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Designing an SME Tax System that Works: Rethinking the goals to rethink the design

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Why do we bother trying to tax SMEs?

The traditional balance sheet for the Revenue Authority

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Time and financial cost of administration

Revenues earned from SME tax administration

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The traditional balance sheet for the SME Taxpayer

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Time and financial cost of compliance

Benefits derived from formalization/compliance

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But are we doing the right balance sheet calculation?

The facts:

- Given experience in even middle income countries, the financial cost of administering an SME tax regime outweighs the **short term** revenues raised
- SMEs don't see benefits of formality beyond reducing sidepayments to tax officials
- . . .so maybe it's time to think about reframing the goals of SME taxation through a political economy lens and adding in the benefits of formalization from a **long-term growth** perspective

Back to First Principles: Shifting lenses to deal with SME tax

Traditional Revenue Goal

- Raise Revenue for government expenditure

Development/Growth Goals

- Create a “culture of taxation”
regularization of the rule of law
- To increase the size of the formal sector
- To promote growth

**Some empirical evidence showing
that we've not yet designed an
SME tax system with a long-run
growth perspective**

METRs in Selected AFR Countries

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(Data from DFID-FIAS Studies 2006, category avgs)

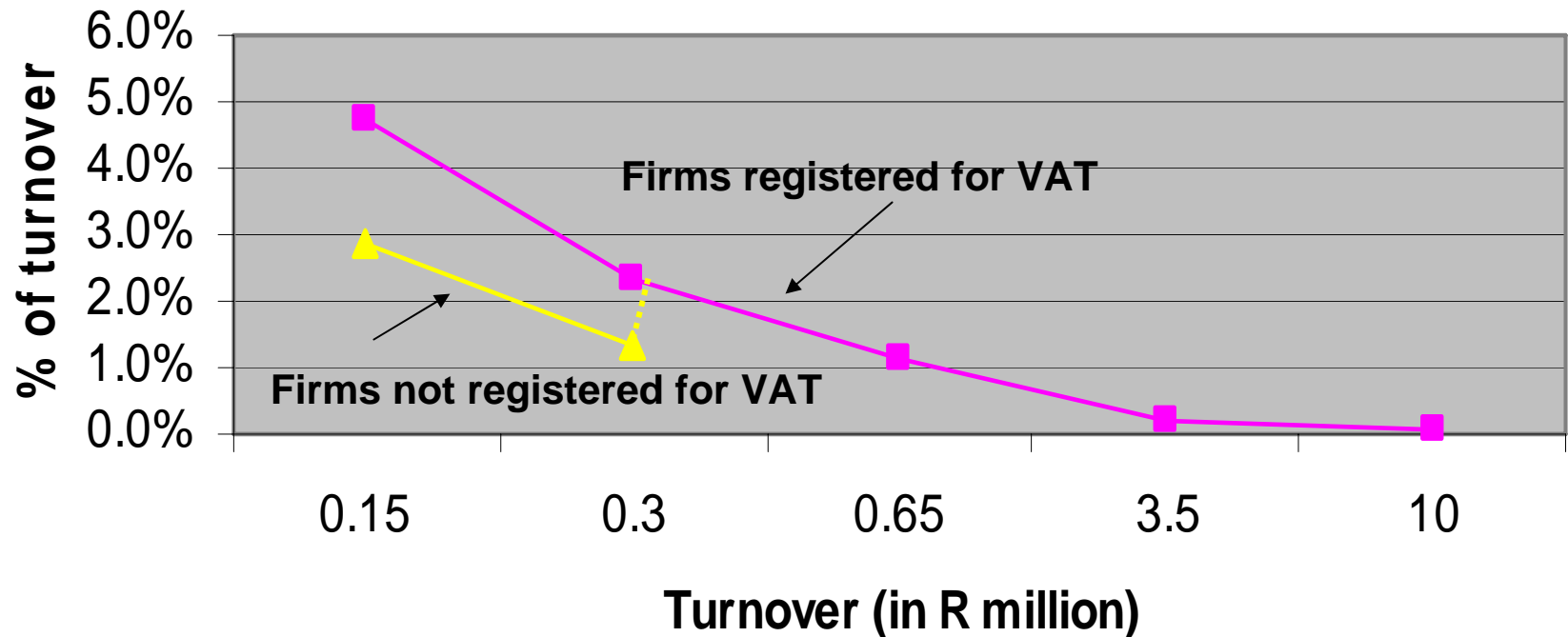
in percent

<u>Country</u> Sector	Manuf	Tourism	AG	Fin	Min	Small Business (No VAT)
Zambia	5	5	10	30	0	25
Rwanda	29	14	7	38	15	34-51
Madagascar	24	14	15	29	11	60
Tanzania	15	15	20	29	23	30-32
South Africa	27	28	23	31	10	22-32

- Time and cost estimates for four main taxes:
 - Income Tax (IT)
 - Provisional Tax (PT)
 - Value Added Tax (VAT)
 - Employees' Tax (ET)
- Significant processes:
 - Registration
 - Preparation, completion and submission of returns
 - Objections & Alternative Dispute Resolutions (ADR's)
 - Audits, inspections & written queries from SARS
- **Costs of compliance for a firm just over the VAT threshold are the equivalent of an extra 12.5% corporate income tax (because tax compliance costs are almost the same for all turnover bands)**

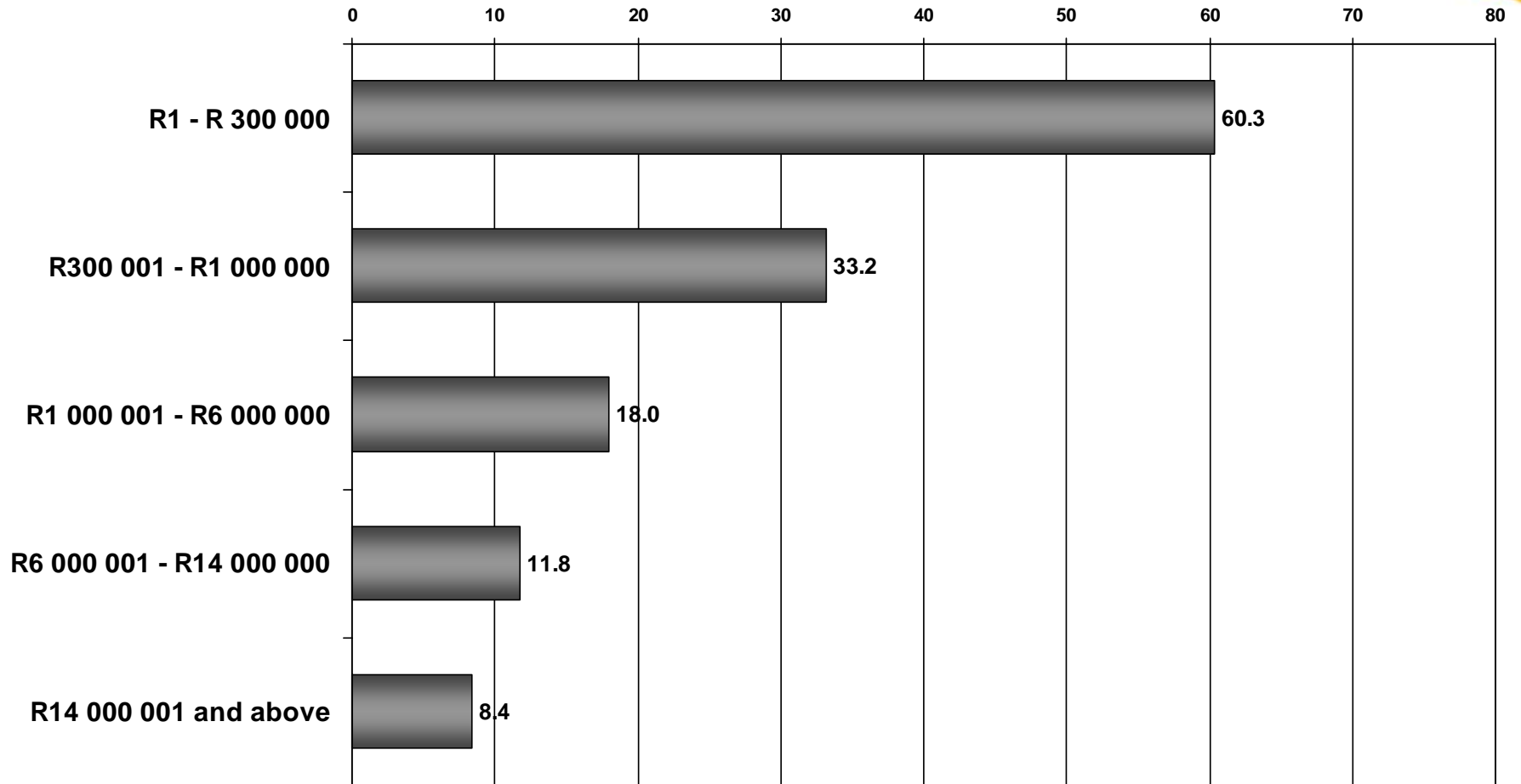
South Africa Tax Compliance Cost Survey

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



Estimated percentage of South African businesses deciding to stay informal

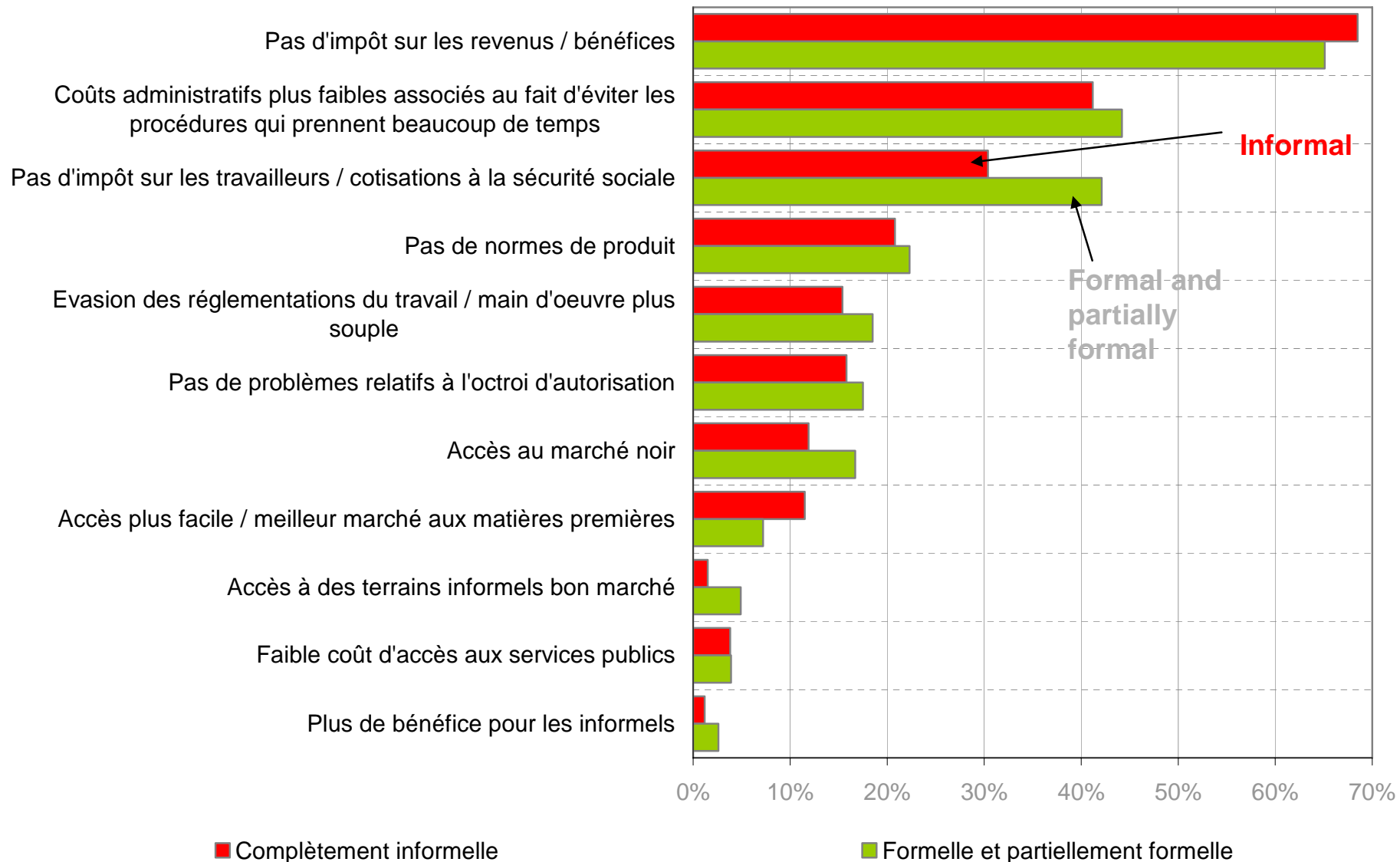
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Why firms in Madagascar choose to be informal

(from 2006 FIAS survey on informality in Madagascar)

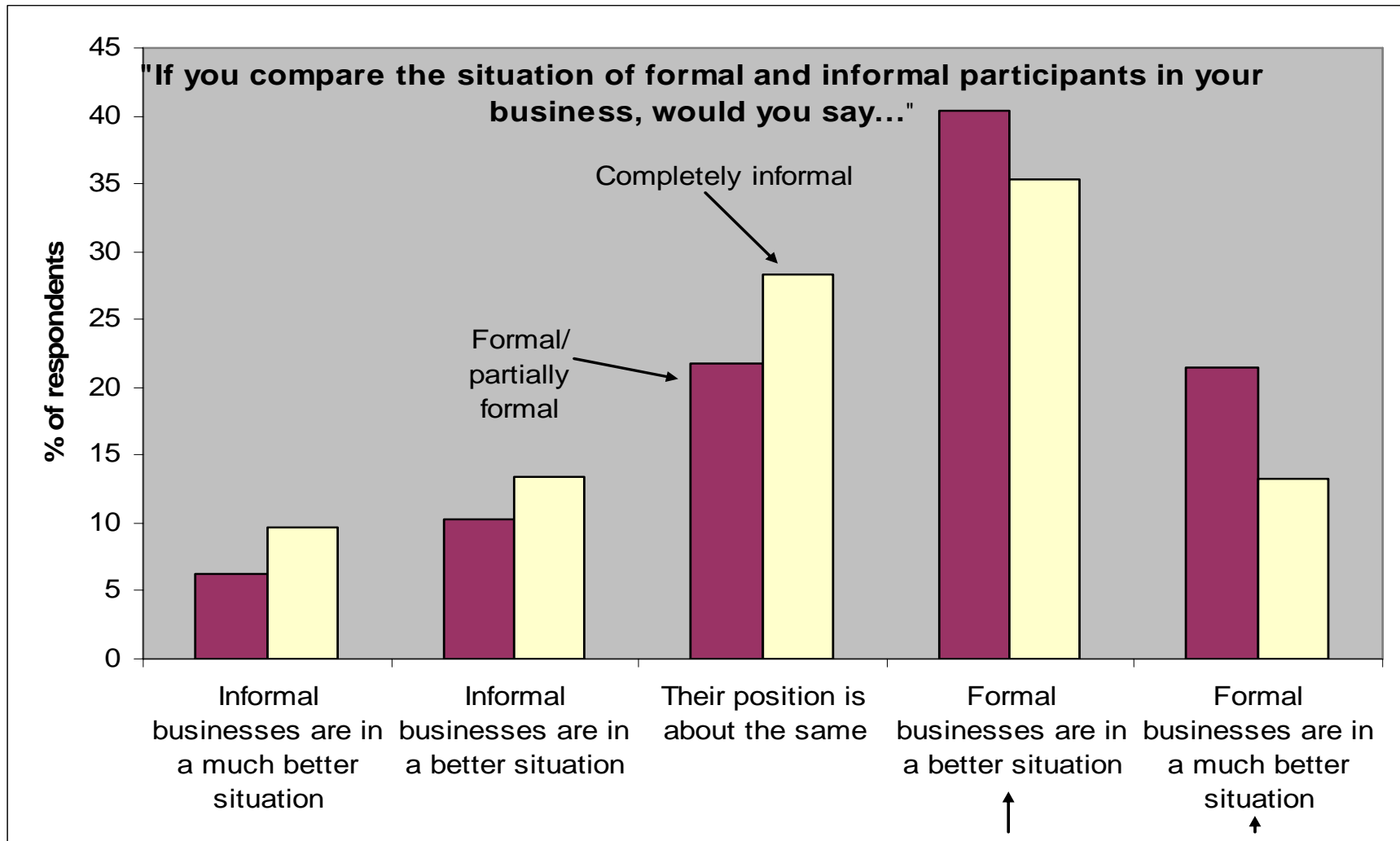
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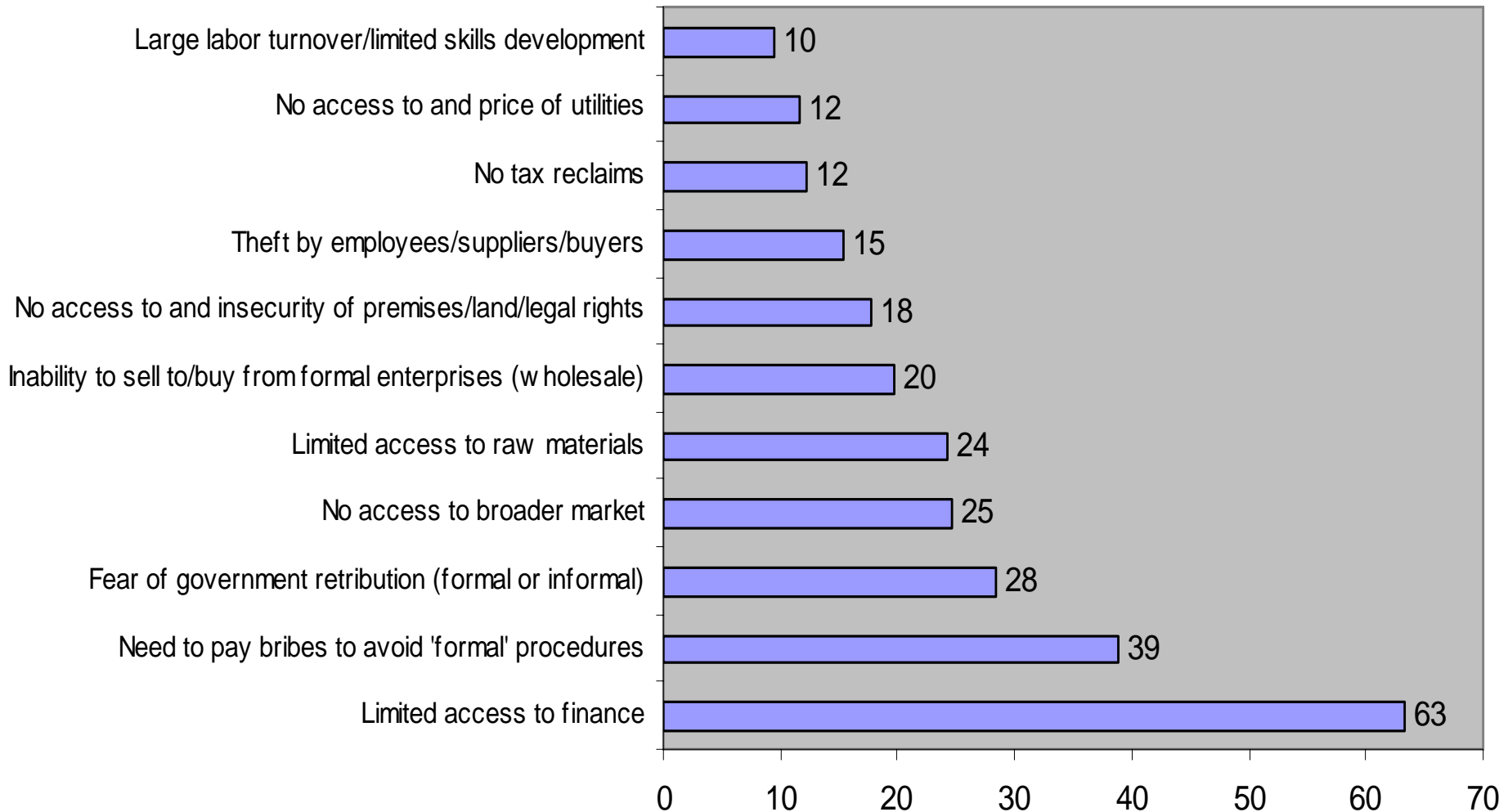
In Sierra Leone, over 60% of businesses believe formalizing is beneficial

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(2006 FIAS survey on informality in Sierra Leone)



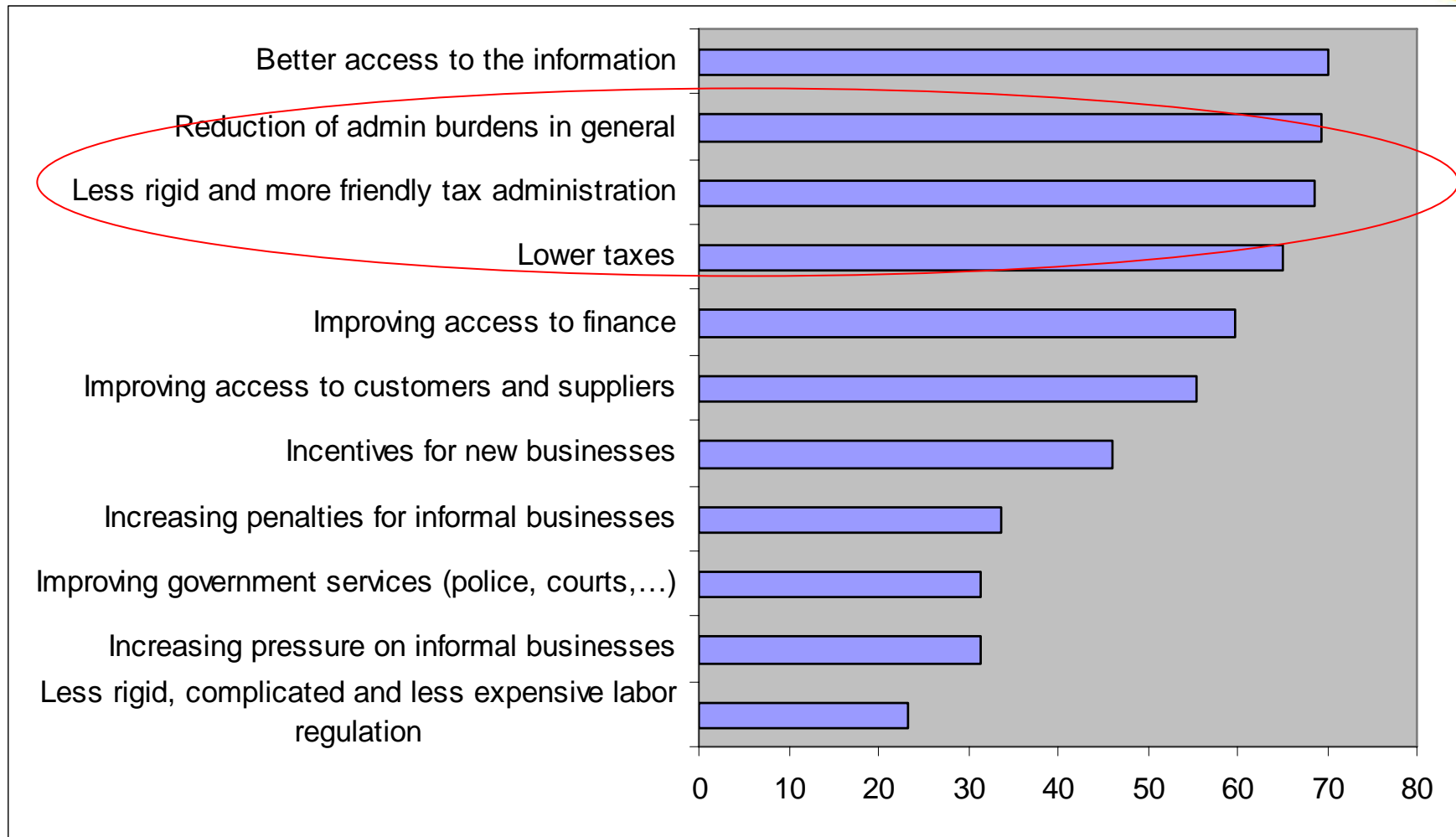
...and recognize disadvantages to informality



How to move businesses to the formal sector

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% of community leaders



SME Tax Systems Designed As Political Governance

Address 2 key Unknowns

- 1. What Political incentives exist for broadening the tax base : SME/informal as Taxpayers or as voters?**
- 2. Are SMEs the 'missing link' in building the Fiscal Social Contract in developing countries?**

3 objectives:

- **Build State Legitimacy**
- **Deliver Growth**
- **End Aid Dependency**

'Pay Your Taxes and Set Your Country Free' – Kenyan Revenue Authority slogan

- **tax systems must be accountable, fair, and effective to build trust between state and society**
- **compliance from emerging sense of political citizenship, as well as delivery of public goods – ie. economic growth**

Broad tax base critical for:

- **Fiscal social contract** – a responsive and accountable government strengthens legitimacy and encourages tax compliance. This in turn generates the tax revenue necessary to deliver services
- **State legitimacy** - essential for sustainable growth
- **Accountability** – only when governments need to raise revenue, requiring bargaining with citizenry/private sector (“no taxation without representation”)

Political Dynamics of SME taxation?

- **SME as Taxpayers or Voters?**
- **Africa:**
 - **Large Business 1% of Taxpayers : 70% of Revenues**
 - **Medium – 10-20% of Taxpayers : 20-25% of Revenues**
 - **Small/Micro – 80-90% of Taxpayers : 5-10% of revenue**

Many voters not Taxpayers

Data: IMF ITD Background Paper 2007

Developing country context

- Most tax paid by *business*

BUT

- **Missing Middle** and **Inverted U-Shape**

Technical reforms not enough...

Political Incentive – Economic Growth with Political Stability

- **Improving tax systems challenges vested interests: corruption**
- **‘Growth coalitions’ champion reforms: not just efficiency and effectiveness but ‘tax for growth’ political bargaining**

Effective tax reform requires:

- Political Voice for SMEs**
- Political vision on the importance of SME taxation for political stability and sustainable growth**
- Good MoF/RA co-operation**
- Operationalising the ‘social fiscal contract’: SME Culture of compliance**
 - Public-Private dialogue**
 - Taxpayer services**
 - RA incentives for upholding taxpayer rights**

What does this tell us about SME tax system design?

- Put political incentive of **state-building and sustainable economic growth** into SME taxation through
 - Leadership/vision on tax policy and its administration to deliver on broader governance impact of ‘fiscal social contract’
 - SMEs/informal sector incentives to comply
- Role for Donors/International Community –
 - Help developing countries take long-term perspective on role of SME taxation for Growth and State-Building – reflected in
 - Strengthened admin/policy capacity

Design of an SME regime



A complete balance sheet

Revenue Authority Balance Sheet

Cost of administration =
Revenues + Benefits of
Formalization (State building)

SME Balance Sheet

Cost of compliance = benefits
of Formalization



Implementation on both sides of the street

- ***For the SME***, the system has to be simple, easy to comply with, and accompanied by capacity building (includes training and information on benefits of formalization)
- **System has to encourage growth of business** (need advantages to graduation)
- ***For the authorities***, the system must not require disproportionate administration
- **A small taxpayer unit, donor funded, to focus on SME issues?**

Incentives built in

- **Simple instruments: (turnover tax, cash flow accounting)**
- **Self-assessment simple administration with training**
- **Risk-based assessment (Revenue authorities)**
- **Effective tax burden should be low, but not as low as general tax regime to foster graduation for those at the top end**
- **Rewards for more sophisticated accounting (lower rates?)**
- **Training, training, training,**
- **Information, information, information**