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Proposals for Further Improvement of the System of Presumptive Income Taxation of Individual Entrepreneurs in Belarus

Summary

Presumptive income taxation is used to combat tax evasion by those taxpayers who lack the financial transparency. Provided the scarce administrative resources, governments have to assess or presume their actual income and assign the appropriate amount of tax. In many countries, these specific groups of taxpayers generally comprise individual entrepreneurs without a legal entity. This is also the case in Belarus.

The Belarusian system of presumptive income taxation of individual entrepreneurs has several advantages. First, it reduces tax evasion and hence leads to a more equitable distribution of the tax burden. Second, it leads to simplification of taxation by reducing the compliance burden for individual entrepreneurs and the corresponding cost of enforcement by tax authorities. Third, it represents a stable source of the government tax revenue. Besides, the existing system broadens the tax base with limited disincentives to earn income. It is administratively simple and closed to corruption. We estimate this system as quite positive. But there is some room for further improvement.

In our view, the following should be done. First, it is necessary to abolish the limitation on the number of physical persons that individual entrepreneurs can employ. Instead, another definition of individual entrepreneurs that are eligible for presumptive income taxation – the VAT threshold – should be introduced. Second, it is necessary to abolish the increased multiplier to the established tax rates in the case of sale of imported goods. Third, the multiplier for startups could be differentiated. Fourth, the issues of adequate differentiation of the tax rates and their level should be subject to consultations between regional governments and business community. According to our estimations, these measures would allow to make the existing system of presumptive income taxation more efficient and equitable, which would have a positive impact on small business development.

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1. Introduction

Presumptive income taxation is employed primarily in economies where specific groups of taxpayers are hard to tax and administrative resources are scarce. These groups of taxpayers lack the financial transparency that allows for effective taxation by the government. The result is that the government assesses or presumes the appropriate income on which taxes should be levied. Presumptive income taxation is considered as an optimal method of curbing widespread non-compliance without employing excessive government resources. At the same time, it provides taxpayers with a simplified option for tax compliance without requiring full financial transparency.

In many countries, these specific groups of taxpayers generally comprise small businesses. The following factors contribute to their being hard to tax: (i) the number of small businesses is great, making it impossible to intensively scrutinize more than a small fraction of them; (ii) their income is small; (iii) they are not compelled by business (i.e. nontax) reasons to keep adequate books of account; (iv) they sell largely to the population for cash so that application of tax withholding to collect their income is not practicable. In part due to the above factors, they can easily conceal their income. Complicated and administratively burdensome tax systems further discourage their compliance with the tax rules. As a result, the tax amounts from this group of taxpayers are quite low compared with the administrative costs that would have to be incurred by the government to assess the proper amount of tax. All of this has led many countries to adopt presumptive income taxation. Belarus also introduced presumptive income taxation of small businesses (individual entrepreneurs without a legal entity). At present, it applies according to the Decree of the President from January 27, 2003 No. 4 "On Single Tax From Individual Entrepreneurs and Other Physical Persons and on Some Measures on Regulation of Entrepreneurial Activity".

The purpose of this paper is to evaluate the existing system of presumptive income taxation and provide some policy recommendations aimed at creation of a favorable environment for small business development. The structure of the paper is as follows. First, the paper considers the concept and possible options of presumptive income taxation. Then, it analyses the existing system of presumptive income taxation of individual entrepreneurs in Belarus and determines main directions of the reform. The paper concludes with policy recommendations.

2. Concept and Possible Options of Presumptive Income Taxation

The term "presumption" means that there is a legal presumption that the taxpayer's actual income is no less than the amount resulting from the application of indirect methods. Presumptive income taxation involves the application of indirect methods to determine tax liability that differ from the regular rules based on the taxpayer's accounts. This works only if the indicators on which the presumption is based are more difficult to hide than those forming the basis for accounting records. The concept covers a wide variety of alternative indicators of determining the tax base. These might be region, industry, gross turnover, number of employees, size of a firm, assets of a taxpayer, etc.

2.1. Types of Presumptive Income Taxation

There are some types of presumptive income taxation that have quite different incentive effects, revenue effects, distributional consequences, and administration costs. These types are the following.

2.1.1. Rebuttable and Irrebuttable Taxation

Presumptive income taxation can be rebuttable and irrebuttable. Rebuttable taxation is one that can be appealed by the taxpayer through proving that his actual income, calculated under the regular rules, was less than that calculated under the presumption. By contrast, irrebuttable taxation cannot be appealed. As a result, rebuttable taxation can encourage taxpayers to keep proper accounts, because they subject taxpayers to a possibly higher tax liability in the absence of such accounts. However, this type of taxation is not used in relation to small businesses. Rebuttable presumptions (typically, based on the visible signs of wealth) generally apply to wealthy individuals to ensure that they pay an appropriate amount of tax.

2.1.2. Exclusive and Minimum Taxation

Irrebuttable taxation can be divided into two types: exclusive taxation, where tax liability is determined under the presumption alone, even if the regular rules might lead to a higher liability, and minimum taxation, where tax liability is no less than that determined under the presumptive rules. The latter type of taxation is also not designed to facilitate compliance and enforcement for small businesses. It is used to reduce tax evasion for all taxpayers by imposing a minimum level of tax (typically, based on the value of gross assets or gross turnover).

Exclusive presumptions have less administration costs than presumptions of the minimum tax type, because minimum tax presumptions require two tax bases to be calculated and compared. At the same time, exclusive presumptions may suffer from a lack of equity. Taxpayers with substantially differing amounts of actual income have to pay the same amount of tax if their presumptive tax base is the same.

The incentive effects of exclusive presumptions differ substantially from those of the income tax. Because of the independence of tax liability on the actual income, exclusive presumptions create no disincentives to earn income. Rather, the incentive effects of the tax will depend on the factors used to determine the presumptive income. These incentive effects will be minimal when the factors on which the presumption is based are in inelastic supply. In fact, exclusive presumptions aren't an income tax at all, but are a tax on whatever is used to determine the presumption.

2.1.3. Formal and Discretionary Taxation

Presumptive income taxation can also be divided into formal and discretionary taxation. Formal taxation means determination of tax liability according to the established rules. By contrast, discretionary taxation assumes a high degree of tax authorities' discretion while determining tax liability. Hence, it appears that formal presumptions are less open to corruption and administratively simpler. But formal presumptions are considered as less equitable because they don't take into account taxpayer-specific conditions.

2.2. Methods of Presumptive Income Taxation

Countries that employ presumptive taxation have developed various methods of estimating income and assessing tax liability. Selected examples of these methods are described below.

2.2.1. Standard Assessment Method

Standard assessments assign the fixed amount of taxes to taxpayers on the basis of occupation or business activity. The payments are established by determining the average taxable income of a few taxpayers selected at random. Average income is income that could be earned by taxpayers who worked an average number of hours, put forth an average level of effort, took average risk, and used an average technology of the time period. A slightly more refined alternative is to use a more complex approach that is based on a number of factors. As a rule, standard assessments are irrebuttable, exclusive, and formal.

The *tachshiv* of Israel is widely referred as the most elaborated standard assessment method. The *tachshiv* employed the objective indicators to estimate the income of taxpayers for a variety of industries. The *tachshiv* for each industry was prepared, often over several years, after extensive research and many visits to a sample of businesses. The average profitability of a particular industry and its relationship to the specific indicators were discussed with representatives of the industry before the official *tachshiv* was issued. Examples of the indicators employed included location, seating capacity (for restaurants), number of employees, skill level of employees (for carpenter's workshops or garages), type of equipment used (for truck and taxi drivers), and water consumption (for ice-producing companies).

2.2.2. Estimated Assessment Method

In this assessment method, each taxpayer's income is individually estimated based on the indicators specific to a given occupation or business activity. This method employs a variety of techniques to derive taxpayer's income, both simple and complex. Simple techniques are based on the single indicators such as the value of gross assets or gross turnover. Complex techniques use various indicators of profitability that can range from location of property to

number of skilled employees to seating capacity. Unlike standard assessments, estimated assessments can be rebuttable or irrebuttable, minimum or exclusive, and discretionary.

The *forfait* (contractual method) of France is recognized as the most elaborated estimated assessment method. Its application is based on advance agreement between the taxpayer and the tax authorities to base tax liability on estimated income instead of on actual income. The taxpayer supplies the following information to the tax authorities (with respect to the preceding year): purchases, sales, value of closing inventory, number of employees, amount of wages paid, and number of cars owned. The tax authorities calculate income based on a sophisticated and detailed estimation procedure, by industry. Once the tax authorities supply its estimated income, it is then subject to agreement with the taxpayer. The agreed figure applies for two years, that is, the preceding year and the current year. It may be different for each of these years, and the figure for the second year may be extended for one or several successive one-year periods.

3. Existing System of Presumptive Income Taxation of Individual Entrepreneurs in Belarus

In Belarus, presumptive income taxation is mandatory for individual entrepreneurs without a legal entity carrying out the following types of business activity: (i) retail trade in the shops with trading area less than 15 square meters, coffee bars, stands, etc.; (ii) public catering through the objects of small-scale retail trade network; (iii) maintenance and repair of automobiles; (iv) transportation services; (v) personal services, and some other. In order to reduce the opportunities for tax avoidance by legal entities, eligible individual entrepreneurs should sell goods and services to physical persons only. Moreover, citizens can carry on business as individual entrepreneurs without a legal entity if they employ no more than 3 physical persons. Otherwise, they are obliged to register as a legal entity and pay taxes according to the regular system.

The presumptive income tax rates are based on the type of business activity. The range of the basic rates is set by the central government in Euros (see Table 1). That is the standard assessment method applies. The fixed amounts of the tax are irrebuttable, exclusive, and formal.

Table 1. Selected Basic Rates of the Presumptive Income Tax

Type of Business Activity	Monthly Tax Rate, EUR
Retail trade of:	
- beer	50-150
- bread, milk, vegetables, and fruits	15-145
- TVs, videotape recorders, household appliances	50-150
- vehicles	60-180
Public catering through the objects of small-scale retail trade network (except for sale of alcoholic beverages)	25-75
Public catering through the objects of small-scale retail trade network (including sale of alcoholic beverages)	80-240
Maintenance and repair of automobiles	45-130
Passenger transportation services within Belarus	20-100
Construction services	20-60
Educational services	20-60
Medical services	20-100
Real estate activities	75-250
Tourist services	150-300

The specific tax rates within the range are established by regional governments depending on the local conditions and peculiarities of business activity. These conditions and peculiarities are type of locality, place of business activity within a given locality, mode of operation, type of trading facilities, and others.

There are also some multipliers applicable to the established specific tax rates. These are as follows:

(a) Reduced multipliers:

- 0.75 – for physical persons that are registered as individual entrepreneurs without a legal entity for the first time (for three months since the day of state registration);

- 0.8 – for individual entrepreneurs that are retired or disabled;
- 0.3, 0.5, and 0.8 – for individual entrepreneurs who sold goods for less than 5 days, 5-10 days, and 11-14 days per month correspondingly (except for sale of goods in shops).

(b) Increased multipliers:

- 1.5, 2.0, and 2.5 – for individual entrepreneurs who sell goods in the trading facilities with total trading area 25-60 square meters, 60-90 square meters, and over 90 square meters correspondingly¹;
- 1.6 – for individual entrepreneurs who employ physical persons (including physical persons who exercise the functions of management, accounting, auditing, etc.)²;
- 1.5 – for individual entrepreneurs who sell imported goods (except for excisable goods) irrespective of their share in the trade assortment.

Furthermore, the established tax rates can be readjusted in the case of temporary disability of individual entrepreneurs or their employees, temporary stoppage of business activity, etc.

As noted earlier, the purpose of presumptive income taxation is to provide alternative methods of assessing actual income of the taxpayers who don't keep adequate books of account. Therefore, the presumptive income tax replaces those taxes that are based on books of account. In Belarus, these taxes are: (i) personal income tax; (ii) value-added tax; (iii) tax on the use of natural resources; and (iv) local taxes and duties (see Table 2).

**Table 2. Taxes and Nontax Payments
Under the Existing System of Presumptive Income Taxation**

Taxes and Nontax Payments	Yes/No
Mixed taxes and nontax payments	
Land tax	yes
Tax on the use of natural resources (within the established limits)	no
Contributions to the State Employment Fund	yes
Contributions to the Social Protection Fund	yes
Direct taxes and nontax payments	
Real estate tax	yes
Personal income tax	no
Tax on the use of natural resources (over the established limits)	no
Tax on the acquisition of motor vehicles	yes
State fees	yes
License and registration fees	yes
Local taxes and duties	no
Indirect taxes and nontax payments	
Value-added tax	no
Excises	yes
Custom payments	yes
Local taxes	no

The existing system of presumptive income taxation relies on self-assessment of taxpayers. Taxpayers are required to declare the base of their assessment to submit a calculation of the tax and to accompany this calculation with payment of the presumptive amount. The role of tax authorities is to check that taxpayers have correctly calculated the tax.

The presumptive income tax is paid in monthly advance payments in Belarusian Rubles at the BYR-EUR exchange rate of the National Bank of Belarus. The tax comes to regional budgets.

4. Evaluation of the Existing System of Presumptive Income Taxation

In general, presumptive income taxation has several advantages. First, this type of taxation reduces tax evasion by individual entrepreneurs. Their income is no longer assessed from accounting records but from indirect indicators such as type of business activity, number of employees, etc. This approach to estimating income on which the tax is levied removes the administrative burden of financial transparency traditionally required for compliance. Second, it leads to a more equitable distribution of the tax burden. It is generally accepted that wages

¹ In the case of sale of goods in several trading facilities, the presumptive income tax is paid for every one of them.

² 60% of the amount of tax is paid for every physical person employed (except for retail trade).

paid by legal entities are taxed more effectively than income earned by individual entrepreneurs due to the introduction of withholding taxes at source. The presumption reduces tax evasion and hence brings more taxpayers into the tax net. As a result, the perceived fairness of the tax system increases. Third, presumptive income taxation leads to simplification of taxation by reducing the compliance burden for individual entrepreneurs and the corresponding cost of enforcement by tax authorities. Fourth, presumptive income taxes are a stable source of the government tax revenue due to the fact that the amount of taxes doesn't depend on actual outcomes of individual entrepreneurs' performance.

The Belarusian system of presumptive income taxation of individual entrepreneurs based on the standard assessment method has additional advantages. First of all, standard assessments have shown to broaden the tax base with limited disincentives to earn income. In the short-run, they can entice individual entrepreneurs into the tax net by providing incentives rewarding efficiency. Taxation based on average income allows taxpayers to retain some profit without being taxed. Furthermore, standard assessments are the most adequate method of taxation of small businesses like individual entrepreneurs without a legal entity. This method implies low administrative costs and less open to corruption. The estimated assessment method would make the presumption just harder to keep transparent and simple and would give a lot of room to political bargaining which would definitely not make it more equitable.

However, the existing system of presumptive income taxation has also several disadvantages. These are as follows.

(i) The fixed amount of taxes doesn't depend on actual outcomes of individual entrepreneurs' performance. As a result, there may be disincentives to earn income in the sense that the presumptive income taxation is an entry barrier. It may deter people from starting a business when they think that the tax is so high that they have little chance to make a profit at all. For the same reason it may force people out of business who make too little profit.

(ii) There are no possibilities to carry losses forward. The presumptive income tax doesn't take into account taxpayer-specific conditions, such as losses in a particular year. This has a negative impact on risk investments.

(iii) The presumption based on the standard assessment method treats equally all individual entrepreneurs within a given category, regardless of their actual income. As a result, it can be regressive by imposing equal tax on individual entrepreneurs in the same category with different income. This leads to violation of the principle of tax equity.

It should be noted that these disadvantages are an inherent feature of presumption in general. It is impossible to remove them. In a certain degree, they can just be alleviated. At the same time, there are some additional disadvantages that are specific for the Belarusian system of presumptive income taxation. These are the following:

(iv) There is an unjustified limitation on the number of physical persons that individual entrepreneurs can employ. This limitation means that individual entrepreneurs who employ more than 3 physical persons are obliged to register as a legal entity and hence use the regular system of taxation. However, the choice of legal status of business should be made by individual entrepreneurs themselves and shouldn't be determined by legislation. Otherwise, this limitation would lead to business split-up.

(v) There is an unjustified increased multiplier to the established tax rates in the case of sale of imported goods (except for excisable goods) irrespective of their share in the trade assortment. In fact, this multiplier is used for protection of national producers what can be particular relevant for transition economies. But such protection should be realized through import duties and other measures of foreign-trade policy. Income taxation shouldn't have any concern with this. Furthermore, legal entities don't face this limitation that leads to unfair competition between small businesses and large enterprises and also violates the principle of tax equity.

(vi) The tax rates are inadequately differentiated by regional governments. As noted earlier, regional governments establish the specific tax rates within the basic tax rates depending on the local conditions and peculiarities of business activity. Some regional governments allowed for several of them (see Table 3). At the same time, they didn't allow for such conditions and peculiarities as place of business activity within a given locality, mode of operation, and some other. In Minsk, there is no differentiation of the tax rates at all. But these conditions and peculiarities have a significant impact on the profitability of individual entrepreneurs. Moreover,

some regional governments established as high as possible tax rates. In Minsk, the maximum tax rates are established for 70% of business activities. As a result, the tax burden on all individual entrepreneurs increased.

Table 3. Differentiation of the Tax Rates by Regional Governments

Region	Differentiation				
	on the type of locality	on the place of business activity	on the mode of operation	on the type of trading facilities	on other conditions
Minsk	–	no	no	no	no
Brest Region	yes	no	no	yes	no
Gomel Region	yes	no	yes	no	no
Grodno Region	yes	no	no	no	no
Minsk Region	yes	no	no	yes	no
Mogilev Region	yes	no	no	yes	no
Vitebsk Region	yes	no	no	yes	no

(vii) The tax rates aren't adjusted according to inflation. But it is important to understand that standard assessments can be a poor revenue-mobilizing method of taxation unless the fixed payments are indexed to inflation. At present, the tax rates are set in Euros. However, the fluctuations of the exchange rate not always correspond to the inflation rates. As a result, there can be changes of the tax burden irrespective of inflation. For example, in January-August 2004, the inflation rate amounted to 8.9% and the Euro lost 1.6% of its value to the Belarusian Ruble. Thus, the government tax revenue in real terms decreased by 10.5%.³

5. Conclusions and Policy Recommendations

In general, we consider the existing system of presumptive income taxation of individual entrepreneurs in Belarus as quite positive. But there is some room for further improvement. In our view, the following should be done.

(i) It is necessary to abolish the limitation on the number of physical persons that individual entrepreneurs can employ. Instead, another definition of individual entrepreneurs that are eligible for presumptive income taxation should be introduced. This definition is based on the ability of taxpayers to maintain records. The presumptive income taxation should be mandatory only for those who are not really in a position to keep books of accounts at all. Thus, it is reasonable to introduce such a limitation as the VAT threshold. In principle, very few registered VAT taxpayers are considered as hard-to-tax. This is because of the extensive record-keeping and invoicing that these taxpayers by definition have to undertake, under heavy penalties for noncompliance. This means that as soon as an individual entrepreneur reaches the three successive month's gross turnover of EUR 40,000 he would have to change to the regular (or simplified) system of taxation, whatever the number of employees.

(ii) The increased multiplier to the established tax rates in the case of sale of imported goods (except for excisable goods) irrespective of their share in the trade assortment should also be abolished. This would allow to make the existing system more neutral.

(iii) The multiplier for start-ups could be differentiated as follows: 0.25 – for the first month, 0.5 – for the second month, and 0.75 – for the third month. This would allow to develop business by physical persons who are registered as individual entrepreneurs for the first time because the state registration doesn't imply the beginning of business activity.

(iv) In order to make an adequate differentiation of the tax rates and establish an adequate level of the tax rates, these issues should be subject to consultations between regional governments and business community, as was the case in Israel. This would allow to make taxation more equal and in a certain degree avoid the above mentioned disadvantages of presumptive income taxation in general.

(v) Because no one proxy of inflation is perfect, we propose to introduce a special tax amount that should be indexed according to inflation and set the tax rates in these amounts (as is the

³ The other proxies of inflation are also imperfect. In January-August 2004, the value of the US Dollar increased by 0.6%. At the same time, the base amount increased by 15.2%. Thus, using the base amount would result in even higher increases in the tax burden in local currency.

case in Chile⁴). The Ministry on Taxes and Duties can publish indices of this amount on the basis of the data of the Ministry of Statistics and Analysis that eliminates a necessity to revise the appropriate legislation every month. However, it should be noted that this problem is broader. It concerns the whole tax legislation that makes it more difficult.

According to our estimations, these measures would allow to make presumptive income taxation more efficient and equitable, which would have a positive impact on small business development.

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Minsk, September 2004

⁴ The base amount can be considered as an analogue of the special tax amount in Chile. However, this analogy is imperfect. First, the base amount isn't indexed according to inflation, but revised periodically. Second, the base amount is used not only for tax purposes. Its revision leads also to changes in the government expenditures.