

INVESTMENT CLIMATE IN PRACTICE

BUSINESS TAXATION

SMALL BUSINESS TAXATION

REFORM TO ENCOURAGE FORMALITY AND FIRM GROWTH

Reforming a tax system for small businesses is complicated. No single best practice can solve all the issues that arise in trying to implement a tax system that is simple, administer-able, and equitable. This note presents a menu of considerations and “good practice” options. It is the first in a series of five notes addressing issues that governments of developing countries face in reforming their tax systems.

When small business taxation is considered solely from a revenue perspective, its potential for developing countries is often overlooked. The benefit of a wider tax base in the medium to long term may not seem to offset the comparatively high cost of administering small contributors. However, small business taxation should be seen as an entry point to formality. A good tax regime for small firms is a key policy tool to pave their way out of the “informality trap” of low growth, limited access to markets, and exclusion from formal financial services. A formal small-business sector advances reciprocal relationships between the state and a majority of its citizens—those involved in small-scale economic activities.

GENERAL DESIGN PRINCIPLES

Innovative and successful taxation strategies to encourage formalization are in short supply, even though the parameters for a good regime seem relatively straightforward. Small business taxation should be designed with minimal compliance costs, requirements commensurate

with taxpayer capacity and skills (in accounting, for instance), and very few interactions with government officials to limit opportunities for corruption. Compliance should be linked to the benefits of being formal. The administrative costs of dealing with small taxpayers must be kept to a minimum for resource- and capacity-constrained tax authorities. Combining and reconciling these objectives into a detailed and actionable strategy is difficult; tax policy-makers always face trade-offs between simplicity, fairness, efficiency, and administrative feasibility.

NO SINGLE “BEST” SOLUTION

There are several options, but no one absolute design for a clear, simple, and transparent system that reduces compliance costs for small firms and administrative costs for the tax authorities. Country specifics and legal tradition require individual solutions, and successful tax regimes are sometimes less dependent on the design of the right instruments than on the quality of tax administration. The design of a

JAN LOEPRICK

Jan Loeprick (jloeprick@worldbank.org) advises client governments as a member of the World Bank Group’s Investment Climate Department (CIC) business taxation product team. His work focuses on tax regime diagnostics and the implementation of reforms that will reduce barriers to compliance, investment, and growth in developing countries.

This note and others in the series of IN PRACTICE notes on business taxation reform were developed as part of a joint program between DFID (the United Kingdom’s Department for International Development) and CIC. The program focuses on operational issues in tax reform, particularly those related to micro-enterprises and small businesses. The CIC business taxation product line helps governments implement effective tax systems to spur investment and economic growth.

small business tax regime needs to be guided by the quality of institutions in place.

Simplify the general system or create a special regime?

At the outset there are basically two options (see Figure 1). First, reform measures can offer a simplified procedure based on the general provisions of the existing tax system. The same instruments apply, but they are streamlined for smaller firms. This approach is relatively common in more developed economies. In countries with high levels of informality, a pronounced departure from the general system may be justified to encourage formalization of small and medium-sized enterprises (SMEs). In these cases, a single presumptive tax is introduced to replace all other fiscal levies.

THE COSTS OF INFORMALITY

Informality comes at a price to both firms and governments. For many reasons, informal firms are less apt to grow and invest. Governments suffer both from the lack of formal entrepreneurship that can drive economic growth and the loss of tax revenues to pay for public goods and services.

- Companies in the informal sector need to operate under the radar of the tax administration. Therefore, they often prefer to restrict firm size and growth to avoid attracting attention.
- The lack of access to formal financial services limits firm investments.
- Informal firms are usually excluded from public procurement contracts, which often constitute a considerable part of the economic activities in developing countries.
- Operating informally is not free of charge. Informal firms may need to frequently change location or activities, pay bribes, or split their businesses into several smaller units at various locations.
- Informal firms tend to have lower productivity because they operate in an uncertain state and do not invest in their businesses and employees.

Source: FIAS (2006).

Presumptive systems are usually based on turnover, assuming that most firms monitor their cash receipts, or on specific indicators (for instance, floor space, number of employees, or electricity consumption) or a combination of the two. Another option, to be implemented in Egypt, is to approximate the small business' taxable income as its cash flow, which is defined as the difference between cash receipts and expenses. The cash flow system has more record-keeping requirements than turnover- or indicator-based regimes, but is better suited in graduating firms to the general system. Turnover can be taxed directly at a low rate, or used to determine assessable income based on a factor approximating profitability.

The main idea behind all presumptive schemes is to reduce the time and costs of compliance and tax administration. These regimes trade fairness for simplicity and may introduce distortions into the system. Indicators are usually crude proxies for business profitability. Turnover-based systems are burdensome for firms with low profit margins and generous for those with high margins. Special simplified regimes for small firms are in demand and frequently recommended to promote compliance. Many developing countries already use some sort of presumptive tax systems for small contributors. Results are mixed; again, the main challenge in most countries is to make presumptive taxation work on an administrative level.¹

ADMINISTERING SMALL BUSINESS TAXATION

In many developing countries, the administration of small firms is an afterthought for tax administrations and in technical assistance programs. This is due to the low benefit-cost ratio of administering small contributors from a revenue perspective.

Whether or not a special tax is introduced, a special administrative approach for small firms is indispensable. Low compliance costs are essential to encourage formalization, because the time and financial burden of complying with tax reporting is relatively higher for small firms. For example, a FIAS survey of tax practitioners in South Africa shows that compliance costs decrease dramatically as firm size grows. Instruments to achieve scale-based efficiencies include the tools of modern tax

administration: self assessment by firms, risk-based auditing by the administration, support services, and technological solutions. However, introducing these requires careful preparation; self-assessment, for example, requires records that many small firms might not be able to provide without support services. Also, tax administrations usually have to develop a general trust in the small taxpayer, conducting only few risk-based audits.

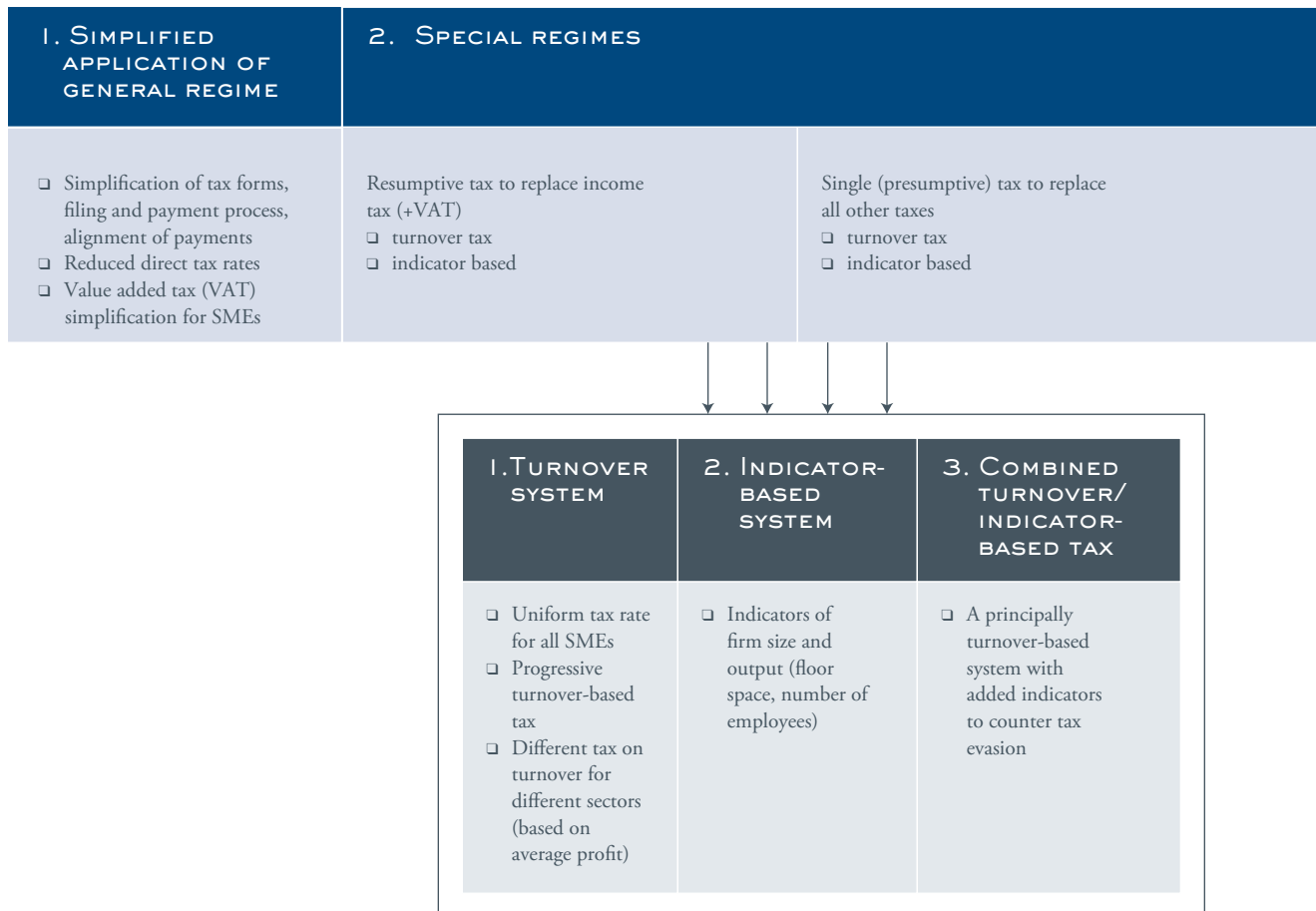
Local administration

Local government often plays a critical role in the tax administration of small operators. Municipal levies may inhibit the creation of formal enterprises.

For example, small operators in Sierra Leone indicated in a FIAS survey that licensing costs and requirements are a key driver of continued informality.

Coordination between government agencies is usually poor, with inconsistent local and central government policies and multiple non-transparent taxes, fees, and non-regulatory “licenses” at the local level. This dynamic provides ample opportunities for corruption and increases both firms’ compliance costs and the administrative costs of local authorities. Creating a successful small business administration is thus closely linked to the decentralization agenda.

FIGURE 1: DESIGNING A SYSTEM FOR TAXING SMALL BUSINESS



As shown at the top of the figure, governments should first consider two basic options when designing tax reform for small business: a simplified application of the general tax regime or a special regime. In developing a special regime with a presumptive tax, how much firms are taxed can be based on one of three measures, as shown at the bottom of the figure.

Fiscal decentralization reduces the distance between firms and their tax administration in order to improve accountability, visible returns, and services, and ultimately, to increase the potential for voluntary compliance. Many countries around the world give significant fiscal autonomy to local authorities. A full devolution of policy and administration of small business taxation to the local level (including setting rates, determining the tax base, and collecting revenues) is consistent with the decentralization agenda of increased local autonomy.

BASIC PARAMETERS FOR SUCCESSFUL SMALL BUSINESS TAXATION

Government policymakers should consider the particular challenges of small firms and those caught in the “informality trap” when designing a taxation regime that will encourage formality and firm growth.

- ❑ In countries with high levels of informality and low administrative capacity, a single presumptive tax that replaces all other fiscal levies may be justified to encourage formalization. This sort of approach would be a departure from the general system for micro and small businesses.
- ❑ Formalization may not always be appropriate, so thresholds need to be set in order to disaggregate micro-, small-, and medium-sized enterprises. This will distinguish subsistence activities from small businesses with a lot to gain from becoming formal.
- ❑ While technical assistance on tax is typically focused on the central government, taxation of small business needs to build on local institutions and address problems of local regulations.
- ❑ A cost-benefit analysis of small business taxation needs to include the state-building impact of tax compliance. The focus of small business taxation should be to encourage voluntary compliance; coercion alone is impractical and counters the idea of a social contract.
- ❑ A simple and streamlined taxation regime is necessary, but not sufficient to encourage enterprise formalization and growth. Tax reforms should be accompanied by the provision of information and basic business services.

However, the role of local administrations should be cautiously assessed. Political capture by non-accountable local elites can be worse than a corrupt, but remote, central authority. Moreover, fully independent taxing power for subnational governments may conflict with tax harmonization and coordination objectives and reinforce the tendency to squeeze revenue from small operators.

A centralized small business tax unit

A specialized tax unit realizes economies of scale in dealing with small businesses, rather than relying on resource- and capacity-constrained local authorities. Such a unit, similar to separate large taxpayers’ administrations, is responsible for guiding policy decisions on small taxpayers’ compliance issues, and for improving services and outreach to small businesses.

The long-term benefit of increasing compliance could justify the significant external funding required to cover the costs of rolling out a cluster of centrally administered, small taxpayer offices. In large countries, where central tax administrations tend to focus activities on the core areas of economic activity, local government structures remain key players for the collection of small taxpayers’ contributions. The main challenge under a new tax regime is to reduce administrator discretion and harassment of taxpayers at all levels of government.

Private intermediaries and new technology

A complementary option to centrally or locally run small business taxation is to outsource the administration of small firms to the private sector. While controversial, private collection is not a new concept² and can help governments reduce administrative costs and achieve more efficient tax administration. However, the state’s long-term interests to expand the tax base and encourage growth tend to conflict with private collectors’ interests in making (short-term) profits. Governments also need to ensure that taxpayer abuses are avoided. Thus, while privatization reduces the direct costs of administering taxpayers, it requires substantial and costly monitoring efforts by governments to ensure justice and equity. As a result, privatization is recommended only for a few

functions that can be easily screened and require little discretion of the private administrator.³

Technology may open additional options for public-private cooperation in administering small firms. E-filing of tax returns to reduce administrative and compliance costs is widespread and offers good opportunities for capacity-constrained governments to cooperate with the private sector. Although the scope for full e-government solutions may be limited in countries with heavy infrastructure constraints, there may still be widely applicable solutions based on technology already in use. For example, tax payments via mobile phone-based banking systems could allow businesses to pay taxes and fees directly, thus reducing interactions with tax collectors and ensuring that payments arrive at their destinations.

APPLYING LESSONS LEARNED TO DESIGN AND IMPLEMENTATION CHALLENGES

Defining and disaggregating smaller firms

There is no universal definition for small and medium-sized enterprises. Small and medium-sized firms in an OECD⁴ environment are considered large in most developing countries. For purposes of taxation, it is misleading to consider smaller firms as one homogenous block; different sized businesses may require different policy approaches. Encouraging voluntary compliance is usually the goal for micro and small businesses. Curbing tax evasion by larger medium-sized firms requires advanced control mechanisms. A variety of criteria including volume of sales, size of workforce or capital, form of ownership, production techniques, capacity, size of premises, and energy consumption can be applied to disaggregate firms. Arguably, the simplest and most common way to segment taxpayers is by turnover.

Setting adequate thresholds

To tap into the growth potential of informal businesses, it is important to target those likely to benefit significantly from becoming formal. These entrepreneurs will see value in accessing new

markets and financial services and in realizing security of tenure and investments. Thresholds should be set to distinguish between three levels: subsistence micro-activities, small firms, and medium-sized operations. These thresholds will inevitably create incentives and result in strategic behavior among firms, so any special presumptive tax regime needs to include safeguards against abuses.

ADMINISTRATIVE REFORMS FOCUSED ON SMALL BUSINESS

The following administrative reforms contribute to a streamlined system for small business taxation that makes it easier for small firms and entrepreneurs to comply.

- ❑ Specialized taxpayer offices and segmented offices can ensure specialized taxpayer services, effective feedback and complaint mechanisms, and a credible and affordable appeals process.
- ❑ Streamlined procedures: overall and for small firms. Procedures, forms, and payment modalities must be tailored to small firm capabilities. Bookkeeping requirements need to be simplified.
- ❑ Self assessment and risk-based verifications. Small businesses should be able to declare turnover, determine their tax liability, and pay in a single step. Audits need to be risk based, selective, and limited to turnover verifications.
- ❑ Improved outreach to small taxpayers and compliance support services (possibly through private intermediaries). Small operators may not have access to information on how to register or operate a firm formally. Education campaigns and support services at the local level are required to facilitate compliance for small taxpayers.
- ❑ Streamlined local regulations and coordination of central and local tax efforts ensure that the local tax burden does not become a deterrent to formalization.
- ❑ Information technology solutions, including e-government and payments through mobile phone banking channels, can streamline the process and simplify access for taxpayers to pay.

Determining profit margins and setting appropriate rates

Constructing appropriate indicators and setting an appropriate tax rate is challenging. It requires extensive analysis of profit margins and will usually be disputed by some in the business community. Small businesses are not necessarily small earners; rates need to be high enough to encourage firms at the upper end of the threshold to join the general system and low enough to encourage informal entrepreneurs to comply. This process requires extensive survey-based analysis of small firms' profit margins to determine presumptive tax rates.

Building linkages between taxation, licensing, and business registration fees

The central goal of small business taxation reform is to further participation in the formal economy and build a culture of compliance. Yet many countries have important non-tax barriers to formalization. Minimizing compliance cost goes beyond taxation issues and should include other start-up and operations procedures (for instance, business licensing and labor regulations). In practice this is often more challenging than it may sound; for example, credible transfer mechanisms may be required to compensate local governments for foregone revenues.

Linking the costs and benefits of formalization—offering “carrots”

Given that operating (in)formally is based on a rational and strategic decision, it is necessary to creatively link the costs of formalizing to the existing and new benefits of formal status. Tax reforms should be accompanied by a plan to provide information and basic business services, such as bookkeeping and marketing. It may be worthwhile to consider establishing an institution to combine simplified compliance with the provision of some targeted services. This gives informal businesses a single point of contact with the state.

Integrating small businesses into the reform process through regular consultative dialogue

Bringing small operators into the formal economy requires their trust in the tax authority. Perceptions can be changed through improved outreach, services, and public-private dialogue to engage the private sector in the reform process from the outset.

CONCLUSION AND OUTLOOK

Moving informal businesses into the formal economy through taxation requires a simple process that can be easily mastered even by small operators. Despite the challenges highlighted above, the simplest approach—a presumptive tax based on turnover—may well be the most appropriate solution for many developing countries with large informal sectors. A single tax is particularly useful in countries with numerous small “nuisance” taxes, and if well-administered, is likely to have a strong signaling effect encouraging informal entrepreneurs to become compliant. Micro-enterprises should be required to pay a one-time fee per year (possibly in several installments) and medium-sized firms should be expected to comply with the general system (with some simplifications, for example, less frequent VAT payments). Special schemes for certain hard-to-tax sectors may be useful tools to consider.

A new design of instruments is often necessary to make administrative improvement possible, but insufficient without reform of day-to-day administration. Perceptions need to be changed on all sides to build a culture of compliance. Better services, outreach, and integration of the private sector into the reform process can go a long way in building trust between small contributors and tax authorities. In addition, existing and newly created benefits of formality need to be linked to tax compliance.

ENDNOTES

- ¹ Because of the small revenue potential of the small and medium-sized business sector, many presumptive regimes were introduced without the necessary resources to properly administer small taxpayers. As a result, tax bills for contributors below the large taxpayer threshold often remained negotiable, with the unsurprising result of widespread corruption.
- ² Private tax collection dates back to the Roman Empire when individuals bid for the right to collect taxes in a territory and subsequently attempt to cover their costs. A more common arrangement today is for private firms to collect taxes on behalf of the state for a set fee.
- ³ See: Stella (1992). A good example of such a privatization of administrative functions is the recent decision to outsource the collection of taxpayers' debts to private agencies in the United States. Similarly, some countries (Mozambique, Singapore) rely on private agents to administer customs systems.
- ⁴ Organisation for Economic Co-operation and Development.

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IN PRACTICE

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