

# MSME Taxation and State Building: Partnering in progress

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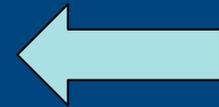


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## Agenda

Why focus on MSME tax design?

Can MSME tax reform contribute to state building?



The technicalities:

Key tax policy and administration issues in  
MSME tax design



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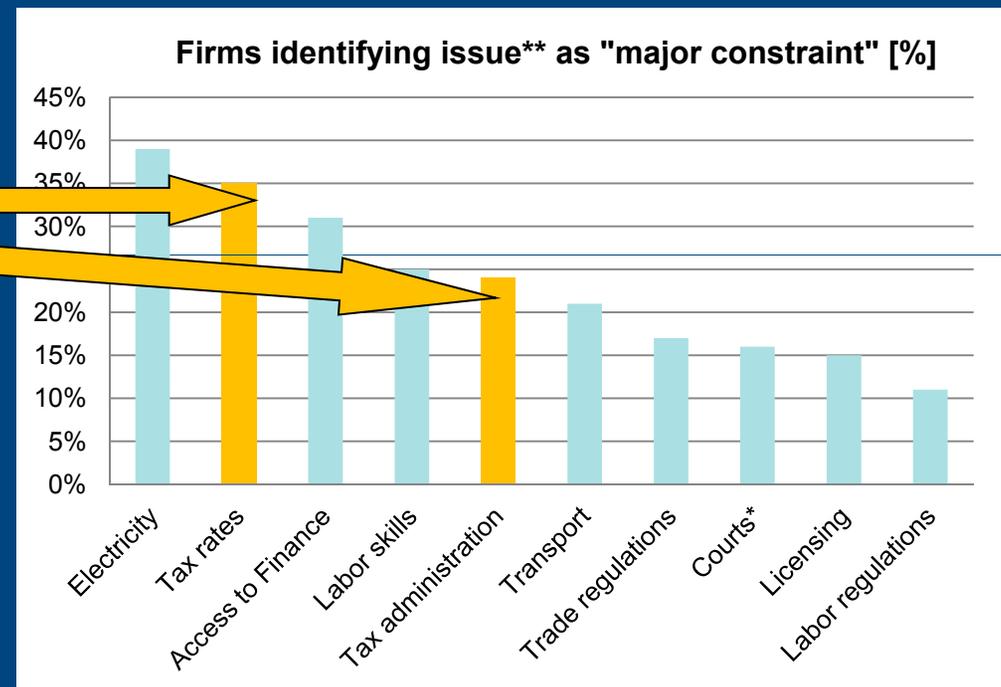
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# Tax regimes are often major constraints to business...

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



• Source: Investment Climate Assessments [all countries, 2002-10]

\* Data for "Courts Functioning" only available since 2006.

\*\* Excludes "corruption", "crime", and "informality".



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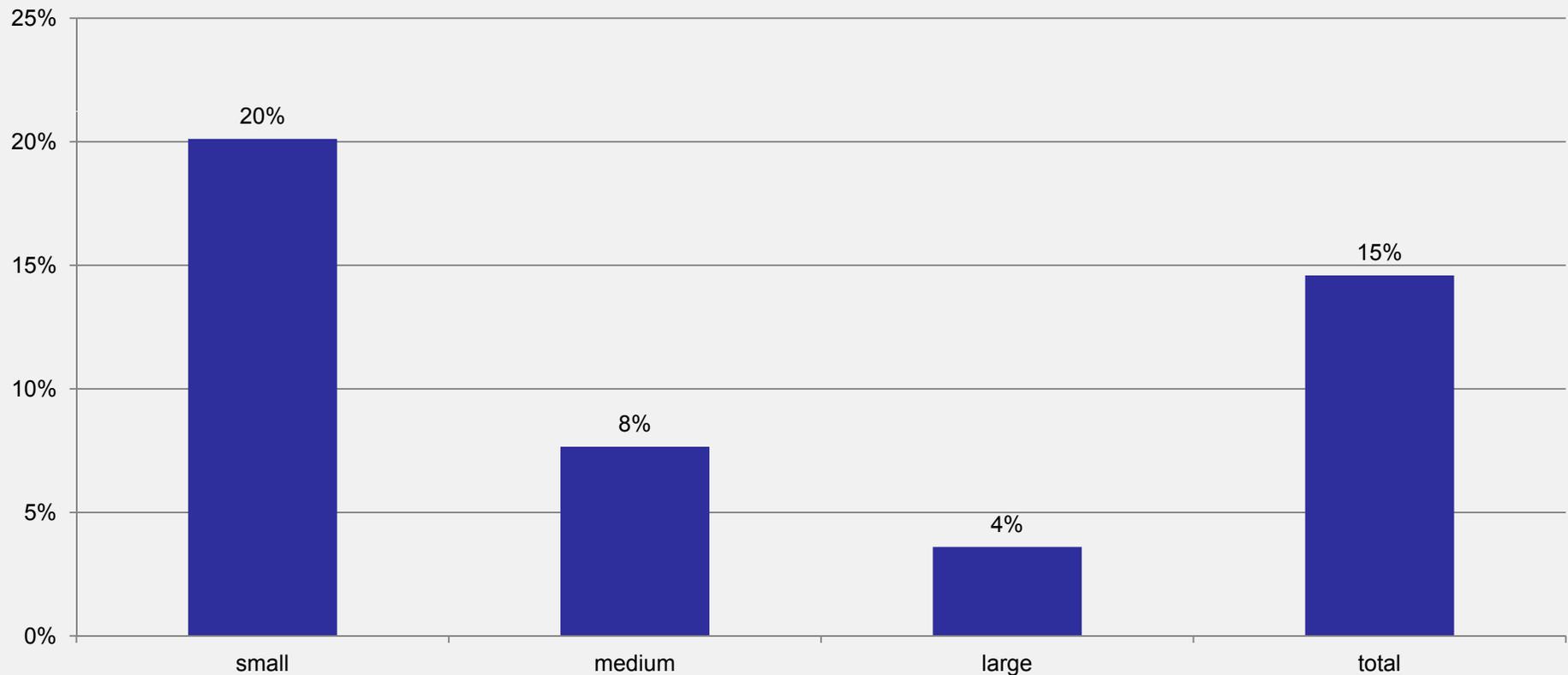


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# ...small firms are typically more burdened – eg. Georgia

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

(Source: Enterprise Survey 2008)



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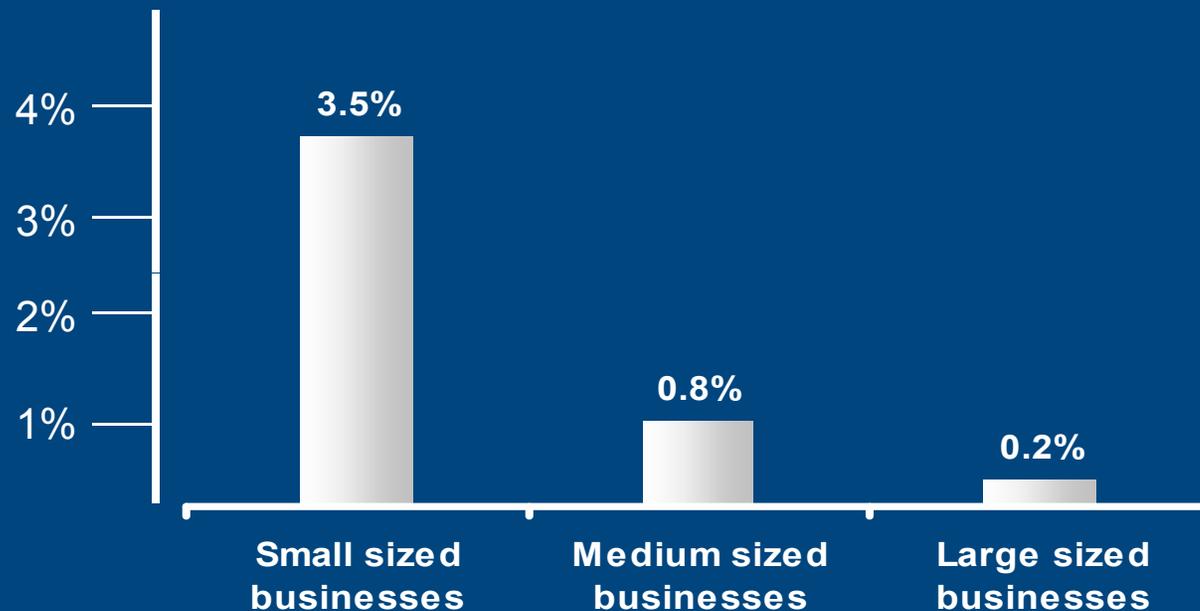


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# Small firms are typically more burdened – eg. Bihar, India



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

Source: IFC Tax Compliance Cost Survey Bihar, 2009



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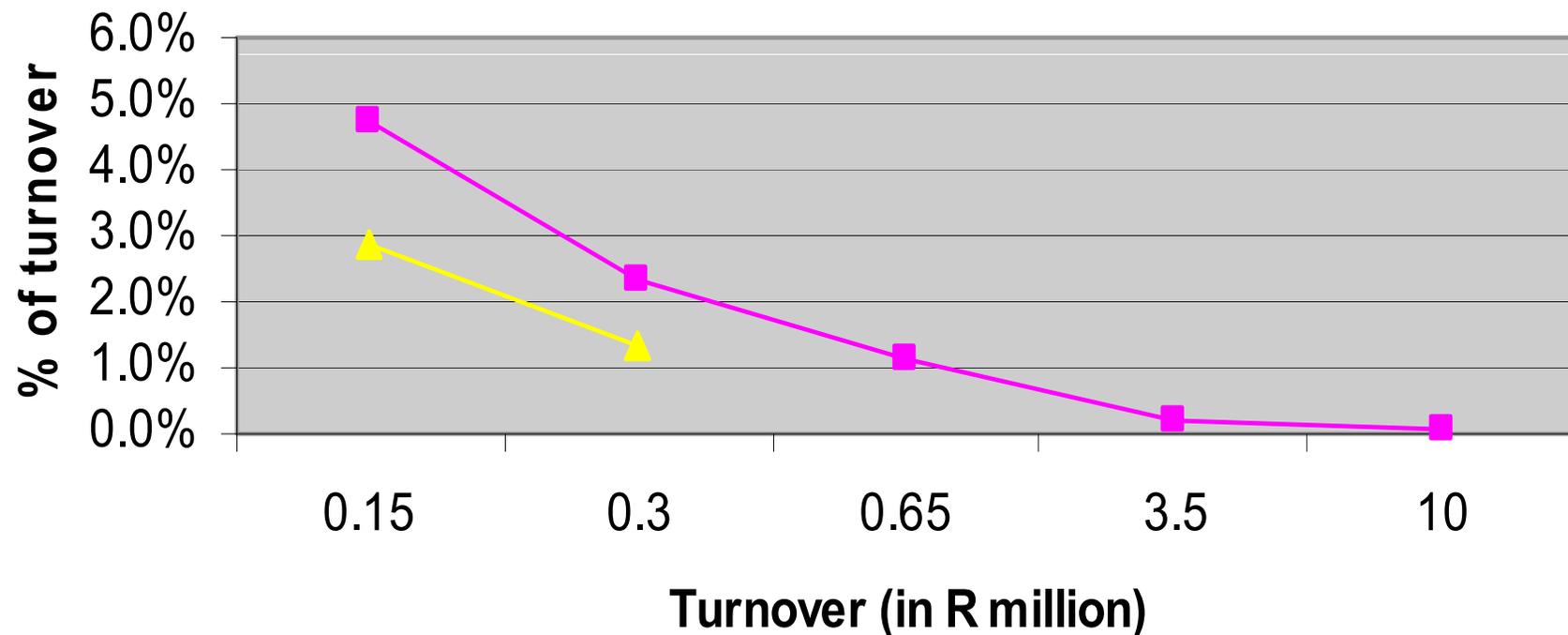
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# Small firms are typically more burdened – eg. South Africa

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



Source: FIAS Tax Compliance Cost Survey South Africa, 2007



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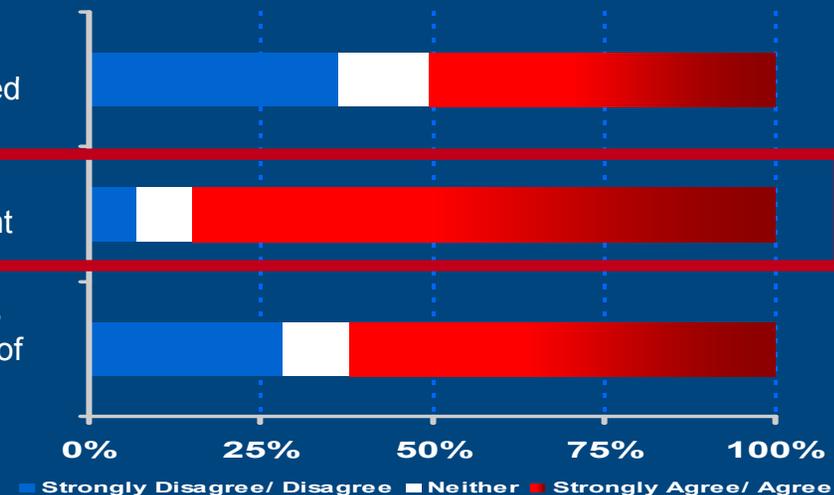
# Corruption is also a major factor

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

It is easier to avoid paying VAT as compared to cost and problems faced with its compliance process

Businesses would be willing to pay more tax if corruption is not prevalent

The process of complying with tax is more burdensome than the amount of tax itself



Source: IFC Tax Compliance Cost Survey Bihar, 2009

# When the costs of tax compliance are too high...



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

# There are actual benefits of MSME tax compliance

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



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# The Theory: A quick summary of pros and cons of taxing MSMEs differently

## Why?

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

## Why not?

- Disincentive to growth (jump in compliance financial burdens)
- Better to address distortions directly
- Threshold effects: Inverted U shape of effective rates
- Distortions can become a source of corruption



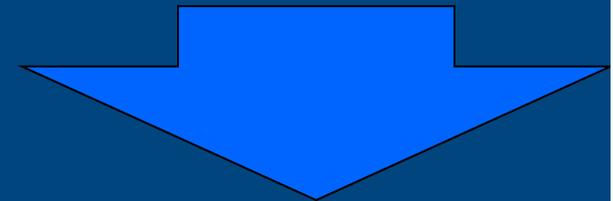
# General guidelines for MSME tax design...:

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



# Design options and key issues

1. Simplification of gen. regime	2. Special regimes	
<ul style="list-style-type: none"> <li>- Simplification of tax forms, filing and payment process, alignment of payments</li> <li>- Reduced direct tax rates</li> <li>- VAT simplification for SMEs</li> </ul>	a. Presumptive tax to replace income tax (+VAT)	b. Single (presumptive) tax replacing all other taxes



- What is “small”? No universal definition
- How should the system be designed to avoid both over- and under-taxation of MSMEs?
- What kind of safeguards are required to avoid abuse of system by larger businesses?
- How to align the MSME regime with the standard tax regime?
- System must be perceived as fair and transparent
- How to provide incentives for keeping proper books and records?

**1. Turnover based**

**2. Indicator based**

**3. Combined turnover and indicator based tax**



# The practice: A wide range of Tax Treatment of MSEs

- From very **simple patent taxes** (e.g. Nepal, Kosovo in the 1990s) to full application of **standard regime** (some OECD countries)
- From high **VAT registration threshold** (Singapore, Italy, Gabon) to no threshold at all (Vietnam)
- From exemption of **micro businesses** from taxation to uniform treatment of all MSEs.

But also on the administrative side:

- From practically exempting most MSEs from tax audit (Korea, Germany) to comprehensive **audit coverage** (some FSU countries)



# There are important regional differences

Region	# Countries analyzed	Countries operating presumptive regimes
European Union	21	8
Transition countries	19	16
The Americas	19	16
Africa	25	23

## A sketch of the situation in Asia:

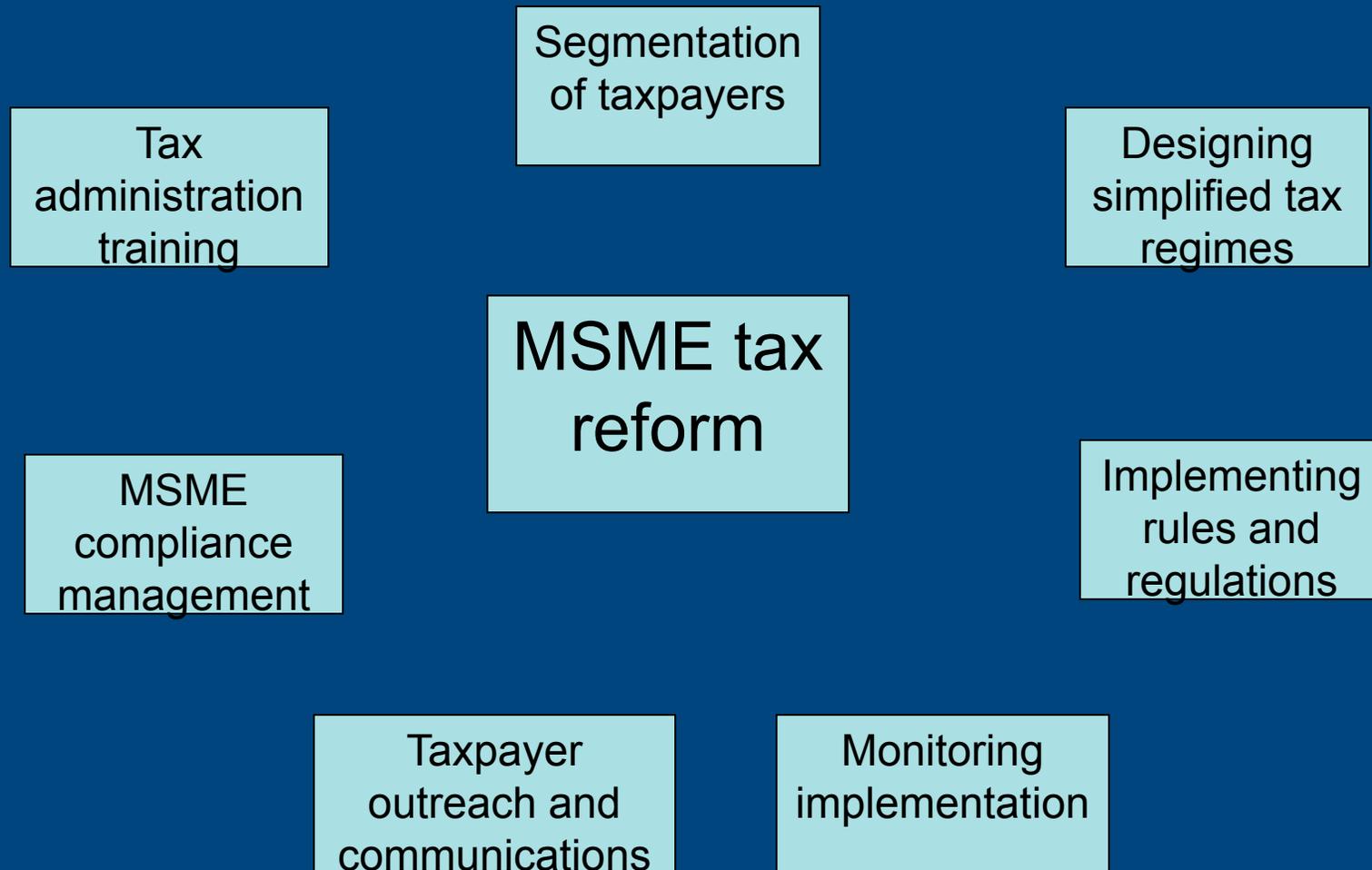
Patent system	Indicator based tax	Refined indicator system	Turnover tax	Turnover tax with net elements	Standard regime, reduced rates	Standard regime
Nepal	Cambodia	Lao PDR	Bangladesh Cambodia India Pakistan (retail trade) Philippines	Vietnam  Thailand	Indonesia	Australia China Japan Korea New Zealand

# Where does the variety in policy come from?

- The **capacity of the state/ tax administrations**: Administrative resources and efficiency?
- **Capacity of MSEs**: Numeracy, literacy and accounting practices?
- Differing **political goals** (equity vs. efficiency, redistribution, formalization vs. better business practices...), legal traditions, ...?



# The basic building blocks of MSME tax reform



# Pointers to a “good” MSME tax reform package - 1

## ■ Segmentation: Micro, Small

### ■ Defining the micro business threshold:

- Subsistence level activities
- Link to PIT exemption threshold

### ■ Defining small business: general approach is straightforward: harmonize with VAT registration threshold

- What if VAT threshold non-existent (VN) or too high (Armenia)

## ■ System design: presumptive regime for micro and small taxpayers

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

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

Small business segment	Tax rate
Trade	Around 2% of turnover
Service sector	Around 6% of turnover
Other small businesses	Around 4% of turnover



# Pointers to a “good” MSME tax reform package - 2

- **Simplification** for medium taxpayers, e.g., reducing filing and payment frequency, simplifying reporting requirements
- Development of special **SME accounting** regime: need guidelines for the operation of a cash accounting system appropriate for turnover based presumptive taxation
- **Implementing regulations**: the devil is in the detail
- **Training and outreach**: partner with private sector (and with tax administration) for reaching out to MSMEs
- **Compliance management**
  - Simplification of the overall business registration process as first important step
  - Can we link tax registration to better access to finance or access to special small business management support?
- **Monitoring**



# Main Lessons Learned

- Ministries of Finance generally are pushing MSME tax reforms much more than tax administrations. But tax administration management needs to be involved early in the reform process.
- System abuse by larger businesses is major problem in many client countries. Need policy and administrative countermeasures.
- Lack of reliable data considerably complicates fallback indicator design. More research and analysis early in the system design process necessary.
- Refining good practice examples is required: not only how have other countries done it, but also why have they done it in a particular way.
- Refining approach to estimating turnover based on indicators and profit margins based on turnover
- Developing guidelines for MSME tax accounting design



Thank you for your attention!



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