MSME Taxation and State Building: Partnering in progress

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THE WORLD BANK
International Finance Corporation
Multilateral Investment Guarantee Agency
Agenda

Why focus on MSME tax design?
Can MSME tax reform contribute to state building?

The technicalities:
Key tax policy and administration issues in
MSME tax design
Tax regimes are often major constraints to business...

- Tax rates and tax administration constantly ranked across regions among top 5 major constraints for businesses

![Bar chart showing firms identifying issues as major constraints]

- Source: Investment Climate Assessments [all countries, 2002-10]
- * Data for "Courts Functioning" only available since 2006.
- ** Excludes "corruption", "crime", and "informality".
small firms are typically more burdened – eg. Georgia

Share of Firms Who Rated Tax Administration as a Major Obstacle to Their Businesses

(Source: Enterprise Survey 2008)

- 20% for small firms
- 8% for medium firms
- 4% for large firms
- 15% for total
Small firms are typically more burdened – eg. Bihar, India

Cost of compliance, as a percentage of turnover significantly higher for small businesses

Source: IFC Tax Compliance Cost Survey Bihar, 2009
Small firms are typically more burdened – eg. South Africa

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

Source: FIAS Tax Compliance Cost Survey South Africa, 2007
Corruption is also a major factor

- Vietnam, 52 per cent, Bangladesh, 85 per cent, reporting need to make informal payments (Enterprise Surveys, 2009 and 2007)
- Yemen, 37% of surveyed formal firms reported they paid bribes (FIAS Survey, 2008)
- Uganda, 52 per cent of firms surveyed reported bribes needed to “get things done”; 23 per cent reported corruption is a “serious concern” (ICA, 2009)

**Bihar, India:**

- It is easier to avoid paying VAT as compared to cost and problems faced with its compliance process
- Businesses would be willing to pay more tax if corruption is not prevalent
- The process of complying with tax is more burdensome than the amount of tax itself

Source: IFC Tax Compliance Cost Survey Bihar, 2009
When the costs of tax compliance are too high...

- Businesses stay out of the formal economy and can get a “free-ride”
- However: more risks, less opportunities (esp. access to finance)
- Serious limitations to business growth...
- Government is not reaching revenue potential
- Spurs vicious cycle of “squeezing” the few compliers => ticket price↑
There are actual benefits of MSME tax compliance

- The risk of tax inspections, both formal and informal, is significantly reduced: less likelihood of having to pay bribes to stay out of tax net
- Remove limitations to business growth…need to split firms and business to stay below turnover, for example…
- Greater opportunities to access formal (i.e., bank) finance
- Opportunities to get government contracts – usually restricted to tax-registered entities
- In a VAT regime, small un-VAT-registered firms lose business opportunities
- MSME taxation a good instrument to strengthen local government and foster links between the local small business community and the local government
- In the medium/long run, higher tax revenues for the government
Agenda

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The technicalities:
Key tax policy and administration issues in MSME tax design
The Theory: A quick summary of pros and cons of taxing MSMEs differently

### Why?
- SMEs role in fostering innovation and growth
- Compensating for Market failures/financing constraint
- **Fixed cost component of tax compliance** + Cost of administering small contributors
- Simplicity can help close avenues for corruption

### Why not?
- Disincentive to growth (jump in compliance financial burdens)
- Better to address distortions directly
- **Threshold effects:** Inverted U shape of effective rates
- Distortions can become a source of corruption
General guidelines for MSME tax design…:

- For small firms, system has to be easy to comply with - minimal compliance costs
- For the authorities, the system must not require excessive administration -
  ideally based on taxpayer self-assessment and risk based verification by the tax-authority, ...
- Tax system has to encourage growth of business (advantages to graduation)
- Special regimes need to include safeguards against abuses
- Need to distinguish firms which have a lot to gain from becoming formal from subsistence activities (SMEs? – Micro vs. Small vs. Medium)
### Design options and key issues

<table>
<thead>
<tr>
<th>1. Simplification of gen. regime</th>
<th>2. Special regimes</th>
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<tbody>
<tr>
<td>- Simplification of tax forms, filing and payment process, alignment of payments</td>
<td>a. Presumptive tax to replace income tax (+VAT)</td>
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<tr>
<td>- Reduced direct tax rates</td>
<td>b. Single (presumptive) tax replacing all other taxes</td>
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<tr>
<td>- VAT simplification for SMEs</td>
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- **What is “small”? No universal definition**
- **How should the system be designed to avoid both over- and under-taxation of MSMEs?**
- **What kind of safeguards are required to avoid abuse of system by larger businesses?**
- **How to align the MSME regime with the standard tax regime?**
- **System must be perceived as fair and transparent**
- **How to provide incentives for keeping proper books and records?**
The practice: A wide range of Tax Treatment of MSEs

- From very simple patent taxes (e.g. Nepal, Kosovo in the 1990s) to full application of standard regime (some OECD countries)

- From high VAT registration threshold (Singapore, Italy, Gabon) to no threshold at all (Vietnam)

- From exemption of micro businesses from taxation to uniform treatment of all MSEs.

But also on the administrative side:

- From practically exempting most MSEs from tax audit (Korea, Germany) to comprehensive audit coverage (some FSU countries)
There are important regional differences

<table>
<thead>
<tr>
<th>Region</th>
<th># Countries analyzed</th>
<th>Countries operating presumptive regimes</th>
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<tbody>
<tr>
<td>European Union</td>
<td>21</td>
<td>8</td>
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<td>Transition countries</td>
<td>19</td>
<td>16</td>
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<td>The Americas</td>
<td>19</td>
<td>16</td>
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<td>Africa</td>
<td>25</td>
<td>23</td>
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A sketch of the situation in Asia:

<table>
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<tr>
<th>Patent system</th>
<th>Indicator based tax</th>
<th>Refined indicator system</th>
<th>Turnover tax</th>
<th>Turnover tax with net elements</th>
<th>Standard regime, reduced rates</th>
<th>Standard regime</th>
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</thead>
<tbody>
<tr>
<td>Nepal</td>
<td>Cambodia</td>
<td>Lao PDR</td>
<td>Bangladesh</td>
<td>Vietnam</td>
<td>Indonesia</td>
<td>Australia</td>
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<td>Cambodia</td>
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<td>Thailand</td>
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<td>(retail trade)</td>
<td>Philippines</td>
<td>New Zealand</td>
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<td>Philippines</td>
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Where does the variety in policy come from?

- The **capacity of the state/ tax administrations**: Administrative resources and efficiency?

- **Capacity of MSEs**: Numeracy, literacy and accounting practices?

- Differing **political goals** (equity vs. efficiency, redistribution, formalization vs. better business practices…), legal traditions, …?
The basic building blocks of MSME tax reform

- Tax administration training
- Segmentation of taxpayers
- Designing simplified tax regimes
- MSME compliance management
- Implementing rules and regulations
- Taxpayer outreach and communications
- Monitoring implementation
Pointers to a “good” MSME tax reform package - 1

**Segmentation**: Micro, Small

- Defining the micro business threshold:
  - Subsistence level activities
  - Link to PIT exemption threshold

- Defining small business: general approach is straightforward: harmonize with VAT registration threshold
  - What if VAT threshold non-existent (VN) or too high (Armenia)

**System design**: presumptive regime for micro and small taxpayers

- Micro businesses: from exemption (Georgia) to super patent distinguishing 28 different types of activities (Tajikistan). Is there a preferred approach?

- Small businesses: A uniform design solution for all our clients?

**Small business segment** | **Tax rate**
--- | ---
Trade | Around 2% of turnover
Service sector | Around 6% of turnover
Other small businesses | Around 4% of turnover
Pointers to a “good” MSME tax reform package - 2

- **Simplification** for medium taxpayers, e.g., reducing filing and payment frequency, simplifying reporting requirements

- Development of special **SME accounting** regime: need guidelines for the operation of a cash accounting system appropriate for turnover based presumptive taxation

- **Implementing regulations**: the devil is in the detail

- **Training and outreach**: partner with private sector (and with tax administration) for reaching out to MSMEs

- **Compliance management**
  - Simplification of the overall business registration process as first important step
  - Can we link tax registration to better access to finance or access to special small business management support?

- **Monitoring**
Main Lessons Learned

- Ministries of Finance generally are pushing MSME tax reforms much more than tax administrations. But tax administration management needs to be involved early in the reform process.

- System abuse by larger businesses is a major problem in many client countries. Need policy and administrative countermeasures.

- Lack of reliable data considerably complicates fallback indicator design. More research and analysis early in the system design process necessary.

- Refining good practice examples is required: not only how have other countries done it, but also why have they done it in a particular way.

- Refining approach to estimating turnover based on indicators and profit margins based on turnover.

- Developing guidelines for MSME tax accounting design.
Thank you for your attention!