WORLD BANK GROUP
Finance, Competitiveness & Innovation

Competitiveness Policy Evaluation
Impact Evaluation Brief

Georgia: Tackling Firm Informality through Tax Reform

Extensive informality of micro and small enterprises (MSEs) is often a major concern for policymakers in developing countries. While many factors are likely to play a role in determining informal economic activity, tax policy is commonly seen as one of the main policy levers. The majority of countries operate special tax regimes geared towards MSEs that are meant to ease the administrative burden of filing taxes.

The results show that the new tax regime for micro businesses increased the number of newly registered formal firms by 18–30 percent below the eligibility threshold during the first year of the reform, but not in subsequent years. The analysis does not find an effect of the new tax regime for small businesses on formal firm creation in any year. Policy makers are often concerned about abuse risks stemming from differentiated tax treatment of micro and small businesses.

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Context

Over the last two decades, the tax treatment of Georgian MSEs has varied extensively with the application of different tax regimes. Several special regimes were introduced, but their design was somewhat complex and they were ultimately replaced by other regimes. Tax reforms in 2005 provided for an equal tax treatment irrespective of business size. Given that compliance costs are largely fixed, this regime placed a comparatively high administrative burden on MSEs.

Intervention

Informed by an initial IFC report (December 2009) and subsequent working discussions, the Ministry of Finance re-introduced a simplified tax regime for Micro Small and Medium Enterprises (MSME) in 2010. Under this new regime, businesses with annual revenue below GEL 30,000 (US$ 18,255) and without employees are designated as "micro" businesses and exempt from income taxation. Firms with annual revenue between GEL 30,000 and GEL 100,000 (US$ 60,850) are designated as "small" businesses and have the option to be taxed based on revenue instead of profits, at a rate of 3 or 5 percent (taxing revenue is simpler than profits because it does not require tracking expenses).

Evaluation Design

The research team obtained an administrative database with anonymized information from the Georgian Tax Authority. The database reports the date when a firm first registered with the tax authority and how much revenue it declared in each tax year (for 2008 through 2012).

To study the effects of the reform, the research team rely on a regression discontinuity design based on the GEL 30,000 and GEL 100,000 eligibility cutoffs in annual revenue. This approach compares eligible firms just below each cutoff to firms just above each cutoff.

Policy Relevance

Extensive informality of micro and small enterprises (MSEs) is often a major concern for policymakers in developing countries. While many factors are likely to play a role in determining informal economic activity, tax policy is commonly seen as one of the main policy levers. The majority of countries operate special tax regimes geared towards MSEs that are meant to ease the administrative burden of filing taxes. These simplified taxation approaches may encourage micro and small firms to formalize, i.e. to register with the tax authority. However, they also raise concerns about strategic behavior around eligibility thresholds, i.e. firms posing as smaller firms by underreporting revenue. A gross 'formalization gain' from registration could thus turn into a net loss in formal economic activity when accompanied by increases in concealment efforts.

There is little empirical evidence on the effects of simplified tax regimes on firm registration and underreporting. A recent tax reform directed at Georgian MSEs provides an opportunity to study how large these effects are in practice.

Results

The micro firm tax regime increased the number of firm registrations below the GEL 30,000 cutoff by 18 to 30 percent in 2010, but there was no effect in later years. Unfortunately, the data do not allow the research team to distinguish whether registrations come from previously informal firms or newly created firms.

At the same time, the research team finds no robust effect on firm registration due to the small firm tax regime below the GEL 100,000 cutoff.

To measure underreporting, the research team examine how much revenue previously registered firms declare in 2010, given their declared revenue in 2009. As shown in Figure 1, there is a downward jump in 2010 revenue declared just below the GEL 30,000 cutoff. That is, firms below the cutoff declare significantly less revenue in 2010 on average – between 6 and 11 percent – than firms just above the cutoff (presumably to be eligible for the new micro tax regime).

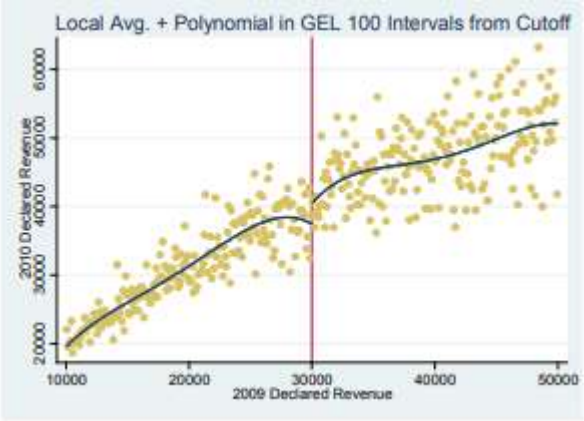

Figure 1. Declared revenue around GEL 30,000 cutoff - 2010 (post-reform)

Materials

Methodology Note

Final Data Analysis

Impact Policy Note

Literature review of various tax impact evaluations

Researchers

Miriam Bruhn, Senior Economist, the World Bank

Jan Loeprick, Senior Economist, the World Bank

Research Funding Partners

World Bank Competitiveness Policy Evaluation Lab