

# ADDRESSING THE DIFFERENT TAX POLICY AND TAX ADMINISTRATIVE CHALLENGES OF MICRO, SMALL AND MEDIUM BUSINESSES

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# INTRODUCTION

- There is no universally accepted definition of Micro Small and Medium Enterprises (MSMEs),
- In Kenya, a business enterprise that employs between 1-9, 10-49, and 50-99 people is considered as micro, small, and medium respectively,
- It was estimated in a survey of the sector carried out in 1999 that Kenya had a total of 1.3 million MSME's employing 2.3 million people. This compares to formal sector employment in the 50+ category of 1.1 million,
- These MSMEs were responsible for production equivalent to 18% of GDP,
- Formal MSMEs totalled 25,020 and employed 584,000 people. Thus, informal MSMEs were responsible for 75% of MSME employment and 98% of enterprises,
- The share of the informal sector's employment to total non agricultural employment in the country rose from 48.9% in 1993 to 78% in 2006.



# CHARACTERISTICS OF MSMEs

The following are the main characteristics of MSMEs in Kenya

- Ease of entry and exit;
- small scale nature of activities;
- self-employment with a high proportion of family workers and apprentices;
- little capital and equipment,
- labour intensive technology,
- low level of skills,
- low level of organization with little access to organized markets,
- unregulated and competitive markets,
- Limited access to formal credit,
- low levels of education and training,
- Limited access to services and amenities.



# Fundamental contributions by the sector include:

- Increased output of goods and services;
- Development of a pool of skilled and semi skilled labour force, which is expected to be a base for future industrial growth;
- Strengthened both forward and backward linkages among socially, economically and geographically diverse sectors of the economy;
- Increased participation of indigenous Kenyans in economic activities of the country, and
- Create opportunities to cultivate and nurture entrepreneurial and managerial skills of the country.



## Taxation and the MSMEs Sector

Despite the fact that the diverse activities are widely noticeable as a source of livelihood for many Kenyans, a number of issues have been raised about the sector.

Concerns have basically revolved around legitimacy of the activities when they are carried out in an informal environment, their operating environment and their implications and impact on the entire economy.

Majority of the firms in the sector do not fulfil business registration requirements and tax obligations. Given the rapid rate at which MSMEs have increased, there is an urgent need to ensure they become tax compliant,



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# METHODS OF TAXING THE MSME SECTOR

## Features of the small taxpayers sector

- Small, transient, and often cash-based businesses.
- High turnover rates - many new businesses created, many others fail, and a few grow. Many of them are family based, sole proprietorships, and partnerships.
- Large numbers often comprising between 70-80 percent of total taxpayers.
- Low revenue potential (typically 5-10 percent) of total revenues.
- Expensive to administer.
- Many remain outside the tax net due to challenges in complying with tax and other government regulations.
- They have weak accounting capabilities coupled with rudimentary accounting systems.



## METHODS OF TAXING THE MSME SECTOR (Cont'd)

From the MSMEs perspective, implementation of regular enforcement measures is expensive and an intensive undertaking owing to the enormous numbers and diversity of the sector. In addition, due to the small nature of their transactions, the tax revenues payable or recovered through such enforcement measures are rarely commensurate with the costs incurred in collecting the tax.



# Approaches to Taxing the Informal Sector

## 1. Legitimatising the Informal Sector Approach

Available literature shows that one way to capture the shadow economy into the tax net is to legitimatise the sector by allowing tax holiday and/or exemptions for certain sectors. For instance, exempting typically low-yield sectors like agriculture from income taxation will significantly reduce the cost of tax administration. This system has been applied in India where the agricultural sector is constitutionally excluded from central income tax.



# Approaches to Taxing the Informal Sector Cont'd)

## 2. The Presumptive Approach

This approach involves simple and cost-effective techniques to capture domestic transactions and sources of income that frequently escape taxation under conventional norms. These techniques include lump-sum levies on small-scale business activities (standard assessments); the assessment of taxes through indicators or proxies that help estimate a taxpayer's income (estimated assessments); and the collection of minimum taxes irrespective of a taxpayer's actual level of business activity (presumptive minimum taxes).



# Approaches to Taxing the Informal Sector Cont'd)

## 3. The Indirect Approach

This approach imposes an appropriate tax burden on those operating in the underground economy. Indirect taxes could potentially substitute for special regimes aimed at the hard to tax sector to the extent that these taxes reach the targeted sector via the shifting of taxes into wages, returns on capital or consumer prices. It is ideal for economies where final consumption taxes significantly capture many of the informal sector activities and where the proportion of the informal sector to the entire economy is relatively large



# Challenges of Administering MSMEs Taxation

**Challenges that underpin small business taxation include:**

- Administering a system that adheres to the principles of designing a presumptive tax system regime namely, ease of compliance, ease of administration, compatibility with existing regimes, fairness, and transition across regimes is a big challenge;
- Dilemma of having a simplified tax regime versus bringing informal sector into the tax bracket. The question remains as to whether policy makers can achieve both principles;
- There is the risk of vendors who were initially maintaining books of accounts for tax purposes stopping doing so since they will now fall below the threshold. This will eventually lead to a huge number of them enjoying a lower tax obligation and hence, the tendency to remain in the regime instead of graduating to the regular regime;



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## Challenges of Administering MSMEs Taxation (Cont'd)

- The issue of requiring vendors operating informal sector businesses without maintaining accounting records to pay fines or penalties could lead to discouragement of compliance altogether in that the vendor will merely try to evade detection and not pay any tax;
- Orienting the tax administration system around the key segments of taxpayers;
- Developing strategies for enhancing compliance based on taxpayer segments and
- Lack of credible data sets that can be used for analysis of taxpayer segments.



# International Practice in Taxing Micro and Small Enterprises (MSEs)

## Sector: The Kenyan Case

This section focuses on the country- specific challenges in taxing the sector, the current practise, and the Turn Over Tax (TOT) regime that is pending implementation and the anticipated challenges and possible solutions.

### Challenges in Taxing the MSMEs

#### 1. Large Size of the Sector

Out of the 43,057 formal establishments in 2006, 25,020, (or 58%) of them are

Micro and Small Enterprises. The high proportion of MSEs in the country is a challenge in the endeavour to tax the sector.



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# Challenges in Taxing the MSMEs (Cont'd)

## 2. High Proportion of Nil and Non-Filers in KRA Database

Out of the total VAT registered taxpayers of 65,528, in 2006 there are 18,200 payment filers, representing 27% of the registered VAT taxpayers. The number of nil and non - filers was 22,617 (or 35%) and 24,711 (or 38%) respectively. Thus, the proportion of nil and non filers to the total number of VAT registered taxpayers was 73%, and hence posing administrative challenges in taxing the MSMEs

## 3. Lack of Vital Statistics on the Sector

Out of the 31,956 MSMEs, 45% are in non-commercial community while 7% are in agriculture. Attempts to tax the sector have therefore been complicated by the high proportion of the MSMEs in the non-commercial community. This is because majority of their transactions are cash based and unrecorded. Moreover, a good number of MSMEs are not registered and hence not captured in the national statistics.



# Challenges in Taxing the MSMEs (Cont'd)

## 4. Low Remuneration of Employees in the Sector

Despite the fact that the sector is a source of livelihood for a high proportion of Kenya's labour force, most of the employees are either unskilled or semi-skilled and therefore, they are paid wages and salaries that are below the PAYE threshold of Kshs 10,163 (US\$ 150).



# The Current Practice

Attempts to bring the MSMEs into the tax net are aimed at reducing informality of the sector by simplifying the tax system. This is intended to reduce administrative and compliance costs and thus evasion.

The following are steps that have been taken in the sector:

## 1. Advance Tax on Passenger Service and Commercial Vehicles

Advance tax on public service and commercial vehicles in use for carriage of persons and goods for gain or profit was introduced under the Income Tax Act Cap. 470 Section 12(A) with effect from January 1st, 1996.

In 2006/07 Fiscal Year advance tax was extended to drivers and conductors of these vehicles,

## 2. The Unified Tax System (UTS)

A Unified Tax System (UTS) for the sector was proposed and designed by a research team after A review of the nature of activities and salient features of the MSMEs in Kenya and the international practice on taxing the sector.



## The Current Practice

### The Unified Tax System (UTS) cont'd

The system caters for licensing fees and tax liabilities that a business entity is required to pay in order to acquire legal protection for a specified period of time, usually one year. The regime was graduated into tax schedules defined on the basis of profitability levels of businesses in the sector. However, since the long-term intention of the initiative was to tie the tax regime to business registration, the tax schedules were aligned to the structure of Single Business Permit Fees.

The proposed regime was reviewed by senior officials of the Ministry of Finance (MOF) and the International Monetary Fund (IMF) who foresaw administrative challenges in the proposed regime. As a result, it was recommended that the proposed regime be re-designed on the basis of turnover



# The Current Practice

## 3. Turnover Tax (TOT) Regime

Following the IMF recommendations on the UTS proposal, the research team embarked on re-designing the presumptive tax regime based on annual turnover of the MSMEs. The team reviewed the VAT database and found that a total of 65,528 businesses were registered for VAT by end of FY 2004/05, of which 20% are businesses in designated sectors where the turnover threshold rule is not applicable while 80% are non-designated businesses at the annual turnover threshold of Kshs 3 million (or US\$ 42,857).



# Anticipated Challenges in the Implementation of TOT Regime

The key challenges anticipated in the implementation of TOT include:

- Addressing the equity principal of taxation in the TOT regimes is an issue. There are difficulties in ensuring that both vertical and horizontal equity is achieved in the regime. Indeed, this is a global challenge for both the regular and presumptive tax regimes.
- Transition from the TOT regime to the regular regime. Some MSMEs may tend to stagnate in the presumptive regime instead of graduating to the regular regime, especially where tax liability is expected to increase with graduation.
- Low voluntary tax compliance: There is a challenge in voluntary compliance and filing of returns is expected to be poor. This will make it difficult to achieve the overall objective of the regime in enhancing tax compliance of the sector at minimal costs.
- Risk of not keeping proper records or manipulating of the records kept.



## Anticipated Challenges in the Implementation of TOT Regime cont'd

- *Imposition of penalties and fines may be ineffective.* The issue of requiring vendors operating informal sector businesses but do not maintain accounting records to pay a fine or a penalty could lead to discouragement of compliance altogether.
- *Incorrect declaration of turnover.* Businesses will have difficulties in determination of turnover and hence the risk of under declarations.
- *Tax avoidance:* A firm that has a turnover of more than Kshs 5.0 million may take advantage of this legislation to split into small firms in order to enjoy the new TOT regime.



# Anticipated Challenges in the Implementation of TOT Regime cont'd

- *Tax evasion and fraud.* If this regime is not well designed, there is a risk that firms will engage in fraudulent activities to evade taxes. This may lead to a decline revenue collections.
- *Taxpayers in informal sector are not easily traceable:* Mobility of taxpayers may make it difficult to locate the taxpayers for audit purposes and other taxpayers' services.
- There is also a considerable risk of administrative costs exceeding the KRA agency fee which may not exceed 2 percent of the revenue to be collected from the regime



## CONCLUSIONS

There are two conclusions that can be drawn from this presentation. First, there is considerable risk in MSME taxation that the total costs of administration are likely to be higher than KRA agency fee of not more than 2 percent.

Secondly, Literature on countries that have implemented simplified tax regimes for MSMEs indicate that they have experienced problems with tax avoidance and fraud schemes used by larger businesses

Revenue Authorities therefore face the challenge of continuously reviewing and updating their simplified tax system to reflect the changing methods used by MSMEs in tax evasion.

This forum should therefore deliberate on this issue and come up with the way forward.



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THANK YOU



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