

# The taxation system for smes in mauritius economics essay

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Small and medium enterprises are universally acknowledged as effective instruments for employment generation and economic growth, and in Africa where the private sector is not well developed, SMEs are playing a critical role in stimulating development and alleviating poverty (Beyene, 2002). It is renowned that SMEs occupy a sine qua non role in their national economy respectively. They are a driving force for the creation of employment. In general, the former not only represent almost 90-95% of the business population of the world but also about 80 percent of the employment as well as around 30-70percent of the gross domestic Product (GDP). Small enterprises constitute more than 90 percent of the industries in some Asian countries such as Philippines, Indonesia, Hong Kong, Thailand, Korea, Japan, India and Sri Lanka. They comprises to the 98 percent of the employment in Indonesia, 78 percent in Thailand, 81 percent in Japan and 87 percent in Bangladesh. Results by researchers over the years made it an undeniable fact that small and medium institutions play a much more vital contribution in economic growth and development. As a result, SMEs serve not only economic of a county but also the mission and goal of a nation. The contributions of this sector in the economy entail its function in industrial base, employment generation, manufacturing output, exports and GDP. On the other hand, the social contribution of SMEs consists of encouraging the employment of social harmony, regional balance, cultural integration and empowerment of poor and unfavourable sectors especially for woman to develop entrepreneurship that will help in increasing gender equality by providing the female population with a source of income.

## **Importance of SMEs**

SMEs are important in most if not all the economies of the world, but the former are of greater importance in developing countries where wealth distribution and employments are challenges. Moreover, SMEs are undeniably essential in the Mauritian economy, more precisely when it comes to employment, contribution to GDP and innovation. The government is looking forward that the SMEs sector contributes more to employment and economic growth of the nation. In Mauritius the SMEs occupy a central place in the economy, accounting for 90% of business stock (those employing up to 50 employees) and employing approximately 25% of private sector employees (Wignaraja and O'Neil, 1999; CSO, 2003; NPF, 2004). Kesseven Padachi (2012) who made an analysis of the importance that accounting services attribute to small Medium sized Mauritian Manufacturing firms states that: " SME'S are the backbone of an economy as they are the major contributor and plays an important role as efficient providers of intermediate goods and services to large firms".

## **SMEs in the Mauritian economy**

Different criteria can be applied to make the difference between large firms and SMEs in a nation. The two most usually used criteria are: Number of employees Annual value of sales Established under the SMIDO act 1993 as a parastatal institution, The Small and Medium Industries Development Organization (SMIDO) was the former support organisation for SMEs in Mauritius. Its objectives were to promote growth and development of SMEs. Small and Medium Enterprise is defined as one whose Production Equipments do not exceed 10 million Mauritian Rupees. Likewise SMEs are

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defined by the Small and Medium enterprise Development Authority (SMEDA) as small enterprise if it has an annual turnover not more than 10 million MUR and as medium enterprise if it has an annual turnover more than 10 million MUR but less than 50 million MUR. Contrary to SMIDO and SMEDA, the Central Statistical Office (CSO) of Mauritius takes into consideration the employment factor rather than production equipment to determine the firm size. A small enterprise is one whose turnover cannot exceed 3 million MUR with a maximum of 10 employees and having an aggregate investment in Production Equipment of up to 1 million MUR while a medium enterprise is one which can employ from 11 to 50 workers, has an annual turnover of up to 80 million MUR and an aggregate investment not exceeding 10 million MUR. As said by the latest figures from the CSO in 2002, there are 75, 267 small units in Mauritius comprising of 45, 586 enterprises and 29, 681 itinerants. The main sectors consist of: Manufacturing, Construction, Wholesale and retail, Transport, storage and communication, Hotels and restaurants. In 2004, small units amounting to 2, 212 were registered as small units with SHEDA (Small Enterprise to Help Development for All) thus resulting with the creation of 16, 942 employments. In 2005, a better amount of small units was recorded amounting to 2, 252 generating 18, 096 jobs and to bring the continuous progress of SMEs into the limelight, 2, 216 new small units were being registered in 2007 with SHEDA. Table 1 below provides a sectoral distribution of SME units registered with SHEDA showing a positive growth of firms in this sector over the four years. Table 1 (Source: Statistics SEHDA 2009) Demonstrating the engagement to promote this sector, the government includes SME sector as part of the budget and governments

over the world are injecting more funds to enhance this sector which is slowly making an appearance in proving its worth as well as its necessity in the economy. From statistics of the CSO, it is crystal clear that SMEs are becoming of more importance not only in the contribution of the economy but also in the generation of employments. In addition, the contributions SMEs usually made to tax revenue are lower than its contributions to output and employment (International Tax Dialogue, 2007).

## **Taxation of SMEs**

Generally, the choice of tax policy that will be employed depends on the utilization of two groups of instrument either exclusively or jointly. The first one is the use of special tax preferences and the second one is the use of incentive which consist of minimising the corporate income tax rates, special exemptions as well as relieves for small enterprises to sustain creation and expansion of SMEs. The main objective of taxation is to collect revenue effectively through means that will not only conform a nation's circumstances but also its administrative capacity. In fulfilling the revenue function, a well designed tax system should be efficient in minimizing the distortionary impact on resource allocation, and equitable in its impact on different groups in society (Bolnick, 2004). It is fundamental that a country's performance is reviewed properly before applying any tax program to have a good system of tax because many adversities with tax authorities are due to poor structure of tax policies and a lack in vision as well as conviction for future changes in the tax structure. Tax policies should aimed at realising accumulated cost savings reducing lost in revenue, economic disturbance, bias and uncertainty in the tax burden. Moreover, tax strategies should

endeavour at levying all big tax payers at a regulated rate so that they are sure of paying their share of tax conveniently while on the other hand, more incentives should be provided to low income earners to facilitate their part of tax payments. Table 2 below shows some example of the trend of the corporate tax rate of some countries of the world from the year 2006 to the year 2013.

## **Table 2**

(Source: KPMG) For the welfare of any country, an efficient and effective tax system is fundamental as this regime will ensure that all business are on equal footing when it comes to their tax filing and paying obligations. Additionally, equilibrium between the educational and supportive role with that of the enforcement role provided by the tax system is essential. The raison d'être behind the entire tax system depends on two main tax theories namely; the Equal Distribution Principle and the Ability-to-Pay Principle. Both of these concepts focus on two characteristics of a good tax system which are none other than equality and fairness. While the Equal Distribution Principle states that revenue, wealth and any transactions should be levied at a fixed rate which means that a person who earns more and purchases more should pay more taxes but not at a higher rate, the Ability-to-Pay theory stresses on the fact that a person should be taxed on their ability to pay; that is, a person who earns more should be levied more taxes compared to a person who earns less.

## **Fairness of a taxation system**

The taxation system is said to be at the heart of a nation having relationships with individuals, families and companies. The former is a crucial tool to a government who is willing to work for the welfare of its nation as this system not only affects the business environment but also the contribution that people make to firms. The Mauritian tax system has increasingly been developed over the years and is now being used for well beyond more than its initial role of raising fund. It has become an economic instrument to encourage efficiency, a political instrument for income and wealth redistribution and a social one to promote welfare and development of the nation. Nowadays civilization expects that the system of tax provides fairness among its people and also competitive framework for enterprises. The system is undeniably confusing and also a real headache when it comes to make efficient use of it. This is due to complexity and also time for amendments to take place. Robert Chote comments, " When discussing how fair or efficient the tax system is, we should really look at the tax, tax credit and benefit systems in their entirety rather than at any tax or set of taxes in isolation ... It is the impact of the overall mix that matters." Philip Broadley and John Whiting, writing in relation to business taxes, say, " The system needs to be looked at in its entirety ..." What makes up a " fair tax" has been the matter of discussion since Adam Smith suggested his four canons of taxation in *The Wealth of Nations* in 1776: Equity: a tax should be seen to be fair in its impact on all individuals. Certainty: taxes should not be arbitrary; the taxpayer should know his or her liability and when and where to pay it. Convenience: it should be easy for taxpayers to pay what they owe.

Efficiency: the tax system should not have an impact on the allocation of resources and it should be cheap to administer. Without any doubt we can conclude that everyone is of the same opinion that tax should be fair. The problem is to give a generally accepted definition of tax fairness so that each and everyone can express their personal view on what contribute to a fair tax system as well as to understand the function of such a system.

### **Is the taxation system for SMEs in Mauritius a fair one?**

In the year 2006, the Ministry of finance of Mauritius chose to embark on a completely new reform programme by doing all the arduous reforms on his very first year. The tax reforms were made purposely to boost the collection of revenue, improve transparency as well as to ease the compliance of tax payers. Actually, in Mauritius, there was neither an increase in the tax rates nor removal of any services. What was more surprising was that Mauritius decreased the tax rates and got more revenue in return. This was done because there was little tax compliance in Mauritius compare to US where for most of the taxpayers were paying their fair part of tax at a low rates.



**Mauritius introduced a new tax rate of 15 per cent on personal returns corporate gains, nearly zero import duties and a consistent 15 per cent rate of GCT (General Consumption Tax). A lower corporate tax rate of 10 per cent was to be implemented to attract more foreigners for investments but this could not be put in practice due to lack of finance. By having both personal income and corporate tax at the same rate, Government curbed the number of people who were setting up companies just to pay a lower rate of tax. The tax system became both sensible and fair. Below in figure 3 is the historical background how corporate tax rate changes over the years.**

Figure 3(Source: Trading economics, World Bank)From a paper based view, this implemented system was believed to be regressive, but when seen in a practical view it was proved to be regressive as this has helped many poor from the tax net. Moreover, lowering the import duties have helped in the reduction of cost of food and other goods which is beneficial to the nation. The essence was to maintain a very simple tax reform, with an aggressive legislation so as to identify any person or company who was escaping their fair part of tax payment. Moreover, in Mauritius both SMEs and large companies pay the same rate of tax which shows no discrimination in terms of size, type or company performance. All companies will have to abide to the same law. MRA is taking its duties seriously leaving no stone unturned by applying all revenue laws objectively and impartially treating all people and firms equitably without any prejudices. Our tax laws being simple facilitate taxpayers to understand the rules along with the conditions which have to be followed so as to comply with the former effectively. Being simple also help in decreasing the amount of mistakes, promotes better compliance and

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increase the worthiness of the system. Simplicity has help Mauritius to move ahead successfully by achieving many objectives of a tax policy such as curbing non-compliance, cost effective collection, payment convenience and transparency. Having a simple tax system allows taxpayers to foresee the results of their economic choices. In a country like Mauritius, tax payers are conscious of the tax rules governing the nation. These help taxpayers to spot the real transaction costs and to be aware of the consequence of the taxation system. Transparency helps to simplifies tax and this help taxpayer who has difficulty to calculate when and whether they will be taxed due to complexity in the provisions.

## **MRA**

The Mauritius Revenue Authority (MRA) was operational under the MRA Act of 2004. The MRA, responsible for the collection of revenue and the imposition of revenue law, always had the support as well as the adherence of the Government to fulfil its aim to renovate the revenue administration in the local country so as to comply with the international standards.

Furthermore, the tax reforms were not only intended to ameliorate the collection of revenue but also to promote fairness in the Mauritian tax system, enhance transparency and to ease compliance of taxpayers. The MRA has been a key player in promoting fairness of the tax system by providing many facilities to SMEs as well as other tax payers. Mauritius is one of the countries in the world to enjoy a fair tax system where it is simple, transparent, having low tax rate and also being always supported by an agency which provided many incentives to taxpayers. Some facilities that taxpayers benefits from the MRA: The use of SMS to pay tax via Orange

Money This service provides a person with the facility to pay his taxes through SMS using his cellular phone on a 24 hour basis without having to go to MRA office to do the payments. E-Filing Service Taxpayers will be able to fill their tax form online on the after registering on the MRA website.

Therefore, there is no need for taxpayers to come to fetch their tax form at the MRA office. Cancellation of Vat Registration : Tax Relief Favouring SMEs The innovation of this financial year for the SMEs is the cancellation of VAT registration for taxpayers who have a return not exceeding Rs 4 million to avoid paying VAT on their revenue. Formerly, the threshold was Rs 2, 000, 000. Providing more facilities show the willingness of the government to build a fairer tax system for the benefits of not only small but also big tax payers. The MRA contribute enormously to the wealth of the nation by collecting 90 percent of the country's annual returns with the remaining being collected by bodies like the Gambling Regulatory Authority and the National Transport Authority. " MRA is among the best Tax Administration Performing around the world. Despite this, we can always improve and further enhance MRA services, " stated the CEO, Sudhamo Lal (2013).

## **Comparing the corporate tax rate of Malta and Tanzania with that of Mauritius**

These two countries were chosen for this comparison because they have about the same population size and democracy as that of Mauritius. This will help us to have a wider thought on the fairness of the Mauritius tax system. The corporate tax rate of Malta and Tanzania is 35 per cent and 30 per cent respectively. This rate of tax can be viewed as high and can discourage investor to come to the county although there are many facilities which

come along with this rate of taxes. Mauritius a small country with same democracy demarcate itself from countries of same economic background with its low rate of tax of 15 per cent which helps to promote growth of small firms as well as large firms with others facilities provided by the government. Having such a low rate of tax eases the tax burden of small newly born firms as well as to promote economic growth of the country as there is a higher compliance in the payment of tax.

## **Conclusion**

In 2012, the financial secretary of the Finance Minister Peter Phillips, Ali Mansoor said that Jamaica should use Mauritius as model for IMF agreement after analysing the performance of the fairness of Mauritian tax system which has evolved successfully trough years with the help of the IMF. Taking Mauritius as an example gives us an overview of how fair is our tax system.

## **Tax Compliance and SMEs**

According to Marti (2010) tax compliance is a complex term to define. It was simply described as all the obligations that a taxpayer has to abide as mentioned by law. It has been found that regulatory burdens fall disproportionately on small and medium enterprises internationally (Pope & Abdul-Jabbar, 2008). The size and nature of SMEs is of great importance for tax compliance due to the limited access to resources and lack of know-how for complying with different and complex policies. It is also believed that high cost of compliance can give rise to tax fraud, tax avoidance and a reduction in investment due to decrease in competitiveness of the nation when it comes to taxation attractiveness. Non-compliance of tax may be of any

types. For example, it can be a failure in submitting a tax return on the predetermined time or a non submission itself, underestimation or overestimation of profits or an outright failure in paying levied tax on time. Analysis has come to the conclusion that tax evasion is becoming a prevalent problem. Furthermore, Fagbemi, Uadile & Noah (2010) found that it is prevalent in developing countries and it hinders development thereby leading to economic stagnation and other socio-economic problems. Chipeta (2002) identified tax rates as one of the causes of tax evasion. He mentioned that higher rate of tax gives taxpayer's burden and reduces their disposable return resulting in a higher probability of escaping tax.

## **Tax Policy and Level of Voluntary Compliance among SMEs**

Small taxpayers under the normal tax system can be said to be disfavoured due to the fact that compliance cost, rate of tax and compliance needs are same for small and large firms. Decreasing the cost of compliance and the rate of tax will increase the profit margin of small enterprise. Additionally, this will also result in an increase in the Government's tax return as the simplified legislations for SMEs will decrease the amount of non-complying taxpayers. Moreover, SMEs generally have to work in a tyrannical managing environment with excess of regulatory agencies, numerous taxes, oppressive importation scheme and high cost which continuously become real obstacles for their operation. An overly complex regulatory system and tax regime or one opaque in its administration and enforcement makes tax compliance unduly burdensome and often have a distortionary effect on the development of SMEs as they are tempted to morph into forms that offer a

lower tax burden or no tax burden at all (Masato, 2009), and this results in a tax system that inflicts high charges on the general public. A poorly executed tax system also leads to low efficiency, high collection charges, waste of time for taxpayers and the staff, and the low amounts of received taxes and the deviation of optimum allocation of resources (Farzbod, 2000). Results from analysis have shown that SMEs pay a higher cost of compliance than large firms when measured by sales or assets.

### **Tax Policy that will Encourage Voluntary Compliance by SMEs**

SMEs constitute untapped revenue potential and an uneven playing field in many countries (International Tax Dialogue, 2007) as such they need to be captured by the tax net. Even if legislations are watchdog for the safeguard of the business world and protection of the economics agents for the erection of important social security policies, by adding more administrative and expenditure obstacles, this can hamper business growth as well as compliance. For a tax system to be efficient, the tax policy needs to be designed such that the tax rates are appropriate and rational, the exemptions are lower in amount, the tax collection organization are more efficient, the tax burden of the indigent people should be lighter and the fight against corruption and tax evasion should be much more intense (Shahroodi, 2010) Tax strategies can be devised so as not to affect SMEs directly as well as to promote for voluntary compliance and growth indirectly. Special tax regimes for SMEs may be appropriate policy instruments for minimizing the cost of collection (Yaobin (2007). Because awareness of the dangers of inadequate taxation of SMEs has grown because

of the potential of uneven tax enforcement to cause distortions of competition, voluntary compliance by larger enterprises and by wage earners, (International Tax Dialogue, 2007), government intervention should help maintain balance while ensuring that countries exploit the social benefits from greater competition and entrepreneurship. A number of studies have consistently shown that both the penalty and the probability of audit have a positive influence on tax compliance (Beck, Jon, & Jung, 1991; Becker, Büchner, & Sleeking, 1987). Even though an audit probability is found to be effective in encouraging tax compliance, Alm, Jackson and McKee (1992) find that using greater penalties is ineffective in enhancing tax compliance. In contrast, other studies point to mixed influences of tax compliance, depending on the group of taxpayers (e. g. Witte & Woodbury, 1985). Pro-business (and Pro-SME) Tax regimes and enforcement should be simple, consistent and predictable should to lower compliance and administrative costs, and hence reduce uncertainty faced by taxpayers as well as improve the levels of voluntary compliance (Kasipillai, 2005).

## **Theories of Tax Compliance**

Various opinions exist about the best ways to improve tax compliance. Given the chance, a lot of businesses will not pay taxes unless there is a motivation to do so. Some believe that the best way is to increase incentives (Feld & Frey, 2007) whereas others believe the best way is to increase penalties. Tax compliance theories can be broadly classified into two. They are: economics based theories and psychology based theories.

## **Economic Based Theories**

They are also known as deterrence theory and they lay emphasis on incentives. The theory suggests that taxpayers are amoral utility maximizers- they are influenced by economic motives such as profit maximization and probability of detection. As such they analyze alternative compliance paths for instance whether or not to evade tax, the likelihood of being detected and the resulting repercussions and then select the alternative that maximises their expected after tax returns after adjusting for risk. This process is referred to as " playing the audit lottery" by Trivedi and Shehata (2005). Therefore according to the theory, in order to improve compliance, audits and penalties for non-compliance should be increased.

## **Psychology Theories Psychology**

These theories on the other hand posit that taxpayers are influenced to comply with their tax obligations by psychological factors. They focus on the taxpayers' morals and ethics. The theories suggest that a taxpayer may comply even when the probability of detection is low. As opposed to the economic theories that emphasize increased audits and penalties as solutions

## **Perception towards government and tax compliance**

Tax compliance is proposed to be studied based on a psychological tax contract representing " a complicated interaction between taxpayers and the government in establishing a fair and reciprocal exchange" (Feld & Frey, 2007, p. 103). The existence and survival of this tax contract is apparent in a number of circumstances in prior studies. For example, if taxes paid and



public services provided by government are regarded as equitable, taxpayers may be inclined to comply with tax laws and this has a significant positive effect on tax compliance (Feld & Frey, 2006; Torgler et al., 2008). The taxpayers indeed are willing to pay taxes even though they were not given the exact value of public goods, as compared to the taxes they have paid, if they perceived the political process as fair and lawful (Feld & Frey, 2007). As shown in many studies, the involvement of taxpayers in a political process has a positive influence on tax compliance and taxpayers with direct democratic rights are found to be more compliant (Pommerehne, Hart, & Frey, 1994; Torgler, 2005; Torgler & Schneider, 2007). The reverse is evident in transition countries such as Russia, Belarus or Latvia after the collapse of communism because of the 'institutional crisis', where the citizens' tax morale is lower, compared to non-transition countries such as Bulgaria and Croatia (Frey & Torgler, 2007, p. 146). Tax compliance is also influenced substantially by trust in government and legal systems (Frey, 2003; Torgler, 2003b) and this trust can only be gained if the government can assure that taxpayers' expectations are fulfilled (Hardin, 1998). The taxpayers' opinion on the tax system either as a fair or an unfair system, is also identified as influencing tax compliance behavior, as apparent in a number of research studies (Alm, Jackson, & McKee, 1993; Murphy, 2003). In general, voluntary tax compliance may be increased if government achieves a policy exchange approach as promised to its nation.

## **Budgetary measures to encourage voluntary compliance by SMES in Mauritius**

In view of the importance of the SME sectors to the local economy, the Government of Mauritius has recognized the need for more sustainability, consistency and uniformity in the provision for supporting SMEs as well as for having a fair system and promoting voluntary compliance. In recent budgets, the Government has contributed enormously for the promotion of this flourishing sector and today is not an exception. The budget has relieved SMEs by capping interest rates, rationalising bank charges and taxes and minimising the tax burden through the increase in the VAT registration threshold from Rs. 2m to Rs. 4m. Having new measures for SMEs, this will help for more compliance for this sector to benefits from these facilities and services granted by the Government.

### **Budgetary measures on SMEs:**

Bank guarantees required for expatriate employees, who work in export oriented enterprises, will be abolished. This will be replaced with an annual fee of Rs. 500 per employee per year.

### **The African Growth and Opportunity Act (AGOA) levy, which is an export tax, is being abolished.**

Foreign insurance companies will be allowed to offer export credit insurance. Any changes in import duty likely to affect local manufacturers will be announced with 6 months prior notice. SME Financing scheme is targeted to increase from Rs. 1 billion to Rs. 1. 25 billion for companies with turnover under Rs. 10 million. Interest rates to the SMEs will be capped at repo rate plus 3 per cent, i. e. currently at 7. 9 per cent. Bank processing fees and

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other related charges will be waived. Government will exceptionally guarantee 50 per cent of any losses incurred by banks. Interest rates on the Leasing Equipment Modernisation Scheme (LEMS) which is currently at 8.5 per cent will be brought down to 7.25 per cent. All capital outstanding that does not exceed Rs. 20,000 from DBM and which is unpaid for 3 years will be waived. There is a multiplicity of schemes that are available to SMEs that are leading to confusion. These are being regrouped and rationalised. Performance bonds will not be required for government contracts of up to Rs. 5 million. The amount of refund to SMEs for participation in international fairs will be doubled - increasing from Rs. 100,000 to Rs. 200,000. The Government will further provide a grant of up to Rs. 20,000 for freight expenses. A special grant of Rs. 10 million is being provided to Enterprise Mauritius to support the marketing effort of the Shoe Industry. Outcome of tender exercise will be displayed on procurement portal for contracts of Rs. 5 million and above instead of Rs. 15 million and above. The measures announced above certainly will provide more choices for SME's to step up against economic challenges and this will help to have a wider range of SMEs' compliance. Moreover, this will promote a fairer taxation system for SMEs and having a fairer system of taxation will promote voluntary compliance as there will be more willingness in the part of SMEs to benefit from facilities as well to be in legal term for operation.