

**International Tax Dialogue Global
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**Special Regimes & Thresholds
for Taxation of SMEs**

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Outline

- Trends in taxation
- Issues arising out of trends
- Informal sector and taxation
- Options for informal sector taxation:
focus on low-income country informal
sector taxation

Trends in Taxation (1)

- Taxpayer-active administration or self-assessed taxation
- Domestic taxes dominance
 - Income tax, especially labor income and payroll taxes
 - VAT/GST/Excises
- High central government revenues with transfers to sub-national governments
- Client-oriented organizations, special focus on servicing large taxpayers
 - Taxpayer service and education to support taxpayer compliance

Trends in Taxation (2)

- More autonomous revenue administration agencies with relatively highly paid professional staffs
- Risk-based external audits
- Computerization and e-governance
- Use of formal sector as tax collection agents and as providers of third party information

Trends in Taxation (3)

- **Result of trends**
 - “Going for the gold”
 - “90% of revenues collected from 10% of registered taxpayers”
 - Cost-effective administration: low administrative and compliance costs per unit tax collection
- **Exceptions:** Taxpayer-passive or agency-assessed taxes
 - Property taxation
 - Income tax from employment income and passive investment income based on third party information
 - Direct presumptive taxes

Issues arising from trends

- **Administrative resource allocation** to support more cost effective **revenue growth**?
 - Dynamic *versus* static view of tax administration
 - LTU *versus* PAYE *versus* Customs *versus* SMEs
- **Size and growth of untaxed or lightly informal sector**
 - Economically inefficient tax structures? Tax induced shifts of production and consumption to informal sector?
 - Tax barrier to entry into formal sector. Causes?
 - Loss of revenues
- **Weakened political responsibility of public sector**, particularly at sub-national government levels through lack of local tax bases that undermines public sector decentralization

Informal sector and taxation (1)

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

Informal sector and taxation (2)

- Informal sector?
 - Sector of economy that is weakly documented by authorities.
 - Lack of official documentation. Who has information?
- Taxation is essentially an information game – who has information on business activities?
 - Business owner(s) or shareholders
 - Business manager(s)
 - Third parties
 - Financiers and bankers
 - Buyers of outputs /suppliers of inputs
 - External accountants/auditors
 - Government
 - Regulatory, audit or service agency
 - Tax agency
- *Information in informal sector concentrated in owner-manager*

Informal sector and taxation (3)

- Two basic types of officially undocumented sectors: *below* and *above ground* informal sectors
- **Underground untaxed activities**
 - Criminal activity, black market or gray activity and tax evasion, which may involve organized groups or gangs
 - Moonlighting, more typically independent individuals with collusion by employer or purchaser of individual services
- **Above ground or parallel market sector**
 - Micro/small scale unincorporated business activity that may also be outside monetary economy
 - “Jua kali” (hot sun) sector in East Africa – development economists “discovered” informal sector in Kenya in 1960s

Informal sector and taxation (4)

- Major characteristics of informal or officially undocumented sector in a country
 - **Compliance capacity** of businesses?
 - General skills? Numeracy, literacy
 - Specific skills? Transaction records and accounting.
Understanding of how to comply with tax provisions
 - **Legal or illegal activity** (tax and other laws)? **Willingness of informal business to comply with tax?**
 - **Sectors** containing informal activity: tradable or non-tradable goods/service; intermediate or final stage; urban or rural; monetary or non-monetary (subsistence)
 - **Size** of the sector in terms of employment and value added in economy.

Informal sector and taxation (5)

Two extremes: High-income OECD *versus* low-income country

High-income OECD country

- About 10% to 20% of employment *and* GDP in informal sector
- Mainly due to unwillingness to comply with formal sector legal requirements (criminal activity, tax and regulation evasion)
- Non-compliance with tax concentrated in self-employed service sector and moonlighting, cash or undocumented employment
- Income levels at or above formal sector
- Income taxes (IT) and social security payroll taxes provide major incentive for untaxed informal employment

Low-income country

- Up to 50% of GDP, but higher share of employment (up to 90%)
- Mainly due to lack of capacity to comply: illiteracy & innumeracy and weak specific accounting and tax compliance capacities
- Significant share (5% to 30%) in non-monetary subsistence sector
- Rural (agriculture and trading) and growing urban sectors (trading, personal services, food and beverage services, petty manufacturing)
- Low average income levels
- Social security payroll taxes insignificant; most below income tax threshold (some minimum income)

Informal sector and taxation (6)

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%
<u>Agricultural informal sector</u>	<u>9.3</u>	<u>56%</u>	<u>18%</u>
Total labor force	16.6		
<u>Population</u>	<u>32.2</u>		

Notes

1. Formal sector is about 11% of work force, but about 70% of labor income, 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. Share of agricultural informal sector in non-monetary subsistence sector.
4. Average income levels in informal sector are significantly lower than formal sector.
5. Revenue Authority has registered about 900,000 businesses, only 30% in formal sector

Options for informal sector taxation (1)

High-income countries

- If lack of tax compliance capacity is *not* an issue, then a range of tax policy and administrative reforms within major domestic taxes may assist in minimizing induced underground business activity and employment
- Measures could include changes in

Tax structure

- Lower tax rates on SME sensitive activities
- Indirect taxation (input taxes or withholding taxes)
- Simple tax structures and procedures

Tax administration

- Use of third party information
- Improved external audits and investigations
- Appropriate penalties and certain application of penalties
- Improved education and service of taxpayer to lower compliance costs, including accounting and tax compliance training

Governance

- Improved public service delivery and political integration

Options for informal sector taxation (2)

- Focus on **low-income countries** where lack of tax compliance capacity dominates and compliance with VAT/GST rather than IT is important issue
- **Options**
 - Indirect taxation
 - Adjustments to traditional taxes
 - Thresholds and tax accounts
 - Administrative strategies
 - Direct presumptive taxes

Options for informal sector taxation (3)

Indirect taxation of informal sector

– VAT on inputs

- Informal business buying VAT paid inputs from domestic supplier or importing bears burden of input tax to extent tax cannot be passed forward

– Import duty on inputs and/or outputs

- Import duty on intermediate and capital goods
- If informal business is competing with imports, then gets same protection as formal business

– Withholding taxes on imports, exports or purchases by formal sector (corporations and government) from unregistered businesses

- Withholding taxes creditable against income tax; otherwise final taxes

Options for informal sector taxation (4)

Adjustments to traditional taxes

– Thresholds

- Income tax: some monthly or annual minimum level of income exempt for individual taxpayer – informal businesses tend to be unincorporated and low income
- VAT/GST: More complex *See next slide*

– Accounts

- Modified cash flow accounts for small or unincorporated businesses

– Administrative support

- Specific tax-skill training *See following slides*
- Modification of documents or procedures to simplify compliance

Options for informal sector taxation (5)

VAT thresholds

- VAT is highly taxpayer compliance intensive.
- Taxpayer may **lack both accounting skills and tax compliance knowledge** – potentially significant up-front one-time fixed costs of registration and compliance
- Typically threshold for registration is defined by **annual business sales or turnover** – compliance and verification requires **invoices and accounts which may not exist**
- **Basic economic criteria for setting threshold:** Balancing economic costs and benefits of raising threshold:
 - Benefits = costs of administration and compliance saved
 - Costs = economic cost of change in tax revenues
- **Net economic benefit from excluding small businesses from VAT registration:** *At what threshold does net benefit fall to zero?*

Options for informal sector taxation (6)

- **Base case:** “Modern VAT” estimate of threshold for **final stage business, z**

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

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

- **Small scale final traders with low value added** (say, 20%) significantly raises threshold
- **Initial one-time costs for new registrants:** Compliance costs are higher the lower the specific tax compliance capacity and the shorter the expected life of the business. Registration/deregistration administrative costs are also higher for short-lived businesses.
- *Little or no data available on compliance costs in developing countries, particularly by size of business*

Options for informal sector taxation (7)

Intermediate stage businesses

- Unregistered or exempt businesses at intermediate stage do not cause loss of revenue as final stage sales still taxable, but rather cause **added taxes on inputs** = $z\alpha\tau$, where α is the share of taxed inputs in turnover z .
- Administrative and compliance costs are saved, but offset by the marginal economic cost (MEC) of tax revenues on inputs. **Two cases arise**
- ***Full sector exemption with tax passed forward into final price.***
The VAT increases the price by more than the VAT rate, τ , resulting in 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. MEC rises and z falls particularly where high price elasticity of demand. This implies the sector should not be exempted if threshold goes to zero!
- ***Partial sector exemption (as only small businesses below threshold are exempted) with tax passed backwards as the unregistered businesses have to compete with the registered businesses or traded goods.*** This is the **threshold case**. Approx $MEC = \frac{1}{2} z\alpha^2\tau^2\varepsilon$, 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 threshold falls. Also as share of taxed inputs, α , rises, tax and MEC rise, or threshold falls. **Voluntary registration is critical to allow high α , but low turnover businesses to register to avoid input tax (but incur compliance costs!)**

Options for informal sector taxation (8)

VAT threshold and taxpayer education

- **Raise VAT thresholds *or* lower compliance costs through VAT compliance skill training?**
- High VAT thresholds (*plus voluntary registration*) are economically justified
- Where problem of compliance capacity, threshold should be in range where issuing invoices and keeping basic books is feasible.
- Specific tax skill training to improve compliance capacity could be cost-effective in range of businesses at or below threshold turnover range
- Target of training?
 - Selected sectors – such as informal taxi and bus services
 - Self-selection: Offer tax compliance training to new registrants in exchange for amnesty from retroactive taxation
- General strengthening of accounting education and profession to support tax compliance should have positive tax externalities.

Options for informal sector taxation (9)

- **Direct presumptive taxes:** two types –
 - withholding
 - direct tax on all or below threshold businesses
- **Presumptive withholding taxes**
 - Requires **formal sector tax collector** such as customs (imports or exports), marketing agency (agricultural, forestry, etc products), government or private corporation (goods and services purchases), corporation (dividends), financial institution (interest income, pensions, etc)
 - Withholding tax offset against income tax for registered taxpayer; but final tax for others, including informal sector
 - Base often limited by sector, market channel, extent of **informal-informal trade**, etc limiting revenues, creating opportunities for avoidance and causing distortions between businesses

Options for informal sector taxation (10)

- **Types of direct presumptive taxes on informal sectors depend upon information about taxpayers**
 - Head tax (registered individuals)
 - Annual business permit/license/lump sum tax (registered businesses)
 - Unit or *ad valorem* sales tax or turnover tax (quantity or value of sales of registered businesses)
- **Regular taxes**
 - Invoice or credit-method VAT (sales and purchase values of registered businesses)
 - Income tax and subtraction or addition method VATs (full accounts of registered businesses)
- **Annual lump sum or turnover tax** are main competitors for direct taxation of informal businesses

Options for informal sector taxation (11)

Limitations of turnover tax

- Requires **turnover information**: compliance problem where capacity does not exist in micro-informal businesses
- Possible as a **sub-layer tax below VAT**: register for turnover tax if turnover above **first threshold** and for VAT if turnover above **second higher threshold** (such as Mozambique), but 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 VAT businesses
- Need turnover tax to be creditable under VAT to allow sales to larger VAT businesses
- Leaves large number of smallest businesses outside of tax net and weakens political responsibility relationships.

Options for informal sector taxation (12)

Design features of **annual lump sum tax on businesses**

(for example, Kenyan **Single Business Permit** from 1998)

- Can apply to *all* businesses (not just businesses below VAT threshold) which allows
 - separate administration of tax for a client-oriented organization
 - revenue contribution for public services by all businesses
 - promotion of political responsibility relationship
- Effective tax rate of lump sum tax declines with business size: hence, set rates for below threshold businesses so that effective rate is low for businesses also paying VAT & IT.
- Scale tax to market size, sector and business size (S/M/L) using simple size criteria such as floor space, number of hotel rooms/beds, restaurant capacity, etc.
- Tax simplification by replacing all business license fees with one annual lump sum tax

Options for informal sector taxation (13)

Need for **cost-effective client-oriented administration of annual lump sum tax. Local government administration** has favorable features --

- Need **agency-assessed tax** where no third party information from formal sector businesses (Central revenue authorities that administer self-assessed taxes not organizationally suitable.)
- Need **low labor cost for tax officials** as small tax yield per business (High-paid professionals of central revenue authority not suitable)
- **Complementary functions** by local government lower costs and increase effectiveness of identifying, registering and assessing businesses in tax base
 - Business registration in jurisdiction
 - Land use regulation, including street vendors
 - Property taxation
 - Utility, waste disposal and other services to business properties
 - Management of public markets, taxi ranks, bus stations, etc

Recommendations

- Information on small business characteristics
 - Labor market surveys
 - Tax data – analyze characteristics of businesses just above compulsory threshold in VAT/GST or just above minimum tax free income in IT
 - Turnover per year
 - Sectors or outputs – non-traded or traded
 - Share of value added in turnover or share of taxed inputs in turnover
 - Time since registration and number of active months since registration
 - Quality of return and accounts from audit reports
 - Characteristics of deregistered businesses
- Estimates of entry and recurring compliance and administrative costs for small businesses
- Raise threshold as appropriate (with voluntary registration provisions)
- Training in minimum records and booking for sector, location or self-selected individuals