

Small Business Taxation & Informality

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Outline

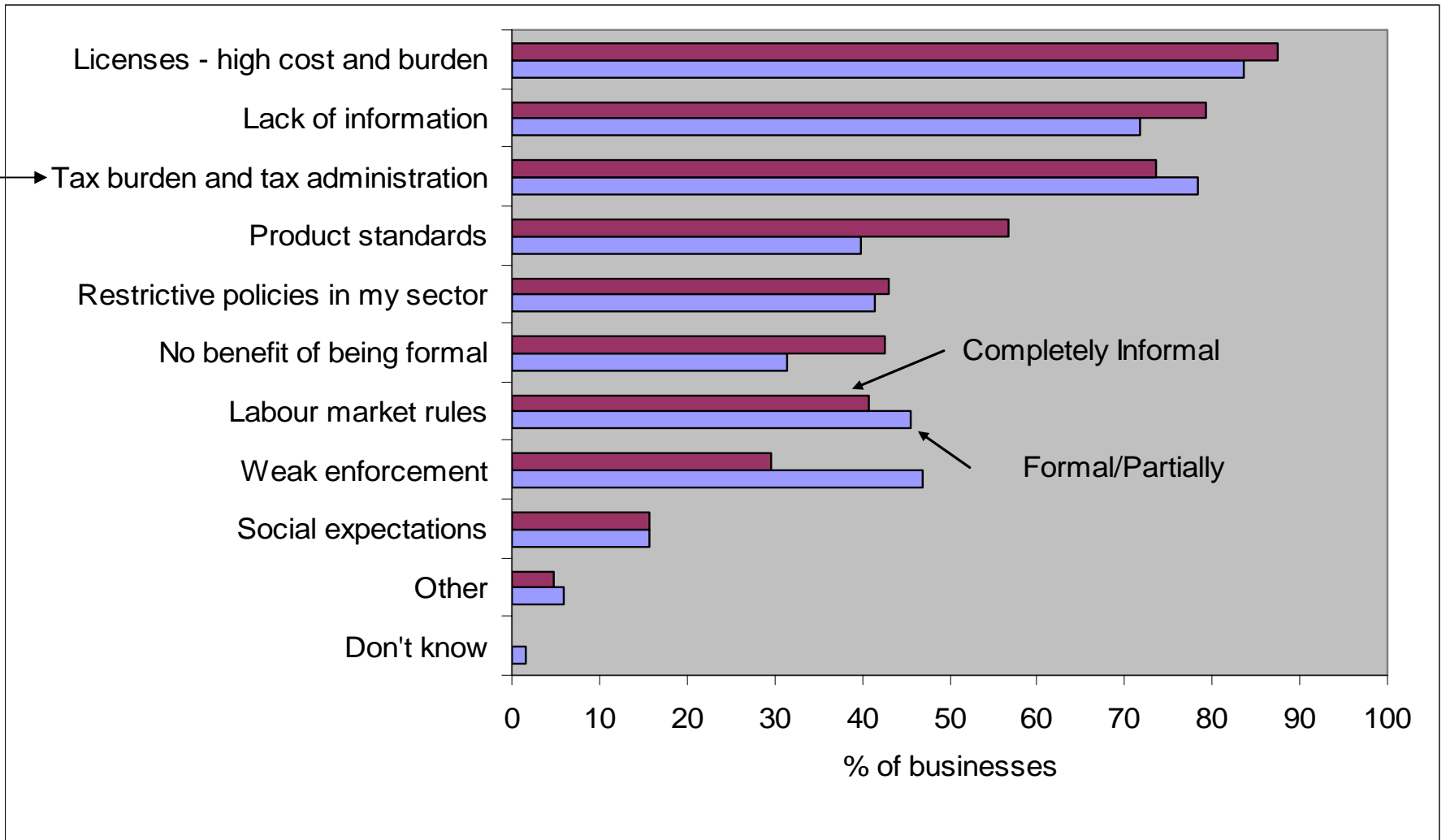
- Tax and informality – the nexus
- Taxing small businesses – issues in design and implementation
- Designing a small business tax regime

Does the tax system encourage informality?

- Sierra Leone – 76% of businesses surveyed believe the main reason for informality is tax (financial and administrative burden).
- Rwanda – 65% of businesses believe the main reason for informality is the high tax burden.
- South Africa – 38% of informal operators identified taxation as biggest disincentive to registration.

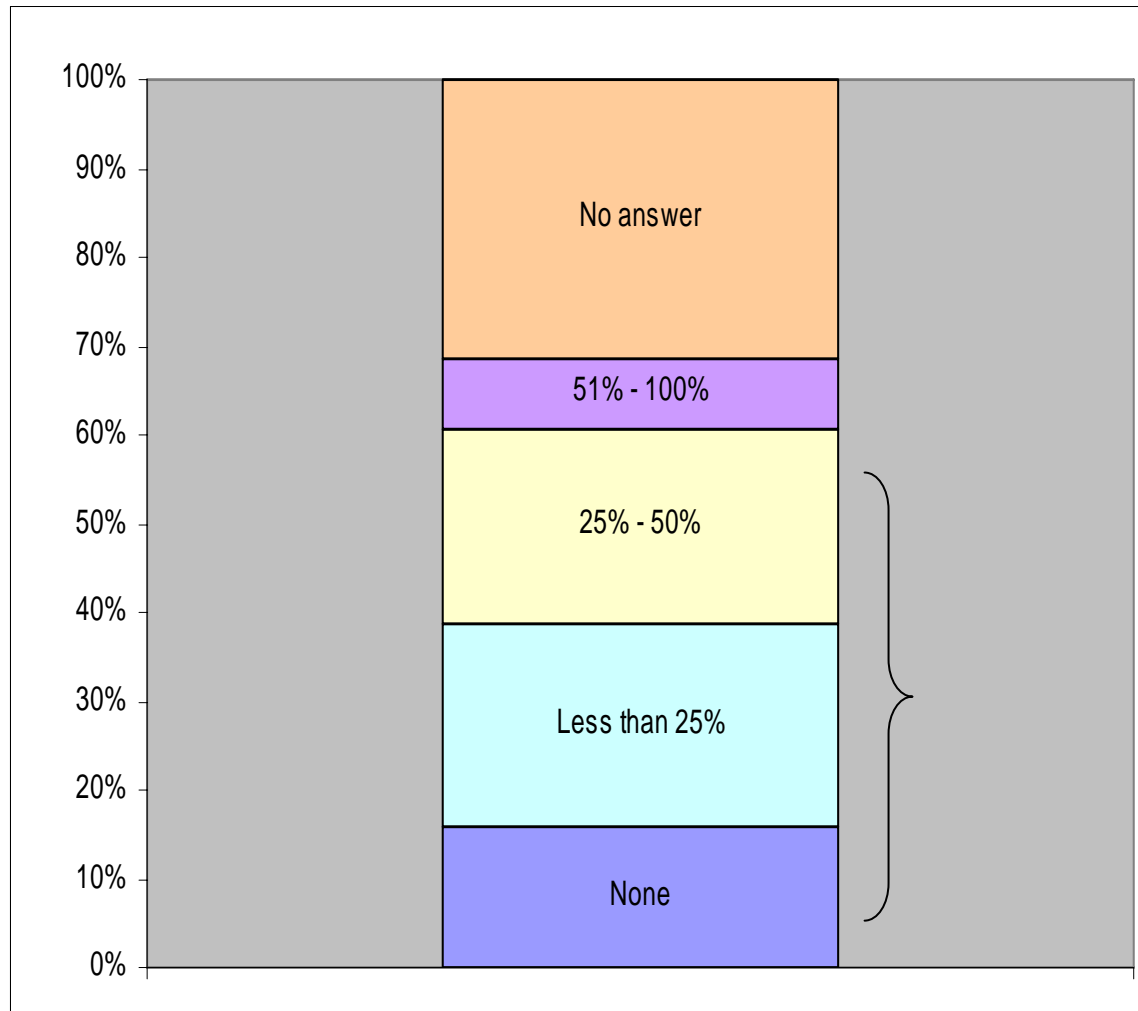
 Total obligations – taxes, local fees, levies – are concern

Reasons behind decision to operate informally – Sierra Leone



How large is tax-related Informality – Sierra Leone

Most businesses claim to report less than 50% turnover



Why are businesses reluctant to join the tax system?

- Level of taxes and administrative costs
- Do not know how to comply with often complex requirements
- Fear consequences of bringing themselves to attention of tax officials
- Do not believe they will receive services in return
- Fear of being caught for non-compliance due to rules not understood or opaque
- Low detection due to weak enforcement

Why tax the informal sector?

- Large size and growth of informal sector
- Revenue generation (longer-term)
- Reinforce social contract between citizens and state (provision of public services and goods in return for payment of tax)
- Impact on tax compliance in formal sector; Large firms squeezed for taxes due to narrow tax base
- Enterprise growth – through formalization allow firms to access formal credit markets, government procurement, and markets
- In many countries the only interface small entrepreneurs have with the government is with tax authorities
- Businesses prefer to pay legitimately to government rather than to corrupt officials to stay in business

Constraints to taxing the informal sector

1. Administrative

- Tax authorities do not have the resources or personnel capacity to implement, monitor and enforce tax laws.
- Informal sector characterized by:
 - transience and uncertainty
 - cash transactions dominate
 - indifference to formal accounting (illiteracy and shortage affordable accountancy services)
 - mobility in operations (transportation, street vending activities) makes enforcement difficult
 - no culture of compliance
 - difficult for revenue authorities to develop closer links and gather data; high cost of administering and low revenue

2. Political (large informal sector represents substantial vote bank)

TO ENCOURAGE SMALL BUSINESSES
TO FORMALIZE, A SIMPLIFIED SMALL
BUSINESS TAX REGIME IS
NECESSARY...

Why a differential treatment for small businesses?

- To correct for market failures due to capital market imperfections (credit constraints due to asymmetric information)
- To maintain a level playing field in face of steeply regressive compliance costs for small businesses
- Problems:
 - discourages “graduation”; discourages growth e.g. division of businesses
 - high cost of administering small businesses for tax authorities and relatively low amount of revenue.

Problems with existing small business tax regimes

- Lack of flexibility to choose the regime (small or standard) which best fits the firm based on capacity and type of business.
- Design issues/rates of the simplified tax system, and lack of built-in incentives for graduation.
- The failure to facilitate capacity building and training on business accounting practices with a view toward helping firms graduate to the standard tax regime.

Problems with existing small business tax regimes (cont.)

Direct Taxes

- Corporate tax design issues: flat taxes vs turnover taxes vs CIT.
- Solution perhaps is a two-tiered system combining special regime with simplified form of the 'large taxpayer' regime.

Indirect Taxes

- VAT issues. Administration costs (to firm and RA) lead to non-registration (voluntarily or involuntarily), which leads to high METR on SMEs.
- Again, perhaps the solution is a simplified form of VAT (UK) with opt-in.

Problems with existing small business tax regimes (cont.)

Other Issues

- *Education and outreach* – ongoing effort required, but long-term gains. Could target certain groups (expanding businesses, rural, women, etc.)
- *Fees and levies*, although technically non-tax, and not collected by the RA, are perceived taxes and are often a large burden (financially and administratively). Flat fees are regressive.
- Links with the *personal tax regime* (many SMEs operate as sole proprietors). Incentives for incorporation. Can be more or less progressive.

Designing a small business taxation regime – some ideas

- **Simplify** to lower costs of complying and administering tax system
- Minimize direct contact between tax officials and taxpayers
- Consider single taxes for micro-businesses (Kenya Brazil)
- Consider simplified general regime or turnover tax for 'larger' small businesses: tax rebates, cash accounting, fast/immediate write-offs for equipment, deductibility of accountant fees, quarterly/bi-annual VAT returns etc.
- Expand education and outreach to facilitate formalization and full compliance; share information on what taxes are used for and how businesses benefit
- Encourage record-keeping abilities and build capacity
- Small taxpayer's unit

Group Exercise

Designing a Small Business Tax Regime in “Taxistan”

- Identify three main goals of the small business regime
- Design the main elements of a small business regime