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▶ Enterprise Formalization: Tailored registration, tax and social security requirements for MSEs

Thematic Brief 3/2021





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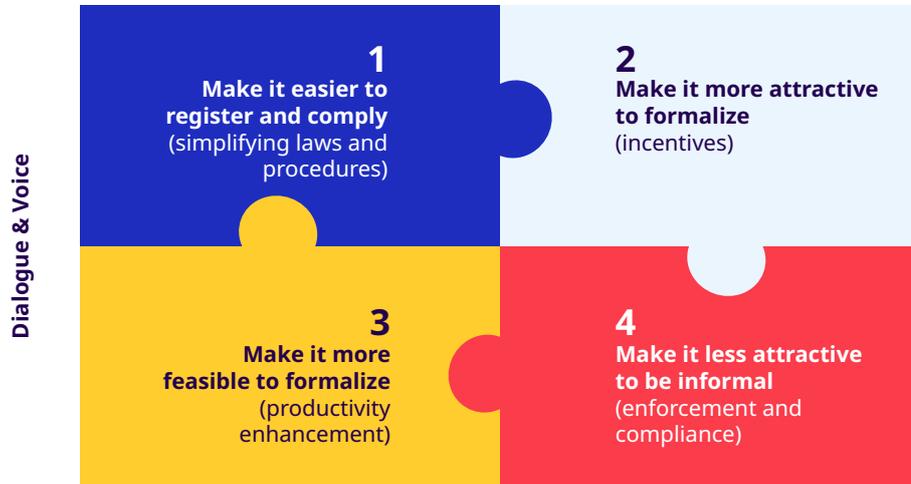
This document is part of a series of briefs on Enterprise Formalization that describe some of the measures that can be taken to support formalization, in line with ILO Recommendation 204 concerning the Transition from the Informal to the Formal Economy. It is recommended to carefully tailor an enterprise formalization strategy to the needs and characteristics of the entrepreneurs, based on an assessment of the situation in a particular country or region. Among those opportunity entrepreneurs that are informal, some would be able to formalize their business if adequate policies, regulations and support measures are put in place. Persons who engage in survivalist activities may engage in livelihood activities and need support to address decent work deficits as a first step towards possible formalization in the future. Enterprise formalization strategies may include measures to make it easier to register and comply with the law (e.g. through simplified laws and procedures), make formalization more attractive (by increasing incentives and removing disincentives to formalize), bring formalization within reach (by enhancing enterprise productivity) and make operating informally less attractive (notably through strengthened enforcement and compliance measures). Strategies may also include reforms to bring small economic units¹ within the scope of the law. The development, implementation, monitoring and evaluation of enterprise formalization strategies rely on a process of dialogue to identify and consider the constraints that affect the targeted informal enterprises and stand in the way of their formalization.

Acknowledgements

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¹ In this context, the term economic units refers to: (a) units that employ hired labour; (b) units that are owned by individuals working on their own account, either alone or with the help of contributing family workers; and (c) cooperatives and social and solidarity economy units. This brief refers to economic units, including own account workers with no employees, as enterprises.

► Figure 1: Recommended enterprise formalization approach



Source: ILO, 2020.

Thematic Brief *Enterprise Formalization: Simplifying and facilitating business start-up and compliance*, No. 2/2021 identifies ways to reduce information gaps and eliminate inefficiencies in the implementation of relevant laws and regulations, with the objective of reducing the monetary and non-monetary cost to enterprises of complying with those laws and regulations. However, experimental evidence indicates that this kind of procedural simplification, on its own, only encourages a small percentage of enterprises to formalize, in particular those that most closely resemble their formal counterparts (Bruhn and McKenzie, 2013). For greater impact, interventions need to consider the broader legal and regulatory framework within which small enterprises operate, the recurring cost of tax and social security contributions that they incur, and the value of the benefits that they receive in return. This Thematic Brief investigates **the role of 'entry level' mechanisms and related business registration, tax and/or social security reforms to tailor requirements to the needs and characteristics of micro and small enterprises (including own-account workers)**, as a

means of making enterprise formalization easier and more attractive.

Why is it important to introduce 'entry-level' mechanisms for micro and small enterprises?

Micro- and small enterprises can find it difficult to operate in the formal economy if compliance formalities, tax and/or social security obligations are overly burdensome for them.

As described in the Thematic Brief *Enterprise Formalization: Simplifying and facilitating business start-up and compliance*, No. 2/2021 and in several other ILO publications², business start-up and ongoing compliance formalities can be tedious, time-consuming and costly for entrepreneurs, who can ill afford to spend time away from their business to fulfil all of the requirements that apply to their small enterprise. Business start-up and ongoing compliance formalities are often not tailored to the size and characteristics of smaller

2 See for more information: ILO, 2017 (Chapter 4), ILO, 2019 (Chapter 5); ILO, 2019a; ILO, 2019b; Ortiz et al, 2019. See also ILO Policy Resource package on extending social security to workers in the informal economy, <http://informaleconomy.social-protection.org>.

enterprises, making it difficult for them to bear the additional monetary and non-monetary costs of formalization. Small enterprises also face challenges in meeting their tax and social security obligations. These difficulties are consistent with the economic principle known as 'economies of scale' (see **Box 1**). Social security contributions are usually calculated as a percentage of wages, increasing the fixed costs of an enterprise that formalizes (and also increasing the short-term costs for the employees), while the value of social security coverage might not be immediately quantifiable. Corporate taxes - and, in many cases, enterprise owners' social security contributions - are usually charged as a percentage of enterprise profits. For informal enterprises, therefore, formalization usually implies a more significant increase in fixed costs as a proportion of overall costs (due to social security contributions) and a decrease in net profits (due to corporate tax), which may render the micro or small enterprise unviable. In addition to this, tax and social security contributions are usually based on complex calculations (including enterprise margins, value added, employees' wages, including in-kind remuneration) which the entrepreneur may be unable to carry out on his/her own. In most cases, entrepreneurs are obliged to hire an accountant to perform these calculations or, at the very least, to validate the calculations that they have carried out themselves. Accounting obligations may be beyond the means of micro and small enterprises, either because entrepreneurs do not have the time or knowledge to do their own bookkeeping, or because they are unable to pay for the services of a chartered accountant. Faced with the prospect of becoming economically unsustainable,

these entrepreneurs may choose instead to remain informal and/or not comply with tax and social security obligations altogether.

To address these challenges, governments can revise the legal and regulatory framework to create 'entry-level' mechanisms for enterprises that meet a specific set of criteria. Entry-level mechanisms for micro- and small enterprises acknowledge that small entrepreneurs lack the time, resources and know-how to deal with complex accounting requirements and may require adapted mechanisms to meet their tax and social security obligations. They attempt to bring the formalization process within reach of micro and small enterprises, through legal and regulatory reforms, thereby facilitating their compliance with their tax and social security obligations, enhancing access to social security for themselves and their workers, and opening opportunities for higher productivity. These mechanisms are targeted at enterprises that meet certain criteria: for example, they may operate in specific economic sectors, be below a certain turnover threshold, or employ only a small number of people. They are particularly relevant in contexts where people value the level of social security benefits, where they are confident that they can access such benefits when these are due, and where they perceive the tax system as fair.

Examples of such 'entry-level' mechanism include the *monotributo* mechanisms in Argentina and Uruguay³, the *auto-entrepreneur* statute in France and Morocco, Brazil's *Micro-Empreendedor Individual*⁴ mechanism and the *statut d'entrepreneur* in Benin and

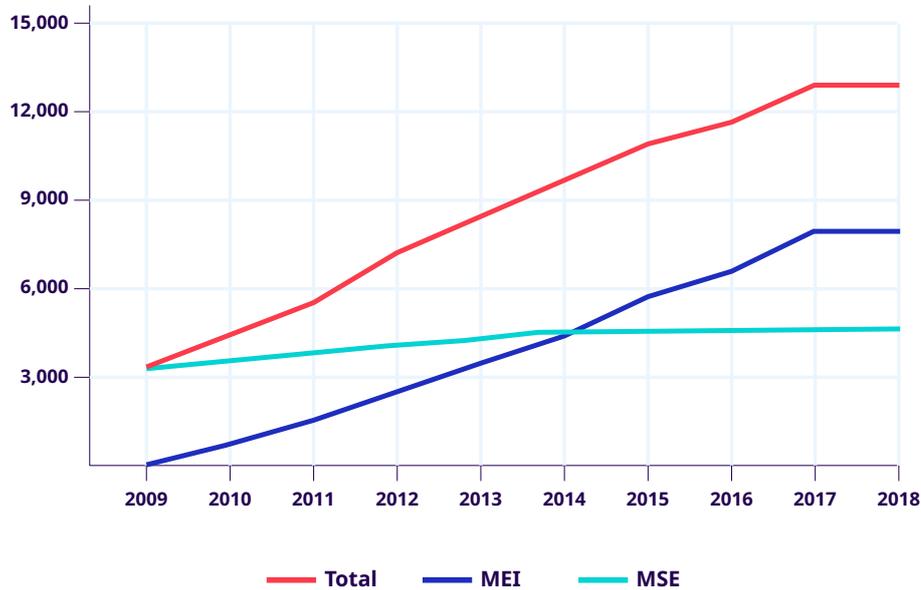
► **Box 1: Economies of scale**

Economists have long observed that, as enterprises grow, their fixed costs represent a decreasing share of their overall costs. According to this principle, a larger enterprise will have higher margins than a smaller one, all else being equal. Increases in sales volumes also tend to result in higher overall profits, as profits per unit are multiplied by a greater number of units or services sold. This implies that enterprises will struggle to increase their margins and their profits unless they grow, meaning that small enterprises generate - on average - lower profits relative to larger ones.

3 These mechanisms provide access to the general social security scheme.

4 Individual micro entrepreneur.

► **Figure 2: Total number of registrations as Individual Micro Entrepreneurs (MEI) and MSEs (in thousands)**



Source: ILO, 2019d.

other OHADA⁵ member countries.⁶ The creation of this kind of mechanism can have a massive impact on the rate of formal enterprise registration. In the case of Brazil, there were 7.7 million registrations in 2018 under the Individual Micro Entrepreneur regime (MEI), while around 5 million MSEs were registered under the monotax regime (see **Figure 2**). Figures from the Federal tax authorities in Brazil (*Receita Federal*) show that there are 11.2 million operational micro-enterprises operational across the country (as of 21/11/2020).⁷

Another type of entry-level mechanism is the presumptive tax. Presumptive methods allow tax collectors to dispense with the need to look through a full set of formal accounts by using a proxy indicator of the tax base (e.g. assets, floor area or the number of employees) to estimate tax liabilities. Presumptive taxes eliminate some accounting requirements and thus reduce the burden of compliance for the small enterprise, but the approximate nature of calculations can lead to inequitable outcomes.

5 Organization for the Harmonization of African Business Law.

6 See here for more information : ILO, 2018; ILO, 2019, Chapter 5; ILO, 2019a; ILO, 2019b; ILO, 2019d.

7 <http://www.portaldoempreendedor.gov.br/estatisticas>

► Box 2: The *auto-entrepreneur* statute in Morocco



In 2015, the government of Morocco created the entry-level statute for *auto-entrepreneurs* (<http://ae.gov.ma/>). This fiscal and legal status enables own-account workers with turnover below a certain threshold to register in the National Auto-Entrepreneur Register (instead of the Trade Register) and formalize their business operations. The target group includes starting entrepreneurs, students, vocational training graduates, unemployed persons and informal operators, including foreigners with an activity in Morocco.

The turnover threshold is set at 500,000 Dirham (approx. \$ 52,000) for operators in small-scale industries, commerce or artisanal activities and at 200,000 Dirham (approx. \$ 21,000) for those engaging in the services sector.

Auto-entrepreneurs submit formal invoices, declare turnover, pay taxes, comply with relevant sectoral and other regulations and announce the termination, transfer or transformation of the business. In return, they benefit from the following:

- ▶ Simplified business creation and termination;
- ▶ Tax reduction: 0.5 per cent of turnover for industrial, commercial or artisanal activities and 1 per cent of turnover for services;
- ▶ Exemption from value added taxes and temporary exemption from business taxes on the rental value of business premises and fixed assets;
- ▶ Exemption from submitting balance sheets to the tax authorities;
- ▶ The possibility of issuing formal invoices;
- ▶ Coverage under the social security scheme from the moment they register as *auto-entrepreneur* (not yet operational). Decrees are currently under preparation to enable auto-entrepreneurs to benefit from the same legal provisions on health care and pensions as those that apply for other types of entrepreneurs;
- ▶ In case of bankruptcy the property of the entrepreneur will not be at risk.

Source: <http://ae.gov.ma/je-veux-devenir-auto-entrepreneur/avantages/>

► Box 3: Experimental evidence from Benin



Boosting the impact of reforms through awareness-raising and 'handholding' for small enterprises. Once there is sufficient interest in formalization (including enrolment in the tax and social security scheme) small enterprises may still need some 'handholding' if they are to register successfully.

An experiment conducted by the World Bank in Benin provides convincing evidence that the uptake of the simplified legal status (the *statut d'entrepreneur*) can be increased if accompanied by 'handholding' services, including:

- ▶ assistance in registering, filling out forms and preparing supporting documents (referred to in the context of the experiment as 'Package A');
- ▶ training on accounting, tax obligations and financial literacy and assistance in opening a bank account ('Package B'); and
- ▶ mediation services in case of dispute between the firm and the tax administration ('Package C').

Enterprises taking part in the experiment were divided into four groups, including a control group, a treatment group (Group 1) that received Package A, a treatment group (Group 2) that received Packages A & B, and a treatment group (Group 3) that received Packages A, B & C. The results showed a formalization rate of 2.3 per cent for the control group, while the positive impact of the assistance packages on the treatment groups amounted to 9.6 per cent for Group 1; 13 per cent for Group 2 and 16.3 per cent for Group 3. In other words, the creation of simplified statutes and the legal and regulatory reforms required to alleviate tax and social security contributions for small enterprises must be accompanied by awareness-raising and 'handholding' services, as these can have a significant impact on formalization rates.

Source: World Bank (2016).

How can entry-level mechanisms support the simplification of tax payments and social security contributions for MSEs and facilitate access to benefits?

The entry-level mechanisms under which entrepreneurs can register their business are often associated with simplified payment mechanisms. They may also be associated with measures to alleviate the financial burden of tax and social security contributions for micro- and small enterprises. But how should these reforms be designed?

Compliance with the legal framework can be facilitated through the introduction of simplified payment mechanisms. Tax payments and/or social security contributions that are linked, should be adapted to fluctuations in enterprise revenues and cash flow. There are three major challenges associated with the design of entry-level tax and social security contribution payment mechanisms for micro and small enterprises:

- ▶ The **first** challenge is to determine the monetary value of the taxes and social security contributions that MSEs should be required to pay in order to enter the formal economy. It is also important to consider the *overall* burden of taxes, social security and fees, as a series of low rates can still add up to an unaffordable sum for the enterprise. When considering tax and contribution rates, policymakers should bear in mind that the primary objective of entry-level mechanisms is *not* to maximize revenue collection, but rather to facilitate a transition to formality and instill an attitude of compliance and promote trust in the system. Governments should design those mechanisms in such a way that negative effects (such as a growth trap, disguised employment relationships) are minimized, while keeping in mind the benefits that the mechanism will generate for the society, such as the value of social security coverage for workers and entrepreneurs, an increase in term of social cohesion and citizenship, a greater 'rule of law' and a net tax gain.

- ▶ The **second** challenge relates to how tax and social security contributions are calculated. To address calculation issues, some countries have introduced a nominal *lump sum* or use a proxy on revenue such as electricity consumption, or the size of a plot of land in the case of farmers (IMF, 1996). In other cases, this calculation should be based on data that is readily available to informal enterprises and simple to work out, even for entrepreneurs with low recordkeeping and accounting skills. They should, moreover, to the extent possible, be based on the principle of self-assessment, whereby the entrepreneurs themselves are responsible for calculating and declaring the amounts that are due. This is the least invasive form of assessment and sends the all-important signal that the State is willing to trust the declaration submitted by the entrepreneur (ILO, 2020). Some control may however be necessary to prevent abuse.

- ▶ The **third** challenge is to devise payment schedules that account for the unpredictable revenue streams and the cash flow constraints faced by MSEs. If tax and social security contributions take the form of a lump sum, and if penalties are imposed for non-payment, this could discourage informal enterprises from enrolling. Demands for up-front payment based on expected revenues or other forecasts could also have a harmful effect, as cash withdrawn on the promise of future reimbursement deprives the enterprise of much-needed working capital. Contributions should instead adjust automatically to real-time fluctuations in enterprise revenues.

Taxes and entry-level schemes

Alleviating the burden of taxes and social security contributions for small enterprises can encourage formalization by reassuring entrepreneurs that the required contributions will not threaten their financial sustainability and by changing the perceived cost-benefit ratio of formalization. Given the difficulties that have been described above, it is important to bear in mind that the inclusion of micro and small enterprises in the tax system should not primarily

be about maximizing the amount of revenue collected from them. Instead, the main objective should be to bring informal enterprises into the realm of the formal economy. One approach is to apply the *de minimis* principle, which is based on the notion that the monetary and non-monetary costs incurred by the State in collecting taxes from MSMEs below a certain revenue threshold is greater than the total revenue that would be collected from those enterprises, and is therefore not worth the effort.⁸ Many informal enterprises across the globe are small enough to fall under a theoretical *de minimis* threshold.⁹ Taxing them could generate high administrative costs (as they are difficult to identify and hard to reach) and yield limited revenue. However, this does not mean that tax authorities should ignore them altogether. There are good reasons to incorporate informal enterprises into the system, even if the tax contributions that are collected from them are merely nominal. **First**, the expansion of the tax base can build a culture of tax compliance and improve ‘tax morale’ among larger firms, which are more likely to comply if they feel that everyone is ‘paying their fair share’. **Second**, tax compliance can stimulate the growth of small enterprises, by allowing them to issue tax invoices to larger companies that demand this from their suppliers, and by rendering them eligible to participate in public procurement tenders. **Third**, taxation has wider implications in the field of political accountability, as tax-payers feel a greater sense of ‘ownership’ over government activities and are therefore more likely to engage with political processes. In other words, taxation can help to build a relationship of trust between enterprises and the State.

Informal enterprises already pay some taxes and make informal payments, but entry-level mechanisms can make the system less regressive and actually reduce the burden for formalizing enterprises. It is a common misconception that informal enterprises do not pay taxes. **Value-added taxes** (VAT), for example, are charged to the final consumer of a product or service. *Formal* enterprises pay value-added tax

on the inputs that they buy from their suppliers and service providers, but these amounts are deducted from the VAT that they collect from their customers before the amounts are passed on to the government. Informal enterprises *also* pay VAT on inputs purchased from formal enterprises, but do not charge VAT to their customers and therefore do not receive reimbursement (see **Figure 3**). The system defaults into treating informal enterprises as final consumers and collects value-added tax from them accordingly. Another form of tax paid by informal operators are **municipal taxes or fees**, such as payments that are collected from market traders or street vendors on a daily or weekly basis. For those informal enterprises that conduct business across borders, there is another form of taxation that is hard to avoid, namely **customs duties**. In a study of informal cross-border traders in Southern Africa, Peberdy et al (2015) found that thirty-seven per cent of traders surveyed made duty payments to importing countries during the study’s ten-day survey period, contributing on average ZAR 2,109 each to the public coffers (or an annualized total of ZAR 315 million);¹⁰ on the export side, a majority of traders purchased their goods from formal wholesalers and retailers, and therefore paid value-added taxes which they never reclaimed at the border upon returning to their home countries. Upon entering Zimbabwe, informal cross-border traders are actually taxed twice: first through the collection of customs duties, then through the collection of a ‘tax’ on all traders who do not have proof of business registration, at the rate of 10 per cent of the value of their goods (see **Table 1**). Needless to say, ‘indirect’ taxation of this kind can be highly regressive, as it is not based in any real sense on informal enterprises’ profits or capacity to pay. Lastly, informal enterprises also often make **informal payments** to keep their business going. Entry-level mechanisms try to remedy this situation by exempting small enterprises from some taxes or reducing the rate at which others are collected, thus contributing to a more progressive tax system across the board.

8 Joshi et al., (2014).

9 Ibid.

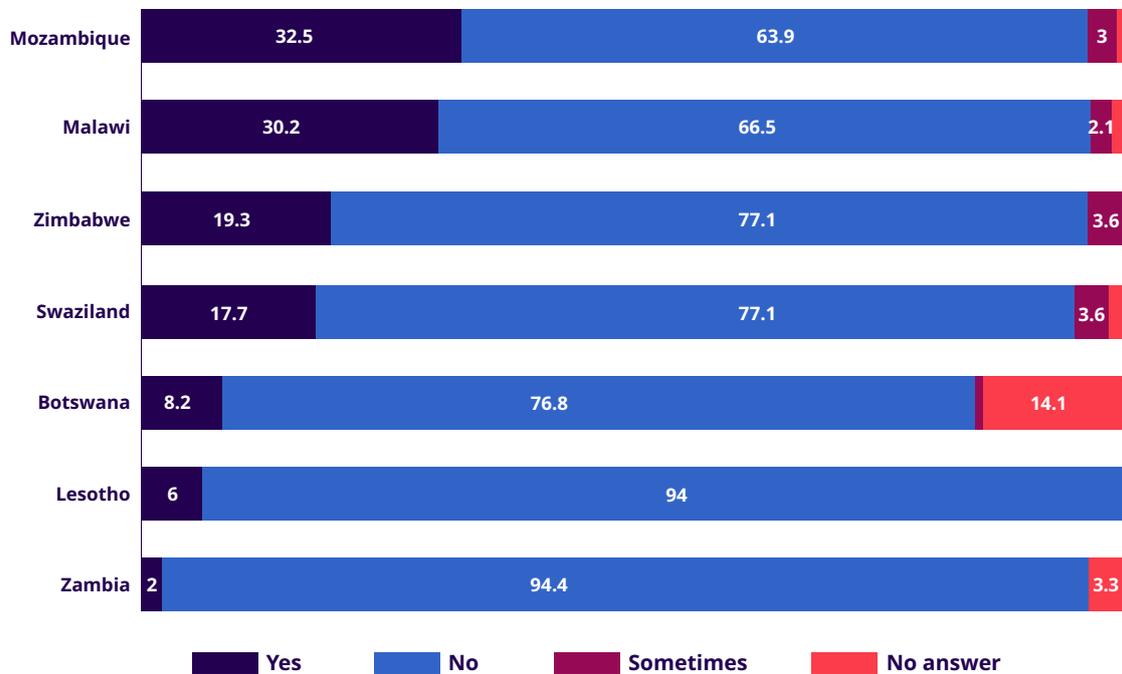
10 USD-ZAR average exchange rate in 2015: 12.8 ZAR.

► **Table 1: Duties paid by informal cross-border traders in the SADC region, by country and by border post**

Country of survey and destination countries	Percentage of traders paying duty	Total duties paid (South African rands)	Average duty per trader (South African rands)
Botswana			
South Africa	94%	15,724	103,45
Zambia	28%	17,886	308,38
Zimbabwe	97%	29,721	73,75
<i>Total</i>	<i>78%</i>	<i>63,331</i>	<i>103,31</i>
Lesotho			
South Africa	0%	-	0,00
<i>Total</i>	<i>0%</i>	<i>-</i>	<i>0,00</i>
Malawi			
Tanzania	100%	140,582	895,43
Mozambique (Mwanza)	96%	33,228	678,12
Mozambique (Dedza)	100%	45,816	487,40
<i>Total</i>	<i>99%</i>	<i>219,627</i>	<i>732,09</i>
Mozambique			
South Africa	12%	-	-
Swaziland	2%	-	-
<i>Total</i>	<i>7%</i>	<i>-</i>	<i>-</i>
Swaziland			
South Africa (Oshoek)	36%	76,565	398,78
South Africa (Lavumisa)	6%	6,242	390,12
<i>Total</i>	<i>26%</i>	<i>82,807</i>	<i>398,11</i>
Zambia			
Zimbabwe	99%	31,648	152,89
Tanzania	99%	101,697	274,86
DRC	4%	34	3,78
<i>Total</i>	<i>75%</i>	<i>133,379</i>	<i>227,61</i>
Zimbabwe			
South Africa	0%	570	285,00
Zambia	1%	428	219,00
Mozambique (Mutare)	7%	1,514	52,21
Mozambique (Nyamapand)	7%	1,470	245,00
<i>Total</i>	<i>3%</i>	<i>3,954</i>	<i>101,38</i>
TOTAL	37%	3,754,154	2109,18

Source: Peberdy et al. 2015.

► Figure 3: Proportion of traders that reclaim VAT from exporting countries



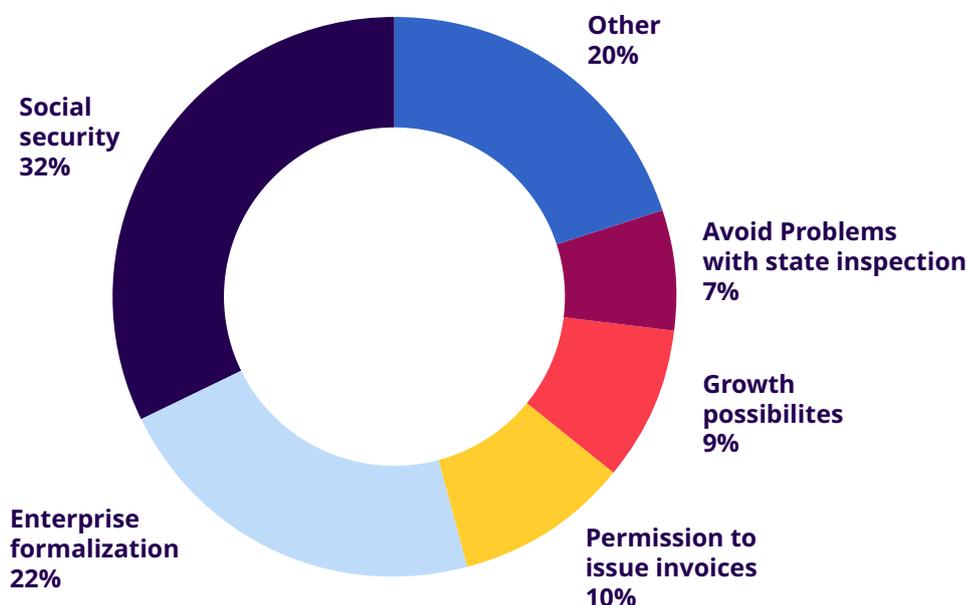
Source: Peberdy et al. 2015.

Social security contributions and entry-level mechanisms

Extending social security coverage to the owners of formalizing enterprises and the workers that they employ goes hand in hand with formalization and should therefore be at the heart of any entry-level mechanism. In most countries, at least some elements of social protection (such as health protection, employment injury, maternity, sickness and unemployment benefits and pensions) are contributory, meaning that only when enterprises are recognized as a legal entity and when business owners and workers make regular contributions, they are effectively covered by the system. Informal enterprises generally do not make contributions on behalf of their employees, or on behalf of the entrepreneurs themselves, depriving both of social security coverage. This gap in social protection creates challenges not only for the realization of human rights to social security for workers, entrepreneurs and their families, but also the achievement of the Sustainable

Development Goals, in particular target 1.3 to implement nationally appropriate social protection systems, including floors, for all. The shortfall in social security contributions has many drivers: small informal enterprises may be unable to enroll in the social security system due to their status; even if they were to formalize, they might struggle to comply with social security legislation due to limited administrative and financial capacities and lack of information and awareness on the existing schemes (ILO, 2019). In some cases, the system itself is designed in a way that effectively excludes small enterprises from participating: for example, enterprises below a certain size threshold or in a certain sector (e.g. agriculture) might be explicitly exempted from making contributions. Entry-level mechanisms can turn this problem on its head by promoting greater access to social security benefits and using these benefits as an incentive for formalization. The Brazilian Individual Micro-Entrepreneur mechanism (MEI) offers evidence that such an approach can yield significant results, with thirty-two per cent of micro-entrepreneurs citing access to social

► **Figure 4: Brazil – Reasons to Register as an Individual Micro-Entrepreneur/ *Micro-Empreendedor Individual***



Source: SEBRAE 2017.

security as a primary motivation for registering (see [Figure 4](#) and ILO, 2019d).

To the extent possible, the creation of entry-level mechanisms should be accompanied by legal, regulatory and institutional reforms and efforts to ensure adequate social security coverage for employees within micro and small enterprises as well as employers and own-account workers. Several strategies exist to extend social security coverage to the target population (ILO, 2019). Registration, contribution payment and compliance formalities can be made less burdensome and complex through a variety of facilitation measures that have been described in the Brief on *Enterprise Formalization: Simplifying and facilitating business start-up and compliance* (Thematic Brief No. 2/2021). Legal coverage under contributory social security schemes can be extended to small enterprises by lowering or removing legal minimum thresholds set out in national legislation, such as on size of enterprise or earnings while at the same time facilitating compliance for those enterprises. Facilitating formalization of enterprises and access to contributory

social security can be achieved by adapting legislation to include additional categories of workers (including business owners), thus accounting for diverse employment status and, among employees, for diverse modalities such as part-time contracts, temporary work or the absence of a formal contract. Tax and social security contributions can be unified into one payment – often referred to as a monotax (*monotributo*)– which makes it easier for small enterprises to understand and predict the total amount that they will have to pay (ILO, 2019d). Some monotax mechanisms also reduce the financial burden faced by MSEs, for instance through a unified rate which is lower than the usual tax and social security contributions paid by entrepreneurs that are outside the mechanism. That said, none of these measures are likely to be effective if the owners of informal enterprises and their employees perceive social security to be unsuited to their individual needs or of insufficient scope and/or quality. They may also lack trust in public institutions and thus be reluctant to join a social security scheme. In addition to extending social protection coverage, it is important, therefore, for governments to

continue efforts to expand the scope of benefits offered, covering both short-term and long-term risks (e.g. maternity and sickness benefits, as well as unemployment insurance) and to provide adequate benefits and services alongside more short-term enterprise formalization strategies (ILO, 2019). A high-quality and comprehensive social security system that is well-governed and managed and adapted to the needs of all is an important incentive for enterprise formalization and should go hand in hand with other measures, as pointed out in **Figure 1**.

Entrepreneurs should also be better informed of the benefits of registering themselves and the workers they employ in the social security scheme (ILO, 2019; ILO, 2019e). Due to a lack of awareness and information or the absence of high-quality services, informal enterprises sometimes do not appreciate the value of social security coverage for themselves and their workers or they may feel that the costs outweigh the benefits. The monetary costs of enrolment and the recurring cost of social security contributions are the first hurdles to be overcome, but entrepreneurs may also be deterred by other factors that may entail non-monetary costs: administrative

procedures for registration, contribution payment and benefit claiming may be difficult to understand, for example; or the overall monetary value of those benefits might be unclear to the entrepreneur, due to complex underlying calculations. When it comes to workers, it can be difficult for an entrepreneur to comprehend some more indirect benefits that social security can generate for the enterprise. The contribution of in-work benefits towards a happier, more healthy and more productive workforce, and their role in improving access to health care as well as bringing down absenteeism and employee turnover, are well documented, but not immediately obvious to entrepreneurs. Social insurance is also valuable from a risk management perspective: Providing coverage based on small predictable contributions relieve the entrepreneur from the risk of paying large amounts in the event of a major crisis, for example in case of a major health problem. Many informal entrepreneurs pay large sums of money to cover the health care costs for themselves and their workers in case of a health problem. This can create enormous challenges for the liquidity and even survival of their informal enterprise. Paying regular small contributions rather than high expenditures in case of an emergency

► Box 4: Viet Nam



In Viet Nam, a study found that firms, which increased the social security coverage by 10 per cent between 2006 and 2011, increased their revenues per worker between 1.1 per cent and 2.6 per cent whereas they increased profits by approximately 1.3 per cent to 3.0 per cent.

Source: *Social security and firm performance: The case of Vietnamese SMEs, International Labour Review 2017.*

► Box 5: Indonesia



In Indonesia, a study based on census data from 2010 to 2014, showed that the provision of social security influenced business performance of small and medium-sized enterprises. A 10 per cent increase in social security spending was associated with a per worker revenue gain of up to 2 per cent. Moreover, profits did not decrease due to the increased social protection coverage.

Source: *To what extent is social security spending associated with better performance? A case study of small and medium-sized Indonesian enterprises, ILO 2019f.*

allows the enterprise to better manage these risks. Enterprise formalization strategies should therefore include awareness-raising and training for entrepreneurs on the topic of social security (ILO, 2019), including the specific characteristics of the national system but also its more general role in boosting productivity.

Avoiding common risks associated with entry-level mechanisms

Entry-level mechanisms should avoid some well-known risks - including growth traps, fiscal shortfalls and disguised employment - while encouraging the graduation of MSEs to the regular rules and procedures (ILO, 2019). Initially, entry-level mechanisms that offer lower tax and social security contribution rates should be based on an assessment of the contributory capacity of the business owner and the workers they employ. For those with limited contributory capacities, this may have to be subsidized or complemented by non-contributory benefits financed through the general tax system, in order to reduce some of the financial implications for MSEs. This approach does not come without risks; recently formalized MSEs may soon be 'stuck' in the entry-level mechanism, deliberately avoiding graduation into the general scheme as to avoid any additional financial implications. At the same time, governments and taxpayers might find themselves subsidizing a liability in the national accounts, which could be massive and unsustainable in the long run if the level of subsidization is high. Entry-level registration, tax and social security schemes therefore need to be carefully designed. The informality status of the economic unit should not be the criterion for eligibility as that may create an undesired incentive to remain in the informal economy or to shift into informality. Other criteria to measure limited contributory capacity could include income status or proxy measures for poverty and vulnerability. Entry-level schemes *must* also include an exit strategy that encourages MSE graduation into the regular scheme, resulting in more revenue collection over the long term. This exit strategy should be developed in collaboration with enterprise

representatives and published extensively from the outset, or it will be perceived as a 'bait-and-switch' manoeuvre and undermine public trust in the system. In addition to this, it is important to integrate safeguards into the scheme, to ensure that larger enterprises do not abuse the scheme by dismissing their formal employees and re-hiring them as own-account subcontractors who are eligible for the 'entry-level rates' (a fraudulent practice sometimes referred to as 'bogus self-employment').

What role for employers' and workers' organizations in entry-level tax and social security schemes?

Employers' and workers' organizations can contribute to the design of entry-level schemes and promote them to ensure satisfactory uptake by small enterprises. Employers' and workers' organizations can help to improve their design. Once reforms have been carried out, employers' and workers' organizations can also offer assistance services to small enterprises or own-account workers that wish to make the transition to formality via the new scheme. Social dialogue mechanisms can be used to monitor success, take stock of lessons learnt and recommend improvements based on experience. As they engage in the process, workers' and employers' organizations should bear in mind that they can represent the enterprises and workers that are being addressed by the formalization drive as these actors in the informal economy need to have a voice in the design and monitoring of policies, reforms and support measures towards their formalization.

Employers' and workers' organizations can contribute to good governance of entry level tax and social security schemes. Entry-level tax and social security schemes may offer reduced contribution rates linked to the size of the enterprise. In this case, they entail the risk of abuse by non-targeted enterprises. Enterprises that have outgrown the scheme may submit false declarations of enterprise activities or turnover to ensure that they continue to fulfil eligibility criteria.

Larger enterprises can subdivide into smaller units, to fall within maximum thresholds and benefit from the scheme. As mentioned above, some enterprises have also used entry-level schemes to maintain disguised employment relationships and undercut worker's rights, by dismissing their formal employees and rehiring them as own-account subcontractors. A careful design of these schemes is therefore important to avoid adverse effects (ILO, 2019). Employers' and workers' organizations have an important role to play as contributors to their design and as 'watchdogs' of entry-level tax and social security schemes. Workers' organizations can establish early warning systems for workers, allowing them to alert the authorities whenever a company is suspected of engaging in disguised employment practices or other fraudulent activities. Employers' organizations can advise government on the design of eligibility criteria, to ensure that entry-level schemes are well-targeted and that larger enterprises with sufficient contributory capacities remain within the general scheme. Employers' organizations can also use their business networks to monitor unfair practices, thus preserving the 'level playing field' for small and large enterprises alike. The duties of employers' and workers' organizations that have been described above are of course open-ended: governance challenges in entry-level schemes need to be addressed, to ensure that they achieve their ultimate goal of integrating MSEs into the general tax and social security system.

In some cases, an organization of workers can also facilitate the collection of tax and social security contributions. Between 1987 and 2003, the Ghanaian Internal Revenue Service employed a technique known as 'Identifiable Grouping Taxation' (IGT) or 'Associational Taxation', to collect tax contributions from actors in the informal economy.¹¹ The arrangement was initially tested

on the Ghana Private Road Transport Union before being extended to thirty-two other associations from different subsectors of the informal economy. Associational Taxation delegates responsibility for tax collection¹² to an organization that represents the target contributors, in exchange for a share of the revenues collected. The Ghanaian IGT scheme is considered to have been beneficial to the associations and their members; the payment of taxes granted them legitimacy and shielded them from the risk of penalization by law enforcement agencies. Over the long run, the experiment inculcated a culture of tax compliance and facilitated a gradual shift to a presumptive tax regime, introduced without facing resistance from enterprises. Collaboration between government and informal actors, including well-governed membership-based associations that had secured the trust of their members, facilitated the inclusion of informal enterprises into the tax and social security system. The scheme was tailored to the realities of the informal economy and offered enough benefits for informal enterprises to secure their adherence.

Collective registration agreements can help overcome some of the barriers to extending coverage and facilitate administrative procedures through using an organization of workers as an intermediary between workers and the social security institution. Such agreements allow own-account workers to enter collective or group insurance agreements with a social insurance scheme, provided that they belong to an organization (such as a trade union, cooperative or rural producers' association) which has the capacity to be an effective partner in such an agreement. Normally, the organization is responsible for grouping and registering workers and collecting previously negotiated contributions from its members, which it then transfers to the social insurance institution. It works in

11 Joshi, Prichard & Heady (2014) *Taxing the Informal Economy*.

12 In Ghana in the mid-to-late 1980s and 1990s, the Ghana Private Road Transport Union (GPTRU) consulted and negotiated with the Internal Revenue Service (IRS) to make reforms to the 'presumptive' tax scheme – a scheme whereby a predetermined lump-sum tax payment is demanded when an income-based figure cannot be determined within the informal sector. Reforms included the creation of the Identifiable Group Taxation (IGT), a form of associational taxation, which used informal sector associations as tax collection agents. These groups – and most successfully the GPTRU – collected tax from their members on a daily or weekly basis in order to reduce the burden on low-income members having to pay large lump sums. The associations were also offered a 2.5 per cent share of the collection (Christian Aid, 2011)

cooperation with the state institution responsible for the management of the social insurance scheme. In this way, registration and payment procedures are organized and conducted by the organization, while members are provided with the benefits granted by social insurance. Thus,

procedures are simplified for workers and the costs of social security administration are reduced. Examples of collective registration with public social insurance schemes can be found in Ecuador (Peasants' Insurance Scheme), Costa Rica, Argentina and Colombia (ILO, 2019).

► Box 6: Democratic Republic of Congo



In 2015, the Democratic Republic of Congo implemented a reform that unified the payment of taxes and employer's contributions to social security.

Prior to the reform, enterprises had to deal separately with a range of different government bodies, including the National Institute of Social Security (*Institut National de Sécurité Sociale - INSS*), the Tax Directorate (*Direction Générale des Impôts*), the National Institute for Professional Training (*Institut National de Préparation Professionnelle - INPP*) and the

National Office for Employment (*Office National de l'Emploi - ONEM*). Separate payments made it difficult for these institutions to check for consistency and detect false declarations.

INSS, DGI, INPP and ONEM have now signed a Memorandum of Understanding which requires them to share information about registered employers and harmonise the calculation of tax and social security contributions.

The DGI is responsible for receiving payment and redistributing the relevant share to the INSS. Enterprises deal exclusively with the DGI on all matters related to tax and social security, thanks to the new 'One Window' system.

The reform has allowed the INSS to raise its revenues, from two-hundred and eighty-four billion Congolese Francs in the eighteen months prior to the reform, to three-hundred and twenty-seven billion Congolese Francs in the eighteen months that followed (an increase in revenues of 15.11 per cent).

Source: ILO (2018). *Initiatives de Promotion de la Promotion de la Formalisation des Entreprises et leurs Travailleurs en Afrique*.

► Box 7: Brazil



One of the most well-known 'entry-level' tax and social security schemes, *Simple Nacional*, was developed in Brazil in the 1990s and the 2000s. This scheme - and one of its subcomponents, the *Individual Micro-Entrepreneur* scheme or *Regime do Microempreendedor Individual* - is credited with having encouraged the registration of 7.7 million individual micro entrepreneurs and 5 million micro and small enterprises from its creation up to 2018 (and 10.4 million individual micro entrepreneurs by July 2020), with a plurality of formerly informal micro-enterprises citing access to social security, enterprise formalization and the permission to issue invoices as the

main reasons for formalizing, and seventy-eight per cent reporting increased sales after formalization.

The establishment of a governance structure capable of unifying tax and social security contributions across all three levels of the Brazilian government structure was no easy feat; it required the establishment of a management committee (the *Comitê Gestor do Simples Nacional*) comprising representatives of the Federal, State and Municipal governments, to coordinate regulation and policymaking and ensure greater coherence for enterprises.

Notwithstanding its achievements, the scheme has faced some misuse, including false declarations of enterprise activities or turnover to ensure eligibility, the use of the system to maintain disguised employment relationships, and the sub-division (or 'horizontal split') of enterprises to avoid exceeding maximum thresholds. The scheme has also increased the maximum thresholds and reduced the minimum contributions (from 11 per cent of the minimum wage to 5 per cent), which has had a distorting effect on incentive structures and which affected its progressivity and sustainability. This shows the importance of careful design of such schemes.

Source: ILO (2019). *Simples Nacional: Monotax Regime for Own-Account Workers, Micro and Small Entrepreneurs*. Geneva.

► **Box 8: Monotax mechanisms: simplification of payment procedures**

In many countries, tax and contribution obligations require various payments to different subsystems at different levels of government (municipal, regional and state) and to different social security institutions, often according to different calculation methods and payment schedules. Combining different contributions into a single simplified payment therefore facilitates the payment process.

In **Argentina**, *monotributo* contributors can make one payment instead of payments to four different systems. Payments have to be effected monthly before the 20th of the following months in cash, online, by credit or by debit card. Contributors do not need to submit a sworn declaration concerning value-added tax (VAT) and income taxes and do not have to keep accounting records. They have to make a self-categorization into one of the 11 contributory groups every four months, which is subject to verification by the entity in charge.

In **Brazil**, companies can file one single simplified annual tax declaration instead of the various tax and social security declarations that they had to present at the municipal, state and federal levels previously. Instead of paying each tax or contribution separately and according to different calculation methods and payment schedules, taxpayers contribute one single amount through the Plan Simples.

In **Uruguay**, small businesses that fall into the category of *monotributo* contributors can choose between paying a *monotributo* on revenue generated by their activities or paying the ordinary social security contributions and normal taxes. Monotax contributions are collected by the Uruguayan Social Security Institute (BPS), which transfers the tax share to the fiscal authority and uses the contribution share to finance social security benefits for those members affiliated through the scheme and their families.

Source: ILO, 2019 (p. 130). *World Solidarity (WSM) 2016. Amussol: informal workers have access to social security in the Dominican Republic! - Thematic Report Latin America • N° 2.*

► **Box 9: Costa Rica: Collective insurance agreements with farmers**



In Costa Rica, own-account workers, including farmers, have been able to join organizations and enter collective insurance agreements with the social insurance system since 1984. To register, the organization files an application with the social insurance system, together with documentation proving its legal personality and associate number. After the organization is accredited, the negotiation procedure begins. Only own-account workers and those performing activities consistent with the nature of the organization may participate. The organization also negotiates group contributions with the Board of Directors. It is responsible for collecting the

previously negotiated contributions from the insured and transferring them, together with a monthly report, to the social insurance institution (Caja Costarricense de Seguro Social (CCSS)).

The CCSS Board of Directors is responsible for establishing general guidelines, approving increases in contribution scales and settling force majeure disputes. Collective agreement registrants have the same rights as those established for employed workers. Contribution levels are set according to the specific productive activity performed by the registered workers of the organization and according to the contributory capacity of the registered group. They are established on the basis of specific and regular reference incomes for certain members, rather than according to income categories as in the case of individual registration. Within the same organization, different contribution scales are established for individual members. The organization itself decides what scale is most appropriate to the person's income. This is periodically verified by inspectors. This mechanism has had a favourable impact on rural development in Costa Rica, especially for organized own-account workers in the agricultural sector and among female farmers.

Source: ILO (2019). *Extending social security to workers in the informal economy - Lessons from international experience.* Geneva: International Labour Office (Box 5.25).

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Enterprise Formalization: An Introduction

Thematic Brief No. 1/2021

Enterprise Formalization: Simplifying and facilitating business start-up and compliance

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Enterprise Formalization: Tailored registration, tax and social security requirements for MSEs

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