

# **Tax Administration and the Small Taxpayer: Concepts, Concerns and Corrections**

By

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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, have formed the opinion that, given the disproportionate revenue intake from large taxpayers, it is beneficial to set up large taxpayer units (LTU) that should be allotted a larger share of administration resources than their numbers would suggest. 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 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 unico*, 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.

It is interesting that we expect and regularly recommend a modern tax administration to be divided along the lines of a functional classification—registration, payment, assessment, audit, litigation, sanctions and penalties. In a developing country where we find some of these separable functions to be overlapped in one department or in the hands of a single tax official, we automatically recommend their separation along functional

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lines. Yet, if we examine LTUs, we find that for large taxpayers, we not only overlook the combining of certain functions, it is even effectively recommended for the supposed benefits to be reaped from an elevated treatment of large taxpayers. I find a certain degree of contradiction in this practice.

Thus, I have prepared my talk today for a workshop environment where the exchange of ideas should be the primary concern. I am aware that I am in the midst of experienced tax administrators, some with considerable international exposure and others with experience in complex tax administration systems. Nevertheless, I feel that this is the ideal forum for me to discuss genuine concerns regarding the small taxpayer/ large taxpayer divide within tax administrations that, in all practicality, is unlikely to be bridged unless corrective policies are introduced. This is the case despite all the right phrases proffered regarding the benefits from LTUs being passed down, over time, to the administration of medium-to-small taxpayers as well. I hope to offer some insights on the basis of what I have observed through my years in the practice of taxation.

I have found that the worthwhile objective of simplification of the tax statute tends to be erroneously co-mingled with the issue of separation of large and small taxpayers. We know that, optimal economic theory would eschew separation of large and small taxpayers because that would lead to distortions in economic decision making for production and consumption. And the very essence of tax theory is that tax structure and practice should be carried out with minimum economic distortions. At the same time, we know that the importance of revenue collection cannot be minimized. Thus the fact that tax administrators face the need to devise ways to attain their revenue goal is well recognized.

The essential question emerges whether the revenue goal is to be realized in conformation with the original intentions of tax policy design or whether the issue of a well designed tax structure that would minimize economic distortions might be allowed to take a secondary role. I think that it is essential to design tax administration tools that are in conformity with the overall purpose, scope and objective of tax policy. Without

ensuring this, neither LTUs nor special regimes for small taxpayers could be justified. Yet I have come across several instances of a lack of awareness of the antecedents of tax policy, and a major challenge that I find today is the need for policy correction in the appropriate direction.

There are two reasons why small taxpayers must be appropriately taxed. First, their potential tax contribution can be quite large, ranging between 20-25 percent of total revenue, only a small portion of which may be actually collected. In an environment in which many countries are suffering from persistent fiscal deficits exacerbating macro-economic problems, potential revenue needs to be meaningfully targeted for collection in a definitive manner. Indeed, some growing economies have experienced a secular lowering in their tax/GDP ratios during the 1990s 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 in 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 more recently. With a changing sectoral composition of GDP, however, habit formation in tax payment in the new growth areas is extremely important if the earlier tax/GDP ratios are to be recouped. And the small business sector lies in the heart of this issue.

The second reason is that the effect of ignoring a quarter of potential tax revenue 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 distortion between large and small. It is likely to result in a faster growth of the small business sector at the expense of the large enterprise sector, not in reflection of optimal economic decision making, but because of the impetus provided by the tax administration's role in emphasizing tax collection from the large rather than from the small. The final outcome may be a sectoral mix determined in a non-neutral fashion by tax administration practices in contrast to the original intention of the tax structure.

In what follows, I will not traverse the familiar descriptions of special schemes constructed for small taxpayers. Indeed we will all be illuminated by selected country

experiences immediately after this morning session. Instead, I shall pose particular relevant issues regarding the role, scope and effects of special small taxpayer regimes. Therefore, I shall first elaborate on the problem, as perceived, of the phenomenon of the small taxpayer and consider if the issue is exaggerated. Second, I shall point towards some of the anomalies that exist when a small taxpayer is attempted to be defined. Third, I shall provide a selective list of small taxpayer treatment that may be acceptable in the short to medium term as a tax administration device. Finally, I shall summarize the main points I hope to have made.

## **II. The Small Taxpayer: What is the Problem?**

Public perception of small businesses can be said to have changed radically 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 (Poutziouris et al, 2001). 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 little 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, People's Republic of China and India follow developed countries of the European Union and the United States in impressive expansions in their service sectors. And the growth is represented largely by small entrepreneurs. It is undoubtedly this sector that comprises today's dynamism in economic growth in many market economies. Thus, first, the small taxpayer would benefit from tax simplification and, second, he cannot and should not be relegated by tax administrations to a secondary

role in the generation of tax revenue given his potential tax output. He has to be placed within an appropriately designed framework that assigns comparable administrative resources to tax collection from this sector.

What is often not understood but has to be underlined is that, if this is not done, then tax administrations cannot be seen to be keeping up with the direction that is pointed towards by macro-economic indicators. Thus, for example, if the small services sector is found to be the engine of economic growth, then it is the responsibility of tax administrations to successfully target that sector for tax intake and to assimilate it as quickly as possible within the overall tax administration framework, rather than devising minimalist tax structures for them. This, in effect downgrades them through disproportionately low assignation of administrative resources and, consequently, resulting in a skewed pattern of resource allocation compared to what market forces would have dictated.

Given the above premise, arguments that favor minimalist taxation because of the lack of infrastructure available to small taxpayers, have to be considered in a new light. For example, 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 <sup>2</sup>...”(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.

Similar results were found in a study focused on the Australian GST<sup>3</sup> by Pope and Rametse (2001). The authors 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-

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<sup>2</sup> Pay-as-you-earn (PAYE).

<sup>3</sup> Goods and Services Tax (GST).

than small 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 lodgment and 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<sup>4</sup> 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.

My conclusions from these kinds of recent studies are two-fold. First, rather than posing a problem for the tax administration, small taxpayers may be neglected and, instead, there may be a fallacious 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 erroneously assumed low potential revenue productivity. Second, under the circumstances, tax administrations continue to focus, target available resources, and expect higher revenue yield mainly from the large enterprise sector.

My conclusions are not based only on the above-mentioned studies but also on observing the modes and general practices of tax administrations. As I have already pointed out before, this kind of policy mix cannot be sustainable in the medium term as the small sector--in particular, services--comprises the driving force of growing economies. As large complexes in the manufacturing sector tighten operations across the globe, continuing exclusive focus on them through LTU operations tends to narrow the tax base by curtailing the possibility of expanding the tax register at a rapid pace, in a manner reflective of the changing patterns of sectoral shares in a country's GDP.

### **III. Constructing The Small Taxpayer**

Having made my argument that differences between large and small taxpayers should be minimized, let me now turn to the issue of how the tax administration goes about defining

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<sup>4</sup> Pay-as-you-go (PAYG).

a small taxpayer and the composite tax that he pays under a “single tax”. The 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 small and large; how is that to be drawn and what are its ramifications;
- (3) does tax evasion really go down through such a “single tax” for the small taxpayer; and
- (4) are there better alternatives to address the small taxpayer within the regular tax structure.

Let me address these issues one by one.

### **1. The concept of a single tax**

Government needs tax revenue to carry out its societal functions. However, taxes are generally perceived as confiscatory rather than contributory despite their intended beneficial use. Thus, Government 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, i.e. the welfare costs of taxation. A vast literature leads inevitably to the conclusion that the central characteristic of such 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 simplistically interpreted, however, as a single tax or a unique tax (Shome, 2002a). Various regions 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. In no instance have they been successful despite occasional claims of lowering tax evasion which, I shall later show, is not necessarily the case either.

Which are the taxes that are to be included under the single tax: income tax, consumption tax, excise tax<sup>5</sup>, 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. When Government includes this tax under the single tax, it not only relieves the taxpayer of his own tax contribution, but allows 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. Tax administrators' short term revenue goal may overlook this kind of long run balance but it is ill afforded from the point of view of the long run health of the social security system.

In sum, the concept of a single tax should be abrogated. There is little economic basis for it. It is more logical to treat each tax separately even for the small taxpayer. Thus, for the income tax, the small taxpayer could be subjected to a minimum tax as I shall describe 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.

## **2. Separating small from large**

The separation between small and large taxpayer poses a problem of determining the right point of division. The criterion is usually based on practical aspects, colored by political lobbying. In India, a fiscally federal country, as states have been planning in recent years to introduce a state level VAT in April 2003<sup>6</sup>, different states have come up with different demarcation points. This could lead to difficulties when VAT credit is considered in the context of inter-state trade<sup>7</sup>.

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<sup>5</sup> In developing countries, local types of cigarettes, such as *bidi* in India, or wine from small vineyards, may be produced by small businesses.

<sup>6</sup> The introduction has been postponed several times in the past reflecting inability to finalize important aspects of a complex set of issues in the heterogeneous economic environment.

<sup>7</sup> The issue of having a *destination* based inter-state VAT, as opposed to *origin* based, has not been resolved thus far.

When a single tax comprises several taxes from the regular tax structure, what may be an appropriate cut-off turnover under the VAT may not equate to an appropriate income cut-off point under the income tax. The same turnover in two different sectors may imply two very 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 cutoff point. Non-registration tends to become the goal of the taxpayer that seems to be quite achievable given the likelihood of getting audited under modern audit systems in which about 5 percent of large taxpayers are audited annually resulting in a probability of getting audited every twenty years, and small taxpayers almost never get audited by the very design of the tax administration framework.<sup>8</sup> The demarcation leads small taxpayers to be certain that they would not be audited since such organized tax administration measures are applied only to large taxpayers. It is therefore felt to be safe to continue year after year just below the threshold without pressure from the tax administration to graduate from it.

Alternatively, in selected small as well as large countries, I have found a tendency for businesses to fragment in order to avoid tax by not reaching the threshold, again leading to an inefficient way to allocate resources. In the end, I have not discovered any clear way to separate small from large. It is based on practical considerations and its political underpinnings, when prevalent, generally tend to be disguised.

### **3. Does the single tax reduce tax evasion**

I return again to Argentina and India where, in recent years, the concept of a single tax has been utilized for small taxpayers<sup>9</sup>. In both countries, the required tax contribution was

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<sup>8</sup> This is the result of recent removals of the role of “assessment”, as termed in many developing countries, whereby there were some minimal checks when the taxpayer filed his return. Its role has been circumscribed mainly in response to international expert advice.

<sup>9</sup> I refer to the *monotributo* or *impuesto unico* in Argentina and the 1400 Levy in India.

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 cut-off point was that 1 percent of turnover should be paid as tax in lieu of the income tax, VAT and social security tax 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, at least some tax could be collected. In India, even that was not successful since those below the tax net interpreted it as a ploy by Government to get them registered. Of course I would like to learn more from the Argentina case study that we all anticipate.

By definition, any special tax regime for small taxpayers could be interpreted to reduce tax evasion since the expectation level of tax revenue to be collected from them is set considerably below the theoretically correct level. Yet I have found this error to be made by many otherwise well experienced tax administrators. The reality is that the argument that a single tax for small taxpayers reduces tax evasion is based on a fallacy, rendering the argument erroneous. Rather, 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. They may be small taxpayers; that does not imply they are small income earners. They are likely to claim to be small income earners under the umbrella of the prevalent scheme that protects them. And as long as the tax administration fails to allocate adequate resources to administer them appropriately, this phenomenon is likely to continue unabated. 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 rest.

Thus, even if they may protect the tax administration from accusations of being unable to curb tax evasion, separation of small taxpayers through special regimes has to be seen as

temporary since tax intake is likely to be lowered by their operation. Even as LTUs continue to function, 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 and large taxpayer units; and (3) an annual calculation of the decrease in revenue loss as more taxpayers graduate above the threshold. This third aspect is important in obliging the tax administration to make relevant revenue yield calculations from meaningful tax administration measures.<sup>10</sup>

#### **4. The issue of tax simplification**

Tax policy experts have time and again pointed towards the need to simplify the tax structure so that compliance costs for small taxpayers may decline. In the case of the United States, Steuerle (1999), among others, has recommended that complexity has to be reduced. In no instance do the authors recommend the actual *separation* of small from large taxpayers. Rather, the emphasis is on overall *simplification* of the tax statute.

Steuerle criticises the tax administration, the Internal Revenue Service (IRS), strongly:

“Many people do not mind paying their fair share of the cost of government, but they highly resent it when they see needless waste—including waste of their time in filling out an unreasonable number of forms.” (p.1)

“...I believe there is a fundamental failure in IRS administrative structure that leads to the Treasury complaints about inadequate information. Indirectly it also leads to some of IRS’ internal problems in managing itself. That defect is the failure of IRS to partially organize itself on a programmatic basis. IRS organizes itself by tax return category, not by the programs under its administration.”(p. 11)

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) Instances from other country experiences could also be cited.

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

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<sup>10</sup> Often tax administrators 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.

maintain a correct balance in the tax structure while adhering to the original intentions of tax policy? I take up these matters next.

#### **IV. Appropriate Taxation of Small Taxpayers**

I shall consider three taxes that are likely to affect the small or micro businesses. These 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. This is to be supported by regular reporting of the number of taxpayers that have graduated from these systems to the regular tax structure.

##### **1. 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 have legislated a MAT based on gross assets. Other countries have based their MATs on net worth such as Colombia and India. However, this version suffers from 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, this, by 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, a MAT based on a combination of gross assets and turnover, whichever is greater, would be the best way to tax income. The manufacturing sector is likely to possess sizeable gross assets in relation to the size of business and a gross asset-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.

Such a MAT 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 ( $35 \times .05$ ). 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 smoothed 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 guiding 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 may be 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 become simple since they are 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. 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 the idea of insignificant revenue from the small sector and that is the very premise that, as argued above, has to be moved away from.

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.

## **2. 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.

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, I found that a secondary market had developed for VAT invoices available in the hands of small taxpayers that could not be utilized by them 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 invoices in the market and taking input tax credit on their basis. I must recall how the Finance Minister complained to me: *“Doctor, en nuestro país, hay muchos elefantes escondidos abajo de las ratas !”* The above episode is to underline the imperative need for a continuing assessment of small business treatment under the VAT and their progressive assimilation into the general VAT administration. Unless these are demonstrated by the VAT administration, I would interpret it as a failure on its part to carry out its job fully successfully.

One of the common experiences in the VAT structure is the tendency to tax manufacture through a “negative list” i.e. only those items that are excluded or exempted are listed, while services are taxed through a “positive list” i.e. only those heads that are taxed are listed. First, given the rapid growth of the services sector, this approach in VAT policy is wrong and even tax administrators would have little difficulty to agree on this point. But the crucial element in the argument is based on the fact that many in the growing services sector are small businessmen. 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 certainly continue to suffer.

The concept of revenue productivity is well worth visiting. Chile has typically collected some 9 percent of GDP in VAT revenue with an 18 percent VAT. Thus it is possible to receive  $\frac{1}{2} X$  percent of GDP in VAT revenue with an X percent VAT and may be used as a benchmark. Chile's coverage under the VAT is extremely wide including all kinds of services as well as the small sector 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  $\frac{1}{3} X$  percent and  $\frac{2}{5} X$  percent of GDP in VAT revenue with an X percent VAT (Shome, 2002b).

My experience has revealed that a VAT collection below  $\frac{1}{3} X$  percent at a VAT rate of X percent typically signifies either excluding many services from the "positive list" or allowing a very high threshold only over which the regular VAT applies. 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 group to the regular taxpayer group.

I am not impractical enough to suggest that this is 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 bring them into 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. But, second, the VAT administration itself often interprets such experiences as a proof of the worthlessness of the policy of VAT extension to small businesses. My argument is that, because of that very experience, and also in reflection of all the negative ramifications of having a large small business sector below the VAT threshold, it is all the more important to implement a vigilant activist administration policy targeted toward them.

There are certain short term measures that have been utilized in order to increase VAT intake from small businesses. For example, in the Netherlands, larger businesses withhold VAT debits accruing to Government from small contractors through a withholding mechanism. This ensures that small taxpayers are paying at least a portion of their VAT liability. However, such mechanisms are mainly useful in the short-run though they have a tendency to be accepted as a viable and stable policy option for small businesses. In fact, the only stable long-run policy would be the graduation policy outlined above, with a perspicacious eye and a regular reporting on the outcome of such policy.

### **3. 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.<sup>11</sup> This has been investigated in countries such as Australia and New Zealand, thereby raising compliance costs for small businesses. 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 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

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<sup>11</sup> Of course the same is true of the income tax if the same responsibility applies.

business sector rapidly within the purview of the organized sector has to be underlined since, only when they are registered and are paying regular taxes, can they be trusted to perform governmental functions successfully.

## V. Concluding Remarks

Let me summarize the main points that I intended to make today.

1. 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. This strategy prescribes that the universe of taxpayers controlled by LTUs should rapidly increase, thus expanding the taxpayer universe ‘from the top’.<sup>12</sup>

2. The stability that is generated should not eschew attention given to other taxpayers. Special care has to be taken to ensure that expanding the universe of taxpayers does not receive low priority, that is, expansion must be carried out also ‘from the bottom’. In an examination of the individual income tax in India, for example, Das Gupta and Mookherjee (1998) found that the number of assesseees has not been an effective constraint on tax collection. Thus, focusing a highly significant amount of resources on large taxpayers may represent an efficient strategy for short term revenue mobilization but, in the medium term, it comprises an insufficient approach.

3. Tax administrators do tend to agree that, ideally, all taxpayers should be targeted. Baer et al (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

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<sup>12</sup> It is not unusual, however, to find that the number of taxpayers that LTUs control does not increase impressively over time, perhaps indicating that the short-term stability of revenue from this source may keep them from becoming a dynamic administrative instrument. See Baer et al (2002) for country experiences.

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) Nevertheless, in general tax administrations are likely to implement a strategy to control and expedite the flow of revenue, focused mainly on large taxpayers. In the absence of constant alertness, a disproportionate amount of administrative resources may, thus, be spent on LTUs.

4. One explanation given for disproportionate resources spent on LTUs is that they cover not only income taxes, but also the VAT, selective excises and other taxes, geared solely towards what large taxpayers are liable to pay. The very design of LTUs in this fashion seems to go against the framework of a pure functional classification of tax administration that is otherwise routinely recommended by tax administration experts. There may be some inconsistency here.

5. In both Asia and Latin America, small taxpayers do possess significant revenue contribution potential, not uncommonly 15 - 25 percent of the total (depending of course on where the line is drawn between large and small which itself is a problem as was discussed). This could imply a high degree of distortion in the allocation of resources by separating small from large taxpayers. In turn, this would affect long term economic growth and, therefore, long term revenue potential, adversely. This is a point that I have found difficult to convince tax administrators about. Only when they take note, can tax administration policy be expected to be modified accordingly. Thus, even where appropriate tax policy is formulated, it can be successfully implemented only with an enhancement in the awareness of tax policy concerns by tax administrators. I can only present this issue at this workshop hoping that my view will be considered in proper light. In terms of our present example, this leads once again to the conclusion that the high significance of large taxpayers in revenue collection should be taken as a temporary shortcoming, albeit understandable, in tax administration, rather than as a rationale for the tax administrator to continue to pour more resources into such an activity in the long run.

6. The revenue potential of small taxpayers 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. Tax administration cannot, therefore, afford to downplay the growing pool of small taxpayers in the present environment of an emerging small business sector.

7. Nevertheless, small taxpayers are often made subject to scaled-back taxation under the concept of a 'single tax' (*monotributo*) which tends to collect less tax from them than their potential. The idea of a single tax is a poor one since it increases inequity and encourages 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 it typically requires small taxpayers to pay less tax than their theoretical tax potential. It also exacerbates the problem of a secondary market for VAT invoices and, thus, could actually increase 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 cited above, in general prefer tax *simplification* but not *separation* between large and small. And there must be a clearly defined strategy to phase out a single tax if it is already in place.

8. Under the circumstances, what would be the acceptable way of taxing small taxpayers?  
(a) For the income tax, they should be subjected to a Minimum Alternate Tax (MAT) based on both gross assets and turnover, whichever yields a higher tax. 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.

(b) For the VAT, there has to be a threshold below which small taxpayers would function. They should be allowed to opt into the general VAT system. The VAT administration should report regularly the pace at which small taxpayers are graduating from below the threshold.

(c) 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.

(d) 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.

9. Tax administration has to improve its techniques of revenue calculations and reporting of trends. To this end, it should regularly report:

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

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

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

10. The ultimate goal has to be for the tax administration 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. In turn, it would be the responsibility of the tax administration to fully apply the tax law without issuing executive orders to create simplistic administrative constructs that may facilitate its operations in the short run but would tend to divert the tax system 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 not to be hampered.

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