What Tax Reforms Say About Tax Use and Abuse

Simplified tax regimes for micro and small enterprises in developing countries are intended to facilitate voluntary tax compliance and encourage businesses to move toward formalization and growth. The present note reviews the experience of simplified tax regimes in low- and middle-income countries, and identifies some critical design and implementation issues.

Overview

Simplified tax regimes are often offered to small businesses (SMEs) to encourage them to move from the informal to the formal economy. They are sometimes perceived as the key to reducing poverty, fostering entrepreneurship, promoting business growth, and improving tax revenue by reducing non-compliance. However, many small business tax regimes are complex for microenterprises in countries with high illiteracy levels. On simplified bookkeeping or turnover is sometimes perceived as too complex for businesses, as is the case where national adult literacy rates are under 90 percent and tax rates are lower at the micro level. Small businesses in these cases, however, may benefit to a lesser extent from complex systems and may be much more willing to comply with a simple, non-compliance-based tax system. This note reviews the experience of simplified tax regimes in low- and middle-income countries and identifies some critical design and implementation issues.

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Two major approaches to simplified tax regimes can be identified: (1) very simple lump sum or fixed amount taxes (which will probably shift over time), coupled with some simplifications for small businesses which are likely to be widely adopted; and (2) presumptive profit taxes or single taxes on turnover, either with the tax liability calculated as a percentage of turnover or with net profit calculated on a sample of turnover. Depending on the design of the regime, one of these two major approaches may or may not be sufficient even in the small business segment. Instead of concentrating on auditing relatively broad audit coverage of the SME segment, there seems to follow an approach of merely ensuring that national adult literacy rates are under 90 percent. The emphasis in South Africa, for example, is on a stratified sample from the relevant tax authorities. The thresholds should be set to practice bookkeeping (for example, in cases where national adult literacy rates are under 90 percent) and have tax rates of at most 20 percent. In the design of simplified regimes appropriate for small businesses to enable businesses to become aware of the tax liabilities calculated as a percentage of turnover or with net profit calculated on a sample of turnover, either with the tax liability calculated as a percentage of turnover or with net profit calculated on a sample of turnover.

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Small Business Tax Regimes

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Simplified MSE tax regimes in survey countries

The World Bank surveys were conducted in Albania, Brazil, Nepal, South Africa, Thailand, and the Republic of Yemen. They cover a total of 21 surveys, the majority of which are from developing countries, along with some on developed countries.

This topic area focuses on the use and abuse of simplified tax regimes among business taxpayers.

The table below lists the countries surveyed, along with their key eligibility criteria for fixed and simplified tax regimes.

### Table: Key eligibility criteria for fixed and simplified tax regimes

<table>
<thead>
<tr>
<th>Country</th>
<th>Survey Year</th>
<th>Fixed Regime Eligibility</th>
<th>Simplified Regime Eligibility</th>
</tr>
</thead>
<tbody>
<tr>
<td>Albania</td>
<td>2011</td>
<td>businesses below EUR 4,000 turnover</td>
<td>businesses below EUR 3,000 turnover</td>
</tr>
<tr>
<td>Brazil</td>
<td>2011</td>
<td>businesses below BRL 10 million turnover</td>
<td>businesses below BRL 1 million turnover</td>
</tr>
<tr>
<td>Nepal</td>
<td>2011</td>
<td>businesses below NPR 50,000 turnover</td>
<td>businesses below NPR 10,000 turnover</td>
</tr>
<tr>
<td>South Africa</td>
<td>2007</td>
<td>businesses below ZAR 5 million turnover</td>
<td>businesses below ZAR 1 million turnover</td>
</tr>
<tr>
<td>Thailand</td>
<td>2011</td>
<td>businesses below THB 500,000 turnover</td>
<td>businesses below THB 50,000 turnover</td>
</tr>
<tr>
<td>Yemen, Rep.</td>
<td>2008</td>
<td>businesses below SAR 1 million turnover</td>
<td>businesses below SAR 500,000 turnover</td>
</tr>
</tbody>
</table>

The survey results suggest that the risk of fixed regime use among those businesses meeting the eligibility criteria is high, leading to the introduction of new simplified regimes. These regimes aim to address the issue of abuse and ensure that only eligible businesses are able to use them.

In some cases, the abuse of simplified regimes has been significant, with up to 90% of businesses reported as using the regime illegally. This highlights the importance of effective monitoring and enforcement measures.

The survey also found that the risk of fixed regime use among those businesses meeting the eligibility criteria is high, leading to the introduction of new simplified regimes. These regimes aim to address the issue of abuse and ensure that only eligible businesses are able to use them.
Simplified MSE tax regimes in survey countries

The World Bank surveys were conducted in Albania, Burundi, Nepal, South Africa, and the Republic of Yemen. They collected information about the use and form of simple tax regimes, along with data on firm characteristics. The surveys included different levels of simplified MSE tax regimes at the time of the survey (table 1).

Although popular, compliance management is a challenging fixed tax regime

Fixed tax regimes (FTR) commonly show low levels of compliance, or they typically combine a rather low tax burden with minimal compliance costs. In practice, fixed tax thresholds are commonly set among the least eligible businesses: the smallest of small and micro enterprises. In most surveyed countries, the average threshold for small businesses is below LEK 8 million (US$63,500) (thus, substantially exceeding simplified accounting. See table 2).

Table 2

<table>
<thead>
<tr>
<th>Country regime analyzed</th>
<th>Fixed tax regime for small businesses using the regime)</th>
<th>Simplified tax regime for small businesses used by the regime)</th>
<th>Percentage of all firms</th>
<th>Percentage of firms using the regime)</th>
<th>Estimated abuse</th>
</tr>
</thead>
<tbody>
<tr>
<td>Albania</td>
<td>FTR 58</td>
<td>Simplified tax 98</td>
<td>&lt; 2a</td>
<td>&lt;1a</td>
<td></td>
</tr>
<tr>
<td>Burundi</td>
<td>FTR 58</td>
<td>Simplified tax 98</td>
<td>&lt; 2a</td>
<td>&lt;1a</td>
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<td>Nepal</td>
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<td></td>
</tr>
<tr>
<td>Ukraine</td>
<td>FTR 58</td>
<td>Simplified tax 98</td>
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<td></td>
</tr>
</tbody>
</table>

Note: FTR abbreviates fixed tax regime; TOT abbreviates turnover tax.

Source: Coolidge and Yılmaz 2015.

Small business turnover tax regimes not necessarily popular among targeted businesses

In South Africa, the Revenue Service had initially considered setting different tax rates for local industry sectors depending on their average output profitability. However, a closer analysis of existing data did not reveal a variation in output profitability. Consequently, the fixed turnover tax rate was set at a single flat rate of 10 percent, for industry sectors varying in average output profitability. As a result, the tax rate was set as a uniformly progressive rate structure ranging from 5 percent to 15 percent (south of the border). Although the TOT liability for the majority of small businesses in South Africa automatically became a fully implemented compliance simplification tool, non-compliance risks increased in two cases in particular: (i) the TOT regime is relatively high: the rate is 10 percent (the TOT liability for the majority of small businesses is also reported keeping regular books. Fortunately, in practice, fixed tax regime thresholds are relatively high: the rate is 10 percent (the TOT liability for the majority of small businesses is also reported keeping regular books. Fortunately, the high level of compliance means that the great majority of businesses are not actually eligible for the TOT regime.

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In fact, existing TOT regimes were relatively low: over 40,000 within the first two years of system application, never rose above subsistence level create perverse incentives for taxpayers to migrate into and out of different tax regimes. This will restrict abuse risks of presumptive tax regimes and ineffective enforcement

Although popular, fixed tax regimes have generally higher risks of abuse than TOT regimes. The evidence is clearer in the cases of Burundi and Nepal. Tax systems in the Republic of Yemen also face the same structural problems as in Burundi. However, substantial evidence exists to countenance the fixed turnover tax for existing businesses in countries in which it has been applied for a sufficient period of time. Although the TOT liability for the majority of small businesses in South Africa automatically became a fully implemented compliance simplification tool, non-compliance risks increased in two cases in particular: (i) the TOT regime is relatively high: the rate is 10 percent (the TOT liability for the majority of small businesses is also reported keeping regular books. Fortunately, the high level of compliance means that the great majority of businesses are not actually eligible for the TOT regime.

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Small business tax regimes in survey countries

The World Bank survey was conducted in Albania, Burundi, Nepal, South Africa, Turkey, and the Republic of Yemen. They collected information about the use and number of simplified tax regimes, along with data on firm characteristics (such as size, location, and industry). The survey also included data on abusive behavior, such as whether businesses underreported income or overstated expenses. The study was designed to cover a broad range of firms, including both formal and informal businesses.

The survey found that the prevalence of simplified tax regimes varied significantly across countries. In some countries, such as Albania and Turkey, more than 90% of firms used simplified tax regimes. In other countries, such as South Africa and Yemen, the prevalence was much lower, with only around 10% of firms using simplified tax regimes. The survey also revealed that the abuse rates of these regimes varied widely, with some countries experiencing high levels of abuse, while others had relatively low levels of abuse.

In summary, the survey provides valuable insights into the use and abuse of small business tax regimes. It highlights the importance of designing and implementing effective tax policies to support small businesses in developing countries. The findings can be used to inform policymakers and practitioners in designing and implementing tax policies that are tailored to the needs of small businesses and that promote compliance and fairness.

The survey was conducted by the World Bank, and the data was collected from a sample of businesses in each country. The sample size varied from country to country, with the largest sample size being in Albania and Turkey, and the smallest sample size being in Yemen. The data was collected through questionnaires, and the response rate was generally high, with most firms completing the questionnaire.

The survey was designed to cover a wide range of issues, including the use and abuse of small business tax regimes, the characteristics of firms using these regimes, and the impacts of these regimes on firm performance and government revenue.

The survey findings are relevant to policymakers and practitioners in developing countries who are designing and implementing tax policies to support small businesses. The findings can be used to inform the design and implementation of tax policies that are tailored to the needs of small businesses and that promote compliance and fairness.
5

countries, as many such businesses are unable
microenterprises in low-income, low-capacity
continuing need for a fixed-tax regime for true
these regimes.

small business tax regimes, which needs to be
ing the base of the general or turnover-based
tax regimes may cause significant damage in erod-

education levels, bookkeeping practices, use of
stances. Surveys of small businesses focusing on
private sectors. Simplified tax regimes should be
in developing and transition countries. These

Conclusion

However, a risk-based small business audit
administrations in almost all countries sur-
quently seems insufficient even in the small

Data from taxpayer surveys suggest that fixed
practically, compliance management fre-
limited in scope to just minor simplifications in
appear to be overly popular, but prone to abuse,
require more precise tailoring of the simplified regimes to their
aspects of realistic tax compliance.

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3.8

OTHERS

Munawar Sultan, Rajul Awasthi, and Jan
Available at: http://www.ifc.org/wps/wcm/connect/725f0b804b5f7ae59f06bf6eac26e1c2/UTCCS_eng

4. A small proportion of these generally eligible busi-

2. This was the case at the time of the survey; more re-

A review of the operation of simplified tax
regimes using results from the World Bank’s Tax
Descriptive and Compliance Cost Survey
shows that developing countries continue to install
deliberately as low as the incentives on tax payment
regarding their scale of activities, depending on
The overall objective of simplified tax
for micro and small enterprises (MSEs) in develop-
ing countries generally is to facilitate voluntary tax
compliance and encourage businesses in moving
toward formalization and growth. While the
simplified tax regimes (STRs) can be more-than-

Notes

If you change the description of the tax, see
Calibrating Perceptions in the Globalized Economy.

3. A small proportion of businesses operating under
simplified regimes might not be overly compli-
cant information concerning the operation of the
taxation law, including risks of punishment for
excessive tax burdens, compliance costs, and
regulatory reforms to encourage dissemination of
market-based solutions for

We are currently an Economist
at the Central Bank of
organizations. Nor do any

the authors on request.

The detailed draft country reports are available from
Coolidge (2012). The surveys all included at least sev-
1. For a complete description of the surveys, see

Notes

What Surveys Reveal about Tax System Use and Abuse
Simplified tax regimes for micro and small enterprises in
developing countries are intended to facilitate voluntary
and reduce compliance costs for micro and small
enterprises; however, there is growing evidence of
virtual non-compliance in the use of these regimes.

Simplified tax regimes continue to be highly popular
among businesses and policy makers alike as a
way to lower tax complexity and incentivize
businesses to formalize and grow. This note begins
by examining the use and abuse of simplified tax
regimes, and then it offers specific recommendations
to policymakers on how to improve the design of
simplified tax regimes that will best suit local conditions.
In practice, compliance management is typically complicated by significant variations in the micro and small business segment. Business evidence suggests that tax administration strategies focused on larger businesses, as well as the underlying tax law design, may not be effective to promote system compliance at the small business level.

Some authors have suggested that business-to-business compliance efforts are more effective at promoting system compliance. However, research evidence suggests that surveys of business compliance often underestimate the extent of compliance activities among small businesses. This represents a missed opportunity, because a small fraction of businesses that report non-compliance may be responsible for a large fraction of unreported income.

Conclusion

The evidence suggests that simplified tax regimes provide an important aspect of realistic tax compliance. However, survey evidence suggests that small business taxation based on turnover to account for business expenses.

It has been generally held that systemic reforms aimed at tax compliance are ineffective. However, research evidence suggests that small business taxation based on turnover to account for business expenses.

Notes

1. For a complete description of the surveys, see Coolidge (2012). The surveys all used a list assisted, stratified, random sampling design to identify businesses for interviews (which will probably shift over time), coupled with well-targeted compliance management to detect and deter abuse. The survey evidence suggests that small business taxation based on turnover to account for business expenses.

2. This was the case at the time of the survey; more recently, the thresholds should be reformed to ensure that they continue to address small businesses without changing tax incentives. Small businesses for tax reasons, bookkeeping practices, use of bank accounts, and similar objective variables may help inform the key parameters of simplified regimes.

3. More broadly, it appears that in many cases the thresholds should be revised and capacity improves both in the public and the private sectors. Simplified tax regimes should be periodically reformed to ensure they continue to address small businesses without changing tax incentives. Small businesses for tax reasons, bookkeeping practices, use of bank accounts, and similar objective variables may help inform the key parameters of simplified regimes.

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References


