



# Taxation and Informality

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## Issues around taxation and informality



- Shades of informality
- Why tax small and micro firms
- Theoretical and empirical considerations
- Lessons for policy design

## Shades of informality

← Value of hidden income increases with size, but not necessarily in relation to total income

Large Firms	Medium Firms	Small Firms	Micro Firms
Hide income (legal/illegal) – e.g. cross-border profit shifting	Hide income (legal/illegal) – e.g. domestic profit shifting	Underreport number of employees	Hide the business
	Undeclared employees, particularly if social contributions are high	Underreport sales – e.g. cash transactions	Underreport sales – e.g. cash transactions
		Involves family in business structure	Involves family in business structure
		Private consumption of business income – e.g. travel, cars	Private consumption of business income – e.g. travel, cars

## Why tax small and micro firms

Arguments in Favor	Validity of Arguments
<p>Equity: everyone should pay tax, even if small amounts; participation is also important for government-citizen relationship</p>	<p>A large proportion of the population is exempt from tax by virtue of the basic deduction under income tax systems – especially true in low-income countries</p>
<p>Economic efficiency: not taxing small and micro firms induces distortions to economic activity</p>	<p>Some support in the empirical literature – e.g. bunching; informal employment or low labor participation rates when marginal tax rates are high</p>
<p>Revenue: informality is large in developing countries and could yield significant revenue to the treasury</p>	<p>Depends on the forms of informality – e.g. hidden income of “<b>visible</b>” individuals and firms is more important than income of “<b>hidden</b>” individuals</p>
<p>Simplicity: easier to tax turnover than apply a regular income tax or VAT</p>	<p>Depends on what the presumptive tax covers: income tax, VAT, social security contributions, etc. and education level of taxpayers</p>

## Theoretical and empirical considerations



Optimal threshold (no behavioral response):

$$Z = \frac{dA + E}{(d - 1) [t^c(1 - c/p) - t]}$$

$d$ : marginal value of public funds

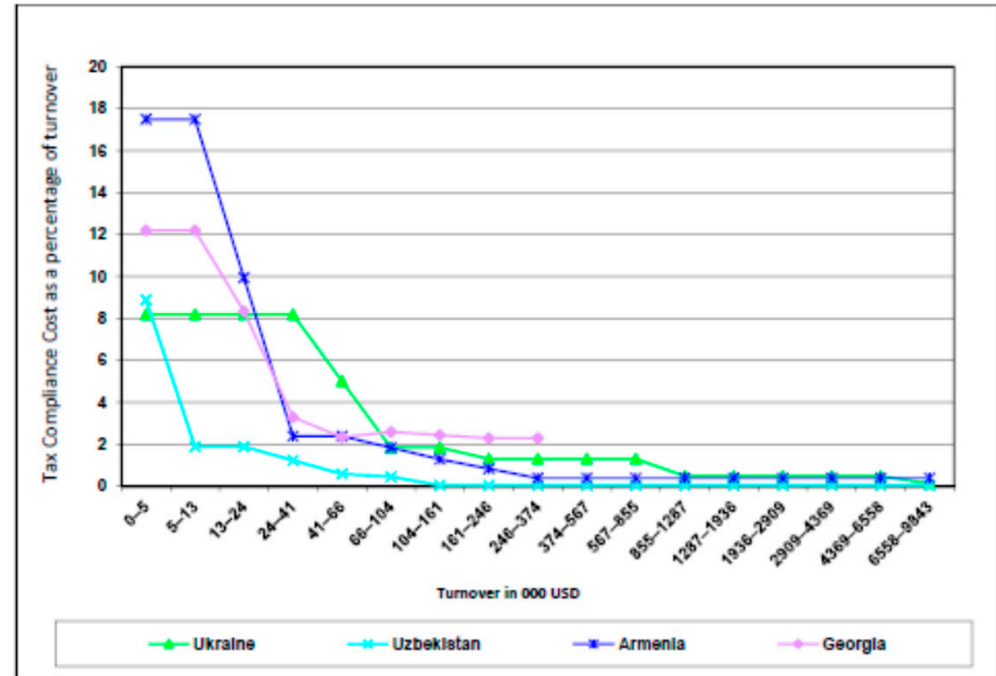
$A, E$ : tax administration and compliance cost

$t^c, t$ : tax rate in formal and informal sector

$c, p$ : cost and output price in the formal sector

## Implications of changes in key parameters

- A decrease in the cost of compliance or administration implies:
  - a decrease in the threshold
  - a decrease in the presumptive tax rate
- An increase in the marginal value of public funds implies:
  - a decrease in the threshold
  - an increase in the presumptive tax rate
- An increase in the productivity parameter implies:
  - a decrease in the threshold
  - a decrease in the presumptive tax



Source: IFC Tax Compliance Cost Surveys 2007-11.

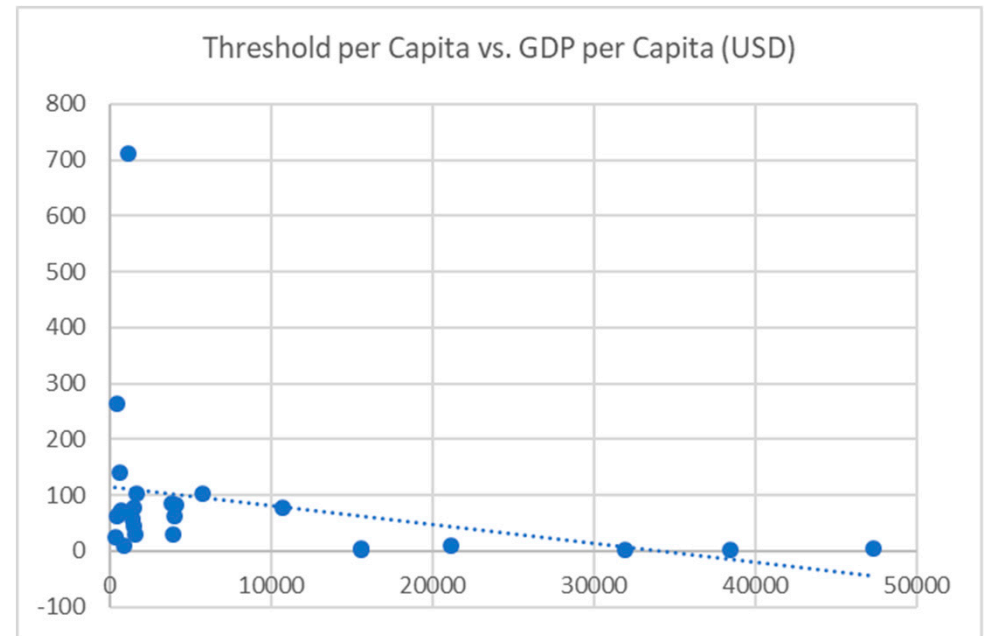
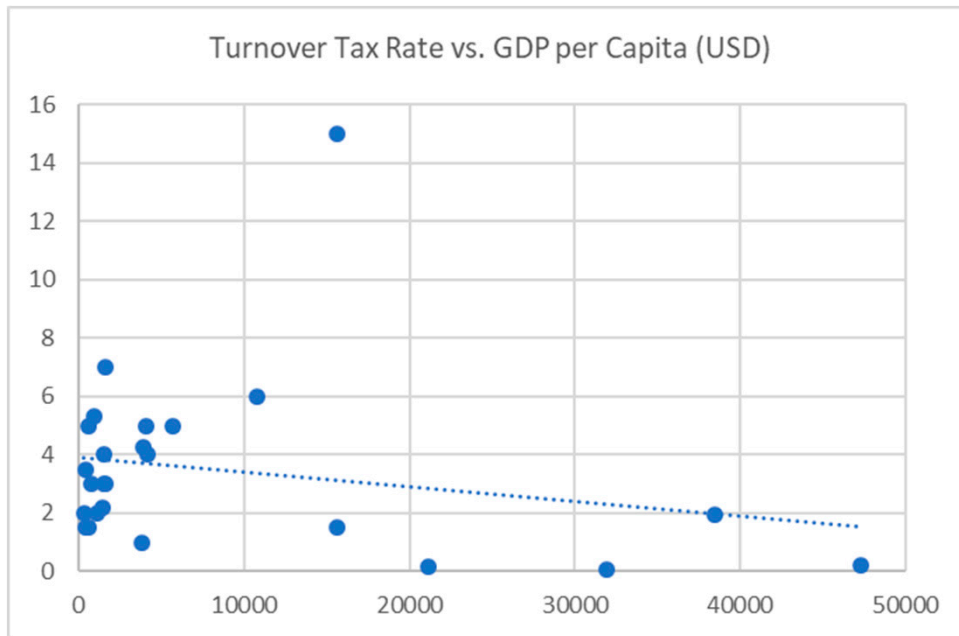
## Theoretical and empirical considerations



- Threshold
  - Bunching around the threshold—behavioral responses to changes in the threshold can be significant
  - Increasing the threshold may:
    - induce efficiency gains related to size – hence more tax revenue
    - Generate more tax revenue from firms constrained by the threshold – as they declare more sales just below the threshold
- Tax rate
  - Tax rate affect the decision to switch regimes when firms are near the threshold
  - High presumptive rate generates more revenues from small firms, but could have a negative production effect

## International experience

Small business turnover threshold decreases with increasing income levels.  
 Presumptive turnover tax rates decreases with income levels.





## Lessons for policy design



- Informality is a multifaceted phenomenon (e.g. micro vs. small)
  - important to tailor policy design to specific issues, while keeping it simple
- Unlikely that policy design could be successful without investment in information and enforcement
- Literature has been confined to rather simple cases – real life is more complex
- It is as much important to prevent firms from falling into the presumptive regime as it is to tax those who are in it
  - Micro and small business' share of income is almost always small
  - VATs acts as good taxes on informality
- Presumptive regimes should be reviewed every 5 years to assess whether their parameters and information requirements are adequate