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**THE TAXATION OF SMALL BUSINESS IN  
DEVELOPING COUNTRIES**

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*Thesis submitted in fulfilment of the requirements for  
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**This thesis is dedicated to my mother, Anowara Khatoon**

## ABSTRACT

The thesis attempts to explore an efficient policy and administrative framework to tax the small businesses in developing countries. In order to approach the policy and administrative problems concerning the taxation of small business in developing countries this thesis asks

*How can small businesses be efficiently taxed in developing countries?*

This thesis over eight chapters qualitatively explores this research question. The analyses conclude that first, in a typical developing country a well-designed simple to follow presumptive tax regime is more efficient than the actual account based tax system.

Second, this thesis argues that the noncompliance of small businesses in developing countries may not be adequately explained by the standard expected utility based compliance models. The leading tax compliance models which mainly emphasise on the perceived reward from evasion might ignore some crucial factor that constitutes the tax compliance environment of small businesses in developing countries. This thesis illustrates broadly the typical tax compliance environment of small businesses. It argues that a simple to follow tax system that requires a minimal level of taxpayer compliance would attract a section of small taxpayers into the formal tax net.

Third, this thesis demonstrates that there are crucial differences between typical urban and rural businesses. A small business tax regime should have a separate set of presumptive instruments for each class of small business in order to make an efficient estimate of their economic activities.

Fourth, this thesis analytically examines the presumptive methods and their practical applications. The findings suggest that in developing countries

presumptive tax methods have been adopted mostly in arbitrary manner, without the objective considerations to many crucial design issues.

Fifth, this thesis has developed a focused analysis on the taxation of urban small businesses in the contexts of developing countries. This thesis analyses some crucial characteristics of urban small businesses and stresses that enterprise formalization should be a key element of urban small business tax policy. For a meaningful expansion of the tax net, tax administration should put more focus on urban small businesses as these businesses have relatively more potential to grow as more stable and sustained taxpayers. This thesis concludes that a turnover based presumptive taxation is more efficient to tax the urban small businesses.

Lastly, this thesis explores the issues concerning the taxation of rural small businesses. This thesis reports that the overall tax burden on the agricultural income had substantially declined over the last few decades. Developing countries should not ignore the tax potential of the rural taxpayers. In a typical developing country an asset based presumptive tax system is more efficient to tax the agricultural income of the rural small businesses. This thesis has argued that it would be more efficient to adopt a single asset based presumptive income tax replacing all the prevailing taxes on the agricultural income such as agricultural land tax, wealth tax and income tax.

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## **LIST OF ACRONYMS**

ADB	Asian Development Bank
ANZCERTA	The Australia-New Zealand Closer Economic Relations Trade Agreement
BDT	Bangladesh Taka
CARICOM	The Caribbean Community
CIT	Corporate Income Tax
CNG	Compressed Natural Gas
ECR	Electronic Cash Register
EU	European Union
FAT	Fixed Agricultural Tax
FIAS	Foreign Investment Advisory Service
GDP	Gross Domestic Product
GNI	Gross National Income
GNP	Gross National Product
GST	General Sales Tax
HTT	Hard to Tax
IFC	International Finance Commission
IMF	International Monetary Fund
ITO	Income Tax Ordinance
LTO	Large Taxpayer Office
LTU	Large Taxpayer Unit
MERCOSUR	Mercado Comum do Sul
MAT	Minimum Alternative Tax
NAFTA	North American Free Trade Agreement
NBR	National Board of Revenue
OECD	Organisation of Economic Co-operation and Development
PIT	Personal Income Tax
PPP	Purchasing Power Parity
Rs	Rupee

SAS	Self-Assessment Scheme
SME	Small Medium Enterprise
STO	Small Tax Office
TRA	Tanzanian Revenue Authority
TAS	Tanzanian Shilling
USD	United States Dollar
UAH	Ukrainian Hryvna
VAT	Value Added Tax
WTO	World Trade Organization
ZMK	Zambian Kwacha

# CHAPTER 1

## INTRODUCTION

### 1.1 Background

Small businesses are considered a very important element of any country's economic environment. There would be little disagreement over the need for creation of favourable business environment for small enterprises. In developing countries, there are growing concerns over the need for creating a business environment conducive to growth of small and medium enterprises. Small businesses generally receive little attention from tax administrations as they regarded as hard to tax and they provide little of a country's overall revenue. Taxation of small businesses is even more challenging in developing countries where the administrative capability of the taxation authority is relatively weak, the size of the shadow economy<sup>1</sup> is large, the level of tax compliance is poor and general tax morale is low.<sup>2</sup> In these countries administrative and policy issues regarding the taxation of small businesses are widely ignored, and has rarely received prominence in tax debates and academic discussions.<sup>3</sup>

Developing countries are persistently suffering from an inadequate supply of tax revenue, either in absolute terms relative to aggregate output. Despite considerable potentials many developing countries fail to raise enough

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<sup>1</sup> Shadow economy is alternatively called cash economy, black economy, underground economy, grey economy, informal economy and so forth. However, distinctive specifications are often used to define each of these terms. A definition of shadow economy is provided at Section 1.8 of Chapter 1 of this thesis. Also Section 4.2 of Chapter 4 contains a detailed discussion on the scope and definition of shadow economy.

<sup>2</sup> Chapter 2 has a detailed discussion regarding the overall taxing environment in developing countries. Section 4.2 of Chapter 4 points out that the size of shadow economy in developing countries is generally large.

<sup>3</sup> Michael Keen and David Butler, 'Taxing SME' (Paper Presented at the International Tax Dialogue Conference, Buenos Aires, 2007).

revenues.<sup>4</sup> Only a very few persons file income tax returns.<sup>5</sup> The tiny size of the formal tax net suggests that most potential taxpayers operate in the shadow economy. Small businesses are the key participants of the shadow economy,<sup>6</sup> and their taxation seems highly linked to the problem of taxing the shadow economy. Small businesses often identify taxation as a core obstacle for business growth and operation.<sup>7</sup> From the other side, tax administrations often find taxing the informal sector costly and economically unfeasible. As a result, countries with a low level of economic development often show a greater reliance on the indirect taxes. Emran and Stiglitz<sup>8</sup> stress that the worldwide focus on value added tax (VAT) as the main instrument of indirect taxation causes inefficiency in resource allocation and affects long-term growth, since it drives firms from the formal economy to the informal one.

Developing and transition countries widely use various methods of presumptive taxation to deal with small taxpayers. Presumptive taxes are rarely found to be more efficient than the standard regime in raising revenue. However, Bird and Wallace<sup>9</sup> point out that it is not proper to judge the success of presumptive taxation solely on the basis of revenue productivity. A proper application of presumptive taxation might fulfil many other important objectives, such as bringing start-ups into the tax net early, simplifying processes, reducing compliance costs, promoting of a sense of fairness, and encouraging certain hard-to-tax (HTT) sectors to participate in

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<sup>4</sup> See, eg, Roy Bahl, 'A Regression Approach to Tax Efforts and Tax Ratio Analysis', IMF Staff Papers No 18 (1971).

<sup>5</sup> Table 2-2 of Chapter 2 illustrates that only less than 3 per cent of total population of selected developing countries files an income tax return.

<sup>6</sup> Jan L. Losby, Marcia E. Kingslow, John F. Else, Elaine L. Edgcomb and Erika T. Malm, 'Informal Economy Literature Review', The Aspen Institute, Washington, D.C. (2002). Available at: <[http://www.kingslow- assoc.com/images/Informal\\_Economy\\_Lit\\_Review.pdf](http://www.kingslow-assoc.com/images/Informal_Economy_Lit_Review.pdf)>.

<sup>7</sup> Mirjam Schiffer and Beatrice Weder, 'Firm Size and the Business Environment: Worldwide Survey Results', International Finance Corporation Discussion Paper No 43 (2001) 14.

<sup>8</sup> Shahe M. Emran and Joseph E. Stiglitz, 'On Selective Indirect Tax Reform in Developing Countries' (2005) 89 *Journal of Public Economics* 599-623.

<sup>9</sup> Richard M. Bird and Sally Wallace, 'It is Really so Hard to Tax the Hard-to-Tax? The Context and Role of Presumptive Taxes' in J Alm, J Martinez-Vazquez and S Wallace (eds.), *Taxing the Hard-to-Tax: Lessons from Theory and Practice* (Elsevier, 2004) 146.

formal systems.<sup>10</sup> The success or the failure of a presumptive tax depends on the objectives that a developing country wants to achieve from it. Also, presumptive tax provisions are often adopted without a systematic consideration of many crucial policy and administrative aspects. In this situation presumptive regimes fail to fulfil both the revenue and the non-revenue objectives. Still a substantial part of the population in developing countries is based in rural areas. Liedholm,<sup>11</sup> surveying a number of developing countries, demonstrates that more than half of the SMEs operate in rural areas. It seems that there are considerable differences in typical rural and urban businesses in terms of many key characteristics such as business concentration, assets structure, business transaction process and compliance attitude.

Taxing noncomplying small businesses in an administratively efficient and economically feasible manner is a challenging issue for developing countries. Many developing countries are very eager to improve the low tax-GDP ratio. It would not be prudent to concentrate only on the largest businesses for the collection of tax revenue and ignore the tax potential of smaller ones. Table 3-5 of Chapter 3 demonstrates that developing country tax administrations are highly dependent on only a few large corporations for the collection of tax revenues. Also, it is important that the taxation system be conducive to small business growth and operation. It is therefore essential that a developing country has a clear policy towards the taxation of small businesses. The tax system of a developing country should be simple and economical for small businesses to comply with. At the same time, the system should be economically cost effective and administratively feasible. Despite the widespread application of presumptive methods, the policy and administrative aspects have not received much academic attention. A great deal of academic research is required to produce an efficient small business tax regime which is revenue productive, supportive for small businesses to

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<sup>10</sup> Bird and Wallace, above n 9, 146.

<sup>11</sup> Carl Liedholm, 'Small Firm Dynamics: Evidence from Africa and Latin America' (2002) 18 *Small Business Economics* 229.

operate and grow and can be administered in economically feasible manner in a difficult taxing environment.

## **1.2 Problem statement**

*Small businesses, a risky group in terms of tax compliance, are widely regarded as hard-to-tax. Taxation of small businesses seems even harder in developing countries where the size of shadow economy is large, tax morale is low, the level of tax compliance is poor, and the administrative capability of the taxation authority is relatively weak. In many countries, the number of registered taxpayers is very few; a major portion of small businesses operate in the shadow economy. The issues concerning the taxation of small businesses seem highly linked with the problem of taxing the shadow economy. There are considerable differences in typical urban and rural businesses in terms of business concentration, assets, size, transaction processes, and production, employment and compliance attitudes. Effectively taxing both noncomplying rural and urban small businesses is a challenging issue. Developing countries widely ignore the tax potential of small businesses and rely only on a handful of large taxpayers for the collection of tax revenue. Small businesses often consider taxation as major impediment for their business operations, and often incur a significant cost to stay outside the tax net. An optimal tax policy should be more efficient in raising revenue from both rural and urban small taxpayers, and at the same time should be supportive of their business operations and growth.*

## **1.3 Aim of the thesis**

This thesis has a number of aims. First, this thesis aims to analyse the prevailing small business taxation policy trends and administration practices in developing countries. Developing countries in general are unable collect much tax revenue from small businesses. A wide majority of small businesses stay outside the tax net or do not properly comply with tax

obligations. Again, small businesses often consider taxation as a major constraint for their business operations. This thesis tries to demonstrate that in a typical developing country a well-designed, simple presumptive taxation regime is more efficient to tax small businesses.

This thesis also aims to demonstrate that tax administrations should recognize the distinguishing features of rural and urban small businesses and adjust the small business tax regime accordingly so that it can effectively assess the economic activities of those two groups of taxpayers. Urban taxpayers generate more income; they are more skilled and operate in less dispersed businesses locations. For an effective expansion of the tax net tax administrations should concentrate most on the urban segment of the noncomplying taxpayers. For this group a turnover- based presumptive taxation is most efficient.

Finally, this thesis aims to demonstrating that in taxing rural small taxpayers the size and the quality of land holding should be the leading indicators for the presumptive tax design. This would be more efficient than the current system, which involves two different administrations each taxing the same tax base. As a replacement of existing agricultural land, wealth and income tax, a single asset-based presumptive income tax would be more efficient for taxing rural small business in developing countries.

## **1.4 Scope of the thesis**

The scope of the thesis is limited to the issues concerning the taxation of small business in developing countries. Here two key terms, ‘small businesses and ‘developing countries’ critically define the focus of this research. It is therefore very important to spell out upfront the scope and meaning of these two terms.

There is no single universally accepted definition of small business. A single criterion or a number of criteria are often used to specify the meaning of small business. By small businesses this thesis generally identifies mostly the proprietorships which are small in terms of turnover and capital, do not keep accounting records very well, mostly are not registered for tax purposes, and many of them are potentially taxable.<sup>12</sup>

It is also very important to define upfront the scope and meaning of developing countries. The recent World Bank country classification identifies 146 countries as low income, lower middle income, or upper middle income economies.<sup>13</sup> This thesis broadly identifies these 146 countries as developing countries. Nevertheless, these countries are hardly homogeneous; they are widely diverse in numerous aspects. It would be beyond the scope of this thesis to analyse core small business taxation issues of all these 146 countries. No specific policy of administrative framework would be highly relevant and applicable for all these countries. However, there are also some significant common patterns with regard to social, institutional, economic and political conditions. A general set of taxation policy and administrative measures are widely practiced by a majority of developing countries. For the purpose of this study developing countries are typically characterized by having a low level of per capita income, high inequality, a low level of productivity, weak institutions, substantial dependence on traditional agriculture, a larger shadow economy, and unstable political conditions.<sup>14</sup>

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<sup>12</sup> A formal definition of small business is provided at section 1.8. See Section 3.2.1 for a detailed discussion on the key small business characteristics.

<sup>13</sup> The World Bank, *World Bank list of Economies*. Available at: <[http://www.who.int/alliance-hpsr/alliancehpsr\\_worldbankcountryclassification.pdf](http://www.who.int/alliance-hpsr/alliancehpsr_worldbankcountryclassification.pdf)>.

<sup>14</sup> A formal definition of developing countries is provided at section 1.8.

## **1.5 The research question**

This thesis attempts to approach the policy and administrative problems concerning the taxation small business in developing countries through asking

*How can small businesses be efficiently taxed in developing countries?*

In the course of answering this question several relevant subsidiary questions emerge and are dealt with. Some examples include whether presumptive tax is the most efficient method to tax small businesses, how small business tax policy can be made supportive of small business operation and growth, how urban small businesses can be taxed efficiently, and how rural small businesses can be taxed efficiently. The answers of the subsidiary research questions constitute the answer of the broader research question.

## **1.6 Evaluative framework**

The thesis asks how small businesses can be efficiently taxed in developing countries. The question is value laden. Therefore a qualitative exploration seems appropriate for finding the answer of this value laden question. The term 'efficiency' has many meanings and dimensions; it is thus not easy to judge whether a tax system is efficient or not. It is essential to establish a benchmark or to set up criteria upon which to judge whether a small business tax system is efficient. The existing literature can give important guidance for evaluating the efficiency of small business tax system.

Adam Smith advocated the canons of taxation in the different economic and political world of the 18<sup>th</sup> century, however his principles still hold

relevance today. Smith<sup>15</sup> stresses that a good tax system should satisfy the following four preconditions:

(1) *'The subjects of every State ought to contribute towards the support of the government as nearly as possible in proportion to their respective abilities—that is, in proportion to the revenue which they respectively enjoy under the protection of the State.'*

(2) *'The tax which each individual is bound to pay ought to be certain and not arbitrary. The form of payment, the manner of payment, the quantity to be paid ought all to be clear and plain to the contributor and to every other person.'*

(3) *'Every tax ought to be levied at the time or in the manner in which it is most likely to be convenient for the contributor to pay it.'*

(4) *'Every tax ought to be so contrived as both to take out and to keep out of the pockets of the people as little as possible, over and above what it brings into the public treasury of the State.'*

These canons require a tax system should ensure *equity*, by imposing a tax burden that is proportionate to the income earned, *certainity*, by making the tax liabilities clear and easily comprehensible, *simplicity*, by making it easy to comply with and pay, and *simplicity and neutrality*, by making the tax collection economically feasible. However, while some of these principles may be applicable some types of tax, it is not equally applicable for all taxes. Theory on what makes a good tax system has extended beyond Smith. Later, a host of public finance literature attempted to identify essential principles of a good tax system.<sup>16</sup> A vast literature commonly referred to as 'optimal

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<sup>15</sup> Adam Smith in Charles F. Bastable, *Public Finance*, book III, ch VII 'The Canons of Taxation' (Macmillan, 1903).

<sup>16</sup> Extensive surveys on a good tax system can be found in Francis Y. Edgeworth, 'The Pure Theory of Taxation' (1897) 7(25) *The Economic Journal* 46-70; Richard Musgrave, *The Theory of Public Finance* (McGraw-Hill, 1959).

taxation' evolved to analyse the best attributes of a good tax system and their desirable mix.<sup>17</sup> However, the practical application of this literature has been very limited.<sup>18</sup> Broadly, most optimal theory literature suggests that an optimal tax system should collect sufficient revenue, treat taxpayers fairly, minimize tax-imposed economic distortions, and should be simple and cost effective for taxpayers and tax administrations.<sup>19</sup> There are countless proposals and opinions for making the tax system 'optimal'. The literature is still expanding, as a host of important research focusing on various aspects of optimality of the tax system remains ongoing. There is still wide disagreement on several issues.

Stiglitz spells out five well accepted properties of a good tax system: economic efficiency, administrative simplicity, flexibility, political responsibility and fairness.<sup>20</sup> A tax system in general should enhance economic efficiency, impose a reasonably low cost burden on the government and the taxpayers, offer the flexibility to adapt changes, be transparent and treat person with similar circumstances similarly.<sup>21</sup> However, it is very difficult to ensure that a tax system satisfies all the desirable properties. It is even more difficult to establish an efficient and effective tax system in developing countries. Chapter 2 gives an overview of the general taxing environment of developing countries. Tanzi and Zee<sup>22</sup> identify four major challenges that developing countries generally face while establishing an efficient tax system. The first challenge is the structure of the economy that create difficulties to impose and collect some taxes; the second is the limited capacity of the tax administration, the third is the shortage and the poor quality of data, and the last is the lack of political

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<sup>17</sup> Frank Ramsey, 'A Contribution to the Theory of Taxation' (1927) 37. *Economic Journal* 47; Arthur Cecil Pigou, *A Study in Public Finance* (Macmillan, 1947); James Mirrlees, 'An Exploration in the Theory of Optimal Income Taxation' (1971) 38 *Review of Economics Studies* 175.

<sup>18</sup> James Alm, 'What is an "Optimal" Tax System?' (1966) 49(1) *National Tax Journal* 118.

<sup>19</sup> Alm, above n18, 122.

<sup>20</sup> Joseph E. Stiglitz, *Economics of the Public Sector* (W.W. Norton and Company, 2000) 458.

<sup>21</sup> Stiglitz, above n 20.

<sup>22</sup> Vito Tanzi and Howell H. Zee, 'Tax Policy for Emerging Markets: Developing Countries' (2000) 53(2) *National Tax Journal* 299.

support for a good tax system.<sup>23</sup> Tanzi and Zee further add that some special characteristics, such as a large share of agriculture in total output and employment, the presence of a large shadow economy, a large number of small businesses, and a small share of wages in national income deter the establishment of modern tax systems, such as income tax, and to some lesser extent value added tax (VAT).<sup>24</sup> Therefore, a country's economic structure and the capability of the tax administration should dictate tax policy choices.<sup>25</sup> The ideal tax principle might be less relevant in the context of the economic structure of certain developing countries than one that simply works. Moreover, there are additional difficulties with taxing small businesses. The level of tax compliance of small businesses is low in most developing countries. Some characteristics of small businesses, such as their size, their small scale of operations, their ability to engage in cash transactions, and their fewer regulatory requirements enable them to hide their income, or part of it, from tax scrutiny.

Memon identifies three core categories of principles for a good tax system: simplicity, efficiency and equity.<sup>26</sup> However, there would be hardly any tax policy that completely adheres to all these principles. In the real world these principles are often competing and contrasting. Memon argues that each policy has relative significance in accordance with the realities of each economy.<sup>27</sup> Therefore, a small business taxation policy in presence of the large shadow economy should prioritize and rank the essential principles to be adopted.<sup>28</sup> In accordance with this, Memon suggests that small business taxation policy in developing countries should put more importance on simplicity and efficiency than on equity.<sup>29</sup> Bird and Zolt too note that an

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<sup>23</sup> Tanzi and Zee, above n 22, 300.

<sup>24</sup> Tanzi and Zee, above n 22, 322.

<sup>25</sup> Richard M. Bird and Eric M. Zolt, 'Introduction to Tax Policy Design and Development', draft paper for a course in practical issues of tax policy in developing countries, The World Bank (2003) 10.

<sup>26</sup> Najeeb Memon, *Analysis of Presumptive Income Tax for Small Economies: A Case of Pakistan* (PhD thesis, The University of New South Wales, 2009).

<sup>27</sup> Memon, above n 26.

<sup>28</sup> Memon, above n 26.

<sup>29</sup> Memon, above n 26.

optimal tax policy has little importance if it cannot be implemented effectively.<sup>30</sup> Bahl and Bird, reviewing the evolving nature of tax policy and administration in developing countries, make the same point again, commenting that in developing countries good tax policy needs to compromise to administrative constraints.<sup>31</sup> An appropriate tax treatment of small and medium businesses is a concern for developing countries.<sup>32</sup> Tanzi and Casanegra<sup>33</sup> stress that the main goal of a simplified tax design for small businesses should be simplicity. Thuronyi argues that equity and simplicity can conflict during designing a simplified tax system.<sup>34</sup> It appears most scholars feel that with this being the case, simplicity should take precedence.

In view of the above this thesis identifies that an 'efficient' small business tax system of a typical developing country should be simple and economically efficient. A tax system should be simple for both the tax administration and the taxpayer. Economic efficiency refers to the cost effectiveness of the system. The system should generate adequate tax revenue, should be cost effective to administer and should reduce the compliance burden of the taxpayer.

## **1.7 Significance of this thesis**

This thesis is an important contribution to the existing literature as:

1. This thesis demonstrates that in a difficult policy and administrative setup where standard account-based income tax-based tax systems are unable to effectively tax a huge number of registered and non-registered noncompliant

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<sup>30</sup> Bird and Zolt, above 25, 10.

<sup>31</sup> Roy Bahl and Richard M. Bird, 'Tax Policy in Developing Countries: Looking Back – and Forward' (2008) LXI (2) *National Tax Journal* 283.

<sup>32</sup> Bahl and Bird, above n 31, 290.

<sup>33</sup> Vito Tanzi and Milka Casanegra de Jantscher, 'Presumptive Income Taxation: Administrative, Efficiency, and Equity Aspects', IMF Working Paper WP/87/54 (1987) 15.

<sup>34</sup> Victor Thuronyi, 'Presumptive Taxation, in Victor Thuronyi (ed) *Tax Law Design and Drafting* (International Monetary Fund, 1996) vol 1, ch 12, 4.

small businesses, a well-designed presumptive taxation might be more efficient in achieving certain revenue and non-revenue objectives.

2. This thesis argues that the existing carrot and stick-type compliance models fail to explain the noncompliance of small businesses in developing countries. The standard tax compliance models, which mainly focus on the perceived rewards of evasion, might ignore some crucial factors that constitute the tax compliance environment of small businesses in developing countries. This thesis broadly illustrates the typical tax compliance environment of small businesses in developing countries.

3. This thesis demonstrates that in developing countries there exists a crucial locational segmentation. It is crucial that a small business tax regime should identify the distinguishing characteristics of urban and rural small businesses in order to effectively tax the entities of both segments.

4. There is, to best of my knowledge, no research that exclusively analyses the taxation of urban small businesses in the context of developing countries. This thesis analyses the core characteristics of urban small businesses and suggests that enterprise formalization should be a key element the tax policy of urban small businesses. For a meaningful expansion of the tax net tax administrations should put more focus on urban small businesses as they have a greater potential to become stable and sustained taxpayers. The thesis concludes that a turnover-based presumptive taxation is the most efficient way to tax urban small businesses.

5. This thesis also has an exclusive discussion on the taxation of rural small businesses in the contexts of developing countries. This thesis reports that the overall tax burden on the agricultural income has substantially declined over the last few decades. The tax potential of rural small businesses is widely ignored. Developing countries should not ignore the tax potential of the rural taxpayers. In a typical developing country an asset-based

presumptive tax system is more efficient for taxing rural small businesses. This thesis argues that a simple asset-based presumptive income tax, to replace the existing taxes on agricultural income such as agricultural land tax, wealth tax and income tax would be the an efficient choice.

## **1.8 Key definitions**

This thesis uses several key terms and concepts. In order to clarify the scope and meaning of those terms it is helpful to define and specify the scope of these terms at the beginning. These terms will later be further explained or expanded on in the various contexts in which they will be used.

### **‘Developing countries’**

For operational and analytical purposes the World Bank classifies an economy with a Gross National Income (GNI) of \$12,276 or more (in 2010) as a high income economy.<sup>35</sup> The World Bank April 2012 list<sup>36</sup> classifies 70 countries as having a high income economies, and the remaining 146 countries have low income, lower middle income, or upper middle income economies. This thesis broadly follows the World Bank country classifications and identifies these 146 low income, lower middle income, or upper middle income economies as developing countries. Developing countries are typically characterized by having a low level of per capita income, high inequality, a low level of productivity, weak institutions, substantial dependence on traditional agriculture, a larger shadow economy, and unstable political conditions.

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<sup>35</sup> World Bank, *The little data book 2012*. Available at: <[http://econ.worldbank.org/external/default/main?pagePK=64165259&theSitePK=469382&piPK=64165421&menuPK=64166322&entityID=000356161\\_20120420031455](http://econ.worldbank.org/external/default/main?pagePK=64165259&theSitePK=469382&piPK=64165421&menuPK=64166322&entityID=000356161_20120420031455)>.

<sup>36</sup> World Bank, *World Bank list of Economies*. Available at: <[http://www.who.int/alliance-hpsr/alliancehpsr\\_worldbankcountryclassification.pdf](http://www.who.int/alliance-hpsr/alliancehpsr_worldbankcountryclassification.pdf)>.

### **‘Shadow economy’**

Shadow economic activities are identified as legal economic activities that are concealed from public authorities for the purpose of avoiding the payment of taxes and social security contributions, or various regulatory measures.

### **‘Small business’**

For tax purposes often a single or a combination of a number of criteria is used to specify small businesses. The most common criteria that are used for defining small business include gross turnover, gross income, net assets, taxable income, number of employee, and equity. In general, this thesis identify small businesses which are mostly proprietorship, small in terms of turnover and capital, employ few employees, do not keep accounting books record very well, mostly are not registered for tax purposes, many of them are legally and potentially taxable.

### **‘Hard to tax’**

Hard to tax (HTT) refers mainly to sole proprietor individuals, farmers and professionals. It is not limited to these entities, however; there is also sophisticated group of hard-to-tax, such as multinationals, highly mobile individuals, offshore operations and ecommerce businesses. However, this thesis uses ‘hard to tax’ to refer to small businesses, farmers and professionals. These businesses may or may not operate in the cash; nonetheless tax authorities find it difficult to monitor and assess their economic activities.

### **‘Tax effort’**

Tax effort is a measure which gives a general indication that how a country is raising tax revenue relative to its given economic and structural potential. The tax effort index is constructed by dividing the actual tax share by an estimated or fitted tax share.

### **‘Presumptive taxation’**

Presumptive taxation is an indirect means of determining tax liability of the taxpayer. Presumptive tax is based on a taxpayer’s assumed income, not on actual income. It is based on the presumption that the real tax liability of the concerned taxpayer is somewhat close to the assumed tax liability made through an indirect method.

### **‘Tax compliance cost’**

Tax compliance cost is the expenditure incurred by a taxpayer to comply with obligations imposed by tax law and administration. Taxpayers need to bear these compliance costs in addition to the actual tax burden.

### **‘Tax compliance’**

Tax compliance is the willingness of a taxpayer to report their actual income and to pay due taxes in accordance with the provisions of taxation law and regulations.

### **‘Formalization’**

Formalization is a process by which a non-compliant or informal sector enterprise graduates from the informal to the formal sector by registering with a tax authority.

### **‘Direct tax’**

Direct taxes, such as income tax, wealth tax and land tax, require the formal burden of the tax to be borne by the person on whom it is imposed.

### **‘Indirect tax’**

Indirect taxes, such as value added tax (VAT), sales tax, import tax, and excise duty, are imposed when a taxable transaction occurs. The formal burden of tax falls indirectly on the taxpayer.

## **1.9 Thesis structure**

The broad objective of this thesis is to find an efficient tax policy and administrative setup for taxing small businesses in developing countries. In order to achieve the objective, it is essential to first understand the existing taxation policies and administrative environments of developing countries. Chapter 2 analyses the prevailing taxation policies and administrations of developing countries and establishes the basis for arguing that an effective tax policy needs to be well grounded in the socioeconomic environment of a given country. This chapter highlights the inadequacy of revenue levels of developing countries and argues that in order to support the budget deficits and satisfy development goals developing countries have no option but to collect more tax revenue. The chapter also reports that, contrary to the recommendations of optimal taxation literature, developing countries rely heavily on indirect taxes. Personal income tax (PIT) has an extremely limited role in contributing to total tax revenue. Peter, Buttrick and Duncan<sup>37</sup> show that in developing countries the contribution of PIT to the GDP is around 1–3 per cent, compared to 9–11 per cent in developed countries. Only a tiny fraction of the total population of developing

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<sup>37</sup> Klara Sabirianova Peter, Steve Buttrick and Denvil Duncan, ‘Global Reform of Personal Income Taxation, 1981–2005: Evidence from 189 countries’ (2010) 63 *National Tax Journal* 447.

countries pays income tax.<sup>38</sup> Given the limited role of PIT, tax systems of developing countries are overall not progressive, and the redistributive features are largely absent.

Many developing countries have adopted variants of VAT as the leading revenue-generating tax instruments. There is a growing literature that supports a greater role of consumption-based taxes in the tax structure. Consumption taxes require relatively small administrative costs and are relatively easy to administer. Chapter 2 analyses the efficiency of VAT and concludes that it is not clearly more efficient than income tax. Moreover, as Stiglitz<sup>39</sup> claims, if a tax structure lacks progressivity, the consequence of using regressive VAT as the leading tax instrument can be severe.

Finally, Chapter 2 argues in developing countries, in an adverse administrative setup, it is not efficient to administer certain theoretically ideal tax policies. Developing countries should instead consider investing more in improving information technology infrastructure of the tax administrations in order to reduce efficiency constraints. Meanwhile, tax policy should be carefully aligned to administrative capacity. Small business tax policies of developing countries should put more emphasis on efficiency and simplicity than on equity and fairness. In developing countries the economic structure and the capacity of the tax administrations should be placed at the forefront while designing a small business tax policy.

Chapter 3 argues that in developing countries the taxation of small businesses is even more challenging to tax the small businesses. Certain special characteristics of small businesses allow them to hide some or all of their economic activities without much difficulty. Contributing to this evasive attitude is the well-founded perception of small businesses that taxation acts as a major impediment of their business operations.

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<sup>38</sup> See, Eg, Table 2–2 of this thesis.

<sup>39</sup> Joseph E. Stiglitz, 'Development Oriented Tax Policy', Columbia University Initiative for Policy Dialogue Working Paper Series (2009) 20.

Consequently, this chapter reports that developing country tax administrations focus on only a handful of large taxpayers for the realization of tax revenue. However, a solution may exist where a satisfactory level of tax revenue can be raised from small businesses without impeding their business operations and growth. This chapter analyses the characteristics of small business and suggest that small businesses in developing countries have two distinct segments, urban and rural. Urban and rural small businesses are considerably different in various aspects. A small business tax regime should have a separate set of taxing methods to efficiently estimate the economic activities of both groups. The chapter then analyses how taxation impacts the operations of small businesses. It reports that small businesses encounter an exorbitantly high compliance cost burden. The high compliance costs and the complex tax paying procedures severely affect the business operations of smaller firms. Also, for tax authorities, given the small amount of tax revenue small firms generate, small businesses are not worthy of much administrative attention. This chapter sets the basis for arguing that an efficiently designed presumptive tax regime which reduces both the compliance cost burden of the taxpayer and the administrative costs of the authority might create a scope for mutual gains of the taxpayer and the tax administration.

Often the arguments in favour of preferential tax treatment for small businesses are based on the important positive externalities they create in the economic environment. This chapter examines these arguments. However, Chapter 3 stresses that designing a concessionary tax system is not the central issue of taxation of small business in developing countries. Rather, the tax policy should be concerned more on developing a system which ensures that the vast majority of small businesses reasonably comply with tax obligations. The chapter concludes that in many developing countries the standard income tax-based tax system is incapable of addressing the core taxation issues of small businesses. An efficiently designed, simple presumptive tax system might be most effective.

Chapter 4 provides an in-depth analysis on the nature, causes and consequences of the shadow economy. This chapter analyses tax compliance issues in greater detail. It demonstrates that small businesses are the key participants of the shadow economy. In developing countries, the success of a small business tax regime greatly depends on its ability to effectively tax the shadow economy. This chapter reports that most research<sup>40</sup> on the causes of the shadow economy identifies taxation as the top-contributing factor. The strict regulations and enforcement provisions of the standard tax regime have gradually increase the size of shadow economy.

Further, this chapter draws a general framework of the small business tax compliance environment in developing countries. A detailed analysis of existing tax compliance models suggests that they may not adequately explain the noncompliance of small businesses of developing countries. In most developing countries the perceived rewards from evasion are not significant, the probability of detection is very slim, and the cost of evasion is negligible. In such a setup, the Allingham and Sandmo<sup>41</sup>-type compliance models, which are mostly constructed on the socioeconomic realities of developed countries, seem hardly applicable.

Chapter 5 discusses theoretical and practical aspects of presumptive taxes in the context of developing countries. Taxation around the world uses different conveniently ascertainable indicators to estimate the actual tax base. This chapter classifies the existing presumptive tax methods in terms of the economic bases they apply to approximate the actual tax base. It also analyses the policy and administrative merits or demerits of each type. This chapter stresses the argument that in many developing countries it is still not

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<sup>40</sup> See, eg, Friedrich Schneider and Dominik H. Enste, 'Shadow Economies: Size, Causes, and Consequences' (2000) 38 *Journal of Economic Literature* 77–114; Simon Johnson, Daniel Kaufmann and Pablo Zoido-Lobaton, 'Regulatory Discretion and Corruption' (1998) 88(2) *American Economic Review* 387–392.

<sup>41</sup> Michael G. Allingham and Agnar Sandmo, 'Income Tax Evasion: A Theoretical Analysis' (1972) (1) *Journal of Public Economics* 323–338.

feasible to allocate many of the scarce tax administration resources to determination of the actual income of small taxpayers. It is not rational to allocate substantial administrative resources to manage taxpayers who generate little revenue, particularly when many are opposed to taxation and likely to be uncooperative. In such a scenario, the application of presumptive taxes is more efficient than the account-based standard regime.

The chapter further suggests that tax policies should explicitly acknowledge the scope and role of presumptive methods. It presents with evidence that in many developing countries presumptive tax provisions are implemented randomly and in ad hoc manner. Often the rates, thresholds and norms are determined based on casual observations. This chapter analyses some important design issues upon which the efficiency of presumptive taxes critically hinges. These design issues include the proper choice of indicators, the determination of the threshold and the targeted taxpayers, the coordination of the presumptive tax regime with the overall tax system, the identification of objectives, and the administration of the tax. In order to construct an efficient presumptive tax regime it is very important for a tax policy to pay a careful consideration to, and to clearly specify the approaches towards, these design issues.

Lastly, Chapter 5 analyses the application of presumptive taxes in four developing countries: Bangladesh, Pakistan, Ukraine and Tanzania. These case studies identify some major policy and administrative shortcomings of those presumptive tax regimes. The analysis finds that in the first two countries the application of presumptive taxes is random and chaotic. In both of these two countries, the role of implicit presumptive provisions is much greater than that of explicit ones. In Ukraine, the scope of the presumptive regime is explicitly defined. However, the coexistence of a number of concurrent, uncoordinated and often overlapping provisions makes the small business tax system overly complex. The Tanzanian small business tax regime is rather explicit and well defined, however the scope of

the regime is highly limited since it targets only a narrow tax base. These countries' experiences highlight the arbitrary adoption of presumptive tax systems in developing countries. A typical developing country is likely to benefit more from presumptive taxes only if the scope and the role of the presumptive regime is explicitly and unambiguously specified and is constructed with due consideration to the crucial design issues.

Consistent with Chapter 3 and Chapter 4, Chapter 6 further demonstrates that urban small businesses are indeed different from rural small businesses in several critical aspects, such as business registration, mode of financial transactions and business locational patterns. The optimal techniques for taxing rural and urban small businesses should be different. This chapter focuses on some characteristics of urban small businesses on which tax policy should pay more attention in order to effectively tax them. This chapter also proposes that the tax policy for urban small businesses should encourage enterprise formalization. It stresses the fact that in a typical developing country a significant number of small businesses are ignorant about the obligations of taxation, the steps required to formalize, or the advantages of being formal. A tax administration with a simplified tax system, which provides proper taxpayer education and services, might attract a significant number of small taxpayers who are, despite generating a considerable amount of taxable income, staying outside the tax net for long period of time. This chapter also stresses that urban small businesses have more potential of growing into stable and sustained taxpayers. A tax policy aiming at a meaningful expansion of the tax net should therefore put more focus on urban small business. Finally, Chapter 6 identifies the core elements of a preferred tax system for urban taxpayers. In order to efficiently tax urban small taxpayers a typical developing country tax policy should adopt a well-designed presumptive tax regime, promote a greater usage of banking channels, provide some incentive for new entrants into the tax net and put more emphasis on tax education. Ideally, the service should be run by a dedicated administrative unit.

Chapter 7 focuses on various issues regarding taxation of rural small businesses. It has two parts. The first part mainly focuses on the prevailing tax policies towards agricultural income. This chapter argues that, in general, the tax policies of developing countries are unenthusiastic about the tax potential of this sector. There are some inherent characteristics of the entities of this sector which make them very hard to tax, and so authorities have largely avoided taxing them with much administrative vigour. This chapter reviews a series of empirical analyses which identify that the presence of a large agricultural sector significantly affects the tax effort in developing countries. Moreover, this chapter reports that over the last few decades the overall tax burden on agricultural income has declined subsequently. Poor tax collection should not, therefore, be solely blamed on the characteristics of agricultural businesses, but also the lack of a proper tax policy towards them. This part suggests that developing countries should not ignore the tax potential of this sector.

The analysis of the second part mainly focuses on the existing taxing methods and their relative merit for taxing the agricultural income of rural taxpayers. The analysis of this chapter suggests that a typical developing country with a large agricultural sector should best rely on a presumptive income tax system to collect tax revenue. It concludes that asset-based presumptions are preferable for taxing agricultural income. In the process, it reports that the current agricultural land tax supplies a negligible amount of tax revenue. Although a land tax has several theoretical advantages, the administration of land tax is costly and extremely difficult. Land records are mostly kept manually, verifying ownership records is excessively complex, and cadastral surveys are extremely costly and conducted once every several decades. The application of a land-based tax should be subject of fresh academic attention as many developing countries are adopting information technology-led land surveys and land record management systems.

Chapter 7 concludes that instead of applying different taxes on agricultural lands and land-based income, developing countries should adopt a single presumptive income tax which uses land area as the leading indicator. The separate taxation of an identical tax base involves significant administrative costs. Moreover, it imposes a separate compliance cost burden on the taxpayers. A small business tax regime should implement a well-designed presumptive income tax replacing the existing agricultural land, wealth and income tax. Finally, Chapter 7 discusses some important design issues regarding the taxation of agricultural income.

## **CHAPTER 2**

# **TAX POLICY AND ADMINISTRATION IN DEVELOPING COUNTRIES: AN OVERVIEW**

### **2.1 Introduction**

The aim of this thesis is to find an efficient tax policy and administrative arrangement to tax small businesses in developing countries. In order to achieve this objective, it seems essential to start this thesis with an overview of the prevailing taxation policy and administration and related economic environment of developing countries.

An increasing number of countries around the world, whether developed or under developed, are becoming increasingly concerned about budget deficits and revenue shortfalls. As the supply of external aids is shrinking, countries that usually fill revenue shortfalls with foreign loans or aids are becoming increasingly concerned with reducing dependence on external support. Obviously for many such developing countries options are limited; countries can increase revenues, decrease expenditure or do some combination of the two. No wonder, then, that many developing countries choose to increase the level of tax revenues in order to reduce budgetary pressures. However, it looks like increasing the level of tax revenue has never been an easy task for developing countries. In 1963, Kaldor,<sup>42</sup> in his article ‘Will Underdeveloped Countries Learn to Tax?’, pointed out that developing countries typically collect tax revenue to the tune of 8 per cent to 15 per cent of Gross National Product, which is insufficient and much lower than the level of tax collected by their developed counterparts. He argued that this poor revenue performance is not the inevitable consequence of poverty.

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<sup>42</sup> Nicholas Kaldor, ‘Will Underdeveloped Countries Learn to Tax?’ (1963) 41 *Foreign Affairs* 410.

Rather, poor revenue performance can be attributed to a high level of inequality in society, and an incidence of taxation which is widely regressive.<sup>43</sup> Quite strikingly, even after half a century, the situation surrounding taxation policy and administration in many developing countries has not changed much. Developing countries continue to collect tax revenue at a level of around 16 per cent of their GDP.<sup>44</sup> Although there is no consensus as to the optimal level of taxation, there is no doubt that developing countries essentially need a modest level taxation in order to meet budgetary necessities and to invest for achieving the development goals.

As it is mentioned in the definition of developing countries, this thesis broadly identifies countries with a Gross National Income less than \$12,276 as developing countries.<sup>45</sup> Developing countries also show considerable diversity in number of areas, such as political structure, religious and ethnic background, demographic factors, cultural factors and resource endowments. Although developing countries are great in number, they are diverse in terms of numerous aspects; there are also some notable common patterns with regard to their fiscal policy and administration. There is a general set of taxation policy and administrative measures widely practiced by a majority of developing countries. There is widespread consensus that the level of revenue that developing countries are generating is inadequate and they should raise sufficient revenues in order to sustain their political and economic activities and to achieve economic development goals.

## **2.2 Revenue level**

As mentioned earlier, developing countries are persistently raising relatively low amount of revenues compared to high income countries. While

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<sup>43</sup> Kaldor, above n 42, 411.

<sup>44</sup> Table 7-2 of Chapter 7 exhibits that the average tax-GDP ratio of 30 selected developing countries is 16.06 per cent.

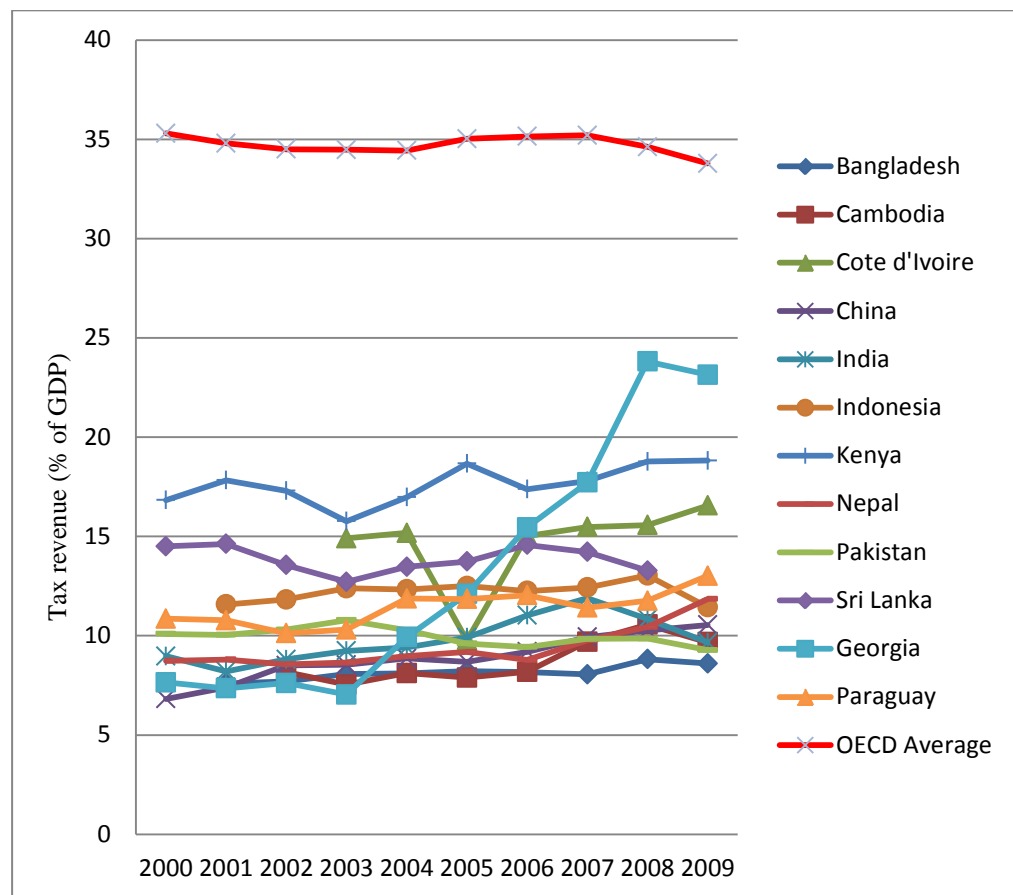
<sup>45</sup> See World Bank, *The little data book 2012* for the World Bank classification of economies.

attempting to explain the low tax effort of developing countries, a number of empirical studies have identified that several economic structural factors significantly impede the revenue raising capability of developing countries.<sup>46</sup> These studies also identify that, despite considerable potential, many developing countries are not raising enough revenues. It seems that the level of taxation largely depends on a country's choice and also on the country's economic, social, and political realities.

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<sup>46</sup> See, eg, Bahl, above n 4 ; Vito Tanzi, 'A Statistical Evaluation of Taxation in Sub-Saharan Africa' in International Monetary Fund, *Taxation in Sub-Saharan Africa* (International Monetary Fund, 1981).

**Figure 2-1 Low tax to GDP ratio of developing countries**



Sources: 1. for OECD data, OECD StatExtracts database;<sup>47</sup> 2. for other countries the World Development Indicators database.<sup>48</sup>

The level and structure of taxation has always been a highly critical issue. In order to explain why some countries fail to collect a sufficient level of revenues, Tanzi<sup>49</sup> demonstrates that there exists a positive correlation between per capita income and the level of taxes. Bird and Zolt<sup>50</sup> argue that taxing capability increases with increased national income, and that the relationship between rising income level and higher taxes is significant in case of low income countries. However, a scatter diagram of 49 low income

<sup>47</sup> Organization of Economic Cooperation and Development (OECD), *StatExtracts Database* (2011).

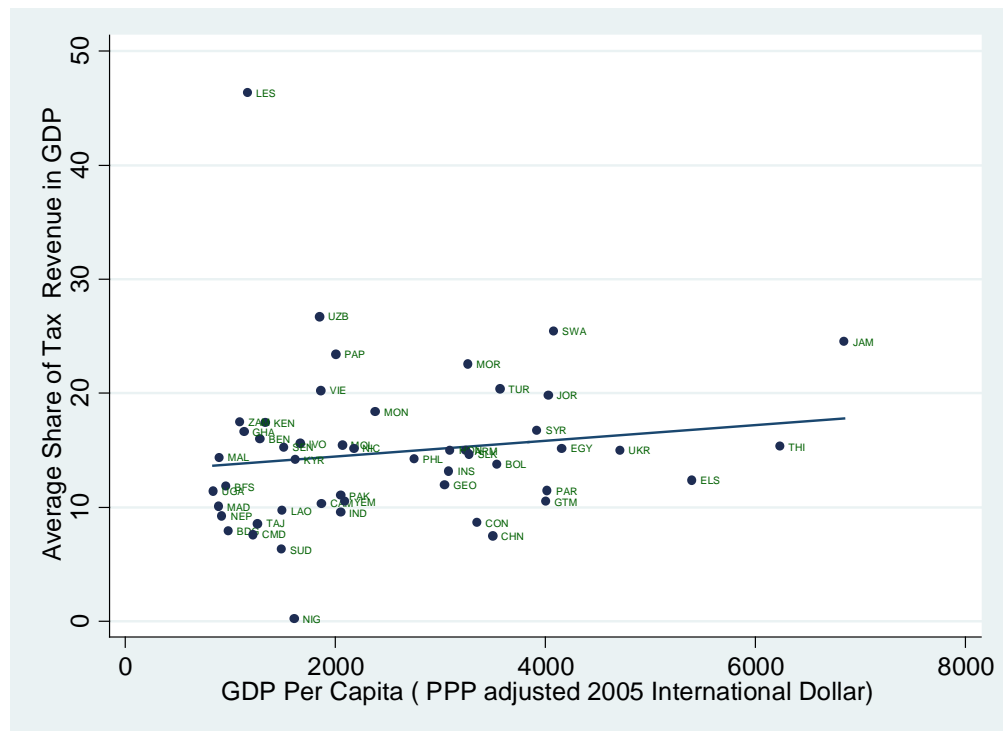
<sup>48</sup> The World Bank, *World Development Indicators Database* (2011).

<sup>49</sup> Vito Tanzi, 'Quantitative Characteristics of the Tax Systems of Developing Countries' in D Newbery and N Stern (eds), *The Theory of Taxation for Developing Countries* (Oxford University Press for the World Bank, 1987).

<sup>50</sup> Bird and Zolt, above n 25, 6.

countries is showing little support for such claim.<sup>51</sup> It seems that no significant correlation exists between level of income and level of taxation.

**Figure 2-2 Tax revenue and PPP adjusted per capita GDP, 1995-2009**



Sources: 1. World Development Indicators Database;<sup>52</sup> 2\*. Asian Development Bank Key Indicators;<sup>53</sup> 3\*. African Economic Outlook.<sup>54</sup>  
 \*Majority of Tax-GDP data is collected from World Bank's World Development Indicators (WDI) database. Only for very few observations are these sources used.

The major objective of a tax system is to raise revenue; however, it is also very important how the revenue is raised. Many argue that for the government to function well, for extending quality public services, for improving a country's economic condition, and for obtaining relief from external debts, developing countries need to mobilise more resources. However, as has been pointed earlier, there is no general agreement about

<sup>51</sup> Countries within the range of US\$ 1000 to US\$7000 GDP per capita (2009 PPP adjusted, Current international dollar) have been selected. A list of full country names is provided in the Appendix.

<sup>52</sup> The World Bank, *World Development Indicators Database* (2011).

<sup>53</sup> Asian Development Bank, *Key Indicators* (2011).

<sup>54</sup> African Development Bank Group, *African Economic Outlook 2011* (2012).

the level of revenue that is optimal for developing countries. The United Nations considers that a tax to GDP ratio of around 20 per cent may be necessary for achieving Millennium Development Goals.<sup>55</sup>

So far the discussion has covered some issues regarding the causal relationship between tax share and national income. Some empirical studies also attempt to investigate the impact of tax levels on growth. Generally, these studies use tax rates as a proxy for the level of taxation of developing countries. The findings of these empirical studies are often in conflict.<sup>56</sup> Rabushka,<sup>57</sup> with a sample of 49 developing countries, finds that average tax rates and economic growth are positively correlated. Conversely, Engen and Skinner<sup>58</sup> find that an increase of average tax burden of 2.5 percentage points can reduce long-term output growth rates by 0.18 percentage points. On a bottom up approach, Engen and Skinner<sup>59</sup> also find that a reduction on marginal tax by 5 per cent and average tax by 2.5 per cent can translate into an increase in long run growth of between 0.2 to 0.3 per cent. Further, they argue that for economic development the composition of tax structure is equally as important as the level of taxation. Countries that have efficient tax administration and that can efficiently collect tax from a broad base are likely to grow faster than countries that do not.<sup>60</sup>

## 2.3 Tax structure

As stated in Chapter 1, Adam Smith's principles regarding a desirable tax system hold that the tax system should ensure: *equality* by imposing a tax burden that is proportionate to income earned, *certainty* by making tax

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<sup>55</sup> United Nations Development Programme, *What Will It Take To Achieve the Millennium Development Goals? An International Assessment* (2010) 26.

<sup>56</sup> Bahl and Bird, above n 31, 283.

<sup>57</sup> Alvin Rabushka, 'Taxation, Economic Growth, and Liberty' (1987) 7 *Cato Journal* 121.

<sup>58</sup> Eric Engen and Jonathan Skinner, 'Fiscal Policy and Economic Growth', National Bureau of Economic Research, Working Paper No 4223 (1992).

<sup>59</sup> Eric Engen and Jonathan Skinner, 'Taxation and Economic Growth' (1996) 49 (4) *National Tax Journal* 617.

<sup>60</sup> Engen and Skinner, above n 59, 617.

liabilities clear and easily comprehensible, *simplicity* by making it easy to comply and pay, and *efficiency* by making tax collection economically feasible. However, some of these principles may be applicable for specific type of taxes, not equally applicable for all types of taxes. Equity features are core elements for income tax design; less relevant for indirect taxes. Later, a host of contributions to public finance literature attempt to identify essential principles of a good tax system. A vast literature commonly referred to as ‘optimal taxation’ evolved to analyse the best attributes of a good tax system and their desirable mix.<sup>61</sup>

Tax creates distortions in economic choices. Classical studies of optimal taxation affirm that a tax induced excess burden or deadweight loss can significantly reduce economic efficiency.<sup>62</sup> Mirrlees<sup>63</sup> suggests that personal income under optimal tax structure best upholds equity and efficiency considerations. In a review of the previous studies of tax induced excess burden, Auerbach and Hines<sup>64</sup> confirm that application of taxation or departure from marginal cost pricing causes an excess burden and quantitatively this excess burden or deadweight loss is approximately proportionate to the square of any such departure. Over the past several decades theoretical works on optimal taxation have provided important insights on optimal revenue level, tax mix, equity, distributional features, and economic efficiency of a tax system. However, very little practical application of these theoretical literature has been seen.<sup>65</sup> The normative and positive analysis of optimal taxation has largely ignored practical fiscal and societal institutional elements in a tax system.<sup>66</sup> Optimal theory literature in general stresses that a tax system should collect sufficient revenues, treat taxpayers fairly, minimise tax laden economic distortions, and it should be

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<sup>61</sup> See, eg, Ramsey, above n 17, 47; Pigou, above n 17; Mirrlees, above n 17, 175.

<sup>62</sup> Ramsey, above n 17.

<sup>63</sup> Mirrlees, above n 17, 175.

<sup>64</sup> Alan J. Auerbach and James R. Hines, ‘Taxation and Economic Efficiency’, NBER Working Paper No 8181 (2001).

<sup>65</sup> Alm, above n 18, 118.

<sup>66</sup> Alm, above n 18, 118 .

simple and cost effective for taxpayers and the tax administration.<sup>67</sup> However, the quest for an optimal tax system remains still elusive as there is wide disagreement on optimality of tax systems. Political, social and economic realities are so diverse that it is extremely difficult to generalise as to a system that can be termed to be optimal. An efficient and desirable tax policy is less distortive as it minimises excess burden as much as possible. However, typical tax structures in developing countries are quite in contrast to what is suggested in the literature of optimal taxation.<sup>68</sup>

### **2.3.1 Income tax**

Developing countries typically use income tax, import and export duty, VAT or GST (Goods and Services Tax), and excise at varied degrees to collect government tax revenues. The majority of developing countries still heavily rely on import duty and consumption taxes as main sources of tax revenues. Compared to developed country tax structure, the contribution of income tax to the total revenue pie is very low in most developing countries.

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<sup>67</sup> Alm, above n 18, 122.

<sup>68</sup> Roger H. Gordon, 'Introduction: Overview of Tax Policy in Developing Countries' in Roger H. Gordon (ed), *Taxation in Developing Countries* (Columbia University Press, 2010) 1.

**Table 2-1 Tax mix of selected developing countries, 2009**

	Taxes on goods and services (% of revenue)	Taxes on income, profits and capital gains (% of revenue)	Taxes on international trade (% of revenue)
Bangladesh	28.8	19.3	24.3
Cambodia	35.5	11.2	16.1
Cote d'Ivoire	20.3	15.3	32.5
China	58.9	24.6	3.7
India	22.7	51.4	11.4
Indonesia	31.4	36.8	2.1
Jamaica	37.1	25.3	7.1
Kenya	40.6	40.0	10.1
Nepal	34.8	14.5	16.1
Pakistan	31.8	25.2	8.0
Georgia	50.7	31.9	0.7
Paraguay	42.9	15.8	7.0

Source: World Development Indicators Database.<sup>69</sup>

The income tax that is collected in developing countries is basically corporate income tax paid by large corporations and the tax withheld from wages, interest, and the income from supply of goods and services. PIT is often merely a wage withholding in developing countries.<sup>70</sup> Using data of 28 developing countries, Alm and Wallace<sup>71</sup> report that during 1996-98 in OECD countries PIT contributed around one third of the total revenues (10.9 per cent of GDP), whereas in developing countries collected PIT accounted for 2.5 per cent of GDP. However, the study further reported that the relative importance of PIT is in decline in OECD countries, and it is slightly in an increasing trend in developing countries.<sup>72</sup> With similar findings, Peter, Buttrick and Duncan<sup>73</sup> also report that the amount of PIT raised is equal to 1 per cent to 3 per cent of GDP in developing countries compared to 9 per cent to 11 per cent of GDP in developed countries. PIT is

<sup>69</sup> The World Bank, *World Development Indicators Database* (2011).

<sup>70</sup> Bird and Zolt, above n 25, 20.

<sup>71</sup> James Alm and Sally Wallace, 'Can Developing Countries Impose an Individual Income Tax?' in James Alm, J Martinez-Vazquez and M. Rider (ed), *The Challenges of Tax Reform in a Global Economy* (Springer, 2006) 221.

<sup>72</sup> Alm and Wallace, above n 71, 221.

<sup>73</sup> Peter, Buttrick and Duncan, above n 37, 447.

a key instrument of equity and redistribution. As the role of PIT is highly limited, tax systems of developing countries seem severely lacking in progressive and redistributive features.

In developing countries very few persons file income tax returns. As Table 2-2 illustrates, less than 3 per cent of total population of selected developing countries files an income tax return, whereas in many developed countries around 50 per cent of the population pays income tax. Income tax has several theoretical advantages such as: it is income elastic; the burden of tax increases as income increases; it is redistributive; and relatively more concerned with tax incidence. Income tax, particularly PIT, is considered a prime instrument for wealth and income redistribution. Given the limited role of PIT in developing countries, Bird and Zolt<sup>74</sup> argue that, first, in developing countries it would be very unrealistic to believe that income tax plays any meaningful role in income or wealth redistribution. Second, PIT imposes considerable administrative, compliance, economic efficiency and political costs. A badly designed and administrated PIT can become too costly. Thirdly, a country intending to utilise redistributive features of a tax system might look for other PIT alternatives. Countries should concentrate more on the efficient use of public expenditure that allocates relatively greater resources to the poor.

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<sup>74</sup> Richard M. Bird and Eric M. Zolt, 'The Limited Role of the Personal Income Tax in Developing Countries' (2005) 16(6) *Journal of Asian Economics* 928.

**Table 2-2 Number of taxpayers in selected developing countries, various years**

Country	Year	Population <sup>6</sup> (million)	Number of income taxpayers (million)	% income tax payers to total population
Bangladesh <sup>1</sup>	2009	160	1.8	1.13
Pakistan <sup>2</sup>	2009	169.7	1.7	1.00
India <sup>3</sup>	2008	1139.9	32.7	2.87
Sri Lanka <sup>4</sup>	2010	20.4	0.41	2.00
China <sup>5</sup>	2009	1331.4	2.7	0.20

Sources:

1. National Board of Revenue, Bangladesh.<sup>75</sup>

2. Khan.<sup>76</sup>

3. Press Information Bureau, India.<sup>77</sup>

4. Department of Inland Revenue, Sri Lanka.<sup>78</sup>

5. Xiaoji.<sup>79</sup>

6. The World Bank.<sup>80</sup>

The principal objective of a tax system is to raise revenues. Tax systems, however, are often used as tools for achieving a wide range of non-revenue objectives such as promoting industrial development, savings, investment, employment, and exports. To achieve these non-revenue objectives often taxation systems in developing countries adopt a host of incentives and exemptions in the tax legislation in order to encourage or discourage certain activities. Many such objectives are mutually conflicting, and often impede revenue efforts.<sup>81</sup> These exemptions or special treatments also become a major source of complexities and loopholes. Nonetheless, in the presence of various externalities, different treatment to different entities in different situations might become obvious. Many countries find it useful to prepare a

<sup>75</sup> National Board of Revenue, Bangladesh, *Annual Report 2008-09*.

<sup>76</sup> Mubarak Zeb Khan, '1.6m of 1.7m taxpayers are in lowest tax bracket', *Daily Dawn*, 16 March 2011, available at: <<http://dawn.com/2011/03/16/16m-of-17m-taxpayers-are-in-lowest-tax-bracket/>>.

<sup>77</sup> Press Information Bureau, *India Number of Income Tax payers in India is 33.73 million*. Available at: <<http://pibmumbai.gov.in/scripts/detail.asp?releaseId=E2012PR3272>>.

<sup>78</sup> Department of Inland Revenue, Sri Lanka, *Performance Report 2010*. Available at: <<http://www.ird.gov.lk/publications/PReports/PR2010E.pdf>>.

<sup>79</sup> Qiang Xiaoji, '2.7m declare personal income tax in 2009, up 12%', *China Daily*, 21 May 2010. Available at: <[http://www.china.org.cn/china/2010-05/21/content\\_20089421.htm](http://www.china.org.cn/china/2010-05/21/content_20089421.htm)>.

<sup>80</sup> The World Bank, *World Development Indicators database* (2012).

<sup>81</sup> Javad Khalilzadeh Shirazi and Anwar Shah, 'Introduction and Overview' in Javad Khalilzadeh Shirazi and Anwar Shah (eds), *Tax Policy in Developing Countries* (World Bank, 1991).

‘tax expenditure’ budget in order to assess or monitor the costs of tax exemptions used for promoting revenue or non-revenue objectives.<sup>82</sup> At a stage of lower economic development a country definitely needs a reliable and modest source of revenue. It is still, as it always has been, a major question how these countries can establish a tax system which ensures fairness, simplicity, and economic efficiency. A desirable tax system is enforceable in an efficient way, and importantly, is conducive to economic growth and stability. It seems more prudent for developing countries to focus first on the practical aspects of revenue raising activities and only as a secondary matter on achieving non-revenue objectives.

PIT generally has a progressive rate schedule where an individual taxpayer’s marginal tax rate increases as income increases and crosses some threshold level. However, most jurisdictions have a single rate company tax structure. Income tax is associated with a complex procedure of determination of net income after deducting allowances and deductions from taxable receipts. The determination of taxable income involves a host of legal provisions, court observations, rules and regulations. In addition to complexities of legal provisions and regulations, an income tax system is also subject to many administrative challenges. Determination of the fiscal profit or income and collection of the relevant tax is not therefore simple. In the quest of finding a simpler income tax system some countries attempt to flatten the PIT rate structure, perhaps to make the applicable tax burden more comprehensible. As discussed below, several East European countries reformed their PIT rate structure and applied a uniform rate structure across the tax system. There are also some reform initiatives to reduce or eliminate existing PIT deductions in order to simplify the present complex income tax. There are also some proposals on implementation of a cash flow tax in order to eliminate the need for the distinction between revenue and capital expenditure. Although these reforms and proposals are fundamentally different, they are often discussed under a broad title ‘flat taxes’.

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<sup>82</sup> Bird and Zolt, above n 25, 34.

### **(a) The rate scale**

Several East European countries have attempted to flatten the income tax rate structure with an objective of bringing about simplification of the income tax system. Although widely termed as ‘flat taxes’, these reforms did not essentially follow the Hall-Rabushka<sup>83</sup> plan. The Eastern European flat rate income taxes, often classified under a broad title ‘flat tax’, differ widely in terms of the types of income subject to the single tax rate, the size of the tax free threshold, the treatment of interest, dividends, and capital gains, and in terms of the interaction between personal and corporate tax.<sup>84</sup> These taxes have a single rate but all the complexity of calculating business income remains and they pay little attention to redistribution considerations. At the first wave the tax rate is fixed at close to the highest marginal tax rate of the old tax structure. However, in the second wave, starting from Russia, a flat tax rate was fixed near to the lowest marginal rate of the pre reform tax structure.<sup>85</sup> The leading flat rate tax adopting countries of Estonia, Lithuania, and Latvia removed withholding from dividends and capital gains; however, many other countries did not.<sup>86</sup> Nonetheless, there are several general similarities in flat rate taxes including removal of several exemptions under the PIT and CIT, higher dependence on indirect taxes, and reduction of social security contributions.<sup>87</sup>

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<sup>83</sup> Robert E Hall and Alvin Rabushka, *Low Tax, Simple Tax, Flat Tax* (McGraw-Hill, 1983). The Hall-Rabushka flat tax plan is explained below at section 2.3.1. (c) of this chapter.

<sup>84</sup> Richard M. Bird and Eric M. Zolt, ‘Dual Income Taxation and Developing Countries’ (2010) 1 *Columbia Journal of Tax Law* 174.

<sup>85</sup> Michael Keen, Yitae Kim and Ricardo Varsano, ‘The “Flat Tax(es)”: Principles and Evidence’, IMF Working Paper WP/06/218 (2006) 8.

<sup>86</sup> Keen, Kim and Varsano, above n 85, 11.

<sup>87</sup> Keen, Kim and Varsano, above n 85, 13.

**Table 2-3 World wide application of flat rate taxes**

	Year	Personal income tax rates			Corporate tax rates		
		Before reform	After reform	2008 rate	Before reform	After reform	2009 rate
Estonia	1994	16-33	26	21	35	26	21
Lithuania	1994	18-33	33	24	29	29	15
Latvia	1997	10-25	25	20	25	25	15
Russia	2001	12-30	13	35	20	35	16-20
Slovak Rep.	2004	10-37	19	19	25	19	19
Ukraine	2004	10-40	13	30	30	25	25
Georgia	2005	12-20	12	25	20	20	15
Romania	2005	18-40	16	16	25	16	16
Macedonia	2007	15-24	12	10	15	12	10
Kazakhstan	2007	5-20	10	10	30	30	20
Czech Rep	2008	12-32	15	15	24	22	20
Bulgaria	2008	10-24	10	10	10	10	10
Iceland	2007		36			18	
Mongolia	2007		10			15	
Kyrgyzstan	2007		10			10	
Mauritius	2007		15			15	
East Timor	2008		10			10	
Paraguay	2010		10			10	
Hungary	2011		16			10	
Belize	2009		25			25	

Sources: 1. Bird and Zolt;<sup>88</sup> 2. Mitchell;<sup>89</sup> 3. Rabushka.<sup>90</sup>

Keen, Kim and Varsano<sup>91</sup> argue that Eastern European flat rate taxes are not optimal; they do not have a Laffer effect.<sup>92</sup> A flat tax can be progressive since, with some basic personal exemptions, the average rate of tax increases with the level of income. Proponents of a flat tax consider that it brings substantial simplification in the tax system, improves compliance, and reduces administration costs. There are indeed some elements of

<sup>88</sup> Bird and Zolt, above n 84, 174.

<sup>89</sup> Daniel Mitchell, 'Iceland Joins the Flat Tax Club' (2007) 43 *Cato Institute Tax & Budget Bulletin*.

<sup>90</sup> Alvin Rabushka, 'Flat Tax Countries and Jurisdictions' on *Flat Tax BlogSpot* (1 September 2010). Available at: < <http://flattaxes.blogspot.com.au/2010/09/flat-tax-countries-and-jurisdictions.html>>.

<sup>91</sup> Keen, Kim and Varsano, above n 85, 31.

<sup>92</sup> The Laffer effect refers to the relationship between the tax rate and the resulting revenue level. An optimal rate yields the maximum revenues: extreme rates 0 per cent and 100 per cent yield no revenues. Flat rate taxes do not ensure an optimised revenue level.

simplification, but there remain considerable complexities associated with specifying and identifying the tax base.<sup>93</sup> Some surveys in Russia suggest that introduction of a flat tax is not perceived to bring about simplification by taxpayers.<sup>94</sup> It is presumed that a lower rate is conducive to enhanced compliance and reduced evasion. Yet, except for Russia, there is no conclusive evidence that Eastern European flat taxes had a significant positive impact on taxpayer compliance. Gale and Gaddy<sup>95</sup> and also Ivanova, Keen and Klemm<sup>96</sup> report that in Russia the flat tax significantly increased taxpayer compliance. The reasons for improved compliance might be many. It is difficult to argue that only the lower rate and the administrative simplifications contributed to this increased compliance. In terms of revenue productivity, the Russian flat tax also demonstrated significant improvement. Just after its introduction in 2001, the PIT saw a remarkable 46 per cent increase, about 26 per cent in real terms.<sup>97</sup> In the following two years PIT revenue grew 21 and 12 per cent respectively.<sup>98</sup> Keen, Kim and Varsano suggest that the increased revenue in Russia is most likely an outcome of the improvement in tax administration, not a result of the change in rate structure.<sup>99</sup> Also, in other Eastern European flat rate tax jurisdictions the revenue performance has not been so impressive; in most cases revenues have declined.<sup>100</sup> A flat rate tax has basically been adopted by the East European transition countries where tax payers had little experience of tax payment or tax cultures. The rate structure in a taxation system is generally not the primary source of complexity.<sup>101</sup> For mature tax administrations application of a single rate might be less appealing if it is not implemented together with a significant reduction in exemption and deduction provisions.

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<sup>93</sup> Keen, Kim and Varsano, above n 85, 30.

<sup>94</sup> Keen, Kim and Varsano, above n 85, 37.

<sup>95</sup> C. G. Gaddy and W. G. Gale, 'Demythologizing the Russian Flat Tax' (2005) *Tax Notes International* 983.

<sup>96</sup> Anna Ivanova, Michael Keen and Alexander Klemm, 'The Russian "Flat Tax" Reform' (2005) 20 *Economic Policy* 397.

<sup>97</sup> Ivanova, Keen and Klemm, above n 96, 397.

<sup>98</sup> Denvil R Duncan, 'Economic Impact of a "Flat" Tax. What have we learned from the Russian Experience?', Indiana University, SPEA Insights (2012).

<sup>99</sup> Keen, Kim and Varsano, above n 85, 36.

<sup>100</sup> Keen, Kim and Varsano, above n 85, 36.

<sup>101</sup> Keen, Kim and Varsano, above n 85, 37.

It looks like typical developing countries would benefit very little if they merely simplify the rate structure of the income tax system.

### **(b) Deductions**

Deductions, exemptions and credits are some of the major sources of complexities in the income tax system. A substantial part of income tax law and rules deals with allowable and non-allowable deductions, credits and exemptions. Several developed countries attempt to reduce or restrict deduction provisions in their PIT systems. In the continual effort to eliminate employee tax deductions and credits, the Canadian authority has announced the complete phasing out of the Overseas Employee Tax Credit (OETC) by 2016.<sup>102</sup> The tax system in the UK has also substantially reduced employee deduction and credit provisions. Most employees registered under the PAYE (Pay As You Earn) system are not required to file a tax return.<sup>103</sup> Depending on their wage level, Japanese employees receive a certain amount in employment deductions.<sup>104</sup> In Japan, for withholding tax and year end adjustment systems, employees with typical wage and interest income are not required to file tax returns.<sup>105</sup>

All these simplification attempts are independent of change to the tax rate structure. In developing countries, however, removal of tax filing requirements would be very difficult to implement as the withholding tax system is not very efficient and there is also ample scope for tax evasion and

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<sup>102</sup> Canada Revenue Agency, *Overseas employment tax credit (OETC) – Phase out*. Available at: <<http://www.cra-arc.gc.ca/gncy/bdgt/2012/qa07-eng.html>>.

<sup>103</sup> HM Revenue and Customs, *Who needs to complete a Self-Assessment tax return?*. Available at: <<http://www.hmrc.gov.uk/payee/payroll/day-to-day/paying.htm#3>>.

<sup>104</sup> Tax Bureau, Ministry of Finance, Japan, *Comprehensive Handbook of Japanese Taxes 2010* (13 February 2013) 36. Available at: <[http://www.mof.go.jp/english/tax\\_policy/publication/taxes2010e/index.htm](http://www.mof.go.jp/english/tax_policy/publication/taxes2010e/index.htm)>.

<sup>105</sup> Tax Bureau, Ministry of Finance, Japan, above n 104, 31.

avoidance. However, the Japanese schedular<sup>106</sup> employment deduction system might be a useful example for developing countries as it involves a simplified way to impute net taxable income for a gross wage. This system is impressively simple and straightforward; however it does entail some compromise on fairness and equity issues. Recently, India has relaxed income tax return submission requirements for certain salary earners. An employee with only salary and interest income having a total income of less than 0.5 million rupees can choose not to file a tax return.<sup>107</sup> The employee needs to secure a prescribed certificate of tax deduction from his or her employer.<sup>108</sup>

In the case of personal income tax, a system of limited or no deductions has been practiced in some countries. If a tax system can effectively limit deductions and exemptions in case of business income, it would definitely reduce many complexities of the system. It would significantly reduce taxpayer record keeping obligations and compliance costs. However, there is no practical evidence of any country being able significantly to reduce its business deduction provisions. If it were to happen, the tax system in effect would be a presumptive tax as, without a strict consideration of the taxpayer's level of real income and expenditure, that tax would approximate the net taxable income from taxpayer turnover or gross receipts. Simplicity of income tax greatly depends on the ability of policy-makers to remove exemptions and deductions from a country's tax system, which is definitely a difficult task to accomplish.<sup>109</sup> Rather than reducing a number of tax

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<sup>106</sup> See, eg, Tax Bureau, Ministry of Finance, Japan, above n 104. For less than 1.8 million Yen of wage income, a 40 per cent deduction is available subject to a guaranteed minimum deduction of 0.65 million Yen. For 1.8 million to 3.6 million Yen of income, the amount of allowable deduction is 0.18 million Yen plus 30 per cent of the salaries. There are three additional tiers for higher wage income.

<sup>107</sup> Ministry of Finance, India, *Notification No 9/2012* (17 February 2012).

<sup>108</sup> Ministry of Finance, India, above n 107.

<sup>109</sup> Sandra Hadler, Christine Moloi and Sally Wallace, 'Flat Rate Taxes; A Policy Note', International Center for Public Policy Working Paper Series, Andrew Young School of Policy Studies, Georgia State University (2007) 24.

brackets to a single one, a tax system can benefit most if the numerous allowances and exemptions can be eliminated.<sup>110</sup>

### **(c) Cash-flow tax**

In the US, in order to find an alternative to the existing complex tax system, a host of tax reform proposals have been the subject of academic and parliamentary discussions. Some, such as the 1977 Blueprints for Basic Tax Reform,<sup>111</sup> advocated a switch from income taxation to expenditure (consumption) taxation. Another, the 1983 Hall-Rabushka<sup>112</sup> proposal, called for a cash-flow tax system combined with a single 19 per cent rate after a tax-free allowance of \$59,000 for a family of four (i.e., effectively removing most persons from the income tax system). Depreciation rates were to be reduced to one single rate with a first-year write-off provision so that firms would be taxed on their cash flow. All business and personal tax deductions, and taxation on dividends were to be eliminated. Hall and Rabushka<sup>113</sup> argue that this proposed tax system is revenue neutral, much simpler than the existing complex tax, hence is more efficient and conducive to economic efficiency. Eliminating personal and business deductions is fundamental to a simplified flat tax design.

Despite the failure of all versions of flat taxes to gain any traction in the US outside of the special interest groups that propose them, since the implementation of *Tax Reform Act of 1986*, which rejected the expenditure tax and cash-flow tax proposals in favour of comprehensive income taxation, more than 50 Bills have been introduced into the US House of Representatives and Senate with proposals for different flat tax variants.<sup>114</sup> There are numerous variations in the proposed US style flat taxes. Many of

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<sup>110</sup> Hadler, Moloi and Wallace, above n 109, 8.

<sup>111</sup> US Department of Treasury, *Blueprints for Basic Tax Reform* (1977).

<sup>112</sup> Hall and Rabushka, above n 90.

<sup>113</sup> Hall and Rabushka, above n 90.

<sup>114</sup> Lane B Teller, 'The Flat Tax: An Analysis of America's Most Controversial Tax Reform Idea' (2011) *The Public Purpose* 151.

those are cash flow taxes that allow deductions rather than depreciation for capital expenses. The Hall-Rabushka plan has a broad effective exemption for most small businesses through a generous zero-rate band and a single rate for those above a threshold. Recently, the Heritage Foundation proposed 'The New Flat Tax', which is claimed to be revenue neutral with a single tax rate of 28 per cent, with two credits for PIT: earned income credit and low and middle income earner credit, and with only three deductions: for the cost of higher education, charitable contributions and interest on home mortgages.<sup>115</sup> The net taxable income of businesses is the gross receipts minus allowable deductions on wages and purchases. There would be no depreciation provisions as businesses would be able to deduct immediately purchases of plant and equipment. The cash-flow version of the 'flat tax' as a reform idea looks impressive for its merits in terms of simplification. However, there is much debate as to its equity and efficiency merits and there are concerns about its practical administration.

Although flat taxes remain as part of the reform agenda mostly in developed countries, it seems relevant for developing countries to analyse how flat taxes can induce simplicity and efficiency in their existing tax system. A developing country which is planning to undertake substantial reform might benefit from useful insights relating to the efficiency and simplification considerations of flat taxes. They can look to the possibility of implementing a cash flow tax with a flat rate. Moreover, small businesses might perceive a tax system to be fairer if it is flatter and simpler, and has a reasonable standard deduction. Proponents of a flat tax argue that in the longer term, simplification induced higher compliance and lower average effective tax rate induced increased economic activity would lead to increased revenues.<sup>116</sup>

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<sup>115</sup> The Heritage Foundation, *The New Flat Tax: Encourages Growth and Job Creation* (19 January 2012). Available at: <<http://www.heritage.org/research/factsheets/2012/01/the-new-flat-tax-encourages-growth-and-job-creation>>.

<sup>116</sup> Hadler, Moloi and Wallace, above n 109, 20.

#### **(d) Removing most people from the income tax**

The Hall-Rabushka<sup>117</sup> plan in the US has a very large tax-free threshold and it removes a large proportion of the population from the income tax system. In developing countries, tax administrations are reluctant to devote scarce administrative resources to taxing the seemingly not so revenue worthy small businesses. Thuronyi<sup>118</sup> argues that it is a better idea to restrict the number of HTT taxpayers that tax administrations would like to deal with. It can be an effective practical approach to exclude a section of the difficult-to-tax sector and focus on the practically manageable tax base. It should be noted that to compensate for the lost revenue caused by rate reduction, some developing and transitional economies have moved in the other direction and reduced or removed tax-free thresholds to bring everyone into the tax system. This makes the tax structure more regressive, and makes the tax system more difficult to administer. The Hall-Rabushka type tax with a large tax threshold might be useful for developing countries.

#### **2.3.2 Consumption tax**

There are many criticisms of prevailing income taxes, the most common of which are: it is very complex, difficult to enforce, excessively costly, messy with tax bases, imposes a heavier burden on capital or wage income, often taxes more than once a single source of income and so forth. In the last 50 years there have been numerous attempts to find a better alternative to the existing income tax. Income tax had been always favoured by most fiscal policy scholars as the best tax instruments. However, in recent years, the question whether consumption tax should replace income tax or not, is gaining more prominence. Common variants of consumption taxes include the VAT or GST, and retail sales tax. Over the last 30 years there has been a

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<sup>117</sup> Hall and Rabushka, above n 90.

<sup>118</sup> Victor Thuronyi, 'Presumptive Taxation of the Hard-to-Tax' in James Alm, J Martinez-Vazquez and S Wallace (eds), *Taxing the Hard-to-Tax: Lessons from Theory and Practice* (Elsevier, 2004) 107.

dramatic increase in the number of countries that have adopted a variation of VAT. The number of countries that adopted VAT jumped from around 30 to around 140 in only the last 30 years.<sup>119</sup> The International Monetary Fund (IMF) through its policy channels actively promoted the introduction of VAT around the world.<sup>120</sup> There are growing numbers of proponents of consumption taxes who consider consumption based taxes should replace the existing income tax. The consumption tax affects current and future consumption but the income tax affects both consumption and savings. Compared to income tax, consumption taxes are relatively less expensive and more easily administered. The most crucial criticism of VAT is that it is regressive. It is often argued that the lack of progressivity of the VAT can be offset by exempting sensitive food and other items that form a relatively higher proportion of the consumption of the poor. Bird and Zolt<sup>121</sup> argue that the VAT is less regressive than was previously thought. They have pointed out that in some developing countries the VAT and the income tax contain a similar level of progressivity.<sup>122</sup> Almost universally, some food items have some type of concession under the VAT. Krever<sup>123</sup> argues that the poor may spend more on foods in terms of the percentage of their income; however, in absolute terms the rich spend much more on expensive food items. According to a New Zealand study, higher income families benefit more from the exemption from GST on food items.<sup>124</sup> It looks like there is no easy fix for the regressiveness of VAT. A desirable VAT should contain a broad base, single rate and fairly high threshold.<sup>125</sup> Different exemptions, differential rates and a narrower base might generate some progressivity in the VAT system, however, these would induce complexity

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<sup>119</sup> International Monetary Fund, *Revenue Mobilization in Developing Countries* (International Monetary Fund, 2011) 24.

<sup>120</sup> International Monetary Fund, above n 119, 9.

<sup>121</sup> Richard M. Bird and Eric M. Zolt, 'Redistribution via Taxation: The Limited Role of the Personal Income Tax in Developing Countries', International Tax Program Papers 0508, Rotman School of Management, University of Toronto (2005) 17.

<sup>122</sup> Bird and Zolt, above n 121.

<sup>123</sup> Richard Krever, 'Vox Pop' (2011) 4 *VCOSS Insight* 11.

<sup>124</sup> Roger Douglas, 'The New Zealand GST Policy Choice and its Political Implications' in Richard Krever and David White (eds), *GST in Retrospect and Prospect* (Thomson Brookers, 2007) 8.

<sup>125</sup> International Monetary Fund, above n 119, 24.

and make the tax system administratively costly and difficult. The VAT is generally seen as regressive but efficient. Stiglitz<sup>126</sup> argues that for developing countries the VAT is not an efficient tax, and moreover it lowers growth and increases unemployment. In the absence of a progressive tax the impact of the regressive VAT should be a subject of serious concern. In developed countries the VAT runs efficiently by virtue of its self-enforcing system. That is, VAT paid at the lower level is credited to businesses further along the supply chain. In developing countries in the presence of a large shadow economy the VAT system usually does not operate in the intended way. In many developing countries more than half of the gross VAT is collected at the import stage by the customs authority.<sup>127</sup> In some countries importers do not obtain a credit for the VAT withheld.<sup>128</sup> Stiglitz<sup>129</sup> further concludes that there are alternative tax options that are more desirable than VAT, such as land taxation and a tax on imported consumption goods, which are less hostile to output and welfare.

Although during the last three decades a large number of countries have adopted VAT or GST, still a number of countries use the sales tax to tax consumption, including Bhutan, Democratic Republic of the Congo, Cuba, Djibouti, Egypt, Equatorial Guinea, Malaysia, Myanmar, and the US.<sup>130</sup> There are several disadvantages of sales tax compared to VAT: first, although retail sales tax is supposed to tax only the final purchases of consumers and not the purchases of businesses, it eventually taxes business inputs.<sup>131</sup> Ring<sup>132</sup> reports that in 1989, 40 per cent of the retail sales tax of the US states was collected from business to business sales. The second and perhaps most serious problem is the administrative problem. VAT is levied

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<sup>126</sup> Stiglitz, above n 39, 20.

<sup>127</sup> Liam Ebrill, Michael Keen, Jean-Paul Bodin and Victoria Summers, *The Modern VAT* (International Monetary Fund, Washington, DC, 2001) 126.

<sup>128</sup> Ebrill, Keen, Bodin and Summers, above n 127, 163.

<sup>129</sup> Stiglitz, above n 39, 17.

<sup>130</sup> Deloitte, *Global Indirect Tax Rates*. Available at: <[http://www.deloitte.com/view/en\\_GX/global/services/tax/indirect-tax/f839dff2d42fb110VgnVCM100000ba42f00aRCRD.htm](http://www.deloitte.com/view/en_GX/global/services/tax/indirect-tax/f839dff2d42fb110VgnVCM100000ba42f00aRCRD.htm)>.

<sup>131</sup> Ebrill, Keen, Bodin and Summers, above n 127, 23.

<sup>132</sup> Raymond Ring, 'The Proportion of Consumers' and Producers' Goods in the General Sales Tax' (1989) 42(2) *National Tax Journal* 167.

at multiple stages of production; inputs are credited against taxes on output. VAT is therefore relatively less prone to evasion.<sup>133</sup> However, a difficult to enforce VAT refund policy and carousel frauds often makes VAT far more prone to evasion and fraud. In the case of high tax rates sales tax often becomes very difficult to enforce and manage for the tax authorities. Again, this type of problem can strike severely in the case of VAT as retail sales taxes commonly have rates far lower than those found in VAT systems – retail sales tax rates of 5-8 per cent are not uncommon while VAT rates of 20-30 per cent are not unusual.

Another variety of consumption tax, excise, is used by many developed and developing countries; however, the importance of this revenue source is in decline.<sup>134</sup> Excise is the opposite of a broad-based tax, a tax levied on particular goods. Excise is generally levied on luxury items, in the case of developing countries or on harmful items. These items themselves often are not necessarily harmful but the market price without the tax does not equal the true social cost of consumption. Excise is imposed in order to discourage certain harmful consumptions and to tap revenues from the tax handles and The majority of the excise revenues comes from fuels, tobacco, alcohol and other drinks, cars and mobile phones.<sup>135</sup>

## **2.4 Tax administration**

No doubt a well-functioning tax administration is essential for mobilising internal resources in developing countries. Tax policy can be of little use if it is not executed by a sound and appropriate tax administration. Tax policy and administration are two separate frontiers ideally dealt with separately. However, in developing countries tax administration in effect dictates how

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<sup>133</sup> Ebrill, Keen, Bodin and Summers, above n 127, 3.

<sup>134</sup> International Monetary Fund, above n 119, 37.

<sup>135</sup> International Monetary Fund, above n 119, 37.

tax laws should be used in practice.<sup>136</sup> In 1990, Casanegra de Jantscher<sup>137</sup> famously noted that in developing countries ‘tax administration is tax policy’. After three decades, the policy and administrative environment in developing countries seems to have changed very little, as the recent high profile Kelkar<sup>138</sup> Committee report on fiscal reform endorses the fact that in India still tax administration is tax policy. This report stresses that the capacity of the tax administration needs to be significantly improved in order to achieve a targeted tax-GDP ratio. Normative and theoretical analyses of taxation generally have ignored the importance of the issues concerning interaction of tax policy and tax administration.<sup>139</sup> Existing public finance literature has failed to pay due attention to tax administration issues.<sup>140</sup>

The findings of most of the studies on developing country tax administration agree on the fact that it is more difficult to establish an efficient and effective tax system in developing countries. Equipped with fewer resources, a tax administration operates in a relatively more difficult environment.<sup>141</sup> Some hurdles such as a strict hierarchical organisational structure, under-paid and under-skilled staff, manual record-keeping, corruption, low tax morale, inadequate enforcing capability, under-staffing, and inadequacy of resource provision typically constrains the efficiency of the tax administrations of many developing countries. These impediments also heavily affect tax reform initiatives. The economic structure of developing countries also in many cases makes taxing more challenging for the administration. Many developing countries have a large traditional

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<sup>136</sup> Charles Y. Mansfield, ‘Tax Administration in Developing Countries: An Economic Perspective’ (1988) 35(1) *International Monetary Fund Staff Papers* 19.

<sup>137</sup> Milka Casanegra de Jantscher, ‘Problems of Administering a Value-Added Tax in Developing Countries’, IMF Working Paper WP/86/15 (1986) 18.

<sup>138</sup> Committee on Roadmap for Fiscal Consolidation, *Report of the Committee on Roadmap for Fiscal Consolidation* (2012) 21. Available at: <[http://www.taxindiaonline.com/RC2/pdffdocs/wnew/Kelkar\\_Committee\\_Report\\_September2012.pdf](http://www.taxindiaonline.com/RC2/pdffdocs/wnew/Kelkar_Committee_Report_September2012.pdf)>.

<sup>139</sup> Casanegra de Jantscher, above n 137, 18.

<sup>140</sup> Shirazi and Shah, above n 81.

<sup>141</sup> Richard M. Bird and Eric M. Zolt, ‘Technology and Taxation in Developing Countries: From Hand to Mouse’, Law-Econ Research Paper No 08-07, UCLA School of Law (2008).

agriculture sector and a large informal economy that remains outside the formal tax structure.<sup>142</sup> Tanzi and Zee<sup>143</sup> identify some major challenges developing countries generally face while establishing an efficient tax system. The challenges include the structure of the economy that makes it difficult for some taxes to be imposed and collected, the limited capacity of the tax administration, the poor quality of data and the lack of political support for a good tax system. Tanzi and Zee<sup>144</sup> further add that some special characteristics such as a large share of agriculture in total output and employment, large shadow economy, many small businesses, a small share of wages in national income and so forth impede the establishment of a modern tax system such as income tax, and to some lesser extent value added tax. Therefore, it does not seem prudent to generalise as to the particular tax policy and administrative arrangement which would be ideal for a whole set of developing countries. A country's economic structure and capability in tax administration should dictate the tax policy choice.<sup>145</sup> It looks like a given ideal tax principle may be less relevant in the context of the economic structure of a particular developing country.

Often tax administrations focus mainly on easily exploitable tax sources for collecting revenues. A good tax administration is not all about how much it collects; it should be concerned a great deal about what it collects.<sup>146</sup> An inefficient tax administration might collect a large amount of tax from tax handles, like wage withholdings or imports, without effectively collecting tax from businesses and professionals.<sup>147</sup> It is a common view that a broader tax base is less distortive; a given amount of revenue can be raised applying a low tax rate. Although base broadening is an important issue in developing

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<sup>142</sup> Bird and Zolt, above n 25, 22.

<sup>143</sup> Vito Tanzi and Howell H Zee, 'Tax Policy for Emerging Markets: Developing Countries', IMF Working Paper WP/00/35 (2000).

<sup>144</sup> Tanzi and Zee, above n 22, 300.

<sup>145</sup> Bird and Zolt, above n 25, 10.

<sup>146</sup> Milka Casanegra de Jantscher and Richard M Bird 'The Reform of Tax Administration', in Richard M. Bird and Milka Casanegra de Jantscher (eds), *Improving Tax Administration in Developing Countries* (International Monetary Fund, 1992) 1.

<sup>147</sup> Casanegra de Jantscher and Bird, above n 146.

countries, as a result of the presence of larger HTT sectors often base broadening attempts do not yield intended results.

Tax law is implemented by the tax administration. Therefore an unnecessarily complex, inadequate, and ill-drafted tax law will often erode the efficiency of a tax administration. The IMF, World Bank and other donor agencies often provide important technical assistance to developing countries in both tax policy and tax administration matters. Due to political instability, change in political regime, change in commitment of the leadership, and for many other practical reasons, reform initiatives most often are implemented in a piecemeal fashion, which seriously affects the efficiency of the overall tax system. Piecemeal or transplanted reforms complicate the existing system; make the overall system relatively more inefficient. Before implementing any reform it is extremely important to consider how a transplanted law or system would operate in local conditions. Many of the recent tax policy and administration reforms in developing countries have been dictated by IMF aid and influence.<sup>148</sup> IMF aid and influence largely shaped the worldwide adaptation of VAT and LTU (Large Taxpayer Unit).<sup>149</sup> Tanzi<sup>150</sup> has emphasised the need for a country to design its own tax policy and administration. However, for many developing countries aid conditions in effect dictate the fiscal reform agendas.<sup>151</sup>

Bahl and Bird<sup>152</sup> in a review of the changing nature of tax policy in developing countries comment that in developing countries where tax policy and administration have accomplished some improvements over the last three decades, in some particular areas still good tax policy needs to surrender to administrative constraints. The appropriate tax treatment of

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<sup>148</sup> Bahl and Bird, above n 31, 286.

<sup>149</sup> Bahl and Bird, above n 31, 286.

<sup>150</sup> Vito Tanzi, 'The IMF and Tax Reform' in Amaresh Bagchi and Nicholas Stern (eds), *Tax Policy and Planning in Developing Countries* (Oxford University Press, 1994) 445.

<sup>151</sup> Bahl and Bird, above n 31, 286.

<sup>152</sup> Bahl and Bird, above n 31, 287.

small and medium businesses is a concern for developing countries.<sup>153</sup> No doubt, there is much more that needs to be done. The worldwide diffusion of information technology might open up opportunities for tax administrations in developing countries to reduce efficiency constraints. Over the last decade, information technology has become dramatically more affordable and more pervasive. Even for a low income country it seems possible to afford an information technology-enabled tax administration. In most developing countries now banking systems are fully operated by computer systems. Thus, it has become possible for tax administrations in many developing countries to trace financial activities of businesses and professionals, which even in the recent past was an extremely difficult task. Some of the key problem areas that a typical developing country tax administration encounters, such as managing and tracking taxpayers, managing withholding information, auditing taxpayers, processing tax returns, collecting payments, and obtaining information from the banking system, might be performed by an information technology-enabled system relatively easily and efficiently. However, every system, either technology enabled or manual, is managed by human beings. During the 1990s, use of computers or information technology was restricted to a select number of people. However, as computers and telecommunication technology become more pervasive, it has now become relatively less challenging to migrate from a traditional paper-based system to an information technology-enabled system. Countries can overcome the problem of a low level of human capacity through efficient usage of information technology.<sup>154</sup> Tax administrations in developing countries are believed to be severely affected by tax evasion and corruption. Effective use of information technology can effectively reduce the interaction between officials, tax agents and tax payers, and so reduce chances of corruption. Similarly, effective tracking of a taxpayer's economic activities can effectively reduce tax evasion. An information technology-enabled tax administration that is guided by efficiently designed tax policy can reduce the efficiency gap of the tax

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<sup>153</sup> Bahl and Bird, above n 31, 290.

<sup>154</sup> Bird and Zolt, above n 25, 25.

system. However, the tax administration strengthening attempts must be supported by political will.<sup>155</sup> Many developing countries are failing to improve efficiency of the tax administration for the lack of commitment of the policy-makers.<sup>156</sup>

This thesis focuses on an efficient tax administration of small businesses. Small businesses, often described as HTT, add additional difficulties for tax systems of developing countries. In terms of tax compliance, small businesses are widely identified as a risky group. Some special characteristics such as size of business, scale of operations, cash transactions, fewer regularity requirements enable small businesses relatively easily to hide the entirety or a part of their economic activities from the regularity authorities. A significant economic cost is involved with the processes of tax administration, tax compliance and tax non-compliance of these businesses.<sup>157</sup> A tax administration is efficient when it keeps these administrative and compliance costs at a minimal level, and imposes the maximum cost on non-compliance. Small businesses with relatively very limited revenue potential require a significant amount of resources to administer. Often a developing country's tax policy and administration find it more convenient, whether officially or not, to exclude a section of small businesses from the formal tax base. There is growing support for establishing a special tax policy and administrative regime for small businesses where tax compliance is very low and administrative capacity is inadequate. Often presumptive taxes that are simple to administer and to comply with are claimed to be a better option to tax small business in a developing country tax environment.<sup>158</sup> Also IMF advocates establishment of small tax offices (STO) in order to make tax compliance easier for the

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<sup>155</sup> Bahl and Bird, above n 31, 288.

<sup>156</sup> Bahl and Bird, above n 31, 283.

<sup>157</sup> Bird and Zolt, above n 25, 24.

<sup>158</sup> Sona Gandhi, Tax Policy and Administration Thematic Group, the World Bank, *Presumptive Direct Taxes* (1 November 2012). Available at: <<http://go.worldbank.org/6J4QTZUYU1>>.

small taxpayers.<sup>159</sup> Chapter 5 of this thesis has an elaborated discussion on a special administrative arrangement for special businesses.<sup>160</sup> The evidence presented in Table 5-4 of Chapter 5 indicates that Indonesia might have achieved substantial benefit from establishment of dedicated tax offices for small tax payers. Bird and Wallace argue that an STO-like arrangement under a universal self-assessment system might be a better alternative to a presumptive tax-based special regime.<sup>161</sup>

Memon<sup>162</sup> argues that in the presence of a large informal economy small business taxation in a developing country should place more stress on simplicity and efficiency than on equity. Bird and Zolt<sup>163</sup> suggest that an optimal or best tax policy has little importance if it cannot be implemented effectively. The appropriate tax treatment of small and medium businesses is a concern for developing countries.<sup>164</sup> Engelschalk<sup>165</sup> argues that equity and simplicity often conflict while designing a tax system for small businesses. Tanzi and Casanegra de Jantscher<sup>166</sup> point out that simplicity should be the main goal of a simplified tax design for small businesses. The tax system should be simple for both the tax administration and the tax payers. It appears that a tax administration should put more emphasis on the simplicity dimensions of the tax system. In the subsequent chapters of this thesis, administrative features regarding small businesses will be discussed in more detail.

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<sup>159</sup> Bird and Wallace, above n 9, 155.

<sup>160</sup> Section 4.4 of Chapter 5 in particular.

<sup>161</sup> Bird and Wallace above n 9, 155.

<sup>162</sup> Memon, above n 26.

<sup>163</sup> Bird and Zolt, above n 25, 10.

<sup>164</sup> Bird and Zolt, above n 25, 10.

<sup>165</sup> Michael Engelschalk, 'Creating a Favourable Tax Environment for Small Business' in J Alm, J Martinez-Vazquez and S Wallace (eds), *Taxing the Hard-to-Tax: Lessons from Theory and Practice* (2004) 310.

<sup>166</sup> Tanzi and Casanegra de Jantscher, above n 33, 15.

## 2.5 Future tax reforms in developing countries

World Trade Organization (WTO) trade liberalization initiatives and global competition for foreign investment have greatly influenced the tax structures of developing countries.<sup>167</sup> Most developing countries were forced to shift their focus from a readily exploitable revenue source, tax or duty on international trade, to other revenue sources such VAT, and income tax. In many instances consumption taxes are used to fill out revenue gaps. Although collection of customs duties and supplementary duties are in a decreasing trend, still many developing countries collect a significant amount of revenues from these sources.

The leading tax reforms that dominated the landscape of tax reforms in developing countries in the recent times might be the global adaptation of VAT and the establishment LTOs. There are a growing number of proponents in support of the VAT playing a greater role in the tax structure of developing countries.<sup>168</sup> Nonetheless, Emran and Stiglitz<sup>169</sup> critically argue that emphasis on VAT as the main source of indirect source is counterproductive in terms of both equity and efficiency considerations. VAT as a reform can have a long term adverse impact on formal sector business growth.<sup>170</sup> Moreover, VAT as a reform in a corruption prone tax administration is more inequitable as the information intensive VAT system puts the less educated small entrepreneurs in a vulnerable position.<sup>171</sup>

Income tax is complex, costly to comply with, often too difficult for a resource and capacity constrained tax administration to manage and enforce. No wonder many developing countries might be interested in finding a tax

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<sup>167</sup> Richard M. Bird, 'Tax Challenges Facing Developing Countries', International Studies Program Working Paper 08-02, Andrew Young School of Policy Studies, Georgia State University (2008), 5.

<sup>168</sup> See, eg, Bird and Zolt, above n 25.

<sup>169</sup> Joseph E. Stiglitz and M. Shahe Emran, *Equity and Efficiency in Tax Reform in Developing Countries* (2007), Available at: <<http://dx.doi.org/10.2139/ssrn.1001269>>.

<sup>170</sup> Stiglitz and Emran, above n 169, 1.

<sup>171</sup> Stiglitz and Emran, above n 169, 10.

system which is more revenue productive, simple to administer and conducive to economic growth. The mounting ineffectiveness of the tax system can bring catastrophic consequences for a country.<sup>172</sup> The history of tax reforms suggests that it is simply not impossible to devise one generic solution for a set of developing countries. A tax system should be built or reformed with a thorough and careful consideration to the economic realities and the institutional capabilities of a country. As Harberger<sup>173</sup> states:

*Seeking an analogy with which to wrap up the main messages of this paper, I can come up with nothing better than the old-fashioned version of marriage. The idea is that the partners spend a long time (while still single) learning the skills they will need in their future roles. This corresponds to the need for serious investment in study and research and preparation of a tax reform. Then, once married, they have to work continually to overcome the frictions and crises of conjugal life. This corresponds to the need to build robust systems of administration, capable of minimizing the number of problems and at the same time of surmounting those that do emerge.*

Definitely, tax reform is not merely a quick and short term solution for a certain fiscal situation. Solid preparation, great attention to local institutions and political realities, simplification, and due regard to the importance of effective administration are the key elements of successful reforms in developing countries.<sup>174</sup>

Looking at around 25 tax reforms in developing countries worldwide, Gillis<sup>175</sup> identifies six important elements of tax reforms: breadth of reform,

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<sup>172</sup> Carl S Shoup, 'The Tax Mission to Japan, 1949-50' in Malcolm Gillis (ed), *Tax Reform in Developing Countries* (Duke University Press, 1989) 177.

<sup>173</sup> Arnold C Harberger, 'Lessons of Tax Reform from the Experiences of Uruguay, Indonesia, and Chile' in Malcolm Gillis (ed), *Tax Reform in Developing Countries* (1989) 42.

<sup>174</sup> Harberger, above n 173, 41.

<sup>175</sup> Malcolm Gillis, 'Toward a Taxonomy for Tax Reform' in Malcolm Gillis (ed), *Tax Reform in Developing Countries* (1989) 7-27.

scope of reform, revenue goals, equity goals, resource allocation goals, and timing of reform. Comparing and contrasting distinctive characteristics of those reforms, Gillis attempts to provide a taxonomy of the reforms that have been initiated in developing countries. According to Gillis, a reform is: comprehensive or partial, involved with tax structures or tax systems, revenue-enhancing or revenue neutral, distributionally neutral or redistributive, economically neutral or an interventionist reform, and contemporaneous or phased and successive. Depending on the range of structural changes with which a reform is involved and the number of objectives it seeks to achieve, a reform may belong to one or more of these categories. Before undertaking a reform, developing countries need to decide which kind of reform they are pursuing and what objectives they wish to accomplish.

In this changed world developing countries can no longer rely on inflation and foreign aid to collect revenues and fill out budgetary gaps. As developing countries are persistently collecting insufficient tax revenues, it looks to be increasingly obvious that a growing number of countries will be looking for reasonably comprehensive and revenue-enhancing tax reforms. Besides the poor level of revenues, often revenues are collected without due consideration for economic growth and distributional consequences. In developing countries most often the politics of taxation prevails over the economics of taxation when reforming the tax structure or tax administration.<sup>176</sup> Tax reform can hardly be successful without the proper support of the stakeholders. Earnest commitment from the political leadership is essential for successful implementation of a tax reform. Even the best planning, administered by the best implementation team, can produce little if the reform is not strongly supported by the political leadership.<sup>177</sup> Often reforms fail when a special reform commission is formed bypassing the original institutional setup.<sup>178</sup> It is important that

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<sup>176</sup> Bird, above n 167, 24.

<sup>177</sup> Bird, above n 167, 24.

<sup>178</sup> Bird, above n 167, 24.

reform is planned, implemented and owned by the organisation concerned.<sup>179</sup>

Finally, a report<sup>180</sup> prepared by the IMF, OECD, UN and World Bank for the G-20 Development Working Group identifies three large challenges that developing countries are facing: i. weak tax administrations, ii. low taxpayer morale, corruption and poor governance, and iii. dealing with sectors that are HTT, including small businesses, small farms, and professionals. Informality is pervasive in developing countries; evasion by qualified professionals is especially a matter of serious concern.<sup>181</sup> This thesis in its subsequent chapters argues that tax systems of developing countries need to be capable of efficiently taxing the HTT sectors. A growth supportive tax system should essentially reduce the cost compliance for the formal sector and increase the cost of operation for the informal sector.<sup>182</sup> Taxation of small business should be an important element of any future tax reform in developing countries.

## 2.6 Conclusion

The aim of this thesis is to find an efficient tax policy and administrative arrangement for taxing small businesses in developing countries. In order to achieve the objectives, it is essential to first understand the existing taxation environment of developing countries. This chapter has provided an analysis of the prevailing taxation policy and administration of developing countries and establishes the basis that an effectively operative tax policy framework needs to be well grounded in the economic structure of developing countries. This chapter has reported that developing countries generally collect an inadequate level of tax revenues. In order to support the budget and to satisfy development needs developing countries need to collect more

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<sup>179</sup> Bird, above n 167, 24.

<sup>180</sup> IMF, OECD, UN and World Bank, *Supporting the Development of More Effective Tax Systems*, Report to the G-20 Development Working Group (2011) 11.

<sup>181</sup> IMF, OECD, UN and World Bank, above n 128, 11.

<sup>182</sup> Bird, above n 167, 24.

revenues. This chapter has also reported that, contrary to the general suggestions of the optimal taxation literature, developing countries rely heavily on indirect taxes. PIT has an extremely limited role in terms of its contribution to total tax revenues and also in terms of the number of people involved with it. Peter, Buttrick and Duncan<sup>183</sup> report that over the period 1981-2005 PIT raised an amount equal to 1 per cent to 3 per cent of GDP in developing countries compared to 9 per cent to 11 per cent of GDP in developed countries. Also Table 2-2 of this chapter demonstrates that only few people file income tax return in developing countries. As the role of PIT is highly limited, tax systems of developing countries seem severely lacking in progressiveness and redistributive features. However, Bird and Zolt<sup>184</sup> argue that it would be very unrealistic to believe that income tax plays any meaningful role in income or wealth redistribution. A country intending to utilise the redistributive features of the tax system might look for alternatives to PIT.<sup>185</sup>

There are growing numbers of proponents of consumption taxes who consider that consumption based taxes should replace existing income taxes. Over the last 30 years there has been a dramatic increase in the number of countries that have adopted a variation of VAT. The number of countries that have adopted VAT has jumped from around 30 to around 140 in only this last 30 years. Consumption taxes are relatively less expensive and more easily administrable than the income tax. However, the most crucial criticism of VAT is that it is regressive. Stiglitz<sup>186</sup> argues that for developing countries the VAT is not an efficient tax, moreover it lowers growth and increases unemployment. In the absence of a progressive tax the impact of regressive VAT should be the subject of serious concern.<sup>187</sup>

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<sup>183</sup> Peter, Buttrick and Duncan, above n 37.

<sup>184</sup> Bird and Zolt, above n 74, 929.

<sup>185</sup> Bird and Zolt, above n 74, 929.

<sup>186</sup> Stiglitz, above n 39, 17.

<sup>187</sup> Stiglitz, above n 39, 17.

This chapter has argued that tax policy can be of little use if it is not executed by a sound and appropriate tax administration. Developing countries still lack administrative capabilities to administer certain good tax policies. Developing countries should concentrate on adopting information technology infrastructure to reduce the efficiency constraints. Moreover, tax policy should be tailored to a country's economic structure and administrative constraints. This chapter has established the basis for arguing that, for taxing small businesses, developing countries need to concentrate more on efficiency and simplicity than on equity and fairness principles. In developing countries economic structure and the capability of the tax administration should dictate the small business tax policy choices.

This chapter has also provided an analysis of the developments in relation to so called flat taxes. The flat rate structure adopted in Eastern European countries and the flat taxes in reform proposals in the US are fundamentally different. Although an impressive number of countries are adopting flattened income tax rate structures, application of merely a single rate would be less appealing if it is not implemented together with some other important elements of simplification, such as exempting certain taxpayers from tax filing requirements, and reducing personal and business deduction provisions. This chapter has argued that developing countries might benefit from a cash flow tax with a single rate and large threshold that eliminates the need for the distinction between revenue and capital expenditure and excludes a section of small taxpayers from the tax base. Small businesses might perceive a tax system to be fairer if it is flatter and simpler; and if it allows a reasonable level of easily comprehensible business deductions.

Finally, this chapter has briefly discussed some policy and administrative dimensions of tax reforms in developing countries. Tax reform is not merely a quick and short term solution for a certain fiscal situation. A successful reform pays great attention to local institutions and political realities, undertakes serious investment in study and research, and is aided by a

dynamic system of administration. It is also important that reform is not imposed from outside; that it is planned, implemented and owned by the stakeholders in the tax system concerned. Moreover, commitment and support from political leadership is essential for a successful tax reform. This chapter has set out the basis for arguing that taxation of small business should be an important element of future tax reforms in developing countries.

# **CHAPTER 3**

## **TAXATION OF SMALL BUSINESSES IN DEVELOPING COUNTRIES: A BRIEF OVERVIEW**

### **3.1 Introduction**

Small business is considered a very important element of the economic environment of any country. The European Commission recognises small enterprises as the backbone of the European economy.<sup>188</sup> In developing countries, there are growing concerns over the need to create a business environment conducive to the growth of small and medium enterprises. Although small businesses are great in number, typically they are considered an insignificant source of government revenues. Often collecting tax from small businesses is considered to be difficult and economically infeasible. In developing countries, a few large businesses and some easily exploitable revenue sources are the traditional focus of the tax administration. Administrative and policy issues regarding taxation of small business are widely ignored. The taxation of small enterprises has rarely received prominence in tax debates and has received relatively little academic attention.<sup>189</sup>

In developing countries, it is estimated that only 5 per cent of potentially liable taxpayers comply with tax obligations.<sup>190</sup> That means that the vast majority of taxpayers are non-compliant. Although there are no reliable data

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<sup>188</sup> European Commission, *The European Charter for Small Enterprises* (2000). Available at: < [http://ec.europa.eu/enterprise/policies/sme/files/charter/docs/charter\\_en.pdf](http://ec.europa.eu/enterprise/policies/sme/files/charter/docs/charter_en.pdf)>.

<sup>189</sup> Keen and Butler, above n 3.

<sup>190</sup> Richard Stern and Jan Loeprick, 'Small Business Taxation: Is this the Key to Formalization? Evidence from Africa and Possible Solutions', World Bank Group, FIAS Tax Team (2007). Available at: < <http://www.businessenvironment.org/dyn/be/docs/159/Coolidge.pdf>>.

as to the extent to which small businesses account for this non-compliance, it can be reasonably assumed that governments of developing countries lose a significant amount of tax revenue due to non-compliance of small businesses. The presence of a large agricultural sector and large shadow economy, widely referred as HTT, is a structural reality for most developing countries. In developing countries, where the level of tax compliance is generally very low and the administrative capability of the taxation authority is very poor, the nexus of taxation of small businesses seems highly linked with the problem of taxing the shadow economy. It is generally believed that a huge number of potentially taxable small and medium businesses operate in the rural and urban shadow economies. Developing countries around the world have experienced rapid urbanisation over the last few decades. Even so, the larger part of the population is based in the rural areas. There are considerable differences in typical urban and rural businesses in terms of business concentration, assets, size, transaction process, production, employment, compliance attitude and so forth. This chapter argues that an efficient small business taxing strategy should identify the distinguishing characteristics of rural and urban small businesses.

Governments of developing countries are becoming increasingly eager to raise their revenue level. It might be prudent to explore the revenue potential of this sector and attempt to collect due taxes from those enterprises. Developing countries generally treat small businesses, formal or informal, as an insignificant source of tax revenue. On the other hand, there is evidence that small businesses consider taxation as a major impediment to their operation and growth. Taxation in developing countries affects small businesses in a number of ways, but it fails to collect a significant amount of revenue. Taxation of small business seems not to be a favourable issue for both taxation authorities and business owners. This thesis aims to find a solution in which the taxation authority can collect a satisfactory level of

revenues without making taxation an obstacle for small business operation and growth.

This chapter outlines the definition, characteristics, and significance of small business. It sketches prevailing policy and administrative aspects; reviews the rationales for and against preferential tax treatment for small businesses. It also discusses the ways in which tax policy can positively impact on the operation and growth of small business and at the same time collect due taxes from them. This chapter argues that the central question of taxation of small business is not whether to adopt a concessionary tax treatment for small business. Rather, it is more important to analyse how to tax the vast majority of small businesses which, whether deliberately or not, stay outside the administrative reach of tax authorities. This chapter argues that the standard income tax regime is not suitable to deal with the core taxation issues of small business. Carefully constructed simple and efficient presumptive methods that are designed to capture the economic activities of both rural and urban small businesses might be more effective means for taxing small businesses in developing countries.

## **3.2 Taxation of small business in developing countries: background issues**

### **3.2.1 Characteristics of small businesses**

In OECD countries, over 95 per cent of enterprises are SMEs (small medium enterprise);<sup>191</sup> SMEs are the employer in around 60 to 70 per cent of total jobs.<sup>192</sup> In Australia during the year 2008-09, 96.5 per cent of all

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<sup>191</sup> OECD, *Small and Medium-sized Enterprises: Local Strength, Global Reach* (2000). Available at: < <http://www.oecd.org/regional/leed/1918307.pdf>>.

<sup>192</sup> OECD, *Small business, job creation and growth: Facts, obstacles and best practices* (1998). Available at: < <http://www.oecd.org/dataoecd/10/59/2090740.pdf>>.

operating businesses were small businesses<sup>193</sup> and those businesses employed 47.2 per cent of the total workforce.<sup>194</sup> It is very difficult to collect reliable data regarding the economic activities of small businesses in developing countries. Ayyagari, Beck and Demirgüç-Kunt<sup>195</sup> found that the SME contribution to total employment is 17.6 per cent in low-income countries and 57.24 per cent in high income countries. Similarly, SMEs contribute 15.5 per cent of GDP in low-income countries and 51.5 per cent of GDP in high income countries. It looks like SMEs play a much more vibrant role in the economies of developed countries. There is so far no conclusive empirical evidence supporting a correlation between a stronger participation of SMEs in the economy and the level of economic development. However, there would be little disagreement over the claim that a vibrant and growth supportive SME sector is a core requirement for economic growth and stability. Developing countries generally contain a relatively much larger informal sector. Ayyagari, Beck and Demirgüç-Kunt<sup>196</sup> report that the size of the informal sector in developing countries is relatively much larger. The size of the informal sector as a percentage of GDP is 47.2 per cent in low-income countries, compared to 13 per cent in high-income countries.<sup>197</sup> Generally the informal sector consists of a huge number of SMEs. Therefore, if the contribution of SMEs of the informal sector is taken into account, the economic importance of SMEs in developing countries in terms of employment and contribution to GDP is not small at all.

Typically, in relation to policy issues small businesses are discussed under the broad title of 'SMEs'. However, the fiscal realities related to small

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<sup>193</sup> The Australian Bureau of Statistics (ABS) defines small businesses as businesses with 0–19 employees.

<sup>194</sup> Commonwealth of Australia, Department of Innovation, Industry, Science and Research, *Australian Small Business Key Statistics* (2011). Available at: <<http://www.innovation.gov.au/SmallBusiness/KeyFacts/Documents/SmallBusinessPublication.pdf>>.

<sup>195</sup> Meghana Ayyagari, Thorsten Beck and Asli Demirgüç-Kunt, 'Small and Medium Enterprises Across the Globe', World Bank Policy Research Working Paper 3127 (2003) 10.

<sup>196</sup> Ayyagari, Beck and Demirgüç-Kunt, above n 195, 11.

<sup>197</sup> Ayyagari, Beck and Demirgüç-Kunt, above n 195, 11.

businesses are quite different to those of medium-sized businesses.<sup>198</sup> There is no single universally accepted definition of small business. The definition of small business widely varies among countries, and even within a country. Business size specifications vary across industries or institutions. For tax purposes often a single criterion or a combination of a number of criteria is used to specify small businesses. The most common criteria that are used for defining small business include gross turnover, gross income, net assets, taxable income, number of employees, and equity. In the United States for tax purposes 40 different qualifying criteria are used to specify small businesses.<sup>199</sup>

In terms of presence, small businesses greatly outnumber medium and large enterprises. However, the tax revenue contribution of these firms is generally very low and in some countries it is negligible. In developing countries small businesses and marginal individual taxpayers are typically huge in numbers, usually small in terms of turnover and capital, and do not keep accounting records very well. The majority of them are not registered for tax purposes, but many of them are legally and potentially taxable. Table 3-1 is helpful to comprehend the features which distinguish small businesses from medium and large businesses.

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<sup>198</sup> Judith Freedman, 'Reforming the Business Tax System: Does Size Matter? Fundamental Issues in Small Business Taxation' in Chris Evans and Richard Krever (eds), *Australian Business Tax Reform in Retrospect and Prospect* (2009) 154.

<sup>199</sup> The Institute of Chartered Accountants in Australia, *Research and recommendations on definition of small business* (2006) 18. Available at:  
< [http://www.charteredaccountants.com.au/~media/Files/Industry%20topics/Tax/leadership%20papers%20and%20toolkits/Definition\\_of\\_small\\_business\\_160206.ashx](http://www.charteredaccountants.com.au/~media/Files/Industry%20topics/Tax/leadership%20papers%20and%20toolkits/Definition_of_small_business_160206.ashx)>.

**Table 3-1 Distinguishing features of small businesses**

Characteristics	Micro and small	Medium and large
Number of employees	0-49	50 and above
Taxpayer category	Mainly individual, few of those are partnership and corporate	Mostly corporate
Presence in Market	Numerous	Moderate to low
Type of Transaction	Mainly cash basis	Mainly accrual basis
Place of business	Non fixed and fixed	Fixed
Managed by	Mainly owner	Manager
Access to financial markets	Highly limited	Not limited
Market reach	Local and regional	National and International
Capital adequacy	Inadequate	Adequate
Level of compliance	Generally non-complying	Complying
Life span	Volatile, stay small or grow	Stable

### **3.2.2 Urban and rural small businesses**

Developing countries around the world have experienced rapid urbanisation over the last few decades. However, still the larger part of the population is based in rural areas. A significant number of SMEs are still located in rural areas in developing countries. Liedholm, using survey data of several developing counties in Africa and Latin America, found that more than half of SMEs are located strictly in rural areas.<sup>200</sup>

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<sup>200</sup> Liedholm, above n 11, 229.

**Table 3-2 Percentage of urban population in selected region, 2010**

Region	Percentile
Least developed countries ( UN classification)	29
South Asia	30
Sub-Saharan Africa	37
World	51
OECD members	77

Source: World Development Indicators Database.<sup>201</sup>

There are considerable differences in typical urban and rural businesses in terms of business concentration, assets, size, transaction process, production, employment, compliance attitude and so forth. In developing countries the shadow economy is generally divided into urban and rural segments. Many developing and transition countries widely use various methods of presumptive taxation to deal with small taxpayers. Presumptive methods are often effective when certain taxpayers do not keep books and records, so that their business activities are very difficult to ascertain. Tax authorities depend on a variety of indicators like purchases, sales, number of employees, and number of cars owned by the taxpayer to assess the presumed tax liability of the taxpayer. In order to design an effective presumptive method, it is very important to analyse and understand important characteristics and crucial features of those businesses. It looks like it is more appropriate to recognise the distinguishing features of rural and urban small businesses and develop taxing methods that can effectively capture economic activities of those two classes of taxpayers.

Most developing countries contain a larger agricultural sector, predominantly operated by a huge number of farming and non-farming small businesses. Most of these small businesses are typically engaged with

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<sup>201</sup> The World Bank, *World Development Indicators Database* (2012).

farming, factory farming, livestock farming, orchard cultivation, poultry farming, fish farming, and some common types of agro businesses. Rural agribusinesses mostly operate on a cash or barter basis and do not maintain books and accounts, and their entitlement to assets is difficult to determine. It is extremely difficult to monitor or assess the economic activities of these businesses. The ownership records of land, the dominant indicator of the business activity, are extremely hard to access. Moreover, these business entities are spread in a very dispersed way and operate near the periphery of the administrative reach of tax administration. The administrative reach towards rural small businesses is extremely weak as tax office locations are highly concentrated in urban areas. All these characteristics make agricultural sector or rural small businesses the hardest to tax.<sup>202</sup> A number of empirical studies identify the presence of a larger agricultural sector as a major impediment for tax efforts of developing countries. Most of these businesses potentially operate near subsistence and generate a very modest amount of taxable income. Nonetheless, many large land owners and agro businesses, despite generating substantial amounts of taxable income, are able to hide their income and stay outside of the reach of tax administration. The agricultural sector represents a sizable portion of GDP, but supplies little tax revenues. In Chapter 2 it was reported that developing countries typically suffer from a narrow tax base, in which only few businesses and individuals actually pay taxes. It seems very important that tax administrations also look seriously into these widely untapped rural small businesses. Taxing efficiently the evaders in rural locations looks important in order to improve revenue collection in developing countries.

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<sup>202</sup> Indira Rajaraman, 'Taxing Agriculture in a Developing Country: A Possible Approach' in James Alm, Jorge Martinez-Vazquez and Sally Wallace (eds), *Taxing the Hard-to-Tax: Lessons from Theory and Practice* (Elsevier, 2004) 245.

**Table 3-3 Typical distinguishing characteristics of urban and rural shadow economic entities**

Key Characteristics	Rural	Urban
Registration	No/local trade licence	Local trade licence
Business transaction	Cash , barter	Cash , banking channel
Number	Often much greater than urban	Often much smaller than urban
Books and accounts	No	No , or basic level
Concentration	Highly dispersed	Highly concentrated
Business indicators	Land size, land quality, crop type, tools or machinery used	Business size, number of employee, business stock, amount of utility consumed
Association	None	Member of local trade association
Employment type	Seasonal	Ongoing

This chapter provides a general overview on the taxation of small business in developing countries. Chapter 6 provides a focused analysis on the key characteristics of urban small businesses such as business registration, mode of business transaction, book-keeping practices, business indicators, location and business clusters. Those discussions point out the key distinguishing characteristics of urban small businesses as opposed to their rural counterparts.

### **3.2.3 Significance of small businesses**

Both in the developed or developing world, small businesses are believed to be the creator of several important positive externalities in the economic environment. Many argue that, in order to strengthen their overall economic condition, developing countries should actively support small businesses through reducing constraints on business growth. The small businesses of many developing countries receive forms of government support to varying

degrees. The forms of support range from concessional or easier access to business finance, skills training, business management advocacy, concessionary tax provisions and so forth. Often, these forms of support become an inducement for making distorted businesses choices. It is very crucial to ensure that the incentives are pro-growth, and that they support businesses to sustain their position and grow. In addition, it needs to be ensured that these incentives do not work as an inducement for distorted business choices, and do not open up avenues of avoidance and evasion.

### **3.2.3.1 Job creation and economic growth**

It is often claimed that small business is a major engine of job creation. The World Bank considers that development of SMEs, both urban and rural, is the core to fostering economic growth, employment and poverty alleviation in developing countries.<sup>203</sup> However, many studies conclude that the claim of small businesses to be the major engine of job creation is merely a conventional wisdom. Birch<sup>204</sup> provides the first empirical evidence that small business is a major source of job growth; that it creates more jobs in net terms than larger firms. Later a series of studies including that by Davis, Haltiwanger and Schuh<sup>205</sup> severely criticized the methodology adopted by Birch commenting that it is subject to ‘regression fallacy’. Brown, Hamilton and Medoff<sup>206</sup> argue that jobs created by small firms offer inferior work conditions, fewer job training opportunities, lower pay and fringe benefits, and involve higher workplace uncertainties, so that small businesses are less

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<sup>203</sup> Meghana Ayyagari, Thorsten Beck and Asli Demirgüç-Kunt, ‘Small and Medium Enterprises Across the Globe’ (2007) 29(4) *Small Business Economics* 415.

<sup>204</sup> David Birch, *The Job Generation Process*, MIT program on Neighbourhood and Regional Change for the Economic Development Administration, US Department of Commerce (1979).

<sup>205</sup> Steven Davis, John Haltiwanger and Scott Schuh, ‘Small Business and Job Creation: Dissecting the Myth and Reassessing the Facts’ (1996) 8(b) *Small Business Economics* 297-315.

<sup>206</sup> Charles Brown, James Hamilton and James Medoff, *Employers: Large and Small* (Harvard University Press, 1990) 109.

beneficial for the economy. However, Neumark, Wall and Zhang<sup>207</sup> demonstrate that small establishments and small firms indeed create more jobs. Using the National Establishment Time Series (NETS) database, observing the overall US economy, the study provides evidence in support of the claim that small establishments in net terms do create more jobs. Using a dataset of 99 developing economies, Ayyagari, Demirgüç-Kunt and Maksimovic<sup>208</sup> find that small firms make important contributions to job creation and growth of total net employment. However, they also find that large firms yield higher productivity growth than small firms.<sup>209</sup> Graham Bannock<sup>210</sup> argues that, apart from job creation, small businesses have many functions in society; the job creation debate to some extent overshadows the point. In the rural areas of many developing countries rural small businesses offer the only employment opportunity.<sup>211</sup>

SMEs apparently play a more active economic role in developed countries. Developed countries have larger SME sectors as SMEs contribute more in total employment and GDP.<sup>212</sup> SMEs in developing countries tend to be less growth-oriented as compared to their developed country counterparts. Hsieh and Klenow<sup>213</sup> demonstrate that in Mexico and India manufacturing suffers from 25 per cent less productivity growth than in the US for the failure of small business to grow larger. Small business creates a huge number of jobs; also they shed jobs in large numbers. An environment conducive to growth needs to be created in order to enable small businesses to contribute to meaningful net job creation.

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<sup>207</sup> David Neumark, Brandon Wall and Junfu Zhang, 'Do Small Businesses Create More Jobs? New Evidence from the National Establishment Time Series', National Bureau of Economic Research, Working Paper No 13818 (2008).

<sup>208</sup> Meghana Ayyagari, Asli Demirgüç-Kunt and Vojislav Maksimovic, 'Small vs. Young Firms Across the World: Contribution to Employment, Job Creation, and Growth', World Bank Policy Research Working Paper Series 5631 (2011).

<sup>209</sup> Ayyagari, Demirgüç-Kunt and Maksimovic, above n 208.

<sup>210</sup> Graham Bannock, *Economics and Management of Small Business: An International Perspective* (Routledge, 2005).

<sup>211</sup> Bannock, above n 210.

<sup>212</sup> Ayyagari, Beck and Demirgüç-Kunt, above n 195.

<sup>213</sup> Chang-Tai Hsieh and Peter J Klenow, 'The Life Cycle of Plants in India and Mexico', Chicago Booth Research Paper No 11-38 (2011).

### **3.2.3.2 Innovation**

Small business is sometimes regarded as an important source of innovation. However this claim is not well supported by any empirical evidence. Some studies such as that by Bruce Tether<sup>214</sup> claim that small business might play a key role in innovation and technology diffusion. However, on the contrary, Pagano and Schivardi<sup>215</sup> demonstrate that larger firms generate more innovation. In developing countries even larger firms are involved in little research and development activity; the major part of technology transfer or innovation comes from foreign sources. Large manufacturing or exporting businesses typically import technology and adapt it to the local conditions.<sup>216</sup>

### **3.2.3.3 Skills development and social and distributional considerations**

It is widely claimed that small businesses develop certain skills and qualities that ultimately benefit the society. Small businesses provide a host of personal skills to the community such as entrepreneurship, craftsmanship, job skills and so forth. In developing countries, opportunity to create micro business is often seen as an important means of poverty alleviation and empowerment. In developing countries, rural small businesses seem to play a greater social and distributional role. The World Bank stresses that in the rural areas of many developing countries small businesses create the only meaningful job opportunity.<sup>217</sup> According to the OECD,<sup>218</sup> the entrepreneurship prompted by small businesses plays a significant role in

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<sup>214</sup> Bruce Tether, 'Small Firms, Innovation and Employment Creation in Britain and Europe: A Question of Expectations' (1999) 20(2) *Technovation* 109.

<sup>215</sup> Patrizio Pagano and Fabiano Schivardi, 'Firm Size Distribution and Growth' (2003) 105(2) *Scandinavian Journal of Economics* 255.

<sup>216</sup> Tyler Biggs, Manju Shah and Pradeep Srivastava, 'Technological Capability and Learning in African Enterprises', World Bank Technical Paper 288 (1996).

<sup>217</sup> International Tax Dialogue, *Taxation of Small and Medium Enterprises*, background paper for the International Tax Dialogue Conference, Buenos Aires, 2007.

<sup>218</sup> OECD, *SME and Entrepreneurship Outlook* (2005) 414.

job creation and poverty alleviation. Berry<sup>219</sup> claims that there is a positive correlation between strong SMEs and low inequality. Compensation for small owners and the disadvantaged definitely has a positive impact on the reduction of inequality.

### **3.3 Small business and taxation: does taxation really matter?**

Small businesses typically interact with a number of regulatory authorities including taxation, customs, business registration and licencing and national standards organisations, occupational health and safety organizations, the judiciary, and trade bodies. Small businesses also need to comply with a number of laws such as company, commercial and contract laws, property laws, taxation laws, and workplace laws. Taxation authorities and taxation laws are one of many externalities that small businesses need to encounter. The question remains to what extent taxation impacts on the operation of small businesses? It is a reality that developing countries generally contain a larger informal economy; a huge number of small businesses for various reasons hide themselves from government regulatory authorities and operate in the shadow economy. A taxation authority having poor administrative capability is for the most part unable to reach most of those potential taxpayers. Even if the tax administration can reach those firms, the overwhelming cost of tax collection and enforcement makes tax collection infeasible. For many of those small businesses taxation is not a very important issue.

#### **3.3.1 Small business and the shadow economy**

Economic activities that remain outside the purview of the government authorities are often referred to as the informal, hidden, shadow or black economy. The scope or definition of the shadow economy varies widely.

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<sup>219</sup> Albert Berry, 'The Importance of SMEs in the Economy', paper presented at the International Tax Dialogue Conference, Buenos Aires (2007).

One commonly used definition of shadow economic activity is ‘all currently unregistered economic activities that contribute to officially calculated or observed Gross Domestic Product (GDP)’.<sup>220</sup> However, Schneider and Enste<sup>221</sup> specify the shadow economy as legal activity that is not reported and therefore not included in official GDP. For the convenience of estimating the extent of the shadow economy, different definitions and specifications are used. In general terms, shadow economic activities are the market based production of goods and services that are concealed from the public authorities to avoid payment of taxes, social security contributions or to avoid various regulatory obligations. A greater presence of shadow economic activities makes taxation even more challenging for a typical developing country tax administration.

The shadow economy is persistently prevalent in all countries around the world. The size of the shadow economy however varies widely among those countries. Most of the empirical works that attempt to measure the size of the shadow economy suggest that the presence of the shadow economy is much higher in developing and transition countries. Estimates by Schneider,<sup>222</sup> and Schneider and Enste,<sup>223</sup> of the world shadow economy as a percentage of GNP in 1999-2000 reveal that the average shadow economy is 41 per cent in Africa, 26 per cent in Asia, 41 per cent in South America, 38 per cent in transition economies, and 17 per cent in OECD countries. Most of the major works on informality estimate that over 30 per cent of output and 70 per cent of the workforce in developing countries are to some extent staying outside the limits of government regulation.<sup>224</sup> It is generally believed that a substantial number of small businesses in developing

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<sup>220</sup> James Alm, Jorge Martinez-Vazquez, and Friedrich Schneider, “Sizing” the Problem of the Hard-to-Tax’, in Alm, Martinez-Vazquez and Wallace (eds), *Taxing the Hard-to-Tax: Lessons from Theory and Practice* (Elsevier, 2004) 15.

<sup>221</sup> Schneider and Enste, above n 40, 78.

<sup>222</sup> Friedrich Schneider, ‘Shadow Economies of 145 Countries all Over the World: What Do We Really Know?’, Center for Research in Economics, Management and the Arts Working Paper No 2005-13, Basel (2005) 28.

<sup>223</sup> Schneider and Enste, above n 221.

<sup>224</sup> Thomas Kenyon, ‘A Framework for Thinking about Enterprise Formalization Policies in Developing Countries’, World Bank Policy Research Working Paper No 4235 (2007) 2.

countries operate in the informal economy. In developing countries where the administrative capability of the taxation authority is relatively poor, it is easier for small and medium-sized businesses to conceal themselves and operate without paying due taxes. It looks like success of small business tax policy greatly depends upon its success in effectively taxing the shadow economy. The involvement of small businesses in shadow economic activities is a very important aspect of small business taxation. Efficient small business taxation systems should analyse and account for the extent, cause, consequences, and business operations of shadow or nearly shadow economic entities. Chapter 4 provides with an elaborated discussion on the issues concerning the taxation of shadow economy SMEs.

Often small business hides in the shadow economy in order to avoid certain taxation and regulatory costs; however, being informal is not costless. Informality on the contrary imposes significant costs on many firms. The Foreign Investment Advisory Service (FIAS) Tax Compliance Cost Survey in Yemen<sup>225</sup> reveals that informality imposes significant costs such as paying bribes to government officials to avoid tax compliance and penalties for non-compliance from other authorities, providing free products or services to avoid tax compliance, temporary shutdown of business to avoid being detected by tax authorities, and relocation of the business to avoid being detected by tax authorities. Using data of a World Bank survey that covered 80 countries and the territory of West Bank and Gaza, Schiffer and Weder<sup>226</sup> find that small and medium firms consider taxation and regulation as one the major obstacles for their business. According to the rank of severity, taxation and regulations rank third for small businesses, and second for medium businesses. It looks like taxation directly or indirectly significantly affects both formal and informal sector small businesses.

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<sup>225</sup> Jacqueline Coolidge, 'Findings of tax compliance cost surveys in developing countries' (2012) 10(2) *eJournal of Tax Research* 270.

<sup>226</sup> Mirjam Schiffer and Beatrice Weder, 'Firm Size and the Business Environment: Worldwide Survey Results', International Finance Corporation Discussion Paper No 43 (2001) 14.

**Table 3-4 Percentage of firms considering tax and regulation to be a major obstacle**

Small firms		Medium firms		Large firms	
Financing	38.9	Financing	38.0	Policy instability	29.8
Inflation	36.9	Taxes and reg.	37.2	Financing	27.9
Taxes and regulation	35.5	Inflation	36.1	Inflation	26.2
Policy instability	35.0	Policy instability	36.0	Street crime	23.9
Street crime	30.6	Exchange	29.7	Corruption	23.4
Corruption	30.1	Corruption	27.4	Exchange	22.4
Exchange rate	28.9	Street crime	25.5	Organised crime	21.7
Organised crime	26.9	Organised crime	23.4	Taxes and regulation	21.4
Anti-comp. practice	23.8	Anti-comp. practice	21.9	Infrastructure	18.2
Infrastructure	16.3	Infrastructure	17.2	Anti-comp. practice	16.9
Judiciary	13.8	Judiciary	14.4	Judiciary	11.6

Source: Schiffer and Weder.<sup>227</sup>

### 3.3.2 Small business: not a substantial source of revenue

In almost every country, a small number of large corporations supply the major share of tax revenue for the government. In developing countries, the revenue administration is particularly dependent on a handful of large corporations for the major share of revenue. Larger corporations are therefore the traditional focus of revenue administrations for the realisation of short-term revenue raising objectives.

It appears that the tax potential of small businesses is widely ignored in developing countries. Table 3-5 illustrates how developing country tax administrations are extremely dependent on a handful of large corporations.

<sup>227</sup> Schiffer and Weder, above n 226.

**Table 3-5 Concentration of tax collection from large corporations in selected countries, 1999**

	Number of taxpayers	Percentage of total taxpayers	Percentage of total domestic tax collection
Argentina	3665	0.1	49.1
Benin	812	1.0	90.0
Bulgaria	842	0.1	51.4
Hungary	369	0.1	42.1
Kenya	600	0.4	61.0
Peru	2450	0.9	64.9
Philippines	833	0.2	36.0
Sri Lanka	1012	0.2	27.6
Mongolia	46	0.2	54.3
Latvia	215	0.5	28.7
Uruguay	13481	..	84.2
Columbia	5308	0.4	57.0

Sources: 1. Bodin;<sup>228</sup> 2. Baer.<sup>229</sup>

This higher dependence on large corporations for tax revenues is the driving rationale for the adoption of a large taxpayers unit (LTU) in around 50 countries worldwide in the last few decades. Many countries with weak revenue administration achieved immediate and visible results through establishment of an LTU.<sup>230</sup> However, the long-term effectiveness of an LTU largely depends on proper synchronization of the LTU with the broader tax administration through improving administration of medium and small taxpayers.<sup>231</sup> Focusing exclusively on an LTU might undermine or neglect the tax potential of a wider tax base, the small taxpayers.

Taxation crucially affects business operations of small businesses. Although small business contributes a negligible portion of tax revenue in developing countries, there might be potential to raise a significant amount of revenue

<sup>228</sup> Jean-Paul Bodin, *LTU Case Studies*, Harvard International Tax Program (2003).

<sup>229</sup> Katherine Baer, 'Improving Large Taxpayer Compliance: A Review of Country Experience', International Monetary Fund, Occasional Paper 215 (2002) 7.

<sup>230</sup> Baer, above n 229, 36.

<sup>231</sup> Baer, above n 229, 38.

without affecting business operations of the small enterprises. Proponents of adopting a simplified tax regime for small businesses argue that a very simple to follow tax system can remove a crucial business environment barrier, increase voluntary compliance, positively impact on productivity and growth, and even increase tax revenues.<sup>232</sup> However, there are many counterarguments too. This thesis argues that enterprise formalisation should be an important element particularly for urban small businesses. Issues regarding taxation and small business formalisation are discussed in more detail in Chapter 6.

### **3.4 Taxation of small business: major issues**

#### **3.4.1 Disproportionately higher burden of tax compliance**

Tax compliance imposes a significant burden of a fixed nature which reduces with increased business volumes. Compliance with the income tax system, VAT or other taxes generally involves a significant fixed cost. A one hundred dollar profit and a one million dollar profit might require the same amount of time and effort for registration and payment of income tax.<sup>233</sup> Due to smaller size, fewer staff, and lower level of expertise, small businesses must incur disproportionately higher tax and other regulatory compliance burdens.<sup>234</sup> Compliance cost increases with the number and types of taxes a taxpayer must encounter, and also with the frequency of returns the taxpayer must submit. Crain and Hopkins<sup>235</sup> demonstrate that small US firms with less than 20 employees face a total annual regulatory burden (including taxation compliance burdens) of around US\$7,000, 60 per

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<sup>232</sup> Stern and Loeprick, above n 190.

<sup>233</sup> Friedrich Schneider, 'The Increase of the Size of the Shadow Economy of 18 OECD-Countries: Some Preliminary Explanations', paper presented at the Annual Public Choice Meeting, Charleston South Carolina, 2000.

<sup>234</sup> Claire Crawford and Judith Freedman, 'Small Business Taxation', Oxford University Centre for Business Taxation Working Papers No 0806 (2008) 44.

<sup>235</sup> Mark Crain and Thomas Hopkins, *The Impact of Regulatory Costs on Small Firms*, report for the US Small Business Administration, Office of Advocacy, Washington, DC (2001) 3.

cent higher than the per employee compliance cost of medium-sized business (businesses with 20 to less than 500 employees), while mid-sized businesses incur 10 per cent higher compliance costs than those of large-sized businesses. Similarly, a report by the US Small Business Administration Office of Advocacy<sup>236</sup> estimates that the cost of regulatory burden to small firms per employee is about 50 per cent higher than the cost to large firms. Compliance cost studies in other OECD<sup>237</sup> jurisdictions have similarly also found that small businesses incur disproportionately a much higher compliance burden than their larger counterparts. Some OECD countries have already adopted concessional fiscal measures to reduce the compliance burden of small businesses. These concessions include less frequent tax remittance and filing requirements, cash basis accounting system, low tax rate, simpler depreciation rules and so forth. The OECD<sup>238</sup> suggests that taxation should minimise the proportionate compliance cost disadvantages of small businesses and should encourage the creation of new small businesses. However, policy-makers of several high income countries are still indecisive about whether small business should receive concessional tax treatment or not and, if they do, to what extent?

While many empirical studies estimate the compliance costs of small businesses in developed countries, there are only a few studies on compliance costs of small businesses in developing jurisdictions. Coolidge<sup>239</sup> analyses a number of compliance cost surveys that were

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<sup>236</sup> US Small Business Administration, Office of the Chief Counsel for Advocacy, *The Changing Burden of Regulation, Paperwork, and Tax Compliance on Small Business: A Report to Congress* (1995).

<sup>237</sup> See eg, Colmar Brunton, *Measuring the Tax Compliance Costs of Small and Medium-Sized Businesses- A Benchmark Survey*, report for the New Zealand Inland Revenue Department (Wellington, 2005); Chris Evans, Katherine Ritchie, Binh Tran-Nam and Michael Walpole, *A Report into Taxpayer Costs of Compliance* (1997); Binh Tran-Nam and John Glover, 'Estimating the Transitional Compliance Costs of the GST in Australia: A Case Study Approach' (2002) 17(4) *Australian Tax Forum* 497; Francis Chittenden, Saleema Kauser and Panikkos Poutziouris, 'PAYE-NIC Compliance Costs: Empirical Evidence from the UK SME Economy' (2005) 23(6) *International Small Business Journal* 635.

<sup>238</sup> OECD, *Small Businesses, Job Creation and Growth: Facts, Obstacles and Best Practices* (1997) 21.

<sup>239</sup> Coolidge, above n 225.

conducted by the World Bank in several developing and transition countries. The study finds that the compliance cost burden that small businesses incur is extremely regressive.<sup>240</sup> In developing countries, the compliance cost burden of small businesses is equivalent to 15 per cent of the turnover of the business. In South Africa, Armenia, India (Bihar) and Georgia, tax compliance cost as a percentage of turnover ranges from 12 to 18 per cent for firms that have 0-5 employees. Tax compliance cost as a percentage of turnover sharply decreases as size of enterprise increases.<sup>241</sup> In the case of firms having more than 374 employees, tax compliance cost as a percentage of turnover reduces to less than 1 per cent.<sup>242</sup> Similarly, in Nepal businesses with turnover ranging from 30,001 to 100,000 rupees incur tax compliance costs of 3.43 per cent of the turnover, while businesses with a turnover of above 250 million rupees incur a tax compliance cost burden amounting to 0.1 per cent of turnover.<sup>243</sup> Clearly, small businesses face a relatively much higher compliance burden than their larger counterparts. Compliance imposes a significant fixed cost on small businesses; on the other hand, the tax administration is also obliged to allocate a considerable amount of resources to collect a relatively smaller amount of tax. It is certain that high compliance cost and complex payment procedures make taxpaying quite burdensome for smaller firms. Conversely, the authorities often find collecting tax from these smaller firms rather unrewarding. Reduction of the compliance burden might offer scope for mutual gains for both tax administration and small firms.

### **3.4.2 Market inefficiency**

Market inefficiencies, such as monopoly power of large firms, might create difficulties especially for urban small firms to enter the market or to raise finance. Imperfections in capital markets might make it difficult for small

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<sup>240</sup> Coolidge, above n 225, 250.

<sup>241</sup> Coolidge, above n 225, 258.

<sup>242</sup> Coolidge, above n 225, 258.

<sup>243</sup> Coolidge, above n 225, 258.

firms to access debt or equity finance. Removal of these disadvantages through fiscal schemes would not only assist the firms, but also would generally improve the market through the spillover effect from the innovative characteristics of small firms.<sup>244</sup> A presence to some degree of market inefficiencies like asymmetry of information, monopoly power of large firms to prevent entry by small firms into the market or the difficulties for small firms in accessing competitive finance might be used as justification for preferential tax treatment for small businesses.<sup>245</sup> However, the conferral of tax concessions as a means of compensating for market inefficiency is questionable.

Losses impose a heavier burden on small businesses than larger ones. Large businesses can offset accumulated losses with taxable profit or obtain relief through offsetting loss with income from new investments. However, small businesses must wait until reaching a mature stage to gain real profit and obtain benefit from accumulated losses.<sup>246</sup> This represents a considerable discrimination against new small businesses without existing taxable profits and for businesses which are at a high growth phase with higher investment spending relative to current profits.<sup>247</sup>

Moreover, large firms can offer lower risk to creditors and can raise business capital from the stock market or borrow through long-term low interest loans from financial institutions. By contrast, for small businesses the option of obtaining funding through borrowing is often limited to entering into costly high yield bank loans. Businesses can claim a deduction on taxable income for interest expense incurred against debt finance. This feature mostly benefits large firms. Larger firms can access low risk credits for operating debt finance and later claim the deductions, so as to lower the tax liability and improve retained earnings. Small start-ups, on the other

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<sup>244</sup> Richard Disney, Jonathan Haskel and Ylva Heden, 'Entry, Exit and Establishment Survival in UK Manufacturing' (2003) 51(1) *Journal of Industrial Economics* 91,112.

<sup>245</sup> Freedman, above n 198, 171.

<sup>246</sup> Freedman, above n 198, 176.

<sup>247</sup> Freedman, above n 198, 176.

hand, initially encounter greater difficulty in obtaining secured debt financing, and tend to incur losses in the initial years for the higher up-front costs relative to the revenues. Deductibility of interest or increases in accumulated losses might help the firm at a mature stage, but not at a stage when small firms struggle the most. However, small businesses are equipped with specialised local knowledge and enjoy certain managerial and operational flexibilities. In order to remain in the business and grow beyond that, small business entrepreneurs must strive to cope with changing circumstances and increased competition. If a small business lacks finance and is unable to compete, it might signify that the screening process of the market mechanism is in action and that that business does not have a good product or idea.<sup>248</sup>

Preferential tax treatments for any group of taxpayers essentially raises the concerns of distortions, complexities, and economic inefficiency. Before adopting any preferential tax policy measure it is essential to analyse very carefully its impact on revenues and the level of distortion it is inviting. A lower rate of tax or tax subsidy provides no benefit to the firms without a taxable income. Many firms, especially the start-ups, might not have any taxable income in the early years. These firms generally incur a substantial amount of capital investment in the early years and often find difficulties in obtaining quality equity financing. These small firms with no taxable income seemingly have strong claims on government support. However those firms are seriously under-represented in any lower rate tax benefit schemes.<sup>249</sup>

Concessional taxation treatment for small businesses is linked to the problem of targeting.<sup>250</sup> A preferential policy instrument that is meant for or targeted to certain groups should provide benefit only to those specified

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<sup>248</sup> Crawford and Freedman, above n 234.

<sup>249</sup> Neil Brooks, 'Taxation of Closely-Held Corporations: The Partnership Option and the Lower Rate of Tax' (1986) 3(4) *Australian Tax Forum* 497.

<sup>250</sup> Freedman, above n 198, 168.

units, and not to others. It is not often easy to specify 'small' or 'medium' and to ensure that only the targeted group enjoys the fiscal benefits. Moreover, incentives for 'small' business might create substantial incentives for staying 'small', and not growing any further. Therefore, tax exemptions might lead to distortions in business choices, and often open up new fronts for evasive schemes, and in addition, this preferential allocation of resources to weaker inefficient firms might cause overall inefficiency in the economy. Johansson *et al*<sup>251</sup> demonstrate that reduced rates of corporate tax for small firms are not likely to support enhanced economic growth.

### **3.5 Common tax incentives for small businesses**

In order to compensate the disadvantaged, or to reduce the compliance burden, or even sometimes simply guided by conventional wisdom, many jurisdictions around the world provide several types of tax concessions to small businesses.

#### **3.5.1 Reduced corporate tax rate**

A reduced corporate tax rate for a qualifying income is a common form of tax incentive offered to small businesses. The reduced rate is targeted at small businesses in a number of ways and administered carefully to limit tax avoidance and revenue leakage. The ability to pay principle might be the driving factor for the almost universal adoption of the progressive individual income tax schedule. Under scheduler systems an individual taxpayer's marginal tax rate increases as income increases and crosses some threshold level. However, most jurisdictions have a single rate flat company tax structure. The corporate tax structure is generally neutral and in its construction the ability to pay consideration is absent. It might be argued that among all taxpayers small corporations are excluded from ability to pay

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<sup>251</sup> Asa Johansson, Christopher Heady, Jens Arnold, Bert Brys and Laura Vartia, 'Tax and Economic Growth', OECD Working Paper Series (2008).

considerations. The main rationale behind adopting a lower tax rate for the small corporations might be the considerations that the larger firms have a greater ability to pay and smaller firms are disadvantaged, thus should be compensated. Targeting efficiency is a very crucial administrative aspect of this incentive. A reduced corporate tax rate for certain taxpayers brings distortions and complexity and imposes a higher administrative cost burden in relation to the tax system.

Several OECD countries including Canada, the UK, and Japan have reduced corporate tax rates for small businesses.<sup>252</sup> Several developing countries also have size-related corporate tax relief. In Indonesia corporations with an annual gross income of less than 50 billion rupiah are entitled to a 50 per cent discount on the corporate tax rate.<sup>253</sup> In Vietnam small and medium-sized corporations with capital of less than 10 billion Dong, or having fewer than 300 employees, are subject to a discount of 30 per cent of their corporate income tax.<sup>254</sup> Thailand has a progressive corporate tax structure with marginal rates of 15, 25 and 30 per cent. A corporation with net profit of less than 1 million baht is subject to the lowest marginal tax rate of 15 per cent.<sup>255</sup> In Malaysia small and medium companies with paid-up capital up to 2.5 million ringgit are subject to a concessional tax rate of 20 per cent for their first 500,000 ringgit in taxable income.<sup>256</sup> However, most developing countries such as Bangladesh, India, Pakistan, Nepal, and Kenya do not have any size-related concessions for small corporations.

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<sup>252</sup> For Canada, see Department of Finance, *Tax Expenditures and Evaluations 2011* (2012); for the United Kingdom, see HM Revenue and Customs, *Tax Expenditures and Ready Reckoners* (2011); and for Japan, see OECD, *Tax Expenditures in OECD Countries* (2010).

<sup>253</sup> Taxrates.cc, *Indonesia Tax Rates* (10 July 2012). Available at: <<http://www.taxrates.cc/html/indonesia-tax-rates.html>>.

<sup>254</sup> Taxrates.cc, *Vietnam Tax Rates* (10 July 2012). Available at: <<http://www.taxrates.cc/html/vietnam-tax-rates.html>>.

<sup>255</sup> Taxrates.cc, *Thailand Tax Rates* (10 July 2012). Available at: <<http://www.taxrates.cc/html/thailand-tax-rates.html>>.

<sup>256</sup> Taxrates.cc, *Malaysia Tax Rates* (10 July 2012). Available at: <<http://www.taxrates.cc/html/malaysia-tax-rates.html>>.

### **3.5.2 Special depreciation allowances and investment credits**

Many jurisdictions allow qualifying firms to receive faster depreciation on certain capital assets. Although accelerated depreciation or faster write off provisions do not change the total depreciation allowances, the increased allowances offer relief from the tax burdens in the initial years. Developed countries generally have differential treatment for small business in case of capital allowances. Few developing countries have adopted preferential depreciation provisions for small businesses. In Malaysia, each small value asset worth 1,000 ringgit or less is eligible for a 100 per cent deduction.<sup>257</sup> Many jurisdictions offer small businesses investment tax credits for a fraction of qualifying expenditure. An investment tax credit is an offset against the payable tax, not an outright deduction from the tax base. An investment tax credit improves the targeting of the relief as it attaches some conditionality on the tax relief. However, this relief offers no immediate respite for the start-ups which remain in a tax loss situation.

### **3.5.3 VAT registration threshold and exemptions**

Most developing countries have a VAT registration threshold. Small businesses with a certain level of turnover are exempt from VAT registration. This exemption provides small businesses with some relief from costly regulatory requirements of VAT administration. Although such firms are not required to pay VAT, often they are subject to turnover tax. Agricultural small businesses receive a relatively greater degree of preferential treatment than their urban counterparts in regard to VAT exemptions. Almost universally, some food items have some type of concession under the VAT. In India, processed meat, fish, vegetables, and

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<sup>257</sup> Jeff Pope and Hijattulah Abdul Jabbar, 'Small and Medium sized Enterprises and Tax Compliance Burden in Malaysia: Issues and Challenges for Tax Administration' (2008) 16(1) *Small Enterprise Research: The Journal of SEAANZ* 47-60.

fruits are charged at a concessional VAT rate of 4 to 5 per cent.<sup>258</sup> In Bangladesh raw agricultural products and foodstuffs are exempt from VAT.<sup>259</sup>

### **3.6 Common approaches to taxation of small business in developing countries**

Although taxing small businesses, which are commonly referred to as HTT, is challenging in all countries, taxing such businesses in developing countries seems even more challenging. The greater presence of the shadow economy, huge subsistence sectors, distortive taxation policy with numerous exemptions, weaker tax administration, low tax morale, and a lower level of education - all these factors make taxation of small businesses very difficult in developing countries. Taxation of small businesses in developing countries seems closely linked with the problem of taxing the shadow economy. A developing country tax policy typically uses a range of fiscal instruments in order to raise revenues from small taxpayers. Each country's level of economic development, quality of institutions, legality, and socio-political environment seem to play a vital role in shaping the existing tax system. Developing countries typically use the following instruments, in varied combinations and to varied extents, in order to tax small businesses.

#### **3.6.1 Presumptive taxation**

Many countries, especially developing and transition countries, widely use various methods of presumptive taxation to deal with small taxpayers. Different presumptions may be used for urban and agricultural SMEs. Land

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<sup>258</sup> KPMG, *India: VAT essentials*. Available at:

<<http://www.kpmg.com/Global/en/IssuesAndInsights/ArticlesPublications/vat-gst-essentials/Pages/india-vat-essentials.aspx>>.

<sup>259</sup> Andrew M. C. Smith, Ainul Islam and M. Moniruzzaman, 'Consumption Taxes in Developing Countries – The Case of Bangladesh' Centre for Accounting, Governance and Taxation Research VAT Working Paper Series No 82, Victoria University Wellington (2011) 8.

size and quality-based presumptive taxes are widely used to tax rural SMEs, while turnover and business indicator-based presumptive methods are generally used to tax urban small taxpayers. As noted by Thuronyi,<sup>260</sup> presumptive taxation is the indirect means to ascertain tax liability, which differs from the usual assessments based on a taxpayer's accounts. Presumptive taxation is based on the legal presumption that the real tax liability of the concerned taxpayer is somewhat close to the assumed tax liability made through indirect method. There are wide varieties of approaches involving presumptive taxation. One approach of presumptive taxation is taxing on the basis of turnover or gross receipt. It is almost universal for VAT to have a threshold. The marginal taxpayers staying below the threshold are taxed on the basis of turnover or gross cash receipt. Income from agriculture is usually taxed on a presumptive basis where the base of tax is the area of land and its quality. The French *forfait* and Israeli *tachshiv* are indicator-based variations of presumptive approaches. Under the classic French *forfait* system, which is not now in practice though, tax liability is calculated on the basis of a variety of indicators like purchases, sales, number of employees, number of cars owned by the taxpayer, and so on. The Israeli *tachshiv* is based on various indicators of a certain industry. For example, a restaurant is taxed on the basis of location, number of seats and average price of items on the menu. Variations of *tachshiv* are in use in many other countries.

The objective of presumptive taxation is to provide an alternative method of assessing the tax liability of certain taxpayers who are not in a position to keep books and records in accordance with the formal requirements of accounting methods. The presumptive method should be sufficiently simple and fair to attract the targeted taxpayers and should provide taxpayers with considerable relief from compliance cost burdens. Although there are many possible options, the proper application of presumptive taxes involves a

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<sup>260</sup> Thuronyi, above n 118, 103.

range of complicated issues.<sup>261</sup> There are many challenging issues like the determination of the thresholds to exclude small taxpayers from the net, the identification of the taxes that presumptive taxation should replace, or the targeting of the class of the taxpayers eligible for presumptive taxes. There is little empirical evidence that presumptive taxes effectively collect more revenue than the regular tax regime. However, Bird and Wallace<sup>262</sup> point out that it is not proper to judge the success of presumptive taxation solely on the basis of revenue productivity. Presumptive taxation also fulfils important goals such as inclusion of start-up businesses in the tax net at an earlier stage, simplification, reduction in compliance costs, promotion of sense of fairness, and encouragement of the HTT sector to participate in formal systems.<sup>263</sup> This section gives a very brief account of presumptive taxation. The application and methods of presumptive taxes widely vary across the world, and as mentioned earlier, efficient application of presumptive taxes involves a range of complicated policy and administrative issues. No doubt, presumptive taxation is a very important element of taxation policy and the administration of small business of developing countries. Chapter 5 of this thesis has a focused analysis on the theoretical and practical aspects of various methods of presumptive taxes.

### **3.6.2 Tax withholding and voluntary compliance**

Inducing greater voluntary compliance might be one approach to reaching the small taxpayers. The global adoption of the so-called Self-Assessment System (SAS) or Universal Self-Assessment System is one way of promoting voluntary compliance among taxpayers. A reasonably simple and efficient SAS system should reduce taxpayer contact with the tax authority and reduce the compliance burden of small taxpayers. The SAS ideally should increase voluntary compliance and raise a reasonable level of revenues from small taxpayers. However, in reality there is little empirical

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<sup>261</sup> Thuronyi, above n 118, 120.

<sup>262</sup> Bird and Wallace, above n 9, 145.

<sup>263</sup> Bird and Wallace, above n 9, 145.

evidence in support of the claim that SAS systems have improved compliance and tax revenues from small taxpayers.

Over the last few decades developing countries have substantially expanded the tax withholding system, which is widely considered to be a low cost and effective method of enhancing compliance. Developing countries collect a substantial portion of income tax as tax withheld. In Bangladesh during the 2010-11 tax year 53.2 per cent of total income tax collection came from tax withholdings.<sup>264</sup> Tax withholding may be one strategy by which the tax administration ensures that at least some tax is collected from registered but non-complying taxpayers. However, the tax withholding system does not function well in the case of self-employed individuals, professionals, and rural small businesses. To deal with non-filing and under-reporting problems, many developing countries require taxpayers to quote a tax identification number when receiving several essential services such as opening a bank account, making utility connections, applying for a business permit, buying properties etc. Increased use of information technology has also enabled tax administrations to use third party data sources for cross-matching business transactions.

### **3.6.3 Exemption**

Exemption is a rather common approach of non-taxation of small businesses. As discussed in Chapter 2, due to many policy and administrative constraints tax administrations often are reluctant to devote scarce administrative resources to taxing seemingly not so revenue worthy small businesses. It can be an effective practical approach to exclude a section of the difficult to tax sector and focus on the practically manageable tax base. Exemption is widely practised particularly in developing countries when the tax administration considers that taxation of an HTT segment is

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<sup>264</sup> National Board of Revenue (Bangladesh), *Annual Report*, 2010-11. Available at: < [http://www.nbr-bd.org/annual\\_report\\_2010-2011.html](http://www.nbr-bd.org/annual_report_2010-2011.html)>.

not worth an administrative effort. Agriculture income enjoys some degree of exemption in many developing countries. However, tax exemption and concessions always open up possible avenues for evaders and avoiders. Bird and Wallace<sup>265</sup> point out that it may be a dangerous strategy since exempting sector *x* opens a new door for firms in sector *y* to exploit the benefits through evasive schemes.

### **3.6.4 Indirect Tax**

Developing countries generally rely to a greater extent on indirect sources of tax revenues. Relatively heavier reliance on indirect taxes can be an approach to raising revenue from informal sector small businesses. Indirect taxes often capture at least some economic activities of the informal sector. In Bangladesh, some small establishments such as retail shops, barber shops, and restaurants might avoid paying income tax, but will, however, pay a lump-sum (not invoice-based) VAT or turnover tax. Developing countries often find these tax handles useful in order to collect revenues. Bird and Wallace<sup>266</sup> argue that these amounts of indirect taxes otherwise could be shifted through wages, return on capital or consumer prices. An economy with a greater prevalence of informal and unrecorded businesses can effectively collect tax from the informal ghosts.<sup>267</sup> However, heavy reliance on indirect revenue raises the obvious concern of equity. As is discussed in Chapter 2, the extremely limited role of PIT in developing countries renders the tax system largely regressive. Heavier reliance on VAT might further worsen the redistributive capability of the tax system. VAT is allegedly considered a major driver of informality in developing countries.<sup>268</sup> The strategy of relying more heavily on indirect taxation might counteract small business operation and growth.

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<sup>265</sup> Bird and Wallace, above n 9, 129.

<sup>266</sup> Bird and Wallace, above n 9, 131.

<sup>267</sup> Bird and Wallace, above n 9, 131.

<sup>268</sup> Emran and Stiglitz, above n 8, 599.

### 3.7 Conclusion

In Chapter 2 the overview of prevailing tax policy and administration in developing countries reported that developing countries depend on indirect sources for tax revenues and still collect inadequate level of tax revenues. Due to the limited role of PIT, tax systems in developing countries lack progressive and redistributive features. The tax administrations of developing countries are also severely constrained in terms of capacity and resources. Equipped with fewer resources, tax administrations operate in a relatively more difficult environment.<sup>269</sup> Developing countries still lack the administrative capabilities to administer certain ideal tax policies.

Small businesses are considered an important part of the economic environment of any country. Both in the developed or developing world, small businesses are believed to be the creator of several important positive externalities in the economic environment. This chapter has outlined the definition, characteristics, and significance of small business. It has sketched the prevailing policy and administrative aspects of small businesses; reviewed the rationales in favour of and against preferential tax treatments for small businesses. It argues that in a difficult policy and administrative environment small businesses give rise to additional difficulties. In terms of tax compliance, small businesses are widely identified as a risky group. Due to some special characteristics such as size of business, scale of operations and completion of transactions in cash, the fewer regulatory requirements enable small businesses relatively easily to hide all or part of their economic activities from the regularity authorities. This chapter has also stressed that small businesses in developing countries have two core segments. There are considerable differences in typical urban and rural businesses in terms of business concentration, assets, size, transaction process, production, employment, compliance attitude and so forth. The larger part of the population and number of SMEs is based in the

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<sup>269</sup> Bird and Zolt, above n 141.

rural areas. This chapter argues that an efficient small businesses taxing strategy should identify the distinguishing characteristics of rural and urban small businesses while designing appropriate taxation policy and administration arrangements. Developing countries generally treat small businesses, whether formal or informal, as an insignificant source of tax revenue. On the other hand, there is evidence that small businesses consider taxation to be a major impediment to the operation and growth of their business. Taxation in developing countries affects small businesses in a number of ways, and yet it fails to collect a significant amount of revenue. Taxation of small business seems to be a troublesome issue for both the taxation authority and business owners. It might be possible to find a solution in which the taxation authority can achieve its revenue and non-revenue objectives without affecting small business operation and growth.

This chapter identifies the major taxation issues that impact operations of small business. Small businesses encounter an unduly high compliance burden. High compliance costs and complex payment procedures undoubtedly make taxpaying quite burdensome for the smaller firms. Conversely, the authorities often find collecting tax from these smaller firms rather unrewarding. Reduction of the compliance burden might offer scope for mutual gain for both the tax administration and small firms. To some degree market inefficiencies such as the monopoly power of large firms might create difficulties for small firms to enter the market or to raise finance. Also large firms can offer lower risk to creditors and can raise business capital from the stock market or borrow through long-term low-interest loans from financial institutions. Government induced distortions, the presence of some degree of market inefficiencies like asymmetry of information, monopoly power of large firms preventing the entry of small firms into the market or difficulties of small firms in accessing competitive finance might also be used as justification for preferential tax treatment for small businesses.<sup>270</sup> This chapter has also described some tax incentives that

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<sup>270</sup> Freedman, above n 198, 171.

are designed to compensate small businesses for the negative externalities that taxation imposes, and the incentives to encourage small businesses for the positive externalities they create. This chapter argues that the central question in taxation of small business is not whether, or how, to design a concessional tax system for small business. Rather, the question is how to tax the vast majority of small businesses which deliberately or otherwise are staying outside the administrative reach of taxation authorities. This chapter has set out the basis for arguing that a standard income tax regime is not suitable to address the core issues regarding the taxation of small business. A carefully designed, simple and efficient presumptive method might be more effective for taxing small businesses in developing countries.

## **CHAPTER 4**

### **TAXING SMALL BUSINESS AND THE SHADOW ECONOMY IN DEVELOPING COUNTRIES**

#### **4.1 Introduction**

Chapter 2 outlines the prevailing taxation policy and administration in developing countries. It argues that an effective tax policy framework needs to be well grounded in the economic structure of developing countries. Developing countries still lack the administrative capabilities to implement certain ideal tax policies. Especially, while taxing of the small business tax policy needs to account for country's economic structure and administrative constraints. Chapter 3 outlines the definition, characteristics, and significance of small business, analyses the prevailing policy and administrative issues regarding taxation of small business, and it reviews the rationales in favour of, and against, preferential tax treatment for small business in the context of developing countries. It is argued that in a difficult policy and administrative setup small businesses add additional difficulties. This chapter also stresses that small businesses in developing countries have two core segments. There are considerable differences in typical urban and rural businesses in terms of business concentration, assets, size, transaction process, production, employment practices, compliance attitude and so forth. Still, the larger portions of the population, as well as the SMEs, are based in the rural areas. An efficient small business taxing strategy should identify the distinguishing characteristics of rural and urban small businesses while designing appropriate taxation policy and administration. Chapter 3 sets the basis for arguing that a standard account-based income tax regime may not be suitable to deal with the core taxation issues regarding taxation of small business. A carefully designed, simple

and efficient presumptive method might be more efficient for taxing small businesses in developing countries.

Chapter 3 initiated a discussion on the nature and the extent of the involvement of small businesses in the shadow economy. The extent to which small business is involved in the shadow economy seems profound. A significant majority of small businesses stay outside the purview of the government authorities. It is apparent that the efficiency of a small business taxation policy greatly hinges on its ability to effectively tax the shadow economy. Before designing a taxation system for small business, it is very important to know the nature and the breadth of the shadow economy and to identify the major causes as to why entities choose not to comply with taxation requirements. Also, it is highly relevant to know the economic consequence of noncompliance by small business. By knowing these developing countries might acquire important insights into what they really can achieve in terms of revenue and non-revenue objectives through taxing the shadow economy. Finally, it appears that the existing literature has very little discussion on compliance behaviour of shadow economic entities in the context of developing countries' socioeconomic environments. In order to formulate an effective taxing strategy, it seems very important to understand the relevant compliance behaviour of shadow economic entities and also to know the basic characteristics of the shadow economy's participants. It appears that a separate chapter should cover all the above mentioned aspects related to the taxation of shadow economy and small businesses. Chapter 4 analyses these issues and sets the basis for arguing that in a non-compliant taxing environment, where administrative capacity is also greatly constrained, a presumptive taxation system might be more efficient for taxing small business. Before a detailed discussion on the principles and the application of presumptive taxation in the contexts of developing countries, it seems essential to understand the small business tax-compliance environment of developing countries.

Shadow economic activities are global and ubiquitous. For many reasons, in developing countries a substantial portion of the economy operates beyond the surveillance of government authorities. Official Gross Domestic Product (GDP) does not account for the value of these hidden outputs. It has long been the conventional wisdom that the size of the shadow economy is strongly related to the level of economic development, such that the extent of shadow economic activities eventually reduce as countries become economically developed. Shadow economies, to varying extents, exist even in highly developed countries. Over the last few decades, the informal and shadow economy has received considerable academic attention. A host of studies attempt to understand and explain the nature, breadth, cause, and consequences of the shadow economy. Shadow economic activities range from informal labour, agro business, informal manufacturing and construction, to shopkeeping, trading, and home based production and so forth. In developing countries small businesses are the key operators of the shadow economy. Small businesses are huge in number; the extent of their participation in overall economic activities is substantial. However, their contribution in tax revenues is very marginal. These small businesses are HTT. Taxing these non-complying small businesses, or the shadow economy, in an administratively and economically feasible manner is a challenging task for developing countries.

This chapter analyses tax compliance issues of informal businesses in greater detail in the context of developing countries. Most researches<sup>271</sup> on the causes of shadow economy identify tax and social security contribution burdens as the top contributing factor. Stricter regulations and enforcement eventually increases the size of the shadow economy.<sup>272</sup> Almost all major empirical studies that investigate causes, consequences and the extent of tax evasion are conducted in relation to the social economic setup of developed

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<sup>271</sup> See, eg, Schneider and Enste, above n 40; Vito Tanzi, 'The Shadow Economy, Its Causes and Its Consequences' (Edited lecture given at the International Seminar on the Shadow Economy Index in Brazil, Brazilian Institute of Ethics in Competition, March 2002) ; Johnson, Kaufmann and Zoido-Lobaton, above n 40.

<sup>272</sup> Schneider and Enste, above n 40, 82.

countries. The leading tax compliance models<sup>273</sup> generally suggest that a taxpayer is more likely to evade tax if he perceives that the probability of successful evasion is considerably higher than the probability of being caught, or if the reward from successful evasion is considerably higher than punishment for evasion. However, in many developing countries, for a typical participant in the shadow economy, the perceived rewards from evasion are not very big, the probability of detection is negligible, and the cost of evasion is also very low. In such a setup, the propositions of Allingham and Sandmo<sup>274</sup> model seem to have little relevance. The existing theories and empirical evidence might be inadequate to understand the issues of tax evasion in developing countries. This chapter draws a general outline of the small business tax compliance environment in developing countries. The analysis leads to the conclusion that a standard tax regime that broadly follows a carrot and stick compliance model may not be efficient for taxing the shadow economy in developing countries. The chapter further sets the basis for arguing that in such a non-compliant taxing environment, presumptive taxation, an indirect means of ascertaining tax obligations, might be a more suitable mode for taxing small businesses.

This chapter also attempts to identify key characteristics of the small business tax compliance environment in developing countries. It also tries to document the socioeconomic characteristics of major participants in the shadow economy. In order to develop an effective taxing strategy it is essential to understand key socioeconomic characteristics of its key operators. Small and micro enterprises are found to be the major participants of informal economies. It is often considered that the majority of shadow economic activities take place in the rural parts of developing countries. However, recent evidence suggests that the majority, around 80%, of urban

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<sup>273</sup> See, eg, Allingham and Sandmo, above n 41.

<sup>274</sup> Allingham and Sandmo, above n 41.

small businesses operate in the shadow economy.<sup>275</sup> Shadow economic entities, as a subset of all small businesses, are also segmented along rural/urban lines. This chapter reiterates the importance of recognizing the distinguishing features of rural and urban small businesses and develop taxing methods that can effectively assess economic activities of those two segments of potential taxpayers.

## 4.2 Shadow economy: scope and definitions

As mentioned earlier, Chapter 3 initiated a discussion on the nature and the extent of small business' involvement in the shadow economy. It appears that the involvement of small business in shadow economic activities is a very important aspect of small business taxation in developing countries. This chapter provides a separate and dedicated discussion of these issues concerning shadow economy SMEs.

Certain economic activities that stay outside of the purview of the government authorities are often referred to as informal, hidden, shadow, cash, underground, grey or black economy. There is no generally agreed upon definition of the 'shadow' or 'informal' economy. Feige<sup>276</sup> explains shadow economies to be the activities that currently are not registered but contribute to the Gross National Product (GNP). A widely used definition of the shadow economy is 'all currently unregistered economic activities that contribute to officially calculated or observed GDP'.<sup>277</sup> However, Schneider and Enste<sup>278</sup> specify the shadow economy as legal activity that is not reported and therefore not included in official GDP. Often in the literature the terms shadow economy, informal economy, underground economy and

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<sup>275</sup> Javier Herrera, Mathias Kuepie, Christophe J. Nordman, Xavier Oudin and Francois Roubaud, 'Overview of Informal Sector and Informal Employment: Data for 11 Cities in 10 Developing Countries', Women in Informal Employment Globalizing and Organizing Working Paper No 9 (2012).

<sup>276</sup> Edgar Feige, *The Underground Economies: Tax Evasion and Information Distortion* (Cambridge University Press, 1989).

<sup>277</sup> Alm, Martinez-Vazquez and Schneider, above n 220, 15.

<sup>278</sup> Schneider and Enste, above n 40, 79.

like-terms are used interchangeably having no substantial difference in scope or definition. Buehn and Karmann<sup>279</sup> point out that a shadow economy is rather a subset of the informal economy and that it is not a part of official GDP because actors in the shadow economy establish informal contracts with their employees and do not comply with tax law and regulations. The other two segments of the informal sector are 1) household based products and services that are distributed within the house hold sector, and 2) illegal products and services that are not being reported to the authority.<sup>280</sup> For convenience in estimating the extent of shadow economies, different definitions and specifications are used. Definitions of the shadow economy vary depending on the purpose and scope of the analysis. Since taxation of small business is the main focus of this thesis, this study identifies shadow economic activities as the legal economic activities that are kept concealed from the public authorities to avoid payment of taxes, social security contributions or to avoid compliance with various regulations.

Although, shadow economy is persistently prevalent in every country, the size of the shadow economy varies widely. Over the last 30 years numerous empirical works have attempted to estimate the scale of shadow economies.<sup>281</sup> Alm, Martinez-Vazquez and Schneider<sup>282</sup> provide a comprehensive overview on different methods that are used to capture the size of a shadow economy. Four mainstream methodologies are being used to estimate the size of shadow economies: 1) Survey method 2) Currency demand approach, 3) Physical input approach and 4) Model or indicator based approach. Survey methodology uses structured questionnaire surveys or voluntary responses from respondents to measure the estimated size of the shadow economy. Under the currency demand approach, underground or hidden transactions are assumed to be done through cash. ‘Excess’ demand

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<sup>279</sup> Buehn Andreas and Alexander Karmann, ‘Shadow Economy and Do-it-Yourself Activities: What Do We Know?’ in Friedrich Schneider (ed.), *Handbook on the Shadow Economy* (Edward Elgar Publishing, 2011) 265.

<sup>280</sup> Andreas and Karmann , above n 279.

<sup>281</sup> For, eg, Schneider and Enste, above n 40; Fiege, above n 276.

<sup>282</sup> Alm, Martinez-Vazquez and Schneider, above n 220.

for currency can therefore be an indicator of the extent of a shadow economy. Under the physical input approach, electricity and power consumption is taken as the predictor of overall economic activity. The size of official plus unofficial GNP, based on power consumptions, minus the officially estimated GNP gives an estimated size of the shadow economy. The final and most widely used method is the model approach. In this method, a set of macroeconomic indicators that can be predictors of the shadow economy's scale, are used to estimate the size of the shadow economy. The Dynamic Multiple Indicators Multiple Causes (or DYMIMIC model) uses a set of observable and unobservable indicators to estimate the structure and size of a shadow economy.

Most empirical works that attempt to measure the size of shadow economies suggest that the presence of shadow economies is much stronger in developing and transitioning countries. Using the DYMIMIC approach Schneider<sup>283</sup> estimates that in 1999-2000 the average size of the shadow economy as a percentage of GNP was 41 per cent in Africa, 28 per cent in Asia, 41 per cent in South America, 38 per cent in transitional economies, and 17 per cent in OECD countries. Later, using MIMIC (Multiple Indicators Multiple Causes) method, Schneider, Buehn and Montenegro<sup>284</sup> estimate that the weighted average size of the shadow economy in Sub-Saharan Africa is 38.4 per cent of official GDP, while it is 13.5 per cent in high-income OECD countries.

### **4.3 Taxation and shadow economy**

There is a severe lack of research on the causes of shadow economies exclusively in the context of developing countries where the size of shadow economy is substantially larger. In order to have an understanding of the

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<sup>283</sup> Schneider, above n 222, 28.

<sup>284</sup> Friedrich Schneider, Andreas Buehn and Claudio E. Montenegro, 'Shadow Economies All Over the World : New Estimates for 162 Countries from 1999 to 2007', The World Bank, Policy Research Working Paper Series 5356 (2010).

causes and consequences of shadow economies this study reviews the available major studies that are conducted in regard to both developed and developing countries. As mentioned earlier, most research<sup>285</sup> on the causes of shadow economies identify tax and social security contribution burdens as the top contributing factor of growing shadow economies. Higher tax rates create a greater incentive for participation in the informal economy. Schneider, Buehn and Montenegro<sup>286</sup> find that the most notable reasons for which people participate in the shadow economy is government taxation and regulations. Schneider,<sup>287</sup> averaging results of a number of empirical studies, finds that increase of the tax and social security contribution burdens are the most significant driving factor of the shadow economy. Among all of the driving factors, this factor alone accounts for 35 -52 per cent of the total positive influence on shadow economies.<sup>288</sup> Schneider and Enste<sup>289</sup> argue that higher marginal tax rates create distortion in the neoclassical labour-leisure determination and increases the supply of labour in the underground economy. Tanzi<sup>290</sup> identifies four major categories of causes for the creation of the shadow economy: taxes, regulations, prohibitions, and corruption. Heavier taxes entice taxpayers to hide their activities ‘underground’ or ‘in the shadows’. Compliance cost is another key factor which contributes to the development of the shadow economy.<sup>291</sup> Compliance costs are costs involved in keeping tax records and filing tax information with the authorities. It also involves costs for taxpayers associated with keeping informed about tax requirements of the tax office and tax consultants. All these impose extra cost obligations in addition to the actual tax burden. In developing countries, due to complicated rules and regulations, cumbersome compliance and tax payment procedures and corruption, small businesses often find that the compliance cost burden is much higher than the actual tax obligation.

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<sup>285</sup> See, eg, Schneider and Enste, above n1; Tanzi, above n1.

<sup>286</sup> Schneider, Buehn and Montenegro, above n 15.

<sup>287</sup> Schneider, above n 222, 13.

<sup>288</sup> Schneider, above n 222, 13.

<sup>289</sup> Schneider and Enste, above n 40, 83.

<sup>290</sup> Tanzi, above n 271, 2.

<sup>291</sup> Tanzi, above n 271, 6.

Too many government regulations are found to be a major contributing factor in increasing the shadow economy. In response to heavy bureaucratic constraints, businesses hide in the shadows so as to avoid complying with and paying taxes.<sup>292</sup> Johnson, Kaufmann, and Shleifer<sup>293</sup> find a positive relationship between the number of general regulations and the size of the shadow economy. Auriol and Warlters<sup>294</sup> argue that the higher fixed cost to enter the formal economy in developing countries is the reason for the development of larger informal economies in those countries. Entities in the formal economy enjoy economic rent which can be confiscated by lowering taxes on profits and lowering administrative costs.<sup>295</sup> In an empirical study with a sample of 76 countries, Friedman, Johnson, Kaufmann, and Zoido-Lobaton<sup>296</sup> find that a one point increase in an index of regulation translates into a 10 per cent increase in the shadow economy of a country.

Other important factors that contribute to increases in size of the shadow economy include socioeconomic factors, corruption, the social transfer system, and quality of public services. A large number of businesses, especially in the developing countries, operate around the subsistence level. Owners and the employees of micro sized firms are mostly not well trained or well-educated and have considerable suspicions about government agencies. In rural areas small entrepreneurs are even less trained and educated. These types of firms prefer to stay in the shadow economy. The social transfer system often creates disincentives for the labour force to participate in the formal economy. Many such micro enterprises do not generate enough taxable income to enter the formal tax net. However, tax authorities might be interested in a huge number of small businesses which generate taxable income, yet prefer to stay outside the tax net.

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<sup>292</sup> Tanzi, above n 271, 8.

<sup>293</sup> Simon Johnson, Daniel Kaufmann and Andrei Shleifer, 'The Unofficial Economy in Transition', Brookings Papers on Economic Activity, Washington D.C. (1997).

<sup>294</sup> Emmanuelle Auriol and Michael Warlters, 'Taxation base in developing countries' (2005) 89(4) *Journal of Public Economics* 625-646.

<sup>295</sup> Auriol and Warlters, above n 294.

<sup>296</sup> Eric Friedman, Simon Johnson, Daniel Kaufmann and Pablo Zoido-Lobaton, 'Dodging the Grabbing Hand: The Determinants of Unofficial Activity in 69 Countries' (2000) 76 *Journal of Public Economics* 476.

#### 4.4 Consequences of shadow economy

The presence of a large shadow economy has a negative impact on equity, the market system and competition.<sup>297</sup> Products produced in the shadow economy do not comply with tax and regulatory obligations. These similar but cheaper products pose unfair competition in the market system.<sup>298</sup> By staying outside of the tax base, entities in the shadow economy restrict the revenue raising capacity of government. Government's resulting reliance on complying taxpayers to fulfil the deficits makes it even more difficult for them to operate. A larger shadow economy also brings distortion to the measurement of important economic variables like national income, rate of unemployment, the economic growth rate, and effective tax burden.<sup>299</sup> The distortions in these statistics may severely mislead policy makers.<sup>300</sup>

Several empirical works attempt to investigate the macroeconomic impact of the informal sector's presence. Alm, Martinez-Vazquez and Schneider<sup>301</sup> find that in developing countries, the size of the shadow economy is associated with a slower rate of GDP growth. However, for developed countries, the relationship between the size of their shadow economy and their economic growth is positive.<sup>302</sup> Braun and Loayza<sup>303</sup> argue that, because of the disadvantages inherent in informality, and due to the loss of tax revenues that restrict the provision of public goods and services, the presence of a larger informal sector results in inefficiency in the economy. This inefficiency ultimately translates into stagnant rates of growth, low rates of return from all investments and sub optimal social welfare. In an empirical investigation with samples from a number of Latin American

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<sup>297</sup> Tanzi, above n 271,10.

<sup>298</sup> Tanzi, above n 271,10.

<sup>299</sup> Tanzi, above n 271,11.

<sup>300</sup> Tanzi, above n 271,14.

<sup>301</sup> Alm, Martinez-Vazquez and Schneider, above n 220.

<sup>302</sup> Alm, Martinez-Vazquez and Schneider, above n 220.

<sup>303</sup> J Braun and Norman V Loayza, 'Taxation, Public Services, and the about Informal Sector in a Model of Endogenous Growth', The World Bank, Policy Research Working Paper No 1334 (1994).

countries, Loayza<sup>304</sup> concludes that where the tax burden is higher than optimal and enforcement is too weak, the relative size of the shadow economy is negatively correlated with economic growth.

Many developing countries are believed to be severely affected by widespread corruption. Johnson, Kaufmann, and Shleifer,<sup>305</sup> using cross-section data from 15 countries, find that corruption and the shadow economy complement each other. Friedman, Johnson, Kaufmann and Zoido-Lobaton<sup>306</sup> with a sample of 69 countries also demonstrate that corruption and the shadow economy are positively correlated. However, Choi and Thum<sup>307</sup> and Dreher, Kotsogiannis and McCorriston<sup>308</sup> demonstrate that the shadow economy and corruption could be substitutes for each other. Dreher and Schneider,<sup>309</sup> using cross section data of a sample of a large number of countries, demonstrate that there exists a significant relationship between the shadow economy and corruption. The shadow economy reduces corruption in high income countries, but increases corruption in low income countries.<sup>310</sup> Torgler, Schneider, and Macintyre<sup>311</sup> show that the legitimacy or responsiveness of the state is the key to reducing the shadow economy. People feel exploited when corruption is widespread, and so they tend to participate in the shadow economy as a means of protest.

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<sup>304</sup> Norman V Loayza, 'The Economics of the Informal Sector: a Simple Model and Some Empirical Evidence from Latin America' (1996) 45 *Carnegie-Rochester Conference Series on Public Policy* 154.

<sup>305</sup> Johnson, Kaufmann, and Shleifer, above n 293.

<sup>306</sup> Friedman, Johnson, Kaufmann and Zoido-Lobaton, above n 296.

<sup>307</sup> Jay Choi and Marcel Thum, 'Corruption and the Shadow Economy' (2004) 12 (4) *International Economic Review* 203-223.

<sup>308</sup> Axel Dreher, C. Kotsogiannis and S. McCorriston, 'How do institutions affect corruption and the shadow economy?', University of Konstanz, Department of Economics Discussion Paper (2005).

<sup>309</sup> Axel Dreher and Friedrich Schneider, 'Corruption and the Shadow Economy: An Empirical Analysis' (2010) 144(1) *Public Choice* 215.

<sup>310</sup> Dreher and Schneider, above n 309.

<sup>311</sup> Benno Torgler, Friedrich Schneider and Alison Macintyr, 'Shadow Economy, Voice and Accountability and Corruption' in Friedrich Schneider (ed.), *Handbook on the Shadow Economy* (Edward Elgar Publishing, 2011).

Cobham<sup>312</sup> estimates that developing countries potentially lose US\$385 billion annually from tax evasion and avoidance. Shadow economic activities<sup>313</sup> account for 74 per cent of these potential revenue leakages. However, it is not mentioned how much of the potential revenue leakage is caused by unregistered small businesses. The other two major sources of revenue leakage identified by Cobham are offshore asset-holding (US\$ 50 billion), and corporate profit-shifting (US\$ 50 billion).<sup>314</sup> The size of the revenue leakage resulting from tax evasion and avoidance is about twice the amount of the official development assistance that developing countries receive. Cobham<sup>315</sup> argues that developing countries can effectively eliminate reliance on external assistance through reducing the extent of tax evasion and avoidance.

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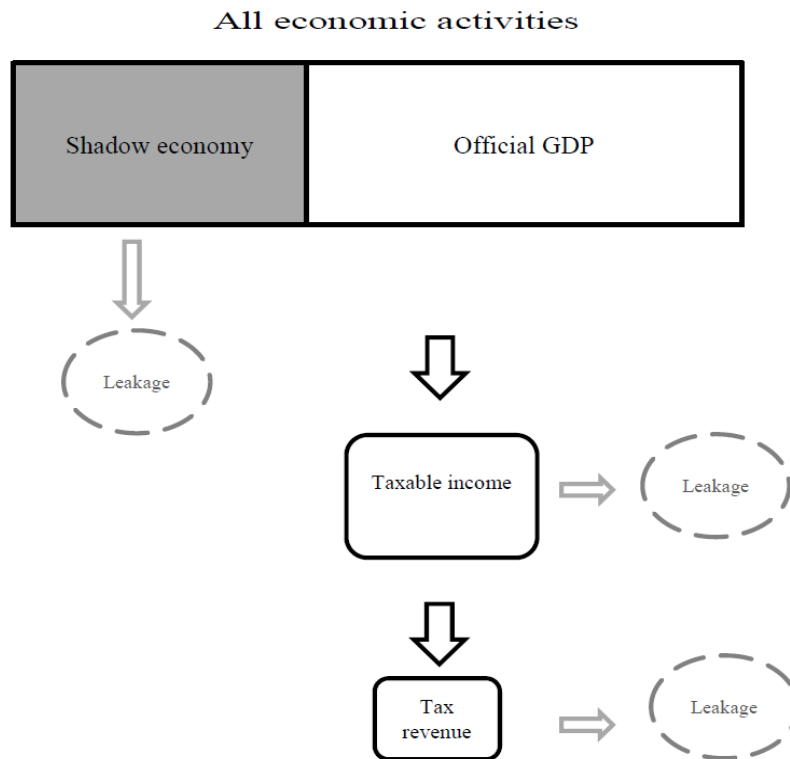
<sup>312</sup> Alex Cobham, 'Tax Evasion, Tax Avoidance and Development Finance' University of Oxford, Queen Elizabeth House Working Papers No. 29 (2005).

<sup>313</sup> According to Cobham shadow economic activities are the economic activities that are not reported to the authorities including the activities of unregistered businesses, undeclared profit of registered businesses and work performed 'off the book'.

<sup>314</sup> Cobham, above n 312, 10.

<sup>315</sup> Cobham, above n 312, 10.

**Figure 4-1 Shadow economy and revenue leakage**



Source: Cobham<sup>316</sup>

The above discussions clearly suggest that larger shadow economy severely affect the overall business environment of developing countries. Where there is a significant shadow economy, a developing country loses important tax revenues and the economy suffers the negative externalities caused by a high level of informality. It is apparent that, through taxation of the shadow economy, developing countries might accomplish several important revenue and non-revenue objectives.

<sup>316</sup> Cobham, above n 312, 16.

## 4.5 Small business, shadow economy and tax compliance

It is very important that tax policies know why numerous small businesses choose to hide their activities in the shadows. There are also a huge number of businesses who, for many reasons, register with tax authorities but fail to maintain the regularity of filing tax returns and eventually become non-filers. In addition to them, there are also many taxpayers who file tax returns but do not disclose all earnings, and do not pay the due taxes. In developing countries noncompliance among small taxpayers is rampant, but before implementing any tax reform that targets small taxpayers, it is very important to understand the key reasons for their noncompliance.

In terms of tax compliance behaviour, small businesses are widely identified as being as 'risky' group. Some special characteristics such as size of business, scale of operations, ability to operate in cash and fewer regulatory requirements enable small businesses to hide their entire or partial economic activities from the tax authorities with relative ease. Policy issues concerning the noncompliance and tax evasion of taxpayers have become particularly prominent over the last few decades. Allingham and Sandmo<sup>317</sup> introduced the basic model of tax evasion choice arguing that evasion is a choice of the taxpayer that is derived from self-motivation and cost-benefit reasoning. A taxpayer is more likely to evade tax if he perceives that the probability of successful evasion is considerably higher than the probability of being caught, or where the reward from successful evasion is considerably higher than the punishment for evasion. Even a risk averse taxpayer is likely to evade tax depending on his personal appeal to the reward of evasion and his risk preferences.<sup>318</sup>

The cost-benefit approach might explain tax evasion behaviour of a taxpayer to some extent; however this model is definitely inadequate to fully

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<sup>317</sup> Allingham and Sandmo, above n 41.

<sup>318</sup> Allingham and Sandmo, above n 41.

explain the tax evasion phenomenon. One of the severe criticisms of this model is that tax evasion cannot be explained merely as a judgment of self-interest or cost-benefit analysis. Where the probability of tax audits is very low, 1.5% in the case of the US, a risk averse person in reality should evade a lot more than what they usually do.<sup>319</sup> Moreover, the basic assumption of this model is that under certain circumstances a taxpayer may be willing to conceal some income. Rewards from evasion, probability of detection, and cost of evasion are thereby key determinants of tax evasion. It is interesting to note that all these expected utility tax compliance models are generally concerned with the behaviour of the individual taxpayers. Therefore, it is a critical limitation that these models cannot be straightforwardly applied to explain tax compliance of corporations and partnerships. In many developing countries, for a typical participant in the shadow economy, perceived rewards from evasion are not very big, probability of detection is negligible, and cost of evasion is also very low. In such a setup, compliance models constructed broadly on expected utility reasoning seem to have little relevance.

However, Allingham and Sandmo<sup>320</sup> model broadly suggests that there are at least three ways of improving voluntary compliance from the HTT sector.<sup>321</sup> First, by improving the probability of detection, increasing the number of audits or by increasing the use of third party information, the chance of detection can effectively be enhanced.<sup>322</sup> The second way is to increase the cost of noncompliance.<sup>323</sup> This can be achieved through instituting adequate penalties followed by the strict enforcement of those

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<sup>319</sup> Joel Slemrod and Shlomo Yitzhaki, 'Tax avoidance, evasion, and administration' in Alan J. Auerbach and M. Feldstein (eds.), *Handbook of Public Economics* (Elsevier, Edition 1, Volume 3, 2002) 1431.

<sup>320</sup> Allingham and Sandmo, above n 41.

<sup>321</sup> Roy Bahl, 'Reaching the Hardest to Tax: Consequences and Possibilities' in James Alm, J Martinez-Vazquez and Sally Wallace (eds.), *Taxing the Hard-to-Tax: Lessons from Theory and Practice* (Elsevier, 2004) 348.

<sup>322</sup> Bahl, above n 321, 348.

<sup>323</sup> Bahl, above n 321, 349.

penalties. The final route might be to reduce the rewards of successful evasion. This might be done by reducing the tax rate.<sup>324</sup>

A deal of subsequent research extends or modifies the Allingham and Sandmo model.<sup>325</sup> Taking a different perspective, Slemrod and Yitzhaki<sup>326</sup> argue that tax evasion involves uncertainty, which is an additional cost, and an excess burden to tax evaders. Increased probability of detection reduces evasion, thus reducing the excess burden.<sup>327</sup> It is argued, however, that the level of administrative enforcement should be increased until the increased marginal cost of evasion equals the marginal decrease in excess burden.<sup>328</sup>

With a departure from a portfolio-based single sector model, Watson<sup>329</sup>, using a two sector model, argues that there are ‘evadable’ and ‘non-evadable’ sectors whereby tax evasion is possible in one sector but is impossible in the other. Kesselman<sup>330</sup> extends the two sector evasion model in order to explain the incidence of labour supply in the underground economy. He uses a general equilibrium framework and two sectors- underground and above ground- in various setups to investigate the differing willingness of individuals to enter the evasion sector. One of the key findings is that if the government consumes outputs from the two sectors in the same pattern, the higher the marginal gain from not being affected by evasion cost, the higher the households drive resources from the compliant sector to the evading sector.<sup>331</sup> Increased tax rates have little effect in controlling tax evasion, rather administrative and enforcement measures that

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<sup>324</sup> Bahl, above n 321, 349.

<sup>325</sup> See, eg. Joel Slemrod and Shlomo Yitzhaki, ‘The Optimal Size of a Tax Collection Agency’ (1987) 89 *Scandinavian Journal of Economics* 183-192; Louis Kaplow, ‘Optimal Taxation with Costly Enforcement and Evasion’ (1990) 43(2) *Journal of Public Economics* 221-236; Joram Mayshar, ‘Taxation with Costly Administration’ (1991) 93(1) *Scandinavian Journal of Economics* 75-88.

<sup>326</sup> Slemrod and Yitzhaki, above n 325, 187.

<sup>327</sup> Slemrod and Yitzhaki, above n 325, 190.

<sup>328</sup> Slemrod and Yitzhaki, above n 325, 188.

<sup>329</sup> Harry Watson, ‘Tax Evasion and Labor Markets’ (1985) 27 *Journal of Public Economics* 231-246.

<sup>330</sup> Jonathan R. Kesselman, ‘Income Tax Evasion: An Intersectoral Analysis’ (1989) 38 *Journal of Public Economics* 137-182.

<sup>331</sup> Kesselman, above n 330.

impact on real and psychological costs of evasion appear to be more effective.<sup>332</sup> However Jung, Snow and Trandel<sup>333</sup> following a model similar to Watson<sup>334</sup> explore the relationship between tax rates and the size of the shadow economy. They argue that the relationship between the tax rate and the size of the underground economy depends on the risk preference of the agent.<sup>335</sup> An increase in tax rate increases number of evaders when they exhibit relatively increased risk aversion.<sup>336</sup>

Cowell<sup>337</sup> also extends Allingham and Sandmo<sup>338</sup> model to explain a number of issues related to evasion and participation in the shadow economy. Cowell's model deals with two basic dilemmas that an agent tries to solve simultaneously: firstly, how to allocate time between work and leisure and, secondly, how to allocate work between 'on the book' and 'off the book' activities.<sup>339</sup> Under certain circumstances, an increase in the probability of detection or an increase in the penalty for evasion will cause some activities to shift from the formal sector to the informal sector.<sup>340</sup> Moreover, the increased progressivity of the income tax will cause increased labour participation in the informal sector.<sup>341</sup>

Noncompliance can be seen as a rational act, based on the individual's judgment of expected benefits from compliance as against noncompliance. Taxpayers are responsive to risks and opportunities. If the tax administration is efficient and equipped with good auditing and surveillance tools, taxpayers tend to cheat only to the extent that they judge to be safe. Again, evasion cannot be sufficiently explained merely as a gamble of self-interest.

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<sup>332</sup> Kesselman, above n 330.

<sup>333</sup> Young H Jung, Arthur Snow and Gregory A. Trandel, 'Tax Evasion and the Size of the Underground Economy' (1994) 54 (3) *Journal of Public Economics* 391-402.

<sup>334</sup> Watson, above n 329.

<sup>335</sup> Jung, Snow and Trandel, above n 333.

<sup>336</sup> Jung, Snow and Trandel, above n 333.

<sup>337</sup> Frank A. Cowell, *Cheating the Government: The Economics of Evasion* (MIT Press, 1990).

<sup>338</sup> Allingham and Sandmo, above n 41.

<sup>339</sup> Cowell, above n 337.

<sup>340</sup> Cowell, above n 337.

<sup>341</sup> Cowell, above n 337.

Beyond cost-benefit analysis of self-interest, some human values such as notions of fairness play a crucial role in forming compliant or non-compliant responses. Diverging from the models of economical rationality, sociologists and political scientists suggest that taxpaying may not merely be the outcome of rational expectations, but that it is rather a result of an individual's focus on doing the 'right thing'. Sense of fairness also motivates taxpayers by maintaining the legitimacy of taxpaying. Taxpayers are likely to be less compliant with a tax administration which they perceive as unfair, unjust, and hence not legitimate.<sup>342</sup> Wenzel<sup>343</sup> argues that when taxpayers perceive a tax system as being fair and legitimate, they even become concerned more about justice, rather than personal outcomes. Erich Kirchler et al.<sup>344</sup> claim that a rational choice approach only partially explains compliance. Knowledge, attitudes, moral appeals, fairness and democracy are important ingredients of voluntary compliance.<sup>345</sup> Hashimzade, Myles and Tran-Nam<sup>346</sup> in their economic behavioural model have incorporated a wide range of social interaction variables which affect the taxpayer's compliance behaviour. The study concludes that the compliance decision of the taxpayer is greatly shaped his or her social environment.<sup>347</sup>

Tax compliance is definitely a central issue for tax administrations all over the world. Almost all major empirical studies that investigate causes, consequences and the extent of tax evasion are conducted in relation to developed countries. It follows that existing theories and empirical findings may be inadequate to understand and analyse the issues involving tax evasion in developing countries. It is widely believed that in developing

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<sup>342</sup> T. R. Tyler, 'The Psychology of Legitimacy: A Relational Perspective on Voluntary Deference to Authorities' (1997) (1) *Personality and Social Psychology Review* 323–345.

<sup>343</sup> Michael Wenzel, 'The Impact of Outcome Orientation and Justice Concerns on Tax Compliance: The Role of Taxpayers' Identity' (2002) 87(4) *Journal of Applied Psychology* 629–645.

<sup>344</sup> Erich Kirchler, Stephan Muehlbacher, Barbara Kastlunger and Ingrid Wahl, 'Why Pay Taxes? A Review of Tax Compliance Decisions', Georgia State University, Andrew Young School of Policy Studies, Working Paper 07-30 (2007).

<sup>345</sup> Kirchler, Muehlbacher, Kastlunger and Wahl, above n 344.

<sup>346</sup> Nigar Hashimzade, Gareth D. Myles and Binh Tran-Nam, 'Applications of Behavioural Economics to Tax Evasion' (2012) 26(4) *Journal of Survey Economics* 1-37.

<sup>347</sup> Hashimzade, Myles and Tran-Nam, above n 346, 32.

countries the level of tax compliance is very low; only a fraction of the potential tax base pays taxes. Most empirical estimates on the size of shadow economies suggest that developing countries typically contain a shadow economy with a size of more than one third of their official GDP. Definitely, non-complying taxpayers in these jurisdictions are to some extent influenced by economic cost-benefit reasoning. They also might be concerned about the legitimacy and fairness of the tax system. However, there might be some other factors that crucially influence the non-compliance of entities in these shadow economies. It seems that the small business tax compliance environment of a typical developing country can be characterized by the following features:

- a. **Risk of detection is low:** Administrative capability of the tax administration is generally low. Risk of getting detected is therefore relatively low.
- b. **Compliance cost burden is often higher than the actual tax burden:** Actual tax burden for small taxpayers is generally low, rewards from successful evasion may not be so high. However, associated legitimate and non-legitimate compliance costs often create a heavier burden for the businesses. Entrepreneurs hide under shadows not only to avoid official taxes but also to reduce the burden of bureaucracy and corruption.<sup>348</sup>
- c. **Inadequate enforcement capacity:** As enforcement is costly and difficult, even after getting detected, often there is little threat of tax liabilities and penalties being enforced.
- d. **Low tax morale:** Tax morale is relatively low.
- e. **Complex tax law and regulations, widespread corruption:** Tax law is often highly complex, administrative procedures are complicated, there is widespread corruption and a high level of uncertainty- all these create the perception that the tax system is illegitimate and unfair.

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<sup>348</sup> Friedman, Johnson, Kaufmann, and Zoido-Lobaton, above n 296.

- f. **Value for money:** From the value for money perspective, taxpayers are often unsatisfied with the service or benefits they receive in exchange for their tax contribution. Taxpayers often do not see any visible benefit of being compliant.
- g. **Education and Tax education:** In developing countries the level of education is generally low. The level of tax awareness and education is often extremely poor.
- h. **Political economy:** A significant majority of the voters in developing countries directly or indirectly belong to the small business community. Policy makers are then generally not willing to undertake any reform which might be perceived as excessive or coercive by the marginal taxpayers.

In such a difficult and non-complying environment developing countries find it extremely challenging to tax small businesses. Often presumptive taxation methods, an indirect means of ascertaining tax obligations, are used to raise some revenue from small business. The next chapter analyses the applicability of presumptive methods in an environment where it is quite difficult to implement standard carrot and stick compliance models.

## 4.6 Participants in the shadow economy

Self-employed individuals are often considered as the major participants in shadow economies. The term ‘self-employed’ commonly refers to the individuals who operate a business or provide services independently, rather than being an employee of another person or organization. Usually, sole proprietors or partners in a partnership of small business, freelance professionals, independent contractors and consultants are identified as self-employed individuals. Braithwaite, Reinhart, and Job<sup>349</sup> report that self-

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<sup>349</sup> Valerie Braithwaite, Monika Reinhart and Jenny Job, ‘Getting On or Getting By? Australians in the Cash Economy’ in Chris Bajada and Friedrich Schneider (eds), *Size, Causes and Consequences of the Underground Economy: An International Perspective* (2005) 64.

employed individuals are the major participants in the Australian cash economy. In developing countries there is also a considerable possibility that these self-employed individuals are the dominant participants in the cash economy. Many self-employed individuals are not required to report all of their income to government agencies. They typically have a greater opportunity to perform a substantial portion of their transactions in cash. As a result, they clearly have greater opportunities than wage earners and incorporated businesses to conceal income. It is not uncommon for some retailers or trades people to offer a small discount when a customer chooses to pay the bill in cash<sup>350</sup>. Even in developed countries where there is widespread usage of debit cards and credit cards, every day a substantial amount of transactions are made in cash. In a family-run small business it is relatively easy for a family member in charge of sales to manipulate the electronic sales register to understate sales figures.<sup>351</sup> In many developing countries cash is still the leading mode of economic transactions and it is not mandatory for businesses to use electronic cash registers. In developing countries there is much wider scope for businesses to participate in the cash economy. Table 4-1 illustrates that in developing countries most of the informal transactions occur through small shop owners, trade labourers, and through the manufacturing, construction, and home based production sectors.

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<sup>350</sup> Peter S. Spiro, 'Tax Policy and the Underground Economy' in Chris Bajada and Friedrich Schneider (eds), *Size, Causes and Consequences of the Underground Economy: An International Perspective* (2005) 194.

<sup>351</sup> Spiro, above n 350, 194.

**Table 4-1 Informal employment by activity in three developing country cities, 2001-2003**

	(Percentages of Total Informal Employment)		
	Abidjan (Cote d'Ivoire)	Lima (Peru)	Ho Chi Minh City (Vietnam)
Informal Employment	100.0	100	100
Informal traders	40.5	28.11	29.5
.... Of which: Street traders	16.0	9.15	11.3
Informal non-trade services	38.8	48.87	35.4
....of which: Informal transportation	7.5	14.1	7.3
....of which: Waste pickers/informal recycling	0.1	0.56	N/A
Informal construction	3.6	6.47	7.1
Informal manufacturing	15.6	15.4	22.1
Home-based informal workers*	10.6	8.2	48.5

Source: Adopted from Herrera, Kuepie, Nordman, Oudin and Roubaud.<sup>352</sup>

\*Refers to non-agricultural workers who designated their home as their place of work.

In Chapter 3 it has been argued that there are considerable differences between typical urban and rural businesses in terms of business concentration, assets, size, transaction process, production, employment, compliance attitude and so forth. Location oriented distinction also can be seen in case of informal labour participation and businesses operations. As discussed earlier, it is true of every country that the major participants in shadow economies are small businesses and self-employed individuals. A number of empirical studies attempt to explain the nature and extent of shadow economies. However, relatively very few empirical studies analyse the socioeconomic characteristics of the informal economy participants. There is still very little known about the social and economic characteristics of participants in the shadow economies of developing countries, such as their firm size and firm type, as well as the age, education, regional distribution and sex of the individuals involved. In developing countries, small and micro enterprises are key participants in the informal economy.<sup>353</sup> Table 4-2 illustrates that, like in many developing countries, almost all of

<sup>352</sup> Herrera, Kuepie, Nordman, Oudin and Roubaud, above n 275.

<sup>353</sup> Losby, Kingslow, Else, Edgcomb and Malm, above n 6.

Tanzania's informal sector enterprises are small. More than 98% of informal sector entities invest USD10,000 or less.

**Table 4-2 Average capital investment in informal sector of Tanzania**

Capital Invested Tanzanian Shilling (TZS)	Money/capital invested to start the business	
	Number	%
1 - 1,620,000	401	68.8
1,620,001 - 5,000,000	125	21.4
5,000,001 - 10,000,000	38	6.5
10,000,001 - 15,000,000	9	1.5
15,000,001 - 20,000,000	3	0.5
20,000,001 - 25,000,000	3	0.5
35,000,001 - 40,000,000	3	0.5
40,000,000+	1	0.2
Total	583	100.0

Source: Tanzanian Revenue Authority.<sup>354</sup>

Over the last few decades developing countries experienced a rapid growth in urbanization. Conventional wisdom may suggest that rural workers migrate to urban places for a higher income and a better term work opportunity. Urban workers and work places might have a greater potential to be significant tax-contributors. To explain dominant trends in urban-rural or formal-informal sector labour participation, Lewis<sup>355</sup> perhaps pioneered the concept of the dualistic labour market by arguing that in developing countries the labour market is segmented such that the rural sector is the supplier of potential migratory workers who seek to fill more highly paid urban jobs in the formal sector. Harris and Todaro,<sup>356</sup> with a two sector model of rural-urban labour migration, assume that urban wages are

<sup>354</sup> Tanzanian Revenue Authority, *Review of Informal Sector for Taxation Purposes* (2011).

<sup>355</sup> W. Arthur Lewis, 'Economic Development with Unlimited Supplies of Labour' (1954) 22 *Manchester School of Economic and Social Studies* 139-191.

<sup>356</sup> J.R. Harris and M.P. Todaro, 'Migration, Unemployment and Development: A Two-Sector Analysis' (1970) 60 *American Economic Review* 126-142.

substantially higher than agricultural earnings. Either a limited wage subsidy or a migration restriction policy is needed to prevent urban-rural migration causing the reduction of the overall welfare of the economy. However, Mazumdar<sup>357</sup> contradicts the dualistic models claiming that the urban-informal sector is not a major entry point for prospective rural migrants, and also that rural-urban earnings differentials are not substantial. Although not much is known about the socioeconomic profile of the shadow economy's participants in developing countries, it looks like shadow economies predominantly consist of numerous urban and rural self-employed individuals. If a standard income tax system administered through individual tax-payer records is unable to capture the taxable activities of these businesses, then that may establish a basis for adopting a tax system which is instead based on taxpayers' income indicators and not on taxpayers' actual accounts.

Taking a different perspective, De Soto<sup>358</sup> describes the informal sector to be productive, and to be an alternative way to secure rights over private property. A law is 'good' when it promotes economic efficiency. It is 'bad' if it impedes growth and economic efficiency.<sup>359</sup> Informal sector firms, in developing countries, chose to operate outside of these 'bad' laws that impose high compliance costs and complex regulations.<sup>360</sup> If the tax system is complicated, it imposes excessive compliance burdens on small businesses who in turn choose the shadow economy as the 'alternative way'. These productive informal operators are the result of rapid urbanization and they should be given the formal property rights which they deserve.<sup>361</sup> However, the presence of a growth-disrupting business environment may not be the only factor that drives firms to informality. Despite enjoying a business friendly environment that supports economic growth, a sizable

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<sup>357</sup> Dipak Mazumdar, 'The Urban Informal Sector' (1976) 4(8) *World Development* 655-679.

<sup>358</sup> Hernando De Soto, *The Other Path: The Invisible Revolution in the Third World* (Harper Row, 1989).

<sup>359</sup> De Soto, above n 358.

<sup>360</sup> De Soto, above n 358.

<sup>361</sup> De Soto, above n 358.

portion of businesses in developed countries operate in the shadow economy. Pratapand and Quintin<sup>362</sup> find that the informal sector predominantly consists of small-scale, self-employed and unskilled labour intensive economic activities. It is highly challenging for a developing country's tax administration to efficiently collect due tax from these activities.

In developing countries, rural small scale businesses are considered highly prone to shadow economy. However, Herrera, Kuepie, Nordman, Oudin and Roubaud<sup>363</sup> surveying 11 cities in developing country, document that in most of those cities an astonishing around 80% of non-agricultural employment is informal employment. In these cities more women participate in the informal sector than men.

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<sup>362</sup> Sangeeta Pratap and Erwan Quintin, 'The Informal Sector in Developing Countries: Output, Assets and Employment', World Institute for Development Economic Research, Working Papers P2006/130 (2006).

<sup>363</sup> Herrera, Kuepie, Nordman, Oudin and Roubaud, above n 275.

**Table 4-3 Informal employment as a percentage of non-agricultural employment in 11 cities of 10 developing countries, 2001-2003**

Cities	Total	Women	Men
Niamey	76.2	83.4	71.9
Ouagadougou	80.2	86.9	75.4
Bamako	82.1	91.1	74.9
Dakar	79.8	88	73.9
Abidjan	79	89.7	69.8
Lomé	83.1	90.3	75.1
Cotonou	81.2	89.3	72.1
Antananarivo	63	67.1	59.5
Lima	58.5	63.9	53.8
Hanoi	46.2	48.3	44.4
Ho Chi Minh City	53.4	55.1	52

Source: Herrera, Kuepie, Nordman, Oudin and Roubaud.<sup>364</sup>

Both rural and urban small businesses are highly involved in the informal sector. The tax policy of developing countries should therefore be concerned about the lost revenues from the informal activities of both rural and urban small businesses.

## 4.7 Conclusion

This chapter demonstrates that small businesses in developing countries are highly involved in shadow economic activities. The taxation of shadow economy appears to be one of the core issues associated with the taxation of small business in developing countries. In developing countries, small business taxation policies are only effective if it can efficiently tax the shadow economy. In order to effectively tax the shadow economy the tax policy of a country should reflect an understanding of basic features of the shadow economy such as its breadth, nature and socioeconomic impact.

<sup>364</sup> Herrera, Kuepie, Nordman, Oudin and Roubaud, above n 275.

This chapter discusses these core issues and also critically analyses the main reasons for the noncompliance of shadow economic entities. The presence of a shadow economy is a reality in both developed and developing countries. The definition of what constitutes a shadow economy widely varies depending on the scope and purpose of the given study. As taxation of small business is the main focus of this thesis, this study specifies shadow economic activities as the legal economic activities that are kept concealed from the public authorities to avoid payment of taxes, social security contributions or to avoid various regulatory requirements.

Developing countries generally contain a much larger shadow economy. There is a lack of research that analyses the causes of shadow economy exclusively in the contexts of developing countries. It has been argued that in developing countries taxation and social security contribution burdens are among the top contributing factors that increase the size of shadow economies. The presence of a large shadow economy restricts the capacity of government to collect enough tax revenues. Moreover, the negative externalities that shadow economy creates badly affect the overall economic environment.

This chapter analyses in greater detail the tax compliance issues in the context of developing countries. The leading tax compliance models generally suggest that a taxpayer is more likely to evade tax if he perceives that the probability of successful evasion is considerably higher than the probability of being caught, or alternatively if the reward from successful evasion is considerably higher than the punishment for evasion. In this chapter, it has been argued that in developing countries the small business tax compliance environment is quite different to that of the developed countries. In developing countries a typical small business does not encounter a high tax burden, and therefore the perceived rewards from evasion are not very big. Also, because the administrative capacity of tax authorities is fairly weak in developing countries, the probability of

detection is negligible, and also the cost of evasion is very low. If small businesses are to be effectively taxed in this context, the adaptation of a carrot and stick type tax compliance model might not be effective. The major empirical studies that investigate causes, consequences and the extent of tax evasion are conducted mostly in the developed country's socioeconomic context. The existing theories and propositions might not be adequate to understand the core determinants of tax evasion in developing countries. This chapter attempts to outline the characteristics of the typical small business tax compliance environment in developing countries. The analysis leads to the conclusion that a standard tax regime that broadly follows the carrot and stick compliance model may not be appropriate for taxing shadow economies in developing countries. This chapter puts forward the argument that in such a non-compliant taxing environment, presumptive taxation might be the more preferable mode for taxing small businesses.

Finally, this chapter argues that in order to develop an effective small business taxing strategy, it is essential to understand key socioeconomic characteristics of its operators. This chapter analyses key socioeconomic characteristics of the shadow economy's participants. It is not surprising that in developing countries small businesses are the key operators of the shadow economy. Small businesses are greatly involved in shadow economies in both rural and urban locations. Like rural small businesses, a great majority of urban small businesses (around 80 per cent) also operate in the shadow economy.<sup>365</sup> It can be argued that like small businesses, shadow economies are also segmented along rural/urban lines. A small business tax policy should recognize the distinguishing characteristics of these two economic environments and develop a taxing policy that can effectively assess the economic activities of both urban and rural taxpayers.

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<sup>365</sup> Herrera, Kuepie, Nordman, Oudin and Roubaud, above n 275.

It seems that the ability to effectively tax the shadow economy is also a key to improving internal resource mobilization in developing countries. In a noncompliance prone taxing environment, developing countries often find it extremely difficult to tax small businesses using standard account-based income tax systems. Often presumptive taxes are used as an indirect means to ascertain a small taxpayer's tax liability. The next chapter analyses the applicability of presumptive methods in an environment where it is quite difficult to implement standard carrot and stick compliance models.

## CHAPTER 5

# PRESUMPTIVE TAXATION IN DEVELOPING COUNTRIES: APPLICATIONS AND EXPERIENCES

### 5.1 Introduction

Ideally, income tax liability should be determined based on taxpayers' reasonably accurate taxable income. However, the world is not an ideal place. Despite radical improvement in taxing technologies, even the most advanced tax authorities rely, to varied extents, on estimated tax liabilities of its taxpayers. General depreciation rates, general deductions, small taxpayer concessions, and taxation of capital are a few examples of areas where tax authorities, developed or developing, make compromises between the rational and the ideal.

Developing countries use various methods of presumptive or imputed methods to collect tax from taxpayers whose actual or desired tax base is difficult to measure or assess.<sup>366</sup> Presumptive taxes, although often used only as an administrative convenience,<sup>367</sup> aim to improve tax collection efficiency through, firstly, the reduction of taxpayer compliance cost, secondly, the reduction of administrative costs and, thirdly, the graduation of small taxpayers from informal to formal activities, and tax assessments from indicator-based to self-assessment based systems.<sup>368</sup> Bulutoglu<sup>369</sup> argues that the primary aim of a successful presumptive taxation is to

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<sup>366</sup> Joel Slemrod and Shlomo Yitzhaki, 'Analyzing the Standard Deduction as a Presumptive Tax' (1994) 1 (1) *International Tax and Public Finance* 25.

<sup>367</sup> Tanzi and Casanegra de Jantscher, above n 33, 1.

<sup>368</sup> Konstantin Pashev, 'Presumptive Taxation and Gray Economy: Lessons from Bulgaria' Center for the Study of Democracy, Working paper WP 0512/1 (2005) 4.

<sup>369</sup> Kenan Bulutoglu, 'Presumptive Taxation' in Parthasarathi Shome (ed), *Tax Policy Handbook* (International Monetary Fund, 1995) 258.

prepare small businesses for graduation to self-assessments, and the secondary aim is to increase tax revenue. A judicious application of presumptive taxation may achieve many crucial policy goals, such as broadening the tax base, increasing the number of taxpayers, and reducing tax evasion — all at relatively low administrative cost.<sup>370</sup>

It appears that the application of presumptive taxation is a reality in developing countries. In these countries it seems that any analysis or discussion on small business taxation policy would be incomplete if it does not cover the theoretical and the practical aspects of presumptive taxes. However, presumptive methods have received very little academic attention. In the previous few chapters major policy and administrative issues concerning taxation of small business have also been discussed. The findings of Chapter 4 suggest that the presence of a larger shadow economy poses one of the greatest challenges for the taxation of small businesses. It was also found that the tax administrations of developing countries can achieve a significant efficiency gain if they can bring the large number of potential taxpayers into the formal tax net in a cost effective way.

So far this thesis has established that in developing countries small businesses are largely non-compliant. In the current environment it is extremely difficult for the highly administratively-constrained tax administration to properly tax small businesses using the standard account based tax system. Chapter 4 investigates the nature and extent of shadow economic involvement of small businesses in developing countries. It has been argued that the effectiveness of small business taxation policy and administration greatly hinges on its ability to effectively tax the shadow economy. This chapter also attempts to outline the typical small business tax compliance environment in developing countries. The findings suggests that standard tax regime compliance mechanisms, which are broadly built up on

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<sup>370</sup> Bulutoglu, above n 369, 258.

carrot and stick compliance models may not be efficient for taxing the shadow economy in developing countries.

Chapter 5 attempts to analyse theoretical and practical aspects of presumptive taxes and to investigate whether presumptive systems have the potential to be a preferable tool for taxing small businesses in developing countries. This chapter focuses on the theoretical aspects of existing presumptive taxes, analyses the practical application in some developing countries, and evaluates the effectiveness and the efficiency of presumptive taxation with regard to the goals a typical developing country may wish to achieve. Developing countries around the world are diverse in terms of social, economic and institutional structures. There can be no one-size-fits-all small business tax policy solution for every developing country. However, a typical developing country, with a considerably small formal tax base, a huge number of unattended potential taxpayers, and a need of an adequate supply of internal resources may benefit from a transitional arrangement where small taxpayers are preferentially treated by a special regime until they are mature enough to transition to the regular tax system. Presumptive methods use a variety of economic bases and different approximation methodologies to estimate income of certain classes of taxpayers. Also, presumptive provisions are applied to varied extents; sometimes comprehensively as separate system or sometimes implicitly as a random and minor part of the standard tax regime. This chapter attempts to analyse the relative efficiency of each of the presumptive methods and approaches. This thesis attempts to establish that small businesses in developing countries are segmented along the rural urban line. So far, no research has highlighted the importance of the recognition of these two clusters of small taxpayers while designing a small business taxing strategy. This thesis argues that a presumptive tax regime of a developing country should have differentiated presumptive methods to tax small businesses of rural and urban sectors. This chapter analyses the suitability of different presumptive methods for taxing urban or rural small taxpayers. The next

two chapters have extensive discussions on taxation policy and presumptive methods in the contexts of taxing urban and rural sector small businesses.

This chapter also analyses crucial presumptive tax policy and design issues. Finally, this chapter analyses the presumptive regime of four different developing countries. The findings suggest that adaptation of presumptive methods in an ad hoc or casual manner can be counterproductive; it can act contrary to the core objectives of implementation of presumptive taxation. Presumptive tax regimes should contain an explicit, unambiguous and comprehensive jurisdiction; it should be well coordinated with the standard tax regime.

## **5.2 Presumptive taxes: definitions and theories**

Instead of using the actual tax base, a presumptive tax uses an estimated tax base in order to approximate taxpayer's tax liability. According to Ahmed and Stern<sup>371</sup>

*The term presumptive taxation covers a number of procedures under which the 'desired' base for taxation (direct or indirect) is not itself measured, but is inferred from some simple indicators which are more easily measured than the base itself.*

As noted by Thuronyi,<sup>372</sup> presumptive taxation is the indirect means to ascertain tax liability, which differs from the usual assessments based on taxpayers' accounts. Presumptive taxation is based on the legal presumption that the real tax liability of the concerned taxpayer is somewhat close to the assumed tax liability made through the indirect method. Presumptive tax systems put more emphasis on apparent effectiveness and simplicity. As an obvious consequence, often there are compromises on fairness and

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<sup>371</sup> Ehtisham Ahmad and Nicholas Stern, *The Theory and Practice of Tax Reform in Developing Countries* (Cambridge University Press, 1991) 276.

<sup>372</sup> Thuronyi, above n 118, 103.

efficiency. Presumptive methods are popularly applied for certain HTT taxpayers, who under standard tax regimes would be very difficult to monitor, assess and have the regimes properly enforced against. There is extremely little systematic research or analysis as to what extent any presumptive system is achieving its objectives. As Bird and Wallace<sup>373</sup> note, most presumptive systems have been adopted more on faith than evidence.

It is noted earlier that although presumptive taxes are used widely around the world, theoretical analysis on presumptive taxes is rare. Luigi Einaudi, mentioned in Tanzi and Casanegra de Jantscher,<sup>374</sup> argues that since presumptive tax is based on 'average income', it can be 'the optimum tax' as it stimulates production. Einaudi claims that when a taxpayer is taxed on average income rather than his actual income, he gets an incentive to produce above the average.<sup>375</sup> Income excess of average is taxed with a marginal tax rate of zero.<sup>376</sup> Einaudi draws on evidence from agriculture in Milan, and argues that these propositions are also generally applicable for other sectors.<sup>377</sup> Einaudi's theories seem to have had little visible influence on policy makers or scholars, as an income tax based on actual income is favoured and adopted in most parts of the world.<sup>378</sup> However, there should be more empirical research on this growth-stimulating attribute of presumptive taxes in the context of developing countries.

It is quite common for many developing and transition countries to use presumptive tax methods to deal specifically with small taxpayers, the logic being that it is more convenient and cost effective to collect taxes on the basis of taxpayers' readily observable economic indicators, rather than on their actual economic transactions. The taxing method that applies a gross estimation of taxpayers' income or asset entitlement is the oldest form of

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<sup>373</sup> Bahl and Bird, above n 31, 290.

<sup>374</sup> Tanzi and Casanegra de Jantscher, above n 33, 6.

<sup>375</sup> Tanzi and Casanegra de Jantscher, above n 33, 6.

<sup>376</sup> Tanzi and Casanegra de Jantscher, above n 33, 6.

<sup>377</sup> Tanzi and Casanegra de Jantscher, above n 33, 7.

<sup>378</sup> Tanzi and Casanegra de Jantscher, above n 33, 7.

taxing strategy. Tanzi and Casanegra de Jantscher<sup>379</sup> report that although presumptive taxes are widely used, its theoretical aspects have hardly appeared in public finance textbooks. This may be due to scholars having a low opinion of presumptive taxes, finding them backward, primitive, and contrary to the principles of modern taxation.<sup>380</sup> However, it is possible that a theoretically ideal tax policy may deliver much poorer results than the more modest presumptive approach.<sup>381</sup> For example, presumptive taxation might be more suitable when assessing the tax liability of taxpayers who are not in a position to keep books and records in accordance with the formal accounting methods.

Due to its targeted group being small, often struggling, businesses, presumptive methods should be simple and should provide taxpayers with a considerable relief from the compliance cost burdens. Although there are many possible options, the proper application of presumptive taxes is no easy matter.<sup>382</sup> There are major challenges, including the determination of thresholds for exclusion from the presumptive scheme, the identification of taxes that presumptive taxation should replace, and the targeting of the class of the taxpayers eligible for presumptive taxes.<sup>383</sup> Theoretically, presumptive taxes are not ideal or optimal, there is also a lack of practical evidence that presumptive taxes have been more successful in extracting revenues than the account based taxation system. However, Bird and Wallace<sup>384</sup> point out that it is not proper to judge the success of presumptive taxation solely on basis of revenue productivity. Presumptive taxation fulfils other important goals, such as bringing start-up businesses into the tax net early, increasing simplification, reducing the compliance cost, promoting a

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<sup>379</sup> Tanzi and Casanegra de Jantscher, above n 33, 5.

<sup>380</sup> Tanzi and Casanegra de Jantscher, above n 33, 6.

<sup>381</sup> Tanzi and Casanegra de Jantscher, above n 33, 6.

<sup>382</sup> Thuronyi, above n 118, 120.

<sup>383</sup> Thuronyi, above n 118, 120.

<sup>384</sup> Bird and Wallace, above n 9, 146.

sense of fairness, and encouraging the HTT sector to participate in the formal systems.<sup>385</sup>

Presumptive tax is basically used for administrative convenience and often is cited as the second best alternative, especially when it is too costly or too difficult to assess certain taxpayers' income on the basis of book and records. Nonetheless, as a widely-used public policy instrument, should undergo a careful and in-depth cost benefit analysis as to when they should be adopted instead of standard taxing methods. In the absence of any widely-accepted analytical tool, often specific presumptive methods are analysed qualitatively on its efficiency, effectiveness, complexity, and fairness. As noted earlier, presumptive taxes are normally adopted simply for administrative convenience. In some situations presumptive taxes are considered to be the only choice, or if not, a more practicable one. In many jurisdictions presumptive methods are adopted merely based on subjective intuitions, not on any systematic objective analysis. Often presumptive methods adopted as ad hoc administrative solutions become permanent elements of the tax system. Often these uncoordinated piecemeal adaptations create detrimental complicity in the overall tax system. There are many crucial issues such as selection of proper indicator, selection of threshold, possibility of evasion, tax rate that fairly approximate the actual tax base, the tax that presumptive tax replaces and so forth. Success of presumptive taxation largely depends on a careful analysis of the environmental factors of taxpayers of the specific jurisdiction, and on the proper consideration of those issues while adopting a particular presumptive tax. There needs to be a cost benefit analysis when choosing from a standard tax instrument and a presumptive tax system. The cost benefit analysis might include a positive and normative analysis on the extent that the policy change is a real or potential Pareto improvement.

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<sup>385</sup> Bird and Wallace, above n 9, 146.

Due to the level of intrinsic uncertainty involved in public policy instruments and the dynamic and endogenous relationship between cost and benefits, it is extremely difficult and hardly possible to apply the standard framework of cost benefit analysis to investigate the suitability of presumptive taxation over income tax or any other kind of tax.<sup>386</sup> Feinstein<sup>387</sup> proposes the Detection Controlled Estimation (DCE) model that investigates evasive characteristics of certain groups of taxpayers. Under this model, using a compliance game, he proposes a way that might be used to approximate the auditing cost of tax authorities to reduce taxpayer evasion.<sup>388</sup> Romanov<sup>389</sup> demonstrates how Feinstein's method of simulation can be applied practically to investigate the feasibility of presumptive methods. This method can be handy to find out the rational level of resources that a tax administration should be allocating in order to tax the HTT.

Slemrod and Yitzhaki<sup>390</sup> develop a 'marginal efficiency cost of funds' (MECF) framework to evaluate the comparative efficiency of tax policies with regard to reduction of deadweight losses or, as it is referred to, social costs of taxation. Slemrod and Yitzhaki<sup>391</sup> define excess burden, administration costs and compliance costs as social costs of taxation. They argue that taxation imposes these social costs. A tax policy is more desirable when it imposes these costs to a lesser extent. The Marginal Cost of Funds ( $MCF_i$ ) associated with tax instrument  $i$  is

$$MCF_i = DC_i * MECF_i \quad (1)$$

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<sup>386</sup> Dmitri Romanov, 'Costs and Benefits of Marginal Reallocation of Tax Agency Resources in Pursuing the Hard-To-Tax' in James Alm, J Martinez-Vazquez and Sally Wallace (eds.), *Taxing the Hard-to-Tax: Lessons from Theory and Practice* (Elsevier, 2004) 187.

<sup>387</sup> J. S. Feinstein, 'Detection controlled estimation' (1990) 33 *Journal of Law and Economics* 233–276.

<sup>388</sup> Feinstein, above n 387.

<sup>389</sup> Romanov, above n 386.

<sup>390</sup> Joel Slemrod and Shlomo Yitzhaki, 'The Cost of Taxation and the Marginal Efficiency Cost of Funds' (1996) 43 (1) *International Monetary Fund Staff Papers* 172-198; Slemrod and Yitzhaki, above n 319.

<sup>391</sup> Slemrod and Yitzhaki, above n 319.

where  $DC_i$  is Feldstein's<sup>392</sup> distributional characteristics.

The revised MECF that includes administrative costs, compliance costs, and excess burden is

$$MECF_i = \frac{\gamma(X_i - MR_i) + C_i + MR_i}{MR_i - A_i} \quad (2)$$

where  $\gamma$  is the value that the taxpayer is sacrificing at the margin in order to save a dollar of tax,  $X_i$  is the potential tax collection associated with the tax instrument  $i$ ,  $MR_i$  is the marginal (actual) collection,  $A_i$  is the marginal administrative cost, and  $C_i$  is the private compliance cost.<sup>393</sup>

However, Yitzhaki<sup>394</sup> argues that introducing a presumptive tax will have the following expected effects:

$$MCF = DC \uparrow * \frac{\gamma(X - MR\uparrow) + C\downarrow + MR\uparrow}{MR\uparrow - A\downarrow} \quad (3)$$

Here  $\downarrow$  and  $\uparrow$  indicate increases and decreases in cost when shifting from regular tax to presumptive tax.

Using a micro level dataset of Israeli tax administration Romanov<sup>395</sup> has demonstrated the practical use of this model to evaluate the relative efficiency of tax policy instruments with regards to its capability to reduce compliance burden and other administrative costs. Romanov's demonstration may suggest that this model can be expanded to identify the efficient means of allocating tax agency resources in pursuing the HTT. However, this model does not incorporate some key tax environment variables, such as corruption, administrative capability to implement policy

<sup>392</sup> Feinstein, above n 387.

<sup>393</sup> Slemrod and Yitzhaki, above n 319.

<sup>394</sup> Shlomo Yitzhaki, 'Cost Benefit Analysis of Presumptive Taxation', Georgia State University, Andrew Young School of Policy Studies, International Center for Public Policy Working Paper 07-14 (2007).

<sup>395</sup> Romanov, above n 386.

instruments and political support or pressure. Moreover, in developing countries, proper data on key variables is extremely difficult to collect or extract. Therefore, econometric analyses on the suitability of certain presumptive tax instruments are extremely difficult, at least in the contexts of developing countries.

In developing countries it is extremely difficult to meaningfully apply these numerical simulations to analyze the feasibility and efficiency of presumptive tax methods as substitutes for regular taxation instruments. Slemrod and Yitzhaki<sup>396</sup> note that MECF concept is not offered as a substitute or a replacement of the traditional analysis of tax system and expert analysis to tax reform. Rather, it can be a helpful analytical tool while choosing from competing alternatives.<sup>397</sup> It appears that it is still more appropriate to depend on a qualitative judgment on these issues.

### **5.3 Application of presumptive taxes: various types**

Taxation around the world uses various methods of presumptive taxes. Different readily available or conveniently ascertainable indicators are used as proxies of the actual tax base. Often indicators related to sales, business assets, number of personnel engaged and personal assets entitlements of the taxpayer are used to assume the tax liability of a taxpayer. Some methods use a systematic approach, or a combination of taxpayer economic indicators to approximate the actual tax bases. The overlaps among principles or methodologies make it difficult to classify presumptive methods. Tanzi and Casanegra<sup>398</sup> categorise presumptive methods as follows:

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<sup>396</sup> Slemrod and Yitzhaki, above n 319, 173.

<sup>397</sup> Slemrod and Yitzhaki, 'The Cost of Taxation and the Marginal Efficiency Cost of Funds', above n 390, 173.

<sup>398</sup> Tanzi and Casanegra de Jantscher, above n 33, 8.

- i. Presumptions based on net wealth or on the value of particular assets
- ii. Presumptions based on gross receipts
- iii. Presumptions based on visible signs of wealth (personal wealth tax)
- iv. Estimated assessment methods, based on a combination of indicators

Bulutoglu <sup>399</sup> also identifies four similar approaches used to apply presumptive taxes. For the convenience of the discussion of theoretical and administrative aspects of different types of presumptive methods this study broadly follows the Tanzi and Casanegra <sup>400</sup> classification.

### **5.3.1 Presumptive methods based on assets**

Many developing countries use the amount of land holding as a proxy for the determination of tax liability of land tax or agricultural income tax. Land tax might be the oldest among all forms of existing taxes. Land-based presumptive taxes have several important theoretical advantages. Land as an economic indicator is difficult to conceal. The burden of tax falls on the owner of the land and the incidence of land tax is not generally shiftable. A tax based on land might be able to stimulate output. However, this tax lacks equity as it is linked to potential income, not to the actual income that it generates. Tax burden can be too heavy for poorer or unsuccessful farmers. However, in developing countries where there is a strong correlation between the land holding and personal wealth, land tax can be an equitable and progressive element of the tax system. <sup>401</sup>

Land, land improvements and attached buildings are usually the bases of land and property taxes. Land tax at its simplest form is often imposed at a flat rate on the amount of landholdings of each owner without any consideration to the income-earning capacity of the land. However in many

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<sup>399</sup> Bulutoglu, above n 369.

<sup>400</sup> Tanzi and Casanegra de Jantscher, above n 33, 8.

<sup>401</sup> John Strasma, James Alm, Eric Shearer and Alfred Waldstein, *Impact of Agricultural Land Revenue Systems on Agricultural Land Usage* (Burlington, 1987) 4.

countries, like India, Bangladesh, Nepal and Sri Lanka, land tax rate is graduated after a certain exemption limit. As a means of equity consideration a broad classification of lands in terms of productive capacity or economic value is often introduced. For developing countries, a simple land classification scheme that accords to a rough notion of fairness may in fact prove more equitable than one which rigorously applies equitable principles but is overly complex.<sup>402</sup> Highly refined and ‘equitable’ classifications that cannot properly be administered might be prove to be useless, and in fact, unfair.<sup>403</sup> Often land-based presumptive taxes are used to tax agriculture-based rural small businesses. Land tax, an asset-based presumptive method, has many apparent advantages to tax rural small businesses. Chapter 7 discusses with greater detail the theoretical and administrative aspects of some presumptive methods, including the land taxes, which can be applied to tax rural small businesses.

Many developing countries, including Bangladesh, Pakistan, Zimbabwe, Zambia and Tanzania, tax income from transport vehicles (for example, buses, taxis and passenger vessels) and cargo under presumptive methods. Usually, commercial transport vehicles are taxed on the basis of its engine capacity, or the number of passengers it can carry. Taxes are generally collected during the annual registration or fitness renewal of the vehicles. The level of difficulty associated with the monitoring and assessment of actual economic transactions of the transport sector makes an argument for applying presumptive methods. However, quite strikingly, the applied presumptive tax burden varies widely across different developing countries. Table 5-1 compares how a typical 50-seat passenger bus is taxed under presumptive methods in four developing countries.

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<sup>402</sup> Richard M. Bird, *Taxing Agricultural Land in Developing Countries* (Harvard University Press, 1974) 147.

<sup>403</sup> Bird, above n 402, 147.

**Table 5-1 Presumptive tax burden on a typical 50 seat passenger bus**

Country	Number of seats	Annual payable tax	Annual tax payable for a typical 50 seat passenger bus (Approx. USD)	Nominal GDP per capita (2011) <sup>1</sup>	Tax free threshold approx. USD (Individual)
Bangladesh <sup>2</sup>	52 or less	7000 Taka	86	678	2460
Pakistan <sup>3</sup>	20 or more	500 Rs per seat	261	1,201	3,661
Zambia <sup>4</sup>	50-63	6,000,000 ZMK	1165	1,413	4,660
Zimbabwe <sup>5</sup>	37 or more	1800 USD	1800	741	3000

Sources:

1. IMF World Economic Outlook Database.<sup>404</sup>
2. National Board of Revenue, Bangladesh.<sup>405</sup>
3. Crowe Horwath.<sup>406</sup>
4. Deloitte.<sup>407</sup>
5. Zimbabwe Revenue Authority.<sup>408</sup>

Although these countries have a similar level of economic development and the amount of tax free income thresholds are almost identical, their presumptive tax burdens in the above situation vary significantly; a typical 50 seat passenger bus bears a tax burden ranging from USD 86 in Bangladesh, to USD 1,800 in Zimbabwe. Similarly, in Bangladesh a goods truck able to carry 5 tonne pays approximately USD 123 tax, while a similar truck pays approximately USD 261 in Pakistan.<sup>409</sup> Very interestingly, in Zimbabwe, a 15-passenger waterborne passenger vessel needs to pay USD 2000 of tax annually, while in Bangladesh a similar vessel pays only around USD 14 tax.<sup>410</sup> Practically, presumptive taxes are not rebuttable in these countries. Application of these extremely arbitrary levels of tax burdens

<sup>404</sup> International Monetary Fund, *World Economic Outlook Database* (April, 2012).

<sup>405</sup> National Board of Revenue, Bangladesh, *Income Tax at a Glance*. Available at: <[http://www.nbr-bd.org/IncomeTax/income\\_tax\\_at\\_a\\_glance\\_2012-13.pdf](http://www.nbr-bd.org/IncomeTax/income_tax_at_a_glance_2012-13.pdf)>.

<sup>406</sup> Crowe Horwath, *Tax Handbook 2012* (2012). Available at: <[www.crowehorwath.net/PK/.../Final\\_Tax\\_HandBook\\_2012-2013.asp](http://www.crowehorwath.net/PK/.../Final_Tax_HandBook_2012-2013.asp)>.

<sup>407</sup> Deloitte, *Zambia Highlights 2012*. Available at: <[http://www.deloitte.com/assets/Dcom-Global/Local%20Assets/Documents/Tax/Taxation%20and%20Investment%20Guides/2012/dttl\\_tax\\_highlight\\_2012\\_Zambia.pdf](http://www.deloitte.com/assets/Dcom-Global/Local%20Assets/Documents/Tax/Taxation%20and%20Investment%20Guides/2012/dttl_tax_highlight_2012_Zambia.pdf)>.

<sup>408</sup> Zimbabwe Revenue Authority, *Presumptive Tax*. Available at: <[http://www.zimra.co.zw/index.php?option=com\\_content&view=article&id=33&Itemid=31](http://www.zimra.co.zw/index.php?option=com_content&view=article&id=33&Itemid=31)>.

<sup>409</sup> National Board of Revenue, Bangladesh, *Income Circular 2011-12*. Available at: <[http://www.nbr-bd.org/IncomeTax/Circular\\_2011.pdf](http://www.nbr-bd.org/IncomeTax/Circular_2011.pdf)>; Crowe Horwath, above n 406.

<sup>410</sup> Zimbabwe Revenue Authority, above n 43; National Board of Revenue, above n 408.

suggest that in developing countries there is a severe lack of research and objective analysis before the adoption of a presumptive tax rate structure.

Bangladesh has an income tax provision of ‘spot assessment’ to encourage certain new small taxpayers enter the tax net.<sup>411</sup> Under the spot assessment system a previously unregistered small business operating in an urban shopping centre or commercial market with a capital of Taka 1 million or less can choose to file a simplified one page tax return to become a regular taxpayer. The taxpayer is required to pay the same low amount of tax for the successive two years. The taxpayer gets immunity from tax audits during the first 3 years and is not required to provide any explanation regarding his initial capital investment. Also, professionals like doctors and lawyers who have been practicing for less than 5 years are eligible to enter the tax net under this spot assessment method. Spot assessment method uses initial capital as the proxy to determine the initial tax liability of the taxpayer. This method aims to reduce the compliance burden of marginal taxpayers, and to encourage them to embrace formalization.

### **5.3.2 Presumptive methods based on turnover or gross receipts**

Using gross sales or turnover as the indicator for determining the payable tax might be the most common method of presumptive taxes. A number of developing countries collect income tax, turnover tax or VAT from certain small taxpayers using turnover as the indicator of income or business volume. It is almost universal for VAT to have a threshold. Often the marginal taxpayers staying below a threshold are taxed on the basis of turnover or gross cash receipt. From an administrative perspective, collection of tax is often relatively easy when gross receipt is the base of the tax. This apparent advantage might be the reason for the wide application of sales volume or gross receipt as the determining indicator of presumptive tax liability. However, gross turnover can be a very crude proxy of the real

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<sup>411</sup> *Income Tax Ordinance 1984*, Bangladesh, s 82D.

income of the taxpayer. In many cases there is no relationship between a taxpayer's level of turnover and their taxable income. It might often be the case that a start-up business with significant turnover incurs a net loss. In such a case, a presumptive income tax based on gross turnover imposes an unfair tax burden on the taxpayers. Thuronyi<sup>412</sup> argues that the application of a uniform rate on gross receipt across an industry may result in highly inaccurate measures of net income. For example, volume and pattern of sales of a retailer would differ greatly from that of a small wholesaler. Moreover, to operate profitably, or even to survive in the market, different products and services require different levels of gross profit margins.

The weak relationship of gross profit and net income has motivated the incorporation of a number of other indicators, such as industry-specific gross profit margins, business nature, capital, power consumption and human resources employed, into presumptive methods in order to obtain a more reliable approximation of net income. This incorporation of enhanced considerations in assessing taxpayers' income-earning potential reduces inaccuracy and unfairness in income presumptions<sup>413</sup> Nevertheless, these more sophisticated and apparently more efficient approaches come with the added costs of complexity, and are more difficult to administer.<sup>414</sup> For some resource- and capacity-constrained tax administrations the most attractive element of a presumptive method may be its simplicity. A presumptive method can be more preferable to the standard tax regime only when it is simpler, easier for taxpayers to comply with and less costly for tax authorities to administer.

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<sup>412</sup> Thuronyi, above n 118, 114.

<sup>413</sup> Thuronyi, above n 118, 115.

<sup>414</sup> Thuronyi, above n 118, 115.

**Table 5-2 Application of presumptive taxes in selected developing countries**

Country	Presumptive tax base	Taxes covered
Albania	Annual turnover up to Leke 8 million	Income Tax, VAT
Algeria	Annual turnover of DA 3,000,000	Income tax, VAT
Argentina	Taxpayers with sales below VAT threshold.	CIT, VAT and social security contribution
Benin	Turnover, location, a turnover of CFAF 40 million for businesses and a turnover of CFAF 15 million for service providers	Income tax, VAT
Bolivia	An individual taxpayer with assets worth below a threshold and the transport sector	Income tax, VAT
Brazil	For businesses with turnover below R\$2,400,000 and for companies with turnover below R\$48,000,000. Restrictions apply depending on turnover level and economic activity	For companies, presumptive tax replaces income tax, for non-companies presumptive tax replaces 8 different taxes including income tax and VAT
Chile	A retailer with sales below a threshold	Mainly VAT
Peru	Sales below USD 72,000 a year. Some constraints apply	Income tax, VAT
Bangladesh	Income arising from certain activities including imports, dividends, exports, prize winnings, petroleum products, brokerage and commission are subject to collection of tax at source. This tax, collected at source by withholding tax agents, is treated as the final settlement of the income tax liability. Income of certain transport vehicles such as ships and busses are subject to presumptive tax. Turnover below VAT registration is subject to 4% turnover tax	Income tax, VAT
India	A non-company assessee with annual gross turnover less than 6 million rupees is eligible for estimation of presumptive income, estimated to be equal to 8% of gross turnover	Income tax
Pakistan	Income arising from certain activities including imports, dividends, exports, prizes winnings, petroleum products, brokerage and commission are subject to collection of tax at source. This tax, that is collected at source by withholding tax agents, is treated the final settlement of the income tax liability. Income of certain transport vehicles such as ships and busses are subject to presumptive tax	Income tax

Mexico	Small taxpayer regime is applicable to certain individuals with gross income below a threshold	Single tax combining both income tax and VAT
Nicaragua	Under the Special Regime of Administration Estimation fixed monthly amounts are payable on the basis of the preceding year's gross income	Single tax combining both income tax and VAT.
Russia	Small business in selected industries. The rate of tax is 6% if based on gross receipts, 15% if based on profits.	Single tax combining both income tax and VAT
Costa Rica	In a Simplified Tax System, taxpayers with an annual purchase volume of less than C150 million is subject to a simplified tax that combine income tax and sales tax	Income tax, sales tax
Ukraine	Eligible small businesses with a certain number of employees and certain level of turnover.	Single tax combining both income tax and VAT

Sources:

1. SME Survey Response for Selected Non-OECD Countries.<sup>415</sup>
2. Inter-American Development Bank (IDB).<sup>416</sup>
3. Western India Regional Council of the Institute of Chartered Accountants.<sup>417</sup>
4. Memon.<sup>418</sup>
5. Bird and Wallace.<sup>419</sup>

Table 5-2 indicates that most developing countries use turnover as a leading indicator for targeting and taxing small taxpayers. Often a constrained tax administration finds turnover-based presumptive taxes the only rational approach to tax certain types of taxpayers. Even a very small business normally keeps a very basic record of turnover. Turnover is relatively easily observable; a presumptive system based on turnover does not require a taxpayer to maintain extensive recordkeeping and imposes relatively low compliance obligations. A simple turnover-based presumptive method is a pragmatic approach to tax the numerous urban small businesses. Chapter 6 discusses the policy, the administrative aspects and the efficiency issues of

<sup>415</sup> International Tax Dialogue, *SME Survey Response for Selected Non-OECD Countries*, International Tax Dialogue Global Conference on Taxation of SMEs Conference Document, Buenos Aires, 2007. Available at: <<http://www.itdweb.org/smeconference/documents/smesurveyresponseforelectednon-oecdcountries.pdf>>.

<sup>416</sup> Inter-American Development Bank (IDB), *Recommendations and Best Practices on Taxation of SMEs in Latin America* (2009).

<sup>417</sup> Western India Regional Council of the Institute of Chartered Accountant of India, *Reference Manual 2011-12 Presumptive Taxation*. Available at: <[http://wirc-icai.org/wirc\\_referencer/income%20tax%20&%20wealth%20tax/Presumptive%20Taxation.htm](http://wirc-icai.org/wirc_referencer/income%20tax%20&%20wealth%20tax/Presumptive%20Taxation.htm)>.

<sup>418</sup> Memon, above n 26.

<sup>419</sup> Bird and Wallace, above n 9.

turnover-based presumptive methods in the context of the taxation of urban small business.

Often presumptive methods are used to collect a lump sum minimum tax irrespective of taxpayers' level of income and expenditure. A number of countries use minimum taxes or alternative minimum taxes to capture a small yet worthwhile amount of tax from certain classes of taxpayers. In Bangladesh, all companies, whether earning a profit or incurring a loss, are required to pay a minimum tax equal to 0.50 per cent of gross receipt.<sup>420</sup> Similarly, in Pakistan a company is required to pay a minimum tax amounting to 0.75 per cent of gross turnover when that company does not pay any tax or when tax is paid but is less than 0.5 per cent of the gross turnover.<sup>421</sup> In India a Minimum Alternative Tax (MAT) is imposed to restrict the practice of reporting excessively lower fiscal profit than the accounting profit.<sup>422</sup> Under Indian income tax, when a company's reported tax liability is less than 18.5% of the book profit, the book profit shall be considered as the taxable income of the company and the applicable tax liability is 18.5% of the book profit. Bird and Wallace<sup>423</sup> argue that there are two leading reasons for applying presumptive taxes: first to bring start-ups in to the tax net and, second, to obtain at least some tax from HTT entities. The simplified systems and the regular tax regimes stress the first objective, while the alternative minimum tax regime focuses on the latter.<sup>424</sup> In many developing countries a significant number of corporate taxpayers submit tax returns reporting a net loss. Moreover, often companies' reported tax profits are much lower than their accounting profits. Many typical developing country tax administrations do not have the resources to audit and assess taxpayers' real taxable income. Moreover, even when tax authorities manage to assess the real taxable income, the taxpayer has the option to undergo lengthy litigation processes. Under those circumstances, the

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<sup>420</sup> *Income Tax Ordinance 1984*, Bangladesh, s 16 CCC.

<sup>421</sup> Crowe Horwath, above n 406.

<sup>422</sup> *Income Tax Act 1961*, India, s 115JB.

<sup>423</sup> Bird and Wallace, above n 9, 137.

<sup>424</sup> Bird and Wallace, above n 9, 137.

imposition of a minimum tax seems to have some valid justifications. Yet again, a minimum tax is highly unfair when it adds miseries to already struggling entities.

### **5.3.3 Individual wealth tax or wealth surcharge**

Many developing countries impose a wealth tax as an additional instrument of income assessment when it is difficult to ascertain how much income is unreported.<sup>425</sup> It is often difficult to detect and assess true income of wealthy individuals for many developing country tax administrations. Specifically, tax administrations find it severely challenging to assess real income of shareholder directors of big corporations, owners of big businesses, and professionals who are generally not under any fixed payroll. It is not uncommon for a shareholder director of several big corporations to pay a lower amount of tax than a mid-level employee of one of those corporations. One way of tackling this issue, as many developing countries follow under the official assessment system, is to estimate the level of expenditure of a particular taxpayer. In many developing countries, under the official assessment system taxpayers need to report some information about their lifestyle and their level of yearly expenditure. This information normally includes the amount of expenditure related to rent, utilities, children's schooling, conveyance and food consumption. When the level of estimated expenditure outmatches the reported income, the unexplained expenses are considered as unexplained income and that amount is added to the reported income. However, under a self-assessment system it is not possible to reassess taxpayers' expenditure levels.

In some jurisdictions an individual wealth tax is imposed as a percentage of net tax liability when the value of declared assets crosses a certain threshold. Again, this system heavily penalises people who earn wages that just marginally crosses the wealth threshold. Moreover, when a person conceals

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<sup>425</sup> Tanzi and Casanegra de Jantscher, above n 33, 12.

a great amount of his income, and a tax is imposed on the vicinity of that declared income, the imposition of the wealth tax or income surcharge does not make the system any fairer. Therefore, the wealth threshold needs to be made sufficiently higher so that it does not penalize the wage earner who is already paying a high tax near the top individual tax bracket. There are other problems with the wealth tax, such as the difficulty in specifying the kind of wealth that should be subject to the wealth tax<sup>426</sup> and judicial issues regarding the application of the book value or the market value of the assets in tax assessment. The official assessment system for taxing personal wealth tax once existed, but has been abolished, in several developing countries including Sri Lanka, Indonesia, Bolivia and Columbia.<sup>427</sup> Many tax administrations found it unfeasible to encounter the level of complexity associated with this seemingly egalitarian tax.<sup>428</sup> Later, in place of the wealth tax, a few developing countries imposed a surcharge on the income of wealthy individuals whose level of wealth entitlement crosses a certain threshold. For example Bangladesh, repealing the *Wealth Tax Act 1963* in 1999, introduced an income tax surcharge on the value of net wealth.<sup>429</sup> This surcharge was also later abolished, but was reintroduced in 2011.<sup>430</sup> The present provisions require an individual to pay an additional surcharge that equals to 10% of his income tax liability if his reported net asset is worth Taka 30 million or more (approximately USD 366,000).<sup>431</sup> In India the wealth tax is governed under the *Wealth Tax Act 1957*.<sup>432</sup> This law charges a tax for all taxpayers, individual and companies, at a rate of 1% of the amount by which the net wealth exceeds Rs. 3,000,000 (approximately USD 56,000). Until abolished in 2002, Pakistan also had a similar wealth tax.<sup>433</sup>

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<sup>426</sup> Tanzi and Casanegra de Jantscher, above n 33, 12.

<sup>427</sup> Richard M. Bird, 'The Taxation of Personal Wealth in International Perspective' (1991) 17(3) *Canadian Public Policy* 322-334.

<sup>428</sup> Bird, above n 427.

<sup>429</sup> *Banglapedia* (at 25 October 2012) Taxation. Available at: <[http://www.banglapedia.org/HT/T\\_0092.HTM](http://www.banglapedia.org/HT/T_0092.HTM)>.

<sup>430</sup> *Finance Act 2011*, Bangladesh, sch 3, para B.

<sup>431</sup> *Finance Act 2011*, Bangladesh,

<sup>432</sup> *Wealth Tax Act 1957*, India.

<sup>433</sup> *Wealth Tax Act 1963*, Pakistan.

### 5.3.4 Presumptive assessment methods based on multiple indicators of income and capital

Tax administrations developed a number of administrative solutions to deal with evasion-prone HTT taxpayers. French *forfait* and Israeli *tachshiv* are two leading presumptive tax systems that use a number of indicators to presume taxable income of small- and medium-sized taxpayers. Income from agriculture is usually taxed on a presumptive basis where the base of tax is the area of land and its quality. Income tax liability of a small proprietary business is often assessed on the basis of the industry-specific presumptive gross profit ratio and the declared turnover. French *forfait* and Israeli *tachshiv* are indicator-based variations of presumptive approaches. Under the classic *forfait* system, which is not currently in practice, tax liability was calculated on the basis of variety of indicators like purchases, sales, number of employees and number of cars owned by the taxpayer. *Forfait* had been the most enduring presumptive tax system, and was based on indicators of agricultural land and farm activities.<sup>434</sup> It was widely accepted in France and had been practised in Morocco and some other francophone countries.<sup>435</sup> *Forfait* is a contractual system where a tax authority and a taxpayer reach an agreement to pay tax on the basis of an estimated income. Under the *forfait* system the taxpayer must supply some information with respect to the previous year's income-earning activities.<sup>436</sup> Based on the taxpayer-supplied information, the tax administration makes estimates of the income the taxpayer might normally produce. The taxpayer has an option to follow the *forfait* system or to follow the regular accounts-based system.<sup>437</sup> Once the option of *forfait* has been taken, the taxpayer must follow it for the following three successive years.<sup>438</sup>

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<sup>434</sup> Indira Rajaraman, 'Presumptive Direct Taxation: Lessons from Experience in Developing Countries' (1995) 30 (18) *Economic and Political Weekly* 1112.

<sup>435</sup> Rajaraman, above n 434, 1112.

<sup>436</sup> Victor Thuronyi, 'Presumptive Taxation' in Victor Thuronyi (ed), *Tax Law Design and Drafting* (International Monetary Fund, 1996) vol 1, 22.

<sup>437</sup> Thuronyi, above n 436, 22.

<sup>438</sup> Thuronyi, above n 436, 22.

The *forfait* system requires taxpayers to maintain books and records to some extent. Tax administrations are also required to be capable of doing sophisticated statistical analyses, and should have extensive information of the industry. Success of *forfait* also depends on high quality and honest tax inspectors.<sup>439</sup> The *Forfait* system may not be suitable for some developing countries that lack essential administrative capacities crucial for the successful implementation of the *forfait* system. Tanzi and Casanegra de Jantscher<sup>440</sup> point out that there are three critical requirements upon which success of a *forfait* type tax system largely depends upon. First, the tax administration must have the technical capabilities and resources to study and analyse different economic activities' profitability.<sup>441</sup> Second, there must be adequate human resources to verify taxpayer provided information.<sup>442</sup> Third, there must be a substantial amount of contact between the taxpayer and tax authorities.<sup>443</sup> Tax officials must be adequately paid and strictly supervised in order to prevent corruption.<sup>444</sup> Tanzi and Casanegra de Jantscher<sup>445</sup> further note that countries that have attempted to implement the *forfait* system without having sufficient resources have ended up with failed outcomes. Nonetheless, *forfait* might be useful and relevant for some developing countries that have relatively strong institutional capabilities, a fair level of information technology resources and a higher taxpayer density.

Israeli *tachshiv* is calculated based on various indicators of a certain industry. For example, a restaurant is taxed on the basis of location, number of seats and average price of items on the menu. Israeli *tachshiv* incorporates more objectivity than *forfait* as it puts more emphasis on objective indicators,<sup>446</sup> and the negotiation arrangements under *tachshiv* are

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<sup>439</sup> Thuronyi, above n 436, 23.

<sup>440</sup> Tanzi and Casanegra de Jantscher, above n 33, 12.

<sup>441</sup> Tanzi and Casanegra de Jantscher, above n 33, 12.

<sup>442</sup> Tanzi and Casanegra de Jantscher, above n 33, 12.

<sup>443</sup> Tanzi and Casanegra de Jantscher, above n 33, 12.

<sup>444</sup> Tanzi and Casanegra de Jantscher, above n 33, 13.

<sup>445</sup> Tanzi and Casanegra de Jantscher, above n 33, 13.

<sup>446</sup> Tanzi and Casanegra de Jantscher, above n 33, 13.

conducted between respective business organizations and the tax authority.<sup>447</sup> This minimizes the potential for corruption, as it eliminates the contact between individual taxpayers and the tax authority. *Tachshiv* was officially been introduced in Israel in 1954 and existed for two decades before being officially abandoned in 1975.<sup>448</sup> Although officially abolished, it has unofficially remained in use,<sup>449</sup> especially when taxpayers fail to produce reliable documentation regarding income-producing activities and the tax authority is required to apply the ‘best judgment’.<sup>450</sup> A major advantage of *tachshiv* is that it is rebuttable. Taxpayers can opt of this method when they see their calculated net income is greater than *tachshiv*. This allows taxpayers to pay the minimum tax.<sup>451</sup> If they opt out, the taxpayer must submit a tax return under the standard self-assessment regime. Yitzhaki<sup>452</sup> illustrates a few examples of how *tachshiv* works. *Tachshiv* has classifications of trade and services and corresponding applicable rates based on enterprise type, mode of operation, location, and product or service type. For example, a restaurant may be identified as European, exclusive, special, Middle Eastern, vegetarian, Chinese, or fast food.<sup>453</sup> It can be further classified on the basis of other certain characteristics, such as hours of operation, duration of customer stay, types of customers served, quality of service and quality of furniture.<sup>454</sup> There are also sub-classifications regarding the location of the outlay. Gross revenue is calculated per waiter within a range.<sup>455</sup> Profit is calculated to be 25 to 30 per cent of the gross revenue.<sup>456</sup> Net profit is calculated after making certain deductions.<sup>457</sup> For vegetable and fruit stores, nine classifications are available depending on city, neighbourhood, and type of products sold.<sup>458</sup> There are also sub-

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<sup>447</sup> Pashev, above n 368, 10.

<sup>448</sup> Yitzhaki, above n 394, 6.

<sup>449</sup> Yitzhaki, above n 394, 7.

<sup>450</sup> Yitzhaki, above n 394, 7.

<sup>451</sup> Pashev, above n 368, 10.

<sup>452</sup> Yitzhaki, above n 394, 8.

<sup>453</sup> Yitzhaki, above n 394, 8.

<sup>454</sup> Yitzhaki, above n 394, 8.

<sup>455</sup> Yitzhaki, above n 394, 8.

<sup>456</sup> Yitzhaki, above n 394, 8.

<sup>457</sup> Yitzhaki, above n 394, 8.

<sup>458</sup> Yitzhaki, above n 394, 8.

classifications based on the sources the stores use as suppliers. Gross profits are pre-determined for each class of taxpayer.<sup>459</sup>

The major advantage of *tachshiv* is that it is relatively more accurate than the other presumptive methods since it is based on sophisticated calculations of key features of the taxpayers' economic activities. This eliminates personal contact with taxpayer and the tax inspectors, and is hence less corruption prone. To some extent it also reduces taxpayer compliance costs and administrative costs for the tax administration. However, the main disadvantage of *tachshiv*, as identified by the committee<sup>460</sup> that recommended *tachshiv*'s abolition, is that it is extremely difficult to maintain and update the survey parameters upon which the calculation of small taxpayer taxable income is based. The committee found that the process of collecting, updating and negotiating the huge amount of data is highly cumbersome, and subject to widespread disagreement and debate.<sup>461</sup>

Another method of presumptive indicator-based method is, *Studi di settore*, which is adopted in Italy to tax small taxpayers. This system aims at estimating a reasonable turnover of small taxpayers. First introduced in 1988, *Studi di settore* has been in operation for over two decades and is applied to around 70 per cent of firms of Italy.<sup>462</sup> Despite its wide and enduring application, it is still widely ignored in international tax literature.<sup>463</sup> Among OECD countries, Italy has one of the largest shadow economies. In 2001–02 and 2002–03 Italy had underground economies that made up 27 per cent and 25.7 per cent of the official GDP respectively.<sup>464</sup> The size and extent of shadow economy in Italy is similar to those in many

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<sup>459</sup> Yitzhaki, above n 394, 7-8.

<sup>460</sup> Ben-Shahar committee, see Yitzhaki, above n 394, 6.

<sup>461</sup> Slemrod and Yitzhaki, above n 319; Yitzhaki, above n 394.

<sup>462</sup> Giampaolo Arachi and Alessandro Santoro, 'Tax Enforcement for SMEs: Lessons from the Italian Experience?' (2007) 5(2) *eJournal of Tax Research* 226.

<sup>463</sup> Arachi and Santoro, above n 462, 226.

<sup>464</sup> Friedrich Schneider and Christopher Bajada, 'An International Comparison of Underground Economic Activity' in Christopher Bajada and Friedrich Schneider (eds), *Size, Causes and Consequences of the Underground Economy: An International Perspective* (2005) 85.

developing countries. Arachi and Santoro<sup>465</sup> argue that the experience of *Studi di settore* in Italy can be very useful for a typical developing country which has a large shadow economy and a large percentage of SMEs.

Under the *Studi di settore* system the tax authority, following certain statistical procedures, determines a benchmark turnover threshold. Firms may be audited if they report a turnover that is lower than the presumed threshold.<sup>466</sup> The presumed turnover is determined based on weighted average of several cost, structure and location related variables.<sup>467</sup> Firm's reported variable inputs and the figures reported by similar firms of the concerned industry help construct the benchmark.<sup>468</sup> Taxpayers know the variables and the turnover threshold, and can use software *Gerico* to calculate the reportable turnover.<sup>469</sup> To make the threshold turnover acceptable, representatives of firms and professions are involved in the process of determining the optimal turnover level.<sup>470</sup> The presumed turnover threshold gives the tax authority a reference point to target risky groups that needed to be audited. Under *Studi di settore* a firm may be selected for audit when the reported level of sales are lower than a certain confidence value, or when a figure reported for an independent variable is found to be too low.<sup>471</sup> *Studi di settore* has several practical and theoretical attractions. It seems more suitable than other methods for taxing urban taxpayers of a developing country with relatively strong institutional capabilities and a fair level of information technology. However, it is still little known whether or not this system increases levels of taxpayer compliance, reduces taxpayer compliance costs, increases revenue productivity or reduces administrative

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<sup>465</sup> Arachi and Santoro, above n 462, 226.

<sup>466</sup> Arachi and Santoro, above n 462, 226.

<sup>467</sup> Arachi and Santoro, above n 462, 235.

<sup>468</sup> Arachi and Santoro, above n 462, 235.

<sup>469</sup> Arachi and Santoro, above n 462, 235.

<sup>470</sup> Bruno Chiarini and Simona Monteleone, 'Discretionary policy, strategic complementarity and tax evasion', The Parthenope University of Naples, Department of Economic Studies Working Paper No. 4/2011 (2011) 3.

<sup>471</sup> Arachi and Santoro, above n 462, 235.

costs. Marchese and Privileggi <sup>472</sup> argue that extensive empirical investigation is required before a decision can be made as to whether this system is a success or not. Until then the performance of this system will remain subject to debates and discussions. Moreover, *Studi di settore* only indicates the optimal gross receipt, not the net income. There remains substantial scope for misreporting costs and deductions.<sup>473</sup>

## 5.4 Presumptive taxes: a few policy and design issues

Developing countries mainly use presumptive methods as a way of administrative compromise in situations where it is not feasible or convenient to apply the regular regime. Presumptive methods are seen as the second best option. While implicit applications of presumptive taxes are widespread, tax administrations rarely acknowledge explicitly the application of presumptive taxes. Presumptive methods are often seen as a deviation from the account based ‘ideal’ tax system. However, many tax administrations are unable to tax the HTT taxpayers using the ‘ideal’ systems. Often, the determination of the actual income of many taxpayers is an unrealistic endeavour, and not worth devoting scarce administration resources to. A close approximation of taxpayers’ true tax base is more suitable.<sup>474</sup> At many instances small taxpayers consider the tax system to be complex, costly and a major impediment for their business operations. In such situations developing countries might find applications of presumptive taxes as more appropriate than the standard regime. In many jurisdictions presumptive tax methods are implemented quite randomly or in ad hoc manner. The rates, thresholds and rules are adopted based on casual observations.<sup>475</sup> To be successfully operative, presumptive methods require

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<sup>472</sup> Carla Marchese and Fabio Privileggi, ‘Increasing the Efficiency of the “Studi di Settore” Might Backfire’ Institute of Public Policy and Public Choice Working Papers 83 (2007) 10.

<sup>473</sup> Marchese and Privileggi, above n 472.

<sup>474</sup> Tanzi and Casanegra de Jantscher, above n 33, 4.

<sup>475</sup> Table 5-1 of this chapter shows that the presumptive taxes burden levied on buses greatly vary across countries.

careful consideration of a host of complex tax design issues.<sup>476</sup> The role of presumptive taxes and its interaction with in the overall tax system is a very crucial factor.<sup>477</sup> Tax administrations therefore should explicitly acknowledge the scope and role of presumptive methods and should pay proper consideration to the factors like threshold, target taxpayers, efficiency, rebuttable or non-rebuttable features, administrative impact, and the interaction of presumptive taxes with the overall tax system.

#### **5.4.1 Threshold, target taxpayers and choice of indicators**

Thuronyi<sup>478</sup> argues that it a better idea to reduce the number of HTT taxpayers. Presumptive tax mostly replaces income tax. A progressive income taxation system requires taxpayers with ‘low’ income levels to be excluded from paying taxes. With due consideration to the revenue objective, the threshold should be set as high as possible to restrict over inclusion of HTT taxpayers. A careful construction of threshold can effectively reduce the administrative costs of the tax administration, and also do justice to certain individuals who, due to low level of income, do not need to file tax returns. Bird and Wallace<sup>479</sup> note that there are normally two thresholds; a lower one that excludes certain taxpayers from paying taxes, and a higher one that disqualifies taxpayers from being considered under presumptive systems. In developing and transition countries VATs usually have a threshold;<sup>480</sup> taxpayers under the threshold are subject to a lump sum minimum tax or a lower rate of turnover tax. This exclusion is justifiable as it saves the scarce resources of revenue administrations and does not result in significant revenue loss.<sup>481</sup> As the capacity of the tax administration improves, the threshold can be adjusted to include more taxpayers.<sup>482</sup> French *forfait* had a threshold of FF 500,000 for small goods-selling traders

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<sup>476</sup> Thuronyi, above n 118, 120.

<sup>477</sup> Thuronyi, above n 118, 106.

<sup>478</sup> Thuronyi, above n 118, 107.

<sup>479</sup> Bird and Wallace, above n 9, 143.

<sup>480</sup> Thuronyi, above n 118, 107.

<sup>481</sup> Thuronyi, above n 118, 107.

<sup>482</sup> Thuronyi, above n 118, 107.

and FF 150000 for service-providing ones.<sup>483</sup> These thresholds were not been adjusted for inflation in subsequent years. As the level of income naturally increased, this system became dysfunctional as fewer people qualified for it.<sup>484</sup> It does, however, provide a good example of how a presumptive tax system can be used to graduate taxpayers into a normal tax regime.

As presumptive taxes are implemented to serve certain objectives, it should have a certain time frame or an explicit plan for moving taxpayers to the regular regime.<sup>485</sup> Bird and Wallace<sup>486</sup> argue that it would be a major limitation of a tax administration if it does not have an exit plan of graduating presumptive taxpayers to the standard system. A qualifying timeframe for taxpayers should exist, at the end of which taxpayers must exit the special regime. There should also be a timeframe after which the special regime itself phases out.<sup>487</sup> If the transition timeframe cannot be implemented properly, there is possibility that certain taxpayers will keep exploiting the benefits of the concessionary tax regime.<sup>488</sup>

For the successful operation of presumptive taxes a proper choice of indicators is also crucial. For a realistic and credible presumption, indicators must be specific to the concerned sector and profession; the rates and norms of which should be established based on surveys and objective evidence.<sup>489</sup> Presumptions can be based on flow indicators, such as gross sales, inputs and outputs, capacity or assets, or on flat presumptions, such as a uniform tax per enterprise.<sup>490</sup> Again, some presumptive methods use more than one kind of indicator. It is important that indicators and norms fairly

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<sup>483</sup> Sally Wallace, 'Imputed and Presumptive Taxes: International Experiences and Lessons for Russia', Georgia State University, Andrew Young School of Policy Studies Working Paper 02-03 (2002) 5.

<sup>484</sup> Wallace, above n 118, 5.

<sup>485</sup> Bird and Wallace, above n 9, 143.

<sup>486</sup> Bird and Wallace, above n 9, 143.

<sup>487</sup> Bird and Wallace, above n 9, 143.

<sup>488</sup> Bird and Wallace, above n 9, 143.

<sup>489</sup> Rajaraman, above n 434, 1104.

<sup>490</sup> Rajaraman, above n 434, 1104.

approximate the specific group of taxpayers. For rural taxpayers, asset-based presumptions seem fairest, since it imposes the tax burden on the owner of the land. However, for a typical urban small retail trader, a turnover-based presumption might be more feasible from an administrative point of view, and for certain self-employed professionals a minimum tax like *patente* might be more appropriate. In the successive Chapters 6 and 7 presumptive methods for rural and urban small taxpayers are discussed with greater details.

### 5.4.2 Efficiency

There is no empirical evidence that presumptive taxes yield more revenue than standard account-based systems. Engelschalk<sup>491</sup> argues that a generous presumptive regime rather deters the revenue objective. However, developing countries generally receive little revenues from small taxpayers. Often tax policies seek to achieve other important objectives apart from the revenue goal. If a nearly revenue-neutral small business taxation system can reduce tax administration costs, it can be considered as net gain situation for the tax authority. Bird and Wallace<sup>492</sup> argue that it might be inappropriate to evaluate efficiency of presumptive taxes solely on the basis of revenue productivity. If tax policies have the goals of broadening the tax net, bringing participants of the informal sector taxpayer into the tax net, educating new taxpayers, reducing compliance costs of the small taxpayers, reducing administrative costs, or collecting some basic level of tax from certain HTT payers, then the application of presumptive taxes might be more efficient than the regular regime.<sup>493</sup> Engelschalk<sup>494</sup> reports that in certain transition countries, such as Russia and Ukraine, presumptive tax regimes register success in broadening the tax net. A typical developing country with a large shadow economy might be very interested in bringing

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<sup>491</sup> Engelschalk, above n 165, 310.

<sup>492</sup> Bird and Wallace, above n 9, 145.

<sup>493</sup> Bird and Wallace, above n 9, 145.

<sup>494</sup> Engelschalk, above n 165, 310.

start-ups into the tax net, so could bring them in under a special regime for specified period and then encourage them eventually to become a part of the regular system. A presumptive tax-based special regime seems to have the potential to bring more small businesses into the formal tax net. However, there is a real possibility that firms already part of the regular system could move ‘backwards’ to the special regime.<sup>495</sup> There is also scope for inefficiency in that it may be providing an incentive for firms to stay ‘small’ to enjoy the benefits of the special regime and to avoid the tax requirements of the regular system. Also, the concern still remains that a firm operating in the shadow economy and generating substantial amount of income with effectively zero tax burden might not be interested to register even for a generous special regime.

### **5.4.3 Rebuttable or non-rebuttable features**

It is generally expected that at the commencement of a financial year a taxpayer knows the applicable tax rates and that at the end they can comprehend the tax liability. After lodging the tax return the taxpayer usually gets an opportunity to defend the tax assessment. This is not the case with presumptive taxes. Presumptive taxes are often charged as withholding taxes; the amount withheld at source is often considered as the final settlement of tax liability. The system thus becomes non-rebuttable, since the taxpayer concerned does not get any chance to challenge the imposed tax liability. Non-rebuttable taxes may be unconstitutional in many countries.<sup>496</sup> It might also be considered as unfair as taxpayer does not get the chance to prove that he has lower tax liability.<sup>497</sup> The problem intensifies when a non-rebuttable tax is also mandatory. Often a taxpayer gets an option to bypass the presumptive regime by choosing to be assessed on the basis of their books and accounts. When this option is not present, there can be problems. For example, in Bangladesh traders who import items and

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<sup>495</sup> Bird and Wallace, above n, 9, 146.

<sup>496</sup> Thuronyi, above n 118, 104.

<sup>497</sup> Bird and Wallace, above n 9, 145.

subsequently trade them are subject to payment of an ‘advance tax’. This tax is non-rebuttable and at the same time mandatory. Although the tax is called an ‘advance tax’, in reality this tax is withheld in advance as the final settlement of tax liability.<sup>498</sup> The taxpayer does not get credit at the end of the year even if he incurs a net loss of income (though they are also not liable to any further tax if they earn excessive profit). No wonder in Bangladesh the list of top individual income taxpayers is often dominated by importers and contractors who are subject to this mandatory non-rebuttable tax regime. To deal with such a problem presumptive tax burdens are almost universally made lower than the average standard tax burden. No doubt a rebuttable tax is fairer and more acceptable to taxpayers. However, this rebuttable feature might come with additional administrative costs when a good number of taxpayers opt for official assessment.<sup>499</sup> Bird and Wallace<sup>500</sup> argue that KIS (keep it simple) is the stronger principle of presumptive tax, the absence of the rebuttable feature is hardly an issue.<sup>501</sup>

#### **5.4.4 Administration of presumptive taxation: is small tax office (STO) a solution?**

Presumptive taxation is adopted in various ways and in various degrees in different tax jurisdictions. For example, Bangladesh and Pakistan use presumptive methods implicitly and randomly, often as administrative fixes merely to raise revenue from small taxpayers. On the other hand, several transition countries such as Ukraine, Bulgaria and Russia have adopted rather explicit and comprehensive simplified regimes for SMEs. However, these ‘simplified’ regimes are often not at all simple for small taxpayers.<sup>502</sup> So far the overall success of these regimes is not clear, though there is evidence of significant success in terms of increasing the number of new

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<sup>498</sup> *Income Tax Ordinance 1984*, Bangladesh, s 82C.

<sup>499</sup> Bird and Wallace, above n 9, 145.

<sup>500</sup> Bird and Wallace, above n 9, 145.

<sup>501</sup> Bird and Wallace, above n 9, 145.

<sup>502</sup> Engelschalk, above n 118, 305.

taxpayers.<sup>503</sup> A number of Latin American countries have also implemented special tax regimes to reduce the compliance costs of small taxpayers and to attract new taxpayers into the formal tax net.

Developing countries around the world have diverse social, economic and political structures. A one-size-fits-all solution cannot work. However, the same general model can be applied, with the specifics tailored for each country. A typical developing country with a tiny formal tax base, a huge number of potential taxpayers and a need for increased tax revenue might be well benefited from a transitional arrangement where small taxpayers fall under a special regime until mature enough to move into the regular tax system. A reform aiming at a special small business tax regime does not put a significant amount of tax revenue at odds since existing small taxpayers supply little tax revenue. Engelschalk<sup>504</sup> argues that a simplified system should not be a substitute of regular system, but should rather be a well-coordinated, integrated part of it. It should support the strengthening of administrative capacities to detect and enforce non-filers.<sup>505</sup> With the advocacy of IMF, many developing countries have adopted the Large Taxpayers Unit (LTU) system. About 50 countries currently have adopted a large LTU to exclusively administer large taxpayers. Beer<sup>506</sup> argues that many countries with weak revenue administration have achieved immediate and visible results through the establishment of LTUs. However, Beer<sup>507</sup> points out that long-term effectiveness of LTUs largely depends on the proper synchronization of the LTU with the broader tax administration through improving administration of medium and small taxpayers as well. The IMF has also more recently advocated the establishment of small tax offices (STO) in order to make tax compliance easier for small taxpayers.<sup>508</sup> Indonesia seems to have achieved substantial benefit out of the

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<sup>503</sup> Engelschalk, above n 118, 276.

<sup>504</sup> Engelschalk, above n 118, 309.

<sup>505</sup> Engelschalk, above n 118, 309.

<sup>506</sup> Baer, above n 229, 37.

<sup>507</sup> Baer, above n 229, 38.

<sup>508</sup> Bird and Wallace, above n 9, 155.

establishment of dedicated tax offices for small taxpayers, which it created under a radical reform. Indonesia rearranged its tax administration on the basis of size and basic function of the taxpayers.

**Table 5-3 Indonesian field tax administration**

Before modernization	Number	After modernization	Number
District Tax Office	182	Large Taxpayer Office (LTO)	3
Tax Audit Office	51	Medium Taxpayer Office (MTO)	28
Property Tax Office	164	Small Taxpayer Office (STO)	300
Total	397		331

Source: Pakpahan.<sup>509</sup>

A key objective for establishing STOs was to promote voluntary compliance through educating small taxpayers about their rights and obligations. Emphasis was also given to achieving a proper balance between service and enforcement.<sup>510</sup> Major revenue administration reform, including the establishment of STOs, was implemented during the years 2002–2008.<sup>511</sup> During that period and immediately afterwards Indonesian tax administration experienced a significant growth in taxpayer numbers (Table 5-4). The growth of STO tax revenue was also higher than the national average.<sup>512</sup>

<sup>509</sup> Robert Pakpahan, ‘Tax Administration Strategies to Respond Small and Medium Enterprises: Case of Indonesia’ paper presented at the IMF-Japan High Level Tax Conference for Asian and Pacific Countries, Tokyo (2012).

<sup>510</sup> Pakpahan, above n 509.

<sup>511</sup> Pakpahan, above n 509.

<sup>512</sup> Pakpahan, above n 509.

**Table 5-4 Growth in number of Indonesian taxpayers**

Year	Personal	Corporate	Government	Total	Growth
2004	2,595,438	1,017,720	197,314	3,812,476	
2005	2,925,525	1,105,694	265,615	4,298,839	13%
2006	3,216,648	1,206,391	317,712	4,742,757	10%
2007	5,293,832	1,323,659	350,673	6,970,171	47%
2008	8,859,431	1,468,336	382,076	10,711,851	54%
2009	14,667,169	1,618,251	436,969	16,724,398	56%
2010	18,149,661	1,790,583	470,455	20,412,709	22%

Source: Robert Pakpahan.<sup>513</sup>

It is important to note that an STO is only an administrative arrangement and that the Indonesian small business tax regime is not based on presumptive systems. A special regime administrated by a STO-type administrative arrangement might be even more effective way of taxing small businesses. A Block Management System (BMS), a dedicated section of the tax authority responsible for administering small and medium taxpayers, administers the Tanzanian presumptive tax regime.<sup>514</sup> However, Bird and Wallace argue that a ‘special regime’ can, at best, be a transitional arrangement of a tax system; it should not have any permanent role.<sup>515</sup> A STO-like arrangement with universal self-assessment might be a better alternative of the presumptive tax-based special regimes.<sup>516</sup>

## **5.5 Presumptive taxation: some countries’ experiences**

This section analyses the application of presumptive taxes in four developing countries: Bangladesh, Pakistan, Ukraine and Tanzania. In Bangladesh and Pakistan presumptive provisions are adopted quite randomly and in an uncoordinated manner. There is hardly any evidence to suggest that the taxation authorities undertake any objective analysis before adapting the presumptive methods. These countries collect a much greater

<sup>513</sup> Pakpahan, above n 509.

<sup>514</sup> Tanzanian Revenue Authority, above n 354, 73.

<sup>515</sup> Bird and Wallace, above n 9, 155.

<sup>516</sup> Bird and Wallace, above n 9, 155.

amount of tax revenues through implicit presumptive provisions. Contrarily, Ukraine has a much more comprehensive and explicitly defined presumptive regime for SMEs. However, the benefit of simplification attempts is less visible due to the existence of a number of similar and often overlapping provisions. Lastly, the scope of the Tanzanian small businesses tax regime is explicit and well specified. However, the qualifying threshold of presumptive taxes is quite narrow. The taxation authority seems keenest to achieve non-revenue objectives such as making the tax system simpler for informal sector operators to register and comply with. Both Tanzania and Ukraine have achieved impressive success in increasing the number of registered taxpayers. Yet, it is not clear whether these regimes are successful in reducing the administrative costs of the tax administration and the compliance costs of the taxpayers. These countries' experiences suggest that in developing countries presumptive tax methods are implemented mostly in an arbitrary manner without objective consideration of many crucial design issues. The adaptation of presumptive methods in an ad hoc or casual manner can be counterproductive, and can make the system complex and inefficient. If a country chooses to adopt a special regime, the regime should contain an unambiguous and comprehensive jurisdiction and should be well coordinated with the standard tax regime.

### **5.5.1 Bangladesh**

Taxation of Bangladesh adopted various presumptive methods in different names and forms, mostly on ad hoc basis to tackle certain administrative situations. Direct taxes of Bangladesh have some explicit presumptive methods, although the amount of revenue collected through these provisions is insignificant. In 2011–12 total collection of presumptive tax was Taka 336.8 million, 0.28 per cent of total income tax collection.<sup>517</sup> However, the

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<sup>517</sup> National Board of Revenue, Bangladesh, Annual Report 2010–11. Available at: < [http://www.nbr-bd.org/annual\\_report\\_2010-2011.html](http://www.nbr-bd.org/annual_report_2010-2011.html) >.

scope of implicit presumptive elements covers a far greater amount of tax revenues.

Section 82C of *Income Tax Ordinance 1984*<sup>518</sup> subject to some conditions and exclusions, requires that for a number of business activities the tax collected at source shall be the final discharge of tax liability.<sup>518</sup> The list of business activities includes supply of goods, execution of contracts, local letter of credit, royalty, fees for technical services, commission from clearing and forwarding agency, the amount of the value of the banderols computed for the purpose of collection of tax on account of the manufacture of cigarettes, the amount received by international gateway services operator or interconnection exchange in respect of international phone calls, goods imported (not the goods imported by an industrial undertaking as raw materials for its own consumption), the amount received on account of export of certain items and the amount on account of winnings. As of July 2012 Section 82C has 23 categories of economic activities that are subject to final settlement of tax liability.<sup>519</sup>

**Table 5-5 Contribution of top 5 withholding tax sources in Bangladesh**

Source	2009–10		2010–11	
	Amount (Million Taka)	% of total collection	Amount (Million Taka)	% of total collection
Supply, execution of contracts	24,686	30.1	31,957	26.1
Imports	14,248	17.3	28,420	23.2
Interest on savings	15,741	19.2	18,151	14.8
Salary	4,824	5.9	6,525	5.3
Dividend	4,861	5.9	6,077	4.9
Total (Withholding tax )	82,118	100	122,335	100

Source: National Board of Revenue.<sup>520</sup>

<sup>518</sup> *Income Tax Ordinance 1984*, Bangladesh, s 82C.

<sup>519</sup> *Income Tax Ordinance 1984*, Bangladesh, s 82C.

<sup>520</sup> National Board of Revenue, above n 517.

As illustrated in Table 5-5, in 2010–11 withholding tax collection accounted for 53 per cent of total income tax collection. The top 2 sources of tax withholding alone account for a 49.3 per cent of total withholding tax and 26.2 per cent of total income tax collection. Clearly, presumptive elements play a significant role in Bangladesh direct tax structure.

In the case of imports large taxpayers are, in effect, excluded from the non-rebuttable tax requirements, since industrial undertakings that use imported items as raw materials or capital machineries are eligible for credits against the amount of tax withheld. Moreover, most presumptive tax rates are flat, not progressive. Non-rebuttable mandatory deduction of tax thus imposes a heavier burden on small taxpayers. Income of certain transport vehicles such as ships and buses are subject to presumptive tax.<sup>521</sup> In official administrative systems, if a business fails to produce reliable books and records, tax officials are allowed to estimate their turnover and a gross profit. While the rate of gross profits is not officially published, there exists an officially acceptable list of rates of gross profits for different types of businesses and professions, based on past records. There are also practices of allowing a lump sum deduction when a taxpayer fails to produce satisfactory documentary evidence. Agricultural income is widely taxed on a presumptive basis. Taxable income is generally determined on the basis of amount and quality of land held. Chapter 7 has more discussion on how Bangladesh tax agro-based rural small businesses. There is also a presumptive method, ‘spot assessment’,<sup>522</sup> under which certain urban small businesses, such as unregistered small shops operating at a commercial market or a shopping mall, can choose to file a one page simplified tax return and pay a certain amount of tax to become a regular taxpayer. Section 5.5.1 of this Chapter has more details on the spot assessment system of Bangladesh.

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<sup>521</sup> National Board of Revenue, above n 405.

<sup>522</sup> *Income Tax Ordinance 1984*, Bangladesh, s 82D.

VAT, the main indirect taxation instrument of Bangladesh, also has various explicit and implicit presumptive methods.<sup>523</sup> The explicit form of presumptive indirect taxation is turnover tax; businesses with an annual turnover of below Taka 6 million (approximately USD 73,350) are subject to a 4 per cent turnover tax.<sup>524</sup> The amount of turnover tax that Bangladesh collects is insignificant. In 2010–11 the total amount of turnover tax collected was only Taka 36.3 million, equivalent to around 0.01 per cent of total VAT collection.<sup>525</sup> However, there exists a range of implicit presumptive provisions, including the adoption of notional values for assessing VAT, such as ‘tariff values’ and a ‘truncated base’ for certain services, and a lump sum VAT for retail traders that have the greatest impact on revenue.<sup>526</sup> Since there are no precise provisions or guidelines on how these presumptive methods have to be followed, there is a wide scope for subjective and discretionary assessment of VAT liability. Saleheen<sup>527</sup> argues that the application of presumptive elements in VAT can be best justified by the lack of credible taxpayer records, but also notes that presumptive provisions, in a VAT system in particular, are discriminatory and contrary to principles of modern taxation.

In conclusion, taxation of Bangladesh contains significant presumptive elements in different names and forms. Mostly, these methods work as convenient sources of revenue. They are overwhelmingly adopted on an ad hoc basis. There is no evidence that fairness, equity and efficiency concerns played any significant role during the adaptation of the presumptive provisions. Rather, in many instances small and medium taxpayers are discriminated against with high, mandatory tax burdens. The core objectives for adopting presumptive taxes are often to reduce the compliance burden of small taxpayers, and to encourage them to enter the formal tax net. The

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<sup>523</sup> Ahmed Munir Saleheen, ‘Presumptive Taxation under Bangladesh VAT’ (2012) 23(5) *International VAT Monitor* 316–321.

<sup>524</sup> Saleheen, above n 523.

<sup>525</sup> National Board of Revenue, above n 517.

<sup>526</sup> Saleheen, above n 523.

<sup>527</sup> Saleheen, above n 523.

existing Bangladesh presumptive tax regime has little coherence with these objectives.

### 5.5.2 Pakistan

Similar to Bangladesh, although to a lesser extent, in Pakistan there exists a list, courtesy of Section 169 of *Income Tax Ordinance 2001*, of a number income-producing activities for which tax deducted or collected at source is subject to the final discharge of tax liability.<sup>528</sup> The list includes imports, dividends, profits on debt, certain business receipts, supply of goods, execution of contracts, exports, prize winnings, petroleum products, brokerage and commission, CNG stations, and certain petroleum products. Here turnover is used as a proxy of the level of income.<sup>529</sup> The tax deducted or collected in connection of these earnings constitutes the final tax liability; no deduction is allowable for any expenditure incurred in deriving those incomes. Any excessive income derived from those sources is not subject to any further taxes, and any tax deducted in excess of the due amount does not create any refunds.<sup>530</sup>

As mentioned in Section 5.5.1, certain transport businesses are subject to a single indicator-based presumptive taxation. Shipping vessels are taxed on the basis of registered tonnage.<sup>531</sup> Also, transport vehicles like passenger buses are required to pay fixed taxes on the basis of the registered passenger seating capacity.<sup>532</sup> The taxes paid during registration settles the final tax liability.<sup>533</sup> Memon<sup>534</sup> reports that since Section 153 excludes large businesses from the final tax regime, it is small businesses, such as retailers and suppliers, who are mainly subject to the presumptive tax regime.

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<sup>528</sup> *Income Tax Ordinance 2001, Pakistan*, s 169.

<sup>529</sup> *Income Tax Ordinance 2001, Pakistan*, s 169.

<sup>530</sup> *Income Tax Ordinance 2001, Pakistan*, s 169.

<sup>531</sup> Crowe Horwath, above n 406.

<sup>532</sup> Crowe Horwath, above n 406.

<sup>533</sup> Crowe Horwath, above n 406.

<sup>534</sup> Memon, above n 26.

Memon<sup>535</sup> argues that the Pakistani presumptive income tax regime is not simple, nor meets efficiency and equity requirements. The existing design is not suitable for the taxation of the large informal economy. The Pakistani presumptive regime should shift from a turnover-based to an asset-based design.<sup>536</sup> Memon also advocates the adoption of incentives or privileges to attract informal enterprises to the formal tax net.<sup>537</sup> Finally, he recommends that all presumptive elements should be well coordinated and rearranged as a separate chapter in the tax ordinance.<sup>538</sup>

### 5.5.3 Ukraine

Ukraine, a non-European Union Eastern European country with a modest per capita income,<sup>539</sup> used to have an overly complex SME business tax regime where SMEs, on average, had to comply with 9 different taxes.<sup>540</sup> A survey conducted in 2000 reveals that three out of four major obstacles that affect SME entrepreneurship are related to taxation.<sup>541</sup> In order to reduce complexity and taxpayer compliance costs, a 'simplified' tax system was enacted under a Presidential decree which came into a full effect in 2000.<sup>542</sup> However, this new system was introduced without abolishing several other existing presumptive tax systems. The small taxpayers in effect now have five different presumptive tax systems to choose from.<sup>543</sup> A taxpayer with well-kept accounting records can choose to pay taxes under the standard tax regime. Ukraine has different presumptive tax systems for urban and rural small businesses. Below is a brief account of the existing Ukrainian presumptive tax systems.

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<sup>535</sup> Memon, above n 26.

<sup>536</sup> Memon, above n 26.

<sup>537</sup> Memon, above n 26.

<sup>538</sup> Memon, above n 26.

<sup>539</sup> According to International Monetary Fund, *World Economic Outlook Database* (April, 2012), the per capita GDP (nominal) of Ukraine is \$ 3971 USD.

<sup>540</sup> Michael Engelschalk, *Designing a Tax System for Micro and Small Businesses: Guide for Practitioners* (International Finance Corporation, 2007) 75.

<sup>541</sup> Engelschalk, above n 177, 10.

<sup>542</sup> Bird and Wallace, above n 9, 138.

<sup>543</sup> Engelschalk, above n 540, 296.

a. *Unified Tax*: This is the leading presumptive tax system for SMEs in Ukraine. This system treats natural persons and legal entities differently. A natural person having up to 10 employees and a turnover less than UAH 50,000 (around 6,000 USD) may opt for this system. The threshold for legal entities is 50 employees and a turnover of 1 million.<sup>544</sup> There are two options for VAT; a 10 per cent tax rate on turnover for a combined income tax and VAT liability, or a 6 per cent tax on turnover against the income tax liability and a separate account-based VAT liability.<sup>545</sup>

b. *Patent*: A person having no more than five employees and a turnover, in the preceding 12 months, up to 7000 times of the ‘tax free minimum income’ can opt for paying a monthly fixed amount of tax.<sup>546</sup> A person who chooses to pay a patent must register at the local council. The local council imposes a monthly fixed amount of tax between UAH 20 to 100.<sup>547</sup>

c. *Fixed agricultural tax*: In 1988 Ukraine adopted a single fixed agricultural tax (FAT) which replaced ten different previously applicable taxes on agricultural income, including income tax, land tax, tax on owners of transport vehicles, communal tax, contributions to the social insurance fund, contributions to the pension fund, and payment for trade patents.<sup>548</sup> Agricultural producers may opt for the FAT regime if they derive at least 50 per cent of their annual income from agricultural produce.<sup>549</sup> However, to qualify for FAT a company must register as an agricultural enterprise and earn at least 75 per cent of its gross income from the sale of agricultural products.<sup>550</sup> The amount of FAT payable is

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<sup>544</sup> Engelschalk, above n 540, 296.

<sup>545</sup> Bird and Wallace, above n 9, 139.

<sup>546</sup> Bird and Wallace, above n 9, 139.

<sup>547</sup> Bird and Wallace, above n 9, 139.

<sup>548</sup> German Economic Team in Belarus (GET), *Presumptive Taxation of Agriculture: International Experiences and Implications for Belarus* (2005) 4.

<sup>549</sup> Deloitte, *Taxation in Ukraine* (2011) 32.

<sup>550</sup> Deloitte, above n 549, 33.

determined on the basis of land area and land value. Table 5-6 reports the existing Ukrainian FAT rate structure.

**Table 5-6 Ukraine FAT rate table**

Types of plots of land owned or used by the taxpayer	FAT rate % per value of hectare
Plough lands, haying lands and pastures	0.15
Plough lands, haying lands and pastures in mountainous regions	0.09
Plots of land subject to a perennial planting regime	0.09
Plots of land subject to a perennial planting regime, located in mountainous regions	0.03
Underwater plots of land used for fishery purposes	0.45
Plough lands, haying lands and pastures, owned or rented by agricultural producers, which are set up to grow plants or crops	1

Source : Deloitte. <sup>551</sup>

d. *Other presumptive taxes*: There are also some other minor presumptive taxes, such as trade permits (for services), the small enterprise tax and the market fee, that are imposed on very small businesses by local councils. <sup>552</sup>

The Ukrainian presumptive system has shown impressive success in increasing the number of registered taxpayers.<sup>553</sup> Thiessen<sup>554</sup> demonstrates that introduction of presumptive tax has also a significant impact in reducing of size of shadow economy. The ability to pay a single tax rather than several might had reduced taxpayer compliance burden to some extent. However, the attempts to reduce complexity for small taxpayers have apparently had little success, mainly because the new system was introduced

<sup>551</sup> Deloitte, above n 540, 33.

<sup>552</sup> Engelschalk, above n 540, 297.

<sup>553</sup> Engelschalk, above n 540, 305.

<sup>554</sup> Ulrich Thiessen, 'The Impact of Fiscal Policy and Deregulation on Shadow Economies in Transition Countries: The Case of Ukraine' (2003) 114 *Public Choice* 309.

without enough coordination with existing presumptive methods. Engelschalk refers to the Ukrainian small business tax regime as an example of a lack of coordination among various existing presumptive taxes.<sup>555</sup> The options to choose from several tax regimes makes the tax system overly complicated and leaves more scope for evasion.<sup>556</sup>

#### 5.5.4 Tanzania

The Tanzanian SME tax regime seems more inclined to achieving non-revenue objectives. The regime mainly focuses on making the tax system easier for informal sector operators to register, formalize and start paying taxes. In accordance with the guidelines of the newly adopted SME policies,<sup>557</sup> the Tanzanian government, in July 2004, adopted a presumptive tax system,<sup>558</sup> under which only sole proprietor businesses with business turnover not exceeding TAS 20,000,000 (USD 14,981) per annum qualify to pay taxes.<sup>559</sup> Tanzanian presumptive taxation is a progressive turnover-based presumptive tax system where a taxpayer enjoys a lower tax burden if they comply with certain recordkeeping requirements.

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<sup>555</sup> Engelschalk, above n 540, 297.

<sup>556</sup> Engelschalk, above n 540, 297.

<sup>557</sup> United Republic Of Tanzania, Ministry of Industry and Trade, *Small and Medium Enterprise Development Policy 2002* (2002).

<sup>558</sup> Tanzanian Revenue Authority, above n 354, 72.

<sup>559</sup> Haraka Mittah, 'Strategies for Improving the Quality and Accuracy of SMEs Bookkeeping', paper presented at International Tax Dialogue Africa Conference on Taxing Micro and Small Businesses, Kigali, Rwanda (2009).

**Table 5-7 Presumptive income taxation in Tanzania: lower tax burden for compliant taxpayers**

Annual turnover (in TAS)	Tax payable where the taxpayer only keeps rudimentary records	Tax payable where the taxpayer keeps complete records for business transactions
Up to 3 million	TAS 35,000	1.1% of turnover
3–7 million	TAS 95,000	TAS 33,000 plus 1.3 per cent of the turnover in excess of TAS 3 million
7–14 million	TAS 291,000	TAS 85,000 plus 2.5 per cent of the turnover in excess of TAS 7 million
14–20 million	TAS 520,000	TAS 260,000 plus 3.3 per cent of the turnover in excess of TAS 14 million

Source: Tanzanian Revenue Authority.<sup>560</sup>

However, there is a major anomaly in the design of this incentive. A ‘non-record keeper’ with annual turnover of TAS 1 million faces an effective tax burden of 3.5 per cent, while a ‘non-record keeper’ with annual turnover of TAS 7 million faces an effective tax burden of 1.4 per cent. The system is thus highly regressive for certain small taxpayers.<sup>561</sup>

Like the Ukrainian system, the Tanzanian presumptive tax system has also achieved success in increasing the number of registered taxpayers. The number of presumptive taxpayers rose from 199,448 in 2005–2006 to 376,673 in 2009–2010.<sup>562</sup> Table 5-8 illustrates that total tax collection figures from presumptive taxes are also on an increasing trend. Moreover, Tanzanian presumptive tax collects much more taxes even from recordkeeping taxpayers. One possible explanation for this might be the effectiveness of the preferential reduced tax burden incentive for recordkeeping taxpayers.

<sup>560</sup> Tanzanian Revenue Authority, above n 354, 77.

<sup>561</sup> Tanzanian Revenue Authority, above n 354, 84.

<sup>562</sup> Tanzanian Revenue Authority, above n 354, 141.

**Table 5-8 Positive trend in presumptive tax collection in Tanzania**

(Million TAS)

Presumptive Taxpayer type	2005–06	2006–07	2007–08	2008–09	2009–10
Taxpayer who keeps accounts	23,933	20,542	25,915	31,198	32,489
Taxpayer who does not	7,612	8,962	8,669	10,912	12,896
Total	31,545	29,504	3,4584	42,110	45,385

Source: Tanzanian Revenue Authority.<sup>563</sup>

According to the Tanzanian Revenue Authority (TRA) the introduction of a presumptive tax system has caused a reduction in administrative costs for the tax authority and compliance costs for taxpayers.<sup>564</sup> The increased number of registered taxpayers definitely has an impact on the overall tax compliance environment. However, in terms of revenue, presumptive taxes have registered little increase. During 2006–2007 and 2007–2008 tax collection from presumptive taxes accounted for only 0.36 per cent and 0.40 per cent of the total tax revenue collection respectively.<sup>565</sup> A narrow qualifying threshold of presumptive taxes might be a reason. Often in developing countries the qualifying threshold is not adjusted for inflation and changed macroscopic conditions. As a result the targeted base gradually gets narrower and is exhausted with time.

## 5.6 Conclusion

In this thesis it has been argued that in many developing countries it remains unrealistic to devote scarce tax administration resources to handling certain small taxpayers who do not generate large amounts of revenue. These small businesses consider the tax system to be complex, costly to comply with, and a major impediment for their business operations. Under such

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<sup>563</sup> Tanzanian Revenue Authority, above n 354, 81.

<sup>564</sup> Tanzanian Revenue Authority, above n 354, 81.

<sup>565</sup> Mittah, above n 559.

circumstances, developing countries might find it more appropriate to use presumptive taxes than the standard regime.

This chapter starts with an analysis of the theories and applications of presumptive methods. Developing countries widely use various methods of presumptive taxation, mainly to tax small taxpayers whose actual income is difficult to assess. This chapter attempts to analyse the relative merits of commonly practised presumptive methods. It becomes apparent that a meaningful numerical analysis of the efficiency of presumptive methods is extremely difficult or nearly impossible to apply in developing countries. It is more appropriate to depend on qualitative judgments in order to identify the method that yields the most appropriate estimate of taxpayer income under certain social, economic and institutional setups.

This chapter firstly classifies the types of presumptive taxes with respect to their economic bases and estimation methodology, and analyses the relative merit of each. In the process it sets the grounds for arguing that asset-based presumptive taxation might be more efficient for taxing the agricultural income of rural small businesses, and establishes that turnover-based presumptive methods are widely used to tax urban small businesses. Secondly, the Chapter analyses the relative merits of different multiple indicator-based presumptive taxes, such as *forfait*, *tachshiv* and *Studi di settore*. *Studi di settore*, which uses sophisticated statistics to estimate the turnover of a business, is most suitable to tax urban taxpayers of a developing country that has relatively strong institutional capabilities, including a fair level of information technology. The next two chapters of this thesis analyse policy and administration issues regarding the application of presumptive methods in taxing rural and urban small taxpayers in developing countries.

Thirdly, this chapter argues that a successful application of presumptive methods should involve a careful consideration of several important design

issues, such as the choice of indicators, the determination of the threshold and targeted taxpayers, the coordination of the presumptive tax regime with the overall tax system, the identification of objectives, and the administration of the tax. A presumptive taxation regime should not over include the HTT. Indicators should be chosen very carefully so that it can provide a credible approximation of taxpayers' income in a certain sector. Presumptive tax rates should be determined based on surveys and objective evidence and should be updated regularly. Non-rebuttable presumptive taxes are often considered as unfair. However, in developing countries, while designing a presumptive tax system, simplicity should override fairness principles. In the case of administration, a presumptive regime administrated by STO-type administrative arrangement might be effective in taxing the small business.

Finally, this chapter analyses four countries' application of presumptive taxes. Application of presumptive taxes in Bangladesh and Pakistan is random and uncoordinated. Implicit presumptive provisions play a large role in collecting taxes. In Ukraine, however, presumptive regimes are more comprehensive and explicitly defined. The existence of a number of similar, uncoordinated and often overlapping simplified regimes makes the overall system overly complex for the small businesses, however. The Tanzanian small businesses tax regime is both explicit and well-specified. Yet, it targets only a narrow tax base. In increasing the number of registered taxpayers both Tanzania and Ukraine has achieved impressive success. Yet, there are also some other crucial efficiency measures such as the reduction of the net administrative costs of the tax administration and the reduction of the compliance costs of the taxpayers. It is not clear whether Tanzania and Ukraine had been successful to address those issues. These country experiences suggest that presumptive tax methods have been adopted mostly in arbitrary manner, without objective consideration of many crucial design issues. A typical developing country is likely to benefit from presumptive taxes if the presumptive regime is explicit and unambiguous, the indicators

are chosen properly, the threshold is well targeted and rational, and the presumptive regime is well coordinated with the overall tax system.

## **CHAPTER 6**

# **THE TAXATION OF URBAN SMALL BUSINESS IN DEVELOPING COUNTRIES**

### **6.1 Introduction**

The findings of Chapter 2 and Chapter 3 suggest that the standard income tax-based tax systems in most developing countries are unable to efficiently tax small businesses. The findings of Chapter 4 suggest that the presence of a larger shadow economy is one of the greatest challenges for tax administrations. Small businesses are greatly involved in the shadow economic activities. A small business taxation policy can only function effectively if it can effectively tax the shadow economy. This chapter also puts forward that there are crucial differences between typical urban and rural businesses. It is appropriate to recognize these distinguishing features of rural and urban small businesses and develop taxing methods that can effectively assess the economic activities of the two classes of taxpayers separately.

Chapter 5 analyses the theoretical aspects of presumptive taxes, analyses their practical application in developing countries, and evaluates the effectiveness and efficiency of presumptive taxation with regard to the goals a typical developing country may wish to achieve. There is no convincing empirical evidence that the presumptive regime generates more revenue than the standard regime. However, if presumptive taxes are applied properly, a developing country can achieve some important objectives, such as bringing more small taxpayers into the tax net, reducing the administrative cost of the tax administration and reducing compliance cost of the small taxpayers. A typical developing country with a considerably small formal tax base and with huge number of unattended potential

taxpayers might benefit from a transitional arrangement where small taxpayers are well-treated by a special presumptive regime until they are mature enough to graduate to the regular tax system. This chapter stresses on the several critical design issues which policymakers should carefully consider while designing a presumptive tax system. Presumptive methods should be very carefully selected after analysis of the targeted taxpayers' key socioeconomic characteristics and business transaction patterns. For example, developing countries should adopt differentiated presumptive methods to estimate the income of rural and urban taxpayers. A presumptive regime might work efficiently if it contains an explicit, unambiguous and comprehensive jurisdiction and it is well coordinated with the overall tax system.

In the previous few chapters it has been argued that small businesses in developing countries have two core segments. The presumptive tax design should reflect the understanding of the core differentiating characteristics of urban and rural small business. This chapter has a focused discussion on the key distinguishing characteristics of urban small businesses. This chapter argues that urban taxpayers are different to rural taxpayers in some critical aspects such as business registration, mode of business transactions, bookkeeping practices, business indicators, and business locations. A presumptive tax system that aims at taxing these urban small businesses should have a careful consideration to these key characteristics.

There are a great number of unregistered small taxpayers who avoid complying with tax obligations. Tax authorities all over the world are concerned with those unregistered but potential taxpayers. Nonetheless, in developing countries, tax authorities should also be concerned about the large number of registered but non-complying taxpayers. Often, developing country tax administrations are incapable of properly monitoring these registered but non complying taxpayers. This chapter suggests the use of a turnover-based presumptive tax that requires minimum record keeping and

minimum compliance obligations as a more pragmatic approach to tax the urban small business in a number of situations.

This chapter provides evidence that the majority of small businesses in developing countries have little or no information about tax obligations, the steps required for registration or the benefits of doing so. Formalization can play a crucial role through reducing the size of shadow economy, increasing the growth potential of small firms, increasing the overall tax potentials and promoting fairness. This chapter proposes that formalization should be an important element of urban small businesses tax policy. Compared to rural taxpayers, urban taxpayers generate comparatively more income, are relatively more educated, have less dispersed business locations, and often operate in clusters near urban facilities. It is more feasible for tax administrations to concentrate on urban small taxpayers to attract more businesses to register onto the tax roll. Finally, this study identifies core elements of a preferred tax system for the taxation of urban taxpayers. In order to tax the urban small taxpayers effectively a tax system should promote a greater use of banking channels, adopt a well-designed simplified or presumptive tax regime, educate the taxpayers about the benefits of paying tax, and maintain a dedicated administrative unit to serve small taxpayers.

## **6.2 Key characteristics of urban small businesses**

As a part of a brief overview of taxation of small businesses in developing countries in Section 3.2.2 of Chapter 3, this thesis has argued that the considerable differences in typical urban and rural businesses in demographic features, business concentration, assets, size, transaction processes, production, employment, and compliance attitudes should be accounted for during designing small business taxation policy and administration. In Chapter 4 this thesis claimed that small businesses in the shadow economy are also segmented along rural/urban lines. In this section

further analytical evidence is provided in order to establish the proposition that urban small businesses are indeed different, not only in terms of socioeconomic characteristics, but also in terms of growth, productivity, and income-earning potential. Studies conducted on income gap or inequality in the context of developing countries generally report that compared to rural areas, the per capita household income is generally higher in urban areas.<sup>566</sup> Drabenstott and Meeker<sup>567</sup> argue that for small businesses demography plays a critical role, since low density of population restricts business growth. Throughout the developing world the distance to markets and the lack of roads and infrastructure limit growth opportunity of the rural communities.<sup>568</sup> Rural businesses generally face higher transport and shipping costs and have a limited pool of experienced labour.<sup>569</sup> Geographical concentration and clustering provide significant benefits to urban small businesses.<sup>570</sup> Liedholm, using data of a set of several developing countries from Africa and Latin America, demonstrates that businesses location is an important factor.<sup>571</sup> The survival rate of urban small enterprises is greater than their rural counterparts.<sup>572</sup> Generally, the complementary or clustered urban small enterprises, grouped close together, are more likely to grow rapidly than businesses that operate in dispersed locations.<sup>573</sup> All this information implies that urban small businesses have more potential to survive and grow than sustained taxpayers. Therefore, a developing country is likely to benefit more if the tax policy can effectively

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<sup>566</sup> Thi Cam Van Cao and Takahiro Akita, 'Urban and Rural Dimensions of Income Inequality in Vietnam', International University of Japan, GSIR Working Papers (2008); Terry Sicular, Yue Ximing, Bjorn Gustafsson and Li Shi, 'The Urban-Rural Income Gap and Inequality in China' (2007) 53(1) *Review of Income and Wealth* 93-126.

<sup>567</sup> M Drabenstott and L Meeker, 'Equity for Rural America: From Wall Street to Main Street a Conference Summary' (1999) 84(2) *Economic Review, Federal Reserve Bank of Kansas City* 77-85.

<sup>568</sup> Food and Agriculture Organization of the United Nations, *Rural Poverty Report 2011* (2010) 192.

<sup>569</sup> Food and Agriculture Organization of the United Nations, above n 568.

<sup>570</sup> Meine Pieter van Dijk and Roberta Rabellotti, 'Clusters and Networks as Sources of Cooperation and Technology Diffusion for Small Enterprises in Developing Countries' in Meine Pieter van Dijk and Roberta Rabellotti (eds), *Enterprise Clusters and Networks in Developing Countries* (Frank Cass, 1997).

<sup>571</sup> Liedholm, above n 11, 229.

<sup>572</sup> Liedholm, above n 11, 233.

<sup>573</sup> Liedholm, above n 11, 234.

encourage the urban small businesses to enter the tax net. To attract such taxpayers taxation regulations have to be easy to comply with. The ultimate goal should be the creation of favourable tax environments for the new entrants, helping make them accustomed to the tax compliance culture so they can eventually graduate to the normal tax regime.

Araujo-Bonjean and Chambas<sup>574</sup> argue that in developing countries rural and urban unrecorded sectors are considered undertaxed. These two sectors require separate analysis because they differ in several characteristics.<sup>575</sup> Urban businesses usually secure trade licences from the local government, operate both in cash and banking channels, and usually keep a basic level of books and records. They generally operate in clusters; a large number of businesses can be found in a relatively small geographic location. The leading business indicators that can be rationally used to assess potential economic activity of urban small businesses are business size, number of employees, business stock, and the amount of utility consumed. Also, urban small businesses are generally affiliated with local trade bodies or business associations.

### **6.2.1 Registration**

Businesses or professions established within certain urban limits are generally required to register and receive a licence from the appropriate local authority. These licences generally require a lump sum fee. They are often valid for one year, and must be renewed. In developing countries, numerous urban informal small businesses carry on business or professional activities without being registered. Many other register with local authorities but do not renew or comply with regulatory obligations. In many instances, business registration in local authorities is processed by manual or nearly

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<sup>574</sup> Catherine Araujo-Bonjean and Gerard Chambas, 'Taxing the Urban Unrecorded Economy in Sub-Saharan Africa' in James Alm, J Martinez-Vazquez and Sally Wallace (eds.), *Taxing the Hard-to-Tax: Lessons from Theory and Practice* (Elsevier, 2004) 314.

<sup>575</sup> Araujo-Bonjean and Chambas, above n 574, 314.

manual systems. Taxation normally has a different registration system. Taxation and business registration authorities usually do not officially interact or share data about registered businesses. Newly registered sole proprietorship or partnership businesses usually have very few regulatory registration or reporting requirements. However, newly incorporated businesses need to go through a number of processes for registration. In developing countries, the registration processes are lengthy, cumbersome and often excessively costly. Table 6-1 illustrates a compelling contrast regarding the growth of new corporations in developed and developing countries. This table also demonstrates that, compared to the costs of developed countries, new firms in developing countries encounter an exorbitant amount of fees and expenses during registration or incorporation. It should be noted that in developing countries businesses often need to incur a great amount of unofficial or unsolicited expenses. In many occasions these undue expenses are higher than due official fees and expenses. These excessive due and undue cost burdens might significantly impact the growth of the unofficial economy.

**Table 6-1 Cost and growth of newly registered corporations in selected developed and developing countries, 2009**

Country	Number of new incorporated firms (in 2009)	New density (in 2009)*	Cost (% of income per capita)**
New Zealand	48358	16.82	0.4
Singapore	26414	7.22	0.6
United Kingdom	340170	8.32	0.7
Canada	174000	7.56	0.4
Australia	86133	5.80	0.7
Sri Lanka	4223	0.31	19.1
India	46000	0.06	49.8
Pakistan	2762	0.03	9.9
Bangladesh	6870	0.07	25.1
Rwanda	3028	0.54	4.3
Zambia	5505	0.85	107
Kenya	17896	0.85	40.4
Philippines	11435	0.19	18.1
Indonesia	28998	0.18	22.7

Source: Doing Business Database.<sup>576</sup>

\* Is the number of newly registered incorporate companies per 1,000 working-age people.

\*\* Cost includes all official fees and professional service fees (excludes bribes or unsolicited expenses).

Businesses generally need to incur costs to comply with laws and regulations. Along with tax burdens, many businesses also incur a significant taxation compliance burden. This could be reduced if the business registration and taxation procedures were better aligned. There are instances when a firm complies only with a registration authority but escapes tax obligations. The reform of business registration processes remains outside the scope of this thesis; however, it should be stressed that in the case of urban businesses, taxation authorities could acquire substantial information from the business registry of the local governments. In many countries the business registration process is integrated or closely linked to the tax registration procedures. Developing countries can achieve a

<sup>576</sup> The World Bank, *Doing Business Database* (2012).

significant efficiency gain if they can reduce the cost of the business registration, automate and integrate the business registration and tax registration systems, and thereby simplify the tax compliance procedures for new businesses.

### **6.2.2 Mode of business transaction**

In many developing countries a significant number of rural small businesses operate predominantly on a cash or barter basis. In urban areas, although cash transactions are very common, many small businesses, specifically those that are suppliers of large businesses, also operate through banking channels. Many urban small businesses need to maintain a banking channel for maintain utility connections and also making purchases from large businesses. Financial institutions have a greater presence in urban areas.

A greater ability to operate on cash enables a business to operate in the shadow economy. To make financial transactions of businesses more verifiable tax polices always try to restrict or discourage cash transactions. In recent years tax policies of many developing countries have increasingly imposed heavier restrictions on the use of cash in business operations. For example, in Bangladesh, income tax law has adopted some provisions that require a banking channel be used for making investments and giving and receiving loans over a certain amount.<sup>577</sup> There are some provisions that also disallow any deduction for payment of salary of remuneration exceeding Taka 15,000 if the payment is not made through a banking channel.<sup>578</sup> *The Finance Act 2012* adds a further requirement, disallowing any business payment exceeding Taka 50,000 not executed through a banking channel.<sup>579</sup> The objective of these obligations is to reduce cash transactions, and thus make taxpayer business transactions more traceable.

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<sup>577</sup> *Income Tax Ordinance 1984*, Bangladesh, s 19(21), 19(24), 19(26), 19(28).

<sup>578</sup> *Income Tax Ordinance 1984*, Bangladesh, s 30(i).

<sup>579</sup> *Income Tax Ordinance 1984*, Bangladesh, s 30(m).

India has introduced similar measures. Section 40A (3) *Income Tax Act*<sup>580</sup> requires that a payment or an aggregate payment exceeding Rupee 20,000 in a day is ineligible for tax deduction if it is not made through a banking channel. Indian tax law also used to contain a provision that, subject to certain limits, imposed a tax on cash withdrawals from a bank.<sup>581</sup> The goals of this type of tax were to restrict cash transactions, increase the documentation of taxpayer transactions, and to place auditable trails on taxpayer financial transactions. This provision, however, was discontinued in 2009. This may have been due to fears the tax could act as a discouragement from bank usage, though may partly have been due to inadequate banking infrastructure throughout the country,<sup>582</sup> Income tax law of Pakistan, however, still contains such a provision, which imposes 0.3% tax on cash withdrawal if the cash withdrawal in a day exceeds 50,000 thousand rupees.<sup>583</sup>

An Indian government White Paper<sup>584</sup> on black money proposes tax incentives for taxpayers who pay their tax obligations through debit or credit cards. In 1999 the South Korean government introduced such tax incentives for credit card usages. This incentive is believed to have resulted in a surge in credit card usage in Korea.<sup>585</sup> Where the credit card expenditure levels stayed around \$30 and \$41 billion in the years 1997–1999, after the introduction of this incentive it surged to \$77 billion, and in 2003, the level of credit card expenses went up to \$165 billion.<sup>586</sup> However, all these legal restrictions on cash transactions mainly impact businesses that are already in the tax net. It is widely considered that a huge number of potentially taxable businesses have chosen to stay outside. These businesses are the major

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<sup>580</sup> *Income Tax Act 1961*, India, s 40A (3).

<sup>581</sup> Isaias Coelho, 'Taxing Bank Transactions: The Experience in Latin America and Elsewhere', paper presented at the International Tax Dialogue Global Conference, Beijing (2009).

<sup>582</sup> Coelho, above n 581.

<sup>583</sup> Coelho, above n 581.

<sup>584</sup> Ministry of Finance, India, Department of Revenue, *White Paper on Black Money* (2012).

<sup>585</sup> Ministry of Finance, India, above n 584.

<sup>586</sup> Engelschalk, above n 540, 67.

building blocks of the shadow economy of developing countries. In accordance with this concern, the White Paper further suggests that to curb the black economy it is essential to rationalise tax rates, and cut transaction costs for compliance and administration.<sup>587</sup>

### 6.2.3 Bookkeeping

For many small businesses it may not be possible to maintain standard record keeping in order meeting the account maintenance requirements. As the level of education and basic skills is relatively higher in urban locations, urban small businesses are comparatively in a better position to maintain at least a rudimentary level of record keeping and follow the basic regulatory obligations. For example, for a turnover-based tax a very basic level of bookkeeping is essential.<sup>588</sup> Many developing countries, including a number of African countries, have introduced the mandatory use of electronic cash registers (ECRs) for certain classes of business that operate at certain city limits.<sup>589</sup> The installation of electronic cash registers requires a significant amount of capital investment for small businesses. This high initial investment cost, coupled with other practical reasons, has seen the usage of electronic cash registers grow very slowly.<sup>590</sup> Engelschalk<sup>591</sup> identifies several reasons for the lack of expected progress in the usage of ECRs in African countries, such as a lack of reliable power supply, inadequate facilities to repair the machine, a culture of limited interest of taking receipts, a culture of bargaining by customers (some customers bargain for VAT exclusive prices) and a lack of administrative capacity of the tax authority to monitor proper use of the ECRs and corruption. The same set of reasons might explain the low level of usage of ECRs in Bangladesh. Many small

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<sup>587</sup> Ministry of Finance, Department of Revenue, India, above n 584.

<sup>588</sup> Engelschalk, above n 540, 64.

<sup>589</sup> In Bangladesh it is mandatory to install electronic cash registers and use point of sales software for 10 types of businesses situated in the metropolitan area and for big shops in the district headquarters. See, Jasim Uddin, '75pc Mandated Retailers yet to Install Electronic Cash Register', *The Age* (Dhaka, Bangladesh), 11 February 2012.

<sup>590</sup> Engelschalk, above n 540, 66.

<sup>591</sup> Engelschalk, above n 540, 66.

business and trade bodies still oppose the installation of ECRs at their businesses. One reason business owners often point to is the reluctance of customers to buy products when VAT is added to the price tag — they fear that upon taking up the use of an ECR they face unfair competition with businesses which do not collect VAT.<sup>592</sup> It goes without saying, therefore, that it is quite challenging for developing country tax administrations to encourage businesses to increase documentation and to decrease cash transactions. It seems some developing country tax administrations still need to rely on the presumptive methods that require taxpayers to maintain just a basic level of record keeping. There are some instances where tax authorities provide tax incentives for the improved maintenance of accounting records. For example, in Tanzania small taxpayers enjoy a lower tax burden if they comply with certain record keeping requirements.<sup>593</sup> The figures of Table 5-8 in Chapter 5 indicate that the incentive that offers a preferential reduced tax burden for record keeping taxpayers might work effectively. The Tanzanian presumptive tax collects much more tax from accounting record keeping taxpayers than the non-accounting record keeping taxpayers.<sup>594</sup>

#### **6.2.4 Business indicators: proxies for income of urban small businesses**

In absence of credible books and records taxation authorities often depend on indirect means of estimating the taxable income of businesses. Presumptive tax systems use one or a combination of indicators as proxies to determine the level of income of a taxpayer. In rural areas of developing countries the major source of income is the land-based farm income. At the basic level the amount of landholding often gives a reasonable estimation of the agricultural income. However, urban businesses are relatively more diverse in nature. Depending on the type of business and industry involved,

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<sup>592</sup> Uddin, above n 589.

<sup>593</sup> Tanzanian Revenue Authority, above n 354, 77.

<sup>594</sup> Tanzanian Revenue Authority, above n 354, 77.

a close approximation of the income of an urban business often requires consideration of a variety of indicators. For a typical urban business location initial capital, size of the premise, number of employees employed, type of products sold, level of utilities consumed, and interior and exterior decoration all can give important clues about the level of income of the business. Most of the indicator-based presumptive tax systems, such as *forfait*, *tachshiv*, and *studi di settore*, use multiple indicators, including the business's location, the type of industry it's in, the size of the business, the type of products it sells and the services it provides. Therefore, it is very important that the tax policy identifies the crucial indicators that are reasonably observable and which give a reasonable indication about the level of income. Mostly, a turnover or gross sale is used as an indicator to estimate the taxable income of urban small businesses.

### **6.2.5 Location and business clusters**

As mentioned above, often a large number of urban small businesses operate within a small geographic location — clustered close to the final demand sources. This locational pattern gives tax administrations the scope to administer a considerable number of taxpayers within a small geographic limit. Also, urban taxpayers generally form a local business body or a market association. Tax administration can utilize these formal or informal organisations to organize tax events and to channel tax related education.

### **6.2.6 Urban concentration of tax administration**

Many standard fiscal federalism theories suggest that it should be the higher-level government that imposes taxes that involve non-benefit elements, such as redistributive purposes, and are imposed upon mobile economic entities.<sup>595</sup> Indeed, income tax is normally imposed at the national

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<sup>595</sup> Wallace E. Oates, 'An Essay on Fiscal Federalism' (1999) 37(3) *Journal of Economic Literature* 1125-26.

level by the central government. The administrative structure of most developing countries is concentrated around the metropolitan or urban areas. In Bangladesh, the National Board of Revenue administers income tax administration at a national level. Until 2011, most income tax offices were situated in metropolitan areas, only a few at the district level, and none at the Thana level (local level). Income tax administration of Bangladesh is divided into several territorial and appellate zones. Each territorial zone is divided into approximately 20 circles. A circle is the smallest administrative unit of tax administration. Table 6-2 illustrates that only around 22 per cent of all taxes circles have mostly non-urban jurisdictions. However, even the offices of these circles are mostly situated at district headquarters, at a place far from the local jurisdiction. Moreover, those predominantly non-urban jurisdictional circles are mostly equipped with a fewer staff and a poorer logistics.

**Table 6-2 Administration setup with regard to rural urban income tax jurisdiction in Bangladesh**

Administrative Divisions	No. of territorial taxes zones	No. of taxes circles	No. of circles with (mostly) non-urban Jurisdiction
Dhaka	8	162	21
Chittagong	3	60	11
Rajshahi	1	18	7
Khulna	1	19	9
Sylhet	1	9	4
Barishal	1	10	5
Rangpur	1	14	8
Total	16	292	65

Sources: Bangladesh Civil Service Taxation Association.<sup>596</sup>

The organizational patterns indicate that the effective administrative reach on rural taxpayers is extremely poor in Bangladesh. Similar situations might be prevalent in many developing countries. For a meaningful expansion of the tax net it seems more rational to concentrate more on urban

<sup>596</sup> Bangladesh Civil Service Taxation Association, *Telephone Directory* (2011).

non-complying taxpayers, since at urban locations tax administrations have relatively more monitoring and enforcement capacity.

### **6.3 Dealing with registered and unregistered urban small businesses: the context of the application of presumptive taxes**

It is widely believed that only a small fraction of taxable income-earning small businesses register with the tax administration. Also, many registered businesses do not properly comply with all tax requirements, and many once-registered taxpayers discontinue submitting tax returns. Many small businesses disclose only a fraction of their income. According to Engelschalk, however, tax noncompliance is not necessarily the main element of informality.<sup>597</sup> Apart from income tax authorities, there are some other regulatory bodies small businesses need to comply with. In Figure 6-1 Engelschalk presents a diagram exhibiting the different shades of informality.<sup>598</sup> There are many firms that might be compliant with registration and social security obligations, but do not pay due taxes.

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<sup>597</sup> Engelschalk, above n 540, 4.

<sup>598</sup> Engelschalk, above n 540, 4.

**Figure 6-1 Informality can take different forms and dimensions**

MSE operates entirely outside the formal economy
MSE complies with a small number of legal and regulatory obligations, but not with others
MSE complies with most legal and regulatory obligations
MSE formally complies with legal and regulatory obligations, but not entirely respects all obligations
MSE is fully compliant with legal and regulatory obligations

Source: Engelschalk.<sup>599</sup>

It is extremely difficult to get reliable data on small business tax compliance. However, given the extremely small number of income tax returns, it can be reasonably assumed that a vast majority of small businesses do not register or do not pay income tax. In Rwanda, it is estimated that the number of micro and small-scale enterprises is nearly 70,000, yet only around 1,000 of those are registered with the tax authority.<sup>600</sup> This implies that tax compliance level among SMEs in Rwanda is less than 2 per cent.<sup>601</sup>

Figure 6-2 attempts to broadly classify the major groups of small business in terms of tax compliance and registration. The figure indicates that there is a group of taxpayers who are willing to register and pay tax if the tax system is easy to comply with. Later in this chapter it is argued that there are some urban small businesses which may fall in this group and have the potential to be relatively stable and compliant taxpayers.

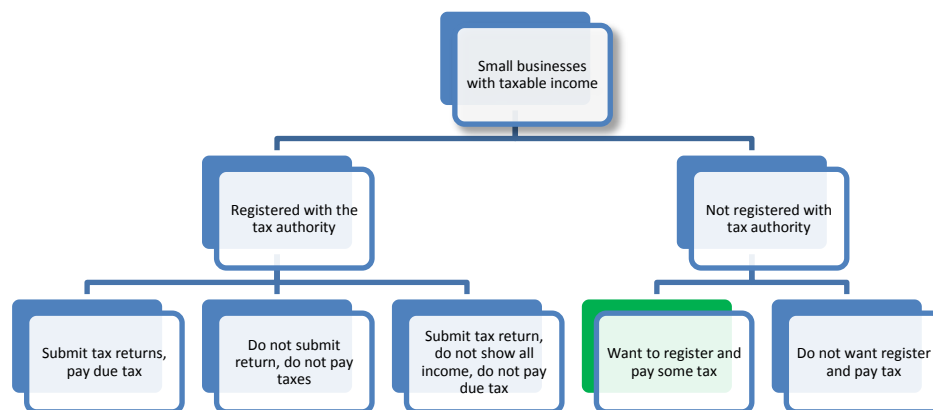
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<sup>599</sup> Engelschalk, above n 540, 4.

<sup>600</sup> Engelschalk, above n 540, 5.

<sup>601</sup> Engelschalk, above n 540, 5.

**Figure 6-2 A Classification of compliant and non-compliant small taxpayers in developing countries**



### 6.3.1 Registered taxpayers

In most developing countries, tax administrations maintain a taxpayer identification number database; each registered taxpayer receives a unique taxpayer identification number. The taxpayer identification numbers are used to fulfil certain regulatory requirements during the carrying out of some service or the making of any investment. Examples include registering a company, opening a bank account, taking out a bank loan, buying or selling properties and taking utility connections. Often taxpayers, after receiving the number, discontinue complying with taxation obligations. Although a significant number of taxpayers are registered on the taxpayer database, the number of taxpayers that submit tax returns is still very low.<sup>602</sup> In Bangladesh for example, in 2011 among 3.5 million registered income

<sup>602</sup> See, eg, Table 2-2 of Chapter 2.

taxpayers only 1.2 million filed income tax returns.<sup>603</sup> The remaining 2.3 million taxpayers (66 per cent) are non-filers or stop-filers who do not comply with income tax obligations.<sup>604</sup>

It seems that there are three major categories of small taxpayers who newly register with the taxpayer database:

- i. Taxpayers willing to continue as a regular taxpayer. This group includes taxpayers who are subject to withholding tax.
- ii. Taxpayers who want to register to serve a one-off purpose, such as buying or selling property, registering a motor vehicle, opening a bank account, taking out a small loan, making the supply of goods or services or forming a limited company.
- iii. Taxpayers who are identified through a new taxpayer identification survey of tax administration, or by surveys carried out by an appointed third party.

Tax administrations keen to expand the existing tax net generally spend substantial resources to detect unregistered potential taxpayers. However, the tax administration should be concerned about not only the huge number of non-registered taxpayers, but also a huge number registered non-filers and stop filers. To this end, it looks more effective to rely on the withholding tax system and the presumptive tax regime when the tax administration lacks the capability to administer the existing tax base.

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<sup>603</sup> Aminul Karim and Md. Alauddin, 'Emerging Tax Issues in Asian Countries', paper presented at the IMF Japan High Level Tax Conference for Asian and Pacific Countries, Tokyo (2012).

<sup>604</sup> Karim and Alauddin, above n 603.

### 6.3.2 Unregistered taxpayers

A large number of potential taxpayers stay outside the tax net in developing countries for a variety of reasons. As a result, tax administrations are increasingly concerned with expanding the existing tax net. Developing countries often take policy and administrative measures to achieve this end. Common policy measures include expanding the tax base, extending tax filing and registration requirements, expanding the scope to withhold taxes, and providing incentives to enter the tax net. As mentioned earlier, tax administrations, through internal survey departments or outsourced organizations, also try to identify potential taxpayers in order to expand the existing tax net. Often due to lack of proper monitoring and enforcement activities, a large portion of newly identified and newly registered taxpayers become non-filers and stop filers. Many taxpayers who enter the tax net for a particular purpose, such as selling a property or for taking a bank loan, also become non-filers and stop filers. For a tax administration with limited monitoring and enforcement capacity, a better taxing mechanism might be a system that requires ex-post monitoring to a lesser extent. In many developing countries the group of registered taxpayers is the tip of an iceberg. Tax policy should be more interested in the group of taxpayers who want to pay some taxes and want to enjoy the benefits of being formal. Later in this chapter the taxation policy towards enterprise formalization is discussed. It is possible for a developing country to identify the leading causes of low tax compliance. A reform of the small business tax regime should address each of those causes and try to create a favourable environment for small businesses to comply with the tax obligations.

If a country is really interested in improving its existing small business tax regime, it is essential for it to have a clear objective. Often a tax reform initiative fails when the objective lacks clarity or when the reform attempts to achieve too many broad social and economic goals.<sup>605</sup> There might be a

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<sup>605</sup> Pashev, above n 368, 18.

range of objectives that a typical developing country might want to achieve through a reform initiative, such as increased tax revenue, simplicity, expansion of the tax net, income and wealth redistribution. Several tax policy and administrative instruments can be used in order to achieve these objectives. Bird and Wallace<sup>606</sup> prepared a table, shown below, which lists a number of taxation policy instruments that can be used for achieving specific HTT taxing objectives.

**Table 6-3 Tax instruments to dealing with the HTT sector**

Objectives	Instruments	Issues
Bringing start-up firms into the tax net, enhance taxpayer education	Some form of simplified /presumptive regime	Critical to keep “presumed” level high enough to encourage movement out; also to periodically evaluate all those in the system to ensure true eligibility
Getting revenue from those who are able to pay	Alternative minimum tax (AMT)	AMTs are often very complicated and cumbersome for both tax administrators and taxpayers
Increased equity in treatment of the HTT	Enforce the law	Politics is especially critical to the success of the tax administration in these cases of getting at the HTT. Lucrative businesses may be run by influential members of society who can affect the success of the tax administration
Getting some revenue from the underground economy	Taxation via indirect taxes	May challenge the equity of the tax system and further encourage tax evasion
Getting to the HTT at low cost in the short-term	Legitimizing the HTT via tax exemptions and tax holidays	Although this instrument may reduce administrative costs for very difficult cases (off-shore activities) or very low yield activities (agriculture), it sets a dangerous precedent which encourages non-compliance

Source: Bird and Wallace.<sup>607</sup>

It is very important to analyse the relative merits of each available instrument in achieving the relevant objective. If expansion of the existing

<sup>606</sup> Bird and Wallace, above n 9, 139.

<sup>607</sup> Bird and Wallace, above n 9, 139.

tax net is a leading objective for a tax policy, it is important to analyse the merit and demerits of various presumptive methods at achieving this. Table 6-3 suggests that a simplified or presumptive tax system is more suitable for the objective of bringing new firms into tax net. In Russia and Ukraine the introduction of a simplified tax regime showed significant success in increasing the number of new taxpayers.<sup>608</sup> Again, there are a number of presumptive tax instruments available to choose from. Depending on the achievable objectives a country should analyse the merits and the demerits of each presumptive instruments. Table 6-4 analyses the relative merits of several presumptive taxation instruments in the context of the merit of bringing new small businesses into the tax net.

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<sup>608</sup> Engelschalk, above n 165, 305.

**Table 6-4 Relative merits of tax policy and administrative instruments in bringing new small businesses into the tax net**

Tax policy and administrative instruments	Critical issues	Major challenges or disadvantages
Asset based presumptive taxes	A more equitable and arguably preferable option for approximating agricultural income. More suitable to apply on rural small taxpayers	An agricultural land survey and updated ownership records are required
Turnover based presumptive taxes	Relatively less complex and easy to comply with. More suitable to apply on urban small taxpayers. Has significant merit with regard to increasing the number of urban small taxpayers	A very rough proxy of taxpayer income, more prone to evasion and avoidance
<i>Tachshiv</i> (indicator-based presumptive taxation)	Might give a reasonable presumption of taxpayer income. Has significant merit with regard to expansion of the tax net	Success of this method largely depends on a regular survey of the income of various trades. Very expensive and resource intensive
<i>Forfait</i> (indicator-based presumptive taxation)	More reasonable presumption of taxpayer income and more equitable than <i>Tachshiv</i> . Has significant merit with regard to expansion of the tax net	Needs direct contact tax officials and taxpayers, and requires many honest and efficient tax inspectors
<i>Studi de settor</i> (indicator-based presumptive taxation)	Reasonably accurate presumption of gross profit. Has significant merit with regard to expansion of the tax net	Needs sophisticated statistical analysis of taxpayer gross profit, and regular up gradation of different industry level business indicators
Tax administration reform (STO)	Special focus on a selected group of taxpayers. With more taxpayer service and education taxpayers might be encouraged to enter the tax net	Significant administrative cost. May not yield expected return in tax revenues in the initial years
Expansion of withholding tax	Can be used to realize some unregistered or informal businesses. Can create incentives for informal firms to register into the tax net	Often unfair for start-ups, and may drive some taxpayers in to the cash economy

Presumptive taxes are not necessarily the ultimate solution for taxing non-complying small businesses. However, Table 6-4 suggests that a typical developing country with a considerably small formal tax base might still find that a turnover-based presumptive tax is the most efficient method for

taxing urban small taxpayers. Bahl<sup>609</sup> argues that presumptive taxes are much more successful if the registration of new taxpayers, the education of taxpayers and the change of culture of taxpaying are considered to be the benchmarks. However, presumptive taxes are definitely not the only mode for achieving the common small business taxation goals. Rather, the Indonesian experience suggests that with some innovative administrative arrangements a typical developing country can manage the taxation of small businesses satisfactorily even with a standard tax regime.<sup>610</sup>

To conclude, if the standard tax regime is unable to efficiently tax the vast majority of potential and existing small taxpayers, if tax policies aim to allocate minimal administrative resources to expanding the tax net, and if existing tax regimes are perceived as excessively complex by small businesses, a turnover-based presumptive tax that requires minimum recordkeeping and compliance obligations is a pragmatic approach to tax urban small businesses. Araujo-Bonjean and Chambas<sup>611</sup> argue that in sub Saharan Africa the urban tax-evading, unrecorded sector can best be taxed by a unified business tax, and that a *tachshiv*-like indicator based tax system with no reference to turnover is the optimal solution.<sup>612</sup> However, as discussed in chapter 5, *tachshiv*-type presumptive taxes require a substantial technical capability of the tax system. The success of a *tachshiv*-type tax greatly hinges on the capacity of tax administration to use sophisticated statistical tools, and on its capacity to monitor and upgrade the database of income indicating variables<sup>613</sup>. This system was formally abandoned by Israel as continuous surveying and upgrading the value of indicators (*tachshivs*) appeared economically infeasible. Moreover, past experiences with *forfait*-type small business tax regimes in francophone Africa have not been very positive.<sup>614</sup> *Forfait*-type systems ultimately increase the level of

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<sup>609</sup> Bahl, above n 321, 352.

<sup>610</sup> Section 5.4.4 of Chapter 5 has a detailed discussion on Indonesian STO.

<sup>611</sup> Araujo-Bonjean and Chambas, above n 574, 326.

<sup>612</sup> Araujo-Bonjean and Chambas, above n 574, 326.

<sup>613</sup> See Section 5.3.4 of Chapter 5 for a detailed discussion on *tachshiv*.

<sup>614</sup> Araujo-Bonjean and Chambas, above n 574, 323.

complexity and corruption.<sup>615</sup> There can be a great deal of doubt on the capacity of the sub Saharan tax administration to implement an indicator-based *tachshiv*-type presumptive tax system. Memon<sup>616</sup> attempts to analyse principles of a good tax system in the contexts of taxing informal economy. He argues that the principles of what makes a good tax system are often competing and conflicting. He also argues that it is not rational to include all good or ideal features in a tax system. Rather, tax administrations need to prioritize the principles of a good tax system in the contexts of taxing informal economy.<sup>617</sup> Memon<sup>618</sup> concludes that while taxing informal economy simplicity and the efficiency elements of a tax system should be regarded as relatively more important than fairness issues.

In addition to tax policy instruments, some tax administrative adjustments might be useful to enhance the efficiency of the overall tax system. The apparent success in Indonesia<sup>619</sup> with regard to the expansion of tax net indicates that for a country with a huge number of unattended potential urban tax payers STO can be a feasible solution. There is also a good possibility that a carefully designed turnover-based presumptive tax system administered by a STO-type administration might be an optimum design for taxing urban small taxpayers. This administrative setup might not result in an immediate economic benefit; however, in medium to long run, it may deliver many far-reaching revenue and non-revenue benefits. These benefits include an expanded tax net, a reduction of the shadow economy, promotion of the tax culture, improved revenue collections, and an improved business environment.

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<sup>615</sup> Araujo-Bonjean and Chambas, above n 574, 326.

<sup>616</sup> Najeeb Memon, Prioritizing Principles of a Good Tax System for Small Business in Informal Economies (2010) 25(1) *Australian Tax Forum* 57-94.

<sup>617</sup> Memon, above n 616, 59.

<sup>618</sup> Memon, above n 616, 87.

<sup>619</sup> Section 5.4.4 of Chapter 5 has a detailed discussion on the Indonesian STO.

## 6.4 Formalization concepts

‘Formalization’ generally refers to a process by which non-compliant or informal sector enterprises graduate from the informal to the formal sector through registering with licensing authorities, business registries or tax-rolls.<sup>620</sup> In developing countries a huge number of potential taxpayers stay outside the reach of the tax administration by avoiding formal registrations. Most of the major works on informality estimate that over 30 per cent of output and 70 per cent of the workforce in developing countries are to some extent off the limits of government regulation.<sup>621</sup> Chapter 5 of this thesis highlights how the presence of a large informal sector restricts government revenue collection efforts, and affects equity, market systems and competition. Many developing countries use various presumptive methods as merely administrative expedients to collect revenues. In this section of this chapter it is argued that presumptive methods also can be used as important tools of formalization of small businesses. Tax policy that encourages formalization might expand the tax net and encourage the growth potential of small firms. This part of this chapter reviews the existing literature and analyses the potential of presumptive taxation as a tool for formalization.

The informal sector is a population of informal entities who, by practice or by custom, have evolved a negative attitude towards formal government regulations.<sup>622</sup> Whether consciously or not, informal operators make the decision of staying outside the government system based on some type of cost-benefit analysis. In broad terms, formalization is graduation from an informal position to a formal one. Formalization provides a different framework of norms and rules of behaviour, and these raise the transactional

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<sup>620</sup> Kenyon, above n 224.

<sup>621</sup> Kenyon, above n 224.

<sup>622</sup> Edwin G. Nelson and Erik J. De Bruijn, ‘The Voluntary Formalization of Enterprises in a Developing Economy—The Case of Tanzania’ (2005) 17 *Journal of International Development* 557-593.

costs.<sup>623</sup> Gauthier and Reinnika<sup>624</sup> argue that in many developing countries distribution of the tax burden with respect to firm size takes an ‘inverted U shape’. Medium sized businesses have the highest share of the tax burden; large firms use political influence to reduce their burden, while small firms just disappear into informality.<sup>625</sup> Many developing countries are keen to bring these non-complying businesses in to the tax net. The administrative measures to identify non-complying small businesses, however, are often ineffective and non-feasible. In recent years, there has been growing literature on tax regimes that encourage enterprise formalization. In Table 6-5 Djankov, Lieberman, Mukherjee and Nenova<sup>626</sup> present a systematic classification of formal and informal sector enterprises with regard to some key characteristics. This matrix suggests that enterprises often graduate from informality to formality. With increased level of formality enterprises tend to become more dynamic; owners are more financially capable, skilled, sophisticated and educated.

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<sup>623</sup> Nelson and Bruijn, above n 622.

<sup>624</sup> B. Gauthier and R. Reinnika, ‘Shifting Tax Burdens through Exemptions and Evasion: An Empirical Investigation of Uganda’ (2006) 15 *Journal of African Economies* 373–398.

<sup>625</sup> Gauthier and Reinnika, above n 624.

<sup>626</sup> Simeon Djankov, Ira Lieberman, Joyita Mukherjee and Tatiana Nenova, ‘Going Informal: Benefits and Costs’ in Boyan Belev (ed), *The Informal Economy in the EU Accession Countries* (Center for the Study of Democracy, 2002).

**Table 6-5 Typology of informal sector enterprises**

	INFORMAL SECTOR			FORMAL
	Subsistence enterprises	Unofficial enterprises	Unofficial enterprises	Official enterprises
<b>Degree of informality</b>	100%	High. Proportion of sales undeclared and workers not registered	Some proportion of sales undeclared and workers unregistered. May use outside the official purview (e.g. internet to deliver software)	
<b>Type of activity</b>	Single street traders, cottage/micro enterprises, subsistence farmers	Small manufacturers, service providers, distributors, contractors	Small and medium manufacturers, service providers, software firms	
<b>Technology</b>	Labour intensive	Mostly labour intensive	Knowledge and capital intensive	
<b>Owner profile</b>	Poor, low education, low level of skills	Poor and non-poor, well educated, high level of skills	Non-poor, highly educated, sophisticated level of skills	
<b>Markets</b>	Insignificant barriers to entry, highly competitive, high product homogeneity	Insignificant barriers to entry, highly competitive, some product differentiation	Significant barriers to entry, established market/product niche	
<b>Finance needs</b>	Working capital	Working capital, some investment capital, supplier credit	Investment capital and working capital, letters of credit, supplier credit	
<b>Other needs</b>	Personal insurance, social protection	Personal and perhaps business insurance	Personal and business insurance, business development services	
	Least dynamic Completely informal		Highly dynamic Partially formal 	

Source: Djankov, Lieberman, Mukherjee and Nenova.<sup>627</sup>

Formalization can be ‘voluntary’ or ‘non-voluntary’. Voluntary formalization is the adaption of a new form or position without the pressure of government enforcement activities. Most research that investigates the

<sup>627</sup> Djankov, Lieberman, Mukherjee and Nenova, above n 626.

cause of the shadow economy identifies taxation as a key driver of informality.<sup>628</sup> In developing countries small taxpayers supply comparatively little tax revenue, but are imposed with substantial administrative costs. Moreover, the political cost of taking a tougher taxing strand towards the small taxpayers is also very high. An appropriate small business taxation regime should not drive small enterprises towards informality, but should rather encourage members of the informal sector to embrace formalization.

#### **6.4.1 Presumptive taxation as a tool for formalization**

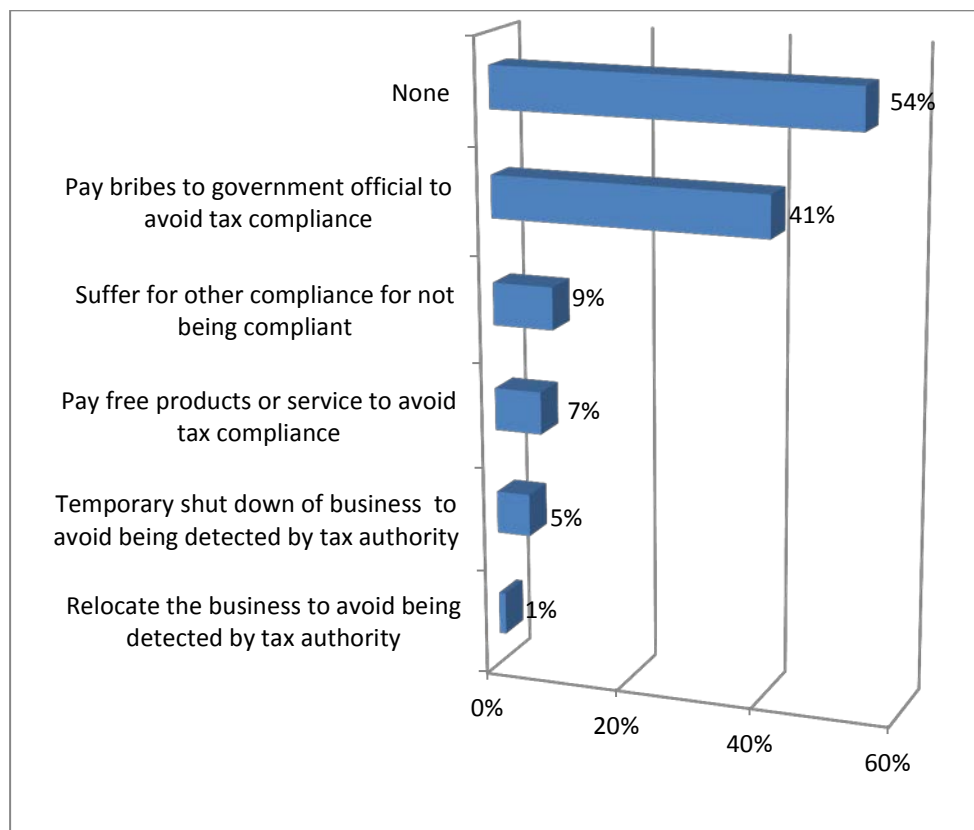
If a firm is enjoying nearly no tax burden, what is its incentive to enter the tax net? There is evidence that even in developing countries tax evasion or tax avoidance comes with a cost. While firms have to bear certain compliance costs for its formal status, staying informal is not costless; rather, informality imposes significant costs to many firms. Figure 6-3 illustrates the typical costs many informal sector firms have to bear. The FIAS Tax Compliance Cost Survey in Yemen<sup>629</sup> reveals that a significant fraction of informal businesses pay bribes to avoid tax compliance.

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<sup>628</sup> Chapter 4 has a detailed discussion on the causes of shadow economy.

<sup>629</sup> Coolidge, above n 225, 270.

**Figure 6-3 Cost of informality, Yemen 2008**



Source: Coolidge.<sup>630</sup>

In many occasions, a typical small firm with a notable amount of taxable income is interested to pay some taxes to enjoy the benefits of formal status while avoiding all illegitimate cost burdens. In addition to those costs, informal sector firms also have to forgo some benefits which only formal firms can access. Some key benefits that formal sector firms can enjoy include access to formal credits, access to certain market segments, and protection by legislation, like social security and insurance provisions. As reported in Stern and Loeprick,<sup>631</sup> a FIAS Tax Compliance Cost Survey in Madagascar showed almost half the respondents in the informal sector have little or no information about the steps or procedures to become formal. In Sierra Leone, 36 per cent of informal sector enterprises do not know

<sup>630</sup> Coolidge, above n 225.

<sup>631</sup> Stern and Loeprick, above n 190.

anything about formalization procedures; around 40 per cent of those know few details.<sup>632</sup> Similar situations might be prevalent in many developing countries. It seems that the communication gap between the authorities and small businesses regarding the benefits of formalization is huge. Moreover, the complex tax system and the high compliance costs drive many potential taxpayers to informality. If a tax agency can educate taxpayers about the benefits of formalization, and at the same time, if the tax regime is simple to follow, not very costly to comply with, small businesses with a fair amount of taxable income might perceive that the net benefit of being formal is higher. A simple small business tax regime that provides provide a suitable level of tax education, allows dissemination of information about the benefits of formalization and promotes the credibility of the tax authority might encourage a number of informal sector enterprises to become formal.

Bahl<sup>633</sup> argues that there would be significant welfare and distributional gain from the reduction of the size of the informal sector, most importantly through the promotion of fairness. Engelschalk and Loeprick<sup>634</sup> argue that a balance between simplification of the general regime for SMEs and adaptation of special regimes for SMEs might deliver the aspired effective design of tax policy and tax administration in developing countries. Simplification of the general regime for SMEs might include reduction of tax rates, a simplified VAT, and simplified tax returns. Special regimes for SMEs might include a presumptive tax replacing income tax or VAT, or a single (presumptive) tax replacing all other taxes.<sup>635</sup> Tax administrations mostly use presumptions to ascertain the tentative tax burden of certain taxpayers who are generally not capable of maintaining actual books and accounts or who are considered not worthwhile of receiving the scarce

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<sup>632</sup> Stern and Loeprick, above n 190.

<sup>633</sup> Bahl, above n 321, 343.

<sup>634</sup> Michael Engelschalk and Jan Loeprick, 'The Nexus of Informality and Tax Policy—Options For the Taxation of Small Enterprises In Africa', paper presented at the International Tax Dialogue Africa Conference on Taxing Micro and Small Business- From Confrontation to Cooperation, Rwanda (2009).

<sup>635</sup> Engelschalk and Loeprick, above n 634.

administrative attention. It seems that presumptive taxation should receive special attention for its potential positive implications on formalization.

A special regime based on a simplified or presumptive taxation system and administered by a dedicated administrative establishment that properly promotes the benefits of formalization might attract a substantial number of informal sector entities into the tax net. It might not attract the marginally taxable businesses which are yet to reach a reasonably stable condition. However, it might attract a large number of small businesses that have been operating in the informal sector for years, generating a substantial amount of income. These businesses may want to operate in a more stable environment. Almost in every country, a small number of large corporations supply the major share of tax revenue for the government. The developing country tax administrations are particularly dependent on a handful of large corporations. Larger corporations are therefore the traditional focus of revenue administrations for revenue raising objectives. Focusing exclusively on large taxpayers, however, undermines the revenue potential of a wider tax base, the small taxpayers. The long-term revenue raising potential of a tax administration in a developing country might significantly increase if the tax policy promotes formalization and thereby meaningfully includes small enterprises into the formal tax net.

#### **6.4.2 Formalization of urban small taxpayers**

In developing countries informality is pervasive in both rural and urban sectors. In rural areas in many developing countries the vast majority of informal businesses are subsistence enterprises. Tax administrations need to cover a wide landscape in searching for potential taxpayers. In urban cities, on the other hand, tax administrations generally have greater administrative coverage, and more potential taxpayers operate within a smaller area. In the urban places businesses generally generate more income, business locations are relatively less dispersed, and businesses often operate in clusters near

income centres. Urban inhabitants are also relatively more skilled or educated. Since tax administrations have limited resources, it would be more feasible concentrate more on urban small taxpayers for achieving the formalization goals and expanding the tax net. This chapter has highlighted that a huge number of small businesses have little knowledge about the benefits of formalization, and they also know very little about formalization procedures. Tax administrations should put more emphasis on tax education in order to bridge the perception and communication gap between the administration and urban small taxpayers. If a tax administration can effectively promote the taxpayer perception towards formalization, a simplified tax system administered by a dedicated administrative structure would be able to attract a significant number of urban informal businesses to enter the tax net.

## **6.5 A preferred tax regime for urban small taxpayers**

So far this chapter attempts to establish that there are a substantial number of unregistered urban small businesses who might be willing to join the tax net if a favourable environment can be created for them. Tax administrations of developing countries, despite the fact they are already struggling with the breadth of existing registered taxpayers, are growingly interested in expanding the tax net. Overly complex tax regulations, poor administrative capacity, relatively high compliance cost burdens, a lack of taxpayer education, an absence of a tax culture and corruption are found to be main barriers that drive small businesses away from the tax net. The OECD<sup>636</sup> points out that in developing countries overly complex and poor tax administration is the main barrier for formalization of informal businesses. Tax administrations put very little importance on understanding the obstacles that informal entities encounter in complying with tax requirements.<sup>637</sup> Durgesh and Joshi<sup>638</sup> report that the first and most

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<sup>636</sup> The OECD, *Promoting Pro-Poor Growth: Private Sector Development* (2006) 30.

<sup>637</sup> The OECD, above n 636.

important strategy that Indian authorities have taken for promoting the registration of unrecorded taxpayers is increasing awareness of and education for voluntary compliance.<sup>639</sup> Other initiatives have included establishing easier norms for the determination of taxable income, reducing the cost taxpayer compliance through simplification of and increased use of presumptive taxes, and expanding withholding tax administration.<sup>640</sup> Much emphasis is given to the simplification and building up of taxpayer trust. The arguments and findings of this chapter are very much at par with all these Indian tax policy and administrative initiatives. The listed tax policy and administrative measures would generally be helpful if they are implemented in the right proportions, and are consistent with overall policy and administrative frameworks.

### **6.5.1 Promotion of greater use of banking channels**

As discussed in Section 2.2 of this chapter, a wide number of urban informal or partly formal small businesses operate predominantly on a cash basis. The mode of their financial operations makes them very hard to assess or to tax. One way to reduce the great reliance on cash is to incorporate legal disincentives against cash transactions over certain limits. Another way is to expand the scope of withholding taxes so that businesses are compelled to pay some tax even though they are not registered in the tax net. It might create some disincentives for businesses that operate in cash to hide taxable income and to avoid paying tax. Since these disincentives normally include thresholds, these provisions should only affect taxpayers who are presumably involved in a good amount of financial transactions or are generating a fair amount of taxable income.

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<sup>638</sup> Durgesh Shankar and M.C Joshi, 'Promotion/Enforcement of the registration of Hidden Taxpayers – the India Way', paper presented at International Tax Dialogue (ITD) Asia Conference, Philippines (2010).

<sup>639</sup> Durgesh and Joshi, above n 638.

<sup>640</sup> Durgesh and Joshi, above n 638.

There is still a big gap between the developed and developing world in regard to financial inclusion. 89 per cent of adults have bank accounts in high-income countries, compared to 41 per cent in the developing world.<sup>641</sup> This gap might be getting narrowed as mobile communication and information technology has led technological developments that are making the access to financial services easier and more affordable. Table 6-6 displays the trend of the growing spread of banking facilities in selected developing countries. As mentioned earlier, India has discontinued the provision of taxing cash withdrawals in 2009, partly due to inadequate banking infrastructure. However, as technology has become more pervasive and affordable, it is might be a good time for a developing country tax policy to discourage cash transactions and to stress the increased use of banking channels. Tax incentives for the increased use of banking channel might be helpful in this regard.<sup>642</sup>

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<sup>641</sup> Asli Demirguc-Kunt and Leora Klapper, 'Measuring Financial Inclusion The Global Findex Database', The World Bank Policy Research Working Paper 6025 (2012).

<sup>642</sup> See, eg, Engelschalk, above n 540, the Korean tax incentives for debit or credit card tax payments.

**Table 6-6 Growth of financial inclusion in selected developing countries**

Country Name	2010	2009	2007	2006	2005	2004
Depositors with commercial banks (per 1,000 adults)						
Bangladesh	418	342	327	326	321	310
India	..	..	681	649	637	637
Pakistan	249	207	203	189	131	119
Kenya	..	370	216	139	115	103
Cameroon	..	72	42	40	36	33
Indonesia	..	..	..	..	..	..
Commercial bank branches (per 100,000 adults)						
Bangladesh	7	7	6	6	6	6
India	11	10	10	10	10	10
Pakistan	9	8	8	8	8	8
Kenya	..	4	4	3	3	3
Cameroon	..	1	1	1	1	1
Indonesia	8	8	6	6	5	5
Automated teller machines (ATMs) (per 100,000 adults)						
Bangladesh	2	1	0	0	0	0
India	..	..	..	..	..	..
Pakistan	4	4	3	2	1	1
Kenya	..	7	5	3	2	2
Cameroon	..	1	1	1	0	0
Indonesia	13	14	12	11	9	9

Source: World Development Indicators Database.<sup>643</sup>

### 6.5.2 A well designed simplified or presumptive tax regime

In this thesis it has been argued that many developing countries still need to rely on the simplified tax or presumptive taxes for a number of reasons. The most obvious reason is the incapability of the developing country tax policy and administration to administer efficiently the registered as well as the numerous prospective unregistered small businesses. If tax policy wants to break the status quo, it should first identify the objectives it wants to accomplish through the small business taxation policy. The objectives should be realistic and based on the realities of the existing policy and administrative environment. Too many non-revenue and mutually

<sup>643</sup> The World Bank, *World Development Indicators Database* (2012).

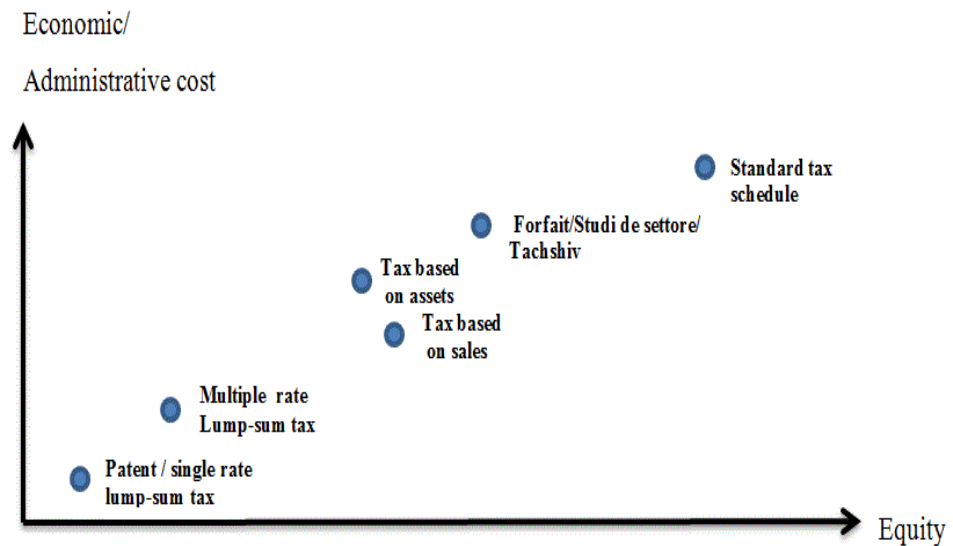
competing objectives lead to the level of complexity that cannot be handled by both the tax administration and the taxpayers.<sup>644</sup> Obviously raising revenues would be a leading objective. However, given the low revenue potential of small firms, bringing unregistered urban small businesses into the tax net might be an equally important objective for a typical developing country tax policy. In that case, tax policy should identify the major obstacles that hinder the voluntary compliance of the small business. There are several presumptive tax instruments for a tax policy to choose from to create a favourable taxing environment for small taxpayers. Pashev<sup>645</sup> has prepared a figure, displayed below, that portrays the general efficiency and equity trade-offs of presumptive tax instruments. However, these equity and the efficiency considerations vary widely depending on a country's specific political, social and economic environment, and also on the type of taxpayers upon whom the tax instrument would be implemented. For example, in Bangladesh, a country with large agriculture sector and large sized informal economy, a single rate turnover-based presumptive tax is economically or administratively not expensive, but less equitable. However, an asset-based presumption might be more expensive and also less equitable.

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<sup>644</sup> Richard M. Bird, 'Administrative Dimensions of Tax Reform' (2004) 10(3) *Asia-Pacific Tax Bulletin* 134–50.

<sup>645</sup> Pashev, above n 368, 7.

**Figure 6-4 Types of presumptive taxes: efficiency and equity tradeoffs**



Source: Adapted from Pashev <sup>646</sup> with additional inputs of the author

Beside the choice of presumptive instrument or indicator, tax policy also needs to analyse critical policy and design issues such as threshold, target taxpayers, coordination with the overall tax system, economic efficiency, and fairness. The choice of presumptive taxation essentially requires a trade-off between the fairness and efficiency considerations. Often attempts to infuse the fairness features in the presumptive system have resulted in increased complexity; sometimes making the so-called simplified system even more complex than the standard regime. The table below, prepared by Engelschalk, <sup>647</sup> proposes the application of different presumptive tools for different classes of small and medium businesses.

<sup>646</sup> Pashev, above n 368, 7.

<sup>647</sup> Engelschalk, above n 540, 98.

**Table 6-7 The choice of the appropriate presumptive tax system**

Micro-Businesses	MSE with Turnover below VAT Threshold	SME above VAT Threshold	
MSE without fixed business location; subsistence level SME	Standard MSE in trading or service business	SME segments with particular high risk of turnover evasion (e.g. transport, business, catering, gambling)	Other SME
Simple patent	Turnover-based system	Indicator-based system	Standard tax regime but simplified bookkeeping and filing

Source: Engelschalk.<sup>648</sup>

The findings of this chapter suggest that a typical developing country with huge unregistered or registered but non-complying urban small taxpayers should rely on a turnover-based presumptive tax system. This tax system should be simple to comply with, explicit and well designed, well-coordinated with the overall tax system, and implemented under a comprehensive reform initiative, not in an ad-hoc manner as an administrative expedient.

### 6.5.2 Incentive for new entrants

This chapter attempts to establish that small business taxation policy should encourage formalization of small businesses, especially urban small businesses. Section 6.4 of this chapter deals with the critical question of why an informal sector firm would be interested in entering the tax net when it currently has no tax burden. Staying informal often involves a considerable cost. Also, formal firms enjoy several benefits which underground businesses cannot. This chapter has also argued that if the tax system can make the tax system simple and less costly to follow and reduce the communication gap between the taxpayer and the tax agency, many small businesses which have been operating in the informal sector for some time and are generating a fair amount of taxable income might perceive that

<sup>648</sup> Engelschalk, above n 540, 98.

the net benefit of being formal is higher. In addition, tax policies can provide incentives for new entrants by, say, offering a lower or concessionary tax burden in the initial years. The spot assessment system of Bangladesh<sup>649</sup> offers certain urban small businesses or professionals with some incentives, such as a simplified registration system, a same fixed tax burden for 3 consecutive years, and a clemency for unexplained or undeclared investment. In Belarus, a newly registered physical person gets the benefit of a 25 per cent tax reduction for the first three months following business registration.<sup>650</sup>

### **6.5.3 Tax education or promotion of benefits of paying tax**

Various FIAS surveys indicate that the general perception of small taxpayers towards tax authorities and the tax system is quite negative.<sup>651</sup> Also, several survey results reveal that small taxpayers consider the tax system to be overly complex and expensive to comply with.<sup>652</sup> Moreover, there is evidence that the majority of small businesses in developing countries have little or no information about tax obligations, steps needed to register, and about the benefits of being formal.<sup>653</sup> The knowledge or information gap is so severe that it can be argued that tax education, dissemination of information about the benefits of formalization and promotion of the credibility of the tax authorities are the keys to encourage a number of informal sector enterprises to become formal.

### **6.5.4 Small tax office**

In section 4.4 of Chapter 5 it is argued that the establishment of a dedicated administrative setup, such as a small tax office (STO), can encourage new businesses to formalize. Indonesia seems to have achieved substantial

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<sup>649</sup> Please see Section 3.1 of Chapter 5 for further details.

<sup>650</sup> Engelschalk, above n 540, 77.

<sup>651</sup> Coolidge above n 225.

<sup>652</sup> Engelschalk, above n 540, 10.

<sup>653</sup> Stern and Loeprick, above n 190.

benefits out of the establishment of dedicated tax offices for small taxpayers, particularly in expanding the tax net. The Indonesian small business tax regime is not based on presumptive system. However, there is a good possibility that a well-designed presumptive tax regime administered through an STO-type administration would benefit small taxpayers as well as the tax administration in developing countries.

## **6.6 Conclusion**

This chapter focuses on some crucial characteristics of urban small businesses that distinguish them from their rural counterparts. This chapter stresses that the small business tax regime should have a separate set of presumptive instruments for each class of small business in order to make an efficient estimate of their economic activities. This chapter argues that urban small businesses are significantly different with regards to business registration processes, modes of business transactions and bookkeeping practices, and also in their business indicators and the pattern of their business locations. Moreover, tax administration offices and facilities are greatly concentrated in urban locations. Developing country tax policy should account for all these crucial elements while designing a tax regime that exclusively targets urban small businesses.

This chapter also argues that developing country tax administration should be concerned about not only the huge number of unregistered small businesses, but also about a large number of taxpayers who are registered yet not compliant. The analysis concludes that to deal with such registered but non complying taxpayers, tax policy needs rely on withholding taxes. However, for bringing up the unregistered potential urban taxpayers into the tax net, a simplified tax regime based on turnover based presumptive taxes would be more efficient.

This chapter also proposes that formalization should be an important element of urban small business taxation policy. It reports that a significant number of small businesses in developing countries have little or no information about tax obligations, the steps needed to register, or the benefits of being formal. This chapter reports that staying informal involves significant costs. Also formal firms enjoy several benefits which underground businesses cannot access. If the tax regime is simple to follow and comply and it can provide with taxpayer education and service, many small businesses which are operating in the informal sector for years and are generating a fair amount of taxable income might perceive that the net benefit of being formal is higher. If a tax system is struggling to administer the vast majority of non-compliant potential and existing small taxpayers, if one of the major objectives of the tax policy is to expand the existing tax net, a turnover based presumptive tax that requires minimum recordkeeping and compliance obligations might be a more effective approach to tax urban small businesses.

Finally, this study identifies the core elements of a preferred tax system for the taxation of urban small taxpayers. A typical developing country small business tax system should promote a greater use of banking channels, adopt a well-designed simplified or presumptive tax regime, provide incentives for new entrants, put more emphasis on tax education, and establish a dedicated administrative unit that handles the taxation of urban small taxpayers. There is a good possibility that a carefully designed turnover-based presumptive tax system administered by a STO-type administration might be an optimum design for taxing urban small business taxpayers.

## **CHAPTER 7**

# **TAXATION OF RURAL SMALL BUSINESSES IN DEVELOPING COUNTRIES**

### **7.1 Introduction**

This thesis attempts to establish that in developing countries the standard tax regime is unable to efficiently tax the vast majority of non-compliant potential and existing small taxpayers. Small businesses in developing countries have two distinctive segments — urban and rural. The shadow economy in developing countries, like the regular economy, is distinctively segmented along rural/urban line. In Chapter 5 it was argued that different presumptive methods have different relative merits for assessing the economic activities of typical rural and urban taxpayers. It is crucial that the presumptive tax design acknowledges the core differentiating characteristics of urban and rural small business. Consequently, Chapter 6 discusses exclusively the taxation of urban small businesses. It starts with a focused analysis on the key characteristics of urban small businesses and argues that small taxpayers are indeed different to rural taxpayers in some critical aspects, such as business registration, the mode of business transactions, bookkeeping practices, business indicators, and business locations. A presumptive tax system that aims at taxing these urban small businesses should give careful consideration to these key characteristics. Chapter 6 also proposes that formalization should be an important element of urban small business tax policy. Urban taxpayers generate more income, are more educated, have less dispersed business locations, and often operate in clusters near urban facilities. Given the limited resources and constrained administrative capabilities, it is more feasible to concentrate more on urban small taxpayers for achieving the formalization and tax net expansion goals.

While Chapter 6 exclusively analyses the issues concerning the taxation of urban-based small businesses, Chapter 7 analyses the taxation of rural-based ones. Rural small businesses in developing countries are mostly linked, directly or indirectly, to the agricultural sector. This chapter presents evidence that the tax potential of the agricultural sector is widely ignored in most developing countries. Generally, tax policy in developing countries seem stuck on some conventional wisdoms that the agricultural sector has little tax potential, that taxation policy should not affect the subsidised prices of agricultural produces, that the agricultural sector should receive preferential tax treatment and that agriculture sector should not be taxed with much administrative vigour. Before going into an in-depth analysis of the prevailing taxation policy and administration of rural small businesses, however, it is important to assess whether the taxation of rural small business is an area that should receive more policy and administrative attention. Section 2 of this chapter attempts to identify the major policy issues regarding the taxation of agricultural income, and tries to assess the rationales behind such conventional wisdoms. It attempts to identify the major impediments to revenue raising attempts, and also investigates whether the agricultural sector has a substantial tax potential or not. Section 3 of this chapter analyses the relative merits of the existing taxation tools with reference to the realities of developing countries. Finally, Section 4 attempts to outline a preferable tax regime for rural small businesses.

The agricultural sector in developing countries can be characterized by the economic activities of the numerous small traditional farming, factory farming, livestock farming, orchard, poultry farming, fish farming and trading businesses. Rural agribusinesses, even those large in size, usually generate a modest amount of taxable income. For taxation purposes most of these businesses can be categorised as small businesses. Due to the existence of a large number of such businesses, however, aggregate tax potential of rural small business is not small. It can be argued that for developing countries with a large agricultural sector, an effective small

business tax policy is synonymous with an effective tax policy of the agricultural income. Countries with a large agricultural sector usually fail to raise a good amount of government revenue. A reason for this might be that the presence of a larger agriculture sector implies a larger subsistence sector, a lower level of development and the presence of a greater proportion of the population who are either exempted from tax or taxed at a lower rate. Due to low revenue yield and very high administrative costs, tax administrations normally prefer to tax the non-agriculture sector. A developing country in need for a greater share of internal revenue needs to look seriously into the potentially untapped area of agriculture. In Chapter 6 it has been argued that urban small taxpayers have more potential to grow as more stable taxpayers, for an effective expansion of the tax net tax administration should put relatively more focus on the urban tax payer. However, at the same time the tax policy of developing countries should utilize the tax potential of the rural small businesses too. It seems imprudent to rely entirely on a group of urban taxpayers for the national tax revenue. The taxation of agricultural income in the contexts of developing countries rarely received any academic attention. This chapter has two important limitations. First, literature on direct and indirect taxes on agriculture is very limited and information and data on the subject very hard to access. Second, this chapter only focuses on the agricultural income of the rural small businesses. A significant part of rural small businesses do not generate any agricultural income. This chapter does not have any separate discussion about the taxation of those entities. this chapter stresses on the need for more academic analysis on many important policy and administrative issues regarding the taxation of rural small businesses in developing countries.

This chapter conducts an extensive survey on the existing literature and presents with evidence that the diminishing implicit and explicit tax burden on agriculture might have transformed it into a lowly taxed sector with a considerable tax potential. This study also argues that asset-based presumptions would be more efficient for taxing agricultural income. The

recent trends suggest that the importance of land taxes have dwindled in many developing countries. The administrative cost of land tax collection is also excessively higher than other existing taxes. Analyses of this chapter suggest that land taxes on agricultural lands should be abolished and replaced by a single broad-based tax, preferably a presumptive income tax. With the advancement of information technology-led land surveys and record management systems, a presumptive income tax which uses the amount of land holding as a leading proxy of taxpayer potential income should replace agricultural land taxes, wealth taxes and other similar taxes. Where land management is information technology-enabled, land area-based presumptive income taxation can be an efficient and equitable source of revenue. Developing countries also can achieve significant efficiency gain if they can eliminate the multiple jurisdictional authorities on the same tax base.

## **7.2 The taxation of rural small businesses: policy issues**

### **7.2.1 Agriculture and rural small business**

Generally, in developing countries the primary sector shares a significant portion of the national income. However, agriculture is highly diverse; the sectoral patterns in terms of farm size, major products, employment patterns, market conditions, technological involvements, and natural resource endowments vary widely. Common types of traditional agribusinesses still dominate the economic scenes of the agricultural sector. In many countries rural non-farm enterprises, which are involved in the general trading or marketing of high-end agro-based product or services, share a significant part of the rural economy. Also, some developing countries, such as Malaysia and Philippines, contain significant plantation agriculture. However, the agricultural sector of most developing countries is comprised of a huge number of small and medium businesses. The rural agribusinesses mostly produce a modest taxable even though some of those are large in size.

For taxation purpose these businesses belong to the small taxpayer category. However, the presence of a large number of such businesses makes the aggregate tax potential of the sector considerably large. For developing countries, the tax policy of agricultural income and rural small business look synonymous.

Rural agribusinesses mostly operate on a cash or barter basis, they do not maintain books or accounts, and the entitlements of their assets are difficult of access. It is extremely difficult to monitor or assess the economic activities of these businesses. The ownership record of land and the dominant indicator of business activity is extremely hard to verify. These characteristics make the agricultural sector the hardest to tax.<sup>654</sup> A developing country in need of a greater share of tax revenue should look seriously into this largely untapped area. Chapter 6 establishes that urban small payers have the potential to grow as comparatively more stable or enduring taxpayers. For an effective expansion of the tax net the tax policy focus relatively more on urban taxpayers. However, this chapter attempts to establish that small business taxation policy in developing country should also utilize the tax potential of rural small businesses. Developing countries should review existing policies towards taxing the income of rural small businesses. The distinctive characteristics of rural small businesses justify the need for a separate discussion on the taxation of rural small businesses in developing countries.

### **7.2.2 Defining the agricultural income**

Most tax laws define agricultural income in order to specify economic activities that can be classified as agricultural activity. Often, agricultural income enjoys exemptions and concessions. Adequate legal provisions are essential to specify effectively the economic activities that qualify for deriving agricultural income. Too broad specification often creates the

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<sup>654</sup> Rajaraman, above n 202, 245.

scope for tax evasion and tax avoidance, while too specific or overly detailed definitions add complexity. The tax laws of different jurisdictions differ in their definitions of agricultural income. Generally, for taxation purpose any income, rent or revenue derived from any land by way of cultivation is defined as agricultural income. There are some major overlaps between agricultural and non-agricultural income, such as income from agro-processing, plantation and rental income from land and buildings. These grey areas often create loopholes for tax avoidance and evasion. In some countries like Bangladesh and India, the rent from buildings that are located within the immediate vicinity of the agricultural land is also defined as agricultural income. In Bangladesh, agricultural income receives concessionary tax treatment, while in India agricultural income is exempt from central government income taxation. It is often not clear whether income from poultry farming, dairy farming, bee hiving or the sale of seeds can be considered agricultural income or not. There is also a range of disputes regarding the tax treatment of the income from plantations and large agro-processing industries. In India there is an array of litigation regarding the treatment of the capital gain derived from the transfer of agricultural land. Subject to several conditions, Section 54B of Indian *Income Tax Act*<sup>655</sup> excludes agricultural land from the definition of a capital asset. Therefore, in India rural agricultural lands often escape capital gain taxes. The targeting is often a major problem for designing a concessionary or a preferential tax provision. When an economy grows, the incentives for tax evasion also grow at the same pace. Taxation authorities need to upgrade the existing policies and legislation so the legal provisions are not left inadequate and insufficient in preventing the plausible tax evasion and avoidances.

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<sup>655</sup> *Income Tax Act 1961*, India, s 54B.

### **7.2.3 Agriculture: a major impediment for tax efforts in developing countries**

The agricultural sector is widely considered HTT. Value added to the agricultural sector results in a lower taxable surplus, because the income of agricultural wage earners is relatively low, farmers usually earn small profit margins and rural income centres are widely dispersed. Individuals and firms engaged in this sector generally do not generate large amount of revenue, are mostly not well educated, mostly use traditional methods for farming, do not keep books and records well, are based in geographically remote areas, and are relatively hard and expensive for tax administrations to administer and enforce laws against. Although there is now reliable statistics on tax revenue from agricultural income, it is widely considered that generally the revenue contribution of this sector is very negligible. Tax policies concerning this sector are normally generous, with various exemption and deductions. Tax administrations often ignore possible tax evasion because the outcome of the detection in terms of tax revenues is often not very productive and also the enforcement is too expensive.

Later, this section reports that the vast majority of tax effort analyses point to agriculture as a significant cause of the poor revenue efforts of developing countries. Findings of these studies conclusively indicate that the presence of a large agriculture sector severely restricts revenue-raising capability. It is also observed that countries with a large agriculture sector generally have a low tax-to-GDP ratio. There is little doubt of the need for collecting more tax revenue in developing countries from domestic sources. The agricultural sector is the key area upon which developing countries should focus to improve tax collections and thereby achieve a more desirable Tax GDP ratio. Table 7-1 illustrates that, compared to developed countries, developing countries have poorer tax-to-GDP ratios and have a significantly larger agriculture sector. The selected 30 developing countries have an average tax-to-GDP ratio of 16 per cent, compared to 36.3 per cent

of a set of 27 OECD countries. In terms of the value added to GDP, the average size of the agricultural sector in developing countries is around 9 times larger than that of developed countries. These figures might indicate that there is a strong correlation between the size of agriculture sector and the level of tax revenue.

**Table 7-1 Agriculture value added and tax share in developed and developing countries in 2008**

<i>Selected 30 Developing Countries</i>			<i>Selected 27 OECD Countries</i>		
	Tax revenue ( % of GDP) <sup>1</sup>	Agriculture value added ( % of GDP) <sup>1</sup>		Tax revenue (% of GDP) <sup>2</sup>	Agriculture value added (% of GDP) <sup>1</sup>
Bangladesh	8.82	19.01	Australia	27.1	2.5
Cambodia	10.56	34.85	Austria	42.7	1.7
China	10.27	10.73	Belgium	44.2	0.7
Cote d'Ivoire	15.57	24.98	Czech Rep.	36.0	2.5
Egypt	15.32	13.22	Denmark	48.2	1
El Salvador	13.88	12.60	Finland	43.1	2.9
Georgia	23.81	9.39	France	43.2	2.1
Ghana	13.90	30.96	Germany	37.0	0.9
Guatemala	11.27	11.97	Greece	32.6	3.1
Honduras	16.03	13.47	Hungary	40.2	4.3
India	11.20	17.59	Iceland	36.8	6.3
Indonesia	13.03	14.67	Ireland	28.8	1.3
Jamaica	26.23	5.39	Italy	43.3	2
Kenya	19.08	21.05	Japan	28.1	1.5
Kyrgyz Rep.	16.51	29.23	Korea	26.5	2.7
Lao PDR	12.04	34.73	Luxembourg	35.5	0.4
Madagascar	12.96	24.81	Netherlands	39.1	1.8

Moldova	20.45	10.71	Norway	42.6	1.2
Mongolia	23.15	21.08	Poland	34.3	3.7
Morocco	27.57	14.64	Portugal	35.2	2.3
Nepal	10.41	33.65	Slovak Rep.	29.3	3.1
Nicaragua	19.12	21.29	Slovenia	37.2	2.4
Pakistan	9.86	20.33	Spain	33.3	2.7
P. N. Guinea	26.60	33.61	Sweden	46.3	1.8
Paraguay	11.76	23.61	Switzerland	29.1	1.3
Philippines	14.16	14.88	U. Kingdom	35.7	0.8
Sri Lanka	13.28	13.38	United States	26.1	1.2
Uganda	12.90	22.74			
Ukraine		8.33			
Vietnam	24.20	22.21			
Average	16.06	19.64	Average	36.34	2.16

Sources: 1. World Bank's WDI Database.<sup>656</sup> 2. OECD.<sup>657</sup>

As mentioned earlier, a number of tax effort analyses point to agriculture as a significant cause of the poor revenue efforts of developing countries. In other world, this may imply that the inability to properly tax the agriculture sector is a major reason that developing countries collect poor level of revenues Very broadly, tax-to-GDP ratio is used to identify one country's overall tax efforts. However, this very broad measure may not provide a realistic picture of the overall tax efforts of a country. There are many factors that may affect revenue collection despite efficient efforts of the revenue administration. Tax effort is a measure which gives a general indication of how a country is raising tax revenue relative to its given economic and structural potentials. Tax effort index is constructed by dividing the actual tax share by an estimated or fitted tax share. This fitted tax share is derived through a regression that employs a set of independent

<sup>656</sup> The World Bank, *World Development Indicators Database* (2012).

<sup>657</sup> OECD, *Revenue Statistics 1965-2010* (2011).

variables of a country's economic and structural characteristics and predicts, given the economic and structural conditions, how much revenue the country should be able to raise. Paying a proper consideration to the revenue potential of the country, this kind of measurement can capture country's revenue efforts more accurately.

Using the tax effort approach, Bahl <sup>658</sup> demonstrates that the sectoral distribution of income has a direct effect on taxable capacity apart from that of the level of overall economic development and the size of external trade sector. This study presented a ranking of 49 countries on the basis of tax efforts and concluded that taxable capacity is higher in the developed countries where the foreign trade sector is larger.<sup>659</sup> Tanzi<sup>660</sup> estimates tax effort indices of a sample of 34 sub-Saharan countries. He finds that mining shares and non-mineral export shares are positively related and significant. However, Tanzi,<sup>661</sup> further extending his study using a sample of 83 developing countries over the period 1978–88, finds that the share of agriculture in the GDP has a strong inverse relationship to tax share and its explanatory capacity is greater than that of per capita income. He also reports that import share and debt share are important determinants of tax share. Stotsky and WoldeMariam,<sup>662</sup> using a sample of 46 sub-Saharan countries, conclude that the shares of agriculture and mining in the GDP are significant determinants of tax revenue share. These variables are negative and significant. Among other variables, the share of exports in the GDP has a positive impact on tax share.

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<sup>658</sup> Bahl, above n 4.

<sup>659</sup> Bahl, above n 4.

<sup>660</sup> Tanzi, above n 46.

<sup>661</sup> Vito Tanzi, 'Structural Factors and Tax Revenue in Developing Countries: A Decade of Evidence' in Gold I. and L. A. Winters (eds.), *Open Economies: Structural Adjustment and Agriculture* (Cambridge University Press, 1992).

<sup>662</sup> Janet G. Stotsky and A. WoldeMariam, 'Tax Effort in Sub-Saharan Africa', IMF Working Paper No WP/97/107 (1997).

Piancastelli<sup>663</sup> took samples of 75 developed and developing countries and applied both cross-section regression and panel data analysis to investigate significant determinants of tax efforts. Results of this study indicate that per capita income, trade-to-GDP ratio and share of agriculture in GDP are the most important determinants in explaining tax ratio. Sen Gupta,<sup>664</sup> employing a panel with data from 105 developing countries, finds that structural factors, such as per capita GDP, share of agriculture in GDP, trade openness, and foreign aid significantly affect revenue attempts of developing countries.

All the above empirical studies identify the agriculture sector as a major problem area upon which developing countries should place more policy and administrative attention. Perhaps a careful policy and administrative reform towards the taxation of the agricultural sector is a key for improving the low tax performance of developing countries.

#### **7.2.4 Taxation of agriculture in developing countries: problems and prospects**

So far it has been argued that a large agricultural sector is a major hindrance to tax efforts in developing countries. In this section it will be demonstrated that the absence of a clear and effective policy towards taxation of agricultural income is also a major reason for the poor revenue collection from this sector. As mentioned earlier, the agricultural sector shares a sizeable part of the GDP of developing countries, yet this sector supplies very little government revenue. There is evidence that both the explicit and implicit tax burden on the agricultural sector has reduced significantly over the last few decades. Before the 1980s a widely practiced government policy in developing countries was to tax the agricultural sector relatively

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<sup>663</sup> M. Piancastelli, 'Measuring the Tax Effort of Developed and Developing Countries, Cross Country Panel Data Analysis ---1985/95', IPEA Discussion Paper (2001).

<sup>664</sup> Abhijit Sen Gupta, 'Determinants of Tax Revenue Efforts in Developing Countries', IMF Working Paper 186 (2007).

heavily, through lowering terms of trade<sup>665</sup> in order to extract investible surplus, which could then be invested in non-agricultural sector.<sup>666</sup> This strategy apparently resulted in a sharp decline in agricultural output and led to economic crises in several sub-Saharan African countries<sup>667</sup> during the early 1980s, so the ‘conventional wisdom’, as Schiff and Valdes<sup>668</sup> put it, began to look less appealing. Partly to deal with such crisis the World Bank and IMF initiated stabilization and structural adjustment programs (SAPs) that enforced the objective of ‘getting the price right’ through improving terms of trade. Basically, the imposition of these conditions for improving the terms of trade and WTO (World Trade Organization) trade liberalization initiatives led to a significant decline in both direct and indirect taxation of agriculture.<sup>669</sup> As a result, the agricultural sector now generally enjoys a lower tax burden, and it is believed that this sector is subject to widespread tax evasion and avoidance. Many empirical studies have demonstrated that the agricultural sector provides a major impediment of to the tax effort of developing countries. There is no compelling economic evidence that this sector should receive generous tax concessions.

The presence of large agriculture sector is one of the most common economic structural features in developing countries. Over the last few decades industrial development has been the core focus for developing country economic development. The size of developing countries’ agriculture sectors is steadily declining; however, the agricultural sector is still a major contributor to the national income of most. Where in OECD countries the share of agriculture in the GDP is around 3 per cent, in developing countries the agriculture sector contributes around 20 per cent of GDP, and this sector is believed to employ around 50 per cent of the labour

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<sup>665</sup> The value of a country's exports relative to that of its imports.

<sup>666</sup> Alexander H. Sarris, ‘Agricultural Taxation under Structural Adjustment’, FAO Economic and Social Development Paper 128 (1994) 57.

<sup>667</sup> Food and Agriculture Organization of the United Nations, *The State of Food and Agriculture* (1993).

<sup>668</sup> Maurice Schiff and Alberto Valdes, ‘The Plundering of Agriculture in Developing Countries’, World Bank Latin America and the Caribbean Region Department Reports 013 (1994).

<sup>669</sup> Sarris, above n 666.

force.<sup>670</sup> For obvious economic, social and political reasons governments of developing countries are keen to ensure the growth and stability of this sector. The sector generally receives various concessionary tax treatments, including lower tax rates, favourable capital gain provisions, favourable depreciation provisions, exemptions, or a generous presumptive tax regime. In many instances, the major beneficiaries of these government supports are big landlords and rural elites.<sup>671</sup> Since the impact of food prices on poor and middle class people is relatively high, government policies towards the agricultural sector are generally focused on suppressing the prices of its products. The major goals governments of developing countries want to achieve through agricultural policies are the reduction of imports through food self-sufficiency, food security, and stable food prices in the domestic market. However, one important policy objective, raising tax revenue from the agricultural sector, seems to have taken a back seat.

As mentioned earlier, the contribution of the agricultural sector to the GDP has been in steady decline over the last few decades, but in most developing countries this sector still generates a significant portion of GDP. During the 60s and 70s this sector was a major source of tax revenue. During the 70s and 80s countries' attempted economic development through rapid industrialization resulted in a decline in the share of agriculture in the GDP. In that period the agricultural sector was stressed by a combination of a high explicit and high implicit tax burden.<sup>672</sup> However, during the 80s explicit agricultural tax revenue and agricultural tax burden significantly declined.<sup>673</sup> Moreover, during the last two decades, many developing countries, to comply with WTO trade liberalization initiatives, eliminated or reduced indirect taxes on agriculture. Table 7-2 demonstrates that the explicit tax burden on agricultural income significantly declined over the 1980s, as did tax collections from this sector.

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<sup>670</sup> See Table 7-1 of this chapter.

<sup>671</sup> M. Ghaffar Chaudhry, 'The Theory and Practice of Agriculture Income Tax in Pakistan and a Viable Solution' (1999) 38(4) *The Pakistan Development Review* 758.

<sup>672</sup> Schiff and Valdes, above n 668, 15.

<sup>673</sup> Food and Agriculture Organization of the United Nations, *Agricultural Taxation in Developing Countries: An Overview of Selected Case-Studies* (1993) 31.

**Table 7-2 Declining trend of agricultural tax revenues and agricultural tax burden in selected developing countries**

	Agricultural tax as a percentage of agricultural GDP		Relative agricultural explicit tax burden	
	1970-80	1981-87	1970s	1980s
	%		%	
Burkina Faso	6.30	0.30		0.03
Ethiopia	6.70	7.20	0.45	0.37
Senegal		1.50		0.04
Tanzania	7.60	1.80	0.3	0.10
Tunisia	1.90	1.60	0.08	0.06
Malaysia	12.10	2.20	0.34	0.05
Philippines	3.00	0.70	0.25	0.06
Sri Lanka	24.40	13.70	1.03	0.62
Argentina	14.10	4.60	0.33	0.31
Chile	11.50	6.30	0.43	0.30
Colombia	15.40	11.30	1.19	0.72
Costa Rica	7.10	7.70	0.63	0.60
Ecuador	4.00	4.60	0.52	0.15
Mexico		0.10		0.01
Uruguay	12.90	15.10	0.43	0.30

Source: Food and Agriculture Organization of the United Nations.<sup>674</sup>

Although the major portion of workforces are engaged in agricultural sector and the contribution of this sector to the national income is still very high, it is widely believed that tax evasion is rampant and very little tax revenue is collected from this sector. It seems that the confused and ambiguous policy towards the taxation of agricultural income is a major problem for collecting the fair share of tax revenues from this sector.

<sup>674</sup> Food and Agriculture Organization of the United Nations, above n 673.

### **7.2.5 Can, or should, developing countries collect more tax from rural small businesses?**

So far this chapter has attempted to establish that many developing countries have overlooked the tax potential of rural small businesses, and that a proper taxation policy towards the agricultural sector is critical to boost the countries' overall tax effort. Certain difficult to tax characteristics makes this sector quite unattractive for developing country tax authorities to devote much administrative attention. This chapter argues that just ignoring or avoiding is not a solution at all. A proper policy towards the taxation of agricultural income is required to utilize the tax potential of this sector. For the overall economic advancement the agricultural sector should supply a fair share of national revenue. For many developing countries, the best method for doing this is the adoption of a single presumptive method for collecting tax from the agricultural sector. In many Indian states, and to some extent in Bangladesh and Pakistan, agriculture is subject to both agricultural income tax and agricultural land tax. Income tax requires the submission of tax returns. In Bangladesh, in the absence of verifiable books and records tax authorities estimate a presumptive gross receipt based on the size of land ownership. In India, for estimating state agricultural income tax and agricultural land tax, lands are classified into categories of dry, wet, garden, and plantation lands. There is a standard rate applicable for a homogeneous group of land with respect to land quality, average yield and the value of the principal crop. State income tax and land taxation in Indian states is therefore presumptive; it is based on the productive potential of land, not its actual production. Both land and income tax use the same indicators like land size, quality, value and output. However, being two separate taxes, they are classified and administered independently. There are reform proposals for the application of one single tax combining the two.<sup>675</sup> In India, these two presumptive taxes use almost the same tax base.

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<sup>675</sup> Finance Department, Government of Karnataka, Final Report of the Tax Reform Commission, *Chapter VII: Taxing Agricultural Income* (2001). Available at: <<http://www.kar.nic.in/finance/trc/ch07.pdf>>.

Developing countries can reduce inefficiency of the tax system to some extent if they eliminate multiple jurisdictional authorities on the same tax base. In other words, as a replacement of existing agricultural land, wealth and income taxes, a single presumptive tax with one or two easily comprehensible asset-based indicators would be a more effective taxing method for developing countries. The following parts of this chapter will focus on how developing countries can efficiently raise more revenue from the agricultural sector.

### **7.3 Explicit instruments to tax agricultural income**

Agricultural income is subject to a number of indirect and direct taxes. Direct tax instruments, such as income tax and land tax, have a direct effect on the government budget; the imposition of these taxes does not result in intersectoral income transfers. Some taxes, like excise tax, sales tax and export tax, also directly affect government budgets, however, cause intersectoral income transfers. These taxes often impact on agricultural income through changes in agricultural prices relative to the non-agricultural prices.<sup>676</sup> Export tax, for example, shifts income from foreign customers and local producers to domestic customers.<sup>677</sup> Governments also impose implicit taxes on agriculture through price control or overvalued exchange rates that do not directly supply government revenue but transfer income from the agricultural sector to the non-agricultural sector.<sup>678</sup>

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<sup>676</sup> Food and Agriculture Organization of the United Nations, above n 673, 9.

<sup>677</sup> Schiff and Valdes, above n 668, 22.

<sup>678</sup> Food and Agriculture Organization of the United Nations, above n 673, 10.

**Table 7-3 Agricultural tax Instruments in developing countries**

Direct taxes	Indirect taxes	Implicit taxes
Land Taxes	Consumption taxes (VAT, Sales tax, GST or turnover taxes)	Exchange rate policies
Income tax	Import and export taxes	Price controls
Personal or poll taxes	Excise	Input subsidies
	Cess	Government procurement programs
	Stamp duty	

The value added by the agricultural sector has steadily declined over the last few decades. Before the 1990s, it was commonly argued that the agriculture sector was heavily taxed in developing countries.<sup>679</sup> However, in present days the scenario has changed considerably. Export tax has become very rare, and land tax, which was once a prominent tax source, has declined significantly. Income tax has become the prominent means of agricultural taxation in many developing countries. Many countries use a combination of taxes on agricultural income to collect government revenue and to achieve other non-revenue objectives.

### **7.3.1 Direct taxes on agriculture**

To collect revenue governments generally impose a number of direct taxes on various types of economic activities. Agricultural activities are no exception. Income tax and property or wealth tax are the two most common types of direct taxes that developing countries apply on agricultural income.

#### **7.3.1.1 Income tax**

With the decline of the prominence of land tax and international trade related taxes, income tax has become the major source of agricultural tax revenue in developing countries. Theoretically, income tax has some merit in that it allows the accomplishment of major policy objectives, such as

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<sup>679</sup> Schiff and Valdes, above n 668, 6.

equity and ability to pay considerations. However, it is little known to what extent income tax is successful in accomplishing tax collection objectives. In developing countries income tax faces serious administrative issues. Farmers and small businesses in the agricultural sector are mostly based in rural areas, the majority of them operate in the subsistence level, they generally make financial transactions using cash and they do not maintain books and accounts well. Therefore, it is very difficult to assess their record-based actual income tax liability. Taxation in many developing countries allows two types of assessment: assessment on the basis of actual accounts and assessment on the basis of presumptive methods. Tax administrations often find it convenient to tax agricultural income on presumptive methods when certain taxpayers are incapable of or reluctant to maintain books and records.

The agricultural sector receives several types of government support and subsidies. The supports include export subsidies, price support through government procurement, market access support through tariffs, non-tariff safeguards, cost subsidies on fertilizer, seed, agriculture tools and equipment, and low interest loans. Some countries also support this sector with concessionary tax treatments. In Nepal income from agricultural activities is fully exempt for individuals.<sup>680</sup> In Bangladesh an individual with only agricultural income enjoys a higher tax-free threshold. The tax exempt threshold is increased by Taka 40,000 (around USD 550) when a person has only agriculture income.<sup>681</sup> Until 2010 income from certain types of agricultural activities were was totally tax-exempt. From 2011 income derived from certain agricultural activities, such as fish farming, poultry farming, cattle farming, dairy farming and horticulture, have been subject to a concessionary tax rate of 5 per cent, where the lowest marginal individual tax rate for all non-agricultural activities is 10 per cent.<sup>682</sup>

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<sup>680</sup> *Income Tax Act 2000*, Nepal, s 11(1).

<sup>681</sup> *Income Tax Ordinance 1984*, Bangladesh, sch 6, para 29.

<sup>682</sup> Ministry of Finance, Internal Resource Department, Bangladesh Statutory Regulatory Order No. 238- Law-Income Tax /2011, 6 July 2011.

Constitutional provisions in India and Pakistan exempt agricultural income from central government taxation.<sup>683</sup> Only state or provincial governments are allowed to collect tax on agricultural income.<sup>684</sup> Since the administrative capacity of state level tax administrations is often very limited and there is severe lack of coordination between central and local government tax authorities, a large amount of agricultural income avoids taxation. In the majority of the developing countries, like Malaysia, Indonesia, Philippines, Thailand, Kenya, Malawi, Morocco, Ghana and Bolivia, income from agriculture does not enjoy any significant preferential treatment.<sup>685</sup> However, the very low level of income tax collection from agriculture in these countries indicates that individuals' or farms' income from agriculture either falls below the general exemption threshold, or tax evasion in this sector is very high.<sup>686</sup>

#### ***i. Income tax on actual income***

Few countries exempt agricultural income from income taxation, while the majority of developing countries, including Malaysia, Indonesia, Philippines, Sri Lanka, Thailand, Nigeria, Ghana, Kenya, Malawi, Mexico, Chile, Colombia, Argentina, Bolivia, Uruguay, Morocco and Tunisia, have largely adopted a global agricultural income tax system based on actual income of the taxpayer.<sup>687</sup> Although data about income tax collection from agricultural-sourced income is extremely difficult to collect, it is widely considered, based on the level of income that the agriculture sector generates, that the amount of tax collected from agricultural producers is negligible.<sup>688</sup> The business nature, the mode of operations, the economic agents involved, and other environmental elements make the agriculture

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<sup>683</sup> Mahmood Hasan Khan and Mohsin S. Khan, 'Taxing Agriculture in Pakistan', International Monetary Fund Policy Discussion Paper 98/3 (1998) 2.

<sup>684</sup> Khan and Khan, above n 683, 2.

<sup>685</sup> Mahmood Hasan Khan, 'Agricultural Taxation in Developing Countries: A Survey of Issues and Policies' (2001) 24 *Agricultural Economics* 321.

<sup>686</sup> Khan, above n 685, 321.

<sup>687</sup> Khan, above n 685, 321.

<sup>688</sup> Food and Agriculture Organization of the United Nations, above n 673, 30.

sector HTT everywhere in the world. In developing countries, there are two additional complications that make taxing agriculture even harder;<sup>689</sup> first, the lack of proper record keeping, and second, the business transactions are mostly made on a cash or kind basis that do not channel through banking systems.<sup>690</sup> Actual income of the taxpayers of this sector is therefore very difficult to determine or verify. In the absence of verifiable information of taxpayer income, in tandem with the interrelated administrative difficulties of actual income taxation, some tax administrations have adopted presumptive methods to estimate the tentative tax liability of taxpayers working in the agricultural sector.

As mentioned earlier, in both India and Pakistan agricultural income is made exempt from central government income taxation by constitutional provisions, and is taxed at the provincial or state level. Following several constitutional amendments and reform attempts each provincial government of Pakistan enacted the Agricultural Income Tax Ordinance in 1997 to tax agriculture income at the provincial level.<sup>691</sup> Taxpayers with more than a certain level of land holdings are required to file the return of their annual agricultural income at the provincial level. In Pakistan the top marginal tax on agricultural income is 15 per cent,<sup>692</sup> while in India the top marginal tax rate is much higher. Top marginal tax rate for agricultural income for individuals in West Bengal is 45 per cent, in Karnataka 40 per cent and in Kerala 50 per cent.<sup>693</sup> Given the wide range of tax rates that are applied on agricultural income, it is apparent that policy makers are still in doubt on the reasonable level of taxation.

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<sup>689</sup> Rajaraman, above n 202, 248.

<sup>690</sup> Rajaraman, above n 202, 248.

<sup>691</sup> Khan and Khan, above n 683, 2.

<sup>692</sup> Finance Department, Government of Karnataka, above n 675.

<sup>693</sup> Finance Department, Government of Karnataka, above n 675.

## **ii. Income tax on presumptive income**

Presumptive taxation is widely recommended and used around the world when the conventional income tax system that relies on the reported or actual income is difficult to implement, whether it be due to a lack of information of taxpayer income or the tax administration's incapacity to reach the concerned taxpayers.<sup>694</sup> Presumptive methods might be the only effective option for tax administrations of some developing countries to tax agricultural income. The revenue collected through presumptive methods might be low, however, there might be substantial spill-over benefit from bringing members of the informal sector into the formal sector.<sup>695</sup>

French *forfait*, which has been repealed and replaced by a system based on business turnover, was once the most enduring presumptive tax system. It adopted indicators of agricultural land and farm activities. It was widely accepted in France and was practised in Morocco and other Francophone countries.<sup>696</sup> The *forfait* is a contractual system where a tax authority and a taxpayer reach an agreement to pay tax on the basis of estimated income. Chapter 5 has a detailed discussion on the *forfait* system. The *forfait* system requires taxpayers to maintain books and records to some extent. Tax administrations are also required to be capable of doing sophisticated statistical analysis and must have extensive information on the industry. Success of *forfait* also depends on skilful and honest tax inspectors.<sup>697</sup> The *forfait* system may not be suitable for some developing countries since many countries still lack essential administrative capacities which are crucial for its successful implementation. However, this system might be useful and relevant for some of developing countries which have relatively better institutional capabilities and where taxpayers are more concentrated.

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<sup>694</sup> Dagny Faulk, Jorge Martinez-Vazquez, Sally Wallace, 'Taxing Potential Income: A Second Look at Presumptive Taxes', Georgia University, Andrew Young School Of policy Studies, Working Paper No. 06-32 (2006).

<sup>695</sup> Khan, above n 685, 322.

<sup>696</sup> Rajaraman, above n 434, 1112.

<sup>697</sup> Thuronyi, above n 118, 113.

Columbia introduced a presumptive-based agricultural income tax system in 1974. Tax collection increased in the initial years; however, administrative adjustments, evasion and inflation led to an erosion of the tax base, and the growth of tax collection became slower in subsequent years.<sup>698</sup> In 1983 the Columbian tax administration introduced an option to be taxed on either presumptive income and or on declared income.<sup>699</sup>

Uruguay has a long history of implementing an agricultural presumptive income tax based on the value of land. In 1968, after several modifications to income tax that incorporated land as a base, Uruguay implemented a tax on Minimum Taxable Production (IMPROME).<sup>700</sup> This tax was based on the 'potential' income from land; it was targeted at providing an incentive to improve productivity of cultivable land and to penalize underutilized or uncultivable land<sup>701</sup>. This tax was substituted by Impuesto a las Actividades Agropecuarias (IMAGRO), another income tax based on presumptive net income aiming to incentivise a better input-output cost structure of production.<sup>702</sup> However, in 1984 the tax administration introduced an option between being taxed on presumptive income or on declared income for farmers earning above a certain income. The implementation of a declared income-based tax resulted in a significant increase in tax collection, raising a question on the effectiveness of presumptive income-based taxes.<sup>703</sup>

In Bangladesh agricultural income is assessed mainly on the basis of presumed market value of the agricultural produce of the land. In absence of credible books and records the taxable income is estimated on the basis of the market value of agricultural produce of the land; 60 per cent of the market value of the produce is allowed as a deduction from the estimated

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<sup>698</sup> Food and Agriculture Organization of the United Nations, above n 673, 49.

<sup>699</sup> Food and Agriculture Organization of the United Nations, above n 673, 46.

<sup>700</sup> Food and Agriculture Organization of the United Nations, above n 673, 50.

<sup>701</sup> Food and Agriculture Organization of the United Nations, above n 673, 50.

<sup>702</sup> Food and Agriculture Organization of the United Nations, above n 673, 51.

<sup>703</sup> Food and Agriculture Organization of the United Nations, above n 673, 51.

income.<sup>704</sup> However, tax administrations do not survey the average yield of land or the market value of crops. There is also no official guideline for estimating the market value of agricultural produce. Assessments of agricultural income are mainly made using past assessment records, or sometimes are based on discretionary estimations.

One of the main problems of presumptive land-based taxation is the lack of information about the quality and quantity of land holdings of the taxpayer. In developing countries landholding inequality is generally severe. In India, during 1995, the top 7.35 per cent of landowners with a land size of 4 hectares or more owned 40.1 per cent of all agricultural lands.<sup>705</sup> In Bangladesh, according to 1978 Land Occupancy Survey data, the top 10 per cent of rural landowners held 52.2 per cent of land, while the top 20 per cent of landowners owned 71.7 per cent of land.<sup>706</sup> There is high concentration of income and wealth in Asia, Latin America, the Middle East and North America.<sup>707</sup> The presence of rural elites, who own and control large-sized lands, is not uncommon in most developing countries. Due to very traditional and paper-based recordkeeping methods, accessing landownership records is extremely difficult. Besides, many large landowners have lands recorded in different land registry offices, or often land titles recorded in the names of family members or close relatives. It becomes very difficult for tax officials to determine the actual land holdings of these types of taxpayers.

### 7.3.1.2 Land taxes

Land tax might be the oldest of all forms of tax that still exists all over the world. Land and property taxes are historically collected and administrated

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<sup>704</sup> *Income Tax Ordinance 1984*, Bangladesh, section 27 (c) (ii).

<sup>705</sup> Anand Kumar Ojha, *Agriculture Census in India*. Available at: < <http://www.fao.org/fileadmin/.../ess/.../WCA2010-RT-BKK-TS6.1.doc> > (4 January 2012).

<sup>706</sup> Barbara D. Miller and James A. Wozny, 'Land Tenure Patterns in Bangladesh: Implications for the Revenue and Distributional Effects of Changes in Land Taxation' (1985) 19(4) *The Journal of Developing Areas* 459-482.

<sup>707</sup> Khan, above n 685, 320.

by local governments. Generally land itself, land improvements and buildings are the bases of land and property taxes. Agricultural lands are usually treated on favourable terms such as lower tax rates, lower assessments, exemptions, and farm tax rebates.<sup>708</sup> though in the Philippines there exists an interesting exception where the market value of farm properties is taxed on higher rates than the residential properties.<sup>709</sup>

Land taxes are collected based on several different measures, such as area of land holding, rental value, the value of output and presumed income. Although collection of taxes from agricultural land has dwindled over the last few decades, developing countries around the world still use one or more of the above approaches to collect taxes from the agricultural land. Theoretically, land-based taxation has several advantages. The burden of tax falls on the owner of the land; the incidence of land tax is therefore not generally shiftable. Moreover, in competitive conditions, if the supply of land is completely fixed, and if all farmers are profit maximisers, the tax on land eventually lowers the price of land, so the price of agricultural commodities is not affected by the tax.<sup>710</sup> The ability of landowners to shift the incidence of tax thus depends on land availability, market competitiveness and the political and institutional strength of tenants and workers. Where supply of the land is abundant and the workers and tenants are mobile, a land tax is borne by the landowner.<sup>711</sup> However, the assumptions of a perfectly competitive market do not hold in many developing countries. Tax in excess of the economic rent of land discourages landowners from making capital investments on their land, which eventually leads to a fall in agricultural production.<sup>712</sup>

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<sup>708</sup> Richard M. Bird and Enid Slack, 'Land and Property Taxation in 25 Developing Countries: A Comparative Review' in Richard M. Bird and Enid Slack (eds.), *International Handbook on Land and Property Taxation* (Edward Elgar, 2004).

<sup>709</sup> Bird and Slack, above n 708.

<sup>710</sup> Bird, above n 402, 163.

<sup>711</sup> Food and Agriculture Organization of the United Nations, above n 673, 46.

<sup>712</sup> Food and Agriculture Organization of the United Nations, above n 673, 46.

### *i. Tax based on land area*

In terms of administration and application, a land tax based on land area is the simplest of all land taxes. Under the land area-based tax system tax is levied on per acre or square metre of land holding of the landowner. The land tax, particularly in developing countries, can be used as a tool for achieving important non-revenue objectives like ensuring more productive or better use of land, and aiding land reform through discouraging large landholdings.<sup>713</sup> Generally, incidence of land tax is not shiftable and, in its pure form, this tax is not based on the output or the income producing capability of the land. It discourages landowners to keep land idle and it creates incentives for generating an above average output. Moreover, if land tax rate is graduated, it can create a disincentive for large landowners. However, this tax lacks equity to some extent as it is linked to potential income of the land rather than the actual income that it generates. Tax burden can be higher than it should for poor or unsuccessful farmers. That said, in developing countries. Where land holding and personal wealth are correlated, land tax can be an equitable and progressive component of the tax system.<sup>714</sup>

Land area tax is inherently subject to risks of inequality unless the tax rate changes with the size of land holding or varies with land productivity.<sup>715</sup> A broad classification of lands in terms of productive capacity or economic value often induces equity considerations. For developing countries, a simple classification scheme that satisfies a rough notion of fairness might prove more equitable than a rigorous, yet more complex, one.<sup>716</sup> Highly refined “equitable” classifications that cannot be properly administered are often, in fact, inequitable.<sup>717</sup>

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<sup>713</sup> Khan, above n 685, 322.

<sup>714</sup> John Strasma, James Alm, Eric Shearer and Alfred Waldstein, *Impact of Agricultural Land Revenue Systems on Agricultural Land Usage* (1987).

<sup>715</sup> Khan, above n 685, 323.

<sup>716</sup> Khan, above n 685, 323.

<sup>717</sup> Bird, above n 402, 147.

Land tax at its simplest form is often imposed at a flat rate based on the size of the landholdings, irrespective of the income-earning capacity of the land.<sup>718</sup> However, in many countries like India, Bangladesh, Nepal and Sri Lanka land tax rate is graduated after certain exemption limit. In Bangladesh a progressive tax schedule is applicable for agricultural lands. Lands up to 8.33 acres are exempted from land tax. A landholding between 8.33 to 10 acres is charged at Taka 0.5 per acre, while lands larger than 10 acres are taxed at a rate of Taka 2 per acre.<sup>719</sup> In Karnataka, Indian land holders of less than 10 acres of dry land are exempt from land tax. However, a nominal 5 Rupees (about US 10 cents) is charged to each small holder for maintenance of a record of right.<sup>720</sup> In Nepal the collection of land tax declined sharply from around 55 per cent of the central government revenue following the World War I to a less than 2 per cent in 1988.<sup>721</sup> In colonial India, before independence, land taxes used to be a major source of government revenue. Land tax collection as a percentage of total tax collection declined from 69 per cent in 1793–94, to 36 per cent in 1891–92, to 16 per cent in 1938–39, to less than 1 per cent in recent years.<sup>722</sup> In Bangladesh the total land tax accounts for less than 1 per cent of total government revenue.<sup>723</sup> There is no reliable data on the individual contribution of agriculture to the total land tax collection. It is assumed, however, that the contribution of agriculture would be minor, as the major part of the land tax comes from residential and commercial properties. Table 7-4 exhibits the declining trend of the land tax collection in Bangladesh over the last three decades.

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<sup>718</sup> Khan, above n 685, 323.

<sup>719</sup> CARE SDU Reports and Studies, *Land Policy and Administration in Bangladesh: A Literature Review* (2003). Available at: [http://www.carebangladesh.org/publication/Publication\\_7013284.pdf](http://www.carebangladesh.org/publication/Publication_7013284.pdf).

<sup>720</sup> Finance Department, Government of Karnataka, above n 675.

<sup>721</sup> Jonathan Skinner, 'Prospects for Agricultural Land Taxation in Developing Countries' (1991) 5(3) *World Bank Economic Review* 493-511.

<sup>722</sup> Skinner, above n 721, 494.

<sup>723</sup> See Table 5-5, Chapter 5 of this thesis.

**Table 7-4 Trend of land tax collection as a percentage of total tax collection in Bangladesh**

	1990	1995	2000	2005	2010
Land tax collection* (Million Taka)	600	1,700	2,140	3,840	5,250
Total tax revenue (Million Taka)	63830	122330	194900	361750	790520
Land tax collection as a percentage of total tax revenue	0.94	1.39	1.10	1.06	0.66

Source: Bangladesh Economic Review 2011.<sup>724</sup>

\* Note: Land tax collection figures include both agricultural and non-agricultural property and land taxes.

Land taxes are generally collected at the local level. Administration costs of land tax collection are generally much higher than other common taxes, on average seven times higher.<sup>725</sup> In Bangladesh, in 1985–86 the administration cost of land tax was equivalent to 66 per cent of the total land tax collection.<sup>726</sup> Despite this, tax on agricultural land provides little government revenue; it merely works as a fee for keeping the ownership records.<sup>727</sup>

In many developing countries the distribution of farm size is highly skewed. The highly unequal land distribution is prevalent in most developing countries. Table 7-5 and Table 7-6 give an account of the high prevalence of small land holdings in developing countries. Since in many countries very small land holdings are exempt from agricultural land taxes, developing countries collect very little tax revenue from agricultural lands.

<sup>724</sup> Ministry of Finance, Bangladesh, *Bangladesh Economic Review 2011* (2011).

<sup>725</sup> Skinner, above n 721, 505.

<sup>726</sup> Skinner, above n 721, 505.

<sup>727</sup> Skinner, above n 721, 505.

**Table 7-5 Regional distribution of the top five countries with the largest number of small farms**

Country	Census year	Number of farms under 2 hectares	Share of farms under 2 hectares, Per cent
Asia			
China	1997	189,394,000	98
India	1995–96	92,822,000	80
Indonesia	1993	17,268,123	88
Bangladesh	1996	16,991,032	96
Viet Nam	2001	9,690,506	95
Africa			
Ethiopia	2001–02	9,374,455	87
Nigeria	2000	6,252,235	74
DR Congo	1990	4,351,000	97
Tanzania	1994–95	2,904,241	75
Egypt	1990	2,616,991	90
Americas			
Mexico	1991	2,174,931	49
Peru	1994	1,004,668	58
Brazil	1996	983,330	21
Ecuador	1999–2000	366,058	43
Venezuela	1996–97	113,421	23
Europe			
Russia	2002	16,000,000	98
Ukraine	2003	6,214,800	99
Romania	1998	2,279,297	58
Bulgaria	1998	1,691,696	95
Poland	2002	1,494,100	51

Source: Oksana Nagayets.<sup>728</sup>

The average farm size is very small in the Asian and African continents, where most developing countries are situated.

<sup>728</sup> Oksana Nagayets, 'Small Farms: Current Status and Key Trends', The Future of Small Farms Research Workshop, Wye College (2005).

**Table 7-6 Approximate farm size by world region, 1997**

World region	Average farm size, hectares
Africa	1.6
Asia	1.6
Latin America and Caribbean	67.0
Europe*	27.0
North America	121.0

Source: Braun.<sup>729</sup>

\*Data includes Western Europe only.

The above discussions indicate that, despite its many apparent theoretical advantages, the importance of traditional land taxes has substantially declined. Developing countries generally collect an insignificant amount of taxes from agricultural lands. Developing countries should therefore abolish the present form of agricultural land tax and replace it with an asset-based presumptive income tax. Since the average farm size in most developing countries is very small, the threshold of this presumptive income tax should be high enough to exclude the huge number of small holders who normally do not generate taxable income, or who just marginally generate a taxable income. Tax administration can then concentrate effectively more on large landowners for the realization of tax revenues.

## ***ii. Tax based on presumed income or on value of output***

The concept of land taxation based on income considers both the income of the land and other factors of production, such as the cost of the labour of the cultivator and the cost of capital invested on land and equipment.<sup>730</sup> French *forfait* might be a good example of this kind of tax. Tax based on gross yield or gross income has dominated in some countries, including Turkey.<sup>731</sup> Very

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<sup>729</sup> Joachim Von Braun, 'Small-Scale Farmers in Liberalized Trade Environment' in T. Huvio, J. Kola and T. Lundstrom (eds), *Small-Scale Farmers in Liberalized Trade Environment* (2005).

<sup>730</sup> Bird, above n 402, 155.

<sup>731</sup> Bird, above n 402, 148.

few countries, such as India, now have a land tax that incorporates the income earning potential of the land and the landowner.

In India the state governments enjoy an exclusive taxing right on agricultural income. Agricultural income in Indian states is typically subject to land tax, agricultural income tax and local cess. Like in several other Indian states, land tax in Karnataka is basically a presumptive levy.<sup>732</sup> Agricultural lands are classified into categories of dry, wet, garden, and plantation land.<sup>733</sup> A detailed cadastral survey or a settlement procedure provides a survey number to each parcel of land. Productive lands are classified after a relative assessment of productivity and quality. For a homogeneous group of land a standard rate is determined by considering land quality, average yield and the value of the principal crop.<sup>734</sup> Land taxation in most Indian states is therefore presumptive; based on productive potential of land, not on actual production. Since the existing Indian land taxation system considers important characteristics in relation to the income-producing capability of land, this system appears fairer and more equitable than land taxation in many other developing countries. However, land taxation based on land quality, fertility, and the types of crops grown requires extensive and up to date land records and cadastral surveys, which may not be possible for many developing countries. Moreover, this apparently fairer but complex assessment system comes with a substantial level of administrative cost.

### ***iii. Land Taxation based on rental value***

While the tax based on the potential income from land includes both income from the land itself and the income derivable from factors of production, the land tax based on rental value is only concerned with the rental or capital value of the land. The rental value of land might be expressed as an annual

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<sup>732</sup> Finance Department, Government of Karnataka, above n 675.

<sup>733</sup> Finance Department, Government of Karnataka, above n 675.

<sup>734</sup> Finance Department, Government of Karnataka, above n 675.

payment made in exchange of the utilization of the land (annual value) or as the market value that represents the present discounted value of those annual payments (capital value).<sup>735</sup> The annual rental value-based land taxation system is assessed based on the estimated rental value of a class of land, and is imposed on the landlord concerned. Due to a lack of recordkeeping, it is most often not possible to depend upon taxpayers' actual rental income.<sup>736</sup> Thus a basic prerequisite of this system is a satisfactory land classification that ensures that the assessment is done based on fair and appropriate level of the rental value of the land.

Generally, there are two groups of assessment methods that are based on annual rental value. The first requires tax officials, depending on the land classification, to estimate income-producing capacity of each class of land, then to derive the estimated rental value of the land.<sup>737</sup> The other system involves a tax official appraising the capital value of the land based on the reference price for the land's sale or an established standard appraisal, and then calculating the rental value of the land derived from the estimated rate of return on the capital value.<sup>738</sup> Both methods are presumptive assessments and sometimes one is used to corroborate the other.<sup>739</sup>

Tax based on capital value in principle accounts for both current income and wealth, while tax based on annual value accounts for current income only.<sup>740</sup> This advantage of taxing capital can have a profound impact for developing countries if applied properly.<sup>741</sup> Taxing capital thus takes the form of a wealth taxation that can add equity into the land taxation structure. Until 1972 Pakistan had a land revenue system, under which an appropriate tax rate (up to a maximum of 25 per cent) was determined for each revenue 'circle' and applied on the 'net assets' of each landowner to determine the

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<sup>735</sup> Strasma et al, above n 401.

<sup>736</sup> Bird, above n 402, 151.

<sup>737</sup> Bird, above n 402, 152.

<sup>738</sup> Bird, above n 402, 152.

<sup>739</sup> Bird, above n 402, 152.

<sup>740</sup> Bird, above n 402, 154.

<sup>741</sup> Bird, above n 402, 154.

payable land tax.<sup>742</sup> ‘Net assets’ were calculated, in the case of owner-producers, by deducting the value of gross produce from the cost of production.<sup>743</sup> This can be contrasted with the calculation of the taxable income for rented land, which is the rent received by the landowner minus the costs incidental to the rent.<sup>744</sup> However, in 1972 a new system was introduced, which applied a flat rate of tax on the value of the Produce Index Unit (PIU) to determine the tax liability. PIU is calculated based on the gross value of one unit of land of a crop and soil type.<sup>745</sup> After a basic exemption level a flat assessment rate per PIU is applied to the amount of landholding.<sup>746</sup>

Many Latin American countries seemingly adopted land taxation as a tool for income redistribution, improving land use and incorporating the ability to pay principle into their tax structure.<sup>747</sup> However, these countries received little success due to poor administrative and assessment practices.<sup>748</sup> Colombia made various attempts to implement presumptive-based land taxation. In 1974, under the presumptive-based land taxation system payable tax was calculated at a rate of 8 per cent of previous years’ declared net patrimony.<sup>749</sup> This system initially increased tax collections, however due to poor modifications, evasion and inflation-led tax base erosions tax collection grew slowly in subsequent years.<sup>750</sup> As a result, in 1983 the additional option of a tax calculated on the basis of declared income was introduced.<sup>751</sup>

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<sup>742</sup> Khan and Khan, above n 683, 8.

<sup>743</sup> Khan and Khan, above n 683, 19.

<sup>744</sup> Khan and Khan, above n 683, 19.

<sup>745</sup> Khan and Khan, above n 683, 26.

<sup>746</sup> Khan and Khan, above n 683, 26.

<sup>747</sup> Bird, above n 402, 5.

<sup>748</sup> Bird, above n 402, 5.

<sup>749</sup> Food and Agriculture Organization of the United Nations, above n 673, 49.

<sup>750</sup> Food and Agriculture Organization of the United Nations, above n 673, 49.

<sup>751</sup> Food and Agriculture Organization of the United Nations, above n 673, 50.

In an effort to discourage renting out agricultural lands, Uruguay, until 1979, had land tax levied on the rental value of rural property.<sup>752</sup> However, the realization of this caused non-revenue objective potential investors and large owners to feel discouraged to rent out or make permanent investment in rural lands.<sup>753</sup> In 1979 this system was replaced by an income tax based on presumptive net income with the aim to incorporate a better input-output cost structure of production.<sup>754</sup> In Chile cultivators were allowed to choose whether to base their tax on their declared income or on the presumed fiscal value of the land. However, the majority of agricultural producers opted to be taxed on the basis of declared income.<sup>755</sup>

Land-based taxes have many apparent theoretical advantages. Moreover, the administration of land taxes is quite straightforward. The question remains, however; why have land taxes failed to appear as a major source of tax revenue in developing countries? Bird argues that even if a tax that looks ideal in theory, it can be catastrophic in practice.<sup>756</sup> A refined tax system with added “efficiency” and “equity” features often has many practical and administrative flaws. These often lead to poor administration that does not produce equity, efficiency or even revenue.<sup>757</sup> A simple uniform tax made on the basis of classified area is most likely the best form of land tax for most developing countries. Strasma et al<sup>758</sup> stresses that the political pressure, high costs and lengthy time periods that are required by cadastral surveys, as well as the shortage of skilled assessors in local tax offices and the inflationary erosion of tax revenue, make land taxes administratively difficult and economically unfeasible.

In spite of this, the increasing use of information technology in land management and land survey systems may have created new prospects of

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<sup>752</sup> Food and Agriculture Organization of the United Nations, above n 673, 50.

<sup>753</sup> Food and Agriculture Organization of the United Nations, above n 673, 50.

<sup>754</sup> Food and Agriculture Organization of the United Nations, above n 673, 52.

<sup>755</sup> Food and Agriculture Organization of the United Nations, above n 673, 52.

<sup>756</sup> Bird, above n 402, 223.

<sup>757</sup> Bird, above n 402, 223.

<sup>758</sup> Strasma et al, above n 401.

identifying large landowners and the extent of their land ownership. Many states of India, including Karnataka, Kerala, Haryana, and West Bengal, already have digitalised land records. From March 2002 Karnataka officially started to use the computerised land records system 'Bhoomi'. The Government of India adopted the policy that Bhoomi should be adopted by all states.<sup>759</sup> Bangladesh has started digitalising land records on a pilot basis. Malaysia is now at an advanced stage of implementing the electronic land management system *e-Tanah* all over the country.<sup>760</sup> The World Bank and the UNDP are advocating to many developing countries to implement electronic land management systems. Countries like Vietnam, Lao PDR, Philippines, Botswana, and Mauritius are now at the implementing stage of electronic land management projects.<sup>761</sup> Rapid advancement in information technology has aided the process. Digitalised land record, land mapping and registration systems may have opened up the opportunity to rethink seriously about what an effective land taxation system in developing countries could and should look like. They can also act as an important tool for the implementation of a presumptive income tax of agricultural income.

### 7.3.1.3 Poll or personal taxes

Poll tax is associated with a long history of conflicts, political tension and public uprising. Poll tax basically is charged uniformly upon all physically capable, typically male, persons of a locality.<sup>762</sup> Poll tax has different variants and has gone under different names, like personal tax, hut tax, minimum tax and development tax. It has usually been used as an alternative to land tax in rural areas where land tenure is not recorded, there are multiple rights over land and where taxpayers represent a homogeneous

<sup>759</sup> Finance Department, Government of Karnataka, above n 675.

<sup>760</sup> Mohd Shukri Ismail, 'Land Administration in Peninsular Malaysia: A General Overview' (2011) 1(1) *Jurnal Pentadbiran Tanah* 12.

<sup>761</sup> The World Bank, *ICT in Agriculture: Connecting Smallholders to Knowledge, Networks, and Institutions* (2011). Available at: < [http://www.cto.int/wp-content/themes/solid/\\_layout/dc/k-r/ICT\\_in\\_Ag\\_Sourcebook\\_web\\_light.pdf](http://www.cto.int/wp-content/themes/solid/_layout/dc/k-r/ICT_in_Ag_Sourcebook_web_light.pdf)>.

<sup>762</sup> Odd-Helge Fjeldstad and Ole Therkildsen, 'Mass Taxation and State-Society Relations in East Africa' in Deborah Brautigam, Odd-Helge Fjeldstad and Mick Moore (eds), *Taxation and State Building in Developing Countries* (2008) 116.

group with small income. Usually, local officials or village chiefs determine poll taxes on a family unit roughly based on indicators like income and wealth.<sup>763</sup> Different developing countries have had different forms of poll taxation; for example several African countries like Ghana, Tanzania, Nigeria, Kenya, Zambia, Sierra Leone, and Uganda each have had different forms of personal or poll taxes.<sup>764</sup> In Tanzania in the late 1890s German colonial administrations imposed an annual head tax on each adult male.<sup>765</sup> In 1923, during the British regime, the Hut and Poll tax Ordinance was enacted.<sup>766</sup> The poll tax per person per annum was exorbitantly high, equivalent to one to two months' wage.<sup>767</sup> Tax defaulters were forced to labour on public works like grass clearing and serving as porters for safaris.<sup>768</sup> In independent Tanzania in 1969, the government abolished the poll tax due to equity concerns, declining revenue yield and widespread public opposition.<sup>769</sup> However, in 1984 a new poll tax was reintroduced at the local level with a title of 'development levy'.<sup>770</sup> Initially this tax supplied around 60 per cent of total local tax revenue, but this eventually dropped substantially, especially when female workers were exempted from paying the tax.<sup>771</sup> As part of a local government taxation reform in 2003 the government abolished the development levy.<sup>772</sup>

Uganda also has a long history poll tax starting in 1900 when the hut tax was first introduced.<sup>773</sup> In 1905 the hut tax was replaced by a poll tax as a revenue source for the colonial government.<sup>774</sup> Local governments in all districts adopted and introduced the tax with the name 'Graduated Personal

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<sup>763</sup> Food and Agriculture Organization of the United Nations, above n 673, 12.

<sup>764</sup> Fjeldstad and Therkildsen, above n 762, 126.

<sup>765</sup> Fjeldstad and Therkildsen, above n 762, 119.

<sup>766</sup> Fjeldstad and Therkildsen, above n 762, 119.

<sup>767</sup> Fjeldstad and Therkildsen, above n 762, 119.

<sup>768</sup> Fjeldstad and Therkildsen, above n 762, 119.

<sup>769</sup> Fjeldstad and Therkildsen, above n 762, 120.

<sup>770</sup> Fjeldstad and Therkildsen, above n 762, 121.

<sup>771</sup> Fjeldstad and Therkildsen, above n 762, 121.

<sup>772</sup> World Bank, *Local Government Taxation Reform in Tanzania: A Poverty and Social Impact Analysis (PSIA)* (2006).

<sup>773</sup> Fjeldstad and Therkildsen, above n 762, 121.

<sup>774</sup> Fjeldstad and Therkildsen, above n 762, 122.

Tax (GPT)' during 1954–60.<sup>775</sup> Initially, GPT served as a major revenue source for the local government, supplying around 91 per cent of total revenue.<sup>776</sup> However, the collection gradually declined, and by 2003 the poll tax made up only 40–50 per cent of local tax collection.<sup>777</sup> In 1961, fewer than 10000 people paid income tax compared to 1.4 million poll taxpayers (20 per cent of total population).<sup>778</sup> In 2005, when the poll tax was finally abolished, around 10 per cent of the total population paid poll tax, while 1 per cent were paying income tax.<sup>779</sup>

Poll tax is regressive and severely lacks fairness. In both Tanzania and Uganda this taxation encountered mass public protest and dissatisfaction. A coercive approach of the tax authority seems essential for successful poll tax collections. In both Tanzania and Uganda default on income tax was a civil offence, while default on poll tax was a criminal offence.<sup>780</sup> During the competitive government regime it became unsustainable applying strict coercive approaches for the collection of taxes. Greater political competition was instrumental for abolishing poll taxes in these countries.<sup>781</sup>

### **7.3.2 Indirect taxes on agriculture**

Many developing countries impose various indirect taxes on agricultural products to collect revenue and to achieve various non-revenue objectives. The most common indirect taxes are export tax and import duties on agricultural inputs. Other indirect taxes are sales tax, value added tax, and the rarely used local cesses.

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<sup>775</sup> Fjeldstad and Therkildsen, above n 762, 122.

<sup>776</sup> Fjeldstad and Therkildsen, above n 762, 122.

<sup>777</sup> Fjeldstad and Therkildsen, above n 762, 123.

<sup>778</sup> Fjeldstad and Therkildsen, above n 762, 124.

<sup>779</sup> Fjeldstad and Therkildsen, above n 762, 124.

<sup>780</sup> Fjeldstad and Therkildsen, above n 762, 124.

<sup>781</sup> Ole Therkildsen, 'The Rise and Fall of Mass Taxation in Uganda 1900-2005', Danish Institute for International Studies Working Paper no 2006/25 (2006).

### 7.3.2.1 Export tax

Many developing countries impose export taxes on agricultural products, such as palm oil, sugar, coffee, rice, forestry products, fishery products, animal hides and skin products. Governments use export tax to try to achieve many objectives beyond the collection of revenue. Some of these include promoting downstream processing industries, preserving natural resources, reducing inflationary pressure through price stabilization, ensuring food safety, and redistributing natural resources and income.<sup>782</sup> In developing countries the agricultural sector receives a number of types of government support, such as subsidized fertilizer, seed, fuel, agricultural tools and equipment, as well as low interest loans. The primary aim of these subsidies is to depress the domestic price and thereby ease inflationary pressure. Governments often impose export taxes to ensure that subsidies and lowered commodity prices go into the hands of domestic consumers rather than not international ones. WTO does not prohibit imposing export taxes; about one third of WTO members actually use export taxes.<sup>783</sup> However, the majority of the regional trade agreements, such as EU, NAFTA, CARICOM, MERCOSUR and ANZCERTA, and some bilateral treaties prohibit export taxes.<sup>784</sup> Export tax is relatively easy to impose and collect, and is often considered a simple and cost effective means for achieving revenue and non-revenue objectives. However, as an indirect tax, export tax is less equitable than direct taxation, can distort resource allocation, and can be a punitive disincentive for particular productive agricultural commodities.

One of the important goals of imposing export tax is to improve terms of trade and the relative price of a country's export compared to import.<sup>785</sup> One way of improving terms of trade is to shift tax burden from domestic

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<sup>782</sup> Roberta Piermartini, 'The Role of Export Taxes in the Field of Primary Commodities', World Trade Organization (2004) 18.

<sup>783</sup> Piermartini, above n 782, 2.

<sup>784</sup> Piermartini, above n 782, 2.

<sup>785</sup> Piermartini, above n 782, 2.

producers to international consumers. Price elasticity of a particular product determines whether export tax can be shifted to a foreign consumer.<sup>786</sup> Developing countries typically supply a small portion of total world export and rarely have a monopolistic control on the exportable.<sup>787</sup> As a small supplier of a product the world demand the country faces is perfectly elastic.<sup>788</sup> In that case, when a developing country imposes an export tax, it does not affect the world price; rather it lowers the price received by the domestic producers, and ultimately lowers domestic production.<sup>789</sup> This lower price benefits domestic consumers, but comes at the cost of domestic producers.<sup>790</sup> A larger exporter, usually a developed country with potential monopolistic power to set the world price, is capable, through imposing export taxes, of shifting the tax burden from domestic producers to foreign consumers and also depressing domestic prices.<sup>791</sup>

Export tax as an indirect tax has three effects on household income: gross income effect, purchasing power effect and disposable income effect.<sup>792</sup> However, as an indirect tax, incidence of export tax is not linked to income and purchasing power of the consumer. Thus, when redistributing higher tax revenues among the poor and rich, it is very crucial to analyse how the tax is affecting factors of production of domestic producers and disposable income of consumers.<sup>793</sup> The overall effect of export tax on the poor greatly depends on the fairness and efficiency of government's redistribution of tax revenues.<sup>794</sup>

Over the last few decades, the worldwide price of primary products relative to other products has steadily declined, and is facing a high level of

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<sup>786</sup> Piermartini, above n 782, 5.

<sup>787</sup> Piermartini, above n 782, 7.

<sup>788</sup> Piermartini, above n 782, 6.

<sup>789</sup> Piermartini, above n 782, 6.

<sup>790</sup> Strasma et al, above n 401.

<sup>791</sup> Strasma et al, above n 401.

<sup>792</sup> Piermartini, above n 782, 15.

<sup>793</sup> Food and Agriculture Organization of the United Nations, above n 673, 57.

<sup>794</sup> Food and Agriculture Organization of the United Nations, above n 673, 57.

volatility.<sup>795</sup> However, the volume of international trades has been increasing, so developing countries are struggling to improve their balance of trade and balance of payment figures. Growth of trade deficit of agricultural commodities in developing countries has been enormous; developing countries, from a surplus of \$1 billion in 1970, encountered a deficit of \$11 billion in 2001.<sup>796</sup> With these realities increasing exports is a huge challenge, and the imposition of export tax is hardly an option. While the export of primary commodities seems an easily exploitable tax base for a typical poor tax administration, during last two decades collection of export tax fell significantly.

**Table 7-7 Collection of export tax as percentage of total revenue in selected developing countries**

Country Name	1990	1995	2000	2005	2009
Congo, Dem. Rep.	4.122	2.558	1.120	-	-
Ghana	12.375	13.810	-	3.060	0.363
India	0.063	0.139	0.195	0	0.005
Indonesia	-	0.292	-	0.017	2.825
Malaysia	9.270	-	2.119	2.587	1.082
Mexico	0.086	0.032	0.001	-	-
Nepal	0.445	1.686	1.303	1.290	0.678
Guatemala	0.197	0	0.01	0.004	0
Tunisia	0.436	0.246	0.197	0.094	0.134
Thailand	-	-	0.34	0.318	0.029
Uruguay	0.795	0.073	0.138	-	-
Sri Lanka	4.165	0.007	0	0.006	-
Panama	1.881	1.041	0.017	-	-

Source: World Development Indicators Database.<sup>797</sup>

<sup>795</sup> Food and Agriculture Organization of the United Nations, *The State of Agricultural Commodity Markets 2009* (2009).

<sup>796</sup> Food and Agriculture Organization of the United Nations, above n 795.

<sup>797</sup> The World Bank, *World Development Indicators Database* (2012).

### 7.3.2.2 Import duty on agricultural inputs

Import duty is still a major source of tax revenue for most developing countries, since imports are an easily administrable tax base for relatively weak tax administrations. Developing countries impose import duty on agricultural inputs, like fertilizers, seeds, and agricultural equipment, usually at lower rates. Food inflation is a major challenge in most developing countries. Higher prices of basic foods affect the poor and lower middle class most, since they spend a greater proportion of their income buying food.<sup>798</sup> Supply of agricultural products is almost perfectly elastic. If there is no domestic production of an agricultural item being imported, the imposition of import duty increases the price and thereby reduces consumption of the product. However, when there is domestic production, import duty subsidizes the domestic producers.<sup>799</sup> The findings of some studies indicate that import tax has an inverse relationship with the usage of agricultural inputs.<sup>800</sup> To suppress domestic food prices and to lower agricultural production costs import duty on food and agricultural inputs is imposed at relatively low rates.

### 7.3.2.3 Marketing tax

Agricultural products are generally exempt from excise, sales or consumption taxes in developing countries.<sup>801</sup> Agricultural share in GDP heavily affects the collection efficiency of a Value Added Tax.<sup>802</sup> It is more difficult to administer and collect a VAT in less urbanized, more rural developing countries.<sup>803</sup> These collection and administrative difficulties, plus the high cost of compliance, seem to be the major justifications for

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<sup>798</sup> FAO Regional Office for Asia and the Pacific, *Asia Pacific Food Situation Update* (February 2011).

<sup>799</sup> Food and Agriculture Organization of the United Nations, above n 673,13.

<sup>800</sup> Food and Agriculture Organization of the United Nations, above n 673,13.

<sup>801</sup> Food and Agriculture Organization of the United Nations, above n 673,14.

<sup>802</sup> Joshua Aizenman and Yothin Jinjark, 'The Collection Efficiency of the Value Added Tax: Theory and International Evidence' NBER Working Paper Series Working Paper 11539 (2005) 4.

<sup>803</sup> Aizenman and Jinjark, above n 802, 4.

granting the VAT exemption for agricultural products. Equity and distributional concerns are also important considerations for adopting these exemptions.

Some developing countries, including India, Pakistan, Malaysia, Sri Lanka, Philippines, Nigeria, Tanzania, Kenya, Zimbabwe, and Ghana, levy a cess or an earmarked levy on marketed cash crops at the local level.<sup>804</sup> The revenue collected by a cess or earmarked levy is reserved for the improvement of the production and marketing of those products.<sup>805</sup>

#### **7.4 A preferred regime for taxing rural small business taxpayers**

In Section 7.2 it has been argued that developing countries collect little tax revenue from the agricultural sector despite it still contributing significantly to the national income. Collecting tax from this sector is very difficult for developing countries due to several inherent problems in the sector. However, ambiguous and unclear policies towards the taxation of agricultural income should also be blamed for the poor revenue collection. This thesis has demonstrated that the burden of implicit and explicit taxes has diminished over the last few decades and has created an untaxed sector with a large tax potential. It has been stressed that developing countries should not ignore the revenue potential of the numerous rural small businesses. In Section 7.3 the available taxing methods that are employed to collect tax from rural small businesses were analysed in detail. Based on the findings of these analyses, this section attempts to outline a desirable small business tax regime for taxing rural small businesses in developing countries.

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<sup>804</sup> Khan, above n 685, 319.

<sup>805</sup> Khan, above n 685, 319.

#### **7.4.1 Abolish the land taxes: apply an asset-based presumptive income tax that replaces the existing income tax, land tax and other similar taxes**

Many developing countries rely on presumptive methods for collecting tax from the difficult-to-tax agricultural sector. Section 7.3.1.2 highlights the theoretical advantages of asset-based land taxes. The administration of land taxes looks, at face value, to be quite straightforward. However, the high costs and lengthy time periods required by cadastral surveys, the shortage of skilled assessors in local tax offices and the inflationary erosion of tax revenue all make land taxes administratively difficult and economically unfeasible.<sup>806</sup> In this chapter it has been argued that the increasing use of information technology-led land management and land survey systems might have created new prospects for land tax-type taxes. However, since the land tax on agricultural lands supplies a negligible amount of revenue, it would be more pragmatic to abolish agricultural land taxes and incorporate them into the presumptive income tax, which adopts asset-based indicators, such as amount of land owned, and others that give a rough proxy for the income potential of that land. Both land and presumptive income tax already use the same indicators, such as land size, quality, value and output. They are classified and administered separately since they are two different taxes. It is more rational to apply a single tax. Taxing these two identical tax bases involves significant administrative costs, and taxpayers need to incur excessive compliance cost burdens. Tax systems of developing countries can achieve significant efficiency gains by amalgamating the taxes together.

Beside the amount of land holdings, a few easily observable indicators that give a broad indication of the productive capacity of the land, such as land quality, fertility, and type of crop grown, can be incorporated into the presumptive tax system. For a realistic and credible presumption the chosen indicators should be specific to the concerned sector and profession; the

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<sup>806</sup> Strasma et al, above n 401.

rates and norms should be established based on surveys and objective evidence.<sup>807</sup> Also, for taxing agricultural income it is extremely important that the number of indicators be few, so it can be easily administrable. Here principles of simplicity should prevail over fairness principles — often that a tax that looks ideal in theory can be catastrophic in practice.<sup>808</sup> A number of Indian states, such as Kerala, Karnataka, and West Bengal, have adopted an agricultural presumptive income tax. However, along with the income tax, agricultural income in several Indian states is also subject to land taxes and agricultural cesses.<sup>809</sup> This thesis stresses that, if possible, an agricultural income tax should replace the other applicable taxes on agricultural lands. For example, the agricultural presumptive tax regime in Ukraine has established one single tax abolishing a number of existing taxes.<sup>810</sup>

#### **7.4.2 The threshold should be high enough**

Considering the administrative constraints of developing country tax administrations and the troublesome characteristics of agricultural taxpayers, it is a rational approach to restrict the number of taxpayers tax administrations want to target for tax collections. As Thuronyi<sup>811</sup> points out, it is a good idea to restrict the number of HTT taxpayers that tax administrations must deal with. Presumptive tax mostly replaces income tax. It has already been argued that raising the threshold of agricultural income tax would do little harm to the overall objective of increasing revenue, since only a few of the small landholders earn even a modest amount of taxable income. Therefore, the threshold should be set as high as possible to restrict over inclusion of HTT taxpayers. Given the large number of rural businesses that can operate outside the tax net, an exclusion of a section such taxpayers would not affect significantly the size of the targeted tax

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<sup>807</sup> Rajaraman, above n 434, 1117.

<sup>808</sup> Bird, above n 402, 223.

<sup>809</sup> Finance Department, Government of Karnataka, above n 675.

<sup>810</sup> German Economic Team in Belarus (GET), above n 548, 4.

<sup>811</sup> Thuronyi, above n 118, 107.

base. A careful construction of threshold can effectively reduce the administrative costs of the tax administration and also do justice to certain individuals who are in spite of earning a low level of income subject to file tax returns. The proper choice of indicators to determine the threshold for taxing small businesses is very crucial for the successful operation of presumptive taxes. Tax administrations also need to be careful about the risks that some tax evaders might take undue advantage of the higher threshold, and that some might hide their non-agricultural income as agricultural income. The threshold should not be big enough to create a significant incentive for potential tax evaders to conceal their income.

#### **7.4.3 Agricultural presumptive taxation as an integral part of the overall tax system**

As noted earlier in Chapter 5, presumptive taxes are normally simply adopted for administrative convenience. In many jurisdictions presumptive methods are adopted based on subjective intuitions, not any objective analysis. Often presumptive methods that were adopted as *ad-hoc* administrative solutions have become permanent elements of the tax system. There are many crucial issues in designing a presumptive tax regime, such as selecting proper indicators, selecting a suitable threshold, safeguarding against the possibility of evasion and fixing the tax rate that fairly approximates the actual tax base. Success of presumptive taxation largely depends on a careful analysis of several environmental factors related to the policy, administration and taxpayers of a specific jurisdiction. A presumptive taxation that targets agricultural income should be an integral part of the small business tax regime and should be implemented under a comprehensive reform. For many developing countries the immediate result of this reform might not be an increase in tax revenue. However, in the medium to long run, there is a good possibility that a typical developing country would generate increased revenues through the enhanced monitoring of larger landholders.

## 7.5 Conclusion

This thesis argues that rural small businesses are significantly different from urban small businesses with regard to several characteristics, and therefore the taxing strategies towards these two segments should be different. The rural sector has considerable tax potential and developing countries should undertake a proper taxing strategy to collect taxes from it. Analysing the existing tax policy and methods in developing countries, this chapter attempts to outline an effective regime for taxing rural small businesses.

Most rural small businesses in developing countries are directly or indirectly linked to the agricultural sector. The agricultural sector is widely regarded as HTT. A number of empirical studies identify the agricultural sector as a major impediment to the tax efforts of developing countries. The administrative reach of the agricultural sector is generally low, and this sector is believed to be subject of rampant tax evasion. This chapter has argued that over the last few decades the explicit and the implicit tax burden on agricultural income has significantly reduced. Tax administrations should therefore consider the agricultural sector as a widely untapped area. A developing country with a large agricultural sector should not ignore the tax potential of this sector.

The analyses of this chapter suggest that a typical developing country with a large agricultural sector should rely on a presumptive tax system to collect tax revenue. In particular this study argues in favour of asset-based presumptions, as they would be most effective for taxing rural small businesses. Under an asset-based presumptive taxation policy the burden of taxation falls upon the landowner, and the imposition of this tax does not have an adverse impact on the price of primary produce. However, land-based taxes are subject to some serious administrative difficulties. The success of a land-based tax greatly depends on land records and regular cadastral surveys. Due to very traditional and paper-based recordkeeping

methods, accessing landownership records is extremely difficult. Cadastral surveys are extremely costly and usually are conducted once every few decades. However, with the advancement in informational technology-led land surveys and record management systems, the applicability of land-based taxes can be a subject of the renewed academic attention. Where land management is information technology-enabled, land-based taxation can be used as an efficient and equitable source of revenue. The size and quality of agricultural landholdings can be the leading indicator of a presumptive agriculture income tax system.

Since the tax on agricultural lands supplies a negligible amount of revenue, it would be pragmatic to abolish the present form of agricultural land taxes and instead make it a part of a presumptive income tax which would be based on asset-based indicators such as size and quality of the land. Both the land and the presumptive income tax use the same tax bases but are classified and administered separately since they are two different taxes. The separate taxation of these two identical tax bases involves significant administrative costs for taxing bodies and compliance costs for taxpayers. Tax systems of developing countries should avoid employing separate administrations to collect tax from the same tax base. As a replacement of existing agricultural land, wealth and income tax, a single presumptive income tax based on a limited number of easily comprehensible indicators would be more effective for developing countries. Considering the administrative constraints and the troublesome characteristics of agricultural taxpayers, it would also act well to restrict the number of taxpayers that the tax administration must target for tax collection. Tax administrations collect a very small amount of tax revenue from marginal rural taxpayers; raising the threshold of the presumptive income tax to a reasonable level would not hurt the revenue objective.

Finally, the presumptive tax regime for rural small business should consider the core design issues discussed in Chapter 5. The design should be well-

grounded to the policy and administrative realities of a country. The threshold and norms should be based on objective analysis of the existing taxing environment. If possible, a small business tax regime should be implemented under a comprehensive reform. Such a reform may not appear as revenue-productive in the short term. However, in the medium to long run, a typical developing country with a large agriculture sector might be benefited in many ways, including a possible increase in revenue through better administration of the existing tax base.

## **CHAPTER 8**

# **CONCLUSIONS AND POLICY RECOMMENDATIONS**

### **8.1 Conclusions and Policy Recommendations**

Over eight chapters this thesis attempts to find an efficient tax policy and administrative arrangement for small businesses in developing countries. The analysis of this thesis suggests that for a typical developing country a well-constructed and simplified presumptive tax regime is the efficient means for taxing small businesses.

The thesis starts with an analysis of the prevailing taxation policy and administration of developing countries. Chapter 2 reports that developing countries historically collect an inadequate level of tax revenue. As external aids for filling budget deficits are becoming more expensive, developing countries are increasingly becoming more serious about raising tax revenue levels. Tax structures of developing countries rely heavily on indirect taxes. The role of PIT is extremely limited. Only a handful of individuals submit tax returns, and the contribution of PIT to total tax revenue is negligible. The limited role of PIT suggests that the tax systems are severely lacking in redistributive features. The noncompliance problem is particularly severe in the case of small businesses, the large majority operating outside the administrative reach of the tax administration.

Growing numbers have called for a wider application of consumption-based taxes. The indirect tax VAT is less expensive to administer than income tax, however, it is regressive in nature. The impact of VAT can have severe consequences in a predominantly non-redistributive tax system.<sup>812</sup>

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<sup>812</sup> Stiglitz, above n 39, 20.

Moreover, for developing countries VAT is hardly efficient, since it also lowers economic growth and employment.<sup>813</sup>

It is apparent that the prevailing major taxing instruments, such as income tax and VAT, are not efficiently working for taxing small businesses in developing countries. Income tax is too complex, and VAT is regressive. Many tax policies, therefore, are looking to adopt alternative means. In an attempt to simplify the tax system many countries have flattened the income tax rate structures. However, there is hardly any evidence that the application of a single rate has achieved any simplification or efficiency goals. The flat rate widely ignores certain crucial elements of simplification, such as the exclusion of certain taxpayers from tax filing requirements, and reduction of personal and business deduction provisions. This thesis argues that a developing country looking for a radical reform should look into the possibility of applying a cash flow tax with a single rate and a large threshold. A tax system might significantly reduce complexity if it eliminates the distinction between the revenue and the capital expenditure and can effectively exempt a fraction of small taxpayers from tax filing requirements. Analysing the policy and administrative dimensions of tax reforms in developing countries, Chapter 2 stresses that the taxation of small businesses should be an important element of the countries' future tax reforms.

This thesis also stresses that the tax policy of a developing country would be largely ineffective if it is not designed with careful consideration of the capacity and constraints of the tax administration. Developing countries still lack the administrative capabilities to administer certain ideal tax principles. An analysis of the overall policy environment and the administrative capacity of the tax administration suggest that developing countries need to concentrate more on efficiency and simplicity features than on equity and fairness principles.

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<sup>813</sup> Stiglitz, above n 39, 17.

Taxing small businesses is even more challenging. Compliance management of small businesses is extremely difficult. Some size-related characteristics, such as the size of business and the scale of operations, and some operational characteristics, such as the ability to transact in cash and the fewer regulatory obligations, enable small businesses to hide all or part of their economic activities from the regulatory authorities. Generally in developing countries small businesses supply an insignificant amount of tax revenue. From the other perspective, small businesses consider taxation to be a major impediment for their operation and growth. Taxation of small business is, apparently, an unpleasant issue for both the taxation authority and business owners. One of the main goals of this thesis is to find a solution where, through a small business tax regime, the taxation authority can achieve its revenue and non-revenue objectives without affecting the operations and growth of small businesses.

This thesis exhibits that small businesses encounter an unduly high compliance burden; it often exceeds the tax burden itself. At the same time, given the administrative costs involved, the net revenue collection from small businesses is often unimpressive. An effective reduction of the compliance burdens might be a common ground where both tax administrations and small firms can gain. Whether or not small businesses should receive preferential tax treatment is not a central issue. Rather, the point of focus should be how to design a tax system that effectively lowers the compliance cost burden of the small taxpayers and also attracts the vast majority of them to register and comply.

The analyses of Chapter 2 and Chapter 3 suggest that the standard income tax-based tax system is not suitable to address the core issues regarding taxation of small business. A carefully designed, simple and efficient presumptive taxation system might be more effective for taxing small businesses in developing countries. Chapter 3 also concludes that small businesses in developing countries have two distinct segments. Urban and

rural small businesses are considerably different in terms of business concentration, assets, size, transaction processes, production, employment, and compliance attitudes. An effective tax policy must identify the distinguishing characteristics between them and be tailored accordingly for each.

Small businesses are the key operators of the shadow economy in developing countries. The extent of shadow economic involvement of small businesses suggests that a small business taxation policy can only be considered as effective if it can efficiently tax the shadow economy. This thesis examines the size, nature and socioeconomic impact of shadow economy. Taxation is identified as a major contributing factor to the growth of a shadow economy. A prominent section of tax compliance literature suggests that a taxpayer is more likely to evade tax if he or she perceives that the probability of successful evasion is considerably higher than the probability of being caught, or alternatively if the reward from successful evasion is considerably higher than the punishment for evasion.<sup>814</sup> However, this thesis holds that in developing countries the small business tax compliance environment is quite different to that of developed countries. In a developing country a typical small business does not encounter a significant tax burden, thus the perceived rewards from evasion are not very big. Moreover, the administrative capacity of the tax authorities is mostly weak, and the probability of detection often negligible; thus, the cost of evasion is very low. A compliance model broadly based on carrot-and-stick propositions might not work effectively in a typical developing country tax environment. The existing literature that investigates causes, consequences and extent of tax evasion are conducted mostly in developed countries' socioeconomic contexts. These standard models and theories might not be adequate to explain the tax noncompliance in developing countries. Chapter 4 attempts to prepare a broad outline of the typical small business tax compliance environment in developing countries. The analysis concludes

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<sup>814</sup> See, eg, Allingham and Sandmo, above n 41.

that a tax system that broadly follows the expected utility models for compliance management is not efficient for taxing the shadow economy in developing countries. A simple to follow tax system requiring a low level of compliance burden might be more appealing to a certain section of small taxpayers.

Chapter 5 analyses the theories and the applications of presumptive methods. It classifies existing presumptive tax methods based on the economic bases it uses, and then analyses the relative merit of each type. These analyses suggest that asset-based presumptive taxation is most efficient to tax agricultural income of rural small businesses while turnover-based presumptive methods are more efficient to tax urban ones. The analysis of the policy and administrative aspects of different multiple indicator-based presumptive tax methods, such as *forfait*, *tachshiv* and *Studi di Settore*, suggest that these methods are only suitable for a developing country which has strong institutional capabilities, including an information technology-enabled tax administration.

The Chapter discusses certain design issues and stresses that developing countries should carefully and objectively consider such issues when designing a tax policy. Firstly, a presumptive tax regime should avoid over inclusion of the HTT. Secondly, the right set of indicators should be selected, and the tax rates and norms should be determined based on surveys and objective evidence, and should be updated periodically. Thirdly, non-rebuttable taxation is unfair, though while designing a small business tax regime simplicity should be the core principle to follow, rather than equity. On the organisational side of things, the thesis argues in favour of an arrangement where a presumptive regime is administrated by a designated STO-type administration.

Chapter 5 also examines the application of presumptive taxes in four developing countries. The examination of these cases highlights that

presumptive methods are adopted arbitrarily across developing countries. In most cases there is no evidence of a proper consideration of many crucial design issues. In Bangladesh and Pakistan the application of presumptive provisions is random and uncoordinated. In both the countries implicit presumptive provisions assume a much greater role than explicit ones. Conversely, the scope of the simplified tax system of Ukraine is clearly and explicitly defined. However, the overall system is overly complex due to the coexistence of a number of concurrent, uncoordinated and often overlapping simplified tax regimes. The Tanzanian small business tax regime is also explicit and well specified, yet it covers only a narrow tax base. Both Tanzania and Ukraine have demonstrated impressive success in increasing the number of registered taxpayers. However, it is not clear whether the presumptive regimes effectively reduce the administration costs of the authority and the compliance costs of the taxpayers. Overall, it is apparent that a typical developing country is likely to benefit from presumptive taxes if the presumptive regime is explicit and unambiguous, the indicators are chosen properly, the threshold is well targeted and rational, the administration requires less monitoring, the system is simple to follow and less costly to comply with, and the presumptive regime is well coordinated with the overall tax system.

This thesis attempts to establish that the small business tax regime should have two set of presumptive instruments in order to make an efficient estimate of the economic activities of both rural and urban small businesses. Chapter 6 aims at finding an efficient taxing system for urban small businesses, while Chapter 7 deals with the taxation of rural small taxpayers. Chapter 6 identifies a set of distinguishing features of urban small businesses that make them different from their rural counterparts. This thesis holds that a small business tax regime that targets urban small taxpayers should concentrate on these differentiating features.

This chapter demonstrates that a typical developing country tax administration should be concerned about both the taxable but unregistered small taxpayers and the registered but non-compliant ones. It recommends that a simplified tax regime based on turnover as a leading indicator is most effective for dealing with urban taxpayers. Formalization should be an important element of policy regarding the taxation of the urban small businesses. A significant number of small businesses in developing countries are ignorant about tax obligations, the steps required for registering, and the crucial benefits that a formal business typically enjoys. Hiding in informality is not costless; in addition to the costs, informality prohibits firms from enjoying several crucial rights and benefits. If the tax authority can properly educate the taxpayers about the benefits of formalization, and the tax regime is widely perceived as being simple to follow, a section of small businesses operating in the informal sector might consider embracing formality. If a tax system lacks the capacity to manage the overwhelming number of registered and unregistered non-complying small businesses a turnover based presumptive tax that imposes lower compliance obligations is a better approach to tax the urban small businesses. Further, an urban small business tax regime should promote a greater use of banking channels, provide incentives for new entrants, put more emphasis on tax education, and establish a dedicated administrative unit that handles the taxation of urban small taxpayers.

Consistent with the findings of Chapter 3, Chapter 4 and Chapter 6, Chapter 7 puts forward the argument that rural small businesses are different in several ways, and the taxing strategies towards them should be different. Most rural small businesses in developing countries are directly or indirectly linked to the agricultural sector. The agricultural sector is widely regarded as hard to tax, and developing countries generally collect little tax revenue from it. The presence of a large agricultural sector is a negative influence on the tax effort of a developing country. This thesis argues that the inherent difficult-to-tax attributes of the agriculture sector are not only to blame for

the meagre tax collection from agricultural income, however. Rather, the absence of a clear and unambiguous tax policy towards agricultural income is also an important factor. Over the last few decades the overall tax burden on agricultural income has reduced significantly. The analysis of this chapter suggests that a developing country with a large agriculture sector should not ignore the sector's tax potential.

Asset-based presumptions should be used for taxing rural small businesses. Under asset-based presumptive taxation the burden of taxation falls upon the landowner, so the imposition of this tax does not have a direct effect on the prices of agricultural output. However, the success of land taxation largely depends on the updated land ownership records. In most developing countries land records are paper-based, and the land ownership is extremely difficult to ascertain. Cadastral surveys are extremely costly and are administered once in several decades. However, this thesis argues that land area-based presumption should be subject of renewed policy attention, since many developing countries are moving towards the adaptation of the electronic land management systems. In a developing country where land management is information technology-enabled, a land-based taxation on agricultural income would be a more equitable source of tax revenue. This thesis holds that a presumptive income tax that uses the size and quality of the landholdings can be an equitable and efficient mode of taxation of agricultural income. Since the existing agricultural land tax supplies a negligible amount of revenue, it would be reasonable to abolish the agricultural land taxes and replace it fully. Both the land tax and the presumptive income tax use the same tax base but they are classified and administered separately since they are two different taxes. This comes with unnecessary additional administrative costs. Moreover, it imposes significant extra compliance cost burdens on the taxpayers. As a replacement of the existing agricultural land, wealth and income tax, a single presumptive income tax that employs a limited number of easily

comprehensible indicators would be more effective to tax agricultural income in developing countries.

Lastly, this thesis emphasises that a small business tax regime should be designed or implemented under a systematic and comprehensive reform. A reform can deliver a meaningful outcome only if it is supported by clear commitments from political stakeholders. Such a reform may not appear as revenue-productive in a short run. However, in medium to long run, a typical developing country would be benefited in many ways by having the ability to collect an increased amount of revenue from a more efficient administration of the existing tax base.

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## APPENDIX

**Table: Full list of 49 developing countries**

<b>Country</b>	<b>Abbreviation</b>
Armenia	ARM
Bangladesh	BAN
Benin	BEN
Bolivia	BOL
Burkina Faso	BUR
Cambodia	CAM
Cameroon	CMN
China	CHI
Congo, Rep.	CON
Cote d'Ivoire	COT
Egypt, Arab Rep.	EGY
El Salvador	ELS
Georgia	GEO
Ghana	GHA
Guatemala	GUA
Honduras	HON
India	IND
Indonesia	INA
Jamaica	JAM
Jordan	JOR
Kenya	KEN
Kyrgyz Republic	KYR
Lao PDR	LAO
Lesotho	LES
Madagascar	MAD
Mali	MAL
Moldova	MOL
Mongolia	MON
Morocco	MOR
Nepal	NEP
Nicaragua	NIC
Pakistan	PAK
Papua New Guinea	PAP
Paraguay	PAR

Philippines	PHI
Senegal	SEN
Sri Lanka	SRI
Sudan	SUD
Swaziland	SWA
Syrian Arab Republic	SYR
Tajikistan	TAJ
Thailand	THA
Turkmenistan	TUR
Uganda	UGA
Ukraine	UKR
Uzbekistan	UZB
Vietnam	VIE
Yemen, Rep.	YEM
Zambia	ZAM