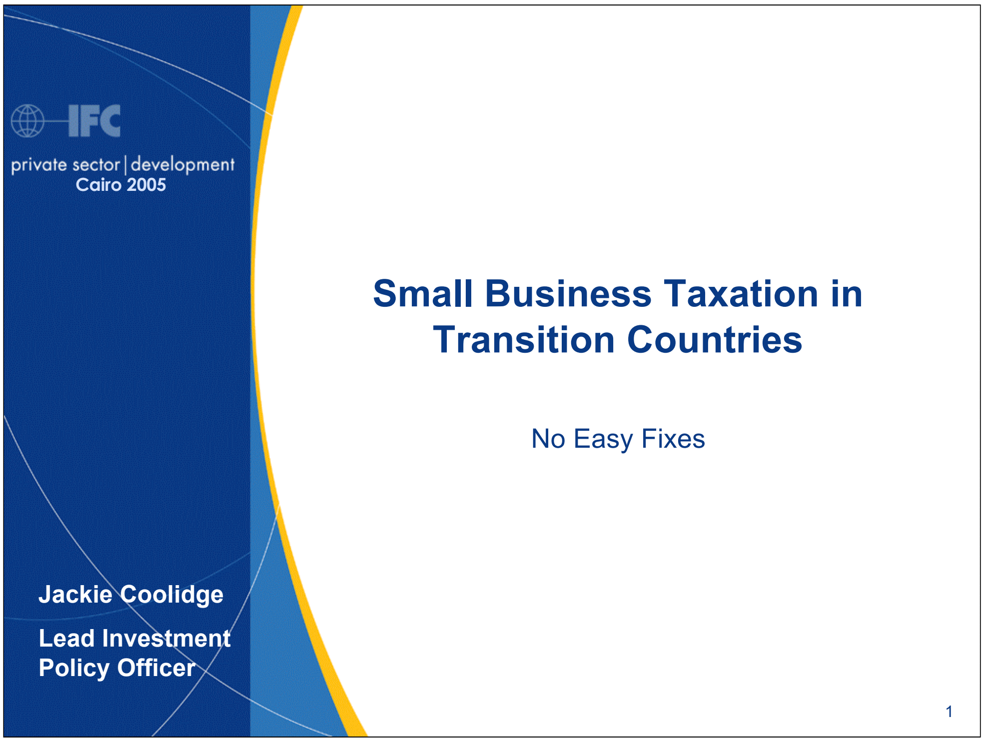


This presentation is based on the report by Michael Engelschalk, PRMPS, which is available to all participants. It is based primarily on information from transition countries, but includes very useful lessons for all WBG client countries.

Goals of Small Business Tax Regimes

private sector | development

- Encourage formality
- Encourage business growth and employment
- Improve tax compliance and revenue

IFC

2

The first thing we see is that there are a range of different SBT regimes, which have had varying elements of success and disappointment across a range of indicators.

The first question, in trying to assess these schemes, is to ascertain what their goals have been. In fact, there have been several, including the desire to encourage formalization of businesses (i.e., movement from the informal economy or grey economy to the formal economy), to encourage new business creation and associated growth in output and employment, and to broaden the tax base by improving tax compliance, leading to improved revenue performance.

These are all worthy goals. However….

But Goals tend to conflict

private sector | development

- Encourage formality
  - Simplicity (≠ fairness)
  - Low tax burdens
- Encourage Growth
  - Low tax burdens
  - No disincentives to graduate
- Improve Compliance
  - Simplicity (and ability to learn bookkeeping)
  - Stability

IFC

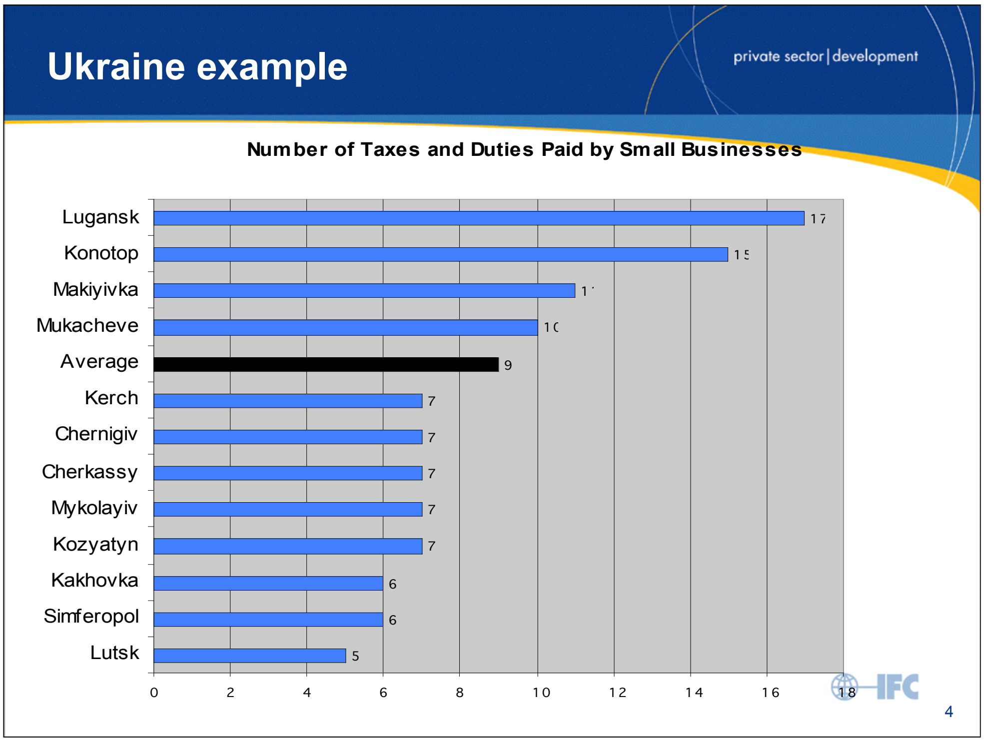
3

Unfortunately, there are often conflicts between these goals. If the goal is to encourage formality, then we usually want a tax regime that is very simple. The most simple system is a “patent” or basic operating license fee. But this puts the same absolute level of tax on all the businesses in the target pool – from the tiniest market trader, who may operate only sporadically, to a fairly successful and sophisticated small business or group of professionals.

We also usually want low tax burdens to coax firms into formality, or into existence at all. But if rates are very low only for “small businesses” then that becomes a disincentive for firms to grow from “small” to anything bigger, and may in fact retard growth and merely reward “smallness.”

As part of improving compliance, and looking forward to a healthy, sustainable tax regime for business, we want to encourage a culture of compliance, including basic accounting – which is needed for elementary corporate governance as well as taxation, and also helps small firms access external finance. This may be difficult for illiterate entrepreneurs, but the more successful among them can hire the needed expertise on an as-needed basis.

Stability is another major goal, as “instability” of tax regimes is a major complaint and problem for businesses. If the regime keeps changing, it is impossible to make medium to long-term plans, which itself tends to deter investment. Unfortunately, SBT regimes are notoriously unstable, as businesses adapt and find ways to abuse the system. The conflicts and evasion tend to worsen over time, and force changes, which then lead to a new set of conflicts.



This chart from Engelschalk's paper illustrates the range of the number of different taxes paid by "small businesses" in Ukraine in various jurisdictions, even with the availability of various SBT schemes. The average is nine, but the range is 5 – 17, but this is better than the 23 national taxes and an additional 16 local-level taxes of various sorts that may be applicable under the "normal" business tax regime.

According to an IFC survey in 2000, The majority of enterprises (61%) reported that they required one dedicated employee to deal with tax issues and that his person spent 20-50% of their working time on tax issues alone.

By contrast, Uzbekistan's SBT regime supersedes a large number of taxes, including the income/profits tax, VAT, property tax, land tax, environmental tax, and mineral tax. Besides the unified tax, small businesses and individual entrepreneurs are therefore only subject to payment of excises and social tax or, in case of individual entrepreneurs, pension fund contributions.

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.

Broadening the Tax Net

private sector | development

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)

IFC 5

Engelschalk notes that presumptive taxation in transition countries has been extremely successful if judged by the number of taxpayers opting to be taxed under the presumptive system. According to the Russian Ministry of Taxation (now the Federal Tax Service), 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 wanted to be taxed under the simplified system rose 3.2 times in the same period.[1]. In Albania, the number of taxpayers registered for the small business tax according to tax administration data increased from 18,000 in 1997 to 35,000 by the end of 2002. Also in Ukraine the presumptive tax system has attracted a large number of SME:

[1] "Simplified tax system will cut tax burden for small businesses", Pravda, Feb. 7, 2003.

… but still no panacea

private sector | development

Table 6: Registered Enterprises in the Presumptive Tax System

Enterprise size	Number of employees	Estimated number of enterprises	Estimated employment	Estimated percentage of registration	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	-	-

IFC

6

Nevertheless, 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.

Types of Systems

private sector | development

- Turnover tax or gross income tax
- Presumptive Tax based on indicators, e.g.
  - Type of business
  - No. employees
  - Location
  - Etc.
- Patent (e.g., operating license for fee)
- Questions of …
  - Which taxes are replaced?
  - Who can be included in the SBT regime?

IFC

7

Turnover taxes include most sales taxes; gross income taxes take into account basic costs and are closer to profit taxes/corporate income taxes. Countries who have used this type of SBT include Azerbaijan and Kyrgyzstan (as the main form of SBT), and several other countries who use it in conjunction with other forms, such as Albania, Armenia, Kazakhstan, Romania, Ukraine, Uzbekistan and Serbia.

Presumptive taxes of various sorts have been used in Bulgaria, Georgia, Russia, Ukraine, and others.

Patents have been used primarily in Belarus, the Central European countries, some Balkan countries, Russia, Ukraine and Uzbekistan.

Estonia, Latvia and Slovenia have no special SBT regime, following the example of most OECD countries.

Another key question is which of the "normal" business taxes are being replaced? Usually the corporate income tax or profit tax; sometimes the VAT (another whole issue), often a range of additional taxes such as property tax, vehicle tax, etc. Occasionally payroll taxes (which leads to another set of incentive problems with employees). Never excise tax.

Another problem is to define the target population – No. employees? Turnover? Capital? Type of business?

Turnover of Gross Income Tax

private sector | development

- Pros
  - Good introduction to basic accounting
  - Smooth transition to regular tax system
- Cons
  - Hard for illiterate or semi-literate entrepreneurs
  - Encourages evasion and under-reporting

IFC

8

Ukraine, for example, has a 6% sales tax to replace income tax, or a 10% sales tax to replace both income tax and VAT. Romania has a "gross income tax", at a rate of 1.5%, available to all small businesses. Kazakhstan has a progressive tax on gross income, ranging from 3 – 9%.

Armenia has a few different categories – traders, caterers, and "other".

Engelschalk notes: When the 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 tax evasion possibilities, but will simply induce an under-declaration of turnover instead of net profit.

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 realistic estimates of turnover or profit, patent rates have to be kept low to avoid the risk of over-taxation.

Presumptive Tax

private sector | development

- Pros
  - Should be based on objective, verifiable indicators
  - Can be tailored to fit circumstances of different types of businesses and locations
- Cons
  - Usually becomes very complex
  - No easy transition to normal tax regime

IFC

9

Indicator-based systems or "Presumptive" taxes have been tried in several transition countries. They try to be more "precise" in estimating the profit potential of the target population, but this is extremely difficult. In practice, they tend to run into conflicts between "fairness" (trying to get close to taxation on the basis of potential profitability) vs. simplicity. Systems tend either to be extremely complicated and unclear or to not sufficiently differentiate between business activities.

Engelschalk gives several concrete examples in his paper, e.g., Georgia, which tried to distinguish between retail trade in booths and in streets vs. farmers markets, vs. other goods production vs transport services vs. jewelry, and also by the size of the town in which the business is located. Bulgaria had more than 300 different tax rates.

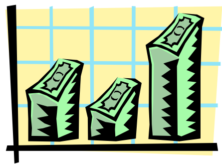
This usually turns into the opposite of simplicity – and if definitions are not clear and based on objective indicators, then there is scope for negotiation and corruption.

Engelschalk notes: "Taxpayers and tax administrations have different expectations regarding the potential benefits of simplified systems. From a taxpayer point of view, stability and clarity of the tax system and a reduction of the compliance as well as the tax burden should be the most important outcome of of presumptive systems. The main interest of tax administration lies in the revenue yields of the system, the reduction of administrative costs, and an increase in voluntary compliance."

Patent

private sector | development

- Pros
  - Very simple
  - Good for illiterate entrepreneurs



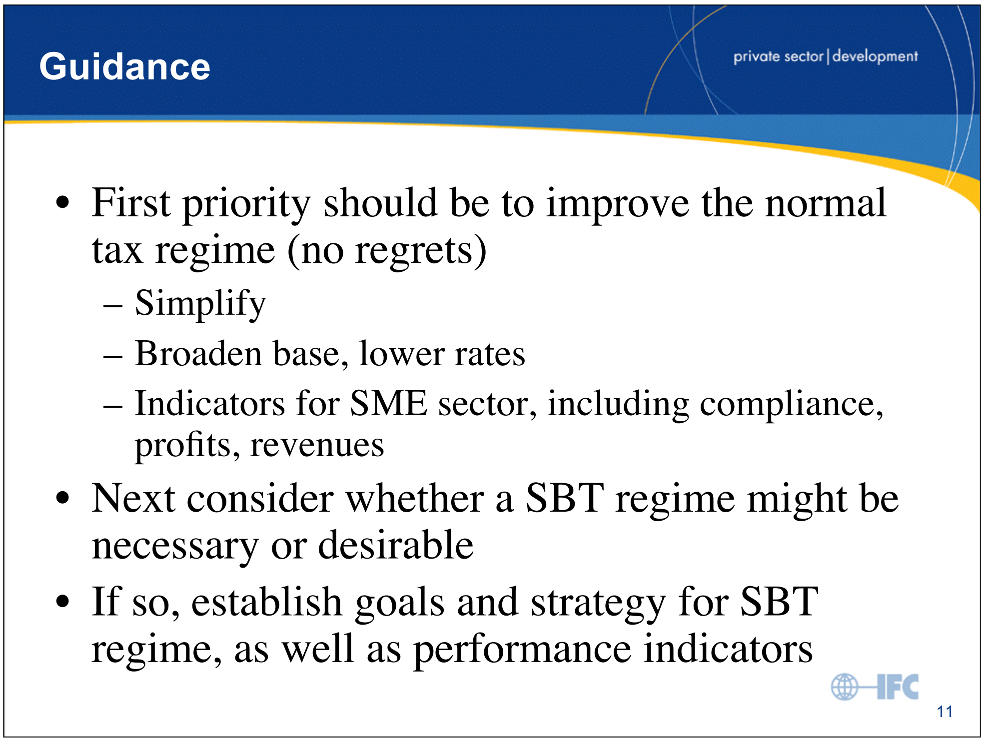
- Cons
  - Very unfair (too expensive for some businesses and too generous for others)
  - No easy transition to normal tax regime

IFC

10

Kosovo managed to "keep it simple", with a patent system for "moving traders, artisans, and other low-income generating activities." They pay a quarterly patent of Euro 37.50.

Albania also had 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.



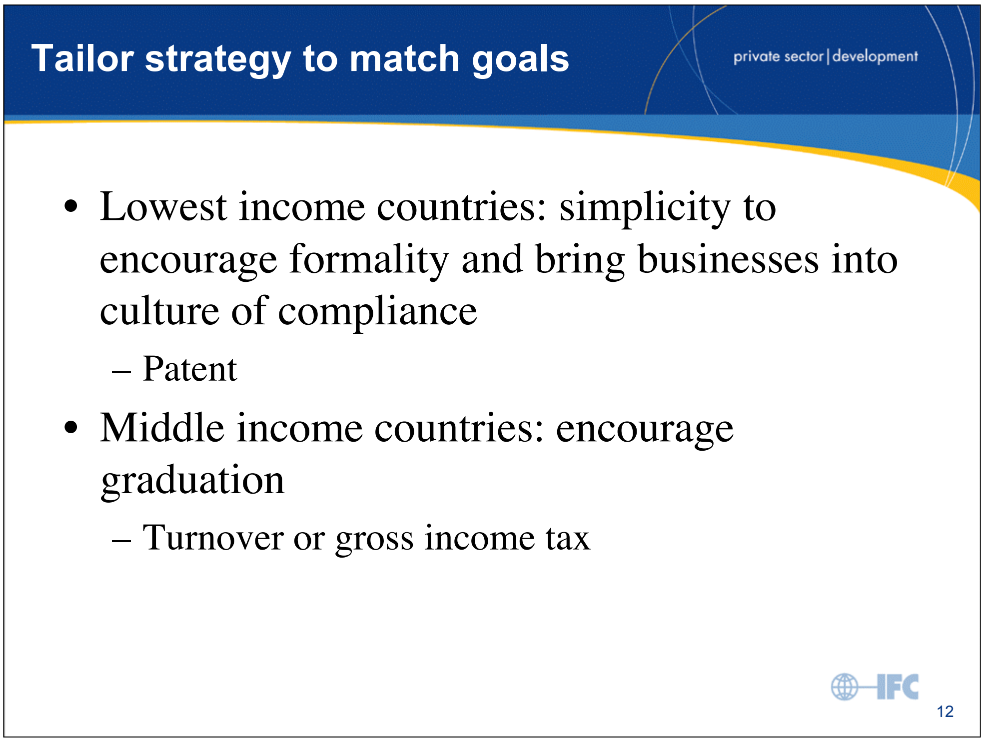
Before leaping to a SBT, it is always worthwhile to consider whether the regular business tax regime can be improved. This should be a "no regrets" policy to simplify taxes (e.g., Russia used to have over 30 different taxes but managed to cut this almost in half), broaden the base and lower rates.

In addition, most tax systems in developing and transition countries should be making stronger efforts to develop better indicators of compliance, of the average profit levels of businesses of various types, sizes, and locations, and to use this information to improve the efficiency of the tax system – bringing in more revenue at lower cost both to government and to businesses.

Only after some significant effort in that area should we be considering whether a special SBT regime might be necessary or desirable. If so, then we should be working with the government authorities first to agree on clear goals and priorities: is the main goal to encourage movement from the informal to the formal sector? To encourage growth? To improve overall compliance? What trade-offs are acceptable? What are the relevant performance indicators? How will they be collected and analyzed?

In particular, drafting a special tax regime for SME requires us to understand the SME segment in the economy and have sufficient data on its composition and performance. This data collection and analysis is a substantial task for developing countries, and TA to improve this capacity in many cases would be very important.

Increasingly tax administrations are moving to a taxpayer segment structure, thus creating special tax office for SMEs. Again, supporting the establishment of a dedicated small business tax administration structure and capacity building in this area would be an important TA activity.



Engelschalk notes: Introducing a simplified system has to be combined with strengthening administrative capacity to detect non-filers and stop-filers if the system really is to become an efficient tool to reduce underground economy activities.

The desire articulated by many small business operators to increase stability and predictability of the tax system has not been addressed by the simplified systems, which tend to undergo frequent and fundamental change in many transition countries.

Simplified taxation has primarily been designed to encourage businesses to register with the tax authorities and to facilitate the operation of small businesses in the formal economy. However, a too generous system risks creating a situation whereby collection and compliance costs exceed the amount of tax collected. In addition, the non-alignment of the tax burden under a presumptive tax with the tax burden under the standard tax regime works as a disincentive to declare business growth and migrate from the presumptive to the standard system.

Finally, 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.

But don't expect many thanks

private sector | development

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

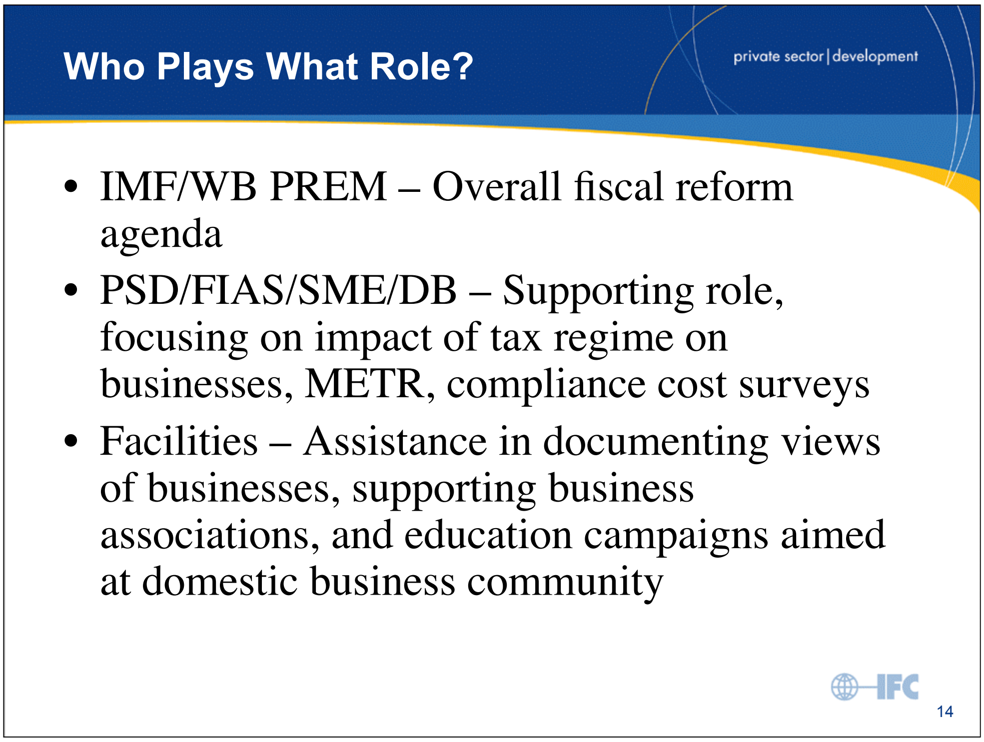
Country		Moderate or major obstacle
Albania	SME	48.3%
	Large businesses	55.5%
Bulgaria	SME	64.2%
	Large businesses	43.7%
Russia	SME	55%
	Large businesses	51.5%
Ukraine	SME	64.3%
	Large businesses	58.3%

IFC

13

Engelschalk notes that the World Bank "Business Environment and Enterprise Performance Survey (BEEPS)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 SME is too high and creates an obstacle for business development. The survey shows that even in countries operating a simplified system, small business owners frequently complain about high taxes – in some countries even more often than larger taxpayers.

But then again, all businesses everywhere always complain about taxes, and show no signs of stopping. Taxes are "normally" at the top of the list of complaints of businesses in perception surveys and there is almost no correlation between the frequency or level of complaint, on the one hand, and the actual burden of taxation on the other. Luckily, actual investment behavior shows a more reliable correlation (e.g., for FDI), but we don't have much reliable data (yet) from developing and transition countries about SBTs, METRs, and investment rates.



"Don't try this at home!"

Any idea to introduce a SBT regime in a client country should be developed in cooperation with our colleagues in PREM and the IMF. They are almost always working on the overall fiscal reform agenda, and have the big-picture about revenue needs and balance within the overall tax system.

Regional PSD departments, FIAS and the SME Department can play an important supporting role by providing more detailed information and analysis about the impact of the current tax regime on businesses, business perceptions, perhaps estimates of the normal profits in various industry sectors and locations. FIAS has often done "marginal effective tax rate" calculations for FDI and more recently for domestic businesses, and is launching a detailed compliance-cost survey for S. Africa as a pilot. Doing Business has simple benchmark data for the number of business taxes, the time required for compliance, and the burden of taxation for 155 countries.

The IFC Facilities (PEP) have on-the-ground presence and can be of tremendous assistance in documenting the view of businesses, supporting business associations in dialog with local authorities, and education campaigns aimed at the domestic business community to help improve compliance.