

Special Regimes & Thresholds for Taxation of SMEs

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Introduction

The taxation of the informal sector requires special tax regimes that can include adaptations to the regular tax structures and administrative strategies as well as the imposition of special additional, typically presumptive taxes with their own structures and administration. While informal sectors have some common features across countries of different income levels, there are enough differences to recognize that tax strategies need to be specially adapted to the different economic structures, potential tax bases, and tax compliance capacities of countries. This paper will recognize this diversity across countries in order to show the need for different tax strategies for the informal sector, but will focus mainly on tax strategies for low-income countries (LICs) such as in Sub Saharan Africa. This will allow the author to draw upon his over twenty years of taxation experience in a range of these countries.

The paper first outlines some major trends in taxation in recent decades in order to point out that many of these trends are not necessarily in a direction that supports the taxation of SMEs², especially micro enterprises in informal sectors. Second, it discusses the nature of the informal sector across countries in order to contrast the situation in high-income OECD countries with that in many LICs. Third, it looks at various options for the taxation of small and informal businesses through: (i) indirect taxation through regular taxes, (ii) adjustments to tax structure (especially the threshold for application of the regular domestic taxes (typically an Income Tax (IT) and VAT or Goods and Services Tax (GST)) and the use of administrative strategies, and (iii) special direct presumptive taxes targeted at the small informal businesses. Finally, some recommendations are provided.

Trends in taxation

Tax revenues over recent decades, particularly among higher income countries, have become dominated by domestic taxes: the income tax along with payroll taxes to support social security schemes, and the VAT or GST and excises or other special consumption taxes.³ In addition, the bulk of these domestic taxes typically accrue to the central government with some of these revenues being shared or transferred to sub-national governments. More importantly, in the context of this paper, tax administration has come to rely more on taxpayer-active or taxpayer-assessed taxation. The tax administration of the IT and VAT/GST relies heavily on the compliance capacity of the taxpayer. This administration strategy is supplemented by (i) greater use of client-oriented organization of tax administration, especially the focus on servicing large taxpayers; (ii) more autonomous tax agencies employing relatively well paid professional tax officials,

² SMEs means small and medium sized enterprises.

³ See for example, Vito Tanzi and Ludger Schukenecht, *Public Spending in the 20th Century* (Cambridge Univ. Press, 2000), Chaps 1-3 or Graham Glenday, "Towards fiscally feasible and efficient trade liberalization," study prepared under the Fiscal Reform in Support of Trade Liberalization Project, DAI/USAID, May 18, 2006, <http://www.fiscalreform.net/research/research.htm>

relying heavily on risk-based external audits and on formal sector private and public bodies to provide third-party information and withhold taxes; (iii) increasing use of computer- and web-based tax administration procedures; and (iv) growing efforts to educate and service taxpayers to increase compliance levels.

The result of these tax trends is cost-effective tax administration, primarily targeted at the large taxpayers. Both compliance and administrative costs per unit of revenue are usually lower the higher the share of taxes from large taxpayers. Typically, the largest 1% of registered taxpayers tends pay at least 50% of the taxes, or the largest 10% pays at least 90% of the tax revenues of central governments, or some similar concentration of tax collection by taxpayer size. These trends are generally moving the strategy and focus of tax administration away from taxing small informal sector businesses.

There are important exceptions to these trends. Importantly, taxpayer-passive or agency-assessed taxes are used in property taxation (often administered by local governments) and in direct presumptive taxes. In addition, the combination of e-governance and reliable third party information on employment and passive investment income is resulting in computer-generated agency assessments of taxpayers with only these types of income.

These general trends raise some broad concerns, which include problems arising for the taxation of small informal businesses. The first issue is whether tax administration resources are being cost effectively allocated when a dynamic or long-term view is taken. A static or short-term view would clearly support allocating the bulk of administrative resources to servicing and enforcing tax collection from large taxpayers. But, from where is the growth of tax revenues going to come? How are future large taxpayers being identified and nurtured? Are there parts of the tax systems that are currently ineffective that could be yielding much higher revenues? For example, would revenue growth be higher if added resources were devoted to strengthening the pay-as-you-go (PAYE) system for collecting employment income, or the border tax collections by customs, rather than the a large VAT and IT taxpayer unit? In developing countries both PAYE (covering employment by all formal sector employers) and customs are significant revenue sources often ineffectively exploited.

A second concern is that the informal sector is large in all economies (rising from 18% of GDP in OECD countries to 38% in transitional countries and 41% in developing countries) and has been growing in size.⁴ This situation raises a number of basic questions about the efficiency of a national tax system. Is the tax system economically inefficient: is it inducing major shifts of consumption and production into the informal sector? Is the tax system putting up a prohibitively high tax and compliance cost barriers to businesses entering the formal sector? Is this resulting in a growing loss of tax revenues over time?

⁴ Friedrich Schneider, "Size and Measurement of the informal economy in 110 countries around the world", University of Linz, Austria, July 2002

A third broad concern is that the concentration of tax revenues in central governments from relatively few taxpayers weakens the important political representation link between the taxpayer and the politician. If the political decision makers at the center see the bulk of the revenues coming from few taxpayers, and at lower levels of government coming from transfers of central revenues, then the responsiveness of the politician to the electorate is weakened. This is a particular concern where decentralization of government is being undertaken, and local governments raise little of their own resources. While equity considerations and efficiency of tax collections may argue for concentrated tax collections, broadening the tax base to have all beneficiaries of public service make some contribution to its cost arguably strengthens the accountability and responsiveness of the public sector to its taxpayers.

These three concerns are considered when reviewing options for taxing small informal businesses below.

Informal sector and taxation

What is the informal sector? How does the informal sector differ across countries? What are useful perspectives on the informal sector from a tax administration perspective? What are the implications for taxation?

The informal sector of the economy is composed of individuals and businesses for which the authorities have little or no information about their business activities. While a government may (or may not) know about the existence of an individual in a jurisdiction, official documentation of his or her business activities is often lacking. Given that information on economic activities is fundamental to assessing taxes, the informal sector poses a severe problem to the tax authorities. Typically, the more different parties have information about and an interest in these business activities; such transparency and accountability makes the accurate assessment of taxes easier or tax evasion more difficult.

Informal sector businesses are typically unincorporated, owner or family managed and operated with few, if any regular employees. The business may not keep books or records, and may do all exchanges for cash or barter. Only to the extent that the business has dealings with a formal sector body – bank, customs service, supplier, buyer, cooperative, etc – will a third party have some formal information on these activities. By contrast, a publicly listed corporation has many owners, professional managers, bankers, external auditors and possibly a range of dealings with various government regulatory or service agencies. Even without taxation, the business affairs of such a corporation would be known to a large number of parties and possibly even be published regularly. There is clearly a wide range of degrees of connectedness of business with the formal sector. Corporations and companies of any size in most countries are subject to varying reporting requirements and degrees of oversight. The small, unincorporated business, however, with no connections to the formal sector can readily hide its business information.

The informal sector can be usefully broken into two basic types: *below* and *above ground* informal sectors. Both may be unregistered for any or some types of tax. Underground,

untaxed activities include criminal activities, black market or gray activities, and tax evasion. These activities could be conducted by individuals or involve organized groups or gangs. Another possibly large underground activity is moonlighting, or individuals taking on undocumented jobs or providing services (often personal or business services) for fee typically paid in cash. Moonlighting may be conducted as an additional job or by a contractor providing added services at night or on weekends over and above formal activities.

Above ground or parallel market activities include micro/small scale unincorporated business activity that may also be outside monetary economy. Such activity is often conducted outside of any formal law (but possibly within some traditional law) or is only partially regulated, and seldom effectively taxed. It includes the majority of economic activity of the labor force in many low-income countries. It can include agricultural, forestry, fishing, mining, petty manufacturing, trading and personal and business services. While some activities may be illegal or constitute tax evasion, the bulk of them are routine or traditional subsistence or self-employment business activities. By contrast with underground or black market activities, in East Africa, for example, informal activities are referred to as the “jua kali” (hot sun) sector, reflecting the open-air nature of the business activities.⁵ Development economists “discovered” the urban informal sector in Kenya in 1960s and it became a key component of labor market models.

From a taxation perspective, the underground or illegal informal activities generally reflect an *unwillingness to comply* rather than a *lack of capacity to comply* with tax laws or regulations. The above ground informal sectors often contain severe compliance capacity limitations ranging from a lack of general skills (innumeracy and illiteracy) to a lack of more specific tax compliance skills such as the ability to issue invoices, maintain transaction records and accounts, or the ability to comply with complex tax provisions.

The table below contrasts the two extreme cases of the informal sectors in high-income OECD and low-income countries. In high-income countries it is expected that all individuals or businesses can comply with tax and other laws. A combination of personal preferences and poorly designed or complex laws can induce underground, illegal activities. With similar shares of the economy and the labor force in the informal sector in high-income countries, it is expected that incomes are similar or possibly higher after tax in the informal compared to formal sectors. The income tax and high social security payroll taxes are found to be important in inducing added underground business and moonlighting activity.

By contrast, in LICs, the informal sector contains a large share of the labor force in a wide range of sectors (from agriculture to trading) in both rural and urban economies, but the average income level of the informal individuals is often significantly lower than formal sector incomes. Informal sector incomes are often below government-prescribed minimum income levels that are also often exempted from income tax. Social security taxes are typically low or non-existent in LICs. Hence, IT and payroll taxes are not

⁵ Jua kali activities more narrowly refer to open-air artisans working in wood and metal, for example, but the term has been more loosely used to cover the urban inform sector.

important influences on informal sector size. Many informal businesses will be dealing with other informal businesses rather than formal business or corporate bodies, which severely limits the use of third party information or tax withholding.

Dominant characteristics of informal sectors in high- and low-income countries		
Characteristic	High-income OECD country	Low income country
Size	About 10% to 20% of employment <i>and</i> GDP in informal sector	Up to 50% of GDP, but higher share of employment (up to 90%)
Compliance	Unwillingness to comply with formal sector legal requirements (criminal activity, tax and regulation evasion)	Lack of capacity to comply: illiteracy & innumeracy and weak specific accounting and tax compliance capacities
Sectors	Non-compliance with tax concentrated in self-employed personal and business service sector, and moonlighting, cash or undocumented employment	Rural (agriculture and trading) and growing urban sectors (trading, personal & business services, food and beverage services, petty manufacturing). Significant share (5% to 30%) in non-monetary subsistence sector
Income level	Income levels at or above formal sector (after tax)	Low average income levels
Tax characteristics	Income taxes (IT) and social security payroll taxes provide major incentive for untaxed informal employment	Social security payroll taxes insignificant; most below income tax threshold (some minimum income)

Kenyan Labor Force, 2003

	<i>Millions</i>	Share of labor force	Growth since 1993
Modern/formal sector	1.8	11%	17%
Non-agricultural informal sector	5.5	33%	85%
Agricultural informal sector	9.3	56%	18%
Total labor force	16.6		
Population	32.2		

Notes

1. Formal sector forms about 11% of work force, but earns about 70% of labor income. There is evidence in recent years of growing share of labor income in modern sector despite slower growth rate in employment.
2. Tax revenues over 20% of GDP, largely out of formal sector.
3. A share of agricultural informal sector is in the non-monetary subsistence sector.
4. Average income levels in informal sector are significantly lower than formal sector.
5. *National Micro and Small Enterprise Baseline Survey 1999* estimated 1.3 million micro and small businesses in Kenya and only 2% of these were in the formal sector.

An example of the size and growth of the informal sector in a LIC is provided by Kenya, which has estimated the size of its urban informal sector in its annual *Economic Survey* as well as the employment provided in its modern or formal sector. The table above for

2003 shows that the majority (56%) of the labor force is in the informal agricultural sector and a further 33% is in the urban or non-agricultural informal sector which has also be growing more than four times faster over the past decade than the other labor force sectors. The remaining 11% are in the formal or modern sector. This number fits with the number of employees covered by the PAYE plus those filing returns with self-employed income under the IT.

Options for informal sector taxation

In high-income countries (HICs), typically it is not expected that a lack of tax compliance capacity is an issue, rather individuals are choosing to operate informally or without official documentation. The primary focus is on minimizing underground business activity and employment, especially that which may be induced by the tax system itself. A range of tax policy and administrative measures within the major domestic taxes may assist in reducing the informal sector. Such measures could include changes in (a) tax structure (lower tax rates on SME sensitive activities to offset higher compliance costs, indirect taxation by means of taxes on inputs or withholding taxes, or simplifying taxes, particularly complex provisions of the income tax); (b) tax administration such as the use of third party information; improved external audits and investigations; appropriate penalties and certainty in the application of penalties; and improved education and service of taxpayer to lower compliance costs, including accounting and tax compliance training; and (c) improved governance that increases the willingness of taxpayers to pay for enhanced public services and involves the taxpayer more in public affairs.

In this paper, however, the focus is on low-income countries where lack of tax compliance capacity is a critical constraint that precedes concerns about willingness to comply. In addition, the primary concern is VAT/GST rather than IT compliance in terms of revenue potential from small businesses.

A number of options are outlined here for taxing informal businesses. These include (i) the imposition of taxes indirectly on business inputs, (ii) adjustments to and administrative support for regular taxes, and (iii) the imposition of special direct presumptive taxes:

1. Indirect taxation of informal sectors

There are three categories of indirect taxes on informal business. All rely on having a formal tax collection agent involved in transactions with informal businesses.

- i. **VAT on inputs:** Informal businesses buying VAT-paid inputs from domestic suppliers or importing them bear the burden of the input tax to extent the tax cannot be passed forward. This input taxation of the informal sector was often a major consideration in switching tax system from single stage sales taxes to multiple stage VATs in LICs.
- ii. **Import duty on inputs and/or outputs:** Import duty charged on the raw materials, intermediate inputs and capital goods of informal businesses add to their tax burden. If informal businesses are competing with imports, then they get the same protection on their outputs as formal businesses.

- iii. **Withholding taxes** on imports, exports or purchases by formal sector corporations and the government from unregistered businesses. Typically, the withholding taxes are creditable against income tax; otherwise they are final taxes. Hence, informal businesses bear these taxes. In some countries, such IT withholding taxes when targeted at selected informal sectors products (often agricultural and forest products) are classified as presumptive taxes.

2. Adjustments to and administrative support for regular taxes

Whether informal businesses are liable for VAT/GST or IT depends critically on the thresholds in these taxes for registration or payment of tax. For small firms entering or within the tax net, a number of actions can be taken to lower compliance costs ranging from raising the thresholds for taxation to providing special training programs.

i. Thresholds

Both the income tax and VAT/GST are highly taxpayer-compliance intensive. Hence, concerns about the capability and costs of compliance become key concerns in the design of thresholds for registration. Taxpayers may be illiterate and/or innumerate or lack accounting skills and/or knowledge of complex tax provisions and procedures.

Under IT, typically some monthly or annual minimum level of income is exempt for individual taxpayers. The tax-free amount of income may be related to prescribed minimum wage levels, may vary by region or household characteristics. Given informal businesses tend to be unincorporated and have low incomes, many would be legally tax free. Such a tax-free amount of income should also be set to exclude businesses that will have severe difficulty in complying with the income tax.

Under the VAT/GST, typically a threshold for compulsory registration is established in terms of annual business turnover. Clearly, compliance and verification of the turnover relative to the threshold requires invoices and accounts, which may not exist. Further, for a growing small business, the acquisition of capability to comply with VAT document and bookkeeping requirements may represent a major up-front one-time fixed cost. This cost also looms larger the shorter the expected life of the business. Small businesses experience high failure rates. Under a VAT, however, a small business may have an incentive to register if it has to bear significant VAT charges on its inputs compared to the costs of compliance. From the perspective of the economy, the costs of administration and the economic efficiency costs of imposing tax also have to enter the decision of setting the level of the threshold.

Ebrill *et al*⁶ have provided an economic criteria for setting the VAT registration threshold which balances the economic costs of administration (δA) and compliance (C) with the net economic value of the tax revenues ($z\nu\tau(\delta - I)$) from a business with turnover, z , and paying VAT at rate, τ , on value-added share ν , where δ is the economic value or cost of public funds (typically greater than one.) At low turnover rates (z), the administrative

⁶ Liam Ebrill, Michael Keen, Jean-Paul Bodin, and Victoria Summers (Editors), *The Modern VAT*, IMF (2001)

and compliance costs can exceed the net economic value of the revenues collected. As z rises, the balance changes and a net economic gain rises from registering and collecting tax from the business. Alternatively, there is a net economic benefit from excluding small businesses from VAT registration. From an economic perspective, therefore, the compulsory threshold for VAT registration can be set at

$$z = \frac{\delta A + C}{v\tau(\delta - 1)}$$

This threshold criterion applies to a business that is a final stage business (typically, a retail stage business.) Using the Ebril *et al* “Modern VAT” parameters, the threshold for a base case is estimated as Case I in the table below as \$51,667. The compliance cost is only about 1% of turnover. It is important to recognize that this threshold estimate is highly sensitive to the parameters. For example if the share of value added in the business is lowered from 40% to 20%, which is more in line with margins of an informal trader in many LICs, the threshold doubles. (See Case II.) Furthermore, if the small business faces an entry compliance cost and has a short expected life, then annualizing this one-time fixed cost causes a significant increase in the compliance cost.⁷ Similarly, registration/deregistration administrative costs are also higher for short-lived businesses. The combined effects of half the value added and 50% higher administrative and compliance costs is a threshold three times higher. (See Case III.)

Case	I	II	III
A = administrative cost per year	\$ 100	\$ 100	\$ 150
C = compliance cost per year	\$ 500	\$ 500	\$ 750
δ = marginal economic cost of revenue	1.2	1.2	1.2
v = value added share of turnover	40%	20%	20%
τ = VAT rate	15%	15%	15%
z = threshold annual turnover	\$ 51,667	\$ 103,333	\$ 155,000

Other cases also have to be considered in setting the threshold. Aside from final stage businesses, small businesses are also operating at intermediate stages in an economy. Unregistered or exempt businesses at intermediate stage do not cause loss of revenue as final stage sales are still taxable, but rather they cause added taxes on inputs of $z\alpha\tau$, where α is the share of taxed inputs in turnover z . In such cases, the administrative and compliance costs of not registering a business are saved, but are offset by the marginal economic cost (MEC) of the tax revenues on inputs.

⁷ Annualizing a compliance a one-time compliance entry cost, E, over n years at interest rate r, becomes $E.r/\{1-1/(1+r)^n\}$. This annualized cost is nearly *four* times higher if a business expects to last only two years compared to ten at a 7% interest rate.

Two cases of unregistered or exempt intermediate businesses can be considered. First, where there is a full sector exemption, tax may be passed forward into the final price. The pass forward of the VAT increases the final price by more than the VAT rate, τ , resulting in an approximate $MEC = -z\alpha\tau^2(1+m)\eta$, where m is the mark up to the final stage and η is price elasticity of demand for final product. The MEC rises and the threshold value of z falls particularly where sectors have a high price elasticity of demand. This implies a sector should not be exempted (assuming it is feasible to subject it to VAT), if the threshold goes to zero! This is consistent with the standard recommendation for a broad tax base covering all close substitutes.

The second case of intermediate businesses is the partial sector exemption, as occurs where only small businesses below a threshold are exempted. Here the input tax is passed backwards as the unregistered businesses have to compete with the registered businesses or with traded goods. This is the threshold case. Now the approximate MEC is $\frac{1}{2}z\alpha^2\tau^2\epsilon$, where ϵ is the price elasticity of supply of the exempted businesses. For inelastic supply and low input share, the breakeven threshold is high. As supply becomes more price responsive, the compulsory threshold falls. Also as the share of taxed inputs, α , rises (or there is a low share of value added), input taxes and MEC both rise, or the compulsory threshold falls. This last case illustrates the strong incentive of small businesses that have to absorb relatively large input taxes ($z\alpha\tau$) to use voluntary registration to avoid input tax (but incur compliance costs) in order to be competitive with larger registered businesses.

Choosing a threshold level should really be an empirical question based on the parameters of the small businesses in a particular economy. There is unfortunately little good data on the characteristics of small or informal business in LICs. Most studies of compliance and administrative costs have been conducted in high-income countries. Even then, some of the more thorough and sophisticated studies do not isolate the critical issue of the one-time entry costs of a new registrant.⁸ It is recognized, however, that the issue of entry costs is more critical in LICs where low tax compliance capacities are common amongst small informal businesses,

It is recommended that studies be undertaken of the characteristics of small business characteristics (annual turnover, sector of output – tradable or not, final or intermediate sales, input tax or value added shares, years since registration, number off active months since registration and estimates of compliance costs and capacities, which could use audit reports to indicate the quality of accounts and returns.) A focus could be put on the currently registered businesses in the range at or just above the compulsory turnover level as well as deregistered businesses. They could be contrasted with the characteristics of large businesses.

⁸ See, for example, Brin-Tran Nam, Chris Evans, and Michael Walpole, “Tax Compliance Costs: Research Methodology and Empirical Evidence from Australia,” National Tax Journal, Vol 53, No 2 (June 2000), pp 229-252.

Despite the lack of data, the theoretical estimates above are suggestive that tax systems should err on the side of higher rather than lower compulsory thresholds as well as recognize the importance of retaining voluntary registration provisions. Low thresholds tend to cause economic losses, and businesses are induced to split themselves to stay under the threshold or to evade registration. Small registered businesses with weak accounts also raise the risks of fraudulent VAT invoices being issued leading to revenue losses through input VAT deductions or credits based on these invoices. Thresholds should be raised to turnover levels where businesses either maintain adequate transaction records and accounts or can reasonably be expected to acquire these skills. It is also recognized that informal sector businesses may be bearing significant indirect taxes on their inputs as well as being subject to direct presumptive taxes.

ii. **Administrative support**

Administrative procedures and accounting requirements can be clarified or simplified to lower compliance costs. For example, within the IT, modified cash flow accounting is often allowed for small unincorporated businesses to avoid the need to maintain a full set of accrual accounts.

With the focus on LICs, the issue of specific tax skill training to improve compliance capacity could be cost-effective for businesses at or below threshold turnover range. A revenue agency could target specific training at

- a. selected sectors – such as informal taxi and bus services, or
- b. use self-selection. This would involve the revenue agency offering free tax compliance training to new registrants. This training could be in exchange for amnesty from retroactive taxation if a business successfully completes the course and maintains compliance standards for a minimum duration. Clearly this should be limited to new registrants that are unincorporated businesses with no likelihood of any reliable past accounts.

In LICs where the accounting profession is small and weak, the government could target general strengthening of accounting education and the accounting profession to support tax compliance. This could involve funding the establishment of accounting training institutes or equivalent programs within universities or technical colleges.

3. Types of direct presumptive taxes on informal sectors

The types of tax that can be charged on the informal sector depend heavily on the available information. If individuals can be identified, they can be registered and a head tax charged. If businesses can be identified, they can be registered and an annual business permit/license/*patente*/fixed or lump sum tax can be charged. If the quantity or value of sales of registered businesses can be assessed, unit or an *ad valorem* sales tax or a turnover tax can be charged. Regular VAT/GST and IT require increasingly more complete transaction records and accounts. The annual lump sum and turnover taxes are the main competitors for direct presumptive taxation of informal businesses. Note that a presumptive tax is effectively presumptive of both VAT/GST and IT. Multiple presumptive taxes are unnecessary.

a. Turnover tax

In the context of many LICs, the turnover tax is typically limited by the requirement of a turnover tax to have reliable turnover information. This is a limiting factor where the capacity to maintain adequate records is weak. It is possible to introduce a turnover tax as a “sub-layer” tax below VAT: businesses register for turnover tax if their turnover is above a *first* threshold, and for the VAT if their turnover is above a higher *second* threshold, but to use this structure there is a need to raise VAT threshold to have a feasible “entry level” or “learning-by-doing” layer of capable small businesses subject to turnover tax below the VAT registered businesses. Mozambique has this dual layer of a turnover tax plus a VAT structure, but it has set its two turnover thresholds fairly (possibly too) low at US\$4,300 and US\$10,700 per annum in 2003.⁹ Kenya is introducing a similar dual structure except at significantly higher thresholds. The existing VAT threshold of Ksh 3 million (about US\$43,000) will be raised to Ksh 5 million (about US\$71,500) and a final turnover tax of 3% of turnover (if a business maintains accounts) or a fixed amount of 3% of Ksh 5 million (if a business does *not* keep accounts) will be charged on businesses with turnovers above Ksh 3 million. This mechanism will encourage the keeping of accounts to avoid paying the higher tax amount (unless a business is understating its turnover.) Based on 2004/05 returns, this mechanism will leave the 14% of VAT registered businesses that pay 85% of the tax in the VAT net, and the remainder will pay the simplified turnover tax. It is noted, however, that only about 20% of these registered businesses with turnovers below Ksh 5 million were active taxpayers that year. Overall this reform could prove cost-effective by simplifying the compliance costs while encouraging the maintenance of accounts.¹⁰

The rate on the turnover tax needs to be set low enough to reflect the VAT that the smaller businesses would be paying on their inputs and the cost of keeping records. Further, the turnover tax needs to be creditable under VAT to allow competitive sales from smaller to larger VAT businesses.

From the perspective of trying to make the tax net as inclusive as possible to encourage political participation and responsibility, the turnover tax can still be expected to leave large numbers of the smallest businesses outside of tax net.

b. Annual lump or fixed sum tax

To discuss the design features of an annual lump sum tax on businesses, the example of the Kenyan *Single Business Permit* (SBP) is used. It was phased into operation from 1998 through 2000. The SBP was essentially an annual registration fee charged on all businesses by local authorities in place of a collage of various business and

⁹ Graham Glenday, “Assessment of the Current State of VAT Implementation in SADC Member States” Report prepared for the Trade, Industry, Finance and Investment (TIFI) Directorate of the Southern African Development Community, November 30, 2005

¹⁰ M.G. Waweru, Commissioner General, Kenya Revenue Authority, “Addressing the Different Tax Policy and Tax Administrative Challenges of Micro, Small and Medium Businesses”, Paper presented at the *International Tax Dialogue Global Conference on Taxation of SMEs*, Buenos Aires, Argentina, October 16-19, 2007

regulatory licenses that local authorities had previously collected. The schedule of charges in any local authority was scaled to the size of the local market and within the each business activity category various physical indicators are used to divide businesses into three size categories – small, medium or large businesses.

A key potential advantage of the lump sum business tax in the context of informal businesses in a LIC is that it can apply to *all* businesses (not just businesses below VAT threshold, for example.) The applicability to all size businesses arises from the effective tax rate of a lump sum tax declining with business size. Hence, if rates are set for the below threshold businesses, then the effective SBP rate becomes low enough for larger businesses to also pay VAT & IT in addition to the SBP. This general applicability avoids the need for a turnover test and allows the separate administration of tax by an organization oriented to cost-effectively service micro and small businesses. It also ensures a revenue contribution for public services by all businesses, and it promotes political responsibility relationships within the jurisdiction.

The lump taxes can be scaled to the market size, sector or business activity, and business size (S/M/L) using simple size criteria such as floor space, number of hotel rooms/beds, restaurant capacity, etc. The structure also allows tax simplification by replacing all business and regulatory license fees with one annual lump or fixed sum tax.

A direct presumptive tax needs a cost-effective client-oriented administration. To this end, local government tax administration has favorable features:

- a. There is a need for agency-assessed tax administration where there is no third party information from formal sector businesses concerning the business activity of informal businesses. Central revenue authorities that administer self-assessed taxes not organizationally suitable for agency assessed taxes without a major reorganization. Agency assessment for the SBP basically means field inspections of whether active businesses have registered and paid the appropriate lump sum tax.
- b. There is a need for low labor costs for the tax officials as there is a small tax yield per business. The high-paid professionals of central revenue authority are not suitable.
- c. The complementary functions of local government should lower costs and increase effectiveness of identifying, registering and assessing businesses in tax base. These complementary activities include business registration in a jurisdiction, 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.

The SBP in Kenya has achieved some of the desired goals. It has been implemented across all local authorities and has been collecting over 15% of local government own source revenues. Recent data on the number of businesses registered shows that only

about 365,000 businesses are actually registered by all local authorities. Compared to the potential number of businesses that are probably in excess of 1.3 million, this number of registered businesses indicates that local authorities to date have been cherry picking in registering business – targeting the larger businesses and omitting registration of most of the micro informal business.¹¹ A combination of incentives and oversight could improve performance in registering the smallest businesses. Stronger incentives for revenue and registration effort could be included into the revenue allocation criteria used to transfer central funds to local authorities. Information sharing between the central and local revenue authorities would also be mutually beneficial in identifying businesses and enhancing the coverage of business activity by both tax administrations.

Recommendations

First, there is a need to collect data on characteristics (as suggested above), compliance costs and administrative costs of micro and small businesses based on economic surveys and on the tax return data of small businesses under VAT/GST and IT in order to estimate minimum efficient thresholds. A special focus needs to be put on the one-time compliance and administrative costs upon registration and deregistration given the short lives of most small businesses. These costs depend on the base level of tax compliance capacity of small businesses, which can vary significantly across countries. Second, the thresholds should err on the side of being too high rather than too low, but voluntary registration rights become more important as thresholds are raised to allow intermediate sector businesses to remain competitive with larger registered businesses. Third, while turnover taxes can play a role for a layer of small businesses below the VAT threshold, the use of fixed or lump sum taxes based on physical indicators and possibly administered by local governments holds potential as simple structure to expand the direct tax net to small informal businesses and improve fiscal responsibility in LICs. Fourth, training programs on specific tax compliance skills and support for deepening the accounting profession are potentially productive activities to enhance compliance and lower its costs.

¹¹ The National Micro and Small Enterprise Baseline Survey 1999 estimated 1.3 million micro and small businesses in Kenya and only 2% of these were in the formal sector. The *Economic Survey* data for 2003 indicates that urban informal employment is some 5.5 million. Even if an average of 5 persons were working per informal business, a high estimate, that would indicate some 1.1 million informal urban businesses.