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Is It Really So Hard to Tax the Hard-To-Tax? The Context and Role of Presumptive Taxes

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IS IT REALLY SO HARD TO TAX THE HARD-TO-TAX? THE CONTEXT AND ROLE
OF PRESUMPTIVE TAXES

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1. Introduction

In all countries, some enterprises and individuals manage to avoid the full impact of the tax system. They do so in many ways. Some have sufficient political influence to remain outside of the scope of the legislation in the first place. Others, also usually at the upper end of the economic spectrum, manage to devise legal ways around the apparent intent of the law. Still others simply cheat, for example, by claiming improper deductions or under-reporting income or sales. At the extreme, some may operate completely outside the scope of the formal tax system.¹ And finally, some may simply refuse to pay their taxes.

Each of these strategies to minimize the effect of taxation can be countered to some degree. Transparency and open debate may reduce the influence of lobbyists. Skilful drafting and tenacious administration are critical elements in the never-ending fight against tax avoidance. Close monitoring and rigorous enforcement is the only answer to non-payers. The central and most difficult task of tax administration, however, is how to deal with tax evasion. Tax evaders, like taxpayers, come in many shapes, sizes, and guises. At the upper end, some may conduct much or all of their business through a baffling array of corporate vehicles and complex and convoluted financial transactions, many allegedly or actually taking place off-shore. At the lower end, some may stay completely off the fiscal radar – so-called “ghosts” who transact business solely in cash and avoid normal business channels and all contact with government agencies. In the middle come those who to a greater or a lesser degree hide some of their sales or income or claim deductions or exemptions improperly.

Each of these categories may be dealt with in different ways. To begin at the top, sophisticated cross-border evaders are the bane of all tax systems, and pose such great problems for administrations that are not well-equipped to play in these leagues that it has sometimes been suggested that it is important to keep some “on-shore” channels of tax evasion sufficiently open to avoid driving not just tax revenues but real resources and real economic activity offshore. Withholding taxes on cross-border financial flows, vigilant policing of cross-border trade, and, especially, cooperating with the neighbors both with respect to such flows and trade and also with respect to both to keeping tax rates roughly in line as well as facilitating information exchange relevant to taxation – such measures may help, though none is without its own problems.

At the bottom of the system, tax officials may walk along the street, sweeping hawkers and peddlers into the tax net, entering premises and confiscating records, etc. A somewhat more sophisticated approach is to follow the audit trail, starting with those who are in the tax net and working outward on the assumption that it is almost impossible in most economies never to have traceable contact with someone who is already known to the authorities. When the cost of such activities exceeds the benefits, presumably the

¹ In many developing and transitional countries, of course, there are substantial “implicit” taxes imposed through regulation and other means as well as sometimes significant “informal” taxes collected by officials but never transmitted to the treasury. Such levies should be taken into account in any thorough analysis, but are necessarily left out of account here.

process should be stopped. Alternatively, operating on the premise that even thieves eat and drink, and perhaps even drive Mercedes, the authorities can attempt to tap the tax potential of the shadow world through indirect rather than direct methods.

Evasion in the “middle range” is of course the focus of tax audit and investigation, the central and in many ways most difficult component of tax administration. Good tax administration may not be rocket science, but it is also not easy and it takes time, skill, and resources, all of which are in short supply in many countries. In effect, when “self-assessments” (whether of sales or income) cannot be trusted, “administrative assessments” are imposed instead, and the onus of rebutting such assessments is generally placed on the taxpayer.

Such administrative assessments are found everywhere in most tax systems – sometimes under this name, but more usually under other labels. The property tax, for instance, is normally assessed entirely in this way. Export taxes have often been applied on “presumed” values. Sometimes the same approach has been used for certain import excise duties. Alternatively, these taxes are often levied not on a value basis but on such characteristics as size, weight, chemical composition, and the like. Official assessments of VAT are sometimes based on presumed sales/purchase ratios for particular industry sectors. Alternatively, VAT may be “withheld in advance” as when sellers are required to remit VAT for which their customers are presumed liable in the expectation that those customers will not in fact ever pay that liability themselves. Income taxes too are often assessed based on presumed profit margins on assets or sales, or imputed from external indicators, or calculated on the basis of estimated changes in net worth. Questionable cross-border transactions (transfer prices and the like) are similarly estimated based on presumed “comparables.” Presumption is thus both a common and an extremely varied tool of tax administration.

Our concern in this paper, however, is with the more limited question of the extent to which “presumptive taxation” can be an effective tool to cope with what are commonly called the “hard-to-tax” group in society. While this category is seldom very clearly defined – often, for example, it excludes those at the top of the power heap who manage to save themselves from the full fury of the taxman in polite and accepted (or at least untouchable) ways – it appears usually to be intended to encompass the so-called “informal” (“hidden” “shadow” “underground”) economy that is such a prominent feature of economic reality in many countries (Schneider and Este, 2002).² Our focus in this paper is thus primarily on the special regimes that have been put into place in a number of developing and transitional countries in an attempt to cope with this problem.³ In Section 2 of the paper, we define more precisely the objectives of such systems. Section 3 reviews several “simplified” systems in place in different countries. In Section 4 we analyze the implications of these special regimes in terms of their impact on economic efficiency, equity, and overall tax administration and compliance. Section 5

² For a useful discussion of the nature and composition of the informal economy, see Thomas (1992).

³ We shall not discuss the extent to which the extent of the underground economy is itself a function of the tax system, a question reviewed in Schneider and Este (2002). For a recent detailed examination of this issue in a developed country, see Giles (2002).

concludes with a brief discussion of the critical problem of developing an “exit strategy” from such special regimes and some alternative policies that might deal with some key elements of the hard-to-tax sector.

2. The Objectives of Presumptive Taxation

As mentioned in Section 1, tax administrators face many problem children from the perspective of tax administration. Potential taxpayers currently escaping the system may include small businesses (small in terms of sales, numbers of employees, or other criteria). But they may also include large- or medium-sized businesses that only look small, as well as money-losing businesses that are in part subsisting by not paying over taxes they withhold. Complicated tax systems may make it difficult and expensive for some taxpayers to act in good faith in terms of tax compliance due to the costs associated with record keeping and the need for specialized information to comply with complex tax laws, especially in the case of a weak taxpaying culture.⁴ Resource- and skill-short tax administrations are often left with the bitter choice of either going after the larger firms already in the tax net, where the potential tax revenue payback may be higher, or pursuing instead the probably less lucrative smaller taxpayers.

The prevalence of widespread perceived (and actual) tax evasion at the lower end of the economic activity scale together with the obvious expense and difficulty for start-up enterprises to comply with complex tax laws has induced some countries to adopt specific tax regimes to deal with the so-called hard-to-tax (HTT). By their very nature, however, such special tax regimes fragment the tax system and may provide incentives that are inconsistent with the overall goals of a tax administration. In this paper, we argue that many of the stated goals of such special presumptive systems may not be attained, owing to a lack of focus on the goal of such systems, to the lack of follow-through (how and when should the special regimes end), and more generally to the “disconnect” between taxation for the HTT sector and the general tax system.

The HTT sector cannot be dealt with in isolation. The tax regime for the HTT sector must be considered as an integral part of the overall tax/revenue system since each can affect the other, and either can influence the short and long term administration and tax policy goals of the entire system. In this more global context the implications of special tax regimes for the HTT sector may be more complex, the advantages less clear, and the need to graduate out of these regimes more important and more difficult than many of those who advocate such approaches seem willing to recognize.⁵ A good HTT

⁴ Theoretically, the impact of tax system complexity on tax compliance is ambiguous and depends among other things on the taxpayer’s uncertainty regarding the tax administration (see, for example, Alm (1988) and Slemrod and Yitzhaki (2000)). There is some anecdotal and empirical evidence in transition countries that complexity does decrease compliance, see Martinez and Wallace (forthcoming), and Hassan (1998). On the notion of “tax culture”, see Nerre (2001).

⁵ The HTT sector is of course not the only sector singled out for special treatment in many countries. In the name of economic development, many countries allow tax preferences for certain industries and in the name of equity (and administrability), many countries exempt certain activities and goods from taxation. All such “line-drawing” exercises to some extent give rise to problems similar to those discussed in the text.

tax solution should include a transition mechanism to link special HTT regimes to the more general tax system within the context of tax administration constraints. We have been hard pressed to find examples of HTT regimes that either do this or pay sufficient attention to the impacts of HTT regimes on economic efficiency, equity, general compliance, and tax administration.

Varieties of HTT

One approach to analyzing the tax methods used for the HTT sector is to begin by classifying the types of taxpayers that we consider HTT and explain why we consider them as such. The goals associated with special tax regimes may differ with respect to different groups of HTT:⁶

- Small and vulnerable taxpayers who should be exempted from most or all tax obligations, essentially because the costs (administrative, compliance, and economic) of including them exceed the benefits from doing so.
- Firms and individuals in the informal sector whose activities are large enough to fall within the scope of the tax system but who are tax evaders. Some in this group may be completely off the fiscal radar – “ghosts.” Others are more like “icebergs,” in that the portion visible to the authorities may be miniscule compared to the hidden reality. There may be interesting sub-groups within this group, such as the “hard core” of those who operate this way owing to the illegality of their trade, and such groups may call for different approaches if they are to be brought into the system.
- Large and medium entities that are capable of complying with the normal tax system but simply fail to do so fully. Such firms may, for example, have large revenue streams coupled with relatively small payroll, property or other physical attributes.

The first group mentioned includes start-up firms as well as taxpayers that are “small” as defined by their economic activity, which may be quantified in different ways. Some such small firms may be in the formal sector. Others might be in the informal sector due to their form of organization—family-owned businesses with poor accounting and record-keeping standards (Terkper, 2003). The simplified tax systems of Russia and Ukraine (see below) are in part aimed at these types of taxpayers, with the aim not only of alleviating some of the compliance burden of the complex tax system but also of educating these taxpayers sufficiently so that they may eventually become members of the “regular” taxpaying population. This approach may sometimes make sense, although, as discussed below, a critical question is how and under what circumstances taxpayers should enter into and graduate from such a simplified or presumptive system.

“Ghosts” and “icebergs” exist in all countries. The order of magnitude of the informal or underground sector is difficult to estimate, and a variety of methods can be

⁶ Some of this discussion is prefigured by Bird and Oldman (1990) and Terkper (2003).

used.⁷ The World Bank provides a summary of estimates for various countries (Box 1). The reasons for informal activity are varied. If we take the World Bank's basic distinction of coping or survival activity versus illegal business activity, some elements of both may be the objective of HTT regimes. The former category includes "casual jobs, temporary jobs, unpaid jobs, subsistence agriculture, and multiple job holding" while the latter includes "tax evasion, avoidance of labor regulation and other government or institutional regulations, no registration of the company, crime, and corruption." Many of these activities may of course in part constitute responses to taxes. Tax evasion, for example, may in part be a behavioral response to high tax rates or it arise from trading in illegal goods. Casual jobs may be more a response to undocumented labor than to the tax system per se. A "one-size-fits-all" special tax regime cannot encompass the range of activities included in the informal sector. The problem with devising a regime for small taxpayers is to balance the costs of benefits of including them in the tax system on one hand and to fit the regime to the circumstances of different classes of small taxpayers on the other. What is right for small peasant agriculturists is most unlikely to be right for capturing unreported smuggling income or street peddlers or artisan manufacturers or small family restaurants.

One of the most serious problems with special presumptive regimes, however, is keep out large and medium enterprises that try to look like small enterprises and hide themselves from the taxman's eye. Just as one must ensure that as the small become bigger they "graduate" into the normal tax system, so one must ensure that those in that system already – or who should really be in that system – do not "migrate" into the simplified system and take on the disguise of smallness to shield themselves from taxation. We shall discuss this problem further below.

Apart from the truly small and the falsely small, an additional problem that bedevils many tax system, particularly in developing countries arises from medium and large enterprises that keep losing money but somehow never die. Within this group there are at least two types: enterprises with large deductible expenses relative to positive revenue and those with little or no revenue. The latter group may continue to exist due to government subsidies or other life-support activities. We do not focus on these types of entities. The former group may evade paying taxes by overstating expenses to the extent of zeroing-out tax liability. Knowledge of the tax system, accounting systems and record-keeping are not an issue for this type of HTT group. In this case, the goal of the tax administration may simply be to collect at least *some* tax from such entities, not to educate the taxpayer about the existing system. This calls for a very different type of tax regime. In many countries, that regime has been found by applying a form of presumptive taxation as an Alternative Minimum Tax (AMT).

⁷ The World Bank classifies two types of informal activity: coping activity (survival activity) and unofficial earning strategies (illegal business activities), <http://lnweb18.worldbank.org/eca/eca.nsf/1f3aa35cab9dea4f85256a77004e4ef4/2e4ede543787a0c085256a940073f4e4?OpenDocument>. The International Labour Organization provides a summary of the various units of analysis used in documenting the informal sector, <http://www.ilo.org/public/english/employment/skills/informal/who.htm>.

Box 1 Estimates of the Informal Economy		
Country	Estimate/year	Source
Armenia	70-90 percent of economically active population at least partially in the informal sector	The World Bank (2003 website)
Georgia	28 percent of GDP 1997	The World Bank (2003 website)
Slovak Republic	7.2 – 12.8 percent of GDP, based on 1993 survey	The World Bank (2003 website)
Russian Federation	20-45 percent of GDP, 1998	USGTA (1998)

Approaches to the HTT

Four general approaches have been followed in attempting to deal with this range of HTT problems: presumptive/imputed taxation methods (including simplified systems and alternative minimum taxes), indirect taxation, direct tax administration (enforcement), and legalization of HTT activity (tax holidays and exemptions). We focus in this paper on the first of these approaches, setting out some specific examples in Section 3, but shall also discuss briefly the other approaches.

The presumptive approach

Presumptive regimes may be classified into four basic groups (Bulutoglu, 1995):

1. Systems which estimate taxpayer income and apply a formula to all taxpayers (by type of taxpayer or by individual taxpayer). Estimation of taxpayer income may be a very simple calculation (such as a lump sum tax based on the average income of a particular profession) or a more complex calculation using information on sales, employees, assets, location, etc.
2. Systems which apply an assets tax (either generally for all businesses or as a minimum tax);
3. Systems which apply a gross receipts or turnover tax (either generally for all businesses or as a minimum tax);
4. Systems which base the tax on external indicators of income (personal

expenditures, wealth, etc.).⁸

Which system a country uses is presumably related to its policy objective – for example, to reduce evasion in general or to simplify the system for small taxpayers – as well as on the sophistication of the tax administration, and the data available.

Some presumptive systems calculate taxable income based on key factors presumably are associated with income generation such as sales, turnover, number of employees, size of firm, assets of the taxpayer, etc. The estimated tax base is typically calculated based on coefficients for different factors applied to specific taxpayers or specific types of taxpayers (certain sized enterprises in particular industries), or in some cases on more aggregate indicators, such as industry and region, or external indicators of income. The essential idea is to take advantage of data that are easier for officials to obtain than the information required to calculate actual taxable income as specified by law. In some instances, taxes administratively assessed by presumptive or imputed measures are rebuttable--that is, the taxpayer can prove a lower tax liability through a full disclosure to the tax authorities. As discussed in Section 4, rebuttability has implications for the impact on tax administration and equity and efficiency of the system. Table 1 presents a summary of some presumptive taxes used in various countries.

Simplified taxes. So-called “simplified” tax systems are, as a rule, a presumptive regime that replaces a number of taxes to which activities are, in theory, legally subject by one presumptive levy. In recent years, a number of transition countries have taken this path, consolidating various parts of the tax system into one or two taxes that utilize simpler accounting and bookkeeping rules and regulations. Among the taxes replaced by such regimes may be, for example, payroll, value-added, and profits taxes. We include simplified systems as a separate category owing to their proliferation in transition countries including Kazakhstan, the Russian Federation, Ukraine, and Uzbekistan.

Gross receipts and assets. Gross receipts and assets taxes are in theory straightforward levies on an identifiable component of business activity. Taxes on business assets are not so common, but of course gross receipts taxes have been used in many countries, often as local business taxes. In Colombia, for example, which had a separate tax on net worth since the 1930s, in 1974, two forms of presumptive income tax were introduced: a tax on the income presumed to be generated by net wealth (initially at a rate of 8%) and a similar levy based on 2% of gross receipts.⁹ In both cases, these taxes were applied when the reported income for tax purposes fell below that presumed on the stated basis. These taxes were subsequently abolished, but similar levies, though based on gross assets, became popular in some other Latin American countries also in the 1980s (Byrne; Tanzi and Sadka). [Note: LA material needs to be updated and checked]

AMT. Such taxes are intended to capture at least some minimum level of tax from entities regardless of true net income. In practice, such minimum taxes often become the

⁸ The first three approaches are also widely used for local business taxation, on which see Bird (2003).

⁹ For description and critique of these taxes, see McLure et al. (1988). Colombia has a local business tax which is levied at 1% of gross receipts (Bird, 2003).

very antithesis of a “simplified” tax. Inherently, they require two separate calculations of tax liability – one in accordance with the normal law and one in accordance with the presumptive base – and sometimes, as in the case of the U.S. corporate and individual income taxes, this can be very complicated. Moreover, like some other HTT measures, they sometimes turn out to be not transitory in nature but a permanent fixture in tax systems. Again, the U.S. illustrates the case, in that the lack of indexing has created a situation in which many tax filers need to calculate their alternative minimum tax in addition to their regular tax. Such presumptions make life more complicated, not simpler, although they may perhaps sometimes produce a bit more revenue than would otherwise arrive.¹⁰

The goal of presumptive methods is typically to get start up firms into the tax net (almost as a form of education for the newer taxpayers) and/or to get some tax revenues from other HTT groups. The simplified systems and official assessment systems are aimed at the former while the minimum tax regimes are aimed at the latter. The problems of truly small enterprises may best be dealt with by presumptive methods. Even though the revenue on an entity-by-entity basis is relatively small, the approach may make sense if the administrative (and compliance) cost is sufficiently low. Moreover, presumptive methods can be useful in terms of education provided that the system requires some approximation of the accounting and record-keeping needed in the regular tax system. On the other hand, the AMT approach – whether based on group methods such as gross receipts or group indicators or on an individual basis determined by detailed accounting of expenses -- may help keep some revenue in the system when the HTT are large entities that lose money (or report relatively low levels of taxable income) and the tax administration is, for whatever reason, unable to cope using normal auditing techniques.

Legitimizing HTT status

An even blunter approach to dealing with the HTT than presumption is to legitimize HTT activities by allowing tax holidays and/or exemptions for certain sectors. Exempting the agricultural sector, for instance, would reduce the costs of tax administration for a typically low-yield sector. This solution for the HTT is probably among the more dangerous in terms of compliance with the overall system, however, since exemptions and holidays are difficult to reign in once they are established. In India, for example, where agricultural income is constitutionally excluded from the central income tax, it is simple to hide taxable income by shunting it through the agricultural sector. In general, exemptions and tax holidays create incentives for enterprises or individuals to re-create themselves in the image of exempted sectors. Exempting the HTT may be relatively easy from an administrative standpoint, but one must wonder what the objective of such a “solution” might be. One can always save administrative resources by giving up, but it seems unlikely that this approach makes long-run sense in any circumstances.

¹⁰ Larin () argues that even this is not true with the AMT in Canada – that is, it is complication without the compensation of revenue.

Enforce the law

Another approach to the HTT problem is the exact opposite: simply let the tax administration to do its job and administer taxes. In some countries, for example, one finds that among the most flagrant tax evaders are prosperous professionals – listed in the phone book, with names in professional registries, often with known premises, and sometimes even with much of their business coming from the public sector in one way or another. When taxes are not applied effectively to such persons, it is because the tax administration is simply not doing its job properly owing to corruption or incompetence or else is being prevented from doing so by powerful political figures. Increased enforcement of existing tax law on those in this segment of the HTT is an option to which most countries pay some attention, but where many could do much more provided they (and especially their political masters) really wanted to do so.

In practice, however, many tax administrations concentrate unduly on the larger taxpayers, especially corporations. Why they do so is obvious: as the bank robber Willie Sutton allegedly said when asked why he robbed banks, “that’s where the money is.” Large taxpayers should indeed be monitored closely and good administration requires that close attention be paid to keeping them to the mark in terms of filing, assessment, and collection. But undue concentration on milking the cows already in the barn runs many long-run dangers. Those in the barn will become increasingly restive as the pressure increases. The incentive to kick down the door and escape either by converting into an allegedly off-shore operation or dividing into a group of small entities beyond the reach of the administration will increase. Even it may not appear to be an immediately cost-effective strategy, close attention needs to be paid to auditing small and medium taxpayers to ensure that some big ones are not hiding among their ranks.

Better tax enforcement (and, perhaps, some taxpayer education) is thus one important solution to reaching the HTT. Indeed, one of the principal dangers of simplified regimes may be the false impression that the HTT problem has been solved when in fact it may actually have been made worse by providing a safe haven for would-be evaders. This problem is particularly important because enterprises that hide within such regimes reduce the amount of information available to the tax administration in general. Even if a simplified system for truly small taxpayers may sometimes be justified, close attention must continue to be paid to the normal tasks of tax administration – registration, filing, assessment, audit, and collection – to provide the paper (or digital) trail on which good tax administration rests.

The indirect approach

A final approach to the HTT problem is to use indirect taxes to impose a tax burden on those in the HTT sector. There are several versions of this story. First, at least in developed countries, some argue that, with the exception of services, there is a decent tax handle for taxes on retail trade (see USGTA, 1998, Martinez and Wallace, 2002). In these circumstances, tax administration might be more effective if it simply concentrated on these taxes versus increasing enforcement directly on the HTT sector or instituting a

special tax regime. Second, indirect taxes could potentially substitute for special regimes aimed at the hard to tax sectors to the extent these taxes reach the HTT sector via shifting of the taxes into wages, returns to capital or consumer prices. Small, tax-avoiding manufacturers, for example, may be effectively taxed via indirect taxes to the extent the tax is capitalized in some way that affects the return to capital or labor, which is a function of capital to labor ratios, price elasticities of demand, etc. This argument has been made in the context of Guatemala and Jamaica by Bahl and Martinez-Vazquez (1989?), for example. Of course, it is not hard to think of cases where this is not likely to happen, as with the professional services of doctors and lawyers. More generally, some (e.g. Mathews) have argued that increased reliance on broad-based indirect taxes can be an effective counter to direct tax evasion to the extent that even evaders must spend to live. As Kesselman () has shown, however, this argument cannot be pushed very far.

If final consumption taxes did capture at least some of the economic activity of the HTT sector, we might expect, holding other things constant, that the estimated tax effort of countries with higher concentrations of final consumption taxes would be greater than in countries with less concentration of final consumption taxes. As a simple test of this proposition, we estimated a simple OLS model that examines whether countries with higher portion of excise and consumption taxes in their tax base have higher levels of tax effort (need to explain this calculation). We ran the following model for 112 countries for 1992 with tax effort as the dependent variable:¹¹

$$\text{Tax effort}_i = \alpha_0 + \alpha_1 (\text{excises}/\text{total central taxes}) + \alpha_2 (\text{consumption}/\text{total central taxes}) + \alpha_3 (\text{GDP per capita}) + \alpha_4 (\text{local consumption}/\text{total local taxes}) + \mu \quad (1)$$

We found evidence of higher tax effort in countries with higher excise taxes as a share of total central government tax revenue (below), which may offer some (weak) evidence of the ability to capture the hard to tax via other means. We also tested some simple correlations between excise taxes as a share of GDP and tax effort. For a sample of 96 countries (OECD, transition and least developed countries), there is a positive and significant correlation between the share of excise tax in the economy (excise tax revenues/GDP) and tax effort.

Regression Results: Tax Effort dependent variable

	<i>Coefficients</i>	<i>Standard Error</i>	<i>t Stat</i>
Intercept	1.055764655	0.144420487	7.310352398
Excise	0.009393152	0.005167659	1.917680493
Sales	-0.00231052	0.003178743	0.726865935
GDPpc	-1.63881E-06	3.11808E-06	0.525582495
Consump	0.002134974	0.00182567	1.169419717

R-sq = 0.12, N=112

¹¹ We tried alternative specifications including log versions and different years with similar results.

In many ways, more reliance on indirect taxes may be the best way to capture HTT “ghosts.” Indirect taxation will not bring those entities into the formal sector, but it may increase the equity in tax treatment between the formal and informal sector. For example, if a country relies heavily on indirect taxation and to at least some extent the informal sector may be thought of as being “taxed” via capitalization of indirect taxes on the non-HTT sector, this approach may be useful – although it will, of course, do nothing to bring HTT into the normal system. An important factor in this respect is the importance of the “shadow economy.” In Ukraine, for example, it is estimated that the “shadow” share of economic activity may be as large as the above-ground share known to the authorities.¹² The existence of a large sector of the economy that is effectively not subject to direct taxation may substantially affect how one assesses the equity effects of different fiscal instruments. The value of a highly progressive PIT to which many high-income recipients are not subjected in practice is, for example, far from evident. Indeed, in Ukrainian conditions, it seems plausible that such indirect taxes as the VAT and excises such as those on motor vehicles may well be more progressive than a tax like the current PIT that in reality essentially burdens only a limited group of wage-earners

Although there have been many proposals to reduce the VAT rate in Ukraine to e.g. 17% or 15%, there thus seems to be no good case on equity grounds for reducing VAT rates in Ukraine. Nor is there a good case for such a reduction on efficiency or administrative grounds, since viewed from either perspective the VAT is, or could be, one of the best taxes in Ukraine. One study, for example, found that the “shadow” economy paid perhaps 7% of its value added in indirect (VAT and excise) taxes, compared to perhaps 25% in the “soft” sector of the official economy – agriculture, energy, and many state enterprises – and up to 50% in the less fortunate private official economy.¹³ Reducing VAT would render this already highly distortionary system even less allocatively desirable and drive still more market-based activities into either the shadow sector or the lengthening queue of those seeking relief from the oppressive taxation of non-favored enterprises. A broader VAT base and better administration, extending the reach of the system increasingly into both the “soft” and the “shadow” economies would enable the same revenues to be obtained with lower rates, thus reducing distortion further.

3. Some Illustrative Cases

A few specific country examples help to give a flavor of the various types of special tax regimes used for the HTT sector.

Greece

¹² For a somewhat smaller estimate – a UAH 60 billion shadow economy in 1998 compared to an official GDP of about UAH 100 billion – see K.M. Sultan, “Tax reforms in Ukraine – Gaps and Lessons,” in J. Szyrmer and K. Sultan, eds., *Ukraine through Transition* (Kyiv: Alterpress, 2000).

¹³ Sultan, op. cit.

The presumptive system used in Greece depends on external indicators to impute taxable economic activity. Individuals may be taxed according to imputed income when imputed income is higher than actual income declared, and the taxpayer can not substantiate the difference. Imputed income is calculated based on criteria such as: rent of second home, operating expenses of vehicles, planes, costs of domestic servant, assets (cars, boats, ships, planes). Additions to imputed income as of January 1, 1995 include the purchase of enterprise shares, purchase or construction of immovable property (excluding first residence of up to 120 square meters), and loans to personal enterprises, partnerships, and limited liability companies. (Coopers and Lybrand, 1997 International Tax Summaries).

Bolivia

Bolivia instituted a number of important changes to its tax code in the mid-1980s. In the 1986, a simple tax on gross sales replaced direct and indirect taxes on small enterprises. Additionally, Bolivia introduced a 3 percent levy on net worth, as a form of presumptive final tax. Bolivia's case was fairly unique in that there was no additional corporate income tax. This has since been changed, and the tax is now levied as a presumptive minimum tax.

Ukraine

A "simplified" tax system was established by Presidential decree in 1998 (On Simplified System of Taxation, Registration and Reporting of Small Business Entities) but came into full effect only in 2000. The system applies differently for individuals and enterprises. Both are based on a threshold and a maximum number of employees. For natural persons subject to personal income tax (PIT), the parameters are 500,000 UAH and a maximum of 15 employees; for legal entities subject to enterprise profits tax (EPT) the respective parameters are 1 million UAH and 50 employees. Two options are given in the case of VAT. A combined income and VAT rate is 10 percent on sales (turnover) tax as a proxy for both taxes. Alternatively, a separate 6 percent tax rate is applied on sales (turnover) tax as the proxy income tax and the taxpayer has the right to issue receipts and apply credits as a normal VAT payer.

Some key features of this system are:

- Physical persons are taxed at fixed rates set for different activities by local councils, within the range of UAH 20-200 per month (less than USD 50-500 per year).
- Legal entities under the simplified system pay a single tax of 6 percent on sales (plus VAT) or 10 percent (and no VAT).
- A fixed share (23 percent) of the proceeds from the single tax imposed on enterprises under this system goes to local budgets.

The potential exclusion of individuals under this system is close to 100 percent. Many employees, particularly perhaps higher-income employees, will not find it all that difficult to become independent contractors if they wish to do so.¹⁴ Some have even estimated that from 45 percent-65 percent of existing business enterprises can choose to adopt this system, and probably some of them have already done so. Total collections from this tax in 2000 were only UAH 251 million, or 0.5 percent of budget receipts; by 2001, the comparable figures were UAH 524 million and 0.8 percent. It is not possible to say whether these amounts represent additional revenue – revenue that would not otherwise have been collected – or simply a substitute for taxes that would otherwise have been collected, and hence perhaps really a net decrease, not increase, in revenue.

Along similar lines, a 1998 law On Fixed Agricultural Tax replaced land tax, payment for use of natural resources, and many other taxes. This tax applies to agricultural enterprises including food processors so long as such sales do not exceed 50 percent of gross revenues. The rates are based on estimated land values per hectare as established in the land cadastre and vary by the type of land between 0.1 percent and 0.5 percent. The tax is paid quarterly, and 30 percent of its proceeds go to local budgets. It seems likely that both the fall in the number of land taxpayers and the stagnation in collections from this source in 1999 may be attributed at least in part to the introduction of the simplified tax.

The new simplified system allows a person to be simultaneously a wage earner (normal) taxpayer and a private entrepreneur for "moonlighting" purposes. Scattered evidence suggests that well-informed liberal professions (lawyers, engineers and consultants) as well as many wage earners have quickly become private "entrepreneurs". Reportedly, over a million people had chosen this option by early 2002. To add to the complexity of the Ukrainian tax system, the new "simplified" system was imposed in addition to another "simplified" system that already existed for small traders in the PIT, in the form of the "patent." This option may be used by those whose annual gross income from entrepreneurial activities in the 12 months preceding the grant of the patent is less than 7000 times the legal minimum wage. A person applies for such a patent to the local revenue authority. Local councils may set patent fees between 20 UAH and 100 UAH per calendar month, and all revenues go to the local budgets. The fixed rate tax on a patent to conduct entrepreneurial activities all over the territory of Ukraine is 100 UAH a month. Rates may be increased by 50 percent for each additional person employed.

Russia

Russia's current tax laws on simplified systems include a Single Tax Law (No.

¹⁴ As a recent paper noted about the "dual income tax" systems applied in a number of OECD countries (under which capital is taxed at a flat rate and wages at progressive rates), "wage and salary earners become sub-contractors overnight" (Jeffrey Owens and Stuart Hamilton, "Experience and Innovation in Other Countries," Paper for Brookings Institute Conference on The Crisis in Tax Administration, October 2002). Sometimes tax administrators in transitional countries seem to assume that the control mechanisms of the old command system -- where a worker is a worker and a business a business and the two cannot be confused -- are still in place, but the vestiges of this system that may remain are likely to prove a weak reed in the face of strong financial incentives to change one's status.

222-FZ) and an imputed tax law (No. 148-FZ). The confusion of the special regimes starts immediately with the admission of two tax laws. The Single Tax is aimed at reducing the complexity of the tax system for small businesses by replacing many taxes with one tax, and also reducing accounting and reporting costs. Small businesses qualify for the Single Tax based on thresholds of the number of employees and gross receipts. The system is optional for small businesses and is largely regulated by regional authorities. The current threshold (100,000 minimum monthly wages) is relatively high by international standards. *Individual entrepreneurs* pay a patent fee, which differs based on industry and region. On the other hand, *legal entities* are taxed based on gross receipts or an alternative income calculation (at the discretion of the regional authorities). The alternative income base allows deductions for some inputs, but not all.

The current law on the Uniform Tax (imputed income tax, Federal Law No. 148-FZ: Imputed Tax) specifies the requirements for imposition of the uniform tax. The tax applies to a variety of industries, and imposes eligibility restrictions based on number of employees only for certain industries (public catering, retail trade, and transportation services; taxi cab services were added later). If a particular firm is eligible for both the single tax law and the uniform tax law by virtue of its size or gross receipts, the firm itself may choose either tax. Under the Uniform Tax, a tax rate of 20 percent is applied to imputed income, which is calculated via a complex formula. The formula is based on the following factors (among others): location, quality of services, quality of premises, distance from highway, inflation, and seasonality. The actual calculation is at the discretion of regional authorities. The tax takes the place of most taxes, with the major exceptions of: state duty and customs duty, land tax, tax on purchase of foreign currency, and withheld income tax and VAT.

Some Other Experiences

Uruguay, Angola, Cameroon, and Morocco – among others -- all have experience with presumptive taxes, specifically on small businesses. In these countries, small businesses are defined by turnover (Uruguay and Angola), or include a large component of the service sector (Cameroon and Morocco). These systems are of the most straightforward presumptive systems where few calculations are required and administration is relatively inexpensive.

4. THE DESIGN AND EFFECTS OF PRESUMPTIVE TAXES

How well any special regime for the HTT functions depends on both the design of policy and its execution. Assuming that the principal aim of such a regime is to move the HTT onto the tax roll and keeping them there, there are several important issues to consider.

The Threshold Issue

Most presumptive tax methods have two thresholds. Below some level, entities are untaxed. Above that level, they are in the presumptive system. Above some other level, they are out of that system and in the normal tax system. These critical thresholds may be stated in terms of assets, receipts, or employees. Too high a threshold undermines the regular tax system and invites too many participants into the special regime. On the other hand, a threshold that is too low may not serve such stated goals of the special regime as simplifying the tax barriers to business entry. Thresholds should be revised systematically so that they continue to achieve their goals. Thresholds in gross receipts terms, for instance, are often defined in nominal terms with no provision for indexing. As the years pass by, the economy grows, and inflation may perhaps run rampant, the threshold in real terms may become so low that the special tax regime is effectively eliminated. While this may sometimes be an acceptable outcome – if the idea is to move everyone into the normal regime over time in any case -- it would seem advisable to achieve this goal deliberately rather than, as it were, by accident. On the other hand, in the case of minimum taxes where the tax is imposed for those above a threshold, non-indexation has the perverse result of more and more “regular” taxpayers being subject to a special tax regime.

Most special regimes do not include explicit plans for growing the objective taxpayers out of the special system into the normal system of taxation. This serious design flaw in many countries increases the potential unintended impacts of special regimes. It can also hinder the success of a special regime in achieving its stated goals. A few countries place limits as to the number of years that a taxpayer can be taxed under the alternative presumptive scheme. But very few countries set the tax levels or rates of the imputed system high enough to encourage taxpayers to “move on” to the regular tax system. On the contrary, the political economy of presumptive systems almost guarantees that the taxes applied by such regimes will make them a favorable place to stay and provide no incentive to ever graduate.

The argument is simple. Essentially, like any line drawn in the tax sand, there are Type I and Type II errors in setting up a presumptive system – some will be included who should not be and some will be excluded who should be included. If the tax “presumed” is below the “real” tax – that due under the normal tax system -- those who are “really” small taxpayers and are excluded will clamor to be included; the others will be silent. But if the presumed tax is above the “real” tax, everyone in the system will scream in protest. Lowering the rate of presumption will silence such protests, but at the expense of increasing the “over-inclusive” error, which has no similarly self-corrective feature. Combining unduly low presumptive rates with (the usual) failure to apply normal tax administration procedures (such as audit) to simplified taxpayers simply aggravates the problem, and makes it even more attractive for people and enterprises to migrate into the safe harbor of the simplified system.

In principle, a country may choose to phase out eligibility of specific taxpayers, for instance, by establishing a limited period of eligibility for a simplified system, or it

may phase out the presumptive tax system entirely. If “education” – bringing taxpayers up to the point at which they can enter the regular system -- is a goal of the special regime, for example, those in the regime might be assumed to graduate automatically after a certain number of years. Or all those in the system might be required to, as it were, requalify by passing a special audit every five or ten years. Graduation might also be facilitated by some version of the Japanese (and Korean) system of awarding certain fiscal privileges, such as depreciation of assets, only to those who enter the regular tax system (Kelley and Oldman). Much the same effect can be achieved by the popular device of “tax clearance certificates,” required in many countries to obtain certain things such as passports, liquor licenses, and the like, by providing that only those filing regular tax returns can qualify, although this treatment may be considered too discriminatory against the truly “small” – though are they likely to travel abroad? – to be acceptable.

Rebuttable or Not?

Whether or not presumptive taxes are rebuttable is another important design issue. Non-rebuttable systems, where administrative assessments cannot be challenged by the taxpayer, may be unconstitutional in some countries. Even if they are legal, they might be considered political intolerable or too inequitable – for example, when a natural disaster destroys a business but the tax is still liable. As a rule in such cases taxpayers are able to present evidence to the tax administration to substantiate a lower tax liability. Rebuttable taxes may have greater acceptance by taxpayers. They may reduce – or increase (if the result is many appeals and adjustments) -- costs associated with legal battles. They certainly increase compliance costs since, like AMTs, rebuttable presumptive taxes in principle require taxpayers who wish to minimize liabilities to calculate taxes under both the regular and the presumptive system to determine which is lower. In practice, however, since the political forces mentioned earlier almost invariably – absent natural disaster or equivalent economic upheavals – ensure that the presumptive levy is lower, this last factor is unlikely to be important. Indeed, one reason why rebuttable presumptive taxes are usually set too low is precisely to reduce or eliminate administrative and legal arguments. In effect, setting presumptive levies “too low” gives them the legal veneer of rebuttable taxes and the practical effect of non-rebuttable ones, thus providing a much desired “quiet life” to both taxpayers and administrators -- albeit almost inevitably at the expense of both equity and revenue.

How Effective are Presumptive Taxes?

It is difficult to evaluate the success of special tax regimes in achieving their goals, whether the goal is increased participation in the formal tax system, getting some basic level of revenue from all economic agents, educating new taxpayers, or reducing compliance costs for at-risk taxpayers. Simply tracking revenues before and after the imposition of a special tax regime seldom serves to answer the question because many of these regimes yield little revenue and other changes to the tax system are difficult to control.

Special tax regimes for the HTT might be considered a success in principle if they yielded the following scenario. A small, start-up firm is outside of the tax net. A special tax regime is instituted with one stated aim being to encourage such firms to become part of the formal sector and to educate them to the point where they are able to do so. The firm stays on the simplified system for a limited period and then graduates to the regular tax system. Such a special regime would clearly be a failure if it encouraged entities that had previously participated in the regular tax system to move to the special regime. It would also be a failure from an educational perspective if firms stayed on the regime for year after year after year. Finally, since another aim of most special regimes is simply to increase revenues, it would also no doubt be considered a failure if its long-run effect on revenues, compared to what would have happened in the absence of the system, is negative.

While it appears that no existing regimes have been examined carefully from any of these perspectives, there is good reason to expect that most of them would fail all of these tests. The firms that are in such systems may like them, because they shelter them from some of the complexity of the tax system and the rapacity of some tax officials. The tax administration as a whole may like them because they no longer have to deal with all these troublesome low-return taxpayers and can concentrate on the big ones, where the money is. Politicians may like them, because the small taxpayer community is large and vociferous and because they think it costs them little or nothing in terms of revenues or is perhaps even a revenue gainer. But anyone concerned with the equity, efficiency, and long-term development of sound taxation should be much less sanguine.

Most forms of taxation imposed on business tend to impose economic costs by distorting decisions on such matters as the decision to incorporate, the debt-equity ratio, dividend policy, and where and how much to invest. Business taxes may also impose significant costs and barriers to the expansion of new and small firms. Taxation of individuals may distort labor supply decisions, savings decisions, and consumption decisions. Special tax regimes intended in part to reduce the costs – mainly the compliance and administrative costs – of taxation may also paradoxically impose some costs themselves in terms of economic efficiency because the systems are not well designed or well integrated with the current system.

Consider first the various presumptive methods used in special tax regimes. As we noted above, there is at least one major distinction to be made among these methods. The “simplified” tax approach would appear best suited for education-related objectives (for small entities including small start-up firms), while the minimum tax approach is more useful for getting money out of well-educated entities. If the indicator approach is used for more sophisticated entities, the education goal is not relevant. Simplified methods that are broadly applicable may encourage sophisticated firms to take advantage of either lower tax rates or lower compliance costs (direct or indirect through lower probabilities of audit if, as is often the case, this is a de jure or de facto condition of the special regime). Not only is much of the purpose of the special regime lost, but tax revenues are likely to suffer. In Russia, for instance, Wallace (2003?) estimated that the difference in average tax rates for firms under the simplified tax and regular systems was

9 percentage points in 1999. In response to this incentive, firms “morphed” into those types that were supported under the special tax regime.

On the other hand, special tax regimes that define eligibility very narrowly may worsen the horizontal equity of the general tax system. Minimum tax systems may have this impact. If the minimum tax calculation is based on a presumed, average relationship between assets and net income, for example, some firms will be treated more harshly than others owing to differences in their ability to use assets to generate net income. If the goal of the minimum tax was to insure some tax payment, the goal might be reached in the short-term but in the long-run, unintended advantages may be given to certain firms and not to others. Of course, from the perspective of national efficiency, the stimulus to shift assets into hands which put them to better use might be considered to more than offset any perceived inequity resulting from this effect.

Another concern regarding the impacts of special tax regimes is the implication for tax compliance at large. A traditional tax system relies on both enforced compliance and voluntary compliance. The education goal of special tax regimes is to bring HTT sectors into the tax net and to encourage participation in the regular tax system. A special regime that does not graduate its students may undermine the tax system as a whole and instead of expanding the regular system end up creating a new generation of taxpayers who rely on special tax regimes for their existence. Since, as noted earlier, all pressures in developing such regimes tend to make them impose taxes that are – bar the exceptional case – lower than those that would be imposed by the regular system, the result is not only to reduce revenues but also to maintain resources in activities that are more tax-efficient than economically efficient. Even well-designed special regimes that graduate their taxpayers to the regular system can be a drag on the tax compliance of those in the regular system if the special regime is seen as “too preferential.”

Moreover, some so-called “simplified” systems are actually very complicated, notably those which impose AMTs. Theoretically, more complication may or may not reduce compliance; in practice, however, there is at least some evidence that it may reduce compliance (Martinez and Wallace). Mexico’s simplified system is a case in point on the implications of special regimes for the hard to tax sector. Before the 2002 tax reform, small enterprises and sectors such as agriculture and transport were subject to a “simplified system” of presumptive and cash-flow taxation. These businesses could use a cash-flow accounting system such that tax was not paid on retained earnings, but simply on money taken out of the firm. As noted in World Bank (2002), this system increased possibilities for tax evasion and complicated the structure of the entire tax system since certain industries were allowed the cash-flow taxation and others were not. Transfer pricing schemes permitted significant tax avoidance under this scheme.

An Example: Ukraine

Similarly, in Ukraine, the new simplified system described in Section 3 above presents a host of problems. The mainstay of Ukraine’s tax system is the VAT. This simplified system, however, creates a major problem for VAT in that the 10 percent

simplified regime breaks the VAT chain at a relatively high threshold. Many transactions are thus legally outside the VAT system. Invoices issued by tax payers who take the 10 percent option cannot be credited by purchasers. Invoices issued on the purchases of these taxpayers by regular VAT sellers are worthless to them—but may of course be used by other taxpayers if sellers agree to issue them in their name, a practice that seems likely to emerge in Ukraine, given its huge shadow economy.

On the other hand, maintaining the chain in the case of the 6 percent regime brings all the VAT complexity to the small taxpayer and implicitly assumes that these taxpayers have the sophistication needed to comply with the VAT common regime. This approach is inconsistent with the notion of simplicity that inspired the system. It makes little sense to consider a person capable of VAT and incapable of income tax compliance in the same article of the law.

In the case of wage earners, the simplified regime may mean in some cases the elimination of social security contributions as part of labor costs to their employers. Given the possibility to substantially reduce the tax burden provided by the simplified system, this creates an incentive to drop out of the payroll even at the expense of losing some social security benefits. This may be particularly true for young workers who do not think of old age as a real possibility and can in this way defer their contributions until later. If this were to happen, both PIT and social security would erode substantially.

For those who remain in the PIT system, the dual connection— simultaneously being a wage earner (normal) taxpayer and a private entrepreneur for "moonlighting" purposes— allows taxpayers to keep their social security contributions and benefits while having a very low rate on marginal income. In terms of tax administration, the system demands additional work because of the additional required registrations and returns.

In the case of the enterprise tax, the 1 million UAH threshold, although not high, may create an incentive to subdivide companies into smaller units, particularly since, as suggested earlier, the limit on the number of employees would seem to be a relatively soft constraint given the exit possibilities for wage earners.

The change in the mandate of tax administration is potentially large in terms of registration and audit of taxpayers. The quarterly returns required in Ukraine imply considerable data processing, and it seems unlikely that much follow-up of taxpayers would be possible. Perhaps the main administrative impact, however, is the total elimination of any real audit possibilities for many taxpayers.

Given the magnitudes involved, the new system creates important risks of migration to the least expensive system within the parameters of the law. The substantial initial threshold created for individuals blurs the focus on truly *small* taxpayers, since almost all PIT payers in principle would be eligible (in terms of "turnover"), provided they could change their "employee" status, as many, particularly higher-income people, can do. Probably over 90 percent of natural persons are below the income range selected as the dividing line. This threshold was about 300 times the (annual) minimum wage in 2000, when the system was created and about 250 times that in 2002. Moreover, it seems

contradictory to include formally created enterprises (legal entities) in a regime created for small “informal” businesses. To do so amounts to "informalizing" for tax purposes what, at the taxpayer's initiative, has already been formalized for other purposes. To establish a legal entity requires at least two key formal steps, preparing a statutory document and opening accounting books. In addition, once created, legal entities are obliged to register in the local (rayon) business registry as well as with the STA and the social security system. All these steps imply the existence of a minimum business capacity well above that of a really small individual private entrepreneur.

From a compliance perspective, the prime areas of risk with the simplified system are the incorrect categorization of income levels, existing taxpayers shifting from normal taxing arrangements to take advantage of concessional rates, and abuse of the system by migration from employment, or the restructuring of legal entities to meet threshold requirements. Finally, and ironically, as established in Ukraine the “simplified” system seems to ignore the real needs of small taxpayers. Small private individual entrepreneurs may know well the trade they are in (butchers, bakers, plumbers, carpenters, mechanics, etc.) but not be good with book keeping and management. Such entrepreneurs should have a system that helps them easily solve their tax problems without the need to incur compliance costs related to professional services to file returns and keep the records. At the same time, however, they should be encouraged to “grow” out of this system and into the normal tax system. Since information is the lifeblood of taxation, they should at a minimum be expected to maintain basic sales and purchase records and should be subject to periodic audit and re-evaluation. Ideally, they should be encouraged by both carrot (possible access to some incentives, access to certain types of licenses, etc.) and stick (periodic audit and re-evaluation, presumptive tax rates that are high enough to make it worthwhile to move out of the system over time). None of these requirements seem to be met by the present system.

Another Example: Russia.

The system in Russia is also quite generous in terms of its reach to business regardless of size. It is also confusing in that some enterprises can choose between the Simple Tax and the Uniform Tax (or presumably, the usual set of taxes). The different treatment of entrepreneurs and legal entities may bias one type of taxpayer against another; entrepreneurs pay a patent fee as total liability, legal entities pay a patent which is creditable against the Single Tax. Since the actual cost of the patents is set by the regions, it is difficult to say which type of taxpayer is disadvantaged. Additionally, legal entities under the Simplified System of Taxation pay the Single Tax on a base of either gross receipts or aggregate income. The choice is at the discretion of the regional authorities, which is not necessarily bad if the same rules apply uniformly throughout the region. However, such discretion may invite negotiation of the tax paid and therefore remove some of the potential gains of such a system.

A qualifying small business subject to the Single Tax must pay value-added tax and sales tax on its inputs, but may not charge VAT or sales tax when goods are sold. Thus, these businesses can not receive a credit for VAT paid. These firms become less

competitive as a result vis-a-vis firms selling to VAT and sales tax payers. The law may be amended to exclude the VAT and sales tax from the Single Tax. Alternatively, a threshold may be set to exempt small entities from the VAT all together.

The threshold for the Single Tax is relatively high at 100,000 times the minimum wage. The threshold is potentially unpredictable if the official minimum wage is not adjusted in a timely fashion. The threshold may be based in currency equivalent units, tied to the exchange rate of the Central Bank. The Government may want to consider that certain taxpayers may not ever transition to the regular tax structure, and as such, the threshold should not be too high.

The current system includes no incentive to move to the regular tax system. Such an incentive may be created by establishing a tax liability under the simple tax that is closer to the average for the regular tax. An additional incentive may be introduced to encourage taxpayers to move to the regular system via a one-time credit or deduction for the individual or enterprise income tax once the taxpayer moves off of the simplified system to the regular system. The credit may be justified on the basis of supporting the initial fixed costs faced by a business of complying with the more complicated regular structure. This should be extended to all taxpayers who move from the simple tax to the regular tax.

The Uniform Tax Law sets a high standard for accounting and bookkeeping. In Russia, gross assets may be quite difficult to estimate and therefore gross revenue may be a more simplified estimate of economic activity, at least over the next decade. The current law requires sophisticated accounting, which may eliminate the benefits of the simplified regime. As an alternative, the tax base may be based on an imputation method that is simpler than that in current law. Additionally, regions should not be allowed to alter the basic calculation. This could then serve as the presumptive minimum tax base.

The fact that the current tax defines eligibility based on very specific industry classifications is likely to be another contributing factor to abuse. In Russia as in many countries, the fine distinctions of industry are very difficult to evaluate in practice. If the law were extended to all businesses (legal and entrepreneurial) the potential abuse of misclassification would be reduced.

The current system provides few incentives or “education tools” to transition to the regular tax system. One potentially helpful link between the imputed system and the regular tax system would be as follows. If the imputed tax were changed to a presumptive minimum tax (based on assets for example), a deduction (or possibly a credit) of this presumptive minimum tax for enterprise profit tax and individual income tax (for entrepreneurs) could be allowed only be taken for cash-tax paying enterprises. This creates two incentives: first, to comply with filing for the income taxes, and second, to pay the enterprise profits tax in cash which has been an added difficulty in Russia.

5. CONCLUSIONS

The title of this paper suggests that it may not be so hard to tax the “hard-to-tax” after all. Much of the text of the paper discusses the role of presumptive regimes in tackling this task. Table 2 sums up much of the argument. Before summarizing our key conclusions, however, one aspect not previously discussed needs to be mentioned. Implicitly, much of the discussion of the HTT both in this paper and more generally seems to envision a normally-distributed universe of potential taxpayers. Thus, for example, we earlier mentioned the very rich, who may be “hard to tax” in some ways especially in some countries, implicitly assuming that there were not many of them, but they had a lot of potential tax base at their disposal. At the other extreme, we discussed the bottom of the tax base – the “small” – as though there might be a lot of them but in total they were not likely to account for much of the total potential tax base. In the middle, we focused on potential evaders who might hide themselves in one or other of the HTT “safe harbors” found in most systems, and we expressed considerable concern about the potential loss of revenue if simplified presumptive regimes led to much migration of such taxpayers out of the regular system in part because we implicitly assumed that the bulk of the potential tax base likely lies in this vast middle range.

And so it does in most developed countries. But is the same likely to be the case in developing or transitional countries. While we know far less about this question than we should, it is not hard to envision several quite different scenarios. Consider first a classic post-colonial low-income developing country, with a marked bimodal income distribution – most people are very poor, a few (those who have taken over from the colonial system) are quite rich, and there is essentially no one in the middle. In such a case, the concept and role of a presumptive system might be quite different than implicitly assumed here. Most people are poor, usually peasant agriculturists, nomadic herders, or in urban areas itinerant hawkers and peddlers, or day laborers. Such people have little taxable capacity. At best, some simple form of head (or equivalent) tax might be levied as a rough – often exceedingly rough in more senses than one – way to plug them into the public economy and to secure some scant revenues to provide at least some (equally scant) services especially to their children and help to start them on the way out and up of their dismal situation. In rural areas, an equivalent might be a low-rate simple land tax, perhaps classified by broad type of land (Bird, 1974).

At the same time, at the other end of the spectrum, those who make and enforce the laws are the rich of such societies and are most unlikely to be willing or able to impose high direct taxes on themselves, especially since they can and usually do opt out of the miserable services provided by the public sector. Short of a revolution, probably the most efficient, equitable, and productive tax in circumstances like this is as broad-based an indirect tax as feasible, coupled with some accepted excises on “luxury” goods. Small businesses in this world are most likely best taxed by some local or regional levy – a form of generalized benefits tax (Bird, 2003) such as the Kenyan Single Business License system (Kelly and Devas, 2002). At the same time, however, some attention needs to be paid to “growing” such businesses over time into a relatively low rate regular corporate income tax – one will in any case be needed to deal with foreigners (Bird, 2002)

-- and their employees into the similarly low rate PIT (wage tax) that should presumably apply both to employees of larger firms and presumably public agencies. There would seem to be little role for much use of presumptive systems beyond the small business sector in this scenario, and the major task facing the tax designer from this perspective is to ensure that there are adequate carrots and sticks to move business income up from one system to another as time goes on. To do so, emphasis should clearly be put on the “educative” aspects of the small business system, on setting appropriate thresholds both to enter and to leave this system, on requiring minimal record-keeping and providing for some periodic evaluation to prevent freezing taxpayers in this regime.

A quite different scenario is that in some transitional countries, where the problem at the upper end may not be all that different in some respects but the basic economic structure is quite different, with a wide spectrum of enterprises operating actively in both the official and the underground economies. Most of these are countries in which both literacy and numeracy are very high and there is in principle no reason why anyone cannot comply with a “normal” tax system. The problem, however, is that the tax system is not always normal, both because it has been unduly complicated by a variety of special regimes and because it is currently administered in what often seems to be an unduly arbitrary way, in part because of the continuous pressure to generate more and more revenues from a shrinking official tax base. In such circumstances, it is quite understandable that almost everyone wants to get out from under the tax system and find a safe haven wherever he or she can. Nonetheless, even though it may be politically unavoidable to create some “simplified” systems in such countries, it is critical from the perspective of developing a sustainable fiscal system that much more care is devoted to exactly how this is done. Systems such as those now in place in Ukraine and Russia, for example, have the potential of destroying rather than fostering the regular tax system. An additional feature in such countries that is less important in (say) most sub-Saharan African countries is likely to be some form of AMT (probably assets-based) to buttress the weak tax administration in dealing with the many economic whales (icebergs?) that currently seem to be fiscal minnows.

In these circumstances, just as there should be a large taxpayer office (LTO) with the task of keeping the big taxpayers up to the mark in revenue terms, so there also should in principle be a small taxpayer office (STO). Such an STO would appear to have several critical tasks, none of which seems to be well done at present in most transitional or developing countries. For example, a good STO should (1) make the life of small taxpayers easier than it would otherwise be (though not necessarily more lightly-taxed!) by reducing the opportunity for harassment and the complexity of the rules, (2) make the life of field officials easier (if not necessarily more financially attractive) by establishing indicators that they can verify easily, (3) make the tax system as a whole more efficient and equitable by estimating carefully the income (or sales) imputed on the basis of such indicators, ensuring also that the indicators are periodically adjusted to reflect changing conditions, and (4) ensure that persons in the small taxpayer system (STS) both keep minimal records and are periodically reviewed and upgraded as appropriate in both record-keeping and the extent to which they are in the regular system, until full graduation.

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Table 1
Presumptive Taxes for Small Businesses

Country	Tax Treatment	Conditions
Belgium	Small businesses: Flat rate for three years	Forfait scheme applying to small businesses based on profession (1992) for income below BF 100,00
Greece	Small businesses: Flat rate applied to purchases and receipts	1992
Spain	Small businesses: Forfait scheme for twenty-eight industries	Began in 1992
Bolivia	Other small businesses covered by a standard flat rate tax	Tax base: sales minus limited expenses
Israel	Small businesses in two sectors: Transport (no threshold)	Tax Base: Turnover
Mexico	Retail and artisans (threshold of \$4,000 turnover)	Tax Base: Total income
Uruguay	Small businesses and professionals (no threshold): Tachiv applies to 140 occupations	Tax Base: a mix of total turnover and inputs
Angola	Small businesses and professional: all industries at a standard percentage	Tax Base: cash flow
Cameroon	Small businesses: all industries with turnover less than \$22,000; taxed as a flat amount	Tax Base: Turnover
Morocco	(unindexed)	

Small businesses: all industries with turnovers
less than \$20,000

Tax Base: Turnover

Small businesses: service sector

Tax Base: Flat presumptive amount

Small businesses: service sector

Tax Base: Turnover, taxed as a fixed percentage

Table 2 Dealing with the HTT Sector

Problem	Characteristics/Objectives	Solution	Efficiency issues	Equity Issues	Tax Administration	Weaning from the System
Very small enterprises	Low record-keeping capacity, facing potentially complex system. Objective is to “educate” them into normal system, to encourage more efficient ones to grow (and implicitly discourage less efficient ones) but not to create excessive inequities, and to collect some revenues	Some form of presumptive simplified regime	Lump-sum tax has some positive efficiency benefits in principle but not likely much in practice	Lump-sum (with respect to any tax period) taxes are inevitably both horizontally and vertically inequitable	To design and keep up to date such systems requires a small well-qualified STO staffed by economists and administrators	Critical to keep “presumed” level high enough to encourage movement out; also to periodically evaluate all those in system to ensure true eligibility
Tax evaders – Ghosts and Icebergs	Get the ghosts in the system and reveal the true size of the icebergs	Normal tax administration methods, supplemented by AMT. The indirect tax approach may be the best in some instances	Assets-based AMT may have some positive efficiency aspects	More reliance on indirect taxation may, if these problems are widespread, actually increase the overall equity of the system	Emphasis is traditional TA reform – facilitate and monitor compliance and enforce law	N.A. – these people should never be in the presumptive system (except for the smallest “ghosts”)

The upper-echelon HTT	The problem here is twofold: lack of political will and difficulty of policing transborder transactions	To coin a phrase, “Just Do It.”	Can be large efficiency losses if real resources driven offshore so care is needed. Low-rate broad-based approaches obviously best	Essential to do something about this problem if tax system ever to be politically sustainable in long run	Requires considerable sophistication (even if get full political support) – need to focus effort and do it as well as possible	N.A.
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