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## **Challenges of Informal Sector and Taxation of SMEs**

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# SMEs and the economy

**SMEs are drivers of sustainable socio-economic development**

**Catalyst of development by;**

**Bringing innovative products to the market,**

**Helping promote competition in the market, culture of entrepreneurship and sustainability.**

**All essential for an efficient market**

**A considerable part of the Egyptian private sector (estimated at )**

**55% of GDP**

**75% of employment**

**Therefore, a simple and tailored tax regime is needed;**

**with specific incentives for SMEs to exit the informal sector and join the formal one,**

**and will enlarge the current tax base and increase tax revenues**

# SMEs and the economy

- Definitions based on values covers revenues up to EGP 200 million revenues, ( per EAS EGP 100 million )
- Estimated to employ 75% of labor force in Egypt
- - 3.8 million micro enterprises
  - 67600 small and medium enterprises
- Significant contribution to economy
- Large and Diverse Group across all sectors with diverse
  - behavior patterns, from traditional to start ups in technology
  - legal and governance setups,
  - capabilities, aspirations
  - desire to grow.

# Of the SME's approximately 84% are informal reflecting a low voluntary compliance rate

This is due to many factors



High burden of compliance



Complicated procedures to establish, obtain licenses, deal with tax authority.



Law makers and regulators are often not cognizant of the need to issue simplified rules for SME ( accounting standards , TP requirements , detailed and complex tax returns)



"Doing Business Report" which is based on perceptions of an SME and covers ease of doing business, Egypt ranked as **128** showing some of the areas that create hindrances



New start ups in Egypt many start informal or semi and get stuck despite their education.

# Should our tax and other policies aim to bring all into the net of the formal economy ?

## Macro economic issues

- Increase tax revenues
- Integrating in the formal sector improves quality and productivity thus improving competitiveness (training etc.)
- Government policies are less influential in the informal sector as no connection to banks or capital markets

## Micro economic issues

- Distortion in resource allocation
- Perceived as higher risk required return on investment higher .
- Cost of informal borrowing higher.
- Resort to short term working capital financing rather than medium /long term sophisticated investments.

# Should our tax and other policies aim to bring all into the net of the formal economy ?



## Do we want to formalize all SME's ?

Arguments against formalization of Micro enterprises and small enterprises;

- Significantly higher cost of operation
  - Loss of competitive edge or even close down
  - Loss of economy's ability to provide low priced goods and services to lower income bracket segments of society
  - High cost of regulation and monitoring
  - Potential loss of employment opportunities for unskilled labor, and in remote areas outside traditional economic centers of activity

# Role of Tax policy

How can tax policy encourage formalization and voluntary compliance by SMEs ?

Who should tax policy target to formalize?

How ?



Legislations may hamper compliance and growth by addition of expenses and administrative obstacles.

- Tax rates must be appropriate and rational
- Tax efficient tax collection authority
- Intense fight against corruption and evasion
- Tax policies must encourage voluntary compliance growth and employment creation, not just tax revenues, they should consider,
  - incentives that support start-up and growth of SMEs, including lowering of corporate income tax rates, special sectoral, location tax exemptions and some relieves.
  - incentives that attract new investors who are potential viable tax payers in the future



# Developed and Developing Countries' Best Practices

SMEs are formalized more with simplification and reduction in tax compliance burden

While in certain developing economies where SMEs are not generally compliant and not easily tracked by the tax administration, most operate within the informal sector,

Different tailored systems for attracting SME to tax compliance are used like;

- Simplified presumptive tax; replacing income tax, capital gains, VAT, etc.,
- Cash flow based; replacing corporate tax and other taxes based on lump sum payment also covering Self- employed,
- Indicator based,
- Simplified inventory (below certain level of turnover based on the value of inventory)
- Simplified bookkeeping requirements for tax purposes,
- Exemption from keeping complete accounting, under certain size threshold,
- Reduced filing requirements (reduction of tax compliance costs); less frequent advance installments of income tax to meet interim reporting requirements

# Egyptian challenges

## Legal Challenges

- Legal Web
- Discretionary authority of government employees leading to uncertainty
- A special law is needed

## Admin Challenges

- numerous rules for establishment and licensing
- cost of procedures and time needed too high
- fragmentation of supervisory role into many entities

## Social Accountability

- Challenges
- Public servants not accountable to public so no pressure to improve services

## Informational Challenges

- No database on business
- no specific list of requirements by each government department for needs

# Policy Recommendation

## Simplified Tax Regimes

### Tier 1 - Micro enterprises

- No tax below threshold
- No VAT registration
- No revenue reporting
- No filing

### Tier 2 - Very Small entities

- Tax / License fixed amount annually
- Trading license /
- No accounting records
- No VAT registration allowed.
- No revenue declaration

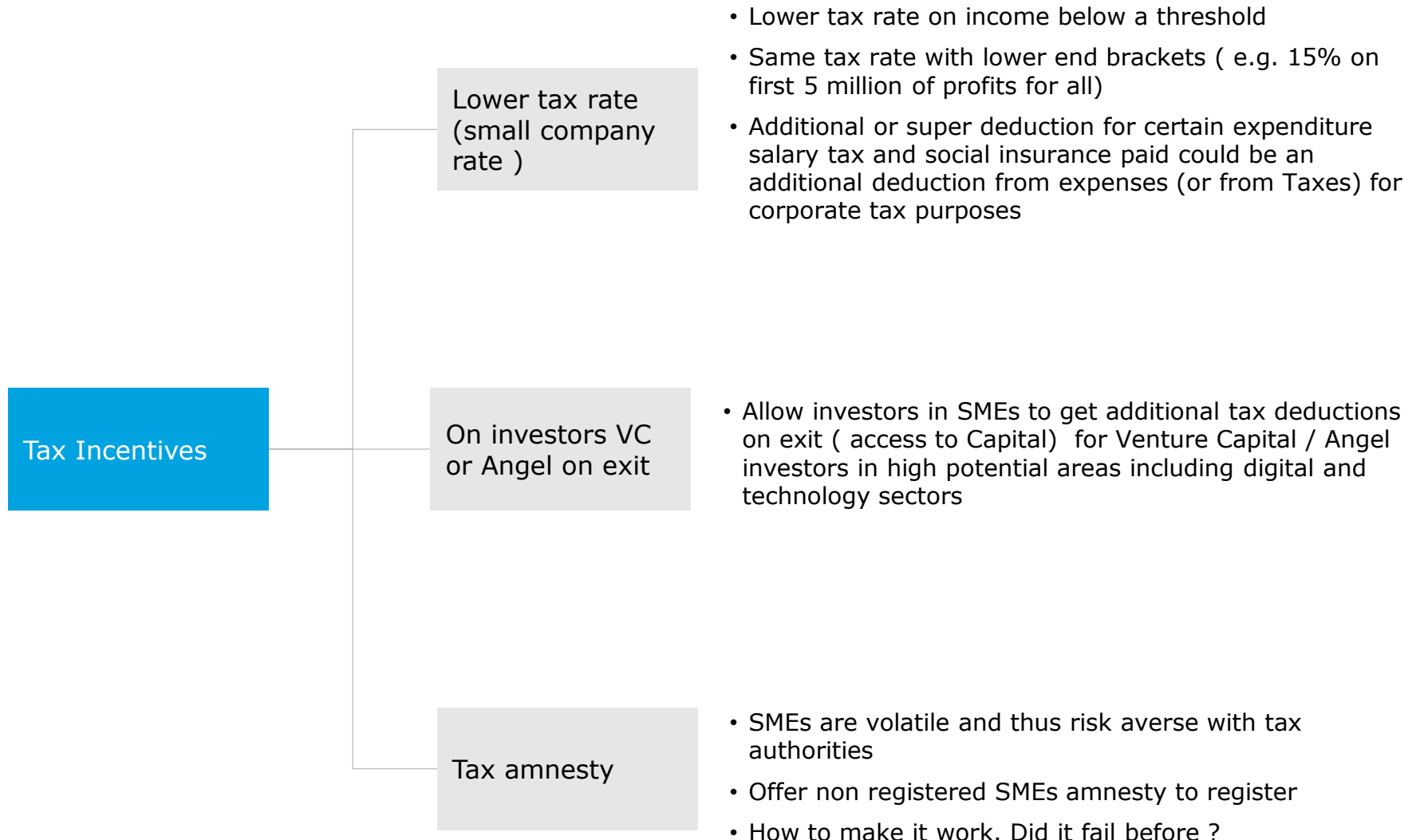
### Tier 3 - Small entities

- Tax % of declared revenues
- If deemed better for tax payer may opt for simplified tax returns on cash basis
- Vat registration required if meeting threshold

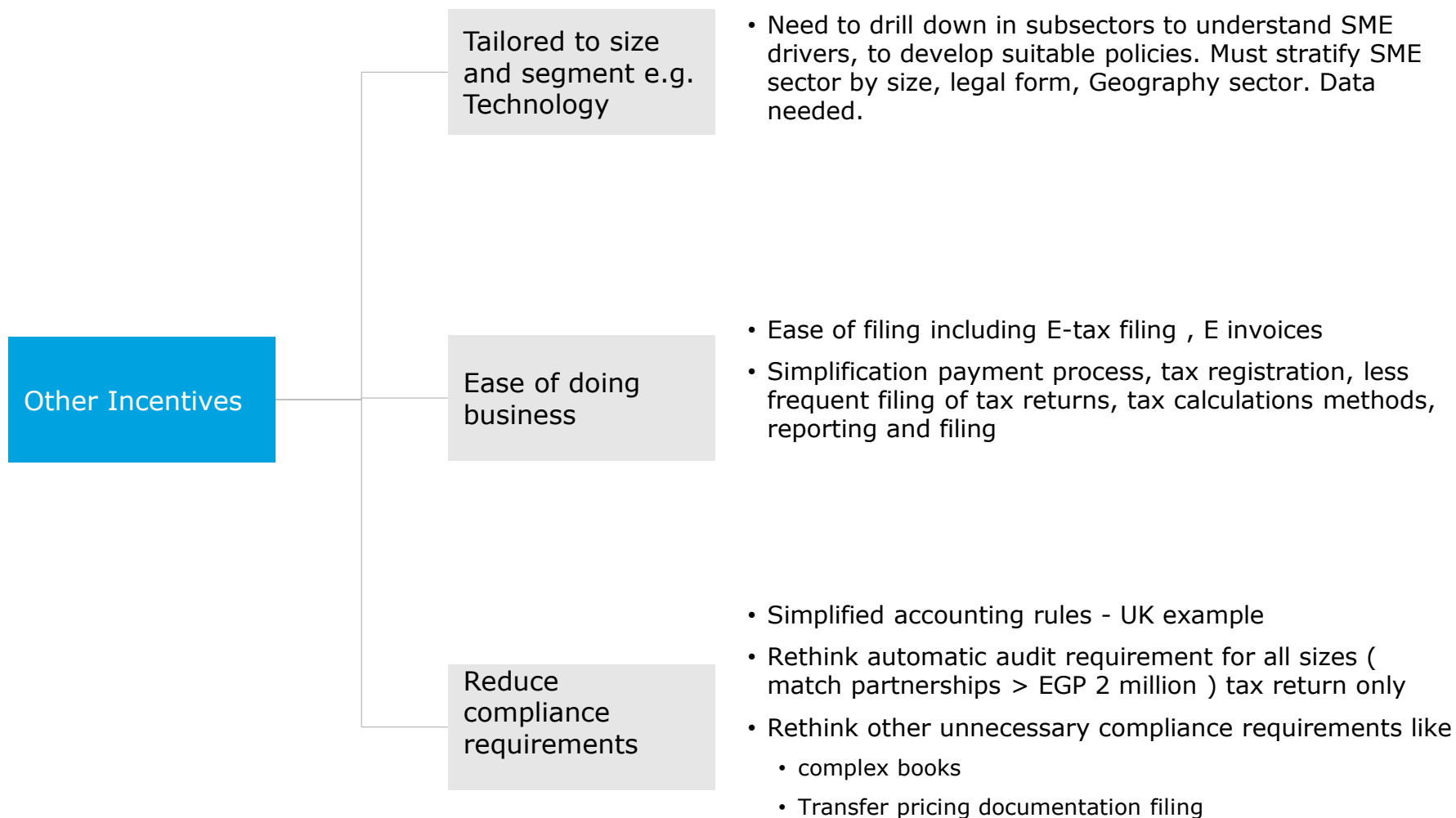
### Tier 4 – All other SMEs

- Tax registration and
- Filing on simplified accounting basis and tax rules
- Full VAT registration
- Reduced tax rate and incentives as attached

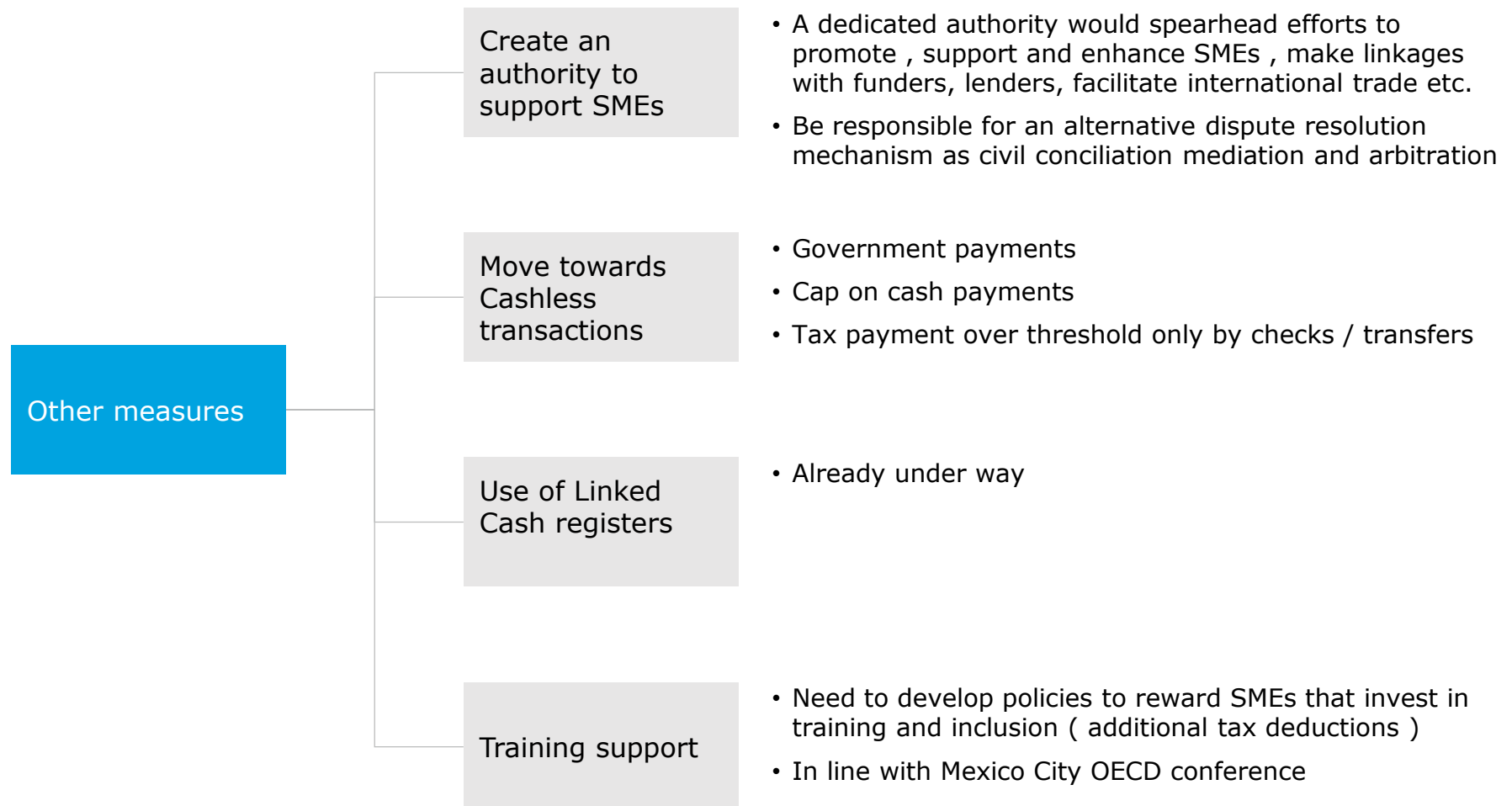
# Policy Recommendation



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