



Reform of the Simplified System of Taxation for Small Business in Belarus

Summary

The creation of an efficient simplified system of taxation that is adequate to the Belarusian circumstances and contributes to small business development is an important task for the government. At present, the existing simplified system of taxation turned out practically unclaimed. Despite its advantages regarding simplification of taxation, bookkeeping, and reporting, this system is only used by 1% of the individual entrepreneurs and small enterprises eligible for it. Apparently, small business finds the simplified system unfavorable and rather uses the general system of taxation. In our view, the main reasons for this are: (i) high rate of gross turnover taxation; (ii) VAT exemption under the invoice method of calculating the tax; (iii) advance taxpaying mechanism. All of this underscores the necessity to reform the existing simplified system of taxation.

Based on this, we propose the following. First, the rate of gross turnover taxation should be decreased from 10 to 8%. Second, individual entrepreneurs and small enterprises should be allowed to charge a value-added tax on a voluntarily basis. In this case they should pay the gross turnover tax at the rate of 6%. Third, the advance taxpaying mechanism should be abolished. The gross turnover tax should be paid quarterly according to the actual outcomes of enterprises' performance. This would also allow to introduce the notification principle of usage the system. According to our estimations, these measures would make the existing simplified system more favorable for small business and comparable to the general system of taxation in terms of tax burden. Besides, we consider it necessary to extend the scope of the simplified system of taxation by increase of the limit on the average monthly number of employees up to 25 persons and the limit on the gross turnover up to 30,000 base amounts per annum. It should be also allowed to use a single-entry bookkeeping for all individual entrepreneurs and small enterprises. In our view, all of this would significantly improve the economic environment for small business development. However, we expect that in the longer-run the disadvantages of gross turnover taxation would be crucial so that cash-flow taxation might be an alternative.

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1. Introduction

Specific regimes of small business taxation exist in most countries. The main reason behind this is that there are significant differences in compliance costs aligned with the complex procedures of business taxation depending on the size of an enterprise, where economies of scale discriminate small business. Specific regimes of taxation can reduce the compliance costs of small business and therefore improve the economic environment for its development. This is the more so as small business is an important sector of the economy. Small enterprises are more flexible in comparison with large ones. They easier accommodate to market changes. The development of small business allows to increase the occupational level and to reduce the government expenditure for unemployment benefits in such a way.

There are two basic approaches to taxation of small business (see Appendix). The first approach is to use reduced rates in relation to the tax base that is determined according to the general rules. This measure is sometimes complemented by various investment allowances or tax holidays. The second and more common approach implies the usage of specific regimes of taxation. One option is to use the different simplified ways of determining the tax base on the basis of actual outcomes of enterprises' performance (e.g. cash-flow or gross turnover taxation). Another option is presumptive taxation, which means an indirect estimation of the potential income of a taxpayer and introduction of a lump-sum tax that replaces one or several taxes. Usually, this alternative is used as a kind of last resort when taxpayers do not comply with the tax rules, i.e. refuse bookkeeping obligations or do not declare their tax base, or if high degree of tax evasion is assumed.

In Belarus, the specific regime of small business taxation includes the simplified system of taxation and presumptive taxation.¹ However, neither of the approaches led to improvement of the economic environment for small business development. Insignificant quantity of small enterprises, minor share of employed at these enterprises in comparison with most successful transition economies, and dissatisfactory dynamics of output indicate the relative unprofitability of small business in the Belarusian economy. Of course, the situation of small business depends not only on taxes. But the influence of taxation is of crucial importance. All of this underscores the necessity to reform the system of small business taxation in Belarus. This paper analyses the main directions of the reform of the simplified system of taxation. In particular, it evaluates the existing simplified system of taxation for small business, considers two possible options of simplified taxation, and concludes with policy recommendations.

2. Existing Simplified System of Taxation for Small Business in Belarus

According to the Law from October 16, 1996 No. 685 "On Government Support of Small Entrepreneurship in the Republic of Belarus", small business comprises entrepreneurs without a legal entity (individual entrepreneurs) and legal entities with a number of employees: (i) up to 100 persons for industry and transport; (ii) up to 60 persons for agriculture and science; (iii) up to 50 persons for construction and wholesale; (iv) up to 30 persons for retail trade and personal services; (v) up to 25 persons for other non-manufacturing sectors (small enterprises).²

However, according to the Law from December 31, 1997 No. 121 "On Simplified System of Taxation for Small Entrepreneurship", only those individual entrepreneurs and small enterprises that have an average monthly number of employees up to 15 persons (including part-time employees and employees of affiliated organizations) and a quarterly gross turnover less than 5,000 base amounts³ (about USD 45,000) can optionally use the simplified system of taxation. The simplified system of taxation cannot be used by individual entrepreneurs carrying out the types of activity liable to a presumptive tax, producers of excisable goods, and organizations with a special bookkeeping and reporting (e.g. financial institutions, insurance companies, investment funds, and some other).

¹ Presumptive taxation also falls into simplified taxation. However, in Belarus, it is generally distinguished between the simplified system of taxation under which the tax base is determined on the basis of actual outcomes of enterprises' performance and presumptive taxation under which the tax is calculated on the basis of profitability's estimations of a certain type of activity. The latter system of taxation, which applies to individual entrepreneurs without a legal entity, will be considered in one of the next policy papers.

² According to the Decree of the President from January 27, 2003 No. 4 "On Single Tax From Individual Entrepreneurs and Other Physical Persons and on Some Measures on Regulation of Entrepreneurial Activity", individual entrepreneurs that employ more than 3 physical persons on a contract basis are obliged to register as a legal entity.

³ The base amount equals BYR 19,000 (about USD 9) as of May 2004.

Under the simplified system, the tax base is gross turnover. The tax rate is 10%. In order to use the system, taxpayers buy a patent which annual cost depends on the type of activity. They pay 1/12 of the patent's annual cost in monthly advance payments. The gross turnover tax is paid on a quarterly basis. If the cost of the patent exceeds the gross turnover tax for the quarter, than the difference is taken into account when calculating the tax liability for the next quarter within the calendar year.

As shown in Table 1, the gross turnover tax replaces mostly the personal income tax (for individual entrepreneurs), the profit tax (for small enterprises), and some mixed and indirect taxes. The other taxes (including taxes from payroll fund) are paid according to the general rules.

Table 1. Simplified System of Taxation for Small Business in Belarus

Taxes and Nontax Payments	Individual Entrepreneurs	Small Enterprises
Mixed taxes and nontax payments		
Land tax	no	no
Tax on the use of natural resources (within the set limits)	no	no
Emergency tax for recovery from the Chernobyl accident	–	no
Contributions to the State Employment Fund	yes	yes
Contributions to the Social Protection Fund	yes	yes
Direct taxes and nontax payments		
Real estate tax	no	no
Profit tax	–	no
Income tax on legal entities	–	yes
Personal income tax	no	–
Tax on the use of natural resources (over the set limits)	yes	yes
Tax on the acquisition of motor vehicles	yes	yes
State fees	yes	yes
License and registration fees	yes	yes
Local taxes and duties	no	no
Indirect taxes and nontax payments		
Value-added tax	no	no
Payments to the local earmarked housing-investment funds and earmarked fee for maintenance and repair of public housing	–	no
Payments to the Republican Fund for Support of Agricultural and Food Producers and Agricultural Science and payments to the Road Fund	–	no
Excises	yes	yes
Custom payments	yes	yes
Local taxes	no	no

Because individual entrepreneurs and small enterprises that use the simplified system of taxation don't pay the main taxes, they shouldn't produce tax calculations, tax declarations, and so on. However, the existing order of cash accounting and statistical reporting still holds. The simplified system of taxation also allows a double-entry bookkeeping with an abridged system of accounts. Moreover, some individual entrepreneurs and small enterprises of the non-manufacturing sectors can use a single-entry bookkeeping. Thus, unlike the general system of taxation, the simplified one leads to simplification of taxation, bookkeeping, and reporting and therefore allows to reduce the costs of compliance with the tax rules for small business.

3. Evaluation of the Existing Simplified System of Taxation

The survey conducted by the Institute for Privatization and Management in October 2002 shows that the simplified system of taxation didn't contribute to improvement of the economic environment for small business. According to the survey, taxation is still the most serious problem for individual entrepreneurs and small enterprises in Belarus. Among the general problems of small business development, the first place takes a large quantity of taxes, the second one – frequent changes in tax legislation, and the fourth place – high tax rates.

The estimation of specific tax problems by individual entrepreneurs and small enterprises according to their seriousness is shown in Table 2.

In estimation of entrepreneurs, the greatest impulse to their business development could be given by the tax reform aimed at reduction of the quantity of taxes (32.5% of the respondents

think so). Among the high-priority measures that should be undertaken by the government, 80.4% of the respondents specified a reduction of the tax burden.

Table 2. Estimation of Tax Problems by Small Business According to Their Seriousness

Problem	Average Value
High tax rates	4.52
Instability of tax legislation	4.27
High penalties for errors	4.26
Complicated and unclear rules of taxation and accounting	3.83
Possibility of write-off of funds without acceptance or non-judicial confiscation of assets	3.33
Determination of future tax burden	3.32
Absolute dependence from wishes of tax inspectors, absence of respect to you as a taxpayer	3.15

Note. 5 – most serious problem, 1 – no problem.

Source: Daneyko, P., Pelipas, I., and Rakova, E. (eds) (2003) *Belarusian Business: Current State, Trends, and Perspectives*, Minsk, Institute for Privatization and Management, 54.

Thus, the results of the survey indicate that the simplified system of taxation performs rather poor in Belarus. Despite simplification of taxation, bookkeeping, and reporting, small business finds this system unfavorable and rather uses the general system of taxation (with its drawbacks). According to the data of the Ministry of Statistics and Analysis, the simplified system of taxation is only used by 1% of the individual entrepreneurs and small enterprises eligible for it⁴. In our view, the main reasons for this are:

(i) **High rate of gross turnover taxation.** Calculations on the basis of the data of the Ministry of Statistics and Analysis show that the effective tax rate for small enterprises under the general system of taxation is about 8% of gross turnover. Hence, the statutory tax rate of 10% under the simplified system of taxation is too high for small enterprises that makes this system unattractive for them.

(ii) **VAT exemption under the invoice method of calculating the tax.** Since small enterprises that use the simplified system of taxation cannot charge a value-added tax, than other enterprises liable to a value-added tax that buy products from these enterprises cannot deduct the “input” value-added tax. As a result, many enterprises refuse to deal with small enterprises that use the simplified system of taxation.

(iii) **Advance taxpaying mechanism.** According to the existing system, individual entrepreneurs and small enterprises have to pay the patent’s cost in monthly advance payments. The gross turnover tax is paid on a quarterly basis. If the cost of the patent exceeds the gross turnover tax for the quarter, than the difference is taken into account when calculating the tax liability for the next quarter within the calendar year. Individual entrepreneurs and small enterprises cannot carry an excess tax forward for the next calendar year. This means that in fact the patent’s cost is a minimum tax. But this tax burden doesn’t depend on actual outcomes of enterprises’ performance. As a result, this can lead to a significant increase of the tax burden for individual entrepreneurs and small enterprises in relation to their economic performance. This is particular relevant for new start-ups.

Moreover, we consider that the existing simplified system of taxation has some other disadvantages. These ones are as follows.

(iv) **Too tight criteria of admission to the simplified system of taxation.** The existing criteria concerning the number of employees and the quarterly gross turnover shorten the circle of small enterprises that can use the simplified system of taxation. These criteria are adequate for small enterprises that engage in retail trade, public catering, personal services, and so on. But most small enterprises of the manufacturing industries don’t meet these criteria (see Table 3 and Table 4). As a result, the simplified system of taxation at most stimulates the development of the non-manufacturing sector of the economy.

⁴ In 2003, there were about 190 thousand individual entrepreneurs and 30 thousand small enterprises in Belarus. As per our estimations, about 35% of the individual entrepreneurs and 70% of the small enterprises were eligible to use the simplified system of taxation.

These criteria are also disproportional: the limit on the number of employees is tighter (taking into account that the number of employees include part-time employees and employees of affiliated organizations). This restrains the growth of employment at small enterprises that use the simplified system of taxation and leads to concealment of the actual number of employees at these enterprises.

Table 3. Limits on the Number of Employees

Industry	Law on the Government Support of Small Entrepreneurship	Actual Average Number of Employees at Small Enterprises in 2002	Law on the Simplified System of Taxation for Small Entrepreneurship
Industry	100	23.1	15
Agriculture	60	19.4	15
Construction	50	16.8	15
Wholesale	50	13.3	15
Retail trade	30	7.8	15
Personal services	30	14.0	15
Other non-manufacturing sectors	25	11.9	15

Sources: Ministry of Statistics and Analysis; author's calculations on the basis of the data of the Ministry of Statistics and Analysis.

Table 4. Limits on the Gross Turnover

Industry	Law on the Simplified System of Taxation for Small Entrepreneurship		Actual Average Gross Turnover at Small Enterprises in 2002, BYR m
	Base Amounts	BYR m¹	
Industry	20,000	283.5	386
Agriculture	20,000	283.5	144
Construction	20,000	283.5	210
Wholesale	20,000	283.5	412
Retail trade	20,000	283.5	597
Personal services	20,000	283.5	59
Other non-manufacturing sectors	20,000	283.5	-

¹ The average monthly base amount was BYR 14,175 as of 2002.

Sources: Ministry of Statistics and Analysis; author's calculations on the basis of the data of the Ministry of Statistics and Analysis.

Moreover, the potential problem is that the limit on the gross turnover is quarterly. But individual entrepreneurs and small enterprises don't always have a similar quarterly gross turnover within the calendar year. Thus, in the case of seasonal fluctuations of economic activity, they can lose the right to use the simplified system of taxation.

(v) **Limitation on the possibility to use a single-entry bookkeeping.** A single-entry bookkeeping can be only used by small enterprises of the non-manufacturing sectors of the economy. The rest of the small enterprises can use a double-entry bookkeeping with an abridged system of accounts that requires a presence of bookkeepers. So, the efficiency of the simplified system of taxation reduces. But a double-entry bookkeeping under the simplified system is excessive because the calculation of tax liabilities is only based on the amount of gross turnover for the accounting period.

4. Possible Options of the Simplified System of Taxation for Small Business

Before we put forward our recommendations concerning the main directions of the reform, let us consider two possible options of the simplified system of taxation for small business, that are discussed in literature and applied in many countries – cash-flow taxation and gross turnover taxation. Both systems of taxation allow to significantly simplify taxation, bookkeeping, and reporting for small business.

4.1. Cash-Flow Taxation

Under cash-flow taxation the tax base is net turnover that is a difference between revenue from sales and input costs of goods and services. There are several types of cash-flow taxes depending on the tax base – R-taxes and RF-taxes.

In the case of **R-taxes** (real-based cash-flow taxes), the tax base is a difference between revenue from sales and input costs of goods and services excluding financial transactions, i.e. a net cash-flow of real transactions. **RF-taxes** (real plus financial-based cash-flow taxes) differs from R-taxes in that their base also include a difference between received loans and paid debts and a difference between received and paid interest payments, i.e. a net financial cash-flow.

Unlike profit taxation, while calculating cash-flow taxes not only current operating expenditures but also capital investments are deducted from the tax base (immediate write-off). In such a situation, small enterprises are allowed to carry losses forward. All of this means that for tax purposes there should be no provisions for circulating assets, anticipated losses or other book reserve arrangements, accrual and deferral etc. Therefore, there is no demand for a fully-fledged annual accounting system with a double-entry bookkeeping. Revenues and expenditures are accounted in a simplified system of annual accounts.

The prime advantage of cash-flow taxes is that profits (value-added) are subject to taxation. So, the amount of taxes does depend on actual financial performance of enterprises. As a result, this system of taxation is more equitable and has no negative impact on enterprises' performance. Moreover, it is conducive to investments. One of the disadvantages of cash-flow taxes is instability of the government tax revenue. In particular, the government runs high risks of misuse and fraud if it allows to write-off losses immediately against other income, or even to refund taxes in the case of losses. Some entrepreneurs may feign business losses in order to reduce the tax burden from other activities or even get refunds from the tax authorities. Therefore, sound carry-forward procedures for losses should be found. An alternative is to run simplified depreciation rules (e.g. 3 boxes of inventory with depreciation ranges by 5 and 15 years), as it is the case in many western economies.

4.2. Gross Turnover Taxation

Unlike cash-flow taxes, the base of gross turnover taxes is simpler to calculate since it is not necessary to estimate the cost of inputs. Besides, the government tax revenue is more stable because the tax base doesn't depend on actual financial performance of enterprises. However, the prime disadvantage of these taxes is that gross turnover (but not value-added) is subject to taxation. So, the introduction of a single gross turnover tax leads to creation of unequal conditions for different enterprises and therefore violates tax equity and efficiency, as it distorts economic processes. The reason is that profits of different enterprises vary as a share of gross turnover, in particular, they vary between industries. This raises the question of introducing different tax rates in order to meet different input ratios related to industries. But this might provoke tax-saving adjustments to be taxed at lower rates – e.g. small enterprises in the manufacturing sector may carry out some retailing activities and therefore demand the lower tax rate for trading. In these cases, the tax authorities have to deal with the sophisticated problems of assigning the center of activity. Moreover, the government has to specify the suited tax rate according to the input ratio. This information could be derived as averages from business statistics, but presumably this process would lead to lobbying pressure in order to get a lower rate. Thus, there is a certain trade-off between simplification in terms of reducing compliance costs at the one hand and to cope with the general tax rules as equity and efficiency on the other hand, in the sense that more simple rules often violate tax justice and distort economic processes.

5. Policy Recommendations

The creation of an efficient simplified system of taxation that is adequate to the Belarusian circumstances and contributes to small business development is an important task for the government. Based on this, first of all we propose to reform the existing simplified system of taxation as follows:

First, the rate of gross turnover taxation should be decreased from 10 to 8% that would make the simplified system comparable to the general system of taxation in terms of tax burden.

Second, individual entrepreneurs and small enterprises should be allowed to charge a value-added tax on a voluntarily basis. In this case they should pay the gross turnover tax at the rate of 6%. This would create the equal conditions for individual entrepreneurs and small en-

terprises that use the simplified system of taxation and those of them who use the general system of taxation.

Third, the advance taxpaying mechanism should be abolished. The gross turnover tax should be paid quarterly according to the actual outcomes of enterprises' performance. This would also allow to introduce the notification principle of usage the system.

Fourth, the scope of the simplified system of taxation should be extended by increase of the limit on the average number of employees up to 25 persons (by 67%) and the limit on the gross turnover up to 30,000 base amounts per annum (by 50%). This would allow to use the simplified system of taxation by individual entrepreneurs and small enterprises of the manufacturing sector of the economy and provide a proportionality of these criteria.

Fifth, it should be allowed to use a single-entry bookkeeping for all individual entrepreneurs and small enterprises within the simplified system of taxation. However, the simplified bookkeeping shouldn't exempt taxpayers from the responsibility to keep invoices, receipts, and other documentation necessary for tax authorities' control. Taxpayers themselves should make the choice between a single-entry bookkeeping and a double-entry bookkeeping. This would increase the efficiency of the simplified system of taxation.

According to our estimations, these measures would significantly improve the economic environment for small business development. However, we expect that in the longer-run the disadvantages of gross turnover taxation would be crucial so that cash-flow taxation might be an alternative. Cash-flow taxation would allow to avoid overtaxation of businesses running small profits or even losses. This "insurance effect" would surmount the enhanced volatility of the government tax revenue, the more so as capital and risk costs are much higher in the case of small enterprises, in particular, in transition economies.

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Special Taxation Regimes for Small Business in Transition Economies

Country	General Tax Allowances	Simplified Taxation		
		Presumptive Tax	Cash-Flow Tax	Gross Turnover Tax
Albania	no	yes ¹	no	4% ²
Armenia	no	yes ³	no	no
Azerbaijan	no	no	no	2% ⁴
Belarus	no	yes	no	10%
Bosnia and Herzegovina (Fed.)	no	no	no	no
Bosnia and Herzegovina (Rep.)	no	no	no	no
Bulgaria	yes ⁵	yes ⁶	no	no
Croatia	no	yes	no	no
Czech Republic	no	yes	no	no
Estonia	no	no	no	no
Georgia	no	yes ⁷	no	no
Hungary	yes ⁸	no	no	no
Kazakhstan	no	yes	no	4-11% and 5-13% ⁹
Kyrgyz Republic	no	no	no	5-10% ¹⁰
Latvia	yes ¹¹	no	no	no
Lithuania	yes ¹²	yes ¹³	no	no
Macedonia	no	yes	no	no
Moldova	yes ¹⁴	yes ¹⁵	no	no
Poland	no	yes	no	no
Romania	yes ¹⁶	no	no	yes ¹⁷
Russia	no	yes	6% ¹⁸	15% ¹⁸
Serbia and Montenegro (Serbia)	yes ¹⁹	no	no	no
Serbia and Montenegro (Montenegro)	–	–	–	–
Slovak Republic	no	yes	no	no
Slovenia	no	no	no	no
Tajikistan	–	no	no	5% ²⁰
Turkmenistan	yes ²¹	yes ²²	no	no
Ukraine	no	yes	no	6 and 10% ²³
Uzbekistan	no	yes ²⁴	no	10 and 25% ²⁵

¹ For micro businesses defined by gross annual turnover less than ALL 2 m (USD 19,000).

² For small businesses defined by gross annual turnover ALL 2-8 m (USD 19,000-75,000).

³ For small scale activities such as hairdressers, gas stations, commercial fishing, and trading activities conducted in stores with trading area less than 30 square meters.

⁴ For micro businesses defined by gross annual turnover less than 300 times the minimum wage (USD 3,600).

⁵ Profit tax discount for small businesses defined by taxable profit less than BGN 50,000 (USD 32,000).

⁶ For sole traders.

⁷ For small businesses defined by gross annual turnover less than GEL 24,000 (USD 12,000).

⁸ Profit tax discount of interests on loans used for investment.

⁹ 4-11% – for individual entrepreneurs without a legal entity, 5-13% – for small enterprises.

¹⁰ For small businesses defined by gross annual turnover less than KGS 3 m (USD 72,000).

¹¹ Profit tax discount for small businesses meeting at least two of the following three criteria: book value of tangible assets – LVL 70,000 (USD 37,000); net annual turnover – LVL 200,000 (USD 107,000); average number of employees – 25 persons.

¹² Profit tax discount for small businesses defined by gross annual turnover less than LTL 500,000 (USD 180,000) and with less than 11 employees.

¹³ For small businesses defined by gross annual turnover less than LTL 100,000 (USD 36,000).

¹⁴ Profit tax discount of 35% for two years.

¹⁵ For individual entrepreneurs without a legal entity.

¹⁶ Profit tax discount for reinvested profit.

¹⁷ For micro businesses defined by gross annual turnover less than EUR 100,000 and with less than 10 employees.

¹⁸ For small businesses defined by gross annual turnover less than RUR 14.7 m (USD 530,000) and with less than 100 employees.

¹⁹ Profit tax discount amounting 30% of new investment.

²⁰ For small businesses not liable to VAT.

²¹ Profit tax discount for small businesses defined by gross annual turnover less than TMM 72 m (USD 14,000), or less than 50 employees in manufacturing enterprises, or less than 10 employees in trading enterprises, or less than 25 employees in all other types of enterprises.

²² For individual entrepreneurs with gross annual turnover less than TMM 72 m (USD 14,000).

²³ For small businesses defined by gross annual turnover less than UAH 1 m (USD 190,000) and with less than 50 employees. Small businesses can pay a 6% tax that doesn't exempt from VAT or a 10% tax that do exempt from VAT.

²⁴ For individual entrepreneurs without a legal entity.

²⁵ 10% – for small manufacturing enterprises, 25% – for small trading enterprises.

Note. Cash-flow or gross turnover taxes replace different taxes in various countries.

Source: Mitra, P., Stern, N. (2002) *Tax Systems in Transition*, Washington, World Bank, 31-32.