Introduction

Small, medium and micro-sized enterprises (SMMEs) continue to play a vital role in the South African economy, especially when it comes to job creation and black economic empowerment.

However, while SMMEs remain an attractive business option (as is evident by the 2.1 millions South African’s who generate their income through, or receive their income from, SMMEs) there are also many regulations that inhibit the development of small businesses. Foremost amongst these is the burden of tax compliance.

If we are to create an environment that facilitates the development of SMMEs and which fosters entrepreneurship, it is essential to (1) analyse the impact of these compliance costs in SMMEs, and (2) find ways to minimise the tax-related regulatory burdens on these firms.

It is precisely this issue which is examined in this policy document, as we search for ways to reduce the tax-related burden, not through a process of deregulation, but of smart regulation.

Examining the Issue of Tax Compliance Locally and Globally

This study draws on local data and global examples to put forth proposals on how the tax-related regulatory burden on SMMEs may be reduced. In the sections that follow this policy document:

• Reviews South Africa’s performance in an international context.
• Looks to global success stories in order to illustrate what can be achieved in a regulatory best practice environment. Here we examine the importance of tax in the broader SME sphere and the attempts at reducing tax compliance costs in the SME-friendly jurisdictions of New Zealand and the United Kingdom.
• Gauges the impact of regulatory compliance costs on South African SMMEs by reviewing three local studies. (These studies are detailed further on in the paper.)
• Presents conclusions and policy proposals.
Establishing a Cost Framework

In order to assess the relative impact of tax-related compliance costs on SMMEs in South Africa, a framework that allows conceptual analysis of the potential relative impacts of various elements of total costs of taxation is required. These are depicted in the following diagram:

**Figure 1: Cost of Taxation**

When looking at the interaction between these various cost components it is important to remember that economic decisions affecting efficiency costs are often politically motivated. Thus, when faced with a choice of reducing efficiency costs or reducing compliance costs, politicians will more often choose compliance costs.

Conclusions and Policy Considerations

The policy considerations emerging from local research and from an examination of the international experience indicate a strong need for:

- **Offering more support to affected institutions** rather than by simply reducing the compliance burden.
- **More information on SMMEs.** This information is essential for the formation of effective policies and accurate impact assessments.
- **Co-ordination of SMME policies amongst government departments.** Currently the SMME policy in South Africa is not co-ordinated or aligned, resulting in duplicated and conflicting efforts and a loss of synergy.
- **A dedicated government unit focused on SMME development.** Such a unit should be empowered to effect change within government and conduct regular regulatory impact assessments.
- **Promoting the use of e-filing** in an effort to simplify compliance.
- **Promoting appropriate bookkeeping software.** This reduces compliance costs while increasing accuracy. Since the cost of purchasing software may be prohibitive to many small firms, a further recommendation is made to consider making these software packages available to SMMEs via SARS.
- **Establish protection mechanisms for SMMEs** within the regulatory authority. While strong internal control mechanisms are essential to the running of SARS, SMMEs may be deterred from using mechanisms such as e-filing because they fear the risk of accidental non-compliance.
- **A dedicated SMME desk should be established** in all SARS offices in an effort to deal more effectively with SMME queries, while also measuring SARS’s performance on dealing with SMME queries against output targets.

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

- **Reducing the tax compliance burden will not necessarily unlock the SMME market** because drivers for growth come from the improvements in the general economic environment. There is therefore a need to implement initiatives to empower business creation.
- **Heed international experience.** Especially regarding potential distortions introduced by well-meaning policy. In the UK, for example, there is evidence of entrepreneurs opting for company types that are inappropriate to their business due to the improved tax regimes applicable to those businesses.
Enacted Changes for Small Business

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 were suggested. These changes have either already been implemented or will be implemented over the coming year, and focus on three main activities:

- **Decreasing the administrative burden.** Changes here are as follows:
  - Only one form will be required to register for all taxes.
  - The principle of Voluntary Disclosure will be implemented to give businesses the chance to enter the tax system and rectify income discrepancies.
  - A single customs declaration will be implemented.
  - Online application for tax clearance certificates will now be possible.
  - The VAT submission period will be reduced from once every two months to once every four months for firms with an annual turnover of less than R1 million.
  - A Small Retailers’ VAT package is introduced from April 2005 onwards.
  - A single national call centre number will service all tax and customs enquiries.

- **Strengthening the focus on small business.** Measures taken here include:
  - Community helpers will support SMMEs with a variety of tax issues.
  - Small business help desks will be made available at all SARS offices.
  - A dedicated VAT campaign will be undertaken.
  - Accounting and payroll packages will be made available to small businesses.

- **Providing SMMEs with financial relief.**
  - RSC levies will be abolished from July 2006, but may be replaced with some other local council tax.
  - Skills Development Levies will no longer apply to small businesses with an annual payroll of less than R500 000 from August 2005.
  - The tax rate for close corporations is decreased from 30 to 29 per cent.
  - Preferential tax is extended to include more service industries.
  - The tax threshold is increased to R35 000 for sole proprietorships and partnerships.

Assessing South Africa’s Performance in the Global Context

The World Bank’s Doing Business series consists of annual reports that assess the impact of doing business within specific countries. As an indication of South Africa’s performance on a global scale, we draw on data from Botswana (our closest neighbour) Argentina, Brazil and Peru (who share our status as developing countries) and New Zealand and the United Kingdom (who are excellent examples of countries with advanced SMME policies).

Table 1: Ease of Paying Taxes

<table>
<thead>
<tr>
<th></th>
<th>South Africa</th>
<th>Botswana</th>
<th>Argentina</th>
<th>Brazil</th>
<th>Peru</th>
<th>New Zealand</th>
<th>United Kingdom</th>
<th>OECD</th>
</tr>
</thead>
<tbody>
<tr>
<td>Payments (number)</td>
<td>52</td>
<td>24</td>
<td>29</td>
<td>22</td>
<td>53</td>
<td>8</td>
<td>22</td>
<td>16</td>
</tr>
<tr>
<td>Time (hours spent on compliance)</td>
<td>350</td>
<td>140</td>
<td>580</td>
<td>2680</td>
<td>402</td>
<td>70</td>
<td>No data</td>
<td>192</td>
</tr>
<tr>
<td>Total tax payable (% of gross profit)</td>
<td>43.8</td>
<td>52.9</td>
<td>97.9</td>
<td>147.9</td>
<td>50.7</td>
<td>44.2</td>
<td>52.9</td>
<td>46.1</td>
</tr>
<tr>
<td>Rank</td>
<td>84</td>
<td>59</td>
<td>143</td>
<td>140</td>
<td>133</td>
<td>18</td>
<td>81</td>
<td>No rank</td>
</tr>
</tbody>
</table>

Source: World Bank 2005 B

As the table shows, the 2005 findings indicate that:

- South Africa ranks 84th worldwide in terms of ease of paying taxes.
- Compared to other developing countries, South Africa is not performing too poorly in terms of compliance costs.

Although this study had a number of downfalls (among these that the definition of SMMEs employed is vastly different from any South African definitions and that there is doubt as to the accuracy of the “total tax payable” figures), it nevertheless serves to provide a good view of where we stand globally.
Learning from Best Practice Jurisdictions

In the sections that follow immediately below, we examine the changes that occurred in both the United Kingdom and New Zealand to reduce compliance costs and improve the legislative environment within which SMMEs operate.

The United Kingdom

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.

In broad terms, steps have been taken to:

- **Reduce regulatory burden.** Policy action in this area includes:
  - The establishment of a Better Regulation Task Force who can make recommendations to government on how to improve regulations.
  - Passing a Regulatory Reform Act in 2001 enabling the minister to remove overly cumbersome regulations.
  - Establishing a Regulatory Impact Unit to promote co-operation between government departments and help ensure that regulations are fair and effective.

- **Improve SME representation.** Here policy initiatives include:
  - Creating the Small Business Service that works towards making the UK the “best place to start and grow a business.”
  - Establishing the Small Business Council, tasked with reporting to the Secretary of State for Trade and Industry on the needs of existing and potential small businesses.
  - Requiring that all regulatory impact assessments include a “Small Firms Impact Test”, except in cases where the proposal only impacts on the public sector.

- **Provide a measure for regulatory burden.** The Standard Cost Model employed in the Netherlands is being considered as a model of measurement.

- **Increasing the 15 per cent tax cap from R150 000 to R200 000 taxable income for SMMEs.**
- **Considering the rapid depreciation of assets** for companies with a capital expenditure of less that R5 million.
- **Reviewing the definition of Employee Company.**
- **Increasing the limit of the new VAT invoicing system** from R3 000 to R10 000.
- **Decreasing tax compliance costs** through a number of improvements in SARS communication channels including the promotion of e-filing and the establishment of an SMME focussed call centre.
- **Reintroducing the cash basis of accounting** for companies with a turnover of R2.5 million, with regard to VAT and allowing SMMEs to choose between VAT payment on a cash or invoice basis. In addition, VAT returns could be reduced from six to three times per annum.
- **Reducing the time taken to issue tax compliance certificates** to 48 hours.
- **Investigating the creation of a special tax regime** for SMMEs.
- **Focus on the simplification of language on forms.**
- **Create a favourable regime for voluntary disclosure of unpaid or underpaid tax.**
- **Government establishing an interdepartmental task team** focussed on the overall regulatory burden impact on SMMEs as well as the creation of a Small Business Ombudsman to facilitate communication between the team and SMMEs.
Recommendations of the dti/UBS Study

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

- Improve the internal reliability of SARS logistics by, for example, making it easier and less time consuming for a business to make small information changes such as registering a new address.
- Expand online filing possibilities using e-filing. This could be supported by the implementation of an education campaign.
- Minimise queuing time spent at SARS offices.
- Promote the use of electronic invoicing and tax software. This could be supplemented by the provision of training.
- Reduce frequency of submission periods. It is of course necessary to consider the cashflow implications of implementing such a change.

Main Findings of the SARS Study

This study does not generate its own empirical data. Rather, it reviews the empirical data of the SBP and the dti/UBS surveys along with the findings of other studies broadly or specifically focussed on SMMEs. The main findings of the SARS study are that:

- The absence of a consistent definition for SMMEs is problematic, as is the lack of co-operation between government departments.
- Smart-regulation rather than de-regulation is required.
- There is a need to manage the tension between the two economies. However, if a dual tax system is created, it needs to be informed by "broad economic policy objectives."
- Formalisation and small business growth needs to be incentivised.
- Fear and apathy of SARS and SARS processes must be combated as this causes many business owners to remain outside the tax net.
- An increase in positive communication from SARS could go a long way towards fostering trust and a positive attitude in small businesses.
- Administrative burdens should be alleviated. Currently businesses feel there are simply too many difficult forms to fill in and complicated procedures to follow.

Recommendations of the SARS Study

A large number of recommendations are presented in the SARS study (2005: 35). In very broad terms, the study recommends:

As a result of the above steps, a number of tax system changes have either been recently implemented or are in the implementation pipeline. These include:

- Establishing a single point of contact for tax-related issues by merging the HM Customs and Inland Revenue Authority.
- Reducing the length of tax return forms from 16 to 4 pages.
- Rolling out a programme to assess the impact of operational changes by the newly formed revenue department on SMMEs.
- Reducing the time spent on tax inspections by SMMEs by moving to a risk-based system of assessment.
- Gaining a greater understanding of SMME needs by making all senior staff in the newly formed revenue department responsible for policy operations.
- Improving businesses’ general understanding of the tax system through, for example, releasing a CD Rom on VAT for small businesses and offering an updated guide on tax to new businesses.

Looking even further back in time, a number of other measures have been implemented since 1997 including:

- Reducing the rate of corporation tax for small businesses from 23 per cent to 19 per cent.
- Introducing Research and Development (R&D) tax credits for small businesses.
- Decreasing the long term capital gains tax to 10 per cent for the sale of business assets.
- Introducing a 40 per cent first year capital allowance on small business plan and machinery expenditure.
- Introducing a number of simplified tax schemes for small business.
- Promoting the use of an e-filing system that allows for tax forms to be submitted online to further reduce compliance costs.

An additional important lesson to be gained from the experiences in the UK is that some businesses may elect to remain sole traders because they do not want to take on the marginal regulatory tax burden. In this case, providing small firms with special tax regimes and implied growth incentives may not be the solution.
It is also worth noting that when looking at total compliance costs for various taxes, findings confirm a highly regressive pattern of compliance costs for smaller employers, with those in the “bottom” 30 per cent (in terms of employee size bands) paying nearly 75 per cent of compliance costs.

New Zealand

New Zealand has implemented a number of initiatives aimed at removing obstacles to tax compliance. These include:

- Initiating compliance cost enquiries.
- Establishing a Ministerial Panel on Business Compliance Costs in 2000 with the purpose of identifying areas where; and make recommendations on how; government could reduce the compliance costs arising from existing legislation. The New Zealand government agreed with the majority of recommendations made by the panel and, eventually, most of the recommendations were implemented.
- Establishing a Business Advisory Group. Formed in 2003 the Group represents the interests of small businesses by providing a small business perspective in the development of any SME-related policies.
- Setting up a Small Business Directorate. Established in 2003, the Directorate’s main role is to articulate the needs of small businesses and to serve as an advocate for these businesses across government.
- Introducing a regulatory impact assessment (RIA) unit which monitors, evaluates and, if necessary, initiates changes in regulation to minimise the negative impact on business.
- Directly developing small business capabilities by supporting small businesses and owners in handling tax and other regulatory requirements.

It is interesting to note that, despite the fact that the World Bank rates New Zealand as the best country in the world in terms of ease of doing business, 39 per cent of New Zealand businesses view “red tape” as a significant constraint on expansion, according to an international survey by Grant Thornton. This of course may indicate that regulatory environment forms a perceptual rather than an actual obstacle to doing business.

- Over-burdensome government regulations constitute the biggest policy obstacle to both growth and expansion of employment.
- The broad category of taxes is by far the most time consuming and troublesome of regulations! Of these, VAT requirements are viewed as most burdensome followed by SARS administration, then UIF regulations and finally PAYE regulations. Interestingly, in companies with more than 100 employees, SARS regulations are seen as more burdensome that VAT requirements.
- The average tax compliance cost is 2.9 per cent of turnover, but this gradually decreases to 0.003 per cent for firms with an annual turnover of more than R1 billion.
- Total recurring compliance costs of R78.9 billion are estimated for the formal sector of South Africa. This is equivalent to 6.5 per cent of the GDP in 2003 and 18 per cent of SARS revenue in 2002/3.

Recommendations of the SBP Study

The study makes no recommendations as to how the compliance costs of tax can be decreased or limited. It does, however, make suggestions as to “how the whole government system could begin to think about how to ensure the costs of regulation are justified by the benefits” (SBP, 2005: 90). Possible regulatory management tools that need to be considered for the South African context (SBP, 2005: 91-95) include:

- Regular regulatory cost surveys.
- Regular regulatory surveys.
- Encouragement of a more competitive economic environment by, for example, expanding the advocacy and education roles of general competition authorities and sector regulators.

Main Findings of the dti/UBS Study

The qualitative findings of the study lead to the following conclusions:

- It is more expensive to outsource recordkeeping and completion of tax returns than to do it in-house.
- The tax burden may be reduced by using advanced tax software for recordkeeping and calculation of final VAT.
- Recurring costs and not once-off burdens are the greatest contributors to non-compliance.
Table 2: Comparison of Reviewed Studies

<table>
<thead>
<tr>
<th></th>
<th>SBP</th>
<th>DUES</th>
<th>SARS</th>
</tr>
</thead>
<tbody>
<tr>
<td>Date</td>
<td>June 2005</td>
<td>September 2004</td>
<td>Released in 2005</td>
</tr>
<tr>
<td>Purpose of study</td>
<td>Determine which regulations have biggest compliance impact; quantitatively compare regulatory costs across six economic sectors. Provide headline figures for total regulatory compliance costs.</td>
<td>Enable the DB to have quantitative evidence to be used to advocate for programmatic reallocation and coordinate efforts to reduce regulatory costs across all economic sectors.</td>
<td>Assess the degree to which the existing tax administration model affects the small business sector.</td>
</tr>
<tr>
<td>Range of Companies Covered</td>
<td>SMMEs, large companies and major corporations</td>
<td>SMMEs</td>
<td>SMMEs</td>
</tr>
<tr>
<td>Definitions used</td>
<td>Definitions not clear, no specific definitions used. Calculations based on typical firm with normal efficiency.</td>
<td>No specific definitions used. Calculations based on typical firm with normal efficiency.</td>
<td>No specific definitions used. Calculations based on typical firm with normal efficiency.</td>
</tr>
<tr>
<td>Data collected</td>
<td>Data collected through interviews with 80 tax and accounting experts.</td>
<td>Data collected through interviews with 80 tax and accounting experts.</td>
<td>No primary data collected.</td>
</tr>
<tr>
<td>Methodology</td>
<td>Top-down approach.</td>
<td>Bottom-up approach, more literature review and qualitative insights drawn from interaction with individuals that have insight into small business tax issues.</td>
<td>Literature review and qualitative insights drawn from interaction with individuals that have insight into small business tax issues.</td>
</tr>
<tr>
<td>Constraints</td>
<td>* Study does not delve deeply into tax compliance costs. * Broad focus potentially dilutes the analysis of tax compliance experienced by SMMEs. * The headline figures given provide only an indication of gross compliance costs. * The monetary estimates of the study risk overestimation.</td>
<td>* Study focuses only on two specific taxes: Income Tax and Regional Service Levies. * It is possible that the small sample size limits the generalisability of the findings. * The monetary estimates of the study risk overestimation.</td>
<td>* As study contains no primary data, cannot evaluate methodologies used and find results.</td>
</tr>
</tbody>
</table>

It should be noted that although these studies did groundbreaking work, there are still a number of gaps in our understanding of the burden, particularly with regard to identifying the exact components of the SMME market in which policy intervention is required.

**Main Findings of the SBP Study**

This pioneering attempt at quantifying broad, regulatory compliance costs to business in South Africa and pinpointing those regulations viewed as barriers to compliance, indicates that:

- **“State interface/regulations” was cited the most troublesome regulation.** This was followed by “labour laws/government regulations in general”.

In addition to the broad developments, a number of specific changes have been made to the tax system, all aimed at simplifying the tax environment and eliminating prominent obstacles. To this end, the New Zealand government:

- **Pays an allowance to payroll agents** to manage the payroll for the first five employees of all businesses. This allows business owners to focus more time on managing their business and increase the accuracy of employees’ salary calculations.
- **Reduced the number of days** during which businesses need to interact with revenue authorities by aligning payment dates for provisional tax and good and services tax (GST).
- **Allow GST-registered businesses** to base provisional tax payments on a percentage of GST turnover.
- **Implemented a financial incentive** for start up businesses to pay tax in their first year of operation.
- **Simplify the language on forms and in legislation.**

It is interesting to note that 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 compliance costs can be reduced. Regulators did not want to select a benchmark as they argue that compliance costs need to be continuously reduced, even if it is absolutely or relatively low.
Lessons for South Africa

The following broad lessons can be extracted from the experiences in the United Kingdom and New Zealand:

- An agency dedicated to articulating small business interests and situated within a specific government department forms an essential link in the co-ordination of SMME policy.
- It is important to have a simple tax system with the least number of exemptions as special tax exemptions or tax rates for SMMEs could lead to unintended policy consequences.
- Innovative and new approaches to the reduction of compliance may be required.
- Decreasing compliance costs is a continuous process.
- It is important to develop the capabilities of small businesses rather than just simplify tax requirements.
- It is vital to determine whether tax compliance costs are a perceptual or an actual problem.
- A regulatory unit situated within government and responsible for the RIAs of proposed legislation could serve as an effective ex ante approach to reducing compliance costs.
- Government needs to create a generally supportive environment for SMMEs.

Reviewing the South African Situation Based on Three Studies

As mentioned in the introduction, this policy document takes into account data from three South African surveys on the impact of tax compliance costs on SMMEs:

- Counting the Cost of Red Tape for Business in South Africa by SBP.
- SMME Facilitation Program (Report Version) by the South African Revenue Services (SARS).

In this section we highlight the key findings and recommendations of these three papers. Before we do so, however, the nature of the individual papers as well as their possible shortcomings is tabulated in Table 2.