

TAXATION OF SMALL BUSINESS AND FAIRNESS

Issues, Tradeoffs, Design Options

Global Tax Simplification Team
World Bank Group
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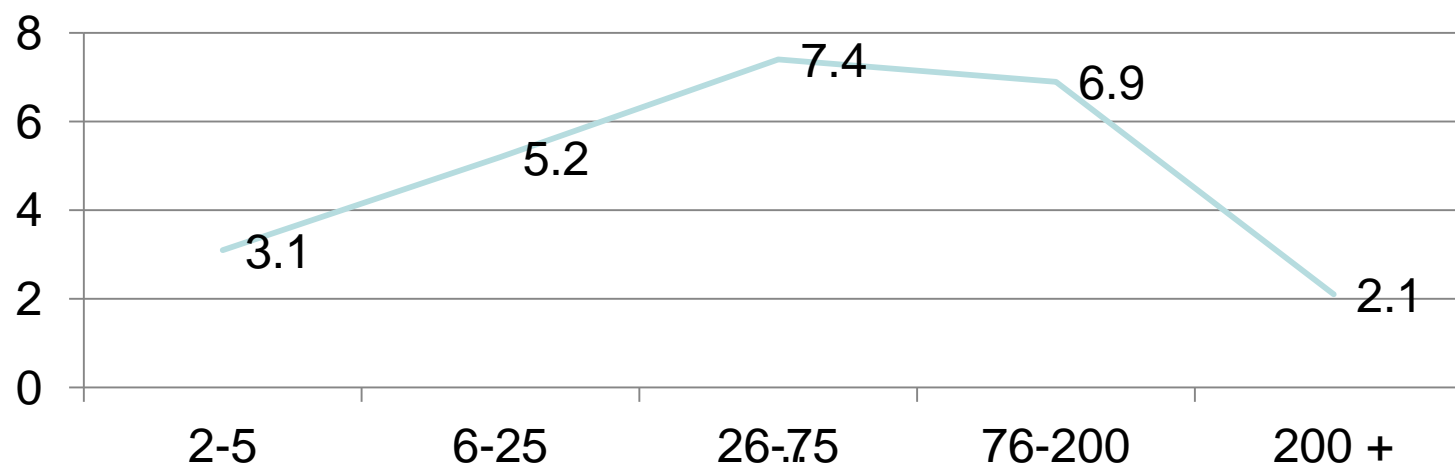
Small Business Taxation and Fairness: What are the Issues?

Perception regarding fairness of small business tax systems varies substantially among stakeholders:

- Are small businesses at a comparative disadvantage?
 - Complaints about “High tax burden”. But what does this mean?
 - Small businesses face more operational challenges than larger businesses. Should tax system compensate for these challenges?
 - High compliance burden
 - Easy targets for corruption and harassment
- Or are small businesses privileged?
 - More options for hiding income than wage earners
 - No requirement to register for VAT
 - Option to work in informal sector
 - Highly preferential presumptive tax regimes

Business Size and Tax Burden

- Evidence from Uganda: Actual tax burden as percentage of sales
- Risk that medium-sized businesses face a disproportionately high tax burden



Source: Gauthier/Reinikka, Shifting tax burdens through exemptions and evasion: an empirical investigation in Uganda, 2001

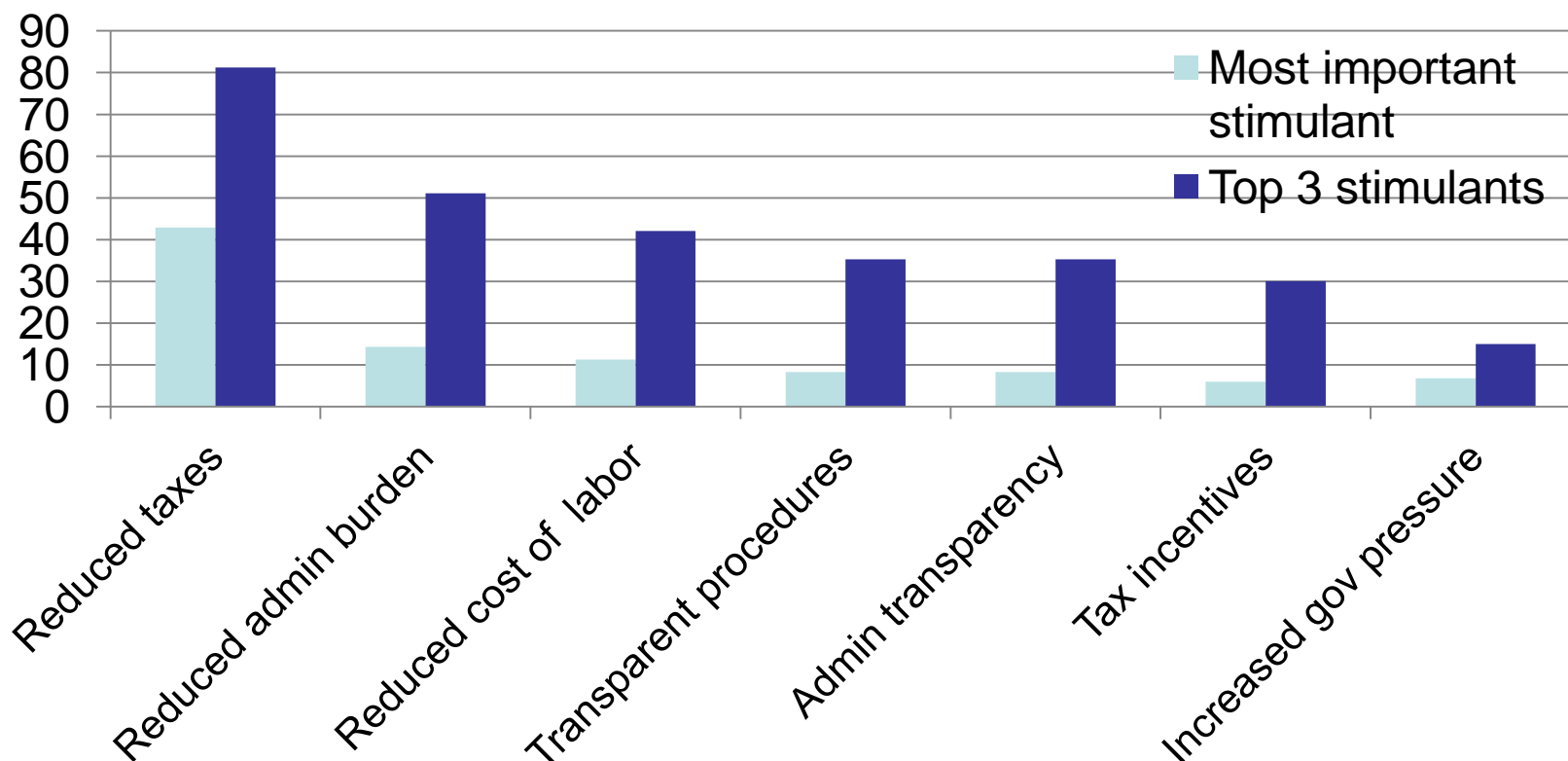
Tax and Informality

■ FIAS surveys on barriers to formality and tax compliance cost:

- Firms are well aware of the benefits and disadvantages of operating (in-)formally
- Tax (rates+admin) is seen as a driver of informality
- Other dimensions of formality are important and linked to tax formality decision
- Fees, licenses and other nuisance taxes are a non-negligible burden, especially for small firms
- Many firms have tried and failed to formalize: assistance is needed

Tax as a Reason for Non-Formalization

■ Evidence from Liberia: when would a business consider formalizing



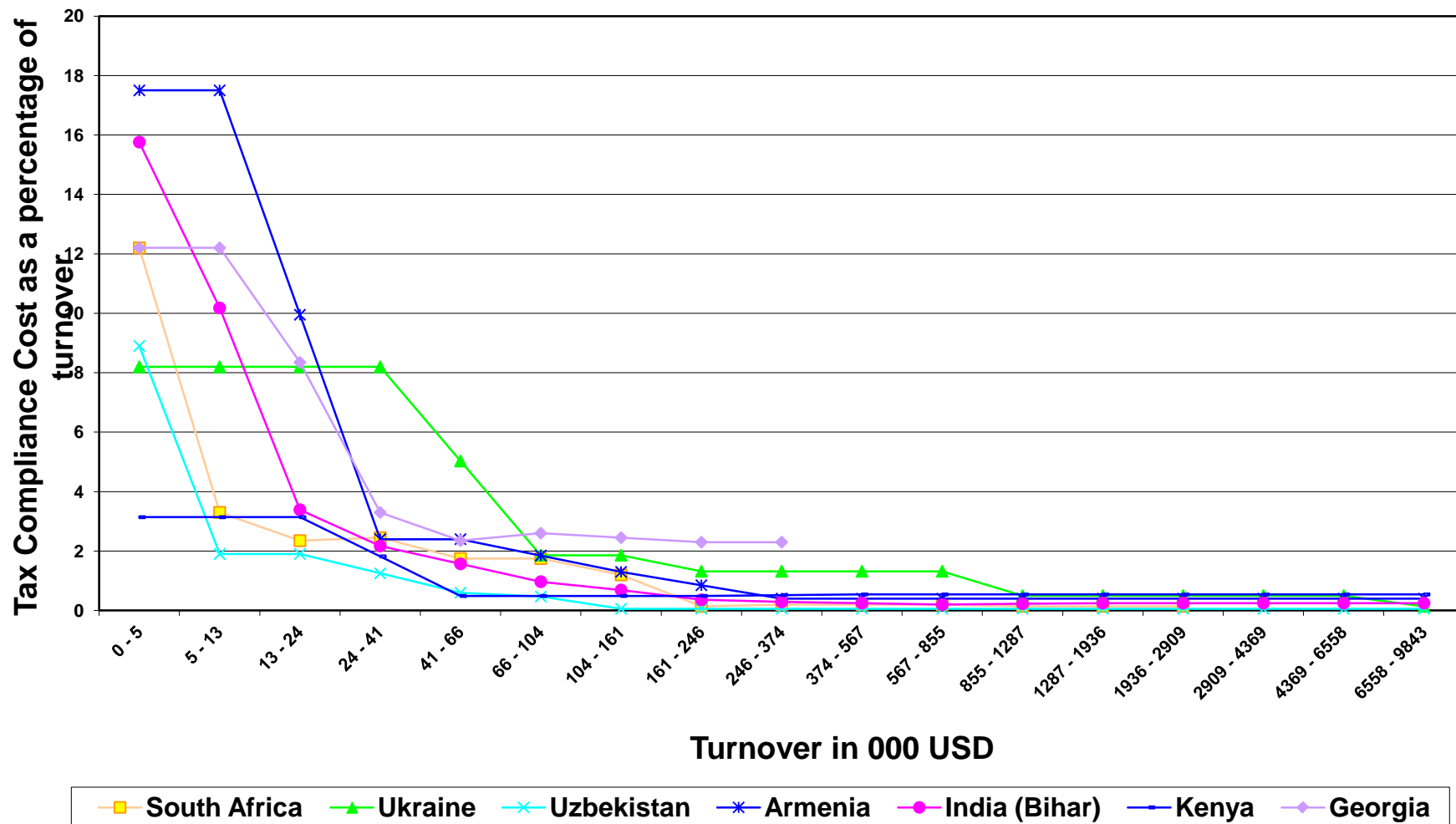
■ Source: FIAS, Removing Barriers to Enterprise Formalisation in Liberia, 2007.

When the “cost” of formalization is too high...



- Argument that certain level of underground economy boosts economic development.
- But from a fairness point of view tax payment burden is shifted to small number of formal business operators

Compliance costs matter a lot for MSEs!



Some Conclusions from this Analysis

- VAT
 - Increasing low VAT registration thresholds can considerably reduce tax related burden on small businesses
 - Additional simplifications for medium sized businesses facilitate transition into standard regime
- Accounting
 - Cash instead of accrual accounting as standard system for small businesses
 - Challenge of coordinating general accounting rules with tax accounting rules
- Income taxation
 - Administrative simplification vs. rate reduction
 - Simple presumptive system for businesses below VAT registration threshold best option in many countries

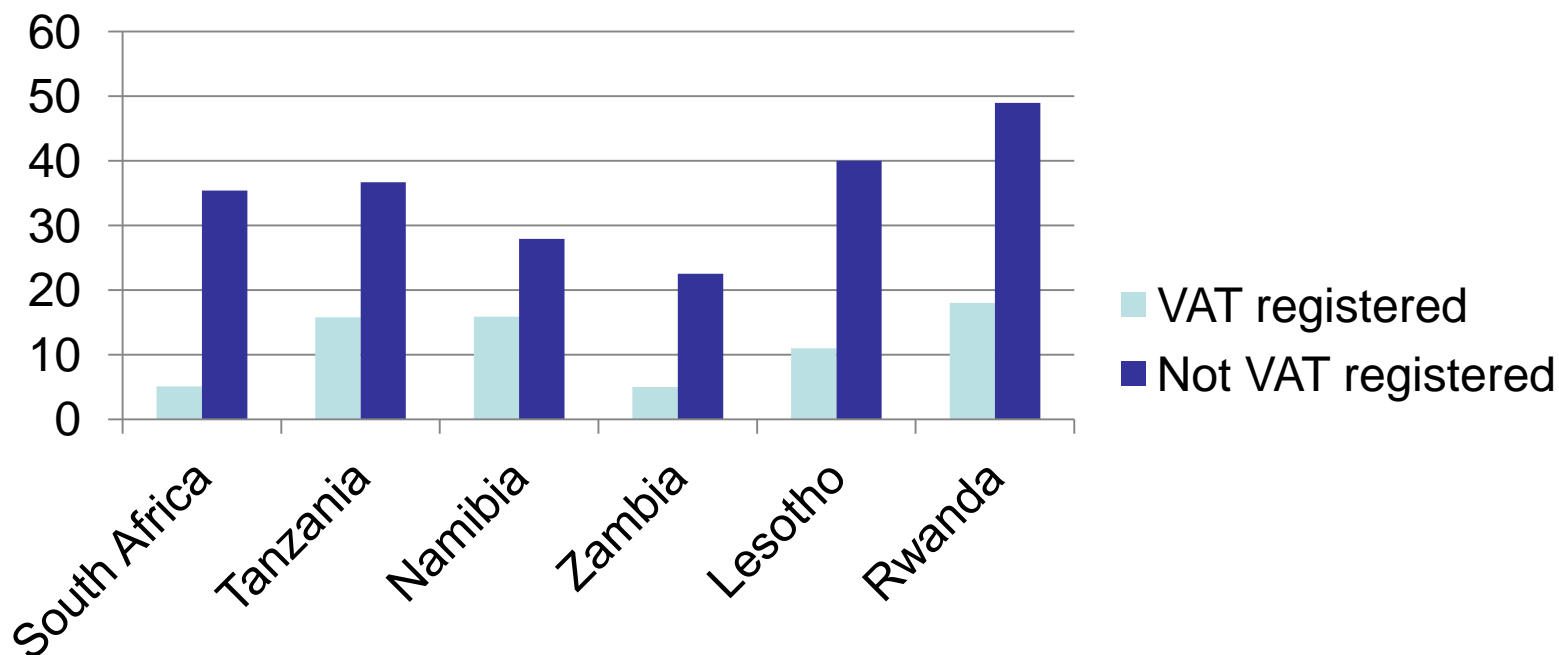
Some Conclusions from this Analysis II

- Reach out to informal sector is important
- Support and advice to businesses trying to formalize: prime objective is voluntary formalization
- Increasing taxation costs of informality (e.g. withholding taxes)
- Target audit program not exclusively to tax registered businesses

Small Business and VAT

- Exclusion of small businesses from VAT system can reduce compliance costs, but can also result in higher METR.

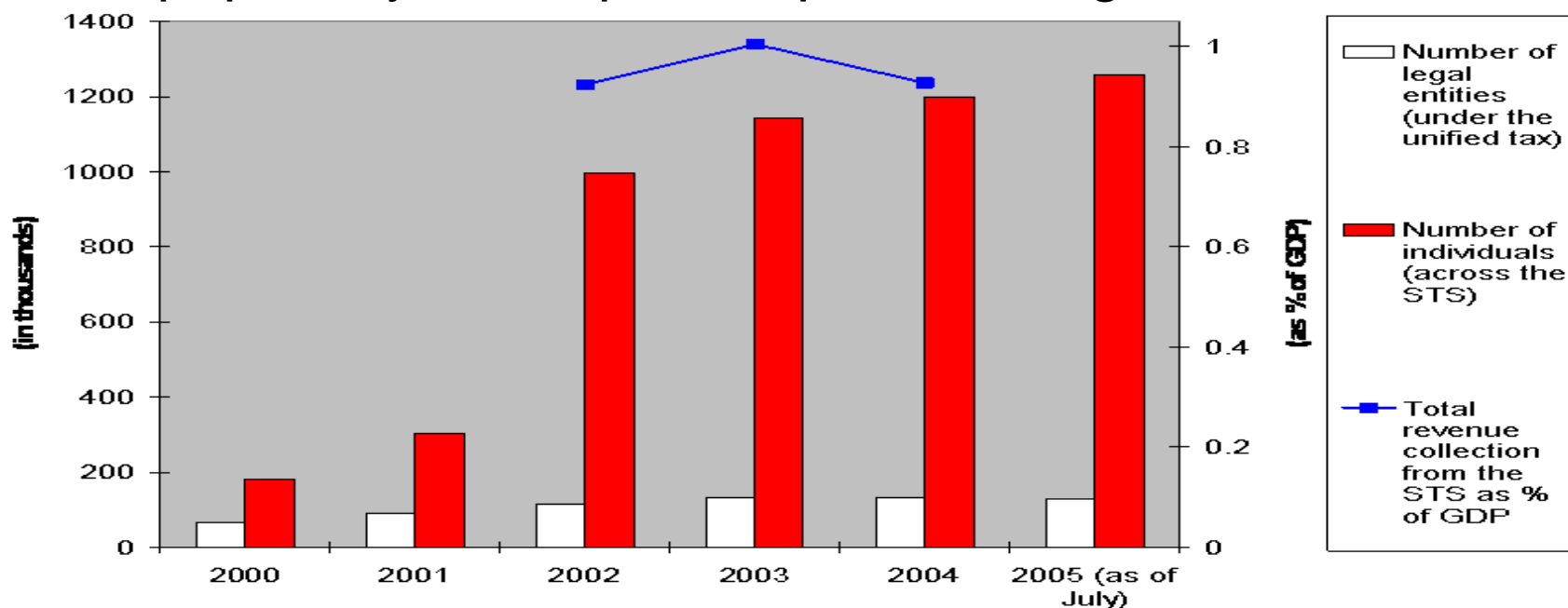
Aggregate METRs on Capital: Small Corporations



- Therefore option to register voluntarily is important.

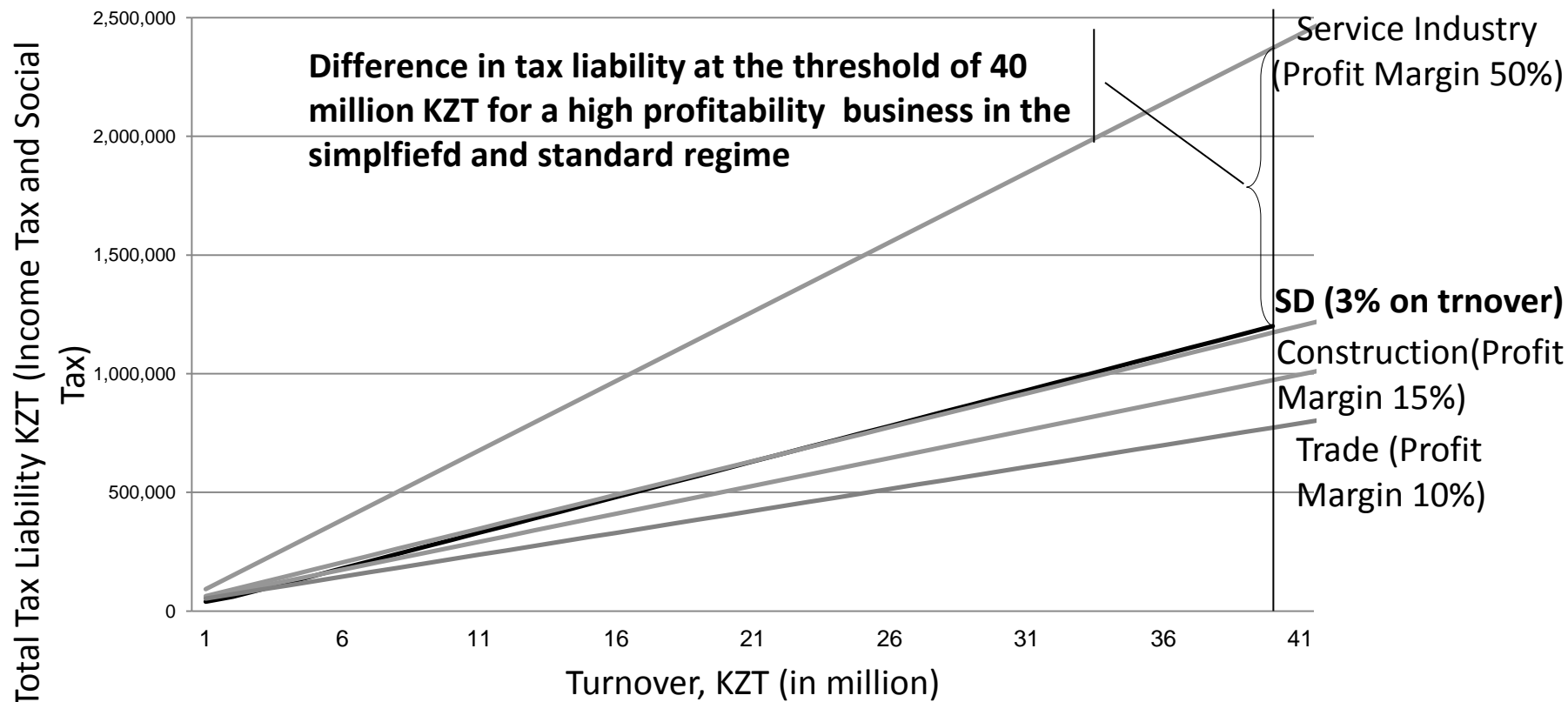
Popularity of Presumptive Tax Systems: A Benefit or a Curse?

- Broadening the presumptive tax net is good in principle – but where do these taxpayers really come from?
- The popularity of the presumptive tax regime in Ukraine:



Presumptive Taxation: Simplicity vs. Fairness

Kazakhstan: Comparison of Liabilities for Businesses in Different Regimes with Varying Profit Margins (Individual Entrepreneurs)



Presumptive System Design: Reform Directions

- Single rate turnover systems discriminate against businesses with low profit margins and provide strong migration disincentives for highly profitable SMEs
- Presumptive system design needs to take into account differences in average profit margins
- The challenge of data collection and analysis:
 - Little existing information on small business segments
 - Audit data not systematically analyzed
 - Profit margin analysis difficult to do

Options for a System Redesign (I)

- Multiple rate turnover system:

Presumptive taxation in Poland:

Small business category	Tax as % of turnover
Retail trade and catering	3%
Manufacturing, construction, cargo transport	5.5%
Services	8.5%
Wholesale trade, car rental, hotels	17%
Liberal professions	20%

Options for System Redesign (II)

Simplified taxation through presumptive calculation of business expenses

<i>Country</i>	<i>Business expenses as percentage of gross income</i>
Bulgaria	40% for craftsmen and artists 25% for liberal professions and civil contract work
Czech Republic	80% for agricultural activities and handicraft 60% for trade 40% for any other type of activity
France	71% for trade 50% for other businesses
Portugal	80% for trade 30% for other businesses
Slovak Republic	60% for craftsmen 25% for other businesses

The Need for Limitations

- Presumptive tax systems are a convenient solution to small business tax problems. However, careful thought should be given to determining when this solution is really needed!
- Is an equal treatment of small incorporated and small non-incorporated businesses necessary / desirable?
- Taxation of professionals: why not net income taxation?
- Presumptive taxation and voluntary VAT registration

The Employee – Self-Employed Discrepancy

- Combination of preferential small business tax rate and higher evasion potential is major source of income tax unfairness
- Disproportional contribution of wage earners to PIT revenue collection in many countries
- Example Sweden: Self-employed households spend 5-7% more on food than wage earners with the same reported income
- Example US: Rate of non-compliance is less than 1% for wages, but 57% for sole proprietors.
- Preferential tax treatment of self-employed has negative impact on labor market

What Can be Done?

- Presumptive tax rates have to be set at reasonably high level
- Increased use of withholding taxes?
- Higher penalties?
- More audits?
- Or an extensive public awareness campaign?
- Any other possibilities to reduce evasion possibilities for self-employed (e.g. cash withdrawal tax; obligation to pay by bank transfer; invoice lotteries; whistleblower mechanisms; cash registers)?

Summary: A Strategy for a Fair Small Business Tax System

- It is important for the tax administration to better understand the small business segment. Dialogue and outreach need to be developed.
- Reducing compliance costs is major contribution to overall fairness of the tax system
- Address disincentives and barriers to business formalization
- Focus of audit and control on major evaders
- Different presumptive tax treatment for trade and services
- Align presumptive tax burden with standard tax regime
- Targeted anti-abuse measures