Not that simple

Expanding the simplified tax system for small businesses may have higher costs than expected and fewer productivity, employment, and income distribution benefits.

SOLANGE MONTEIRO

SINCE THE CONGRESSIONAL recess ended, awaiting its turn to be voted in the Senate has been Bill 125/2015, which grants benefits and simplifies tax preparation for small businesses opting for the National Simple tax system. For instance, it doubles the annual gross revenue ceiling from R$3.6 million to R$7.2 million in 2017, and doubles it again to R$14.4 million in 2018. For the individual microentrepreneur (MEI) the ceiling increases from R$60,000 to R$90,000 a year.

On September 2015, the House of Representatived approved the bill unanimously, as is not unusual given the support that small businesses usually attract. Around the world, small businesses are considered an engine of growth, and in some cases innovation. In OECD member countries, for example, businesses with up to nine employees represent 90% of all businesses and account for a quarter of total employment. In Brazil, more than 5 million firms qualify for the Simple option and another 5.6 million for the MEI; in 2015 they paid R$69.5 billion in taxes.

If the bill is approved, however, Brazil’s new gross revenue ceilings for small businesses to benefit from the simplified tax system (about
US$1.8 million) will be diverging further from international practice. In 2011, for example, Colombia’s gross revenue ceiling for small businesses was US$60,000; in Argentina US$48,760 (services) and US$73,140 (commerce); and in the United States US$48,900. In addition, in many countries, unlike Brazil, benefits for small businesses are much more focused on reducing red tape to facilitate formalization than on tax cuts, points out IBRE researcher Fernando Veloso. “Spain—where the gross income ceiling to be considered a small business is US$4.7 million, higher than in Brazil—has set a limit for the tax benefits of US$488,000 million,” he says.

According to Brazil’s federal revenue service, approval of Bill 125/2015 will reduce tax revenues by R$12.7 billion in 2017 and R$16.1 billion in 2018—although the Brazilian Micro and Small Enterprises Support Service (Sebrae) contests those numbers. Fernando de Holanda Barbosa Filho, also an IBRE researcher, advises that to accept a cut in tax revenue of this magnitude, the country should have a clear idea of the costs as well as the benefits. “In Brazil, we have an incorrect view that formalizing small businesses and reducing the tax burden is a good thing in itself, regardless of the fiscal cost,” he says. Yet there is already evidence from several countries, including Brazil, that this policy has done little to increase the formalization and productivity on small businesses. Barbosa Filho notes that “First, because unproductive subsidized companies will remain active, more efficient companies cannot replace them, which brings down the productivity of the economy. Furthermore, raising the gross revenue ceiling to be considered a small business will benefit companies that do not need this kind of support—a company with R$14 million gross revenue is not considered small anywhere in the world—and it removes any incentives for these companies to support the broader tax reform Brazil desperately needs.”

Joana Monteiro, professor at the Brazilian School of Public and Business Administration (Ebape/FGV), agrees with Barbosa Filho: “We live in an incredibly bureaucratic country. Initiatives to cut red tape and reduce taxes are worthwhile. What worries me, in the case of the Simple, is that it is an exception system, which creates a problem for those who are not in it. If we expand the Simple, it will certainly reduce the pressure for more structural reforms that benefit everyone.”

**Bridge for growth**

The Simple was created in 1996. It consolidated six federal taxes and other federal contributions into a single tax. According to the Federal Revenue Service, in 1997 two-thirds of Brazil’s formal businesses joined the simplified system. In 2006, the Simple was expanded to cover
Brazil’s new gross revenue ceiling for small businesses to benefit from the simplified tax system is far above international practice

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<th>Ceilings in US dollars</th>
<th>Ceilings as multiples of income per capita</th>
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<tbody>
<tr>
<td>Argentina</td>
<td>48,760 (services) and 73,140 (commerce)</td>
<td>5.36 (services) and 8.05 (commerce)</td>
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<tr>
<td>Brazil</td>
<td>1,000,000</td>
<td>132.2</td>
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<tr>
<td>Canada</td>
<td>121,400</td>
<td>2.8</td>
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<tr>
<td>Colombia</td>
<td>60,136</td>
<td>9.7</td>
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<tr>
<td>United States</td>
<td>48,000</td>
<td>1.0</td>
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<tr>
<td>Mexico</td>
<td>148,624</td>
<td>15.9</td>
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<tr>
<td>United Kingdom</td>
<td>114,072</td>
<td>3.2</td>
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Sources: Inter-American Development Bank, Central Bank of Brazil, government statistics agency IBGE.
Note: Data for Brazil are based on an exchange rate of R$3.60 per US$ and GDP and population of 2014. For other countries, data refer to 2011.

The construction industry is less sensitive to policies that reduce operational costs such as the SIMPLE simplified tax systems, according to IBRE.

state and municipal taxes. Eight years later, in 2014, the Simple was again revised, to cover regulated professions, such as engineers, lawyers, architects, and economists.

Sergio Gustavo da Costa, who helped to coordinate the FGV study that contributed to the formulation of Bill 125, considers the bill a good initiative that comes at a time when the government is in a difficult fiscal situation. The purpose of the bill, he says, is to improve the growth potential of companies opting for the Simple by reducing distortions in the current system that lead companies to break up into smaller ones to qualify for the simplified tax system and benefit from lower taxes. “The focus of the proposal is not to expand the system (although this is expected to happen), but to coordinate the migration of the company to the estimated profit taxation system or taxable income more competitively,” he says.

For Bernard Appy, director of the Tax Citizenship Center, the bill does not address the main problem of the Simple, which is that it taxes gross income. Smaller firms tend to compete directly with informal businesses that do not pay taxes,
and so they have to reduce their profit margins. For companies with low profit margins and low profitability, however, taxing gross income, he says, is much more expensive than taxing value added, wages, and profits. Appy compares two businesses with the same gross income, which spent the same, and are subject to the same tax rate as the Simple: “For the business operating with a lower profit margin of 20%, the tax may be up to 20% of the profit margin; for the business with a profit margin of 50%, the tax is a much lower 8%.”

Appy points out that Brazil’s tax system today opens a huge space for tax arbitration because of different rules for the MEI, Simple, the estimated profit taxation system, and taxable income—which in general also benefit higher-income people and entrepreneurs. For example, the tax on legal services would be 35.4% in the taxable income regime, 23.3% in the estimated income regime, and 13.5% in the Simple. This encourages people to form companies using arrangements that increase revenue and reduce taxes. Another problem of the Simple is that profits distributed to owners of small business are exempted from the owners’ personal income tax. Thus, Appy says, “Employees and civil servants account for

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Joana Monteiro

Brazil has one of the highest costs of compliance with tax obligation

Hours per year spent to comply with tax obligations

Sources: IBRE and National Treasury Department.
According to Brazil’s federal revenue service, approval of Bill 125/2015 will reduce tax revenues by R$12.7 billion in 2017 and R$16.1 billion in 2018.

47.6% of total income and 69.1% of the income tax paid; business owners account for 22.8% of income and 7.6% of the income tax paid.” Other countries give benefits to companies, such as tax exemptions on value added tax (VAT), but the individual’s income is still taxed.

Measuring the policy impact

Ebape’s Monteiro believes the Simple, like other public policies in Brazil, needs an impact assessment to support decisions about it. “We design policies on the premise that they will have results, but we don’t know if that’s true unless we measure their impact. In recent years, we have cut payroll taxes and expanded the Simple—policies that have had a huge fiscal cost—but we have not measured their effects,” she says. She has reviewed the Simple’s first year outcome using data from the Urban Informal Economy Survey by government statistics agency IBGE and found that in 1997, the Simple pushed up by 13 percentage points the likelihood that a retail microenterprise would formalize, but there was no statistically significant impact in construction, manufacturing, transportation, and services. During that year the policy costs exceeded the benefits by a large margin. In the commerce sector, the estimated benefits in terms of increased formalization (measured by increases in average revenues and taxes) amounted to R$11.8 million—but the tax loss was R$86.2 million.

Carlos Henrique Corseuil of the Institute of Applied Economics (IPEA) and Rodrigo Leandro de Moura of the Federal Treasury Department analyzed the performance of the Simple in 1997, 1999, 2006, and 2007 in terms of total and formal employment, average salaries, and the value of manufacturing as benefit measures.
Again, the Simple had no positive impact on employment and company performance for companies close to the gross revenue ceiling.

Veloso and Barbosa Filho of IBRE and Gabriel Ulyssea of the Department of Economics of the Catholic University of Rio de Janeiro point out that Mexico and several other countries have found that policies to promote formalization are most successful when applied to groups whose characteristics are similar to those of formal employers, especially the level of education.

“Today, the evidence is that informality is more the result of low productivity than its cause,” Veloso says, noting that in Brazil, less educated people have the highest degree of informality. The Corseuil and Moura study corroborated this. They estimated that informality in the Brazilian labor market between 2002 and 2012 declined by more than 11 percentage points because of greater participation by people with more education and experience—common attributes of the formal labor market. This, says Veloso, suggests that policies to reduce entry and operational costs to participate in the formal economy are not sufficient to ensure more efficient and profitable businesses; policies to boost productivity are also necessary.

Brazil has still much to do to raise productivity. The Organization for Economic Co-operation and Development (OECD) study points out that while in Spain and France companies with one to nine employees are generating about 25% of value added, Brazil’s small companies are generating only about 10%. Daniel Barcelos Vargas, professor in the FGV Law School Rio, says that the changes needed in public policy do not necessarily include tax subsidies: “Regarding economic production, the discussion before was largely limited to how to simplify or facilitate the rules for small and medium-sized enterprises. Today, however, there is a more
“[Bill 125] is a palliative. Rather than making a broad tax reform, we are expanding tax privileges to certain groups in an appalling tax structure.”

Gabriel Ulyssea

important agenda: upgrading the economy.”

Vargas underscores the lack of instruments to supply capital for small innovative enterprises, as well as the obstacles the Simple creates to attracting capital. “The paradox is that venture capital funds can invest in a new business only if it is a corporation, but corporations cannot benefit from the Simple,” he says. “So on the one hand, the Simple streamlines and promotes social justice; on the other it gets in the way of upgrading the economy. Brazilian policy to promote formalization is focused on low-skilled entrepreneurs, not on appreciation and inclusion of more sophisticated and highly skilled entrepreneurs.”

Costa of FGV Projects stresses that Bill 125 is intended to improve what already exists. “From a tax point of view, we agreed that the best reform would be to improve the VAT. But we have to work with reality. We have discussed this issue for 20 years without success. What we see today is the government seeking approval of the Provisional Contribution on Financial Transactions (CPMF), which is a cumulative tax,” he says. Ulyssea of PUC-Rio argues that, instead of expanding the Simple, the country should move to a more horizontal and rational policy: “This is a palliative,” he says. “Rather than making a broad tax reform, we are expanding tax privileges to certain groups in an appalling tax structure,” he says. Appy argues for the same tax system for both small and large companies based on the VAT, the payroll tax, and income tax: “This choice would limit the scope for injustice in the treatment of high and low profit-margin businesses as well as allow for the possibility of granting specific benefits for businesses with high payroll taxes.” Monteiro is convinced that, despite the difficulties it entails, what is needed is a broad tax reform to promote efficiency and proper fiscal management, and reduce taxes on production as a whole.

A study published by IBRE points out that in the first year of the SIMPLE simplified tax system in 1997, only retail showed increased formalization.