

Recent Findings on Tax-Related Regulatory Burden on SMMEs in South Africa

Literature Review and Policy Options

Doubell Chamberlain

Anja Smith

Genesis Analytics

doubellc@genesis-analytics.com

Acknowledgement

This Working Paper is one in a series emanating from the SMME project, within the Employment Promotion Programme, which is aimed at Understanding the Regulatory Environment for Small Business in South Africa. The DPRU are the Programme Managers of this DFID funded project whose goal is to promote an enabling environment for employment creation in South Africa, and to contribute to the Government's goal of reducing unemployment.

Development Policy Research Unit
Tel: +27 21 650 5705
Fax: +27 21 650 5711

Information about our Working Papers and other published titles are available on our website at:
<http://www.commerce.uct.ac.za/dpru/>

Glossary

dti	–	Department of Trade and Industry
GST	–	Goods and services tax
PAYE	–	Pay-as-you-earn tax
RIAs	–	Regulatory impact assessments
SARS	–	South African Revenue Service
SBS	–	Small Business Service
SBC	–	Small Business Council
SBC	–	Small business corporation
SDL	–	Skills Development Levy
SMMEs	–	Small, medium and micro-sized enterprises
UK	–	United Kingdom
VAT	–	Value-added tax

Table of Contents

1.	Introduction.....	1
2.	Rationale for Assessing the Impact of Compliance Costs of Taxation on SMMEs.....	3
3.	Cost Framework.....	5
4.	International Context.....	7
4.1.	<i>Relative South African Performance.....</i>	<i>7</i>
4.2.	<i>Best Practice Jurisdictions.....</i>	<i>9</i>
4.2.1.	<i>United Kingdom.....</i>	<i>10</i>
4.2.2.	<i>New Zealand.....</i>	<i>14</i>
4.2.3.	<i>Lessons for South Africa.....</i>	<i>20</i>
5.	Reviewed South African Studies.....	22
5.1.	<i>SBP: Counting The Cost Of Red Tape For Business In South Africa (July 2005).....</i>	<i>23</i>
5.2.	<i>Upstart Business Strategies (UBS): Measurement of Value-Added Tax and Regional Services Councils Act-Induced Administrative Burdens for South African Small Businesses (September 2004).....</i>	<i>28</i>
5.2.1.	<i>Main Findings.....</i>	<i>30</i>
5.2.2.	<i>Recommendations.....</i>	<i>32</i>
5.3.	<i>SARS: SMME Facilitation Programme Report Version (Released in 2005).....</i>	<i>33</i>
5.3.1.	<i>Main Findings.....</i>	<i>34</i>
5.3.2.	<i>Recommendations.....</i>	<i>36</i>
6.	Enacted Tax Changes for Small Business (2005/06 Budget).....	38
	Decreasing the administrative burden.....	39
	A stronger small business focus.....	40
	Financial relief.....	40
7.	Policy Considerations and Conclusions.....	42
	Policy Issues to Consider.....	43
	Is the Tax Compliance Burden a Problem for SMMEs in South Africa?.....	43
	Need to Co-ordinate SMME Policy Amongst Government Departments.....	44
	Incentivise the Use of Existing More Efficient Compliance Mechanisms.....	45
	Establish Protection Mechanisms for SMMEs within the Regulatory Authority.....	46
	Do not Expect Reductions in the Tax Compliance Burden to Unlock the SMME Market.....	47
	Heed International Experience on Potential Distortions Introduced by Well-Meaning Policy.....	48
8.	References.....	49
	Appendix A: The Standard Cost Model.....	53
	Appendix B: Assumptions About the Business for Paying Taxes in <i>Doing Business</i>.....	54

Executive Summary

Regulatory compliance costs impose a deadweight burden on firms and therefore should be minimised. In achieving this goal, it is necessary to embrace a process of smart regulation, rather than focus on deregulation. Tax compliance cost is one type of regulatory costs that is often viewed to have a large negative impact on SMMEs. To gauge the impact of this cost on small business in South Africa, this document reviews three available studies on the impact of tax compliance costs on South African SMMEs. The three studies reviewed are:

- *Counting the Cost of Red Tape for Business in South Africa by SBP (2005);*
- *Measurement of Value Added Tax Act and Regional Services Councils Act-induced Administrative Burdens for South African Small Businesses by Upstart Business Strategies (2004), commissioned by the Department of Trade and Industry (dti); and*
- *SMME Facilitation Program (Report Version) by the South African Revenue Services (SARS) to be released in 2005.*

South African tax compliance costs cannot be judged in isolation. It is therefore necessary to also review the country's performance in an international context. South Africa's performance in the area of *paying taxes* in the most recent World Bank *Doing Business* report is briefly highlighted. South Africa ranks 84th out of all assessed countries, performing better than Peru, Brazil and Argentina, and only two positions behind the United Kingdom.

In order to illustrate what can be achieved in a regulatory best practice environment, the importance of tax in the broader SME development sphere and attempts to reducing tax compliance cost in New Zealand and the United Kingdom are reviewed. From these two country experiences, it is evident that an agency dedicated to articulating small business interests and providing small business inputs to all government departments is essential in national co-ordination of SMME policy. Simplification of tax requirements should not occur in isolation of broader SMME policies and often requires new innovative approaches.

Available information on South African tax compliance costs and their impact on SMMEs are captured in the three reviewed studies.

The SBP (2005) study is the first ever to provide an estimate for total regulatory compliance costs in South Africa and therefore makes a very valuable contribution to this realm of available information. It estimates total regulatory compliance costs for formal firms in South Africa to have been approximately R79 billion in 2004, 6.5 per cent of GDP, and total tax compliance costs to have been roughly R20 billion in the same year. In evaluating these estimates it is important to keep in mind that the study, due to “top-down” approach of questions posed in the questionnaire, is prone to overestimation. Furthermore, it was not solely focused on tax compliance costs and thus did not delve as deep as possible into this issue. However, the provision of information on the distribution of tax compliance cost across firms by turnover size provides a necessary benchmark which can be used to assess South African tax compliance costs relative to those of other countries, even if only indicatively. Due to the nature of the report, it makes no tax-specific recommendations and only focuses on broad regulatory compliance recommendations.

The Upstart Business Strategies (2004) study focuses on two specific taxes, Value-Added Tax (VAT) and Regional Service Council Levies (not administered by SARS, but by regional service councils). As it has since the publication of the study been announced that Regional Service Council Levies will be cancelled in August 2006, the findings and recommendations pertaining to this tax are not discussed here. The study employs Mistral®, a proprietary “bottom-up” technique to quantify tax compliance costs. This methodology allows for analytically rigorous and standardised calculation of compliance costs. However, the small sample of specialists consulted in gathering the required information casts some doubt on the statistically representative nature of the findings. The study finds that the average SMME spends approximately R6 027 on two compliance activities associated with VAT – recordkeeping and completion tax returns. The total VAT compliance cost for an average SMME is estimated to range between R6 000 and R8 000 annually. The recommendations of the study are of a broad practical nature and focused on reducing the time spent on specific tax compliance activities. It does not specify the how of its recommendations, for example, it suggests that the internal reliability of SARS logistics needs to be improved and that queuing time spent at SARS needs to be reduced, but does not explain how these outcomes should be achieved.

The SARS (2005) study does not generate its own empirical data. It reviews the empirical findings of the above two studies and findings of other studies broadly or specifically focused on SMMEs and the formal/informal economic divide. In addition, it draws on a number of qualitative insights gained during interaction with a range of individuals and organisations aware of small business concerns. A number of recommendations with regards to SARS structures (for example, creation of a Small Business Centre and Small

Business help desks), SARS communication channels and SARS products (specifically VAT) are made. However, the underlying key conclusion of the study is that despite the fact that a large number of simple-to-implement changes can be made to reduce tax compliance costs, what is actually required is a much wider and comprehensive policy focus. This is best summarised by the assertion that “small business will not live or die by SARS intervention alone” (SARS, 2005: 24). Rather than simply focusing on small “cosmetic” tax changes, what is required is intensive co-ordination of SMME policy across different government departments.

The narrow focus of the reviewed studies, excluding the SARS report, strengthen the idea that relevant policy considerations do not extend beyond the implementation of technical changes to tax legislation. However, a strong case can be made for a number of other SMME policy-related issues to receive greater emphasis than tax compliance costs. Firstly, vast information shortages exist that limit the base for broad SMME policy development and impact assessments. This needs to be speedily addressed. Secondly, South Africa lacks a coordinated SMME policy, a state of affairs that is very visible in a simple problem such as a lack of consistent SMME definitions. Conclusions relative to tax compliance cost include the fact that a large component of tax compliance costs can be ascribed to firm-level inefficiencies. This problem will not be easily addressed by simply making technical changes to the current tax system, but will require more intensive interventions such as education campaigns. Inefficient firm-level choices are also often motivated by firms’ perception of the risks associated with accidental non-compliance, e.g. penalties that could result from losing a tax submission in the e-filing process. While a reduction in the tax compliance burden can help to create a more enabling environment for business, a special tax regime for small businesses might not be the best way to achieve lower compliance costs. Far more than simply tax changes will be required to unlock the South African SMME market.

1. Introduction

Internationally, the cost of compliance with regulation is noted as a key inhibitor to small, micro and medium enterprise (SMME) development. Increasingly governments are realising that, while regulation may be necessary, the cost of regulation should be monitored and controlled. This is particularly true for SMMEs that, due to their size, are more vulnerable to regulatory burden than larger firms. The focus is, therefore, to move to smart regulation rather than no regulation.

Compliance with tax regulation is one area of regulation that is rated as a high burden. Recent studies in South Africa have confirmed that regulations and particularly tax compliance is an issue for SMMEs. This document reviews the findings and recommendations of three studies on the *impact of tax compliance costs on SMMEs in South Africa* and the policy options emerging from these. The review is contextualised by considering international research and the experience of SME-friendly international jurisdictions.

The three studies reviewed are:

- *Counting the Cost of Red Tape for Business in South Africa* by SBP (2005);
- *Measurement of Value Added Tax Act and Regional Services Councils Act-induced Administrative Burdens for South African Small Businesses* by Upstart Business Strategies (2004), commissioned by the Department of Trade and Industry (dti); and
- *SMME Facilitation Program (Report Version)* by the South African Revenue Services (SARS) to be released in 2005.

Of the three reviewed studies, the first two are of a quantitative nature and present the first ever attempts at quantifying tax and other compliance costs in South Africa. The third study by SARS (2005) contains a literature review covering the first two studies and other available studies on SMMEs and the formal/informal economic divide in South Africa. In addition, a number of qualitative insights drawn from interaction with small businesses and other individuals that are aware of small business issues and problems are also included.

The scope of this review, while aimed at SMMEs in general, is to some extent determined by the content and definitions used in the three studies reviewed. While the studies mainly focus on SMMEs, the SBP (2005) study also covers large firms and “major corporations”

and the SARS (2005) study implicitly includes survivalist enterprises through its coverage of the formal/informal economic divide. The issue of comparability and alignment of definitions is not only an issue for this review, but raises a general concern over the lack of alignment in definition and focus of various government departments and initiatives.

Although focused on tax compliance costs, the review also touches on issues related to the total tax-related regulatory burden for SMMEs and contextualises the discussion within broader SMME development debate and policy.

Before initiating a discussion on tax compliance costs it is necessary to gain a broad understanding of why the impact of these costs on SMMEs is important. Consequently, the first section of the documents is focused on the rationale for assessing the impact of tax compliance costs on SMMEs in South Africa. Following on this section is a short review of a possible tax framework, indicating that tax compliance costs is only one of many costs associated with taxation. This is followed by a brief discussion of two tax jurisdictions that are known for their wide attempts at creating enabling environments for small business, the United Kingdom and New Zealand. Broad lessons that can also be applied in the South African context are extracted from the regulatory and tax compliance costs experiences of these two countries. Thereafter, the findings and recommendations of the three available South African studies on tax compliance costs are reviewed and assessed. Lastly, the review is concluded by a discussion on broad policy issues that need to be considered before deciding if and how to expend resources on actively reducing tax compliance costs.

2. Rationale for Assessing the Impact of Compliance Costs of Taxation on SMMEs

The 2004 Global Entrepreneurship Monitor (GEM) concludes that approximately 5-7.5 per cent of all South Africans aged 18-65 are self-employed, while other GEM estimates indicate that the owner-managed sector provides employment to 2.1 million individuals (Orford, Herrington & Wood, 2004). Berry et al (2002: 13) estimate the number of SMMEs in South Africa to be between 1.6 and 3 million. Of this total, it is further estimated that micro enterprises represent between 1.2 and 2.8 million businesses – between 69 per cent and 80 per cent of all SMMEs in South Africa (Berry et al, 2002: 13). It should be evident that even if these estimates are not a totally true reflection of the size of the SMME sector in South Africa, a large proportion of the South African adult labour force generates its income through self-employment or through employment provided by the owners of small businesses. The economic importance of this sector is nested in its demand-generating ability, its income-generating potential and ability to act as driver of employment creation and human capital consolidation. A successful small business sector could also make a large contribution to black economic empowerment. Even if the SMME sector is unable to deliver the above economic and social benefits, Hallberg (2000: 5) argues that “developing country governments should be interested in microenterprises and SMEs...because they account for a large share of firms and employment – in other words, because *“they are there”* (emphasis added).

The promotion of the growth and development of small, micro and medium-sized enterprises (SMME) in South Africa fits into a framework of broad social and economic development goals. The White Paper on the National Strategy for the Development and Promotion of Small Business in South Africa (RSA, 1995) notes that “the economy needs to move on a growth path of increased investment, enhanced productivity and expanding employment opportunities”. It then implies that in order to reach this growth path, “the transformation of the small-enterprise sector requires and *justifies concerted policies of wider scope as well as the deliberate creation of an enabling environment* (emphasis added)”. The White Paper proceeds to delineate nine objectives underlying a support framework for small business. Of these nine objectives, a focus on compliance costs explicitly fits into at least two objectives, namely *creating an enabling environment for small enterprises and levelling the playing fields between big and small business*.

The growing importance of the regulatory impact on businesses to government has also been noted in a number of statements by government officials, the most recent during the 2005 Budget Speech made by Finance Minister, Trevor Manuel, on 23 February 2005¹:

...we have directed attention this year at the costs and complexity for small businesses of the tax code, because there is compelling evidence that simplified arrangements can assist significantly in creating an environment conducive to enterprise development.

In addition, there also exists a sound economic rationale for easing the tax compliance costs imposed on SMMEs – efficiency (Small Business Policy Brand, Industry Canada, 2003). It is argued that the special regulatory treatment of small firms may be economically justified if the cost difference between large and small firms for complying with a specific regulation drastically reduces the competitiveness of the small firms and leads to the dominance of a few large firms (Small Business Policy Brand, Industry Canada, 2003: 11).

Furthermore, tax is different from other types of regulation (e.g. health and insurance) as it is not primarily focused on changing behaviour but is an income collection mechanism for government. Hence, the cost of collecting tax (or government income) should be minimised as it provides no productive contribution to the economy and essentially imposes a deadweight loss.

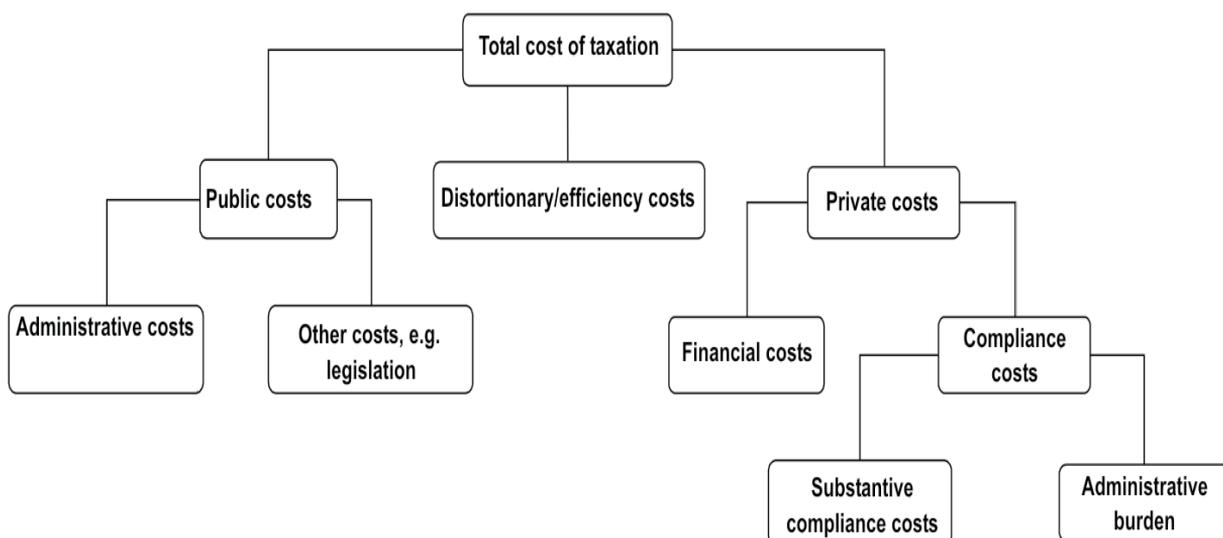
Despite many arguments for the lowering of tax compliance costs, it is important to keep in mind that while a more competitive regulatory regime, including less complex tax arrangements, could contribute to creating an enabling environment for business, a number of other factors could potentially inhibit or promote entrepreneurship to an even greater degree. These include factors as diverse as financial support or access to finance, the quality of education available through the national school system and, more specifically, the quality and availability of entrepreneurship education and the quality of government support services available to small enterprises (Orford, Herrington & Wood, 2004).

1 Available at: <http://www.dfa.gov.za/docs/speeches/2005/budget2005.pdf>

3. Cost Framework

In order to assess the relative impact of compliance costs of taxation on small, micro and medium enterprises (SMMEs) in South Africa, a framework that allows conceptual analysis of the potential relative impacts of various elements of the total costs of taxation is required. The various differentiable costs are discussed in the following paragraphs and depicted in Figure 1.

Figure 1: Cost of Taxation Framework



Public sector costs. Although this concept is relatively difficult to define, it can broadly be explained as “the public sector costs which would be saved if the tax were abolished” (Sandford et al, 1989: 3). The most important subcomponent of this cost category is administrative costs, defined as “the public sector costs incurred in administering an existing tax code (including advice on its own modification)” (Sandford et al, 1989: 5). Although other public sector costs categories can be identified, administrative costs appear to be the main determinant of total public sector costs.

Private sector costs. This main category of taxation costs encompasses a number of subcomponents. Foremost is the *financial costs* of taxation, “a result of a concrete and direct obligation to transfer a sum of money to the Government or the competent authority” (International working group on Administrative Burdens, 2004). This subcomponent can

include dues, taxes, premiums, administrative charges and fines and is unrelated to any information requirement by government.

The *compliance costs* of taxation are determined by two discrete cost categories, substantive compliance costs and administrative burdens. While compliance costs are the general costs businesses incur complying with government or taxation regulation, *substantive compliance costs* are “the costs that businesses make in order to comply with the content obligations that legislation and regulations require *of a production process or product* (emphasis added)” (International working group on Administrative Burdens, 2004). In the case of taxation, an example of a substantive cost would be the amount paid to acquire an accounting software package. *Administrative burdens*, on the other hand, refer to the cost incurred by business *in complying with a specific information obligation in regulation*, e.g. calculating the total value-added tax owed to the revenue authority for a specific tax period. Although other private cost categories can be identified, for example, psychological costs, the reviewed cost components and their subcomponents form the main determinants of the total private costs of taxation.

Efficiency/Distortionary costs. Efficiency costs refer to so-called welfare losses which arise due to the distortion of economic choices by imposition of a specific tax system and tax requirements, e.g. distortions imposed by income taxes on the choice between work and leisure (Sandford et al, 1989: 9).

Although efficiency costs can be categorised as a component of personal costs, it is arguable that these costs are imposed on the economic system as a whole, thus justifying a main cost category separate from both personal and public costs.

Interaction between different costs components. Economic decisions that affect efficiency costs are often politically motivated. Consequently, reducing compliance costs “can be relatively quick and non-controversial compared to lowering efficiency costs” (SBP, 2005: 19). From a political perspective, it is much easier to ease the administrative burden than to decrease efficiency costs, for example, by abolishing employment equity legislation. Thus, when faced with the choice between reducing efficiency costs or reducing compliance costs, politicians will more often choose compliance costs as it is an often hidden element of the cost of regulation.

4. International Context

4.1. Relative South African Performance

The World Bank's *Doing Business* series consists of annual reports that assess the impact of regulations on the ease of doing business within specific countries. In addition to the business indicators included in previous reports, *Doing Business in 2006* for the first time also includes a set of measures on "paying taxes" (World Bank, 2005b). The main indicators for "paying taxes" include:

- Total number of taxes paid;
- Time it takes to comply with corporate income tax, value-added tax and social security contributions (measured in hours per year); and
- Total amount of taxes payable by business (excluding labour taxes) expressed as percentage of gross profit.

The indicators are calculated for a "medium-sized company" and based on a large number of assumptions about the business.² It has to be noted that two of the central assumption are that the medium-sized business has 60 employees and an annual turnover of 1 050 times annual per capital income. These assumptions immediately place the business far above any South African definitions for small business.

In order to measure the tax paid by the average medium-sized business and the complexity of any specific country's tax law, a case study containing a set of financial statements, together with the aforementioned assumptions were presented to tax experts in every country. The experts then calculated the taxes owed for the business, given current regulations, as well as provided estimates on the frequency of filing, audits and other compliance costs (World Bank, 2005b). It is important to note that a survey of small business was thus not employed, limiting the statically representative nature of findings.

The relevant indicators for South Africa, Botswana, Argentina, Brazil, Peru, New Zealand, United Kingdom and OECD are contained in Table 1. Botswana is included due to the fact that it is an immediate South African neighbour as well as a developing country, while

² See comprehensive list of assumptions in Appendix B.

Argentina, Brazil and Peru are selected due to their developing country status. South Africa is often compared (in terms of economic indicators) with Argentina and Brazil, while Peru is considered a developing country that has made vast gains in simplifying its regulatory environment for small business. New Zealand and the United Kingdom are included due to their status as SMME-friendly environments and purposeful foci on reducing the compliance costs of taxation, as discussed in the Section 4.

Table 1: Ease of Paying Taxes

	South Africa	Botswana	Argentina	Brazil	Peru	New Zealand	United Kingdom	OECD
Payments (number)	32	24	35	23	53	8	22	16
Time (hours)	350	140	580	2600	424	70	No data	192
Total tax payable (% of gross profits)	43.8	52.9	97.9	147.9	50.7	44.2	52.9	46.1
Rank	84	59	143	140	133	16	81	No rank

Source: World Bank, 2005b

Compliance costs, of which the number of payments is a key driver, are captured by the indicator of time (hours) spent on doing taxes. From Table 1 it is evident that relative to other developing countries, South Africa is not performing too poorly on total hours spent on compliance costs. A medium-sized business in Brazil spends an average of 2 600 hours per year on tax compliance, while the same business in Argentina and Peru dedicates respectively 580 and 424 hours to the same activities. However, relative to New Zealand, the OECD average and even Botswana, the owner of a medium-sized business in South Africa has to spend far more time complying with tax requirements.

The high total tax payable as percentage of gross profits indicators casts some doubt on the methodology employed in the study. This indicator is defined measuring “total amount of taxes payable by business in the second year of operation except for labor taxes”, while total taxes is defined as “the sum of all the different taxes payable after accounting for deductions and exemptions” (World Bank, 2005b). The total tax payable for Brazil and Argentina seems almost implausibly high – their tax systems would need to be examined to determine whether the high rates are the result of a country-specific anomaly.

Globally, South Africa is placed in the 84th position in terms of the ease of paying taxes. Latvia is just below South Africa in the 83rd position (i.e. performs slightly better), while Croatia is found in the 85th position. It is interesting to note that the United Kingdom is placed in the 81st position, just two positions below South Africa.

4.2. Best Practice Jurisdictions

An examination of regulatory and tax best practice jurisdictions allows a number of specific insights to be gained for the issue of tax compliance costs within the South African context. The following benefits can be obtained from such an international review:

- An opportunity to gauge the impact of administrative burdens on SMME development in the context of other, broader SMME development policies.
- Identification of benchmarks indicating what the relative compliance costs of taxation can and should be; and
- Consideration of international experience on changes within the tax system that are likely to have the largest positive impact on SMMEs.

The United Kingdom and New Zealand were selected as two tax and regulatory best practice jurisdictions due to their widely acknowledged attempts and successes in fostering economic environments conducive to the growth and development of small and medium enterprises. Both these countries have extensive coordinated SME policies. This allows for consideration of the importance of tax in the broader SME development sphere and implementation histories that demonstrate successes, problems and impacts in dealing with tax compliance costs.

Attempts at creating enabling environments for small business in these jurisdictions have not been limited to reducing taxation compliance costs, although this has often been a focus area. Rather, these countries have focused on creating environments in which all proposed government policies are scrutinised under a small business lens and the interests of small business voiced through co-ordinated and centralised small business advocacy units, often situated in or linked to government. These small business units have been essential in articulating the needs of and implied required policy changes for small businesses.

The question may arise why no developing countries were included in this section. While it may be useful to gain a better understanding of South Africa's position as a developing

country, it will not be of particular use to policy makers. We have chosen the United Kingdom and New Zealand as they are quite advanced in their SME policies and have implemented a number of changes in their tax systems. This will provide insight for South Africa on the relative impact that could be expected from specific changes and will provide assistance in assessing the importance of administrative burden changes relative to other SME policy elements. South Africa also has quite an advanced tax system and comparison to developed jurisdictions may therefore be more relevant.

4.2.1. United Kingdom

4.2.1.1. The Regulatory Environment for Small Business

Since the late 1990s, the United Kingdom regulatory environment has been characterised by a number of initiatives aimed at minimising regulatory burden and stimulating business growth and development.

Reducing regulatory burden. The first recent policy action aimed at decreasing regulatory burden was the formation of the “Better Regulation Task Force” in July 1997, replacing the former Conservative government “Deregulation Task Force” (Keter, 2004: 21). This signifies a broad policy shift away from so-called “no regulation” to “smart regulation”. The main roles of the Task Force are to make recommendations to government on how to improve regulations and to provide general advice to government departments on creating regulations with the lowest possible administrative burden. Another policy initiative also explicitly aimed at creating a less burdensome regulatory environment was the passing of the Regulatory Reform Act in 2001. This Act enables ministers, subject to parliamentary scrutiny, to change or repeal laws in order to remove or reduce over-cumbersome regulatory burdens (Keter, 2004: 3). Also, the Regulatory Impact Unit (RIU), placed at the centre of government in the Cabinet Office, was created to “work with other government departments, agencies and regulators to help ensure that regulations are fair and effective” (Keter, 2004: 36). Since August 1998, regulatory impact assessments (RIAs) have been a standard requirement for any legislation to be presented to parliament which could potentially impact on business (Keter, 2004: 34).

SME representation. Certain regulatory policy initiatives have been explicitly aimed at articulating small business interests. This includes creation of the Small Business Service (SBS), an agency of the Department of Trade and Industry (dti) that works towards the goal of making the UK “the best place in the world to start and grow a business”. Central to the SBS’s function is its policy co-ordination role – it provides small business-specific inputs to all government departments. The SBS is supplemented by the Small Business

Council (SBC), an advisory non-departmental body, consisting of representatives of small business (mostly business owners), that reports to the Secretary of State for Trade and Industry on the needs of existing and potential small business, advises the Chief Executive of the SBS and advises and reports on the effects of government (including the SBS) on small business activities. In addition, the Cabinet Office guidance for RIAs includes a requirement that all RIAs must include a so-called “Small Firms Impact Test”, except in cases where the proposal only impacts on the public sector (Keter, 2004: 46).

Measure for regulatory burden. Despite the fact that the United Kingdom regulatory environment is often made subject to public and political scrutiny, the absence of an agreed upon measure of regulatory burden is notable (Keter, 2004: 42). The government has now turned to the experience of the Netherlands for guidance and is considering its pioneering methodology for calculating regulatory compliance cost, the Standard Cost Model, as possible option for measuring regulatory burden (Sullivan, 2005). The Model has already been accepted in a number of European countries as best practice for benchmarking regulatory costs.³

4.2.1.2. Specific Changes to the Tax System

Recently, a number of tax system changes have been either implemented or are in the implementation pipeline. These changes are considered to be “easy wins” in the process of lowering compliance costs (Sullivan, 2005; Inland Revenue, 2005) and include the following:

- Merging the HM Customs and Excise and the Inland Revenue Authority into one department so businesses will only have to interact with a single point of contact for tax purposes;
- Reducing the tax return from a 16 to 4-page form for 500 000 of the smallest businesses;
- Roll-out of a programme intended to assess the impact of any operational changes by the newly formed revenue department on small business. Each time an information requirement or a business practice is changed that could potentially impact on small businesses, an assessment of the impact will be made and published.

³ See Appendix A for information on the Standard Cost Model.

- Reducing small business time spent on tax inspections through movement to a risk-based system of assessment where only high-risk businesses, rather than mainly small businesses, are targeted for inspections;
- Having all senior staff responsible for policy and operations for small business in the newly formed revenue department actually spend time with small businesses in order to gain greater understanding of small business needs and issues; and
- Improving businesses' general understanding of the tax system through:
 - Release of a CD Rom on VAT for new businesses;
 - Providing better targeted information on the VAT Flat Rate scheme;
 - Offering an updated guide to tax for newly formed businesses; and
 - Trial programmes offering assistance to newly formed and small businesses when it is most needed, e.g. during start-up, tax registration or when the first employee is appointed.

Other tax measures since 1997, aimed at promoting business growth and development (and not necessarily lowering compliance costs) include the following (Inland Revenue, 2005: 5):

- Reducing the small companies' rate of corporation tax from 23 per cent to 19 per cent and introducing a zero rate of corporation tax for companies that retain up to the first £10 000 of profits;
- Introducing Research and Development (R&D) tax credits for small businesses;
- Decreasing the long term capital gains tax rate to 10 per cent for the sale of business assets;
- Introducing 40 per cent first year capital allowance on small business plan and machinery expenditure (accelerated depreciation); and
- Introducing a number of simplified tax schemes for small businesses.⁴

⁴ Although these initiatives are all aimed at promoting the growth of small businesses, it is important to note that these exemptions and benefits are viewed as one of the biggest drivers of tax complexity in the UK (Sullivan, 2005).

E-filing. In addition, promotion and use of e-filing is viewed as an essential avenue through which the compliance cost of taxation can be drastically reduced. However, even within the UK there still exists a great reluctance amongst taxpayers to submit tax forms online (Sullivan, 2005). The UK government currently plans to force taxpayers to submit tax forms online (Sullivan, 2005). The SBS, however, prefers a more incentivised approach. In addition, the SBS considers it important to promote early online submission as simultaneous submission of a large number of forms can cause computer systems to experience difficulties, exacerbating taxpayers' negative perceptions of e-filing (Sullivan, 2005).

Minimising administrative burden vs. unintended consequences. The difficulty of successfully minimising the administrative burden for small firms, while at the same time avoiding the unintended consequences of special small business tax regimes or exemptions, is clearly illustrated by the UK experience. Increasing evidence exists that some businesses purposefully stay sole traders as they do not want to take on the marginal regulatory burden implied by appointing additional employees (Sullivan, 2005). However, providing small firms with special tax regimes and implied growth incentives might not be the solution. The UK has a tax structure that provides certain tax rate benefits to small businesses linked to company legal form. The result has been that increasing numbers of self-employed individuals have been adopting the corporate legal form, despite this not being a suitable legal structure for all small businesses (HM Treasury, 2004).

4.2.1.3. Quantifying Compliance Costs

According to a regulator associated with the Small Business Service, the last reputable study which quantified compliance costs of taxation was released in 1998 by the University of Bath (Sullivan, 2005). A succinct drawback of this study, in comparing its findings to South African compliance costs, is that it only measured and analysed the compliance costs to employers of operating Pay-as-You-Earn (PAYE), Expenses and Benefits-in-Kind, National Insurance, Statutory Sick Pay and Statutory Maternity Pay (Centre for Fiscal Studies, 1998: 7). Other taxes such as income tax and corporate tax were not included. These taxes, excluding PAYE, are not directly comparable to South African taxes. Also, the compliance cost associated with PAYE was not quantified in a manner suitable for comparison with South African PAYE as its cost was combined with that of the other covered taxes.

Total compliance cost for the relevant taxes for 1995-96 was approximately £1.32 billion, amounting to 1.3 per cent of tax receipts or 0.2 per cent of GDP (Centre for Fiscal Studies, 1998: 7). The findings confirmed the fact that that the pattern of compliance costs is

highly regressive for smaller employers – the “bottom” 30 per cent of firms (in terms of employee size bands) pay nearly 75 per cent of the compliance costs for PAYE and National Insurance (Centre for Fiscal Studies, 1998: 7).

4.2.2. New Zealand

4.2.2.1. The Regulatory Environment For Small Business

The regulatory environment for small business in New Zealand is characterised by a seeming discrepancy. The World Bank rates New Zealand as the best country in the world in terms of the “ease of doing business” (World Bank, 2005a). Yet 39 per cent of New Zealand businesses in an international survey by Grant Thornton view “red tape” as a significant constraint to expansion. Next to lack of availability of skilled workforce (cited by 50 per cent of businesses), this is the second biggest constraint on New Zealand businesses (Grant Thornton, 2005). It is thus a possibility that the regulatory environment forms a *perceptual*, rather than real obstacle to doing business. This possibility is reflected in a relatively recent study commissioned by the government on the perceptions of New Zealand firms on the impact of business compliance. A main finding of the study was that despite firm owners’ seeming dissatisfaction with domestic business regulations, regulations imposed by the governments of other countries forms a bigger obstacle to firm growth and expansion, with the New Zealand government “not automatically [being] blamed for restricting growth” (Massey, 2003: 42). Furthermore, the issue of compliance costs may have been brought to the attention of New Zealand businesses through a number of recent government initiatives (discussed below) aimed at reducing compliance costs. It is possible that before these initiatives were undertaken, businesses did not really find compliance costs to be a serious obstacle and that it only thereafter became a perceptual obstacle (Group of New Zealand Regulators, 2005).

Compliance Cost Enquiries. The New Zealand government has initiated at least two enquiries specifically focused on the compliance costs of regulation on business.⁵ The first enquiry, in 1998, was conducted by Parliament’s Commerce Committee into broad regulatory compliance costs (not only tax) imposed on businesses (English & Birch, 1999: 5). The second enquiry, in the same year, was conducted by the then newly established Committee of Experts on Tax Compliance. The Committee’s terms of reference required it to investigate and make recommendations on tax compliance costs, as well as

⁵ These initiatives did not have a specific small business focus, but examined the question of compliance costs for all businesses.

the ability of the tax system to withstand tax avoidance and evasion (English & Birch, 1999: 6).

Ministerial Panel on Business Compliance Costs. In 2000, the New Zealand Cabinet established the Ministerial Panel on Business Compliance Costs, a seeming once-off exercise, to identify areas where and make recommendations on how government could reduce the compliance costs arising from then existing legislation (Ministry of Economic Development, 2005a). The Ministerial Panel released its report on 11 July 2001, leading to an iterative process during which the public was consulted and changes were made to legislation (Ministry of Economic Development, 2005a). In total, 162 recommendations were made in the Ministerial Panel report on ways for government to reduce compliance costs for business. In December 2001, the government published its response to the Ministerial Panel report and voiced agreement in some or other form to 155 of the recommendations made in the original report (Ministry of Economic Development, 2005b). In 2003, the New Zealand government reported back on implementation of the Panel's recommendations, while a co-ordinated, cross-departmental report-back on implementation of the recommendations was released in July 2005 (Ministry of Economic Development, 2005b). In the last report-back it was indicated that most of the accepted changes had already been implemented or are in the process of being implemented.

Small Business Advisory Group. The New Zealand Small Business Advisory Group was formed in 2003. It consists of nine members "from a diverse range of sectors and regions", but with the common denominator of "hands-on experience in small business" (Ministry of Economic Development, 2003a). It is intended that the Small Business Advisory group provide a business perspective in the development of all SME-related policy. The Advisory Group reports directly to the Ministerial Group for Small Business on any issues impacting on SMEs. Its first report on issues affecting small and medium-sized businesses in New Zealand was released in August 2004. In the report it was concluded, based on data collected during a number of Small Business Day events⁶, that the burden of regulatory compliance is "the single most important perceived barrier to SME growth" (Small Business Advisory Group, 2004: 16). It was also acknowledged that other policy issues where government could contribute positively to SME growth and development are the provision of business support services, access to finance and in enhancing the general environment for business (Small Business Advisory Group, 2004: i).

⁶ These events were organised with the sole intent of facilitating interaction between the Advisory Group and small business owners. This provided a direct communication channel through which small business issues and problems can be articulated.

Small Business Directorate. One of the strengths of the New Zealand government in creating an enabling environment for small business has been its co-ordinated approach. In 2003 a Small Business Directorate within the Industry and Regional Development Branch of the Ministry of Economic Development was established (Ministry of Economic Development, 2003b). The Directorate's main role is articulating small business needs and serving as advocate for small business across government. Its focus, as defined on the Ministry of Economic Development's website (2003b), include the following:

- “Informed advocacy;
- Effective small business input into development of policies that affect small business;
- Developing better understanding of Small Business; and
- Improved government service delivery to Small Business.”

The Directorate also provides secretariat services to and interacts with the Ministerial Group for Small Business, the Small Business Advisory Group and the SME Senior Officials Group.⁷ These groups meet both independently and with each other to ensure a co-ordinated government approach on the issues facing small business (Ministry of Economic Development, 2003b).

RIA Unit. In addition to the Small Business Directorate, another permanent government institution also monitors, evaluates and, if necessary, initiates changes in regulation to minimise the negative impact on business. The Regulatory Impact Analysis Unit, situated within the Regulatory and Competition Policy Branch of the Ministry of Economic Development is responsible for developing and implementing specific measures to reduce compliance costs, although not specifically aimed at small business (Ministry of Economic Development, 2005a). All policy and legislative proposals submitted to cabinet need to be accompanied by a Regulatory Impact Statement (unless an exemption applies to the particular proposal), while since April 2001 all policy proposal submitted to cabinet which are accompanied by a Regulatory Impact Assessment also need to include a Business Compliance Cost statement⁸ in the Regulatory Impact Assessment (Ministry of Economic Development, 2005c).

⁷ The SME Senior Officials Group consists of a number of senior government officials from different departments that meet on a regular basis to discuss and address SME issues.

⁸ Not specifically focused on small business.

Developing Small Business Capabilities. Complementary to the New Zealand government's focus on simplifying tax requirements for small business, is their current approach of directly developing small business capabilities. Through this approach the government can support small business owners and employees to better handle tax and other regulatory requirements (Group of New Zealand Regulators, 2005). This includes initiatives such as the provision of business training courses, provision of mentoring services and a public-private partnership specifically aimed at developing the skills of small business owners (Group of New Zealand Regulators, 2005). These training and mentoring services are provided free of charge and thus funded by government.

4.2.2.2. Specific Changes To The Tax System

The New Zealand's government's attempts at reducing the tax-related administrative burden for small business is characterised by a willingness to consult with taxpayers in order to identify their problems and to then directly address prominent obstacles and issues. For example, a government discussion document released in 2003, *Making tax easier for small businesses*, was the result of an extensive consultation process by Inland Revenue with a large number of small businesses. The consultation process included 15 formal focus groups with taxpayers and tax agents, a number of informal meetings with small businesses, a large number of telephone interviews conducted by a market research company, an internet survey, formal meetings with 30 small businesses and consultation with various industry representatives (Cullen & Cuncliffe, 2003: 5-6). The two main problems for small businesses, as identified through the consultation process, is time spent on filling in forms and the fact that provisional tax payments are not aligned with cashflow (Cullen & Cuncliffe, 2003: 7). Recommendations made in the resultant report directly address these problems.

The government's continuous commitment to simplifying the tax environment and reducing compliance costs was re-emphasised through several announcements in its 2005 national budget. Most of these announcements directly address the concerns mentioned above and enact proposals made in the 2003 government discussion document.

Innovation. An innovative change is that *payroll agents will now be paid an allowance to actively manage the payroll for the first five employees of all businesses* (Barker, 2005). It is envisaged that this will reduce the compliance cost of employment tax, especially for

small businesses. Besides the obvious benefit of allowing small business owners more time to focus on managing their businesses, it is thought that this change will increase the accuracy of employees' pay (salary) calculations, increase the accuracy of PAYE (Pay as you earn tax) calculations, reduce the risk of PAYE payment default and lead to more efficient communication between payroll agents and government (Cullen & Cuncliffe, 2003: 18-19).

More changes. Other changes also recommended in the 2003 discussion document *and formally announced in the 2005 national budget*⁹ include (Cullen, 2005):

- Alignment of payment dates for provisional tax and goods and services tax (GST), thus reducing the number of days for which interaction with the revenue authority is required.
- Moving to a system where GST-registered businesses are given the option of basing their provisional tax payments on a percentage of GST turnover, thus helping to align tax payment with cashflow needs.
- Implementation of a financial incentive for start-up businesses to pay tax in their first year of operation. Self-employed individuals and members of partnerships are offered an incentive in the form of a 6.7 per cent discount against their end-of-year tax liability for every dollar of tax paid during the first year. This equals a 10 per cent pre-tax discount.
- Simplification of the language on forms and in legislation, the complexity of which has long been recognised as a significant source of tax-related compliance cost. An initiative currently under way in this specific area is the rewriting of different parts of the Income Tax Act in order to improve its clarity and to make the language less complex.

Simplicity. Through an interview with a number of government regulators and officials it was determined that one of the main focus areas of the tax system is simplicity (Group of New Zealand Regulators, 2005). While there is often adhered to the idea that special tax regimes can encourage desired economic behaviour and potentially stimulate growth, these tax regimes can add to the complexity of the tax system and distort economic

9 Announcement of these changes in the 2005 national budget imply that they will be either fully implemented or their implementation initiated over the financial year 2005/06.

decisions. It was therefore decided to not create a special small business tax regime as can be found in the United Kingdom and Australia.

4.2.2.3. Quantifying Compliance Costs

A large benchmark survey, commissioned by Inland Revenue, on the tax compliance costs of small, micro and medium enterprises was released in June 2005. The research is intended to inform policy proposals arising over the next few years (Colmar Bruton, 2005: 7).

It is found that, on average, New Zealand SMMEs faced a combined (including internal and external costs) tax compliance cost of \$4 024¹⁰ in 2004 (Colmar Bruton, 2005: 97). Although the absolute value of tax compliance costs increases with business size (from \$2 932 for businesses with no employees to \$7 649 for businesses with more than 20 employees), the *relative* tax compliance costs displays a clearly regressive pattern.

Although compliance costs form one of the biggest obstacles to small business growth and development in New Zealand, the government has not selected a specific benchmark in terms of which tax compliance costs can be reduced. Regulators argue that whatever their relative or absolute size, compliance costs need to be continuously reduced (Group of New Zealand Regulators, 2005). This argument is supported by the fact that net compliance costs are deadweight costs. A baseline measurement of compliance costs thus simply serves as aid in determining whether compliance costs have indeed decreased on a year-on-year basis.

¹⁰ New Zealand dollar

4.2.3. Lessons for South Africa

The following broad lessons can be extracted from the United Kingdom and New Zealand experiences with creating more enabling regulatory environments, promoting small business development and reducing tax compliance costs:

1. An agency dedicated to articulating small business interests and situated within a specific government department (e.g. Small Business Service of the UK and Small Business Directorate of New Zealand) forms an essential link in the co-ordination of SMME policy. New Zealand started off with enquiries into compliance costs, but soon established a separate entity to pursue the SME agenda. This unit is relatively high-powered, situated within a specific government department and directly interacts with private sector advisory boards.
2. Special tax exemptions or tax rates for SMMEs could lead to unintended policy consequences, for example, the adoption of inappropriate legal forms (as found in the United Kingdom). It is important to have a simple tax system with the least possible number of exemptions – tax exemptions and special tax regimes, even those benefiting SMMEs, can form a main driver of tax compliance costs.
3. Innovative and new approaches to the reduction of compliance costs may be required, e.g. the New Zealand payroll decision.
4. Decreasing compliance costs is a continuous process – once-off changes cannot simply be made and then forgotten. It is necessary to commission a baseline study which can be continuously updated and used to inform the ongoing compliance cost reduction process.
5. Rather than only simplifying tax requirements, it could also prove necessary to develop the capabilities of small businesses in order to better address specific requirements.

6. Despite relatively intensive attempts at reducing regulatory compliance costs and more specific, tax compliance costs for SMMEs, no real impacts on SMME firm growth and start-up rates have been discernable. Determining whether tax compliance costs is a perceptual rather than real problem for SMMEs is important in, firstly, deciding how many resources to devote to compliance cost reduction and, secondly, for developing a successful approach to creating a more competitive regulatory environment.
7. A Regulatory Impact Unit situated within government and responsible for Regulatory Impact Analyses (RIAs) of newly proposed legislation could serve as an effective *ex ante* approach to reducing compliance costs of regulation.
8. Creating a generally supportive environment for SMMEs through initiatives such as free training and mentorship and funding the payroll agents for small business (such as in New Zealand) could prove more important for SMME growth than reducing compliance costs.

5. Reviewed South African Studies

In this section, key findings and recommendations from three available South African studies on the impact of tax compliance costs on SMMEs¹¹ are highlighted. The relevance and accuracy of the studies are discussed in the two sub-sections for each study – findings and recommendations.

In general, comparability between the three studies is limited. Broad differences are described in Table 2. While the first two reviewed studies are of a quantitative nature, the third draws on the findings of the first two and on qualitative insights gained from interaction with a number of organisations or individuals aware of small business issues. The first two studies differ in both their scope and methodology – the first covers the compliance costs of all broad regulations, while the second only focuses on VAT and Regional Service Council (RSC) Levies. In terms of quantitative methodology, the first employs the so-called “top-down” approach, while the second uses Mistral®, a so-called “bottom-up” approach.

11 The first reviewed study focuses on businesses of all sizes (micro to large corporates), while the last specifically investigates tax compliance cost issues relevant to SMMEs.

Table 2: Comparison of reviewed studies

	SBP	dti/UBS	SARS
Date	June 2005	September 2004	To be released in 2005
Purpose of study	Determine which regulations have biggest compliance impact; quantify compliance cost of most regulations; and compare regulatory costs across six economic sectors. Provide headline figure for total regulatory compliance costs.	"Enable the dti to have quantitative evidence to be used to advocate for regulatory change and to motivate for the removal of regulations that not necessary or harmful to SMMEs". Calculate the compliance costs of VAT and Regional Council Service Levies.	"Assess the degree to which the existing tax administration model affects tax compliance in the small business sector".
Range of companies covered	SMEs, large companies and "major corporations"	SMMEs	SMMEs
Definitions used	Definitions not clear. Companies categorised according to turnover and employment sizes.	No specific SMME definitions used. Calculations based on "typical firm" with "normal efficiency". It is asserted that these concepts are defined in Appendix 2. However, not included.	No specific definitions used. Highlights inconsistency and challenges of current government definitions for SMMEs. However, many of recommendations apply to very small firms, i.e. those with turnover less than R1 million.
Data	Data collected through surveys covering 1800 enterprises.	Data collected through interviews with 50 tax and accounting experts.	No primary data collected. Cites secondary data.
Methodology	"Top-down" approach.	"Bottom-up" approach, more specifically, Mistral®.	Literature review and qualitative insights drawn from interaction with individuals that have insight into small business tax issues.

5.1. SBP: Counting The Cost Of Red Tape For Business In South Africa (July 2005)

This was a pioneering attempt at quantifying broad, regulatory compliance costs (not just tax) to business in South Africa, for the first time providing politicians, regulators, business owners and ordinary South Africans with a baseline figure for the costs imposed by government regulations. The study covered a wide variety of regulations and assessed their impact on a range of firms (from micro to large).

The analysis is based on a set of business surveys covering 1800 businesses during 2004. The report uses the information gathered in the survey to assess the impact of regulations on firms over a range of specific turnover and employment size bands and to assess which of the regulations are most problematic (SBP, 2005: 5). It also estimates the impact on firms' plans to expand and extend employment, while providing comparisons between the regulatory costs faced by firms in a representative sample of South African businesses and detailing the impact on businesses in six, purposefully selected, economic sectors of interest (SBP, 2005: 5). Included in the 1800 surveyed businesses,

is 150 informal enterprises. A special in-depth survey of these informal enterprises was commissioned in order to learn more about the way regulations affect these businesses (SBP, 2005: 68).

However, despite its contribution to a better understanding of regulatory compliance costs in South Africa, the study suffers from a number of constraints if it has to be assessed relative to other international studies quantifying the compliance costs of taxation for SMMEs:

- It focuses on all regulatory barriers to business imposed by the South African government, of which tax is only one. Thus it does not delve as deeply as possible into tax compliance costs, excluding many questions which could inform policy changes aimed at decreasing tax compliance costs.
- It focuses on all sizes of formal businesses, also major corporations, and not only on SMMEs. This broad focus potentially causes the study to dilute analysis of many possible tax problems only experienced by SMMEs.
- It is not clear whether the benefits arising from tax requirements such as greater access to financial management information were quantified. The resulting headline figures thus only provide an indication of *gross compliance costs*, while the issue of net compliance costs is ignored.
- The monetary estimates of the study risk overestimation. It became clear from an interview with one of the authors of the report that respondents were asked to estimate *the monetary value* of compliance costs, rather than *time spent on specific compliance activities* (Dagut, 2005). Such an approach runs the risk of overestimation.

5.1.1. Main Findings

Most troublesome regulations. On the question about factors inhibiting the expansion of businesses, the “state interface/regulations” (thus regulation in the broad sense) was noted as the second largest obstacle to business growth (SBP, 2005: 26). Similarly, on the question of constraints on increased employment, “labour laws/government regulations in general” was also rated as the second biggest constraint (SBP, 2005: 27). For both these questions, the biggest obstacle or inhibitor was *lack of demand* in the economy. It can thus be argued that the biggest *policy obstacle*¹² to both firm growth and the expansion of employment is over-burdensome government regulations. However, regulation is a broad concept and needs to be explored further.

Specific questions on the “most time-consuming and troublesome” regulations revealed that the broad category of taxes is by far the most burdensome set of regulations (SBP, 2005: 32). Of total responses, 19 per cent cited requirements associated with VAT as the most burdensome set of regulations, while “SARS tax administration”¹³ formed the third most burdensome set of regulations (12 per cent of responses), requirements associated with UIF the fourth most burdensome set of regulations (approximately 10.5 per cent of responses) and regulatory requirements associated with PAYE the fifth most cumbersome and time-consuming set of regulations (roughly 8.5 per cent of responses). In the discussion of these findings, it is argued that a large part of tax compliance costs is due to the complexity of tax forms and other paperwork (SBP, 2005: 32).

If analysed by firm size, responses on the most troublesome regulations reveal that VAT is associated with the most troublesome set of regulations for the smallest categories of firms’ sizes with less than 100 employees (<5; 5-9; 11-49; 50-99), but is replaced by SARS tax administration as the most troublesome regulation for firms with more than 100 employees (SBP, 2005: 33). It is interesting to note that the firm size band that finds VAT the most troublesome is the “fewer than 50 employees” band, with approximately 32 per cent of responses in this band citing VAT as the most troublesome regulation (SBP, 2005: 34). One explanation suggested for the peak in this size category is the likely perception amongst firms in this category that their workload will increase significantly if they employ more than 50 employees (SBP, 2005: 34). However, the relevance of this explanation is questionable as the amount of compliance cost associated with VAT is more likely to be directly linked to turnover size, rather than employment size.

¹² While poor demand in the economy can be considered a policy outcomes, it is not a policy in itself.

¹³ The precise definition of this compliance activity was not made clear in the report.

Analysis by economic sectors (Pharmaceuticals; ICT; Tourism; Clothing & Textiles; Agri-processing; Automotive) reveals the sectors that find VAT the most troublesome is the ICT and textile sectors (SBP, 2005: 34). It is not very clear why firms in these sectors find the compliance requirements associated with VAT more troublesome than those in other sectors. It may be because of the absence of sector-specific regulations, increasing the *relative* burden of VAT.

Quantifying compliance costs. The study also includes quantification of the impact of tax compliance cost as percentage of firm turnover. The data, as found in Table 3, displays a clearly regressive pattern. While firms with a turnover size of less than R1 million are faced by average tax compliance costs of 2.9 per cent of turnover, this gradually decreases to 0.003 per cent for firms with an annual turnover of more than R1 billion. However, it must be noted that there is a quite a large decrease between the first turnover and second turnover categories. This can probably be ascribed to the large difference in median firm turnover sizes in these two categories. While the median turnover size for firms in the first category equals R390 000, that for the second category is R2.75 million – more than seven times larger than the median firm in the first category.

Despite the fact that the SBP study allows for quantification of the impact of tax compliance cost by turnover size, it does not allow for the identification of particular problematic business categories. Although the employment and turnover categories are useful, it does not distinguish between the sector and nature of businesses (which will be relevant for VAT). It also does not provide details of how finances are managed, e.g. accounting software, outsourced recordkeeping, etc. The specific distribution of firms according to different turnover categories as illustrated in Table 3 is also not clear.

Table 3: Tax Compliance Cost as Percentage of Firm Turnover

Business size (by turnover in R)	Annual cost of compliance with tax regulations as percentage of turnover
<R 1 000 000	2.90%
R 1 000 000 - R5 000 000	0.90%
R5 000 000 - R10 000 000	0.40%
R10 000 000 - R25 000 000	0.30%
R25 000 000 - R100 000 000	0.15%
R100 000 000 - R500 000 000	0.04%
R500 000 000 - R1 billion	0.03%
>R1 billion	0.003%

Source: Source: SBP, 2005

Tax vs. total compliance costs. The SBP study (2005: 73-74) estimates that the total recurring compliance costs (for all surveyed regulations) for the formal sector in South Africa amounted to R78.90 billion, an amount equivalent to 6.5 per cent of GDP in 2003 and 18 per cent of SARS revenue in 2002/03. The tax compliance costs are estimated to be R20.5 billion, roughly 26 per cent of the total compliance burden and slightly more than 1.5 per cent of GDP in South Africa for 2003 (SBP, 2005: 87) The final aggregate figure for tax compliance is based on an estimate that the average annual tax compliance cost totals R27 298 (SBP, 2004: 40). This number encompasses two sub-totals, one R15 709 for tax compliance (internal) and the other R11 589 for professional fees (external).

5.1.2. Recommendations

This study makes no specific recommendations on *how the compliance costs of tax can be decreased or limited*. It is, however, important to note that a number of “suggestions on how the whole government system could begin to think about how to ensure that the costs of regulation are justified by the benefits” are made (SBP, 2005: 90). The relevant suggestions are supported by the notion that a strong movement to the principles of regulatory best practice (RBP) is required, while “creative and flexible” approaches to regulation must also be followed (SBP, 2005: 90). Such approaches entail identifying all possible policy options, carefully considering each of these options and also identifying their potential unintended consequences. However, in addition to creative and flexible approaches to regulation, it is argued that more concrete, practical tools for the management of the regulatory environment are essential (SBP, 2005: 90). Possible regulatory management tools which need to be considered for the South African context include (SBP, 2005: 91-95):

- Regular regulatory costs surveys;
- Regular regulatory reviews, which can include *retrospective* regulatory reviews and *prospective* regulatory reviews (Regulatory Impact Assessments); and
- Encouragement of a more competitive economic environment through, for example, expanding the advocacy and education roles of the general competition authorities and sector regulators.

5.2. Upstart Business Strategies (UBS): Measurement of Value-Added Tax and Regional Services Councils Act-Induced Administrative Burdens for South African Small Businesses (September 2004)

This study was commissioned by the Department of Trade and Industry (dti) in order to quantify the cost of regulatory compliance by SMMs. The original terms of reference required the quantification of the compliance costs of the broad areas of taxation legislation, labour legislation, business trade, commercial laws, foreign trade and certain by-laws and regulation (UBS, 2005: 17-18). However, it became clear that analytically rigorous and reliable quantification could not be achieved for all the areas of regulation within the scope of the study. The focus was therefore narrowed to include only the area of taxation legislation and, more specifically, two pieces of legislation, the Income Tax Act and the Regional Services Levies Act. These pieces of legislation were selected based on a preliminary survey where SMEs were asked to rank the burdens of various regulations (UBS, 2005).

The study utilises the so-called “bottom-up” approach to measurement of regulatory impact. More specifically, Mistral®, a proprietary regulatory measurement technique originally developed in the Netherlands, is used¹⁴ (UBS, 2004: 13, 19). Common to this specific technique and the more general “bottom up” approach is the fact that they mainly focus on quantification of data transfers.¹⁵ The specific actions and sub-actions associated with a particular data transfer are first identified, where after investigations into the time taken to carry out the activities lead to the calculation of a standard time per average activity and the calculation of a standard frequency per activity (UBS, 2004: 19). The standard time and frequency, together with average labour cost per hour (depending on the level of employee performing the activity) are then used to calculate an average cost per compliance activity per firm.

The Mistral® approach is characterised by the fact that the administrative activities enterprises would carry out in the absence of legislation/regulation are not included in the final quantitative estimates of compliance costs (UBS, 2004: 19) To do this, the study

14 A “derivative” of Mistral®, the Standard Cost Model, has since been developed in the Netherlands and is being used by a number of European countries to facilitate comprehensive and standardised measurement of administrative burdens (UBS, 2004: 13). See Appendix A.

15 Within the Mistral® approach, data transfers are defined as “any information transfer between businesses and government agencies to inform the government agencies in order to facilitate (a) the actions of these government agencies and (b) the process of maintaining compliance” (UBS, 2004: 19).

makes the assumption that only 25 per cent of recordkeeping activities can be directly ascribed to tax compliance and that the other 75 per cent of recordkeeping activities are due to essential management activities and thus to the benefit of the firm (UBS, 2004: 27). The analysis is quite sensitive to this assumption, particular in cases where recordkeeping is outsourced.

The main constraint of the study is that it only focuses on two specific taxes – Income Tax and Regional Service Council Levies. In addition, it was recently announced that Regional Social Council Levies would be abolished from August 2006 onwards (see Section 6). It is not clear whether this decision was inspired by the findings of the study or driven by other issues. Thus only the findings specific to one tax are relevant here.

It is possible that the small sample size of the study¹⁶ limits the statistically representative nature of the findings. The gathering of information from accountants is a novel idea, but may skew the findings.

The final data collected for the study were not accessible for the purpose of this review. More specifically, at least three questions related to the data generated need to be answered using available data:

1. How sensitive are the final VAT estimates to the 25 per cent assumption made in the study?
2. How large are the reductions in VAT compliance costs that can be attained by actively promoting the use of e-filing?
3. How large are the reductions in VAT compliance costs that can potentially be achieved by actively promoting the use of accounting software?

¹⁶ The baseline measurement is based on structured interviews with 50 experts, including tax specialists, accountants and bookkeepers (UBS, 2004: 23)

5.2.1. Main Findings

Table 4: Cost of Complying with VAT for Recordkeeping and Completion of Tax Return

	Recordkeeping	Tax return	Total
Average cost for all enterprises	R3 556	R2 471	R6 027
Manually	R 890	R2 130	R3 020
Tax software	R 890	R 586	R1 476
Outsourcing	R5 333	R3 728	R9 051

Source: UBS, 2004

Table 4 contains information on the compliance cost of recordkeeping and the completion of the tax return according to different categories of complying with VAT (manually, using tax software and outsourcing). Taken at face value, the quantitative findings suggest two key conclusions:

- Firstly, it is much more expensive to outsource recordkeeping and completion of the tax return than to do it in-house. While the average annual cost per enterprises for outsourced recordkeeping and completion of the tax return is R9 051, performing the same function manually within the firms costs R3 020. This finding is counter-intuitive and may be driven by the 25 per cent assumption.¹⁷ The internal cost of time spent on recordkeeping, as used here, may be misleading. The study should not only quantify the time estimated to be spent on compliance with tax as an annual salary is paid irrespective of work done. If 25 per cent of time is spent on compliance, 25 per cent of the annual salary of an employee should be allocated to recordkeeping.

¹⁷ According to the 25 per cent assumption, only 25 per cent of total recordkeeping costs are directly ascribable to tax compliance costs.

- Secondly, using advanced tax software for recordkeeping and calculation of final VAT can significantly reduce the administrative burden. In fact, using tax software is by far the cheapest option for complying with VAT requirements. While manual recordkeeping and completion of the tax return have an average cost per enterprise of R3 020 per annum, the average cost per enterprise for performing the same functions using tax software only costs R 1 476 per annum.

Table 5: Once-Off and Structural Burdens Imposed on SMMEs by VAT Requirements

Information obligation	Total in Rm	Average per SMME in R
Once-off burdens		
Registration for VAT	30	1063
Communication with the SARS	12	97
Inspections by the Commissioner	26	506
Notify changes	3	83
Deregistration for VAT	1	664
<i>Total once-off burdens</i>	72	2 414
Structural/recurring burdens		
Recordkeeping	3 071	3 556
Tax return	1 227	2 471
<i>Total structural burdens</i>	4 298	6 027
Final total (structural and once-off burdens)	4 370	8 414

Source: UBS, 2004

As illustrated in Table 5, once-off burdens such as registration of VAT, communication with the SARS, inspections by the Commissioner, notification of changes and deregistration for VAT are not the greatest contributors to total compliance costs of VAT. Rather, it is the structural or recurring burdens, namely recordkeeping and completion of the tax return, that make the greatest contribution to total VAT compliance cost. The aggregate compliance cost of VAT costs South African firms approximately R4.3 billion per annum.¹⁸ If it is assumed that not all so-called once-off burdens occur within any specific year, it

¹⁸ The overall Rm figure is obviously sensitive to the number of SMEs used in its final calculation.

can be concluded that the annual VAT compliance cost per average SMME is an amount between R6 027 and R8 414.

5.2.2. Recommendations

The following recommendations were made to decrease the compliance costs associated with VAT (UBS, 2004: 45-46):

- *Improve the internal reliability of SARS logistics.* Often small informational changes such as the registration of a new address and provision of other information to SARS takes much longer than it should. By improving internal SARS logistics and even providing taxpayers with the option of online or telephonic changes, it is possible to minimise administrative burdens. However, it must be noted that this is a relatively infrequent activity and improvement of SARS logistics will thus not have a large impact on compliance cost reduction.
- *Expand online filing possibilities (e-filing).* Using e-filing, rather than manual submission of tax forms, has the potential to reduce the compliance costs of firms substantially. The implementation of education campaigns to expand taxpayers' confidence in e-filing is a potential mechanism that can be used to achieve this goal.
- *Minimise queuing time spent at SARS offices.* Often taxpayers that submit their tax forms manually as they do not trust e-filing, spend long time periods queuing at SARS offices. It is estimated that if SARS could reduce the average time spent on submitting a VAT return form from 45 minutes to 20 minutes, the administrative burden can be reduced by as much as R38 million (58 per cent of the estimated total cost of the activity). However, it might be a more efficient approach to focus on promotion of e-filing than improving internal SARS processes.
- *Promote the use of electronic invoicing and tax software.* The use of electronic invoicing and tax software can reduce the time, and thus also compliance cost, associated with recordkeeping. However, not all SMMEs can afford computers and tax software, or know how to operate it. Provision of training could help solve the latter problem.

- *Reduce the frequency of submission periods.*¹⁹ The report argues that a reduction in the submission frequency from, for example, every two months to twice a year for all SMMEs, could reduce the administrative burden for this activity by as much as R1.17 billion (67 per cent of the estimated total cost of the activity). However, it is necessary to also consider the cashflow problems which can be stimulated by such a change.

5.3. SARS: SMME Facilitation Programme Report Version (Released in 2005)

An increased focus by government on SMMEs in 2004 led to the South African Revenue Services (SARS) being asked by the Minister of Finance, Trevor Manuel, to “assess the degree to which the existing tax administration model affects tax compliance in the small business sector” (SARS, 2005: 4). In response, SARS convened the National SARS SMME Task Team, a body consisting of independent academics, representatives of organised business, SARS representatives and representatives from other government departments (SARS, 2004: 4). The team’s mandate was to “review and identify” tax administrative burdens, tax compliance costs burdens and “general administrative concerns among small businesses such as understanding requirements and time spent dealing with SARS” (SARS, 2004: 4). In fulfilling this mandate, the team reviewed a number of available documents on the South African SMME context, the existence and nature of the dual economies in South Africa, as well as the two studies reviewed above (the only available South African studies that quantify regulatory compliance costs). In addition, the team also consulted with many stakeholders, “including tax specialists, accounting bodies such as the SAICA, CFA, ACCA and others”, as well as meeting directly with small businesses, the representatives of SMME apex bodies and female entrepreneurs (SARS, 2004: 4).

While not necessarily adding any new quantitative information to the compliance cost debate, the resultant report contributes a number of valuable qualitative insights and serves as a starting point for changes that need to be made to the South African tax system to ease the compliance burden of SMMEs. It is important to note that the findings and recommendations are made in a context where the main focus is not income maximising

¹⁹ The implementation of this recommendation was announced during the most recent budget speech in February 2005. For firms with an annual turnover of less than R1 million, the VAT submission period has been reduced from once every two months to once every four months from August 2005, i.e. from six to three times per annum

income for government, but rather stimulating employment and incentivising informal businesses to formalise.

5.3.1. Main Findings

Probably the most prominent conclusion of the SARS study, after examining both the broader SMME policy environment and specifically tax and compliance cost issues, is “that small business will not live or die by SARS intervention alone” (SARS, 2005: 24). This sets the scene for a number of broad findings, which in turn, form the basis for the recommendations discussed in the followings section. Some of the main findings,²⁰ with a few clustered under common headings, are discussed below (SARS, 2005: 24-31):

- *Absence of a consistent definition for SMMEs and lack of co-ordination in government policy.* The literature revealed that there is no consistent definition for small business in South Africa, even between different government departments. This has proved highly problematic in formulating coherent government policy. A lack of co-ordination between government departments is also increasing the time spent by small businesses on compliance. Business registration requirements are currently handled by 5 different government offices and cannot be considered a co-ordinated process.
- *Smart regulation.* Rather than enabling reform through deregulation, an approach of so-called “smart regulation” is required.
- *Manage the tension between two economies.* It is necessary to manage the tension between the two economies. However, it needs to be acknowledged that a dual tax system “may compromise the principle of equity and fairness” and if a special small business tax regime is created it needs to be informed by “broad economic policy objectives”.
- *Incentivising formalisation and small business growth.* Mechanisms are required to incentivise formalisation of the second economy. In enabling/ promoting formalisation of businesses, two key aspects are essential, i.e. offering protection by state institutions (e.g. safety and security) and more efficient businesses processes for formal sector businesses, for example, shorter tax processing times.

²⁰ Although the conclusions are presented as “findings”, in some cases they appear to be similar to recommendations.

- *Fear and apathy.* Many business owners are staying outside the tax net due to fear and apathy regarding SARS and SARS processes. In order to eliminate negative perceptions, it is necessary for SARS to *move from a negative-feedback approach to a positive-feedback approach.* This implies communicating with taxpayers not only when something goes wrong in the tax process, but communicating beforehand in a positive, constructive manner as to establish a trust relationships.
- *Burdensome taxes.* The most burdensome taxes for SMMEs are VAT and the Skills Development Levy (SDL). Benefits from the Skills Development Levy can only be obtained if businesses comply with a number of complex requirements. The RSC levies are viewed more as an irritation than as a real burden.
- *Improved communication with SARS.* A number of changes can be made to improve communication between businesses and SARS, as well as businesses and government. This can include actions as diverse as improving general services provided to taxpayers and co-ordinating compliance strategies by government as a whole.
- *Administrative burdens.* Specific administrative burdens cited by business owners during the interaction process include too many procedures in filing for tax, too many forms to complete to function as a formal business entity, the general administratively time-consuming nature of tax, complexly written tax codes and the high frequency of submitting tax returns.

5.3.2. Recommendations

A large number of detailed recommendations are presented in the SARS study (2005: 35). It is important to note, however, that the recommendations are introduced by a general disclaimer stating that not all proposed changes or recommendations can be implemented at the same time and that some are only intended to be investigated over the longer term. Although most of these recommendations will help to reduce tax compliance costs, *it is not clear what their relative impacts will be*. It is important to note that many of the recommendations address issues raised in the two preceding studies. As the recommendations contained in the report are relatively detailed, the main recommendations are reviewed in very broad terms here²¹:

- Increase the 15 per cent tax cap from R150 000 to R200 000 taxable income for SMMEs.²² In addition, also consider rapid depreciation of assets for companies with capital expenditure less than R5 million, review the definition of Employee Company²³ and increase the limit of the new VAT invoicing system from R3000 to R10 000.
- Decrease tax compliance cost through a number of improvements in SARS communication channels, including promotion of e-filing to all SMMEs, establishment of an SMME-focused call centre service and the creation of single point of registration for all levies and taxes at a Small Business Centre (to be accompanied by Small Business Desks in all SARS offices nationwide).²⁴

21 The reviewed recommendations are not exhaustive of all recommendations made in the report.

22 Although the recommendation was phrased in terms of SMMEs, it most probably refers to Small Business Corporations (SBCs). This recommendation has already been implemented in the current budget and to an even more lenient degree than suggested here.

23 So-called Employee Companies are currently excluded from the formal definition of Small Business Corporations (SBCs) and are thus not eligible for the benefits received by SBCs. An Employee Company is a labour broker as defined in the Income Tax Act of 1965 and/or a personal service company

24 The placement of small business help desks in all SARS offices nationwide was announced in the 2005/06 budget.

- With respect to VAT, the following include some of the suggestions and recommendations made:
 - Reintroduce the cash basis of accounting for companies with a turnover of up to R2.5 million²⁵ ;
 - Allow small businesses to choose between VAT payment on cash basis and VAT payment on invoice basis; and
 - Reduce VAT returns from six to three per annum.
- Reduce the time it takes to issue tax compliance certificates to 48 hours through establishment of an electronic link between tender boards, government departments, parastatals and the private sector.
- Investigate creation of a special tax regime for small businesses. A presumptive tax for small businesses in some sectors of the economy needs to be considered.²⁶
- Focus on simplification of the language used on forms, combine different forms into one and promote general taxpayer education.
- Create a favourable regime for voluntary disclosure of underpaid or overpaid tax. This is intended to function as *an alternative to a tax amnesty*.
- Special recommendations to government include the establishment of an *interdepartmental task team* that should focus on the overall regulatory burden impacting on small businesses and creation of a *Small Business Ombudsman* whose main function would be to establish communication between the interdepartmental task team and small businesses. Other general recommendations to government included considering cancellation of RSC levies and revising Skills Development Levy requirements for small businesses.²⁷

25 Currently the invoice basis of accounting is being used.

26 Given the warnings against the potential distortionary impacts of a special tax regime for small business in the SARS study's findings, it is interesting that this recommendation was made.

27 These two recommendations were acted upon in the most recent national budget.

6. Enacted Tax Changes for Small Business (2005/06 Budget²⁸)

In the 2005/06 financial year, a number of measures aimed at reducing the compliance cost of taxation and promoting the growth of small business, e.g. through the lowering of tax rates and broadening the tax brackets of Small Business Corporations (SBCs)²⁹, were announced. It is important to review these announced changes as they address some of the recommendations made in the reviewed studies and also have direct implications for remaining policy options. It is important to note that announcement of these changes in the 2005/06 budget imply that they either have already been implemented or will be implemented over the course of the financial year, except if noted otherwise. The announced changes are briefly highlighted in the remainder of the section under three main headings:

- Decreasing the administrative burden;
- A stronger small business focus; and
- Financial relief.

28 This section is mainly based on information provided by SARS to small businesses through a pamphlet entitled What is in the Budget for small business? 2005/06...in a smaller nutshell and a document titled Small Businesses: FAQs, available at <http://www.sars.gov.za/Contents%20page/Small%20Business%20FAQs%20final.doc> (Accessed on 18/08/2005).

29 A recent SARS document on "Small Businesses: FAQs" (2005) asserts that "in order to qualify as a small business corporation (SBC), you must comply with the following requirements:

- Shareholders or members must be natural persons and must hold the entire shareholding during the entire year of assessment;
- The gross income for the year of assessment may not exceed R6-million;
- Not more than 20 per cent of the gross income (receipts, accruals and all capital gains) of the company or close corporation must consist collectively of investment income and income from the rendering of a personal service;
- Shareholders or members may not at any time during the year of assessment hold any shares or interest in another company or close corporation (other than a listed company, unit trust, share block company or sectional title body corporate); and
- The company or close corporation must not be an employment company.

Decreasing the administrative burden:

- Only one form will be required to register for all taxes, also Income tax and VAT.
- The principle of *Voluntary Disclosure* will be implemented. All small businesses not registered for tax or those that did not declare all income are given the opportunity of entering the tax system and rectifying income discrepancies without the threat of prosecution.
- A single customs declaration will be implemented, i.e. imports and exports are captured in one form.
- Applications for tax clearance certificates can now be made online using the e-filing system.
- For firms with an annual turnover of less than R1 million, the VAT submission period is reduced from once every two months to once every four months from August 2005 onwards, i.e. from six to three times per annum. *Although this is a commendable change, it is necessary to ask why it has not been extended to larger firms.*
- The Small Retailers' VAT package is introduced from April 2005 onwards. This package is a simplification of VAT accounting and is aimed at business registered for VAT with a turnover of less than R1 million that mainly function in the retail sector and do not have access to cash registers that can distinguish between zero-rated and standard-rated sales. The package includes a free set of pre-printed books that will help vendors keep track of stock purchases and daily sales. This change can thus be seen as directly targeting those small businesses in the greatest need of compliance cost reduction.
- A single national call centre number will be established for all tax and customs queries.

A stronger small business focus:

- SARS will be sending community tax helpers to support small businesses with tax issues such as registration, tax returns and other complexities.
- Small business help desks will be made available for small businesses in the call centre and at SARS offices.
- A dedicated VAT information campaign will be undertaken³⁰.
- Accounting and payroll packages will be made available by SARS to small businesses. Small businesses can obtain the software from SARS or use dedicated computer kiosks in the SARS offices.

Financial relief:

- Abolishment of all regional social council (RSC) levies from July 2006. However, it must be noted that the levy will most probably be replaced by some other local council tax. A replacement income collection mechanism is still being considered.
- Small businesses with an annual payroll of less than R500 000 are made exempt from paying Skills Development Levies from August 2005 onwards.
- The tax rate for close corporations and companies is decreased from 30 to 29 per cent.
- Preferential tax treatment for Small Business Corporations (SBCs) is extended to include more service industries. The maximum annual turnover to qualify as a SBC is also increased from R5 million to R6 million, while the tax brackets for this category of small businesses are broadened. In addition to the current 100 per cent write-off for manufacturing assets, SBCs are now eligible for accelerated depreciation on a 50:30:20 basis for all other assets over a period of three years.

³⁰ As small businesses tend to carry the largest relative tax burden, it can be argued that this action will mainly be to the benefit of SMMEs

- The tax threshold for sole proprietorships and partnerships is increased to R35 000, i.e. those with taxable income less than R35 000 pay no tax, while tax brackets for this category of small business owners are also broadened.

7. Policy Considerations and Conclusions

The preceding sections provide a critical review of three recent studies on the compliance cost of taxation for SMMEs. The first two of these studies (by SBP and UBS/dti) focused on quantifying various aspects of the compliance burden and are the first studies to do so for South Africa. The review showed that, although the studies did groundbreaking work, there are still a number of gaps in our understanding of the burden and particularly identifying the exact components of the SMME market in which policy intervention is required. The third study (by SARS) draws on the first two as well as qualitative insights gained from interaction with a range of SMMEs and organisations aware of small business concerns, to make concrete recommendations on how to address the key compliance issues identified. The recommendations speak directly to the problems identified in the three studies and will provide compliance relief for the key problem areas identified. The recommendations also extend beyond technical tax proposals to also include recommendation better co-ordination of SMME policy.

In addition, this document provided a high level review of the importance of tax compliance burden as a policy issue in two of the leading SMME-friendly jurisdictions internationally. The selection of developed country case studies, although not directly comparable, was intentional as these jurisdictions have already progressed on the path of implementing SMME friendly regulation and creating a supportive environment for SMME development. The review also found that South Africa has a quite advanced tax regime and is ahead of many of its peers. Comparison with developed jurisdictions is, therefore, relevant and provides useful insight into the potential impact of specific policy options. It is particularly useful to note the position of initiatives around tax regulation within the broader SMME development framework implemented in these countries.

Based on the review of the South African situation and international experience, the discussion in this section will highlight a number of policy issues and questions emerging from the research and international context. Policy considerations extend beyond the implementation of technical changes to tax legislation (which may be one component) to include consideration of the broader direction and strategy pursued by government with regards to SMMEs.

Policy Issues to Consider:

Is the Tax Compliance Burden a Problem for SMMEs in South Africa?

Insufficient information allows limited inference. Information available on SMMEs in South Africa varies substantially and does not provide an accurate or sufficiently detailed base for policy development or impact assessment. The SBP and UBS studies reviewed in this report did groundbreaking work based on their own surveys but have constraints which affect the extent to which policy options can be drawn.

The SBP study focused on all categories of regulation across companies of all sizes and, therefore, does not provide sufficient detail for the development of targeted policy initiatives. Although it is clear that the problem is mostly in the category of smallest firms, the analysis does not provide insight into the various types of firms or life stages within that category. It also does not provide insight into potential causes of the burden (e.g. not using tax software, skills levels, etc.). Cost estimates are also based on the respondents' estimate of compliance cost, rather than measuring time/effort required, which can then be quantified using reasonable remuneration rates. This may result in costs being over-estimated.

The UBS study followed best practice cost estimation methodologies, but is hampered by the small sample size, which also does not allow for a sufficiently detailed exploration of the causes of the compliance burden. Some of the assumptions are also questioned in this review and may result in an over-estimation of the burden. The primary example is the assumption that 25 per cent of bookkeeping time is spent on compliance, which seems exaggerated. The impact could be substantial as the record keeping component is the largest contributor to estimated compliance cost.

For both studies, the overall estimate of cost to the economy relies on estimates of the number of SMMEs in the market from other surveys. The results of the various surveys are widely diverging and accuracy is questionable. This is problematic as the estimates of cost to the economy are highly sensitive to the underlying estimates of number of firms.

The surveys therefore confirm that tax compliance burden ranks highly for SMMEs but the estimates of cost to individual SMMEs and the economy still needs to be debated.

Reduced or supported compliance. Linked to the issue of information quality is the question over what level of compliance burden is acceptable? It may be useful to have a 'lowest possible cost' policy approach but this may not be the most efficient.

In an environment of constrained resources and capacity, it would be more appropriate to direct the energy and efforts to those areas that offer the biggest gains. In addition, international experience suggests that there is a point beyond which further reductions in compliance burden is difficult to achieve. At this point, it becomes more effective to support affected institutions in complying rather than to reduce the compliance burden. To do this, it would, for example, be necessary to compare further effort in reducing compliance burden with efforts to support specific categories of SMMEs in compliance.

Compliance cost should be minimised. This report does not argue against the finding that compliance burden results in unnecessary costs for SMMEs. What is questioned is the size of the impact, the gains that could reasonable be achieved by improving tax systems, and the priority it should receive in policy aimed at SMME development. On the issue of the size of the impact, we conclude that there is a risk of overestimation on the one hand and on the other, an inability to accurately identify the key areas for policy intervention. Strategies should be put in place to improve the information available on the SMME market. *Improved information would allow a more accurate assessment of the impact and the identification of key market segments (e.g. start-up companies or specific industries) to focus policy on. It will also allow for the assessment of policy related to reducing compliance costs relative to other support strategies available.*

Need to Co-ordinate SMME Policy Amongst Government Departments

Despite the intentions encapsulated in the White Paper on the National Strategy for the Development and Promotion of Small Business in South Africa, SMME policy is not coordinated or aligned. In its simplest form this can be seen in the different SMME definitions used across government departments. The result is duplicated and conflicting efforts and a loss of the synergy that could be achieved if, for example, SMME tax policy is aligned with dti support initiatives.

Acknowledging this problem, the SARS (2005) study recommends the creation of a more co-ordinated approach to the development of SMME policy. This includes establishment of an interdepartmental task team by SARS and Treasury to focus on "overall regulatory burdens affecting small businesses in general" and the possibility of establishment of a Small Business Ombudsman who would need to facilitate interaction between the task team and small business and represent the interests of small business.

While we strongly support the call for co-ordination, the role of an ombudsman is to deal with complaints and we believe a more pro-active approach is required. The review of international experience shows that process of effecting SMME policy changes commences with once-off research and task teams to investigate the problem, but that one of the first steps beyond this initial phase is to establish a dedicated government unit focusing on SMME development. The role of this unit extends beyond dealing with complaints to representing SMME interests at all levels of government and playing a pro-active role in ensuring that all policy initiatives consider the needs of SMMEs. Such a unit should be sufficiently empowered to effect change within government. In addition, the international review showed that the small business co-ordination units also support the process of regulatory impact assessments.

Incentivise the Use of Existing More Efficient Compliance Mechanisms

Tax burden or firm-level inefficiencies? The UBS study showed that the cost of compliance can be substantially reduced if e-filing and appropriate bookkeeping software is used. The study found that firms moving from manual bookkeeping to using software can halve their compliance cost (see Table 4). The use of e-filing (rather than queuing at SARS) will reduce this further. From a policy perspective, it is therefore essential to also consider efficient implementation of existing mechanisms before creating new mechanisms to deal with the same problems. The compliance burden reported by firms may, therefore, reflect poor management decisions and not just burdensome compliance processes. A Canadian study notes that “firms that do not incorporate best business practices may have more difficulty meeting regulatory requirements, thereby leading to the conclusion that there is a compliance problem, rather than a management skills one” (Small Business Policy Branch, Industry Canada, 2003).

This is expected to be particularly relevant for the smallest firms who are the least likely to be using software and e-filing. Although the data did not allow further interrogation, we believe that this may contribute a significant proportion of the excessive burden found for the smallest company category in the SBP study (see Table 3). The smallest company category (<R1m turnover) showed a burden of 2.9 per cent of turnover relative to 0.9 per cent for the second category (R1m to R5m). Closer investigation revealed that the median turnover in the first category was R390 000, which means that many of the firms in this category were micro companies. It is, therefore, quite likely that they would not be using accounting software and e-filing.

Cost and risk deter use of efficient mechanisms. In addition to simplified compliance, it is also in the business interest to use software to more accurately manage its financial position. The major deterrents for smaller companies, which may delay the purchase of such software, may be the cost. Incentivising the use of software should focus on educating SMMEs on the benefits of using accounting software and reducing the cost for SMMEs to acquire the appropriate software. It is promising to note that the SARS study includes a recommendation on making accounting and payroll packages available to SMMEs. It is, however, not clear how this will be done. Another recommendation which has been implemented is provision of accounting software kiosks within SARS offices, but whether firms will actually make use of these facilities is questionable.

It should also be noted that while potentially large compliance cost reductions can be achieved through increased usage of accounting software and e-filing, not all small firms will have the internal capabilities to manage these tools.

While the use of tax software may simply be a cost issue, convincing companies to move to e-filing may be more complicated. The UK government has noted the benefits of e-filing for smaller firms (in addition to reducing the administrative cost of regulation for the tax authority) and are considering making the use of e-filing compulsory. System capacity, particularly dealing with high volumes around submission dates, has been a major source of frustration for firms and would have to be corrected before compelling firms to use it.

In South Africa, the risk of accidental non-compliance due to system failure is a potential barrier to extending the use of the e-filing system (see below).

Establish Protection Mechanisms for SMMEs within the Regulatory Authority

Risk of accidental non-compliance deters the use of more efficient mechanisms. One reason why smaller firms are hesitant to use e-filing is that they face a substantial risk in the case of accidental non-compliance. Ironically, this is in large part due to the efficiency of SARS' enforcement drive, which far outweighs the efficiency of its support initiatives for SMMEs.

As an example, a problem with the e-filing system in which a submission is lost will immediately result in penalties and a protracted (and often legal) interaction with SARS in order to rectify the situation. This is the case, even if the problem is in the SARS system and not on the side of the SMME. As the burden of proof of compliance rests with the SMME, it is up to SMME to engage with the complicated internal systems and hierarchies

in order to rectify the problem. This weighs particularly heavily on smaller companies who often do not have the resources to engage with SARS.

Strong enforcement and internal control mechanisms are essential for a tax authority and it is understandable that this may lead to a complicated bureaucracy. The current system, however, places a heavy burden on SMMEs and ways should be sought to address this.

Define output targets. Some improvements in the management of queries and tax bureaucracy can be achieved and the recommendations of the SARS document present steps in the right direction. More important from a policy perspective, however, is that protection mechanisms for SMMEs should be put in place. The recommendations in the SARS documents speak to this in the proposal that a dedicated SMME desk should be set up in each SARS office. In light of the above, one of the key tasks of the SMME division should be to deal with SMME queries. More powerful would be to commit the regulatory authority to output targets by, for example, imposing a maximum turnaround time for SMME queries. In our view, the continued drive to extend the tax net to include smaller firms should be made pending the proof that these firms can be appropriately managed by the regulatory authority.

Finally, two cautionary notes from international experience need to be highlighted.

Do not Expect Reductions in the Tax Compliance Burden to Unlock the SMME Market

Although important for long-term development, reducing the burden of tax compliance is unlikely to result in dramatic development of the SMME market in the short-term. It is more likely to be a catalyst or facilitator of development rather than a driver of growth. Drivers for growth will come from improvements in the general economic environment and demand conditions combined with initiatives to empower individuals to start their own businesses.

This finding is echoed in the SARS study, which concludes that “small business will not live or die by SARS intervention alone”. It is also confirmed by the experience of international jurisdictions, which found that incremental improvements in the tax compliance burden have not directly resulted in substantial growth in the SMME market. This does not negate the fact that the cumulative impact of such changes may be substantial, but simply serves to temper the expectations of what can be achieved over the short-term.

Heed International Experience on Potential Distortions Introduced by Well-Meaning Policy

The experience of the UK provides an interesting insight into the trade-offs faced by policy and the potential distortions introduced into the market. On the one hand, a high compliance burden on specific firm types disincentivises entrepreneurs to grow their business beyond a certain level. On the other, improving the tax regime for particular types of firms has resulted in entrepreneurs opting for company types that are inappropriate to its business.

South Africa has put much effort into creating a simplified tax system. Care should be exercised not to create room for regulatory arbitrage and undermining the benefit of such simplicity by introducing multiple tax regimes for different types of firms or company size.

8. References

- Barker, R. 2005. *Budget 2005 and SMEs*. 20 May. Available at: <http://www.beehive.govt.nz/Print/PrintDocument.aspx?DocumentID=23256> (Accessed on 1 September 2005).
- Berry, A. B., Von Blottnitz, M., Cassim, A., Rajaratnam, B. & Van Seventer, D.E. 2002. *The Economics of SMMEs in South Africa*. December. Trade and Industrial Policy Strategies (TIPS).
- Bird, R.M. & Zolt, E.M. 2003. *Introduction to Tax Policy Design and Development*. Draft prepared for a course on Practical Issues of Tax Policy in Developing Countries, World Bank, April 28-May 1, 2003. World Bank: Washington D.C.
- Centre for Fiscal Studies, 1998. *The tax compliance costs for employers of PAYE and National Insurance in 1995-6*. Report by the Centre of Fiscal Studies, University of Bath for Inland Revenue and the Department of Social Security.
- Carroll, R., Holtz-Eakin, D., Rider, M. & Rosen, H.S. 2000. *Personal income taxes and the growth of small firms*. NBER Working Paper 7980. National Bureau of Economic Research: Cambridge, Massachusetts.
- Chittenden, F., Kauser, S. & Poutziouris, P. 2001. *Tax regulation and small business: A review*. Paper presented to the Kingston University/Small Business Service Seminar, 6 November 2001, Sheffield.
- Colmar Bruton. 2005. *Measuring the tax compliance costs of small and medium-sized businesses – a benchmark survey*. 20 June. Report prepared for Inland Revenue.
- Cullen, M. & Cuncliffe, D. 2003. *Making tax easier for small businesses*. Policy Advice Division, Inland Revenue Department: Wellington.
- Cullen, M., 2005. Address to the 28th Annual International Fiscal Association Conference. Crown Plaza Hotel, Christchurch, 29 April. Available at: <http://taxpolicy.ird.govt.nz/news/archive.php?year=2005&view+356> (Accessed on 6 September 2005).

Dagut, S. 2005. *Personal Communication*. Research manager, SBP, Johannesburg. 26 August 2005.

English, B. & Birch, W. 1999. *Less taxing tax: A Government discussion document*. Inland Revenue: Wellington.

Grant Thornton. 2005. *Compare the key findings for New Zealand with the results from Grant Thornton's International Business Owners Survey*. Available at: http://www.consumerfutures.com/gtbs/main/pdfs/csummary_newzealand.pdf (Accessed on 6 September 2005).

Group of New Zealand Regulators³¹. 2005. *Personal Communication*. 12 September. New Zealand Government.

Hallberg, K. 2000. *A market-oriented strategy for small and medium-scale enterprises*. International Finance Corporation (IFC) Discussion Paper Nr. 40. World bank: Washington D.C.

HM Treasury. 2004. *Small companies, the self-employed and the tax system*. Discussion Paper. December. HM Treasury: London.

Keter, V. 2004. *Small Firms: Red Tape*. Research Paper 04/25. 28 June. House of Commons Library: London.

Inland Revenue. 2005. *Working towards a new relationship: a consultation on priorities for reducing the administrative burden of the tax system on small business*. Discussion Paper. Inland Revenue: Norwich.

31 The following individuals provided inputs to this telephone conference:

- Simon Hughes, Private Secretary Small Business and Senior Advisor SMEs, Ministry of Economic Development;
- Robyn Henderson, Regulatory Impact Analysis Unit, Ministry of Economic Development;
- Martin Garcia, Acting Manager, Regulatory Policy, Regulatory and Competition Policy Branch, Ministry of Economic Development.
- Andrew McLoughlin, Senior Analyst, Tax Policy Section of Regulatory and Tax Policy Branch, Treasury.

- International Working Group on Administrative Burdens. 2004. *The Standard Cost Model: A framework for defining and quantifying administrative burdens for businesses*. Available at: <http://www.oecd.org/dataoecd/32/54/34227698.pdf> (Accessed on 26 August 2005).
- Massey, C. 2003. *The impact of business compliance: perceptions of New Zealand firms*. Report prepared for the Ministry of Economic Development. New Zealand Centre for Small & Medium Enterprise Research, Massey University: Massey.
- Ministry of Economic Development. 2003a. *Wealth of talent and experience in small business advisory group*. Media release by Hon John Tamihere, Minister for Small Business. Available at: http://www.med.govt.nz/irdev/ind_dev/sbag/media/20031014.html (Accessed on 6 September 2005).
- Ministry of Economic Development. 2003b. *Establishment of Small Business Directorate*. 11 September. Available at: http://www.med.govt.nz/irdev/ind_dev/small-bus-dir-est/ (Accessed on 12 September 2005).
- Ministry of Economic Development. 2005a. *Compliance Costs*. Available at: <http://www.med.govt.nz/buslt/compliance.html> (Accessed on 5 September 2005).
- Ministry of Economic Development. 2005b. *Business Compliance Cost Reduction Report-Back*. Available at: <http://www.med.govt.nz/buslt/compliance/report-back/index.html> (Accessed on 5 September 2005).
- Ministry of Economic Development. 2005c. *Regulatory Impact Statements / Business Compliance Cost Statements*. Available at: <http://www.med.govt.nz/buslt/compliance/risbccs/index.html> (Accessed on 6 September 2005).
- Orford, J., Herrington, M. & Wood, E. (eds.). 2004. *Global Entrepreneurship Monitor: South African Report 2004*. Global Entrepreneurship Monitor (GEM), London Business School: London.
- Republic of South Africa (RSA), 1995. *White Paper on the National Strategy for the Development and Promotion of Small Business in South Africa, Notice 213 of 1995*. 20 March 1995. Cape Town.

- Sandford, C., Godwin, M. & Hardwick, P. 1989. *Administrative and Compliance Costs of Taxation*. Fiscal Publications: Perrymead.
- SBP. 2005. *Counting the cost of red tape for business in South Africa*. June. SBP: Johannesburg.
- Shome, P. 2004. *Tax administration and the small taxpayer*. IMF Policy Discussion Paper 04/2. International Monetary Fund: Washington D.C.
- South African Revenue Service (SARS). 2005. *SMME Facilitation Programme: Report Version*. South African Revenue Service: Pretoria.
- Sullivan, S. 2005. *Personal Communication*. Seconded accountant and tax specialist to Small Business Service, United Kingdom. 31 August.
- Small Business Advisory Group. 2004. *Small and Medium Businesses in New Zealand: Report of the Small Business Advisory Group*. August. Small Business Advisory Group.
- Small Business Policy Brand, Industry Canada. 2003. October. Available at: [http://strategis.ic.gc.ca/epic/internet/inbrp-rppe.nsf/vwapj/SmallBusinessandRegulatoryBurden.pdf/\\$FILE/SmallBusinessandRegulatoryBurden.pdf](http://strategis.ic.gc.ca/epic/internet/inbrp-rppe.nsf/vwapj/SmallBusinessandRegulatoryBurden.pdf/$FILE/SmallBusinessandRegulatoryBurden.pdf) (Accessed on 29 August 2005).
- Stevenson, L. & Lundström, A. 2001. *Patterns and trends in entrepreneurship/SME policy and practice in ten economies*. Volume 3 of the Entrepreneurship for the Future Series. Swedish Foundation for Small Business Research.
- Upstart Business Strategies. 2004. *Measurement of Value Added Tax Act and Regional Services Councils Act-induced administrative burdens for South African small businesses*. Final Report. Upstart Business Strategies: Johannesburg.
- World Bank. 2004a. *Doing Business in 2005: Removing Obstacles to Growth*. World Bank: Washington D.C.
- World Bank, 2005b. *Doing Business in 2006: Creating Jobs*. World Bank: Washington D.C.

Appendix A: The Standard Cost Model

The Standard Cost Model is defined as “a model designed to present the AB [administrative burden] arising from regulation per Ministry and country over a certain point of time, in a way that provides insight and allows for comparison of the figures” (International working group on Administrative Burdens, 2004: 18). It was first developed in the Netherlands, but is now being used in the Netherlands, Denmark, Norway and Sweden (International Working Group on Administrative Burdens, 2004). Its basic structure is explained in Box 1.

Box 1. Basic structure of the Standard Cost Model

“In as far as it is possible, the standard cost model is designed to fit the structure of the regulations. When starting a measurement, the regulation under examination is carefully mapped, in order to identify the inherent information obligations. In order to comply with an information obligation (an obligation to obtain a permit, for instance) businesses have to procure the required pieces of data or messages (company name and address, VAT-payable etc.) that constitute the information obligation.

Each message has to be delivered by a certain amount of companies a certain amount of times each year this constitutes Q in the SCM, i.e. the total number of times that the message is delivered per year. In order to be able to deliver these messages, businesses have to perform certain administrative activities.

Each activity takes a certain amount of time to perform, and therefore carries a cost to companies since they have to pay wages to those employees, who perform the task this constitutes P in the SCM, i.e. the costs of an administrative activity.

Together P and Q add up to a certain cost for businesses when complying with each information obligation contained in the law under examination.”

Source: International Working Group on Administrative Burdens, 2004

Appendix B: Assumptions about the Business for Paying Taxes in *Doing Business*

The following assumptions about the business and taxes are used for calculating the tax measure in *Doing Business*³²:

“The business:

- Is a limited liability, taxable company. If there is more than one type of limited liability company in the country, the most popular limited liability form among domestic firms is chosen. Information on the most popular form is obtained from incorporation lawyers or the statistical office.
- Started operations on January 1, 2003. At that time the company purchased all the assets shown in its balance sheet and hired all its workers.
- Operates in the country’s most populous city.
- Is 100 per cent domestically owned and has 5 owners, all of whom are natural persons.
- Has a start-up capital of 102 times income per capita at the end of 2003.
- Performs general industrial or commercial activities. Specifically, it produces ceramic flowerpots and sells them at retail. It does not participate in foreign trade (no import or export) and does not handle products subject to a special tax regime, for example, liquor or tobacco.
- Owns 2 plots of land, 1 building, machinery, office equipment, computers and 1 truck and leases another truck.
- Does not qualify for investment incentives or any special benefits apart from those related to the age or size of the company.

32 Information available at <http://www.doingbusiness.org/Methodology/PayingTaxes.aspx> (Accessed on 21 September 2005).

- Has 60 employees – 4 managers, 8 assistants and 48 workers. All are nationals, and one of the managers is also an owner.
- Has a turnover of 1,050 times income per capita.
- Makes a loss in the first year of operation.
- Distributes 50 per cent of its profits as dividends to the owners at the end of the second year.
- Sells one of its plots of land at a profit during the second year.
- Is subject to a series of detailed assumptions on expenses and transactions to further standardize the case.

Taxes:

- All the taxes paid or withheld in the second year of operation are recorded. A tax is considered distinct if it has a different name or is collected by a different agency. Taxes with the same name and agency, but charged at different rates depending on the business, are counted as the same tax.
- The number of times the company pays or withholds taxes in a year is the number of different taxes multiplied by the frequency of payment (or withholding) for each tax. The frequency of payment includes advance payments (or withholding) as well as regular payments (or withholding).”