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Tax Administration and the Small Taxpayer

Parthasarathi Shome

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Prepared by Parthasarathi Shome[1]

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Abstract

Small taxpayers should pay their appropriate revenue share while their compliance costs should be reduced. This assumes importance as restructuring in emerging markets has meant rapid growth in services through self-employed small entrepreneurs, who have good revenue potential. Administrative facilitators such as a single tax covering income tax, VAT, and social security tax, at a reduced rate, do not lower tax evasion. They increase vertical and horizontal inequity, and lead to adverse resource allocation. A strategy is needed, extending modernization achieved in large taxpayer units (LTUs) to small taxpayers, including rationalization of collection and reporting of revenue data for policy formulation.

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Author's E-Mail Address: pshome@imf.org

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I. Introduction

It is commonly argued that small taxpayers pose a problem for tax administration. In fact, tax administrations, by and large, favor the view that, given the high proportion of revenue intake from large taxpayers, it is beneficial to set up large taxpayer units (LTU). Indeed, LTUs are so popular among advisors on tax administration policy that, without an LTU, a tax administration is unlikely to be called modern.

The flip side of buttressing this argument is that small taxpayers cannot be expected to pay tax on the basis of a complex tax structure and that a simplified tax regime needs to be set up for them. This is the genesis of the idea of a “single tax,” or *impuesto único*, or *monotributo*, that emerged mainly in Latin America, though the idea has certainly not been confined to this part of the world alone. Within such a framework, small taxpayers would have to pay only one tax, combined from various taxes that larger taxpayers would have to pay separately. On the basis of the introduction of such a composite tax, many tax administrators have argued that tax evasion among small taxpayers has gone down.

However, the argument that tax evasion by small taxpayers has gone down is obtained by definition since the simplified regimes tend to require less revenue from them compared to their revenue potential. Thus, while the importance of the role of LTUs cannot be minimized, care has to be taken that a focus on large taxpayers is extended to the others, including small taxpayers, because: (1) it is likely that it would improve the equity, efficiency, and revenue objectives of the tax system as a whole; and (2) it makes sense to allocate administrative resources to all groups of taxpayers keeping in mind the revenue that can potentially be collected from them.

The objective of simplification of the tax statute, though worthwhile in itself, tends to be comingled with the issue of administrative separation of large, medium, and small taxpayers. Usually, the same tax structure applies to large and medium. It is for the small taxpayer, in particular, that an altogether different structure is often applicable in the form of a single tax for administrative convenience. Optimal economic theory would question such separation because that would lead to distortions in economic decision making for production and consumption. And the essence of tax theory is that tax structure and practice should be carried out with minimum economic distortions.

Further, it is reality that the importance of revenue collection cannot be minimized. For example, recently, Keen and Mintz (2004) have pointed towards the opportunity costs associated with raising a small taxpayer threshold. On the one hand, there is revenue loss when the small taxpayer threshold is raised. On the other hand, there is higher output from producers at the margin who can expand production while staying under a newly raised threshold. An essential question that emerges is to what extent a revenue goal set by administrative instruments, albeit subject to resource constraints, should preserve close conformity with the original intentions of tax policy design. In the final analysis, the need for designing tax administration tools that are in accordance with the overall purpose, scope, and objective of tax policy must remain intact.

There are two reasons why small taxpayers must be appropriately taxed. First, their potential tax contribution in combination with that of medium-sized taxpayers, can be quite large, perhaps over a quarter of total revenue. Only a small portion of the small taxpayer share may be actually collected, however. In an environment in which many countries are suffering from persistent fiscal deficits exacerbating macroeconomic problems, potential revenue needs to be meaningfully targeted for collection in a definitive manner. Indeed, some growing economies have experienced difficulties in maintaining their 1990s tax/GDP ratios, reflecting a rapid growth in the small and micro business sector and its inadequate harnessing for taxation. In turn, this has meant a rapid growth of the informal economy. These economies are now under intense pressure not to lose the tax base that they had already achieved but have been losing recently. With a changing sectoral composition of GDP, however, habitual payment of taxes in the new growth areas is important if the earlier tax/GDP ratios are to be recouped. And the small business sector lies at the heart of this issue.

The second reason why small taxpayers must be appropriately taxed is that the effect of ignoring a large amount of potential tax revenue from particular sectors is likely to be strong for the dynamics of economic growth. The impact on marginal decisions to save and invest can be quite high as a result of this separation of taxpayer size, especially if the small size category allows a high number to be included in it. It is likely to result in a faster growth of the smaller at the expense of the larger enterprise sector, not in reflection of optimal economic decision making, but mainly because of the impetus or exacerbation effect of taxation's focus on the latter. The final outcome may be a sectoral mix determined in a nonneutral fashion by tax practices in contrast to the original intention of the tax structure.

It is not a contention that small taxpayers are a problem, in particular, because it is difficult to collect the traditional combination of taxes from them; hence the typical tax regime for small taxpayers may have to be modified. In what follows, familiar descriptions of special schemes constructed for small taxpayers are not traversed except to provide illustrative examples. Instead, particular relevant issues regarding the role, scope, and effects of special small taxpayer regimes are presented. Therefore, the problem, as perceived, of the phenomenon of the small taxpayer is first described. Second, some of the anomalies that are faced when we attempt to define a small taxpayer are identified. Third, a selective list of small taxpayer treatments is provided, which may be acceptable in the short- to medium-term as a tax administration instrument. Finally, the main thrusts of this paper are summarized in the conclusion.

The issues raised in this paper apply more directly to developing countries, where much revenue tends to be collected from large taxpayers (hence the case for LTUs). The critical mass of medium taxpayers may remain relatively small, while small taxpayers may be a good potential source of collectible revenue. In developed countries, however, most revenue is collected from medium-sized taxpayers (the fat tails of the income and wealth distributions get thinner with economic growth). The issues addressed in this paper, therefore, relate mainly to the small taxpayer, in particular, in developing countries, with lessons drawn also from the experiences of more developed countries.

II. The Small Taxpayer: What is the Problem?

Public perception of small businesses can be said to have changed considerably over the last decades. From the 1950s to the 1970s, they were perceived as marginal to the mainstream of economic activity, and were typically cast as habitual tax avoiders and evaders. By the early 1980s, however, as the services sector took off and represented a higher and growing proportion of GDP in many countries, it was small firms that accounted for much of this growth, creating employment and efficient utilization of capital along the way. While they are increasingly seen as engines of economic growth, many tax policy researchers believe that compliance costs for tax payment by small taxpayers are quite high. It is not, therefore, their habit but rather, the complex tax structure as well as the scarce resources the tax administration invests in them. Relatedly, these factors tend to lead to high compliance costs that might, in turn, result in a pattern of behavior of tax avoidance or evasion.

This aspect has assumed greater importance as rapidly growing, large developing countries such as Brazil, India, and, to some extent, China, experience impressive growth in their service sectors (Table 1) as in the developed countries of the European Union and the United States. And the growth is represented significantly by small entrepreneurs, contributing to the dynamism in the recently experienced economic growth. Thus, first, the small taxpayer would benefit from tax simplification and, second, to the extent feasible, he cannot and should not be assigned a secondary role in the generation of tax revenue given his potential taxability. He has to be placed within an appropriately designed framework that assigns comparable administrative resources to potential tax collection from this group.

Table 1. Selected Countries: Percentage Composition of GDP
(1985-2000)

	Agriculture				Industry				Services, etc.			
	1985	1990	1995	2000	1985	1990	1995	2000	1985	1990	1995	2000
Brazil	11.54	8.10	9.01	7.38	45.31	38.69	36.67	28.29	43.15	53.21	54.32	64.33
China	28.35	27.05	20.51	15.90	43.13	41.61	48.80	50.88	28.52	31.34	30.69	33.22
India	33.72	31.27	28.24	24.90	26.40	27.64	28.12	26.92	39.88	41.10	43.64	48.18

Source: World Bank, World Development Indicators (2003).

If this is not done, tax practices cannot be seen to be keeping up with the direction of macroeconomic indicators. Thus, for example, if the small services sector is viewed as an engine of economic growth, then this sector has to be successfully targeted for revenue intake and has to be assimilated as quickly as possible within the overall tax administration framework, rather than being subject to minimalist tax structures especially devised for them. If not, it would result in a lower-than-intended tax intake from small taxpayers. Consequently it would lead to a skewed pattern of resource allocation compared to what market forces would have dictated. One way to accomplish the necessary policies would be to develop a clear strategy of progression out of small taxpayer size.

Given the above premise, arguments that favor minimalist taxation because of the lack of infrastructure available to small taxpayers for preparation, submission and follow-up of tax returns, have to be considered in a new light. Some relevant examples are available on developed country experiences. Ritchie (2001), studying a sample of small businesses for payment of the value added tax in New Zealand (GST), indicates, “Businesses with computerized accounting systems report a very minimal amount of time spent on end-of-year tax activities” (p.313). Similarly, he found that, “Time spent on income tax collections…(was) easy to determine …(through) monthly or twice monthly (payments) for PAYE [2]…”(p.313). Thus there seems to have been little need for differentiation between large and small taxpayers in this sample study based on New Zealand taxpayers.

In a study focused on the Australian GST,[3] Pope and Rametse (2001) found that start-up costs for GST, introduced in July 2000, had been around A$ 3,000 and 70 hours (in owner, management or staff time) per small business. “The GST has been smoothly introduced into Australia with small businesses appearing to cope particularly well.” (p.24) But compliance costs remain considerably higher for small businesses (2 percent of a turnover of say A$100,000) than for larger businesses (0.04 percent of a turnover of say A$2 million). There are high managerial benefits and savings arising from technology. For example, on-line transfers and the greater use of electronic submission and transfers, are likely to reduce compliance costs for small businesses. The authors point out that the effect of both the GST and PAYG [4] systems on small business cash flow may become a critical issue if recurrent compliance costs appear to be onerous. That would tend to force government to compensate small taxpayers for having to act as an unpaid tax collector.

[2] Pay-as-you-earn (PAYE).

[3] Goods and Services Tax (GST).

[4] Pay-as-you-go (PAYG).

The main conclusions from these kinds of recent studies are two-fold. First, there may be a tendency for small taxpayers to receive less attention while, at the same time, there may be an expectation that they should provide a free service to government in helping to operate its PAYG system. Government may base this expectation as a compensation for the small sector's assumed low, potential revenue productivity. Second, under the circumstances, in practice, available administrative resources are geared towards the medium and large taxpayer groups from whom a higher revenue yield is expected. If this is the experience in a developed country, it may be expected that in a developing country environment with scarce administrative resources, it is more likely to be the case.

As has already been pointed out before, in the medium term, the small sector—in particular, services—has also got to be appropriately covered since it increasingly comprises the driving force of growing economies, in a manner reflective of the changing patterns of sectoral shares in a country's GDP. This would imply, in many cases, the scaling up of the quality and focus of administrative resources that are allocated for the administration of small taxpayers. They can then be realistically expected to graduate out of any special regimes to a more general tax treatment.

III. Constructing the Small Taxpayer

Having made the argument that differential tax treatment arising from differences in taxpayer size should be minimized, let us turn to the issue of how a small taxpayer is usually defined and the composite tax that he pays under a "single tax." Pertinent questions that pose themselves are:

(1) which are the taxes that are to be included in a "single tax" for the small taxpayer;

(2) what is the dividing line between the small and the next category of taxpayer; how is that to be drawn and what are its ramifications;

(3) does tax evasion go down as a result of such a "single tax" for the small taxpayer; and

(4) are there better alternatives to address the small taxpayer within the regular tax structure.

These issues are addressed individually.

A. The Concept of a Single Tax

Government needs tax revenue to carry out its societal functions. It has to be mindful of taxing its citizens through a system that minimizes taxation's likely adverse ramifications for private decisions to consume and invest, that is, the welfare costs of taxation. A vast literature leads inevitably to the conclusion that the central characteristic of a tax system should be *simplicity*. It is from this widely accepted premise that notions of a single tax system or a unique tax system, have emerged. They have occasionally been narrowly interpreted, however, as a single tax or a unique tax (Shome, 2003). Some regions, in particular Latin America, have suffered waves of this simplistic thought in the form of populist movements, albeit ephemeral. Fortunately, the concept has never taken hold for the tax system as a whole. Its remnants do show up, however, in the context of the small taxpayer, and such unique taxes have been implemented from time to time in large economies such as Argentina and India. Despite claims to the contrary, they tend to yield little revenue and are likely to be unsuccessful in reducing tax evasion, as is amplified later.

Which are the taxes that are to be included under the single tax: income tax, consumption tax, excise tax[5], social security tax? Or other taxes as well? There is no easy answer to this question if one reflects on economic principles. For example, social security is a contribution that the employer makes on behalf of his employees. If government includes this tax under the single tax, it would not only reprieve the taxpayer from his own tax contribution, but would allow him to cut down his contribution on behalf of his employees. This is clearly distortionary since there is no accounting for how the social security system is likely to compensate the employee at the point of his retirement. A short term revenue goal with the objective purely of simplification in effect overlooks this kind of long run balance and should be detrimental to the long run health of the social security system.

In sum, there appears to be little economic basis for the concept of a single tax. It is more logical to treat each tax separately. Thus, for the income tax, the small taxpayer could be subjected to a minimum tax as described later. And for the value added tax (VAT), a threshold may be applied below which the VAT payer can voluntarily opt into the system. There seems to be no such basis for the social security tax.

[5] In developing countries, local types of cigarettes, such as *bidi* in India, or wine from small vineyards in Latin America, may be produced by small businesses and, therefore, could be conceptualized to be taxed under the single tax.

B. Separating the Small Taxpayer

Separation of the small taxpayer poses the problem of determining the right point of division. The decision is usually based on practical aspects, colored by political lobbying.[6] When a single tax comprises several taxes drawn from the regular tax structure, what may be an appropriate cutoff turnover under the VAT may not equate to an appropriate income cutoff point under the income tax. Further, the same turnover in two different sectors may imply two different incomes. A compromise based on gross turnover is essentially reached in determining the cutoff point. It is likely to have little economic significance or relevance reflective of the original intentions in the design of the tax structure that was supposed to apply to all taxpayers.

An important ramification of the demarcation is the expectable clustering of taxpayers below the threshold. Nonregistration tends to become a goal of the taxpayer that seems to be achievable, given the likelihood of getting audited under modern audit systems. About 5 percent of taxpayers are targeted to be audited annually resulting in a probability of getting audited every twenty years.[7] And small taxpayers almost never get audited by the very design

[6] In India, a fiscally federal country, the introduction of a state level VAT has been postponed several times in the past reflecting both political factors and an inability to finalize particular aspects of a complex set of issues in the heterogeneous economic environment. For example, different states have come up with different VAT thresholds. This could lead to difficulties when VAT credit, to be applied above a threshold, is considered in the context of inter-state trade. It would require the simultaneous recognition of different thresholds of trading states.

[7] Of course, selection of taxpayers for audit is not always random. This does make it feasible for sectors with high tax evasion and tax avoidance to be audited more frequently.

of the tax administration framework.[8] Though the probability of audit even for large and medium taxpayers is small, the cutoff for small taxpayers leads them to feel confident that they would not be audited since such organized tax administration measures tend to be applied primarily to other taxpayers. It is therefore felt to be safe to continue year after year just below the threshold without effective pressure from the tax administration to graduate from it.[9]

Alternatively, in some small as well as large countries, a tendency for businesses to fragment, typically within the business family, seems to prevail. Again, this is propelled by the objective of tax avoidance by not reaching the threshold. In terms of efficiency, this supports inefficient allocation of the economy's productive resources, a point recently raised in a simulation study by Keen and Mintz (2004) mentioned earlier. They conclude that "the importance in thinking about the optimal VAT threshold *for* [sic] production efficiency considerations....are....ignored....very often in the practical advice given in this area" (p. 574).[10] In the end, it is not easy to identify any clear way to separate small from medium or large. That demarcation is often based on practical considerations and underpinnings that generally tend not to be fully apparent.

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[8] This is the result of recent removals of the role of "assessment," as termed in many developing countries, in which there were some minimal audit-type checks when the taxpayer filed his return.

[9] To some extent, the cross-checking of information and other mechanisms for detecting taxpayers that are incorrectly registered under the threshold do improve the probability.

[10] Relatedly, Gersovitz (2004) has also shown that the pattern of tax payment is likely to be related to firm size.

C. Does the Single Tax Reduce Tax Evasion

Returning again to Argentina and India, the concept of a single tax has been utilized for small taxpayers in recent years.[11] In both countries, the required tax contribution was estimated at such a low percent of income at the cut-off point, that claiming that the single tax reduced tax evasion would be a *non sequitur*. For example, if the requirement at the cutoff point was that 1 percent of turnover should be paid as tax in lieu of the income tax and VAT combined, and subsequent tax collection came close to it, would it be judicious to claim that tax evasion from small taxpayers has been well nigh eradicated? In Argentina, preliminary reports indicated that less than 5 percent of participants were accounted for by new registrants. Most taxpayers who opted for the scheme were already registered. However, the scheme did enable the tax administration to successfully renew their coverage in the tax system. The impact on revenue has been marginal (1.4 percent of total revenue in 2000, the initial year) and declining (0.9 percent of total revenue in 2002) (Salim, 2002).[12] The Indian experience has also not been successful since those outside the tax net interpreted the scheme as a ploy by Government to get them registered. To quote:

> "The scheme of simplified procedure for assessment of income earned by small shopkeepers and petty professionals did not generate much confidence amongst the targeted categories of taxpayers for a variety of reasons, chief amongst them being the mistrust of the department about its potential for harassment of initiating actions for

[11] Reference is being made to the *monotributo* or *impuesto único* in Argentina and the *1400 Levy* in India.

[12] This was also a period of an economic crisis in Argentina, however.

> earlier years, resentment on the part of tax practitioners due to loss of potential clientele and general apathy of tax officials. The scheme was discontinued in 1997 in the wake of the initiation of a Voluntary Disclosure Scheme (Amnesty Scheme)." (Shende, 2002, p.22).

Any special tax regime for small taxpayers could be interpreted to reduce tax evasion since the expected level of tax revenue to be collected from them is set considerably below the theoretically correct level. Yet, it is often claimed that small taxpayer schemes reduce tax evasion. The reality is that the revenue objective is set at a low level so that, by definition, that objective is likely to be met. It is as if the phenomenon of tax evasion is assumed away by requiring small taxpayers to pay considerably lower than what they should have paid on the basis of their incomes.

Small taxpayers are not necessarily small income earners. They are likely to claim to be small income earners under the umbrella of the prevalent scheme that protects them. As long as the tax administration desists from allocating sufficient resources to administer them appropriately, this phenomenon is likely to be prevalent in a significant way. And, as argued earlier, expecting them to carry out other duties or perform other services as a *quid pro quo* is not an efficient alternative. Neither is it equitable since there is always the possibility of *moral hazard* in that some small taxpayers may already be paying the right tax so that any additional service they are expected to provide would increase their burden to levels higher than on the others. Indeed, even if it may provide a window of protection for the tax administration from accusations that it is unable to curb tax evasion, separation of small taxpayers through special regimes must comprise only a temporary instrument by virtue of the fact that revenue intake is likely to be lowered in the longer term by such separation.

To ensure progress, even as taxpayers continue to be divided by size category, there must be regular reporting of: (1) the increase in taxpayer register/roll below the threshold or demarcation point; (2) the trend in the relative allocation of administration resources between small, medium and large taxpayer units; (3) an annual calculation of the decrease in revenue loss as more taxpayers graduate above the small taxpayer threshold (an important element in making relevant revenue yield calculations from meaningful tax administration measures);[13] and (4) a progressive lowering of the thresholds as a natural part of the development of a tax system that would be more efficient in generating revenue.

D. The Issue of Tax Simplification

Tax policy experts have routinely emphasized the need to simplify the tax structure so that compliance costs for small taxpayers may decline. For example, a VAT structure with multiple tax rates and many exemptions may result in being too difficult to handle by non-computerized retailers. Similarly, too complex a business income tax structure would make it inaccessible to the operation of small businesses. In addition, complex or unstable VAT structures can also lead to high compliance costs as shown by Klun (2003) for a transition

[13] Often tax administrations are observed not to subject themselves to making revenue yield calculations from carrying out tax administration improvements under the premise that structural administration improvements cannot be directly connected to revenue enhancement. On the other hand, it is common to find many tax administration schemes, such as the LTUs, as well as various executive orders, to have enhancement of revenue in the short to medium term as a primary objective.

economy such as Slovenia. The author attributed the high costs not only to the newness of the VAT, but also to the rapid changes in VAT regulations during 2000-01, the period of the study, when VAT regulations were amended every three to four months.

However, experts do not necessarily recommend the actual *separation* of small from large taxpayers. Rather, the emphasis is on overall *simplification* of the tax statute. In the case of the United States, Steuerle (1999) has recommended that complexity has to be reduced through appropriate organization, improved information, and a reduction in the number of forms. Of course such improvements need to be supported by simplification of the tax code itself. Again, Bardsley (1995) suggests for Australia: “Tax simplification should…lead to an expansion at the smaller end of the small business sector and a relative contraction at the larger end.” (p.1) These experiences have relevance for developing countries as well.

Nevertheless, admitting that small taxpayer separation may have to be lived with in the short- to medium-term, how then should small taxpayers be adequately targeted to maintain an appropriate balance in the tax administration while adhering to the original intentions of tax policy? These matters are taken up next.

IV. Appropriate Taxation of Small Taxpayers

Three taxes that are likely to affect the small or micro businesses are income tax, VAT and social security tax. As explained above, the objective is to design tax substitutes for them that correspond as closely to the main tax structure as possible. That would, of course, need to be supported by regular reporting on the number of taxpayers that have graduated from these systems to the regular tax structure.

A. Income Tax

As far as the income tax is concerned, the best method to tax small businesses would be through a minimum alternate tax (MAT). Indeed, the MAT is a tax that is applicable to the corporate or business sector as a whole. The base for a MAT could be gross assets, book profits, turnover, or some combination thereof. In North America and Europe—for example, United States, Canada, Denmark and Norway—the MAT is based on a recalculation of deductions from income. In the United States, the MAT is computed by making certain adjustments and adding selected tax preferences to income. In Latin America, Argentina, Ecuador, Mexico, and Peru legislated a MAT based on gross assets.[14] Other countries have based their MATs on net worth such as Colombia and India. However, the version based on net worth suffers from the likelihood of base erosion since it is easier for businesses to manipulate net worth because of the allowable deductions. This problem is minimized under the gross assets-based MAT.

Another variation would be to base the MAT on fixed assets—land, plant and equipment—but this would discriminate against manufacturing and favor services. Since services mainly comprise the growing small sector in many countries that need to be taxed, fixed assets, by

[14] In some cases, they have been removed, for example, it was eliminated in Peru in 1999. It was replaced by a minimum advance payment scheme for income taxes that is based on the greater of a progressive tax on net assets or a flat rate attached to the prior year's earnings.

itself, would not be a good base for the MAT. Some African countries have introduced MATs based on turnover since turnover is an easily measurable financial variable for a business and may be made conveniently available to the tax administration.

For small businesses in particular, where presumptive taxation may have to be employed, a MAT based on a combination of gross assets and turnover, whichever is greater, would be a good way to tax income. The manufacturing sector is likely to possess sizeable gross assets in relation to the size of business and a gross assets-based MAT would be appropriate. However, the services sector may have low gross assets but high sales, and a turnover based MAT may be appropriate for it. Thus the combination should work out well for the small business sector as a whole.

The MAT has tended to be misunderstood even among tax experts. Yet, the MAT described above would improve the equity of the income tax since all potential taxpayers, large or small, would come under it. It should eliminate "zero tax" businesses that avoid tax by manipulating the complexities inherent in a mature tax system. The MAT is also economically efficient, in particular, the version based on gross assets. Let us take an example. Assume that the business income tax rate is 35 percent, and the average rate of return on gross assets is 5 percent. Then the MAT based on gross assets would imply a tax rate of 1.75 percent (35 X .05). Irrespective of taxable income, a taxpayer would have to pay a tax of 1.75 percent of gross assets employed in the enterprise. The burden can be smoothened by allowing a ten or fifteen year loss carry forward and backward as in the case of Mexico (McLees, 1991). In essence this implies that the tax administration expects this minimum alone to be paid in the long term since any excess tax payment would be adjusted against years of loss. At the same time, a 5 percent return on gross assets must be made; otherwise the business would have to close down and allocate its resources in an economic activity in which the 5 percent return could be accomplished. Thus, throughout the economy, activities in which the return is less than 5 percent would eventually close down. This is the aspect that guides the efficiency of resource allocation under the MAT based on gross assets.

The inclusion of turnover in the MAT base is simply to ensure that the rapidly expanding services sector is adequately covered under the MAT. In combination, the small business sector could be meaningfully targeted under the income tax. If a business is satisfied to pay the MAT without filing a full fledged income tax return, that option may be favorably considered as long as registration remains on the files. As indicated earlier, at a demarcated point in time, a graduation has to occur regarding the filing of income tax return. However, note that, if the treatment of loss carry over results in the effective tax rate equilibrating at the MAT rate, filing an income tax return would become superfluous. And, from the point of view of the taxpayer, tax calculations would become simple since they would be based on gross assets and turnover, obviating the need for complicated calculations through deductions or arriving at any net figures.

For the small agricultural sector, Mexico uses a cash-flow type tax. There is considerable debate over the advantages and disadvantages of this tax. For example, McLure (1991) has, in general, favored the tax for its simplicity while Shome and Schutte (1993) found many of its ramifications to be unfavorable, including its low revenue productivity. The advantage of using this tax for small businesses is that the only calculation they have to arrive at is cash flow or, in essence, total revenue minus total cost for each tax period (Poutziouris et al, 2001). Thus, maintaining accounts for tax purposes would be relatively easy. However, it also implies that depreciation allowances are given in full in the first period itself. That implies a narrow tax base and, to maintain adequate revenue productivity, it would require a high tax rate. The alternative would be to accept a high probability of low revenue intake from the small sector (and the growing services sector) in proportion to the large sector (heavily represented by the manufacturing sector), a premise that, as argued above, should be eschewed to the extent possible.

In conclusion, income tax for the small business sector is best tackled through a MAT-like arrangement based on a combination of gross assets and turnover whichever yields higher revenue. This has to operate in combination with regular and updated reporting of the number of businesses that graduate from this arrangement to filing a full income tax return. Of course, they would continue to be subjected to the MAT.

B. Value Added Tax

A VAT regime suitable for small businesses is one that puts them below a threshold and allows them to opt into the system. In fact there should be some mechanism whereby the tax administration regularly reports on: (1) businesses that have remained under the threshold for a number of years and should provide adequate rationalization for it; and (2) the rate at which the overall taxpayer register and, in particular, the small taxpayer register, has been changing, and attach appropriate explanations to such movements. There should be no clubbing together of small VAT payers with their income tax liabilities.

A mix of three factors could lead to low VAT yields: (1) a high VAT threshold; (2) undercoverage of services in the VAT base; and (3) hiding by medium-sized enterprises under the threshold. The long continuation of the same taxpayers under the small category under the VAT could lead to particular phenomena for abetting tax evasion. For example, in one small economy, it was found that a secondary market had developed for VAT invoices available in the hands of small taxpayers who could not utilize the invoices for claiming VAT input tax credit since they were below the threshold. Given that the threshold was high, a large segment of potential VAT payers belonged to the small category and a viable market for their invoices had developed, where they were the suppliers. The demanders of the invoices were the large or regular VAT payers who were a smaller group, were therefore bearing a disproportionate burden of the tax, and had incentives to work out ways to avoid, or even evade the tax, by buying, in the market, invoices that did not relate to their own business activities, and taking input tax credit on their basis. To recall a Finance Minister's observation: *En nuestro país, hay muchos elefantes escondidos dentro de las ratas* !"[15] This phenomenon of hiding by medium-sized enterprises under the VAT threshold essentially requires strong administrative vigilance. It underlines the need for a continuing assessment of small business treatment under the VAT and their progressive assimilation into the general VAT administration.

[15] "In our country, there are many elephants hidden among the mice!"

One common experience in the VAT structure is the tendency to tax manufacture through a "negative list," that is, only those items that are excluded or exempted are listed, while services are taxed through a "positive list," that is, only those heads that are taxed are listed. First, given the rapid growth of the services sector, this approach in VAT policy is to be avoided. But the crucial element in the argument is based on the fact that many economic agents in the growing services sector are small entrepreneurs. Here too they must be covered adequately under the VAT net and not merely in appearance. If this is not carried out, VAT revenue productivity would continue to suffer.

The concept of revenue productivity is well worth visiting. Chile has typically collected over 8 percent of GDP in VAT revenue with an 18 percent VAT. Thus it is possible to receive almost ½ X percent of GDP in VAT revenue with an X percent VAT. This relationship may be used as a benchmark. Chile's coverage under the VAT is extremely wide including: (1) all kinds of services; as well as (2) the small sector producing items such as unprocessed food. That of New Zealand is also so wide that it is said that the VAT covers an individual from birth to death since even funeral services are taxed under the VAT! In general, countries tend to collect between 1/3 X percent and 2/5 X percent of GDP in VAT revenue with an X percent VAT (Shome, 2002).

Experience reveals that a VAT collection below 1/3 X percent of GDP at a VAT rate of X percent typically signifies either excluding many services from the "positive list" or allowing a very high threshold only above which the regular VAT applies.[16] Thus it is of utmost importance to: (1) include as many services as possible in the VAT base, preferably with the support of a "negative list" for services; and (2) have an ongoing program of moving an increasing number of taxpayers from the small taxpayer category to the regular taxpayer category.

This is of course not an easy task. In fact, difficulties may be expected from two directions. First, small business lobbies can be quite powerful in many countries especially where they represent a large overall size of the GDP from a particular sector. It could be quite difficult to gain their confidence by the tax administration. Even after much negotiation and apparent agreement, it is not unlikely that they will become adamant at the last moment against extending the VAT to them.[17] But, second, the VAT administration itself often interprets such experiences as supportive of the view that a low value should be attached to a policy of VAT extension to small businesses. However, to the contrary, because of that very experience, and also in reflection of all the negative ramifications of having a significant business sector below the VAT threshold, it is all the more important to implement a vigilant administration policy targeted toward them.

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[16] The revenue productivity rate is, of course, also affected by the administration of the tax.

[17] In India, no doubt slow administrative preparations at the level of some states as well as cross-state differences in VAT legislation and an inability to arrive at an agreement on taxation of inter-state trade delayed the introduction of a subnational VAT. However, an immediate reason for the latest postponement in the introduction of a sub-national VAT in 2003 appeared to reflect demonstrations in the nation's capital by small businessmen whose confidence could not be garnered.

C. Social Security Tax

The social security tax is one that could impinge upon a small business if it was required to perform an administrative function for Government through a withholding function, thereby raising compliance costs for small businesses.[18] This has been investigated in countries such as Australia and New Zealand. In several Latin American countries, the costs of the withholding function are somewhat compensated by allowing businesses to use the money withheld for some time, say a week, before transferring it to Government. This is the case with the VAT in Colombia. In other countries the period may be longer or a bit shorter. Though tax administrations are not often in agreement with this "free" use of public funds by the private sector, the use could be interpreted, with some perspicuity, as a compensation for a free service that the private sector performs for the public sector. It is the length of time between withholding from employees and transfer to Government that needs to be appropriately worked out.

The same principle may be applied to the social security tax. Small businesses may be allowed to transfer withheld tax after a prescribed period of time. If they are withholding income tax, the same procedure could be followed. Thus an important administration function could be performed in the case of all major taxes—income tax, VAT, and social security tax—by small businesses provided they are given some time to use the cash resources they withhold. Of course, once again the importance of bringing the small business sector rapidly within the purview of the organized sector has to be underlined since, only

[18] Of course this is true of the income tax if the same responsibility applies.

when they are registered and are paying regular taxes, can they be relied upon adequately to perform governmental functions supportively.

V. Concluding Remarks

The main points made above are summarized in this concluding section.

Almost all modern tax administrations in developing countries in Latin America and Asia have moved towards establishing large taxpayer units (LTUs) since often a small number—anywhere between 1,000 and 50,000—of large taxpayers contribute between 80-90 percent of the tax revenue collected. This has become a practical device in securing tax revenue in an expected manner. Baer and others (2002) provide country experiences.

The revenue stability that is generated from the LTU model should be extended to other taxpayers. Special care has to be taken to ensure an expansion of the taxpayer base. In an examination of the individual income tax in India, for example, Das Gupta and Mookherjee (1998) found that the number of assessees has not been an effective constraint on tax collection. There is an accompanying need to allocate adequate administrative resources to bring the small taxpayer into the tax net. Without, of course, causing unduly high cost to the revenue administration, the strategy must include a credible threat of audits for all taxpayers.

Tax administrators do tend to agree that, ideally, all taxpayers should be targeted. Baer and others (2002), for example, point to the problem of sustainability of reforms introduced through LTUs: "The tax administration may lack an overall reform strategy that spells out clearly how the modernization effort introduced through the LTU will be extended to the rest of the tax administration (and the medium-size and small taxpayers)" (p. #37). This view provides support to the formulation of a well-defined strategy to target small taxpayers.

In both Asia and Latin America, small to medium taxpayers do possess significant revenue contribution potential, possibly a quarter of the total (depending, of course, on where the line is drawn between large, medium, and small, which itself is a problem). This could imply a significant degree of distortion in the allocation of resources resultant from a policy of separating taxpayers by size, and subjecting them to different tax regimes. In the long run, this separation would adversely affect economic growth and, therefore, long term revenue potential, unless an overall reform strategy mentioned above is consciously implemented.

The revenue potential of different taxpayer groups has assumed additional importance with structural changes in many economies. With privatization of large public sector enterprises and utility companies in Latin America, Asia, and Eastern Europe, self-employment in the small-scale services and manufacturing sectors has tended to grow. This impact has been studied, for example, in large economies such as Brazil and India that are undergoing fundamental structural changes. With it, captive revenue sources such as large public enterprises have given way to smaller entities with revenue potential. The tax administration, therefore, needs to address the growing pool of small taxpayers in the present environment of an emerging small business sector.

Nevertheless, small taxpayers are often made subject to scaled-back taxation under the concept of a "single tax" (*monotributo*), which typically collects less tax from them than their potential. The idea of a single tax is a poor one since it tends to increase inequity and encourage the unwillingness of small taxpayers to graduate from the single tax. Any loss in revenue has to be made up by those who are above the threshold, leading to a reversal of vertical equity. Even horizontal equity suffers when a wage-earner in a factory is subjected to a tax (typically through tax deduction at source, TDS) that is not collected from a wage-earner in a restaurant (by the restaurant owner), or a self-employed worker with the same income. A single tax does not reduce evasion except by definition since, by design, it requires small taxpayers to pay less tax than their theoretical tax potential. In combination with the existence of a threshold, it also encourages the formation and functioning of a secondary market for VAT invoices and, thus, is known to have exacerbated tax evasion. In a like manner, a single tax also leads to inefficiency by encouraging resource allocation towards the lower-taxed sector. It is no surprise that tax policy experts, as indicated above, in general prefer tax *simplification* rather than *separation* between large, medium and small taxpayers. Thus there must be a clearly defined strategy to phase out a single tax if it is already in place.

In the circumstances, what would be the acceptable way of taxing small taxpayers?
(i) For the income tax, they should be subjected to a Minimum Alternate Tax (MAT) based on both gross assets and turnover, whichever yields higher revenue. The tax rate of MAT should be set to equivalence with the lower marginal income tax rate under the assumption of a reasonable rate of return on capital.

(ii) For the VAT, there has to be a threshold below which small taxpayers would function. The threshold should not be inappropriately high. Small taxpayers should be allowed to opt into the general VAT system. The VAT administration should regularly report the pace at which small taxpayers are graduating from below the threshold.

(iii) For the social security tax, small taxpayers should be given a reasonable period for utilization of the money they withhold before transferring it to government, as a means to compensate them indirectly for the free withholding and transfer service they perform for government.

(iv) A single tax covering all taxes—income tax, VAT, social security tax, or other taxes—that small taxpayers are liable to pay, should not be enacted.

The tax administration has to buttress its techniques of revenue calculations and reporting of trends. To this end, it should regularly report:

(i) the increase in taxpayer register/roll below the threshold;

(ii) the trend in the relative allocation of administration resources between small, medium and large taxpayer units; and

(iii) an annual calculation of the decrease in revenue loss as more taxpayers graduate above the threshold. This third aspect is important in making relevant revenue yield calculations from meaningful tax administration measures.

The ultimate goal has to be for tax practices to fully reflect the original intentions of tax policy as expressed in the tax statute. This should be achievable if the complexity in the tax structure is reduced through a continuous process of tax simplification. It would be buttressed by limiting executive orders that tend to create tax arrangements for administrative convenience per se. They may facilitate operations in the short run but would tend to divert the tax system away from its principles of efficiency and equity. These principles must remain the tax system's central premise if long run economic growth and, in turn, robust revenue productivity, are to be encouraged.

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