

Creating a Favorable Tax Environment for Small Business Development in Transition Countries

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Abstract

With the move to a market economy the number of small businesses has grown substantially in most transition countries. However, cumbersome legal provisions and administrative practices and the lack of a culture of voluntary compliance often provide strong incentives to operate outside the formal economy. The paper first discusses the growth of the SME sector in the region and its impact on tax policy and tax administration. It then describes approaches chosen by different countries in the region to reduce the tax burden and compliance costs for SMEs. It shows that the design of a clear and reasonably fair simplified tax system is a task which often has been underestimated by Ministries of Finance and tax administrations. As a consequence, simplified taxation systems risk to lack stability and transparency. With a growing and increasingly powerful small business lobby in transition countries, policy makers face more and more pressure to further reduce the small business tax burden, risking to broaden the gap between the simplified and the standard tax system and to provide incentives for the use of evasion and avoidance techniques by larger businesses as well as employees. The paper looks at policy changes in Georgia, Ukraine, Russia, and Albania and analyzes their motives and impact. In the final section the paper shows that, despite the often very generous tax reductions offered by simplified regimes, these regimes have not significantly altered the tax behavior of SME operators. Small businesses generally continue to view the tax system as a key obstacle to business development and the overall tax burden as too high. This may partly be due to the fact that simplified regimes in many cases have been introduced in lieu of income tax only, so that the business operator continues to be confronted with a large number of tax obligations and high compliance costs.

One of the core elements of the transition to a market economy in Central and Eastern Europe and the countries of the Former Soviet Union has been the creation of a large number of small and medium size businesses. The SME sector in transition countries emerged as a result of the privatization and breakup of large state-owned enterprises, as well as through a large number of new, generally very small firms that were created as a consequence of the market liberalization process¹. Today on average 82% of firms in Eastern Europe are small businesses, ranging from a relatively low percentage of the economy in Russia (48.98%) and Ukraine (54.33%) to as much as 97.8% in Estonia². This development creates major challenges for tax systems that are still in an early stage of development and, in particular, tax administrations that lack both professional experience and a proper organizational structure and resources. Many transition countries have attempted to facilitate the taxation of small taxpayers by designing simplified taxation schemes. This paper first will discuss design options and examine the key problems and weaknesses in the design of simplified small business taxation schemes in transition countries. It then raises the question as to whether these schemes in practice have been able to meet the expectations of the small business community as well as the tax administration.

Small business development and compliance

Rapid development of a small business segment in the economy from a tax administration point of view signifies a rapid increase in the number of ‘hard-to-tax’ taxpayers. Given that an independent, self-employed and small business sector was virtually non-existent as a separate category of taxpayers in the socialist tax system, this represents an increase in the taxpayer population, which any tax administration, but especially the inexperienced tax administrations in transition countries, would find difficult to manage. In Russia the number of small businesses grew quickly in the first phase of transition, from 268,000 in 1991 to a peak of 896,000 in 1994³. In Armenia the number of small businesses recorded in the state register in May 1999 had increased 8.3 times compared to 1994, 82.8% of which were firms with 1-10 employees. Furthermore, 47,625 self-employed persons were in the state register in May 1999, which is nearly 6.8 times the number registered in 1994⁴. Development of a small business sector was also extremely rapid in Poland, where in only one decade of free markets two million small enterprises were established⁵, and in Hungary, where the rate of self-employed doubled between 1988 and 1993. Even in the later stage of transition, growth in the number of small business taxpayers was remarkable in some transition countries. In Bulgaria for example, the number of enterprises registered by the General Tax Department (GTD) increased by more than 25% within two years, from 573,000 in 1997 to more than 721,000 in 1999. More than 93% of these registered businesses were small taxpayers. None of the tax administrations in the region had any possibility to adapt their capacity to the growing number of taxpayers. Due to the lack of sufficient audit experts, the non-

¹ See Svejnar (2002).

² See Klapper, Sarria-Allende, Sulla (2002).

³ It then slipped to 877,000 in 1996, however, and continued to decline to 840,000 in 1997.

⁴ Ministry of Statistics, State Registers and Analysis Armenia (1999).

⁵ FEED (1998).

existence of a proper risk analysis capacity to determine priorities for taxpayer control, and the natural emphasis of tax administration reform on assuring the appropriate administration and collection of taxes from large taxpayers, there was very little chance in practice to design and implement a compliance strategy for the small business sector.

The culture inherited from the communist period in many transition countries saw small businesses and general private economic activities as parasitic, hence more as an enemy of the state rather than as source of prosperity and a larger tax base. This perception impeded the development of a cooperative relationship between the small business community and the tax administration. Lack of appropriate compliance management combined with the non-existence of a voluntary compliance tradition facilitated rapid development of the underground economy in many transition countries. Estimations indicate that in several countries in the region a larger share of small business activities is carried out in the underground than in the official economy. The observation in a Hungarian research paper that, “Examining Hungarian data, it appears that some of the innovation in small businesses indeed took the form of tax evasion in informal activities”⁶, is equally valid for other countries in the region. Gërkhani, e.g., estimates that in Albania the average ratio of tax evasion in the self-employed sector of the economy is 56.5%⁷. A survey carried out by the Armenian statistical office in December 1998-January 1999, covering 2,046 self-employed listed in the state register and 1,800 employers and self-employed identified in the labor force survey, revealed that in the 12 months preceding the survey, 75% of the self-employed and employers surveyed had engaged in unregistered economic activity⁸. Finally, for Lithuania, Chandler estimates the percentage of undeclared income by retail traders with less than 9 employees to be 35%⁹. Difficulties with the tax system, with respect to both the level of the tax burden and tax administration processes and behavior figure prominently among the key reasons given by small businesses for working underground in many transition countries. For this reason changing and simplifying the tax system for small businesses became an obvious element of tax reform in the region.

From a tax administration perspective the mere number of registered small businesses does not reflect the full compliance management problem, however. In addition to having to administer a large number of taxpayers with relatively low revenue potential the volatility in the sector creates difficulties for tax administration. Only in a small number of cases has the small business boom lead to the creation of actually viable enterprises. Many of the new SMEs were created from the break-up of larger and inefficient state enterprises and from the privatization of smaller units of large firms, and had low survival rates¹⁰. A large share of SMEs in transition countries thus are newly created, while older enterprises cease to exist. This leads to a situation where, e.g., in Estonia, Lithuania, Russia and the Slovak Republic, more than 20% of total firms were incorporated in the last three years¹¹. In this scenario there is very little chance to

⁶ Scharle (2002)

⁷ Gërkhani (2003)

⁸ Ministry of Statistics, State Registers and Analysis Armenia (1999)

⁹ Chandler (2002)

¹⁰ See Klapper, Sarria-Allende, Sulla (2002)

¹¹ See Klapper, Sarria-Allende, Sulla (2002)

successfully familiarize small business owners with bookkeeping and taxation rules. The probability is high that until a business owner has gained experience with properly keeping his books and filing a tax return, his business will no longer be active. Again, simplifying the taxation rules represents one possibility for dealing with this problem.

There is another aspect to business fluctuation, however, which even simplified systems cannot really address. This is illustrated by the findings of a survey carried out in Hungary in 1994. The survey showed that only 10-15% of the companies employing 10 or less persons registered in Budapest in the tax registry of the Tax Administration Authority (APEH) could be reached at their 1992 address in spring 1994. The vast majority of small businesses seem to either only have existed in a formal sense or were operating from an address different from the official one, mostly in private homes¹². Tracing registered taxpayers and following up in case they have stopped filing returns or paying patents thus remains a high administrative burden and difficult task irrespective of a standard or a simplified regime.

System Design

The spread of presumptive systems

Almost all transition countries now have introduced some kind of simplified tax system for SMEs and sole proprietors, as the table 1 shows:

Country	Kind of system	Remarks
Albania	Lump sum or gross turnover tax	Fixed tax for micro businesses = annual turnover under 2 million Lek (US\$14,000) 4% gross turnover tax for small businesses = annual turnover 2-8 million Lek (US\$57,000)
Armenia	Lump sum	Fixed payment for small-scale activities such as hairdressers, gas stations, commercial fishing, and trading activities conducted in locals with trading areas less than 30 square meters
Azerbaijan	Gross turnover tax	2% gross turnover tax when turnover less than 300 times the minimum tax-exempt wage (US\$ 6400)
Belarus	Lump sum	Lump sum tax for stores that are single owned and total trading space less than 25 square meters, plus public catering enterprises, and at markets and sales exhibitions
Bosnia & Herzegovina	No system	
Bulgaria	Lump sum	For individuals in specific business sectors with annual turnover under 75,000 BGN
Croatia	Lump sum	
Czech Republic	Lump sum	
Estonia	No system	
Georgia	Lump sum	For enterprises with turnover less than GEL 24,000 (US\$ 11,000)

¹² See Tóth, Semjén (1996)

Hungary	Lump-sum	Small entrepreneurs may choose an itemized presumptive tax in lieu of personal income tax and VAT
Kazakhstan	Lump sum or gross income tax	Special regime based on simplified return for individuals with not more than 15 staff and gross income max. T 4.5 million and legal persons with not more than 25 staff and gross income max. T 9 million. Lump-sum tax for gambling business.
Kosovo	Lump sum tax	Any taxpayer other than an insurance company with gross receipts less than 15,000 DEM
Kyrgyzstan	Gross turnover tax	SMEs (total revenue up to 3 million soms or approximately US\$ 63,000) may pay from 5 to 10% gross turnover tax instead of all national taxes. Individual entrepreneurs can optionally obtain a patent and pay a monthly gross turnover tax, i.e., in retail trade 4%
Latvia	No system	
Lithuania	Presumptive tax	Optional for firms with gross income less than 100,000 LTL (US\$ 26,000)
(FYR) Macedonia	Lump sum	
Moldova	Lump sum	Individual entrepreneurs can buy patent which involve a monthly fee
Poland	Lump sum	
Romania	Gross income tax	Micro enterprises with less than 10 employees and an annual turnover less than Euro 100,000
Russia	Uniform (unified) tax Single tax	Uniform tax for entrepreneurs and companies in selected industries -- retail trade, public catering, car maintenance, transportation services, personal and veterinarian services: 15% imputed income tax. Single tax for entrepreneurs and companies with up to 100 employees and 11 million RUR (US\$ 352,000) turnover: 6% gross turnover tax, and 15% gross turnover minus expenses tax. Both taxes replace profits/personal income tax, property tax, sales tax and single social security tax; exempt firms and entrepreneurs from VAT, and provide tax credit for pension contributions.
Slovak Republic	Lump sum	
Slovenia	No system	
Tajikistan	N.A.	
Turkmenistan	Lump sum	Lump sum license for entrepreneurs without a legal entity and with an annual turnover of less than 72 million manats (US\$ 14,000)
Ukraine	Unified (gross turnover) tax, fixed tax; trade permit; small enterprise tax	Unified tax for companies with up to 50 employees and turnover less than UAH 1 million (US\$ 190,000) and individuals with up to 10 employees and turnover less than UAH 500,000: 6% gross turnover tax which does not exempt actor from VAT, or 10% gross turnover tax, which does exempt firms from VAT.
Uzbekistan	Gross turnover tax or lump sum tax	Unified tax on gross revenues for wholesale trade 3-5% of turnover (depending on location), for public catering 7-10% of turnover (depending on location). Lump sum tax for individual entrepreneurs without a legal entity

FYR Montenegro	N.A.	
FYR Serbia	Gross turnover tax, lump sum tax	Enterprises can opt for 2% tax on gross receipts. Condition: 50 employees or less; turnover less than 8,000 average monthly gross wages; average value of assets less than 6,000 average monthly gross wages. Lump-sum taxation for individual entrepreneurs.
Source: Mitra and Stern (2002)		

To a considerable extent these simplified regimes have been initiated or recommended by the donor community and providers of technical assistance, including the IMF and the World Bank. Key motives generally have been either the improvement of the business environment or the simplification of tax administration and the fight against the underground economy. The World Bank's Foreign Investment Advisory Service (FIAS) analysis of the tax system in Georgia, for example, assumes that the introduction of a fixed or simplified tax scheme for small businesses could contribute to easing some of the problems with tax administration that deter new enterprise creation¹³. Similarly USAID has supported an initiative launched by the Federation of Business Circles of Kyrgyzstan to expand the use of the patent system to a broader range of small businesses in order to decrease the costs of small business compliance with the tax system. In Ukraine a USAID report lists presumptive taxation as an instrument to facilitate the collection of revenues from the shadow economy; similarly, the Letter of Intent of the Government of Moldova of November 30, 2000, which describes the policies that Moldova intends to implement in the context of its request for financial support from the IMF, includes a commitment to analyze the appropriateness of a presumptive tax on small enterprises to draw new private businesses into the tax net. Along the same lines, a senior IMF official considers simple presumptive taxes, such as small business license fees, as a way to raise revenues and as an easy way to bring new taxpayers into the tax net and compile information that will eventually allow them to be transferred to the standard tax system¹⁴. For transition countries aiming at accession to the European Union, the EU Commission recommendation on improving and simplifying the business environment for business start-ups¹⁵ has become an additional incentive for the introduction of presumptive systems although the recommendation does not propose specific taxation regimes, but states in general that "Member States should consider introducing, where appropriate, derogations or simplified procedures to help SMEs which do not unacceptably reduce the objective of the regulation. For example, in regulations dealing with taxation, ..., the introduction of threshold levels or reduced monitoring and reporting requirements can significantly reduce the burden and compliance costs for SMEs". On the other hand, several World Bank reports also have pointed to the weaknesses and risks of presumptive systems. The FIAS (2001) report on Georgia, apart from highlighting the potential benefits of a simplified scheme, considers a fixed tax to be very complicated, and a recent World Bank report on tax policy and tax administration in Ukraine discusses the risk of lack of focus and unjustified generosity of presumptive systems. Surprisingly little

¹³ FIAS, p. C-41.

¹⁴ Cheasty (1996).

¹⁵ Recommendation C(97) 1161 final of 22 April 1997.

attention has been given in these discussions to the risk of imposing a comparatively high tax burden on small businesses in their start-up phase¹⁶. This apparently is not considered an issue in the presumptive tax systems of transition countries.

Choice of system

Obviously there is a relatively short history of small business taxation in transition countries. In the initial stage of tax reform some countries experimented with the use of tax incentive schemes not only for large businesses and foreign investments but also for small business development. In Kazakhstan, in the first stage of transition (1990-1993) tax incentives for SMEs were introduced, exempting SMEs from profit tax for the first three years after establishment. For the fourth year they paid 50% of the tax rate, with the full rate applied only after five years. During that period, the number of small businesses grew rapidly, in part because of re-registration of the previously established Coops. Many small businesses were set up by big state-owned enterprises whose managers, using the incentives granted to small businesses, often put state resources into them. This resulted in serious abuse and embezzlement since there were no legal criteria for the status of small business entities. In order to improve the situation, the government had to take extreme measures and abolished all privileges¹⁷. Similarly, in Moldova the law, "On Supporting and Protecting Small Businesses" of May 1994, established tax holidays for five years for micro-enterprises and two years for small enterprises engaged in priority activities, such as construction, production of medical equipment, and production of children's foodstuff. In case of non-priority activities, the tax holidays were reduced to three years for micro-enterprises and one year for small businesses.

Recognizing that tax holiday schemes are not an appropriate instrument to address tax evasion in the small business sector, and the specific compliance problems of micro-enterprises and self-employed, transition countries generally have moved to the design of simplified systems for hard-to-tax taxpayers along the lines of systems applied in other developing and developed countries. There are three main types of systems in place in the region: (i) they are based on turnover/gross income, (ii) specific indicators for the size and output of the business, such as the floor space, the number of employees, or the location of the business, or they are (iii) general patents for specific professions irrespective of the size, location, and turnover of the business.

Turnover/gross income-based presumptive systems: a number of transition countries use turnover or gross income as a parameter to determine the tax liability of small businesses. Turnover or gross-income-based systems can be structured in different ways. One alternative is to apply the same tax rate to all businesses subject to the tax, irrespective of the business activity. This approach fails to consider that profit margins can be substantially different in different business sectors. Examples are the unified tax in Ukraine, which operates in principle with only one rate of six percent on sales¹⁸. The new Russian small business tax also has as one of the components a 6% flat tax on turnover,

¹⁶ World Bank (August 2002).

¹⁷ Statement made by Bektas Mukhamedjanov, Advisor to the Prime Minister of Kazakhstan, at OECD Forum on Entrepreneurship and Enterprise Development in Istanbul March 1998; see FEED (1998).

¹⁸ Except in cases where the simplified tax also replaces the VAT; in these cases a 10% rate applies.

and the new simplified system introduced for micro-businesses in Romania from September 2001 operates with a very low rate of 1.5% on gross income¹⁹. Also the proposal for a simplified tax system developed by the Ministry of Finance in Georgia planned to introduce a flat 7% tax on gross income for all businesses below the VAT threshold which have some basic accounting in place.

A second alternative is to divide the small business community into a number of business segments with different tax rates for the individual segments. This is supposed to take into account the different profit margins in business segments, although the number of segments under a turnover based system is relatively small. It is generally far less differentiated than an indicator based system. Examples for this alternative are the Armenian small business tax, which distinguishes three categories of businesses: traders, who pay 4% of gross turnover, caterers with a 7% rate on gross turnover, and other businesses, for which the rate is 7% for turnover up to Dram 30 million and 12% for the portion of turnover exceeding Dram 30 million. Similarly, the new Kyrgyz simplified system introduced in 2002 establishes different turnover tax rates depending on the type of business; rates vary between 5% and 10% of turnover. A third alternative introduces a progressive tax on gross income. This system is rather unusual, and the special regime based on simplified returns in Kazakhstan is the only obvious example in the region. The system taxes gross income at rates between 4% and 13%. It needs to be emphasized in this context that the differences in tax rates between countries only partly reflect a difference in the actual tax burden, as the number and type of taxes replaced by the presumptive tax also varies widely (see Table 2).

Indicator-based systems: Presumptive systems based on indicators have become increasingly popular in transition countries. These systems aim at being more precise than turnover-based systems in estimating the profit potential of the individual entrepreneur. However, this brings up a clear conflict of objectives; the objective to tax the true potential profit of the small business conflicts with the objective to design a simple and transparent system. Policy-makers in transition countries face considerable difficulties designing indicator-based systems that establish an acceptable balance between these objectives; systems tend either to be extremely complicated and unclear or they do not sufficiently differentiate between business activities. The latter is the case in Georgia, where the presumptive system only distinguishes between five groups of activities:

Activity	Number of population		
	Up to 30,000	30,000 – 100,000	Above 100,000
a) retail trade in booths in streets (except farmers markets and markets), waysides, retail trading from counters and agricultural products trading on	10 Lari	18 Lari	35 Lari

¹⁹ Government Ordinance Nr 24 of July 26, 2001.

markets, except people that produce these products			
b) retail and wholesale trade at farmers market and markets (booth, containers, shops, warehouses, etc.) except trade from counters	20 Lari	30 Lari	35 Lari
c) goods production, rendering of services, work fulfillment, except as stated in sections 'd' and 'e' of the table	10 Lari	25 Lari	50 Lari
d) transport service up to 17 seats accommodation, shipment	20 Lari	50 Lari	100 Lari
e) production of jewellery, repair of jewellery and watches, transportation services above 17 seats	30 Lari	75 Lari	150 Lari

In this case, except for retail trade, transportation and jewellery shops (and restaurants, which are subject to a different regime), all small business production and service activities are in the same category and thus subject to the same tax burden. The system therefore has not achieved its objective to tax according to the profitability of the small business.

The Bulgarian “levy of a final annual (license) tax”²⁰, on the other hand, is an example of a system putting the emphasis more on the profit margin of the individual business activity. As a consequence, it established 43 different small business sectors. As the potential profit in each business sector depends substantially on the location of the business, the country was divided into nine zones (of which four are in Sofia municipality). With a different tax rate applying depending on the zone where the taxpayer’s business is located, more than 300 tax rates were established and have to be updated regularly. But even small businesses grouped in the same segment can be very different. The business category “mass-catering and amusement establishments”, for example, includes everything from very basic food kiosks to luxury bars and nightclubs. To avoid under- or over-taxation the category had to be divided into six sub-categories; those sub-categories again were divided according to the quality of the establishment, distinguishing, e.g., one-star from three-star restaurants, and all establishments had to be treated differently according to their location. This required setting 52 different tax rates for one segment of the small business community.

How confusing and questionable such a system risks becoming can be demonstrated by looking at the category “construction and building-repair”. The Bulgarian law distinguishes three kinds of businesses: general construction and building repair; repair of

²⁰ Chapter 14 of the Bulgarian income tax law

wiring and plumbing systems; and glazier services. Again, dividing the country into nine zones, 27 tax rates had to be established. The first striking issue is that the nine different rates for glazier services are exactly the same as for general construction services; so it becomes unclear why it was necessary to establish two separate sub-categories. What is even more confusing and questionable from the point of view of a business is why the tax rates for repair of wiring and plumbing systems are considerably lower than the rates for general construction in seven zones, but are equal to the tax burden of general construction business in the other two zones. This is hard to comprehend and leads in practice to an ongoing discussion between businesses, the tax administration, and the Ministry of Finance about the need to modify the system. A second issue of concern to the business community in practice has become the question which businesses should be included in the system and which excluded. Indicator-based systems, unlike turnover-based systems, have to establish detailed lists of businesses covered. This leads in practice to an ongoing dispute about the fact that certain businesses either are taxed under the simplified system and would like to be transferred to the general system, or, more frequently, are not covered by the simplified system but would like to be included. In Bulgaria, for example, there is strong pressure from the service sector to extend the system to more categories of services. In fact, it is difficult for the Ministry of Finance to justify why the lease of public lavatories or the rental of video cassettes is taxed under the presumptive system, while bicycle and car rental are taxed under the standard system; or if clairvoyants, psychics and bioenergy therapists are taxed under the presumptive system, why do doctors and dentists get excluded. Overall it appears that the degree of acceptance of indicator-based systems is not high. The categories in the Bulgarian system, introduced in 1998, have been revised almost every year since, and will probably be changed with the same frequency in coming years.

General patents: Some countries apply a general patent scheme for the taxation of micro-businesses. The micro-business patent is not based on any indicators of the profit potential of the business. The amount of the patent only depends on the kind of business, so taxation is irrespective of the size, the location of the business or the business turnover. Kosovo, for example, has introduced such a system in 2000 for moving traders, artisans and other low-income generating activities (defined as small businesses with quarterly gross receipts of less than DEM 2,500). These businesses are subject to the payment of a quarterly patent of DEM 75.

Other design issues

Apart from the choice of the simplified system there are a number of other design issues that have been addressed somewhat differently by the countries operating a simplified system. This relates in particular to the treatment of legal versus natural persons, the determination of the threshold for the application of the system, and the number of taxes replaced by the simplified system.

Treatment of individuals versus legal persons: The most uniform approach in the region to taxing small businesses is the extent to which legal entities have been classified as hard-to-tax. The approach chosen by transition countries does not differ substantially from common practice in other regions. Micro-business patents and presumptive systems

based on indicators generally only apply to individuals. An exception is the presumptive tax based on indicators in Kosovo, which defines small taxpayers as “any taxpayer (other than an insurance company) that had gross receipts of less than 15,000 DEM per quarter in all previous calendar quarters”. Turnover/gross income-based simplified systems, on the other hand, generally apply to both legal entities and small businesses operated by individuals. The tax burden normally is the same for both types of businesses. A special case is the “Special tax regime based on a simplified return” in Kazakhstan, which establishes a different tax burden for individuals and legal entities. Art. 377 of the Kazakh Tax Code says: “The income of an *individual entrepreneur* shall be subject to taxation at the following rates (Table 3):

Table 3	
Income per quarter	Rate
Up to and including T 1,500,000	4 percent on the income amount
More than T 1,500,000 and up to and including T 3,000,000	T 60,000 + 7 percent on the amount of income in excess of T 1,500,000
More than T 3,000,000	T 165,000 + 11 percent on the amount of income in excess of T 3,000,000

The income of a *legal entity* shall be subject to taxation at the following rates in Table 4:

Table 4	
Income per quarter	Rate
Up to and including T 1,500,000	5 percent on the income amount
More than T 1,500,000 and up to and including T 3,000,000	T 75,000 + 7 percent on the amount of income in excess of T 1,500,000
More than T 3,000,000 and up to and including T 4,500,000	T 180,000 + 9 percent on the amount of income in excess of T 3,000,000
More than T 4,500,000 and up to and including T 6,500,000	T 315,000 + 11 percent on the amount of income in excess of T 4,500,000
More than T 6,500,000	T 535,000 + 13 percent on the amount of income in excess of T 6,500,000

Determination of the system threshold: A key design issue for a presumptive system is to determine a threshold for the application of the system that is both high enough to include most hard-to-tax businesses, but not too high to preclude larger businesses who should keep books and comply with the filing and assessment requirements of the general tax system. Different from the situation in many developing countries, the level of literacy and basic knowledge of bookkeeping and accounting practices is relatively high in transition economies even among small business owners. The inability of small business owners to comply with standard or simplified accounting rules therefore is no valid reason for operating a presumptive taxation system for SMEs in the region. Therefore, it is more considerations of small business promotion and tax administration capacity constraints that determine the number and size of businesses subject to presumptive taxation. From the small business development point of view the application of a presumptive taxation scheme can protect small entrepreneurs from having to understand and apply cumbersome and often ambiguous taxation rules and being subject to unpredictable and arbitrary decisions of tax administration bodies.

From a tax administration point of view, the limited capacity of the newly established tax administrations in transition countries is not sufficient to guarantee a full compliance management of all taxpayers under the general system. The application of a simplified system to a large number of small taxpayers reduces this compliance management burden and permits to focus tax administration attention and capacity on larger and more important taxpayers.

This means that the decision on the appropriate threshold for a presumptive system has to take into consideration the small business development strategy of the country and the actual capacity of its tax administration. It also means that the threshold must not necessarily be constant in the long term. With improving clarity and quality of tax policy and increasing capacity of tax administration the threshold should eventually be lowered and more taxpayers brought into the standard taxation system.

Current experience shows that the determination of an appropriate system threshold is a more serious issue for turnover-based systems open to individuals and legal entities, but it can also lead to serious under-taxation should individual entrepreneurs be in a position to benefit from a presumptive system regardless of the size of their business. Not all systems are sufficiently strict in this respect. In the Armenian presumptive system, the turnover threshold of 30 million Dram does not apply in the case of traders or persons engaged in catering, including restaurants. The Kazakh special taxation regime for certain types of entrepreneurial activity (Chapter 67 of the Tax Code), which mainly applies to various gambling activities, covers gambling businesses irrespective of the legal form or size of the business. A different, but equally dubious case in this respect is the Serbian lump sum taxation system for individuals, which sets a threshold without precisely defining its criteria. Art. 40 of the Income Tax Law says “Any sole proprietor who in view of the circumstances is unable to keep books, or the keeping of which would impede the conduct of his business, may apply for being allowed to pay tax on a lump-sum basis”. Such an approach facilitates negotiation and corruption.

Clear thresholds for presumptive systems either are based exclusively on the business turnover (e.g. Albania, Bulgaria, Georgia, Kyrgyz Republic) or on turnover combined with other criteria, most frequently the number of employees. The definition of a small business in non-tax laws, especially for statistical as well as for company law purposes, in most countries is not based on a single quantitative indicator, but generally uses business turnover and number of employees as criteria to determine which firms are to be considered as small. Countries aiming at coordinating the application of the presumptive tax system with the scope of application of simplified accounting and disclosure requirements in their company law therefore will generally have to use multiple indicators to define the system threshold for presumptive taxation. Only in cases where either the company law defines a small business exclusively based on the business turnover, or where the presumptive tax system is applied irrespective of the accounting rules in the company law, a single, turnover-based system threshold is appropriate.

Systems covering both legal entities and individuals often establish different thresholds. In Ukraine the threshold for the unified tax is up to 50 employees with an annual gross income of up to 1 million UAH for companies, and up to 10 employees with an annual

gross income of not more than UAH 500,000 for businesses run by individuals. In Kazakhstan, the threshold for the system based on a simplified return is a maximum of 25 regular staff and 9 million T income for legal entities, and a maximum of 15 staff and 4.5 million T income for individual entrepreneurs. Depending on the design of the system, it might be appropriate to exclude certain categories of businesses from the simplified systems either because of special characteristics of these businesses or to force them to keep books and records. Good examples are the Kyrgyz and the Russian systems, which do not apply to financial services, insurance companies, and businesses producing excisable goods.

The dispute over a revised threshold in Russia: Determining an appropriate threshold for the simplified system can be a rather challenging task and expose tax policy makers to substantial pressure from the business community. The reform of the presumptive taxation system in Russia is the most recent example of such a policy debate. Russia reformed its small business tax system in 2002. The Russian system applies a single tax and a uniform tax. Small businesses originally qualified for the single tax based on thresholds pertaining to the number of employees and gross receipts; the threshold was 100,000 minimum monthly wages and a maximum of 15 employees. The threshold for the uniform tax was based on the number of employees and differentiated among business sectors: e.g., for public catering the threshold was 50 employees, for retail trade 30 employees, and for transportation services 100 employees.

The gross receipts threshold was considered rather high by international standards, while on the other hand the government's perception was that some of the staff-related thresholds were too low. The government as part of the reform of the simplified system therefore aimed at addressing the threshold issue. Government plans were to reduce the gross receipts threshold to 22,000 minimum monthly wages, equal to 10 million rubles or US\$ 320,000²¹. The threshold of the single tax pertaining to the number of employees was supposed to be increased from 15 to 20 employees. Small businesses, in particular the Russian Union of Small Businesses (OPORa), and other small business associations, considered the increase in the threshold of the number of employees unsatisfactory. They argued that this increase would not basically change the situation and the threshold would cover only kiosks, street vendors, and mini repair shops. They also raised the question about the seasonal workers who, under the proposed legislation, would be treated as contractors and included in the threshold²². The government, supported by some members of the Duma, nevertheless stuck to the suggested threshold, arguing that a higher number of employees would encourage the split of larger businesses into small units. In response to this concern, the Union of Small Businesses emphasized that the costs of a business split-up would be much greater than the potential tax benefits. Of course small businesses also were extremely dissatisfied with the reduction of the gross receipts threshold. Business unions argued that relatively successful small businesses had a turnover of 15-20 million rubles²³. The government insisted that, based on government

²¹ As of May 2002, the minimum monthly wage was 450 rubles.

²² See "Reference with trip", Profil, No. 14 (284), April 8, 2002.

²³ See Korop, (April 4, 2002).

estimates, 95 percent of small businesses, according to the definition provided by the Law on State Support of Small Businesses, were eligible for simplified taxation.

At this stage some large enterprises joined the small business lobby and tried to broaden the coverage of the simplified system. They started to push for an increase in the gross receipts threshold to three billion rubles (!), which obviously was refused by the government immediately. Nevertheless the government was forced to concede to the small business community. Following intense discussions between the government and small business representatives, the government agreed to keep the issue of the thresholds open in the draft law. Thus, the discussion of the threshold was left completely to the Duma. In the end, the success of the small business lobby was mixed: the threshold for the number of employees was raised substantially -- from 20 to 100 employees maximum. The gross receipts threshold however was only slightly increased – from 10 to 11 million rubles.

Number of taxes replaced by the simplified system: The simplified system can only be introduced in lieu of the income tax, or it can replace a large number of central and even subnational taxes. This issue is discussed in the following sections.

Operation of the Systems

Taxpayers and tax administrations have different expectations regarding the benefits of simplified systems. From a taxpayer point of view, stability of the tax system, reduction of the compliance as well as the tax burden, and clarity of the rules, which is required to reduce harassment and opportunities for corruption, should be the most important outcome of the operation of presumptive systems. The main interest of tax administrations is the revenue yield of the system, the reduction of administrative costs, and an increase in voluntary compliance.

Stability and Predictability of the Taxation Regime

Stability has been identified by many owners of small businesses as a core element of a good tax system. Policy instability was identified as the second major obstacle for doing business in the CIS countries according to a private sector survey for the 1997 World Development Report²⁴. The regular SME surveys carried out by the Economic Research Institute in Kazakhstan consistently reveal that the vast majority of small business operators are concerned mostly about the instability of the tax regime²⁵. The survey carried out by Tóth and Semjén shows that nearly all SME operators surveyed said that the Hungarian tax rules changed too often (93%), and only a little less (81%) that the extent of changes endangers the security of their business calculation²⁶. Stability, however, in practice is a feature of very few tax systems in the world. This is true in particular for tax systems in transition countries. The Kazakh tax code, which was adopted in 1995 and considered a model for the region, was amended so many times that the need for a complete revision and drafting a new code emerged in 2001. The tax code

²⁴ See Brunetti, Kisunko, Weder (1997)

²⁵ See Chursov (2001)

²⁶ Tóth, Semjén (1996)

of Georgia, adopted in June 1997, was changed 44 times in the first four years of its existence, which has considerably reduced the internal consistency of the Code. An IFC report on Ukraine²⁷ highlights that in the last quarter of 1999 alone, 27 pieces of legislation were introduced or amended that affected SME taxation. The question to what extent a special presumptive tax system can protect small taxpayers and tax administrators from frequent changes in tax rates and procedures therefore is crucial to evaluate the benefits of a simplified regime.

Experience unfortunately shows that presumptive systems are only marginally more stable than the general tax system. There are two factors contributing to this instability. The first is a practical problem in the design of the system. A simplified tax regime is not an isolated part of the tax system. The simplified regime was introduced in lieu of a certain number of other taxes, and the system is supposed to establish a tax burden that either equals the tax burden under the general tax regime, or is slightly lower to provide an incentive for small businesses to operate in the formal economy. To design such a system the Ministry of Finance and the tax administration would need to collect and analyze a large number of data on profit margins and the relationship between the size of the business, its location, and the profit potential. In practice, however, an in-depth analysis is seldom done, and the calculation of the tax burden is based on rough estimates of business profitability. In this scenario, it is difficult to defend the system against criticism from the business community or government institutions responsible for small business development. The second factor, the assumption that pressure for tax reform from small businesses would be less strong and effective than lobbying from foreign investors or large industry associations, has been proven wrong. As Barbone and Sanchez (2003) note, the growing number and success of small businesses in transition countries has turned them into a powerful interest group²⁸. This recently appeared in Bulgaria, where protests of taxi drivers against an increase in the presumptive tax in 2002 led to a significant reduction in tax rates and caused the resignation of the accountable Deputy Minister of Finance.

Due to uncertainty about the appropriate design of simplified systems, and the lack of data justifying the scheme in place, changes in simplified taxation schemes in practice often take the form of substantial modifications of the approach to small business taxation, and are thus not limited to simple rate changes. This can be seen from the following country examples.

Simplified taxation in the Tax Code of Georgia: The history of presumptive taxation in Georgia is a typical example of the uncertainty of policy-makers regarding the appropriate design of a presumptive system. Georgia first applied an area-based presumptive tax levied only on traders during 1994-95. This system did not sufficiently take into account the nature and profit potential of the business, and was abolished in 1996. Two years elapsed before a new presumptive system was adopted (1998) and IMF technical assistance recommendations for the design of the system were available; however, the new system fell short of expectations. It established a patent regime for six

²⁷ International Finance Corporation (June 2000), 38

taxpayer segments, in particular retail traders, goods production and services, transportation, and jewelry shops as well as repair of watches (see above). In addition, an indicator-based presumptive tax was introduced for restaurants, with the number of places used as the indicator. The most striking feature of the Georgian approach is that the simplified system was included in the transitional provisions of the Tax Code (Art. 273 of the Code) and became effective only for a 12-month period. Every year a decision of the parliament to extend the system for another 12 month is required. Clearly no consideration was given to introducing a stable tax system for small businesses.

Ministry of Finance officials designing the system had very little data on profits of small businesses, which made it difficult to determine appropriate presumptive rates. The revenue yield of the tax was disappointing; in 2000 the presumptive tax collection was only 5 million GEL or 0.7% of total tax revenues. Therefore, the Ministry of Finance, only two years after the introduction of the presumptive system, decided to change it fundamentally. However, while there was recognition that the system needed revision, it was totally unclear what the appropriate reform strategy should be. Three very different options were discussed in the ministry: the complete replacement of the existing presumptive tax system by a simple patent; the introduction of a presumptive tax based on business turnover; or modification of the existing system by increasing the tax rates and incorporating the social tax into the presumptive system. In the end, a mixed approach was chosen, and the package of tax code amendments submitted to parliament in September 2001 proposed to introduce two different presumptive taxes from January 1, 2002. The former presumptive tax was renamed fixed tax, and the number of business categories was increased from 5 to 31. The system went into as much detail as distinguishing between the manufacture of knitted and crouched pullovers, other outerwear, underwear, and hats and caps or establishing a special taxation category for manufacturers of brooms and brushes. For taxpayers not qualifying for the fixed tax, but with a business turnover below the VAT registration threshold, the package proposed the introduction of a simplified tax combining the income/profits tax and the social tax, and levied at a rate of 7% of gross income of taxpayers. The Georgian parliament however rejected the proposed new simplified system because it considered the tax rate too high and the coverage of the tax too narrow. In particular, a number of parliamentarians started to lobby for an extension of the simplified system to some larger businesses. As a consequence of the failure to change the system, the patent system continues to be renewed on an annual basis.

Presumptive taxation in Albania Similar to the situation in Georgia, the Albanian small business tax rules have not created a stable tax environment for the hard-to-tax. A first special tax regime for individuals engaged in trading activities, handicrafts, and a number of other services was introduced in Albania in early 1992. Only one year later this system was replaced with the passage of a new law for small business tax²⁹. The system introduced in 1993 had two components: a fixed tax and a tax based on gross revenues. The law listed 10 categories of taxable activities subject to a gross income tax, including a number of liberal professions such as attorneys, physicians, and dentists (8% of gross income) and experts such as engineers, teachers, veterinarians, financial advisors, and

²⁹ Law No 7679 of March 3, 1993.

agronomists (3% of gross income). The gross income tax also included gambling halls (10% of income) and the operation of all seagoing vessels used for the transportation of people and goods (3% of income). A very vague paragraph in Article 3 of the law extended the application of the gross income tax to “any other economic activities performed for profit-making purposes that are not included under the categories of this article, but are performed in shops or other separate units”, specifying that these activities were subject to a tax of 5% on gross income. Individuals performing economic activities without a fixed place of business were subject to a fixed tax per business per year, except for tourist boat rental services, in which case the tax was calculated per vehicle or boat.

The 1993 small business tax law certainly had a number of major flaws. In particular, it did not introduce an upper threshold, so that any business run by an individual, even a major law firm or shipping business, benefited from a relatively low presumptive tax burden. It did not define well the individual categories and thus opened up the possibility to dispute as to which category a taxpayer should be taxed under. In addition, it tended to group quite different professions in the same category, while at the same time rather similar professions, e.g., doctors, dentists, and veterinarians, were taxed differently. Some obvious hard-to-tax businesses, especially restaurants and bars, were not listed in any category. Clearly, the system required substantial improvement. This led to a complete overhaul of the system in 1998, when again a new law on small business tax was passed³⁰. The simplified system was extended to legal entities, and a turnover threshold of 5 million Lek was introduced. The design of the system then was changed completely. The new small business tax law introduced a fixed patent for all businesses with an annual turnover under 2 million Lek. Differing from the previous system, the patent now not only depends on the type of the business but also on its location. Also the taxpayer categories were revised substantially. For businesses with an annual turnover between 2 and 5 million Lek, an annual turnover tax of 4% was introduced. The tax has to be paid in two installments instead of four, as was the case under the previous system.

The next change was to increase the threshold from 5 to 8 million Lek in order to coordinate the application of the small business tax with the VAT threshold. Finally, in 2002 another revision of the small business tax system was initiated. A new proposal for a draft law has been prepared by a consultant company. According to this proposal, the tax will again have two components: a fixed tax, called ‘Local Government Business Tax’, and a turnover tax, called ‘Simplified Profits Tax’. The former is to be paid by all business with a turnover less than 8 million Lek, while the latter will be paid by those businesses whose turnover is between 2-8 million Lek. While, if implemented as proposed, the changes will be less fundamental than in 1998, the perception in the small business community that the simplified taxation scheme is highly unstable, could increase even more.

Clarity and simplicity of simplified systems

A well-designed, simplified system should establish clear and transparent rules for the taxation of small businesses. Only a high degree of transparency reduces the costs of

³⁰ Law No. 8313 of 26 March 1998.

compliance and the risk of corruption and harassment of businesses. Experience has shown that in a number of cases the objective of simplicity of the system was not achieved. The main reasons are an excessive number of presumptive taxes and lack of clarity in defining taxpayer categories. The presumptive tax system in force in Ukraine is an example of a lack of coordination between various presumptive taxes.

Presumptive taxation in Ukraine: Presumptive taxation in Ukraine was introduced in 1998 by presidential decree to foster the development of SMEs and to curtail the informal economy. The tax system offers small businesses the choice to opt either for the standard tax system or to select one of several presumptive tax systems. In total five different small business taxes currently exist in Ukraine:

i) *unified tax*: the unified tax is the most important presumptive tax. It applies to businesses operated by natural persons with up to 10 employees and an annual gross income of not more than UAH 500,000. Legal entities are subject to the unified tax in case they have not more than 50 employees and an annual gross income of not more than 1 million UAH. The tax rate is 6% on turnover. However, businesses subject to VAT also can opt for a 10% tax on turnover, which then, in addition to replacing the income/profits tax, also is levied in lieu of VAT.

ii) *fixed tax*: a second important presumptive tax is the fixed tax in the form of a patent. This option may be used by natural persons with a gross income from entrepreneurial activities in the 12 month preceding the grant of the patent of up to 7,000 times the “tax-free minimum income, in case the business has no more than 5 employees. A person applies for such a patent to the local revenue authority. Patent fees are set by local councils between 20 UAH and 100 UAH.

iii) There are three other presumptive taxes for very small businesses, that can be assessed by the local administration within certain limits: the so-called trade permit (for services), the small enterprise tax (for intermittent trade activities), and the market fee (for selling agricultural produce)³¹.

As Thiessen³² notes correctly, it is hard to understand why sole entrepreneurs in the service sector with no employees and a gross income below UAH 119,000 per year should have the choice of three presumptive taxes. Such an entrepreneur can either opt for the unified tax, the fixed tax, or for the trade permit. Many other small businesses have at least a choice between two taxes, the unified tax and the fixed tax. The Ukrainian approach offers small businesses the possibility of tax shopping, unnecessarily complicates the tax system, and reduces the revenue collection from this sector of the economy.

It should be noted in this context that tax policy-makers in Ukraine only one year after the establishment of the system have made an attempt to address these problems. The 1999 draft law for a new tax code included a proposal for unification. This proposal intended to reduce the number of presumptive taxes to two: a 5% “gains tax” for corporations with up to 50 employees and a gross income of not more than 1 million

³¹ See for details Thiessen, (March 2001).

³² Thiessen (March 2001), 7.

UAH, and a 10% presumptive tax on an estimated fictitious “unit income” for natural persons with up to 5 employees and an annual gross income of up to UAH 200,000³³. However, plans to pass a tax code in Ukraine have failed and have now been shelved. The presumptive tax system therefore has not been revised.

Difficulties in defining taxpayer categories, especially in the case of indicator-based systems, and patent amounts are the second most prominent element reducing clarity and transparency of the system and opening the door to negotiations between taxpayers and tax inspectors. A typical example of a vague definition is the category in the Albanian fixed-amount tax regime “Photographing services, photo-copying, beauty saloons, restaurants, hotels, motels, discos, cafes, driving-schools, auto-repairs, parking, agencies, computer courses, gambling and other similar activities”³⁴, that leaves substantial room for interpreting what is meant by ‘similar activity’ or by ‘agency’. The World Bank in one of its PREM notes³⁵ listed the introduction of presumptive taxes as a tax structure reform with a potential to reduce the opportunity for corruption. While this generally seems true, the use of business designations that are not sufficiently clear, and the widely used approach to regulate that ‘similar activities’ be treated in the same way as activities specifically listed although it cannot be clearly determined which activities are similar and which are not has the opposite effect and increases instead of reduces the opportunity for negotiation and corruption.

Reducing the compliance burden for taxpayers

One of the main reasons for designing a presumptive tax for small businesses is to reduce the compliance burden for this business segment. This objective generally has been achieved insofar as small business tax laws permit businesses to maintain simplified books and records and reduce filing frequency. In transition countries, cumbersome registration requirements create another serious compliance burden for small businesses and reduce the incentives provided by the simplified taxation scheme to formalize business activities. In Russia, until July 2002 the registration of a small business took about one month at a cost of Rub 5,000, more than twice the amount prescribed by the law, and entrepreneurs had to visit five or six different government offices to complete their registration³⁶. Registration problems thus have to be addressed through additional reform steps, e.g. the creation of a one-stop window. Russia has addressed the issue by passing a new law that sets clear and acceptable standards for small business registration. The Albanian small business tax law has not sufficiently recognized the registration element of compliance management and has increased the registration-related compliance burden for small businesses instead of attempting to decrease this burden. Any person intending to start a small business has to register with the tax office of the district where he/she plans to operate. A substantial amount of information must be supplied to complete the registration, including a) name and surname of the business owner; b) a court decision confirming his capability to conduct the business; c) a description of the types of activities that the person will carry out; d) the address of the business premises;

³³ Thiesses (March 2001), 7.

³⁴ Art. 3 Law No. 8213

³⁵ See DasGupta, Engelschalk, Mayville (1999)

³⁶ See Zamulin (2002)

e) a declaration of the turnover realized in the preceding calendar year; f) an estimation of the turnover for the current year; and g) any other information required by the tax authority. Should the small business be carried out in more than one location, a registration certificate is required for each business location. What has a particularly negative impact on compliance costs is that the registration is not permanent, but is valid for one year only. Article 4 of the small business tax law requires the business owner to re-register the business again with the tax authorities every year in February. The re-registration will only be granted if the applicant can prove that he has paid his small business tax liability for the previous year and 50% of the fixed quota component for the current year, and once the tax administration has verified that local taxes, social security contributions and other duties have been paid. This compares unfavorably with the registration process for large businesses, which are required to register only once. Thus, while the law generally facilitates the calculation of the tax and reduces bookkeeping requirements, the objectives of reducing the compliance burden and costs are no longer pursued when it comes to registration of the business. Small business tax regimes obviously do not always take the comprehensive approach required to improve the tax environment for SMEs. While the tax burden may be reduced, there is no consideration of the administrative costs for the taxpayer or the tax administration.

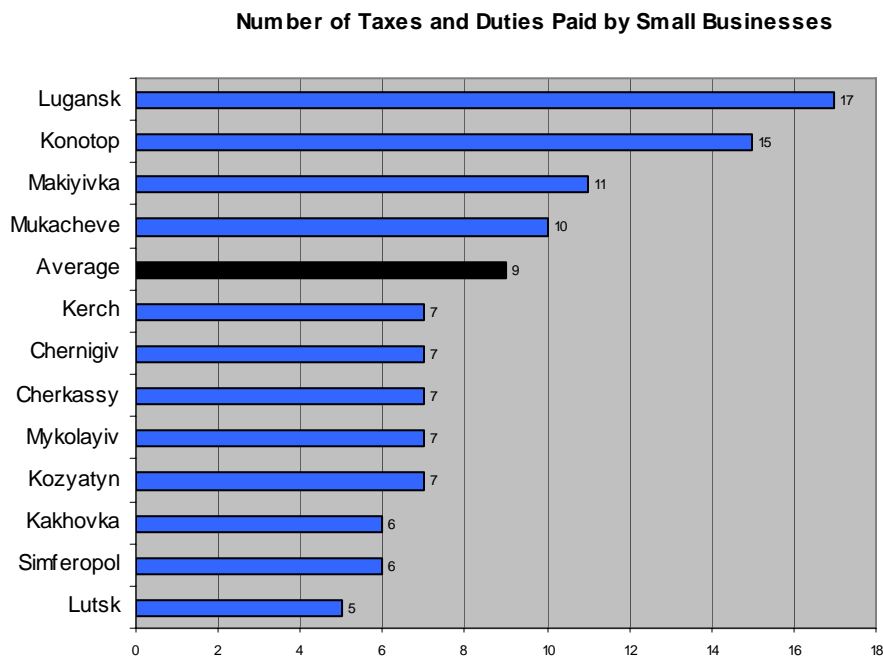
A second crucial issue for determining the impact of presumptive taxation on compliance costs is whether the presumptive tax is paid only in lieu of income tax or if it replaces a larger number of direct and indirect taxes. Compliance costs can be reduced significantly if the simplified tax is a substitute for a variety of taxes. Only in a few transition countries however, the introduction of the presumptive tax system has substantially reduced the total number of taxes to be paid by small businesses. The unified tax in Uzbekistan, introduced with the new tax code in January 1998, is an example of such an approach. It supersedes a large number of taxes, including the income/profits tax, VAT, property tax, land tax, environmental tax, and mineral tax. Small businesses and individual entrepreneurs therefore – in addition to the unified tax - are only subject to payment of excises and social tax or, in case of individual entrepreneurs, pension fund contributions. This reduction in the number of taxes to be paid by small businesses has been greatly welcomed by the Uzbek business community³⁷. Similarly, the single tax and the uniform tax in Russia were established to replace a large number of federal, regional, and local taxes with a single tax and to simplify accounting and reporting. The only taxes small businesses have to pay, in addition to the uniform tax, are customs duties, land tax, license fees, tax on purchases of motor vehicles, tax on owners of motor vehicles, and withheld income tax and VAT. The unified tax in Ukraine allows eligible businesses to pay one tax in lieu of the income/profits tax, VAT (if the 10% unified tax is selected), property tax, fee on extracting and processing natural resources, Chernobyl fund tax, communal tax, national insurance tax, social security mandatory collection, mandatory

³⁷ The statement of the Association of Businesswomen of Uzbekistan at the OECD forum on entrepreneurship and enterprise development in Istanbul in 1998, considered the reduction in the number of taxes levied to be the first priority for tax reform in Uzbekistan and considered the introduction of the unified tax very important for the further development of small and medium businesses in Uzbekistan. See FEED (1998)

employment fund collection, and duty on obtaining a permit for trade and customer service outlets.

Other systems are less comprehensive; in most countries in the region simplified taxation schemes are either only introduced in lieu of income/profits tax or income/profits tax and VAT. In this case, the impact of the simplified system on overall compliance costs may be only marginal. The case of Ukraine demonstrates the scope of the problem: In Ukraine 23 national taxes are levied on businesses. Local authorities can levy an additional 16 taxes and obligatory payments. Examples include communal tax, market duties, and transport duties. In addition, there are numerous so-called non-budget funds to which entrepreneurs are strongly ‘encouraged’ to contribute, that can act exactly like a tax and are sometimes used for their punitive effect³⁸. As a consequence Ukrainian SMEs on average paid nine different taxes and duties in 1999. However, the average number varies substantially by city, as can be seen chart1:

Chart 1



Source: IFC

The majority of enterprises (61%) reported that they need to have one dedicated employee dealing with tax issues, spending 20-50% of his working time on tax issues alone³⁹. VAT was considered to be the most problematic tax from a compliance point of view by SME operators, followed closely by corporate profit tax and then payroll tax⁴⁰. The situation was different with regard to which tax/duty is seen as the most problematic

³⁸ See International Finance Corporation (2000).
³⁹ See . International Finance Corporation (2000).
⁴⁰ See International Finance Corporation, (2002).

for planning business activities. In this case small business operators see the corporate profit tax as the key obstacle, with the VAT coming second. In Russia small businesses viewed as the main benefit of the simplified system the exemption from the single social security tax⁴¹. In any case, a presumptive tax that addresses only the income tax compliance problem is not considered by the small business community as particularly helpful. There is therefore pressure in several countries to extend the system to cover a broader range of taxes. This pressure has at least been partly successful in some cases. In the Krygyz Republic, the 1999 tax reform initiative envisaged the introduction of an optional tax system for small businesses in lieu of income/profits tax. While the direction of the reform was welcomed by the business community, there were concerns expressed about the scope of the tax, and the State Fund for the Support of Small and Medium-Sized Businesses developed a counter-proposal to establish a presumptive tax in lieu of all taxes. The final draft of the law, which was approved by parliament in November 2001, took some of the requests of the business community into account, introducing a turnover-based simplified tax replacing the income/profits tax, the road fund tax, the emergency fund tax, and the retail sales tax.

Tax burden and revenue potential

Generally simplified taxation schemes in the region appear to be very generous. This might be intentional to encourage small business activities through a reduced tax burden. This is the case in Russia, where the new simplified taxation regime adopted in July 2002, according to government calculations, is expected to have a collection potential of almost 50% less than the simplified system it replaces. The government estimates that the tax burden on small businesses was reduced by 50% - 75% with the new law⁴². This is due to the government intention to reduce dramatically the tax burden on small businesses in order to foster small business development. But another reason frequently is the lack of reliable data on actual small business profit ratios. For example, a survey of restaurants in Tbilisi and nearby districts carried out by the State Department for Statistics in Georgia in 1999 revealed that the real monthly turnover of the restaurants surveyed was 3.8 times the official turnover declared by the restaurant owner, and amounted to GEL 18,505.⁴³ This obviously demonstrates the deficiencies of a turnover-based presumptive system. If a weak tax administration is not in a position to at least approximate the real turnover of a small business, a turnover-based presumptive tax will not reduce the evasion possibilities and the actual degree of tax evasion. But the Georgia example shows that moving to other indicators does not necessarily solve the problem. As long as the tax administration or Ministry of Finance cannot base the patent rates on sound estimates of actual turnover or business profit, patent rates have to be kept low to avoid the risk of over-taxation. In Georgia the case is extreme as the presumptive tax on restaurants is only 10 GEL per month per place. For a restaurant with 60 places, the presumptive tax thus may amount to only 3.2% of actual turnover. For Armenia the IMF made a calculation in 2001 showing that for an average retail trader, the tax burden under the presumptive system may be around 40% less than using the regular tax regime. In

⁴¹ See analysis in Pravda (Economic section), December 18, 2002.

⁴² See Grigoriyeva and Korop (2002).

⁴³ Report GE51 GR01, "Informal economy".

Ukraine some of the patent rates are extremely low and can go down to an equivalent of less than US\$4 per month. But even the turnover tax rates assume a very low value added, considering that with a 10% tax on turnover, all profit tax and VAT liabilities of a business are covered. This preferential tax treatment given to SMEs is reflected in the results of the IFC survey on tax burden as a share of value added by firm size in Ukraine⁴⁴. The survey results show that the average tax burden exceeds half the value created by an average company (55%); however, the tax burden differs substantially when analyzed by firm size, origin and sector. While medium-sized enterprises are hardest hit, particularly in the case of medium-sized manufacturing enterprises, the average tax burden as a share of value added of small businesses is somewhat lower, with around 46% in 2000, declining to around 42% in 2001, which reflects the increasing transfer of businesses from the regular to the simplified system.

Countries for which data are available show very low revenue yield from presumptive taxes. In Bulgaria the total revenue performance of the patent scheme amounted to only 4.1% of personal income tax collection in 1999. In Georgia the presumptive tax collection was only 5 million GEL or 0.7% of total tax revenues in 2000. In Azerbaijan, according to the 2002 budget, presumptive tax revenues amounted to 1.5% of income tax collection. In Armenia, presumptive tax revenues were calculated to be 1.7% of total tax revenues in 2000. In Albania in 2000, small business tax collection amounted to roughly 2% of total tax collection. In Russia the tax administration expects to collect about US\$154 million from small businesses in 2003; this represents an average annual tax payment of around US\$300 per business. The proportion is somewhat higher in Ukraine, where 4.6% of total tax revenue was derived from various presumptive taxes in 2001⁴⁵.

There are two conclusions that can be drawn from these data. First, there is considerable risk in some cases that the total costs of administration and collection of patents are higher than the actual revenue collected. Second, the low tax burden under the presumptive tax risks to provide incentives for larger businesses to structure their operations in a way to benefit from the lower presumptive tax regime, and will also act as a disincentive for SMEs to grow out of the system. Several countries indicate that they have experienced problems with tax avoidance schemes used by larger businesses. But there are also avoidance schemes designed by individuals, partly in cooperation with larger businesses.

A typical example is a scheme that has been designed to reduce the relatively high combined income tax and social security tax burden on labor in many transition countries. To avoid income tax withholding and payment of social security contributions, employers encourage their employees to register as self-employed under the presumptive tax. Once registered, they render the same services to the business as previously, when they were employees. However, instead of paying high income taxes and social security contributions, they pay a relatively small presumptive tax. In Ukraine, e.g., an employee who is paid a monthly salary of 510 UAH (30 times the minimum wage) is subject to

⁴⁴ International Finance Corporation (October 2002).

⁴⁵ Revenues from the various presumptive taxes were: 619.83 million UAH unified tax from legal entities, 439.03 million UAH unified tax from natural persons, 40 million UAH patent, and 250.1 million UAH fixed tax.

personal income tax amounting to 108.8 UAH. In addition, a number of social taxes are due, which can be as high as 40.2% (37.2% on employers and 1.75 – 3.0% on employees). Should the same person formally operate for the business as an independent contractor, and then opt for the fixed tax system, the total monthly tax burden amounts to 20 –100 UAH only, which is beneficial both to the employee and the employer. In Russia the pure difference in the tax rate between the standard 13% personal income tax and the 6% single tax rate according to reports received have created an incentive for employees to supply their labor services as small businesses. The systems therefore provide a clear disincentive for entering into employment contracts. Another risk of abuse of the system is the practice of larger businesses to divest themselves of certain smaller operations and have these managed by SMEs under the presumptive tax regime. This practice has, e.g., been observed in Ukraine⁴⁶ and Kazakhstan.

The revenue potential of presumptive taxes obviously could be considerably increased by adjusting tax rates and bringing the actual tax burden more in line with that under the standard tax system. However, this would also require a restructuring of the tax, establishing closer links between tax rates and business activities to avoid an over-taxation of certain businesses, and a much improved collection and analysis of data on business profit margins. This is not easy to achieve and requires a much greater focus of Ministries of Finance and tax administrations on designing and updating simplified systems than is currently the case. In addition, the challenge to align the tax burden of a small business taxed under a presumptive system with the tax burden under the standard system, while avoiding over-taxation of some taxpayers, may require reducing the simplicity of the system. Serbia has attempted to take into consideration more fully the particularities of individual businesses in calculating the presumptive tax burden. However, as a consequence, the following data must be collected to calculate the amount of the patent: 1) Average monthly wage per employee in the Republic, municipality, city and district realized in the year, or part thereof, preceding the year for which the patent is determined; 2) location of business premises; 3) appointment of business premises; 4) number of employees and working family members; 5) market conditions under which the business is conducted; 6) floor area of business premises; 7) age of the taxpayer and his/her capacity to work; 8) Revenues of another taxpayer conducting the same or similar business under the same or similar conditions; 9) other circumstances affecting the generation of profits⁴⁷. The Russian law on the uniform tax follows a similar approach, and imputed income is calculated using a complex formula, which, among various other elements, takes into consideration location of the business, quality of services, quality of premises, distance from highway, inflation, and seasonality⁴⁸. Under these conditions the simplified system can no longer be called ‘simple’ any more, and the question arises if both the taxpayer and the tax administration would not fare better applying the standard taxation regime.

Broadening the tax net

⁴⁶ See Thiessen (March 2001).

⁴⁷ Art 41 Individual Income Tax Law

⁴⁸ See Wallace (2002)

Presumptive taxation in transition countries has been extremely successful if one only looks at the number of taxpayers opting to be taxed under the presumptive system. According to the head of the small business taxation department in the Russian Ministry of Taxation, the number of legal entities applying for taxation under the simplified system rose 2.8 times in 2002 and the number of individual SME operators who want to be taxed under the simplified system rose 3.2 times in the same period.⁴⁹ In Albania, the number of taxpayers registered for the small business tax according to tax administration data has increased from 18,000 in 1997 to 35,000 at the end of 2002. Also in Ukraine the success of the presumptive tax system has been extremely impressive if judged by the number of registered taxpayers (Table 5):

Table 5: Ukraine's Presumptive Tax System				
Year	Unified/Single tax		Number of special trade patents purchased (units)	Number of fixed tax payers ('000)
	Legal entities ('000)	Natural persons ('000)		
1999	28.6	66.1	16,873	318
2000	66.6	182	7,411	327.4
2001	91.7	345.1	6,986	339.3
Source: Barbone and Sanchez (2003)				

In 2002 most businesses qualified for the unified tax found the system appealing, and 61% of these firms had already switched to the simplified system, with another 13% planning to do so. Only 13% of respondents considered a switch useless because they considered the regular taxation system as good as the simplified one. The popularity of the system has considerably increased compared to 2000, when only 52% of eligible respondents to the survey were actually using the system⁵⁰. Thiessen (2001) estimates that the presumptive tax in Ukraine has reduced the total size of the shadow economy by 11-14% during 1999 and 2000⁵¹. According to his assessment of the business environment in Ukraine, the growth of the shadow economy during 1993-97 was caused by three factors: increases in the regulatory burden, tax system complexity, and overdue inter-enterprise arrears. Factors that reduced it since then were: reduced tax system complexity during 1998-99, the introduction of the presumptive tax, the reduction in real overdue inter-enterprise arrears, and a continuation of the decrease of the tax burden, in particular lower social security contributions. However, despite continued decrease in tax pressure, growing acceptance of the presumptive tax, and lower real overdue inter-

⁴⁹ See "Simplified tax system will cut tax burden for small businesses", Pravda, Feb. 7, 2003.

⁵⁰ International Finance Corporation (October 2002)

enterprise arrears, the shadow economy's decline appears to have been halted in 2000 because of increases in the regulatory burden and tax system complexity.

A survey initiated by USAID one year after the introduction of the presumptive tax system in Ukraine shows a very high percentage of non-registered businesses, especially very small enterprises as shown in Table 6.

Table 6: Registered Enterprises in the Presumptive Tax System

Enterprise size	Number of employees	Estimated number of enterprises	Estimated employment	Estimated percentage of all registered enterprises	Estimated non-registered employment (in %)
	0 (Sole entrepreneur)	2,651,433	2,651,435	24.6	75.4
Small	1 to 5	148,976	516,947	37.6	62.3
	6 to 10	104,608	850,460	94.1	5.9
	11 to 50	123,757	3,189,226	99.5	0.5
Medium	51 to 250	33,169	4,206,444	99.5	0.5
Large	more than 250	10,851	9,822,542	99.4	0.6
	Total	3,073,244	21,237,054	-	-

Source: Thiessen (2001)

This could to some extent reflect a decision of small businesses to wait and see how the new presumptive system is being implemented. However, it might also reflect the fact that small businesses operating in the underground economy still do not see sufficient incentive to legalize their business. The experience of transition countries with the operation of simplified systems indicates that the creation of a presumptive tax system as such does not provide sufficient incentives for businesses to register. To really achieve major improvements in voluntary compliance, the introduction of the system has to be combined with administrative improvements, in particular improvements in tax enforcement and the development of a compliance management strategy. This is reflected in findings from Georgia and Albania. In Georgia, with a weak tax administration capacity and little success in tax enforcement, the Explanatory Note to the 2001 Draft State Budget had to recognize: "Approximately 150-200 thousand persons can be covered by presumptive income tax base. Considering the peculiarities of the sector and rates of income tax, potential revenues may comprise Lari 180-240 million (one half of this amount should be attributed to social tax accounts). Though because of registration problems significant amount of potential revenues are lost and only Lari 10-15 million can be expected". In Albania, on the other hand, major efforts to improve tax enforcement implemented in 1999 have resulted in an increase in the number of registered active small business taxpayers by 28% in one year.

Business perception

The World Bank "Business Environment and Enterprise Performance Survey 2", carried out in transition countries in 2002, indicates that the introduction of simplified tax systems has not substantially changed the perception of the small business community

that the tax burden for SMEs is too high and creates an obstacle for business development. The survey shows that even in countries operating a simplified system, complaints about high tax rates are as frequent or even more frequent among small businesses than among large businesses. Data from Albania, Bulgaria, Russia, and Ukraine illustrate this finding in Table 7

Table 7. Question: Can you tell me how problematic current tax rates are for the operation and the growth of your business?

Country	No or minor obstacle	Moderate or major obstacle
Albania SME	51.7%	48.3%
Large businesses	44.4%	55.5%
Bulgaria SME	35.8%	64.2%
Large businesses	56.3%	43.7%
Russia SME	45%	55%
Large businesses	48.5%	51.5%
Ukraine SME	35.7%	64.3%
Large businesses	41.7%	58.3%
Source: The World Bank		

An analysis by Ikiz (2002) in Bulgaria confirms that despite the existence of a rather generous presumptive tax system, small businesses continue to consider the tax burden as the most significant barrier for their business. It seems to be more the tax burden, considered to be too high, than the dealings with the tax administration that drives businesses underground. The introduction of a presumptive tax thus has been welcomed by small businesses as a reform facilitating tax compliance and reporting, but has not actually been perceived as a measure to introduce a reasonable tax burden for SMEs. As a consequence, the incentive to work underground or hide at least part of the real turnover remains.

Conclusion

In most transition countries simplified tax systems for hard-to-tax businesses have become a component of the new market-economy-oriented tax system. They have either been introduced in the form of a turnover tax, a presumptive tax based on certain business indicators, or a simple patent. Considering the enormous growth of the small business sector in the region, the lack of a true voluntary compliance culture, and the weak tax

administration capacity, simplified taxation can be an important part of the strategy to address the small business compliance challenge.

Experience with simplified taxation schemes indicates that at least in one area these schemes have been successful: they contributed to broadening the tax net. Simplified taxation schemes have proven to be more appealing to the business community than the standard taxation regime, and the number of taxpayers registered under such schemes has increased substantially in all countries. However, the design of a simplified system alone is not sufficient to achieve major improvements in taxpayer compliance. Introducing a simplified system is not a substitute for, but has to be combined with strengthening administrative capacity in the tax administration to detect non-filers and stop-filers if the system really is to become an efficient tool to reduce underground economy activity.

The systems have not changed fundamentally the perception of taxpayers of tax systems being burdensome and tax rates too high. Despite the introduction of simplified systems, taxation remains one of the key obstacles to business development identified by small business operators in the region. This is a striking contrast to the actual tax burden under simplified systems, which seems to be much lower than the tax burden under the standard tax regime. One reason why complaints about the tax system continue to be put forward by the small business community could be that in most countries the simplified system only has been introduced in lieu of income tax or income tax and VAT. Only in a small number of countries has the simplified tax replaced all or most of the national and subnational taxes. Taxpayers therefore continue having to deal with a large number of taxes and filing requirements, and therefore also continue to view the tax system as complicated and cumbersome. Another factor contributing considerably to this perception is the instability of simplified tax systems. The desire clearly articulated by many small business operators to have increased stability and predictability of the tax system has not been addressed by the simplified systems, which tend to be changed rather frequently and fundamentally in many transition countries.

As the simplified systems operated in transition countries generally not only reduce compliance costs bookkeeping, and reporting standards but also considerably lower the actual small business tax burden, revenue yields mostly are minor and represent a negligible share of total tax collection. Clearly revenue collection is not the key objective of simplified systems in transition countries. They have more been designed to encourage businesses to register with the tax authorities and facilitate the operation of small businesses in the formal economy and to support the establishment of formal links between the small business community and government agencies. However, a too generous system risks to create a situation where collection and compliance costs exceed the amount of tax collected. In addition, the lack of coordination of the tax burden under a presumptive tax with the tax burden under the standard tax system works as a disincentive to declare business growth and migrate from the presumptive to the standard system.

There are a number of system design issues that will need to be addressed to further improve simplified tax systems. Clearly in a number of countries the simplified system in practice is not simple at all. Some of the key issues are the classification of taxpayers,

the determination of the tax due, and the overly large number of presumptive taxes in several countries.

While some transition countries allocate part of the yield from presumptive taxes to subnational governments, little consideration has been given to the option of turning presumptive taxes into local taxes administered by local governments.

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