FORMALISING THE INFORMAL SECTOR

Working Paper for

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SMALL BUSINESS TAXATION IN EASTERN EUROPE
Experience with Presumptive Taxation – 1999 to 2008

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1 Introduction

This paper is to contribute to the Appropriate Taxation component of the Formalising the Informal Sector Study for Tanzania. It looks at Eastern European experience with the use of presumptive taxation as a way to broaden the tax base, to encourage the formalisation of informal enterprises, and to promote economic growth and employment. This experience is used as the base for a review of the current Small Business Tax regime in Tanzania.

2 Presumptive Taxation and Formalisation

Presumptive taxation is principally used for classes of taxpayers which are 'hard to tax'. In most cases this is because the taxpayer does not have, or is not willing to make available, the financial records needed to prove what tax they owe. This is a common situation for enterprises in the informal sector, which do not have the skills needed to keep full,written accounts, and which may see avoidance of taxation as a key benefit of their informal status.

2.1 Logic and Objectives

The idea of presumptive tax is to reduce the time and cost of paying tax for small enterprises. Because paying tax is an essential part of formal status, presumptive taxes are often seen as a central element in formalisation strategies. Ideally, presumptive tax is the first step on a ladder, at the top of which enterprises graduate to the status of a registered company paying full tax.

Presumptive taxes are also expected to broaden the tax base, reduce avoidance and reduce the cost of raising revenue from hard-to-tax sectors of the economy.

The objectives can be summed up as follows:

- To encourage formality
- To stimulate business growth and employment
- To broaden the tax base and raise revenues
- To reduce the cost of tax collection

These objectives are conflicting. To encourage formality, a tax regime should be as simple as possible. The simplest system is a "patent" or basic operating license fee. But this means all businesses in the sector pay the same tax, from the tiniest market trader to a sophisticated small business with substantial turnover. Similarly, low taxes will encourage firms to register, but they will give them no incentive to grow and graduate to the next level. In the worst case, larger firms may deliberately downsize, or manipulate their operations in such a way as to qualify for the lower tax applied to smaller companies. In other words, a low entry-level tax may merely reward "smallness."

Similarly, a very simple system will reduce the cost of tax collection, but it may do little to broaden the tax base and raise revenues. A more complex system will cost more, but do more to bring about genuine formalisation and encourage an ultimate graduation to full tax status. A number of studies recommend that tax authorities invest more in taxpayer awareness and education for informal enterprises. This encourages the enterprises to develop the culture of compliance, including basic accounting, which is needed for elementary corporate governance. Apart from supporting tax compliance, it also helps enterprises to gain access to formal credit.

2.2 Direct and Indirect Presumptive Taxes

Modern taxation systems, including Tanzania, seek to balance direct taxes on income with indirect taxes on consumption, usually in the form of a Value Added Tax. Enterprises are made responsible for paying both kind of tax. VAT, in particular, depends on each company keeping complete sets of accounts and submitting a relatively complex monthly or quarterly return.

To help small businesses, it is almost unavoidable that presumptive taxes must replace both income tax and VAT. This can be done either as one unified tax, or as two separate presumptive taxes: one for income and one for VAT. Tanzania, for example, has opted for two: a presumptive turnover tax on income and stamp duty for VAT.

The VAT element poses particular difficulties. The whole purpose of VAT is to eliminate 'cascading': the way a sales tax applied at each stage of a value chain adds up to a much large percentage tax on the final sale. Unless special provision is made to prevent it, a presumptive tax replacing VAT will cascade. In addition, it may discourage companies which are registered for VAT from buying from smaller enterprises which are not; because they will not be able to reclaim the VAT. In an economy such as Tanzania, which has a large body of smaller enterprises, this could be a significant factor. In the worst case it might mean that larger companies will prefer to import inputs, on which they can reclaim VAT, rather than buy locally.

3 The Eastern European Experience

The Communist States of Eastern Europe had their own unique tax regimes, with little private sector production and limited market exchange. With the fall of the Soviet Union and the end of socialism, these countries had to develop market-oriented tax regimes. A large number of private sector enterprises, big and small, were created, with no previous experience of paying tax. This put great strain on the tax authorities, which had to create new systems, almost from nothing, and deal with large numbers of hard-to-tax enterprises. A number of Eastern European countries adopted presumptive taxation as a way to deal with this situation. Table 1, on the following page, summarises the situation in over 25 E. European countries. A large majority have some form of presumptive tax for small enterprises.[1]

The main source for this section is the study cited by M. Engelschalk, who is the main analyst of, and authority on Eastern European experience with presumptive taxation.

[1] From - Creating a Favorable Tax Environment for Small Business Development in Transition Countries, M. Engelschalk, World Bank, 2007

Table 1 Small Business Tax Systems in Eastern Europe

Table I		
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)
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 firms 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

The table shows three types of presumptive tax: i) as a percent of turnover/gross income, (ii) according to an indicator of business size, eg the number of employees, and (iii) as a standard patent, or license fee, for all enterprises in a specific profession.

How to capture differences in profitability is a common difficulty. A turnover tax of say 3% may be too high for low-margin businesses but excessively generous for others. For example, a consumer goods firm with a large number of employees may be significantly less profitable than a small professional practice with only three partners. Similarly, an annual patent or license fee may be too much for a small trader, but far less than the tax a large merchant in the same sector should pay.

Some countries have sought to address this by setting separate presumptive tax rates for different sectors, or by increasing the percentage payable as turnover increases.[2] The box taken from Engelschalk's paper illustrates the level of complexity this can lead to. It shows how attempts to fine-tune presumptive taxation systems can rapidly undermine the principal objective: simplicity.

> <u>Bulgaria's Patent System</u>
> The Bulgarian "levy of a final annual (license) tax", ... established 43 different small business sectors. As the potential profit ... depends on the location, the country was divided into nine zones. With a different tax rate depending on the zone, more than 300 tax rates were established and have to be updated regularly. But even businesses in the same segment can be very different. "Mass-catering and amusement establishments", for example, includes everything from food kiosks to luxury nightclubs. To avoid under- or over-taxation the category had to be divided into six sub-categories; those sub-categories again were divided, distinguishing, e.g. one-star from three-star restaurants, ... This required setting 52 different tax rates for one segment of the small business community.

Nevertheless, the lack of a reliable link between profitability and tax paid is a significant weakness of presumptive taxation. This is especially the case with turnover taxes. The table shows Russia charging a 6% gross turnover tax. It is perfectly possible that many companies have a profit before tax of less than 10% of turnover. At that level, the Russian tax would equate to a 60% tax on corporate income. For a 6% turnover tax to equal a 20% profit tax, a company would need to be making a pre-tax profit of 30%. In many sectors this would be quite unlikely.

After the fall of communism, large informal sectors developed in many E. European countries. These "*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 process.*" By the mid-2000s, some 82% of firms were small businesses. Although most of them were registered, a majority were informal in that they were avoiding tax and other regulatory requirements. Unlike most 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.*"[3] GDP and per capita incomes were also significantly higher than in developing countries. Presumptive taxation was not, therefore, adopted because entrepreneurs were unable to comply with the requirements of regular taxation. Instead, the aim was to encourage businesses to register; to help the relatively weak tax authorities to manage a large

[2] As is the current situation in Tanzania.
[3] Engelschalk, op. cit.

number of hard-to-tax enterprises; and to protect small businesses from the complex and sometimes arbitrary application of tax laws.

The small business sector in eastern Europe was volatile. There were lots of small firms, but a high turnover, as some firms collapsed and others were formed. *"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 years. In this scenario there is very little chance to successfully familiarize small business owners with bookkeeping and taxation rules."*[4] SMEs were also mobile, and tax registers could not keep up with the frequent changes of address.

3.1 A Strategy for Small Business Taxation

The Eastern European experience has led to a recognition that presumptive taxation needs to be considered as part of a wider strategy for small business taxation (SBT). A key lesson is that simplifying the overall tax regime must be the first step. Whether the aim is to encourage small businesses to formalise, or to reduce the cost of tax administration, or to raise revenue, a general simplification of the tax system will have more impact than the establishment of a separate Small Business Tax (SBT) system.

Besides which, a SBT system cannot be effective while the overall tax regime continues to be complex and arbitrary. In 1999, Ukraine had 23 national taxes on businesses and local authorities were able to levy up to 16 additional taxes and fees. Even after the introduction of a unified turnover tax, to replace income tax and VAT, small businesses had to pay between five and 17 different taxes or duties, depending where they were.[5]

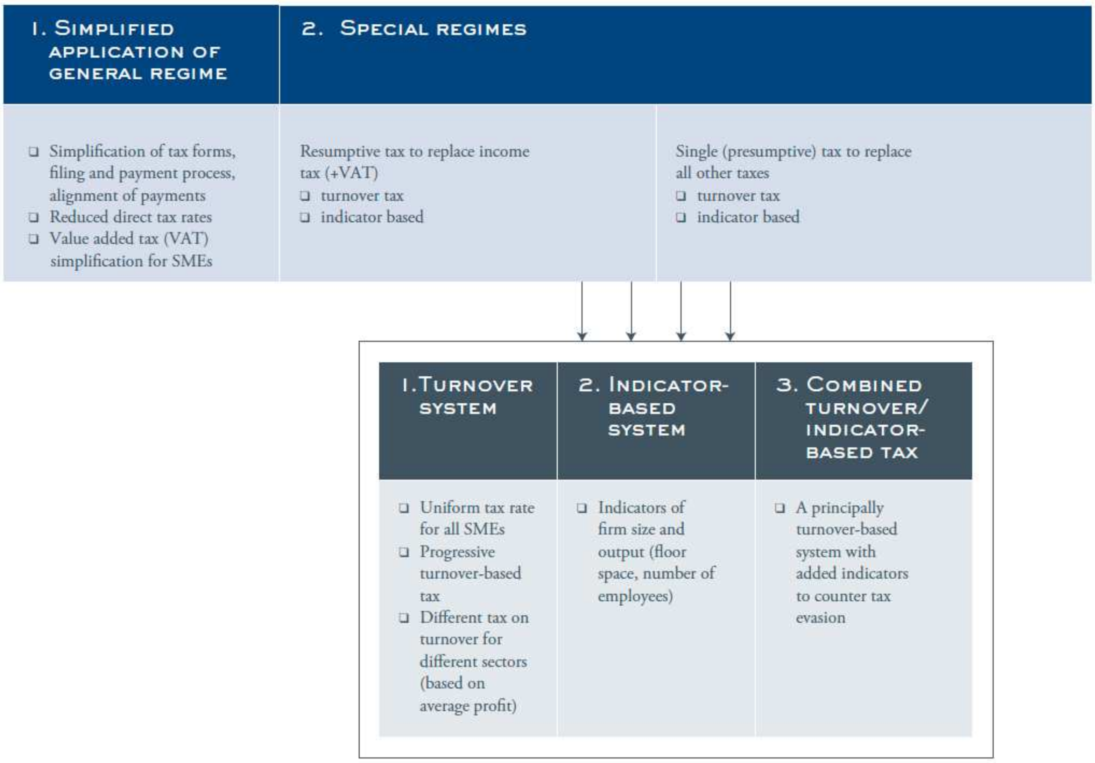
Engelschalk sets out the following stages for developing a coherent SBT strategy:

- The first priority should be to improve the normal tax regime
  - Simplify
  - Broaden the base, lower rates
  - Measure indicators for SME sector, including compliance, profits, revenues
- Next consider whether a SBT regime might be necessary or desirable
- If so, establish goals and strategy for the SBT regime, as well as performance indicators

The figure on the next page summarises a central policy choice between: a simplified application of the general tax regime, which makes it easier for small businesses without changing the nature of the tax; and setting up a separate special regime for small businesses.

[4] Engelschalk, op. cit.
[5] Engelschalk, op. cit.

Figure 1 Designing a System for Small Business Taxation[6]



A number of Eastern European countries have radically simplified their tax systems, at all levels not just for small businesses. The most notable of these is Slovakia. In its tax reform of 2004, Slovakia replaced 21 different types of income tax with a single flat tax of 19%. The rate of corporate taxation was also reduced to 19% and VAT was standardised at the same rate: 19%. A high tax threshold, 1.6 times the Slovak poverty line, was a key feature of the reform. More commonly, countries have combined some simplification of the overall regime with special arrangements for small businesses. Russia, for example, almost halved the 30 taxes which used to be in force, and introduced SBT as well.

It is worth noting some of Engelschalk's recommendations for developing an SBT strategy:

- Good data must be gathered on tax compliance, and on average profit levels of businesses of various types, sizes, and locations.
- This information should be used to improve the efficiency of the general tax system to bring in more revenue at lower cost both to government and to businesses.

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[6] Taken from Small Business Taxation, J. Loeprick, Investment Climate Department, World Bank, 2009

- A special SBT regime should only be considered after these first two steps have been completed.
- If it is decided a special SBT regime is appropriate, then Government should decide clear goals and priorities:
  - is the main goal to encourage movement from the informal to the formal sector? To encourage growth? To improve overall tax compliance?
  - What trade-offs are acceptable?
  - What are the relevant performance indicators? How will they be collected and analyzed?
- A special tax regime for SME must be based on a good understanding of the SME sector, and sufficient data on its composition and performance. Collecting this data is a substantial task.
- Government may need to create a special SBT office to handle the sector.

3.2 Ceilings and Floors – Critical Decisions on Thresholds

Some businesses are so small that collecting tax costs more than the revenue it raises. Where the owners earn little more than the minimum wage, less than the starting threshold for personal income tax, there is no reason to tax them anyway. At the other end of the scale, there comes a point at which businesses are so large, or so profitable, that they must be required to pay regular tax. Setting a threshold, or floor, below which small businesses are not required to pay tax at all, and a threshold or ceiling, above which they can no longer qualify for small business taxation, are two critical decisions for any small business regime. In Tanzania there is no floor for income tax, and the ceiling, or threshold above which a business can no longer pay presumptive tax is turnover of TSh 20 million.

3.2.1 The Small Business Tax Ceiling

The threshold at which firms must stop paying a presumptive tax and become subject to regular taxation is critical. It needs to be set at a level which leaves the majority of hard-to-tax businesses subject to presumptive tax, but which ensures large businesses do not escape regular taxation. Some Eastern European countries set high thresholds. Russia, for example, started with a threshold of gross receipts equivalent to 100,000 minimum monthly wages, and a maximum of 15 employees. The gross receipts threshold was worth more than $1 million. This was later reduced to 22,000 minimum monthly wages, equal to $320,000. At the same time, the employment threshold was increased to 100 employees. This can be compared with the current Tanzanian threshold of TSh 20 million: just $14,000. It is worth noting how a number of countries use the poverty line, or the minimum wage as a benchmark against which to set these thresholds.

Russian experience showed that SBT can become a political issue. Powerful small business groups can apply strong pressure over the design of presumptive taxes. The substantial rise in the employee threshold described above was the result of political action. There was also strong pressure against the reduction in the gross receipts threshold, but Government was able to resist this. If they are to meet their policy objectives, governments must be prepared to manage the politics of small business taxation.

If the long term objective is to broaden the tax base and encourage businesses to graduate to regular tax status, the optimum policy may be to start with a relatively high threshold and gradually lower it. The revenue authority's capacity to deal with hard-to-tax enterprises may be the deciding factor. If, for example, it only has the capacity to manage one million regular business taxpayers, then a threshold can be set which only leaves the largest million enterprises above it. As the revenue authority capacity grows, so the threshold can be lowered. However, political resistance to lowering the threshold may be strong.

3.2.2 Tax Floors

In Moldova, personal income tax was applied to all workers, regardless of income, but the poorest 47 percent contributed only 3 percent of the revenue raised. Analysis showed that if a floor was set for personal income tax, it would be possible to remove 47 percent taxpayers from the system, while losing very little revenue.[7] Since most of these persons were entitled to tax refunds, the loss would be even less. In Croatia, employers proposed that the personal deduction (ie the tax floor) should be tripled. If this was offset by the elimination of special allowances and the introduction of taxes on property and capital income, revenues would be maintained while reducing the number of taxpayers by a more than a third.

Similar arguments apply to VAT. In developed countries, the average threshold for VAT registration (ie the VAT floor) in 2001 was annual turnover equivalent to $90,000. In Eastern Europe, Moldava for example, floors were set around $30,000. Studies have shown that the vast majority of firms can be excluded from VAT with minimal loss of revenue.[8]

3.3 Tailoring Presumptive Taxes to Circumstances

The E. European experience has shown that each of the three categories of presumptive tax has advantages and disadvantages.

Patents, or annual licence fees, are simple to manage and easy for poorly educated businessmen to deal with. However, they are unfair, because large firms pay the same as small ones. And they do not encourage firms to develop the accounting and other skills they need to grow and graduate to operating as formal sector companies. Because they must be set at a level which will not discourage the smallest firm, they may do little to broaden the tax base or raise revenues.

Presumptive taxes based on indicators – number of employees, floor space, capital assets, etc – are designed to be tailored to the circumstances of different businesses and locations. It has proved difficult to make them work in practice. In the effort to make the indicators precise, systems have become unmanageably complex. In the worst case this has created opportunities for negotiation and corrruption. Like patents, systems based on indicators offer no route for an enterprise to make the transition to normal taxation.

Taxes on Turnover or Gross Receipts require a business to keep a basic record of its revenues, a first step towards keeping full accounts. In this way they offer a good transition to normal taxation. They also provide at least some link between the size of a firm and the tax paid. On the negative side, illiterate businessmen may have difficulty with the paperwork required, and there will be a direct incentive to under-report, or conceal, revenues to avoid tax. Even turnover taxes are unfair, in that firms with large turnover and low margins are penalised, relative to smaller, more profitable firms.

[7] Lowering Taxpayer Compliance Costs, M. Gallagher & A. Jacobs, Developing Alternatives, Washington, 2009

[8] Gallagher & Jacobs, op. cit.

The policy recommendation developed from E. European experience is that Patents are the best approach where there are large numbers of very small, poorly educated businessmen. Here the priority is not to raise revenue, or offer an immediate route to full taxation. Instead, it is to encourage a first step towards formality and a culture of compliance. Where the informal sector is made up of larger enterprises, with educated staff, turnover taxes are the better option; with the aim of moving as many firms as possible to full taxation as soon as the revenue authorities have the capacity to deal with them. This was more nearly the situation in most E. European countries.

Although the first situation is more common in many African countries, it is more correct to see them as having a combination of the two. The informal sector does include firms which would, if required, be perfectly capable of dealing with a turnover tax and of graduating from it to full taxation in a relatively short period. However, there are also large numbers of smaller firms which may struggle to comply even with the simplest of turnover taxes, and which may not be ready to graduate to full taxation for many years, if ever.

The E. European situation described in this section dates from the middle of the decade. Reforms were already underway to deal with the weaknesses. It is likely that most countries will end up with a two-tier system which combines full taxation with an SBT regime based on a turnover tax. In Africa, governments may find a three-tier system more effective: full taxation, turnover tax for established SMEs, and patents for the smallest firms.

3.4 The Tax Ladder – Growth vs Graduation

Four levels of taxation can be described:[9]

a) regular tax
b) simplified tax: ie on turnover
c) super-simplified: ie a patent
d) non-tax: ie the informal sector

Enterprises will inevitably develop strategies to put themselves into the most advantageous category. An SBT regime must be designed, therefore, to encourage them to progress up the ladder from d) to a). At the same time it must discourage attempts by taxpayers on the higher levels to move down again. If for example the thresholds and rates for simplified tax (position b) are set to high, then firms will not move up from c). However, if they are made too generous, then regular taxpayers on level a) will try to move down. The latter has been a widespread problem in E. Europe.

The most critical step is between b) simplified tax and a) regular tax. Ideally, tax rates for level b) should be equal to, or slightly more than what would be payable under regular taxation. That way businesses can balance the extra cost of complying with regular taxation against the probability that they will pay less tax. As they grow the balance will tip and they will transfer to regular tax. However, this is a difficult balance to achieve. As already pointed out, a fixed percentage tax on turnover equates to a much lower profit tax for firms which have high margins. Some countries, including Tanzania, apply a progressive turnover tax. The rate increases for firms with larger turnover. In principle, this gives larger firms a greater incentive to make the changeover to regular tax. In practice, it risks giving low-margin firms,

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9 Engelschalk, 2003 – Creating a Favorable Tax Environment for Small Business Development, presentation in Atlanta, Georgia

usually those with larger numbers of employees, an incentive to under report their turnover, or even to stay in the informal sector and pay no tax at all. At the same time, highly profitable firms with low turnover do better to continue paying turnover tax, will have an incentive to under-report their turnover to avoid being forced to pay regular tax.

Table 2 uses the current turnover tax regulations for Tanzania as an example to illustrate the difficulty.

Table 2 **Impact of a Progressive Turnover Tax**

			At 10% Profit Margin		At 30% Profit Margin	
Turnover Band TSh	Tax %	Tax at Band Ceiling	Profits TSh	Implied Tax Rate %	Profits TSh	Implied Tax Rate %
< 3,000,000	1.1	35,000	300,000	12	900,000	4
< 7,000,000	1.3	95,000	700,000	14	2,100,000	5
< 14,000,000	2.5	291,000	1,400,000	21	4,200,000	7
< 20,000,000	3.3	520,000	2,000,000	26	6,000,000	9

The table illustrates a number of points:

- At TSh 35,000, the revenue from the lowest turnover band may barely cover the cost of collection, let alone the costs the business incurs in paying it.
- Except at the highest profit margin, profits on the lowest two turnover bands are less than the Personal Income Tax threshold of TSh 1.2 million. This implies that these businesses would not be liable for any tax under the regular tax system.
- The implied tax rate, ie the turnover tax expressed as a percentage of the business' net income, is three times higher for low margin businesses than it is for high margin businesses.

The most important point concerns the incentives this structure offers businesses to formalise, so they start paying tax under the simplified turnover tax. And then the incentives it offers them to graduate from presumptive to regular taxation. In other words: Does it encourage businesses to move from taxpayer group d), informal, to taxpayer group b), simplified tax? And does it give businesses a further incentive to move on from group b), simplified tax, to group a), regular tax? Or does it give group a) businesses an opportunity to drop back to group b), so as to reduce their tax?

The answers to these questions are mixed, and they depend crucially on the profit margin. In the lower turnover bands, the tax rate is low, but it is likely to be higher than would be payable under regular taxation. In that sense it offers little encouragement to register. At the higher levels, low-margin businesses may have some incentive to transfer to regular taxation, if the regular tax rate is 20% or lower. However, high-margin businesses may well do better to stay in group b). And, high-margin group a) businesses may well have an incentive to de-register as regular taxpayers and drop back to group b), simplified tax.

The top turnover threshold of TSh 20 million ($14,000) is quite low. Even at a high profit margin, the likely net profit of a business this size will be less than eight times the Tanzania minimum wage[10], and less than 10 times a poverty line income of $1.25 a day, approximately TSh 650,000 per year. Assuming the business is supporting a family of 5, this equates to less than two times the poverty line income per capita. There is a risk that this threshold will become a barrier to formalisation, if it forces

[10] At TSh 65,000 per month.

businesses which are not ready to keep regular accounts either to under-report their turnover or to revert to the informal sector. It may also discourage high-margin businesses from growing, because they have a stronger incentive to stay below the threshold.

This analysis reinforces the point made earlier, that optimum design of a Small Business Tax regime requires a good understanding of the structure of the SME sector, and reliable data on turnover and profitability.

3.5 Non Tax Barriers to Formalisation

A number of Eastern European countries introduced presumptive taxes for small businesses without addressing other barriers to formalisation. SBT laws permitted businesses to maintain simplified records and file less frequent tax returns, but registration requirements created other burdens and reduced the incentive to formalise the business. In some cases, such as Albania, the small business tax law actually increased the registration requirements with a "*patent system, which was relatively straightforward in principle, but required an annual registration process with so many administrative barriers associated with it that it created a major compliance burden, including the need to prove the business paid all its previous years' local taxes, social security taxes, and other duties.*"

This is a further argument for the need to consider presumptive taxation as part of a wider strategy to support small businesses and encourage formalisation.

3.6 Managing Diversity

Informal sector enterprises take many different forms: from established manufacturing and service companies to sole-traders who only operate part of the year and who move their place of business from market to market. Some E. European countries have tried to recognise this diversity by offering a range of different presumptive tax arrangements. Ukraine, for example, allowed small businesses to opt for the standard tax system or to select one of five different small business taxes:

i) *unified tax*: for businesses with up to 50 employees, a 6% turnover tax, 10% if replacing VAT as well.

ii) *fixed tax*: a patent or license from the local revenue authority, for businesses with no more than 5 employees.

iii) 3 taxes for very small businesses: a) a trade permit for services, b) small enterprise tax for intermittent trade activities, c) a market fee for selling agricultural produce.

Some authorities criticise this kind of arrangement, because it might allow small businesses the possibility of 'tax-shopping' to find the best of the options offered. It is suggested it complicates the system unnecessarily and reduces revenue collection. As against that it can be argued that this is the only way to capture effectively the diverse nature of the informal sector.

This is another example of the need for a good understanding of how different parts of the informal sector work before deciding on the design of an SBT regime.

3.7 Stability

In the transition period after the end of communism, tax regimes in E. European countries were quite unstable. In Georgia, for example, the 1997 tax code was amended 44 times in the first four years. Presumptive tax regimes for small business were also unstable, and surveys reported this as a major concern for SMEs. There were two main reasons for the constant changes. The first was the difficulty described above in setting the presumptive tax at a level which matched the profitability of businesses in different sectors and sizes. Tax authorities made frequent adjustments in their efforts to do this. They were under pressure to do this. Unexpectedly, small business groups proved politically powerful and lobbied effectively wherever there was a case to argue that tax rates were too high, or discriminated between groups. An example was the way taxi drivers in Bulgaria forced a reduction in rates and the resignation of the deputy Finance Minister in 2002.

A second factor, was the speed at which SMEs adapted to the new taxes and found ways to abuse the system. This created conflicts and evasion which forced changes in the tax system, only to create further difficulties.[11]

3.8 Results

Small Business Tax regimes are designed to achieve some or all of the following:

- To encourage formality
- To stimulate business growth and employment
- To broaden the tax base and raise revenues
- To reduce the cost of tax collection

Eastern European experience shows how well this has worked in the particular circumstances of the transition from socialist to market economies.

3.8.1 Encouraging Formality

When they were introduced, large numbers of E. European businesses opted for presumptive taxation. In Ukraine, the number of legal entities registered for simplified tax rose from 28,000 to 92,000 between 1999 and 2001. Sole-proprietors paying simplified tax rose from 66,000 to 345,000. However, a proportion of these, possibly the majority, seem to have been firms which were already in the tax net and which opted to move from regular to presumptive taxation. It is estimated that presumptive tax over the period may have reduced the size of the shadow economy by 10-14%. Here too it is not clear how much of this reduction came from a reduction in avoidance by registered firms, and how much from small enterprises moving from the informal to formal sectors.

The size of the enterprise is key. One year after the Ukraine SBT regime was introduced, it was estimated only 25% of sole traders and 38% of firms with five or less employees were registered in the presumptive tax system. Above five employees the proportion jumped to 94%.

Engelschalk sums this up as follows:

"*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*

[11] Engelschalk, op. cit.

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."

"*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.*"

The shadow economy, ie the economy which is outside the tax net, includes tax avoidance by registered enterprises in the formal sector, as well as by wholly informal enterprises which are not registered at all. The material on Eastern Europe focusses on the shadow economy as a whole, without clear evidence on the size of the unregistered informal sector. Some indication can be gained from a USAID survey in Ukraine. Table 3 shows estimates of the proportion of enterprises registered by size.

Table 3 **Registered Enterprises in Ukraine**[12]

Firm Size	Employment	Percent of Total Employment	Registered %
Sole Trader	2,651,433	12.5	24.6
0 – 5 Employees	148,976	2.4	37.6
6 – 10 Employees	104,608	4.0	94.1
> 10 Employees	18,332,037	81.1	99.5

On these figures the unregistered informal sector represented some 10.9% of employment. However, value added per employee is likely to be considerably higher in larger entreprises; so it is unlikely that the sector contributed significantly more than 5% of GDP.

Section 3.8.3 below discusses the extent to which simplified tax schemes broadened the tax base and raised revenues. The evidence is that the greater contribution came from improved tax compliance among formal sector enterprises, with little impact on the size of the informal sector.

3.8.2 Growth, Employment and Poverty Reduction

Available material does not review the extent to which presumptive taxation has contributed to growth and employment. As noted in the next section, some countries used their new SBT regimes to reduce the tax burden on small businesses, but it is not clear that this had a direct effect on the SME sector's performance.

Table 3 shows Per Capita GDP for the 26 Eastern European countries listed in Table 1, compared to Tanzania and the three East African (EA) countries which are its immediate neighbours. In 15 of the European countries, GDP per capita is more than ten times greater than Tanzania. Of the remainder, there is only one country, Tajikistan, where GDP Per Capita is at East African levels and it is still 35% higher than for Tanzania. This wide disparity between the poor countries of East Africa and

[12] Calculated from data in Engelschalk, op. cit.

the mainly Upper Middle Income Countries of Eastern Europe mean the European experience with presumptive taxation has little relevance for poverty reduction in Africa. In Europe, redistribution, insurance and social safety nets are the primary tools for poverty reduction. Tax policy is important, but only through the levels set for minimum tax thresholds and through progressive taxation on high earners for redistribution to those on low incomes.

Table 4 **GDP Per Capita In Eastern Europes and East Africa**[13]

	Country	US $ 2010
1	Slovenia	23,706
2	Czech Republic	18,288
3	Slovakia	16,104
4	Estonia	14,836
5	Croatia	13,720
6	Hungary	12,879
7	Poland	12,300
8	Lithuania	11,044
9	Latvia	10,695
10	Russia	10,437
11	Kazakhstan	8,883
12	Romania	7,542
13	Bulgaria	6,334
14	Azerbaijan	6,008
15	Belarus	5,800
16	Macedonia, Republic of	4,431
17	Bosnia and Herzegovina	4,319
18	Turkmenistan	3,939
19	Albania	3,677
20	Ukraine	3,000
21	Armenia	2,846
22	Georgia	2,658
23	Moldova	1,630
24	Uzbekistan	1,380
25	Kyrgyzstan	864
EA	Kenya	809
26	Tajikistan	741
EA	Rwanda	562
EA	Tanzania	548
EA	Uganda	501

3.8.3 Broadening the Tax Base and Raising Revenue

"*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.*" When it was introduced in the early 2000s, Russia, Albania and Ukraine saw very rapid expansion in the number of enterprises registered for simplified taxation. It is clear that the majority of these were firms which had switched from the regular tax system, not informal sector enterprises which were paying tax for the first time. Nevertheless, it was estimated that presumptive tax in Ukraine had

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13 World Economic Outlook Database-April 2011, International Monetary Fund

reduced the shadow economy by over 10%, at the cost of some reduction in tax pressure.[14]

Russia, as a matter of policy, designed its SBT regime to substantially reduce the tax burden on small businesses, by as much as 50%. Without data on profitability, it is impossible to estimate accurately, what the tax yield might have been under regular taxation, for comparison with the yield under presumptive taxation. However, SBT in most E. European countries appeared "*very generous*", and to reflect low estimates of business profitability, quite apart from the greater scope for under-reporting in a simplified regime.

The result was that *"Countries for which data are available show very low revenue yield from presumptive taxes."*[15] In no country did presumptive taxation contribute more than 5% of total income tax revenues:

Bulgaria	4.1% (1999)
Georgia	0.7% (2000)
Azerbaijan	1.5% (2002)
Armenia	1.7% (2000)
Albania	2.0% (2000)
Ukraine	4.6% (2001)

These low yields mean that the cost of operating the presumptive tax scheme may be greater than the revenue collected. They also create a significant risk that the presumptive tax system will become a tool for tax avoidance, if not evasion. Larger businesses may hive off certain operations to SMEs which can pay simplified tax and SMEs may avoid expanding so as not to graduate to regular tax status. A number of Eastern European countries experienced these problems.

3.8.4 Reducing the Cost of Tax Collection

Judged by the rapid increase in the number of firms registered for simplified taxation, presumptive taxes are popular. The main factor may have been their generosity, relative to regular taxation, but presumably the reduction in the paperwork required of businesses was also welcome. However, more recent evidence suggests that these benefits may not have lasted. A 2009 survey in Ukraine showed how the administrative burden of tax compliance is much higher as a proportion of turnover on small businesses: 3% compared to less than 0.5% for a business only two categories larger.

Table 2. Annual costs of tax compliance procedures per one average company and among different companies by turnover band (in UAH and $)

Tax procedure	Less than UAH 200,000	UAH 200,000 – UAH 1 million	UAH 1 million – UAH 5 million	UAH 5 million – UAH 25 million	Over UAH 25 million	Overall average
Tax accounting	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Visits to support services	[illegible]	[illegible]	[illegible]	[illegible]	2,160	[illegible]
Inspections*	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Overall average (per one company)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]

Source: The Costs of Tax Compliance in Ukraine, 2009, IFC Washington

There is no evidence available on how much presumptive taxation has reduced costs for the revenue authorities. In principle, the saving should be substantial. However, it very much depends on how the authorities strike the balance between simplification and accuracy, and how much effort they put into compliance.

4 Conclusions and Recommendations

The Eastern European experience has shown that presumptive taxation can be attractive to businesses and encourage some reduction in the size of the shadow economy. However, it must be carefully designed to match the circumstances. While it may reduce the cost of tax collection, it will only be effective if it is implemented by a capable and well-funded tax administration. Without these two essentials, there is a considerable risk that it will allow businesses scope for widespread avoidance, especially if larger businesses are able to restructure their operations to allow them to qualify for presumptive taxation. A common tactic is for a large firm to encourage its employees to register as sole-proprietors, paying low presumptive taxes, so as to avoid payroll taxes and social security contributions.

Presumptive taxation does help to broaden the tax base, but it does not necessarily do much to encourage informal enterprises to register. Nor is it likely, even without avoidance, to make an immediate and significant impact on revenues. It seems to have been most successful as a means to encourage small businesses which were already registered to regularise their affairs and raise the quality of their book keeping and reporting.

Eastern Europe in the late 1990s and early 2000s was a special situation, involving a complex but relatively rapid transition from an industrialised socialist economy to an industrialised market economy. It is not comparable with African countries like Tanzania, where the slower, more deep-rooted processes of urbanisation and industrialisation raise different issues. Because presumptive taxation is better at helping businesses to start to formalise than it is at generating short term increases in tax revenues, it may be that it has a larger role to play in Tanzania than it did in Ukraine or Russia, for example. There is a larger population of very small businesses which have had no previous experience of dealing with government agencies, and which lack the literacy and other skills to keep even the simplest set of books.

Nevertheless, Eastern Europe has useful lessons to offer. The most important is that presumptive taxation must be part of a coherent Small Business Taxation strategy: which is based on a strong understanding of how the different SME sectors work; which is designed to match the number of taxpayers with the revenue authority's capacity to deal with them; and which provides businesses with the incentive to move from super-simplified to simplified to regular tax status.

The following recommendations can be made:

1 That accurate data on the structure of the informal sector is essential to the design of a successful Small Business Taxation regime: profitability, net incomes per employee, and value added per enterprise.

2 That a three-tiered SBT system is most likely to meet the needs of different categories of enterprise:
   - Patents for sole traders and micro enterprises in the informal sector
   - Presumptive turnover taxes for larger, better established enterprises

- Regular taxation with simplified procedures to be encourage early graduation

3 That presumptive tax levels are set to ensure that all those with net earnings below the minimum threshold for regular income tax are exempted, APART FROM a very low Patent/License fee to encourage registration.

4 That Tanzania should consider raising its Turnover Tax Thresholds substantially.

5 That the progressive element in the Turnover Tax structure be eliminated, and replaced by separate rates for low and high margin firms, with particular attention to professional firms: lawyers, doctors etc.

6 That the TRA should develop a long-term plan to develop its capacity and, at the same time, adjust the Turnover Tax Thresholds to ensure that the number of firms paying regular taxes matches the Authority's capacity to manage their compliance.

7 That TRA should develop a programme to raise public awareness of the Small Business Taxation regime and provide training and business management support to help enterprises register and comply with the system.