the wider system. But this can be hard to achieve: some turnover-based tax may suggest itself, for instance, as both a presumptive income tax and to substitute for the VAT—but it clearly cannot fully replicate the economic effects of two such different instruments.

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\(^{144}\) In contrast, in most developed countries, it is to be expected that small businesses operating essentially at any level above that of the occasional small transaction should be able to keep records.
A third set of considerations concerns the economic incentives created by the tax. Standard assessment methods, for example, invite enterprises to substitute away from the indicators on which liability is based: if the tax payable by a restaurant relates to the number of tables, for example, guests will soon find themselves sharing tables with a wide set of new friends; perhaps more seriously, use of employment-related indicators may discourage formal employment. Such distortions can clearly be costly: even though the enterprises affected may be individually small: there are, after all, lots of them. But it is also important to note that presumptive taxes can, in principle at least, actually have attractive incentive effects: to the extent that they capture potential rather than actual income, they in effect impose a marginal tax rate on the latter of zero: under an asset tax, for example, extracting higher returns from a given capital base has no impact on tax liability, whereas under an income tax it would. (Against this, however, asset taxes do raise the METR and so discourage investment). This raises deeper issues in tax design than can be addressed here: see Faulk, Martinez-Vazquez and Wallace (2006) for further discussion.

A fourth consideration is that the replacement tax be reasonably robust against corruption and extortion in its collection. It points to simple systems relying on minimal discretion by the tax authorities, avoiding excessive differentiation across taxpayers—with just a few distinct rates of turnover tax, or only one, especially if the general taxation level is fairly low. When the regimes use a variety of enrolment criteria and assessments are made administratively, they may create undesirable scope for arbitrary decisions and collusion between tax officers and taxpayers. Difficulties created by negotiation and discretion were a key reason, for example, behind the decision in France to move away from the forfeit and towards turnover–based methods in the 1990s.

Fifth, effective tax rates, relative to those in the standard regime, need to be high enough not to discourage transition to the latter, or encourage firms to hide their growth by underreporting income or splitting into multiple entities. Indeed one could argue that the statutory tax provisions should include a premium to claw back some of the associated compliance cost savings to smaller enterprises, so as not to discourage movement to the normal system. The balance is a difficult one to strike, however, since setting the presumptive tax rates too high may instead encourage outright informality. As Bird and Wallace (2003) note, there appear to be few if any careful studies of experience on the issue, but some sense that many countries may have erred in the direction of setting inappropriately low effective rates. One clear implication, also stressed by Engelschalk (2004), is that the success of a reform to some special regime is not to be judged by the increase in the number of taxpayers subjected to it, or even in the revenue it collects, since both can be increased by offering special treatment so attractive as to lead to migration out of the standard regime.

This last consideration raises the important question as to whether a presumptive tax should be rebuttable—that is, whether taxpayers otherwise subject to presumption should have the right to opt instead for treatment under the standard regime (subject, of course, to the associated bookkeeping and other obligations). There are strong arguments in favour, to the extent—as
discussed above—that it is an object of policy to expand the scope of the standard regime. Moreover, some companies may wish to be subject to the normal regime in order for their parent overseas to access foreign tax credit; or they simply find it commercially advantageous to signal an elevated status by being subject to the normal regime. Against this, however, enterprises are evidently more likely to opt in when doing so reduces their tax payment, and, moreover, by doing so they are likely to add to the costs incurred by the tax administration. The government may thus find itself spending more to collect less (though the loss may be small given the concentration of tax payments in larger taxpayers). The desirability of allowing rebuttability thus depends to a large degree on the extent of the wider external benefits felt to be associated with inclusion in the standard regime, as discussed above. Where tax administration is strong, rebuttability—with limitations on the ability to move back to the presumptive regime—is likely to be appropriate. Where administration is weak, however, denial of rebuttability may be a coherent device for focusing limited resources on more important activities.

C. STRATEGIES FOR TAXING SMALL BUSINESSES IN DEVELOPING AND EMERGING MARKET COUNTRIES

The substantial variation across countries in the taxation of MSMEs often seems to reflect traditional practice and occasional piecemeal reform rather than a fully articulated view of how this element of the wider tax system should fit into the whole. It is hard to resist the conclusion that current systems are all too often something of an after-thought, with little careful attention as to their proper role in the wider tax system. Yet one of the lessons from the introduction and reform of the VAT over the last decades, and increasing interest in reform of the income tax, is precisely that the strategy towards MSMEs is a critical element of the overall tax architecture. There are, as will be seen, a number of forms such a strategy might take. This section briefly outlines one approach to the taxation of MSMEs, variants of which are underway, or under discussion, in a number of non-OECD countries, that has significant appeal as a means to progressively broaden the tax system, reduce informality and, ultimately, expand the scope of the standard tax system—in the process minimizing impediments to the development of the MSME sector.

This approach uses the VAT threshold—set based on the methodology described above—as an anchor for the partitioning of taxpayers into regimes for special treatment. It thus presumes that, in developing and emerging countries, the threshold is set at a fairly high level. In practice, many Latin American countries, and some others, do not have VAT thresholds—or rather have very low ones, hard to rationalize in terms of the principles set out above.\(^{145}\) This presents them with particular challenges in dealing with small and micro businesses, one manifestation of

\(^{145}\) Although it is often said that many Latin American countries do not have VAT thresholds, this is not quite accurate; in some cases, businesses with lower turnover are subject to simplified or presumptive ‘VATs’ rather than the ‘full’ VAT.
which is the development of such supplementary devices as widespread VAT withholding. We discuss later strategies that might be employed in such contexts. Here we focus on MSME regime design when—as with many more modern VATs—the threshold has been set so as to exclude the majority of enterprises from full operation of the tax.

The importance of such a VAT threshold in designing a tax regime for MSMEs is that any enterprise capable of complying with the normal VAT should be familiar with methods of self-assessment and able to keep reasonably sophisticated books. It should thus also be able—and required, given the revenue likely to be at stake—to comply with the real business income tax (meaning accrual accounting, depreciation of large investments, and so on). For purposes of this paper, given the costs-based methodology assumed to be used to set the VAT threshold, those above it would be considered ‘medium-sized’ businesses. By the same token, businesses that register voluntarily for the VAT should also be subject to the regular income tax: the choice to register should apply to both taxes or neither, not selectively.

What though of those enterprises that remain below the VAT threshold? These, in practice, will be small or micro, rather than medium-sized enterprises. Given such a partitioning, the key issues are how to treat these smaller enterprises in relation to each of the other main tax instruments: the taxation of business income, the taxation of sales, and the withholding of wage tax and social contributions on employees.

1. Micro enterprises

As the term is interpreted here, micro enterprises are those which can be assumed unlikely to have incomes above the personal tax threshold. They operate at the subsistence level as family businesses and generally do not hire any employees. It would make no sense to tax self-employed marginal workers when their counterparts earning the same amount but as wages from employment are not subject to personal income tax. Further, the potential revenue from subjecting them to other taxes, such as the VAT, is likely to be small relative to implementation costs. There is thus much to be said for simply excluding from explicit taxation at the national level all businesses with turnover assumed to produce income below a level corresponding broadly to the personal exemption. The strongest argument for including them in the tax system is the view that this is important to securing participation in political processes and strengthening accountability of the authorities. Successful informal sector taxation may support the growth of broader and more inclusive business associations that can constructively engage with the government.146 But in order to be successful the system must be simple with low compliance and administration costs. It points to a simple patente system acting akin to a license fee.147 With their limited revenue potential and assessment practices different from standard tax assessments such patents normally are better administered by local governments than by the

146 OECD (2010).
147 For a discussion of the use of the patente synthétique in Africa see Chambas (2005).
national tax administration. While the contribution of micro businesses to national tax revenues is negligible, their importance for local budgets can be substantial: also accountability and participation objectives are equally relevant in relation to local authorities.

2. **Replacing the Income Tax**

Businesses with turnover above the level identifying micro enterprises but below the VAT threshold would be subject, as a presumptive income tax, to a tax based on turnover, set at levels that will generally approximate the tax burden that would apply to such businesses if they were subject to the standard net business income tax. Though not without its difficulties, turnover has the particular appeal in this context of being fairly well known to the taxpayer and resting on a simple form of accounts, so providing some link with more precise accounts-based methods. This turnover-based regime could operate in either of the two ways noted above: either tax due or presumed income could be specified as some fixed proportion of turnover, with the regular income tax schedule then being applied in the latter case to determine liability. The two will be equivalent, of course, if there is only a single average rate of tax in the relevant range; and the case for the latter approach (to be weighed against some loss of simplicity) is then stronger the more steeply progressive is the schedule at lower income levels. It is important to attempt to mimic the tax burden on profits arising under the real regime in the presumptive regime. This avoids the temptation to distort behaviour or to hide true turnover that arises when the burden under the presumptive system is markedly lower than that in the real system. Such distortions are likely to arise most sharply, of course, in the case of businesses at or near the upper turnover threshold. Experience suggests, however, that it is unwise to adopt a large number of different rates based on industry sector or business type: this creates difficulties in relation to enterprises with multiple activities, and is vulnerable to game-playing and abuse. Two or three distinct rates are likely to be enough.

Depending to a large degree on precisely how high the VAT threshold is, there may be a case for a second cut-off point between the very low micro business threshold and the VAT threshold. Those in the lower part of this range would be treated as just described above, while those in the upper part of the range would be subject to a cash flow form of income tax, based on simplified cash accounting and immediate expensing of investment. These businesses would be expected to maintain not only the simple cash receipts journals needed by the smaller

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148 For a more detailed discussion of the merits of micro enterprise taxation at the local level see Joshi, Prichard and Heady (2012).

149 See also Keen (2012).

150 If the simplified cash flow tax option were adopted for the somewhat larger ‘medium’ businesses, as described above, a single tax rate should apply to their business profits calculated by that simplified method, and should approximate that used under the real income tax. If there are a series of rates under the latter, the appropriate rate can be derived using average profits based upon turnover at the VAT threshold.

151 If the tax rate is 10 percent, for instance, then imputing income as 20 percent of turnover is equivalent to simply taxing turnover at 2 percent.
businesses subject to the simple turnover tax, but also records of cash based expenditures, including investments. The latter, somewhat more complex system, has the advantage of providing a smoother transition into the real regime than does the straight turnover based presumptive tax.\textsuperscript{152}

The question also arises as to whether such a presumptive income tax should also apply in respect of the corporate tax. In some countries, such as Kenya, businesses are not entitled to operate in corporate form unless they are able to maintain full accounting records and books. In such circumstances, even companies with turnover below the VAT threshold might be required to comply with the normal income tax; and this, it seems, is common though by no means universal practice. The case for proceeding in this way is not entirely clear cut, however. First, in many developing countries compliance with regulatory requirements may be weak. Second, policy needs to be decided with administration as well as compliance costs in mind: even if some enterprises can comply with more demanding requirements, it may be that the revenue at stake is so limited that it is wiser to save administration costs by treating them on a simpler basis. And third, differentiating tax liability by organisational form risks distorting the incorporation decision. Again country-specific circumstances must play a key role in policy design: but it should not be taken for granted that all corporations should be taxed under a real regime.

3. Substituting for the VAT?

There is little disagreement that smaller enterprises should pay some simplified form of income tax (subject to any generally applicable exempt amount). It is much less clear that some tax is needed to mimic the effects of the VAT for those below the VAT threshold.

To see why, note first that enterprises selling to VAT-registered firms will in any event want to register voluntarily. Any problem thus arises from exempted firms selling to final consumers. In the absence of any replacement tax, these will be placed at a competitive advantage relative to those required to pay VAT, distorting competition and eroding revenue. This is mitigated, however, to the extent that they will in any event bear some unrecovered VAT on their own purchases. Such implicit taxation of their sales weakens the case for explicit presumptive taxation in substitution for the VAT. However, the strength of this effect depends on the level of the threshold and the extent of informality: those wishing to supply to enterprises that are exempt—either because they are themselves below the turnover limit or because they are evading the VAT—have an incentive to avoid paying VAT themselves, leading potentially to chains of non-compliance (de Paula and Scheinkman, 2006).

\textsuperscript{152} It might be argued that such an interval is unnecessary, since a firm that can cope with a cash flow tax should be able to cope with a VAT. The greater (or at least more visible) opportunities for fraud under the VAT, however, may nevertheless rationalize excluding from it some such firms.
The question of whether to replace the full VAT for smaller enterprises has received little attention. A reasonable conjecture, however, is that the case for doing so is likely to be stronger the higher is the VAT threshold and the greater is the degree of informality.

Supposing some replacement for the VAT to be under consideration, further questions arise as to the form it might take. Perhaps the most obvious candidate is a low rate turnover tax; the main difficulty with this, of course, is that, taken too far, the cascading effect of such a tax leads to all the problems that the VAT was intended to resolve. Other alternatives include: (i) a subtraction rather than invoice-credit form of VAT, which should be feasible for any enterprise subject to cash flow income taxation (but again can give rise to cascading when some enterprises remain subject to the invoice-credit VAT), and/or (ii) withholding taxes of the kinds mentioned earlier that are deliberately intended to reinforce the effects of the VAT in raising the input costs of smaller traders (which, however, raise their own administrative challenges: if crediting mechanisms do not work smoothly, they can increase input costs for large and compliant enterprises too).

This is clearly an area in which further thought and experience-sharing is needed. What is clear, however, is that the case for a presumptive tax to replace the VAT is weaker than that for a replacement for the standard income tax. Importantly, this would not mean excluding firms from the tax system: they would, recall—all but the very smallest—remain subject to the simplified income tax.

4. Withholding on Employees: Payroll Taxes and Social Contributions

Perhaps the greatest problem in dealing with small businesses is to determine how to handle social contributions and personal income taxes on employees, which are normally collected by employers. In the large and growing number of countries in which the social security system is accounts-based and provides retirement and/or health insurance schemes aimed at specific individuals rather than a simple support mechanism funded from general revenues, it is important to attribute collections to individual workers. Subsuming this sometimes multiple set of social collections into a single presumptive tax regime is therefore impractical. Similarly, failing to account for and charge personal income taxes normally paid through employer withholding would create a distortion between those employed by small businesses and those employed by larger businesses or government. It would make little sense to require employees of the smallest businesses to take responsibility for filing their tax returns (or paying their own personal income tax); nor is it desirable to simply exclude them from tax. Thus there is little alternative to withholding on employees, potentially by quite small enterprises.

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153 As noted in the previous sub-section, social contributions for the sole proprietor or smallest business owners themselves should therefore, above whatever income threshold is normally applied, be accounted and remitted by them under the regular regime.
In the case of self-employed individuals operating at or near the subsistence level in developing countries—whose business income will likely fall below the proposed exemption level equivalent to the personal income tax exemption, as described above—it may be sensible or necessary to provide an exemption from social tax collections, as well as from personal income taxes (though it would then be more sensible to exempt persons with similarly low employment incomes arising from larger employers from the social collections as well). For such people, there may in any event be some minimum subsistence support old-age scheme in place outside of the accounts based insurance scheme.

For those small businesses with one or more employees, exemption from either employee personal income tax withholding requirements or social collections is neither feasible nor desirable. They need to both pay social contributions on their own account and withhold contributions and taxes from any employees. This may of course lead to collusion between employer and employee to understate wages paid (a practice not unknown even in larger companies),\(^{154}\) to which some countries have responded by adopting minimum wages for purpose of payroll charged, leading to further distortions and potential inequities.

These are evidently difficult issues, and this may be the one area in which the structure of the business (that is, the presence of employee(s)), not simply its turnover, should determine at least a part of the tax treatment of the small business. Some countries have devised more complex presumptive systems that attempt to address this: see Box 2. But it is not at all clear whether this is superior to simply requiring that such businesses comply with the normal withholding requirements. While evidence from Brazil shows that the introduction of the presumptive SIMPLES regime including social security payments has created a strong incentive to hire new employees and/or legalize already existing labour relationships\(^{155}\) it is not clear if this effect stems from the system design or merely from the reduction in the tax burden and in labour costs. These issues are likely to become increasingly important in many lower income countries as social insurance schemes are developed—and clearly require more discussion.

**BOX 2- SOCIAL SECURITY PAYMENTS UNDER PRESUMPTIVE SYSTEMS**

Brazil and Argentina have adopted presumptive systems that substitute for social security payments in addition to the major taxes. The rationale for these regimes goes beyond administrative simplification and aims at reducing impediments to job formalization. The solution is tailored for environments of high informality and low access to the social security network, the idea being that the tax base itself would be broadened as a result of the

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\(^{154}\) This consideration may in turn influence the choice of any special regime applied to owners: under a cash-flow tax, for example, but not under a turnover-based one, charges saved by overstating the wage bill are to some degree offset by increased income tax payments.

\(^{155}\) Fajnzylber, Maloney, Montes-Rojas (2009)
formalization process.

The Brazilian "Simples" was introduced in 1997 and cut the direct link between the employer’s payment to the social security system and the value of the wage bill. Importantly, the employee’s contribution continues to be charged under the regular system. Under Simples, eight different federal and sub-national taxes and social contributions are paid at once, calculated as a percentage of the business’s turnover. The employer’s contributions to the social security system become a function of the turnover, independent of the number of employees and the payroll. The greatest challenge is to maintain a balance between contributions and benefits, given that Simples employees keep the same rights to benefits as any other employee in the country. This was attempted through rate calibration and by restricting some labour-intensive activities from opting for this mechanism. However, there is an estimated tax expenditure of US$ 2.5 billion for 2007 arising from foregone social security collections, showing that the regime does operate as a preferential system. The rates vary from 1.80 percent to 4.60 percent of turnover for businesses operating in commerce or industry. For the more labour-intensive service sector, the rates range from 2.42 percent to 7.83 percent. Some specific service activities, such as construction, are obliged to pay social security contributions under the normal regime (20 percent of the payroll) or are simply prohibited from opting for Simples. Naturally these needed differentiations add to the complexity of the system. The Brazilian social security system works under the PAYG method. Individual benefits are linked to earnings history, but there are no funded individual cash accounts in the public social security system.

The Argentine ‘Monotributo’ has also been applied in lieu of social security contributions since 1998. It works under a patent system, whereby taxpayers pay a fixed quota which is a function of some variables (turnover, physical area, electricity bill). This regime replaces, in addition to the social payments, the income tax, the minimum tax on assets, and the VAT. The fixed quota varies from ARG$ 92.44 to 564.44 per month, and also applies differently across economic activities. One of the major goals of the Monotributo was to include low-income taxpayers into the social security network, and a substantial amount of the revenue it raises is used to address the solvency of the social security system. As in the case of the Brazilian "Simples", the Monotributo produces a preferential rate relative to the regular system; the patent represents around 33 percent of what would be expected under the normal system.

V. TAX ADMINISTRATION FOR MSMEs

As discussed above, administrative and compliance concerns provide the most convincing rationale for size-tailored tax policies and administrative approaches, especially in the context of non-industrial countries. This section looks briefly at some of the underlying administrative issues in MSME taxation; then describes some existing responses to the MSME challenge, including administrative differentiation; and finally draws some preliminary conclusions.
It is critical to recognize that ‘MSMEs’ are not, as discussed above, a uniform category in any country. Much of the discussion that follows in fact relates to small and micro enterprises. ‘Medium sized’ enterprises—which, depending on country context, could mean anything from businesses with 20 or more employees to those employing hundreds—should be, and generally are, treated in policy terms in the same manner as ‘large’ taxpayers. Administrative approaches to these taxpayers will also likely be more or less qualitatively the same as those applied to large taxpayers. The differences will come rather in the intensity of focus applied to each individual business, determined largely by a cost/benefit trade-off based on potential revenue at stake. Such medium sized enterprises often have some level of professional management, separate from or in addition to the business owners; they may have (indeed almost certainly will have, in industrial countries) professional accounting and legal advice; and it will be harder for such businesses to operate invisibly, in the informal sector, although that is not to say that avoidance and evasion will not occur. Thus, when the implementation problems of the ‘MSME’ sector are mentioned, it is frequently small and micro enterprises that are being referred to, including the self-employed, small family run businesses, or informal partnerships. The term also generally implicitly refers to self-employed professionals. Many small enterprises, including these, may be quite profitable, with their owner/employees being high income individuals.

A. ISSUES IN ADMINISTERING MSMEs—BACKGROUND

1. COSTS AND BENEFITS OF COMPLIANCE AND ADMINISTRATION

The basic problems in the tax administration of small enterprises stem, under any policy environment, from what is essentially a cost/benefit calculus. From the taxpayer’s standpoint, low risk of detection and penalization, coupled with high costs of compliance relative to income, provide poor incentives for voluntary compliance. This tax behaviour is not homogenous, can be both intentional and unintentional, and is affected by MSME characteristics. Unintentional noncompliance, for example, is commonly linked to limited understanding of the laws, poor recordkeeping, and the lack of professional tax advice—and is reflected in non-filing and mistaken underreporting. Intentional noncompliance stems from businesses operating in the informal economy with hard-to-trace cash and barter transactions which mask evasion (deliberate non-registration, non-filing, and under-reporting).

For all tax administrations, and particularly those in developing countries, a key objective is to reduce administrative and compliance costs per small taxpayer in such a way that more attention can be paid to them and risk and return more appropriately aligned. Conversely, and equally or more problematic, some tax administrations devote the vast majority of their staff time to small taxpayers, despite the relative lack of impact this has on revenue. This can result,

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156 This is also true in less developed economies, but the emphasis on and importance of that group is likely lower relative to small scale subsistence level economic activity, as a proportion of the total economic activity.
in addition to the sheer number of MSMEs\textsuperscript{157}, from antiquated methods of administration and organization, which may require administrative assessment, and/or are bolstered by a legal structure that requires, for example, audit of all VAT refund claims, or of all business income tax filings. Successful tax administration means not simply increasing revenue, but rather increasing voluntary compliance. Solutions that are well suited for developed and some advanced transition economies (such as e-government) may not work well in countries with a much lower level of infrastructure development. And the critical issues will vary from country to country and even within a country over time. For example, countries with high levels of economic informality are typically more concerned with bringing unregistered small enterprises into the tax net; industrial countries, on the other hand, may find that a large portion of the small-enterprise tax gap arises from underreporting of income by registered businesses.\textsuperscript{158}

B. Administrative Methodologies

Modern tax administration depends upon taxpayer self-assessment, which in turn depends on effective taxpayer service approaches buttressed by enforcement efforts directed at those taxpayers who are most likely to misunderstand or to intentionally avoid their obligations. Collectively, a risk-based and balanced service and enforcement strategy in the context of a self-assessment environment aims to maximize voluntary compliance and revenue mobilization within the law. These techniques must, as a practical matter, group taxpayers by a few major types of risks, picking visible characteristics as a proxy for underlying compliance behaviour. Size is typically a starting point for this process, although multiple criteria are commonly used.\textsuperscript{159} Indicators of risks posed by small taxpayers may include dynamic firm creation and dissolution; poor or absent record-keeping; cash or barter-based transactions; high participation in the informal economy; and many small retail transactions, which are particularly difficult to track in the service sector. For the tax administration, these pose a variety of challenges. Firm turnover, for example, puts a burden on the registration function, as well as on the service function. Poor records—a particular problem in developing economies where a portion of the self-employed and micro-business sector may not be fully literate—can undermine the self-assessment system by leading to the use of administrative assessments.

\textsuperscript{157} Generally the vast majority of businesses in the micro and small business segment are micro businesses; therefore the administrative burden to collect taxes from this segment can be substantially reduced by transferring collection responsibility for micro businesses to local governments.

\textsuperscript{158} See, for example, U.S. Department of the Treasury (2006): over 80 percent of the U.S. gross tax gap is attributable to under-reporting (by either understating income or overstating deductions and credits).

\textsuperscript{159} In many large taxpayer operations, for example, individual compliance strategies for the largest taxpayers are further refined by industry sector to develop industry financial norms and staff expertise necessary to perform effective audits of complex multinational businesses. And specific targeting of groups within the small taxpayer population is also undertaken, particularly for categories of businesses that have been identified as posing compliance problems: for example, construction, food and beverage establishments, taxis, truckers.
1. PROVIDING EFFECTIVE SERVICE

Tax administrations with limited resources often attach relatively little priority to a growing MSME population, given a perceived low potential tax yield. This is particularly true where past or current practice is to evaluate tax administration performance largely on revenue yield. Successful self-assessment systems are based upon fair and impartial administration that includes transparent laws and regulations, access to clear information about tax obligations, assistance in meeting those obligations via telephone, counter, and correspondence, and appeal rights. Services designed to facilitate taxpayer compliance with the tax law are a complementary and integral part of a revenue administration. Further, though often hard to measure, it is arguable that in cost benefit terms, revenue mobilization from the provision of more effective service is higher than that from additional enforcement.\textsuperscript{160} Education is an important element in addressing compliance risks up-front.\textsuperscript{161} And tax administrations increasingly find that public expectations for service are growing as, more and more, comparisons are drawn between the performance of public sector organizations and that of the private sector.

The challenges of offering quality services to MSME taxpayers, especially in developing countries, are significant: (i) these taxpayers are numerous and diverse; (ii) they typically have poor knowledge of tax laws and obligations; (iii) there is sometimes little trust in the tax administration being a reliable source of information; (iv) they tend to be less sophisticated and often historically had limited IT access\textsuperscript{162} and thus required costly face-to-face services and more extensive support through printed brochures and leaflets; and (v) they are a “revolving clientele,” because their short business life cycle demands on-going effort to educate newcomers.

To meet these challenges, tax administrations must understand the relative costs and benefits of the different service delivery options to support taxpayers (such as correspondence, public counters in local offices, advisory visits to business premises, telephone call centres, leaflets and booklets, leveraged services through others, and web-based options). In countries with established taxpayer service programs, the strategy is usually to manage costs by moving taxpayers to self-help options (web and e-based services, for instance, and automated telephone options). The tax administration lowers its overall costs by minimizing the need for direct services which are provided through more costly correspondence and counter services at local

\textsuperscript{160} Because the revenue contribution of services is often relatively harder to measure, the operational budgets for taxpayer services are often under more pressure than for enforcement programs.

\textsuperscript{161} OECD (2012a)

\textsuperscript{162} This is increasingly no longer true. In advanced tax administrations one of the questions now being addressed is how to take advantage of the increasingly sophisticated IT systems that SMEs are able to exploit since the advent of cloud computing has made these easy to access at low cost. In the developing world IT is also offering opportunities as mobile technology is becoming more and more ubiquitous and exploited for business transactions.
offices, and maximizing the use of telephones and encouraging web-based access to information. Updated guidance on these issues has been published by the FTA.\(^{163}\)

For developing countries seeking to build a service program, a key design consideration is the degree to which MSMEs have access to telephone service, media outlets, and the internet. In many countries, e-services and self-help options may currently have limited applicability. In such cases, even though these should be medium- to long-term goals, taxpayer services must necessarily be delivered more frequently through higher cost walk-in and telephone services. In these countries, outreach activities (community meetings and the like), tax education programs and media outlets are of great importance.

Services and products should be tailored to meet the transaction and life-cycle needs of MSMEs and designed from their perspective. MSMEs need clear and understandable answers to specific questions: How do I start a business? How do I file and pay my tax return? What records must I keep? What are my obligations as an employer? What income is reportable and what expenses are deductible? How do I dissolve a business? Simply providing access to the tax code or tax procedure law—however simple they are—will not meet the needs of a self-employed contractor who is about to hire an employee for the first time.

Many tax administrations now develop specialized advice for small businesses on an industry basis (such as construction, bars and restaurants, agriculture, retail, manufacturing). Often, tax professionals and industry groups assist in the development of these products; the role of tax professionals and others should be leveraged to increase MSME service at low cost. Tax administrations should seek ways to help third parties help MSMEs to meet their tax obligations. In a number of developing countries good quality advice to MSMEs by tax professionals is not available; however in those countries where tax professionals also target MSMEs tax administrations should recognize the role of tax professionals, and indeed a growing number of tax agencies develop tailored products and services such as specialized information alerts, call centre services, internet portals, and seminars for these advisors. Partnerships with MSME industry groups, small business associations, bankers and financial advisors are also very useful in providing information to their membership and clientele on general tax compliance topics and specific issues related to their field. Generally, advice and information received by MSMEs through these sources has high credibility. Other governmental agencies with MSME responsibilities (including those involved in registration, licensing, small business support) can be helpful and low cost distribution channels to reach the MSME taxpayer.

2. **Reducing the Compliance Burden**

Some evidence of the heavy burden that many companies continue to face in terms of the time and expense involved in meeting their tax obligations have been documented. Simplifying these

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requirements can result in significant benefits to both the MSME taxpayer and the tax administration. A PWC report (*Paying Taxes – The compliance burden*, 2012) estimates that the compliance time for businesses increases by an average of 39 percent in economies where tax rules are considered to be complicated or very complicated. Key aspects of simplification include procedures to register, make and deal with inquiries, file and submit returns, pay taxes, complete an audit, and solve tax disputes. Given the limitations on MSME’s compliance capacities, tax administrations should streamline procedures, guided in this by four principles: (i) do not request more information than will be processed and used for the tax administration’s purposes; (ii) provide simple and clear information on what, how, where, and by when actions should be completed, and clearly delineate record keeping requirements; (iii) standardize procedures nationwide in order to avoid different treatment across different offices; and (iv) operate with transparency and public accountability. All of these of course argue for the critical importance of simplifying legislation, regulations, and forms.

Registration practices are often needlessly bureaucratic (involving multiple agencies, and multiple crosschecks), complex (different laws, norms, documents and forms), expensive, and time-consuming. Delays in business registration, which often involves multiple government institutions including the tax administration, can be a significant impediment to business formation and particularly harmful to the small entrepreneur with limited start-up cash reserves. For the MSME operating with limited capital and professional support, such start-up delays and increased costs raise the risk of failure. Best practices include adopting a single unique taxpayer identification number for tax and customs; coordinating efforts with other revenue administrations and agencies involved in the registration process, and integrating and streamlining procedures. \(^{164}\) Improvements can be achieved through the creation of one-stop shops for business registration.

Filing returns and paying taxes can be extremely burdensome, particularly if the forms are complex, the requested information hard to obtain, and return filing requires time-consuming visits to a local tax office in order to comply with tax obligations. For tax administrations, MSME returns represent the bulk of forms received and processed and, unlike large taxpayers’ returns, they have a disproportionate number of inconsistencies, missing information, and unintentional errors. The benefits are therefore very high for return simplification, plain language instructions, bank payment processing, reductions in filing and payment frequency, and e-filing and e-payment acceptance, when feasible.

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\(^{164}\) Ideally, registration should be a one-stop service that minimizes multiple visits to different agencies. Given the importance of the TIN to the overall integrity of the tax system, proof of identity is a critical element of the registration process. For VAT, particular, care is needed to validate the business to protect against fraud.
3. **Enforcement: Non-filing and Under-reporting**

**a) Informality and Non-registration**

As noted earlier, in developing countries the extent of informality amongst smaller enterprises is one of the greatest problems faced by tax administrations. Registration is a major compliance problem in terms of base inclusion and reliable information—identification of unregistered taxpayers is extremely costly and typically requires efforts both in enforcement and education. For example, a pilot study in Mexico found that: (i) 24 percent of the active businesses (of which 93 percent were MSMEs) were not incorporated in the tax register; (ii) 38 percent of the total active taxpayers had inaccurate addresses on file; and (iii) of those that had accurate address information, 71 percent of files were missing data (González, 2006). Non-registration (and non-filing) can, therefore, generate a significant component of the tax gap in some low-income countries. A differentiated look at the non-registration issue is appropriate, however, and analysis available indicates that in particular for micro businesses the decision to work in the informal sector frequently is driven less by tax compliance cost and tax burden arguments or difficult registration procedures, but by the simple consideration that the business is too small to benefit sufficiently from formality to overcome its various costs.

**b) Non-filers and UnderReporting Problems**

Unlike large businesses with strong internal controls, or the wage earner subject to withholding, MSMEs with closer ownership/management linkages have greater propensity to underreport some or all of their income. Despite the strong foundation provided by the service and streamlined procedures discussed above, many MSMEs exploit the openings afforded by, for example, single-owner operations and cash intensive businesses. The overall integrity of any tax system depends on public perceptions of its enforcement effectiveness through predictable and prompt enforcement action against non-registration and following non-filing and non-payment, and through a balanced but risk-based audit program across all tax types and taxpayers. The administration therefore must aggressively pursue, at a minimum, medium-to-high-risk non-filers and taxpayers who misreport. A special emphasis should in this respect be put on businesses declaring over a longer period of time a turnover slightly below the VAT threshold as well as small businesses which might have been created as a result of an artificial split-up of larger enterprises.

Low cost approaches designed to target MSME compliance issues often include: (i) requiring a taxpayer identification number to open a bank account; (ii) establishing proof of tax compliance for government contracts; (iii) prohibiting cash business transactions over a certain threshold;

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165 The proportion of non-compliance attributable to non-registration and non-filing may differ between developed and developing countries, and between individual countries. For example, in the United States, recent IRS research indicates that only about 7 percent of the overall compliance gap stems from non-filing, while 32 percent of the total gap comes from underreporting of business income.

(iv) tying the issuance of business licenses and other permits, such as construction, to tax registration; and (v) offering easy validation of VAT registration for business-to-business and business-to-customer transactions.

c) Third-party reporting and cross-matching

Third-party information reporting can be an effective tool for tax administrations. The mandatory reporting of payments and payee information for some types of income by third parties is widely used, for example for salaries, interest and dividends. Some countries go further and require this for other types of income (such as non-employee compensation, capital gains distributions, real estate transactions, brokerage fees, government contract payments, and international funds transfers).167 168

Information reporting is only effective if the data are cross-matched—which is difficult because the necessary document matching volumes can be exceptionally large. For example, the U.S. matched 1.8 billion documents in 2011, China cross-matched 409 million invoices representing 93 percent of the VAT revenue (2006), and Australia will match over 600 million transactions in 2012-13.169 Consequently, effective data-matching programs are dependent upon electronic matching facilitated by a single taxpayer identification number. In developing countries, cross-matching of import and export data can be one of the more effective techniques. Done well, these matching efforts can be cost effective and the transparency afforded by third party information reporting does result in improved voluntary reporting. In the U.S., income subject to information and withholding is reported at an impressive 98.8 percent rate, and reporting of income subject to some information reporting falls only to 91.4 percent. On the other hand, reporting drops precipitously to an estimated 44.1 percent where the income is subject to little or no information reporting—as is typical of income earned by MSMEs.

d) Industry-based compliance projects

These can be effective where there is persistent and widespread abuse (such as informal transactions or smuggling). These initiatives should contain education and enforcement components and be highly visible to the public to maximize their deterrent effect. Australia, through its cash/informal economy task force, has taken a holistic approach and developed a full range of strategies and tactical activities which begin with educating MSME customers to the

167 While it has generally not been seen as best practice, a few countries seek to increase VAT compliance by requiring submission of purchase and sales invoices to identify fake and falsified invoices, verify input credit entitlements, and ensure that invoiced taxable sales are reported in VAT returns. Of note, intra-governmental exchanges are also a very useful source of compliance information, e.g., national governments can secure information from local governments on assets (real property and business assets) and locally licensed businesses, while both can share enforcement results which may be relevant to identifying taxpayer underreporting of other taxes.

168 Advanced tax administrations use selective cross-checking methods based upon risk assessment, which are less burdensome for taxpayers in general.

169 2011 Data Book, US Internal Revenue Service; State Administration of Taxation, China; and 2012-13 Compliance Program, Australian Tax Office.
downsides of doing business with an unregistered taxpayer to the strongest enforcement actions.\textsuperscript{170}

e) RISK SCORING

A more broadly applicable national system for risk-scoring taxpayers across major tax types, such as VAT and income tax, provides consistency and efficiency in the targeting of high-risk compliance workload. Risk scoring systems use the characteristics of taxpayers to identify and assess their risk of noncompliance. This allows appropriate prioritization of audit workload and allocates resources against the highest risks. Tax administrations in many countries use these systems to: (1) provide a comprehensive assessment of the risks of all taxpayers; (2) ensure that their compliance activities are directed to the areas of highest risks; (3) increase the tax revenues generated by their compliance programs; (4) reduce the burden of audit for compliant taxpayers; (5) provide information for compliance research, such as evaluating compliance strategies; and (6) deliver high-risk compliance workloads to local offices.\textsuperscript{171} Countries are also increasingly focusing compliance improvement programs on specific high-risk industry sectors. Such sectors tend to be in particular personal services, the hospitality sector, and retail trade.\textsuperscript{172}

f) MSME AUDITS

Auditing an MSME often requires using indirect methods and authority to secure third-party information, e.g., bank transactions, and purchases and sales. Determining the scope of off-the-books income requires skilled auditors to determine the amount of unreported income. There are several accepted techniques for this (retail mark-up method, proof of expenditures, analysis of bank deposits, and net worth analysis) but all require extensive information and analysis. The tax administration must have the legal authority to pursue the needed information, importantly including regarding bank accounts, (often requiring a summons) and make assessments based on indirect estimates. Tax administrations lacking skilled personnel and an adequate legal framework will be ill-equipped to tackle MSME non-compliance. Potentially as challenging is the problem posed by the sheer number and variety of MSMEs to designing an effective risk-based audit program in an environment when tax policy design is not reflective of taxpayer and administrative capacity, and thresholds for the formal system are set unrealistically low. Considering scarce audit resources and low revenue risks in the micro and small business segment audit coverage in practice is low in many countries and often does not exceed 1 percent of businesses in the segment. This highlights the importance of effective audit selection and targeting mayor cases of system abuse.

\textsuperscript{170} The Commissioner of Taxation established the Cash Economy Task Force in November 1996. Its objectives are to examine the nature of the cash economy, determine what are the likely compliance issues, and develop a view about what additional steps can be taken by the Australian Taxation Office to address tax evasion in the cash economy (\url{http://www.ato.gov.au}).

\textsuperscript{171} For country practices see Khwaja, Awasthi and Loeprick (2011), „Risk-Based Tax Audits“, World Bank.

\textsuperscript{172} OECD (2012b).
g) DEBT COLLECTION ISSUES

MSME debt collection presents unique challenges: (i) although the individual cases may be small, collectively the debt is often substantial; (ii) many businesses operate with marginal cash flow and few distrainable assets; (iii) some have no formal place of business and are hard to locate; and (iv) others fail quickly leaving behind tax arrears that are hard to recover.

Tax administrations should implement a comprehensive MSME debt management strategy based on risk management, legislative authority, sound debt collection policies, and debt management techniques. Important elements include: (i) streamlining the collection process to speed debt collection activity; (ii) risk-scoring each case based type of debt, age, amount owed, past payment history, asset information (from third-parties, for instance, such as banks, credit bureaus, and other government institutions);¹⁷³ (iii) using appropriate channels to communicate with taxpayers (letters, call centres, e-mails, in-person visits, as appropriate to the taxpayer’s profile); and (iv) providing taxpayers with opportunities to resolve the debt by instalment arrangement or full payment based on the situation.

Tax administrations should have appropriate legal powers to effectively recover MSME arrears and manage collection inventories. Resolving MSME tax debts often requires action against assets (with proper notification) held by the taxpayer (which may effectively end business operations) and third parties, such as bank funds and accounts receivable. Tax administrations should be able to exercise this authority without court approval. Often corporate officers can be held personally liable for failing to remit taxes that are collected by a business from its employees or customers on behalf of the government, such as personal income tax, social security contributions, value-added taxes, and excise taxes. Where assets have been transferred without due consideration, legal authority is needed to transfer the tax liability to the person receiving the assets.

When debts are determined to be uncollectible, the arrears should be written-off (with proper internal controls to avoid corruption and misuse). However, general amnesties should be avoided. While there may be a short-term revenue gain, they serve to undermine and weaken the compliance culture in the longer term (Baer and le Borgne, 2007).

C. TAX ADMINISTRATION ORGANIZATIONAL RESPONSES

Organizational choices for tax administrations revolve around three basic models: tax type, functional, and client-segment: see Box 3. While each model has advantages and disadvantages, most countries have adopted, as the basic approach to domestic revenue collection, a functional

¹⁷³ This risk analysis may result in speeding collection action on newer and potentially smaller—but more collectible—debt, at the expense of larger debt with lower collection potential.
organizational structure, including local offices responsible for all taxes and organized by function (registration, services, revenue accounting, returns/payments processing, collections enforcement, and audit). Within the overall function-based approach, a separate, full-service department, dedicated to large taxpayers has frequently been established in recognition of the revenue risks posed by these taxpayers.\(^{174}\)

Because the organizational structure is a tool to properly align the tax administration’s work to MSME risks, organizational responses to such risks have varied according to the specific needs of the country. For example, beginning the early 1990’s, several countries developed tax administrations organized principally around customer segments: these included, for example, Australia, Denmark, Finland, New Zealand, Sweden and the U.S. It should be noted that these countries did not necessarily adopt the sort of office-type by segment organization which is typically meant in discussions of "segmentation" in developing countries. In New Zealand, for example, the segmentation was more programmatic, rather than physical. It is also of interest that some of these countries—including the US—have either returned to a functional alignment or reintroduced some functional elements because of concerns with cost and a desire to ensure consistent approaches to core activities (such as audit and arrears). And others—for example New Zealand, US, Australia, Canada, UK—have continued the evolution of their organizations, to take advantage of technological and telecommunication changes, moving to create organizational efficiencies and strategies (processing centres; modern 24 hour central call centres) for handling most taxpayers services and less complex compliance issues, while reserving more resource intensive one-on-one interactions for complex audit and collection activity, typically directed towards medium- and large-sized businesses and high wealth individuals.

\(^{174}\) For a further discussion of the organization of tax administration operations within OECD countries see OECD (2013). [http://www.oecd.org/ctp/administration/tax-administration-series.htm](http://www.oecd.org/ctp/administration/tax-administration-series.htm)
BOX 3- TYPICAL TAX ADMINISTRATION ORGANIZATIONAL STRUCTURES

There are essentially three types of organizational structures for revenue administrations.

**Type of tax.** One of the oldest structures is the tax-based model under which separate departments are set up to administer specific types of taxes. Each revenue department performs virtually all of the functions required to administer the taxes for which it is responsible. The main advantage of this approach is that it establishes clear accountability and control for each tax. The main disadvantages are: (1) high administrative costs; (2) high compliance costs for taxpayers (through having to deal with a variety of departments); and (3) vulnerability to collusion between taxpayers and tax officials (with fewer checks and balances as each department operates autonomously).

**Function.** Under this model, separate departments are established for each of the major administrative functions (e.g., processing returns and payments, auditing, and collecting arrears). The major advantages of this approach are: (1) improved taxpayers’ compliance (through for example the ability to conduct joint audits for all taxes); (2) increased staff productivity; and (3) reduced scope for collusion between taxpayers and officials. The main disadvantage is that unique taxpayer service needs and compliance issues may not be adequately addressed.

**Taxpayer segment.** In this approach, the staff provides a full range of administrative services to designated group of taxpayers. The groups are usually based on the taxpayers’ scale of operations and the corresponding risk to the revenue and service needs. The advantages of this approach include: (1) strengthened accountability for organizational outcomes; (2) allocation of resources based on risk to the revenue; and, (3) better matching of enforcement, service, and educational programs to types of taxpayers. Typically, these organizations have divisions responsible for large corporations, medium-size enterprises, and small businesses. A disadvantage is the added costs created by functional redundancy (processing returns and payments, auditing, and collecting arrears) that occurs within each taxpayer segment.

Recently, a few tax administrations in developing and emerging countries, notably in Africa and the Middle East, but also in some Asian countries such as Indonesia, have developed integrated client segmentation and tax policy reforms to better address MSME compliance. Building on their function-based headquarters and large taxpayer office model, these countries have established special programs and, notably, special offices—medium tax offices (MTOs) and small tax offices (SMOs)—to deal with their medium-size and small enterprises.\(^{175}\) The advantages of this approach include: (1) better allocation of resources based on risk-revenue considerations;

\(^{175}\) For a review of progress made see Kloeden (2011).
(2) better matching of enforcement, service, and education programs to small and medium-size taxpayers’ compliance patterns; and (3) strengthened accountability for outcomes, including clear lines of reporting to support MSME compliance strategies. In these countries, MTOs typically handle enterprises with a turnover above the VAT threshold and SMOs, small and micro businesses with a turnover below the threshold. One such planned arrangement in Algeria is described in Box 4.

BOX 4- ALGERIA CASE STUDY

Since 2001, Algeria has been developing a tax administration reform strategy based on a major restructuring of its network of local offices and their operations. The purpose of the reform is to address a number of impediments to the modernization of the tax administration, including:

Four levels of administration: headquarters, regional directorate (in 9 regions), departmental directorate (in 54 departments), and a fragmented network of about 1800 field offices.

Weak management capacity at the headquarters level to supervise, and provide guidelines to, field offices.

Lack of focus on taxpayer segmentation—large enterprises and medium-sized businesses were handled in the same offices as small and micro taxpayers.

A complex forfeit system for the taxation of small businesses.

The initial phase of the modernization strategy (2001–03) focused on (a) establishing a large taxpayer office (the Direction des grandes entreprises or DGE) administering 600 large enterprises located in Algiers and its region, with a petroleum and gas unit dedicated to the control of those enterprises operating in this sector; and (b) strengthening the headquarters and the regional directorates.

The second phase (2004–06) focused on the preparations for the restructuring of the tax offices network, beginning with implementation of two pilot offices for medium-size taxpayers (Centre des impôts—CDI) in Algiers, and implementation of a pilot office (the Centres de proximité—CDP) for the administration of small businesses (meaning those with a turnover below the VAT threshold). During the same period, the authorities eliminated the forfeit and adopted a presumptive tax regime for the small businesses.

Since January 2007, the authorities have embarked on the implementation of the CDIs and CDPs, beginning with Algiers and other important regions. The plan is to implement about 20 CDIs and 50 CDPs, initially in the four main regions. The vision for the longer term (5–6 years) is to replace the current network of 1,800 units by 60 CDIs for the medium-size taxpayers, and about 200 CDPs for the small and micro taxpayers.
D. Taxpayer inclusion as a path to modernization

The possible approach to taxing MSMEs described in Section IV.C above presumed a fairly high VAT threshold, and suggested the application of a presumptive regime to most of those businesses falling below that threshold. However, regional circumstances differ. In particular, many Latin American countries which implemented a ‘first-generation’ VAT in the 1970s did not provide for a threshold. Under these circumstances, as noted earlier in the paper, a variety of second-best policy solutions have been adopted in many countries.

An alternative approach, based instead upon facilitating the inclusion of MSMEs into the formal tax system, has been suggested for implementation in Chile (Toro, 2006). Well known for its highly successful tax administration reform of the late 1980s and early 1990s, Chile now has a strong tradition of compliance and enforcement. Since the late 1990s, the administration has re-oriented its approaches to a more balanced use of programs of service to taxpayers, along with enforcement. Under these circumstances, it is perhaps not surprising that Chile is now giving particular focus to the provision of e-services to small businesses.

While acknowledging that many tax administrations are not yet ready to take on the full management of all taxpayers under the regular tax system, this model posits as the ultimate goal that as many taxpayers as possible should be ‘mainstreamed’. Further, this approach advocates the use of the tax system to assist in the formalization of the small business sector. The strategy advocated under this proposal is to provide intensive focus on MSME taxpayers through a service-oriented approach heavily dependent on advanced information technology (as opposed to through the adoption of special regimes). The aim would be to run an on-line tax life cycle in parallel with an on-line business life cycle for small taxpayers, ultimately resulting in universal electronic tax administration communication, registration, filing and payment.

Clearly such an approach would not possible in many countries less advanced both technologically and in terms of the existing tax administration. And deep practical and logistical support to taxpayers, through the provision of hardware and software access, training, and taxpayer assistance, is required to make this work, as the approach acknowledges: in the case of Chile, this is to be undertaken in part through the development of public-private partnerships with private internet provider centres, building a network of 2,800 internet access points available for completing tax procedures online. The goal is to provide an accounting module

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176 To some extent these two views do coincide, with the one described here acknowledging that, for example, the smallest taxpayers must fall under a simplified cash accounting system. A principal difference—in addition to the VAT threshold—would be in whether the smallest taxpayers were expected to maintain cash expenditure books as well as simple cash receipts. But the basic premise would use turnover as a basis for taxation, as suggested in part A above. Chile in fact presently has multiple simplified regimes.

177 It is perhaps worth noting that Chile, like many other countries, has a number of rather burdensome procedures that would be made available electronically under this approach (e.g., mandatory issuance and tax authority certification of invoices for all sorts of transactions). To the extent that such procedures can be eliminated altogether, there would be less need for frequent interaction between the small taxpayers and the administration—electronically or otherwise—in order to ‘formalize’ their behavior.
to MSMEs on line that would not only permit them to carry out their tax affairs electronically, but, importantly, would enable them to maintain their business records electronically, where otherwise they would be using paper records (if anything). Ultimately, one effect of the program, in terms of the threshold model discussed in Section IV.B, above, is that both administrative and compliance costs should be lowered. While it would be unwise to lower VAT thresholds in countries with weak administrative capacity,\textsuperscript{178} the taxpayer education and services programs developed in Chile may serve as an example of good practice when a cash flow system is implemented for the income tax.

VI. CONCLUDING REMARKS

The tax treatment of MSMEs is marked by wide variation in country practice and—perhaps linked—by a relative paucity of analytical work. But it is also attracting increasing attention in many countries. The coverage in these chapters on MSMEs is by no means exhaustive. A number of countries, for instance, use taxes on smaller enterprises as sources of finance for lower-level governments, raising further issue of fiscal federalism and administrative structures. The tax treatment of business transfers, including under the inheritance tax, is another concern in many countries that is not addressed here. Nor the potentially significant implications of the challenges faced in taxing MSMEs for the design of the system applied to larger enterprises been explored, but rather has taken the latter as given: if cash flow taxation is good enough for smaller enterprises, for example, why not—given its conceptual appeal—for larger enterprises too?

The core issues that have been raised here, nevertheless, clearly create much scope for discussion and further thought. Although micro and small businesses play only a limited (although not negligible) role for tax revenue collection, the tax treatment of MSMEs affects the overall operation of the tax system in particular with regard to tax neutrality and fairness, overall tax compliance management – including compliance behaviour of medium and large businesses –and reduction of tax evasion possibilities. Taxation of MSMEs also affects the level of informality and opportunities for business growth. However not only have many of these interconnections not been fully analysed, but also access of tax policy makers and tax administrators to data and information about the MSME segment frequently are limited. This complicates the design of effective MSME tax systems and the development of effective compliance management programs.

There is also increasing recognition worldwide that MSMEs in no way are a homogenous business segment. Obviously medium-sized businesses are different in the operations, compliance capacity and revenue potential from small businesses. But also small and micro

\textsuperscript{178} And even some of the most advanced administrations—such as those of France and the U.K.—have raised their VAT thresholds.
businesses should be distinguished and treated differently. This requires determining criteria and thresholds for the allocation of a business to the micro, small or medium business category.

Many countries have introduced tax incentives and a preferential tax treatment for MSMEs. Such rules can, e.g., take the form of reduced tax rates, tax holidays for start-ups, special tax incentives for hiring labour or investing in R&D, or preferential depreciation rules. In many cases such incentives have been justified using market failure arguments. However neither is the existence and extent of such failures always sufficiently clear, nor is it obvious that tax privileges are the best instrument to address such failures.

There is a huge diversity both in the theoretical approach and in country practices with regard to the design and operation of simplified (presumptive) tax regimes for small businesses. Again data about the impact of simplified regimes on compliance costs, compliance levels and on distortions created by such regimes are scarce and would be urgently needed. In practice many countries struggle with the trade-off between system simplicity and fairness, and simplified regimes risk either not being really simple or favouring certain types of businesses over others. A careful analysis is required for which groups of taxpayers and to what extent a simplified regime is needed and appropriate, and there is certainly no model simplified regime which fits all circumstances.

Abuse of simplified regimes has become a major concern. Such abuse can take the form of employed labour being declared as self-employment, which may in particular affect the social security system and reduces wage withholding tax collection. An even greater risk to the revenue system can stem from larger businesses hiding in small business tax regimes, and cases of artificial business split-ups to reduce business turnover of individual entities to a level below the small business threshold have been discovered in a number of countries. In addition to strengthening the risk-based audit system anti-avoidance rules counteracting such practices are required.

On the administrative side the need to develop a cost-efficient system for collecting taxes from MSMEs is self-evident. In practice the large number of micro and small businesses induces tax administrations to spend the bulk of their resources on this segment. To counteract such a situation the development of risk-based approaches to small business tax audits and compliance management, and the increased use of IT solutions to reach out, manage and assist small taxpayers is crucial. Successful examples from developed countries also have shown that effective compliance management does not rely on audits as the single most important tool, but applies a more holistic approach, including in particular outreach and cooperation with private sector institutions, in particular small business associations and tax intermediaries, and effective taxpayer service and information. However developing a service culture and a more cooperative approach to compliance management requires changing the attitude of tax administrators, which not always is an easy exercise.
There is vast country experience available on policy and administrative approaches to facilitate taxation of micro and small businesses. While some of these approaches have produced good results, others have not achieved their objectives. But learning from failures can be as effective as trying to replicate success stories. Therefore, as discussions during the various ITD conferences on MSME taxation have shown, continuing and fostering international experience sharing on good practices in the area of MSME taxation remains a valuable tool to support countries in their reform efforts.
CHAPTER 4

Taxing the Financial Sector

I. INTRODUCTION

The following sections begin by examining a key set of issues for financial sector tax policy and administration which revolve around neutrality as a benchmark. Its precise meaning and desirability are discussed; raising questions along the way as to how can it be achieved. The current and prospective challenges for taxation of the financial sector are described, and a description of how they are, and could be addressed in future, provided.

The financial sector encompasses banks, insurance companies, mortgage companies, investment and pension funds, stock brokerages, and a wide range of investment advisory services and other institutions, including informal lenders. Its core functions are to intermediate between, and share risk across, savers and borrowers, providing the credit and liquidity upon which business activity hinges. The effective and smooth operation of these functions is crucial not only for microeconomic efficiency and fairness, but also for long-term growth performance and for macroeconomic stability. The development of the financial sector is a crucial part of the growth process in developing countries since it has major implications for the effectiveness of capital allocation across the rest of the economy and the ease with which the government or central bank can implement monetary policy operations. The centrality of these functions has long lent the sector special importance. Even in normal economic times, the financial sector receives an exceptional degree of support from government in the form of central bank “lender of last resort” and other guarantees (implicit or explicit), and often in more subtle ways too. At the same time, it takes on a range of quasi-governmental functions, ranging from its central role in credit creation to more prosaic functions such as tax collection.

The challenge facing tax policy makers and administrators is to determine how the taxation of the financial services sector, and the payments and income generated within it, is best structured and implemented so as to best realize strong performance in terms of microeconomic efficiency, sustained growth and macroeconomic stability.

The issues are many. Should taxes bearing on financial markets and activities strive for the conventional objective of “neutrality” relative to what the situation would be in their absence? How exactly can such neutrality be achieved? Are there, on the other hand, non-tax distortions and inefficiencies that the tax system should seek to address by introducing deliberate non-
neutralities, or should this be left to regulatory policy? Does financial innovation require a rethinking of the concepts and arrangements that underlie current tax practice? What are the emerging challenges—and opportunities—for tax administrators in dealing with the financial sector, and how can they be addressed?

The following sets out some of the key issues that arise in addressing these and other core questions in the taxation of the financial sector.

A. Taxing the Financial Sector—Why is it so important?

There is considerable evidence that a well-functioning financial sector has a key role to play in fostering sustainable economic, social and political development—and corresponding risk that ill-constructed tax systems, possibly in combination with poorly designed regulatory interventions, can significantly impede the progress on all these fronts.

There is substantial tax revenue at stake in the financial sector, both directly, in terms of tax on the income of the financial institutions themselves, and indirectly, through its role in collecting a broad range of withholding and transaction taxes. With responses to the 2008 world financial crisis and looming demographic challenges in many countries implying severe fiscal pressures in the following decade or even longer, sheer revenue concerns are even more to the fore.

The financial sector is a vital source of information for tax administration—virtually a modern tax handle to match the role played by customs border controls in the past. In developing countries in particular, dealing with the pervasive problem of informality is in large part a matter of fostering development of the financial sector (Gordon and Lei, 2005).179 The importance of the financial sector within the wider tax implementation context has been brought into even sharper focus by two recent developments championed by the G-20: addressing tax base erosion and profit shifting (BEPS) and creating a new global standard of automatic exchange of financial account information.

The need to prevent base erosion and profit shifting was first explicitly referred to at the G20 leaders’ summit in Los Cabos, Mexico on 18-19 June 2012.180 At the request of the G20, the OECD published Addressing Base Erosion and Profit Shifting in February 2013.181 The Report identifies the root causes of BEPS and concludes that, in addition to a need for increased transparency on effective tax rates of MNEs, there are a number of pressure areas that should be addressed. In


180 Base erosion and profit shifting (BEPS) essentially refers to tax planning strategies that exploit gaps and mismatches in tax rules to make profits ‘disappear’ for tax purposes or to shift profits to locations where there is little or no real activity but the taxes are low resulting in little or no overall corporate tax being paid.

July 2013, the OECD launched the Action Plan on Base Erosion and Profit Shifting (BEPS Action Plan)\textsuperscript{182}, identifying 15 specific actions to address BEPS in a comprehensive and coordinated manner. It was fully endorsed by G20 leaders at their meeting in Saint-Petersburg in September 2013. Based on three core concepts of coherence, substance and transparency, the 15 actions will be delivered over a period of 9 to 24 months within the framework of the “G20/OECD BEPS Project”.\textsuperscript{183} Although this initiative is not specifically focused on the financial sector, several of the 15 actions will affect rules on the taxation of the financial sector.

In contrast, the move towards automatic exchange of financial account information will directly affect the role of the financial sector in ensuring compliance with the tax laws. Since 2009, the G20 has focused on fighting tax evasion and avoidance through increased transparency and exchange of information for tax purposes, in particular as regards financial information, building on the OECD work in these areas. Further recent regulatory developments, such as the US FATCA regulations, prompted the G8 and G20 to call for a single common global standard of automatic exchange of financial account information.\textsuperscript{184} The work on that standard is moving forward quickly and is expected to be completed by the end of 2014.

A lesson of the 2008 global financial crisis is that while taxation did not cause the deep failures of the financial system, it may well have exacerbated it: the tax bias towards the use of debt finance and aspects of the use of complex financial instruments (including their opacity) may well have proved more damaging than had previously been thought\textsuperscript{185}--and the potential gains from reforming aspects of the tax treatment of financial instruments and institutions consequently larger than previously supposed.

Clearly, there is much at stake—for developing, emerging and developed countries alike—in seeking to get the taxation of the financial sector right. However, there is considerable debate

\textsuperscript{182} OECD, Action Plan on Base Erosion and Profit Shifting (2013)

\textsuperscript{183} All G20 countries have committed to the G20/OECD BEPS Project, where non-OECD G20 members participate on an equal footing with the OECD members. Other developing countries will be involved through the UN’s participation and through the extensive networks for global and regional dialogue established by the OECD such as the Global Forum on Tax Treaties, the Global Forum on Transfer Pricing, the Global Forum on VAT, the Task Force on Tax and Development, and various regional meetings to be held to solicit developing country input, as well as the possibility of commenting on proposals in the course of their development. Business and civil society will be invited to comment on the different proposals developed in the course of the work and a high-level policy dialogue with all interested parties will be organised on an annual basis.

\textsuperscript{184} https://www.gov.uk/government/publications/2013-lough-erne-g8-leaders-communique

And http://www.g20.org/documents/

about how best to do this in practice as opinion often differs significantly, with the central banking community generally opposed to ideas such as that of a general financial transactions tax that has gained support amongst other interest groups since the onset of the global economic crisis.

B. WHY IS IT SO CHALLENGING?

The challenges in imposing taxation on the financial sector are large. These arise from elements that make the sector almost uniquely complex and subtle. There are considerable technical difficulties in taxing both income arising in the sector and the services it sells. These begin with the basic task of defining what constitutes "income," under varying circumstances, and include the characterization of that income for tax purposes, and continue through to the identification of the consumption of services it generates.

The ease with which financial instruments can be created and transformed\(^{186}\) means that any tax rules applied in this sector are particularly susceptible to arbitrage and manipulation through the development and deployment of potentially complex instruments. This in turn has implications not only for tax revenue but for the efficiency of financial arrangements: does arbitrage ease the impact of arbitrary tax design, or does it jeopardize the stability of the wider financial system?

Conceptually, market failures abound in the financial sector: problems of asymmetric information—borrowers knowing more of their prospects than lenders, financial institutions knowing more of their circumstances than do the government and regulators—are pervasive. Profound questions then arise as to whether the conventional prescription of ‘neutrality’—that taxation should interfere as little as possible with private decision-making—is appropriate, and as to the proper roles of tax and regulatory policies in addressing these failures, without which the financial sector might not even exist.

International spill overs arise throughout the financial sector. Even detecting them may be difficult, with further issues arising as to what forms of international coordination might be capable of dealing with them in a way that operates to all countries’ benefit.

Some countries would also like to use the tax system to curb excessive speculation in the financial sector, although the resulting impact of such interventions in terms of price stability is uncertain.

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\(^{186}\) For example, BIS data indicates that the total value of over the counter derivative securities in December 2012 stood at nearly 25 trillion U.S. dollars. These included foreign exchange, interest rate, equity-linked, and commodity contracts, and credit-default swaps. By comparison, total worldwide GDP for 2012 was $72 trillion (IMF, World Economic Report, 2013).
The financial sector has been at the cutting edge of globalization with very significant growth in cross border financial positions in recent decades\(^{187}\), and marked by rapid innovation. While this has been most evident in higher income countries, the impact is felt by all. Developing countries dealing with sophisticated multinationals—indeed often deriving much of their tax revenue from them—can be substantially affected by their use of hedging and other devices for risk-management: they need to understand their properties and implications, and perhaps avoid the mistakes that higher income countries have made in dealing with them.

C. Neutrality—A Key Benchmark

A ‘neutral’ tax system is one that leaves private decisions as they would be in the absence of taxation.\(^{188}\) In the present context, this would mean that the financial assets investors held and the institutional arrangements by which they held them would all be unaffected by the tax system. The importance of neutrality in evaluating tax systems is in placing the onus on policy makers to justify using the tax system in a way which distorts the operation of the market. There may in some cases be good reason to suppose that the markets do not in practice work perfectly: for example, non-tax factors such as limited liability create an inherent tendency toward excessive corporate leverage. While this can create a case for tax non-neutralities, there may be non-tax responses—regulatory capital requirements are generally seen as the appropriate response to dangers of excess leverage, for instance—that are better-suited to addressing such market failures. More generally, the nature of these potential inefficiencies is clearly less than fully understood. Care needs to be taken, in any case, that government interventions do not ultimately result in worsening matters.

The importance and usefulness of neutrality is thus not an absolute, but is rather a benchmark relative to which differential treatments may be identified and evaluated, providing a check on special pleading, inadvertent side effects and inequities. Of course, neutrality considerations in taxing the financial sector need to be tempered by distributional and other social concerns, as well as by the practicalities of administration and compliance—all of which may be quite country-specific.

The following sections break down the detailed discussion of these questions into four areas.\(^{189}\) Section II considers the appropriate taxation of financial instruments and the capital income they represent. Section III turns to the appropriate taxation of financial institutions—with the main

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\(^{187}\) Lane (2012) provides a good brief overview of measures and trends in the growth of cross border financial positions between 1980 and 2010.

\(^{188}\) Apart, that is, from the effects from the transfer of resources out of the private sector that is inherent in any form of tax.

\(^{189}\) The focus is on issues that are unique to the sector, not on all that arise within it. The tax treatment of alternative forms of executive remuneration, for instance, looms large in the financial sector but, not being inherently unique to it, is not addressed.
focus being on taxing the income they generate. The appropriate taxation of financial sector services and transactions is considered in Section IV. Administration issues, challenges and opportunities are the topic of Section V. The goal is not to reach firm conclusions, but rather to raise issues that those responsible for tax policy and administration must consider when making decisions at the national and international level. These are summarised in Section VI.

II. TAXING FINANCIAL INSTRUMENTS AND OTHER CAPITAL INCOME

A. THE FINANCIAL SECTOR AND THE TAXATION OF CAPITAL—INCOME PRINCIPLE

A large part of what the financial system does is to channel capital income from the users of funds to the suppliers of funds, so that the questions at the heart of issues about taxation of the financial sector are intimately connected with the taxation of capital income. There are, importantly, genuine questions as to whether capital income ought to be taxed at all. These though are usually unrelated to the financial system: many of the theoretical arguments that taxing capital income is inappropriate\(^\text{190}\) would apply even if capital income did not take the form of financial claims but, quite literally, came in the form of the fruit growing on trees purchased by past investments. Conversely, equity principles do provide a strong rationale for supporting the taxation of capital income. To generate capital governments need to provide infrastructure which has to be paid by all taxpayers to share the tax burden. It may be argued that since individuals are taxed on the income that they receive therefore why tax them at the level of the company. This would be valid assumption if all holders of capital were resident in the same country as the company, but in an increasingly global world this is not the case. The view one takes on these deeper questions will affect some of the issues we are concerned with (such as those relating to capital income arising from the sector’s own service-providing role and tax withholding roles). We simply take it that one part of the reason for being interested in the tax treatment of the financial sector is because of an interest in taxing—or, indeed, in not taxing—capital income.\(^\text{191}\)

With that in mind, the rest of this section introduces core concepts and challenges relating to the role of financial institutions and instruments in taxing capital income.

1. WHAT IS CAPITAL INCOME?

Capital income is the return on an asset—interest paid on a bank deposit, for example, or capital gains on shares in a company. It can include several types of return—a pure time value of money

\(^{190}\) Because, for instance, it implies huge distortions to the price of future consumption in relation to current consumption.

\(^{191}\) Thus we do not enter into the debate as to which of either income or consumption should be taxed (the latter being achieved not necessarily only by indirect taxation but, potentially, with explicit progressivity by either exempting capital income or allowing a deduction for saving). The issues addressed in the paper would not all disappear under the consumption tax route, though they would take a somewhat different form.
return (also known as the risk-free or safe return) representing compensation for deferring the use of the funds invested in an asset; a risk premium return to compensate the investor for bearing whatever degree of risk the asset entails; and the income over and above the risk-adjusted return generated by the use of an asset, commonly known as economic rents, extra-normal returns or infra-marginal returns.

Some capital income is easy to identify, but much is not. Interest on bonds and bank deposits, dividends from shares of public companies and rents from the ownership of a house, for example, are all easily recognizable forms of capital income. However, an important component of capital income can be represented by changes in asset values, and valuations are often based on judgment and convention rather than arms-length prices. Moreover, labour and capital income cannot be separated easily in many circumstances, particularly in the case of closely held firms: colourful jargon like “sweat equity” is sometimes used to refer to the capital invested in a company represented by the efforts of entrepreneurs in a venture. How capital income is defined also depends on contractual arrangements required by financial intermediaries and financial markets, which are evolving over time. Their complexity can give rise to problems of definition, especially in the case of derivative instruments and contingent contracts, where gross payment flows between counterparties often do not solely represent the returns on capital.

2. The role of the corporate tax

Corporate taxation has a critical role in taxing capital income. It acts as a means of withholding against the personal capital income of domestic and foreign shareholders, and also provides a backstop to the taxation of labour income, particularly in the case of closely held firms. A key issue here is the difficulty of taxing capital gains on an accruals basis—that is when they arise—at the personal level: if, as is almost invariably the case in practice, capital gains are taxed only on a realization basis—that is, when the asset is sold—then income that is retained and reinvested in the corporate sector can be sheltered from personal tax until it is taken out by either selling shares or taking dividends. Taxing corporate income as it is earned is a way of bringing this income into the tax system at the appropriate time. Tax rules for cross-border transactions, and the interactions between national tax systems, also complicate the use of the tax since corporate taxation is important in terms of its role as a withholding device against foreign shareholders, which in turn necessitates mechanisms to relieve and prevent any double taxation that would otherwise deter cross border investment flows.

A corporate level tax may also be a particularly convenient way of levying a tax on economic rents arising in the corporate sector, the attractive feature of such a tax being that—since rents are by definition payments in excess of the minimum required by the investor—they can be taxed without causing any distortion. International considerations matter here again, however. To the extent that the source of the rents is not specific to a particular location—access to a particular mineral deposit, for instance, or to a protected local market—a tax on economic rents levied by one country may simply drive investments to other jurisdictions offering a lower rate of tax. For a
small open economy, there is indeed a fairly robust theoretical argument that no source-based tax should be levied, though the practical importance of this is muted by, for instance, the backstop role of the corporate tax mentioned above, and by the availability of foreign tax credits for investors from countries applying worldwide taxation.

Most corporate taxes serve this rent-extraction role only imperfectly, however, since, in particular, they allow a deduction for interest paid from the tax base but for not the normal return to equity finance (though of course a full assessment would need to take account of personal level taxes too). Alternative forms of corporate tax can be envisaged—and have been applied in a few countries—that would seek to tax only rents, routes to this end being to allow a deduction for a normal return to equity (the ‘Allowance for Corporate Equity’, or ACE, system) or allowing immediate expensing of investment but no financial deductions (‘cash-flow’ taxes). These also serve to mitigate the pro-debt bias implied by most corporate taxes.

3. Risk-taking

The tax treatment of capital income can affect risk-taking by investors, but the effects are complex. In theory, if tax systems provided full offsets for losses, governments would share in both the upside (through taxation of gains) and downside (through full deduction of losses) of risky projects and so reduce risk for investors. In practice, however, non-linearities in the tax system, such as limited loss offsets, may actually discourage risky investment, which is one reason why some countries impose lower levels of tax on capital gains tax than on income. In addition, capital by its very nature is mobile and therefore countries compete with each other to attract investment.

B. The Financial Sector and the Taxation of Capital Income—Problems

In practice, tax systems are far from neutral in their treatment of capital income—and are often extremely complex. Financial income is not subject to a uniform treatment (rates, base etc.) under most income tax systems. The assorted provisions that coexist side by side are often the result of accident, a piecemeal approach or the pursuit of political and social objectives. The international dimension of finance has also added to the differential treatment of instruments. The ensuing asymmetries have opened up numerous arbitrage possibilities that potentially

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192 With perfect international capital mobility, a small open economy faces a perfectly elastic supply of capital from abroad, so the burden of a source based capital tax will be fully shifted onto workers and other immobile domestic factors via an outflow of capital which drives up the pre-tax return. In this process, the productivity of the domestic immobile factors will fall due to a lower capital intensity of production. To avoid this drop in productivity, it is more efficient to tax the immobile factors directly rather than indirectly via the capital tax. Note that this argument for a zero source-based tax on investment is distinct from the argument referred to above for a zero –residence-based tax on saving.

193 Investors can scale up their holdings to offset the implicit “equity” participation of the government and attain their desired pre-tax portfolio, leaving them exactly the same net capital income as in the absence of tax. In this case, the capital income tax would apply in effect only to economic rents and the riskless (“normal”) return to capital.
endanger tax revenues. In the absence of satisfactory overarching solutions a patchwork of complex norms and regulations has been set up to protect the tax base. The following paragraphs outline some of the more common asymmetries seen in practice.

1. **REALISATION**

For practical reasons, tax systems are largely based on the measurement of income at the time of realisation—generally through a market transaction. A realisation-based system leads to reductions in the tax burden on some forms of capital income because taxpayers can defer the sale of appreciated assets and hence the payment of taxes (and, conversely, accelerate the sale of loss-carrying assets). Deferral can result in two types of behavioural response. First, as just described, it distorts decisions on when assets are sold, creating potential lock-in or acceleration effects. The second potentially more harmful effect is that deferral may promote activities that are tax-favoured over equally productive activities that are taxed on a current basis. Where capital appreciation takes the form of ex-ante definable income the tax system can be adjusted to offset the benefits of deferral, and thus to eliminate the distortion. The solution found for original issue discount bonds, for example, is to distribute tax over time on the basis of the yield to maturity, which is known at the time of issue of the security. This is more difficult in situations where future returns are uncertain.

2. **UNCERTAINTY-CAPITAL VERSUS ORDINARY INCOME TAXATION**

Tax systems generally distinguish between ex-ante definable income flows and contracts whose final value is contingent on some uncertainty which will be resolved only over time. This differentiation is often based on the historic legal (but non-economic) distinction between ‘ordinary’ capital income, which is considered to be the fruit resulting from the use of a capital asset, and capital gains and losses, which result from the sale or exchange of capital assets. In some instances, this asymmetry is compounded because the treatment of gains and losses may differ according to whether they have occurred on assets or liabilities, are an income or expense item, or depending upon the type of taxpayer—individual, financial institution, corporation or institutional investor. These distinctions between capital and ordinary income become untenable when derivatives allow a nominally contingent claim to be created from what are basically certain cash flows.

3. **NON-UNIFORMITY**

The tax systems of most countries subdivide transactions into particular categories which then are subject to specific provisions, resulting in non-uniform characterization of transactions. For example, typically dividends and interest are subject to different tax regimes. Their tax treatment in turn differs from that of other generic forms of payment between third parties. In many jurisdictions it has been debated whether cash flows exchanged under swap arrangements should be treated as interest. Since derivatives and other financial instruments allow easy modification of the external attributes of financial arrangements—transforming dividends into interest payments,
for example, through the lending of shares—these distinctions have become increasingly arbitrary.

4. **NON-LINEARITIES**

Imperfect loss carry-forward and backward provisions, different marginal tax rates according to the characterisation of assets and liabilities and asymmetries of treatment for similar transactions across different types of market participant and jurisdictions produce kinks and non-linearities in tax schedules. Such non-linearities lead to incentives for tax planning and the trading of tax positions.

5. **TAX ARBITRAGE**

‘Tax arbitrage’ generally refers to the earning of a relatively high after-tax rate of return through tax-favoured instruments, strategies or organizational forms, while financing this using a low-tax source. For example, a high tax bracket investor can borrow from a tax-exempt lender, with the result that the borrower deducts the interest cost while the lender is not taxed on the receipt of the interest. As a result of these behaviours, for any specific investor, the tax system is not neutral. This can lead to imperfections in the workings of capital markets and undesired distortions in the allocation of resources. Tax arbitrage can potentially eliminate tax, or even result in tax rates being negative. The globalisation of finance has expanded the opportunity for arbitrage by facilitating the exploitation of differences in tax treatments across jurisdictions. Transactions may be structured to place at least one end in a low- or no-tax jurisdiction. Cursory evidence, such as the growth of business channelled through offshore tax havens, suggests that arbitrage activity and revenue loss can be significant and may be growing. There is as yet little empirical evidence to quantify the extent of revenue loss resulting from the imperfections of the tax systems and aggressive avoidance behaviour by taxpayers, although recent work done at the OECD on aggressive tax planning and offshore non-compliance suggest it is large and growing. The Report *Addressing Base Erosion and Profit Shifting* concluded that while most research was inconclusive there was abundant circumstantial evidence that BEPS behaviours are widespread.194 Action 11 of the BEPS Action Plan will address this question by requiring the development by September 2015 of recommendations regarding indicators of the scale and economic impact of BEPS, and ensuring that tools are available to monitor and evaluate the effectiveness and economic impact of the actions taken to address BEPS on an on-going basis.

Although taxation was not at the root of the on-going financial and economic crisis, tax arbitrage may have exacerbated global imbalances in some regions by creating distortions in the composition of banks’ portfolios, and/or by shaping the debt structure of multinational financial

institutions, by affecting subsidiary/parent firm location decisions, or by making foreign lending more attractive than domestic.

6. INFLATION

The correct calculation of capital income hinges on its accurate measurement in real (inflation corrected) terms. Inflation alters the tax base by (a) reducing the real value of deductions based on historical cost for depreciation and materials (b) reducing the real burden (for debtors) and value (for creditors) of debt repayment and (c) distorting the computation of capital gains. With an un-indexed tax system, inflation reduces the real after-tax return of taxable assets. 195 Assuming a given pre-tax real rate of return and that the inflation rate is fully reflected in nominal interest rates, higher rates of inflation will result in higher effective tax rates for a given statutory rate of tax. By contrast, with leverage and preferred taxation of capital income, inflation can lead to negative tax rates. Indexing the taxation of capital income has been attempted in several countries, but it is difficult to have a fully inflation-proof tax system. Many problems have been encountered with indexation, particularly where inflation indexed securities and un-indexed securities co-exist side by side.

C. TAXATION AND CORPORATE FINANCE

1. THE DEBT-EQUITY DECISION

The distinction between debt and equity draws on the historic legal division between creditor interests (bonds and other interest obligations) and ownership interests (shareholders). The extent to which these debt/equity distinctions matter from an economic standpoint in company decisions is the subject of a longstanding controversy. In the absence of tax factors, economists have generally taken the view that the legal distinctions between debt and equity are irrelevant to firm valuation and the cost of capital. Famously, the Modigliani-Miller theorem (and later extensions) established conditions under which a company’s decision in respect of real investments is independent of its financial decisions. Changes in debt/equity ratios merely represent a change in the sharing arrangement of a given return and risk profile between creditors and shareholders. In other words, a portfolio consisting of a little risky equity and a lot of safe debt should have the same value as a second portfolio with a lot of less risky equity and a little safe debt, if the underlying total risk of each of the two portfolios is comparable.

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195 For example, suppose a bond pays 8 percent interest of which 4 percent represents a real return and 4 percent represents inflation. At a 25 percent tax rate, the after-tax nominal return is reduced to 6 percent, or a 2 percent real after-tax return. The 25 percent statutory tax rate becomes a 50 percent effective tax rate on the real return.
For tax purposes, however, interest payments are generally deductible in computing corporate profits, and dividends on equity are not.\footnote{For every $1 of interest paid, bondholder gets $\$(1−t_p)$ (where $t_p$ is the rate of personal tax on the interest payment). For every $1 of interest not paid, the company can provide shareholders with $\$(1−t_c)$ (where $t_c$ is the rate of tax on corporate profits) of which they take home $\$(1−t_c)$ (where $t_c$ is some composite of the tax on either dividends or capital gains). So, the net benefit of $1 of interest is $(1−t_p)−(1−t_c)(1−t_c)$. For example, if $t_p = 40$ percent, $t_c = 35$ percent and $t_c = 20$ percent, then the net benefit from debt is 8 percent. Importantly, the tax benefit to debt is greater the lower the marginal tax rate faced by the investor on interest: in this example if the recipient of interest were tax exempt the net benefit from debt would be 48 percent. For brevity this argument ignores the distinction between equity finance in the form of retaining earnings and subscribing to new equity: on this, see footnote 198 below.} Financial decisions then cease to be irrelevant. The taxation of a company financed wholly through debt would thus be equivalent to that of a business in unincorporated form.\footnote{If the marginal tax rate on debt is equal to that on other investments.} Debt can be seen as a way of eliminating double taxation in the corporate form—a way of achieving an “integration” of the corporate and personal tax systems.

In the absence of personal taxes on equity income—as for tax-exempt investors, including for example pension and sovereign wealth funds—debt would clearly be tax-favoured. If taxes on equity income are high enough, the preference could be reversed.\footnote{Under the traditional view of dividend payments on equity ownership, this difference between debt and equity would affect the cost of capital. Since the late 1970s, however, some economists have argued that the additional, personal-level tax on dividend income has little or no effect on the cost of capital, because marginal investment is financed primarily through retained earnings rather than new investments from outside the corporation, and a dividend tax reduces both the implicit cost of retaining income (in dividend income currently forgone) and the return from retaining income (in future dividend income). Taxing dividends thus has no effect on the cost of retention finance, but does increase that of new equity finance.} While there is little evidence on this, the scale and activism of exempt investors, and opportunities for the deferral of personal taxation, suggest that debt will in many cases be tax-preferred.

Most recent econometric studies find that taxation does have a small but significant effect on firms’ financial policy and capital structure. This is so in various studies covering different regions and using differing methodologies. Empirical evidence on the debt-equity ratios of subsidiaries of multinationals has yielded particularly strong results. One issue which is not fully addressed by this literature is the extent to which leverage has changed over time, and why. This is important for assessing the extent to which tax factors or rather other exogenous factors—such as the growth of capital markets or globalization—have affected leverage. One might have expected, for instance, that the decline in statutory tax rates in recent years would have reduced the tax incentive to use debt.
Nonetheless, companies appear to be far from exploiting fully interest deductibility to reduce their expected tax liability to nil. This is partly due to the non-tax costs of debt, including the costs associated with financial distress. A number of features of the tax system may also attenuate in practice the incentive to leverage associated with the tax deductibility of interest. These include differences in the value of a corporate tax deduction (for example between profitable and loss-making firms), differences in the taxation of individuals (including differences from investing through institutions or investment vehicles rather than directly), the definition of the tax base and the possibility of alternative means of reducing taxable corporate income (i.e. the existence of so-called non-debt tax shields), and explicit restrictions on the deductibility of interest (such as thin capitalisation rules).

The incentives to leverage a company when financed by investors located in other jurisdictions may be much higher. Shifting of revenue from one jurisdiction to another can lead potentially to the absence of any taxation.

A sharp distinction between equity and debt is in any event often misleading. Debt and equity encompass a continuum of different types of claims that mix elements of each. The dividing line between different types of claims has become increasingly tenuous as the widespread use of contingent claims and the growth of so-called hybrid financial instruments have blurred the distinction between equity and debt.

D. INNOVATIVE FINANCIAL INSTRUMENTS

The use of innovative financial transactions and instruments has expanded in recent years, primarily due to the need for greater risk management by businesses and financial investors which has spurred the development of sophisticated instruments tailored to meet such demands. However, they also create problems where such financial instruments are purely developed for tax reasons. This latter aspect of financial innovation can lead to forgone tax revenue, including withholding taxes in a cross-border situation, and the misallocation of resources as investors choose products for perceived tax benefits rather than their underlying economic benefits.

A broad group of innovative financial instruments, referred to as "derivative" contracts, call for specified cash flows to be made between the counterparties over time. Unlike traditional debt and equity securities, these instruments generally do not involve a return on an initial investment.

199 And presumably also partly due to constraints in issuing hybrid instruments which qualify as debt for tax purposes and function as equity.

200 The Report Addressing Base Erosion and Profit Shifting also picked up this issue, noting that key pressure areas for BEPS are international mismatches in entity and instrument characterization including hybrid mismatch arrangements and arbitrage as well as the tax treatment of related party debt-financing, captive insurance and other intra-group financial transactions. Work in these areas is already underway in the context of Action 2 (Neutralize the effects of hybrid mismatch arrangements) and Action 4 (Limit base erosion via interest deductions and other financial payments) of the BEPS Action Plan.
Rather, derivative contracts are constructed and priced by reference to values "derived" from an underlying index, commodity, or other item, and their value fluctuates with the market movement of that referenced item. The basic building blocks of derivative instruments can be combined in any number of ways as specified by the counterparties. In particular, derivative contracts can separate each of the discrete economic attributes of a particular position or recombine them into new forms. Significantly, they can also be constructed to replicate any specified set of economic attributes (including those of debt or equity instruments) in a variety of forms (as shown in Box 1). Traditional patterns of investment have also been expanded through securities lending and repurchase agreements. These arrangements permit the owner to transfer title or possession of underlying securities, while retaining the economic attributes of the position.

Derivative instruments and other innovative financial transactions serve legitimate business and investment purposes. The holder can use such products either to take a position carrying specifically defined opportunities for profit and loss, or to offset (i.e., "hedge") the inherent risks of other investments or business activities. This ability to shift, substitute, or transform risks through the use of financial products is an essential tool of modern business and investment.

**BOX 5- FINANCIAL EQUIVALENCES—PUT-CALL PARITY**

The "put-call parity" theorem shows a fundamental relationship between debt, stock, and options to purchase or sell such stock. It provides a stark illustration of how innovative instruments can be used to construct positions that have different form but are economically equivalent.

Assume that Investor 1 holds a zero coupon bond that matures at date $T$ and has a face value of $X$, and a call option to purchase a share of stock on date $T$ at an exercise price of $X$. Investor 2, on the other hand, purchases a share of stock at its current value, and also buys a put option which allows her to sell the stock on date $T$ at an exercise price of $X$. Put-call parity states that the two investors have economically equivalent positions. That is:

$$\text{Debt (}X\text{)} + \text{Call Option (}X\text{)} = \text{Stock} + \text{Put Option (}X\text{)}$$

(This simplified form ignores the offsetting effects of dividends paid on the stock, as well as transaction costs.) To see this, consider the alternatives for each investor as of date $T$. Investor 1 holds debt that will return $X$ on date $T$; he will then have the choice of keeping $X$ in cash or using the cash to exercise the call, thus acquiring stock. Clearly, Investor 1 will exercise the call only if the stock is worth more than $X$ at date $T$. Thus, the investment participates in any appreciation of Stock, but is protected from a drop in its value below $X$.

Similarly, Investor 2 holds the stock and the right to sell the stock to another party for at least $X$; thus she will also participate in any appreciation of the stock above $X$, but due to the put rights,
While playing a critical role in risk management, innovative financial instruments also present a number of serious challenges for income tax systems. The traditional income tax categorizations of character, source, and the timing and amount of income are difficult to maintain given the emergence of instruments that can mirror economic attributes of investments in any number of diverse forms. Similarly, the fundamental distinctions in most income tax systems between debt and equity are muddied by instruments providing for returns and risks that are economically equivalent to the financial attributes of debt and equity investments, or any "hybrid" combination of those attributes. "Ownership" of an instrument is also difficult to determine in contracts that replicate, shift or eliminate some or all of the returns and risks of an investment, or under securities lending and repurchase arrangements that transfer legal title but retain economic attributes of an investment.

Tax systems are challenged by two broad and sometimes competing concerns: (a) removing artificial tax barriers to effective risk management strategies; and (b) limiting the opportunities for tax arbitrage. This raises the more general issue of whether reductions in transaction costs associated with financial innovation, and more generally deregulation, have increased the significance of long-standing non-uniformities in the tax system and undermined net revenues. In other words, tax systems in the past may have worked as well (or badly) as they have only because non-tax factors caused risk not to be able to be fully hedged, and transactions were costly. Hence, financial innovation may raise new threats to tax revenue collection.

E. DEALING WITH ASYMMETRIES IN THE TAXATION OF CAPITAL INCOME

New tax rules designed to meet these challenges must address—or at least be assessed relative to—the overall tax policy objectives of neutrality and equity, in order both to promote the efficiency of financial markets and to protect the revenue base. This must be accomplished with appropriate attention to the goals of certainty and administrability.

In the light of the challenges and tax law asymmetries described above, countries have applied a range of approaches (or combinations of those) in recent years. These include adopting elements of: (a) elimination of differential treatment through the adoption of transactional analysis; (b)

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201 See Aggressive Tax Planning based on After-Tax Hedging (OECD 2013) and Hybrid Mismatch Arrangements: Tax Policy and Compliance Issues (OECD 2012).
taxation on the basis of accruals; (c) the application of specific formulas; (d) anti-avoidance provisions.

1. TRANSACTIONAL ANALYSIS

The transactional (or so-called "independent instrument" approach) consists in examining each innovative transaction and attempting to achieve substantive consistency in treatment with other known transactions. This independent instrument approach maintains the artificial differences in the character of income flows which are at the origin of the distortions mentioned in the previous section; each transaction is defined and treated separately before aggregating the overall liability. This approach overlooks the similarities between cash flows, forces taxpayers to define the purpose for which each transaction has been undertaken, and largely ignores overarching financial strategies or methods of managing overall risk exposures. In addition, since there is no unique definition of income the distinction between various types of categories also entails increasingly complex legislation meant, on the one hand, to pigeonhole each new instrument into the specific categories defined by the tax code and, on the other, to establish anti-avoidance provisions.

A typical form of this transactional analysis is the bifurcation approach. Often cited is the example of a convertible bond which carries the right of conversion into shares at a specified price. Economically, the instrument consists of a discount bond and an equity option. Adopting bifurcation, each component could be taxed separately according to the provisions for each of these instruments. Bifurcation has the attractive feature that it would permit the individual transaction approach (if it were viewed as worth maintaining) to be applied in a wide range of circumstances once the various categories of each transaction have been identified. In practice, it runs into a number of problems of implementation. First, as already mentioned the system is indeterminate: there are always a number of different ways of subdividing a transaction into component parts. Second, the valuation of the segments may not always be possible if prices for the individual components or comparable instruments are not available. Finally, there may be synergies between the individual components so that the sum of the parts is greater (or less!) than the value of the whole.

Another such approach entails the aggregation of various individual transactions. Several countries have adopted "hedge accounting," under which the tax treatment follows economic substance in reflecting a deemed single aggregate transaction, where that is appropriate, rather than the result of looking at each actual component of that wider whole in isolation. A simple example of such a hedge or aggregate transaction is that consisting of a long position in a portfolio of shares against which a futures contract has been sold: the decline in value of the portfolio would be offset by the increase in the value of the position in futures. In an EU context and for large companies like banks that normally require with international accounting standards, which includes IAS on hedge accounting/derivatives, tax authorities have largely accepted this as a valuation basis for taxation purposes (with a number of adjustments). However where tax
systems have moved towards hedge accounting on a much more selective basis, this may have introduced new non-linearities.

2. **ACCRUALS TAXATION**

One of the conditions for the consistent treatment of financial instruments is that capital gains and losses must be taxed at the same rate as other sources of revenue or expense. In practice this means that capital gains should be taxed on an accrual basis, via the marking to market of positions. Full accrual and marking-to-market would be the cleanest approach and that which most closely approximates the true rate of return on a portfolio over a particular period. Marking to market has been increasingly adopted for accounting purposes for those financial market participants that frequently turn over their portfolios.

However, marking to market for tax purposes suffers from three distinct problems: (a) not all market participants—especially households—can accurately or conveniently mark to market their position; (b) non-traded assets (or instruments which are traded infrequently) are not easy to mark to market if prices of comparable assets are not available; (c) taxation of unrealised gains may pose cash flow problems\(^\text{202}\) that may require borrowing or forced liquidation at the time of tax payment—a legitimate concern if this interferes with the efficiency with which the underlying assets are used. Some of these problems can in part be solved. The marking to market of positions held by households should not be difficult, at least for regularly traded assets, if intermediaries can produce accounts on this basis. Similarly, accrued gains (losses) can be carried forward, held in tax suspension and charged a market rate of interest reflecting the deferral of tax liability, and liquidated either when actual realisations take place or at discrete time intervals. Similarly, to avoid problem (c), tax on accrued income of illiquid instruments may be recognised at a particular period and carried forward at a market rate of interest until the position is sold. Various options could be given for the timing of tax payment which would guaranty neutrality.

There are problems with this approach, however. The financial crisis has highlighted the problem of valuation in the presence of illiquidity. Movements in bid-offer rates during the course of 2009 have shown, at times even for government bonds of major EU countries, that liquidity premia can be substantial and extremely volatile. Scenarios of the individual relocating abroad, absent effective and appropriate exit charges, would further complicate the system.

Full marking-to-market will not be possible for a number of taxpayers and will be imperfect for assets which are not traded frequently.\(^\text{203}\) In the light of these problems and given that accrual accounting has increasingly been adopted for a number of transactions, the issues become (a)

\(^{202}\) The fact that a large part of financial income obtained by individuals through intermediaries usually is subject to (advance or final) withholding taxes is another obstacle to accruals taxation of individuals.

\(^{203}\) As would be the case not only for some financial assets but also for many non-financial ones, such as works of art.
which type of adjustment to a pure realisation system is preferable in order to avoid deferral and selectivity in the timing of gains and losses; (b) where to draw the line for accrual accounting; (c) how to integrate the taxation of instruments subject to accrual accounting with that of other transactions valued on an adjusted realisation basis. These issues are particularly relevant for the taxation of financial institutions (see Section III).

In contrast, taxation on the basis of the market value of assets has been operating historically as part of wealth taxes imposed on individuals and in practical terms can be seen as a partial remedy for any inconsistency of tax treatment of financial products between individuals and companies.

3. FORMULAIC SOLUTIONS

Even when capital gains are not observed as they accrue but only when realized, the objective of taxing capital gains and losses at the same rate as other sources of revenue or expense can be theoretically achieved by taking account retroactively of past tax accruals. An approximation of the economic effects of accruals taxation may be achieved through some form of retrospective averaging formula or via the imputation of interest to take account of the time value of money gained via the deferral of taxation of accrued gains until realisation. The choice between these methods boils down to practical questions of measurement and of the different information requirements necessary for implementing these mechanisms.

4. ANTI-AVOIDANCE PROVISIONS

In recent years, governments have stepped up their effort to curtail the perceived increase in avoidance strategies pursued aggressively by both corporations and individuals. This has acted as a backstop protection against the effects of certain asymmetries in the tax system, including, principally, protecting against the resulting loss of tax revenues. For example, the United States and many other countries have longstanding judicial decisions that prohibit ‘sham transactions’, mandate a business purpose, and provide that a transaction be taxed in accordance with its substance rather than its form. There are also some regulatory provisions that allow government wide discretion to reformulate transactions. The BEPS Action Plan also identifies the prevention of treaty abuse as a key area of pressure. Action 6 of the BEPS Action Plan will involve the development, by September 2014, of model treaty provisions and recommendations regarding the design of domestic rules to prevent the granting of treaty benefits in inappropriate circumstances.

More recently new disclosure requirements for corporate “tax shelters” have been enacted in order to discourage taxpayers from entering into questionable transactions and to give the

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204 See, for example, the publications “Engaging with High Net Worth Individuals” OECD September 2009 and Building Transparent Tax Compliance by Banks, OECD June 2009.
government earlier notice of such transactions.\textsuperscript{205} There are similar measures in other countries too, suggesting that an alternative (or supplementary) response to the problems highlighted above would be to grant more authority to tax administrators to disregard tax-motivated transactions. Disclosure requirements have also been a focus of the G20/OECD BEPS Project. Action 12 of the BEPS Action Plan calls for the development of recommendations regarding the design of mandatory disclosure rules for aggressive or abusive transactions, arrangements, or structures, taking into consideration the administrative costs for tax administrations and businesses and drawing on experiences of the increasing number of countries that have such rules. The work will use a modular design allowing for maximum consistency but allowing for country specific needs and risks. One focus will be international tax schemes, where the work will explore using a wide definition of “tax benefit” in order to capture such transactions. The work will be co-ordinated with the work on co-operative compliance. It will also involve designing and putting in place enhanced models of information sharing for international tax schemes between tax administrations. The deadline for this work is September 2015.

\section*{F. ISLAMIC FINANCE}

Islamic finance refers to a system of banking or other financial activity that is consistent with the principles of Islamic law (Sharia). The basic principle of Islamic banking is the sharing of profit and loss, and the prohibition of riba (usury). The volume of Islamic banking has increased substantially in recent years.

Islamic financial transactions use a variety of techniques instead of loaning money at interest. For example, instead of lending a client money to purchase an item, a bank might buy the item itself from the seller, and re-sell it to the client for one or more deferred payments which include a mark-up. Similarly, in place of a home loan, the bank and the homeowner may form a partnership, both providing part of the capital to purchase the property. The partnership then rents out the property to the home buyer and charges rent, while the home buyer gradually accumulates equity and eventually complete ownership. A profit-sharing arrangement may also be used to provide capital to a business (and the arrangement may be securitized by issuing securities that pay a return based on the borrower’s profitability instead of paying interest). Another technique for providing capital to businesses is for the bank to engage in an equipment lease (i.e., a finance lease). Finally, instead of bank deposits which pay interest, Islamic banks may attract deposits by paying a return to depositors that is linked to the bank’s profitability.

A widely accepted tax policy goal is that the tax system should not impede Islamic financial transactions. Achieving this may require various adjustments to tax rules, depending upon the details of a country's tax system. Whether or not a conventional tax system is able to cope with Islamic finance transactions without a need for specific legislation will depend broadly on the

\textsuperscript{205} See Tackling Aggressive Tax Planning through Improved Transparency and Disclosure (OECD 2011)
extent to which it follows the economic substance or the legal form of transactions: the closer the alignment of conventional tax rules with economic substance, the less adjustment is likely to be needed for Islamic finance transactions. The U.K. is an example of a country which has needed to introduce—and has done so—significant changes to overcome obstacles for Islamic finance within its general tax system. These are couched in terms of ‘alternative finance arrangements’, rather than expressly in terms of Islamic finance, but address certain types of transactions widely used in Islamic finance. For example, the rules ensure that something which is equivalent, in substance, to the return on an investment of money at interest is treated for tax purposes in the same way as interest. Similarly, the rules disapply anti-avoidance measures to the extent that they would have an unintended impact on Islamic transactions while leaving equivalent conventional transactions unaffected.

Cross-border Islamic financial transactions may raise questions under tax treaties, which may have been negotiated at a time when such transactions were not frequent. Depending on the terms of the treaty, and the specific transaction at issue, there may be difficulties in applying the treaty so as to achieve a level playing field between Islamic and conventional transactions.

III. Taxing Financial Institutions

Financial markets and institutions play a fundamental role in the economy by matching borrowers and lenders, evaluating borrowers, facilitating risk spreading, providing liquidity and making available a wide range of safekeeping and payment related services. This fundamental role is accompanied by a complex regulatory and accounting framework that sets out rules of behaviour as well as standards for the calculation of income and risk.

Though there are important overlaps, the objectives of tax policy must be recognized as distinct from those of regulatory and accounting practices. Tax policy with respect to financial institutions is appropriately charged with raising revenue without creating excessive distortions. Elimination of non-tax distortions to financial decisions is a task generally thought to be best left to regulatory policy. Clearly, though, there are monitoring and compliance advantages in applying common definitions and concepts for tax and accounting purposes. There have been substantive discussions of the possible corporate governance advantages in closely aligning the measurement of tax and book profits. And in some cases where tax policy conflicts with desirable regulatory objectives or policies, it may be appropriate to realign tax policy to support these objectives. An example of this is the potential obstacle which loss carry forward restrictions in some countries presented to desirable bank restructuring and mergers in the wake of the global financial crisis. Nevertheless, the ideal tax base is not necessarily the most accurate measure of income. There could, for instance, be advantages in allowing full expensing of investment for tax purposes, although this would not most accurately measure income for accounting purposes. Similarly, even if marking to market were deemed inappropriate for financial accounting purposes, a strong tax rationale for doing so would remain, in order to avoid distortions.
A number of special issues arise in the taxation of banks and insurance companies. These largely reflect the fact that the “outputs” of financial intermediaries, while easy to identify in theory, can be difficult to measure in practice. The product is typically a complex bundle of services that cannot be easily disentangled. Moreover, some specific types of transactions are unique to financial intermediaries. And, not least, banks and insurance companies loom large in most economies both in terms of asset size and income produced. As such they both provide a very visible target for raising revenue, and also, importantly, operate as remitters of tax for third parties.

A. Banks

Banks\textsuperscript{206} are a special form of financial intermediary.\textsuperscript{207} Although many of the specific features of banking—such as monitoring and evaluating borrowers, providing liquidity, and combining lending and liquidity provision—are carried out by other types of financial intermediaries and through the capital markets, bank lending is indeed special, providing a service that is not easily replicated elsewhere. Banks are unique in that interest income and expenses represent the core of their cash flows; their depreciation allowances for fixed assets are relatively minimal; and the need to value their complex financial transactions (such as activities in the foreign exchange markets, trading in securities and operations in derivative products) is recurrent. Banks are not simply intermediaries, but in many cases also engage in transactions on their own behalf (“proprietary trading”). Banks' and securities companies' valuation of assets and liabilities depends on whether assets and liabilities are held in trading or investment portfolios. If they are held in trading portfolios they are typically marked-to-market; whereas if they are in investment portfolios, they may be subject to accruals accounting.

By the nature of their business, financial institutions are typically highly leveraged\textsuperscript{208}, although this is subject to regulation designed to ensure banks' solvency within a competitive environment through sufficient capitalization. Banks face qualitatively the same tax considerations in balancing equity and debt finance (the latter including deposits) as do non-financial corporations. By reducing the perceived probability of default, however, the implicit or explicit guarantee of deposits enables banks in particular to sustain particularly high debt-equity ratios. Indeed the effect of such guarantees in encouraging leverage is one rationale for capital adequacy rules.


\textsuperscript{207} Building Transparent Tax Compliance by Banks, OECD June 2009.

\textsuperscript{208} The Basel III rules which are being phased in requires a minimum leverage ratio of 3% equity, but many now think this ratio may have been set too low. There is discussion of backstopping the Basel III core tier 1 equity to risk weighted assets requirements by a higher leverage ratio since measures of the former may be more easily manipulated. However, this problem could also be tackled by multiple capital requirements designed to discourage risky behavior and that make it harder to evade the rules.
The effect of capital adequacy rules, combined with the mobility of financial capital, may encourage banks to prefer to be organized as a network of branches rather than subsidiaries, with internal trading books. This can raise uncertainty over the location of profit for tax purposes.

Tax and regulatory arbitrage are often linked in the case of banks. “Hybrid” financing instruments—instruments functioning as debt for tax purposes but as equity for regulatory and rating agency purposes—have been used to reduce the cost of equity capital. Banks have been very significant users of hybrids as a means to bolster their capital requirements while still obtaining deductions for interest on this capital. The high profitability of financial institutions in recent years—accounting for 25 percent or more of the corporate tax base in some OECD countries—is likely to have made debt more attractive for them than for many non-financial corporations, since the low probability of "tax exhaustion" it implies means that banks are subject to a relatively high effective rate of corporate income tax.

There are many tax asymmetries which can produce distortions in the composition of banks' portfolios. When banks acquire tax-exempt securities, a portion of their interest expenses may be allocated under applicable tax laws to these purchases (and made non-deductible) in order to prevent arbitrage. Such arbitrage problems existed in Italy prior to changes made in the tax code in 1986, which made government bonds there taxable. In countries without such preventive provisions—such as Peru—arbitrage problems continue to exist. And, while helpful, such preventive tax provisions generally work imperfectly. In the United States, for example, in spite of such allocation of interest expenses banks, at least until reforms in 1986, found municipal bonds and other tax-exempt securities to be tax-favoured.

Interest income received by banks on foreign loans is subject to special rules, which in some instances increase the profitability of such lending. In general, withholding taxes are levied on a gross interest basis in borrowing countries whereas income taxes are normally imposed on the net income of banks in lending countries. Since the foreign tax credit available to the lender can exceed the net interest margin, foreign lending can be more attractive than domestic business.209

Financial traders are subject to tax on all their financial income (on a mark-to-market basis) at regular income rates, and can use losses on this financial income against other forms of income. In principle, financial trading income is viewed to arise largely as compensation for work effort, similar to employment income and other forms of business income. On the other hand, financial portfolio income is treated on the presumption that taxpayers are not engaged primarily in financial trading. Typically, income arising from sales of portfolio assets will be treated more favourably for purposes of tax, which in part offsets the disadvantage of losses from such activity being ring-fenced.

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209 In recent years, however, this favorable tax rule has been clawed back in at least the United Kingdom and the United States.
The tax treatment of loan losses is a central tax policy issue for banks given the importance of loans in bank assets and the correspondingly large potential for bad debts. Losses are an inevitable cost that banks incur in providing credit and are recognized as an expense for financial, regulatory and tax purposes. The principal issues surrounding the treatment of loan losses concern the timing and manner in which expenses are recognized. These may differ depending on the different objectives pursued by auditors, regulators and the tax authorities. Three constraints affect the level of provisioning and the amounts of write-offs which a bank may make. Supervisors are concerned to see that banks follow a prudent and responsible approach to making provisions. For this purpose they allow general reserves, which have not been earmarked, to be included in bank capital and have generally excluded provisions for specific loans from such calculations. Tax law and administrative practice set out guidelines as to what deductions are allowed against profits, which differ from those requirements. Finally, under applicable securities or corporate law, what banks are required to disclose as doubtful loans on their balance sheets may be different still.

One of the problems in understanding provisioning and its possible effects is that each of these various types of valuation may differ markedly from country to country, and even within a single country. There are broadly two approaches. The so-called charge-off method recognizes a tax deduction only when loans become worthless. Countries which follow this approach are the United States, Australia, Korea, Malaysia and the Philippines. The tax authorities in most other countries tend to allow specific provisions but this treatment differs widely in terms of the degree of conformity with financial accounting for loan losses, the required evidence regarding the deterioration in asset values, and in some instances the maximum amount of loan-losses allowed in a single year. Among the most generous countries from this standpoint are France, Germany and the Netherlands. Finally, a few countries (for example, Germany and Singapore) also allow deduction for tax purposes of general provisions, calculated as a percentage of qualifying loans, subject to limitations.

Provisioning rules can have several effects on the international activities of banks of different nationalities and the allocation of banks' assets across financial centres. Banks may decide to allocate their loans to centres where provisioning is most generous. Generous provisioning policy can be an implicit subsidy to banking relative to other forms of financial intermediation and can affect interest rates charged on differing forms of financing. Generous provisioning may allow certain financial institutions to shield a sizeable part of their income from tax and thereby obtain a competitive advantage. Second, where accounting and fiscal definitions of income do not broadly coincide, banks may be unwilling to set aside an appropriate level of provisions unless the tax authorities permit tax deductibility. This may have significant implications for financial stability. Early recognition of expected losses through provisioning helps to contain excessive expansion of

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210 See Addressing Tax Risks Involving Bank Losses (OECD 2012).
credit and risk-taking in booms, and provides better buffering of losses in the downturn. The costs of financial instability caused by inadequate provisioning should therefore be weighed against the revenue costs of allowing tax deductibility. Finally, different tax provisioning policies can affect the character of risk-taking by banks and the distribution of their profits over time. In those countries where tax provisioning for doubtful debts is limited, there is an incentive for banks to realize losses outright, through sales of their loans in secondary markets or by establishing losses through specially authorized loan sales. Such sales can be economically inefficient, given that secondary loan markets are typically illiquid. By contrast, the possibility of tax deductions for provisions has encouraged banks in some countries to allocate large amounts of their capital to developing country assets, possibly inhibiting the disposal of their assets on the secondary market for country loans.

The financial crisis has brought a number of tax issues affecting bank losses to the fore. The sheer scale of losses (made up of both credit losses and trading losses) makes tax relief for losses a significant issue both for banks and for governments’ tax revenues. Banks will be seeking to monetise the value of potential tax relief for losses, and there may be tax compliance risks from attempts to shift the character or location of losses to permit them to be deducted. On the other hand, governments may wish to ensure that these restrictions do not hamper restructuring and consolidation of the banking sector, as it positions itself to emerge from the crisis.

Proposals for procyclical provisioning, forcibly made in the wake of the crisis, may also raise longer term issues for tax policy. Should such provisioning be fostered by corresponding tax deductions? This would be a significant departure for countries following the usual practice of not allowing deductions for general provisions.

The Basel III proposals will toughen capital requirements for banks, in the light of experience of events during the global financial crisis. The proposals also include increased liquidity standards, such that banks have enough cash and liquid assets to survive a 30 day period without access to wholesale funding. In addition banks will be required to hold more capital to account for counterparty risks – the so called Credit Value Adjustment. The overall impact of these changes on the future levels of lending and bank profitability are much disputed.

A small but growing number of countries, including Austria, Belgium, the UK, Germany and France, have introduced bank levy regimes along the broad lines of the Financial Stability contribution Proposed by the IMF (2010). These tax subsets of either the assets (as in France) or

211 Under Basel III rules “deferred tax assets” cannot be counted as part of the capital buffer, since they would have no value if a bank fell into liquidation. At the time of writing, Spanish banks are lobbying the Spanish government and regulators for some of these to be converted into payable tax credits which would be countable as part of the Basel III capital requirements.

212 See Addressing Tax Risks Involving Bank Losses (OECD 2012).
the liabilities (in Germany and the UK) of bank balance sheets. Tables 6 and 7 in Annex 3 provide some details of these and other financial sector taxes in OECD countries.

These taxes were introduced both to raise revenue (around 2.5bn pounds per annum in the case of the UK), in some cases explicitly feeding a fund to cover the cost of future interventions, and to some extent to provide an incentive to banks to reduce their dependence on more risky sources of financing (for levies on the liabilities side) or to engage less in more risky lending, in the case of the French levy on the assets side of the balance sheet.213 Hence, one aspect of this issue is alleviating debt bias so as to establish neutrality debt/equity.214 Another is whether such levies should actually tax penalizing debt because of externalities from systemic failures, where the potential social costs of excess leverage can be especially high. However, the extent to which such levies interact with existing regulation is relatively unclear. Little exists in the way of publicly available analysis on how these kinds of levies interact with regulation and the net impact.

One issue that arises from these levies is the extent to which they create either explicit or implicit promises of further bailouts of banks which get into trouble. Policy makers clearly intend that they should not, and have been very clear on this. The key and much wider issue here is the development of more effective resolution regimes and practices. Schich and Kim (2012)215 surveyed recent evidence on the value of implicit guarantees for bank debts and found that the observed decline in the estimated value of implicit guarantees is consistent with the view that current efforts to establish more effective resolution regimes have been credible. An important international aspect to this is whether a country which taxes the balance sheet of foreign banks operating in their country is then duty bound, and will be expected to contribute to the cost of any bailout and the extent to which such costs will be shared with the home country of the bank, which may well not impose such a levy. The UK consultation document explicitly ruled out future bailouts but the credibility of such a statement is hard to determine ex ante. One possible explanation may be that policy makers are assuming that tighter regulation and improved resolution regimes which impose greater potential losses on bank equity and bond investors will prevent the need for such statements to be tested in the future, i.e. that the effect of regulation would have been sufficient in itself to make banks hold the right level of capital, highly liquid assets and reduce dependence on risky funding to a safe level. These taxes then become

213 These levies are separate from, and additionl to, the bank deposit protection schemes which exist in many countries, and have generally done so for a long period of time, e.g. the US federal deposit protection scheme has existed since 1934. In the United States the US President’s proposed Financial Crisis Responsibility Fee takes account of this existing deposit levy by excluding insured deposits, along with Tier 1 capital, from the other assets that would constitute the tax base.


essentially revenue raising vehicle, rather than significantly contributing to the stability of banks by themselves.

A minor technical issue from a national accounts perspective the above raises is the question as to whether such levies should be classified as taxes, or (insurance) fees. This issue is the matter of on-going discussion by international statistical bodies and national statistical agencies.

When such balance sheet taxes or levies were introduced no arrangements existed to deal with or relieve double taxation (or to provide for information exchange) between those countries adopting them. The UK and Germany have now agreed a convention which sets out the mechanisms for determining and claiming double taxation relief. Agreement has also been reached between the UK and France on the DT issue but with somewhat different rules and principles. Any spread in the number of countries imposing bank levies is likely to require more discussion about international norms for providing double taxation relief and over taxing rights than currently exists.

Since levies on bank balance sheets for the purposes of revenue rising are a very recent phenomenon, little work has been carried out on their actual incidence. The extent to which such tax burdens are passed on is an empirical question which may differ between countries dependent on the structure of financial providers and the demand for credit. An analysis by Blancard and Havrylchyk (2013)\textsuperscript{216} of Hungarian Central Bank data following the introduction of such bank levies showed that almost 100% of these costs were passed on to existing household and small firm customers in the form of increased fees and interest rates.

The debt bias toward excess leverage induced, in almost all countries, by the deductibility against corporate taxation of interest payments but not of the return to equity may have significant welfare implications if it increases the likelihood of financial crisis. IMF economists, De Moujij, Keen and Oriahra (2013)\textsuperscript{217}, provide a first attempt to establish and quantify an empirical link between the tax incentives that encourage banks to finance themselves by debt rather than equity and the likelihood of financial crises erupting. They attempt to quantify the welfare gains that policies to address this bias might consequently yield, including the introduction of bank levies. They estimated that a bank levy of 10 basis points would reduce financial leverage by between 0.1 and 0.4 percentage points (from 93 percent to 92.9 or 92.6 in their model) The bank levy of 10 basis points however—a rate at the upper end of those observed in practice—has much smaller effects than alternative policies examined such as the introduction of an allowance for corporate equity or a cut in the corporate tax rate, except when both tax responsiveness and


initial leverage are high. However the estimated gain in expected GDP could be as much as 3% of GDP. A corrective case can therefore be made for exploring whether bank levies at substantially higher rates than at present might be justified, in the absence of more radical reforms to corporate tax systems which would address the problem of debt bias more directly.

It is clear from the above discussions that the issue of these interactions between regulation and taxation of the financial sector require a much greater degree of analytical attention than occurred when bank levies were introduced.218

**B. INSURANCE COMPANIES**

Taxation of insurance companies, and the products they sell, poses additional challenges beyond the challenges common to all financial intermediaries that were noted in Section 4.I.B. above. The extra challenges posed by insurance are due primarily to three characteristics of insurance products. They are: (1) insurance products pool risk; (2) insurance products typically bundle into a single transaction multiple components that each require different tax treatment; (3) insurance transactions typically occur across multiple years. Proper taxation of insurance requires special and often complex rules for both insurance companies (“insurers”) and for insurance customers. Many jurisdictions do not attempt to achieve comprehensive taxation of insurance, rather they institute rules that generate politically acceptable levels of tax revenue without having to solve these complex tax policy and administrative problems. This section will examine the tax policy problems posed by insurance in the context of an income tax. Consumption taxation of insurance raises additional complexities and will not be discussed here.219

There are many types of insurance, including life insurance, annuities, credit insurance, fire, auto, homeowners, renters, business coverage, health insurance, and re-insurance (that is, one insurer insuring another insurer). Insurance products are often categorized into two broad sectors, namely life insurance and property and casualty (P&C) insurance, which is also known as general insurance or catastrophic insurance. Life insurance typically includes life insurance, credit insurance, annuities, and two types of health insurance, namely long term care and disability income insurance. P&C generally includes everything else, except re-insurance. Reinsurance can be provided for either life or P&C insurance.220 In general, life insurance covers longer periods of time and often includes bundling of savings with insurance. This makes the tax challenges posed

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220 Reinsurance will not be discussed in this paper. Reinsurance, in which a reinsurer insures a direct insurer who in turn provides insurance to the policyholder, is conceptually no different from direct insurance. It involves more parties and transactions, and the mechanics of the tax rules may differ somewhat.
by life insurance even more complex than the challenges of P&C insurance, although many of the fundamental problems apply to both sectors. This section will discuss P&C insurance first, and then turn to life insurance.

All insurance is based on risk pooling.\(^\text{221}\) Insurance only works if: (1) there is a relatively large group of policyholders (i.e., the people or businesses who buy an insurance policy) participating in the risk pool, (2) only a small percentage of policyholders are likely to suffer an insured loss during the life of the risk pool,\(^\text{222}\) and (3) the risk facing each policyholder is roughly equal. Risk is assessed through actuarial (statistical) analysis of past losses. In a pure risk pool, each policyholder puts a relatively small amount of money (the insurance “premium”) into the risk pool. Insurance coverage doesn’t start until premiums are paid in. The money in the pool is then distributed to the relatively small number of policyholders who suffer a loss during some predetermined time period (typically a year). Those who do not suffer a loss receive no payment from the pool, although everyone receives the economic benefit of insurance coverage during the life of the pool.\(^\text{223}\)

Before discussing taxation of insurance companies, it is important to note how pure insurance should be taxed to the policyholder who purchases it and to the beneficiary who receives insurance payments following a loss. For businesses, insurance coverage is generally an ordinary cost of doing business and therefore insurance premiums are tax-deductible. For individuals, insurance represents consumption (just like buying any other service) and therefore premiums are not tax-deductible. In general, receipt of insurance benefits should not be considered a taxable event. A benefit payment is compensation for some loss (e.g., a house destroyed by fire), which only returns the recipient (“beneficiary” or “claimant”) to his or her previous economic state.\(^\text{224}\) While these are the guiding principles for insurance taxation at the policyholder and beneficiary level, it will be necessary to return to this subject after discussing the complexities of insurance company taxation.

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\(^\text{221}\) There are non-insurance products that provide risk pooling and insurers are not the only financial institutions that provide risk pooling. For instance, contracts for transactions in different currencies may contain provisions that share the risks of currency fluctuations among different market participants. Options and other financial instruments may be used to hedge against shifts in prices of commodities (or currencies). However, the core of the insurance industry is risk pooling and the justification and or requirement for special tax rules for insurers is generally based on that fact.

\(^\text{222}\) Insurance protection cannot be provided against events that are likely to affect a high percentage of the policyholders in the pool. In the extreme case, if everyone expects to face a loss, then the cost of insurance for each policyholder is the same (or higher, given operating expenses) as the cost to cover the loss without insurance.

\(^\text{223}\) Having insurance coverage is a real economic benefit. It means the policyholder does not have to self-insure, which requires having enough liquid assets to cover the cost of a potential catastrophe.

\(^\text{224}\) Indeed, insurance benefit payments are often called “insurance compensation”.

Taxing a company offering only pure insurance would be relatively straightforward, if all of the transactions related to the risk pool were to take place in a single taxable year. Gross income would consist of sales (i.e., premiums and separate fees, if any), plus investment income. Deductions would be allowed for all ordinary business expenses and for benefit payments to policyholders who suffer insurance losses. Indeed, a deduction for loss payments to policyholders is conceptually no different from any other ordinary business expense, since compensating policyholders for losses is the “ordinary business” of an insurance company. Whatever money is left over from the risk pool after paying all benefits and other expenses would be the insurer’s profit, and it would also equal the company’s taxable income.

Even in this overly simple example, there are a few features of insurance that require particular attention. First, the policyholder pays for insurance before receiving the insurance service. Paying for a service before it is provided does occur with other services, but what makes insurance highly unusual is that most of an insurer’s costs (i.e., benefit payments) are incurred after their revenue is received. Second, benefit payments transfer money from one policyholder to another policyholder (or to another policyholder’s beneficiary). Everyone contributes to the pool, but only a few get benefit payments from it. Third, the benefit payments effectively consist of two components, namely the premiums paid into the pool, plus the investment income earned on those premiums between the time of premium receipt and the time of benefit payment. The premiums originally paid in are essentially a return of savings (principle) which would not normally be taxable, and the investment income would normally be taxable.

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225 Most P&C insurance is term insurance that provides coverage for one year, with future coverage, whether automatically renewable or not, provided by a contract extension or a separate contract. However, policies start randomly throughout the year, so no real insurance company would fit this description.

226 Premiums effectively consist of multiple components, one of which is a deposit-like asset which will eventually be returned to a beneficiary. Unlike in banking, however, the “deposit” contained in a premium is not (and generally cannot be) accounted for separately, so it cannot be treated as a deposit for tax purposes. Therefore, an income tax on insurers must take premiums into gross income.

227 For the moment, we assume that all insurance company investments are in fixed-income securities which always trade at par. That is, there are no capital gains or losses within the insurer. Further, we assume that the income tax system taxes interest income as ordinary income, not under some preferential rules.

228 In the case of a mutual, or cooperative, insurer, some or all of the profit generated at the company level may be returned to owners (who are policyholders) via rebates, future price reductions, policyholder dividends, and/or other means. How to tax mutual insurers adds extra complexities which are not discussed in this section.

229 In manufacturing and most services, the bulk of costs are incurred before a sale is made. In insurance, the sale is made first, and then costs are incurred. There are also up-front costs that must be capitalized, but these are generally relatively small.

230 In an actual insurance business, there would be operating expenses and profits that are not distributed as benefit payments, so some portion of the premiums received and investment income earned would not be distributed, but benefit payment potentially consist of both.
If benefit payments are treated as an ordinary business expense (as suggested above), then the investment income earned at the company level will not be taxed, because the deduction for benefit payments and operating expenses will offset the investment income included in gross income (except for the excess that becomes company profits). Furthermore, if benefit payments received by the policyholder are treated as compensation for a loss (as suggested above), then the investment income included in those benefit payment will not be subject to tax. In short, under standard income tax principles, investment income flowing through a simple insurance risk pool is not taxed at either the business or the individual level. The investment income component of insurance contracts (products) is often referred to as “inside buildup”.\footnote{The term inside buildup often means slightly different things in different contexts. The term is usually applied to the investment component of cash value life insurance contracts rather than to term insurance (either life or P&C), but the concept is the same even for the simple short-term risk pool, because some or all of the investment income built up inside the contract is eventually paid out to policyholders or beneficiaries.} For simple short-term risk pools, the amount of investment income relative to premiums or benefits is quite small. But the fact that insurance contracts can generate tax free inside buildup allows for the creation of products that can shelter large amounts of investment income from tax. Whether or not it is appropriate as a matter of tax policy for this investment income to go untaxed is a complex question addressed below.

The next challenge in taxing insurance is that the transactions of an insurance pool typically span multiple years, even in the case of a one-year insurance pool, which is typical of real world P&C contracts. Looking at one pool only, this means that premiums would be included in taxable income in the first year, but some portion of benefit payments (which are deductible) would not occur until later years.\footnote{While the covered losses are limited to those losses that occur within one year of the contract start, reporting and adjudication of losses may take longer than one year. In practice, a high percentage of P&C insurance losses are paid out within the covered year (particularly for homeowner and auto insurance), and virtually all losses are paid out within a short period (usually within three years) for most lines of business. However, loss payments on some business lines, such as workers compensation or indemnifying business officers (which are called “long-tailed” lines) stretch for much longer periods (usually up to 15 years) due to delays in loss recognition and disputes over extent of liability.} Without some special rules, an insurance company would be forced to pay tax on its premium income in the first year (when it has large income and small deductions). In subsequent years, the insurer would require a refund from the tax authorities, including interest, because it would have deductions for loss payments but no premium income against which to take those deductions. In practical terms, this is not a viable option.

The solution to this problem is for the income tax system to allow a tax deduction for the increase in an insurer’s policy reserves, and require a corresponding increase in taxable income (a negative deduction) for a decrease in policy reserves. When premiums are received, insurers establish a policy reserve equal to the present value of expected future claims for insurance losses. Insurers are typically regulated by their host governments and a key requirement of that regulation is maintenance of safely invested policy reserves that are adequate to cover all expected future
claims (losses) with some high degree of confidence. The regulatory definition of net income is based on this system, that is, a deduction for the increase in reserves. Regulatory and tax reserves are typically different amounts, but both systems provide a deduction for the increase in policy reserves.

After the policy reserve is established (from the first premium), it grows from investment earnings on the funds in the reserve and shrinks when funds are withdrawn to pay benefits covering losses. At the end of a pool’s lifetime, all the funds in the reserve will have been withdrawn. Therefore, for a single risk pool, the lifetime change in reserves is always zero. Hence, over the life of one risk pool, the net impact of reserves on taxable income will be zero, but in any single year the tax deduction for change in reserves can be positive or negative. Typically there is a large tax deduction at the beginning of a pool (when premiums go into the policy reserve), followed by a series of negative tax deductions as the reserve is depleted over time. Reported reserves for an insurance company combine the individual reserves for each pool. As a result, reported reserves typically increase over time (as a company business grows), which masks the changes in the reserve for a single pool of policies.

Since the deduction for change in reserves is typically the largest tax deduction available to an insurer, the details of the tax reserve calculation have a major impact on an insurer’s taxable income. The two parameters that have the biggest impact on the size and pattern of reserves (and therefore the reserve deduction) are the interest rate used to discount future reserves and the expected confidence that actual losses will not exceed the losses for which reserves have been provided. Lower discount rates and higher confidence about actual losses not exceeding predicted losses each generate higher reserves. Typically insurance regulatory systems use lower rates and higher confidences, because their primarily concern is the solvency of insurers, which is best protected by a larger reserve. But the tax system should aim for the most accurate reserve, one in which the change in tax reserves each year is just enough to cover loss payments plus the investment income necessary to fund future loss payments. Since neither losses nor investment

233 The calculation of regulatory and tax reserves are generally done in the same way, but with different key parameters such as the profile of expected losses over time and the interest rate used for discounting.

234 Financial accounting also includes a policy reserve calculation, and the amount of the financial accounting reserve is typically different from either the regulatory or the tax reserve.

235 The detailed calculation of reserves is highly complex, particularly in the case of life insurance, since a policy reserve is based on the probability of loss, which will likely be different from actual losses. But at the end of a risk pool’s lifetime, the policy reserve is always zero, either because all the reserve has been paid out to claimants, or because the residual has been taken by the company as profit.

236 Other factors that affect reserve are the assumptions made about when losses are paid during a year (i.e., a the beginning, middle, end of the year), interaction of sales commissions and reserves, and assumptions about policy cancellations.
income can be forecast with perfect accuracy, there is much debate over how to craft the most accurate tax reserve.237

Life insurance adds extra complications. Since everyone will eventually die, life insurance can only provide protection against “pre-mature” death, that is, the risk of dying relatively young. The risk of dying sometime during the insured year is primarily a function of age and gender.238 A one-year term life policy is similar to the one-year term P&C policies just described, except for one crucial feature. The cost of P&C insurance doesn’t necessarily change over time, but the cost of term life insurance always increases from year to year, because the risk of death increases as the policyholder ages.

Because the cost of life insurance increases with age, insurance companies have long offered “whole life” and other forms of “permanent” life insurance.239 In a whole life policy, level premiums are charged every year. Premiums in earlier years are higher than the premium on a term policy of the same “face value” (that is, the amount of the benefit to be paid in the event of death). Premiums in later years are smaller than on a term policy with the same face value. A portion of the early premiums are saved inside the policy. Those savings (including the investment earnings on those savings) are used to pay a portion of premiums in later years. Following the precepts above, the investment income on the savings inside the policy (the inside buildup) would not be taxed while inside the company. Permanent insurance makes life insurance more affordable. It also makes taxing insurance much more complex.

Assuming a policy is not cancelled, the owner of a whole life policy will always suffers a loss, because death is inevitable. Therefore, the savings inside that policy is always returned to the policyholder’s beneficiaries, not transferred to some other policyholder or his beneficiaries (unlike in a P&C policy, were generally one’s premium payments end up funding loss payments to another policyholder). If a policyholder dies soon after purchasing a whole life policy, then most of the benefit paid to the beneficiary comes from the risk pool (i.e., transferred from other policyholders) and only a little comes from the accumulated savings that was contributed by the policyholder. But if a policyholder dies later, then much of the benefit payment is a return of savings and only a relatively small portion comes from the risk pool. Furthermore, much of the benefits paid derive from the investment income (inside buildup) on the savings inside the policy. While inside buildup exists in all insurance policies, it is generally relatively small in all policies except for permanent life insurance policies, where it can be very large.

237 In the case of life insurance, where reserves extend for decades, minor changes in interest rates or loss predictions can lead to very large changes in reserves.

238 As with other types of insurance, there are also many secondary factors which in practice are very important, such as family medical history, smoking behavior, and participation in risky employment or recreation.

239 In addition to whole life, permanent insurance includes variable life, universal life, universal variable life, and other variants, none of which will be discussed in detail in this section.
Following the precepts set forth above, the investment income (inside buildup) generated inside a whole life policy and then distributed as a death benefit upon a policyholder’s death would not be taxed at either the company or the individual level. This is how life insurance taxation works in many developed countries. Whether this is appropriate tax treatment is a difficult question. When a death benefit is paid to a young widow or widower raising children, it seems pretty clear that the death benefit is compensation for the economic loss of the spouse. Taxing a portion of the death benefit because it is derived from interest income would violate the principle that compensation for a loss should not be taxable. Furthermore, many tax systems that exempt inside buildup from tax also exempt the investment earnings inside pension distributions. If it is good social or tax policy to exempt pensions, why would it not be good policy to exempt death benefits?  

But it is unclear that these arguments in favor of allowing un-taxed death benefits remain valid in the case of a policyholder who dies at a very old age. In this case, nearly all the death benefit represents investment income and return of savings, not a true insurance payment (coming from a risk pool). There is also little or no economic loss to the beneficiaries when a very old policyholder dies. In these circumstances, a life insurance policy becomes primarily a vehicle for transferring tax-exempt investment income from one generation to another.

Assuming for the moment that it is good policy to exempt from tax the inside buildup contained in death benefits, there remains the question of how to tax the savings returned to a policyholder when he or she cancels (or “surrenders”) a whole life policy. When a policy is surrendered there is no loss, and all the savings held in the policy (the “cash surrender value”) is returned to the policyholder. There clearly is no argument for the surrender value being compensation for a loss, so a surrender distribution should be a taxable event. The surrender distribution consists of both investment income and return of the initial savings, so only the investment income should be subject to tax. While a surrender distribution should be (and typically is) a taxable event, the

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240 The traditional pension distribution is subject is taxation, but if the contribution to the pension was deductible, which is generally the case, then investment income inside the pension is effectively exempt from tax. In fact, if tax rates at distribution are lower than at time of contribution, which is true for most pension recipients, then the effective tax rate on investment income is actually negative.

241 It is important to note that the tax benefits provided for pensions are generally limited in some fashion, either by size of the pension payment and/or income of the pensioner. So it is not a straight parallel that if pensions exempt from tax investment income, then life insurance should also exempt from tax inside buildup, unless the limitations are similar. However, it does follow that providing no tax benefit for life insurance seems at least inconsistent if tax benefits are provided for pensions.

242 Whole life policies specify the “cash surrender value” (CSV) during each year of the policy’s life. CSV is the amount of the savings in the policy that would be returned to the policy holder when a policy is surrendered. The CSV is not the same as the reserve for a policy, and it is typically somewhat less than the policy reserve.

243 Exactly how to calculate what portion of the surrender benefits represents investment income and what portion is return of principle can be difficult. The calculation often used, namely, surrender distribution minus sum of premiums paid (less policyholder dividends paid), overstates the return of principle and understates the investment earnings in the distribution.
policyholder has been able to defer tax from the time when the investment income was earned (but was inside the policy) to the time of surrender, which might be decades later. Tax deferral, of course, can dramatically reduce the effective tax rate levied on investment income.

In short, allowing tax-free inside buildup may be appropriate tax policy for P&C policies and for those life insurance policies that pay benefits on premature (rather than old-age) death. However, allowing tax-free inside buildup on life insurance opens the door to many situations in which investment income inappropriately receives preferential tax treatment. Indeed, in developed economies, many life insurance products are designed to maximize tax-preferred investment returns. Defining the line between appropriate and inappropriate tax preferences for life insurance products is controversial and largely arbitrary. Furthermore, once defined, preventing or limiting the inappropriate preferences requires complex tax rules and administration. It is possible to tax inside buildup, but most countries that impose income tax on life insurance do not do so.

Many governments also impose premium taxes on insurance companies. Premium taxes may be imposed in lieu of, or in addition to, an income tax or a Value Added Tax (VAT). The advantage of a premium tax is that it provides a relatively simple tax that avoids the problem of having to define and accurately measure insurance company net income (or value added). A premium tax can provide a politically acceptable level of tax from an industry that has very large financial assets. The major problem with a premium tax is that it is not an income tax (nor is it a value added tax); it is a tax on gross revenue. A premium tax bears little relation to the income tax (or VAT) that ought to be imposed on insurance company profits (or value added) to make insurance taxation consistent with how other businesses are taxed. Since insurance premiums generally include large asset transfers, a premium tax often imposes a large effective tax on income (or

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244 Any definition of what counts as premature death, as opposed to old-age death, is arbitrary and would pose the additional problem of transition from preferential tax treatment for policies covering younger people to non-preferential tax treatment for the same policies on the same people as they age.

245 These rules, for instance as in the U.S. or Canada, often define an acceptable amount of investment income relative to mortality risk inside a life insurance contract. Contracts that meet the requirements receive “normal” tax-free inside buildup, while those that do not (called Modified Endowment Contracts in the U.S., or non-exempt contracts in Canada) lose some, but not necessarily all, of the preferential tax treatment afforded “normal” contracts.

246 New Zealand is an example of a country that does generally inside buildup (as opposed to taxing inside buildup in only not “normal” contracts). It does so by splitting insurer assets into shareholder and policyholder bases. The income derived from shareholder base is taxed as ordinary corporate earnings, while the income derived from the policyholder base is taxed at the corporate level as a proxy tax for the tax that should be paid at the individual level. The proxy tax is indirectly passed to the policyholder in the form of higher premiums and/or lower investment returns or benefits.

247 In many European countries, a premium tax is imposed in lieu of VAT, and the insurer is also subject to income taxes. At the state level in the United States, insurers are generally subject to a premium tax in lieu of state level corporate income tax.

248 This section has not addressed VAT taxation of insurance, but imposing a VAT on insurance poses many of the same problems that have been discussed here, plus some additional problems.
value added). Even if it were true that on average and over time a premium tax generated the same tax revenue as would an income tax (or VAT), a premium tax would seldom generate the correct tax for any individual company in any individual year.

Table 8 (in Annex 2) provides an overview of insurance premium taxes in selected OECD countries. As can be seen in the table, most governments apply different rates to different kinds of insurance contracts. While distinguishing between P&C and life premiums is generally straightforward, many of the other distinctions require more detailed contract information (such as whether the covered risk is domestic or foreign) that can pose significant administrative and compliance burdens. In addition, some countries provide further complicating exemptions and adjustments. While premium taxes may be simpler than income taxes, they are not always that simple.

C. COLLECTIVE INVESTMENT VEHICLES

1. INVESTMENT FUNDS

Collective investment vehicles (CIVs)\(^{249}\) are entities which allow for the pooling of assets by individual investors, and the sharing of costs of investment. Differing legal requirements, and the diversity of investment objectives pursued by different types of CIV, have led to the creation of organizational forms that differ quite widely amongst themselves and for which the tax treatment is also diverse.

Mutual funds (or investment funds or trusts) account for a substantial and increasing portion of the world’s portfolio investments. They allow small and medium-sized investors to invest their savings in the market, offering them the advantages of financial expertise, economies of scale for such items as market research, portfolio management, and trading activity, and the opportunity to diversify and pool investments.

The taxation of investment vehicles aims to balance various objectives. First, given their potential social advantages one overriding objective is not to hamper or prevent their development. Second, tax rules generally aim to achieve “neutrality”, i.e., to devise tax rules that are comparable to those that would apply if the investment were carried out directly by the ultimate investor. A final objective is to adopt tax rules that can be easily administered and enforced.

A major difficulty in designing a tax regime for investment funds and their investors is the number of different combinations of components that policymakers need to consider in applying the principle of "transparency". If funds are really "look-through" investment vehicles, for tax purposes, individuals should be indifferent between a direct purchase of the underlying assets and the acquisition of the same investments through a fund. But as a result of the varying forms

of taxation of capital income otherwise applicable to direct investments, this has resulted in vast differences across countries in the treatment of investment funds.

2. **PENSION FUNDS**

Ensuring that individuals have adequate provision for their old age, including through the use of private pension plans, has long been a major policy objective in higher income countries, and is increasingly a concern in developing countries too. Typically, countries have chosen to provide preferential treatment—relative to the normal income tax treatment—for such savings. While practice varies, most OECD countries in effect provide consumption tax treatment by combining three elements:

- Contributions by individuals to approved private pension schemes are deductible from those individuals’ taxable income, with contributions paid by employers deductible in calculating taxable business profits (both commonly up to some ceiling), and not taxed as a benefit at the level of the employee;

- Income earned by approved pension funds from their investments is exempt from tax;

- Pensions paid out are most commonly taxed as employment income, although these too (and/or lump sum payments made on retirement) are sometimes given special tax relief.

This standard tax regime for pensions (frequently referred to as “EET”—exempt-exempt-taxed) treats individuals’ savings through private pension funds more favourably than most direct forms of savings (return on investment), which would in the absence of special rules under an income tax be treated as “TTE” (saved from after tax income, return on savings currently taxed, and untaxed on withdrawal).\(^{250}\) This difference likely distorts savings choices, and is indeed designed to provide an incentive for individuals to provide for their old age, when it is coupled with provisions penalizing withdrawal of savings prior to retirement. How effective such provisions are in encouraging genuinely ‘new’ saving—rather than a reshuffling of assets from taxable to non-taxable form—has been a matter of controversy, with a quite widespread view that only 25–40 percent of saving in these forms is additional.

What is clear, however, is that many countries on the verge of establishing significant private pension provision have yet to establish coherent tax regimes for their treatment. There are cases, for instance, in which rules provide ‘EEE’ treatment—even more generous than the standard above, and an effective subsidy to retirement savings.

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\(^{250}\) In effect, it provides consumption tax treatment (on a registered asset basis).
3. **REITs**

Recent years have seen the growth of vehicles for collective investments in real estate. In Europe these vehicles have until recently tended to take the form of specialized companies or closed-end funds, whereas in the United States the preferred form of organisation is the Real Estate Investment Trust (REIT), a form of corporation subject to special tax rules. These entities, however organised, hold, manage and maintain real estate for investment purposes and receive most of their earnings from rental income or trading in real estate. In the US, the REIT tax regime enables these corporations to deduct from their taxable profits the dividends which they pay to their shareholders. These distributions are then taxed at shareholder level.

In the EU, many MS exempt REIT-type companies under the condition that they distribute 90% of their profits and meet some other specific requirements. If these requirements are met then the earnings are attributed to beneficiaries or shareholders. Hence REITs completely or mostly avoid entity level tax, and have spread to a number of countries in recent years, including Japan, France, and the United Kingdom.

Structuring property investment vehicles raises a number of issues from a tax standpoint. How is neutrality achieved between direct holdings of property and indirect investments through a pooled investment vehicle? Should the vehicle itself be taxed or is pass-through treatment most appropriate? How are the investment activities carried out by the vehicle “ring-fenced” from other business activities which would ordinarily be subject to corporate tax? What is the appropriate level of withholding taxes that should be applied to foreign investors? These questions need to be answered by any country intending to establish pooled property investment market.

**D. PRIVATE EQUITY AND HEDGE FUNDS**

1. **PRIVATE EQUITY**

Broadly speaking, the term ‘private equity’ refers to all forms of equity or quasi-equity financing that is not obtained through organized stock exchanges. Private equity (PE) funds are used generically to refer to two types of investment fund: early stage or venture capital (VC) funds and later stage or restructuring (expansion capital, leveraged buyouts, buy-ins, public to private) funds. VC funds invest in start-up companies with the hope of a public offering of shares in the successful venture at some time in the future. Later-stage funds purchase existing companies with the hope of restructuring the businesses and selling them at a profit. Most later-stage fund acquisitions involve private, rather than publicly listed, firms.

Private equity and venture capital funds established themselves in the United States in the 1960s but have spread rapidly elsewhere. In the past few decades they have grown in terms of value, number of transactions and geographic reach, had a pronounced impact on investment and employment in certain sectors, and attracted a widening investor base particularly among savings
institutions. Although mature industries such as chemicals, machinery and retailing still provide popular buyout targets, the fraction of LBOs undertaken in high-growth, “high-tech” sectors such as computers and biotech has been growing significantly in the past decade. Given the size and scope of private equity funds it is not surprising that they have been at the centre of a multifaceted debate surrounding their influence on the governance of companies and the time horizon of investments, their impact on the innovative activity of firms, their effects on employment—and their tax treatment. Many such funds are now held offshore.

The structuring of PE and VC funds in various countries is driven in large measure by various tax factors. The first is the tax treatment of investments by the fund and of the proceeds from those investments received by various categories of investors. Attention has focused, in particular, on their placement of substantial debt in acquired later-stage companies—in some cases eliminating corporate tax liability for several years. They are often seen, in this respect, as providing a leading exemplar of the tax bias towards debt finance, perhaps not only in the firms they acquire but also in those that fear they might be acquired. The second issue, which may be in part related to the first, concerns the tax treatment of the sponsors or managers of the fund in respect of on-going management fees but most importantly (and controversially) of “carried interest.” Thirdly, there a number of cross-border tax issues regarding the tax treatment of the operations of management companies operating outside their home jurisdictions, of foreign investors in domestic funds and funds investing outside of their domestic jurisdiction e.g. the use of offshore jurisdiction for funds which pay little tax, and for investors who may be resident in low tax jurisdictions behind the fund who would not normally gain the benefit of the DTT if the investment was made directly by the investor into the target company. Finally, PE and VC funds raise a number of potential VAT related issues in certain jurisdictions.

One of the crucial issues surrounding private equity is whether it deserves special tax treatment relative to other forms of collective investment. The reason for such special treatment would be (it is argued) its close connection with entrepreneurship. The tax treatment of investors in private equity funds depends on the structure of funds allowed in various jurisdictions. In many countries, private equity funds are tax transparent; in others the vehicles used have corporate status and normal or preferential corporate tax rates apply.

Managers of PE and VC funds receive two types of compensation – a management fee, which is treated as ordinary income, and “carried interest,” a form of partnership “profits interest,” which retains its underlying character as received by the partnership – whether ordinary income, capital gains or dividend – when distributed to the managing partner. Disposal of a partnership profits interest generally receives capital gain treatment. A feature of U.S. partnership tax law since the 1950s, profits interests—which are usually granted to managing partners in exchange for their labour contribution (although fund sponsors typically contribute some capital as well)—were enacted to encourage entrepreneurship. When they were used principally in operating partnerships (which generate mostly ordinary income), this tax treatment remained
uncontroversial. However, the recent explosion of private equity and hedge funds, which generate substantial capital gain income, coupled with the divergence between income and capital gains tax rates, highlighted the potential distortions of the tax break. In the US, for example, the tax rates (15 percent) are substantially lower than the rates on ordinary income (35 percent). A similar reduced rate capital gains tax (18 percent) also applies in the U.K.

The tax treatment of “carried interest” has come under attack in recent years, and there have been various proposals to have carried interest re-characterized as ordinary income. The focus of discussion has concerned the nature of activity carried out by fund managers, the impact on tax revenues of such arrangements and the behavioural responses that would result from such changes in tax treatment. For instance, if one took the view that some part of carried interest received by managing partners ought to be charged as labour income, other partners would in theory be entitled to deduct a corresponding amount in calculating any tax they paid on their partnership interest. The discussion of carried interest highlights two key problems in taxing capital income: the distortions to behaviour induced by differences in tax rates and the difficulty of distinguishing labour from capital income. In this as other areas incentives to income shifting are perhaps inevitable and certainly give rise to complexity.

Private equity funds are faced with a further potential tax problem because of their reliance on local ‘advisors’ when managing investee companies in other countries. As these advisors are based in the local country, providing the necessary support to the management of the investee company, it could be argued that they are creating a ‘permanent establishment’ for the fund by the local tax authorities—to which all of the fund profits are attributed for tax purposes (although the fund is usually structured to avoid this). For PE and VC funds in several jurisdictions there are also uncertainties over whether the services provided by management companies are liable to VAT.

2. HEDGE FUNDS

Like private equity, hedge fund activity ballooned over the past two decades, with global assets under management rising from roughly $7 billion in 1990 to about $2 trillion in 2007, before dropping sharply as a result of the global financial crisis. The amount has now increased again and in 2012 had reached about $2.1 trillion, slightly above the level reached in 2007. And like private equity, many hedge funds are held offshore. There is a wide variety of hedge fund investment styles, from global macro to equity and credit arbitrage to commodities trading; most, however, share certain common traits. In contrast to private equity funds, hedge funds tend to invest in relatively liquid securities and derivatives over the short- to medium-term, and frequently use leverage to enhance returns.

Hedge funds do not raise the same tax issues as private equity in respect of leveraged buy outs, but the remuneration issues are essentially the same: the typical fee structure comprises a percentage of assets (typically two percent), which is ordinary income (deduction) to the profits
partner (partnership), plus a carried interest (typically 20 percent). Because hedge funds typically generate fewer long-term capital gains and dividends than private equity funds—about 20 percent of income versus 50 percent or more—treating carried interest as ordinary income would have less of an impact on hedge funds than private equity funds. However, hedge funds are often located in offshore jurisdictions which can make ensuring compliance in regard to the taxation of remuneration more difficult to police in practice.

E. SOVEREIGN WEALTH FUNDS

A sovereign wealth fund (SWF) is a government-owned, actively managed investment fund constituted from foreign exchange earnings. Generally established by countries with large commodity (mainly oil) or manufacturing-based trade surpluses, SWFs have grown rapidly over the last two decades, from about $500 billion in 1990 to roughly $5 trillion in 2012, as a result of commodity price gains and global trade imbalances—relative to a total value of traded securities (debt and equity) denominated in U.S. dollars of over $50 trillion, this makes them significant participants in financial markets, though not huge ones.

SWFs are typically exempt from tax on their cross-border investment income, although the scope and mechanism of exemption differ from country to country. For example, SWFs are generally not taxed on their investments in the United States, provided those investments are passive (e.g., securities and bank deposits) and do not constitute commercial activities. Where SWF investment activities are not exempted (i.e., commercial activities and certain real property investments), they are taxed the same as foreign corporations. Foreign corporations are taxable on any income effectively connected with a U.S. trade or business, as well as fixed or determinable, annual or periodic (FDAP) income; the major exceptions to FDAP income are portfolio interest and capital gains. Depending on how a SWF is classified—as an “integral part” or “controlled entity” of a foreign government—participation in commercial activity anywhere in the world may disqualify it for treatment as a sovereign entity.

Australia, Canada and the United Kingdom also exempt SWF passive investment from taxation, generally on an administrative basis. Australia and Canada apply this treatment on a case-by-case basis. Broadly speaking, the impact of the growth of SWFs in such cases is to in effect increase the significance of tax exempt investors in the market, which increases the distortion associated with the coexistence of tax-exempt and taxable investors.

Not all countries follow the same treatment, however; Japan, while exempting foreign governments from taxation, does not extend this treatment to SWFs, but treats them like foreign corporations except as specified by bilateral tax treaties. Germany does not extend tax-exemption to foreign governments or SWFs, treating them the same as foreign corporations; however, Germany generally exempts foreign investors from taxation on interest and most capital gains. Switzerland also provides no exemption for foreign governments, except by tax treaty.
IV. TAXING FINANCIAL SERVICES AND TRANSACTIONS

A. THE VALUE ADDED TAX

Taxation of financial services under a VAT presents both theoretical and operational problems.\(^{251}\) It can be difficult to identify the tax base for an individual transaction, so exemption without credit for related input tax has become a standard approach. From the theoretical standpoint, there is some debate on which financial services, if any, should ideally be taxed. It is generally agreed that, because a VAT should be levied only on final consumption and not intermediate inputs to production, financial services purchased by VAT-registered businesses should not be taxed. While there has been some dispute on this issue, it is now also widely accepted that purchases of financial services by final consumers should be taxed.\(^{252}\)

The question is how to achieve this. For services provided by financial institutions and charged for by means of an explicit fee, such as safe deposit boxes and management fees, there is no particular conceptual problem as the base is identifiable. Many jurisdictions impose VAT on financial services compensated through these explicit fees. Input credits for firms providing both exempt financial services and non-exempt fee-based services must therefore be allocated between the two. Market and regulatory pressure for greater pricing transparency has resulted in more financial products being compensated through explicit fees, potentially broadening the scope for taxation under the VAT. However, in some cases the differentiation between fee-based and margin-based services is not so straightforward. For example, in the EU, exemption often extends to specific fees, particularly where the institution’s remuneration is a combination of fees and margins. This approach likely had its origins in concerns that exempting one and taxing the other would encourage distortion when there is a degree of flexibility in structuring the overall price.

The difficulties arise for margin trades—such as accepting a deposit and lending the proceeds. There is no problem in identifying the value added by the intermediary—the excess of the lending rate over the deposit rate. But it is not obvious how to allocate that margin between the two sides of the transaction, so as to ensure that the crediting mechanism works appropriately. And disclosure of even the aggregate margin on specific transactions can also be an issue for financial intermediaries. Business to business (B2B) transactions would presumably require a tax invoice so that the recipient could recover VAT.

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\(^{252}\) It should, however, be noted that since non-recoverable VAT incurred by financial and insurance institutions has become an established source of revenue for many counties and might exceed that from taxing only sales to final consumers, many of them resist change and may not find this view congenial.
The dominant treatment of such non-fee based financial services has for these reasons—notably in the EU—been to exempt them from VAT.\textsuperscript{253} This means that financial institutions do not charge tax on their supply of exempt services and they are unable to recover tax on their purchase of taxable inputs.\textsuperscript{254} Exemption therefore overtaxes business use of financial services but undertaxes consumer purchases of financial services. For developed countries at least, the revenue cost of the latter is generally believed to outweigh the revenue gain from overtaxing the former although the lack of available data means that the evidence is scant.

Exemption is problematic, however. Tax cascading promotes vertical integration of financial institutions—to avoid unrecoverable input taxes, financial firms produce more of their own inputs than would otherwise be efficient. Financial institutions subject to VAT exemption also face a competitive disadvantage as compared to financial institutions in countries without a VAT. The EU therefore zero rates financial transactions between the EU and non-EU countries, and allows for input tax recovery. The EU does not zero-rate intra-Community transactions. However, as the internal EU market for financial services becomes more integrated, EU member states which are net suppliers of financial services to other member states will benefit from this non-credited (and therefore retained) tax at the expense of the latter.

There is another fundamental difficulty with exemption. This is that although the supply of financial services will bear a certain amount of VAT in the price, we cannot say with any certainty what this rate of tax is. Perhaps even worse, for the same service this rate of tax will vary between one financial service provider and another depending, \textit{inter alia}, on the institutions’ degree of vertical or horizontal integration. It seems difficult to reconcile this with the concept of neutrality as benchmark and the risk of distortion of competition must be real.

The European Commission has made comprehensive proposals for revising the current VAT treatment of financial and insurance services by redefining in detail the scope and character of the exempt services so as to ensure that the exemption better reflects the complexity and diversity of the modern industries, by conceptualizing an industry-specific exemption on cost-sharing arrangements and by extending the possibility to opt to tax\textsuperscript{255}. These proposals have however not met with success in moving towards legislation and, notwithstanding the effort that has been expended, must now be considered as largely moribund.

\textsuperscript{253} The EU “option to tax,” permits member countries to allow financial institutions to elect VAT taxation for particular products or customers, which has the potential to alleviate the overtaxation of business purchases (though without alleviating the problem of allocating value-added across transactions and customers). This is, however, not widely used and most EU tax administrations seem opposed to expanding its use.

\textsuperscript{254} Thus, only the value added of the firm itself, and not that provided earlier in the chain of production, escapes the tax.

Countries outside the EU have developed other methods for addressing the problems of VAT taxation of margin-based financial services. Some developing countries, for example, charge VAT on gross interest receipts. At one level this might be rationalized as a device to prevent avoidance of the VAT, by providing a service at minimal nominal cost but effectively charging an additional price in the form of interest. The risk of adopting this approach, however, is of overcharging for financial services when supplied to end users—which can be a particular concern when development of the financial sector may be key to wider development goals. On the other hand, if business acquirers of these services are in a position to recover input tax, there will of course be no direct impact on their input costs.

France levies an additional tax on payrolls of firms whose output is at least 90 percent exempt from VAT, which addresses the undertaxation of consumer services but exacerbates the overtaxation of business financial services. Israel levies an addition method VAT on payroll plus profits in the financial sector, which does not allow per transaction tax assessment and thus precludes business users from claiming VAT credit, resulting again in overtaxation. Singapore and Australia tax financial services compensated through fees and commissions, as well as permitting financial institutions to recover a fixed percentage of the VAT on their inputs for margin services.

There are theoretical ways in which the fundamental allocation problem can be solved. A comprehensive cash flow tax—treating all inflows to financial institutions (including of principal) as taxable sales, and outflows as creditable purchases—could accurately tax the value added embedded in financial services compensated through financial margins on a per-transaction basis. Ultimately, the tax would be equivalent in present value to the implicit value of services received by the household sector. The main objection to this method of taxation is the potentially large liquidity demands it would place on financial customers. One proposal to deal with this is by the use of “tax calculation accounts” (TCAs), which defer the tax on principal flows until reversed at maturity. Rather than charging borrowers an up-front tax on loan principal, the principal amount would be credited to a TCA, and the borrower would pay interest on that amount until the principal was repaid at maturity, substantially smoothing tax liabilities over time. A pilot study for financial sector taxation using TCAs was conducted by the EU, but it was not enacted due to over-complexity and implementation costs. Most importantly perhaps, the need for change was not sufficiently established at the time. An alternative that has been suggested is to zero-rate B2B financial transactions while subjecting business to consumer (B2C) transactions to a cash flow form of VAT. New Zealand has recently introduced this approach as part of a wider package of taxation reform. In any event, more work is needed on finding a workable methodology and what degree of complexity this really needs.

1. Financial activities tax

Recognizing both the problems created by exempting financial services and the remoteness of the prospect of their full inclusion in the VAT, IMF (2010) proposes that countries consider the introduction of a ‘Financial Activities Tax’ (FAT). The tax base for the FAT would be the sum of
profit and remuneration of financial sector institutions, with ‘profit’ for this purpose defined (as it implicitly is under the VAT in cash flow terms (or present value equivalent). Three alternative versions of the FAT were considered by the IMF, with variations in the objectives of the tax determining variations in the exact nature of how the tax base would be calculated.

The simplest form of FAT (‘FAT1’) would simply tax the sum of profits and remuneration. This equates closely to an addition method VAT—as applied to the financial sector in Israel—and represents one way of taxing value added by the financial sector. Under this option a cash flow tax, with immediate expensing of investment and no deductions for financial costs, would be implemented with profits plus wages, minus capital formation, as the base. For sales to final consumers, the combination of exemption under the VAT and a FAT on the providers of financial services would ensure appropriate treatment. The difficulty is that a FAT (addition VAT) is not compatible with invoice based VAT systems in terms of avoiding intermediate taxation (since it is difficult to devise a workable credit mechanism for business purchasers). There are issues to as to whether the FAT would be levied on a destination basis (excluding an element corresponding to services provided to non-residents or on an origin basis. The IMF suggests that the simplest solution to mitigate these problems would be a tax rate for the FAT that is lower than the general VAT rate. While the FAT approach, as IMF (2010) stress, is inferior to a proper functioning VAT on financial services, it may be superior to exemption both in raising revenue and alleviating distortions.

IMF (2010) considers variants of the FAT. ‘FAT2’ would exclude remuneration above some level, perhaps with an intention of in some imperfect way reaching rents received by managers. ‘FAT3’ is aimed at discouraging risky behaviour by targeting returns on equity above some (high) benchmark level. The drawback to be weighed against this is of that it would not differentiate between higher returns created by efficiency and therefore mute the efficiently of capital markets in allocating investment between companies.

B. Financial transactions taxes

Financial transaction taxes (FTTs)—meaning broadly those levied on the face value of some set of financial transactions—have been used in a numerous countries—many in Latin America, but also in countries ranging from some European OECD member countries to developing nations. The European Commission introduced FTT proposals256 in September 2011 and February 2013 for a

256 The objectives of the EC’s proposed FTT were to prevent the fragmentation of the Single Market that could result from numerous uncoordinated national approaches to taxing financial transactions, and also to ensure that the financial sector made a fair and substantial contribution to public finances. A secondary objective was to discourage financial transactions which the EC deemed not to contribute to the efficiency of financial markets. The proposal was to harmonise the tax base and set minimum rates for all transactions on (secondary) financial markets, once in principle at least one party established in the determined FTT zone (financial institution) was involved in this transaction. The minimum tax rates foreseen were 0.1% for the trading in shares and bonds, and 0.01% for derivative agreements such as options, futures, contracts for difference or interest rate swaps. The proposal took a “triple A” approach, i.e. the tax
wide ranging FTT that is the subject of ongoing negotiations by EU member states. Only those EU member states that have agreed to harmonise such a tax under the enhanced cooperation (i.e. amongst some but not all EU states) process will decide on the final outcome. However, all the EU 28 Member States participate in the discussion at the EU Council’s meetings.

FTT’s can be introduced for a variety of purposes: (i) to increase taxation of the financial sector; (ii) to reduce volatility of financial asset prices (including exchange rates, if applied to international currency transactions); (iii) as a convenient, effective, and quick way of increasing government revenue in general.\(^\text{257}\) The feasibility of raising revenue from such taxes increases as there is greater use of centralized clearing and settlement of over-the-counter derivatives and currency contracts.

However, many are sceptical about whether such taxes can achieve these aims, or whether there are not better ways to achieve them. Whether FTTs reduce volatility is unclear both conceptually and empirically.\(^\text{258}\) Unless set at prohibitive rates, FTTs might not prevent major capital flows or exchange rate movements in a crisis. Given differences in the micro-structure of different financial markets in terms of the types of traders and possible trading strategies, any FTT is likely to have very different effects across different financial markets. Central banks in the EU have raised particular concerns about the effects the EU FTT proposals would have on bond trading, and on repurchase (repo) agreements and the negative consequences this would have for them in relation to their regulatory functions, since these markets play an important role in the day to day liquidity management of banks and the rest of the financial system more generally. Rate differentiation according to the term structure of the product could mitigate these concerns. Italy and France have introduced special taxes on high frequency trade which are intended to address to what they deem to be socially useless trading, although the issue remains whether regulation would be a better solution. The use of circuit breakers in the face of erratic market movements has been introduced by some stock exchanges, following “flash crashes”. This example of a regulatory approach was driven by the problems some exchanges have experienced that were related to automated or programmed trading in general rather than high frequency trading specifically, since the distinction between these two is not always widely appreciated, and therefore the distinct issues they raise can a times become blurred in debate.

\(^{257}\)FTTs have in some cases been introduced to circumvent secrecy rules preventing banks sharing information with tax authorities: but they are clearly not the best response to secrecy problems, and the argument in any event presumably calls for only miniscule tax rates.

Too regional and narrow scope FTTs suffers a high risk of tax avoidance. First, it is often possible to design equivalent transactions that avoid the tax (e.g. contracts for difference in currencies) in a case the where the tax base of an FTT was limited to a subset of financial products only. Second, unless taken up internationally, transactions simply migrate to other countries, as they are independent of the location of businesses and thereby particularly mobile. This is also why the EU Commission proposed a harmonisation of the existing EU Member States’ regimes by means of a broad based FTT and that it is not only relevant where a transaction is carried out but also where the products traded have been issued and where the parties to a transaction are established.

FTTs levied on centralized clearing systems only might well increase systemic risk. The majority of global currency transactions are now cleared through CLS (Continuous Linked Settlement), so reducing counterparty risk. Without sufficient regulatory measures, imposing an FTT only on transactions cleared through CLS risks pushing transactions outside such systems.

There is some evidence that FTTs are inefficient in that they tax intermediate transactions, can result in arbitrary cascading taxation, and so distort production decisions. Well targeted exemptions may be able to mitigate this issue, without jeopardising the effect of a FTT on deflating the pattern of what some deem to be excessive own account intermediation. Depending on their design, they might have the particular effect of discouraging use of the formal financial system. Exactly the opposite of what the evidence cited at the outset suggests is needed to support development.

As with all taxes, the incidence of FTT—who actually bears the real reduction in private sector income they imply—is unclear (although likely to be borne by current owners of financial assets if values fell). There appear to be some reason however to believe, for instance, that FTTs and FATs would be broadly progressive in nature.

Defining the tax base for any FTT is challenging once one moves beyond spot transactions in assets such as equities, bonds and foreign exchange markets. There has been significant and somewhat inconclusive debate about how you one should define the taxable transactions for derivatives. The notional value of such transactions, due to leverage, can be very high relative to the actual fees paid for any contract. One solution debated is to tax the notional value of derivative contracts at a lower rate than spot transactions.259 Another option would be to tax the price paid for the contract. However, the tax base would be correspondingly much smaller, and for several derivative agreements, such as swaps, the price is typically zero. Reaching any conclusion about how a broad based FTT might be operationalized in terms of defining the tax base also depends on clear agreement about the objectives of any FTT, e.g. is the intention to tax

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259 The European Commission’s proposal for a European Financial Transaction Tax takes this approach with a suggested tax rate of 0.1% for buyers and sellers of securities and other financial instruments (i.e. 0.2% in total), and a tax of 0.001% on both parties on the notional value of derivatives. This is expected to reduce turnover in shares and bonds by around 15% and in derivatives by around 75%.
the notional value of derivative contracts so as deter the use of such leveraged instruments? It is obvious that the setting of taxable amount and rate go hand in hand. Therefore, another solution consists in analysing a more differentiated treatment of derivatives both in terms of rates and taxable amount.

Whilst it can be argued that there may be some reduction in the likelihood of future major financial crisis from the introduction of a wide ranging FTT, the effect may be marginal given that major financial crises are very often linked to (physical) property market bubbles where transaction costs are already very high compared to those in financial instruments. Other tax instruments, notably the bank levies discussed above, are better suited to this aim. This objective is in any event more directly and traditionally addressed by regulatory measures, notably capital requirements and, for instance, a more direct approach to controlling excessive lending for property through tougher requirements for higher deposit levels to qualify for mortgage loans in the domestic mortgage market.

V. ADMINISTRATION

A. FINANCIAL INSTITUTIONS PLAY KEY ROLES IN IMPLEMENTING THE WIDER TAX SYSTEM

Financial institutions play a key role in implementing the tax system. They collect and remit details of tax payments, and in many countries, in collaboration with their respective revenue bodies, they enable electronic payment of taxes and refunds of overpaid taxes to be directly credited to taxpayers’ accounts.

In many countries, financial institutions also have responsibilities in withholding tax regimes, in respect of payments of interest income made to non-resident taxpayers and sometimes resident taxpayers. For example, financial institutions in 26 of the 34 OECD countries are required to generally withhold tax on payments of interest income to resident taxpayers. Further, in many countries they facilitate the detection of unreported income, by providing certain information on third party income to revenue bodies for systematic matching with taxpayers’ records. In the United States, for example, such third party matching provisions are credited to a great extent with the extremely low tax gap now associated with interest income. And in a few countries (e.g., Australia, Denmark, Finland, Netherlands, Norway and Sweden) this information is also used to assist with the preparation of pre-filled tax returns by the tax authorities.

Financial institutions are often required to execute levies or garnishments\(^{261}\) in respect of deposits held by them. These can arise in respect of unpaid tax debts. Financial institutions also assist with tax audit inquiries and tax fraud investigations in respect of specific taxpayers by providing access to financial records. Although not all countries’ domestic laws permit such information to be obtained from banks, banking secrecy is increasingly being recognized as a potential obstacle to effective tax compliance.

Financial institutions play a major role worldwide in the battle against crime, including tax crimes, through cooperation with law enforcement and revenue bodies. For example, they track and report large cash transactions and suspicious transactions, and apply laws to combat fraud and money laundering.

**B. CONTROLLING FINANCIAL INSTITUTIONS IN DEVELOPING COUNTRIES**

Incorporating the financial system into the wider tax structure in these ways can play an important role in achieving the wider developmental objective of combating the informality that is so pervasive in many lower income countries. A first step towards this, as well as towards ensuring that the institutions themselves are properly taxed, is establishing effective monitoring of financial institutions by the tax authorities. And a sound starting point for this is to strengthen administration of the largest taxpayers more generally, with financial institutions commonly prominent amongst them.\(^{262}\) This would typically involve implementing a large taxpayer office (LTO) structured around key industry segments,\(^{263}\) including a dedicated unit to administer taxpayers in the finance/banking/insurance sector. Steps to be undertaken in establishing an effective LTO, and financial sector unit in particular, would include:

- Recruiting LTO staff of sufficiently high calibre to deal with complex tax issues and transactions related to the financial sector.
- Creating a professional atmosphere that discourages tax officials from corrupt practices.
- Developing financial sector industry knowledge, expertise, and ‘commercial awareness’ of LTO staff.
- Training LTO staff in areas of legal interpretation, audit methodology, and appeals case management.

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\(^{261}\) A garnishment prevents a third party holder (such as a bank) from allowing the dispersion or transfer of assets when it has been notified that money or property belonging to another has been seized under legal writ.

\(^{262}\) As a simplification—there are often relatively few of them—it is common for all financial institutions to be included in the LTO.

• Developing a service strategy, whereby the LTO banking unit would provide a single point of access for banking sector inquiries, requests for rulings on technical issues, and so on.

• Developing a responsive audit strategy aimed at early detection of financial sector-related risks to the tax system.

C. FINANCIAL INSTITUTIONS AND AGGRESSIVE TAX PLANNING

This degree of exposure to the tax system inevitably leads to a substantial degree of interaction between financial institutions and revenue bodies. Among the issues which surface in this interaction are appropriate levels of service to the industry, the appropriate balance between the requirements of the tax system and the cost of compliance, and differing perspectives on interpretations of the tax code and on what constitutes acceptable tax strategies.

The OECD Banks and Tax Intermediaries studies adopted a common definition of "aggressive tax planning" by identifying two areas of concern:\textsuperscript{264, 265}

• Planning involving a tax position that is arguably valid, but has unintended and unexpected tax revenue consequences relative to the legislative intent of the provision at issue;

• Taking a tax position that is favourable to the taxpayer without openly disclosing that there is significant uncertainty as to whether it accords with the law.

Drawing on a number of sources including court decisions, general legal concepts, experience of general anti-avoidance provisions in a number of countries, and published revenue body guidance, the banks study identified a range of features which might indicate the presence of aggressive tax planning. Factors included transactions which have no commercial rationale, which have non-commercial terms, or have steps where the tax benefit is disproportionate to the other benefits in the transaction.

There is nevertheless still a gap between the perceptions of revenue bodies and those of many financial institutions about acceptable and unacceptable tax planning, although financial scandals and the need for state support for many banks has led some to declare that ethics would be given

\textsuperscript{264} The OECD Study into the Role of Tax Intermediaries (2008). This study recommended a follow up study on investment banking. This study was updated in Co-operative Compliance: A Framework from Enhanced Relationship to Co-operative Compliance (OECD 2013).

\textsuperscript{265} Building Transparent Tax Compliance by Banks was a joint Australian Tax Office, HMRC (U.K.) and OECD Secretariat study. It took the view that while tax administration issues were not significant contributors to the financial crisis, the crisis had highlighted issues which have implications for revenue bodies.
as greater weight and tax avoidance activities scaled bank or eliminated. Revenue bodies have long been concerned about tax compliance in the financial services industry, particularly in banking. The Tax Intermediaries study noted that banks provide aggressive tax planning for their clients and also for themselves through proprietary trading and inter-bank finance market transactions. It went on to signal a need ‘to improve understanding of the role banks play in designing and implementing aggressive tax planning and how this relates to their wider commercial activities’. The financial crisis also highlighted a number of issues with potential significance for tax compliance which needed to be examined. The Banks study identified a number of these issues, including the extent to which the complexity and limited transparency associated with many financial products clouded the issues for revenue bodies, and the potential impact on tax compliance of deficiencies in corporate governance and risk management strategies.

The most significant concerns of revenue bodies about aggressive tax planning by banks center on the use of complex structured financing transactions (CSFTs). This is the case whether these products are provided for clients (either corporate clients or wealthy individuals) or for the banks themselves where they engaged in proprietary trading or inter-bank finance market transactions. Both the Tax Intermediaries study and the Banks study pointed out the need for revenue bodies to be able to distinguish CSFTs that have a commercial (non-tax) purpose from those which are specifically designed for aggressive tax planning purposes. But revenue bodies’ concerns about banks’ use of CSFTs centre precisely on their complexity and cross-jurisdictional impact. These financial products involve the use of financial instruments—e.g. loans, derivatives, repos—which attempt to exploit mismatches in tax treatment between different countries.

Aggressive tax planning in the financial services sector is not unique to banks, however. For example, in the insurance industry loan transactions may be disguised as reinsurance transactions in an attempt to avoid withholding tax and to shift income inappropriately to a foreign related company.

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266 E.g. Rich Ricci, of Barclays Bank who was the bank’s investment banking chief, announced in September 2012 that they would undertake a thorough analysis of the 54 service lines provided by the investment bank with the help of Deloitte, which would eventually lead to cutbacks. "We have to take a fresh look to see if there are products and services in which... we no longer deem it appropriate to do business, regardless of financial return," he said. Previously, the tax structuring unit at Barclay’s investment bank had accounted for a significant share of total profits. In 2013 Barclays announced it was shutting down its tax structuring unit on the grounds that its main activities were incompatible with its new approach to corporate responsibility which involves reduced exposure to investment banking and activities which create reputational risks.
Revenue bodies across the world have responded to the threat to revenues posed by aggressive tax planning in the financial services and other business sectors. This response includes a range of administrative initiatives, sometimes underpinned by specific tax policy initiatives.  

D. Tax Policy Initiatives

Statutory advance disclosure regimes have been introduced in a number of countries including the U.S. and the U.K., providing these revenue bodies with information sources needed to enable them to move quickly to challenge the bona fides of particular schemes, where necessary through the appeal process, or through recommending urgent amendments to legislation.

General anti-avoidance rules and ‘abuse of law’ principles are becoming more common, with the objective of disallowing the tax advantages of tax planning arrangements. Particular penalty regimes which target the promoters of aggressive tax planning and effectively change the economics of aggressive tax planning have been introduced in some jurisdictions (e.g., Australia). As previously mentioned, on the basis of Action 12 of the BEPS Action Plan, the G20/OECD BEPS Project is also focused on developing recommendations for tax administrations regarding the design of mandatory disclosure rules for aggressive tax planning schemes, which will be published by September 2015.

E. Administrative Initiatives

Some of the more radical changes in the approach to influencing the compliance of large business, including the financial services industry, have taken place through new administrative initiatives. These have been aimed at improving compliance partly through building higher degrees of trust between revenue bodies and business including the financial services industry. Initiatives are being taken in a number of countries to promote new approaches to transparency by both sides. Financial institutions are being urged to share their tax planning strategies with revenue bodies, as far as practicable in real time, and some revenue bodies are putting in place structures to provide rulings or non-statutory guidance to these taxpayers, thus offering certainty in relation to the tax consequences of tax planning strategies.

Moves are being made to improve awareness of the needs of business in revenue bodies, by building in revenue bodies greater understanding of the business and products of financial institutions. In a number of countries this has involved a greater degree of specialisation in

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267 See Tackling Aggressive Tax Planning through Improved Transparency and Disclosure (OECD 2011). These efforts will be complimented by the G20/OECD BEPS Project’s work on mandatory disclosure rules in the framework of Action 12 of the BEPS Action Plan (Require Taxpayers to disclose their aggressive tax planning arrangements).

268 The United States disclosure regime contains a total of 6 categories of reportable transactions. The United Kingdom regime requires promoters of direct taxes schemes to disclose schemes falling within certain criteria.

269 These initiatives are detailed in a report by the OECD Forum on Tax Administration Task Group on Compliance Management of Large Business (2009).
industry segments in financial services. Generally greater capability to deal with the financial services industry is being built in revenue bodies. This covers the spectrum of accounting, taxation, legal and sector specific issues associated with the industry and is also leading to a greater understanding of the distinction between business-driven and tax-driven decision making and products in the industry.

Enforcement with respect to the financial services industry is increasingly being made on the basis of more sophisticated tax risk analysis. This analysis is drawing on country and growing international experience of acceptable and unacceptable tax planning, with the degree of cooperation and transparency exhibited by particular taxpayers and their advisors increasingly influencing decisions about tax risk and about the prioritisation of enforcement resources.

In a number of countries, a new structured approach to the basic relationship between the revenue body, the financial institution and the tax intermediary is being implemented. Sometimes described as "co-operative compliance,"270 this is ideally characterised by openness, transparency and responsiveness on both sides. It normally involves board-level engagement by the financial institution with the revenue body, clear lines of communication and a joint approach to tax risk analysis potentially leading to lower risk ratings, less intrusive interventions and consequently lower compliance costs for the business. As part of this, there is a growing focus on how tax compliance can be positioned as a recognised good practice element in corporate governance, and integrated into corporate risk management systems. This would ensure that tax compliance and important tax risk issues are considered at board-level in financial institutions and other large corporate business. Revenue bodies are increasingly interested in adding scrutiny of financial institutions’ corporate governance (including tax governance) to their tax risk assessment process.

### F. INTERNATIONAL EXCHANGE OF TAX INFORMATION

Effective exchange of tax information between tax agencies in different countries is a critical part of enforcement of taxpayer obligations and information held by financial institutions is of particular relevance. Normally, such effective information exchange takes place under the terms of bilateral tax treaties, either general or specifically drafted to cover administrative issues including in particular information exchange. Within the EU, along with the exchange of information under double tax treaties, exchange of information on request for direct taxation purposes under EU law has been in operation since 1979 and automatically for savings income since 2005271.

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271 Under the network of savings agreements, that mechanism is applicable to Aruba as well as the municipalities of Bonaire-St Eustatius-Saba, Anguilla, Cayman Islands, Montserrat, Guernsey, Isle of Man, British Virgin Islands and Turks and Caicos.
Unavailability of information exchange has long been recognized as a particularly important factor permitting the sheltering offshore of, especially, financial income, and the resulting growth in the use of tax havens. But exchange of information has been hampered both by a lack of transparency and strict secrecy rules applicable in some jurisdictions, on the one hand, and by a lack of capacity to produce required information in usable forms on the part of many countries, on the other. Unprecedented progress has been made on this issue, over the last few years, in the wake of international incidents involving tax secrecy linked to taxpayer evasion and fraud in various jurisdictions. Steps undertaken through the expanded G-20-inspired Global Forum mechanism are radically improving the ability of tax administrations in both developed and developing countries to obtain information previously protected by bank secrecy laws and non-transparent practices.

The Global Forum on Transparency and Exchange of Information for Tax Purposes was originally established in 2000 to facilitate the development of internationally accepted standards of transparency and information exchange on request. In 2002, a model Agreement on Exchange of Information in Tax Matters was issued, and in 2005 standards on availability and reliability of accounting records were developed. In 2009, the Global Forum was restructured and now includes over 120 member jurisdictions that carry out comprehensive peer reviews to ensure that these standards are implemented in law and in practice in member jurisdictions as well as other jurisdictions where appropriate. To date, the Global Forum has issued over 650 recommendations for improvement, many of these concerning access to bank information. More than 400 of these recommendations have been acted upon and over 1500 new exchange of information relationships have been put in place. Jurisdictions will come under increasing pressure to fully comply with the Global Forum’s standards with the publication of ratings of jurisdictions as compliant, largely compliant, partially compliant and non-compliant. The Global Forum’s first set of ratings were published in November 2013.

More recently, political momentum has gathered to establish automatic exchange of financial account information, with G20 leaders having endorsed it at their St. Petersburg Summit in September 2013 as the new global standard. The G20 decision followed earlier announcements by a number of European countries of their intention to develop and pilot multilateral tax information exchange based on the Model Intergovernmental Agreement (IGA) to Improve International Tax Compliance and to implement the U.S. legislation known as FATCA

\[ \text{272 A total of 113 peer review reports have been published thus far on the Global Forum’s website: http://www.oecd.org/tax/transparency/.} \]

\[ \text{273 Available at http://www.g20.org/documents/} \]

\[ \text{274 On 9 April 2013, France, Germany, Italy, Spain and the United Kingdom announced their intention to exchange FATCA-type information amongst themselves in addition to exchanging such information with the United States. This approach was subsequently endorsed by another 17 countries, with Mexico and Norway joining the initiative in early June and Australia in July.} \]
(Foreign Account Tax Compliance Act). The G20 Leaders also called on international organisations to ensure that developing countries can benefit from automatic exchange of information.

The goal of the OECD’s work on a single global standard on automatic exchange of information is to maximise compliance benefits for residence countries, reduce costs for financial institutions and provide all necessary safeguards through the development of one standard (rather than a proliferation of different ones). It is essential that jurisdictions have in place the legal framework and administrative capacity and processes to ensure the confidentiality of the information received and that such information is only used for the purposes specified in the exchange of information instrument.

The growing interest in automatic exchange of information has also led to growing interest in moving from bilateral tax information exchange agreements to the signing of the multilateral Convention on Mutual Administrative Assistance in Tax Matters, which was originally developed by the OECD and the Council of Europe in the 1980’s and amended in 2010 to allow all countries to join it. This Convention provides for all forms of administrative tax co-operation, including exchange of information on request and on an automatic basis. The Convention will enable interested countries to rapidly implement automatic exchange.

VI. CONCLUDING REMARKS

The problems created by the global financial crisis which began in 2007 led to a complete re-evaluation of the regulatory apparatus governing the financial sector at national and international levels. Many of the changes needed to prevent a reoccurrence of such a crisis are still in the process of implementation with long phase in periods, whilst other proposals such as the breaking up of too big to fail banks are still the subject of fierce debate. Taxation of the financial sector will therefore need to continue to evolve in the light of these wider changes. In particular much more thought is needed about how the changes in the tax system might best be designed to support the new regulatory objective and approaches being adopted towards the sector. However, care is also needed to ensure that the sector is not so burdened with new taxes as a result of anti-bank populist and related political sentiments that it undermines more important macroeconomic and growth objectives given the central role financial markets, and particularly banks, play in credit allocation. Some of the seeds of the global financial crisis were sown by governments themselves in the form of both housing and loose monetary policies. Better tax policy and administration towards the financial sector is a complement to good policy in such areas, not a direct substitute.

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The initiatives to address BEPS and towards a standardised, secure and cost effective model of bilateral automatic exchange of information in a multilateral context will require considerable international collaboration on the part of finance ministries and revenue authorities. Considerable consultation with companies that operate within the financial sector is necessary if domestic financial institutions are not to be overly burdened with expensive to comply with reporting requirements that create further barriers to new entrants to the sector.

Finally, it is worth noting that the widespread interest in how the financial sector operates and the spotlight on potential economic and social costs it can impose, in addition to the valuable positive role financial intermediaries have, creates a window of opportunity for some long needed changes to taxation of the sector over the next few years. As some have previously remarked, this is too good a crisis to waste.
# ANNEX 1: VATs OF THE WORLD

## VATs of the world

<table>
<thead>
<tr>
<th>Country</th>
<th>Date Introduced</th>
<th>Standard Rate on Introduction</th>
<th>Current Standard Rate</th>
<th>Other rates</th>
</tr>
</thead>
<tbody>
<tr>
<td>Albania</td>
<td>Jul. 1996</td>
<td>12.5%</td>
<td>20%</td>
<td>10%;</td>
</tr>
<tr>
<td>Algeria</td>
<td>Apr. 1992</td>
<td>13%</td>
<td>17%</td>
<td>7%</td>
</tr>
<tr>
<td>Andorra</td>
<td></td>
<td>4.5%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Angola</td>
<td></td>
<td>10%</td>
<td>2%; 20%; 30%</td>
<td></td>
</tr>
<tr>
<td>Anguilla</td>
<td></td>
<td>-</td>
<td>-</td>
<td></td>
</tr>
<tr>
<td>Antigua and Barbuda</td>
<td>Jan. 2007</td>
<td>15%</td>
<td>15%</td>
<td>10.5%</td>
</tr>
<tr>
<td>Argentina</td>
<td>Jan. 1975</td>
<td>16%</td>
<td>21%</td>
<td>10.5%; 27%</td>
</tr>
<tr>
<td>Armenia</td>
<td>Jan. 1992</td>
<td>28%</td>
<td>20%</td>
<td></td>
</tr>
<tr>
<td>Australia</td>
<td>Jul. 2000</td>
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<td>Jan. 1970</td>
<td>20%</td>
<td>25%</td>
<td>15%; 8%</td>
</tr>
<tr>
<td>Oman</td>
<td></td>
<td>20%</td>
<td>20%</td>
<td></td>
</tr>
<tr>
<td>Pakistan</td>
<td>Nov. 1990</td>
<td>12.5%</td>
<td>16%</td>
<td>15%; 21%; 18.5%; 2%</td>
</tr>
<tr>
<td>Palau</td>
<td></td>
<td>12%</td>
<td>12%</td>
<td></td>
</tr>
<tr>
<td>Palestine</td>
<td></td>
<td>15%</td>
<td>15%</td>
<td></td>
</tr>
<tr>
<td>Panama</td>
<td>Mar. 1977</td>
<td>5%</td>
<td>7%</td>
<td>15%; 10%</td>
</tr>
<tr>
<td>Country</td>
<td>Date Introduced</td>
<td>Standard Rate on Introduction</td>
<td>Current Standard Rate</td>
<td>Other rates</td>
</tr>
<tr>
<td>------------------</td>
<td>-----------------</td>
<td>-------------------------------</td>
<td>-----------------------</td>
<td>------------------------</td>
</tr>
<tr>
<td>Papua New Guinea</td>
<td>Jul. 1999</td>
<td>10%</td>
<td>10%</td>
<td></td>
</tr>
<tr>
<td>Paraguay</td>
<td>Jul. 1993</td>
<td>12%</td>
<td>10%</td>
<td>5%</td>
</tr>
<tr>
<td>Peru</td>
<td>Jan. 1973</td>
<td>20%</td>
<td>16%</td>
<td></td>
</tr>
<tr>
<td>Philippines</td>
<td>Jan. 1988</td>
<td>10%</td>
<td>12%</td>
<td>5%</td>
</tr>
<tr>
<td>Poland</td>
<td>Jul. 1993</td>
<td>22%</td>
<td>23%</td>
<td>8%; 5%</td>
</tr>
<tr>
<td>Portugal (Azores) (Madeira)</td>
<td>Jan. 1986</td>
<td>17%</td>
<td>23% (16%) (22%)</td>
<td>13%; 6% (9%; 4%) (12%; 5%)</td>
</tr>
<tr>
<td>Puerto Rico</td>
<td></td>
<td>-</td>
<td>-</td>
<td></td>
</tr>
<tr>
<td>Qatar</td>
<td></td>
<td>-</td>
<td>-</td>
<td></td>
</tr>
<tr>
<td>Romania</td>
<td>Jul. 1993</td>
<td>18%</td>
<td>24%</td>
<td>9%; 5%</td>
</tr>
<tr>
<td>Russia</td>
<td>Jan. 1992</td>
<td>28%</td>
<td>18%</td>
<td>10%</td>
</tr>
<tr>
<td>Rwanda</td>
<td>Jan. 2001</td>
<td>15%</td>
<td>18%</td>
<td></td>
</tr>
<tr>
<td>Samoa</td>
<td>Jan. 1994</td>
<td>10%</td>
<td>15%</td>
<td></td>
</tr>
<tr>
<td>San Marino</td>
<td></td>
<td>-</td>
<td>-</td>
<td></td>
</tr>
<tr>
<td>Saudi Arabia</td>
<td></td>
<td>-</td>
<td>-</td>
<td></td>
</tr>
<tr>
<td>Senegal</td>
<td>Mar. 1961; 1980</td>
<td>20%</td>
<td>18%</td>
<td></td>
</tr>
<tr>
<td>Serbia</td>
<td>Apr. 2003</td>
<td>17%</td>
<td>18%</td>
<td>8%</td>
</tr>
<tr>
<td>Seychelles</td>
<td>Jan. 2013</td>
<td>12%</td>
<td>15%</td>
<td></td>
</tr>
<tr>
<td>Sierra Leone</td>
<td></td>
<td>15%</td>
<td>0%</td>
<td></td>
</tr>
<tr>
<td>Singapore</td>
<td>Apr. 1994</td>
<td>3%</td>
<td>7%</td>
<td></td>
</tr>
<tr>
<td>Slovak Republic</td>
<td>Jan. 1993</td>
<td>23%</td>
<td>20%</td>
<td>10%</td>
</tr>
<tr>
<td>Slovenia</td>
<td>Jul. 1990</td>
<td>19%</td>
<td>20%</td>
<td>8.5%</td>
</tr>
<tr>
<td>South Africa</td>
<td>Sep. 1991</td>
<td>10%</td>
<td>14%</td>
<td></td>
</tr>
<tr>
<td>Spain</td>
<td>Jan. 1986</td>
<td>12%</td>
<td>18%</td>
<td>8%; 4%</td>
</tr>
<tr>
<td>Sri Lanka</td>
<td>Apr. 1998</td>
<td>12.5%</td>
<td>15%</td>
<td>20%; 5%</td>
</tr>
<tr>
<td>St. Kitts and Nevis</td>
<td>Nov. 2010</td>
<td>17%</td>
<td>17%</td>
<td>10%</td>
</tr>
<tr>
<td>St. Lucia</td>
<td>Oct. 2012</td>
<td>15%</td>
<td>15%</td>
<td>8%</td>
</tr>
<tr>
<td>St. Vincent and Grenadines</td>
<td>Mai 2007</td>
<td>15%</td>
<td>15%</td>
<td>10%</td>
</tr>
<tr>
<td>Sudan</td>
<td>Jun. 2000</td>
<td>10%</td>
<td>15%</td>
<td>30%</td>
</tr>
<tr>
<td>Suriname</td>
<td>Apr. 1999</td>
<td>7%</td>
<td>Goods: 10%</td>
<td>25%; 50%</td>
</tr>
<tr>
<td>Swaziland</td>
<td>Apr. 2012</td>
<td></td>
<td>14%</td>
<td></td>
</tr>
<tr>
<td>Sweden</td>
<td>Jan. 1969</td>
<td>11.1%</td>
<td>25%</td>
<td>12%; 6%</td>
</tr>
<tr>
<td>Switzerland (Federal)</td>
<td>Jan. 1995</td>
<td>6.5%</td>
<td>8%</td>
<td>3.8%; 2.5%</td>
</tr>
<tr>
<td>Syria</td>
<td></td>
<td>-</td>
<td>-</td>
<td></td>
</tr>
<tr>
<td>Taiwan</td>
<td>Apr. 1986</td>
<td>5%</td>
<td>5%</td>
<td></td>
</tr>
<tr>
<td>Tajikistan</td>
<td>Jan. 1992</td>
<td>28%</td>
<td>18%</td>
<td></td>
</tr>
<tr>
<td>Tanzania</td>
<td>Jul. 1998</td>
<td>20%</td>
<td>18%</td>
<td></td>
</tr>
<tr>
<td>Thailand</td>
<td>Jan. 1992</td>
<td>7%</td>
<td>7%</td>
<td></td>
</tr>
<tr>
<td>Country</td>
<td>Date Introduced</td>
<td>Standard Rate on Introduction</td>
<td>Current Standard Rate</td>
<td>Other rates</td>
</tr>
<tr>
<td>--------------------------</td>
<td>----------------</td>
<td>-------------------------------</td>
<td>-----------------------</td>
<td>-------------------------------------</td>
</tr>
<tr>
<td>Timor-Leste</td>
<td></td>
<td>-</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Togo</td>
<td>Jul. 1995</td>
<td>18%</td>
<td>18%</td>
<td></td>
</tr>
<tr>
<td>Trinidad and Tobago</td>
<td>Jan. 1990</td>
<td>15%</td>
<td>15%</td>
<td></td>
</tr>
<tr>
<td>Tunisia</td>
<td>Jul. 1998</td>
<td>17%</td>
<td>18%; 12% (services)</td>
<td>6%</td>
</tr>
<tr>
<td>Turkey</td>
<td>Jan. 1985</td>
<td>19%</td>
<td>18%</td>
<td>8%; 1%</td>
</tr>
<tr>
<td>Turkmenistan</td>
<td>Jan. 1992</td>
<td>28%</td>
<td>15%</td>
<td></td>
</tr>
<tr>
<td>Turks and Caicos Islands</td>
<td></td>
<td></td>
<td>Scheduled to be introduced in 2013</td>
<td></td>
</tr>
<tr>
<td>Uganda</td>
<td>Jul. 1996</td>
<td>17%</td>
<td>18%</td>
<td></td>
</tr>
<tr>
<td>Ukraine</td>
<td>Jan. 1992</td>
<td>28%</td>
<td>20%</td>
<td></td>
</tr>
<tr>
<td>United Arab Emirates</td>
<td></td>
<td>-</td>
<td>-</td>
<td></td>
</tr>
<tr>
<td>United Kingdom</td>
<td>Apr. 1973</td>
<td>10%</td>
<td>20%</td>
<td>5%</td>
</tr>
<tr>
<td>United States</td>
<td></td>
<td></td>
<td>State and municipal sales taxes from 4%-12%</td>
<td></td>
</tr>
<tr>
<td>US Virgin Islands</td>
<td></td>
<td>-</td>
<td>-</td>
<td></td>
</tr>
<tr>
<td>Uruguay</td>
<td>Jan. 1968</td>
<td>14%</td>
<td>22%</td>
<td>10%</td>
</tr>
<tr>
<td>Uzbekistan</td>
<td>Jan. 1992</td>
<td>30%</td>
<td>20%</td>
<td></td>
</tr>
<tr>
<td>Vanuatu</td>
<td>Aug. 1998</td>
<td>12.5%</td>
<td>12.5%</td>
<td></td>
</tr>
<tr>
<td>Venezuela</td>
<td>Oct. 1993</td>
<td>10%</td>
<td>12%</td>
<td>22%; 8%</td>
</tr>
<tr>
<td>Vietnam</td>
<td>Jan. 1999</td>
<td>10%</td>
<td>10%</td>
<td>5%</td>
</tr>
<tr>
<td>West Bank and Gaza</td>
<td>Jul. 1976</td>
<td>8%</td>
<td>14.5%</td>
<td>16%</td>
</tr>
<tr>
<td>Zambia</td>
<td>Jul. 1995</td>
<td>20%</td>
<td>16%</td>
<td></td>
</tr>
<tr>
<td>Zimbabwe</td>
<td>Jan. 2004</td>
<td>15%</td>
<td>15%</td>
<td></td>
</tr>
</tbody>
</table>

Sources: *International Bureau of Fiscal Documentation* (IBFD, 2012); *International Monetary Fund* (IMF, 2012)
ANNEX 2: SMALL BUSINESS CORPORATE INCOME TAX RATES AND OTHER TARGETED PROVISIONS

<table>
<thead>
<tr>
<th>Country</th>
<th>Small business corporate tax rates</th>
<th>Other targeted provisions</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Central govt(^2)</td>
<td>Adjusted central govt(^3)</td>
</tr>
<tr>
<td>Australia*</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Belgium*</td>
<td>24.98 (24.25)</td>
<td>24.98 (24.25)</td>
</tr>
<tr>
<td>Canada</td>
<td>11.0</td>
<td>11.0</td>
</tr>
<tr>
<td>Chile*</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Czech Republic</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>France*</td>
<td>15.0</td>
<td>-</td>
</tr>
<tr>
<td>Greece</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Hungary*</td>
<td>10.0</td>
<td>10.0</td>
</tr>
<tr>
<td>Iceland*</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Israel*</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Japan*</td>
<td>16.5(15.0)</td>
<td>15.7</td>
</tr>
<tr>
<td>Korea*</td>
<td>10.0</td>
<td>10.0</td>
</tr>
<tr>
<td>Luxembourg</td>
<td>21.4 (20.0)</td>
<td>21.4</td>
</tr>
<tr>
<td>Mexico*</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Netherlands*</td>
<td>20.0</td>
<td>20.0</td>
</tr>
<tr>
<td>Norway</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Portugal</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Spain*</td>
<td>25.0</td>
<td>25.0</td>
</tr>
<tr>
<td>Turkey</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>United Kingdom*</td>
<td>20.0</td>
<td>20.0</td>
</tr>
<tr>
<td>United States*</td>
<td>15.0</td>
<td>14.1</td>
</tr>
</tbody>
</table>

Source: OECD Tax Database. For comparison main CIT rates can also be accessed at: [http://www.oecd.org/ctp/tax-policy/tax-database.htm#C_CorporateCapital](http://www.oecd.org/ctp/tax-policy/tax-database.htm#C_CorporateCapital)

**Key to abbreviations:**

n.a.: not available

*: country specific information

-: not applicable

gov’t: Government

ACT: Business activity    LOC: Geographical location    OTH: Other
Explanatory notes:

1. This first part of table reports central, sub-central and combined corporate income tax rates typically applying for or targeted at 'small (incorporated) business', where such 'targeting' is on the basis of size alone (e.g. number of employees, amount of assets, turnover or taxable income) and not on the basis of expenditures or other targeting criteria. A 'small business corporate tax rate' may be a special statutory corporate tax rate applicable to (all or part of) the taxable income of qualifying 'small' firms (e.g., meeting a turnover, income, or asset test), or an effective corporate tax rate below the basic statutory corporate rate provided through a tax deduction or credit for 'small' firms determined as a percentage of qualifying taxable income (e.g., up to a given threshold). If corporate income is taxed at progressive rates, the rate typically applying for 'small' firms should be reported. Where the central government, or sub-central government, or both, have a lower small business tax rate, the applicable central and sub-central rates are both shown (to enable a combined rate calculation). Thus, for example, where only the sub-central government has a small business rate, the basic central corporate income tax rate is shown in order to compute the combined central and sub-central tax rate on small business (a cross-check with Table II.3 shows whether the central or sub-central rate is basic or not).

The second part of the table also indicates whether other targeting provisions apply (reduced statutory rates, tax deductions or credits for firms meeting qualifying criteria), determined independently of taxpayer expenditures.

2. This column shows the central government corporate tax rate targeted at 'small' business. The basic central government rate is shown where a preferential small business rate applies only at the sub-central government level. Where surtax applies, the statutory corporate rate exclusive of surtax is shown in round brackets ( ).

3. This column shows the basic central government small business statutory corporate income tax rate (inclusive of surtax (if any), adjusted (if applicable) to show the net rate where the central government provides a deduction in respect of sub-central income tax.

4. This column shows the sub-central government (combined state/regional and local) corporate tax rate targeted at small businesses. The rate should be a representative rate calculated as that reported in Table II.3, where such targeting exists at the sub-central level. The basic sub-central government rate is shown where small business targeting occurs only at the central government level.

5. This column shows other targeting factors (see key to abbreviations) independent of taxpayer expenditures to give other (non-basic) targeted rates. More detailed information may be found in the Explanatory Annexes to the OECD tax database.

Country-specific footnotes:

**Australia:** has a non-calendar tax year, the rates shown are those in effect as of 1 July.

**Belgium:** applicable on the first EUR 25 000 of taxable income when taxable income is less than EUR 322 500. The rate is 31.93% (31) up to a taxable income of EUR 90 000, and 35.535% (34.5) on the remaining taxable income up to EUR 322 500. The effective CIT rate can be substantially reduced by a notional allowance for corporate equity
(ACE). E.g. the effective tax rate is only half the nominal tax rate when the return on equity before tax is twice the national interest rate (3.242% for SMEs in 2013).

**Chile:** the targeted provisions relate to a 40% surtax on state-owned enterprises and the specific tax on mining activities.

**France:** applicable where turnover does not exceed EUR 7.63 million, and on the part of the profit that does not exceed EUR 38 120.

**Hungary:** a preferential tax rate of 10% is applicable on the first HUF 500 million, without any specific limitations.

**Iceland:** a special income tax of 6% on institutions’ corporate income tax base in excess of ISK 1 billion.

**Israel:** see Explanatory Annex at OECD tax database.

**Japan:** from 1 April 2012 'Small business corporate tax rates' are:

- The small business central government corporate income tax rate is reduced to 15.0%. At the same time, 'The Special Corporation Tax for Reconstruction' was imposed for three years at a rate of 10% resulting in an overall 16.5% tax rate. These figures would be presented as 16.5(15.0) in the table above. The 'Adjusted central government corporate income tax rate' has been reduced to 15.7%.

- The Sub-central government corporate income tax rate has been reduced to 7.1%.

- As a result of these changes, the 'Combined corporate income tax rate' has been reduced to 22.9%.

Applicable on the first JPY 4 million of taxable income of corporations whose capital is JPY 100 million or less. The combined rate is 24.56 per cent between taxable income of JPY 4 million and 8 million.

**Korea:** applicable on the first KRW 200 million.

**Mexico:** a reduced CIT rate of 21% and an exemption equivalent to a maximum of 200 minimum wages, applies to companies which are involved exclusively in the primary sector.

**Netherlands:** the reduced rate of 20% applies to the first EUR 200 000 of taxable income. Income derived from domestically created R&D is taxed in a separate 'innovation box'. The rate for income in this box is 5%.

**Spain:** qualifying SMEs are taxed at 25% on first EUR 300,000.00 of taxable income. Furthermore, SME's with a turnover below EUR 5,000,000 and an average payroll of less than 25 employees are eligible for CIT rate of 20%.

**United Kingdom:** for companies with tax-adjusted profits below GBP 300 000 the rate is 20% (see also Explanatory Annex). Rates as of 1 April.

**United States:** applicable on first USD 50 000.
## ANNEX 3: SELECTED FINANCIAL SECTOR TAXES IN OECD COUNTRIES

### TABLE 6- BANK LEVIES AND STABILITY FEES

<table>
<thead>
<tr>
<th>Country</th>
<th>Type of levy</th>
<th>When introduced</th>
<th>Base</th>
<th>Tax rate</th>
<th>Main exceptions</th>
<th>Estimated revenues</th>
<th>2012 modifications</th>
<th>2013 plans</th>
</tr>
</thead>
<tbody>
<tr>
<td>Australia</td>
<td>Supervisory levy</td>
<td>1998</td>
<td>The Australian Prudential Regulation Authority (APRA) collects levies from the financial sector to recover the operational costs of APRA, and other specific costs incurred by certain Australian Commonwealth agencies and departments. Asset value of entities regulated by APRA within the banking, general insurance, life insurance and superannuation industries. APRA supervisory levies are broken into two components: one based on the cost of supervision (the restricted component) and the other on financial system impact (the unrestricted component). The rate of the levy varies between industries within the financial sector. For authorised deposit taking institutions, the restricted levy rate is calculated at 0.00414 per cent of assets held by the entity, subject to minimum of $490 and a maximum of $2.1 million. The unrestricted component of the levy is 0.000566 per</td>
<td>Some participants of the financial system (such as specialist credit card institutions and providers of purchased payment facilities and foreign authorised deposit-taking institutions) have smaller restricted component levies. In the case of foreign deposit taking institutions, this reflects reduced supervisory effort relative to domestic deposit taking institutions.</td>
<td>AUS$266.4 million in 2012-13</td>
<td>The cost of the Government’s ‘Super Stream’ reforms (which seek to deliver greater efficiency in back-office processing across the superannuation industry), will be funded through a temporary levy on APRA regulated superannuation funds.</td>
<td>Consistent with past practice, the Government will consult with the financial sector prior to any changes in the APRA levy.</td>
<td></td>
</tr>
<tr>
<td>Country</td>
<td>Type of levy</td>
<td>When introduced</td>
<td>Base</td>
<td>Tax rate</td>
<td>Main exceptions</td>
<td>Estimated revenues</td>
<td>2012 modifications</td>
<td>2013 plans</td>
</tr>
<tr>
<td>---------</td>
<td>--------------</td>
<td>-----------------</td>
<td>------</td>
<td>----------</td>
<td>-----------------</td>
<td>-------------------</td>
<td>-------------------</td>
<td>------------</td>
</tr>
<tr>
<td>Austria</td>
<td>Stability levy</td>
<td>01-Jan-2011</td>
<td>A stability levy is paid by all entities classified as banks according to the Austrian Bank Act. The levy is calculated as a percentage of a bank’s balance sheets total after subtracting secured deposits, equity and trust transactions. The trading volume of derivatives is subject to an additional levy. The trading volume and balance sheet totals of 2010 are used as the tax base for the levies paid between 2011 and 2013. From 2014 onwards the balance sheet of the foregoing year will be used.</td>
<td>The stability levy is progressive, with no payments for the first bracket up to € 1,000 million, 0.055% for the bracket up to € 20,000 million and 0.085% for any amount exceeding this threshold. The additional levy on the trading volume of derivatives amounts to 0.013% of a bank’s trading volume.</td>
<td>None</td>
<td>2011: EUR 510 million</td>
<td>A temporary increase in the levy by 25 % (for the years 2012 to 2017).</td>
<td></td>
</tr>
<tr>
<td>Belgium</td>
<td>Subscription tax</td>
<td>1 July 1993</td>
<td>The tax is due on (a) the net outstanding amounts of investment funds, etc., (b) qualifying savings deposits (credit institutions) and (c) the mathematical and technical reserves related to life insurances and investment funds commercialised via insurances (insurance</td>
<td>Until 31 December 2004: 0.06% 1 January 2005 – 31 December 2006: 0.07% Since 1 January 2007: 0.08%. 17 June 2013 ( ): From 1 January 2013:</td>
<td>Deposits etc. of professional and institutional investors are taxed at 0.01% when held by Belgian investment funds</td>
<td>304 mill. euro in 2013</td>
<td>At the November 2012 Conclave, the government coalition agreed to impose an additional contribution of 50 million euro on the financial sector in 2013, either by increasing the stability levy or the subscription tax. In April 2013 the budgetary estimated was increased from 258.7 to 304.0 million euro (+ 45.4). In June 2013</td>
<td></td>
</tr>
<tr>
<td>Country</td>
<td>Type of levy</td>
<td>When introduced</td>
<td>Base</td>
<td>Tax rate</td>
<td>Main exceptions</td>
<td>Estimated revenues</td>
<td>2012 modifications</td>
<td>2013 plans</td>
</tr>
<tr>
<td>---------</td>
<td>--------------</td>
<td>-----------------</td>
<td>------</td>
<td>----------</td>
<td>-----------------</td>
<td>-------------------</td>
<td>-------------------</td>
<td>------------</td>
</tr>
<tr>
<td>Belgium</td>
<td>Stability levy</td>
<td>1 January 2012 (Law of 28 December 2011).</td>
<td>All credit institutions are subject to the financial stability contribution levied on the total amount of liabilities less equity and deposits subject to the guarantee scheme of the Belgian Special Protection Fund. The annual levy refers to the amounts outstanding on 31 December of the preceding year.</td>
<td>The rate is 0.035%.</td>
<td>The Law of 17 June 2013 introduced specific provisions (already applicable from 1 January 2013 onwards) for recognized central depositories of financial instruments</td>
<td>Modified budget April 2013: 245.1 million euro (-68.0)</td>
<td>Introduced in 2012</td>
<td>At the November 2012 Conclave, the government coalition agreed to impose an additional contribution of 50 million euro on the financial sector in 2013, either by increasing the stability levy or the subscription tax. The Law of 17 June 2013 introduced some provisions from 2013 onwards and makes the rate dependent upon a risk indicator from 1 January 2014 onwards for “system relevant” financial institutions. The risk indicator represents the average ratio of financial trading assets (minus 80% of financial trading derivatives) to the balance sheet total at the end of 2012.</td>
</tr>
<tr>
<td>Country</td>
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<tr>
<td>Belgium</td>
<td>Annual tax on credit institutions</td>
<td>Formally introduced in July 2012 but retroactively applicable since 1 January 2012</td>
<td>All banks are subject to the new annual tax on saving deposits</td>
<td>The reference rate is 0.05% but the actual rate varies from 0.03% to 0.12% depending upon the ratio of loans granted to the “real economy” of the European Union. The more loans granted directly to the real economy (as opposed to other financial institutions), the lower the rate.</td>
<td>EUR 81 million (budget 2012)</td>
<td>Introduced in 2012</td>
<td>each quarter in the preceding year. For “non system relevant” institutions the rate will vary from 0.03% to 0.0325% depending upon fulfilment of equity requirements.</td>
<td></td>
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</tbody>
</table>

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276 The saving deposit of which the interest income is tax exempted for private persons (up to an interest income of 1,830 euro per person in 2012)
<table>
<thead>
<tr>
<th>Country</th>
<th>Type of levy</th>
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</tr>
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<tbody>
<tr>
<td>Chile</td>
<td>None</td>
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<td>In April 2013, a bill was introduced to Congress. It reduces Stamp tax rates, from a monthly 0.033% with an annual maximum of 0.4%, to a monthly 0.0166% with an annual maximum of 0.2% for credit operations with maturity date. Regarding credit operations without maturity date, the tax rate would be reduced from 0.166% to 0.083%.</td>
</tr>
<tr>
<td>France</td>
<td>Bank levy</td>
<td>2011</td>
<td>A 'tax on systemic risks' specific to banks with capital requirement above EUR 500 million. It is levied on the amount of risk-weighted banks’ assets, which are used for the determination of banks' capital requirement.</td>
<td>0.5 % as of 2012.</td>
<td>PEs of foreign banks resident in an EEA country are not subject to this levy</td>
<td>EUR 550 million for 2012</td>
<td>The rate will increase from 0.25% to 0.5% as of 2013. A temporary 0.25% additional contribution was added to the original rate of 0.25 % from July 2012 to the end of that year.</td>
<td></td>
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<tr>
<td>Germany</td>
<td>Bank levy</td>
<td>01-Jan-2011</td>
<td>The levy is paid by all credit institutions with a permission under the German Banking Act to provide banking operations and aims to charge the size and connectedness of a</td>
<td>The main component is a levy with progressive rates. Liabilities below €300 mill are exempt. Then the rate is 0.02% up to €10 bn, 0.03% for amounts</td>
<td>Equity capital, subsidized loans, jouissance right capital with a holding period exceeding 2 years, fund for general banking risks and</td>
<td>The target volume of the fund is legally set at EUR 70 billion. The levy raised approx. EUR 590 million in</td>
<td>Subsidized loans (“Förderkreditgeschäft”) ceased to be chargeable.</td>
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<tr>
<td>Country</td>
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<tr>
<td>Greece</td>
<td>Bank levy</td>
<td>Bank debt is subject to a special levy on the loan value</td>
<td>0.6% annually on the business &amp; consumption loans. 0.12% annually on the mortgage loans</td>
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bank/credit institution. The base of the main component of the levy is an institution’s liabilities, with some exemptions.

In addition to this is a smaller component which charges the nominal value of derivatives held by an institution (on- and off-balance-sheet).

between €10 bn to €100 bn, 0.04% for amounts between €100 bn to €200 bn, 0.05% for amounts from 200 to €300 bn, 0.06% for amounts above €300 bn. The addition component amounts to 0.0003% of the nominal amount of derivatives. The bank levy is limited to either a maximum of 20% of the annual profits (adjusted by certain other items) or to a maximum of 50% of the average annual profits (adjusted by certain other items) of the recent 3 yrs. The minor amount of both is the relevant maximum. Banks have to pay at least 5% of the calculated annual contribution (minimum bank levy).

non-bank deposits (liabilities to clients).

2011 and EUR 690 million in 2012.

None | None
<table>
<thead>
<tr>
<th>Country</th>
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<tr>
<td>Hungary</td>
<td>Surtax on financial corporations</td>
<td>27-Sep-10</td>
<td>All financial corporations are obliged to pay the surtax, but the tax assessment rules vary between institutions engaged in different activities. For banks and credit institutions the tax is calculated on the adjusted balance sheet total (i.e. less inter-bank lending and loan receivables, etc.). Insurance companies are obliged to pay on the basis of the amount of insurance premiums received.</td>
<td>For banks and credit institutions the surtax is levied with a rate of 0.15% up to HUF 50 billion and 0.53%. For insurance companies the surtax is levied with a rate of 1.5% up to HUF 1 billion, 3% between HUF 1 billion and HUF 8 billion and 6.4% on the excess. The tax is also applicable to other financial institutions for which different rates may apply.</td>
<td>Budgeted planned revenue for 2012 was HUF 187 billion on cash basis, not taking into account write-offs described in the next column. Actual revenue accrued to the budget in 2012 was HUF 85 billion on cash basis.</td>
<td>Banks which increase their existing SME credit portfolio by 30 September 2012 may deduct the HUF value of their portfolio growth from the base of tax in 2012. Also, banks are given the possibility to reduce their tax liability in the following ways: - Deduct 30% of their losses from the conversion scheme for foreign currency mortgages. - Write off 30% of the loss arising from the early repayment of foreign currency loans on fixed HUF exchange rate.</td>
<td>A planned halving of the tax from 2013 has been withdrawn. However, insurance companies are not subject to the tax from 2013.</td>
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<tr>
<td>Iceland</td>
<td>Bank levy</td>
<td>01-Jan-11</td>
<td>Depository institutions' year-end total liabilities.</td>
<td>0.04%</td>
<td>In 2012: ISK 1.1 billion. In 2013: ISK 1.1 billion.</td>
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<tr>
<td>Korea</td>
<td>Bank levy</td>
<td>2011</td>
<td>The bank levy is put based on banks' balance sheets and is charged on banks' outstanding foreign currency.</td>
<td>The bank levy is charged at between 2~20bp, depending on the maturities of debt instruments and its potential risks being imposed on the</td>
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<tr>
<td>Netherlands</td>
<td>Bank levy</td>
<td>01-Oct-12</td>
<td>The tax base is the total amount of the so called unsecured debts of banks. These unsecured debts equal the total amount of equity and liabilities on the balance sheet minus the amount of tier 1 capital, the actually secured deposits under a deposit insurance scheme and the liabilities connected with the assurance activities of the bank.</td>
<td>The levy has two rates. In principle, short term unsecured debts are taxed at a rate of 0,044% and long term unsecured debts at a rate of 0,022%. If, however, a director (bestuurder) of a taxable person receives a variable remuneration, (the part of a remuneration which depends on the achievement of targets or the occurrence of events) that is more than 100% (in 2012 and 2013) or 25% (in later years) of his/her fixed remuneration, both rates are multiplied by a factor of 1.1 (and will become 0.0484% and 0.0242%</td>
<td>EUR 600 million yearly</td>
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<td>Country</td>
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<tr>
<td>Portugal</td>
<td>Bank levy</td>
<td>2011</td>
<td>The banking sector is subject to a levy on</td>
<td>Tax rate on base I: 0.05%</td>
<td>Exemptions for base I:</td>
<td>EUR 147.6 million in 2011 (source: CGE, State General Account)</td>
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<td></td>
<td>• Base I: Total liabilities (with some exemption)</td>
<td>Tax rate on base II: 0.00015%</td>
<td>• Items that are accounted for as equity;</td>
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<td>• Base II: The notional amount of off-balance sheet financial derivatives, excluding hedging derivatives and back to back derivatives.</td>
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<td>• Liabilities for defined benefit retirement plans;</td>
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<td>• Provisions;</td>
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<td>• Liabilities concerning revaluation of financial derivatives;</td>
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<td></td>
<td>• Receipts related to deferred income, irrespective liabilities’ operations;</td>
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<td></td>
<td>• Liabilities related with assets which were not accounted for in securitization’s operations. Part of the bank deposit actually covered by the Deposits Guarantee Fund</td>
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<tr>
<td>Slovak Republic</td>
<td>Bank levy</td>
<td>01-Jan-12</td>
<td>The tax is levied on the sum liabilities.</td>
<td>• 0.4% - the general starting rate,</td>
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<td>As of 1 September 2012, the tax base includes retail (protected) deposits that have previously been exempted.</td>
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<td>• 0.2% - if the total amount of levies collected was (&gt; 500) million EUR and (\leq 750) million EUR in the preceding year,</td>
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<td>• 0.1% - if the total amount of levies was (&gt; 750) million EUR and (&lt; 1.45)% of total amount of assets of the banking sector in the Slovak republic in the preceding year,</td>
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<td>• 0% - (1) if the total amount of levies was (&gt; 750) million EUR in the preceding year and (2) was (\geq 1.45)% of total amount of assets of the banking sector in the Slovak Republic in the preceding year,</td>
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<td>• 0.05% - if (2) was fulfilled in year -2 but not in year -1</td>
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2012: EUR 120.3 million
2013: EUR 206.1 million
2014: EUR 154.6 million
<table>
<thead>
<tr>
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</tr>
</thead>
<tbody>
<tr>
<td>Slovenia</td>
<td>Bank levy</td>
<td>The bank balance sheet tax act entered into force on July 26, 2011, and was applicable from 1 August 2011.</td>
<td>The tax base is the balance sheet, calculated as an average value of balances at the last day of each month in the calendar year.</td>
<td>0.1 % of the tax base</td>
<td>The tax can be reduced by 0.1 % (until 31 December 2012, by 0.167 %) of loan balance granted to non-financial corporations and sole traders and this reduction can reduce the tax liability to zero. The tax is not applicable when: • The loan balance granted to non-financial corporations and sole traders in the calendar year for which the tax shall be paid exceeds the balance of such loans in the previous calendar year by at least 5 %. • The loan balance granted to non-financial</td>
<td>Approximately EUR 7.4 million in 2012. With the 2012 modifications, revenues for 2013 are expected to increase to about EUR 14 million.</td>
<td>Act Amending the Bank Balance Sheet Tax Act was published in the Official Journal of the Republic of Slovenia on 17 December 2012. Amendments provide abolition of the tax on 1 January 2015, reduction of the percentage of loan balance granted to non-financial corporations and sole traders for which the tax can be reduced and introduction of prepayments.</td>
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<tr>
<td>Sweden</td>
<td>Stability fee</td>
<td>30 December 2009</td>
<td>The tax is paid by banks and other credit institutions and is levied on an institution’s total liabilities.</td>
<td>The rate is 0.036%. The levy was set at 50% of the general rate for the first two years.</td>
<td>Equity capital and some junior securities</td>
<td>2011 income: SEK 1,447 million</td>
<td>Expected revenue SEK 3,000 million</td>
<td>SEK 3,100 million</td>
</tr>
</tbody>
</table>
| United Kingdom | Bank levy    | 1 January 2011. | • the global (i.e. including foreign subsidiaries) consolidated balance sheet of UK banking groups and building societies;  
• the aggregated UK-group and UK subsidiary balance sheets, together with a proportion of the balance sheets of foreign banks operating in the United Kingdom through permanent | For 2012 the rate was set at 0.088%. The levy was set at 0.05% from 1 January to 28 February 2011, 0.1% from 1 March 2011 to 30 April 2011, 0.075% from 1 May 2011 to 31 December 2011. | Certain amounts are excluded from “chargeable equity and liabilities”, including:  
• Tier 1 capital,  
• certain “protected deposits” (i.e. deposits covered by depositor protection schemes), | For the period 1 April 2011 to 31 March 2012: £1612 million. | Rate raised to 0.088% | Rate raised to 0.130% as of 1 January 2013. |

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277 This does not represent a full year of liabilities as the Bank Levy does not become due immediately that the charge accrues. Payment is made by quarterly installments and receipts in 2011-12 will typically include three out of four installments for the first year of the Bank Levy.
<table>
<thead>
<tr>
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<td>establishments (branches) which are members of foreign banking groups;</td>
<td>• liabilities that arise from certain insurance business within banking groups,</td>
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<td></td>
<td>the balance sheets of UK banks and banking sub-groups in non-banking groups; and</td>
<td>• liabilities representing segregated client money, and</td>
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<td>the balance sheets of UK banks that are not members of groups.</td>
<td>• repo liabilities secured against sovereign debt.</td>
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</tbody>
</table>

Liabilities with a maturity greater than one year at the balance sheet date are subject to a half rate. The levy is not charged on the first £20 billion of chargeable liabilities.

<table>
<thead>
<tr>
<th>Country</th>
<th>Type of tax/fee</th>
<th>When introduced</th>
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<th>2012 modifications</th>
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</thead>
<tbody>
<tr>
<td>Australia</td>
<td>None</td>
<td>(Note: some FTTs imposed at sub-central level).</td>
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<tr>
<td>Austria</td>
<td>Tax on Stock Exchange Transactions</td>
<td>1935</td>
<td>First time issues of (new) shares, etc., by a cooperation. The tax base is value of the shares, etc.</td>
<td>1%</td>
<td>Some corporations are exempted (e.g. non-profit cooperation)</td>
<td>2011: EUR 77 million.</td>
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<tr>
<td>Belgium</td>
<td>Tax on Stock Exchange Transactions</td>
<td>Introduced well before World War II</td>
<td>All security transactions are covered. The tax is due on the transaction value of any purchase and any sale of public (listed) securities carried out or concluded in Belgium.</td>
<td>Since 1 August 2012 the standard rate is 0, 25% with an upper ceiling of EUR 740 per transaction. There exists however a lower rate of 0.09% for bonds and some investment funds and a higher rate of 1% for investment funds not distributing but capitalizing investment income. The actual ceiling is EUR 650 per transaction when the lower rate applies and EUR 1,500 per transaction when the higher rate applies. A reduced rate of 0.085% applies to carry-over transactions.</td>
<td>Transactions not involving a financial intermediary are exempted. There is also an exemption for non-residents and for the financial sector acting for its own account as well as for transactions concerning treasury bonds or linear bonds issued by the State.</td>
<td>2011: EUR 131.5 million 2012: EUR 159.2 million</td>
<td>In 2012 a first rate increase was followed by a second, but temporary (from 1 August 2012 until the end of 2014), increase for some transactions. The standard rate was temporarily increased from 0.22% to 0.25%, and the maximum amount was increased from EUR 650 to EUR 740. For capitalization shares investment funds, the rate was temporarily increased from 0.65% to 1%, and the maximum amount was increased from EUR 975 to EUR 1,500.</td>
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<tr>
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<tr>
<td>Chile</td>
<td>Stamp duty</td>
<td>1980</td>
<td>1) A stamp duty applies to documents containing a money credit agreement, for instance bills of exchange or promissory notes. The tax base is the amount of the capital specified in the document. 2) Protest checks, without funds are charged with a 1% tax rate (minimum of CLP $ 3,135 and a maximum of 1 UTM). In this case the tax base is the amount of the check.</td>
<td>For loans with a maturity date the rate is set at 0.033% monthly, with an annual maximum of 0.4%. For credit operations without a maturity date, the tax rate is 0.166%.</td>
<td>Exempted entities: the State; municipalities; universities, Fire Depts.; cooperatives; legal entities whose purpose is to worship; Chilean Red Cross; among others. Exempted documents (among others):</td>
<td>CLP $ 265,560 million in 2011</td>
<td></td>
<td>One measure of the Tax Reform Law 20 630, enacted and published in September 2012.</td>
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<tr>
<td>Chile</td>
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<td>1. Foreign loans by multilateral financial institutions and those linked to bonds issue to be placed abroad, issued or underwritten by the State or the Central Bank of Chile. 2. Documents required to perform credit transactions of money intended for export</td>
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<tr>
<td>Country</td>
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<tr>
<td>Denmark</td>
<td>Registration Duty</td>
<td>• The purchase price/assessed value of the real estate • The amount of a loan</td>
<td>A standard duty on all registrations: DKR 1,660. Plus variable rate: • Change of</td>
<td>financing. The Superintendence of Banks and Financial Institutions shall indicate, by general resolutions, the documents that have that character. 3. Credit letters for imports to be opened with funds from the importer. 4. Bonds, promissory notes, bills of exchange and other instruments and agreements referred to in the N°1, Art.3 of the Stamps Tax Decree Law, issued or accepted by the State</td>
<td>Yearly revenue, billion DKK: 2012: 4.9,</td>
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<td>ownership of real estate: 0.6 % of price/value</td>
<td>2013: 4.9</td>
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<td>2014*: 5.1</td>
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<td>Liens (security) in real estate: 1.5 % of the secured amount</td>
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<td>Liens (security) in motor vehicles: 1.5 % of the secured amount</td>
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<td>Change of ownership of vessels: 0.1 % of price/value (fishing vessels and yachts 0.4 %)</td>
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<td>Liens (security) in vessels: 0.1 % of secured value (yachts 1.5 %)</td>
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<td>Change of ownership of airplanes: 0.1 % of price/value</td>
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<td>Liens (security) in airplanes: 0.1 % of secured amount (small airplanes: 1.5%)</td>
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<tr>
<td>Finland</td>
<td>Transfer tax</td>
<td>1996</td>
<td>Finnish securities, e.g. equities, PPL, stock options, but not debt securities or derivatives</td>
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<td>1.60%</td>
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<td>Debt securities and derivatives; transfers made through stock exchanges; (generally) shares of foreign companies</td>
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<td>EUR 10 million</td>
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<td>A rise in the transfer tax on real property (apartments) and securities from 1.6% to 2% will come into force on 1.3.13.</td>
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<td>At the same time, the tax base is proposed to be broadened by including the housing-co-op loan share of apartments.</td>
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<td>France</td>
<td>Transfer tax and high frequency tax</td>
<td>2012</td>
<td>Notional volumes of transactions on shares of publicly traded companies established in France, whose market capitalization is over EUR 1 billion (Transfer Tax) High frequency and automated trading operations are taxed on the amount of cancelled or modified orders above a ceiling, which will be defined by a Ministerial Decree; and Purchase of a Credit Default Swap (CDS) by a French Company is taxed on the amount of contract covered by the CDS.</td>
<td>0.2% for shares (as of 1 August 2012), 0.01% for HFT and CDS</td>
<td>Transactions undertaken for the purpose of market making - Primary market transactions - Transactions undertaken by clearing houses - Transactions between entities of the same group - Transactions undertaken on behalf of the issuer - Transactions on behalf of employees’ savings and pension plans - Transactions on convertible debt - Temporary share transfers are exempted from the Financial</td>
<td>EUR 600 million</td>
<td>Came into force in August 2012; originally 0.1%, the rate was doubled to 0.2% before the tax came into force.</td>
<td>The Growth Pact agreed upon at the European Summit of June 2012 forecasts the adoption of a Financial Transaction Tax by a set of core countries within the legal framework of reinforced cooperation.</td>
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<td>Greece</td>
<td>Transaction duty</td>
<td>1998 (Art. 9, par. 2 Law 2579/1998, art.27 and par.2 Law 2703/1999)</td>
<td>Greek or foreign listed shares and compound products such as equity swaps, call options, futures etc.</td>
<td>0.2%</td>
<td>Behavioural tax to limit High Frequency activity on French shares. Therefore the corresponding budgetary document does not refer to any fiscal revenue.</td>
<td></td>
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<td>The transaction duty continue to apply for the sale of listed shares acquired after 2013. In addition, capital gains from the sale of listed shares acquired by individuals or legal entities from 1.7.2013 onwards are subject to a 20% tax rate, which exhausts the tax liability of individuals and non-profit legal entities. S.A.s and LTDs are further taxed with the general provisions.</td>
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<td>Hungary</td>
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<td>A new levy was introduced as of 1 January 2013. This is a duty on financial transactions with a rate of 0.2% and is capped at HUF 6,000. The duty is levied on</td>
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<tr>
<td>Ireland</td>
<td>Stamp duty</td>
<td>prior to 1891</td>
<td>Stocks or marketable securities (including derivatives) of an Irish company or Irish immovable property.</td>
<td>1%</td>
<td></td>
<td>2011: EUR 195 million</td>
<td>2012 estimation: EUR 170 million</td>
<td>financial transactions such as cash withdrawals, bank transfers of economic actors, direct debits, bank card payments, postal financial services and certain transactions of the Hungarian State Treasury. With the aim of restraining payments in cash which could strengthen the grey economy, the rate on cash withdrawals is 0.3%.</td>
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<tr>
<td>Italy</td>
<td>Stamp duty</td>
<td>March 2013</td>
<td>Netting intraday amount concerning transactions of equity related to resident companies. Notional value of financial derivatives on equity related to resident companies. Total amount of HFT (High Frequency Trading) annulled orders above a determined threshold (it will be fixed by a Government Decree not</td>
<td>For shares, two rates of 0.1% and 0.2% are applied, depending respectively on whether the securities are traded on regulated (transparent) markets or “over the counter” without any control by supervisory authorities. However for 2013 only, the two rates</td>
<td>Transactions of equity concerning companies with average market capitalization lower than 500 million euros. Market makers according to the definition given by EU Regulation 236/2012, article 2, paragraph 1, letter K.</td>
<td>2013: 1004.4 millions of euro. 2014: 1214.8 millions of euro. 2015: 1201.9 millions of euro.</td>
<td>Introduced 2013</td>
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<td>Japan</td>
<td>Stamp Tax</td>
<td>1967</td>
<td>Stamp Tax is imposed on taxable documents listed in Appendix Table 1 of the Stamp Tax Act. (e.g., deed of contract concerning transfer real property, deeds of contracts concerning loans, deeds of contracts concerning contracting for work, promissory notes; bills of exchange; share certificates, receipt of money or securities, and deposit certificates, etc. Since the Stamp Tax is due on each document, it is not imposed without taxable documents even if shares are issued or any contracts are made.</td>
<td>The Stamp Tax is imposed on each document at flat or progressive rate according to the type of documents. (For example, in the case of share certificates, tax rate is from 200JPY to 20,000JPY according to the amount written in the certificate)</td>
<td>As a general exception, the documents prepared by governments are non-taxable. Also, tax exemption system exists regarding to the specific type of documents.</td>
<td>About 40 billion JPY in total (in the 2012FY budget).</td>
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<td>New Zealand</td>
<td>Cheque Duty</td>
<td>1908</td>
<td>Bills of exchange and promissory notes. A cheque is a bill of exchange. (It does not include EFTPOS transactions or other electronic withdrawals such as via ATM or direct debit).</td>
<td>5 cents per bill of exchange.</td>
<td>Exceptions are minor: including the Crown, a couple of named charitable organisations and certain societies such as credit unions and friendly societies.</td>
<td>$3.5 million</td>
<td>(year to June 2012)</td>
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<td>Poland</td>
<td>Tax on sale or exchange of property rights</td>
<td>2000</td>
<td>Sale or exchange of securities and derivatives, except Polish treasury bonds etc.</td>
<td>1%</td>
<td>Exemption for transactions within an organized market.</td>
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<td>Portugal</td>
<td>None</td>
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<td>Legislative authorization, in art. 239 of the State Budget. Possible stamp duty.</td>
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<tr>
<td>Switzerland</td>
<td>Transfer duty (a federal tax)</td>
<td>4 October 1917 in a first version</td>
<td>Transfer duty is levied on the transfer of domestic or foreign securities and similar negotiable instruments. The tax is due on any transaction of securities by a domestic securities broker; the latter is liable for the tax. Eurobonds (bonds issued by non-domestic debtors and in foreign currencies) and other bonds denominated in foreign currencies are exempted.</td>
<td>0.15% for domestic securities and 0.3% for foreign securities. The domestic securities broker is liable for the duty; in principle, for each non-exempted party of a transfer half of the transfer duty is owed.</td>
<td>Exceptions include: issuance or cancellation of securities, trade in subscription rights, trade in money market papers, transfer related to a restructuring. Exempted parties include: investment funds, foreign companies listed abroad, foreign social security and pension funds, foreign states and</td>
<td>CHF 1.1 billion</td>
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<td>Switzerland</td>
<td>Issuance duty (a federal tax)</td>
<td>4. October 1917 in a first version</td>
<td>Issuance duty is levied on the issuance of shares of Swiss corporations, Swiss private companies, Swiss cooperative societies, of bonds and money market papers. The tax liability rests with the issuing company.</td>
<td>1% for equity, 1.2% for each year of duration on corporate debt securities and 0.6 o/oo for each year of duration on money market papers. No issuance duty is levied on mergers, changes of legal structure, spin-off of corporations or on the transfer of a company’s seat from abroad to Switzerland. Exempted parties include: Foreign banks, securities dealers and corporate debt securities, amongst others, are exempted.</td>
<td>CHF 600-900m (until 2011), around CHF 350m in 2012</td>
<td>The stamp duty on the issuance of corporate debt securities (bonds) and money market papers was abolished in 2012.</td>
<td>The stamp duty on the issuance of equity is currently under discussion for possible abolition; no timetable has been set.</td>
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</table>
| Turkey    | Resource Utilization Support Fund levy | 26 August 1989  | The principal amount of consumer loans supplied by banks and financial institutions | A) Credits supplied by Turkish Banks & financial institutions; -Consumer credits 15 % (Cabinet Decree 2010/974) - Other credits 0%  
B) Credits obtained by Turkish Banks and financial institutions from abroad 0%  
C) Credits obtained by Turkish residents, other than banks and financial institutions, Housing, building savings loans and residential construction loans extended to persons for their own needs | End of 2012 estimated revenue: RUSF (3.300.000.000 TL) 2012 budget target: RUSF (2.998.684.000 TL) |                                                                                       |                                                                                     |
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<td>Turkey</td>
<td>Banking and insurance transaction tax</td>
<td>1 March 1957</td>
<td>The gain (fees minus the cost of the transaction) obtained by financial companies operating in Turkey (e.g., banking charges, insurance premiums, brokerage fees) that arise from any kind of an activity excluding financial leasing, are subject to BITT, regardless of the fact that they are actually paid or recorded as an income accrual.</td>
<td>3% from abroad&lt;br&gt;6% D) Imports realized under acceptance credits, term letter of credit &amp; cash against goods basis (Cabinet Decree 2011/2304).&lt;br&gt;5% The general current rate of BITT is 5%.&lt;br&gt;For foreign currency transactions, BITT is applied over the amount of foreign exchange sold at the rate of 0%.&lt;br&gt;For the income arising from the deposit transactions between banks, stock exchange money market transactions, repo and reverse-repo transactions and the sale of Treasury Bills and Government Bonds prior to their maturity, the applicable BITT rate is 1%.&lt;br&gt;- Dividend, coupon payment and interest income of tax exempt</td>
<td>- Income generated from the transactions carried out by Turkish resident banks with their branch offices or agents and the transactions carried out between those branch offices and agents.&lt;br&gt;- Income generated from transactions carried out between Turkish branch offices or agents of non-resident banks and their headquarters.</td>
<td>End of 2012 estimated revenue: 4.700.000.000 TL&lt;br&gt;2012 budget target: 4.545.262.000 TL</td>
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<td>United Kingdom</td>
<td>SDRT</td>
<td>1986 - when most transactions became paperless</td>
<td>Purchase price of existing shares in a company incorporated in the UK, or in a foreign company that maintains a share register in the UK. It also applies to an option to buy shares; rights arising from shares, like the rights under a rights issue; and an interest in shares, like an interest in the money from selling them.</td>
<td>0.5%</td>
<td>New issues of shares.</td>
<td>£2.5bn per year</td>
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<td>bonds and bills based on exclusive laws.</td>
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<td>Paper transactions for a consideration over UKP 1000 are also taxed at 0.5%.</td>
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<td>- The cash obtained by the bank from its client and totally transferred to a third party service provider for the purpose of making a service fee payment on behalf of the client.</td>
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<td>For transfers of shares into “depositary receipt schemes” or “clearance services”, a higher rate of Stamp Duty Reserve Tax or</td>
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<td>- The income generated from arbitrage transactions.</td>
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<td>- The emission premiums generated by the banks.</td>
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<td>Stamp Duty applies (1.5%).</td>
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Note: A recent decision by the First Tier Tax Tribunal has changed the scope of the higher rate. More details can be found here: [http://www.hmrc.gov.uk/so/hsbc-holdings.htm](http://www.hmrc.gov.uk/so/hsbc-holdings.htm).
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<td>Australia</td>
<td>None</td>
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</table>
| Austria  | 1953           | Insurance premiums paid to private insurance companies | • 1.0%: Health insurance  
• 2.5% :Life insurance, private pension insurance  
• 4%: All other premiums paid to insurances  
• 11%: short run endowment insurance (duration less than 15 years) | Social security contributions, reinsurance, premiums paid within the mandatory system of dismissal system, etc. | 2011: EUR 1,071 million |                    |                         |
| Belgium  | Included in the Code of miscellaneous duties and taxes (CMDT) introduced in 2007. However, the tax existed before and was included in the Code of taxes assimilated to stamp duties (until 2007) | The tax is levied on premiums (including charges) of insurance contracts with risks located in Belgium. Although the insurance companies are commonly liable to the tax, the burden is generally passed on explicitly to policyholders. | There are four rates :  
1. 9.25%: standard rate;  
2. 4.40%: rate i.a. for life insurances  
(not not taken out individually), death insurance, life annuities and temporary annuities, certain collective additional undertakings for disability and liabilities contracted by pension funds (provided every employee has an “equal right” to be in the scheme);  
3. 1.40%: rate for insurance policies related to the transportation of goods,  
4. 11%: short run endowment insurance (duration less than 15 years) | Various contracts are exempt from this tax, notably credit insurance contracts against commercial risks and/or country risks, contracts for reinsurance, certain insurances in the context of social security, certain healthcare insurances offering a high level of protection, insurances against risks incurred abroad, insurances in the context of pension savings schemes, insurances in the context of the supplementary pension for the self-employed, the | 2011: EUR 1,383.5 million | 2012: EUR 1,646.7 million | The life insurance premium tax increased from 1.1% to 2% from 1 January 2013 onwards, the increase does however not apply to (mortgage) credit balance insurances (‘schuldsaldoverzekerking / assurance solde restant dû’). While insurances in the context of pension savings schemes are still exempted. |
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<td>Canada</td>
<td>The Federal Government first introduced a tax on premiums of certain insurance</td>
<td>A federal excise tax of 10% is levied on certain insurance premiums if the insurance against a risk in Canada is placed with a</td>
<td>10%</td>
<td>This excise tax does not apply to any contract of life, personal accident, sickness, marine insurance or insurance for certain nuclear risks, nor does it apply to any other contract of</td>
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<td>related to liability insurance policies for motor vehicles and to property damage insurance policies in respect of taxis, buses, coaches and vehicles intended for the transportation of goods where the maximum allowable mass exceeds 3.5 tons but is less than 12 tons; 4. 1.10%: rate for life insurances, even in respect of investment funds, and life annuities or temporary annuities built up by natural persons.</td>
<td>conversion of a life insurance payment into an annuity, hull insurances for sea-going vessels, inland vessels and certain aeroplanes, all other insurance policies related to seagoing and inland navigation (except those subject to the 1.40% charge). Compulsory liability insurance policies related to motor vehicles and property damage insurance policies related to motor vehicles or compound vehicles used exclusively for the transportation of goods by road and having a maximum allowable mass of not less than 12 tons, some legal expenses insurance contracts, etc.</td>
<td>The amount of revenues generated annually from this excise tax is not significant.</td>
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<td>policies in 1915. Since then, the tax has been amended 19 times (including its repeal and re-introduction in different form), with the most recent amendment in 1999.</td>
<td>non-authorized insurer, or if the insurance is entered into or renewed through a broker or agent outside Canada, unless the insurance is not available within Canada. In general, a non-authorized insurer is one that is not authorized under the laws of Canada, or of any province, to transact the business of insurance.</td>
<td>insurance that is not available within Canada.</td>
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<td>Denmark</td>
<td>Insurance Premium Tax</td>
<td>2013 (replaces the Stamp Duty which has been in force from 1969 to 2013)</td>
<td>Insurance premium charged in the previous month</td>
<td>1.1 % of annual insurance premium</td>
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<td>1983</td>
<td>Yearly duty on the insurance sum for privately owned boats</td>
<td>1.34 %</td>
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<td></td>
<td>The duty was increased from 1 to 1.34 % from 2012 to 2013</td>
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<td>Finland</td>
<td>1994</td>
<td>Insurance premiums when the insured property/interest in situated in Finland, or the insured interest is related to activity carried out in Finland</td>
<td>23% (net of tax, payable monthly)</td>
<td></td>
<td>EUR 655 million (2012).</td>
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<td>The tax rate will be increased to 24 % at the beginning of 2013.</td>
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<td>France</td>
<td>Established by an act of 31 January 1944</td>
<td>Insurance premiums and other amounts paid to the benefit of the insurer. Insurance conventions concerned: those with a company or with any other insurer or insurance company.</td>
<td>Common rate of 9%, but there are many exceptions. The rates vary from 7% to 30% depending on the insured risk.</td>
<td>Reinsurance contracts, life insurance. The large majority of complementary health contracts (not setting their contributions based on the state of health of the insured) were previously exempt, but are now subject to TSCA since 1st January 2011 with reduced tax rate of 3,5% (instead of 7%). A majored rate of 9% is</td>
<td></td>
<td>TSCA revenues increased by 48% from 2002 to 2011 (EUR 4.7 bn in 2002 and a little more than EUR 7bn in 2011). TSCA revenues should increase by EUR 2 bn from 2012, under the effect of taxation in 2011 to the TSCA of the contracts of complementary health previously exempt, which takes full effect</td>
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<td>Germany</td>
<td>08.04.1922</td>
<td>Gross premiums for direct business (special cases are listed below at “tax rate”)</td>
<td>19% Exceptions: tax rates (as of 1 July 2010) on home contents insurance (19% of 85% of the insurance premium), residential building insurance (19% of 86% of the insurance premium), and fire insurance and insurance against business interruptions due to fire (22% of 60% of the insurance premium). Other rates include 3% of the premium for marine hull insurance and 3.8% of the premium for accident</td>
<td>No premium taxes on health insurance, reinsurance or life insurance, and statutory unemployment insurance</td>
<td>2012: 11,100 Mill. € (on cash basis)</td>
<td>Change of the tax law “Gesetz zur Änderung des Versicherungsteuergesetzes und des Kraftfahrzeugsteuergesetzes (Verkehrsteueränderungsgesetz - VerkehrStÄndG) vom 5. Dezember 2012</td>
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<td>insurance with no-claims bonus. For hail damage insurance, the rate is at 0.02% (from 1.1.2013: 0.03% - also for &quot;storm, mayor frost, floods&quot;) of the policy amount.</td>
<td></td>
<td>(BGBl. I S. 2431), in Kraft seit 12.12.2012&quot; as described at „tax rate“</td>
<td>The tax is levied on insurances except for life insurance as of 2013. The rate is 10% for property and accident insurance; and 15% for casco motor vehicle insurance. At the same time, the existing 2 surtaxes to be currently paid by insurance companies were abolished (surtax on financial corporation, fire protection contribution).</td>
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<td>Hungary</td>
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<td>1982 non life premiums, 2009 life premiums, 2011 pension schemes (for a period of 4 years)</td>
<td>Non life and life policies - the insurance premium, Pension schemes – asset value of scheme</td>
<td>Non life – 3% of premium Life – 1% of premium Pension scheme – 0.6%</td>
<td>2012: Non-life €101m Life €22m Pension €475m</td>
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<td>Ireland</td>
<td>1982 non life premiums, 2009 life premiums, 2011 pension schemes (for a period of 4 years)</td>
<td>Non life and life policies - the insurance premium, Pension schemes – asset value of scheme</td>
<td>Non life – 3% of premium Life – 1% of premium Pension scheme – 0.6%</td>
<td>In the case of non-life premiums, the exceptions are re-insurance, voluntary health insurance, marine, aviation and transit insurance, export credit insurance and certain dental insurance contracts.</td>
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<td>Luxembourg</td>
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<td>Insurance premium, provided that risk insured or policyholder is located in Luxembourg</td>
<td>4% (and an additional 6% for fire insurance)</td>
<td>Life insurance premiums, reinsurance premiums</td>
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<td>Netherlands</td>
<td>01-Jan-72</td>
<td>Total amount of premium charged to the insured</td>
<td>from 1 March 1983: 7%; from 1 March 2008: 7.5%; from 1 March 2011: 9.7%</td>
<td>Life, Marine Insurance, Vehicles registered in another EU-country, Aircraft used for international public transport or registered in another EU country, Goods in transit, Health insurance/individual accident, Travel insurance, Export credit insurance, Reinsurance</td>
<td>EUR 2,247 million (2013)</td>
<td></td>
<td>Tax rate to be increased from 9.7% to 21% (not legislated) by January 1st</td>
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</tbody>
</table>
| Portugal     | In 2003 (Decree-Law n.º 287/2003) (last update). | 22.1 Insurance contracts 22.2 Commissions on intermediation activities | Insurance Contracts:  
  - Guarantee: 3%  
  - Accident, Illness, Credit, Agriculture and Stockbreeding, Transport of Goods, Ships and Airplanes: 5%  
  - Other: 9%  
  Tax rate on 22.2 Commissions on Intermediation Activities is 2% | a) Ceded reinsurance from companies legally operating in Portugal.  
  b) “Life” insurance premiums and commissions | 2010: EUR 309.1 million (National Accounts) |                     |                                                     |
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<tr>
<td>Slovenia</td>
<td>Insurance contracts tax was introduced in the year 1999.</td>
<td>The insurance premium or contribution paid on the basis of the concluded insurance contract.</td>
<td>6.5% of the tax base.</td>
<td>The tax is not charged on:</td>
<td>Revenues from the insurance contracts tax added up to EUR 69.2 million in the year 2010, EUR 71.2 million in the year 2011 and are estimated to remain at the same level in years to follow.</td>
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<td>Spain</td>
<td>01-Jan-1997</td>
<td>Insurance and Capitalization Transactions. The tax is passed on to the party paying the insurance premium. The tax base is based upon the insurance</td>
<td>6%</td>
<td>Life Insurance Policies; Re-insurance; Capitalization Transactions, Credit Insurance, Agricultural Insurance; Insurance Linked to Exports and International Transport; Social Insurance and</td>
<td>Around 0.15 of GDP (figures below in million EUR)</td>
<td>• 2005 – 1 404</td>
<td>• 2006 – 1 478</td>
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<td>Sweden</td>
<td>1991</td>
<td>premium paid.</td>
<td>45%</td>
<td>For the government and possible other employers who, instead of using group life insurance, pay an amount comparable to compensation in group life insurance the tax is 81.83% on the whole paid amount.</td>
<td>SEK 953 million</td>
<td>est. revenue: SEK 852 million</td>
<td>est. revenue SEK 813 million</td>
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<tr>
<td>Switzerland</td>
<td>4. October 1917 in a first version</td>
<td>Insurance duty on insurance premiums is due on payments of premiums on liability and collision insurance policies as well as for certain property insurances. In general, the domestic insurer is liable.</td>
<td>5% in general and 2.5% for life insurance (redeemable, single premium)</td>
<td>The duty is not charged on, among others, policies covering life (non-redeemable life insurance or redeemable life insurance with periodic premium payment, life insurance as part of an occupational pension plan), old-age, illness (health and disability insurance), unemployment, natural hazards, accidents, and</td>
<td>CHF 680 million</td>
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| **United Kingdom** | 1 October 1994  | Insurance Premium Tax is a tax on general insurance premiums, where the insured risk is located in the UK. | There are two rates:  
  • a standard rate of 6 per cent (increased from 5 per cent on the 4 January 2011)  
  • a higher rate of 20 per cent (increased from 17.5 per cent on the 4 January 2011) for travel insurance and some insurance for vehicles and domestic/electrical appliances | Most long-term insurance is exempted from the tax, as is reinsurance, insurance for commercial ships and aircraft and insurance for commercial goods in international transit.  
Premiums for risks located outside the UK are also exempt, but they may be liable to similar taxes imposed by other countries. | Total revenue was £2.9bn in 2011/12. An estimate has been made of the amount of Insurance Premium Tax which is paid by the banking sector using information provided by HMRC banking sector teams.  
Companies without a UK establishment can be liable to IPT where the risks being insured are located in the UK, so the IPT population will include non-UK resident companies.  
HMRC estimates that net cash IPT receipts of the banking sector are £0.3bn in 2011-12.  
These figures include tax paid at both the standard and higher rates. |                      |           |

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The International Tax Dialogue (ITD) is a joint initiative of the European Commission (EC), Inter-American Development Bank (IDB), International Monetary Fund (IMF), Organisation for Economic Co-operation and Development (OECD), World Bank Group and Inter-American Center of Tax Administrations (CIAT). The ITD aims to encourage and facilitate discussion of tax matters among national tax officials, regional tax organisations, international organisations and other key stakeholders.