

# **The Taxation of Micro and Small Businesses in Transition Economies: Country Experience of the Introduction of Special Tax Regimes**

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## **Abstract**

This paper analyzes the design of simplified small business tax regimes in Eastern Europe and Central Asia and the impact of such regimes on small business tax compliance. While there are many options for tax simplification, the general trend in the region is to offer small businesses the option to be taxed based on their turnover rather than net income. This study finds that many of the regimes in place are not well targeted, and neither take into account fairness considerations nor facilitate business growth and migration to the standard tax regime. While revenue generation is not a main objective of such regimes, the extremely low revenue performance and the risk of system abuse by larger businesses should be issues of concern. More attention should therefore be devoted to improving the design of simplified regimes and monitoring their application. This will require, in particular, a more profound analysis of the economic situation and the tax compliance challenges facing the small business segment, and increased efforts to improve the quality of bookkeeping.

**JEL codes:** H25, H26, O17

**Keywords:** Presumptive taxation; business formalization and growth; tax compliance; compliance costs.

## **INTRODUCTION**

Business taxation is at the heart of the relationship between the state and its economic constituents. The transition toward market principles in the Eastern Europe and Central Asia (ECA) region has thus required a fundamental change in the principles underlying public revenue collection for a growing number of private enterprises: a move away from reliance on transfers, typically predetermined by state owned enterprises (SOEs), toward the assessment of actual taxable income.

As part of this major change in revenue administration and wider privatization and deregulation efforts, many transition countries established special programmes to administer and support the growth and competitiveness of micro, small and medium enterprises (MSMEs). The development of small business activity during the transition resulted in major administrative challenges and a range of policy experiments to

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address these, not least regarding their tax treatment. Facing an ever-growing number of business “clients”, the introduction of various simplified taxation schemes was partly an attempt by tax policy makers to alleviate the administrative workload. In practice, however, audit coverage remained relatively intense, given the common starting point of regular audits of all businesses before the transition (Engelschalk, 2004). At the same time, starting with De Soto’s influential work (1989), the extensive informality of small firms and individual entrepreneurs has attracted increasing attention as a challenge for transition economies (Schneider & Enste, 2000), with simplified tax policy and administrative requirements commonly seen as one of the main policy levers.

In light of these ambitious objectives, experience over the last 20 years casts some doubt on the effectiveness of simplified and preferential tax treatment in reducing compliance costs and burdens for tax administrations, or in improving formal business creation and small enterprise growth. In some instances, widespread non-compliance and under-reporting linked to simplified taxation may become a major constraint on investment activities, as unfair competition from businesses availing themselves of tax avoidance schemes increases economic pressure on formal businesses in the standard tax regime and reduces their competitiveness (World Bank, 2011).

Research on a number of tax challenges for transition economies, in particular regarding the use of presumptive taxation regimes and the control of rampant corruption, has been scarce (Holmes, 2002), aside from general guidance on MSME taxation (ITD, 2007; IFC, 2007) and select efforts to summarize country practices (Engelschalk, 2004). Little evidence is on offer for policy makers interested in how to proceed in these areas of second-, or rather third-best, policy and administrative solutions, which are prevalent given persisting capacity and resource constraints on both taxpayers and tax administrations.

This paper aims to contribute to filling this gap based on documented country experience. We focus on the tax treatment of micro and small businesses,<sup>3</sup> and provide an overview of policy trends and a general discussion of country experiences in MSME tax policy in the region. This country practice then informs a summary of lessons

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<sup>3</sup> Most countries in the region have a general definition of what constitutes a micro and a small business, either in a special SME law or in commercial laws, and all countries define MSMEs for statistical purposes. These definitions generally refer to several parameters. In the Russian Federation, for example, a business is considered to be small if annual turnover is not more than 11.2 million US\$ and the number of employees does not exceed 100 (Law 209-FZ). In Croatia, the national accounting law sets small business thresholds at asset values below 4.8 million US\$, annual revenues below 9.5 million US\$, and average number of employees during the business year not more than 50. However, such definitions are generally not relevant for taxation purposes. Tax laws include special micro and small business thresholds, based on the revenue potential of the segment and its compliance capacity. These definitions are generally turnover-based and are discussed in more detail later in the paper.

learned and policy recommendations, which are presented in the second part of the paper.

## **Regional overview: Development and issues regarding the tax treatment of MSMEs**

### *Income/profit taxes and compliance costs*

In the ECA region, presumptive tax instruments were typically introduced in the late 1990s or early 2000s, with the objective of promoting private-sector development and facilitating compliance management in an environment characterized by low tax administration capacity and a rapidly growing number of private small business operators. Prioritizing the effective compliance management of larger businesses to ensure sufficient revenue mobilization required tools to minimize the administrative efforts of smaller entities. The goal was to encourage voluntary compliance of small businesses, while allowing for a simple examination of low-revenue tax returns.

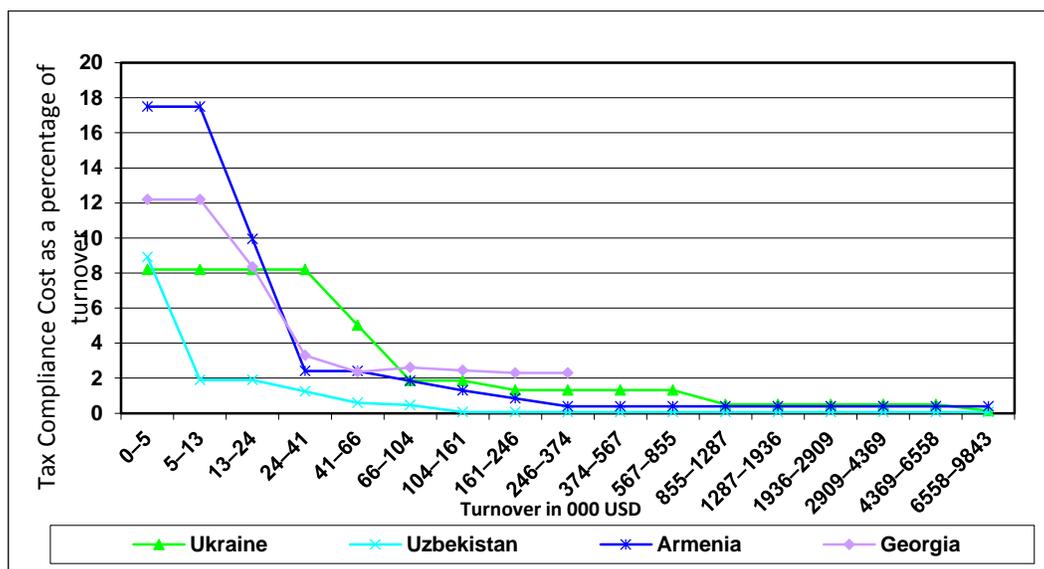
Moreover, a number of compliance burden and compliance cost studies has highlighted regressive features of tax compliance costs and stressed the need for developing simplified systems of taxation. Klun and Blasic (2005) provide estimates for Slovenia and Croatia and, similarly, survey-based analysis by the World Bank in Ukraine (2009), Uzbekistan (2008), Armenia (2010) and Georgia (2011) supports earlier findings on compliance cost assessment in the OECD, depicting a highly regressive burden. Given the high fixed-cost component of tax compliance, the general trend identified in these surveys is hardly surprising: the smaller the business, the higher the tax compliance cost it faces as a share of its turnover.

It is notable that, even for businesses operating at more than \$100,000 in turnover, measured compliance costs may still surpass three per cent of their turnover level. The reasons for such high compliance burdens vary, including complicated reporting procedures and time spent on inspection visits and/or audits, a frequent challenge for MSMEs in the region (Engelschalk & Loeprick, 2011). For example, Kireeva and Rudy highlight that, in Belarus, to comply with the general tax regime, a small business with up to 50 employees on its books has to employ an average of two accountants. They estimate that monthly costs incurred by the SME segment on tax compliance may exceed \$3.5 million (National Report for Belarus, in Lang, Obermair, Schuch, Staringer, & Weninger, 2008, pp. 91-110).

Compliance costs may be burdensome, irrespective of legal status, and participation in the presumptive regime may be a tool to reduce these and thereby increase the competitiveness of small corporations. Moreover, small corporations do not necessarily have better in-house accounting capacity than non-incorporated businesses. On the other hand, however, different accounting obligations may already require more

comprehensive records for corporations, and the risks of system abuse and downward migration increase markedly when corporations are eligible for simplified income tax treatment.

**Figure 1. Regressive tax compliance costs for micro and small businesses in the region**



Source: IFC Tax Compliance Cost Surveys, 2007-11.

Attempts made in a number of countries to abolish presumptive tax regimes for small businesses have generally been unsustainable. For example, in Georgia, a patent system for small businesses was in place until 2005, when a new tax code was introduced. However, taxation of small businesses based on net income resulted in high compliance costs, and in 2011 Georgia adopted a new simplified tax regime. Micro businesses with a turnover below GEL 30,000 (\$18,100) are exempt from income taxation, while small businesses with a turnover below GEL 100,000 pay a presumptive tax based on turnover. Romania operated a micro-enterprise tax (MET) regime with a three per cent rate on turnover until January 2010, when the regime was abolished and small taxpayers were moved to the general tax regime. A year later, the system was reintroduced and, starting from January 2013, presumptive taxation became mandatory even for incorporated small businesses. The system was used by 92,000 taxpayers prior to its abolition, representing about 20 per cent of eligible small businesses, and around 60,000 of these businesses immediately moved back to presumptive taxation after its reintroduction. Armenia had a turnover tax for businesses with turnover below AMD 30 million (\$71,700). This was abolished in 2008 as part of a major tax reform exercise, which also increased the VAT threshold to AMD 58.25 million (\$180,000). Only the patent regime for micro businesses and a presumptive small business tax for a few selected activities, such as barber shops, remained in place. The repeal of the turnover

tax regime was motivated partly by widespread abuse of the regime by larger businesses. However, it resulted in a significant additional compliance burden for many small businesses, and therefore presumptive taxation based on turnover was reintroduced in 2013.

### *Basic system design*

Most regimes targeting micro, small and medium-sized businesses in the region have changed fundamentally since their first introduction, and many regimes are modified on a regular basis. While, in the 1990s, simple fixed-tax or patent regimes were also widely used for the small business segment, today, such regimes are largely limited to micro businesses, and a turnover-based approach has become the standard method for taxing small businesses (see Table 1).

**Table 1. Approach to simplified small business taxation, 2000 and 2014**

Country	Tax regime 2000 <sup>4</sup>	Tax regime 2014
Albania	Turnover	Net income
Armenia	Lump sum	Turnover
Azerbaijan	Turnover	Turnover
Belarus	Lump sum	Turnover
Bosnia	None	Turnover
Bulgaria	Lump sum	Lump sum
Croatia	Lump sum	Net income
Czech Republic	Lump sum	Standard deduction from gross income
Estonia	Net income tax	Net income tax
Georgia	None	Turnover
Hungary	None	Standard deduction from gross income
Kazakhstan	Lump sum or turnover	Turnover
Kosovo	Turnover	Turnover
Kyrgyz Republic	Turnover	Turnover
Latvia	None	Turnover
Lithuania	Presumptive tax	Lump sum
Macedonia	Lump sum	Turnover
Moldova	Lump sum	Turnover
Poland	Lump sum	Turnover
Romania	Turnover	Turnover
Russia	Turnover	Turnover
Serbia	None	Turnover
Slovak Republic	Lump sum	Standard deduction from gross income
Slovenia	None	Standard deduction from gross income
Ukraine	Turnover	Turnover
Uzbekistan	Turnover	Turnover

Source: Authors, based on Mitra and Stern, 2002 and World Bank Group Country Reports.

Experimentation with the tax treatment has been common in many countries. Kazakhstan, for example, first introduced simplified taxation for micro and small

<sup>4</sup> Based on Mitra & Stern, 2002

businesses in 1995. The system has been modified several times since, including a move from a fixed tax to a turnover-based tax and the replacement of a progressive presumptive tax with a single rate on turnover.

**Table 2. Presumptive tax regimes for micro and small businesses in Kazakhstan**

—1995	1995	2001	2002	2004	2007—
No presumptive regime	Patent regime				
	Introduction of the patent regime with tax rates differentiated by type of profession (c.150 different professions)	Limitation of the patent regime to individual entrepreneurs	Replacement of fixed patent with flat 3% rate on turnover	Increase of the turnover threshold (aligning it with minimum monthly wages)	Flat tax rate lowered to 2%
		Simplified declaration regime			
		Introduction of simplified declaration regime with progressive tax scale (4-11% of turnover for physical entities; 5-13% for corporations)	Rate reduction to 3-7% for physical entities and 4-9% for corporations	Further reduction in tax liabilities (progression limited to 3-5% for physical entities and 3-7% for corporations)	Introduction of a flat 3% rate on turnover

Source: World Bank Group, 2010.

In addition to the move toward a turnover-based calculation of presumptive tax liability, it was increasingly recognized that the MSE segment of the taxpayer population actually consists of two different taxpayer groups: micro and small businesses. Further segmentation to differentiate between the small and micro business categories constitutes the second major system reform trend (see below for a definition of micro businesses). Frequently, segmentation was combined with an effort to improve local revenue mobilization, and micro business tax revenues were allocated to local budgets.

#### *Flat income taxation and simplified small business regimes*

The ECA region is not only a region with widespread use of presumptive tax regimes for small businesses; it is also a region in which many countries have introduced flat income tax regimes, an approach pioneered by Estonia in 1994. Following Estonia and its Baltic neighbors, the Russian flat tax reform in 2001 attracted global attention as a result of subsequent improvements in revenue collection. This triggered a wave of

similar reform efforts throughout the region (see Table 3). The general objective was to promote economic growth through creation of a business- and investment-friendly environment for individuals and companies, as well as to achieve a high degree of tax fairness (see Brook & Leibfritz. 2005), to simplify administration and compliance, and to introduce greater tax transparency.

**Table 3. Overview of spread of flat tax reforms in ECA**

Country	Year flat tax introduced	Rate (%)	Impact on small business regimes
Albania	2007 (abolished 2014)	10	Presumptive regime had been transferred to local governments and remained in place
Bosnia & Herzegovina	2009	10	None
Bulgaria	2007	10	Presumptive tax transferred to local governments in 2008
Czech Republic	2008	15	Lump-sum deduction scheme already in place before flat tax was introduced and maintained
Estonia	1994	21 <sup>5</sup>	No special MSME tax regime developed
Georgia	2005	12	Presumptive regime abolished with new tax code, but later re-introduced
Kyrgyz Republic	2006	10	None
Latvia	1997	25	Micro-enterprise tax introduced in 2010
Lithuania	1994	33	N/A
Macedonia	2007	10	N/A
Montenegro	2009	9	N/A
Romania	2005	16	Turnover tax regime introduced in 2004, remained in place
Russia	2001	13	Simplified tax regime introduced in 2003
Slovak Republic	2004 (abolished 2013)	19	Presumptive regime abolished with flat tax introduction
Ukraine	2004	13	Simplified regime introduced in 1998, remained unchanged

The move toward flat income taxation typically affected a broad range of related taxation areas,<sup>6</sup> although details of the reform programmes differed, as summarized by Keen, Kim, and Varsano (2008). The revenue impact varied depending on the degree and effectiveness of accompanying measures to increase the tax base, economic growth at the time of the reform, and complementing enhancements of the tax administration (World Bank, 2007). Generally, flat tax regimes, which tended to provide important alleviations of the tax burden in the upper income brackets, reduced personal income

<sup>5</sup> The rate in Estonia was initially set at 26 per cent and subsequently lowered.

<sup>6</sup> Spanning the treatment of corporate and capital income, reforms of indirect taxation and social contributions, and solutions chosen as measures to protect low-income groups.

tax revenues – Latvia, Lithuania and Russia being exceptions – and triggered heavier reliance on indirect instruments such as VAT and excise (Keen et al., 2008).

In the majority of countries, the introduction of a flat tax regime was unconnected with the operation of a presumptive small business tax regime and had no impact on presumptive regime design and operation. Remarkable exceptions are the Slovak Republic and Georgia: in both cases, the introduction of a flat income tax was combined with a broader simplification of the tax regime. In the Slovak Republic, the 2004 tax reform process aimed to eliminate a large number of exemptions and special regimes, and introduce a consistent and comprehensive approach to direct taxation. As part of this process, the small business presumptive regime was replaced with a standard cost deduction ratio for the self-employed. This change in the small business taxation approach seems to have had a positive impact on voluntary tax compliance: the number of income tax returns submitted by the self-employed increased by 14.6 per cent in the first year of flat tax implementation.<sup>7</sup>

A similar approach was taken in Georgia, where the move to a flat income tax was combined with a comprehensive and successful tax simplification approach. The 2005 tax reform reduced the number of taxes from 22 to seven, the number of required visits to the tax office dropped sharply, and the estimated tax compliance rate increased from 35 per cent to around 80 per cent. Introduction of the flat tax was seen as an appropriate occasion to abolish the dysfunctional patent regime that had been in place since 1998. Unlike the Slovak Republic, no further simplification measures were foreseen for MSMEs, which were expected to comply with the standard income tax regime. However, following the far-reaching simplification of the general tax system, small businesses still experienced an increase in compliance requirements. While taxpayer perceptions improved dramatically among large businesses, an increasing number of small businesses identified tax administration as a key barrier to doing business following the reform. This is one factor that explains the decision to reintroduce a presumptive tax regime in 2010.

Another special case is Estonia, which introduced a simple flat tax regime early in the transition process, before a separate presumptive small business tax regime had been developed. The Estonian regime does not include any special rules or simplifications for small businesses. In an environment with a relatively highly educated and IT-literate small business community (more than 97 per cent of corporate tax returns and 93 per cent of personal income tax returns are filed electronically) and the absence of unofficial costs relating to taxation (Dickinson, 2012), a simple cash-based general taxation system has proved sufficient to support small business tax compliance.

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<sup>7</sup> The Slovak reform combined a number of related measures, including increased labour market flexibility and a range of indirect tax reforms.

The Georgian example demonstrates that even a successful flat tax introduction, combined with a comprehensive tax system simplification, does not automatically guarantee that special simplification rules for small businesses are no longer needed. In particular, the requirement to calculate and document business expenses and the risk of disputes about the deductibility of such expenses may be considered an additional burden of flat tax regimes compared with presumptive tax regimes. Experience in other ECA countries, such as Bulgaria, has shown that a move to a flat tax does not substantially reduce the complexity of filing and documentation requirements, making compliance with the flat tax regime still burdensome for small business operators. This is even more of a challenge when the overall tax simplification measures combined with the flat tax introduction do not go far enough. The flat tax introduction in the Russian Federation, for example, was part of an exercise to introduce a new tax code. The first part of the code became effective in 1999 and fundamentally reformed the system of tax administration, while the second part, dealing with specific taxes, was approved in 2000 and became effective from 2001. The centrepiece of the Russian reform – a single marginal personal income tax rate of 13 per cent – was followed by an impressive increase in real personal income tax revenues of about 26 per cent in the first year after its introduction. However, using micro-level data, Ivanova, Keen, and Klemm (2005) provide cautionary insights, suggesting that attribution of revenue performance to personal income tax reform alone is questionable.<sup>8</sup> Moreover, the new Russian tax regime still consisted of around 40 different taxes, and small businesses remained confronted with an average of 9.56 types of tax (Shetin, Zamulin, Zhuravskaya, & Yakovlev, 2005). Despite the flat tax introduction, the move to a more simplified tax regime for small businesses thus remained a valid concern, which was addressed with the introduction of the simplified tax system (STS) in 2003. A similar development occurred in Ukraine.

Pressure to introduce or maintain presumptive tax regimes with a low effective tax burden may also build up in the case of a flat tax regime that uses a high tax rate. Flat tax reforms in the ECA region did not necessarily lower the average and marginal tax rates for small businesses. Some people saw no change in their marginal tax rates, since many governments selected the marginal rate from one of the tax brackets used previously. This happened, for instance, in Lithuania, Latvia and Georgia.<sup>9</sup> The rates selected in the early flat tax reforms in the Baltics corresponded either to the highest marginal rate before the reform (Lithuania, Latvia), or to the middle of pre-reform rates (Estonia). With rates that remained high in comparison with those used under the

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<sup>8</sup> Importantly, not only personal income tax, but revenue from all major sources increased in 2001 in Russia, suggesting broader drivers contributing to the observed performance. Analysis by Ivanova et al. (2005) underscores the importance of improved compliance, which may be linked to both the policy and administrative measures of the reform.

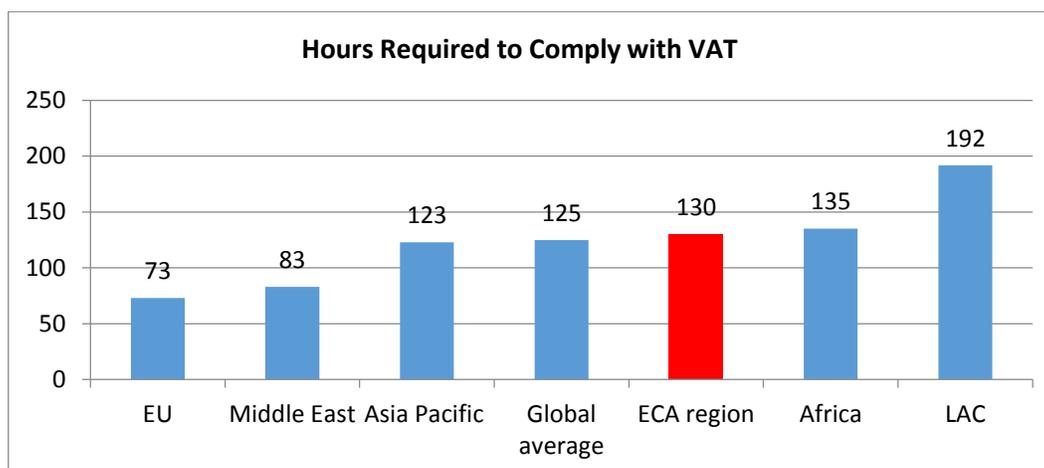
<sup>9</sup> However, individuals whose marginal tax rates did not change may have experienced a change in their average tax rates.

preceding income tax regime brackets (Easterbrook, 2008), small business lobby groups continued to have grounds for requesting preferential tax treatment.

### *Small businesses and the VAT system*

In theory, strong arguments can be made in favour of including small businesses in the VAT net. As a tax on consumption, the VAT chain would ideally stretch from the point of production (or import) to the point of sale to the final consumer, thereby including the retail sector and the provision of services to private consumers. Indeed, when VAT was introduced in the ECA region in the 1990s, a number of VAT laws included no or a very low VAT threshold. For example, Russian VAT started with a very low threshold of 100,000 Russian Rubles (Rub) in 1992 (quickly increased to Rub 500,000), Hungary operated a threshold of \$9,000, and Romania operated a threshold of \$6,000 in the early 1990s (Jack, 1996). The VAT systems in Belarus and Uzbekistan still operate without a threshold for incorporated businesses. From the business perspective, an advantage for small businesses of being part of the VAT net might be to facilitate interaction with VAT-registered businesses, assuming that a VAT-registered larger business will prefer to order goods and services from clients who can issue VAT invoices. However, this might not always be the case; not all VAT-registered businesses are equally interested in formally deducting input VAT, and lowering the sales price of goods or services rendered may be a preferred alternative to issuing a VAT invoice. In addition, as highlighted by Bird and Gendron (2007), in some countries, vibrant markets have been established in the trading of VAT invoices. Nevertheless, good practice suggests providing small businesses with an option to register voluntarily for VAT, even if their turnover is below the registration threshold, if they can prove that they are capable and willing to comply with VAT requirements (in particular, keeping the necessary books and records, issuing VAT invoices and operating cash registers).

In practice, there are several strong arguments against an approach of extending the VAT net to the small business segment. IMF experience has shown that setting too low a threshold for VAT may significantly compromise the political and administrative feasibility of a VAT regime (Ebrill, Keen, & Summers, 2001). Furthermore, World Bank Group/IFC tax compliance cost surveys show that joining a VAT regime substantially increases tax compliance costs for small businesses. Feedback received from small businesses in European Union member countries demonstrates that small businesses consider VAT legislation to be one of the 10 most burdensome EU laws. The compliance challenge is thus increased when VAT systems require extensive documentation, where taxpayers are subject to frequent VAT audits, or when filing procedures have not been streamlined and simplified. This is the case in a number of ECA countries, as comparative analysis indicates that the time required for VAT compliance in the region substantially exceeds compliance time in EU countries.

**Figure 2. VAT compliance time across regions**

Source: PwC (2010).

A more detailed compliance cost analysis for VAT was conducted in Slovenia in 2001, two years after VAT had been introduced with a relatively low threshold of SIT 5 million (\$22,700), demonstrating the high compliance burden for small businesses.

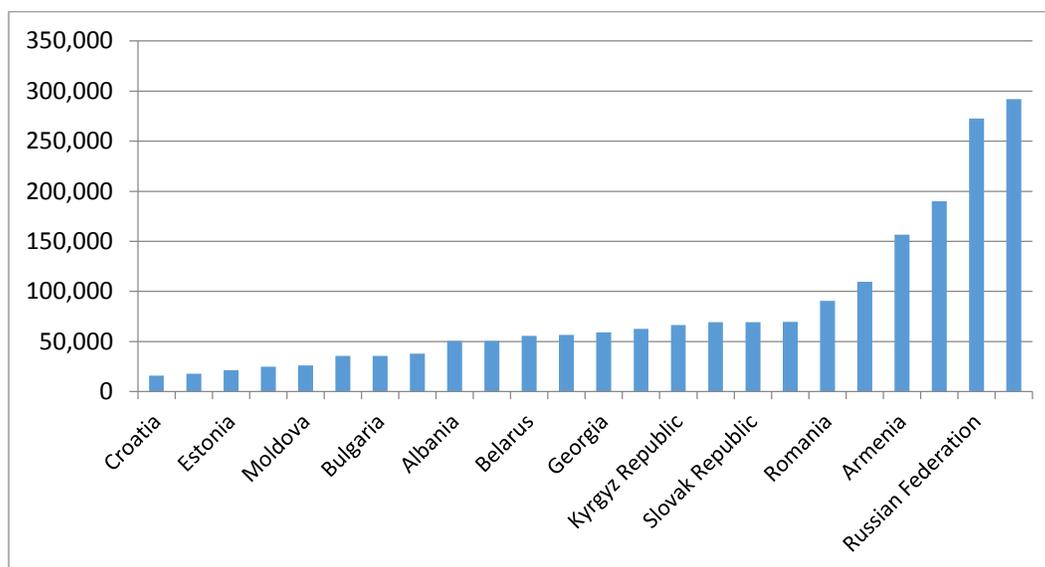
The risk to small businesses of complying with VAT requirements increases further in an environment of low administrative efficiency. Non-payment of VAT refunds or delays in the processing of refund requests may severely affect the liquidity of a business. Liquidity problems may also arise in the case of an accrual-based VAT system, when the VAT due has to be transferred to the Treasury before the business receives payment for goods or services from its customers. At the same time, the revenue benefits of including small businesses in the VAT net are minimal, as their contribution to total VAT collection is generally below 10 per cent.

**Table 4. VAT compliance costs as a share of business turnover in Slovenia**

Taxpayer size(turnover)	Compliance costs as percentage of turnover
Up to SIT 100 million	3.73%
SIT 100 million–1 billion	0.73%
Above SIT 1 billion	0.08%

Source: Klun, 2003.

A reasonably high VAT registration threshold is the main tool for protecting small businesses from problems and costs relating to VAT compliance. Country practice in the region varies considerably here, and a considerable number of countries apply a rather low threshold of less than \$50,000 turnover, which also risks forcing many small businesses to join the VAT net.

**Figure 3. Mandatory registration thresholds for VAT in ECA (in USD)**

Source: USAID (2009) – Collecting Taxes 2012-13.

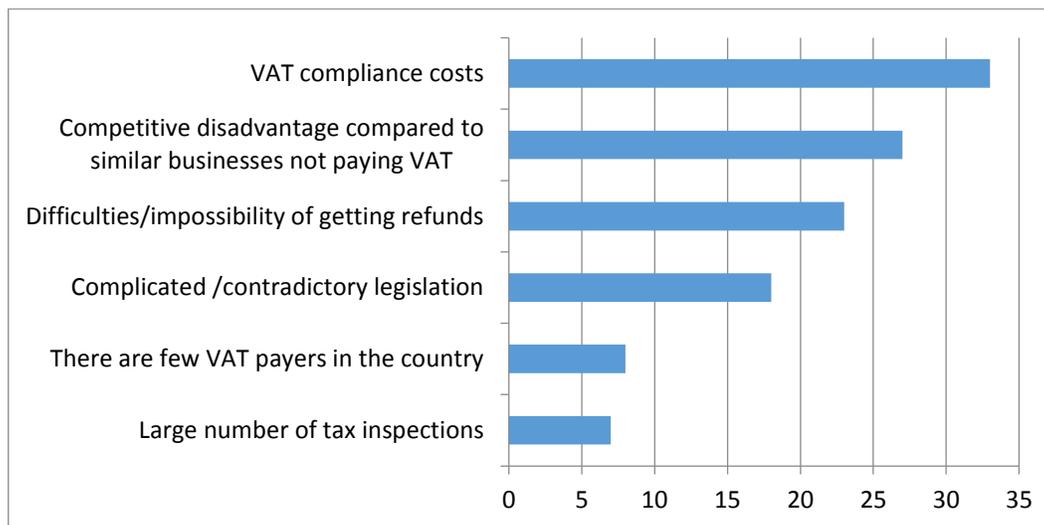
Several FSU countries (Russia, Ukraine and Belarus) have taken a different approach by integrating the VAT liability into the presumptive single tax regime. In these regimes, part of the single tax payment is considered to cover the VAT liability of the business. However, the benefits of including VAT in the single tax are questionable. From a tax administration point of view, the VAT net is not really broadened, and additional data to check the VAT compliance of larger businesses are not generated. For businesses, the tax burden is increased with the application of a higher presumptive turnover tax rate, but the business cannot deduct input VAT, nor issue VAT invoices. Consequently, the competitive position of single taxpayers supplying VAT-registered businesses does not improve. Therefore, while a single tax approach may have many benefits in general, the inclusion of VAT in the scope of tax does not generally seem sensible. The far more appropriate approach, from both the VAT revenue generation and the compliance/administration cost points of view, would be to set the VAT threshold sufficiently high to exclude small businesses from the VAT net, combined with the possibility of registering voluntarily for VAT.<sup>10</sup>

While the introduction of a reasonably high threshold is a convenient solution for protecting small businesses from a high VAT compliance burden, the challenges of reducing obstacles to small business growth and facilitating their transition into the VAT system remains, irrespective of the threshold level. Small businesses are likely to be reluctant to migrate into the VAT regime, even in the case of a reasonably high VAT threshold. In Uzbekistan, for example, 58 per cent of taxpayers who registered for VAT

<sup>10</sup> For a definition of the VAT threshold, see Keen & Mintz (2004).

saw no advantage to their business in being a VAT taxpayer, and business operators cited many disadvantages relating to joining the VAT net. Only 14 per cent of businesses saw no disadvantages to VAT registration.

**Figure 4. Business perceptions of disadvantages of being VAT registered in Uzbekistan**



Source: IFC (2010).

Facilitating compliance for smaller businesses in the VAT net should thus be an important part of a small business growth facilitation strategy. For many CEE countries, the EU VAT rules provide an orientation for such VAT simplification. Article 281 of the EU VAT Directive allows EU member countries to apply simplified procedures, such as flat rate schemes, for charging and collecting VAT from smaller VAT-registered businesses. The most widespread simplification measure in CEE countries is the use of VAT cash accounting schemes. These schemes allow a business to postpone its VAT payment to the date it receives payment for goods supplied and services rendered. Such schemes are in place for businesses with annual turnovers below the following thresholds for these countries: Estonia €208,646 (\$236,000), Slovenia €400,000 (\$453,000), Latvia (for small businesses) €100,000 (\$114,000), Romania RON 2,250,000 (\$682,600), Serbia (since 2013) SRD 50 million (\$598,000), and Bulgaria (since 2014) €500,000 (\$566,000).

Another measure with a major impact on compliance and administrative costs is a reduction in the VAT filing frequency. Analysis in the EU suggests that, for a micro business, the costs of filing monthly VAT returns amount to more than €100 (around \$140) per return (European Commission, 2013). In Hungary, submitting three monthly returns rather than one quarterly return increases filing costs by 35 per cent (PwC, 2013). A move from monthly to quarterly filing would therefore reduce the annual filing costs for a micro business by \$430. Quarterly filing for small businesses has now

become a widespread compliance facilitation approach, although some countries, such as Bulgaria and Estonia, require all VAT-registered businesses to file monthly VAT returns.

Table 5 shows that some countries have reduced the filing frequency still further for very small VAT payers. The most extensive approach has been taken by Hungary, offering annual VAT filing if the annual consolidated sum of the difference between the total tax payable in the second year preceding the relevant year and the tax deductible during the same year is less than Ft 250,000 (\$1,100). Latvia and Lithuania offer bi-annual filing for small VAT payers.<sup>11</sup> Among non-EU ECA countries, several countries, such as Georgia and Russia, have simplified VAT compliance beyond the micro and small business segment with the introduction of quarterly VAT filing as a standard rule for all businesses.

While, in many countries, a reluctance by small business operators to join the VAT system can be observed, in some situations the opposite may occur. In Romania, analysis conducted in 2010 showed that almost 380,000 small businesses with a turnover below the VAT registration threshold were voluntarily VAT registered. This meant that more than 60 per cent of the VAT net comprised small businesses that, according to system design, should have remained outside the VAT system, complicating VAT administration for the tax offices and contributing only 1.3 per cent to total VAT revenues. Closer analysis is required in such situations to understand the dynamics that force small businesses into the VAT system and increase their compliance costs. A more drastic approach is to exclude micro businesses from voluntary VAT registration. This approach was tried for some time in Serbia, with the operation of a threshold for mandatory VAT registration at the level of SRD 4 million (\$47,800) and a threshold for voluntary VAT registration of SRD 2 million (\$23,900). The reform of the VAT law in 2012 abolished the threshold for voluntary registration, as it resulted in an obligation for registered businesses to deregister when the business turnover dropped below the SRD 2 million threshold. At the same time, the threshold for mandatory registration was increased to SRD 8 million (\$95,600).

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<sup>11</sup> In Latvia, for taxpayers with a previous year turnover below LVL (Latvian lats) 10,000 or \$19,400; in Lithuania, for businesses with previous year turnover below LTL (Lithuanian centai) 200,000 or \$79,300.

**Table 5. Annual VAT filing frequency and number of VAT returns filed in CEE EU member states**

Country	Large	Medium	Small	Micro <sup>12</sup>		
Bulgaria	12	12	12	12		
	429	2,361	13,953	197,917		
Czech Republic	12	12	12	12	4	
	1,006	5,531	32,681	65,472	398,093	
Estonia	12	12	12	12		
	143	785	4,640	65,818		
Hungary	12	12	12	12	4	1
	1,101	6,055	35,778	84,428	280,524	142,541
Latvia	12	12	12	12	4	2
	174	959	5,669	34,161	20,107	26,151
Lithuania	12	12	12	12		2
	148	815	4,815	52,298		16,000
Poland	12	12	12	12	4	
	3,200	17,600	104,000	1,255,200	220,000	
Romania	12	12	12	12	4	
	1,136	6,250	36,932	141,334	382,537	
Slovak Republic	12	12	12	12	4	
	393	2,162	12,774	43,733	137,456	
Slovenia	12	12	12	12	4	
	206	1,133	6,694	31,703	63,248	

Source: European Commission (2013).

### *Small businesses and social security systems*

Social taxes constitute an important component of the tax systems of many ECA countries, and the need for compliance may be an obstacle to small business operators in formalizing and legalizing labour.

For the self-employed, a number of ECA countries offer preferential social tax treatment as an incentive for voluntary compliance and compensation for higher compliance costs. As Leibfritz (2011) points out, such an approach creates a distortionary element in the tax regime and encourages employees to change their status from dependent employment to self-employment.<sup>13</sup> Even without the explicit objective of reducing the social tax burden, tax policy makers face difficulties in applying the general social contribution regime to self-employed operating in a presumptive tax regime. While the level of social tax payment is generally a fraction of the net income of the self-employed, a presumptive tax regime does not produce any information on the net business income, and the requirement to calculate net income only for social tax purposes would conflict with the simplification objective of the

<sup>12</sup> The EU definition of a micro business refers to businesses with fewer than 10 employees and an annual turnover and/or annual balance sheet of not more than €2 million.

<sup>13</sup> For a detailed discussion, see Leibfritz (2011) and Packard, Koettl, and Montenegro (2012).

presumptive regime. An alternative calculation method in this situation is to apply the minimum wage as a tax base for the social tax, irrespective of the actual income of the self-employed. This was the case in Hungary under the EVA system and is applied for turnover tax payers in Poland. The result of this approach is that the self-employed tend to have a much lower tax wedge than regular employees, while incentives for salaried employees to become self-employed contractors (at least on paper) increases (see, for Poland, OECD, 2008a). Such a trend can be observed in Ukraine, where it is assumed that a remarkable increase in the number of unincorporated small businesses has been caused largely by salaried employees who register as small entrepreneurs and pretend to operate as independent contractors in order to secure the benefits of the simplified tax system (STS).

**Table 6. Labour tax compliance times in ECA countries (hours)**

Albania	94	Hungary	146	Romania	102
Armenia	162	Kazakhstan	70	Russia	76
Azerbaijan	97	Kosovo	41	Serbia	126
Belarus	88	Kyrgyz Republic	71	Slovak Republic	62
Bosnia	81	Latvia	139	Slovenia	96
Bulgaria	256	Lithuania	85	Tajikistan	48
Croatia	96	Macedonia	56	Ukraine	140
Czech Republic	217	Moldova	94	Uzbekistan	69
Estonia	34	Montenegro	98		
Georgia	56	Poland	124		

Source: PwC (2014)

Comparing small business development in Ukraine and the Russian Federation, an OECD analysis finds that the average unincorporated small business in Ukraine employs only approximately 1.6 persons. This figure has been falling, slowly but steadily, over the last six years. In Russia, by contrast, the average urban unincorporated small business in 2004 employed approximately 4.5 persons and the average number of employees had risen. The fact that so many Ukrainians who appear to work entirely alone have registered as individual entrepreneurs reinforces the perception that many are not actually self-employed entrepreneurs at all, but are seeking to exploit the benefits of the STS. A similar phenomenon may be observed in the small companies sector: the average number of employees in small companies fell from around eight to 6.4 persons between 2000 and 2006 (OECD, 2007).

A parallel but somewhat different issue is the social tax treatment of salaried employees in small businesses. Given the fact that social benefits such as health insurance, unemployment insurance and pensions are generally linked to the duration and level of contributions to insurance and pension schemes, the only transparent and reliable compliance method is for small business employers to calculate and transfer the precise employer contributions to these schemes and deduct employee contributions from salaries paid. There is thus no difference in the approach between small and larger business employers. For obvious reasons, this approach is not favoured by small

business operators using presumptive tax regimes to comply with their business income tax obligations.

Turnover tax regimes are biased against taking on formal sector employees, because – unlike the standard tax regime – the costs of hiring labour cannot be deducted as expenses, which effectively increases the small business tax burden. This bias is heightened by a social tax compliance burden which may equal, or even exceed, the presumptive tax compliance burden. While simple turnover-based presumptive tax regimes are expected to promote business formalization and migration out of the shadow economy for the actual business entity, they simultaneously create incentives for labour to move into the shadow economy.

Some ECA countries have tried to find ways to mitigate this risk and reduce the social tax compliance burden. A typical approach is to integrate social tax into the presumptive tax regime. In Latvia, the micro business turnover tax of nine per cent exempts the business from withholding employee personal income tax (general personal income tax rate of 25 per cent) and includes both employer and employee mandatory contributions to the social security system (employer share of 24.09 per cent; employee share of 11 per cent of income). The system works in its basic design for businesses of up to five employees. In the case of larger staff numbers, an additional two per cent on turnover is charged for each additional employee. Also, if the monthly salary of an employee exceeds €700 (\$792), the excess amount is taxed at a rate of 20 per cent. In Ukraine, a business paying the unified tax of six per cent on turnover does not have to comply with income tax, social security, property tax, and some local tax payment obligations. Unified tax revenues are allocated based on a fixed ratio: 43 per cent of revenues is considered as the tax share, while 42 per cent goes to the state pension fund, and 15 per cent to the state social security fund.

The major difficulty with this approach is the lack of a clear attribution of the social tax payment to the beneficiaries of social benefits. In particular, when transfers to social agencies do not depend on the number of employees hired, a relationship between benefits and payments cannot be established. It may also be difficult for individual employees to prove that they have acquired social benefits while working for employers that are presumptive taxpayers. There is thus no real alternative to imposing regular compliance with the social contributions system on small businesses in the presumptive tax regime. A certain incentive for remaining in the formal labour system can be provided, as in the case of the Russian simplified tax system, by allowing the deduction of payments made to social security agencies from taxable turnover.

## Approaches to taxing micro businesses

### *Defining the segment*

Recognizing the fact that both the growth potential and the compliance capacity of micro businesses is substantially lower than for small businesses, many ECA countries have introduced specific tax instruments for the micro business segment. Thresholds defining the micro segment are frequently in the range of US\$ 15,000 to 80,000, with Russia being the major outlier.

**Table 7. Micro taxpayer thresholds and tax treatment in selected economies**

<b>Distinguishing micro and small businesses</b>		
<b>Country</b>	<b>Micro business turnover threshold</b>	<b>Micro business regime (income tax treatment)</b>
Albania	ALL 2 million (\$19,100)	Patent
Armenia	AMD 6 million (\$14,750)	Patent
Bulgaria	BGN 50,000 (\$34,700)	Patent
Croatia	HRK 149,500 (\$28,900)	Patent
Hungary	HUF 6 million (\$26,000)	Patent
Georgia	GEL 30,000(\$18,000)	Exemption
Kazakhstan	KZT 3,732,000 (\$23,700)	Patent
Kosovo	€5,000 (\$6,700)	Patent
Kyrgyz Republic	KGS 4,000,000 (\$78,200)	Patent
Latvia	€50,000 (\$56,500)	Patent
Macedonia	MKD 3 million (\$66,000)	Exemption
Poland	Depends on number of employees	Patent
Russian Federation	RUB 60 million (\$1.7 million) + not more than 15 employees	Patent
Serbia	SRD 6 million (\$71,700)	Patent
Tajikistan	TJS 100,000 (\$20,800)	Patent
Ukraine	UAH 1 Million (\$110,000) + not more than 15 employees	Fixed single tax

Source: Authors, based on World Bank Group country reports.

Table 7 shows that not all systems have managed to limit the application of micro business regimes to very small entities operating around subsistence levels. Analysis of experiences in the region shows that one risk of micro business segmentation is that the very simple (and often very preferential) micro regimes also become an attractive model for businesses above the size of a micro business, and pressure to extend the regime up to the VAT threshold level is building.

The Serbian experience provides a good illustration of this dynamic. The patent regime in Serbia was initially targeted at micro operations at a level below SRD 2 million turnover (\$23,900). However, the threshold was soon increased to SRD 3 million and, in 2013, the system was extended further to businesses with a turnover of up to SRD 6 million (\$71,700). In principle, the system is targeted at “Any sole proprietor who, in

view of circumstances, is unable to keep books” (Article 40 of the Income Tax Law); however, it is also accessible to the well-educated and self-employed. The 2013 system reform at least managed to deny patent regime access to accountants, auditors, tax advisors and marketing agencies. However, an initiative by the Ministry of Finance also to exclude doctors and lawyers was not well received by lawmakers and was rejected by parliament. On the other hand, some countries, have demonstrated that, despite such pressure, a better alignment of the system threshold with the concept of targeting micro businesses may be feasible. An example is Tajikistan, which has limited the application of its micro regime from a previous turnover of \$41,600 to \$20,800 in 2014.

### *The micro business tax regime*

The standard approach to micro business taxation in the region is the application of a patent regime. Frequently, these regimes are administered by local governments, and revenues go to local budgets. Only in a few cases, such as in Georgia, are micro businesses exempt from income taxation. Patent fees are generally determined by local governments, while national tax laws provide the basic structure for the regime and determine minimum and maximum patent rates. The actual design of patent regimes varies considerably in practice. In a few countries, a very basic patent regime has been put in place, with a fixed amount for all micro businesses, irrespective of business type and location.

**Table 8. Patent regimes in Albania, Hungary and Kosovo**

Country	Patent amount
Albania	ALL 25,000 annually (\$240 )
Hungary	HUF 50,000 monthly (\$2,600 annually)
Kosovo	€37.50 quarterly (\$200 annually)

Source: Authors, based on WBG country reports.

Much more frequent is the development of a detailed list of micro business activities and the determination of individual patent fees for each activity. A typical example of such an approach is the micro business regime in Bulgaria.

Bulgaria has experimented with its patent system for quite some time, at both national and local levels. While patents were initially administered by the national tax administration, the patent regime was transferred to local governments in 2008. The Law on Local Taxes and Fees lists 40 different categories of activity and specifies a minimum and maximum amount per established indicator. Local governments then determine the applicable amount for businesses in their territory, taking into consideration the precise location of the business, its economic importance, population

density in the area in which the business has been established, and the seasonal or permanent nature of the activity carried out.

**Table 9. Patent regime in Bulgaria**

<b>Patent rates for artisans in Bulgaria (annual fee in Lev)</b> (Exchange rate: BGN 100 = \$66.2)			
<b>Activity</b>	<b>Indicator</b>	<b>Min.</b>	<b>Max.</b>
Retail trade (up to 100 m <sup>2</sup> )	Square metres of sales area	2	20
Shoemaker	Tax determined considering the location of business premises	40	120
Repair of computers	Tax determined considering the location of business premises	300	1,300
Fortune teller	Tax determined considering the location of business premises	2,000	5,600
Hotels (1 & 2 stars) up to 20 rooms	Per room in consideration of location of establishment	25	250
Bowling hall	Per bowling alley	40	140
Restaurant (1 & 2 stars)	Per seat in consideration of location of establishment	1	35
Restaurant (3 stars)	Per seat in consideration of location of establishment	6	60

Source: Law on Local Taxes and Fees of the Republic of Bulgaria

Similar approaches are followed in a number of other Eastern European and FSU countries. The downside of such an approach is that the patent list becomes extremely voluminous and complicated. Patent lists distinguishing more than 100 categories of micro business activity are not uncommon. The Polish *Tax Card* system and the Latvian patent regime are examples of such approaches. In the Kyrgyz Republic, the patent list for the city of Bishkek includes 125 main categories of patent activity with an extensive list of sub-categories distinguishing, for example, whether a business stall is located in the first, second, or third lane of a local market. While such an approach intends to better align the patent amount with the presumed income of the micro business, the design of the regime risks creating a number of implementation problems:

- *Distinguishing activities of similar nature:* Many detailed patent lists could be simplified. In particular, the same patent rates are set for a variety of activities of similar nature, and thus unnecessarily complicate the list. The patent list for Bishkek, for example, includes eight different activities in the area of clothes manufacturing (activity list nos. 77-84); however, the patent rate for all eight activities is exactly the same. Merging similar activities into a single category is an easy option to simplify convoluted systems.
- *Mixed activities:* The more detailed the activity list, the higher the probability that a micro business carries out more than one listed activity. The Bishkek example

given above includes separate patents for the manufacturing of working clothes, other clothing and accessories, and underwear. In cases like this, micro businesses that are not highly specialized face the risk of multiplying their tax liability without necessarily achieving a higher profit than businesses that are active in only one area. There is therefore no clear justification for creating such a risk.

- *The gap issue:* Even a very extensive activity list can never be comprehensive. In fact, the more detail-oriented the list, the higher the probability that some micro business activities are missing. For affected business operators, it is then unclear how their patent rate will be determined or whether they can access the regime at all.
- *Determination and update of patent rates:* It is a major exercise to set more than 100 different rates and ensure that they are properly updated and reflect changes in the business environment, profitability and costs. Ministries of finance and tax administrations are typically not well equipped, nor do they have the required resources to perform this task properly. Sufficient data and information to allow a thorough calculation of appropriate rates for very specific activities is rarely available.
- *Acceptance and fairness:* As a result of the rate-setting problems, international experience shows that the acceptance level of detailed patent regimes in the micro business community is low. Business operators tend to consider the rate-setting process to be non-transparent. They also perceive the patent rate that they have to pay as arbitrary and unfair.

**Table 10. Service businesses in patent category 111 (computer and copier material processing) operating in Bishkek City**

Annual turnover	KGS 100,000	KGS 500,000	KGS 1 million	KGS 3 million
Tax burden under patent regime	12,000	12,000	12,000	12,000
Tax burden under simplified tax regime	6,000	30,000	60,000	180,000
Tax burden under standard regime (assuming a profit margin of 30%)	Income tax: 3,000 Sales tax of 3.5%: 3,500 TOTAL: 6,500	Income tax: 15,000 Sales tax: 17,500 TOTAL: 32,500	Income tax: 30,000 Sales tax: 35,000 TOTAL: 65,000	Income tax: 90,000 Sales tax: 105,000 TOTAL: 195,000

It is therefore desirable to streamline the detailed patent lists and categorize micro business activities more broadly. A reform in this direction has been implemented in Tajikistan.

*Improving the operation of a patent regime: micro business tax reform in Tajikistan*

Tajikistan operates a patent system for individual entrepreneurs with a turnover of up to SM (Tajik somoni) 100,000 (\$20,800) annual turnover and size of business premises up to 30 square metres. The cost of the patent is fixed according to type of activity, and varies from SM 240 (\$50) per month for transportation of oil, liquid gas, and cement by specialized transport, to SM 30 (\$6) for transportation by motor-scooter. The patent was initially only valid for one narrowly specified category of activity and had to be renewed annually. A reform of the patent system in 2008 introduced major simplifications. First, the new patent system offers an expanded scope of permitted economic activities. It reduced the number of patent categories from 49 patents (with 70 sub-activities) to 28 (covering 169 sub-activities). Second, tax inspection of patent holders is limited to verification that the individual entrepreneur has a patent, that the business activity is allowed by the patent, and that the patent holder has a receipt of payment for the patent. Previously, the patent holder was required to keep a cash register and maintain transaction logs, on the basis of which the tax inspector would determine tax obligations. Third, the patent no longer has to be updated annually. The patent system has become much more attractive since this reform, and 15 per cent more patents were issued in 2008 than in 2007 (IFC, 2009a).

*Use of additional indicators*

While a general patent regime establishes the same tax liability for all micro businesses active in a specific field, such an approach might be considered inappropriate, as the prospect of earning income depends critically on certain criteria, such as the business location or facilities. Some patent regimes have therefore introduced a small number of critical indicators to take account of the specific business situation. By far the most popular and, at the same time, most transparent indicators are the number of employees and the location of business premises. One example of a system combining the use of these indicators is the *Tax Card* regime in Poland.

The use of other indicators tends to be much more problematic. This is the case particularly where turnover elements have been introduced to create a progressive patent regime. In Croatia, for example, the lump sum tax amount depends on the level of the micro business turnover. The micro business in this case is still required to maintain a cash book and calculate its annual turnover. With regard to calculation of the tax liability, a normal turnover tax could obviously be applied in this case, which would eliminate the jump in the tax burden arising from moving from a higher turnover band.

**Table 11. Poland: Monthly patent rates for selected micro-business activities for 2014 (in US\$)**

Type of business	No. of employees	Business location (number of inhabitants)		
		Less than 5,000	5,000–50,000	More than 50,000
Jewelry shop	0	136	149	149
	1	232	266	266
	2	348	388	388
Barber shop (ladies)	0	38	45	51
	1	103	116	129
	2	143	161	172
	3	172	185	201
	4	185	201	218
	5	225	257	291
Flower shop	0	161–218	177–278	218–356
	1	177–281	218–356	278–406
	2	218–356	278–406	375–507

**Table 12. Calculating the micro business tax liability in Croatia (in HRK)**

Business turnover	Tax liability
Up to 85,000 (\$14,900)	12,750 (\$2,230)
85,001–115,000 (\$20,100)	17,250 (\$3,000)
115,001–149,500 (\$26,100)	22,425 (\$3,920)

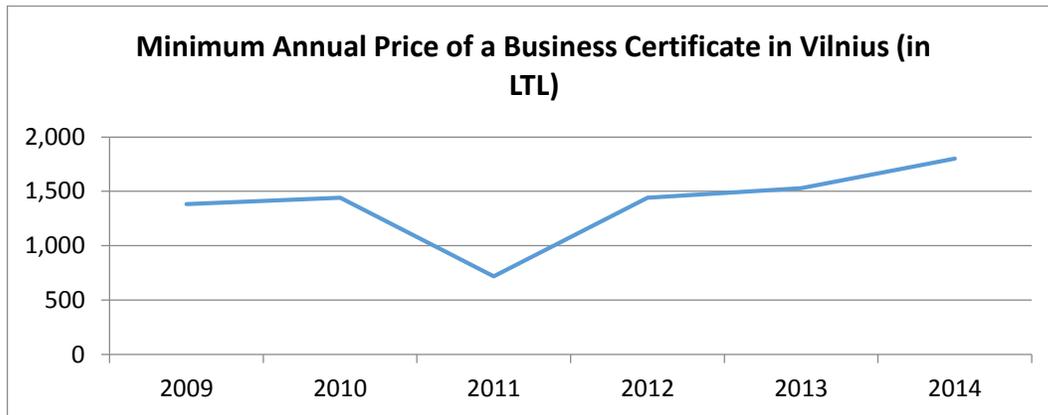
*Patent system stability and predictability*

While patent systems have the potential to provide a transparent approach to micro business taxation and reduce micro business compliance costs, the unpredictability of tax rates can be a major issue in practice, particularly when patent rates are set by and changed based on the revenue needs of local governments. In Lithuania, for example, a country where the patent regime extends to small businesses up to the VAT registration threshold, patent rates are determined annually by local councils, and the patent levels change substantially. Although an important revenue source for local governments, the unpredictability of the regime may add further disincentives to business formalization.

*Abuse risks of micro regimes*

For small businesses in the higher turnover range, patent-based taxation may be an easy and attractive way to reduce the overall tax liability. In principle, patent regimes may therefore create a risk of downward migration. In practice, such a risk can be largely mitigated by (i) an appropriate limitation of the application of the micro regime, and (ii) a design of the small business regime taking into account small business profitability and ability to pay.

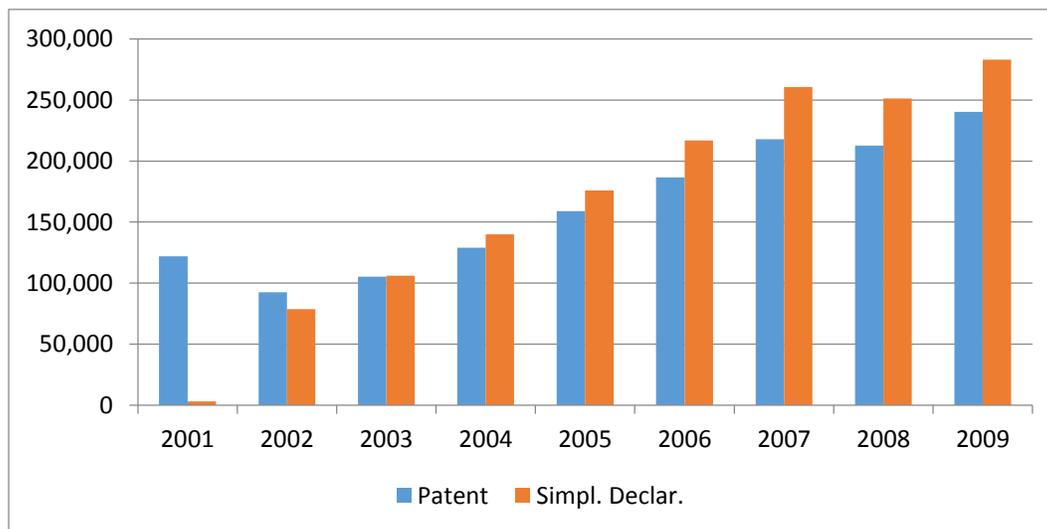
**Figure 5. Volatility of patent rates in Lithuania**



Source: Vilnius City Council data.

In the case of Georgia, which exempted micro businesses from taxation, initial assessments of taxpayer behaviour following the reform suggest there was no noticeable downward migration of small businesses (Bruhn & Loeprick, 2014). Downward migration is thus not a given, provided that the micro threshold is sufficiently low while effective compliance management covers the segment and the small business regime is operated reasonably well.

**Figure 6. Number of taxpayers applying simplified tax regimes in Kazakhstan**



Source: Kazakh Revenue Service

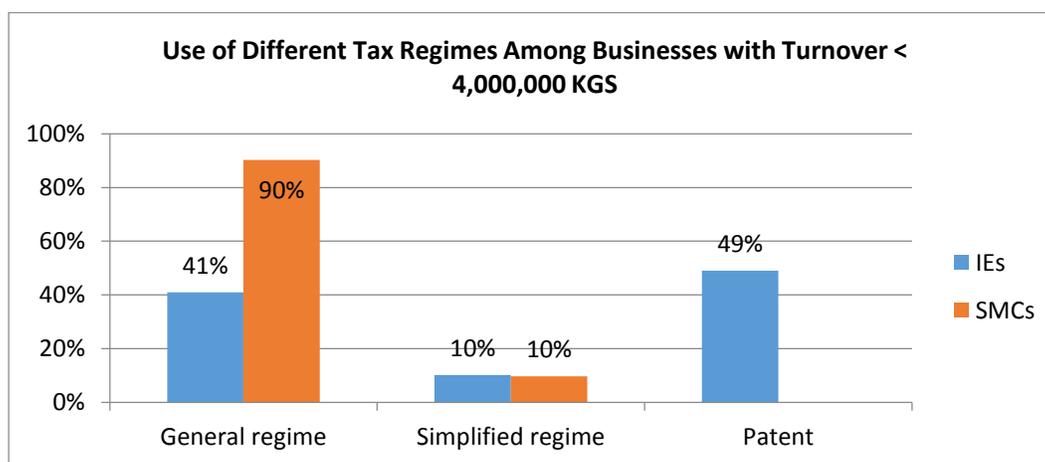
The risk of system abuse increases with high patent-system thresholds. In Kazakhstan, the upper threshold of the micro business (patent) regime of a turnover of around KZT

4 million<sup>14</sup> (\$25,400) extends to net incomes above the average annual wage of KZT 1.6 million<sup>15</sup> for businesses with profit margins above 40 per cent. The regime is very popular, with ample anecdotal evidence that high-income self-employed use the regime to lower their tax liability.

A patent regime may thus erode the small business tax regime and create major disincentives for small business growth when it reaches out to businesses up to the VAT registration threshold. This can be observed in Bulgaria, the Kyrgyz Republic and Lithuania.

In the Kyrgyz Republic, small businesses have the choice to apply either the turnover-based small business tax regime (simplified regime) or the micro business patent regime, with the patent regime generally offering a comparatively favourable tax treatment, as demonstrated in Table 13. As a result, acceptance of the simplified regime is minimal and most small businesses request patents. As the patent regime does not require any books and records, business growth and migration into the VAT system and the standard income tax regime becomes less likely, while the tax administration faces difficulties in controlling abuse of the regime effectively.

**Figure 7. Use of tax regimes in Kyrgyz Republic**



Source: IFC SME Survey, 2009

<sup>14</sup> Two hundred times the minimum monthly wage of KZT 19,966.

<sup>15</sup> The average monthly nominal wage in December 2013 was KZT 137,043.

## Small business taxation

### *Defining a small business system threshold*

International good practice recommends aligning the upper threshold of a simplified small business tax regime with the VAT registration threshold. Businesses registered for VAT must comply with advanced accounting standards, and should therefore also be in a position to calculate their net income easily for income tax purposes. In addition, VAT compliance management benefits from the possibility of cross-checking information from income tax and VAT returns. However, using the VAT threshold as a criterion to determine the ceiling of the simplified small business tax regime is less evident in cases where the VAT threshold is either very high – thereby limiting the application of VAT to large businesses – or very low. In the first scenario, the simplified regime would extend to the medium business segment, and thus to a group of businesses which are able – and should be obliged – to calculate their net income; while, in the second scenario, a low VAT threshold also impedes compliance cost reductions on the direct taxation side.

One notable feature of presumptive tax design in the ECA region is a frequent lack of proper system coordination between the presumptive tax regime and the VAT regime, in particular with presumptive regimes extending to medium-sized businesses required to register for VAT, as in Belarus, Macedonia and Ukraine.

### *Approaches to turnover-based small business taxation*

Turnover has become the most widely-used base for small business tax systems, and its design varies considerably from country to country. The two key system design alternatives are:

- Presumptive income tax regimes replacing only personal income tax or corporate income tax, versus single tax regimes offering small businesses the option to pay only one tax rather than a variety of taxes.<sup>16</sup>
- Single tax regimes with a single tax rate for all types of small business (as in Azerbaijan, with regional tax rate variations), versus multiple rate regimes using different tax rates for different business categories to account for different (assumed) average profit margins, particularly in the trade versus service segment.

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<sup>16</sup> If a general VAT exemption threshold is in place, typically no VAT component will have to be included in the presumptive tax amount. Small businesses will not be able to recover VAT on inputs purchased, and should be required to comply with regular income tax obligations if they decide to register voluntarily for VAT. If a presumptive VAT payment is determined for taxpayers below the threshold, the associated filing and payment obligations should be aligned with the presumptive income tax requirements.

**Table 13. Design characteristics of turnover tax regimes in the region**

Country	Single rate regime	Multiple rate regime	Turnover rate	Replaces income / profit tax only	Single tax regime	Application to incorporated businesses
Armenia		x	3.5% for production and trade 10% for rental income 12% for notaries 5% for other activities		Replaces income tax and VAT	Yes
Azerbaijan	x		4% for businesses in Baku 2% for other businesses		Replaces income tax, property tax and VAT	Yes
Belarus	x		5% in case system also replaces VAT 3% in case VAT is paid separately		Unified tax replacing general tax regime	Yes
Georgia	x		5% (possibility to reduce to 3%)	x		No
Kazakhstan	x		3%		Unified tax including social security	Yes
Kosovo		x	3% for trade and transport 5% for services, professional activities, entertainment	x		Yes
Kyrgyz Rep.		x	4% for trade 6% for other activities		Profit tax and sales tax	Yes
Latvia	x		9% tax rate increase if more than five employees by two additional percent points per employee		Income tax, social insurance payments, state duty on entrepreneurship risks for employees	Yes
Macedonia	x		1%	x		Yes
Romania	x		3%	x		Yes
Russia	x		6%		Single tax regime, also replacing social taxes	Yes
Tajikistan	x					
Turkmenistan	x		2%			Yes
Ukraine	x		3% when also includes VAT 5% without VAT		Income tax, land tax, trade patent fee, social security and pension contributions, some local taxes	Yes
Uzbekistan	x		6% with different rates for specific areas, such as, for example, 5% for wholesale trade		All government taxes and local taxes and charges, except local fee for commercial activities	Yes

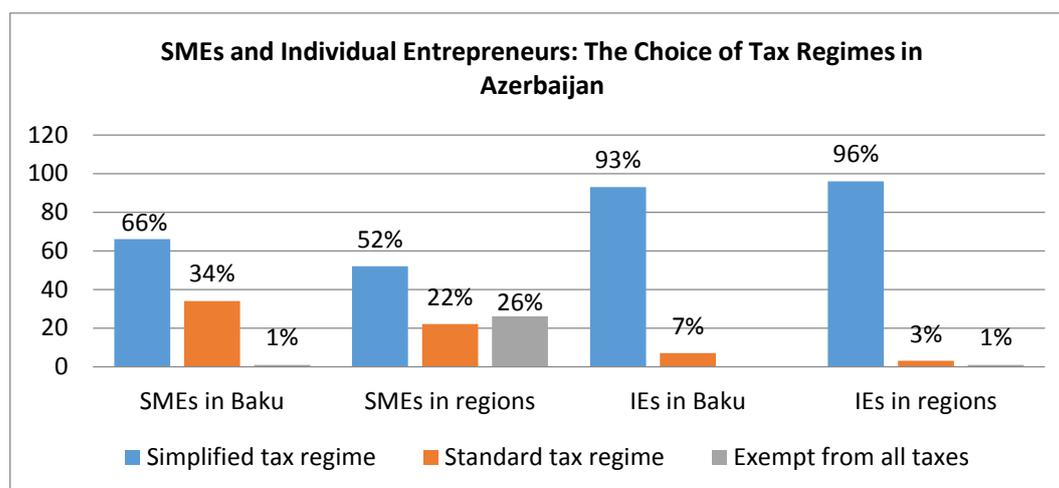
## Use of presumptive regimes: lessons learned

### *Low take-up and the design of appropriate rate structures*

Two conclusions can be drawn regarding the use of presumptive tax regimes. First, experience shows that newly-introduced presumptive regimes are not automatically widely applied by small businesses. Regime take-up rates tend to be low initially, and only increase as a result of taxpayer information campaigns and trust being built in the small business community with regard to the practical application and potential benefits of the regime.

Second, the use and popularity of presumptive regimes is not directly correlated with the turnover rate applied. Turnover tax regimes with a low tax rate do not automatically attract more businesses than regimes with a higher tax rate. Azerbaijan is an example of a country applying different turnover rates depending on the location of the business: while a four per cent rate on turnover is applied for businesses located in Baku, businesses in the regions only have to pay a two per cent turnover rate. Survey results suggest that this rate differentiation has no measurable impact on the level of system use.

**Figure 8. Use of tax regimes in Azerbaijan**

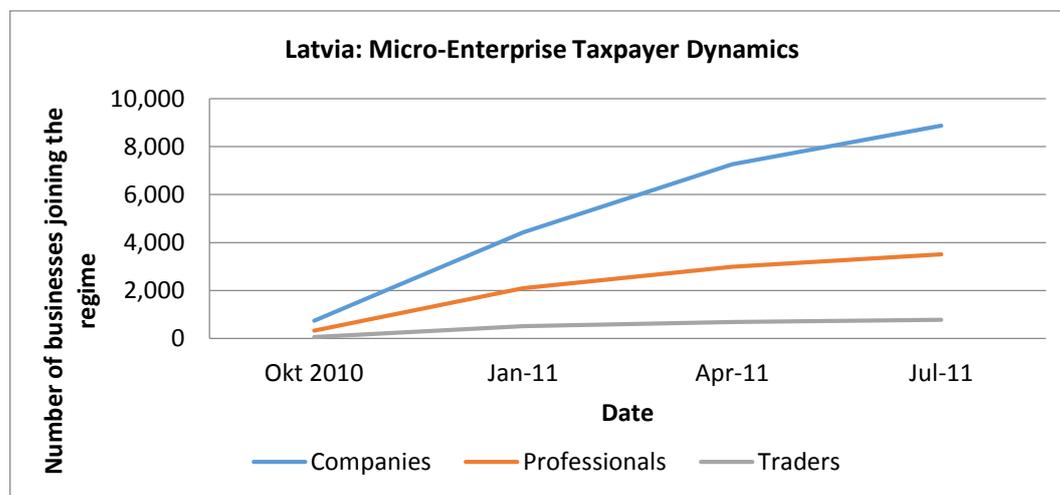


Source: IFC (2009b).

The level of the tax burden as a percentage of turnover may impact on the composition of the presumptive taxpayer group. A system with higher turnover tax rates may become less attractive for businesses with low profit margins. This is an unwelcome result, as businesses with lower profit margins, which frequently operate in the retail trade, generally have less capacity to comply with net income taxation than service businesses and professionals. The system thus risks being biased toward segments of the small business population that have less need for compliance simplification. An example of such a phenomenon is the micro-enterprise tax regime in Latvia, which has a comparatively high rate of nine per cent on turnover. In practice, this has translated into a situation in which the regime has

generated very little interest among small traders. Its primary users are self-employed professionals and, in particular, small limited-liability companies.

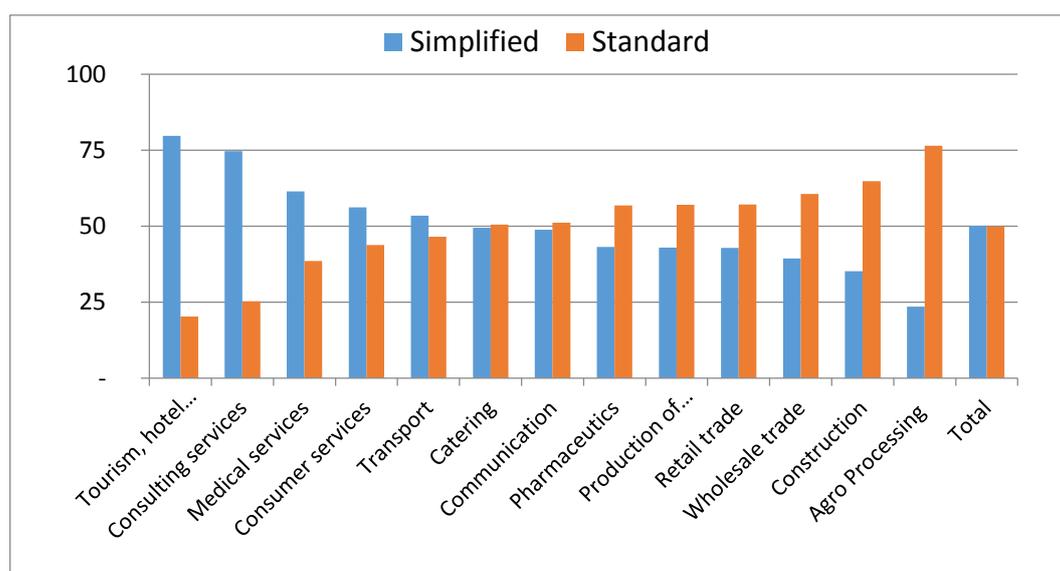
**Figure 9. Latvia: Businesses opting for presumptive taxation by type of business**



Source: Bruna & Sneidere (2011), with additional data from the Revenue Service.

Interestingly, the same phenomenon can be observed even in countries with a much lower turnover tax rate, as shown in the example of Tajikistan, which operates only a four per cent turnover tax (five per cent for turnover above SM 200,000). While the turnover tax regime is applied by 80 per cent of small tourism operators, 75 per cent of small consultancy service providers, 61 per cent of medical service providers, and 67 per cent of consumer service businesses, the take-up rate is only 39 per cent for retail businesses and 35 per cent for construction companies.

**Figure 10. Tajik Firms in the simplified versus standard regime by sector**



Source: IFC SME Survey, 2008

A gradual change in the composition of businesses using the simplified tax regime has also been experienced in Hungary with the operation of simplified entrepreneurial tax (EVA) and the gradual increase of the EVA tax rate. EVA was introduced in Hungary in 2003 as a flat tax paid on sales revenues. Eligibility was limited to private entrepreneurs and business entities that had been in business for at least two years, had an annual income (including VAT) not exceeding Ft 25 million (approximately \$115,000), and with individuals as owners. EVA payers were not subject to income tax, dividend tax, company car tax or VAT. The EVA rate was initially one per cent, levied on turnover with some minor adjustments. EVA quickly became very popular, and the number of businesses applying for taxation under the simplified tax increased from 59,000 in 2003 to 83,000 in 2004 and close to 100,000 in 2006, when the tax rate was increased to 25 per cent. Surprisingly, the participation level remained stable and still covered around 96,000 businesses in 2010. As the system was attractive primarily to businesses with margins exceeding 60 per cent, it seemed to be used extensively by engineers, lawyers and accountants, who operate with low cost/income ratios, implying that EVA reduced their tax burden. Some entrepreneurs used EVA even if it entailed a higher tax burden because it reduced their administrative costs (OECD, 2008b, based on Semjén, Tóth, & Razakan, 2008). The EVA rate was further increased to 30 per cent in 2010 and to 37 per cent in 2012, before being abolished in 2013.

The risk of factual discrimination of low-profit trading businesses can be avoided by introducing a rate differentiation into the turnover tax regime. Small businesses in the trade segment can be offered a lower turnover tax rate, while service businesses and, in particular, self-employed can be taxed at higher rates. While such an approach is still a rarity in the region, it has been tried successfully by some ECA countries. Poland, which has developed the most sophisticated rate differentiation, demonstrates that the benefits of this approach are twofold: it eliminates system entry barriers for businesses in retail and wholesale trades, and improves presumptive tax revenue generation, as higher turnover rates on high-profit segments considerably increase overall presumptive tax collection.

**Table 14. Registered small businesses in the Polish turnover tax system**

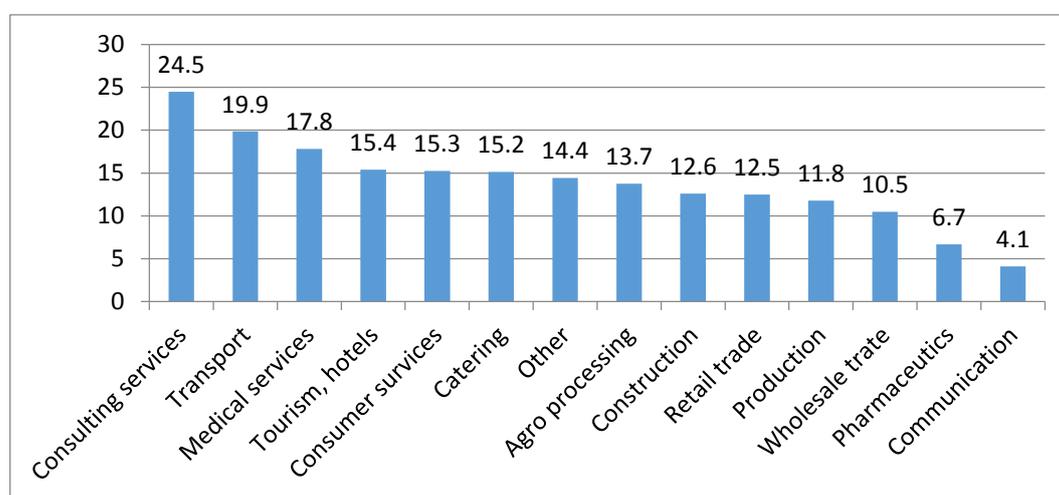
Category	Turnover rate (%)	Number of taxpayers	Tax revenues (million \$)	Tax collection per business (\$)
Trade and catering	3	177,837	77	433
Manufacturing, construction, transport	5.5	178,302	274	1,537
Service businesses	8.5	370,715	257	693
Car rental services	17	4,554	5	1,098
Liberal professions	20	56,292	72	1,279

Source: Grabowski (2011).

The major drawback of applying the approach in practice is the lack of reliable data on average small business profit margins to justify the scope and level of rate differentiations. Data from statistical offices in ECA countries have frequently

proved insufficient as a basis for rate differentiation, and attempts to collect information on average profit margins in various small business segments through targeted taxpayer surveys have generally not provided sufficiently reliable data. Consequently, such survey results are difficult to interpret and provide only a limited basis for policy decisions. An example of such a situation is the IFC SME survey conducted in Tajikistan in 2009. This survey shows major differences in profit margins within the service segment, while most activities listed generally only show a relatively small overall profit margin ranging between 10 and 15 per cent. This does not explain the considerable differences in simplified system use discussed above, and probably indicates that real profit margins are substantially different from the margins provided for the survey.

**Figure 11. Small business profit margin analysis in Tajikistan**



Source: IFC SME survey, 2009

A reliable profit margin differentiation for tax purposes requires input from tax administrations, particularly through the collection and analysis of SME tax audit data, and ideally as a combination of targeted risk-based audits, as well as a number of random audits conducted to verify margin estimates. However, such audit data are not generally available, or at least have not yet been systematically analyzed.

With an incomplete and unreliable basis for turnover rate differentiation, an approach such as in Poland, which distinguishes five small business segments, becomes questionable. More appropriate in this situation would be a simpler two-rate system, as practiced in Kosovo and the Kyrgyz Republic. A further alternative to consider might be the approach introduced in Georgia in 2011. Here, the small business tax regime for businesses with a turnover of up to GEL 100,000 (\$57,500) has a standard rate of five per cent for small businesses in all segments; however, a business can benefit from a reduced rate of three per cent if it can document, by presenting corresponding invoices, that business expenses amount to at least 60 per cent of turnover. This rate differentiation is not directly linked to the business activity, but is supposed to reflect the actual business profit margin. Undoubted

disadvantages of this approach are the need for the tax administration to verify invoices presented by small businesses and the risk of disputes about the tax recognition of these invoices, but it provides an innovative method for increasing the fairness of a turnover-based presumptive tax regime. A similar approach is currently being discussed for the trade segment in Armenia.

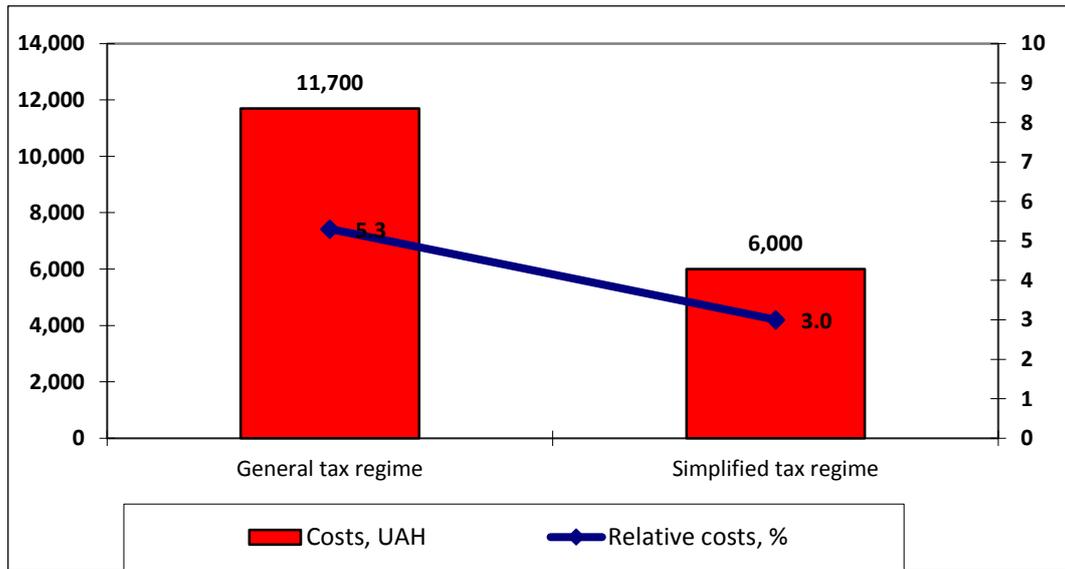
*Presumptive regimes, the business environment and compliance management*

Surprisingly, despite the extensive use of presumptive tax regimes in the region, analysis of the impact of the system is still sporadic. Of particular importance is impact analysis of tax compliance costs and business formalization.

**Compliance cost reduction**

Business surveys provide some indication of compliance costs associated with different tax regimes. A simple comparison of compliance costs in Ukraine, for instance, indicates a cost reduction of almost 50 per cent for small businesses operating in the presumptive regime.

**Figure 12. Comparison of tax compliance costs in Ukraine in the presumptive versus standard tax regime**

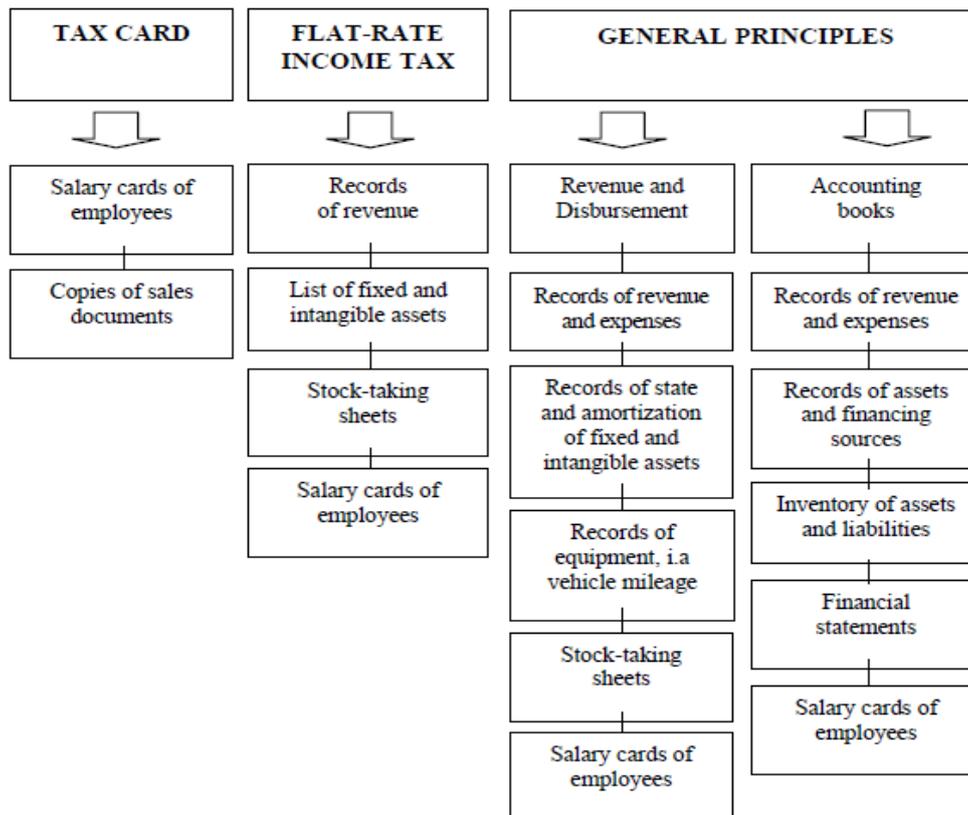


Source: IFC, 2009c.

Similar survey-based reviews consistently identify accounting and tax filing obligations as a major element of compliance costs, thus supporting general claims of cost reduction following the introduction of simplified accounting and filing requirements for presumptive taxpayers. Fully exploiting the cost-benefit potential of presumptive taxation therefore requires appropriate simplification of bookkeeping and reporting requirements. A full alignment of bookkeeping standards with the requirements of a turnover-based tax system would, in principle,

require the business only to keep records of its turnover. This approach, however, would not provide sufficient data for a presumptive taxpayer risk analysis and identification of businesses abusing the regime; therefore, tax administrations generally require more extensive documentation of business transactions. Nevertheless, compared with accounting requirements in the general tax regime, a major simplification of the accounting burden can be achieved.

**Figure 13. Comparison of accounting obligations in the micro business (tax card), small business (flat rate income tax) and general tax regimes in Poland**



Source: Jaworski, 2011a.

Small businesses also consistently highlight problems with the number of taxes with which they are required to comply. Armenian businesses, for example, cited the number of taxes as their most widespread concern with regard to the operation of the tax system (see IFC, 2011). In Belarus, businesses complained that a normal SME in the general tax regime has to pay on average 12 taxes and duties (Kireeva & Rudy, 2007). Single small business taxes, which combine various national (and, in some countries, local) taxes into one tax payment, therefore create additional compliance cost reductions for small businesses. This can be a major benefit in practice. The single tax in Ukraine, for example, substitutes 12 other taxes and duties in addition to income/profit tax, VAT and land tax.

## Business formalization and compliance

Little thorough analysis is available with regard to the impact of simplified small business taxation on business formalization and compliance behaviour in the ECA region.<sup>17</sup>

**Figure 14. Ukrainian businesses registered for unified taxation**



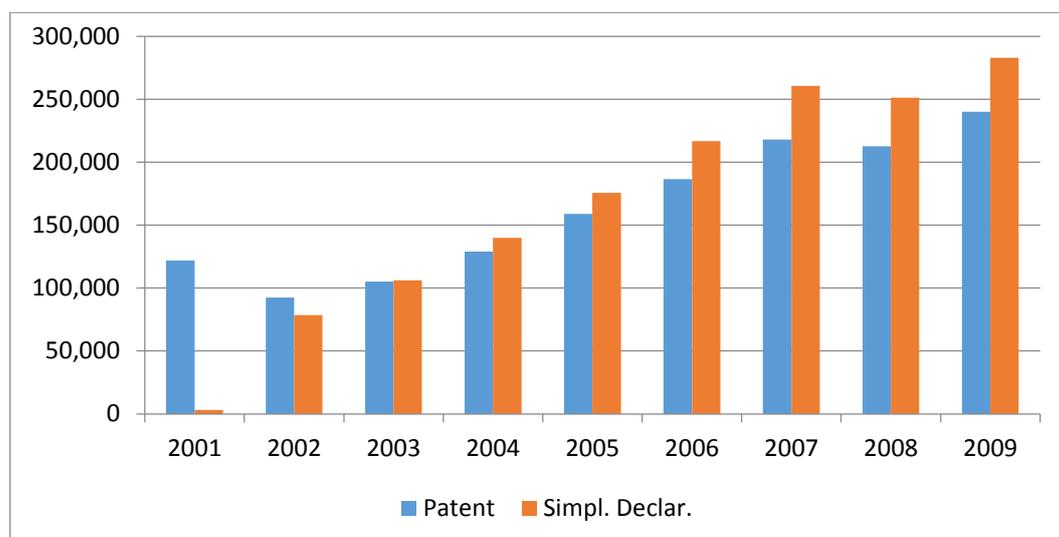
Source: World Bank (2006) and additional data from the Revenue Service.

At first sight, when considering registration trends, the experience in many ECA countries looks impressive. In the short term, presumptive systems may have a relatively low initial take-up rate, probably due to a lack of information on the part of small business operators about the regime and its benefits, or distrust in its stability and implementation. Generally, however, participation tends to grow remarkably over time.

A typical example of such a development is Kazakhstan where, since 2002, the number of taxpayers applying one of the simplified regimes has been growing annually by an average of 27 per cent in the case of the simplified declaration regime and by 18 per cent in the case of the patent regime. This growth rate exceeds the overall growth of the taxpayer population.

<sup>17</sup> Studies revealing a positive impact of presumptive taxation on business formalization have been conducted in some non-ECA countries, such as Brazil. See Fajnzylber, Maloney, and Montes-Rojas (2011), and Monteiro and Assunção (2006).

**Figure 15. Number of taxpayers applying simplified tax regimes in Kazakhstan (2001-09)**



Source: Tax Committee of the Ministry of Finance of the Republic of Kazakhstan.

However, such growth figures do not provide any information on the actual effects of presumptive tax regimes on the formalization decisions of businesses. What is generally lacking in ECA countries (and worldwide) is analysis of the previous tax situation of small businesses joining the regime. The presumptive taxpayer population includes (i) tax-registered small businesses changing their tax status and moving from the general to the presumptive regime (see also the example of Uzbekistan below); (ii) newly-established businesses registering with the tax authority and selecting the presumptive taxation approach; (iii) some – hopefully not too many – larger businesses migrating into the presumptive regime. It is therefore completely unclear whether and to what extent growth in registration can be attributed to informal businesses deciding to formalize.

Several analyses of the dynamics around presumptive tax regimes provide an indication that these have contributed to improved voluntary tax compliance. For Ukraine, Thiessen (2003) estimates that, looking at the years 1999 and 2000, the presumptive tax for small and medium-sized businesses has reduced the shadow economy by 11-14 per cent. More recently, the Russian SME Resource Center conducted a survey and analysis of businesses using the simplified taxation system in the Russian Federation (Mikhalkin & Alexeeva, 2009), concluding that adoption of the simplified tax system resulted in the legalization of about 30 per cent of SME income. Looking at the use and performance of simplified tax systems in the period 2003-07, the analysis finds that the number of legal entities and individual entrepreneurs taxed on a presumptive basis had almost tripled in 2007 compared with 2003 (the number grew from 692,000 to 1,602,000); at the same time, the revenue performance of the simplified tax regime increased by a factor of almost five, from Rub 17.2 billion in 2003 to Rub 84.1 billion in 2007. This means that the presumptive tax payment per small business more than doubled in the period

reviewed, from Rub 23,000 in 2003 to Rub 52,000 in 2007, indicating a greater willingness of presumptive taxpayers to legalize their business transactions and declare their actual turnover.

Similar revenue increases were reported in Ukraine following the introduction of a fixed tax regime, and the tax administration found that the amount of tax collected from businesses that decided to move into the fixed-tax regime quadrupled compared with the amount collected from the same group of businesses before the fixed tax was introduced (Semikolenova, 1999).

### **Presumptive regime threshold and business development distortions**

While the existence of a simplified presumptive tax regime may have considerable benefits for the SME segment, multiple risks are associated with the impact of the presumptive regime on revenue generation and the integrity of the tax regime, as well as potential detriments to business growth and development. These detriments result, in particular, from a major tax burden and compliance cost increase for businesses migrating from the presumptive to the standard tax regime, and an undesirable incentive for larger businesses to migrate downwards into the presumptive regime.

As a result, country analysis tends to reveal the erosion of the general tax regime due to the attractiveness and popularity of presumptive tax regimes. This erosion needs to be balanced against the benefits of the regime, and may not always be as serious as might be assumed when glancing at anecdotal evidence. Sometimes, a skewed taxpayer distribution may simply reflect the predominance of the micro and small business segment in an economy.

Presumptive tax regimes for many small businesses offer the possibility not only of facilitating tax compliance and reducing compliance costs, but also reducing the actual business tax burden. There is no sound justification for such tax liability reduction, which violates the ability-to-pay principle;<sup>18</sup> in practice, however, many presumptive tax regimes result in a comparatively low tax burden compared with similar businesses operating in the standard tax regime.

### **Upward migration**

Indeed, the percentage of small businesses taxed on a presumptive basis that eventually migrate voluntarily into the standard tax regime is low. However, this observation, as such, is insufficient to assume that the presumptive regime threshold establishes a business growth barrier. Such a conclusion would require the additional diagnosis that presumptive taxpayers tend to grow to a level close to this

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<sup>18</sup> This situation is similar to the practice of offering lower corporate income tax rates to small companies, although in that case, at least an argument could be made that the lower tax rate compensates for higher compliance costs. This is not a valid argument in the case of presumptive taxation, as the presumptive regime is already supposed to align the compliance burden with the compliance capacity of the business.

threshold and then show no further increase in their turnover. Many small businesses tend to remain small and operate at the lower, not the upper, end of the presumptive regime turnover scale. In Ukraine, for example, looking at the distribution of unified taxpayers according to turnover levels, Alm and Saavedra (2006) find a remarkable upward migration within the system. Over five years, 2000 to 2004, the total number of individual simplified taxpayers more than tripled. However, while the increase in the lowest band has been modest (an increase of 69 per cent), taxpayers with payment obligations in the four highest bands (more than Hrv 200,000) increased by more than 12 times. This is only to a small extent due to inflation, as annual inflation rates were below 10 per cent in the years analyzed.

**Table 15. Number of taxpayers and tax payments of physical persons in the Ukrainian simplified tax system**

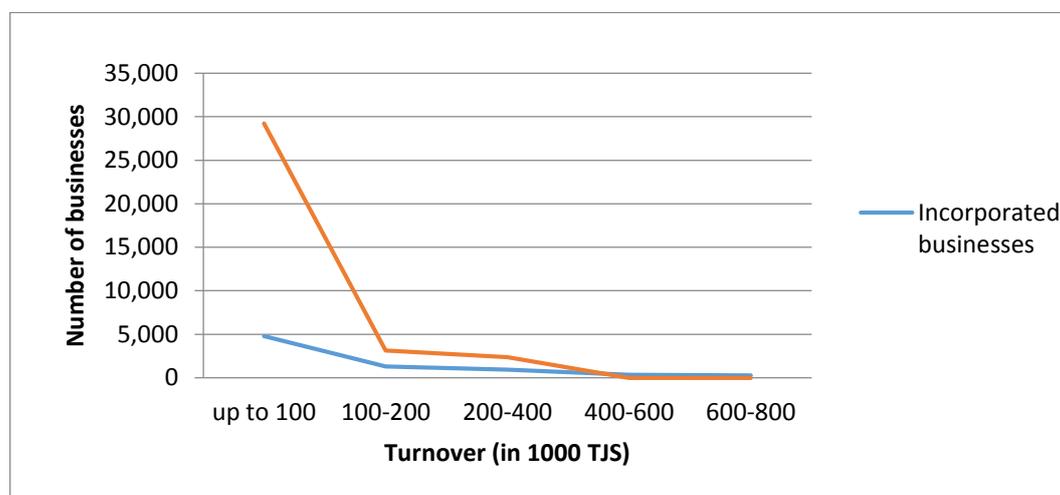
Annual tax payment (in UAH)	Number of taxpayers					
	2000	2001	2002	2003	2004	Increase (%)
0–2,400	88,077	146,351	173,765	162,227	148,541	68.6
2,400–7,200	26,797	39,950	56,421	72,355	73,369	173.8
7,200–55,000	44,512	73,356	113,767	163,902	188,158	322.7
55,000–100,000	8,681	15,472	26,292	41,043	52,297	502.4
100,000–200,000	7,593	14,065	25,035	40,458	53,046	598.6
200,000–300,000	2,918	6,110	11,853	20,294	28,277	848.6
300,000–400,000	1,664	3,524	7,736	13,974	20,456	1129.3
400,000–500,000	1,710	3,707	10,895	23,446	34,506	1917.9
Over 500,000	605	741	1,089	2,251	3,800	528.1
TOTAL	182,557	303,276	426,853	539,950	602,400	230

Source: Alm & Saavedra, 2006.

Still, more than two-thirds of presumptive taxpayers are grouped into the three lowest bands of the regime and do not operate even close to its upper threshold, suggesting that the large majority of small businesses in the regime are not concerned with a potential system threshold growth obstacle.

This review of taxpayer distributions does not imply that a system threshold barrier for small business growth does not exist. Rather, it indicates that the number of presumptive taxpayers affected by the system threshold is comparatively small. In addition, it is important to take into account that the presumptive regime threshold is not necessarily the only obstacle to business growth. Even without the need to abandon the preferential presumptive regime treatment, reaching the VAT threshold can become a major barrier to small business growth. A strategy to facilitate the transition from the presumptive to the standard tax regime therefore needs to include, as a core element, the facilitation of VAT compliance procedures for medium-sized businesses, in particular by offering VAT cash accounting schemes. A cash accounting option might also be considered for income taxation of medium-sized businesses.

**Figure 16. Tajikistan: Number of taxpayers in simplified tax regime according to turnover bracket**

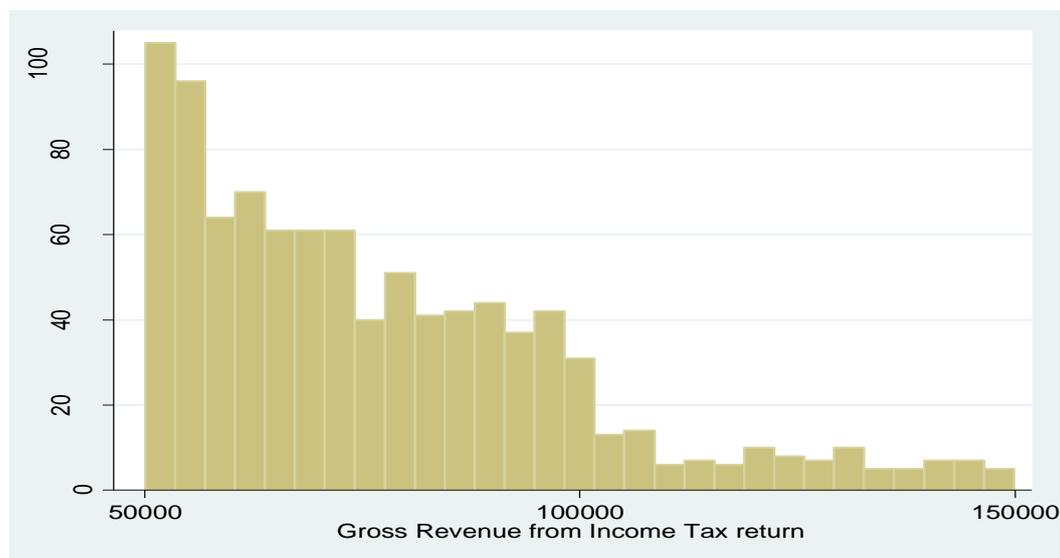


Source: Tajikistan Tax Administration, 2010.

While several Central and Eastern European countries have reduced the barrier for migration out of the presumptive regime by better aligning their small business tax regime with the general tax regime (see below), Russia, Ukraine and Belarus have considerably increased the eligibility thresholds of their presumptive regimes. In the Russian Federation, the threshold for application of the STS for incorporated businesses was raised in 2010 from RUB 26.8 million to Rub 60 million turnover, with the staffing threshold of a maximum of 100 employees remaining unchanged; similarly, in Ukraine, the presumptive regime threshold increased in 2012 for incorporated businesses from one million to five million UAH, with the maximum staffing of 50 employees also remaining unchanged.

Increasing the threshold largely eliminates the growth obstacle for businesses with a turnover below the old threshold, but does not provide an overall solution to the problem. As Alexeev and Conrad (2013) point out, a business at the RUB 60 million threshold may still face a RUB 400,000 tax increase as a result of a one RUB increase in turnover. This may also increase problems of system operation, and the risk of system abuse becomes more acute. Rather than raising the system threshold, an effective strategy for facilitating business migration should at least include the following components: (i) aligning the tax burden in the presumptive regime with the tax burden in the standard tax regime; (ii) imposing basic bookkeeping standards on presumptive taxpayers; (iii) introducing some compliance facilitation measures, in particular for VAT compliance, for medium-sized businesses; (iv) offering targeted taxpayer services for business migration. In addition, a risk-based audit approach aimed at identifying businesses that should be moved into the standard tax regime should be applied in order to avoid unfair competition for medium-sized businesses in the standard regime.

**Figure 17. Distribution of firms in Georgia by turnover below and above the VAT threshold of 100,000 GEL<sup>19</sup>**



Source: Bruhn & Loeprick, 2014.

### Downward migration

In a number of cases, migration of businesses from the standard tax regime to the presumptive tax regime is perfectly legitimate. It may be a result of either a shrinking business turnover – making the business eligible for the presumptive regime – or a business that always qualified for presumptive taxation but opted to be taxed in the standard regime and subsequently changed its system selection.

Tax administrations frequently report incidences of widespread presumptive regime abuse by larger businesses. An extreme case is Ukraine, where the tax administration found cases of larger firms splitting into 20 or more small businesses, thereby qualifying them for the presumptive tax regime. As such, government officials are concerned that as much as 50 per cent of all presumptive taxpayers in the system may be fraudulent (World Bank, 2006). Apart from such anecdotal evidence, OECD analysis shows that, while the number of small companies increased between 2000 and 2015, the total industrial output of small businesses decreased from 8.1 per cent to 5.5 per cent during that time. Along with the decrease in the average number of small business employees from eight per cent to 6.4 per cent in 2006, this evidence suggests that companies close to the simplified system thresholds of 10 or 50 employees either fragment the business or under-report employment in order to remain eligible for presumptive taxation. Despite the concentration of small businesses in booming, consumption-oriented sectors such as the retail trade, the officially reported consolidated financial results for small

<sup>19</sup> Based on data from 2009, when Georgia did not offer presumptive income taxation to MSMEs.

businesses in all sectors except health, education and social services was negative in 2004/05, suggesting large-scale concealment of profits (OECD, 2007).

Unusual migration trends may be an important indicator of system abuse, and the non-existence of a substantial medium-sized business category may indicate the downward migration of medium-sized businesses. Both elements can be observed in Kazakhstan, where the number of individual entrepreneurs with a registered turnover below the presumptive regime threshold of KZT 40 million suddenly increased significantly in 2009, coinciding with a reduction in the presumptive tax rate from five to three per cent.

**Table 16. Kazakhstan: Number of active taxpayers by turnover in 2007–09**

Turnover (million KZT)	Legal entities*			Individual entrepreneurs**		
	2007	2008	2009	2007	2008	2009
Above 2,000	1,817	1,947	1,537	1	3	5
500–2,000	4,593	4,574	3,839	47	85	57
100–500	11,765	11,757	10,448	480	757	491
40–100	10,073	10,043	9,339	820	1,120	893
20–40	8,464	8,587	8,665	2,208	2,998	4,745
Below 20	96,195	107,636	114,370	342,277	359,916	402,145
<b>Total</b>	<b>132,907</b>	<b>144,544</b>	<b>148,198</b>	<b>345,833</b>	<b>364,879</b>	<b>408,336</b>

Source: Tax Committee of the Ministry of Finance of the Republic of Kazakhstan, 2010

\* Public agencies and associations excluded; \*\* taxpayers under patent regime and single land tax excluded.

The number of individual entrepreneurs above the eligibility threshold declined, and the number of incorporated businesses in the medium taxpayer segment (9,339 in 2009) was comparatively low. These might be seen as an indication of downward migration dynamics.

In a situation in which the number of businesses migrating into the presumptive regime continuously and substantially exceeds the number of businesses migrating out of it, the base of the standard tax regime erodes, tax revenue collection decreases, and competition increases for the few businesses remaining in the standard regime. As an example, migration trends in Uzbekistan from 2010 to 2012 raise concerns about the long-term effect of its presumptive tax regime.

**Table 17. Uzbekistan: Number of taxpayers changing their taxation regime**

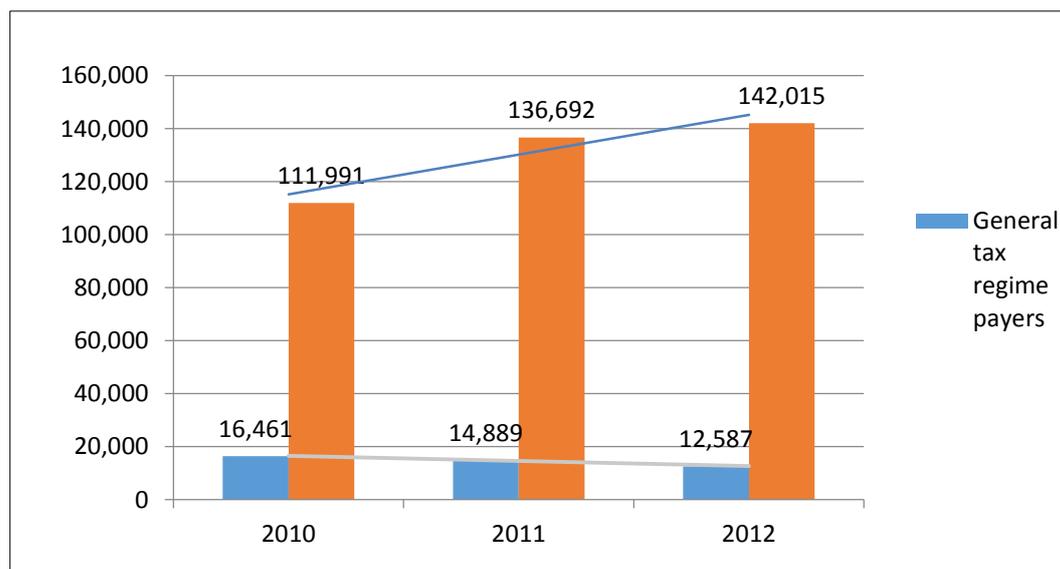
	2010	2011	2012
Number of companies that shifted from generally established tax system to simplified taxation system	1,642	1,849	1,666
Number of simplified taxpayers who shifted from simplified to generally established tax system	606	667	692

Source: Uzbekistan State Tax Committee.

In Uzbekistan, the number of net income taxpayers decreased by 25 per cent over a period of two years and is now less than 10 per cent of the taxpayer population.

The artificial splitting up of businesses in order to abuse the presumptive tax regime results in a reduction in the overall cost efficiency of business operations. Assuming rational business decision making, such splitting-up is therefore only attractive if savings in both tax payments and compliance costs exceed these efficiency losses. Eliminating differences in the tax burden between the standard and presumptive regimes substantially reduces the incentives for these business divisions. Also, the higher the efficiency losses, the smaller the newly-generated business entities need to be to qualify for the presumptive regime. The split-up option is therefore more attractive in a country like Ukraine, with a presumptive regime threshold of 50 employees and UAH 5 million (\$520,000) turnover, than Latvia, with a turnover threshold of €100,000 (\$113,000) and a staffing threshold of five employees. An essential step towards reducing system abuse risks is to define a presumptive regime threshold which limits regime application to small businesses facing capacity constraints and compliance difficulties with the standard tax regime.

**Figure 18. Number of generally established tax payers and single tax payment payers in Uzbekistan (at 1 January each year)**



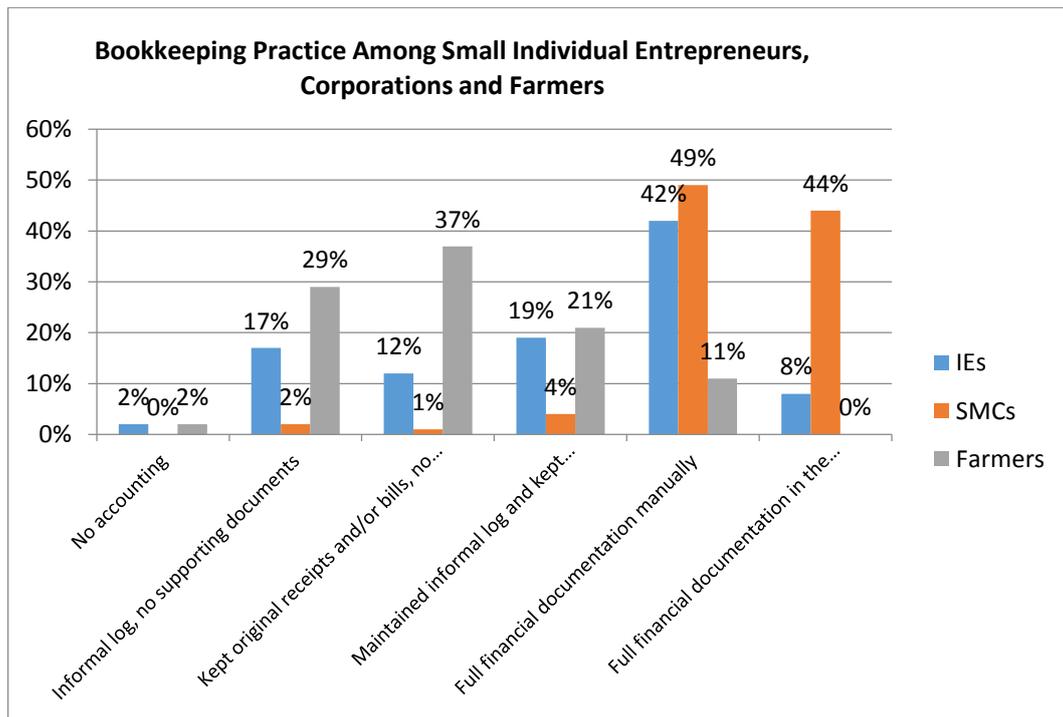
Source: State Tax Committee of Uzbekistan.

Transparent rules for the application of the regime are a second essential element. This relates in particular to the level of bookkeeping required and imposed. While a simplified cash-based bookkeeping standard is appropriate for the operation of a turnover-based presumptive tax regime, this standard is not always sufficiently enforced to verify the size of business operations in practice. For incorporated businesses, expanded reporting requirements can be considered. An extreme approach in this respect has been taken by the Russian Federation, where an

increase in the presumptive regime threshold was combined with the introduction of comprehensive accounting requirements for companies. While this is not necessarily an appropriate approach for all countries, analysis in the Kyrgyz Republic demonstrates that the enforcement of a higher level of accounting can be well in line with the actual practice of small corporations.

Due to limited transparency and control, possibilities for system abuse risks are particularly high when patent regimes with no bookkeeping requirements are extended to the small business segment. Additional safeguards need to be put in place in this case to counteract the access of larger businesses to the patent regime. In Tajikistan, for example, while the patent regime turnover threshold was relatively high at SM 200,000 (\$42,000), the additional eligibility criterion of operating the business with no (non-family) employees hampered system access for larger businesses. As a result, the level of system abuse seemed rather moderate, with about 3.5 per cent of patent holders reporting, in an anonymous survey, a turnover above the patent regime threshold (SME Survey, 2009). Nevertheless, in 2013, the Tajik government used a general revision of the tax code to lower the patent threshold to SM 100,000 in order to better monitor the regime.

**Figure 19: Actual bookkeeping practice of small businesses in the Kyrgyz Republic**



Source: IFC SME Surveys.

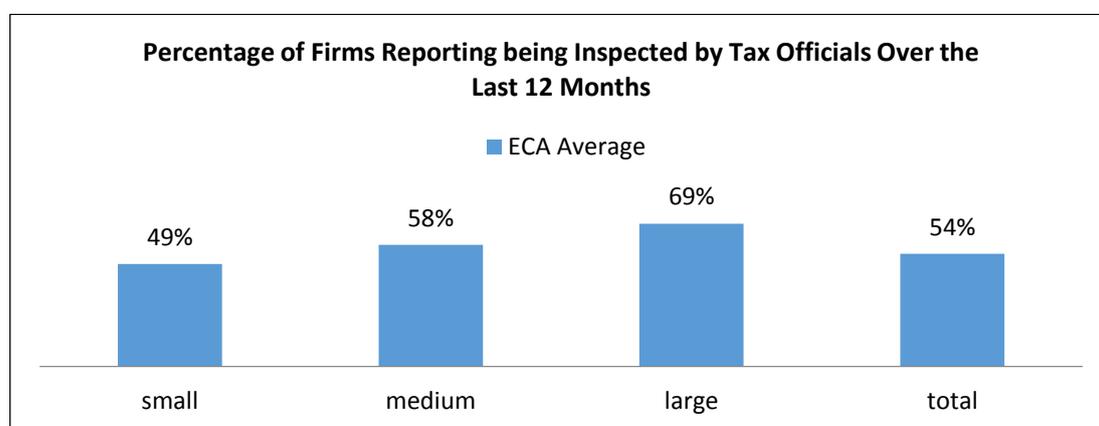
Additional system eligibility criteria and specific anti-abuse provisions create further barriers to system abuse. Such criteria may include, as in Russia, a requirement that the majority of shares (75 per cent in Russia) are owned by private individuals, that the business has no branches or representative offices, and that it does not operate in any high-risk areas such as financial services, manufacturing of

excisable goods or trading in minerals. In Latvia, in addition to restrictions regarding the number of employees, only limited liability companies having solely individuals as shareholders can apply for the micro enterprise regime.

### Monitoring MSMEs

While the approach practised in the early phase of transition to target a 100 per cent audit of all registered businesses has been abolished in all countries in the region, an inappropriately high share of administrative capacity still seems to be consumed by visits to small businesses with low potential tax yields. From a business perspective, compliance costs are increased due to the time and resources required to prepare for, be available during, and respond to queries following audits.

**Figure 20. Reported tax inspections in the ECA region**



Source: Enterprise Survey Data, 2009-11.

The main focus of any audit programme for the small business segment must be the identification of taxpayers who abuse the presumptive tax regime for tax minimization purposes, either by substantially under-declaring their turnover or by artificially splitting up business operations. It is therefore necessary to define criteria that indicate when an artificial separation of business activities is evident. Audit activities should focus on small businesses with a turnover close to the upper threshold of the presumptive regime to verify whether, according to their actual turnover, these businesses should have migrated to the medium-sized business category. Moving to a more risk-based approach to tax audit, targeting particularly businesses that should be transferred to the general tax regime and major cases of turnover under-reporting, must therefore be a priority for tax audit reform in the region. Many Central and Eastern European countries have successfully implemented reforms in this direction, and some FSU countries, such as Kazakhstan and the Kyrgyz Republic, are following this path.

Even a well-designed and well-administered MSME regime generates only a very small and often even negligible percentage of total tax revenues.<sup>20</sup> This renders the administration of presumptive tax regimes relatively unattractive to national tax administrations, and several countries in the region have therefore transferred the administration of presumptive tax regimes to local governments. In such cases, successful coordination of different levels of administration is critical for effective compliance management.

In Albania, since the introduction of its first simplified scheme in the early 1990s, it has tested different special regimes and moved towards a decentralized administrative approach aiming to account for regional differences. Since 2005, income tax for small businesses with a turnover of up to ALL 8 million has been administered at the local level. For micro businesses with less than two million ALL in turnover, a simple patent applies; for businesses with a turnover between two million and eight million ALL, a turnover tax is used (with seven different turnover and three district categories).

**Figure 21. Overview of presumptive taxation policies for MSMEs in Albania**

Year	System/Revisions
1992	Special tax regime for individuals (trading activities, handicrafts, and other services)
1993	“Law for small business tax”: fixed tax and a tax based on gross revenues (rates of 3%, 5%, and 8% on gross income)
1998	Eligibility extended to legal entities; turnover threshold of ALL 5 million introduced. Turnover tax of 4% applied to all small business with turnover between ALL 2–5 million. Fixed patent for businesses with annual turnover < ALL 2 million (differentiated by sector and location).
2002	Alignment of presumptive and VAT threshold at ALL 8 million; Fixed tax at the local level.
2005	Reduction of the rate of the simplified profits tax from 4% to 3% from 2005. Assignment of administration (and revenue) from small business tax to the local level.
2006	Turnover rate schedule introduced for 7 turnover levels and differentiated by region and sectors
2008	Introduction of balance sheet requirement for all small business with a turnover above ALL 2 million
2010	VAT threshold lowered to ALL 5 million
2014	Simplified net profit taxation with reduced rate of 7.5% for businesses with turnover between ALL 2 million and ALL 8 million. Administered by central tax administration and no longer by local governments.

The assignment of small business tax administration to local government was rather unusual, resulting in important coordination challenges between municipal authorities and regional GDT offices. Most notably, the tax base of the

<sup>20</sup> Tajikistan, where small businesses account for 4.2 per cent of total tax collection (patent tax 1.4 per cent, simplified tax 2.8 per cent), is an example of a comparatively high level of micro and small business contribution to total tax collection. In 2009, the Polish tax card and turnover tax regimes amounted to a total of around \$500 million in tax collections, thereby accounting for just 8.5 per cent of individual business tax revenues in the country. In Armenia, following the reintroduction of the turnover tax for small businesses, the tax accounted for just 1.1 per cent of total tax revenue (EBRD, 2013)

municipalities was at risk from small business growth. Following the assignment of small business taxation to the local level, revenue dropped sharply. In Tirana, for example, between 2005 and 2010, total revenue collected from the sector dropped by almost a third, from ALL 1.4 billion to one billion, despite an increase in the number of registered small taxpayers (Tirana Municipality). There are several explanations for this decline in revenue. Political considerations resulting from conflicting agendas at the local, regional and central level are reported to have interfered with efficient tax administration. USAID (2009) highlights that the reduction in the SBT rate is the main driver of declining revenue. Also, transitional challenges and the need to build municipal authority capacity in managing small taxpayers are frequently highlighted as the main drivers of a sharp decline in revenue, particularly in light of coordination challenges. In some municipalities, rather than relying on the tax ID issued by the national registration office, a different coding system was developed to monitor the local tax base, undermining efficient information sharing. This lack of coordination has facilitated the abuse of the patent and small business regimes, as businesses that were broken up into multiple small entities and registered with different municipalities cannot be properly tracked.

*Possibilities for further improvement of the presumptive regime design*

One characteristic of simplified taxation in the ECA region is the continuous reform and modification of presumptive tax regimes. The directions of these reforms differ across the region, and there is thus no clear development of a new general architecture for presumptive taxation regimes. As a general observation, differences in approaches to presumptive tax design between Central and Eastern European countries and FSU countries are increasing. While, in the countries of the Former Soviet Union, a single-rate turnover tax is still the predominant approach to simplified small business taxation, CEE countries have begun to phase out pure turnover taxes and are aiming at a better alignment of presumptive and standard tax regimes.

One method of achieving such alignment is to replace turnover as the small business tax base with a simplified net income calculation. With this approach, small businesses are integrated into the standard income tax regime; however, the requirement to calculate business expenses and determine net business profit is replaced by a lump-sum cost deduction. Similar to turnover tax regimes, the business thus only has to calculate its gross income. Lump-sum cost deduction ratios may be established for different categories of small business activity to reflect average income/expense ratios. The standard income/profit tax rate is then applied on the presumed net business income.

**Table 18: Examples of lump-sum cost deduction ratios in ECA**

Country	Ratio
Czech Republic	80% for agricultural activities and handcraft 60% for trade 40% for any other type of activity
Slovak Republic	60% for craftsmen 25% for other businesses
Slovenia	25–70% depending on business activity

Lump-sum cost deduction elements for certain expense types are a standard feature of many personal and corporate income tax laws. Unlike a pure turnover tax, the simplified net income calculation, while facilitating compliance, integrates the business into the normal income tax regime and reduces the barrier to transition to the standard taxation regime. As in the case of turnover rate differentiation, the determination of appropriate lump-sum deduction ratios is the main challenge for system design, and lengthy discussions may emerge between ministries of finance and small business associations on acceptable deduction levels. The example of the Czech Republic illustrates this potential variability in lump-sum deduction levels.

**Table 19. Changes in lump-sum expense ratios in the Czech Republic**

Type of income	2004%	2005%	2010%	2011%
Income from agricultural production	50	80	80	80
Income from craft trade	25	60	80	80
Income from other trading activities	25	50	60	60
Income from an independent activity and other business categories	25	40	60	40
Income from the use or provision of industrial or other intellectual property	30	40	60	40

Source: Mincic, 2011.

The next step in the alignment of special regimes for MSMEs with the general regime would be to move to a cash flow-based net income tax for small businesses. This approach has been recommended by some experts (see, for example, Bodin & Koukpaizan, 2008, p.121) as the best possible small business taxation regime. It would probably be most suitable for countries in the ECA region – especially CEE countries – where SME operators have a comparatively high level of education and access to bookkeeping services. Such a cash-based approach is generally practised for corporate income tax in Estonia and was introduced in Hungary in 2013 with the new small business tax (KIVA) for incorporated businesses; the KIVA is a tax of 16 per cent on the adjusted sum of the company's cash-based profit and salary payments. A cash-flow tax as an alternative to a turnover tax is operated in the Russian Federation, where small businesses can opt to pay either six per cent on their turnover or 15 per cent on their net cash flow. However, the Russian approach creates the typical result associated with system competition: businesses with higher profit margins have an incentive to switch to the turnover tax regime, while

businesses with lower margins prefer the net cash flow base. For higher profit businesses, this creates a simple opportunity to reduce their tax liability (for discussion of this problem, see Alexeev & Conrad, 2013). Indeed, cash-flow based taxation of net income of small businesses is a simplification approach that avoids deviation from the general principles of income taxation.

In practice, the major problems of this approach lie in the determination and verification of deductible business expenses. In particular, a proper distinction between deductible business expenses and non-deductible private expenses and the misreporting of business expenses, which is a serious small business compliance problem even in advanced OECD countries (see, for example, GAO, 2007), may create disputes between tax administrations and businesses and increase the compliance and administrative burden. The introduction of a cash-flow tax therefore requires sufficient administrative capacity to monitor a large number of small business net income returns and extensive education of business operators in order to facilitate the correct calculation of net business income.

## CONCLUSIONS

The effects of presumptive tax treatments of micro and small firms are an understudied area in tax policy. We have presented a summary of reported effects in the ECA region, with an emerging storyline of the potential benefits in terms of compliance cost reductions, along with some indications that presumptive tax regimes encourage higher participation rates. At the same time, country experiences suggest that poorly designed small business taxation in the region acts as a disincentive for small businesses to grow to a turnover level above the presumptive regime threshold (barrier to migration upwards out of the system) and attracts larger businesses looking for areas in which to reduce their tax liability (incentive to migrate downwards into the system). Both phenomena distort business development, and thus fundamentally contradict the purpose of operating a presumptive tax regime.

The tax treatment of MSMEs differs notably across the ECA region, and the more recent move toward lump-sum cost deduction for a better alignment of presumptive and general tax treatment, seems to be an example that may find more support in future. However, the challenges of proper regime design will remain rather similar to those experienced to date. For both pure turnover taxes and lump-sum cost deductions, determination of applicable rates is often driven more by political pressures than by a sensible alignment with taxpayer profitability. Misaligned rates are problematic, given the strong incentives for high-profit activities to maintain presumptive tax treatment. When the design of tax rates and eligibility thresholds is driven by politically motivated guesswork, the risk of misalignment, which incentivizes system abuse, increases. Determining appropriate rates and defining a presumptive regime threshold that limits regime application to small businesses facing capacity constraints and difficulties in complying with the standard tax

regime therefore remains an essential step, irrespective of the simplification measures adopted.

Even the best MSME taxation design will fail to achieve its objectives of encouraging formalization and generating revenue if not implemented properly. Tailored compliance management to account for the characteristics of the segment is thus critical, and our review of the experience in ECA suggests that shortcomings in the implementation of MSME tax policy are widespread. Sometimes this is due to capacity constraints and structural challenges; sometimes it seems to be a deliberate political choice to neglect the enforcement of the rule of law for this segment; and sometimes it is a combination of the two.

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