

Fiscal Affairs Department

# TAXING MICRO, SMALL- (AND MEDIUM-) SIZED ENTERPRISES



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Views should not be attributed to the IMF

## The Topic Is:

- **Diverse**—circumstances, and even notions of ‘small,’ vary widely
- **Difficult**—policy and administration are both key
- **Neglected**—rarely the centerpiece of tax debate, relatively little rigorous academic attention, and few generalized models

# Outline

- Context: MSMEs in the Economy and Tax System
- Tax Design for MSMEs when Implementation is Costless, and...
- ...When it is Costly
- Tax Administration for SMEs

(Drawing on ITD (2007), “Taxing Small and Medium Enterprises,” at [www.itdweb.org](http://www.itdweb.org) )

CONTEXT

MSMEs in the Economy and Tax  
System

## No Single Definition of MSME Suffices:

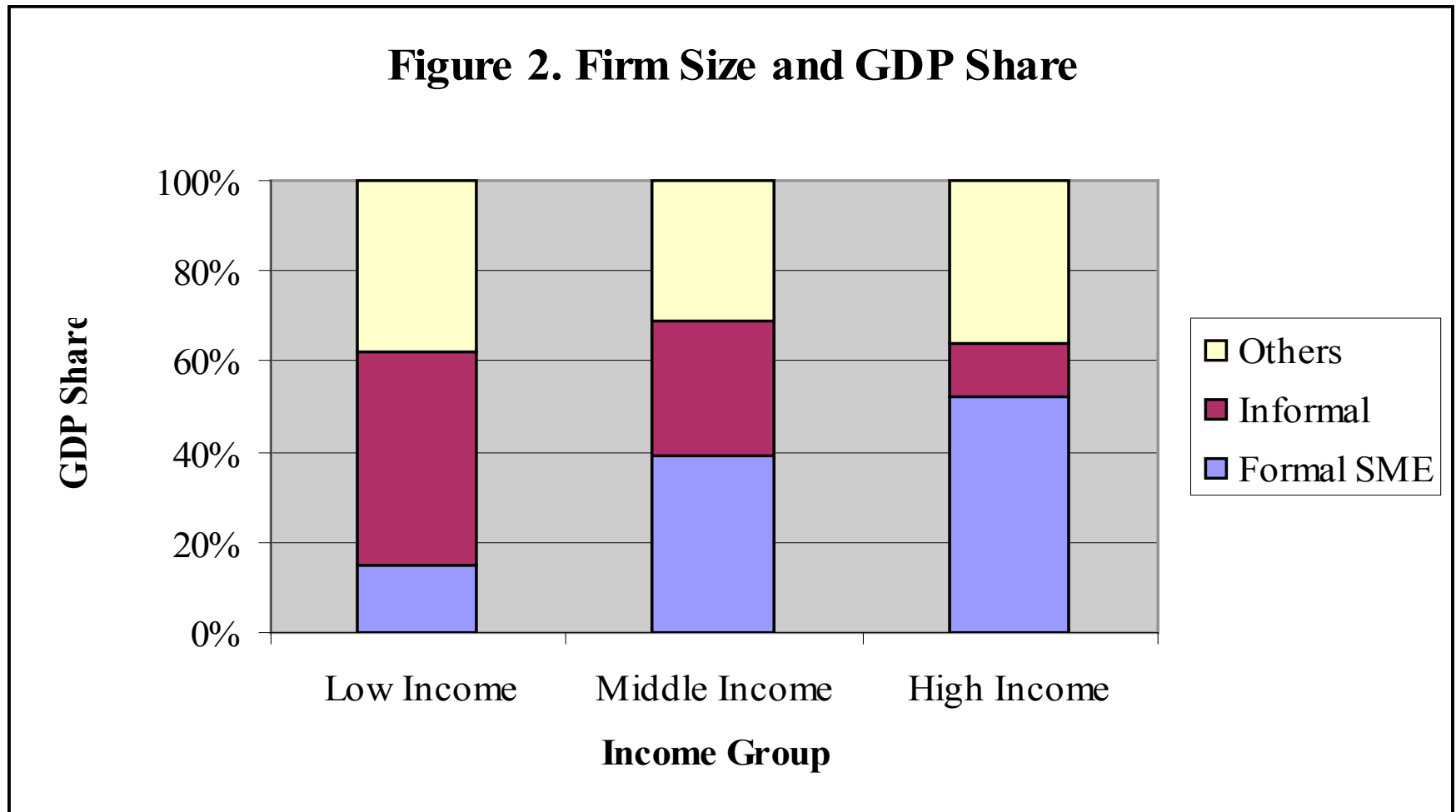
- An enterprise that is small by EU standards could be in the LTU in a small developing country (*so relative size matters*)...
- ...but it is also true that the largest enterprises are large everywhere (*so absolute size matters too*)

So, a Looser Vision:

- **Micro** = sole traders, highly informal
- **Small** = generally owner-managed, maybe some employees, limited bookkeeping
- **Medium** = the rest, except those likely in LTU

# MSMEs in the Economy

Their Contribution to GDP is Substantial...



...increases with income level, and combined with share of the informal sector, is broadly constant across development levels



## (But a Puzzle: Informality is Not Declining)

- Do MSMEs drive growth/employment/innovation?
  - Many/most SMEs fail quickly or never grow much
  - ‘New’ is not the same as small
  - Beware of statistics
    - e.g., Expressing gross MSME job creation as % of total net

# MSMEs in the Tax System

- MSMEs' Share of Tax Payments is Much Lower than Their GDP Share

- Largest 1 percent of taxpayers commonly remit over 70 percent of tax revenue
- ...while micro/small are 80 percent of taxpayers but remit only 5–10 percent of revenue

This concentration of tax payments seems even more marked in developing countries

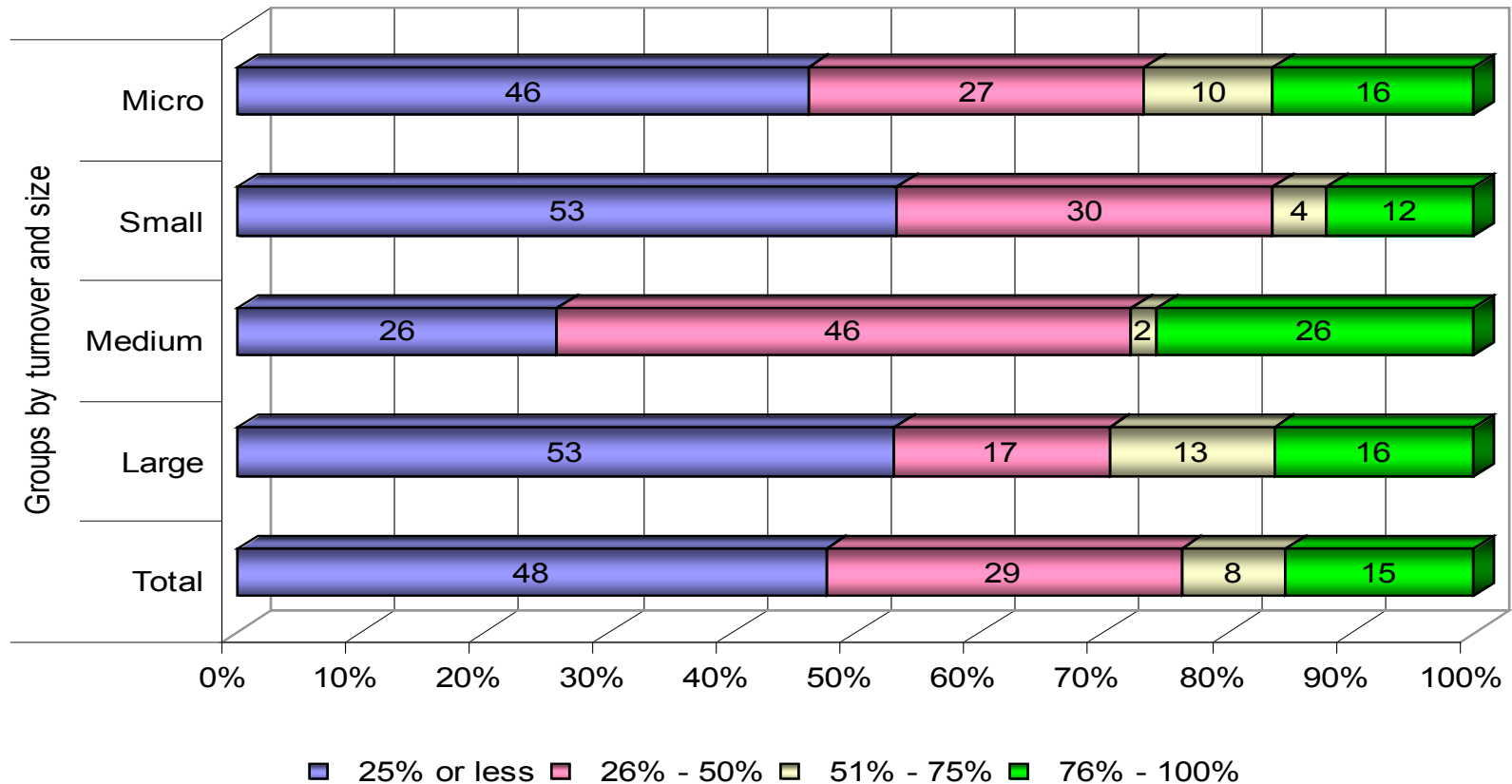
- But Must Interpret Massive Concentration of Payments with Care—and by Same Token Should Not Overstate Untapped Revenue Potential
  - Larger taxpayers act as withholding agents, including on smaller taxpayers (e.g., VAT withholding)
  - Real incidence of taxes may nevertheless be on smaller companies (e.g., input VAT)
  - Collecting revenue from smaller taxpayers may not be worth the implementation costs
  - GDP is not the tax base

- Their Compliance is Poor

- Both as ghosts

- And in incomplete remittance

e.g., for Yemen:

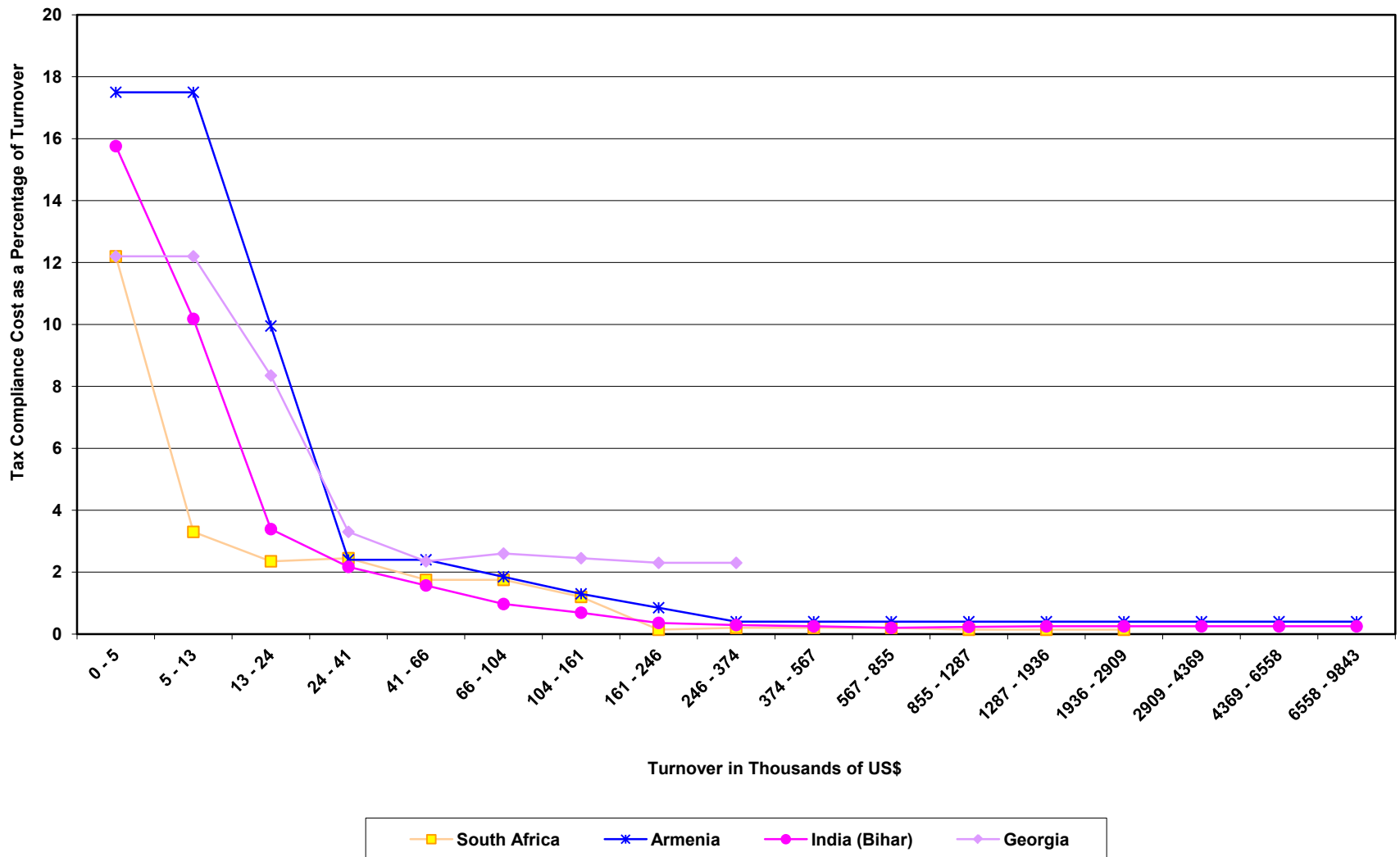


- **A Missing Middle in Developing Countries?**

Signs that the distribution of tax remittances is inverse-U shaped, because (?):

- Smallest enterprises evade
- Largest enterprises enjoy exemptions and benefit from tax planning

- Tax Compliance Costs Highly Regressive
  - Emerging evidence for developing countries (IFC):



# TAX DESIGN FOR SMEs—WHEN IMPLEMENTATION IS COSTLESS



## Arguments Sometimes Heard for Preferential Tax Treatment for Smaller Enterprises Are Not Persuasive:

- **Financing Constraints:** If smaller enterprises face imperfections in raising external finance, possible tax responses include:
  - A reduced corporate tax rate
    - But this also benefits those not constrained, and either loses revenue or requires high marginal tax rates
    - Little value to start-ups
  - Additional/specific investment provisions
    - But this can also benefit the unconstrained and discourage growth

- **Inefficiency:** If smaller firms are inefficient, it could be optimal to tax them more heavily! This, though, is mitigated to the extent that they discipline larger firms (for example, pricing)
- **Compensating for Other Disadvantages:** But if these arise outside the tax system—for example, registration costs—best response is to act on them directly
- **Developing Business Practices:** But is this a proper job for the tax administration?

- **Distributional Concerns:** But enterprises are not people—a job in a large company may be as rewarding as one in an SME
- **International Mobility:** If SMEs were less mobile, it would be efficient to tax them *more* heavily—other things equal

# Lessons

- Case for Support May Be Stronger for New Firms
  - But identification can be problematic
- Best Policy Likely that Targeted Directly on the Problem, Which Generally Isn't Size Per Se
  - Subsidized loans, support for microfinance...
- Neutrality in Tax Treatment by Size (and Organizational Form) a Key Policy Benchmark
  - But hard to achieve

TAX DESIGN FOR SMEs—  
WHEN COMPLIANCE AND ADMINISTRATION  
ARE COSTLY

## Country Circumstances Differ Greatly:

- Where Literacy, Access to Technology, and Professional Advice Are Good, Case to Just Simplify Imposition of the Same Taxes
  - e.g., through less frequent filings, exclusion of the smallest
- Where They Are Not—Main Concern Here—May Need to Apply Taxes on a Different Basis for small enterprises

# Partitions, Thresholds and Presumption

Two Interdependent Decisions for MSME Regime Design:

- How to Partition Taxpayers into Distinct Groups for Distinct Treatment?
  - Generally by some thresholds specified in terms of “size”
- What Form of Special Tax Regime—if Any—Should Apply to Each Category Thus Identified?

And these must be addressed for each type of major tax levied in the “normal” regime.

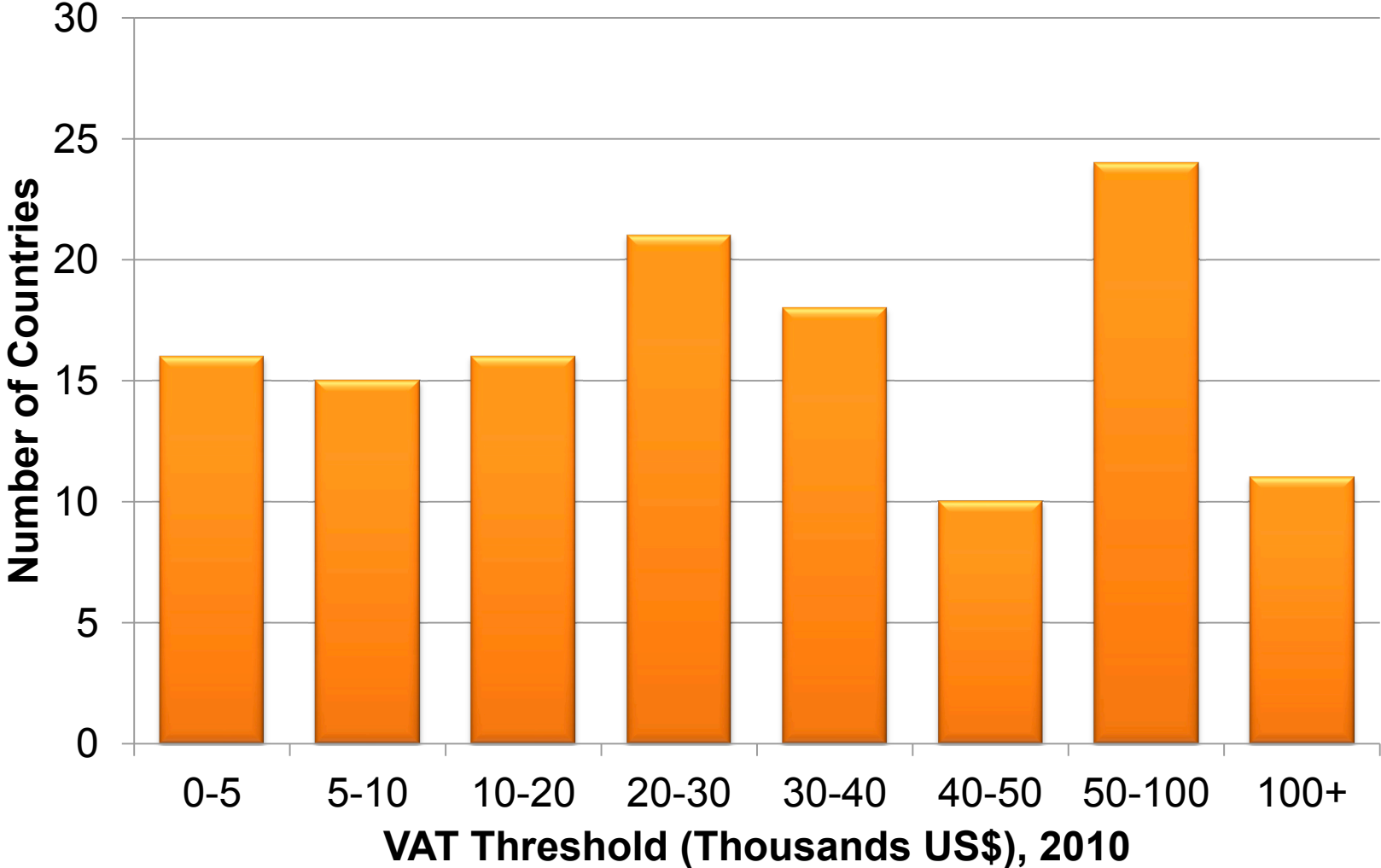
- Theorists have given these problems little attention; practitioners have addressed them in many ways.

# Thresholds

- VAT
  - Costly Implementation Means Best Threshold Not Zero
  - Where to Draw It Depends on Administration and Compliance Costs and Net Social Gain from Tax Revenue
    - Formula in Ebrill and others (2001), *The Modern VAT*
  - Affected by, and in Turn Affects Case for, the Presence of Simpler Tax Below the VAT Threshold



# Practice Varies (Very) Widely:



- **Income Tax and Social Contributions:**
  - Microbusinesses likely below any reasonable PIT threshold
  - Align treatment of self-employed, partnerships and corporations
  - Apply to business owners same threshold/rates as for wage earners
    - Some give more favorable treatment for wage earners as compensation for lesser ability to evade; wise?
  - Ensuring income tax is paid above threshold may argue for simplified forms of taxation
  - Withholding for employees: thresholds should not differ from those applicable to employees of larger businesses
    - But levying SC for employees of small enterprises is a big problem

# Special Regimes and Presumption

- **Special Regimes Are Pervasive**
  - Serving different purposes: to *replace* one tax, many or even all (in West Africa, the *regimes synthétiques*)
    - The form of these regimes is extremely diverse, even within (e.g.) the OECD
- **...and Diverse**
  - Turnover- (gross receipts) based
  - Cash flow (replacing the income tax)
  - Indicator-based
    - Forfait
    - Standard assessment systems
    - Patente
    - Asset based methods

## Key Considerations in Designing Special Regimes:

- Which tax(es) is it intended to mimic?
- Compatible with compliance capacity of the target group, and authorities' administrative capacity
- Robust against corruption/collusion?
- Rates high enough to not discourage transition to the normal regime or encourage underreporting, but not so high as to worsen noncompliance
- Transition between regimes manageable?
- Rebuttable?

# A Strategy for Developing/Emerging Countries

- Structure Around Reasonably High VAT Threshold
  - The point being that those above should be able to comply with 'real' income tax, and there is enough revenue at stake for it to be worth having them do so

What about below the threshold?

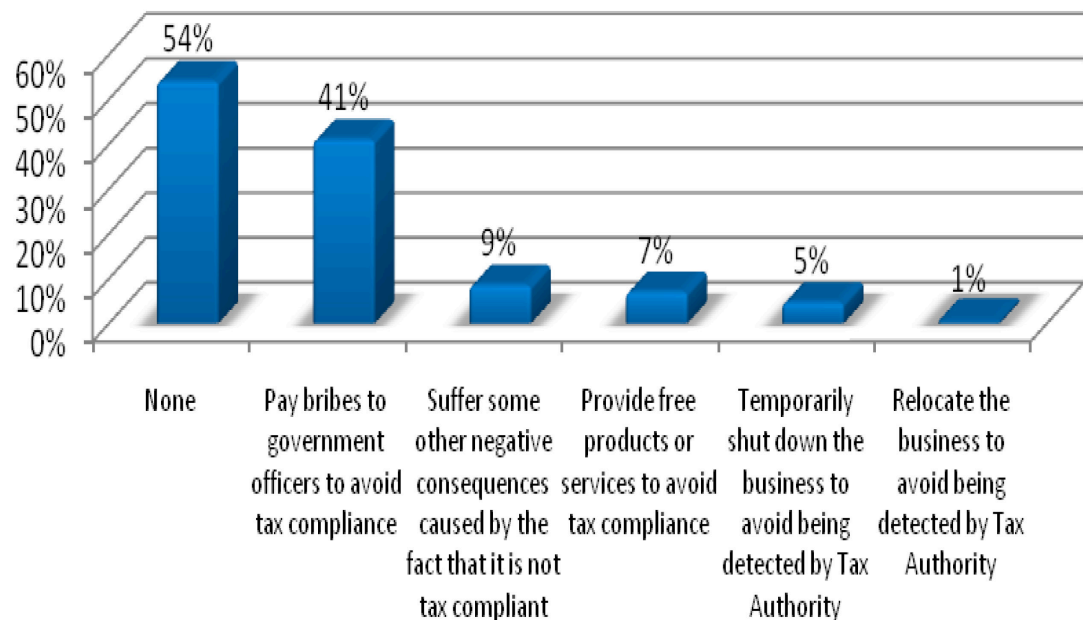
- **Microbusinesses:** Exclude, or use simple patent
- **VAT:** Unregistered in any event pay VAT on imports and taxed inputs—is a replacement necessary?
- **Business Income Tax:** Accounts-based special regime (to ease transition to standard regime), turnover maybe simplest but cash-flow also possible
  - And this should apply to corporations too
- **Payroll Taxes and Social Contributions:** An increasingly serious issue, given growth of contribution-based support schemes
  - With limited scope for presumption, there is a case for requiring those with employees above some threshold to participate in the standard regime

# TAX ADMINISTRATION FOR MSMEs

# Challenges (Many!):

- Non-registration
- Non-filers and Underreporting Problems
- Risk of Collusion, Especially Where There is Direct Assessment

In Yemen:





- Little Taxpayer Knowledge of Tax Obligations
- Limited Bookkeeping Capacity (?)
- Rapid Turnover of Businesses
- Limited IT and Telecommunication Access

# Standard Principles of Good Tax Administration Apply

## Foster Voluntary Compliance, Plus Risk Management

- **Strong Taxpayer Service:** Cheaper, relative to revenue raised, than compliance enforcement
  - Internet-based service provisions; where access is limited, interim approaches through walk-in offices and broad dissemination of publications
    - In some cases, administration can resist e-filing
  - Provide clear answers to basic questions, in easily understandable form (e.g., “How do I file my tax return?”)
  - Work with third parties, especially tax professionals and industry groups

- **Ease Compliance**

- Don't ask for more information than is needed
- Provide clear information on basic tasks required
- Simplify legislation, regulation, and forms

- **Focus Enforcement on Those Most Likely to Misunderstand/Intentionally Avoid Their Obligations, *and* the Greatest Revenue Risks, by e.g.,**

- SME audits (with some focus around thresholds)
- Debt collection approaches
- Third-party reporting and cross-matching
- Unannounced visits
- Industry-based compliance projects
- Risk scoring

# Organizational Aspects

In line with strategy above, and building on LTO experience:

- Establish Dedicated Taxpayer Offices for Medium (Above-VAT Threshold) and Small (Below-VAT Threshold) Taxpayers
  - Advantages: (1) Better allocation of resources on risk-revenue considerations; (2) Better matching of service and enforcement programs to SME needs; (3) Strengthened accountability for outcomes

Underway in a few countries

## But Two Additions to Usual Benefit-Cost Calculation in Allocating Administrative Resources:

- Important for State-Building Reasons to have MSEs Pay at Least Some Tax?
- Role for Tax Administration in Fostering Good Business Practices?

Each (and efficiency) can imply that taxes on smaller enterprises need not cover administrative costs...

...but, even with this in mind, allocation of resources to MSMEs often seems excessive

## On the Latter:

- Where VAT thresholds are low/zero, one approach (e.g., Chile) has been to **Use the Tax Administration to Help Formalization of the Small Business Sector by Providing Accounting Modules to SMEs**
  - Necessary Conditions:
    - Relatively advanced and credible tax administration;
    - Relatively high level of technological penetration in country;
    - Intensive partnerships with private sector;
    - Adoption of simplified income tax for small enterprises

**CONCLUDING**

- What have been experiences in using special tax provisions for SMEs to addressing perceived economic distortions or needs?
- What has been the experience with alternative forms of presumptive taxation? Can a 'single tax' work for SMEs?
- How can SMEs best be brought into the formal economy? Are there any encouraging country experiences on this?



- To what extent should the tax treatment of SMEs take improving business practices as an objective?
- How can the challenges posed by the need to withhold payroll taxes and social contributions from employees of smaller enterprises be met?