Designing a Tax System for Micro and Small Businesses: 
*Guide for Practitioners*

The World Bank Group  
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<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Full Form</th>
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<tr>
<td>ATO</td>
<td>Australian Taxation Office</td>
</tr>
<tr>
<td>CIT</td>
<td>Corporate Income Tax</td>
</tr>
<tr>
<td>CRA</td>
<td>Canada Revenue Agency</td>
</tr>
<tr>
<td>DAC</td>
<td>OECD Development Assistance Committee</td>
</tr>
<tr>
<td>DFID</td>
<td>Department for International Development (UK)</td>
</tr>
<tr>
<td>ECR</td>
<td>Electronic Cash Register</td>
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<tr>
<td>EU</td>
<td>European Union</td>
</tr>
<tr>
<td>FIAS</td>
<td>Foreign Investment Advisory Service</td>
</tr>
<tr>
<td>GST</td>
<td>Goods and Services Tax</td>
</tr>
<tr>
<td>HST</td>
<td>Harmonized Sales Tax (Canada)</td>
</tr>
<tr>
<td>IFC</td>
<td>International Finance Corporation</td>
</tr>
<tr>
<td>IMF</td>
<td>International Monetary Fund</td>
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<tr>
<td>ITAA</td>
<td>Income Tax Assessment Act</td>
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<tr>
<td>ITD</td>
<td>International Tax Dialogue</td>
</tr>
<tr>
<td>METR</td>
<td>Marginal Effective Tax Rate</td>
</tr>
<tr>
<td>MSE</td>
<td>Micro and Small Enterprise</td>
</tr>
<tr>
<td>MSME</td>
<td>Micro, Small and Medium Enterprise</td>
</tr>
<tr>
<td>OECD</td>
<td>Organisation for Economic Co-operation and Development</td>
</tr>
<tr>
<td>PAYE</td>
<td>Pay As You Earn</td>
</tr>
<tr>
<td>PPS</td>
<td>Prescribed Payment System</td>
</tr>
<tr>
<td>PWC</td>
<td>PricewaterhouseCoopers</td>
</tr>
<tr>
<td>R&amp;D</td>
<td>Research and Development</td>
</tr>
<tr>
<td>RPS</td>
<td>Redeemable Preference Shares</td>
</tr>
<tr>
<td>SARS</td>
<td>South African Revenue Service</td>
</tr>
<tr>
<td>SME</td>
<td>Small and Medium Enterprise</td>
</tr>
<tr>
<td>SMEDA</td>
<td>Small and Medium Enterprise Development Authority (Pakistan)</td>
</tr>
<tr>
<td>TAA</td>
<td>Tax Administration Act</td>
</tr>
<tr>
<td>TIN</td>
<td>Taxpayer Identification Number</td>
</tr>
<tr>
<td>VAT</td>
<td>Value Added Tax</td>
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</tbody>
</table>
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Introduction

Small businesses are a unique phenomenon for the tax system: besides wage earners, who generally are only subject to income tax withholding, they form the bulk of taxpayers in the tax net. At the same time, however, small businesses are the major contributors to the informal economy operating outside the tax net. This is not an antagonism. In many developing and transition countries, micro and small enterprises (MSEs) are the most rapidly growing business segment. Their characteristics and also their tax compliance attitude vary significantly. On the one hand, a large number of MSEs register with the tax authority—voluntarily or as a result of enforcement actions. On the other hand, high costs, difficult formalization procedures, or the expectation of gaining a comparative advantage from not complying with tax obligations drive many small businesses into operating in the informal economy.

Compliance risks and attitudes in the small business segment of the taxpayer population are fundamentally different from large taxpayer compliance behavior. In case of larger businesses, the core risk for the tax system is the recourse to tax avoidance strategies. Large businesses (and wealthy individuals) have access to sophisticated tax advice to develop strategies for the reduction of their tax liabilities, e.g. through the use of transfer pricing techniques. Smaller businesses are more likely to engage in tax evasion practices and either operate completely outside the tax net or hide a certain part of their business transactions from the tax inspector. The risk of detection of such tax evasion practices can be rather modest in countries with weak tax administration enforcement capacity or a high level of corruption in the tax administration.

Operating in the informal economy negatively impacts society as a whole, especially the compliant part of the business community. It also affects the growth potential of informal businesses. Reforms to foster private sector development and to support innovation and growth, therefore, need to address and eliminate obstacles for small business formalization. The cumbersome tax system in most countries, both on the policy and the administration side, is considered as one of the top reasons for operating in the informal economy. This toolkit provides a number of
options for reforming the tax system to facilitate small business compliance. While it does include some tax administration reform options, the focus of the toolkit is on the tax policy side. Further guidance on tax administration reform is provided by the paper “Tax Administrations and SMEs in Developing Countries,” IFC, July 2005. (http://rru.worldbank.org/Toolkits/TaxAdministration/)

The toolkit specifically discusses strategies and options to facilitate small business compliance with the tax system. It thus addresses one—although a particularly important—element of MSE formalization. Providing sufficient incentives for formalization has much broader dimensions, of course. As research in African countries has shown, “tax resistance is likely to continue (and increase) if service provision does not improve, necessitating costly and coercive methods of tax enforcement that may undermine the legitimacy of the government. Improvement in service delivery for the majority of citizens is therefore a necessary condition to improve tax compliance. The existence of positive benefits in the form of public services, security, etc., may therefore increase the probability that taxpayers will comply voluntarily, without direct coercion.”1 These findings confirm the importance of combining tax policy and tax administration reforms with improvements in public expenditure management and service delivery.

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1 Fjeldstad/Rakner, Taxation and Tax Reforms in Developing Countries: Illustrations from Sub-Saharan Africa, 2003.
Impact of the Tax System on Small Business Development

The chapters in this section discuss the compliance attitude of MSEs and the consequences of non-compliance with the tax system for small business development, the economy, and public sector governance. A complicated tax system and arbitrary tax administration are among the main reasons for small businesses to operate in the informal economy. Tax compliance costs are regressive and put a disproportional burden on small businesses. After a review of the core factors contributing to high compliance costs, this section of the toolkit analyzes the impact of non-compliance. But non-compliance is not a free option for MSEs. It entails substantial costs, which result from expenditures (e.g. bribes) required to avoid penalties and forced registration, and from the lack of services and business development opportunities, such as access to credit, public sector contracts, and publicity programs to promote the small business. While the impact of non-compliance on the overall tax yield might be negligible, it seriously affects the equity of the tax system and increases the tax burden (and reduces the competitiveness) of compliant, registered businesses. Finally, strengthening government accountability requires broadening of the tax net.
Chapter 1.1: Informal Economy and Complexity of the Tax System: The Size of the Problem

Small businesses\(^2\) form the core group of hard-to-tax taxpayers. It is not uncommon in developing countries that a larger percentage of small businesses operate in the informal rather than in the formal economy. While small businesses in no way constitute the only source of underground economy activities, data about the size of the underground economy still can provide a proxy for the scope of the problem. Schneider and Klingmair, using various statistical procedures and data from 110 developing, transition, and OECD countries, estimate the size of the underground economy in developing, developed, and transition countries\(^3\).

**KEY POINTS**

- There are substantial intra-regional variations in the size of the informal economy.
- Informality can take different forms and dimensions.
- Compliance behavior is influenced by a number of factors, which are partly business-related and partly influenced by economic and psychological factors.

**Shadow economy as percent of GDP 2000**

<table>
<thead>
<tr>
<th>Region</th>
<th>Average Size of the Shadow Economy – Value added as % of official GDP 2000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Africa</td>
<td></td>
</tr>
<tr>
<td>Central and South America</td>
<td></td>
</tr>
<tr>
<td>Asia</td>
<td></td>
</tr>
<tr>
<td>Economies in Transition</td>
<td></td>
</tr>
<tr>
<td>European OECD countries</td>
<td></td>
</tr>
<tr>
<td>North American and Pacific OECD countries</td>
<td></td>
</tr>
</tbody>
</table>

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\(^2\) For a discussion of the definition of what constitutes an SME see part two chapter one.

Designing a Tax System for Micro and Small Businesses

Analysis on a regional basis thus indicates that the level of activities of the underground economy is substantially higher in developing and transition countries compared to developed countries. In addition to regional differences, substantial intra-regional variations can be observed. The average size of the informal sector varies considerably within a given region. While some developing countries show a level of informal sector activities comparable to OECD countries, the informal economy in other countries in the same region exceeds 50% of GDP.

Regional Variations in the Size of the Informal Economy

<table>
<thead>
<tr>
<th>Region</th>
<th>High</th>
<th>Low</th>
</tr>
</thead>
<tbody>
<tr>
<td>Africa</td>
<td></td>
<td></td>
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<tr>
<td>Zimbabwe – 59%</td>
<td></td>
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<tr>
<td>South Africa – 28%</td>
<td></td>
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<tr>
<td>Asia</td>
<td></td>
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<tr>
<td>Thailand – 53%</td>
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<tr>
<td>Japan – 11%</td>
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<tr>
<td>Australasia</td>
<td></td>
<td></td>
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<tr>
<td>Australia – 15 %</td>
<td></td>
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<tr>
<td>New Zealand – 13%</td>
<td></td>
<td></td>
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<tr>
<td>Economies in Transition</td>
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<tr>
<td>Georgia – 67%</td>
<td></td>
<td></td>
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<tr>
<td>Slovak Republic – 19%</td>
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<td></td>
</tr>
<tr>
<td>OECD countries</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Greece – 29%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Switzerland – 9%</td>
<td></td>
<td></td>
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<tr>
<td>South America</td>
<td></td>
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<tr>
<td>Bolivia – 67%</td>
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<tr>
<td>Chile – 20%</td>
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</table>

Source: Schneider 2002

Informality and tax compliance

While there is a certain correlation between the size of the underground economy and the level of non-compliance with the tax system, a complete equation would be misleading. Informality can take different forms and dimensions:

- MSE formally complies with legal and regulatory obligations, but not entirely respects all obligations
- MSE is fully compliant with legal and regulatory obligations
- MSE operates entirely outside the formal economy
- MSE complies with a small number of legal and regulatory obligations, but not others
- MSE complies with most legal and regulatory obligations
- MSE is fully compliant with legal and regulatory obligations

Non-compliance with tax obligations is not always and necessarily the main element of informality. In countries with a high social security burden (such as in a number of transition countries) or in countries with particularly cumbersome labor laws, small businesses may be willing to register for tax purposes, but may not want to comply with labor and social standards. Such a situation could be found in Morocco, for example. It is also not uncommon for MSEs to comply with local

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government (including local taxation) requirements, but to evade central government taxes.

To make a more accurate estimate of the level of tax compliance, an alternative approach can be to compare the number of tax registered businesses with estimates of the level of business activities in a given country. A recent study in Rwanda, for example, estimates that nearly 70,000 micro and small-scale enterprises exist in the country; however, only around 1,000 small businesses are currently registered with the tax authority, which indicates a tax compliance level of less than 2%. Comparisons with other countries at comparable levels of economic development can also be useful. For example, the Philippines, with a total population of 85 million, has 270,000 businesses registered for value-added taxes (VAT), which gives a ratio of 0.32%. This compares rather unfavorably with the VAT registration levels in countries such as Mexico with 1.23% (total population 106 million, and 1.3 million registered VAT taxpayers); Turkey with 4.2% (population of 69 million, and 2.9 million businesses registered for VAT); or South Africa with 1.02% (population of 47 million, and 480,000 registered VAT taxpayers). While certain adjustments are required to take into account the different VAT registration thresholds in the countries mentioned, the comparison still suggests major compliance problems with VAT registration in the Philippines.

Not surprisingly, research shows a correlation between the stability of small businesses and tax compliance attitudes. The higher the percentage of small businesses with fixed business premises and with multiple years of operation in a country, the higher will be the compliance with tax registration requirements. This is illustrated using data from Morocco.

**Morocco: Registration for Simplified Taxation of SMEs**

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Alami, op.cit.
The overall level of tax compliance in a country is determined by a number of factors. These are partly business-related and partly reflect the economic and social environments. The educational level of MSE operators, the general tax morale in the country, and the fear of the tax authority can also be important factors in this context. Research carried out by the OECD has produced the following list of key determinants for the tax compliance behavior of businesses:

### Factors Influencing the Compliance Behavior of Businesses

<table>
<thead>
<tr>
<th>Category</th>
<th>Generic characteristics</th>
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Source: OECD, Compliance risk management
Informal Economy and Complexity of the Tax System: The Size of the Problem

Based on the general impact of external factors on the tax compliance attitude of the MSE community, combined with personal characteristics (e.g. level of risk aversion) of the individual MSE operator, four levels of taxpayer compliance attitudes can be distinguished:\(^6\):

1. **The disengaged**: At the top of the pyramid is an attitude of disengagement. It characterizes those who have decided not to comply. People with this attitude either deliberately evade their responsibilities or choose to opt out. Cynicism about the tax system is usually matched by cynicism about the role of government.

2. **Resisters**: The attitude of resistance characterizes active confrontation. The system is seen as oppressive, burdensome, and inflexible. This attitude characterizes those who don’t want to comply but who will if they can be persuaded that their concerns are being addressed.

3. **Triers**: Those who are basically willing to comply have a more positive attitude. But they also have difficulty complying and don’t always succeed. They may have difficulty understanding or meeting their obligations, but their expectation is that, in any dispute, trust and cooperation will prevail.

4. **Supporters**: The attitude here is one of willingness to do the right thing. There is a conscious commitment to support the system and accept and manage effectively its demands. There is an acceptance of the legitimacy of the role of tax officers and a belief that they are fundamentally trustworthy.\(^7\)

\(^6\) Braithwaite, Improving Tax Compliance in the Cash Economy, 1998

\(^7\) OECD, Compliance Risk Management, 2004
In countries with a high percentage of MSE operators who fall under the categories of supporters and triers, one can expect a direct and visible impact of compliance facilitation initiatives on the actual level of voluntary tax compliance. Noticeable improvements in the compliance behavior of resisters require a broader set of measures, comprising in particular of strengthening tax enforcement capacity and developing programs to change their overall attitude towards government.
Chapter 1.2: Taxation as Core Obstacle to MSE Formalization

The decision to operate outside the formal economy can be motivated by manifold reasons and is not always linked primarily to taxation. However, the majority of empirical studies on the growth of the informal economy conclude that tax and social security contributions are key factors discouraging MSEs to operate in the formal sector. This is equally true for developing and developed countries. Among OECD countries, Schneider found that the direct tax burden in Austria (including social security payments) has the biggest influence on taxpayers’ behavior, followed by the intensity of regulation and the complexity of the tax system. In the Scandinavian countries, the average direct tax rate, the average total tax rate, and the marginal tax rates are key factors in the decision to work in the informal economy. Looking at developing and transition countries, Schneider and Torgler found that tax morale plays a significant role in determining the size of the shadow economy. Schneider and Hametner found unemployment and taxation to be the main factors driving the shadow economy in Columbia. Nashchekina and Timoshenko identify taxation as the main barrier to business development in Ukraine.

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8 See Schneider/Klinglmair, op.cit
9 The Increase of the Size of the Shadow Economy of 18 OECD Countries: Some Preliminary Explanations, 2000
13 Naschekina/Timoshenko, Hard to Bear, Hard to Measure: The Costs of Small Business Legalization in Ukraine, 2005
The findings of analytical studies are confirmed by the results of business surveys carried out in developing and transition countries. According to the World Bank/PriceWaterhouseCoopers (PWC) global report on Paying Taxes (http://www.doingbusiness.org/documents/DB_Paying_Taxes.pdf), companies in 90% of surveyed countries rank the tax system among the top five obstacles to doing business. The main reasons for business problems with the tax system are: (i) the large number of business taxes to pay; (ii) lengthy and complex administrative procedures, (iii) complex tax legislation; and (iv) high tax rates. Consequently, the report finds a direct relationship between burdensome taxation and the level of informality.

Country-specific surveys in South Africa highlight that paying taxes, bureaucratic procedures attached to formalization, and government levies are among the main reasons for operating in the informal economy. In Kenya, research in rural villages showed that villagers identified taxation as one of the most important barriers to achieving a satisfactory living. In Pakistan, 67% of small businesses list tax regulations as most problematic, while 28% of SMEs felt that taxes in the country are too high. In Bulgaria, small businesses consider the tax burden to be the most significant barrier for their investment. In Ukraine, a survey showed that out of the four key problems hindering entrepreneurship, three were related to taxation: high tax rates; many different taxes; and frequently changing tax reporting.

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14 SME alert, October 2003.
16 SMEDA, Developing SME Policy in Pakistan,
17 Ahmet Salik Ikiz , Shadow Economy in Bulgaria: Small and Medium Enterprises and Taxation, 2002
18 IFC, The State of Small Business in Ukraine, June 2000
A high tax burden is not necessarily due to high tax rates. Tax compliance costs can add substantially to the overall costs of formalizing a small business. While some costs arise in all areas of complying with laws and regulations, these costs tend to be particularly high in the tax area. This is the case even in countries with a modern tax system and a highly efficient tax administration. A 2006 compliance cost survey in New Zealand revealed that businesses allocated over 41% of total compliance costs to tax-related issues. Many survey respondents felt that tax compliance is too complicated and is stifling growth in small businesses, and that there is no relief offered to small businesses that would lead to increased investment and growth.

Compliance costs according to the definition developed by Cedric Sanford include “the costs incurred by taxpayers or by third parties (such as businesses) in meeting the requirements of the tax system, over and above the tax liability itself and over and above any harmful distortions of consumption or production to which the tax may give rise.” For individuals, compliance costs include the costs of acquiring sufficient knowledge to meet legal requirements; of compiling the necessary receipts and other data; making the relevant calculations and completing tax returns; paying professional advisors for tax advice; and paying incidental costs of postage, telephone, and travel to communicate with tax advisors or the tax office. For a business, the compliance costs include the costs of collecting, remitting, and accounting for tax on the products or profits of the business, and on the wages and salaries of its employees. Compliance costs for businesses also include the costs of acquiring the knowledge to enable this work to be done, including knowledge of their legal obligations and penalties.

Compliance costs thus have monetary and non-monetary elements. They can be divided into three main categories:

<table>
<thead>
<tr>
<th>Monetary costs</th>
<th>Time costs</th>
<th>Psychological costs</th>
</tr>
</thead>
</table>

20 Sandford et all, Administrative and Compliance Costs of Taxation, 1989
21 Sandford et all, op.cit.
Compliance cost surveys help identify the main factors contributing to a high compliance burden. Such surveys have been carried out for a number of years in several OECD countries. In developing countries, compliance cost analysis is a rather recent phenomenon and few data are available to compare findings from developed countries with compliance cost analysis in developing countries. Collecting information regularly on tax compliance costs and trends is important information for tax policy makers, tax agencies, and the business community in developing countries. More technical assistance should therefore be provided by donor agencies to strengthen compliance cost analysis capacity in developing countries.

OECD country data identify quite clearly the major compliance cost factors for SMEs. A survey carried out in New Zealand in 2003 showed filing and reporting requirements (closely followed by advance tax payments not aligned with cash flows) as the main problem areas:

**Tax compliance costs in New Zealand in 2003 – What businesses see as a problem (in % of respondents)**

- Time filling in forms: 36%
- Provisional payments not aligned with cashflow: 34%
- Good compliance history not considered: 30%
- Penalties and interest: 26%
- Difficulty getting information or help: 24%
- Having to employ an accountant: 22%
- Too much information: 18%

*Source: Business New Zealand-KPMG First Compliance Cost Survey, July 2003*

This is largely in line with the results of a compliance cost survey carried out in Canada in 2004. It revealed that business owners consider the amount of paperwork to be the main factor contributing to compliance costs, followed by complexity of the tax system, and frequent changes to tax legislation:
Among developing countries, income tax compliance cost surveys of South African and Indian companies, carried out respectively in 2006 and 2003, are the most recent major analyses available.

The South African survey of “tax practitioners” (professional accountants and bookkeepers who provide tax preparation services to small businesses on a fee-for-service basis) identified the “capturing and processing errors made by the South African Revenue Service (SARS) and the time taken to correct these errors “as the most burdensome aspect of corporate income tax, provisional tax, and employees’ taxes. For VAT, it was the period taken to register as a VAT vendor and the time taken to be notified of such registration.”

The Indian survey identified the following main issues contributing to high compliance costs:

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### Rating of Selected Activities Contributing to Internal Costs

<table>
<thead>
<tr>
<th>Activity</th>
<th>Very important</th>
<th>Quite important</th>
<th>Average (unimportant)</th>
<th>Unimportant</th>
<th>Can’t say</th>
<th>Mean Score</th>
</tr>
</thead>
<tbody>
<tr>
<td>Information asked for during scrutiny</td>
<td>22</td>
<td>14</td>
<td>2</td>
<td>0</td>
<td>1</td>
<td>3.08</td>
</tr>
<tr>
<td>Maintaining account books</td>
<td>15</td>
<td>3</td>
<td>3</td>
<td>0</td>
<td>1</td>
<td>3.41</td>
</tr>
<tr>
<td>Completing and submitting financial reports</td>
<td>21</td>
<td>11</td>
<td>6</td>
<td>0</td>
<td>0</td>
<td>3.39</td>
</tr>
<tr>
<td>Completing and submitting income tax returns</td>
<td>21</td>
<td>10</td>
<td>5</td>
<td>1</td>
<td>1</td>
<td>3.29</td>
</tr>
<tr>
<td>To obtain a tax refund</td>
<td>13</td>
<td>17</td>
<td>6</td>
<td>0</td>
<td>0</td>
<td>3.24</td>
</tr>
<tr>
<td>Research and tax planning</td>
<td>4</td>
<td>6</td>
<td>13</td>
<td>1</td>
<td>4</td>
<td>2.16</td>
</tr>
<tr>
<td>Tax related training for employees</td>
<td>6</td>
<td>9</td>
<td>12</td>
<td>6</td>
<td>8</td>
<td>2.03</td>
</tr>
<tr>
<td>Providing assistance to employees</td>
<td>5</td>
<td>5</td>
<td>8</td>
<td>9</td>
<td>10</td>
<td>1.62</td>
</tr>
</tbody>
</table>


Bookkeeping and filing requirements figure high on the Indian survey as well. In addition, the workload and psychological costs linked to tax audits are higher in developing compared to developed countries (probably because their frequency tends to be higher in developing countries than in developed countries). This is also confirmed by feedback received from MSEs in other developing countries and is related to low efficiency and professionalism, as well as a higher risk of taxpayer harassment in the course of conducting a tax audit.

### The regressive effect of tax compliance costs

Analysis indicates that the costs of compliance with the tax system are largely regressive and can put a particularly high burden on small businesses in the formal economy. Cedric Sandford, whose research contributed significantly to the spread of compliance cost analysis studies in OECD countries, noted: “They are frequently inequitable in their incidence and, in particular the compliance costs of business taxes fall … especially on small firms. Compliance costs tend to be particularly...
resented by some small businessmen and are thus a seedbed for tax evasion.”\textsuperscript{23}\n
Sandford’s analysis of tax compliance costs in the UK in the 1980s presented initial data on their level and regressive nature:

**Compliance costs as a percentage of taxable turnover in the UK 1986–87**

<table>
<thead>
<tr>
<th>Size</th>
<th>VAT %</th>
<th>PAYE %</th>
<th>CIT %</th>
<th>All Taxes %</th>
</tr>
</thead>
<tbody>
<tr>
<td>Small</td>
<td>1.48%</td>
<td>1.39%</td>
<td>0.79%</td>
<td>3.36%</td>
</tr>
<tr>
<td>Medium</td>
<td>0.28%</td>
<td>0.19%</td>
<td>0.15%</td>
<td>0.62%</td>
</tr>
<tr>
<td>Large</td>
<td>0.05%</td>
<td>0.08%</td>
<td>0.04%</td>
<td>0.17%</td>
</tr>
</tbody>
</table>

Similar results can be found in more recent compliance cost studies in OECD countries. An analysis for New Zealand in 2006\textsuperscript{24} reveals that even in case of a well-established and efficient VAT regime, overall tax compliance costs remain highly regressive.

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\textsuperscript{23} Sandford et. all, Administrative and Compliance Costs of Taxation, 1989

\textsuperscript{24} ATAX University New South-Wales, Tax compliance costs of New Zealand small and medium sized businesses, 2006.
A European tax survey launched by the European Commission in 2004 compares total compliance costs of SMEs and large businesses in EU member countries, and confirms that SMEs face disproportionately high compliance costs.  

### Estimated total tax compliance costs

<table>
<thead>
<tr>
<th></th>
<th>SMEs</th>
<th>Large businesses</th>
</tr>
</thead>
<tbody>
<tr>
<td>Absolute total compliance costs</td>
<td>203</td>
<td>1460</td>
</tr>
<tr>
<td>(in 1000 Euros), weighted average</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Absolute total compliance costs/taxes</td>
<td>30.9%</td>
<td>1.9%</td>
</tr>
<tr>
<td>(cost-to-tax revenue ratio, weighted average)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Absolute total compliance costs/sales</td>
<td>2.6%</td>
<td>0.02%</td>
</tr>
<tr>
<td>(weighted average)</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Comparatively little information on the incidence of compliance costs is available from developing and transition countries. Klun and Blažič conducted an analysis of tax compliance costs for companies in Slovenia and Croatia in 2004. Results are similar to the data for OECD countries:

### Compliance costs as percentage of turnover

<table>
<thead>
<tr>
<th>Business size</th>
<th>Slovenia</th>
<th>Croatia</th>
</tr>
</thead>
<tbody>
<tr>
<td>Small</td>
<td>3.73</td>
<td>3.42</td>
</tr>
<tr>
<td>Medium</td>
<td>0.73</td>
<td>0.76</td>
</tr>
<tr>
<td>Large</td>
<td>0.08</td>
<td>0.09</td>
</tr>
</tbody>
</table>

FIAS’ tax compliance cost study in S. Africa showed the same pattern:

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26 Tax Compliance Costs for Companies in Slovenia and Croatia, FinanzArchiv vol. 61 n° 3, 418.
The study by Arindam Das-Gupta on income tax compliance costs of Indian corporations is the first in-depth analysis of compliance problems of businesses with the Indian tax system. The study analyzes compliance costs in relation to business turnover, number of employees, and book value of business assets. It finds that in all respects there is a highly regressive incidence.

**India: Legal compliance costs as percentage of turnover**

<table>
<thead>
<tr>
<th>Turnover</th>
<th>Below Rs. 20 million</th>
<th>Rs 20–500 million</th>
<th>Rs. 500–1000 million</th>
<th>Rs. 1–5 billion</th>
<th>Over Rs. 5 billion</th>
</tr>
</thead>
</table>

A reduction of MSE compliance costs with the tax system therefore has to be a priority area for any small business development program. Part Two of this toolkit offers a variety of options available to reduce the reporting and tax payment burden and compensate small businesses for the regressive incidence of tax compliance costs.
Chapter 1.3: Downside of Informality for MSE Development

Non-compliance with the tax system does have a number of advantages for small businesses. Small businesses may gain a competitive advantage, as they are able to offer their goods and services at lower prices than their compliant competitors. They avoid frustration resulting from the obligation to comply with complicated tax procedures and from harassment by tax officials. However, disadvantages resulting from non-compliance with the tax system may largely exceed potential benefits.

The cost of informality

Businesses not registered for tax purposes do not entirely escape taxation. In fact, their indirect tax burden may be substantial. While firms operating in the informal sector may escape VAT liability on their sales, they also will not be able to reclaim credit for any VAT paid on inputs. The operation of an efficient consumption tax therefore generally is considered a way of imposing an appropriate tax burden on businesses in the informal sector. The level of such indirect tax burden depends on the extent informal businesses rely on purchasing inputs (goods or services) from VAT-registered suppliers. Analysis in South Africa has shown that non-VAT registered small businesses face among the highest marginal effective tax rates (METRs) on capital investment of any sector.\(^{27}\) MSEs with substantial business relations with formal sector enterprises thus may

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\(^{27}\) FIAS, Sector Study of the Effective Tax Burden – South Africa, 2006
<table>
<thead>
<tr>
<th>For businesses:</th>
<th>For tax administration:</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Comparative advantage due to possibility of offering products at lower prices.</td>
<td>• Lower administrative costs.</td>
</tr>
<tr>
<td>• Less harassment from tax officers.</td>
<td>• Possibility of allocating scarce resources to administering high-potential taxpayers.</td>
</tr>
<tr>
<td>• Avoidance of high compliance costs.</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>For businesses:</th>
<th>For government:</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Inability to obtain formal licenses and permits from local and other government agencies.</td>
<td>• Incorrect estimation of revenue potential of MSE segment.</td>
</tr>
<tr>
<td>• Challenge in securing credit from formal sources, while credit from informal sources may be under extortionate conditions and rates.</td>
<td>• Violation of tax equity.</td>
</tr>
<tr>
<td>• To avoid attracting the attention of the authorities, informal businesses may need to maintain a low profile that will exclude the use of advertising. This will diminish growth for the business and the broader economy and suppress employment opportunities.</td>
<td>• Risk of erosion of general compliance attitude.</td>
</tr>
<tr>
<td>• Being outside the net is prone to rent-seeking by officials to turn a blind eye to informality that effectively results in a corruption tax.</td>
<td>• Non-compliance with the tax system risks being associated with non-compliance with other laws, so that industry regulations are ignored (e.g. environmental standards, safety standards).</td>
</tr>
<tr>
<td>• Impediment to trading with the formal sector that may only buy from registered VAT taxpayers.</td>
<td></td>
</tr>
<tr>
<td>• Inability to claim and offset withheld tax, possibly leading to over-taxation in some cases.</td>
<td></td>
</tr>
<tr>
<td>• Higher tax burden on compliant businesses.</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>For the public:</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>• Less tax revenues available for public services.</td>
<td></td>
</tr>
<tr>
<td>• Less government accountability.</td>
<td></td>
</tr>
</tbody>
</table>

obtain major advantages from VAT registration, due to the ability to claim a refund for tax paid on inputs.

The burden naturally is lower in case of direct taxes and social taxes. However, even in this case, informality is not entirely free of charge. MSEs may be subject to substantial demands for bribes from tax officials in exchange for overlooking non-compliance and not prosecuting the business owner for tax evasion. Analysis in India by Das Gupta estimates non-filer compliance costs to amount to 3.4% of non-corporate income tax collections. Around 75% of these costs are due to foregone consumption benefits, 30% due to income loss from distorted investment, and 5% from expected non-filing penalties28.

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28 Das-Gupta, Tax Compliance Costs and Non-Filing Behaviour, 2002
Business opportunities of MSEs automatically get reduced as a result of non-registra-
tion. Potential customers of goods and services offered by the small business may be reluctant to deal with informal businesses as these cannot present a VAT invoice. For a VAT-registered client, the possibility to buy VAT-free inputs is not particularly attractive, as it may expose the registered business to penalties for supporting illicit work. In addition, any VAT charged on inputs can be reclaimed and does not add to production costs.

In addition, in many developing countries the government tends to be the main client for goods produced and services offered by MSEs. It is standard practice in these cases that a business is required to present a tax clearance certificate to be allowed to tender for a government contract. Frequently, such certificates are also required for other purposes, e.g. to acquire licenses, such as a road transport license in case of a transport business. A Tax Clearance Certificate is a written confirmation from the tax authority that a person's tax affairs are in order at the date of issue of the certificate. Businesses not registered for tax purposes cannot obtain such a certificate and therefore are deprived from selling goods or services to the government.

Finally, non-registered MSEs are seriously restrained in their flexibility to public-
ly advertise their business and attract new customers, as this increases the risk of being detected by the tax administration. Tax administrations have long started to regularly check newspaper advertisements, telephone books, and business directories to find hidden taxpayers. However, the need to operate more covertly than registered businesses also reduces business opportunities and growth potential.

**Limited access to credits**

An equally severe disadvantage may be denied access to MSE business development credits. MSEs in particular face considerable difficulties in mobilizing credits to finance the creation or expansion of their business. Government and donor-supported microfinance facilities frequently are the most important source of credits available to MSE operators. However, in many cases the application for an MSE credit requires the presentation of a taxpayer identification number (TIN) and therefore the credit is not available to businesses not registered for tax purposes.

**Violation of tax equity**

The benefit and the ability to pay principles are the two fundamental components of tax equity. Failure to ensure tax compliance from small businesses risks violating the equity principle in two ways: (i) it disproportionally shifts the burden of paying
Designing a Tax System for Micro and Small Businesses

The violation of the equity principle in taxation as a result of a high level of tax evasion in the MSE community can be illustrated using examples from Africa. Analysis from Uganda shows that the combination of a system of tax exemptions, which in many developing countries tend to be targeted primarily to larger businesses, and a high incidence of tax evasion in the small business segment of the economy result in a disproportionate share of the total tax burden borne by medium-sized businesses. While the average domestic tax burden for the three main domestic taxes (VAT, corporate income tax – CIT, Social Security) in Uganda is at the level of three percent of sales value for small businesses (businesses with 2–5 employees), and only two percent for large businesses with more than 200 employees, it jumps to seven percent of sales value in case of medium-sized businesses (26–75 employees).

Gloppen and Rakner find that in Tanzania, Uganda, and Zambia, there is a widespread perception in the business community that the tax administration has concentrated unduly on known corporate taxpayers rather than on efforts to widen the tax base. This leads to a general perception among corporate taxpayers that the tax system is unfair. Such a perception increases the vulnerability of the overall compliance behavior even of larger businesses. In extreme cases, as suggested by the Zambian case, differences in the actual treatment of formal and informal sector enterprises by tax authorities may create incentives for businesses to deregister in order to avoid taxation.

In addition, in a number of countries the pressure on tax administrations to meet revenue collection targets has induced a strategy to extort additional tax payments from the small number of registered taxpayers instead of pursuing efforts to broaden the tax net. In such a situation, few taxpayers in the official economy are forced to shoulder the contribution to total tax revenue collection that should have been borne by businesses outside the tax net. This situation increases the unfairness of the system and undermines the business climate in the country.

Horizontal equity is violated when taxpayers with a comparable level of net income face a substantially different tax burden. This tends to be the case when comparing the effective tax burden of wage earners, who are subject to income tax withholding and thus have no possibility to escape their tax liability, with the tax burden of self-employed with a roughly similar net income level. Tax evasion prac-

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Downside of Informality for MSE Development

Practices for wage earners require a collusion of employer and employee, while small businesses find many ways to under-declare their profit or entirely operate outside the tax net. This may easily lead to a situation as described in the 2007 budget statement of the Republic of Ghana:

“...one of the major challenges facing Ghana is how to broaden the tax net. Out of a pool of five million potential taxpayers, only one million are paying income taxes. Apart from employees on the Government payroll, only about 350,000 employees in the private formal sector pay taxes.”

The perceived unfairness of such a situation caused one of the first strikes of taxpayers in Italy a number of years ago. Also for Zambia, Mulenga notes that the few workers in formal employment have been complaining for a long time that they were being over-taxed. This shows that a large informal economy negatively affects the development of the official labor market by reducing the attractiveness of salaried labor and increasing incentives for moonlighting, which deprives employees of social protection.

Impact on growth potential of the formal sector

Unfair competition from non-registered businesses can reduce growth in the formal sector and market access of registered businesses. Different from business clients, who are able to deduct VAT paid on inputs from their indirect tax liability, final consumers will look for the lowest price option to acquire goods and services. When businesses operating outside the tax net are able to offer their services or sell goods at lower prices than tax-registered businesses, they reduce the market share of the formal sector. Experience in Pakistan, for example, has shown that loopholes for evasion by smaller, informal shops that are able to sell goods cheaper than formal and more productive supermarkets have become major barriers to growth of larger retail outlets. More generally, Alm/Martinez-Vazquez/Wallace finds a statistically significant negative impact of the shadow economy of developing countries on the growth rate of the official economy. According to their estimates, an increase in the informal economy by one percentage point of official GDP is associated with a decrease in the official growth rate of the GDP by 4.9%.

The informal economy also has a gender dimension. Statistically, women are more likely to be forced to earn their living in the informal economy than men. According to data from the International Labour Organization (ILO), 84% of female

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32 FIAS, Pakistan: Improving the Performance of the Housing, Tourism and Retail Sectors, August 2005
33 Taxing the Hard-to-Tax, Chapter 1: Introduction to the Volume, 2004
34 While there is a positive influence of the informal economy on the growth rate of industrialized countries.
non-agricultural workers in Sub-Saharan Africa are informally employed compared to only 63% of male non-agricultural workers. In Latin America, figures are 58% for women, compared to 48% for men, while in Asia the proportion of male and female non-agricultural workers in informal employment is roughly equivalent. This gender dimension is demonstrated by figures from Zambia:

<table>
<thead>
<tr>
<th>Residence</th>
<th>Gender, both sexes</th>
<th>Male</th>
<th>Female</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>All Zambia</td>
<td>85%</td>
<td>76%</td>
<td>91%</td>
<td>3,517,371</td>
</tr>
<tr>
<td>Rural</td>
<td>93%</td>
<td>89%</td>
<td>96%</td>
<td>2,571,153</td>
</tr>
<tr>
<td>Urban</td>
<td>56%</td>
<td>47%</td>
<td>71%</td>
<td>946,218</td>
</tr>
</tbody>
</table>

Source: Mulenga, Broadening the Tax Base to the Informal Economy in Zambia, 2006.

The impediments to business growth for informal MSEs and the lack of social security benefits to employees due to non-registration therefore affect women more heavily than men. Increased formalization of MSE operations provides more social protection to women in developing countries and increases their business opportunities.

**Formalization and revenue collection**

Taxes collected from small businesses generally represent only a small portion of the total tax yield. But this is not necessarily an irrevocable fact. The revenue potential of the small business segment could be increased substantially. In many developing countries, MSEs are a much more dynamic business segment than large enterprises. They tend to be particularly active in the service sector and in innovative business areas, which represent the major economic growth potential. Looking at calculations by Asian and Latin American tax administrations, a report published by the UN Department for Economic and Social Affairs (DESA) finds that small taxpayers possess a significant revenue potential, not uncommonly around one-third of total potential from a tax. This leads DESA to the conclusion that the high significance of large taxpayers in revenue collection should be taken as a temporary shortcoming in tax administration.

Specific country experience illustrates the importance of MSEs for the revenue system. In Vietnam, the 2006 Development Report shows a rapid increase in the

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36 UN DESA, Improving Resource Mobilization in Developing and Transition Countries, 2002.
number of newly registered private businesses. More than 100,000 small businesses were newly created in the period 2003–2005, of which 40,000 were established in the first nine month of 2005. The booming small business segment makes it an increasingly important factor of economic development. According to the assumptions of the report, a failure to ensure small business tax compliance could result in a decline in total tax revenues by 7–9% within a decade.

**Tax Revenue and the Emergence of Small and Medium Enterprises**

Chapter 1.4: The Politics of MSE Taxation

**Politics Matters**

Taxation is always political. In designing MSE taxes, reformers must look beyond the technicalities of tax to ensure that technically desirable changes are politically feasible. This requires solid political economy analysis of the local context and constructive engagement with the political process, not least the capacities of political leadership and organizations for energizing potential beneficiaries and tackling vested interests.

It has been too easy, perhaps even self-indulgent, to promote tax reform based on technocratic merits rather than its political significance. Tax reform must aspire to promote the wider political importance of taxation as one of the basic building blocks for effective states on which poverty reduction depends. Historical and political science research shows clear connections between how states obtain revenue, and the quality of their governance. Widening the tax net sparks off a virtuous cycle of taxation and accountability that is at the heart of consolidating effective and democratic states because it is hard to raise taxes effectively or efficiently without “bargaining” with citizens. Historically this bargaining between rulers and taxpayers simultaneously increased the state’s capacity to collect and administer taxes, and its accountability to citizen taxpayers. Governments had incentives to promote broad economic prosperity; while negotiation with taxpayers led to better public policy.

This development of genuine tax-paying citizenship needs to extend beyond big and medium business class to the MSE and informal sector if developing coun-
tries are to achieve sustainable development. Surprisingly little seems to be known in detail about the complex relationship in contemporary developing country contexts between improving tax design, poverty reduction, and the creation of better governance. A well-designed MSE tax base appears critical as the “missing link” from narrow tax bases and weak citizenship prevalent in many developing countries, to OECD strong democracies with broad-based tax systems: tax reform is “an exercise in political legitimization”. Successful broadening of the tax net through better MSE tax regimes should have a positive impact on government accountability, since the “culture of compliance” depends on “tax morale”—the extent to which the citizen-as-taxpayer trusts in the state. “A more legitimate and responsive state is likely an essential precondition for a more adequate level of tax effort in developing countries”.

Mick Moore usefully summarizes the effects on governance of state dependence on broad taxation in the following table:

<table>
<thead>
<tr>
<th>Immediate effects</th>
<th>Intermediate effects</th>
<th>Direct governance outcome</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

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38 http://isp-aysps.gsu.edu/academics/conferences/conf2004/Martinezbirdtorgler.pdf
39 How Does Taxation Affect the Quality of Governance, IDS Working Paper 280, April 2007
Citizens who pay taxes demand more responsive government. This process of state-society bargaining and negotiation is central to the concept of a fiscal social contract: a pattern of regular and routine accountability based on the principle of reciprocity and mutual obligations, rather than patronage and coercion. If governments are not dependent on taxes for their finance, they will be less accountable and responsive to citizen taxpayers, and have little incentive to build political and organizational capacity to negotiate and collect revenue, and spend it effectively. Tax therefore, in states with weak political governance, should be explicitly designed to stimulate accountable and responsive governance. Tax reform should also seek ways to encourage greater demand for transparency in the way public resources are raised and managed. This in turn can stimulate greater government capability, building a more legitimate and effective state.

Informality is therefore a political challenge: “No Representation without Taxation” as much as “No Taxation without Representation.” The importance of promoting MSE taxation reflects two challenges for better tax design for developing countries:

- The “Missing Middle”\(^40\): the comparative lack of medium-sized firms in many developing countries.
- The “Inverted U-Shape”\(^41\): that in many developing countries medium-sized business pays a disproportionate share of the tax burden, since large business use political clout to secure through political influence, and the small disappear into informality.

In developing countries, MSE tax may represent the “missing political middle” in building the fiscal social contract because personal income tax still plays only a marginal role: while personal income taxes yield about 7% of GDP in developed countries (and are paid by around 45% of the adult population), the corresponding figure for developing countries is only about 2% of GDP (paid by less than 5% of the population).\(^42\) Viewed from a fiscal social contract and state-building perspective, the “Missing Middle” and “Inverted U-Shape” phenomena are therefore highly disturbing. How can a state, especially in high aid dependency contexts, build up not just its tax base but its legitimacy and engagement with the citizenry? This is actually the


heart of the development challenge—the Missing Middle is a political and social, not just economic and fiscal challenge.

**MSEs as Voters or Taxpayers? The Politics of Better MSE Tax Systems**

The potential MSE taxpayer is, by definition, close to the average citizen’s concern for whether the state is effective in promoting the interests of all, not just of political and economic elites.\(^{43}\) In any responsive and particularly democratic system, micro and small businesses represent the overwhelming majority of the votes in the business community, and are not necessarily less politically active.\(^{44}\) IMF data\(^{45}\) suggest that in Africa, as everywhere, the MSE sector will represent the overwhelming proportion of the business community’s votes:

- The largest businesses represent 1% of taxpayers but pay 70% of all revenues.
- Medium-sized businesses represent 10–20% of taxpayers and pay 20–25% of revenues.
- Small/micro firms comprise 80–90% of taxpayers, but pay only 5–10% of revenues.

In addition, many voters in poor countries are of course not taxpayers; and these non-tax-paying voters are most likely to be politically concerned about the interests of the 80–90% of the taxpaying business population in the informal, micro, and small sectors. They are also least politically connected to the interests of the 1% of taxpayers in the largest business section.

MSE tax reform and broadening the tax base is therefore politically contentious: considerable political pain for apparently limited fiscal gain. Any MSE tax reform to be politically feasible and sustainable has therefore to go beyond technocratic solutions to consider the political process and political challenge of delivering equity in the tax system.\(^{46}\) Judith Tendler refers to the problem as the “devil’s deal”—the unspoken arrangement between politicians and the informal sector in democracies that:

“If you vote for me, I won’t collect taxes from you; I won’t make you comply with other tax, environmental or labor regulations; and I will keep the police and inspectors from harassing you”.\(^{47}\)

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\(^{45}\) ITD 2007 Conference Background Paper.


Once this informal political deal has been struck between the MSE sector and politicians, it is very difficult to get out of it, and to formalize the economy (including through an effective tax system) and promote economic growth. Without clear political determination, the informal sector can exploit the disincentives of tax administrations to tackle the problem. The political economy dynamics are likely to be different by different sectors, degrees of informality, size of MSEs, and other distinguishing characteristics. But the above ratios of voters to taxpayers suggest that no reform of MSE taxation, especially in low-income country contexts, is likely to succeed without clear political leadership and vision. The MSE/informal sector is willing to pay taxes if and when this is in exchange for improving legitimacy, stability, and protection from arbitrary harassment from state agents. What is the likely political incentive for reform?

Political Incentive for Effective MSE Taxation – Sustainable Economic Growth and Political Stability

Ignoring informal sector activities lowers tax morale across the whole economy and increases the risk of low tax compliance; tax compliance in the formal sector is higher in countries that have a relatively small informal sector. Cross-cultural tax compliance studies suggest that increased trust in government, officialdom, and the legal system significantly improve tax morale. But MSEs are a major engine of job creation, an overwhelming political concern to most developing country governments facing a demographic bulge of young people. One of the platforms for the success of East Asian “developmental states” was their attention to building broad-based tax systems. Only a tax regime that addresses both promoting economic growth and strengthening political stability is likely to have any political traction.

Political Leadership and Vision

The political economy dynamics suggest that the political effectiveness of MSE tax reform requires general tax system reform designed with political commitment to promote economic growth with political stability. Broadening the tax base through simplification of taxes can only reduce informality when this is part of a political process of change. The relative size of the informal sector (as a percentage both of

GDP and total employment) is apparently increasing in all regions of the world.\textsuperscript{53} Africa saw a decline or stagnation in formal sector employment and an increase in informal-sector activities during the 1990s, even though the Index of Economic Freedom for the region improved over the same period.\textsuperscript{54} Effective leadership across the public and private sectors is essential for sustainable tax reform motivated by a vision of building effective states through political stability and economic growth. This will require setting MSE tax reform within political leadership and vision for growth and development—the apparent basis for success, for instance, of tax reforms in Rwanda from 1998 and in Egypt since 2004. This needs to be taken into account in all reform efforts.

\section*{Fight or Flight? Public-Private Dialogue for MSE Political Mobilization around Tax}

Better governance develops from citizens’ capacity to demand more from the state through organized civil society mobilization. An example of political mobilization by the MSE/informal sector around tax was the relationship that developed between the Ghana Private Road Transport Union and Rawlings’ Provisional National Defence Council in the mid-1980s. This partnership resulted in the Union collecting taxes

\textsuperscript{54} Jantjie Xaba: \textit{The Informal Sector in Sub-Saharan Africa} International Labour Organization. 2002.
from its members, starting in 1987, surviving the change of government.55 Please also see a box on associational taxation in Ghana on page 74.

Any bargaining with the informal sector over taxes is of course highly political—so even in Ghana, while successive governments publicly espoused widening the tax net and taking tough measures to sanction tax defaulters, this intention did not lead to action, possibly because of the risk of losing electoral support. But in the long-term, although the amounts collected may be small relative to total revenues, a culture of taxpaying was created in the informal sector, which had until then avoided taxation.

So the Missing Middle and the Inverted U-Shape suggest that the politics of MSE taxation develops around “Fight or Flight” strategies: in most cases the problems of political mobilization of the invariably highly heterogeneous MSE sector makes “flight” to informality much easier than attempting to build up any politically effective organizational way to try to shape the politics and administration of MSE treatment within the tax system.

So what works—both for developing effective political mobilization and at the same time mobilizing revenue for the state, which in turn can deliver legitimacy through improving public goods? The Ghana Road Transport Union mentioned earlier did succeed in building up an effective political voice with government that lasted a significant change in regime. Political bargaining will require some form of MSE voice—dependent on the size; strength, and autonomy of MSEs; the government belief in the importance of MSEs to deliver growth within an overall growth vision; and the forms of public-private dialogue and linkages between the state and the business sector regardless of the type of the regime.

Even in economies with quite small formal sectors, the representative bodies of MSEs are potentially a key group for increasing mobilization around tax. Unlike other typical forms of social protest, such mobilization is likely to be sustained (because taxation is an ongoing process), and it is potentially constructive, because the concerns typically raised are susceptible to bargaining and compromise.56 A holistic approach in government is needed. A study in 2006 on tax compliance costs to MSMEs in South Africa found that even there, the country lacked general understanding that relevant policy considerations extend beyond the implementation of technical changes to tax legislation. The study found that vast information shortages exist that limit the base for any coordinated MSME policy.57 In Cameroon, the development of tax systems adapted to MSEs implied the simplification of other obligations, nota-

bly accounting requirements. The implementation of standards established through OHADA (Organization of Business Legislation, *Organisation de l’harmonisation du droit des affaires*) supports simplification for the smallest enterprises, thanks to the establishment of a very simplified accounting system.\(^{58}\) Tax reform needs therefore to be anchored in, and explicitly supporting, a broader reform effort.

**The Hierarchy of Development Objectives for MSE Taxation**

Understanding political economy dynamics suggests tax reform needs to fit within a broad approach to MSEs as an engine of economic growth and political stability: this can be seen as a hierarchy of development needs:

<table>
<thead>
<tr>
<th>Time Horizon</th>
<th>Aim</th>
<th>Institutions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Short-term:</td>
<td>Immediate Revenue Mobilisation</td>
<td>IMF; Tax Administration</td>
</tr>
<tr>
<td>Medium-term:</td>
<td>Promote Economic Growth</td>
<td>World Bank; Finance Ministry</td>
</tr>
<tr>
<td>Long-term:</td>
<td>Fiscal Social Contract</td>
<td>Donors; Political Leadership</td>
</tr>
</tbody>
</table>

The role of international institutions and donors may lie in helping developing country governments discover how in practical terms to integrate long-term state-building and growth concerns *explicitly* into tax design objectives. On one practical level this means accepting that increased tax administration costs are a long-term investment in the legitimacy of the state by delivering a “fiscal social contract” and sustained growth rates. How to do that should be the focus of international collaboration among major donors, the international financial institutions, and partner governments.

**From the “What” to the “How” and the “Why”: the Political Feasibility of MSE Tax Reform**

Tax reform requires that: “those who will have to pay more must be convinced that they will, so to speak, get something worthwhile for their money. Those who will not pay more must also get behind a reform if it is to succeed. The bureaucracy, those who will have to implement the reform, must also support it, or at least not actively oppose it.”\(^{59}\) Technical solutions to tax design are not enough: “outcome of reforms is largely determined by societal reaction to efforts to change existing

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conditions among groups and interests that are most affected by the reforms”. The international community has learned in the last decade that if any reform is to be effective and sustainable, it is not sufficient to analyze what is needed—it is also essential to understand how change can be successfully achieved and why it is politically acceptable or desired. “Tax policy decisions…reflect a set of complex social and political interactions between different groups in society in a context established by history and state administrative capacity.”

Any MSE tax reform, to be sustainable, must therefore be based on “drivers of change” political economy analysis of reform opportunities presented by political timing, strong leadership and clear vision for economic growth and political stability. Attention should also be paid to administrative actions to build legitimacy and trust between MSEs and the tax authority through change in the culture on both sides, towards voluntary compliance by business and for service from the tax administration, to see the private sector as clients not victims through transparent procedures and taxpayer rights. The political challenge includes the potentially perverse incentives tax administrations face. Not only do tax administrations logically try to concentrate on large taxpayers, but they have strong incentives to actively discourage MSEs that potentially provide only low return for tax effort. Then, in many developing country contexts, corruption around tax is endemic; not just from underpaid staff in tax administration, but through the politics of rent-seeking and vested interests reflected in the uncertain manner in which many tax concessions are offered. Large and perhaps medium sized businesses are best placed to find corruption a cost-effective way to handle relations with politicians and tax administrations. MSE taxation must therefore be carefully designed to prevent opportunities for corruption (see Chapter 2.5).

Many MSEs are affected most by local revenue raising; such as through license, and at this level may see most of the service delivery that helps contribute towards state-building. However, few developing countries have been willing to trust local governments with either the authority or the responsibility to make their own tax decisions. Fiscal decentralization affects constitutional issues beyond the remit of this toolkit, but the impact must be taken into account when making central government reforms.

Tax systems need expressly to broaden the tax base in ways that promote economic growth and better governance (the “social fiscal contract” of taxpaying citizenship). How to achieve this in developing country contexts? The evidence is

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fragmentary on how to link better tax systems to the broader governance challenge that many developing countries face. The ambition however must be not only tax systems that promote economic growth, but also explicitly explore practical ways to generate a stronger political culture around the fiscal social contract.
Options for Facilitating Small Business Tax Compliance

Reducing compliance costs for small businesses requires reforms both on the policy and the administrative side. On the tax policy side, the most fundamental reform approach is the introduction of a special simplified tax system for MSEs. This reform approach is discussed in part three of this toolkit. However, simplified, presumptive taxation is not the only and not always the most appropriate way for designing a small business tax system. There are a number of specific policy reform options that might better address the need to reduce the compliance burden, as well as specific small business concerns with the operation of the tax system.
Any tax system aiming to facilitate tax compliance for MSEs or provide special incentives for MSE development needs to define the segment of the business community that is considered a small or micro taxpayer. A definition of what is understood by the term “MSE” generally is also required for a number of other purposes, in particular for statistical purposes and to define access to MSE development programs outside the tax area. The definition of the term “MSE” is not necessarily uniform for all areas. While some countries use a standard definition for tax as well as statistical and other purposes, other countries prefer a specific definition of who is to be treated as a small and medium taxpayer in the tax laws.

An example of a standard definition is the approach adopted by the European Commission. Recommendation 2003/361/EC contains the following definition of a medium-sized, small and micro enterprise:

<table>
<thead>
<tr>
<th>Enterprise category</th>
<th>Headcount</th>
<th>Turnover</th>
<th>Balance sheet total</th>
</tr>
</thead>
<tbody>
<tr>
<td>medium-sized</td>
<td>&lt; 250</td>
<td>≤ 50 million</td>
<td>≤ 43 million</td>
</tr>
<tr>
<td>small</td>
<td>&lt; 50</td>
<td>≤ 10 million</td>
<td>≤ 10 million</td>
</tr>
<tr>
<td>micro</td>
<td>&lt; 10</td>
<td>≤ 2 million</td>
<td>≤ 2 million</td>
</tr>
</tbody>
</table>

This definition concerns all Community policies applied within the European Economic Area in favor of MSMEs. It is based on the understanding that a legally
secure and user-friendly definition is necessary in order to avoid distortions in the Single Market.

More frequently, however, tax laws define specific criteria to determine the eligibility for special small business tax regimes. These criteria differ from the definition of “MSME” used for statistical purposes. For the latter, the number of employees is frequently used as the key factor determining whether a business is of micro, small, or medium size. Other factors, such as balance sheets, may also be applied.\textsuperscript{63} For tax purposes, there are several possibilities to determine the size of a taxpayer, none of which is ideal, as they all have disadvantages or negative side-effects.

### Measures of Taxpayer Size

<table>
<thead>
<tr>
<th>Criteria</th>
<th>Problem</th>
</tr>
</thead>
<tbody>
<tr>
<td>Business turnover</td>
<td>With high volume of cash transactions and low recordkeeping standards, determining the correct amount of turnover is difficult. Turnover under-declaration is widespread.</td>
</tr>
<tr>
<td>Tax paid or tax liability</td>
<td>Losses result in zero tax liability, including for some very large businesses. Fails to account for tax holidays. Conversely, some capital or technology intensive sectors with few employees may be highly profitable.</td>
</tr>
<tr>
<td>Number of employees</td>
<td>Some industries may be very labor intensive, but have low productivity, and hence low profitability and tax liabilities. Conversely, some capital or technology intensive sectors with few employees may be highly profitable.</td>
</tr>
<tr>
<td>Capital base</td>
<td>Not all capital intensive industries remain profitable, particularly in declining or subsidized sectors. Conversely, the burgeoning, and often highly profitable service sectors may have minimal capitalization.</td>
</tr>
<tr>
<td>Entity type</td>
<td>While many large taxpayers are incorporated, not all corporations are large. Furthermore, some unincorporated enterprises may be quite large.</td>
</tr>
<tr>
<td>Industry type</td>
<td>Large taxpayers may be common in highly regulated (banking, or capital intensive (oil/energy) industries, but the businesses that service these sectors may range widely in size, as well as in highly competitive sectors.</td>
</tr>
<tr>
<td>International transactions</td>
<td>Economic globalization is now affecting businesses of all sizes, particularly importers, exporters, and certain service sectors.</td>
</tr>
</tbody>
</table>

Source: IMF, Tax regimes and administration for small business (and additions by the author)

Irrespective of the statistical definition, business turnover is the most widely used criteria to define an MSE. Indeed, there is no requirement to harmonize the statistical and tax definitions. A separate MSE definition for tax purposes allows to better target tax incentives and simplified tax regimes to businesses requiring a special treatment. For example, the MSE definition for statistical purposes does not

\textsuperscript{63} An overview of definitions used is provided by the IFC database on micro, small and medium enterprises: http://rru.worldbank.org/Documents/other/MSMEdatabase/msme_database.htm
distinguish between incorporated and unincorporated businesses, while on the tax side there could be good reasons for limiting some simplification initiatives to unincorporated small businesses. Turnover is a criteria used frequently in the tax system, and therefore a turnover-based MSE definition facilitates the coordination of the MSE tax regime with the standard tax regime. The criteria of number of employees, while inoffensive for statistical purposes, could act as a disincentive for tax purposes to officially hire additional labor.

Tax laws often do not require a proper definition of the term “MSE” at all. They indirectly define small businesses by defining eligibility criteria for incentives and special regimes targeted at MSEs. The VAT threshold is a typical example of such an approach. It defines up to what level of turnover a business is not required to register for VAT without necessarily mentioning that the businesses below the registration threshold are to be qualified as MSEs. Such thresholds and eligibility criteria for special regimes may be found in several tax laws; therefore, there is no consistent approach in the tax system to determine which businesses are considered small businesses. Such consistency is also not absolutely necessary and may not even be desirable. However, a certain level of coordination is required. In particular, the threshold for the application of a simplified, presumptive tax system should be coordinated with the threshold for VAT registration.

**The different definitions of an MSME: South African case study**

<table>
<thead>
<tr>
<th>Statistics</th>
<th>Taxation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Micro: 0–9 employees</td>
<td>VAT threshold up to 300,000 R turnover</td>
</tr>
<tr>
<td>Small: 10–49 employees</td>
<td>VAT filing simplification for small businesses up to 1.2 million R turnover</td>
</tr>
<tr>
<td>Medium: 50–100 employees</td>
<td>Definition of small business corporation up to 14 million R gross income for income tax purposes</td>
</tr>
<tr>
<td>Threshold for MSE tax amnesty scheme 2006/07 up to 10 million R turnover</td>
<td></td>
</tr>
</tbody>
</table>

In countries that do not explicitly use and define the term “MSE” in their tax laws, there are two main areas that require the definition of standards for the qualification as small taxpayer:

a) In countries operating a presumptive tax system for small businesses, the threshold for the application of such system can serve as one proxy for the definition of a small business for tax purposes. This threshold varies considerably from country to country, and part three of this toolkit provides some further recommendations for the determination of the system threshold.
### Designing a Tax System for Micro and Small Businesses

<table>
<thead>
<tr>
<th>Country</th>
<th>Threshold Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Armenia</td>
<td>Turnover below AMD 30 million (US$89,000)</td>
</tr>
<tr>
<td>Brazil</td>
<td>Gross income not more than R$240,000 (US$103,000) for individuals and R$2,400,000 (US$1.03 million) for incorporated SMEs</td>
</tr>
<tr>
<td>Bulgaria</td>
<td>Turnover below BGL 75,000 (US$52,000)</td>
</tr>
<tr>
<td>Hungary</td>
<td>Turnover below HUF 25 million (US$120,000)</td>
</tr>
<tr>
<td>Peru</td>
<td>Gross income below PEN 240,000 (US$71,000)</td>
</tr>
<tr>
<td>Russian Federation</td>
<td>Up to 1000 employees plus turnover below RUB 11 million (US$342,000)</td>
</tr>
<tr>
<td>Zambia</td>
<td>Turnover below ZMK 200 million (US$50,000)</td>
</tr>
</tbody>
</table>

b) Many countries offer special incentives in their standard tax regimes targeted specifically to MSEs, and aim to promote MSE growth and reduce MSE tax compliance costs. Here again, the tax system needs to define which businesses should be eligible for such incentives. As opposed to the presumptive system, which primarily targets micro and small taxpayers, these incentives frequently are also supposed to benefit medium size businesses. The threshold, therefore, tends to be much higher than the threshold for the application of the presumptive system.
Chapter 2.2: Recommendations by International Organizations on Tax Compliance Simplification

International initiatives to promote small business development unanimously emphasize the importance of tax system reform. Looking at requirements for SME growth in developed countries, the OECD Istanbul Ministerial Declaration on Fostering the Growth of Innovative and Internationally Competitive SMEs\(^6^4\) stresses that SMEs need “enabling regulatory frameworks, which are developed taking into account the needs of SMEs and facilitating their integration into the formal sector.” This requires in particular, according to the Declaration, “tax systems that entail low compliance costs.” The OECD Bologna Charter on SME Policies\(^6^5\) highlights the importance of “fostering the implementation of transparent, stable, and non-discriminatory tax regimes.”

The Commission of the European Union in its recommendation on April 22, 1997 on improving and simplifying the business environment for business start-ups\(^6^6\) highlighted that a difficult or complex regulatory environment can discourage entrepreneurship and the creation of new businesses. The Commission therefore recommended to EU Member states to apply “The ‘Think Small First’ concept, which takes account the interests of SMEs at the earliest stage of considering new legislation and its accompanying procedures. This includes in particular:

a) where appropriate, introduction of derogations, thresholds, or simplified procedures benefiting SMEs;

b) review of different reporting requirements to which SMEs are subject; e.g. the nature of the reports, their frequency, and the period of time that records have to be kept, in order to simplify and consolidate requirements as much as possible; and

\(^6^4\) Endorsed by OECD Ministers and government representatives in Istanbul, 3–5 June 2004 (https://www.oecd.org/document/16/0,3343,en_2649_34197_52020176_1_1_1_1,00.html )

\(^6^5\) Adopted on 15 June 2000 (http://www.oecd.org/document/29/0,2340,en_2649_34197_1809105_1_1_1_1,00.html ).

\(^6^6\) Document C(97) 1161 final (http://ec.europa.eu/enterprise/entrepreneurship/support_measures/start-ups/rec_start-ups/rec_start-ups_97en.pdf)
c) establishment of a dialogue between social security and taxation offices with a
view to reaching a coordinated interface with businesses.

The “European Charter for Small Enterprises”\(^{67}\), approved by the Feira
European Council in June 2000, calls upon EU member states and the European
Commission to take action to support and encourage small enterprises in 10 key
areas, including taxation. Article 7 of the Charter stresses that:

“Tax systems should be adapted to reward success, encourage start-ups, favor
small business expansion and job creation, and facilitate the creation and the
succession in small enterprises”

Looking more specifically at reform requirements in developing countries, the
OECD Development Co-Operation Directorate (DAC) made a number of recommen-
dations in its Development Cooperation Report 2005\(^{68}\). Pointing at the high level
of businesses in the informal economy in many developing and transition countries,
the report cites overly complex tax regulations and poor tax and tariff administration
as some of the main barriers to formalization. The report mentions that “Informal
enterprises shy away from joining tax regimes for other reasons: they are worried
about tax levels; they do not understand how to comply with tax requirements;
they fear the behavior of revenue officials; or they do not believe they will receive
services in return for payment.” The report stresses that “unfortunately, little work
on improving tax administration focuses closely enough on the informal economy
to understand which of these obstacles are more problematic and in need of atten-
tion. Too little tax reform work considers alternative, more indirect approaches to
income-based taxation, which is a burden to smaller firms.”

The report recommends good practice for donors in reducing regulatory and
administrative barriers to formalization:

- Avoid retroactive taxation for businesses that formalize: enterprises will be re-
luctant to formalize if they fear a large tax bill.

- Simplify tax administration. Tax administration is more often cited as a problem
than tax rates. Consider single taxes for MSEs as a way of reducing the number
of payments. Offer different payment options, one-off or by installment.

- Share information on what taxes are used for, and how businesses will benefit
from enhanced services. Evidence suggests that compliance rates go up when
businesses know what they are getting in return for their payments.

\(^{67}\) http://ec.europa.eu/enterprise/enterprise_policy/charter/index_en.htm
Chapter 2.3: VAT Reform Options

Tax policy reform with an objective of creating a tax environment conducive to MSE growth needs to pay particular attention to VAT design. Among the variety of taxes MSEs have to comply with, VAT generally is classified as particularly difficult and burdensome. IFC business surveys in Ukraine, for example, revealed that small business operators considered the VAT to be the most problematic tax from a compliance point of view, followed by the corporate income tax and the payroll tax. The high and extremely regressive cost of compliance with the VAT system reflects these difficulties. Recent VAT compliance cost analysis in Sweden found that a small business with between one and four employees has 35 times higher compliance costs per employee than a large business with between 50 and 499 employees.

Adjusting the VAT threshold

Setting a high VAT registration threshold and relieving most MSEs from the need to comply with VAT regulations thus seems to be a straightforward option to address small business concerns. This strategy becomes even more attractive when considering the fact that the contribution of small businesses to total VAT revenues tends to be minimal. Indeed, a situation in which the combined compliance and administrative costs of VAT for certain taxpayers exceed the amount of tax collected is not completely unusual. In the U.S., for example, research...

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69 IFC, Ukraine: An Assessment of the Business Enabling Environment, 2002
70 Compliance costs of value-added tax in Sweden, Skatteverket 2006.
conducted some time ago into options for the design of a Business Transfer Tax showed that covering businesses below US$50,000 turnover would increase the number of returns to be filed from 5 million to 20 million and the cost of administration from US$200 million to US$700 million. But revenue collected would only increase by 2%.71 Tanzania conducted a study in 2003 into possibilities for increasing the efficiency of the tax system. Following this exercise the VAT registration threshold was increased from 20 million TShs (US$15,800) to 40 million TShs. As a result 7,000 out of the total number of 15,320 VAT taxpayers were deregistered effective from 1st July 2004. VAT revenues were not affected by this reform; in fact they increased from 230 billion TShs in June 2004 to 336 billion TShs in June 2006.

This seems to be a strong argument for simply exempting small businesses from VAT. Such an approach is indeed taken by a number of countries. However, while increasing the VAT threshold can be an attractive reform option from a tax administration point of views, it can entail serious disadvantages for some businesses that are forced to operate outside the VAT system.

<table>
<thead>
<tr>
<th>Advantages of VAT exemption</th>
<th>Disadvantages of VAT exemption</th>
</tr>
</thead>
<tbody>
<tr>
<td>Reduction of compliance burden</td>
<td>No possibility to get refund for VAT paid on inputs</td>
</tr>
<tr>
<td>Elimination for the smallest firms of regressive character of VAT compliance costs</td>
<td>Reduced business credibility – some businesses prefer dealing with suppliers with a VAT number</td>
</tr>
<tr>
<td>Reduction of administrative costs</td>
<td>Borderline businesses may be encouraged to under-report turnover to take advantage of exemption</td>
</tr>
<tr>
<td>Possibility for tax administration to concentrate resources on counteracting high-risk evasion</td>
<td>Distortion of competitive neutrality between registered and non-registered businesses</td>
</tr>
</tbody>
</table>

Choosing the optimal registration threshold

There are substantial variations in the level of the VAT registration threshold in practice. While some countries do not have a VAT threshold at all (and operate a simplified VAT system for small businesses), the VAT system in Singapore has a threshold of more than US$ 700,000.

The mean VAT threshold looking at developed and developing countries worldwide is in the range of US$90,000.72 The determination of the appropriate threshold for a given country requires a thorough analysis of the number of taxpayers and their expected contribution to overall VAT revenue yield per turnover band, as well as structure and characteristics of the MSE community, and the level of administrative and compliance costs per turnover band.

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72 Ebrill/Keen/Bodin/Summers, The Modern VAT, IMF 2001
The IMF proposes a formula for adjusting the VAT threshold (Z) to an optimal level (Z*):

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

where \( \tau \) is the rate at which VAT is levied and \( v \) denotes value added per unit output, so that the tax paid at the threshold level of turnover is \( \tau vz \). For each firm taken out of the tax net as a consequence of raising the registration threshold the government loses revenue of \( \tau vz \), but saves administration costs of \( A \); each firm taken out of the tax net, on the other hand, gains after-tax income of \( \tau vz \) and saves compliance costs of \( C \). Weighting the net loss to the government by \( \delta \) and equating it to the gain to the private sector gives the formula for the determination of the optimal threshold.\(^{73}\) The optimal threshold is higher the more costly is administration and compliance and also increases with a low ratio of value added to sales. However, the more urgent the need for funds, the lower the threshold may need to be.

**Voluntary VAT registration**

To avoid the disadvantages of non-registration, small businesses below the registration threshold should be permitted to register voluntarily. Precaution needs to be taken in this case to avoid VAT frauds by “fly-by-night” traders. This requires careful screening of the application for registration and ascertaining that a refund claim is not made by a “fly-by-night” trader before processing any refund payments.\(^{74}\)

Not all VAT systems offer an option to register voluntarily, as from a tax administration point of view it contradicts the objective of administrative simplification. This should not be a major concern, however. Practice shows that the percentage of MSEs below the threshold applying for voluntary registration generally remains at a manageable level and does not create a major additional burden to the tax administration. On the other hand, from an MSE development point of view, the possibility to register voluntarily can be extremely important to avoid high marginal effective

\(^{73}\) Ebrill/Keen/Bodin/Summers, op. cit.

\(^{74}\) For further information see Keen/Smith, VAT Fraud and Evasion: What Do We Know, and What Can be Done?, IMF Working Paper WP/07/31, 2007
tax rates due to the inability to claim input tax credits for indirect taxes paid on capital inputs. Analysis by FIAS and the Department for International Development (DFID-UK) has shown that the aggregate METRs on capital for non-VAT registered small corporations generally are substantially higher than for VAT registered (large and small) corporations\textsuperscript{75}:

**Aggregate METRs on Capital: Small Corporations**

<table>
<thead>
<tr>
<th>Country</th>
<th>VAT registered</th>
<th>Not VAT registered</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
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<tr>
<td></td>
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<td></td>
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</tbody>
</table>

**Simplifying the VAT rate structure**

Best practice in VAT design suggests that the ideal VAT should only have one rate. In reality, many VAT systems in developing countries operate with multiple rates. While there might be political justification for imposing a higher or lower than standard VAT rate on certain goods and services, such differentiation causes an increase in compliance costs, which is particularly felt by smaller businesses. A study on VAT compliance costs in Sweden\textsuperscript{76} found that there is a distinct correlation between the

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\textsuperscript{75} Analysis of the Effects of the Taxation System on Business Investment in Africa, 2007

\textsuperscript{76} Compliance costs of value-added tax in Sweden, Skatteverket 2006
costs of handling VAT in businesses and the number of VAT rates businesses have to apply. The study calculated that VAT compliance costs of businesses having to apply more than one rate on their transactions would decrease by on average 30% if a single VAT rate was introduced:

**Sweden: Costs of handling multiple VAT rates in the case of a MSE with 1–4 employees**

<table>
<thead>
<tr>
<th>No. of VAT rates</th>
<th>Cost/business (in SKr)</th>
<th>Increase over single rate VAT (percent)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2</td>
<td></td>
<td></td>
</tr>
<tr>
<td>At least 3</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Compensating MSEs for high compliance costs**

Consideration could also be given to providing some relief to MSEs to compensate for high compliance costs. This is not uncommon in OECD countries. Such concessions could take various forms.

The most straightforward method of VAT relief is the introduction of a special, reduced VAT rate for small businesses of a size slightly above the VAT registration threshold. Pakistan introduced a highly preferential VAT rate of only 2% (compared to the standard rate of 18%) for MSEs in 1995 in order to provide incentives for small business formalization. The system was operated for a number of years, until in 2004 a uniform VAT rate of 15% was introduced to reduce compliance and administrative costs. More recently, Korea introduced a preferential VAT treatment for MSEs as part of the tax reform package 2005, reducing the rate for MSEs in the retail sector by 5% and for restaurants and lodging businesses by 10%. Such approach has major drawbacks, however. While the reduced rate is supposed to compensate businesses for high compliance costs, at the same time it complicates the VAT system and increases compliance and administrative costs. In addition, it creates additional tax evasion risks.

Alternative relief methods for MSEs therefore should be considered. One option is to allow a standard small business deduction from the amount of VAT payable. Such an approach reduces the VAT tax burden for MSEs or even exempts MSEs with only a minor VAT liability from transferring small amounts to the Treasury. The approach also reduces the risk of administration and compliance costs exceeding the amount of VAT actually paid. A system of standard deduction is applied in a number of developed countries. A typical example is the small business VAT scheme in the Netherlands, which allows a natural person registered for VAT to claim a deduction
from the amount of VAT due, if his VAT payable after the deduction of prepaid tax amounts to less than €1,883. Should the liability not exceed €1,345, the payment obligation is waived entirely.

**Return filing simplification and payment flexibility**

The filing frequency of the VAT system is one of the main reasons for high compliance costs. Many VAT systems provide a standard requirement to file monthly VAT returns. Reducing the filing frequency for small businesses can work as an important simplification measure.

Similar systems are in operation in other countries. In New Zealand, for example, taxpayers generally are obliged to file every two months, while MSEs can opt to file a return only twice a year, and filing can be timed to coincide with the accounts reporting date. In Canada, returns are normally filed within one month of the reporting date, while small firms have three months after their reporting date to file their returns.

Analysis from Australia shows that cash flow benefits from less-frequent payment obligations can be substantial. Based on an interest rate of 10%, the cash flow benefits from a less-frequent remittance of VAT are calculated as follows\(^\text{77}\):

Providing a possibility of remitting the VAT every three months instead of on a monthly basis would thus provide the small business with a cash flow benefit of (1.25 less 0.42) 0.83%.

\(^{77}\) Fernandez/Oats, GST and the Small Business, 1998
Many small businesses face cash flow problems. As VAT is generally based on accrual accounting, a small business may face serious problems by having to pay VAT before the payment for a taxable transaction has actually been received. This problem can be addressed by offering MSEs the option of paying VAT based on cash accounting. In this case, small businesses can pay VAT on receipt of payment from its customers rather than at the time a sale is made. Cash accounting systems can be classified, in order of complexity, into three broad types to cater to the differences among SMEs:

- Cash book records based on daily entries of actual cash receipts and payments.
- Cash book entries and basic documentation like sales or purchase invoices and bank statements.
- Cash entries, basic documentation, and abridged financial statements.

### Simplified VAT calculation

To reduce VAT compliance costs for MSEs, a number of countries have designed simplified schemes to facilitate the calculation of the VAT liability. These schemes are open to small businesses above the VAT registration threshold up to a certain business size. The small business eligible for such a regime still charges the normal VAT to its customers and issues a VAT receipt; however, the VAT liability to the government is calculated on a lump sum basis instead of a detailed calculation.

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Terkper, Managing Small and Medium-Size Taxpayers in Developing Countries, 2003
A similar simplification is provided by the flat-rate scheme in the UK.

**Introduction of flexible thresholds for simplified systems**

Simplified/preferential systems require the introduction of an additional threshold in the VAT law. The threshold should block the access of larger businesses, who are supposed to apply general rules and reporting standards, to simplified schemes set up for MSEs. But such a threshold can also act as a disincentive for MSE growth: a small business with a turnover slightly below the upper threshold might be reluctant to further increase its business volume in order to be able to continue benefiting from lower compliance costs under the simplified system. Rules should be devised to reduce the risk of thresholds becoming an obstacle to MSE growth.

The introduction of flexible thresholds is a simple and convenient way to avoid an abrupt switch from a simplified to the standard taxation regime. The UK annual accounting scheme for VAT described above operates with such a flexible threshold. The system has been designed for SMEs with an annual turnover not expected to exceed £1,350,000. However, SMEs having opted for the scheme and having reached the threshold are not obliged to quit immediately; they may remain in the system until their annual turnover exceeds £1,600,000. The system thus allows an SME to remain in the preferential scheme as long as the business turnover does not exceed the turnover threshold level of the scheme by a considerable percentage.

The requirement to exit a preferential scheme can also be linked to the period an MSE exceeds the eligibility criteria for the system. A move to the standard system in this case could be required, if, for example, an MSE shows an annual business turnover exceeding the threshold in three consecutive years.
Chapter 2.4: Reforming Direct Taxes

Rate reduction

Considering comparatively high compliance costs of MSEs also in the area of direct taxation and the desire to promote small business development, a number of countries worldwide have introduced lower income tax rates to increase the competitiveness of MSEs. A reduced tax rate can provide an additional incentive for small businesses to formalize. However, rate reductions also have some disadvantages. Apart from a possible reduction in overall revenue collection, there is a risk of abuse of the preferential system by larger businesses and a potential impediment to small business growth for MSEs that are required moving from the application of the preferential to the standard tax rate. The importance of income tax rate reductions for MSEs is decreasing with the general trend to reduce personal and corporate income tax rates. With the introduction of flat income tax systems with low rates in a number of transition countries, a special MSE tax rate has become obsolete.

Income tax rate reductions for MSEs can be quite substantial. Since 2007 Canada has been operating a standard corporate income tax rate of 21%, while small businesses subject to corporate income taxes with a turnover below CAD 400,000 (US$345,000) pay taxes at a rate of only 12%. Some countries in Europe, such as Belgium, Spain, Ireland, the UK, and the Netherlands, offer reduced corporate tax rates for small companies with a business turnover below a certain threshold. Also, transition and developing countries have introduced reduced tax rates for MSEs. In Lithuania, the standard tax rate for business profits is 15%. MSMEs with not more than 10 employees and an annual income of up to 500,000 LTL (US$190,000) benefit from a reduced rate of 13%. South Africa provides an exemption from corporate taxation for MSEs with taxable income below R 40,000. MSMEs with taxable income between
R 35,000 and R 250,000 benefit from a reduced CIT rate of 10% (compared to the standard rate of 29%). Such zero CIT band can, however, result in a tax discrimination of non-incorporated MSEs. In the UK, tax-motivated incorporation became particularly apparent following the introduction of a zero percent CIT band for the first £ 10,000 of profit in 2002–03, so that after three years of operation the zero band was withdrawn again.

The risk of the threshold for a lower tax burden for MSEs becoming an obstacle for MSE growth can be alleviated by designing a phased approach. Such a system was introduced in Australia in 2005. SMEs in Australia benefit from a 25% tax offset on their income tax liability if their annual turnover is less than $50,000 (US$ 40,000). When the business turnover increases above this threshold, the tax offset will be progressively phased out and is reduced to zero in case of a turnover level of $75,000 (US$ 60,000).

**Tax incentives for MSE development**

Tax rate reductions provide a general tax relief for small business operations. To further promote the creation of new MSEs, some developing and transition countries offer tax holidays for small businesses in the start-up phase. Moldova, for example, fully exempts newly created MSEs from profit tax for a period of three years and provides a 35% reduction of taxable income for the following two years. Such an approach is prone to abuse, however, as it provides an incentive for MSE owners to cease the operation of a business just before the expiration of the tax holiday and re-establish the business under a new name to again enjoy a three-year tax-free business operation. A tax holiday scheme is also not appropriate for highly profitable start-up MSEs. The undesirable privilege for high-profit MSEs can be avoided by establishing a ceiling for the tax holiday scheme. In Singapore, the full exemption from profit taxation granted to SMEs in the first three years of operation only applies to profits up to SGD 100,000 (USD$66,000).

A generally more efficient alternative to a general incentive and tax holiday scheme is the design of targeted incentives to address specific operational challenges faced by MSEs or to promote investments to facilitate MSE growth. Such incentives generally take the form of tax deductions or tax credits. There are three areas in which direct MSE development tax incentives are of particular importance: (i) to support improvement of the equity basis of MSEs; (ii) to promote innovation; (iii) to foster investment.

**Improvement of the MSE equity basis:** Tax systems can have a strong impact on economic decisions. Tax systems favoring debt financing over the retaining of a small businesses own earnings support the development of a weak equity basis, which makes businesses vulnerable and aggravates the problem of structural chang-
es and re-orientation of businesses. Incentives should be provided by the tax system to support re-investment of profits in MSE development.

**Investments in R&D.** Innovation and investment in research and development is key to improving the viability of MSEs. While promoting R&D activities generally is also an element of the standard tax system for larger businesses, a number of countries offer specific and more favorable incentive schemes for MSEs. The main element of R&D incentives is the possibility of deducting a larger amount than the actual expenses incurred in R&D activities from the tax base. In Hungary, 200% of R&D costs can be deducted. In some systems, such as in the UK, cash refunds for R&D expenses can be claimed.

**Investments to increase business assets:** One of the typical MSE operational constraints is limited access to loans for investment and development. MSEs often face higher costs when they have to borrow money to invest in business assets and expand their operations. The tax system can be used to alleviate this burden and promote MSE investment. An example of a system in this respect is the Hungarian **tax relief on credit for investment**, which offers SMEs the possibility of deducting 40% of interest paid for credits to purchase fixed assets from their tax liability up to a maximum of HUF 6 million (US$ 31,200).

An innovative tax support to promote loans to start-up MSEs is the “Durfkapitaal” approach (former ‘Tante Agath Regeling”) in the Netherlands.
The Durfkapitaal System

The system aims at stimulating third parties to make investments in start-up MSEs. The loan has to be registered and has to be used for financing assets that are an integral part of the MSE’s basic assets. It has to be a subordinated loan, so that the money is part of the risk capital in the company. The private creditor is exempted from tax on the interest received and, should the loan not be paid back due to bankruptcy or other financial problems of the MSE, the creditor gets a tax compensation up to a maximum of 50,000 Euros (US$66,000).

Simplified depreciation

A number of countries offer simplified and more favorable depreciation schemes for MSEs. In South Africa, registered manufacturing MSMEs are able to write off machinery and equipment immediately at 100%, rather than the typical write-off rate of 20% per annum. In Australia, low-cost assets can be deducted immediately for tax purposes instead of over several years. Also, for assets with an effective lifetime of up to 25 years, instead of separate depreciation calculations for each asset and deductions calculated for each asset based on the its effective life, assets can be allocated to a general simplified tax system pool. This is treated as a single asset and does not require separate calculations for each asset. Deductions are calculated at the rate of 30%.
Chapter 2.5: Simplified (Presumptive) Taxation

The application of the standard taxation regime generally requires keeping appropriate books and records. For MSEs, complying with standard recordkeeping requirements not only is costly, but often exceeds the capacity and skills of the small business operator. Non-compliance with obligatory bookkeeping requirements, even if is unintentional, can severely hurt the small business. An analysis under the umbrella of the Small Business Survey Program in Australia\textsuperscript{79} showed that there is a direct link between poor recordkeeping and the likelihood of an amended assessment when the MSE has been subject to a tax audit. Once a business is selected for audit, those with poor recordkeeping systems and processes are more likely to have their assessments amended adversely.

Therefore, methods need to be identified to adjust the tax system for MSEs to their poor recordkeeping and accounting capabilities. The

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\textsuperscript{79} Record Keeping: Its Effect on Tax Compliance, Melbourne, May 2005
operation of a simplified presumptive tax system is the most frequent and popular approach in this respect. Some sort of presumptive tax system for MSEs can be found in a large number of developed and developing countries worldwide. These systems vary considerably in their scope of application, the criteria used to determine the tax liability of the MSE, and their performance. There are neither standard principles nor is there uniform experience with the design and application of presumptive systems.

The introduction of a presumptive taxation system generally is much welcomed by the MSE community. However, it needs to be highlighted that a presumptive system is not necessarily purely advantageous for an MSE.

**Possible advantages and disadvantages of presumptive tax systems**

<table>
<thead>
<tr>
<th>Advantages</th>
<th>Disadvantages</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lower compliance costs</td>
<td>No incentive to improve bookkeeping</td>
</tr>
<tr>
<td>Tax liability more predictable</td>
<td>No relief in case of loss making</td>
</tr>
<tr>
<td>Less interaction with tax administration</td>
<td>Potential disincentive to grow</td>
</tr>
<tr>
<td>Generally lower tax burden</td>
<td>Risk of abuse</td>
</tr>
<tr>
<td></td>
<td>Fairness concerns</td>
</tr>
</tbody>
</table>

Contrary to the view expressed sometimes by tax policymakers in developing countries, presumptive tax systems are not easy to design and require substantial preparatory work. In particular, the risks are high of arbitrary features of presumptive taxation, with an excessive tax burden on some groups of small taxpayers and under-taxation of others, and of an excessive gap between the standard and the presumptive tax regimes, causing severe problems of migration into the standard regime for successfully operating and expanding MSEs. Options to reduce compliance costs by facilitating compliance of small businesses with standard taxation rules should not be neglected because of the existence of a presumptive system. In particular, businesses that are in a position to comply with simplified bookkeeping and accounting standards should be required to keep books in accordance with these simplified standards. Depending on the level of literacy and education, this could limit the application of proper presumptive systems to the taxation of micro-businesses, which are large in number but small in size and profitability.

**Main categories of presumptive taxes**

Presumptive tax systems basically can be grouped in four categories:

(i) Systems based on turnover or gross income.

(ii) Systems based on indicators.
(iii) Simple lump-sum patents.

(iv) Systems based on agreement between taxpayer and tax administration.

In addition to these four categories of presumptive taxes, which are operated in lieu of certain parts of the standard tax system, or which entirely replace the standard tax system, some countries operate presumptive taxes with the sole purpose of guaranteeing at least a minimum amount of tax revenue from businesses (Alternative Minimum Taxes). These presumptive taxes neither are limited to MSEs, nor do they replace the application of standard taxation rules. The major form of such presumptive tax is an asset-based presumptive minimum tax\(^80\). Because such taxes do not aim at facilitating MSE compliance with the tax system, they are not discussed further here.

A number of countries, particularly in Sub-Saharan Africa, levy withholding taxes to reduce MSE tax evasion possibilities. However, such taxes have also been tried by OECD countries to reduce income tax evasion by MSEs\(^81\). Profit withholding taxes are levied either on imports or on domestic sales at a rate generally ranging from 1–3%. The tax is withheld either by customs or by registered providers of goods and services. If the tax withheld exceeds the actual profit tax dues, the MSE may claim a tax refund. For non-registered MSEs, the advance payment becomes a final tax.\(^82\) Withholding taxes therefore can be an efficient tool to ensure a contribution of non-registered businesses to overall tax revenues. Withholding taxes also provide additional incentives to formalize and register for tax purposes. On the other hand, the obligation to collect and transfer withholding taxes creates an additional compliance burden for the withholding agent and therefore cannot be extended beyond large manufacturers and wholesale suppliers. In practice, it is not uncommon to limit withholding obligations to government institutions and public entities.

For each of the categories listed above, there are generally a number of alternatives, and categories as well as subcategories differ substantially in resources required to operate the system (both on the side of the taxpayer and the tax administration). Taxonomy of presumptive systems could be as follows:

\(^{80}\) For further discussion of presumptive minimum taxes see Thuronyi, Presumptive Taxes, 1997.

\(^{81}\) E.g. Australia operated in the 1980s and 1990s withholding tax system for intra-industry payments in certain business sectors. For a description of the system see Wallschutzky, Australia: Reforming a Tax system to Reduce Opportunities for Tax Evasion, BIFD 1991, 165.

Designing a Tax System for Micro and Small Businesses

Types of presumptive taxes: efficiency and equity

This kind of presumption can be applied as an exclusive way of taxing income, as a minimum tax, or as a forfeit. Turnover or gross income based systems are the most popular kind of presumptive tax systems. Turnover-based presumptive systems offer a number of important advantages:

- Different from pure indicator-based systems, the tax burden gets reduced for periods or businesses with below-average volume of business transactions. This also benefits start-up businesses for the period they are not yet fully operating.
- They oblige small businesses to keep at least some basic books and records without imposing any burdensome accounting requirements on MSE operators.
- As a consequence of the requirement to observe basic bookkeeping standards, the transition from the presumptive to the standard tax regime is facilitated.
- Turnover has the potential of being a better proxy for profit estimation than indicators such as the size of business premises or the number of employees. Negative effects of indicator-based systems, such as the incentive to reduce the number of staff in order to lower the presumptive tax burden, can be avoided.
- Rules for the calculation of the tax burden can be kept simple.

The principle alternatives for the design of a turnover-based presumptive tax are:

A. Application of a uniform tax rate on a standard percentage of turnover for all MSEs taxed under the presumptive regime. This is the most basic alternative of turnover-based presumptive systems. It does not take into account

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83 This graph is based on Pashev, Presumptive Taxation and Grey Economy: Lessons for Bulgaria; CSD Working Paper 0512/1, December 2005
<table>
<thead>
<tr>
<th>Patent</th>
<th>Characteristics of the main Categories of Presumptive Taxes</th>
</tr>
</thead>
<tbody>
<tr>
<td>Type of activity</td>
<td>Bulgaria, Kosovo, Egypt, a number of African countries</td>
</tr>
<tr>
<td>Selected countries</td>
<td>Spain, Italy, Argentina</td>
</tr>
<tr>
<td>Indicator-based system</td>
<td>Group of indicators as proxy for business income</td>
</tr>
<tr>
<td>Spain, Italy, Argentina</td>
<td>Business turnover plus agreement between taxpaye and tax administration</td>
</tr>
<tr>
<td>Agreee systems</td>
<td>France, Israel</td>
</tr>
<tr>
<td>(a) Easy to administer</td>
<td>(b) Positive incentive effects as additional earnings above average (presumed) income taxed at a zero rate</td>
</tr>
<tr>
<td>(c) Minimize tax administration discretion, therefore reducing risk of corruption</td>
<td></td>
</tr>
<tr>
<td>(a) Positive incentive effects as additional earnings above presumed income taxed at a zero rate</td>
<td></td>
</tr>
<tr>
<td>(b) Tax burden differentiated according to size of business operation</td>
<td></td>
</tr>
<tr>
<td>(a) Guarantees minimum level of vertical and horizontal equity</td>
<td></td>
</tr>
<tr>
<td>(b) Easier transition from presumptive to standard regime, as turnover is also decisive element of tax calculation in standard systems</td>
<td></td>
</tr>
<tr>
<td>(c) High revenue potential compared to other presumptive systems</td>
<td></td>
</tr>
<tr>
<td>(a) System reflects taxpayer specifics</td>
<td></td>
</tr>
<tr>
<td>(b) System generally favors businesses with high profit margins</td>
<td></td>
</tr>
<tr>
<td>(a) Extremely high corruption and collusion risk</td>
<td></td>
</tr>
<tr>
<td>(b) System requires extensive data collection and analysis and is costly and time-consuming</td>
<td></td>
</tr>
<tr>
<td>(a) Poor revenue performance</td>
<td></td>
</tr>
<tr>
<td>(b) Does not take into account taxpayer specifics</td>
<td></td>
</tr>
<tr>
<td>(c) Violates vertical equity</td>
<td></td>
</tr>
<tr>
<td>(d) Regressive</td>
<td></td>
</tr>
<tr>
<td>(a)Prospects investment decision (in particular may create disincentives for hiring labor and expanding business assets)</td>
<td></td>
</tr>
<tr>
<td>(d) Selection of appropriate indicators, studying sectoral profitability, and establishing specific correlations between indicators and presumed income is difficult and requires substantial resources</td>
<td></td>
</tr>
<tr>
<td>(c) No tax reduction for loss-making MSEs</td>
<td></td>
</tr>
<tr>
<td>(b) System design requires substantial amount of external data, which may not be available</td>
<td></td>
</tr>
<tr>
<td>(a) High risk of turnover under-declaration</td>
<td></td>
</tr>
<tr>
<td>(b) High risk of corruption</td>
<td></td>
</tr>
<tr>
<td>(c) System generally favors businesses with high profit margins</td>
<td></td>
</tr>
</tbody>
</table>
different profit margins in the various business segments. As a consequence, such a system needs to operate with a rather low tax rate or a high standard deduction from turnover for the tax base calculation to avoid over-taxation of certain business segments. A typical example of such an approach is the simplified tax system for MSEs (legal entities) in Ukraine, which applies to small businesses with a turnover of less than 1 million UAH (US$208,000) and a maximum of 50 employees. The system operates with a uniform tax rate of 6% on turnover if it is only supposed to replace income tax, and a 10% rate on turnover in case the taxpayer opts for presumptive taxation in lieu of standard income tax and VAT. Albania has also introduced a small enterprise tax regime, applying a flat rate of 1.5% of enterprise turnover.

**B. Progressive turnover-based presumptive tax.** Alternatively, the uniform turnover-based presumptive tax can also be designed as a progressive tax. In this case, different MSE segments are still treated uniformly; however, the tax rate increases according to the level of business turnover.

**Simplified Declaration Scheme for Individuals in Kazakhstan**

<table>
<thead>
<tr>
<th>Income within a Quarter (in KZT)</th>
<th>Tax rate</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
</tr>
</tbody>
</table>

The progressive turnover-based tax has a major advantage over the basic uniform turnover tax, as it should reduce the difference in tax burden between the upper band of the presumptive system and the lower band of the standard system. It therefore reduces disincentives for business growth and facilitates transition from the presumptive to the standard regime (albeit at the cost of somewhat increasing the complexity of the system).

**C. Application of different tax rates on a standardized tax base.** Different business segments may have substantially different turnover/net profit ratios. To avoid major differences in the real (net) income tax burden, it is necessary to either apply different deductions from turnover for the calculation of the tax base or to apply different tax rates on turnover according to the average profit ratio. The differentiation will have to be kept at a minimum, however, for reasons of simplicity, and to avoid tax evasion possibilities and disputes between taxpayers and the tax administration over the rate or deduction to apply. Typically, such an approach dif-
ferentiates between traders and businesses in the service sector. The approach tends to increase the fairness of the system but is difficult to administer for MSEs carrying out both trade and service activities.

Certainly the differentiation between business categories can go much beyond a distinction of service and trade-oriented businesses. The Ethiopian presumptive tax system lists 69 different professions and 19 turnover bands with a progressive rate. This requires setting and adjusting 1,311 tax rates. This seems an overly complicated approach, which, compared to the risk of reduced transparency of the system and increased administrative burden, produced little value added in terms of fairness and acceptance of the system.

The challenge of tax rate determination. Turnover-based presumptive tax systems seem easy to design. They also reduce risks of disputes over the applicable tax rate and do not require complicated comparisons of profit margins in different small business segments. There is a substantial design challenge, however, when it comes to fixing the level of standard deduction from turnover/gross income, or the tax rate to be applied. An implicit feature of turnover-based systems is that they may result

in a comparatively high tax burden for businesses with a comparatively low profit margin, and a relatively low tax burden for MSEs with very high profit margins. On the one end of the spectrum such a situation forces MSEs to either opt out of the system and bear the substantially higher compliance costs of the standard tax system or to cease formal business activities. On the other end of the spectrum it creates incentives for businesses above the threshold to under-declare turnover or to split up in order to be able to move into the presumptive system, thus causing revenue losses for the Treasury. A high tax rate on turnover quickly becomes prohibitive, as can be seen from the example of Cuba.

As the attractiveness of the simplified regime largely depends on the actual profit margin of the business, more sophisticated small taxpayers in high cost/turnover business sectors get an unintended incentive to move out of the system, which can significantly change the mix of small taxpayer categories taxed on a presumptive basis. Such experience has been made in Hungary with the application of the simplified entrepreneurial tax.

There is no general guideline for the determination of the tax rate in case of a turnover-based presumptive system. Extensive analysis into average MSE profit margins is required before setting the rate.

**Providing incentives for improving recordkeeping.** Turnover-based systems are the only kind of presumptive tax systems that require the taxpayer to follow at least some basic recordkeeping procedures by accounting business turnover on a regular basis. This only requires a very rudimentary bookkeeping. Turnover-based systems, if well designed, offer a good possibility of providing specific incentives for improving recordkeeping standards. The presumptive tax system in Tanzania is a good example of such an approach.
Presumptive Income Taxation in Tanzania

Tax payable in case taxpayer only keeps rudimentary records for business transactions:

<table>
<thead>
<tr>
<th>Annual Turnover (in TZSh)</th>
<th>Tax Payable (in TZSh)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Up to 3 million</td>
<td>TShs 35,000</td>
</tr>
<tr>
<td>3–7 million</td>
<td>TShs 95,000</td>
</tr>
<tr>
<td>7–14 million</td>
<td>TShs 291,000</td>
</tr>
<tr>
<td>14–20 million</td>
<td>TShs 520,000</td>
</tr>
</tbody>
</table>

Taxpayers who keep simplified records have the chance to considerably reduce their tax liabilities, which more than compensates for the increased compliance costs incurred as a result of recordkeeping. For a taxpayer with an annual turnover of 10 million TZShs, for example, presumptive tax liability is 160,000 TZSh. in case of recordkeeping compared to 291,000 TZShs. without keeping simplified records. The system seems attractive, as it both introduces a progressive feature of presumptive small business taxation, and provides incentives for improving recordkeeping. A downside of the system, however, is the potential difficulty in determining the turnover of a small business that does not keep any books and records. This difficulty has been taken into account in the design of the Kenyan turnover-based presumptive tax, which abstains from introducing multiple turnover bands. MSEs below the VAT threshold of 5 million Ksh (US$ 71,500) are subject to a presumptive tax at a rate of 3% on declared turnover in case the business maintains accounts and 3% of 5 million Ksh if a business does not keep accounts. In practice, experience in Tanzania so far has been that, despite the substantial reduction in the tax burden for recordkeeping MSEs, the level of recordkeeping among Tanzanian MSEs has not increased much. This demonstrates that, in addition to monetary incentives, major taxpayer assistance and sensitization programs are required to support the establishment of a bookkeeping culture.

**Possibilities to counteract turnover under-declaration**

From a tax administration point of view, turnover-based systems incur a high evasion risk, as true turnover can be concealed easily. In a cash economy environment the possibility for the tax administration to detect cases of under-declaration is extremely limited. Disputes over the true business turnover can also lead to harassment of taxpayers. A number of approaches have been tried to reduce risk of under-declaration of business turnover:
**Use of cash registers:** A number of countries, particularly in Africa, have introduced a compulsory use of electronic cash registers (ECRs) to facilitate turnover verification. It needs to be considered, however, that for many small businesses; electronic cash registers constitute a major business expense and thus contribute significantly to overall compliance costs. In addition, practical experience in African countries has shown that, due to a number of external factors, cash registers cannot fully achieve their objectives. Key issues in this respect are\(^86\): (i) lack of or unreliability of electric power supply reduces the possible use of electronic cash registers. Battery operated cash registers, which theoretically would constitute a feasible alternative, are too costly in practice to be imposed on small business owners; (ii) lack of or inadequate facilities for repairing and maintaining ECRs; (iii) a culture of limited interest in receipts; (iv) a bargaining culture that leads retailers to offer pre-VAT/sales taxes prices provided no receipt is issued; (v) lack of administrative capacity to monitor the proper usage of the ECRs and match the multitude of data collected from numerous small business operators; (vi) corruption.

**Tax invoice lotteries:** The obligation on small business operators to keep electronic cash registers therefore generally is not a recommended approach to reduce evasion risks. A more promising approach is the introduction of incentives for issuing receipts. This can be done, for example, in the form of organizing receipt lotteries.

**Promotion of credit card use:** Under-declaration of turnover is much facilitated in a cash-dominated economy. Increasing the use of credit cards therefore offers one possibility to reduce the tax evasion risk. An interesting approach in this respect has been tried in Korea.

\(^86\) The author would like to thank Anka Kitunzi, USAID/ARD project on strengthening decentralization in Uganda for his input into this section.
Credit Card Policy in Korea

The Korean government in 1999 decided to encourage people to use credit cards. Twenty percent of credit card expenditures can be deducted from the credit card user’s taxable income. A lottery system was organized in 2000, which distributed $17 million to credit card users. As a result, credit card expenditure increased sharply. While it was relatively constant at a level between $30 and $41 billion in the years 1997–1999, it skyrocketed to $77 billion in 2000, and further increased to $165 billion in 2003.

Obligation to use financial system for payments: Some countries have established a legal requirement to use the banking system for making payments for purchases or services above a specified amount. Major transactions thus can be traced more easily and the risk of not including the transaction in the turnover declaration is increased. Although such obligation is difficult to enforce and requires access of both parties of the transaction to banking services, it can be a useful tool for reducing evasion possibilities.

Combination of turnover-based system with indicator system: The impact of turnover under-declaration on the tax liability can be reduced, when external indicators in addition to turnover determine the minimum tax liability. Such an approach is discussed more in detail below.

Despite the high risk of turnover evasion, the system must be based on actual and not on presumed turnover. A badly designed turnover-based system, which does not sufficiently take into account actual business turnover as a base for calculation of the presumptive tax burden, in fact turns into a simple patent system (see below). This was the case with the simplified system that operated in India in the 1990s.

The reference to business turnover would not have been required in the system, as it was based on deemed instead of actual business turnover. The activities covered also were typical activities for which a simple patent solution could be considered.

The main alternative to a turnover-based system is a presumptive tax system based on external indicators. It is crucial for the acceptance of the system to refer to indicators that provide a proxy for the actual income of the taxpayer.

**Selecting the right indicators.** “Good” indicators should meet the following criteria:

- They must be easy to verify and record.
- They must have a low risk of falsification, concealment, and substitution.
- They must show a sufficient and stable correlation to actual income.\(^{88}\)

Most common indicators are the floor space of business premises, number of employees, value of inventory, capacity of machinery, and number of years of operation of the business. Also, data about business inputs that can easily be obtained from third parties can be useful indicators, particularly data about electricity and water consumption. A few countries have also been working with collecting data from wholesale suppliers to small traders. However, this is reliable only in case of little risk that the MSE can get supplies from unrecorded sources.

The annual taxable income in the Spanish case is the total of presumed income per unit. A restaurant operated by the owner with one salaried employee, energy consumption of 100 KW and one piece of machinery type B thus has a presumed income of 41,709 Euros (3,438 + 15,434 + 100x192 + 3,636). Assuming a tax rate of 25%, the application of a presumptive tax results in a tax burden of 10,427 Euros.

The example also demonstrates that the system may have a very different impact on the marginal tax rate depending on the actual change of indicators. If the

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**Operation of an indicator-based system: taxation of restaurants in Spain**

<table>
<thead>
<tr>
<th>Indicator</th>
<th>Unit</th>
<th>Annual income per unit (Euros)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Salaried employees</td>
<td>Person</td>
<td>3,438</td>
</tr>
<tr>
<td>Non-salaried persons</td>
<td>Person</td>
<td>15,434</td>
</tr>
<tr>
<td>Energy consumption</td>
<td>kilowatt</td>
<td>192</td>
</tr>
<tr>
<td>Equipment type A</td>
<td>Piece</td>
<td>1,028</td>
</tr>
<tr>
<td>Equipment type B</td>
<td>Piece</td>
<td>3,636</td>
</tr>
</tbody>
</table>

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\(^{88}\) Rajaraman, Presumptive Direct Taxation, 1995
A restaurant owner in the example given has an actual net income of 45,000 Euros and manages to increase his net income to 48,000 Euros without hiring additional staff and changing any of the other indicators, his METR on the additional income of 3,000 Euros is zero. If, however, he hires a second waiter to reduce the workload, his METR on the 3,000 additional income increases to 28.7%. In fact, a presumptive income tax which is levied not on income but on indicators such as the number of employees or the level of machinery in reality becomes a tax on the indicator. This can carry adverse effects with respect to employment generation or capital usage, as firms limit their use of these inputs in order to reduce tax liabilities. 

**Design challenges of indicator-based systems**

Indicator-based systems are supposed to have some major advantages over turnover-based systems:

- They are less prone to tax evasion: it is more complicated to conceal the existence or the size and amount of most of the common indicators in use than to under-declare business turnover.

- They should give less reason for disputes between the business owner and the tax administration over the presumptive tax liability.

- They supersede even basic bookkeeping requirements and thus may reduce tax compliance costs even further than a turnover-based system.

Despite these arguments, practice shows that indicator-based systems are difficult to design and risk causing problems for businesses and for the tax administration in practice. These are some of the key design problems:
It is difficult to define indicators that sufficiently reflect the profit potential and a small business owner's ability to pay. It is not obvious, for example, that the mere size of business premises allows drawing a conclusion regarding business profits.

The profit potential of comparable businesses with identical indicators considerably depends on the business location. A retail store in a busy main street downtown generally is much more profitable than a similar business in a remote village. Many indicator-based presumptive systems therefore introduce an additional factor of quality of business location, which makes the system non-transparent and overly complicated.

The requirement to apply basic bookkeeping rules nominally may add to compliance costs. In fact, however, it supports proper business management and helps MSE owners to better control business operations and make investment decisions. The income tax compliance cost survey in India is revealing in this respect. While business owners complained about the complicated tax system and high compliance costs, they also found a number of important advantages in complying with the tax system: 62% of respondents found it to be an advantage for business operations that due to tax requirements income statements and balance sheets were better prepared.

Indicator-based systems require extensive and well-documented research on profit margins in the various business segments covered. Otherwise, there is a risk of ongoing disputes with the MSE community over the estimates used.

Indicator-based systems may have undesirable effects on business decisions. They may affect the size of business premises or act as an incentive for either a staff reduction or for not registering employees. This is linked to an uneven impact of marginal tax rates.

They create a particular problem for start-ups and loss-making MSEs. Special relief provisions for start-up businesses need to be designed to avoid that the presumptive tax system leads to inappropriate tax liabilities for new businesses. In practice, however, such relief to start-ups is rarely offered.

Indicator-based systems, unlike turnover-based systems, have to establish detailed lists of the businesses covered. As a result, the systems risk lacking transparency and causing ongoing disputes about fairness and appropriate determination of taxpayer categories, which impacts negatively on the stability of the system.

Interestingly another major advantage was seen in the fact that tax auditing requirements were useful in detecting dishonest employees!
Overall it appears that the degree of acceptance of indicator-based systems is not high. Disputes about the right definition, delineation of individual categories, and the scope of coverage of the system undermine the credibility of the system.

An indicator-based system therefore normally should not be the prime option for the design of a presumptive tax system. It should be limited to a small number of business segments with a particularly high risk of under-declaration of turnover. An indicator-based system could, however, be an option for countries with very low tax administration capacity and a high level of illiteracy in the SME community.

### 3. Combination of turnover and indicator-based systems

The risk of tax evasion as a result of under-declaration of turnover/gross income can be reduced by adding indicator elements to a principally turnover based system. This is the case, e.g., of the Monotributo in Argentina.

The system provides clear counter-evasion features from a tax administration point of view. It is assumed that an MSE, which has an electricity consumption of 4,000 KW or which has business premises of 35m² cannot have a turnover of less than $24,000, irrespective of the actual turnover declared. The relevant indicators are clear and difficult to manipulate. So the system seems to have some advantages over a purely turnover based presumptive system. However, this is not the case from a small business point of view. It punishes MSEs having at their disposal sizeable business premises during phases of low business activities, and it does not take into account that the level of energy consumption might be very different in one service sector compared to another. Mixed systems therefore do not provide a true alternative to a purely turnover bases system.

### Argentina: Monotributo in case of service providers

<table>
<thead>
<tr>
<th>Category</th>
<th>Gross income</th>
<th>Size of business premises</th>
<th>Annual energy consumption</th>
<th>Monotributo (tax component)</th>
<th>Monotributo (social security component)</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>Up to $12,000</td>
<td>Up to 20 m²</td>
<td>Up to 2,000 KW</td>
<td>$33</td>
<td>$59.44</td>
<td>$92.44</td>
</tr>
<tr>
<td>B</td>
<td>Up to $24,000</td>
<td>Up to 30 m²</td>
<td>Up to 3,300 KW</td>
<td>$39</td>
<td>$59.44</td>
<td>$98.44</td>
</tr>
<tr>
<td>C</td>
<td>Up to $36,000</td>
<td>Up to 45 m²</td>
<td>Up to 5,000 KW</td>
<td>$75</td>
<td>$59.44</td>
<td>$134.44</td>
</tr>
<tr>
<td>D</td>
<td>Up to $48,000</td>
<td>Up to 60 m²</td>
<td>Up to 6,700 KW</td>
<td>$128</td>
<td>$59.44</td>
<td>$187.44</td>
</tr>
<tr>
<td>E</td>
<td>Up to $72,000</td>
<td>Up to 85 m²</td>
<td>Up to 10,000 KW</td>
<td>$210</td>
<td>$59.44</td>
<td>$269.44</td>
</tr>
</tbody>
</table>

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Patents are the least sophisticated version of a presumptive tax system. The characteristic of a patent is the application of a uniform tax on a business segment irrespective of the size or turnover of the individual business taxed.

Patent systems have a number of major advantages and disadvantages:

**Potential advantages of patent systems:**
- No estimation of potential business profit required.
- No disincentives for business growth (until the business is required to move into the standard tax regime).
- Tax burden transparent and predictable for business owner.

**Potential disadvantages of patent systems:**
- High risk of over-taxation of less profitable MSEs.
- System is highly unfair and ignores “ability to pay” principle.

In practice, patent systems can be extremely simple and rudimentary: An example is the taxation of moving traders, artisans, and other low-income-generating activities in Kosovo that are subject to the payment of a quarterly patent of EURO 37.50.

Patent systems can also aim at capturing more precisely the actual profit potential of a certain profession. In this case, the system needs to determine specific patent rates according to the precise category of the business and (possibly) also

**Patent rates for artisans in Bulgaria (annual license fee in Lei)**

<table>
<thead>
<tr>
<th></th>
<th>Major cities</th>
<th>Regional centers</th>
<th>Smaller regional centers</th>
<th>Small towns</th>
<th>Villages</th>
</tr>
</thead>
<tbody>
<tr>
<td>Carpenter services</td>
<td>500</td>
<td>360</td>
<td>220</td>
<td>100</td>
<td>50</td>
</tr>
<tr>
<td>Tailor, currier, furrier</td>
<td>540</td>
<td>390</td>
<td>240</td>
<td>110</td>
<td>40</td>
</tr>
<tr>
<td>Knitting services</td>
<td>450</td>
<td>390</td>
<td>240</td>
<td>132</td>
<td>60</td>
</tr>
<tr>
<td>Cobbler, hatter, milliner</td>
<td>90</td>
<td>60</td>
<td>50</td>
<td>40</td>
<td>40</td>
</tr>
<tr>
<td>Hairdresser and barber</td>
<td>608</td>
<td>390</td>
<td>240</td>
<td>132</td>
<td>60</td>
</tr>
<tr>
<td>Typing and/or photocopying</td>
<td>508</td>
<td>427</td>
<td>336</td>
<td>224</td>
<td>180</td>
</tr>
<tr>
<td>services</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
taking into account advantages and disadvantages of the business location. Such a system has been designed in Bulgaria.

In total, the system lists 43 different small business sectors. With varying tax rates based on the zone where the taxpayer’s business is located, this requires the determination and regular updating of more than 300 specific tax rates. But even this is not enough to guarantee the fairness of the system, as business operations within one business segment can vary substantially. To avoid over- or under-taxation, the system therefore additionally divides the 43 sectors into subcategories and these sub-categories again have to be divided according to the characteristics of the individual business. As a result, 52 different tax rates had to be set for the MSE segment “mass catering and amusement establishments.” Not surprisingly the system is not well accepted, and the definitions of business categories as well as the tax rates are challenged regularly. Indeed, it is questionable if a hairdresser in a bad location of a major city really has a much higher profit expectation than a hairdresser in a good location in a small city, so that it is justified that his tax burden is more than four times the tax burden of his small town colleague.

Due to these substantial downsides, the application of patent systems should be limited to a few hard-to-tax micro-businesses. Tax rates should be set low. The primary objective of a patent system should not be to generate tax revenues, but to familiarize very small businesses with the requirement to pay taxes. Patent systems therefore are more investments into the future with the long-term objective of improving the overall tax culture than short-term revenue generating instruments. This long-term perspective also justifies the fact that in many cases the amount of patent collected will barely exceed costs of collection.

5. Agreed systems

Presumptive systems requiring an agreement between the tax administration and the taxpayer represent the fourth option for systems design. The most prominent example of such an approach was the “Forfait” method in France, which now has been repealed and replaced by a system based on business turnover. The Forfait system required an extensive collection of data and development of estimates of business profit expectations by the tax administration. The taxpayer had to supplement this data collection by providing information on purchases, sales, value of closing inventory, number of employees, wages paid, and number of cars owned. Based on these data the tax administration prepared an estimate of the MSE’s net profit, which was then discussed and agreed with the taxpayer. Not surprisingly, according to statistics, the agreed profit for tax purposes in many cases was substantially lower than the initial estimate prepared by the tax administration. Another famous example of a (semi)-agreed system is the “Tachshiv” method, which was operated in Israel officially until 1975.
Agreed systems are not common in practice. A system which is largely similar to the “Forfait” is still operated in Syria.

Agreed systems produce high administrative costs, as they require the tax administration to prepare a detailed profit estimate of the individual small taxpayer’s business profits as a basis for negotiation. With such an approach, the system contradicts the principle of self-assessment, which is a key element of tax system modernization in developing countries and which requires the taxpayer (or his authorized representative) instead of tax administration staff to assess his tax liability. More important, however, is the fact that agreed systems require extensive contact between taxpayer and tax officials and therefore can become a major opportunity for corruption. Agreed systems are not appropriate for MSE taxation in developing countries.

Specific issues regarding the design of a presumptive tax system

Once the general characteristics of the presumptive tax system have been determined, a number of specifics need to be addressed.

Number and kind of taxes replaced by the presumptive tax

In practice there are two major alternatives to be considered here. The presumptive tax can either be a substitute for personal (or personal and corporate, if corporations are included) income tax, or it can replace a larger number of direct and indirect taxes up to a situation, in which the presumptive tax becomes the only tax liability for the small business. The fact that a presumptive tax aims at taxing presumed income of a small business, while other taxes may have a fundamentally different tax base, is a strong argument for operating a presumptive tax in lieu of income tax only. Also, the accounting and bookkeeping burden on MSE owners is rather limited in cases of property and similar taxes, so that a further simplification of tax calculation and payment obligations does not seem to be required.

The situation is different in the case of VAT. However, in this case, the operation of a sufficiently high VAT registration threshold generally is a more appropriate design option to facilitate MSE tax compliance.
Businesses, however, generally prefer a broader coverage of the presumptive tax. The Association of Businesswomen of Uzbekistan, e.g., considered the reduction in the number of taxes levied to be the first priority for tax reform in Uzbekistan and the introduction of a unified tax to be of particular importance for the further development of MSEs in the country. Indeed, such an approach can make sense in countries that operate a particularly complex tax system with a large number of different taxes applicable to small businesses. Under such circumstances, MSEs can quickly enter into a situation in which they have to hire an additional employee to deal with tax issues, and the risk of harassment by tax officials and of unintended violation of tax obligations, e.g. by ignoring due dates for tax payments, multiplies.

In countries with a large number of different taxes levied on MSEs, a more comprehensive substitution of tax liabilities by a presumptive tax therefore should be considered.

In case of designing a single small business tax, issues of fiscal federalism and central government—local government tax relations may emerge. Frequently most of the small taxes that increase small business compliance costs are taxes levied by local governments and not by the central government. The single tax approach in this case only produces the results desired if the tax is levied not only in lieu of central taxes, but also in lieu of local taxes. This may require complicated negotiations with local governments and lead to disputes over revenue sharing arrangements.

While a single presumptive tax can replace a variety of direct and indirect taxes, including property taxes and environmental taxes, the Ukraine example given above insofar does not represent international good practice, as social taxes generally should not be integrated into the presumptive system. Different from the general tax system, which raises revenues for the national and subnational budgets without linking tax payments to service entitlements, social tax payments create a right to receive social benefits and thus require a precise correlation of future benefits to individual contributions. Also personal income tax obligations of hired employees must continue to be met, either through continued participation of small employers
in the pay-as-you-earn (PAYE) withholding regime, or by shifting the onus to the employee.92

**Treatment of professionals**

Professionals are a particularly difficult business segment for a presumptive system design. There are a number of strong arguments for general net income taxation of professionals. In particular, professionals are well educated and should not have problems with keeping records and filing standard tax returns. Also many professionals have a comparatively high income that should be taxed on a net basis according to the ability-to-pay principle in order to increase tax equity and revenue collection. But professionals also are a business segment with a particularly high tax evasion risk, and the objectives of improved tax equity and increased revenue collection will only be achieved when the tax administration has the capacity to properly enforce compliance. In particular, sufficient audit capacity should be created to monitor the compliance of professionals. Targeted compliance improvement initiatives should be designed, ideally in cooperation with professional associations. A presumptive taxation of professionals should be envisaged only in countries with very low tax administration efficiency. With increased capacity, professionals should be transferred to the net income tax regime.

The determination of an appropriate indicator for presumptive taxation of professionals is challenging. Given the high tax evasion risk, turnover is not an appropriate criterion for calculating tax liability. Size of business premises and number of staff could be an indicator for some professions such as lawyers, pharmacists, and architects. For doctors, the number of years in practice is a quite common criterion. It has been recommended by a Canadian technical assistance project for Egypt93:

The separation in only two bands and the high difference in the tax burden between band one and band two is highly questionable in the given case and should not be replicated. However, the suggestion as such represents a possible approach for the taxation of certain groups of professionals.

<table>
<thead>
<tr>
<th>Years of Practice</th>
<th>Suggested Annual Tax (in US$)</th>
</tr>
</thead>
<tbody>
<tr>
<td>From</td>
<td>To</td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
</tbody>
</table>

92 Kloeden, Tax Regimes and Administration for Small Business, IMF 2006
93 Megacom, Applying Patent System on Micro Enterprises in Egypt, 2005
A presumptive tax system can be particularly burdensome for newly created MSEs, which still have to be fully established and which have not yet reached the profit-making stage. Presumptive systems normally do not differentiate between newly created and well established MSEs. The full tax liability applies from the first day of business operations. Considering the vulnerability of newly established MSEs, the risk that the tax burden drives these MSEs into bankruptcy is obvious. Small business operators and associations therefore frequently argue for tax holidays as a way to provide a temporary relief for new MSEs.

Tax holidays generally are the most questionable form of tax incentives. Assessments of tax incentive schemes in many OECD countries came to the conclusion that tax holidays largely are inefficient and prone to abuse. These findings should be taken into consideration when discussing tax holiday schemes for MSEs. The two major risks of these schemes are:

- There is no gradual integration into the tax system. Tax holidays fully exempt MSEs from tax payments for a limited period of time, after which they immediately face the full tax burden.

- MSEs can easily change their name and nominal ownership. Tax holidays risk becoming a convenient tax avoidance scheme for MSEs, which change their business registration shortly before expiration of the tax holiday scheme and reapply for the scheme under a new name.

Should tax holiday schemes be considered as a tool to support newly created MSEs, it is important to limit the period of availability of the scheme to a minimum, e.g. up to the first six months after the registration of the small business, followed by a gradual increase of the tax burden up to the full level. A more appropriate alternative to a tax holiday scheme could be a temporary tax reduction for start-up MSEs. In the presumptive tax system in Belarus, physical persons registering as individual entrepreneurs for the first time benefit from a 25% tax reduction for the first three months following business registration. Different from a tax holiday scheme, this approach creates immediate awareness of the necessity to pay taxes. The level and period of tax reduction could be shaped more generously than in the Belorussian case.

A more appropriate way of providing relief to newly established MSEs (and to avoid an undue tax burden on existing MSEs during a loss-making period) is to permit a deduction and carry forward of losses from business or investment even in case of presumptive taxation. This requires at least a basic level of recordkeeping by the small business and thus also provides further incentives for improving recordkeeping standards. It also requires the determination of a proper formula to
calculate the amount of deduction, as presumptive systems are based on turnover or indicators, and do not have net income as a tax base.

Further relief to start-ups can be provided by offering the possibility of a flexible due date for the tax payment and relief from advance tax payments.

**Facilitating graduation from the presumptive into the standard tax regime**

A presumptive tax system can create major obstacles to small business growth if the transition from the presumptive into the standard taxation regime is costly or complicated. This is particularly the case when substantial differences in the effective tax burden or the tax compliance requirements result from such migration. Therefore, to avoid disincentives for MSE development, a certain level of alignment of the presumptive tax system with the standard tax regime for businesses is desirable (although it might be difficult to achieve in practice). At the same time, the objectives of facilitating compliance and encouraging MSE formalization, which are the core motives for operating a presumptive system, need to be preserved.

The task of aligning the presumptive with the standard tax regime is not exclusively an issue of standard tax regime design. Also, the presumptive tax system needs to be designed in a way that ensures that businesses close to the upper threshold of the presumptive system face a tax burden not substantially lower than businesses at the lower end of the standard tax regime, and are obliged to comply with certain basic accounting requirements. This result can be achieved by a progressive feature of the presumptive system and the level of recordkeeping required of MSEs in the presumptive system increasing with MSE turnover.

Such coordination could be ensured by a system comprising of the following steps:

<table>
<thead>
<tr>
<th>Business Size</th>
<th>Tax Base and Rate</th>
<th>Accounting and Filing Requirements</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
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<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Offering some incentives to improve recordkeeping of businesses in the presumptive system is important for facilitating compliance with general (simplified) recordkeeping requirements after migration into the standard regime. A sufficient level of recordkeeping also improves business management and planning.

Despite these considerations, many presumptive systems provide little or no incentives for small businesses to improve their recordkeeping standards. In the case of indicator-based systems in particular, even basic records are not required for tax purposes. But improving recordkeeping practices is also challenging for turnover-based systems. The most straightforward and transparent incentive is the application of a lower presumptive tax rate for small businesses meeting certain recordkeeping standards. Such an approach is applied in the presumptive tax system in Tanzania, which offers a substantial tax reduction to reward recordkeeping MSEs. A small business with a turnover of 10 Million TShs, for example, only has to pay 1.24% of turnover as presumptive tax in case of recordkeeping compared to 2.91% of turnover without recordkeeping.

However, despite these incentives, the actual level of recordkeeping among Tanzanian MSEs remains low and the majority of MSEs are taxed under the non-recordkeeping alternative of the system. This demonstrates that the mere provision of tax incentives is not sufficient to improve recordkeeping standards in the MSE community. It needs to be combined with extensive assistance and information campaigns on the importance and details of recordkeeping. The Tanzania Revenue Authority now has launched a major education campaign to assist MSEs in understanding the importance of recordkeeping and tax compliance, including the publication of a booklet on “Norms of Doing Business,” which is distributed free of charge to MSE owners.

There are a number of other features that could facilitate and encourage a transition from the presumptive into the standard regime. The possibility to claim and carry forward losses is an important element of the standard regime, which benefits MSEs during loss-making periods.

Consideration could also be given to establishing a limited period of eligibility for a simplified system. This requires, however, the operation of an efficient taxpayer service program, which provides sufficient support to MSE owners during the period of application of the presumptive system to enable them to cope with the compliance requirements of the standard tax regime afterwards. In practice, such a system will be difficult to enforce, as MSEs will avoid moving to the standard system by closing their business and re-registering under a new name.

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Chapter 2.6: Reforming Tax Administration

In practice, tax administrations in developing countries do not always put great emphasis on facilitating tax compliance of MSEs. Confronted with the pressure to meet tax revenue collection targets, tax administrations feel a need to concentrate on the small number of major taxpayers who contribute the bulk of tax revenues to the Treasury.

**Important Dos and Don’ts in Small Business Tax Administration**

<table>
<thead>
<tr>
<th>WHAT TO DO</th>
<th>WHAT TO AVOID</th>
</tr>
</thead>
<tbody>
<tr>
<td>Create dedicated administrative structures to deal with small taxpayers.</td>
<td>Tax mapping exercises biased in favor of enforcement considerations.</td>
</tr>
<tr>
<td>Establish ongoing formalized dialogue with MSE community.</td>
<td>Advanced payment of the full amount of taxes in dispute in case of appeal.</td>
</tr>
<tr>
<td>Launch a comprehensive approach for MSE compliance management.</td>
<td>Legal obligation to audit all small businesses on a regular basis.</td>
</tr>
<tr>
<td>Facilitate filing and payment procedures through electronic means.</td>
<td>Annual re-registration obligation.</td>
</tr>
</tbody>
</table>

**Taxpayer segments – their population and revenue contribution characteristics**

- **Large taxpayers**
  - Proportion of registered taxpayers: > 1%
  - Proportion of Tax Revenue contribution: 70+ %

- **Medium taxpayers**
  - Proportion of registered taxpayers: 5–25%
  - Proportion of Tax Revenue contribution: 10–25%

- **Small taxpayers**
  - Proportion of registered taxpayers: 70–95%
  - Proportion of Tax Revenue contribution: 0–10%

Source: IMF
The creation in many countries of special large taxpayer offices responsible for the administration of the 100–200 major taxpayers demonstrates the focus of tax administration reform on maximizing revenue collection. By contrast, attention given to small businesses in practice is very limited, and some tax administrations even tend to discourage the inclusion of small businesses in the tax net because of high administration costs. This approach is comprehensible from a short-sighted administrative cost-benefit ratio point of view. Indeed, administrative costs per dollar of collection rise considerably with efforts to increase the compliance rate beyond a given point, which is determined by the tax administration capacity and the size and structure of the hard-to-tax group of potential taxpayers. This has been illustrated by Bahl with the cost of compliance curve:

![Cost of compliance curve](image)

The curve AA describes the cost path, for the least-cost tax administration approach, and for a given tax structure. For example, a country targeting a 50% compliance rate, would need to invest the costs indicated as point a on the AA curve. How far out on the compliance curve a tax administration should move is a choice made by each country and is determined by the amount it accepts to invest in its administration.

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95 See, e.g., FIAS, Sector Study of the Effective Tax Burden – South Africa, 2006
96 Bahl Reaching the Hardest to Tax: Consequences and Possibilities, in: Alm/Martinez-Vazquez/Wallace, Taxing the Hard-to-Tax, 2004
97 Cost of compliance in this context refers to the administrative costs incurred by the tax administration for managing SME tax compliance. It does not include compliance costs of taxpayers.
98 Bahl, op.cit.
But improving small business tax administration should not be viewed purely from the perspective of short-term revenue yield. For any small business tax system, an efficient, professional, and honest tax administration is required to properly implement the system. Improving small business tax administration also has to be considered a longer-term investment in improving the compliance behavior of the MSE business segment. Managing small business tax compliance requires organizational and procedural reforms, which put the tax administration in a position to address specifically the factors and circumstances which contribute to a high compliance burden. The reforms should also enable the tax administration to efficiently combat tax evasion in the MSE community.

A number of general principles for tax administration reform have already been provided in the publication “Tax Administrations and Small and Medium Enterprises (SMEs) in Developing Countries” (IFC 2005). The discussion of tax administration issues in this toolkit therefore is limited to highlighting a number of tax administration reform challenges that are particularly relevant for the operation of a special small business tax regime.

Creating dedicated administrative structures for dealing with MSEs

The full implementation of a taxpayer segment approach of tax administration organization can substantially facilitate addressing the specific needs and compliance management challenges of MSEs. In many countries, the creation of special Large Taxpayer Offices responsible for the administration of the core group of major taxpayers in the country accounting for the administration of 50%–70% of total tax revenues has been a successful first step in the taxpayer segmentation process. It has not only resulted in better compliance management, but also in more comprehensive and better targeted services provided to this taxpayer group. Some countries more recently have also started to set up medium taxpayer offices. The logical and necessary third step in taxpayer segmentation is the creation of special, dedicated, small taxpayer offices, which provide the necessary organizational structure to address the specific needs of small businesses. Taxpayer segmentation has to be understood in an administrative reform to respond to the particular situation and compliance management requirements of the individual taxpayer segments. It should not result in a reduction of tax administration efforts to ensure large taxpayer compliance. Large taxpayers in any country remain the focal point for ensuring appropriate revenue mobilization, and improving small business tax administration should not be achieved at the cost of reduced efficiency of large taxpayer administration.
Tax administrations need to put special emphasis on developing needs-oriented taxpayer service programs. Small taxpayers must know and understand their rights and obligations. Experience has demonstrated that even in advanced OECD countries small taxpayers frequently are not aware of important elements of the MSE taxation system. In the UK, a survey carried out by PWC in 2006 showed that the awareness level for incentives and tax relief opportunities for small taxpayers was only 41%, while the actual usage level of these schemes was only 11%. Tax incentives and policy measures to facilitate tax compliance are non-effective as long as taxpayer do not get appropriate assistance in understanding and applying these measures. This requires the tax authorities to design and offer specific information material and training courses and seminars. Also, advisory visits by tax administration staff to newly created MSEs can be an important contribution to effective taxpayer service and information. The nomination of a special service representative as the permanent contact person for MSEs in case of complaints or queries could be a way to build confidence, improve MSE–tax administration relations, and address service needs.
Facilitating tax registration

The business registration process for new MSEs can be the first and one of the most fundamental obstacles to working in the formal economy. Registration for tax purposes frequently is only one step in a cumbersome business registration process that may easily involve more than 10 different locations for, e.g., social security, statistical, business, trade registers, and so forth. At each registration point, forms have to be filled in, often containing similar requests for information. On the tax side, the registration ends with the allocation of a taxpayer identification number (TIN), which is required for the operation of the business.

The introduction of a business-friendly registration process for tax purposes from a business and from a tax administration point of view entails three critical challenges: i) simplification of the registration process; ii) acceleration of the TIN allocation; and iii) guaranteeing the accuracy of the tax register.

Simplifying the tax registration process for MSEs. Reducing compliance costs related to business registration can be a major factor facilitating the formalization of MSEs. Identifying formalities at all levels that are required to start up a business and ways to coordinate and simplify them are important contributions to MSE formalization. Ideally a single contact point for business registration should be set up. This contact point could also become an intermediary for all the formalities that have to be complied with during the life of the business, e.g., change of address or statutes, transfer of ownership, employment issues, permits and licenses, etc. A single registration form should be developed to capture all the information required by any part of the administration to register the new enterprise.
Accelerating the TIN allocation. Delays in processing TIN requests impede the proper starting of business operations. As discussed earlier in this paper, tax practitioners in South Africa, for example, consider the period taken to register as a VAT vendor and the time taken to be notified of such registration to be the most burdensome aspect of the VAT system for MSEs. There were even cases reported where the tax administration charged a fine for late filing of VAT returns when the taxpayer had not even been notified of his registration, which is a very unpleasant first experience of an MSE operator with the VAT system. Delays are caused mainly by a manual TIN allocation process and concerns of tax administrations about the risk of a multiple TIN allocation to the same business entity. Computerization of TIN allocation is important to guarantee a quick and proper process. Major progress has already been made in the TIN allocation process in many countries. However, there still is a risk of major regional disparities in the time required to process a request for a tax registration number, depending on progress made in rolling out the IT system, re-engineering tax registration business processes, and connecting regional offices to the central TIN database, as can be seen from the example of Tanzania:

![Tax Registration – results](image-url)
Updating the tax register. Keeping the tax register for MSEs up-to-date can be a major challenge, considering the high level of fluctuation in the MSE community. Analysis in the European Union has shown that, while 80% of newly established SMEs were still operating after one year, only 65% were still in business after three years, and only 50% after five years\(^\text{100}\). The fluctuation is substantially higher in developing and transition countries. Tax administrations therefore are concerned that their taxpayer register quickly becomes incorrect and includes many businesses that have ceased to exist in practice. This is a valid concern that needs to be addressed.

Various ways have been explored by tax administrations to reduce the number of inactive businesses in the tax register. Some countries, such as Albania, the Philippines, and some Indian states, require businesses to periodically re-register with the tax authorities every 1–2 years. Businesses thus confirm that they are still operating and report relevant data changes, including changes in ownership or location. However, this is a costly and burdensome procedure that shifts the responsibility for updating the tax register from the tax administration to taxpayers. It increases incentives to operate outside the tax net. Instead, the problem needs to be addressed by an appropriate stop-filer system, which automatically initiates follow-up actions in case a taxpayer no longer files returns. Good practice would be the operation of a computer system that detects stop filers soon after the statutory date for filing and automatically issues form letters to them asking for compliance.

Electronic and mobile communication with the tax administration

In countries with widespread access to Internet and mobile phones, the expansion of IT-based filing and payment opportunities for the small business community should be considered. Frequently, these facilities currently are limited to large taxpayers administered by the Large Taxpayer Office. However, they should also be used to reduce the MSE compliance burden. In Latvia, around 20,000 taxpayers use a fully paperless, web-based secure e-tax declaration system; out of this group 80% are SMEs.

\(^{100}\) EUROSTAT, Sixth Enterprises in Europe Report, 2001
Tax audits are core instruments for ensuring compliance from registered small businesses. However, tax audits also pose a major risk of corruption and harassment of small taxpayers. International good practice suggests a number of reform options to improve the efficiency while at the same time reducing the burden on taxpayers of a small business tax audit program. A primary requirement is the move from a comprehensive to a targeted, risk-based audit selection of small businesses. This requires a thorough analysis of compliance risks in the small business segment of the taxpayer community. A legal obligation to audit 100% of tax-registered businesses every year or every other year, which still was common practice in a number of transition countries some years ago, reduces the tax audit process to a mere formality and unnecessarily encumbers small businesses with good compliance records and low risk. As tax audit resources generally are scarce, priorities for tax audits need to be defined, and these priorities necessarily lie with large and medium taxpayers. The audit coverage and audit frequency of small and micro-businesses therefore is much lower than in the case of large and medium size businesses. This can be illustrated using the example of Germany.

### Tax Audits in Germany (year 2000)

<table>
<thead>
<tr>
<th>Business size</th>
<th>Number of registered businesses</th>
<th>Number of tax audits conducted</th>
<th>Average audit frequency</th>
</tr>
</thead>
<tbody>
<tr>
<td>Large</td>
<td>167,164</td>
<td>38,115</td>
<td>every 4.3 years</td>
</tr>
<tr>
<td>Medium</td>
<td>755,061</td>
<td>67,457</td>
<td>every 11.1 years</td>
</tr>
<tr>
<td>Small</td>
<td>1,169,364</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Micro</td>
<td>4,394,539</td>
<td>119,111</td>
<td>Risk-based selection of a small number of small and micro-businesses for audit</td>
</tr>
</tbody>
</table>

On the other hand, it is imperative that MSEs understand that there is a risk of being audited. Legal restrictions on carrying out a tax MSE audit therefore need to be considered carefully. In no case should a business get a guarantee that it will not be audited for a certain period of time as an incentive for voluntary registration or for correct filing and payment of taxes. Laws limiting the number of possible tax audits (e.g. stating that a business can only be audited once a year) should at least provide an exception in case suspicion of tax evasion arises. On the other hand, in countries with a highly corrupt tax administration, a limitation on carrying out multiple tax audits within one business year without clear justification could be a way to reduce taxpayer harassment. The simplified small business tax regime, which will be introduced in Korea in 2008, includes a provision exempting small businesses...
Reforming Tax Administration

from tax audits, except in case tax evasion is distinctively noticed. Such an approach seems desirable from a small business point of view. From a tax administration point of view, however, the possibility of carrying out issue-oriented audits (e.g. the audit of specific transactions) and selecting a high-risk, small business segment (such as transport businesses or jewelry shops) as a focal point for the national audit program, should not be unduly restricted.

Objectives and approaches of the MSE audit program will differ substantially from large taxpayer audits. It therefore is highly desirable to select and train auditors specifically for small taxpayer audits. The IMF technical note on “Tax Regimes and Administration for Small Business” explains “Taxpayer audit should focus on corroborating whether the taxpayer’s cash books reasonably reflect the level of business activity, particularly testing the likelihood of unrecorded income. The audit methods and adjustment techniques will evolve as understanding develops on industry characteristics and ratios.” While MSE tax audits have an important deterrent effect, particularly for newly established MSEs, the service and advisory aspect should not be neglected. An advisory audit of new MSEs checking the quality of bookkeeping and recommending improvements to bookkeeping, tax filing, and payment obligations can be important ways to establish contact between the taxpayer and the tax administration.

Involving the private sector in tax collection

In many developing countries, the tax administration does not have broad knowledge of MSE activities and sufficient understanding of the special risks and constraints of MSE operations. Business associations frequently have better knowledge of and access to MSEs. Involving the private sector in the collection of an MSE tax therefore may both contribute to broadening the tax net and address capacity constraints in the tax administration. Contracting out tax administration responsibilities to the private sector is a risky undertaking, however, and many tax farming approaches tried in the past have resulted in increased harassment of taxpayers and lower net collection results.101 Efforts to involve the private sector in collecting taxes from MSEs therefore need to be considered carefully and should only be supported when:

- the private sector partner is a well-established institution with a high level of acceptance in the MSE community and a high level of integrity;

- the private sector partner has sufficient capacity to effectively collect the amount of tax due from MSE operators;

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the private sector partner has sufficient incentives, including monetary incentives, to guarantee efficient collection; and

- clear and efficient reporting and accountability mechanisms between the government and the private sector partner have been established and are actually implemented.

The role of local governments

Little consideration has been given in academic discussions and in country practice to the role of local governments in collecting taxes from small and micro businesses. Similar to the case of business associations, local governments frequently have better knowledge of small businesses activities and better access to MSEs than the central government tax administration. In addition, several other considerations could support an increased involvement of local governments in small business tax collection:

- The presumptive small business tax burden frequently is assessed by the tax administration instead of self-assessment by the taxpayer. However, most taxes

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in the general tax system are self-assessed taxes, and a central tax administration that administers self-assessed taxes may not organizationally be prepared for agency assessment without major reorganization.

- There is a need for low labor costs for the tax officials as there is a small tax yield per business. High-paid professionals of central revenue authorities may not be cost-efficient revenue collectors for small business taxes.

- The complementary functions of local government should lower costs and increase effectiveness of identifying and registering small businesses and assessing their tax liability. These complementary activities include local business registration, land use regulation, property taxation, management of public markets, taxi ranks, bus stations, etc. All these activities require a local government to actively deal with businesses in its jurisdiction.

There are three basic alternatives for the role of local government in small business taxation:

a) Central government tax administration and local governments cooperate in the collection of MSE taxes. This could be in the form of information exchange and access of central government tax administration to data administered by local governments (e.g. data on local business registration or fees and user charges collection). Such cooperative arrangements are highly desirable.

b) Consideration could also be given to shifting the responsibility for the collection of small business taxes to local governments. Local governments would collect the taxes on behalf of the central government and be compensated for collection costs incurred (probably topped up with incentives for efficient collection and achieving collection targets). Such arrangements need to be considered carefully, however, and the risk of them not working very well in practice is considerable. Administrative capacity at the local level in many developing countries is weak and expertise in the area of tax administration and compliance management is not available. This not only decreases the efficiency of revenue collection, but also results in a lack of sufficient service and support programs. In addition, the relationship between central and local authorities is tense in many countries and there is a risk that revenues collected by local governments on behalf of the central government are not properly transferred to the Treasury. Finally, collection by local governments is not necessarily more efficient. Data from Kenya show that the number of businesses actually registered by local authorities is less than 30% of the estimated number of existing businesses.

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104 Glenday, op.cit.
Cooperative arrangements therefore generally should be a preferred approach to full transfer of the collection responsibility to the local level.

c) Finally, small business taxes could become true local taxes, administered by local governments and the revenue yield going to the local budget. To satisfy the criteria of a good local tax, local governments in this case should have certain discretion to determine the tax base and set the tax rate. Small business taxes can be an attractive revenue source for local governments. Despite the deficiencies in collection, the Kenyan small business tax, e.g., has been collecting more than 15% of local government own source revenues. A major risk, however, is to guarantee a smooth transfer of small businesses from the presumptive to the standard tax regime. Local governments have little incentives to encourage small business growth and transfer the taxpayer to the central tax administration once the MSE grows beyond the small business system threshold. It is also possible that problems of tax competition emerge; the dimension of such risk depends on the mobility of the tax base (the business operation).

A comprehensive approach to ensuring MSE tax compliance

Integrating MSEs into the tax net should not be perceived as primarily an enforcement oriented task. Voluntary compliance necessitates an appropriate mix of incentives, compliance simplification measures, and enforcement programs. This frequently calls for a new approach to dealing with taxpayers that requires technical assistance to successfully design and implement such a strategy. The Cash Economy Task Force in Australia is a good example of a broad-based compliance promotion program. An extract from the recommendations produced by the task force is provided in Annex 6.
Guidelines for the Design of a Small Business Tax Regime

Determinants for the Design of a Small Business Tax Regime

Small businesses are not a homogeneous segment of the business community. Nor are the characteristics of small businesses identical in all developing and transition countries. As for the tax system in general, there is no solution regarding specific taxation rules for MSEs that fits all countries and can be applied to all kinds of small businesses. Key determinants for the design of a simplified system are:

- Literacy rate and education of small business owners: a high level of literacy and education among the MSE community facilitates the promotion of recordkeeping rules and decreases the need for overly simplified presumptive taxation rules.

- Availability of reliable data on small business transactions and profit margins: the fairness and acceptance of a simplified system for MSE taxation can be substantially increased if the system design can be based on a sound analysis of MSE profitability and business risks.
Access to tax consultancy services, either by private tax consultants or small business associations. In many countries, MSEs do not have access to tax consultancy services, because these services are too costly or a tax consultancy profession has not yet been developed. For MSE segments that have access to tax consultancy services, the application of the standard tax regime is more feasible than for MSEs, which do not get any assistance in complying with their tax obligations.

Importance of local taxation for MSE compliance costs. Frequently simplifying taxation rules is limited to reducing the compliance burden with central government taxes. Such reforms do not achieve their objectives, however, if a major part of the compliance burden stems from local taxes. In this case, reform efforts need to be broadened to include an overhaul of the local tax system, including the system of vertical transfers.

Access to information technology. In case a substantial part of the MSE community has access to IT, then IT-based solutions to facilitating compliance, such as electronic filing of returns or electronic payment of taxes, can be introduced. Also, taxpayer services can be provided through the Internet.

Efficiency and honesty of the tax administration. Small business taxation puts a burden not only on the MSE owner, but also on the tax administration. The design of a tax system for MSEs needs to take into account the capacity of the tax administration to properly administer the system.

**Determining System Objectives**

The design of a special tax system to reach small taxpayers operating in the informal sector can pursue a number of objectives. These objectives are often in conflict and therefore may be difficult to coordinate (e.g. tax equity vs. system simplicity; improving revenue collection vs. providing incentives for MSE growth). Policymakers, therefore, are required to prioritize and decide what the main goal of the MSE tax system should be. Design instruments obviously vary in accordance with the objective pursued. Bird and Wallace have developed a matrix of approaches to tax hard-to-tax taxpayers:

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105 Is it Really so Hard to Tax the hard-to-Tax, in Alm/Martinez-Vazquez/Wallace, Taxing the Hard-to-Tax, 2004
### Dealing with the Hard-to-Tax Sector

#### Objectives
- Bringing start-up firms into the tax net, enhancing taxpayer education
- Getting revenue from those able to pay
- Increasing equity in treatment of the HTT
- Getting to the HTT at low cost in the short-term

#### Critical Instruments
- Alternative minimum tax (AMT) approach
- Enforce the law
- Simplified/presumptive regime

#### Issues
- Critical to keep “presumed” level of tax liability high enough to encourage movement out, also to periodically evaluate all those in the system to ensure true eligibility.
- Alternative minimum taxes (AMTs) are often very complicated and cause some for both tax administrators and taxpayers.
- Politics is especially critical to the success of the tax administration in these cases of getting at the HTT. Lucrative businesses may be run by influential members of society who can affect the success of the tax administration.
- May challenge the equity of the tax system and further encourage tax evasion.
- Although this instrument may reduce administrative costs for very difficult cases (off-shore activities) or very low yield activities (agriculture), it sets a dangerous precedent which encourages non-compliance.

#### Segmentation of the MSE Community

In any country, small businesses consist of different segments that require different tax approaches. The following taxpayer groups in particular usually merit segmentation:

- **Micro-businesses**: Micro-businesses at the subsistence level (many of them being mobile traders and service providers or small retail outlets) should remain tax exempt. Integration of micro-businesses above pure subsistence level into the tax net is important to achieve the longer-term objective of creating a taxpaying culture. However, the compliance burden for the taxpayer as well as the administrative burden for the tax administration should be reduced to the extent possible.
  - A simple uniform patent irrespective of the location and precise category of business of the micro-enterprise generally is the most appropriate way of taxing this segment of the MSE population. Patent rates should be modest and the patent should be the only tax the micro-business is liable to. Consideration could be given to shifting the responsibility for the collection of the patent to local governments. The potential advantage of such transfer is that local governments often have a better knowledge of micro-business activities in their territory than central government tax offices. However, such transfer should only be envisaged for local governments with sufficient
administrative capacity. The patent could also become a true local tax, in which case local governments should have discretion to determine patent rates.

- **Unincorporated small businesses above the micro-business level:** For small, non-incorporated businesses above the micro-business level, a simplified, presumptive tax system should be designed. This approach reduces both the compliance costs for the business and the burden on the tax administration to assess the tax liability of a large number of taxpayers with comparatively low revenue yield.
  
  - The presumptive tax regime should be optional, allowing the small business to opt for standard taxation. For guidance on the design of a presumptive small business tax, see below.

- **Incorporated small businesses:** Consideration could be given to limiting exemptions from the requirement to keep books and records for tax purposes to non-incorporated small businesses and to tax incorporated small businesses according to the standard tax regime. Indeed, this is the approach followed by many African countries and some European countries (e.g. Austria, Spain). However, the mere fact of incorporation does not automatically signal sufficient capacity to comply with full CIT accounting requirements\(^\text{106}\). In addition, application of the standard tax regime risks substantially increasing tax compliance costs for small corporations. Differentiating between incorporated and non-incorporated MSEs risks distorting the incorporation decision. For this reason, there are arguments for not imposing higher compliance requirements on incorporated MSEs. The feasibility of standard taxation of incorporated MSEs will ultimately depend on the level of development of the corporate sector in a given country.

### Simplification of the Standard Tax Regime

As discussed above, not all small businesses will and should be taxed on a presumptive basis. Part of the MSE community will—either voluntarily or on a compulsory basis—be taxed under the standard tax regime. Because of the regressive character of tax compliance costs and as an incentive for MSE formalization and development, some incentives/simplified rules should be incorporated into the standard tax regime.

\(^\text{106}\) The situation is different of course in countries, such as Kenya, in which businesses are not entitled to operate in corporate form unless they are able to maintain full accounting records and books.
Special consideration should be given to VAT when aiming at reducing MSE compliance costs. Several options are available in this respect, with the key reform elements listed above.

There is no uniform international best practice for setting the threshold for obligatory VAT registration. However, the threshold should be sufficiently high to exclude micro-businesses and smaller businesses from obligatory VAT registration.

Tax administrations have a strong interest in reducing voluntary registration of businesses below the threshold to a minimum. A large number of voluntary registrations increase the tax administration workload without contributing much to VAT revenue collection. Despite this argument, voluntary registration should be made possible.

Simplification of return filing has two dimensions: return frequency and complexity. The filing frequency for MSEs should be reduced to a maximum of four VAT returns per year. The possibility of moving to annual or at least semi-annual filings should be considered. Introduction of simplified schemes along the lines of the UK annual accounting scheme (see Part Two, Chapter two) provide further simplification possibilities. Tax administrations should consider simplifying returns by making VAT forms shorter or reducing paperwork requirements.

To facilitate compliance with accounting requirements, cash accounting should be permitted.

Well-targeted tax incentives combined with simplified accounting and return filing requirements generally are the preferred approaches to simplifying MSE compliance with the income tax system and increase the MSE growth potential. General incentives, in particular tax holidays and rate reductions, not only complicate the tax system and increase the risk of abuse, but also do not support longer-term viability and growth of
MSEs. A targeted incentive scheme should in particular promote efforts to consolidate the equity base of the business and implement business expansion strategies.

**Designing a Presumptive Tax System for Small Businesses**

The challenge of designing a simplified (presumptive) tax system for MSEs often is underestimated. Good presumptive systems need to be:

- well coordinated with the standard tax regime to avoid a conflict of rules, as well as obstacles for the move from one system to the other, in particular for migration from the presumptive to the standard regime;
- based on thorough data analysis to avoid both over- as well as under-taxation of small businesses;
- transparent and fair to be accepted by the small business community and to avoid disputes between tax administration and small businesses over the amount of tax due;
- accepted by public sector stakeholders to be stable;
- easy to administer so that they do not absorb a large part of tax administration capacity; and
- supported by taxpayer education and information programs that really reach the MSE community.

**The Choice of the Appropriate System**

<table>
<thead>
<tr>
<th>Micro-Businesses</th>
<th>MSME with Turnover below VAT Threshold</th>
<th>SME above VAT Threshold</th>
</tr>
</thead>
<tbody>
<tr>
<td>MSE without fixed business location; subsistence level SME</td>
<td>Standard MSME in trading or service business</td>
<td>SME segments with particular high risk of turnover evasion (e.g. transport) business, catering, gambling</td>
</tr>
<tr>
<td>Simple patent</td>
<td>Turnover-based system</td>
<td>Indicator-based system</td>
</tr>
<tr>
<td>Other SMEs</td>
<td>Standard tax regime but simplified bookkeeping and return filing</td>
<td></td>
</tr>
</tbody>
</table>
Presumptive small business tax regimes are becoming increasingly popular in developing and transition (as well as in some developed) countries. However, considering the design challenges mentioned, it is not surprising to find that many of the systems in place are facing major drawbacks or difficulties of application.

**Checklist for the Design of a Presumptive Tax System**

- **Kind of taxpayers** subject to presumptive taxation: should the presumptive tax apply to individuals only, or should certain corporate MSEs benefit from presumptive tax regimes? Should it apply to certain segments of the MSE community only (e.g., retail traders)? Should certain businesses, despite being small, be excluded from the system (e.g., certain self-employed individuals, such as lawyers)?

  **Recommendation**: Presumptive tax regimes should be limited to small businesses operated by individuals. Incorporated firms could be subject to the standard taxation regime if feasible. Also, freelance professions generally should be required to keep (simplified) books and to file an income tax return. The presumptive tax system may provide for different rules to calculate the tax liability of the different MSE segments, but all MSEs apart from incorporated MSEs and freelancers may be taxed on a presumptive basis.

- **System threshold**: what is the appropriate threshold for a presumptive tax system? Which criteria should be used to determine the threshold (e.g., turnover, business assets, number of staff, or a combination of several criteria)? Should there be a unique threshold for all businesses taxed under the presumptive system, or should the threshold differentiate between taxpayer groups? Should there be business segments (e.g., catering, road transport), for which no threshold should apply?

  **Recommendation**: There is no ideal system threshold for the application of a presumptive regime that can be applied to all countries. The key design requirement is to avoid an overlap of the presumptive tax regime with the standard VAT. Except for countries operating a particularly high VAT registration threshold (such as Senegal and Morocco) the threshold for presumptive taxation should correspond to the VAT registration threshold. Harmonizing both thresholds also requires using business turnover as the sole criteria to determine the threshold for the application of the presumptive system. While other criteria, such as the number of business employees, sometimes are used as additional system limitations, there is little value added in broadening the set of threshold criteria, and additional criteria risk negatively affecting business decisions (e.g., they work as a disincentive for hiring additional labor). The desirability of coordination with the VAT threshold also argues for a uniform threshold for all small taxpayer
categories. However, a number of countries operate lower VAT registration thresholds for businesses in the service sector than for traders. Such differentiation could also be applied to determine the presumptive tax threshold. A further threshold differentiation based on more specific MSE categories is not appropriate. A system threshold should apply to all MSE categories without any exception. The system applied in some countries, where certain professions are taxed under a presumptive regime without any size limitation (e.g. catering business in Armenia) generally is not appropriate and impairs the fairness of the tax system.

- **Criteria to determine tax liability**: what should be the principle indicator to determine the tax liability? Many presumptive systems are based on business turnover, some use indicators such as the size of business premises, the value of business assets, or number of staff.

**Recommendation**: Given the disadvantages and design problems of indicator-based systems, it normally should not be the prime option for the design of a presumptive tax system. Using turnover as a tax base better reflects the situation of the individual business, facilitates migration to the standard regime, and is a better starting point for introducing basic bookkeeping rules. Indicator-based systems, if used at all, should be limited to a small number of business segments with a particularly high risk of under-declaration of turnover. Typical examples in practice are MSEs in the transport sector (in particular taxi drivers), restaurants and bars, and gambling establishments.

- **Tax rate**: Should different tax rates apply for different segments of MSEs? Should the presumptive tax have progressive features? Should the presumptive tax burden broadly correspond to the tax burden under the standard tax regime or should it be substantially lower?

**Recommendation**: The trading and the service sectors have substantially different profit margins as a percentage of turnover. It therefore makes sense for a turnover-based presumptive tax system to distinguish between traders and service MSEs when calculating tax liability. However, instead of applying different tax rates, it is more appropriate to establish different levels of deductions from turnover and to apply the standard rate schedule on the amount of turnover minus standard deduction. Further differentiations according to business activities should not be envisaged, because borderlines between various service segments are not always clear, many businesses engage in various service activities, and disputes over the fairness of the differentiation may arise. A slightly progressive rate structure is recommended to reduce the difference in the tax burden between businesses in the top band of the presumptive system and businesses in the standard tax regime.
Number and kind of taxes replaced by the presumptive tax: will the presumptive tax only be applied in lieu of one specific tax, e.g. personal income tax or VAT, will it replace a certain group of taxes (e.g. operate as a single direct tax), or will it work as the only tax the MSE is subject to?

Recommendation: Ideally, presumptive tax is operated in lieu of a large number of central and local taxes. Given the objective to reduce the overall MSE compliance burden, it should not only replace income tax and other turnover-based taxes. The main exception to the general principle is social taxes. While a number of presumptive tax systems also replace social taxes, this does not represent international good practice. Different for the general tax system, which raises revenues for the state budget; social taxes are earmarked to fund specific social services. This correlation between payment and service entitlement gets disconnected when a comprehensive presumptive tax is levied in lieu of social tax. Presumptive taxation can also not replace income tax withholding obligations for MSE employees. The income tax in this case is a tax of the employee and not of the MSE, which only acts as the withholding agent.

Should taxpayers be allowed to opt out of the presumptive system and be taxed according to standard taxation rules (rebuttability of the system)?

Recommendation: In principle, any small business able and willing to comply with bookkeeping and accounting requirements should be allowed to opt for being taxed under the standard regime. Such option will be particularly important for loss-making MSEs and small businesses with a much lower profit margin than the margin presumed by the simplified system. Tax administration generally will be less open to allowing opting-out of the presumptive system, as it increases tax administration costs without contributing to higher revenue collection. The ITD SME conference background document therefore argues that the desirability of allowing rebuttability depends to a large degree on the extent of the wider external benefits felt to be associated with inclusion in the standard regime. Where tax administration is strong, rebuttability is likely to be appropriate. Where administration is weak, denial of rebuttability may be a coherent device for focusing limited resources on more important activities. These are important considerations that need to be taken into account. Nevertheless, given the importance of the possibility to opt out of the system for loss-making MSEs and the fact that the number of MSEs choosing standard taxation can be expected to be relatively small, rebuttability generally should not be excluded. What needs to be avoided, however, is ongoing migration.

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108 See page 33 of the background paper
in and out of the simplified system. MSEs should not be permitted to select on an annual basis the system that is more advantageous to them. The option to migrate from the presumptive to the standard tax regime therefore should entail an obligation to remain in the standard regime for at least three consecutive years.

- Should there be special rules for start-up businesses to provide additional incentives for formalization?

**Recommendation:** The most crucial “incentive” for a newly registered MSE is the guarantee that no tax liability for periods of activity will be assessed for the period before official registration arises. While non-registered MSEs that are uncovered by the tax administration and forced to register should be liable for taxes evaded before registration, a tax amnesty for MSEs registering voluntarily could be contemplated (although amnesties are risky and need to be considered with care (see the next section109). In addition, consideration could be given to refraining from requiring payment of installments for the first year of operation. Loss carry forward provisions, although generally relevant for all MSEs, are particularly important for start-ups, given the likelihood of losses incurred in the start-up phase. Tax holidays, on the other hand, generally are not an appropriate option to support business start-ups, for reasons discussed earlier.

- What other special incentives should the presumptive system offer?

**Recommendation:** Presumptive systems generally do not require any further bookkeeping apart from recording gross turnover. Providing incentives for developing simplified bookkeeping practice is highly desirable not only for tax purposes, but primarily for providing a sound business planning tool to the MSE owner. Incentives to promote the keeping of books and records could take the form of a lower tax rate for businesses complying with simplified bookkeeping standards. Also additional deductions from the tax liability for investments into MSE expansion and R&D could be conditioned on keeping books and records.

- Should there be time limits for taxation under the presumptive system, so that MSEs are required to transit to the standard taxation regime after a certain period of time?

**Recommendation:** Some countries have established time limits for an MSE to be taxed on a presumptive basis. Upon expiration of the time limit, the MSE is required to migrate to the standard regime. The reason for this approach is to

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109 For a discussion of tax amnesties see also the World Bank Tax Policy Administration subsite: http://go.worldbank.org/PP2XJQTX80
force MSEs to obey to bookkeeping requirements after a certain period of time. In developing countries, however, many MSEs will not be able to cope with the requirements of the standard tax regime even after a number of years of existence. MSEs that grow will automatically move to the standard regime once they reach the eligibility threshold for being taxed on a presumptive basis. Other MSE should be able to remain in the presumptive system without any time limit (otherwise many will simply close and re-open under a new name).

Facilitating the Formalization of MSEs

Newly registered MSEs can either be start-ups or small businesses that in the past operated in the informal sector and now have decided to formalize. From a tax point of view there is a major difference between these two cases. Former shadow economy businesses have neglected their obligation to pay taxes in the past and therefore are to be considered tax evaders. This makes them liable for the amount of taxes evaded during the period of informality plus interest and fines (including the possibility of imprisonment of the business owner for criminal offence). This would be, however, a highly counterproductive result of formalization, as there is a high interest of policymakers, compliant businesses, and society in facilitating the migration of shadow economy MSEs into the formal economy. Such a migration becomes virtually impossible when business interested in regularizing their status risk to be confronted with a huge tax bill for past business years. Guidelines for SME taxation, such as the OECD DAC Development Cooperation Report 2005 therefore recommend avoiding retroactive taxation for businesses that formalize, as SMEs will be reluctant to formalize if they fear a large tax bill.

Waiving past tax payment obligations on the other hand can be perceived as unfair by compliant businesses, which regularly paid their taxes and may even have been confronted with interest charges for late payment or penalties for mistakes made in their tax declaration. In practice, a distinction will need to be made: MSEs that did not formalize voluntarily, but which were forced to register as a result of tax administration action, should be fully liable for all taxes evaded. On the other hand, to promote voluntary registration of informal businesses, a targeted partial or complete tax amnesty scheme could be introduced. Policymakers should be aware, however, that experience with tax amnesties in a number of countries has shown that not every amnesty offered is automatically accepted and successful. Conditions for the success of a tax amnesty are a clear time frame for legalizing tax affairs, an attractive and transparent design of the amnesty scheme, an efficient advertisement of the amnesty, and a credible threat that tax administration efforts to identify informal businesses will be intensified after the expiration of the amnesty scheme.
Unfortunately distrust in the MSE community regarding the consequences of formalization is not always unwarranted. For example, in one of the major cities in a North-African country, the city government had publicly guaranteed street vendors a reduced tax rate in case of voluntary registration. Once small businesses were in the system, the local tax administration charged four times the promised amount and required the businesses to pay back taxes for the last five years. Such an approach completely undermines the taxpayer–tax administration relationship and the willingness of businesses to comply with the tax system.

The Importance of Private Sector Involvement in the Reform Process

Any tax reform program should seek active stakeholder involvement and solicit private sector support from the very early stages of the reform process. A number of World Bank tax administration reform projects therefore have included the establishment of reform advisory committees with private sector participation to steer the reform process, or support regular consultations with private sector groups. A close cooperation with the business community is particularly important for reform initiatives aiming at facilitating business compliance with the tax system, such as for the design of a presumptive tax system. Beyond isolated consultations on MSE tax design issues, it is desirable to set up an institutionalized dialogue between tax policymakers/tax administration and the MSE community. One model for such institutionalized dialogue is the Tax Practitioner Forum (ATPF) SME Sub-Committee in Australia. The membership of the ATPF SME Sub-committee comprises of senior Tax Office personnel who are responsible for managing Tax Office SME compliance activities, and registered tax agents that have SME clients. The committee meets on a quarterly basis. Its role is to identify, discuss, and co-design approaches to resolving significant tax administration issues facing MSEs and to identify, discuss, and com-
mission work in relation to initiatives that would support tax agents in representing MSEs. Similar approaches could be followed on the tax policy side and with direct involvement of small business representatives.

Also, a number of developing countries have established a dialogue between the revenue authority and the business community\textsuperscript{110}. In Rwanda, for instance, tax policy is made through a continuous consultative process that involves the private sector. The Rwanda Private Sector Federation and its small business representatives are consulted on tax reform issues. In Tanzania, the Taskforce for Tax Policy Reform provides an important forum for dialogue between the private and public sectors on tax issues. However, country studies have shown that the interaction with the private sector often occurs after a tax policy has been adopted by the government, and there is still scope for improving the mechanism of the dialogue and the timely exchange of views and information.

\textsuperscript{110} Fjeldstad, A Political-Economy Analysis of the Effects of the Taxation System on Business Investment in Africa, 2007
Annex 1: Key Issues for Designing a Small Business Tax System

### Voluntary tax compliance of small businesses
- Setting the base for small business tax reform requires analyzing the level of compliance of small businesses with tax obligations.
- The main reasons for small business to operate in the informal economy need to be determined. The key question is: To what extent do tax policy and tax administration drive informality?

### Data collection
- Design of a small business tax system should not be based on unfounded guesswork. It requires solid data analysis.
- As in many countries, reliable data are not readily available, substantial data collection efforts will need to be made.
- Basing tax system design on reliable data analysis not only increases the fairness of the system, but is also essential to promoting broad acceptance of the system.
- Ideally, studies should be undertaken to analyze characteristics of the small business segment of the taxpayer population (average annual turnover, profit margins, sector of output—tradable or not, final or intermediate sales, average lifespan, number of salaried employees and gross salaries paid; percentage of small (micro) businesses operating at pure subsistence level; compliance capacity—literacy rate, use of cash accounting; compliance costs—main issues contributing to compliance costs).
- Ongoing data collection should be initiated. Of crucial importance is the preparation of taxpayer feedback surveys, which should be carried out on a regular basis (e.g. every two years).

### Selecting the target group
- There is no universally applicable definition of “small taxpayers”. The borderline between small, medium, and large taxpayers depends on the level of economic development, the size of the country and the structure of the economy. It thus has to be determined in a country-specific way.
- Small businesses in most countries account for more than 90% of the taxpayer population. Policymakers must be aware that the small business segment is not a homogeneous group and therefore should not be treated uniformly.
- At a minimum, three sub-groups need to be distinguished: subsistence level businesses, micro businesses above the subsistence level; and small businesses with a more stable and extensive level of business activity and growth potential and expectation. Different tax policy approaches are required for these sub-groups.

### Reform areas
- Small business taxation frequently is associated with the operation of a presumptive tax system. However, while presumptive taxation could be the core element of a small business tax system, reforms should not be limited to presumptive taxation. It is equally important to address compliance problems in direct and indirect taxation.
- A good small business tax system that is not administered properly can have as bad an impact on the business environment as a badly designed system. Enabling tax administration to respond to specific small business compliance problems and service needs therefore is as important as the system design.
- Small business tax reform is also likely to have a subnational dimension, as in many countries local governments levy taxes on MSEs, which could create greater compliance problems than central government taxes.

### VAT
- Many small businesses consider compliance with VAT particularly burdensome and costly. It therefore is important to set the threshold for compulsory VAT registration at a reasonably high level, balancing the objective to reduce compliance and administration costs with the objective to limit considerable reductions in the potential VAT yield.
- Voluntary registration should be introduced for small businesses with a turnover below the registration threshold. However, at the same time safeguards against fraudulent registration of “fly-by-night” traders must be introduced.

(continued on next page)
Designing a Tax System for Micro and Small Businesses

Filing frequency is one of the main reasons for high VAT compliance costs. Reducing the filing frequency therefore can be an important simplification measure.

VAT is generally based on accrual accounting. This can create payment problems for small businesses. Small businesses should therefore get the option of paying VAT on a cash accounting basis.

Simplified schemes for VAT calculations can substantially reduce the compliance burden. A possible approach is to calculate the VAT liability as a simple percentage of business turnover.

Income tax

Tax holidays generally are not an appropriate tool to support MSE development. Better targeted incentives should be used to promote specific investment decisions. Key examples are simplified and attractive depreciation rules, additional incentives to promote investments in R&D, and tax exemptions for re-invested profits.

A number of countries have introduced lower income tax rates for small businesses to compensate for higher compliance costs. However, due to the risk of abuse and reduction in the tax yield, measures aiming at directly reducing actual compliance costs are preferable to a tax rate reduction.

Presumptive taxation

A presumptive tax system is not necessarily the best option to improve small business taxation. The need to move beyond simplifications in compliance with standard direct taxes and increase the VAT threshold to a sufficiently high level depends on tax administration capacity and the ability of taxpayers to comply with simplified income tax filing and self-assessment requirements.

Efforts to broaden the tax net should be limited to businesses operating above the subsistence level. Micro businesses at the subsistence level should be tax exempt for (i) poverty reduction reasons, and (ii) a disproportion in the relationship between potential revenue collection and administration, plus compliance costs.

For micro businesses above the subsistence level (mainly owner-operated small businesses in the retail sector), a simple lump-sum patent generally is the most cost-efficient approach. The patent approach also reduces corruption and harassment risks.

For small businesses above the micro level, several alternative approaches to presumptive taxation are available. Main alternatives are turnover-based systems, systems based on objective business indicators, and agreed systems. For reasons of accuracy, transparency, and coordination with the standard tax regime, turnover-based systems generally should be preferred over indicator-based or agreed systems.

Key objective of a presumptive system is compliance simplification and not tax burden reduction. The tax burden under the presumptive system should roughly equal the tax burden under the standard regime to avoid discouraging businesses to grow and migrate from the presumptive into the standard regime.

Ideally presumptive taxes should not only substitute income tax, but replace a broader range of direct and indirect central and possibly also local taxes. An exception applies to social security contributions and employee income withholding taxes.

A presumptive system should include incentives to promote maintaining simplified books and records (in particular a cash book). Such incentive could be in the form of a rate reduction, more flexible payment options, and loss carry forward opportunities.

Retroactive taxation for businesses that move from the informal into the formal economy should be avoided. Enterprises will be discouraged to formalize if this results in the obligation to pay huge tax arrears, interests and penalties.

Tax administration reform must accompany tax policy reforms.

Given the special compliance problems and service needs of small taxpayers, creating dedicated administrative structures in the tax administration to manage small taxpayer compliance and satisfy service needs could be a promising reform option. Similar to the operation of large taxpayer offices existing in many countries, specialized small taxpayer offices could be created.

In a number of countries the registration of businesses for tax purposes still is a slow, cumbersome and often costly process. Streamlining taxpayer registration is an important administrative reform. It should be linked to the reform of business registration requirements on a broader base. Ideally a one-stop shop approach to registration should be introduced.

Small taxpayers have special service and information needs. This concerns both the content and delivery mode of services. As the use of modern technology (internet, mobile phones) is becoming more widespread in the small busi...
Annex 1: Key Issues for Designing a Small Business Tax System

(continued from previous page)

- Cooperation with the private sector, in particular small business associations, is important for successful compliance management. Consideration could be given to introducing some elements of associational taxation and involving small business associations in the tax collection process.
- A close cooperation with local governments (in particular information sharing) should be established.

- Little consideration has been given to the devolution of small business tax collection. However, any small business tax reform should take into consideration its impact on the fiscal federalism system.
- For micro business patents, there is a clear possibility to be turned into a true local tax with local governments having discretion over setting the tax rate, collection responsibility and revenues going to the local budget.
- Devolution is less obvious in case of small business taxes, as these require greater tax administration capacity and better taxpayer services than many local governments can provide. In addition, problems may arise of proper transfer of small businesses to the central tax administration in case these businesses show a turnover above the small business tax threshold.
Annex 2: Checklist for Designing a Small Business Tax System

### Preparatory Analysis

- What is the size of the informal economy?
- What are the main reasons for operating in the informal economy? What role does the tax system (tax policy and tax administration) play for the decision to operate in the informal economy?
- What is the definition of small business / micro business in general laws / regulations (e.g. for statistical purposes)? Is this definition appropriate for tax purposes?
- What are the characteristics of the small and micro segment of the business population (e.g. estimated number of businesses; average lifespan of a small business; number of salaried employees; type of business activity; percentage of micro businesses operating at pure subsistence level; literacy rate of small business operators; use of cash books)
- What is the average annual turnover and profit margin in key business areas?

### Small And Micro Businesses And The Tax System

- What is the estimated level of voluntary compliance of small businesses with tax obligations?
- How high are tax compliance costs and what are the main factors contributing to compliance costs?
- How many taxes do small businesses have to pay? Which of these taxes are considered most problematic from a compliance point of view?
- What role do local taxes play (number and kind of local taxes; compliance problems of businesses with the local tax system)?
- What is the small business perception regarding the efficiency and integrity of the tax administration?

### Simplification Of The Standard Tax System

**a) VAT**
- Is there a reasonably high VAT threshold to exempt most small businesses from compulsory VAT registration? If not, is there at least a simplified system available for small businesses to calculate their VAT liability?
- Can small businesses below the registration threshold voluntarily register for VAT?
- Are there safeguards in place to avoid fraudulent registration of fly-by-night businesses?
- Is there a potential for simplifying return forms for small businesses?
- How frequently do small businesses have to file VAT returns? Can the filing frequency be reduced to biannual or annual filing (with monthly or quarterly installments)?
- Do small businesses have an option to pay VAT based on cash instead of accrual accounting?

**b) Income tax**
- Are micro businesses at the subsistence level exempt from income taxation?
- Is there a potential for simplifying return forms for small businesses?
- Do loss-making small businesses have sufficient loss carry forward possibilities?
- Are there sufficiently simple and attractive depreciation rules to write off machinery and equipment?
- Does the tax system promote investment in research and development?
- Is there a need to review the efficiency of tax incentive schemes (in particular tax holidays) and replace such incentives by more efficient rules (in particular, loss carry forward and depreciation rules)?

### Design of a Presumptive Tax System

- Is there an overall need to introduce a presumptive tax system, or can taxpayers and tax administration be expected to ensure compliance with the (reformed) standard tax system?
- Which taxpayers should be subject to presumptive taxation? Should the system only apply to individuals, or should small corporate taxpayers benefit from presumptive taxation too?

(continued on next page)
Designing a Tax System for Micro and Small Businesses

What should be the tax base of the system? Can turnover be used to determine presumptive tax liability?

Are there sufficient data available to estimate business profit based on turnover?

What safeguards can be introduced to reduce the risk of turnover under-declaration (e.g. obligation to use the banking system for transaction above a certain limit; receipt lotteries)?

What kind of incentives can be introduced to promote record keeping?

What should be the upper threshold of the system? Can it be coordinated with the VAT registration threshold?

Which taxes should the presumptive system replace? Should it be operated in lieu of income tax only or should it replace a broader range of taxes?

Should subnational taxes be replaced by the presumptive system too? What are the consequences for the fiscal federalism system?

How should the tax burden be determined? Should there be different standard deductions from turnover for different groups of taxpayers (e.g. for trading businesses and for service businesses)?

Should taxpayers have an option to be taxed under the standard system? If yes, are there rules limiting the possibility to move back to presumptive taxation?

Are there possibilities to prove losses (subject to sufficient bookkeeping) and avoid a tax liability during loss-making periods?

Should a simple patent be introduced for micro businesses above the subsistence level?

What is the attitude of tax administration towards small business compliance management?

Does the tax administration have sufficient capacity to respond to small business compliance problems without reducing the focus on ensuring large taxpayer compliance?

Is the organizational structure of tax administration appropriate to facilitate and ensure small taxpayer compliance?

Is there sufficient understanding and information in the tax administration about the small business segment of the taxpayer population and the specific compliance issues and service needs of this segment?

Is there sufficient communication between the tax administration and small businesses (small business associations)? Can small business associations be involved in the compliance management process?

Have registration processes been sufficiently streamlined and accelerated to ensure quick and easy issuance of a TIN? Have efforts been undertaken to harmonize various registration processes and create a one-stop shop for registration?

Is there a special taxpayer service and information program targeted towards small businesses?

Is there cooperation with local governments in the administration of small business taxes?

Have electronic and mobile communication devices been used to facilitate the interaction of small businesses with the tax administration?

Do tax audits of small businesses include advisory components to support small businesses in their compliance efforts?

Are there complaint mechanisms to report cases of harassment and corruption?
ANNEX 3: Examples of Indicators of Compliance Used in OECD Jurisdictions

<table>
<thead>
<tr>
<th>Type of Risk</th>
<th>Example</th>
</tr>
</thead>
<tbody>
<tr>
<td>Registration</td>
<td>Number of individuals filing income tax returns in comparison to statistics on the population of individuals more than 15 years old</td>
</tr>
<tr>
<td></td>
<td>Trend in the number of registered taxpayers (by specific entity type) compared to estimates of total population</td>
</tr>
<tr>
<td>Filing</td>
<td>Trend in the percentage of returns filed on time by type of tax</td>
</tr>
<tr>
<td></td>
<td>Trend in the percentage of returns filed on time by entity type</td>
</tr>
<tr>
<td>Correct Reporting</td>
<td>Net VAT revenues tracked against changes in consumer expenditures at all levels</td>
</tr>
<tr>
<td></td>
<td>Net VAT collections / estimates of VAT base (derived from national accounts data)</td>
</tr>
<tr>
<td></td>
<td>Trend in extent of unreported income / aggregate income paid (e.g. as measured by random audit program or macro measure)</td>
</tr>
<tr>
<td></td>
<td>Trends in effective tax rates by entity type, e.g. comparing corporate income tax revenues assessed to corporate profits</td>
</tr>
<tr>
<td>Payment</td>
<td>Trend in the percentage of tax paid on time by revenue type</td>
</tr>
<tr>
<td></td>
<td>Trend in the percentage of tax paid on time by entity type</td>
</tr>
<tr>
<td></td>
<td>Trend in the value of year-end debt inventory (gross debt and collectable debt) as a proportion of net annual revenue collections</td>
</tr>
</tbody>
</table>

Source: OECD, Managing and Improving Tax Compliance
ANNEX 4: Examples of Indicators to Measure Results of Small Business Tax Reforms

<table>
<thead>
<tr>
<th>Area</th>
<th>Possible Indicator</th>
<th>Feasible approach and data collection instrument</th>
</tr>
</thead>
<tbody>
<tr>
<td>Business environment</td>
<td>Increase in the level of overall satisfaction of MSE owners with the tax system / tax administration</td>
<td></td>
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<tr>
<td></td>
<td>Decrease in the importance of the tax system as obstacle to MSE formalization</td>
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<td></td>
<td>Time required to resolve administration dispute on tax issues</td>
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<tr>
<td></td>
<td>Time required to issue a TIN</td>
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<tr>
<td></td>
<td>Percentage of increase in the number of MSEs registered with the tax authority</td>
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<tr>
<td></td>
<td>Increase in the level of voluntary tax compliance</td>
<td></td>
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<tr>
<td></td>
<td>Number of taxes (central and local taxes) to be paid</td>
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<tr>
<td></td>
<td>Number of returns to be filed (total per year)</td>
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</tr>
<tr>
<td></td>
<td>Number of tax payments to be made (per year)</td>
<td></td>
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<tr>
<td></td>
<td>Level of VAT registration threshold (compared to regional / international average)</td>
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</tr>
<tr>
<td></td>
<td>Time spent on complying with tax obligations (hours per year)</td>
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<tr>
<td></td>
<td>Cost of outsourcing tax preparation</td>
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<tr>
<td></td>
<td>Percent of businesses that outsource</td>
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<tr>
<td></td>
<td>Incidence of errors/disputes / inspections / fines / appeals</td>
<td></td>
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<tr>
<td></td>
<td>Duration of inspections</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Possibility to file tax returns electronically</td>
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<tr>
<td></td>
<td>Average tax burden</td>
<td></td>
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<td></td>
<td>METR on capital</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Possibility of voluntary VAT registration</td>
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<tr>
<td></td>
<td>Number of training courses/seminars organized by the tax administration for MSEs</td>
<td></td>
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<tr>
<td></td>
<td>Number of participants trained</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Number of enquiries answered from MSE taxpayers</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Number of publications/ newsletters / information brochures</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Level of MSE satisfaction with service and information provided</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Regular consultative mechanism between tax policy makers / tax administration and small business community established</td>
<td></td>
</tr>
<tr>
<td></td>
<td>MSE community consulted ahead of tax policy changes affecting small business tax liability</td>
<td></td>
</tr>
</tbody>
</table>

Periodic surveys

Tax administration statistics

Taxpayer surveys

Information collected from tax advisors

Country case study analysis

Taxpayer feedback surveys

Information collected from MoF, tax administration, small business associations

The Canada Revenue Agency (CRA) set up an Action Task Force on Small Business Issues in August 2006. The objective of the Task Force is to ensure that the administrative policies and practices of the CRA impose the least burden possible on small businesses, while providing the CRA with the information it needs to confirm compliance with tax-related regulations and to identify and effectively address instances of non-compliance. The Task Force has developed a performance monitoring framework to measure the compliance burden faced by small businesses. It identified two types of measures frequently used by other levels of government and countries to assess the compliance burden on small business. These measures relate to the time and money expended by small businesses to comply. The Task Force divided these measures into two categories: a) direct measures—measures that have a direct impact on the time and money expenditures by small business; and b) indirect or proxy measures—measures of factors that indirectly affect time and money expenditures.

The structure of the framework is:

<table>
<thead>
<tr>
<th>Category</th>
<th>Measure</th>
<th>Indicator</th>
</tr>
</thead>
<tbody>
<tr>
<td>Direct Measures</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

(continued on next page)
<table>
<thead>
<tr>
<th>Measures of factors that affect time and money</th>
<th>Complexity of the compliance process</th>
<th>Indirect or Proxy Measures</th>
</tr>
</thead>
<tbody>
<tr>
<td>Measuring the effectiveness of tax services</td>
<td>Complexit... of the compliance...</td>
<td>CRA files – surveys (e.g. CRA Business Web Site User Survey)</td>
</tr>
<tr>
<td>4.1 User satisfaction with CRA services and staff</td>
<td>CRA files</td>
<td>CRA files</td>
</tr>
<tr>
<td>4.2 Time spent on CRA Web site</td>
<td>CRA files</td>
<td>CRA files</td>
</tr>
<tr>
<td>4.3 Accuracy and clarity of information provided by the CRA – rated by CRA and users</td>
<td>CRA Quality Assurance</td>
<td>CRA files</td>
</tr>
<tr>
<td>4.4 CRA Outreach activities</td>
<td>CRA Business Web Site User Survey</td>
<td>Outreach activity feedback</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Publications in non-official languages</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Small business seminars</td>
</tr>
</tbody>
</table>

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Annex 6: Main Elements of Terms of Reference for a Consultancy to Improve the Tax Environment for Small Businesses

Terms of Reference for a consultancy to design a small business tax regime need to be country specific and based on a preliminary assessment of the system available and the reform directions desired and feasible. This annex therefore only intends to outline key elements of TOR, which would need to be modified and complemented according to the specific country situation.

Objectives and Scope of the Consultancy

The consultancy can be a stand-alone consultancy on small business tax reform. It is also possible to include a special small business tax reform consultancy in a broader tax policy and tax administration reform project or an operation dealing with improving the MSE business environment. In any case, the specific objectives of the small business tax reform consultancy need to be outlined clearly.

A typical description of the overall objective of the consultancy could be to (i) support the design of a simplified taxation system for small and micro businesses and (ii) support the implementation of the system through recommending appropriate reforms in tax administration organization and procedures. Specific emphasis should be given to facilitating the formalization of small businesses operating in the informal economy and supporting the viability of business start-ups.

The section should include a description of the objectives of the simplified taxation scheme for MSEs and start-ups. Such objectives could be:

1. Creating incentives for businesses that currently operate in “informal” sector of the economy to graduate into the formal sector as well for new entrepreneurs to start-up new businesses.
2. Reducing costs of compliance of micro and small businesses with tax obligations.
3. Reducing tax administration costs of managing MSE tax compliance.
4. Supporting the development of a tax paying culture, further introducing good business practices.
5. Decreasing opportunities for unfair competition by informal sector businesses with formal sector enterprises.

6. Reducing harassment of businesses and corruption risks by developing a transparent and clear system of MSE taxation.

7. Laying ground for better tax revenue collection due to increasing rate of compliance with streamlined business regulations.

The target group for this assignment would be:

1. The current “informal” sector comprised of businesses that do not pay taxes and frequently do not comply with the full range of registration requirements;

2. Entrepreneurs, who are planning to start their business; and

3. Existing small businesses, which would benefit from introduction of the simplified and understandable taxation regime.

The actual taxation of micro and small businesses is determined by tax policy decisions (tax laws) and by the actual implementation of the tax system (administrative practices). The section on the scope of the task therefore should make clear that the consultancy will look at both tax policy and tax administration reform requirements.

Tasks

Generally the consultancy will require work in three major areas: (i) analytical; (ii) policy design); (iii) administrative reforms. These can be supplemented by adding, as appropriate, additional modules putting special emphasis on specific tasks (reform areas).

(i) Analytical work. A critical condition for an efficient, fair and widely accepted system of small business taxation is the availability of sufficient and reliable data and information on:

a) The structure, size, and composition of the micro and small business segment of the economy;

b) The size of the informal sector and the role of the tax system for the decision to operate in the informal sector;

c) Major compliance problems of MSEs with the tax system;

d) Recordkeeping practices in the MSE community;

e) Availability and use of private tax advisory services;

f) Profit expectations and margins of typical MSEs.
The consultancy should be required to prepare a detailed analytical report addressing the issues listed above. This report should also identify sources of information on small and micro business activities and assess their quality and comprehensiveness (e.g., information from the Bureau of Statistics, business register; chamber of commerce and small business associations).

(ii) System design: The consultancy should prepare a proposal for a simplified taxation system for micro and small businesses. The TOR should specify that the system should primarily be based on one variable, in general annual turnover. However, tasks could include designing a fixed patent scheme for micro businesses. In countries with very weak tax administration capacity and largely non-existing bookkeeping practices in the small business community elements of an indicator-based system could be requested to be incorporated in the system design.

Tasks should include in particular:

- Defining micro and small business for tax purposes.
- Drafting a proposal for a simplified small business tax system. Key design requirements for the system should be: (i) the system should be turnover-based; (ii) the tax burden should, to the extent possible, be aligned with the tax burden under the standard tax system to facilitate migration from the presumptive into the standard regime; (iii) the system should provide incentives for keeping simplified books and records.
- Coordinating the simplified system with the VAT system in place. The consultant would need to analyze if the VAT threshold is set at a level appropriate to become the upper threshold of the simplified system. Should according to the findings of the consultant the VAT threshold be set a level which is too low to become the ceiling for the simplified system (or should there be no VAT threshold at all), the consultant should be required to prepare a proposal for simplified compliance of small businesses with the VAT system.
- Determining the lower threshold of the simplified system. The lower threshold of the system should—to the extent feasible—be coordinated with the zero rate band of the personal income tax system. The system design needs to ensure that micro-businesses at a pure subsistence level are tax exempt.
- Evaluating the appropriateness of a simple patent system for micro businesses above the subsistence level. Further simplification objectives and a low potential revenue yield of a simplified tax on micro businesses might induce the introduction of a simple patent system for the taxation of micro businesses. The consultant should evaluate the appropriateness of such a system, taking into account compliance and enforcement challenges of a simplified small business tax regime at the micro business level. Should the consultant propose a patent
scheme for the taxation of micro businesses, the report will include an outline of the design of such system.

- Determining the taxes to be replaced by the simplified system. The consultant should analyze the number and kind of (national and subnational) taxes levied on small businesses. The consultant should then be required to propose which of these taxes should be substituted by the simplified system. Social taxes that are directly linked to entitlements to social benefits should not be replaced by a simplified taxation scheme. The consultant should analyze the feasibility of the simplified scheme replacing certain subnational taxes and levies in addition to central government taxes.

- Determining appropriate mechanisms to reduce the risk of an over-taxation of start-ups and loss-making MSEs. Risk mitigation measures should primarily be devised in the form of loss carry forward and flexible payment rules; tax holidays generally should not be proposed as risk mitigation approach.

- Determining appropriate mechanisms to facilitate tax registration of businesses operating in the informal economy.

(iii) **Tax administration reform:** The consultancy should include as a third major component the reform of tax administration organization and processes to facilitate the implementation of the simplified regime. The task description should include in particular:

- Reviewing the current organizational structure of the tax administration and assessing its appropriateness for managing small taxpayer compliance. Proposing organizational changes to reduce administrative costs and better prepare the tax administration for responding to the particular compliance problems and challenges of the MSE segment.

- Reviewing the operational processes of tax administration with regard to small business taxation and propose improvements. This refers in particular to:
  - Registration of MSEs for tax purposes. The consultancy should propose amendments to streamline the registration process and accelerate the allocation of a taxpayer identification number (TIN). While the consultancy generally focuses on tax administration processes, in the area of registration of start-ups a unified registration process covering business registration requirements in various areas (one-stop-shop approach) should be introduced. The consultant therefore should coordinate efforts with other registration reform initiatives and support the establishment of a one-stop shop for business registration. The consultancy should aim at balancing efforts to facilitate and accelerate MSE tax registration with the need to avoid fraudulent registration and maintain an accurate tax registry. Safeguard measures
therefore should be devised to reduce the risk of fraudulent registration and multiple TIN allocations.

- Return filing and tax payment processes. The consultancy should review and propose improvements to return filing and tax payment processes. Objective of the task should in particular be exploring possibilities for simplifying tax forms and reducing return filing frequency, improving filing instructions, simplifying tax payment processes (in particular facilitating payments through commercial banks) and exploring possibilities for e-filing and e-payment.

- MSE audits. Review the approach to auditing MSEs. Support the design of a risk-based audit program. Review audit processes and guidelines with the objective to reduce tax administration discretion and increase efficiency of desk and field audits.

- Debt collection. Review the legal powers for arrears collection. Streamline the collection process with the objective to accelerate debt collection activities. Support the introduction of risk based debt collection management, based on type of debt, amount owed, and past compliance history. Design opportunities for taxpayers to resolve the debt by installments.

- Taxpayer services and information. Evaluate the effectiveness and appropriateness of the current service and information program, considering the specific service needs of small businesses. Determine service priorities from a small business point of view and gaps in the current taxpayer service and information program (both with regard to topics and issues as well as delivery modes). Assess the capacity of the tax administration to design and deliver an efficient taxpayer service program to the small business community and propose organizational and procedural reforms to increase the efficiency of the taxpayer service function (including exploring the option to contract out the design and delivery of specific services). Support the introduction of new service products. Support the development of a feedback mechanism to assess taxpayer satisfaction with services and information.

Additional areas for consultant input could be added to these three core modules. Depending on the country situation, two areas with particular relevance could be addressing governance issues and fiscal federalism arrangements. On the governance side, the consultancy could be asked to devise accountability mechanisms which benefit small businesses. A core task (which should also be part of a general tax administration reform program) is to develop and support the implementation of a regular small taxpayer feedback survey, collecting information on compliance costs, taxpayer satisfaction with the tax system and tax administration, and problems related to corruption. Cooperative mechanisms between the tax administration and
private sector (small business) institutions could be strengthened to improve the public-private dialogue on small business tax policy and tax administration issues and reforms.

In the area of central government – local government relations, the consultant could be asked to:

- Assess the feasibility and desirability of reconfiguring a presumptive tax on small and micro businesses (or certain elements of the small and micro business tax system, such as a patent on micro businesses) as a local tax, giving local governments discretion over setting the tax rate and shifting the collection responsibility to local governments;

- Analyze possibilities to improve the cooperation between the central government tax administration and local governments in broadening the tax net and administering a simplified tax on small businesses. The analysis should include a discussion of possible incentives to increase local government interest in supporting tax collection from small businesses.
Annex 7: Summary of MSE Accounting Requirements

<table>
<thead>
<tr>
<th>Type</th>
<th>Purpose</th>
<th>Large Entities</th>
<th>Medium-Size Businesses</th>
<th>Small Businesses</th>
<th>Micro Businesses</th>
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<tbody>
<tr>
<td>Basic documents — evidence of transactions</td>
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<td>Subsidiary records — analysis for &quot;posting&quot; to the ledger</td>
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<td>Ledger records — double entry records</td>
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128  Designing a Tax System for Micro and Small Businesses

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<table>
<thead>
<tr>
<th>Type</th>
<th>Purpose</th>
<th>Operating statement (profit and loss account)</th>
<th>Summary of incomes and expenses account for the period (closes the current account item; net figure is profit or loss)</th>
<th>Detailed and separate for members of group (section for appropriation or distribution of profits). Group (consolidated) income statement</th>
<th>Abridged cash or accrual statement; may involve branch accounts. Separate section for profit distribution (e.g., partnerships and companies).</th>
<th>Simple cash or accrual statement for a few entities. Profits accrue to owners and often taken out as drawings.</th>
<th>Rare – cashbook is sufficient.</th>
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<tr>
<td>Micro</td>
<td>Basic documents — evidence of transactions</td>
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<td>Small</td>
<td>Financial statements — period and end-year schedules and reporting statements</td>
<td>Operating statement (profit and loss account)</td>
<td>Summary of incomes and expenses account for the period (closes the current account item; net figure is profit or loss)</td>
<td>Detailed and separate for members of group (section for appropriation or distribution of profits). Group (consolidated) income statement</td>
<td>Abridged cash or accrual statement; may involve branch accounts. Separate section for profit distribution (e.g., partnerships and companies).</td>
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<td>Rare – cashbook is sufficient.</td>
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<td>Medium</td>
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<td>Operating statement (profit and loss account)</td>
<td>Summary of incomes and expenses account for the period (closes the current account item; net figure is profit or loss)</td>
<td>Detailed and separate for members of group (section for appropriation or distribution of profits). Group (consolidated) income statement</td>
<td>Abridged cash or accrual statement; may involve branch accounts. Separate section for profit distribution (e.g., partnerships and companies).</td>
<td>Simple cash or accrual statement for a few entities. Profits accrue to owners and often taken out as drawings.</td>
<td>Rare – cashbook is sufficient.</td>
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<tr>
<td>Large</td>
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<td>Operating statement (profit and loss account)</td>
<td>Summary of incomes and expenses account for the period (closes the current account item; net figure is profit or loss)</td>
<td>Detailed and separate for members of group (section for appropriation or distribution of profits). Group (consolidated) income statement</td>
<td>Abridged cash or accrual statement; may involve branch accounts. Separate section for profit distribution (e.g., partnerships and companies).</td>
<td>Simple cash or accrual statement for a few entities. Profits accrue to owners and often taken out as drawings.</td>
<td>Rare – cashbook is sufficient.</td>
</tr>
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<td>Balance sheet</td>
<td>Summary of asset, equity (including profit/loss), and liability account balances (after preparing operating statement)</td>
<td>Summary of asset, equity (including profit/loss), and liability account balances (after preparing operating statement)</td>
<td>Detailed balance sheet, for separate entities in a group. Group (consolidated) balance sheet may be required.</td>
<td>Abridged balance sheet, including branches.</td>
<td>Simple, based on cashbook and basic ledger records (if any). Net worth method to determine profit or loss.</td>
<td>Optional, often not required.</td>
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<td>Funds flow statement</td>
<td>Statement of source and application of funds (i.e., change in liquidity) due to operating, financing, and investing activities.</td>
<td>Statement of source and application of funds (i.e., change in liquidity) due to operating, financing, and investing activities.</td>
<td>Detailed and separate for members in a group. Group statement may be required.</td>
<td>Simple statement or summary of cashbook.</td>
<td>Simple, but cashbook summary often sufficient.</td>
<td>Optional, often not required.</td>
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<td></td>
<td>Director’s report</td>
<td>Further explanations (to support the financial statements).</td>
<td>Required for companies.</td>
<td>Required for companies.</td>
<td>Not required</td>
<td>Not required</td>
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Annex 8: Key Recommendations of the Australian Cash Economy Task Force on Encouraging and Supporting Tax Compliance

Australia has made major efforts in implementing initiatives to better understand compliance problems of MSEs and developing strategies to facilitate and improve MSE tax compliance. The major step in this respect was the establishment of a Cash Economy Task Force by the Commissioner of Taxation in November 1996. The objective of the Task Force is to examine the nature of the cash economy, to determine what the likely compliance issues are and to develop a view about what additional steps can be taken by the Australian Taxation Office (ATO) to address tax evasion in the cash economy. The Task Force so far has produced three comprehensive reports. The recommendations included in these reports can also provide some guidance to tax reform efforts in developing countries. A core part of the recommendations deals with possibilities to reduce the tax compliance burden and facilitate voluntary tax compliance.

This annex presents some of the main recommendations produced by the Task Force:

Record keeping

Some form of recordkeeping is essential for all business operations and is one of the most important elements of running a successful business. For example, research into small business in Australia concluded that one of the reasons that small businesses fail is inadequate, inaccurate or non-existent books and records.

The extent, nature, and detail of the records maintained will depend on the type of business and the information required.

Records provide feedback on the effectiveness and profitability of operations on a regular basis. Good records enable a business to analyze growth and identify new opportunities. More importantly, good records provide evidence for the true value of a business. With regard to taxation, good records lead to more accurate reporting of income and expenses in business tax returns.

Recordkeeping is an essential element of business meeting its tax obligations. Taxpayers are required to retain records that are relevant to the calculation of their
taxable income, including records that verify claims for deductions. If a taxpayer does not comply with the recordkeeping requirements, he or she is liable for a fine or conviction under the ITAA and the TAA.

From a practical perspective, if a business keeps good records, it is quite likely that when these records are taken to the tax agent at the end of the year, the tax agent will have all the information needed to accurately complete the tax return. If good records are not kept, there are numerous adverse consequences for the taxpayer, including the accountant preparing an inaccurate tax return and the taxpayer having to spend a lot of time and energy trying to recreate the records.

The ATO undertakes a recordkeeping program to improve the quality of reporting by taxpayers. Currently, this program is focused on new businesses. The program is primarily an education initiative that seeks to improve business practices and to increase taxpayer compliance by encouraging more complete and comprehensive recordkeeping practices by small business operators. A major objective of real time reviews is also to ensure proper record keeping practices are in place.

Importantly, the ATO should ensure that its recordkeeping programs and real time reviews take into account the practical operations of business to ensure the recordkeeping advice provided is relevant to different types of taxpayers. Industry participants should be invited to work with the ATO on tailoring recordkeeping advice for particular market sectors.

The Task Force considers that the ATO should further promote the benefits to be obtained from good recordkeeping practices and consider introducing additional education programs (for example, public tax workshops on maintaining books and records). In particular, the ATO should explore opportunities to enlist tax professionals and industry representatives to conduct these promotional and educational programs.

**Increased flexibility in compliance strategies**

The ATO already has in place and makes use of various compliance strategies, such as penalties, audits, and, infrequently, prosecutions. However, the enforcement strategies currently used are not applied consistently on an escalating basis of sever-
ity. Also, they tend to be applied in a routine manner without taking into account taxpayer’s particular circumstances.

There are few options for either the ATO staff or the taxpayer if taxpayers do not fulfill their obligations by the due date. Enforcement strategies tend to be applied in a routine manner without taking into account circumstances which may create difficulty for individual taxpayers or for particular industries to meet their taxation obligations.

The compliance model, which advocates an escalating range of options and sanctions, requires the ATO to make the assumption that the majority of people are “good citizens” and would be willing to comply if they understood the tax system and were treated fairly and with trust. Positive reinforcement for compliance will help to reinforce the benefits of cooperation. It also requires the ATO to put in place, and to make it known, that if its trust is breached the ATO will strengthen enforcement methods as necessary.

The compliance model requires that the ATO forgive past poor behavior – taxpayers should not be labeled and continually persecuted just because they were punished in the past if they now agree to voluntarily comply. In most instances, they should simply be subject to the same enforcement approaches as any other taxpayer. Where there is a high risk of further offences, they could be subject to monitoring or increased supervision.

The ATO needs to work with those taxpayers who generally set out to do the right thing to make it easier for them to meet their responsibilities and to make it harder for others to avoid them.

The Task Force considers that most taxpayers generally set out to do the right thing. The ATO could recognize past “good” compliance behavior when assessing whether penalties or further enforcement activities are appropriate. For example, where the ATO discovers inadvertent errors during an examination of a taxpayer’s affairs, the focus should be on ensuring future compliance and not on imposing penalties. Follow-up contact to ensure that errors are no longer being made could be more effective than a one-off adjustment and penalty.

The Task Force considers that to deal effectively with tax evasion in cash businesses it may be necessary for the ATO to require more information to be lodged with tax returns and required to be kept in business records (for example, to enable financial ratio analysis). This may involve additional items to be completed on the return form, attachments of specific schedules or attachment to financial statements.
Rather than applying differential reporting requirements across the board, it may be more appropriate to require additional information from taxpayers whose returns appear abnormal when compared to similar type and size businesses or at least from taxpayers who have been found to be non compliant. This appears to be the thinking behind the Blue and White tax returns in Japan that reward good compliers with reduced reporting requirements.

The ATO should consider relaxing regulatory requirements for taxpayers with exemplary compliance records. For example, taxpayers or industries which have a history of compliance, have an approved compliance program in place, or which subject themselves to a regular compliance audit by an independent assessor would be eligible for less onerous record keeping obligations and allowed to complete a simpler return form.

Targeted amnesties

Tax amnesties seek to obtain improved compliance outcomes, generally in return for indemnity from prosecution or whole or partial remission of monetary penalties that would otherwise apply. Tax amnesties are usually instituted to seek improved outcomes in terms of:

- taxpayer registration;
- lodgment of tax documents (e.g. income tax returns);
- reporting of correct information in tax documents (e.g. unreported income, overclaimed expenses); or
- payment of outstanding taxes.

Amnesties have also been used in other areas of public administration, including social security overpayments, immigration offences and firearm registration.

Tax compliance literature indicates that an amnesty must offer incentives, and that these incentives should contain both reward and consequence components—reward for taking up the amnesty offer, and consequences for not taking up the offer. As mentioned above, the reward component is generally a reduction or elimination of penalties that would normally apply to non compliant behavior. The consequence component is generally a credible threat that, after the amnesty, non-compliant behavior will be detected and dealt with severely. In the United States, state taxing authorities have generally held amnesties just prior to increasing enforcement activity or making significant changes to the tax system (in particular, the introduction of more severe penalty regimes).
While there is no direct evidence about their impact on the cash economy, there is evidence that amnesties can play a significant positive role in improving compliance given the right conditions.

An amnesty targeted at the cash economy could cover:

- unreported cash receipts;
- false records;
- failure to lodge returns;
- outstanding tax payments; and
- compliance with sales tax, PAYE, PPS and RPS obligations.

Experience suggests that, including social security, studies assistance and perhaps other government programs in a wider-than-tax business amnesty could provide significant benefits to business, the government, and ultimately the community. It seems desirable to include social security at least in an amnesty for the cash economy.

Naturally, taking advantage of the amnesty would not prevent a business from being subsequently audited. In fact, it is important to ensure that a proportion of businesses using an amnesty are subjected to subsequent scrutiny to ensure that the amnesty is not used to deflect ATO attention away from serious non-compliance. It would be expected, however, that businesses using an amnesty would make the most of the opportunity to ‘come clean’, and subsequent scrutiny should find no significant non-compliance.

The success of an amnesty is dependent on the ATO’s ability to detect and follow up those taxpayers who do not participate in the amnesty. Therefore, prior to the amnesty the ATO should conduct extensive research and benchmarking and should also encourage community tip-offs in order to enhance the ATO’s follow-up effectiveness.

Accordingly, the Task Force supports the use of targeted amnesties to address non-compliance in the cash economy provided the ATO can mount effective communication and enforcement activities.

The Task Force considers that:

- the most appropriate approach for the ATO would be to offer amnesties on an industry basis where that industry has been the subject of a comprehensive risk assessment;
- there should be a specific limited time frame imposed;
- up-front activity be conducted to identify the problem and demonstrate the ATO’s intention to follow-up;
- to be effective, the amnesty would need to be across the whole of government; and
- it is imperative that the amnesty is supported by an effective communication strategy.

**Industry self regulation**

The Task Force does not believe that the ATO is solely responsible for dealing with tax non compliance. For example, in many cases the victims of tax evasion are other businesses and their employees who are subject to unfair price competition.

Industry and community groups should be encouraged to develop their own solutions to the problems posed by the cash economy that affect them. The ATO could provide important support to help such initiatives succeed.

An example of a community proposal is demonstrated in the following case study.

While it is not the ATO’s role to implement the cooperative proposal, the Task Force believes that the ATO could investigate how it could help to encourage, influence or promote, the establishment of such arrangements in the industry.

The Task Force considers that the accreditation requirements, currently before the Parliament, to combat sales tax fraud in the PC retail trade is another innovative approach that recognizes that specific industries may require specific solutions. The Task Force acknowledges that this approach, with its increased compliance burden on innocent taxpayers and more
onerous legislation, is only possible because of the industry requests for its implementation but considers that it demonstrates the benefits that can be achieved by working closely with industry.

‘New business’ market

The Task Force believes that there is merit in managing new businesses as a discrete group. It ensures that the Tax Office positions itself to take advantage of the limited window of opportunity that occurs at the beginning of its association with the client to lay the foundations for an ongoing cooperative and constructive relationship. The aim is to prevent, rather than treat, arising compliance issues.

Hallmarks of a well-managed approach to encouraging new businesses to be compliant include the early identification of a business as being new, ongoing monitoring of the business in its early stages, and the timely and proactive provision of assistance if and when a potential problem arises.

Currently, the Tax Office is developing and implementing an integrated assistance and compliance plan for the new to business sector which includes the development of appropriate assistance and education products as an outcome.

The Task Force believes these products should include an information ‘starter pack’ addressing the specific requirements of government and industry as well as identifying and offering approaches to manage a range of common pitfalls faced by new business. Specifically, these products would assist new business, by complementing the current products and approaches, to focus on the common pitfalls of poor record keeping, poor cash flow management, incomplete or inapplicable tax invoices, incorrect use of the Australian Business Number (ABN) and not applying withholding when an ABN is not quoted.

Strategic alliances with third parties to help small business

The Task Force has keenly observed the success of the tax seminars and other educational activities by the Tax Office, industry associations and other groups during the introduction of the new tax system. Education and assistance provided by third parties to complement Tax Office activities has also enabled much wider coverage and has assisted in tailoring information to the needs of specific
groups. The Task Force believes the Tax Office needs to build on the earlier successes and provide ongoing support for industry and business groups to deliver education and assistance to small businesses.

**Cash flow products**

Cash flow problems have been identified as a potential key driver of non-compliance in the cash economy for both new and established businesses. For this reason, the Task Force believes that the Tax Office needs to take a leading role in promoting options to business to assist in addressing their cash flow issues. Two options, arising from the introduction of the new tax system, which the Task Force believes should be marketed more strongly to small businesses, are:

a) **Voluntary payments** at times other than required (that is, through the normal activity statement and income tax return payment procedures). This should include marketing the benefits to be gained, where these can be made, how often they can be made and how payments can be made without holding a BAS remittance slip. Currently, the Tax Office and the taxi industry are working together to explore opportunities to simplify this process such as a bar coded easy-pay card.

b) **Voluntary agreements** between a payer and payee business to withhold tax from payments and remit these to the Tax Office for the payee business’s benefit. This should include marketing the GST advantages to a payee business and the cash flow advantages achieved through having installments deducted from receipts which are available as a credit against the quarterly liability.

**Accredited and industry-based training**

There are opportunities for training to include tax and compliance education, especially to address prevalent compliance problems, in accreditation schemes such as recognized business certificates. This could be achieved by the Tax Office developing and promoting a small business ‘best practice’ tax curriculum which enables a
business to reach an approved level of competence in managing its records and meeting its tax obligations.

Assistance from educational institutions and universities should be sought in the design of this curriculum. Training could be delivered by a range of groups including industry bodies or indeed self-taught.

Under one scenario, business operators successfully completing the curriculum would be accredited and this information passed to the Tax Office (linked to the ABN). Recognized accreditation by the Tax Office could contribute to a business being identified as at a lower risk of non-compliance than a business which is not accredited, all other things being equal. Regular refreshes or updates would need to be included in the strategy. Opportunities could also be explored for working with industry and business associations to include tax accreditation in their industry and other registration requirements.

Recommendation

The Tax Office should call for expressions of interest from relevant groups to develop a best practice tax curriculum for small business and work with providers of business education to deliver the curriculum and accredit business operators upon successful completion of the curriculum. Further, the Tax Office should record such accreditation against a business's ABN and use this in its risk assessment processes.
Annex 9: Selected Key Readings


Heady, 2002, *Tax Policy in Developing Countries: What Can be Learned from OECD Experience?*, OECD, Paris


Yitzhaki, 2006, *Cost Benefit Analysis of Presumptive Taxation*, Georgia State University, Atlanta
Designing a Tax System for Micro and Small Businesses: Guide for Practitioners