Small Business Taxation 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, complicated tax laws and administrative practices as well as the lack of a culture of voluntary tax compliance provide strong incentives to operate outside the formal economy. This paper begins by outlining 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 SME. It shows that the design of a clear and reasonably fair simplified tax system is a task which has often been underestimated by ministries of finance and tax administrations. As a consequence, simplified taxation systems risk lacking 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. This 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 small business operators continue to be confronted with a large number of tax obligations and high compliance costs.

Small business development and tax compliance

One of the main elements in the transition process to a market economy in Central and Eastern Europe and the countries of the Former Soviet Union was 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 process[1]. 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 Estonia[2]. This creates major challenges for tax systems and, in particular, tax administrations. Many transition countries have attempted to facilitate the taxation of SME by designing simplified taxation schemes. This paper will first 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 and the tax administration.

From a tax administration point of view the rapid development of a small business segment in the economy signifies a rapid increase in the number of ‘hard-to-tax’ taxpayers. Given that in the socialist tax system small businesses were virtually non-existent as a separate category of taxpayers, this represents an increase in the taxpayer population, which any tax administration, but especially the rather inexperienced tax administrations in transition countries, would find difficult to manage. In Russia the number of small businesses in the first phase of transition grew from 268,000 in 1991 to 896,000 in 1994. 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 these small businesses were firms with 1-10 employees. Furthermore, 47,625 self-employed persons were registered in the state register in May 1999, which is nearly 6.8 times the number registered in 1994[3]. Development of a small business sector was also extremely rapid in Poland, where in the first decade of market liberalization two million small enterprises were established[4]. 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 qualified audit experts, the non-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

1 Svejnar (2002).
2 Klapper/Sarria-Allende/Sulla (2002).
3 Ministry of Statistics, State Registers and Analysis Armenia (1999).
4 FEED (1998).

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.

In many transition countries the culture inherited from the communist period saw small businesses and private economic activities as parasitic, hence more as an enemy of the state rather than a 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 a rapid development of the underground economy. Estimates 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[5]. 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. Gërxhani, for example, 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 1998/1999, 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 activity[8]. 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 relating to both the level of the tax burden and the 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.

However, the mere number of registered small businesses does not reflect the full compliance management problem. 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 led to the creation of truly viable enterprises. Many of the new SME were created from the break-up of larger and inefficient state enterprises and from the privatization of smaller units of large firms, and thus had low survival rates[10]. A large share of SME in transition countries thus are newly created, while older enterprises cease to exist. This led to a situation where, for example, in Estonia, Lithuania, Russia and the Slovak Republic in 2002, more than 20% of registered SME existed for less than three years[11]. In this scenario there is very little chance to successfully familiarize small business owners with

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[5] Ivanova/Keen/Klemm (2005), table 17.
[6] Scharle (2002)
[7] Gērxhani (2003)
[8] Ministry of Statistics, State Registers and Analysis Armenia (1999)
[9] Chandler (2002)
[10] Klapper/Sarria-Allende/Sulla (2002)
[11] Klapper/Sarria-Allende/Sulla (2002)

bookkeeping and taxation rules. The probability is high that until a business owner fully understands his tax obligations and has gained experience with properly 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 address. This is illustrated by the findings of a survey carried out in Hungary in 1994. The survey showed that in spring 1994 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 still be reached at the address they had specified in 1992. The vast majority of small businesses seemed to either have only existed in a formal sense or were operating from an address different to the official one, mostly in private homes[12]. Tracing registered taxpayers and following up in case they have stopped filing returns or paying patents thus remains a high administrative burden and a difficult task irrespective of the operation of a standard or a simplified tax regime.

System Design

The spread of presumptive systems

Most transition countries have introduced some kind of simplified tax system for SME and sole proprietors, as table 1 shows:

Table 1

Country	Kind of system	Remarks
Albania	Turnover tax , patent	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	Turnover tax, patent	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. Turnover based tax for small traders, restaurants and businesses with turnover under 30 million Dram.
Azerbaijan	Turnover tax	2% gross turnover tax when turnover less than 300 times the minimum tax-exempt wage (US$ 6400)
Belarus	Patent	Lump sum tax for single ownership stores and total trading space less than 25 square meters, plus public catering enterprises, and at markets and sales exhibitions
Bosnia & Herzegovina	No system	
Bulgaria	Patent	For individuals in specific business sectors with annual turnover under 75,000 BGN
Croatia	Patent	
Czech Republic	Patent	
Estonia	No system	

[12] Tóth/Semjēn (1996)

Georgia	No system	
Hungary	Patent	Small entrepreneurs may choose an itemized presumptive tax in lieu of personal income tax and VAT
Kazakhstan	Gross income tax, patent	Special regime based on simplified returns for individuals with no more than 15 staff and gross income max. T 4.5 million and legal persons with no more than 25 staff and gross income max. T 9 million. Patent for micro-business.
Kosovo	Patent	Any taxpayer other than an insurance company with gross receipts less than 7,500 Euro.
Kyrgyzstan	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, e.g., in retail trade 4%
Latvia	No system	
Lithuania	Patent	Business certificate for certain activities carried out by individuals
(FYR) Macedonia	Patent	
Moldova	Patent	Individual entrepreneurs can buy patent which entails a monthly fee
Poland	Patent	
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	Patent	
Slovenia	No system	
Tajikistan	No information available	
Turkmenistan	Patent	Lump sum license for entrepreneurs without a legal entity and with an annual turnover of less than 72 million Manats (US$ 14,000)
Ukraine (until 2005)	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, patent	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	No information available	
FYR Serbia	Turnover tax, patent	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), updated		

Frequently the introduction of simplified SME tax regimes was recommended by technical assistance providers, including the IMF and the World Bank. Key motives were generally the improvement of the business environment, the facilitation 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, assumed 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 creation[13]. Similarly USAID 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; also 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 effectiveness 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 system[14]. For transition countries aiming at accession to the European Union, the EU Commission recommendation on improving and simplifying the business environment for business start-ups[15] 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 SME 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 SME". On the other hand, several World Bank reports also have pointed to the weaknesses and risks of presumptive systems. A FIAS report on Georgia, apart from highlighting the potential benefits of a simplified scheme, considers a fixed tax to be very complicated, and a World Bank report on tax policy and tax administration in Ukraine

[13] FIAS (2001), p. C-41.
[14] Cheasty (1996).
[15] Recommendation C(97) 1161 final of 22 April 1997.

discusses the risk of lack of focus and unjustified generosity of presumptive systems[16]. Surprisingly little attention has been given in these discussions to the risk of imposing a comparatively high tax burden on small businesses in their start-up phase. This apparently is not considered a potential result of presumptive tax systems in transition countries.

Choices for simplified SME taxation

Obviously there is a relatively short history of small business taxation in transition countries. In the initial stage of tax reforms some countries experimented with the use of standard tax incentive schemes not only for large businesses and foreign investments but also for small business development. Kazakhstan from 1990-1993 operated a tax holiday scheme for SME, exempting SME from profit tax for the first three years after establishment and granting a 50% profit tax reduction for the fourth year. 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 remedy the situation, the government had to take extreme measures and abolished all privileges[17]. Similarly, in Moldova the law on "On Supporting and Protecting Small Businesses" passed in 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 to 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 presumptive 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) systems based on turnover/gross income, (ii) systems using specific indicators to determine the size and output of a small business, such as floor space, number of employees, or the location of the business, or (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. Either the same tax rate applies to all businesses irrespective of the business activity. Examples are the unified tax existing in Ukraine, which operates in principle with only one rate of six percent on sales, except where the simplified tax also replaces the VAT, in which case a

[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).

10% rate applies. Also the Russian small business tax has as one of its components a 6% flat tax on turnover, and the simplified system introduced for micro-businesses in Romania from September 2001 operates with a very low rate of 1.5% on gross income. This approach abstains from grouping the SME sector into different categories and drawing borderlines which might be called into question. However, it also fails to consider that profit margins can differ substantially in different business sectors.

As an alternative the small business community is divided into several business segments with a different tax rate for each segment. This is designed to take into account the different profit margins of SME, although the number of segments under a turnover based system tends to be relatively small, so that these systems are far less differentiated than indicator based systems. 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 Kyrgyz simplified system 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 prominent example in the region. The system taxes gross income at rates between 3% and 9%. 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.

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 to not sufficiently differentiate between business activities. The latter was the case in Georgia until the new tax code was introduced in 2005, whereby the presumptive system only distinguished five groups of activities:

Table 2

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 markets, except people that produce these	10 Lari	18 Lari	35 Lari

products			
b) retail and wholesale trade at farmers markets 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 jewelry, repair of jewelry and watches, transportation services above 17 seats	30 Lari	75 Lari	150 Lari

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

The Bulgarian “Levy of a final annual (license) tax”[18], on the other hand, is an example of a system that emphasises the profit margin of the individual business activity. As a consequence, it lists 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 was divided into six sub-categories; those sub-categories again were divided according to the quality of the establishment, distinguishing, for instance, one-star from three-star restaurants. Furthermore all establishments were treated differently according to their location. This required setting 52 different tax rates for one segment of the small business community.

How complex such a system risks becoming can be illustrated by analyzing the category “construction and building-repair”. The Bulgarian law distinguishes three kinds of businesses in this field: general construction and building repair; repair of wiring and plumbing systems; and glazier services. Again, dividing the country into nine zones, 27 tax rates had to be set. But the nine different rates for glazier services are exactly the

[18] Chapter 14 of the Bulgarian income tax law

same as for general construction services, which raises the question why it was necessary to establish two separate sub-categories. In addition someone interpreting the law may ask why the tax rates for repair of wiring and plumbing systems are considerably lower than the rates for general construction services in seven zones, but identical to the rates for general construction business in the other two zones. Such differentiation is difficult 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.

Yet another issue of concern to the business community has become the question as to 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 frequently causes an ongoing dispute about the fact that certain businesses are either 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 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 services are taxed under the standard system; or if clairvoyants, psychics and bioenergy therapists are taxed under the presumptive system, why then are doctors and dentists 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 are likely to be changed as frequently in coming years.

Micro-business patents: Some countries use general patent schemes for the taxation of micro-businesses. The micro-business patent is not based on any indicator 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, introduced such a system in 2000 for moving traders, artisans and other low-income generating activities. These businesses are subject to the payment of a quarterly patent of Euro 37.50.

Other design issues

Apart from the general design of the 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 7,500 Euro 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. An exception 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):

<table>
<tr><th colspan="3">Table 3</th></tr>
<tr><th>Income within a quarter (in KZT)</th><th>Tax rate for individual entrepreneurs</th><th>Tax rate for legal entities</th></tr>
<tr><td>Up to KZT 1.5 million</td><td>3% of gross income</td><td>4 % of gross income</td></tr>
<tr><td>from KZT 1.5 to 3 million</td><td>KZT 45,000 + 5% of income exceeding KZT 1.5 million</td><td rowspan="2">KZT 60,000 + 5% of income in excess of KZT 1.5 million</td></tr>
<tr><td>from KZT 3 to 4.5 million</td><td>KZT 120,000 + 7% of income exceeding KZT 3 million</td></tr>
<tr><td>from KZT 4.5 to 6.5 million</td><td></td><td>KZT 210,000 + 7% of income in excess of KZT 4.5 million</td></tr>
<tr><td>from KZT 6.5 to 9 million</td><td></td><td>KZT 350,000 + 9% of income in excess of KZT 6.5 million</td></tr>
</table>

Determination of the system threshold: A key design issue for a presumptive system is the determination of a system threshold which is high enough to include most hard-to-tax businesses, but does not extend the system to businesses that are in a position to keep books and comply with the return filing requirements of the general tax system. In contrast to 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 accounting rules therefore rarely is the main reason for operating a presumptive taxation system for SME in the region. More frequently, considerations of small business promotion and tax administration capacity constraints 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 being subject to unpredictable and arbitrary practices and decisions of tax administration bodies. From a tax administration point of view, the limited capacity of 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 considerably reduces the compliance management burden and allows tax administration attention and capacity to focus on larger taxpayers with a higher revenue potential.

This means that the decision regarding 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 is not necessarily constant in the long term. With increasing quality and stability of tax policy and improved tax administration capacity the threshold could eventually be lowered and more taxpayers transferred to the standard taxation system.

Experience shows that the determination of an appropriate system threshold is particularly important in the case of turnover-based systems, which also apply to legal entities. However, inappropriate thresholds can also result in a 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 stringent 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 questionable 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 risks facilitating negotiation and corruption.

Clear thresholds for presumptive systems are either based exclusively on the business turnover (e.g. Albania, Bulgaria, Kyrgyz Republic) or a combination of turnover and other criteria, most frequently the number of employees. The definition of a small business in non-tax laws, especially for statistical or company law purposes, in most countries is not based on the business turnover as single quantitative indicator, but generally uses criteria such as the number of employees or total net assets[19]. 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 for the two groups. 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 no 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 KZT income for legal entities, and a maximum of 15 staff and 4.5 million KZT 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 due to specific characteristics of these businesses or to force them to keep books and records. Typical examples are the

[19] Ayyagari/Beck/Demirgüç-Kunt (2003)

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 a 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. As part of the reform of the simplified system the government therefore aimed to address 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$ 320,000[20]. The threshold of the single tax pertaining to the number of employees was envisaged to increase from 15 to 20 employees. Small businesses, in particular the Russian Union of Small Businesses and other small business associations, considered the increase in the threshold of the number of employees unsatisfactory. They argued that this increase would not change the situation and that the system would still cover only kiosks, street vendors, and mini repair shops. They also raised the question of seasonal workers who, under the proposed legislation, would be treated as contractors and included in the threshold[21]. The government, supported by some Duma (parliament) deputies, nevertheless retained 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 far greater than the potential tax benefits. Of course small businesses were also 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 rubles[22]. The government insisted that, based on government 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 a number of 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 the government refused immediately. Nevertheless the government was forced to concede to the small business community. Following intense debate between the government and small business

[20] As of May 2002, the minimum monthly wage was 450 rubles.
[21] See "Reference with trip", Profil, No. 14 (284), April 8, 2002.
[22] See Korop, (April 4, 2002).

representatives, the government agreed to keep the issue of the thresholds open in the draft law. Thus, the discussion of the threshold was left 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: Simplified systems either apply in lieu of income/profit taxation, or replace a multitude of national 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 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 presumptive systems. The main interest of tax administrations lies in 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 Report[23]. 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 mainly about the instability of the tax regime[24]. A survey carried out in Hungary by Tōth and Semjēn 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 calculation[25].Worldwide however, only few tax systems can be characterized as stable. This lack of stability particularly applies to tax systems in transition countries. In Ukraine, for example, in the last quarter of 1999 alone, 27 pieces of legislation were introduced or amended that affected SME taxation (IFC 2000).

The question to what extent a special presumptive tax system can protect small taxpayers from frequent changes in tax rates and procedures therefore is crucial when attempting 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 main factors contributing to this instability: Simplified tax regimes are not an isolated part of the tax system; they were introduced in lieu of a certain number of other taxes and are 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. This would require the collection and analysis of a large

[23] Brunetti/Kisunko/Weder (1997)
[24] Chursov (2001)
[25] Tōth/Semjēn (1996)

number of data on profit margins and the relationship between business indicators such as the size of a business, its activities or location, and the profit potential. In practice, however, such in-depth analysis is rare; instead the calculation of the tax burden is based on rough estimates of business profitability. In this scenario, it is difficult for ministries of finance to present solid arguments when faced by criticism from the business community or from government agencies responsible for small business development. Second, pressure from the small business community to modify presumptive taxation rules tends to be stronger than expected, as the growing number and success of small businesses in transition countries has turned them into a powerful interest group[26]. This became apparent in Bulgaria in 2002, when protests of taxi drivers against a presumptive tax increase led to a significant reduction in tax rates and caused the resignation of the Deputy Minister of Finance.

Due to the uncertainty about the appropriate design of simplified systems, and the lack of data justifying the system in place, changes in simplified taxation systems often take the form of substantial modifications of the approach to small business taxation, and are not limited to simple rate changes. This is illustrated by the following country examples.

Simplified taxation in the Tax Code of Georgia: The history of presumptive taxation in Georgia demonstrates 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 from 1994 to 1995. This system did not sufficiently take into account the nature and profit potential of the businesses covered, and was abolished in 1996. Two years elapsed before a new presumptive system was adopted in 1998, based on technical assistance recommendations from the IMF. However, the new system fell short of expectations. It established a patent regime for six 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 indicator. The most striking feature of the Georgian approach was that the simplified system became part of the transitional provisions of the Tax Code (Art. 273 of the Code), so that its validity was limited to a 12-month period. Every year a decision of the parliament to extend the system for another 12 month was required, so that 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, only two years after the introduction of the presumptive system, the Ministry of Finance decided to implement fundamental changes. However, while there was recognition that the system needed revision, it was unclear what the appropriate reform strategy should be. Three very different options were discussed by 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 the modification of the existing system by increasing the tax

[26] Barbone/Sanchez (2003)

rates and incorporating the social tax into the presumptive system. In the end, a mixed approach was adopted, and the package of tax code amendments submitted to parliament in September 2001 proposed the introduction of 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 great detail, distinguishing for example between the manufacture of knitted and crouched pullovers, other outerwear, underwear, and hats and caps as well as 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 continued to be renewed on an annual basis. Finally, in December 2004 a completely new tax code was adopted, which simplified the overall tax system by reducing the total number of taxes from 21 to 7 and introducing a 12% flat income tax. At the same time the special small business tax regime was abolished.

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. This system was replaced only one year later, when a new "Law for small business tax" was passed[27]. The system which was 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 (tax rate 8% of gross income) and professions such as engineers, teachers, veterinarians, financial advisors, and agronomists (tax rate: 3% of gross income). The gross income tax also included gambling halls (tax rate: 10% of gross income) and the operation of seagoing vessels used for the transportation of people and goods (tax rate: 3% of gross 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 had a number of major deficiencies. 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 the relatively low presumptive tax. It did not clearly define the individual categories and thus favored dispute as to which category a taxpayer should be allocated to. In addition, it tended to group quite different

[27] Law No 7679 of March 3, 1993.

professions in the same category, while at the same time rather similar professions, such as 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 yet again a new law on small business tax was passed[28]. The simplified system was extended to legal entities, and a turnover threshold of 5 million Lek was introduced. The design of the system was changed completely. The new small business tax law introduced a fixed patent for all businesses with an annual turnover under 2 million Lek. In contrast to the previous system, the patent not only depended on the type of 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 had 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 align the application of the small business tax with the VAT threshold. Finally, in 2002 another revision of the small business tax system was initiated. The small business tax regime now has two components: a simplified profits tax for businesses not required to pay VAT (meaning businesses with an annual gross income up to 8 million Lek) amounting to 4% of gross income, and a local small business tax in the form of a fixed tax, based on the type of business and the business location. Finally, the last step in the long list of changes was the reduction of the rate of the simplified profits tax from 4% to 3% from 2005 onwards.

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 compliance and the risk of corruption and harassment of businesses. Experience has shown that the objective of simplicity of the system could not always be achieved. Main reasons are an excessive number of presumptive taxes and lack of clarity in defining taxpayer categories. The Ukranian presumptive tax system 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 SME 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 taxes. In total five different small business taxes were designed:

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 no more than UAH 500,000. Legal entities can opt for the unified tax if they have no more than 50 employees and an annual gross income of no more than 1 million UAH. The tax rate is 6% on turnover. However, businesses subject to VAT can also opt

[28] Law No. 8313 of 26 March 1998.

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 is available to 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, providing the business has no more than 5 employees. A small business may apply 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)[29].

As Thiessen[30] rightly points out, it is hard to understand why sole entrepreneurs in the service sector with no employees and a gross income of less than 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 can at least choose 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 only one year after the establishment of the system tax policy-makers in Ukraine 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 no more than 1 million 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 200,000[31]. However, plans to pass a tax code in Ukraine have failed so far and the presumptive tax system has not yet been revised[32].

Definition of taxpayer categories

Difficulties in defining taxpayer categories, especially in the case of indicator-based systems, and the determination of patent amounts are the second main factor that can reduce clarity and transparency of the system and create opportunities for negotiations between taxpayers and tax inspectors. A typical example of an unclear definition can be found in the Albanian fixed-amount tax regime, which defines as one category of eligible taxpayers "Photographing services, photo-copying, beauty saloons, restaurants, hotels, motels, discos, cafes, driving-schools, auto-repairs, parking, agencies, computer courses,

[29] See for details Thiessen, (2001).
[30] Thiessen (2001), 7.
[31] Thiesses (2001), 7.
[32] President Yushchenko now has announced that a new Tax Code would be adopted as of January 2006.

gambling and other similar activities"[33]. This leaves substantial room for interpretation as to what is meant by 'similar activity' or by 'agency'. A World Bank analysis listed the introduction of presumptive taxes as a reform option to reduce the opportunity for corruption[34]. However, the use of unclear business designations and the widely used approach to refer to 'similar activities', which are supposed to be treated in the same way as activities specifically listed in the law, can have the opposite effect and increase the opportunity for negotiation and corruption instead of contributing to its reduction.

Reducing the compliance burden for taxpayers

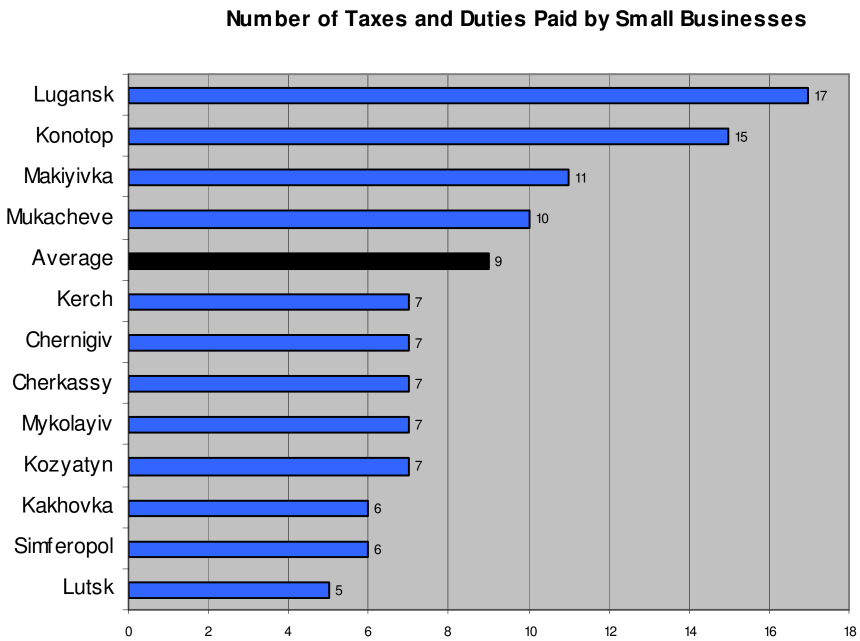
One of the main reasons for designing a presumptive tax for small businesses is to reduce the compliance burden for this business segment. This objective has generally been achieved insofar as small business tax laws do not require SMEs to keep books and records and also permit simplified accounting and return filing. Yet, in transition countries cumbersome registration requirements create another serious compliance burden for small businesses and reduce the incentives 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 registration[35]. 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, on the other hand, has not sufficiently recognized the importance of simple registration procedures for 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 and has to supply a substantial amount of information, including a court decision confirming the business owner's capability to conduct the business; a description of the types of activities that the person will carry out; a declaration of the turnover realized in the preceding calendar year; an estimation of the turnover for the current year; and any other information required by the tax authority. Should the small business operate in more than one location, a registration certificate is required for each business location. In addition, the registration is not permanent, but only valid for one year. Business owners are required to re-register their business with the tax authorities every year in February. The re-registration is only 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.

[33] Art. 3 Law No. 8213
[34] DasGupta/Engelschalk/Mayville (1999)
[35] Zamulin (2002)

A second crucial issue when 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 acts as a substitute for a multitude of taxes. 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 effect[36]. As a consequence Ukrainian SME on average paid nine different taxes and duties in 1999. However, the average number varied substantially by city:

Chart 1



Source: IFC

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[37]. SME operators considered VAT to be the most problematic tax from a compliance point of view, followed closely by corporate profit tax and payroll tax[38]. From a business planning point of view, corporate profit tax was considered the main obstacle, with VAT ranking second. In Russia small businesses viewed the exemption from social security taxation as the main benefit of the simplified system[39].

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[36] International Finance Corporation (2000).
[37] International Finance Corporation (2000).
[38] International Finance Corporation, (2002).
[39] Analysis in Pravda (Economic section), December 18, 2002.

Only in a few transition countries however, has the introduction of the presumptive tax system substantially reduced the total number of taxes small businesses are obliged to pay. 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. 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. This reduction in the number of taxes to be paid by small businesses has been greatly welcomed by the Uzbek business community[40]. Similarly, the single tax and the uniform tax in Russia were established to replace a large number of federal, regional, and local taxes 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 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 marginal. Hence, a presumptive tax that only addresses the income tax compliance problem is not considered by the small business community to be a sufficiently comprehensive reform, and there is pressure in several countries to extend the system to cover a broader range of taxes. This pressure in some cases resulted in a modification and broadening of the small business tax system. In the Kyrgyz 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, concerns were 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 countries of Central and Eastern Europe and the former Soviet Union appear to be rather generous. This is partly a deliberate move to encourage small business development by reducing the overall tax burden. Such is the

[40] A 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 the introduction of the unified tax to be very important for the further development of small and medium businesses in Uzbekistan. See FEED (1998)

case in Russia, where according to government calculations the simplified taxation regime adopted in July 2002, reduced the tax burden on small businesses by 50% - 75%, reflecting the government strategy to foster small business development by means of tax reductions[41].

It could, however, also be a consequence of the fact that government lacks reliable data on actual small business profit ratios and turnover levels. 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 owners[42]. This demonstrates the deficiencies of a turnover-based presumptive system. 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. In Georgia the presumptive tax on restaurants was only 10 GEL (approx. 5 US$) per month per seat. For a restaurant with 60 seats in Tbilisi, the presumptive tax according to the findings of the State Department for Statistics amounted to an average of just 3.2% of actual turnover. For Armenia the IMF carried out 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 Ukraine some of the patent rates amount to less than US$4 per month. But even the turnover tax rates assume a very low value added, considering that the 10% tax on turnover covers all profit tax and VAT liabilities of a business. This preferential tax treatment given to SME is highlighted by an IFC survey on tax burden by firm size as a share of value added in Ukraine[43]. The survey shows 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 the most disadvantaged, particularly in the case of medium-sized manufacturing enterprises, the average tax burden as a share of value added for small businesses is somewhat lower, at around 46% in 2000, declining to around 42% in 2001, reflecting the increasing transfer of businesses from the regular to the simplified system.

Countries for which data are available show a very low revenue yield from presumptive taxes. In Bulgaria the 268,000 patent taxpayers in 2002 paid roughly BGL 56 million (35 million US$) in taxes, which represents approximately 1% of all tax revenues[44]. 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 represented 1.7% of total tax revenues in 2000. In Albania in 2000, small business tax

[41] Grigoriyeva and Korop (2002).
[42] Report GE51 GR01, "Informal economy".
[43] International Finance Corporation (2002).
[44] Pashev (2005).

collection amounted to roughly 2% of total tax collection. The proportion is somewhat higher in Ukraine, where 4.6% of total tax revenue was derived from various presumptive taxes in 2001[45].

There are two conclusions to be drawn from these data. First of all, there is a risk that the total costs of administration and collection of some presumptive taxes will amount to more than the actual revenue collected. Secondly, the low tax burden under the presumptive tax is in danger of providing incentives for larger businesses to structure their operations in such a way as to benefit from the presumptive tax regime. It can also act as a disincentive for SME to grow and thus be transferred to the standard tax system.

Several countries indicate that they have experienced problems with tax avoidance schemes used by larger businesses. The tendency of larger businesses to divest themselves of certain smaller operations and have these managed by SME under the presumptive tax regime has for instance been observed in Ukraine[46] and Kazakhstan. In Ukraine major tax avoidance problems involving the small business tax regime recently even led to a discussion about its abolishment. A typical avoidance scheme has been designed to reduce the relatively high combined income tax and social security tax burden on labor. Employers encourage their employees to register as self-employed under the presumptive tax. Once registered, they render the same services to the company; however, instead of paying high income taxes and social security contributions, they merely pay the considerably lower presumptive tax.

In Ukraine, for example, an employee who receives a monthly salary of 510 UAH (30 times the minimum wage) is subject to 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 to both the employee and the employer. In Russia the sheer difference in the tax rate between the standard 13% personal income tax and the 6% single tax rate according to reports has created an incentive for employees to supply their labor services as small businesses.

The revenue potential of presumptive taxes could be considerably increased by adjusting tax rates and bringing the actual tax burden more in line with 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 difficult to achieve and requires a greater focus of ministries of finance and tax administrations on designing and updating simplified systems. 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

[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.
[46] Thiessen (2001).

consideration more fully the particularities of individual businesses in calculating the presumptive tax burden. However, as a consequence, data collection requirements had to be substantially expanded and include: "i) the 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; ii) location of business premises; iii) appointment of business premises; iv) number of employees and working family members; v) market conditions under which the business is conducted; vi) floor area of business premises; vii) age of the taxpayer and his/her capacity to work; viii) revenues of another taxpayer conducting the same or similar business under the same or similar conditions; ix) other circumstances affecting the generation of profits"[47]. 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 seasonality[48]. In this case the simplified system risks no longer being perceived as 'simple', and both the taxpayer and the tax administration might in some cases fare better applying the standard taxation regime.

Broadening the tax net

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.[49]. 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:

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)

[47] Art 41 Individual Income Tax Law
[48] Wallace (2002)
[49] "Simplified tax system will cut tax burden for small businesses", Pravda, Feb. 7, 2003.

In 2002 most businesses qualifying 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 pointless because they considered the regular taxation system to be as good as the simplified regime. The popularity of the system thus had considerably increased compared to 2000, when only 52% of eligible survey respondents were actually using the system[50]. Thiessen estimates that the presumptive tax in Ukraine has reduced the total size of the shadow economy by 11-14% during 1999 and 2000[51].

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:

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	-	-

Source: Thiessen (2001)

This could, to some extent, reflect a decision of small business owners to wait and see how the new presumptive system was implemented. However, it might also reflect the fact that small businesses operating in the underground economy still did not see sufficient incentives to legalize their business. Experience indicates that the operation of a presumptive tax system as such does not provide sufficiently strong incentives for businesses to register. To guarantee major improvements in voluntary compliance, the introduction of the presumptive 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 the Explanatory Note to the 2001 Draft State Budget stated that due to weak tax administration capacity and limited success in tax enforcement only GEL 10-15 million could be expected instead of potential presumptive tax revenues of GEL 180-240 million. In Albania, on the other hand, major efforts to improve tax enforcement implemented in 1999 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

[50] International Finance Corporation (2002)

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:

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		

Also an analysis by Ikiz in Bulgaria demonstrates 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[52]. The introduction of a presumptive tax has been welcomed by small businesses as a reform that facilitates tax compliance and reporting, but has not been perceived as a measure that guarantees a reasonable tax burden for SME. As a consequence, the incentive to work underground or under-report real turnover remains.

Conclusion

In most transition countries simplified taxation for hard-to-tax businesses has become a component of the new tax system. Simplified taxation either takes 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

[52] Ikiz (2002)

taxation can be an important element of a strategy to address the problem of a growing underground economy.

Experience with simplified taxation schemes indicates that these schemes have at least been successful in one respect: they have 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 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.

Simplified systems have not fundamentally changed the taxpayers' perception of the tax system as burdensome or their opinion that tax rates are 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 can generally be regarded as significantly 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 has been introduced in lieu of income tax or income tax and VAT only. In only a small number of countries has the simplified tax replaced all or most of the national and subnational taxes. Small businesses therefore still have 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 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.

As the simplified systems that are operational in transition countries generally not only aim to reduce compliance costs as well as bookkeeping and reporting requirements, but also to considerably lower the actual small business tax burden, revenue yields are low in most cases and represent a negligible share of total tax collection. Clearly revenue collection is not the key objective of simplified taxation in 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.

There are a number of system design issues that will need to be addressed to further improve simplified tax systems. In a number of countries the simplified system that has been implemented is not simple at all. Some of the key problem areas are the classification of taxpayers, the determination of the tax due, and an overly large number of presumptive taxes.

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.

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