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The design of presumptive tax regimes

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The Design of Presumptive Tax Regimes

By Mariona Mas-Montserrat, Céline Colin, Eugénie Ribault and Bert Brys



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Abstract

Presumptive tax regimes (also known as simplified tax regimes) aim at encouraging tax compliance and business formalisation by reducing tax compliance costs and by levying lower tax rates as compared to the standard tax system. These regimes usually target micro and small businesses and levy tax on a presumed tax base that intends to approximate taxable income by indirect means. Hence, they can be particularly relevant where actual taxable income is difficult to assess accurately. These regimes are present in many tax systems and differ widely in their design dimensions. This OECD working paper presents an analytical framework that allows for the systematic characterisation of country-specific presumptive regimes and the identification of their differences and commonalities. It also signals some of the key design questions worthy of receiving closer attention in the future and concludes with a series of best practices for the design and administration of presumptive tax regimes.

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1 Introduction

Presumptive tax regimes levy tax on a presumed tax base that intends to approximate net taxable income by indirect means (Iordachi and Tirlea, 2016^[1]) (Thuronyi, 2004^[2]). These regimes can be particularly relevant where actual taxable income is difficult to assess accurately (Logue and Vettori, 2011^[3]). This is the case, for instance, where businesses do not keep complete books or where cash payments are prevalent.

Presumptive tax regimes (also sometimes referred to as simplified tax regimes in the literature) aim at reducing compliance costs for taxpayers and monitoring costs for the tax administration. In certain circumstances, applying the rules of the standard tax system to micro and small businesses might impose excessive compliance and enforcement costs on taxpayers and the tax administration, respectively. Presumptive regimes establish simplified rules to encourage tax compliance and business formalisation (i.e. registering with public authorities such as the tax administration and the social security institution).

These regimes are present in many tax systems and differ widely in their design dimensions (e.g. the target group, the eligibility criteria, the presumption of the tax base and the tax liability, etc.) (Bucci, 2020^[4]). These multi-dimensional differences complicate cross-country comparability and thus the extraction of solid conclusions for an optimal design of presumptive tax regimes.

This working paper develops an analytical framework that allows for the systematic characterisation of country-specific presumptive tax regimes and the identification of their differences and commonalities. This benchmarking exercise will allow for an examination of the strengths and weaknesses of each regime so as to identify opportunities for improved tax design on a country-by-country basis. The framework can also play a role in identifying some of the key design questions worthy of receiving closer analytical attention in the future.

Based on the issues derived from the design features discussed, this working paper lists a series of best practices for the design and administration of presumptive tax regimes. The best practices are accompanied by potential challenges the tax administration might face or desirable conditions that should be met at the time of their implementation.

Presumptive tax regimes differ from simplified tax provisions foreseen in the standard tax system, such as reduced corporate income tax (CIT) or value-added tax (VAT) rates (Loeprick, 2009^[5]) or simplified accounting practices. However, simplified tax measures can be an integral part of the design of a presumptive tax regime. This working paper focuses on presumptive tax regimes only. It does not cover simplified or presumed tax provisions established in the standard tax system such as presumed costs deductions¹, simplified CIT rules for micro and small businesses or presumptive input VAT deductions that might be integrated within the standard tax system to ease VAT compliance costs for small businesses.

¹ In income tax systems that allow presumed cost deductions, taxpayers declare their actual income with their costs being determined on a presumptive basis. In general, countries with systems based on presumptive cost deductions allow taxpayers to opt for deduction of actual costs if they wish to do so.

The remainder of this working paper proceeds as follows. Section 2 will briefly describe the objectives, advantages, shortcomings and documented impacts of presumptive tax regimes. Section 3 will present the analytical framework and discuss in detail each design area involved. Section 4 will then present a series of best practices (and their potential challenges) derived from the design and administrative issues introduced in Section 3.

2 Objectives, advantages, shortcomings and documented impacts of presumptive tax regimes

Presumptive tax regimes target taxpayers that are “hard-to-tax” businesses (i.e. self-employed, unincorporated businesses, micro and small enterprises, farmers²). Hard-to-tax businesses usually have low incomes, do not register voluntarily with the tax administration, do not keep complete books, do not file tax returns and use cash payments which make it difficult for the tax administration to monitor them and ensure compliance (Rajaraman, 1995^[6]) (Thuronyi, 2004^[2]).

Presumptive tax regimes aim at encouraging tax compliance by reducing tax compliance costs and by levying lower tax rates as compared to the standard tax system (Loeprick, 2009^[5]) (Balestrino and Galmarini, 2005^[7]). Tax compliance costs are associated with recording transactions, maintaining accounting records and financial statements, calculating tax liabilities, and following tax payment procedures (OECD, 2009^[8]). Small taxpayers with generally lower profits than larger ones tend to be disproportionately impacted by fixed compliance costs (OECD, 2009^[8]) (OECD, 2015^[9]) (ILO, 2021^[10]). By reducing the administrative burden (e.g. with simplified book-keeping rules), presumptive tax regimes contribute to reducing informality and broadening the tax base (Engelschalk, 2007^[11]).

For the tax administration, presumptive tax regimes reduce the administrative costs of monitoring hard-to-tax businesses and ensuring their compliance. Regular assessment of their books can be difficult, especially where non-compliance is extensive and administrative resources are limited (Bucci, 2020^[4]). Presumptive tax regimes allow the tax administration to easily determine the tax liabilities of a large number of small taxpayers (Engelschalk, 2007^[11]) – without preventing the administration from conducting regular and thorough controls of at-risk businesses (Bulutoglu, 1995^[12]).

Presumptive tax regimes could help to increase social protection coverage where they include social security contributions (Thuronyi, 2004^[2]). Granting access to social protection might act as an incentive for individuals to formalise their activity. Thus, through the regime’s registration, presumptive tax regimes can operate as a channel for extending social protection to a large number of self-employed workers, and possibly also their employees and/or family dependants, previously operating in the informal sector.

Presumptive tax regimes do not aim to raise significant amounts of tax revenues, but seek to reinforce tax compliance (ILO, 2021^[13]) (BP 20).³ Although these regimes can generate additional tax

² This paper does not focus on the agricultural sector.

³ Throughout the text, the reference “BP (number)” is used to refer to the corresponding good practice set out in Section 4. In this case, BP 20 refers to best practice point 20.

revenues, the amounts are generally small even when the regime is well designed and well administered (Engelschalk and Loeprick, 2015^[14]). Instead, those regimes seek to improve tax compliance over the long term which, to some extent, justifies that tax revenue collection costs may exceed the tax revenues collected in the short term (Engelschalk, 2007^[11]).

Presumptive tax regimes often have shortcomings (Engelschalk and Loeprick, 2015^[14]) (Engelschalk, 2007^[11]) (Engelschalk, 2004^[15]), such as:

- **They can deter businesses from growing.** They may create a tax-induced incentive for businesses to remain small and not grow beyond the regime's eligibility threshold in order for the business to continue to enjoy the regime's preferential tax treatment and compliance advantages ("bunching effect").
- **They can induce tax avoidance and/or evasion behaviour.** They may provide a tax-induced incentive to businesses to split their activities (tax avoidance) or under-declare their turnover (or over-declare their costs if the eligibility threshold is defined according to the net income) so as to remain within the eligibility threshold(s) (tax evasion). Presumptive tax regimes may also induce employers to request their employees become artificially self-employed when, for example, these regimes do not allow registered businesses to have (one or multiple) employees or when the tax differential between a self-employed individual in the presumptive tax regime and an employee in the standard tax system is large. Specific tax provisions will be needed to prohibit these strategies. Similarly, if there is more than one presumptive tax regime, taxpayers can try to reduce their tax liabilities by switching from one regime to another.
- **They can erode tax equity.** Taxpayers within the same target group may face similar tax liabilities despite having different profits; i.e. the regime may result in vertical inequity. In contrast, taxpayers with similar profits may be subject to very different effective tax rates depending on whether or not they have passed the regime's eligibility threshold; i.e. the regime may result in horizontal inequity.
- **They might not incentivise the formalisation of businesses' purchases.** Since presumptive tax regimes do not allow the taxpayer to deduct actual costs, registered businesses might have incentives to acquire their inputs from businesses operating in the informal sector as long as this involves lower costs.

Presumptive tax regimes may encounter institutional and administrative challenges (Waiswa et al., 2021^[16]) (Aditya, 2020^[17]) (Onias et al., 2014^[18]) (IDB, 2009^[19]). This can be the case when the presumptive tax regime is not managed by the Ministry of Finance (BP 47), or when administrative capacities are insufficient to collect information, monitor and audit registered taxpayers (e.g. ensuring that the eligibility criteria are met by businesses claiming the benefits of the regime, detecting artificial self-employment arrangements, etc.) (BP 7).

The number of empirical studies that have evaluated the impact of presumptive tax regimes remains relatively limited. This can be explained by a lack of data and because tax administrations and Ministries of Finance have tended to pay less attention to these regimes given that they typically raise such small amounts of revenue (Bucci, 2020^[4]). The impact of presumptive tax regimes can be measured directly (e.g. by measuring the additional number of taxpayers or informal workers that have formalised or the additional tax revenues that are collected), or indirectly by identifying the regime's positive externalities (e.g. the possible drop in poverty rates and increase in social protection for low-income workers).

Recent studies have found that presumptive tax regimes encourage business formalisation when the regimes are introduced (ILO, 2021^[10]) (Aditya, 2020^[17]) (Engelschalk, 2004^[15]). However, the formalisation effect levels off over time, which suggests that regimes can persuade taxpayers whose

practices are closest to the formal system to formalise, but are not necessarily sufficient to encourage those whose practices are furthest away to do so.

While presumptive tax regimes may not reach all targeted businesses, registered taxpayers usually remain in the regime. Low take-up upon introduction can be explained by a lack of communication about the new regime or tax uncertainty (e.g. tax rules that change frequently or that are complex and might be subject to interpretation) (BP 11, BP 21). Nonetheless, participation in presumptive tax regimes generally persists over time, as the number of businesses that grow out of the regime into the standard tax system remains limited (ILO, 2021^[10]). Bunching effects, whereby large groups of taxpayers can be observed just below the eligibility threshold, are more frequently observed in regimes aimed at small or medium-sized businesses than at self-employed and micro-businesses.

Presumptive tax regimes that integrate social security contributions have positive effects on labour formalisation, especially for the self-employed. However, labour audits on employer social security contributions, the imposition of penalties where appropriate, stricter implementation of labour regulations, or the quality of services and benefits received in exchange for contributions paid are also key formalisation drivers (Teixeira, 2021^[20]).

3 Analytical framework for presumptive tax regimes

This working paper develops an analytical framework for presumptive tax regimes which allows for the systematic characterisation of country-specific presumptive tax regimes and the identification of their differences and commonalities.

The framework focuses on several design and administration areas:

1. Target group
2. Eligibility criteria
3. Type of regime
4. Tax liability
5. Taxes covered
6. Regime administration
7. Non-tax support instruments
8. Interaction with the standard tax system

Table 3.1 highlights how this framework will be applied to country-specific presumptive regimes. The remainder of this Section will discuss in detail each of the eight design and administration areas.

Table 3.1 Analytical framework to apply to country-specific presumptive tax regimes

Country			Regime
Year of introduction			Date
Dates of main tax design changes			Date
1. Target group	Number of taxpayers		Number
	Business type	Unincorporated	Yes / No
		Incorporated	Yes / No
	Business size	In terms of employment	Several possible answers: <ul style="list-style-type: none"> • Self-employed with no employees • Micro-businesses (1-9 employees) • Small businesses (10-49 employees) • Medium-sized businesses (50-249 employees) • No limit on employment
		In terms of turnover	Several possible answers, according to each country's definition: <ul style="list-style-type: none"> • Micro-businesses • Small businesses • Medium-sized businesses • No limit on turnover
	Type of activity	Liberal professions	Yes / No

		Specific sectors	Yes / No
2. Eligibility criteria	Turnover threshold		Detailed information
	Type of activity / sector		Detailed information
	Possibility to hire employees		Yes / No + information on the maximum number of employees
	Other		Detailed information
3. Type of regime			Possible answers: <ul style="list-style-type: none">• Lump-sum taxation method• Regime based on indicators of economic activity:<ul style="list-style-type: none">• Turnover• Other indicators:<ul style="list-style-type: none">• Facility's indicators (surface area, location)• Inputs consumption• Years of professional experience• Machinery capacity• Number of employees• Inventory value• Turnover + Other indicators• Cash flows• Fixed assets• Wealth• Regime based on an agreement with the tax administration
4. Tax liability			Possible answers: <ul style="list-style-type: none">• Lump-sum<ul style="list-style-type: none">• Fixed amount• Differentiated amounts• Tax rate<ul style="list-style-type: none">• Proportional rate• Differentiated rates• Progressive rates• Combination of differentiated and progressive rates
5. Taxes covered	Taxes substituted by the regime's contribution		Possible answers for each category: <ul style="list-style-type: none">• Personal income tax• Corporate income tax• Social security contributions• VAT• Local taxes• Fees• Other
	Taxes to be paid separately as a result of the business activity		
	Taxes exempted by the regime's rules		
	Taxes exempted by the tax system (rules enforced independently from the regime's scope)		
5.1 Social security contributions	Contribution	Computation	Possible answers: <ul style="list-style-type: none">• Lump-sum• Proportional rate on a specific base (e.g. minimum wage)
		Scalable over time	Yes / No
	Social benefits		Possible answers: <ul style="list-style-type: none">• Same as the standard regime• Specific + detailed information
	Payment		Possible answers: <ul style="list-style-type: none">• Mandatory• Partially mandatory• Voluntary
	Single collecting body		Yes / No
	Co-financing from the general budget		Detailed information
6. Regime administration	Facilitation of taxpayer's procedures	Digital services	Detailed information
		Simplified accounting	Detailed information

		procedures	
		Reduced frequency of tax filing and payments	Detailed information
		Other	Detailed information
	Institution responsible for the design/revision of the regime		Possible answers: <ul style="list-style-type: none">• Central administration• Local administration
	Institution responsible for the monitoring/control of the regime		Possible answers: <ul style="list-style-type: none">• Central administration• Local administration
Specialized unit or staff within the tax administration to monitor the target group		Yes / No + detailed information	
7. Non-tax support instruments			Possible answers: <ul style="list-style-type: none">• Bank credits• Training/capacity building• Other
8. Interaction with the standard tax system	Facilitating the transition: specific tax provisions and procedures in the standard tax system	Reduced rates	Detailed information
		Simplified accounting procedures	Detailed information
		Reduced frequency of tax filing and payments	Detailed information
		Other	Detailed information
	Existence of several presumptive tax regimes		Yes / No + number
	Registration in the presumptive tax regime		Possible answers: <ul style="list-style-type: none">• Voluntary• Mandatory
	Permanence in the presumptive tax regime		Possible answers: <ul style="list-style-type: none">• Unlimited• Limited / renewable• Limited / non-renewable
	VAT	Eligibility threshold aligned with the VAT registration threshold	Yes / No + VAT registration threshold
		Option to register to VAT and remain in the regime	Possible answers: <ul style="list-style-type: none">• Yes / No• With / without conditions
	Existence of studies on the interaction between the presumptive tax regime and the standard tax system		Yes / No + detailed information

Source: OECD.

3.1. Target group

Presumptive tax regimes may target various sub-groups within the broader category of hard-to-tax businesses, possibly including self-employed entrepreneurs, micro, small and medium-sized (unincorporated and/or incorporated) businesses and liberal professions. They can target specific economic sectors or be generally applicable but exclude certain sectors, in particular those that are highly profitable and whose businesses ought to be capable of complying with the general tax regime.

The target group should be limited to businesses that face challenges in keeping complete and up-to-date books and records (Engelschalk, 2007^[11]) (BP 1). As a result, presumptive tax regimes

frequently exclude liberal professions as these professionals tend to be highly educated and earn significant levels of income, and they should therefore be capable of keeping books and filing a tax declaration under the standard tax system (BP 6). Indeed, the fact that a certain category of businesses is (largely) non-compliant with the tax regulations in place should not automatically qualify them for being included in the presumptive tax regime's target group (BP 3).

The self-employed and small unincorporated businesses are commonly included in the target group. The exclusion of incorporated businesses from presumptive tax regimes is often aimed at reducing tax optimisation opportunities ("downward migration"), where incorporated businesses artificially reduce or split their activity in order to migrate from the standard tax system into the presumptive tax regime (Engelschalk and Loeprick, 2015^[14]).

The introduction of a presumptive tax regime for a specific target group requires careful planning and analysis (BP 2, BP 5). The definition of the target group and the overall design of the presumptive tax regime needs to be based on an empirical analysis of the hard-to-tax businesses operating in the country. For this to be possible, the tax administration needs to put information systems in place that allow for the collection of information on business activity and the characteristics of the businesses that are in scope, including those operating in the informal sector. Relevant information includes turnover and other indicators related to business economic activity, average business profitability by business segments, the level and type of taxes and fees supported by businesses that are in scope and their difficulties in complying with the standard tax system requirements. This analysis should allow the tax administration to examine which typology of businesses are under-represented in their registries, which kinds of activities are likely to involve the under-reporting of taxable income, what is the average business profitability by activity type and preferably by location, which indicators could be used to approximate taxable income of hard-to-tax businesses, what are the costs of complying with the standard tax system for micro and small businesses and what is the effective tax burden currently applicable to this type of business.

3.2. Eligibility criteria

Eligibility criteria must be set to exclude from the presumptive tax regime those taxpayers that do not belong to the target group (BP 3). Eligibility criteria (or thresholds) based on turnover are often implemented, sometimes with distinctions drawn across activities or sectors (Thuronyi, 2004^[2]). Additional eligibility criteria exist, such as restrictions on the number of employees an eligible business can hire, the use of premises to pursue the business activity, the number of activities developed or conditions on the personal properties owned. In practice, a combination of eligibility criteria are often used and they are linked to the type of regime. Ideally, eligibility criteria must be simple and easily auditable (including via digitalised tax systems to reduce on-the-ground inspections that are potentially costly and open to corruption) (BP 12).

Several possibilities exist when defining the eligibility criteria:

- There is only one single eligibility criterion for all taxpayers under the regime.
- There are several eligibility criteria to distinguish between groups within the regime (e.g. different criteria and eligibility thresholds might be set between incorporated businesses and unincorporated taxpayers (Engelschalk, 2004^[15]), or some countries have different VAT registration thresholds across sectors, which are reflected in a presumptive tax regime's eligibility criteria).
- The eligibility criteria do not apply to certain specific business segments (but this practice does not improve the regime's equity) (Engelschalk, 2007^[11]).

- There can be two thresholds for “entry” in and “exit” out of the regime. The first, which is not always included in the design, excludes very small taxpayers. The second, excludes taxpayers capable of bearing the compliance costs of the standard tax system (Thuronyi, 2004^[2]).

Other design aspects must be considered regarding eligibility criteria. First, if the eligibility criterion is turnover, good practice is to index the turnover threshold(s) to inflation to prevent erosion (Thuronyi, 2004^[2]) (Bird and Wallace, 2004^[21]). Additionally, the higher the turnover threshold, the greater the number of medium-sized businesses that will have access to the regime. Hence, the threshold for the presumptive regime should not be set too high, as this could have the effect of extending eligibility to too many taxpayers and empty the standard tax system (BP 3). Moreover, the eligibility criteria should be aligned (and should evolve) with the tax administration’s capacities (Engelschalk and Loeprick, 2015^[14]).

3.3. Type of regime

All presumptive tax regimes presume taxable income. The various regimes differ on the method used to make that presumption. The more accurate the method for evaluating an entity’s profitability, and thus its taxable income, the better the design of the regime (BP 28) (Logue and Vettori, 2011^[3]). Therefore, before the regime is introduced, detailed estimates of the average profits of the targeted businesses are needed (Engelschalk, 2007^[11]).

3.3.1. Lump-sum taxation method

Regimes based on a lump-sum tax are the simplest version of a presumptive tax regime. A lump-sum tax is transparent and predictable (BP 11) and, therefore, results in low compliance costs for taxpayers and low administrative costs for the tax administration. This type of regime does not require a wide range of individual information on business size, turnover and activity, and can be applied to all registered businesses. In practice, the lump-sum taxation method is generally applied to individuals with low incomes, often with limited levels of literacy and very low capacity to meet book-keeping requirements and comply with tax obligations (Thuronyi, 2004^[2]) (BP 4). The lump-sum might depend on a type of activity or sector and is typically unrelated to an entity’s size, location or turnover (Engelschalk, 2004^[15]). Hence, this taxation method avoids the issues arising from turnover under-reporting. The lump-sum is often set low in order to ensure voluntary compliance and to avoid creating disincentives for businesses to grow. Since this taxation method cannot take into account the different abilities to pay tax among the target group, it may result in a high effective tax burden on less profitable businesses and create liquidity constraints for new businesses or those experiencing a drop in their activity. In general, this kind of regime is popular in the countries that implement it, making it difficult to abolish (Bucci, 2020^[4]).

3.3.2. Regime based on an indicator of economic activity

Turnover

Turnover-based regimes are often the most popular type of presumptive tax regime (Engelschalk, 2007^[11]) (Engelschalk, 2004^[15]). Regimes based on business turnover reflect taxpayers’ profitability more accurately than a regime based on a lump-sum or on other indicators of economic activity, such as the value of business capital or the number of employees. A turnover-based presumptive tax regime requires taxpayers to keep books, which will facilitate the possible future inclusion of the business into the standard tax system (BP 5, BP 9). Tax liabilities fluctuate with the business’ economic cycle (BP 29), which can benefit new businesses making low or no sales, or businesses experiencing a sales drop.

Finally, the method of calculation is straightforward, and requires less human and financial resources as compared to methods based on other indicators of economic activity.

Taxation of turnover (rather than profit) is advantageous to taxpayers with high profit margins, whereas taxpayers with low profit margins are taxed relatively heavily (ILO, 2021^[10]). As the ratio of turnover to profit varies across sectors, turnover-based regimes are often adjusted to reflect the sectoral differences in average profitability. When the regimes apply to more than one sector, adjustments to turnover using sectoral coefficients or differentiated rates can be implemented in order to improve the alignment of the turnover-based tax with the average business profitability of each sector (BP 31).

Turnover-based regimes create a tax-induced incentive to under-declare turnover, which will raise concerns in particular where the tax administration's auditing capacity is low and/or cash payments are frequent (BP 9). Tools exist to reduce under-declaration of turnover (Engelschalk, 2007^[11]) (BP 44). For instance, businesses can be encouraged or required to use electronic cash registers, which will simplify turnover verification. Where the single tax payment includes the VAT, detecting under-declaration of turnover will be more difficult as there is no separate VAT compliance procedure (OECD, 2009^[8]) (BP 43). In order to overcome turnover under-reporting and approach actual business profitability as closely as possible, given the existing constraints, tax administrations can use a combination of turnover and other indicators of economic activity which are difficult to falsify to determine the presumed tax base (BP 45).

Cash flow

Business cash flow (i.e. the difference between funds that are received and expenditures being paid) can provide a basis for estimating taxable income of small businesses. Cash-flow based regimes require more detailed book-keeping than turnover-based regimes (Aditya, 2020^[17]), which may present an administrative challenge for taxpayers with less capacity, but would further facilitate the migration into the standard tax system.

Fixed assets

Fixed assets reflect different capital intensities across sectors and are more difficult to misreport than turnover. However, a skilled tax administration is a pre-requisite for using this indicator in presumptive tax regimes (BP 10). In addition, the use of fixed assets might discourage capital investment if taxpayers aim at staying within the presumptive tax regime (ILO, 2021^[10]).

Wealth

Wealth can constitute another indicator used to presume taxable income (Logue and Vettori, 2011^[3]). However, asset valuation is a complex exercise and many taxpayers do not have any tangible assets, which explain why this indicator is rarely used. Nonetheless, indicators of personal wealth (e.g. personal property or vehicles) can sometimes be used as part of the eligibility criteria to exclude taxpayers from the regime (Thuronyi, 2004^[2]) (BP 3).

Other indicators of economic activity

Indicators of economic activity other than turnover can be the basis of presumptive taxation. For example, the number of employees in the business, the size of the business premises, water or electricity consumption, the use of other inputs, the value of the inventory, the capacity of machinery (e.g. storage capacity, vehicle capacity), the number of years of operation of the business, or the taxpayer's number of years of professional experience can all be used to determine the presumptive tax base.

These methods are less open to indicator misreporting and have the advantage of providing a more accurate basis for estimating taxpayers' profits than regimes based exclusively on turnover (Engelschalk, 2004^[15]) (BP 10). They are also less likely to lead to discussions between the tax administration and the taxpayer on tax liabilities. Finally, these methods do not require any book-keeping, thus reducing taxpayers' tax compliance costs.

However, such regimes are difficult to design and not always well-accepted. For example, they are not best suited to new or loss-making businesses as tax liabilities are incurred despite low or no profit. Another challenge lies in choosing the right indicators. The indicators must sufficiently reflect a taxpayer's profitability and ability to pay, which requires extensive prior research into businesses' profitability. They must be easy to verify, present a low risk of misreporting, concealment and substitution, and show a sufficient correlation to actual income (Engelschalk, 2007^[11]) (BP 10). In some cases, information on business inputs obtained from third parties can be useful, including water or electricity suppliers. Location can act as an additional indicator of the differences in profitability between businesses operating in the same sector but in different geographical areas (however this can complicate the regime significantly). Once the indicators are selected, sectoral adjustments with coefficients might be required to reflect differences in profitability across sectors.

The number of employees is not the most appropriate indicator. Although this indicator is easy to calculate and monitor through labour inspections, it could act as a disincentive to recruit formal employees (BP 26).

The use of water or electricity consumption as an indicator is less common but offers some advantages. It is difficult to misreport and may involve positive externalities through reduced water and/or electricity consumption leading to a reduction in waste and pollution. However, establishing a clear relationship between input consumption and taxable income requires technical knowledge and skills in areas that are typically not mastered by tax administration officials (BP 10).

3.3.3. Regimes based on an agreement between the tax administration and the taxpayer

Regimes based on an agreement between the tax administration and the taxpayer require an estimation of each taxpayer's profits. This then acts as a basis for discussion between the business and the tax administration (Engelschalk, 2007^[11]). While it has the advantage of taking into account each taxpayer's individual circumstances, it requires frequent interaction between taxpayers and the tax administration, leading potentially to corruption or collusion, and high administrative costs (BP 15).

3.3.4. Rebuttable versus non-rebuttable presumptions

Presumptions can be rebuttable or non-rebuttable (Thuronyi, 2004^[2]). A rebuttable presumption is based on the tax administration's estimate of a taxpayer's income with the taxpayer allowed to prove that its actual income is lower than the figure estimated by the administration. A non-rebuttable presumption can be: (i) a minimum tax, where tax liabilities are no less than those determined under the presumptive rules (this involves calculating and comparing the two tax liabilities according to the presumptive and the standard tax system rules, which can be more complex); or (ii) an exclusive tax, where tax liabilities are determined solely using the presumptive rules.

3.4. Tax liability

The tax liability of the business can be determined by levying a lump-sum amount or a tax rate. The lump-sum amount may be a single amount (similar for all taxpayers) or may vary by tax brackets

(based on specific criteria). Alternatively, a tax rate might be applied to the presumptive tax base (e.g., turnover), with several options: a proportional rate, differentiated rates, progressive rates or a combination of differentiated and progressive rates.

Several criteria should be considered when setting the tax level (Engelschalk and Loeprick, 2015^[14]) (Engelschalk, 2007^[11]) (Bulutoglu, 1995^[12]). It should be low enough to be attractive and to encourage taxpayers to register in the presumptive tax regime, while being high enough not to deter them from migrating into the standard tax system (BP 23, BP 35). Analysis of the profitability of the target group(s) is often necessary to ensure a tax level that is proportionate to actual income (BP 28). Similarly, it is preferable that the tax differential between a self-employed business in the presumptive tax regime and an employee in the standard tax system be limited in order not to encourage artificial self-employment (BP 42).

3.4.1. Lump-sum amount

A lump-sum amount has advantages (Engelschalk, 2007^[11]). It is transparent and predictable, reduces the likelihood of corruption because of limited interaction between taxpayers and the tax administration, does not disincentivise business growth (provided that the tax level is not linked to turnover), is easy to compute (for the taxpayers) and manage (for the tax administration), and can be adapted to the economic cycle (Engelschalk, 2007^[11]) (BP 4, BP 8).

However, drawbacks include its regressivity, the creation of an entry barrier for small businesses that do not generate profits and the violation of the vertical equity tax principle. Lump-sum taxes treat all taxpayers in a similar way despite their differences in income and ability to pay. Hence a significant tax burden can weigh heavily on the least profitable businesses. Finally, lump-sum amounts do not allow the tax burden to fluctuate with a drop in the economic activity of a specific business and may therefore create cash flow difficulties (ILO, 2021^[10]). However, governments may adjust the lump-sum amount across the business cycle in order to avoid imposing a tax burden that is too high or too low given the state of the economy faced by all businesses (BP 29).

Differentiated lump-sum amounts induce some form of tax progressivity, but they can create other challenges. Differentiated lump-sum amounts can vary across or within sectors, which might lead to differentiation between activities that can be similar in nature (e.g. vendors of different products) (BP 31). The greater the differentiation, the greater the likelihood that a single business engaged in various activities will belong to more than one tax bracket. It is therefore often more desirable to have a small number of lump-sum amounts covering a broad spectrum of activities (Engelschalk and Loeprick, 2015^[14]) (Iordachi and Tirlea, 2016^[1]). Differentiated lump-sum amounts can also vary across turnover bands, for instance, where businesses with turnover within the lower band pay a lower lump-sum amount than businesses that have higher turnover. However, this differentiation might lead to a disproportionate increase in the tax burden as a result of a marginal turnover increase. This particular design would create bunching effects around the turnover level where the tax liability would increase (BP 32). Where location is used as the differentiating factor, the taxation of businesses that operate on more than one site can become complex. Finally, the differentiation should be based upon a thorough analysis of the businesses' profit levels.

3.4.2. Tax rates

The application of a proportional tax rate levied on turnover is simple but does not capture the spread of profitability across taxpayers. Levying a proportional tax rate reduces taxpayers' compliance costs and makes the regime easier to administer by the tax administration. Proportional rates result in a tax liability that is linear in relation to turnover, which may not capture profitability very well, in particular if business profitability is increasing with turnover levels (BP 33).

The application of a proportional rate to an indicator of economic activity is equivalent to a tax on that indicator, and discourages investment in or the use of that production factor (OECD, 2009^[8]). For example, a tax imposed at a proportional rate on the number of employees is likely to discourage recruitment of formal employees and, indirectly, promote growth in the informal sector.

Tax rates can be differentiated across defined criteria. Tax differentiation is possible, for example, with rates varying across economic sectors (e.g. service providers and retailers). Differentiated rates across sectors would allow levying a higher rate on the activities that are, on average, more profitable (BP 31). This would prevent that businesses that are highly profitable but that face a low presumptive tax burden would face a tax-induced incentive to remain within the presumptive tax regime. On the other hand, it would avoid imposing a high implicit tax rate on business sectors that face a low average profitability rate.

In the case of turnover-based regimes, progressive tax rate schedules are sometimes implemented. Progressive tax rates that are increasing in turnover are less distortive than differentiated lump-sum amounts across turnover bands because they dilute the incentives for taxpayers to bunch below turnover thresholds (BP 32). Moreover, progressive tax rates could create a tax-induced incentive for businesses to transition into the regular tax system if the rate schedule was set in such a way as to ensure once a business achieves a certain turnover level, it would pay less tax under the standard system than under the presumptive tax regime.

3.5. Taxes covered by the presumptive tax regime

The single tax payment can be a substitute for the personal (or corporate) income tax for unincorporated (or incorporated) businesses and potentially for a wider range of direct and indirect taxes that businesses need to pay, including social security contributions. The general view is that it is beneficial for as many direct taxes as possible to be substituted by the single tax payment in order to reduce businesses' tax compliance costs (Engelschalk, 2007^[11]), particularly when the number of direct taxes that hard-to-tax businesses face is high (Engelschalk and Loeprick, 2015^[14]) (BP 13). Whether or not to cover indirect taxes, and in particular the VAT/GST, by the presumptive tax remains somewhat an open question. The appropriateness of including indirect taxes under the regime's scope will depend on different factors such as the size and characteristics of the target group, the complexities and particularities of the standard tax system (e.g. whether the VAT system foresees a registration threshold or not) and the administrative capacities of the tax administration.

The single tax payment can include local taxes or fees that businesses are required to pay. In this case, tax revenues will have to be shared between central and local governments. The integration of local taxes and fees simplifies compliance costs and provides an opportunity for the tax administration to involve local governments in the administration and enforcement of the tax regime (BP 14). Local governments are closer to the economic activity of local businesses and the cooperation across levels of government may therefore be mutually beneficial. However, revenue-sharing difficulties may arise if there is insufficient co-operation between different levels of governments (Engelschalk, 2007^[11]). Where local taxes and fees are not covered by the presumptive tax regime, their existence should still be considered when setting the regime's tax liability to avoid levying an excessively high tax burden (BP 30).

3.5.1. Social security contributions

The single tax payment can also be a substitute for social security contributions, which may be attractive for several reasons (BP 13, BP 24). It reduces the number of taxes that need to be paid, it reduces administrative costs and encourages tax compliance (IDB, 2009^[19]). Second, it provides social

protection to a large number of self-employed individuals who otherwise would operate in the informal sector (Azuara et al., 2019^[22]). Nevertheless, the inclusion of self-employed social security contributions within the presumptive tax regime breaks the link between social security contributions made and benefits received (Engelschalk, 2007^[11]), which provides an argument for keeping social security contributions outside the scope of the presumptive tax. And third, it encourages labour formalisation if employees' social protection is provided through regime's registration. Empirical evidence has found that a presumptive tax regime can induce businesses to formalise with the tax administration without necessarily formalising its employees in the social security system (Teixeira, 2021^[20]) (Díaz et al., 2018^[23]). Including employee and employer social security contributions within the scope of the presumptive tax may then induce businesses to formalise also their workers.

A number of design questions can be raised with respect to social security contributions paid by employers or self-employed workers under a presumptive tax regime, including:

- **Which type of social security contributions are included in the regime?** It is quite a common practice to integrate the social security contributions of the self-employed in the regime's single tax payment, however, few regimes cover employee social security contributions (Azuara et al., 2019^[22]). This uncommon practice requires further consideration since, as previously stated, including employee and employer social security contributions within the scope of the presumptive tax regime might incentivise workers' formalisation, and would therefore extend social protection coverage to a large number of workers. The advantages and challenges of this inclusion are further discussed at the end of this Section.
- **What is the level of social security contributions that is raised and how are they calculated as part of the presumptive tax regime?** Social security contributions might be levied as a presumptive lump-sum amount, as a proportional rate levied on a presumptive base (e.g. an average, minimum or subsistence wage), or as a percentage of the single tax payment.
- **Are social security contributions gradually increasing over time?** Some regimes allow initial reductions in the self-employed or employers social security contributions with gradual increases over time (Azuara et al., 2019^[22]).
- **What are the associated social benefits that the self-employed and/or employees are entitled to?** Some presumptive tax regimes provide the same social benefits as under the standard tax system to the self-employed and/or employees. Other regimes differentiate the range of benefits provided, typically by providing less generous social benefits to employees and the self-employed under the presumptive tax regime. In general, social security contributions paid under presumptive tax regimes provide employees/the self-employed with an entitlement to health care and a future (possibly minimum) pension.
- **Are social security contributions paid under the presumptive regime compulsory or voluntary?** Because the objective is to encourage formalisation, some regimes are flexible by giving the option to the taxpayer to choose among a range of potential benefits depending on the worker's ability to pay. Some regimes also allow taxpayers to extend the social protection coverage to dependant family members by paying higher contributions.
- **Which institution collects the social security contributions and redistributes the funds across the bodies involved (tax administration, social security funds)?** Where social security contributions are included in the single payment, the collecting institution should have sufficient administrative capacity to redistribute funds on a pre-determined basis across the various bodies involved (ILO, 2021^[24]) (BP 49). In most countries, the tax administration collects and redistributes revenue from social security contributions to the social insurance system (Azuara et al., 2019^[22]). Where social security contributions are not included in the single tax payment, they can still be made to the same collecting body with responsibility for transferring the funds, which eases the administrative burden for taxpayers (ILO, 2021^[24]).

- **Does the general budget top-up the social security contributions collected within the regime and if so, by how much?** The social benefits provided under presumptive regimes should be co-financed from the general budget (in a similar way as non-contributory schemes are) to ensure their quality (ILO, 2021^[24]). Transfers from the general budget to the social security funds could be costly and therefore requires a proper evaluation of the financial sustainability of the benefits associated with presumptive tax regimes (IMF, 2016^[25]) (Azuara et al., 2019^[22]) (BP 24).

3.5.2. Indirect taxes

In addition to direct taxes, presumptive tax regimes can also replace indirect taxes including the VAT/GST. Integrating the VAT within the regime's tax payment implies that registered taxpayers do not have to collect and remit VAT and cannot deduct the VAT paid on its inputs. Whether or not to include the VAT within the scope of the presumptive tax remains an open question, with the advantages and disadvantages of doing so discussed at the end of this Section. Businesses may face other indirect taxes, such as excise duties on the fuels they use in their economic activity. These taxes seem out of scope of most presumptive tax regimes that can be found in countries, which means that businesses that are liable for the presumptive tax are also required to pay the excise duties that are levied on the inputs they use.

Many jurisdictions foresee a VAT registration threshold below which it is not compulsory for businesses to register for VAT. Below the VAT threshold, businesses are not obliged to collect VAT on their sales, but they do not receive a refund for the VAT they have paid on their inputs. In many countries, businesses that qualify for the VAT exemption can voluntarily register and comply with the VAT rules as other businesses do. Jurisdictions that implement a VAT registration threshold will have to evaluate how the threshold interacts with the presumptive tax regime(s) that is in place. This is discussed in more detail at the end of this Section.

3.6. Regime administration

3.6.1. In relation to taxpayers

Simplified administrative procedures make presumptive regimes attractive to taxpayers (Aditya, 2020^[17]). The regimes often allow for simplified accounting rules and procedures (e.g. cash accounting instead of accrual accounting) (Baurer, 2005^[26]) (BP 16). In addition, the frequency of tax filings and payments is reduced (e.g. annual payment with the option to pay by instalments) and tax returns are less complex compared to the standard tax system (BP 17).

Interacting with one single public counterpart eases the administrative burden on taxpayers. Public bodies are represented by various structures (ministries, agencies, departments) with mandates that could possibly be overlapping. For example, a small business may be required to enrol in the business register (national institution), obtain a business licence (local institution), and register its employees (social security institution), sometimes with the obligation to provide similar documentation to each institution. One-stop shops can be helpful in order to centralise and streamline administrative requests and procedures and reduce direct interaction between taxpayers and multiple public authorities (Engelschalk and Loeprick, 2015^[14]) (ILO, 2021^[27]) (BP 18).

Finally, digitised services simplify taxpayers' administrative procedures (BP 19). In particular declaring and paying taxes and social security contributions online or by mobile phone can help to reduce the time spent on administrative matters (IFC, MIGA and WB, 2009^[28]).

3.6.2. *In relation to the tax administration*

Presumptive tax regimes require regular monitoring by the tax administration to ensure compliance (BP 7, BP 40) (Engelschalk and Loeprick, 2015^[14]) (IDB, 2009^[19]). In particular, the tax administration needs to monitor businesses to detect, avoid and penalise, where applicable, their fraudulent behaviour (BP 41) (e.g. under-declaration of turnover and other indicators used to compute their tax liability, artificial split up of their activities or concealment of artificial self-employment arrangements). The analysis of tax return data can provide insight into the prevalence of tax evasion, for example when many taxpayers are clustered just below the regime's eligibility threshold (known as "bunching") (OECD, 2021^[29]). Similarly, businesses in the standard tax system sometimes artificially inflate their costs using fake invoices issued by businesses subject to the presumptive regime (Bulutoglu, 1995^[12]). In practice, many tax administrations relax their monitoring of businesses under the presumptive tax regime as little revenue is at stake (or delegate it to local governments) and audit strategies based on risk analysis often fall short.

There are ways for the tax administration to perform these monitoring tasks at a lower cost. Establishing a presumptive tax regime may lead to a significant increase in the number of small taxpayers (Bulutoglu, 1995^[12]). Economies of scale can be made by setting up a unit specialised in the monitoring and audit of the presumptive tax regime (and more generally of small businesses and the self-employed) (IDB, 2009^[19]) (BP 40). In addition, the costs of managing the regime can be reduced if the tax liabilities are fixed for a set period of time (Engelschalk, 2007^[11]).

Synergies exist when central and local tax administrations work together to conduct compliance activities (BP 14, BP 48). Local administrations are closer to taxpayers and often have more information about businesses that operate within their territory than central tax administration. When regimes are based on indicators of economic activity, it is easier for local agents to verify that a taxpayer is not under-declaring its activity, although personal visits might also lead to corruption. Local officials can share their information with the central tax administration so they can work together in updating the country's presumptive tax regime databases. Finally, other types of cooperation can be explored such as making receipt of specific official documents, such as business licences issued by local governments, dependent on payment of the regime's contribution (BP 46).

Nonetheless, local management of presumptive regimes can be a source of tax instability. In some cases, local governments can set the rate and base of the presumptive tax regime and collect tax revenues that are channelled to local budgets. However, regular increases in rates in order to increase local tax revenues, or frequent changes in the tax base, can be a source of tax instability (Thuronyi, 2004^[2]) (Engelschalk and Loeprick, 2015^[14]). In addition, giving local governments legislative capacities on tax rates and tax bases can also create a source of tax competition (BP 48).

In order to encourage informal businesses to voluntarily register for the presumptive tax regime, the tax administration should avoid a punitive or confrontational attitude towards registered taxpayers (BP 27). The registration of the business under the presumptive tax regime should not be used as an opportunity for the tax administration to start auditing procedures related to taxable events occurred prior to the registration, except in exceptional circumstances such as where there is a link to suspected criminal activity or fraud.

The design of the presumptive tax regime should be a dynamic process. Where tax administration capacities are low, the regime can be initially framed as a lump-sum taxation method and gradually converted to a more complex regime (e.g. a turnover-based regime, possibly complemented with other economic activity indicators) as administration capacities grow (BP 7). On the other hand, the regime's tax burden might increase over time. It can be set initially at very low levels, when the taxpayer enters the regime, to incentivise registration and increased gradually over time to reach the desired level of taxation (BP 23).

3.7. Non-tax support instruments

Easier access to credit is sometimes observed as a support instrument for taxpayers under a presumptive tax regime (BP 22). It can encourage taxpayers to join the regime and develop their business, thus generating a virtuous circle (higher income, opportunities to access larger bank loans, etc.). However, typically several conditions must be met. First, the cooperation of the banking sector is required as taxpayers covered by presumptive tax regimes generally do not meet the lending criteria. Second, the cost of such support shall be carefully assessed as it has the potential to be significant, particularly if the State acts as guarantor of the loans provided.

Other support instruments, such as training on how to keep books and follow standard accounting practices, could be offered to businesses within the target group (BP 37). Such training can make it easier to comply with more sophisticated accounting procedures, and thus facilitate taxpayer transition into the standard tax system. In practice, few countries provide such training, even though its importance is reinforced by the fact that experience shows that specific tax provisions conditional upon book-keeping, such as tax deductions, are not useful to improve book-keeping levels (Engelschalk, 2007^[11]). Other training, such as on business development, could also be offered.

Finally, taxpayers under the presumptive tax regime can benefit from other economic advantages (e.g. subsidies) linked to their characteristics. These measures are not directly linked to the presumptive tax regimes themselves but could be considered when designing and analysing such regimes. Where non-tax support instruments are linked to business size, challenges might arise because of differences in the definition of micro/small/medium enterprise across ministries and government agencies. Therefore, a uniform definition of micro/small/medium enterprise shared by public bodies helps to ensure consistency when delivering public support (BP 50). However, harmonising such definitions can take time and be difficult to accomplish politically. In the face of these difficulties, at a minimum, countries could assess the consequences of the differences in definitions on the tax and non-tax treatments of taxpayers under the presumptive regime.

3.8. Interaction with the standard tax system

The presumptive tax regime is part of a wider tax system and cannot be designed or analysed in isolation. This Section presents a number of considerations that need to be taken into account when designing the presumptive tax regime as part of the broader tax system.

Having a large number of presumptive tax regimes is not recommended (BP 1). It increases tax complexity, might be a source of horizontal inequity between businesses which have similar abilities to pay but develop different activities or differ in other characteristics (e.g. having or not employees) and consequently are taxed under different regimes, and facilitates tax evasion if taxpayers can easily shift from one regime to another (Engelschalk and Loeprick, 2015^[14]).

It is preferable for the presumptive tax regime to be optional so that taxpayers can register under the standard tax system if they wish to do so (Engelschalk, 2007^[11]) (BP 36). For example, new businesses often face high costs and generate low or no profits when they launch their activities. Those taxpayers do not benefit from enrolling in the presumptive tax regime if the latter does not allow losses to be offset against future tax liabilities as under the standard tax system. In practice, tax administrations are unwilling to allow taxpayers to enter and leave the regime on a regular basis in order to reduce their tax burden as it increases tax administration costs without contributing to higher revenue collection. Thus migration into the standard tax system could be linked to a requirement to remain within the standard system for a specified number of years (e.g. three or five consecutive years) (Engelschalk,

2007^[11]). Similarly, where admission to the presumptive regime is voluntary, minimum periods of adherence might be required (IMF, 2022^[30]).

In some cases, taxpayers covered by the presumptive regime cannot voluntarily register for the VAT which puts a limit on the incentives for businesses to enter the formal economy (Iordachi and Tirlea, 2016^[1]) (BP 25). This is usually the case when the VAT is also substituted by the presumptive regime's tax payment.

Presumptive tax regimes can include an eligibility period, which may or may not be renewable, beyond which a taxpayer is no longer entitled to participate in the regime. In practice, few regimes have eligibility periods (Bucci, 2020^[4]). When regimes do have eligibility periods, supporting instruments such as accounting training may be necessary to enable taxpayers to comply with the rules of the standard tax system (Engelschalk, 2007^[11]) (BP 37).

The design of the tax system should provide businesses with an incentive to migrate from the presumptive tax regime into the standard tax system. Simplified tax provisions and administrative procedures can be introduced in the standard tax system to smooth the transition from the presumptive regime (e.g. reduced rates, simplified accounting system, simplification of VAT-related administrative procedures, less frequent declaration and payment of taxes, loss carry forward opportunities, etc.) (Engelschalk, 2007^[11]) (BP 34). Maintaining such features on a permanent basis would bring some disadvantages (e.g. bunching effects similar to what can be observed in presumptive regimes; artificial closing and reopening of business activities) and it is therefore recommended to allow businesses to benefit from them for a limited period of time and/or to tie them with a previous registration to the presumptive regime. Similarly, the tax provisions of the presumptive regime should not create tax-induced disincentives to grow into the regular tax system (e.g. tax levels shall converge to those in the standard system for taxpayers close to the eligibility threshold) (BP 35).

Tax policy design should take into account the impact of changes in the standard tax system, in particular to the personal and corporate income tax and the VAT, on the functioning of the presumptive tax regime (BP 38). A comprehensive approach should be taken when considering reforms in the standard tax system as they might affect, directly or indirectly, the taxpayers and the design of the presumptive regime. For example, simplification in the VAT system may encourage businesses under the presumptive tax regime to migrate into the standard tax system. Similarly, improvements in VAT refunds can make the standard tax system more attractive for businesses with limited cash flow. Alternatively, income tax reforms that make the standard income tax regime less complex might lead to an increase in the number of firms that are registered under the standard system. On the contrary, increasing accounting, invoice or other administrative requirements might deter migration into the standard tax system.

3.9. Open questions on the design of presumptive tax regimes

There are no firm recommendations on determining the presumptive tax regime's eligibility threshold (Wei and Wen, 2019^[31]). Countries differ in the design of their presumptive tax regime and in particular in the turnover beyond which businesses need to comply with the standard tax system. The choice of this ceiling will be country-specific and depend on many variables, including the complexity of the regular tax system, the level of tax burden it imposes, the characteristics and structure of the business sector, the skills of entrepreneurs to deal with the rules of the standard tax system, the capacity of the tax administration to deal with a large number of smaller businesses, etc.

For countries with a VAT registration threshold, the theoretical guidance often states that the VAT-registration threshold and the eligibility threshold for presumptive tax regimes should be aligned, and that businesses should be taxed under the standard system (for both direct and indirect

tax purposes) beyond that threshold. The reason relates to the fact that businesses that are able to comply with VAT-related accounting and administrative procedures will also be able to calculate their taxable profits under the standard business tax system.

However, aligning the two thresholds creates a more significant administrative barrier for taxpayers migrating into the standard tax system. This issue arising from a common threshold is less relevant where the VAT registration threshold is very high (so that only large businesses are subject to VAT) (Engelschalk and Loeprick, 2015^[14]). However, in these circumstances, aligning the thresholds will mean that too many taxpayers will fall under the presumptive regime and this will excessively narrow the coverage of the standard tax system. Alternatively, if the regime's eligibility threshold is high, and thus the target group is large, setting the VAT threshold lower than the presumptive regime's eligibility threshold could help taxpayers in the regime to transition into the standard tax system (BP 39). In this context, further options to smooth the taxpayer's transition could involve the use of partial presumptions, such as presumed input VAT deductions (OECD, 2015^[9]) (OECD, 2021^[32]), once the VAT registration threshold is exceeded but the regime's eligibility threshold is not (i.e., measures applicable to taxpayers that are taxed under the presumptive regime and are also liable to the VAT).

Therefore, setting the optimal eligibility threshold for the presumptive regime and the optimal VAT registration threshold needs to be a coherent decision that will be determined by many interrelated factors. These factors include the characteristics of the micro, small and medium-sized businesses in the country, the complexity of the standard tax system and, in particular, the complexity of the standard income tax and VAT regimes, the effective tax burden imposed by the standard tax system, the level and spread of tax non-compliance, the information available to the tax administration and its administrative and monitoring capacities. For example, countries that have a simple income tax regime that levies a low rate on the profits of small businesses may consider setting the presumptive regime's eligibility threshold at a lower level than the (voluntary) VAT registration threshold. In contrast, when the standard income tax regime is complex and imposes various taxes that are levied at relatively high rates, it might be optimal to set the presumptive regime's eligibility threshold above the VAT registration threshold. However, besides the complexity and the tax burden imposed under the standard tax system reflected in these examples, additional factors need to be considered when assessing whether to set aligned or separate thresholds for the presumptive tax regime and the VAT, such as the difficulties faced by the tax administration in monitoring turnover under-reporting, especially in the cases where the VAT is not enforced, and other potential administrative or enforcement challenges that could arise from setting separate thresholds.

The VAT could also be covered by the presumptive tax regime (i.e. the regime's tax payment substitutes the standard VAT rules such that no VAT collection is required for businesses registered in the regime and no input VAT deduction is allowed). Including the VAT within the scope of the presumptive tax regime has similar effects on VAT compliance as setting a VAT registration threshold. However, the former option allows for the enforcement of a (presumed) tax liability and limits this preferential VAT treatment to a specific group of businesses. Hence, the inclusion of the VAT within the presumptive tax regime will be particularly relevant for jurisdictions that do not implement a VAT registration threshold and that, therefore, require all businesses to be liable for VAT. In these circumstances, including the VAT within the presumptive tax regime's scope will significantly reduce compliance costs for taxpayers and enforcement costs for the tax administration. Its inclusion is therefore an option that could be considered, especially in presumptive regimes that target micro-businesses and self-employed with low incomes (BP 13). If the VAT is included within the scope of the presumptive tax regime and the regime is turnover-based, the presumptive VAT could be levied on overall turnover (i.e. no individual VAT invoicing would be required) at a rate that is significantly lower than the standard VAT rate but without businesses being entitled to receive a refund for the input VAT they have paid. That being said, the design and the calculation of the presumptive VAT would need to

take into account the key characteristics of the standard VAT regime, including the existence of (often multiple) reduced VAT rates and VAT exemptions, among many others features.⁴

However, substituting the VAT with a presumptive tax regime also has disadvantages. It complicates the monitoring of turnover under-reporting as there is no separate VAT compliance procedure (BP 45). Additionally, allowing businesses that are taxed under the presumptive regime to register under the standard VAT system becomes operationally difficult when the VAT is integrated in the regime's single tax payment. This challenge raises a set of tax policy design questions such as whether the regime's VAT rules should be compulsory for registered taxpayers or whether taxpayers should maintain the option to register for the standard VAT regime; and whether the presumptive VAT component should be integrated in the regime as a separate tax liability.

Overall, whether countries would prefer implementing a VAT registration threshold or whether the VAT could be integrated within the presumptive tax regime remains an open question. The answer will depend on many factors such as the specific design of the VAT system in the country, the compliance costs that businesses face to comply with the VAT, and the scope and potential implementation challenges that a VAT registration threshold would involve.

Besides the VAT, it remains an open question whether the scope of the presumptive tax regime should be broadened to other taxes that are not directly linked to a business' income. For instance, should recurrent business property taxes be included within the scope of the presumptive tax? To substitute as many direct taxes as possible by the presumptive tax payment reduces compliance costs for taxpayers and enforcement costs for the tax administration. However, it might intensify horizontal and vertical inequity issues raised by the design of presumptive tax regimes and it will heighten the administrative barrier for taxpayers migrating into the standard tax system.

Integrating employer and employee social security contributions in the presumptive tax regime requires further consideration. Their inclusion might complicate the design and administration of the regime and the financing of the social protection system if contributions are set at lower levels than the standard system. One possibility could be that social security payments are included in the regime's tax filing, albeit being determined under the standard rules. On the other hand, the advantages of including employee and employer social security contributions within the regime's scope are the simplification of business compliance costs and their potential for incentivising employee formalisation, since access to social protection creates an incentive for employees to enter the formal economy. Indeed, the design of the presumptive tax regime should take into consideration how to empower employees indirectly involved in the regime – through the firm's registration – to request a formalisation of their arrangements. This will depend on their bargaining power, which in turn depends on an employee's visibility, size and organisational capacities; hence, it is important that these issues be addressed when designing the presumptive regime.

Another design aspect that should be further assessed is taxpayers' permanence in the regime. Eligibility periods prevent businesses from remaining indefinitely in the presumptive regime. As evidence shows, relatively few businesses migrate into the standard tax system although they experience growth and could develop the capacities to comply with book-keeping and administrative procedures required under the standard system (ILO, 2021^[10]). Eligibility periods could also deter tax avoidance and evasion behaviours from businesses under the standard system in order to qualify for the presumptive tax regime (e.g. turnover misreporting, tax-induced business segmentation, etc.). However, eligibility periods can also exclude from the formal sector taxpayers that lack managerial

⁴ Such as input VAT recovery, zero-rated exported supplies, reverse charged services, VAT incurred on imported goods, and the impact on the business-to-business value chain (including on the right of input VAT deduction of the business customers).

capacities and are not able to transition into the standard system (e.g. micro-entrepreneurs, self-employed with low incomes). Hence, this time-limited eligibility might act as a disincentive to the business registering in the regime in the first place. In practice, few regimes have eligibility periods (Bucci, 2020^[4]).

4 Best practices in the design and administration of presumptive tax regimes

This Section sets out best practices in presumptive tax regime design and administration, which are listed in Table 4.1. It also discusses their associated potential challenges or the desirable conditions that should be met upon implementation. Each best practice is linked to the analytical framework described in Section 3.

The best practices presented below develop the following main guidelines on design and administration of presumptive tax regimes:

- The target group(s) will determine the design of the presumptive tax regime(s).
- The design of the presumptive tax regime should evolve in line with improvements in the capacity of the tax administration to administer the regime.
- The presumptive tax regime should reduce compliance costs for taxpayers and enforcement costs for the tax administration.
- The design features of the presumptive tax regime should provide an incentive to formalise.
- The level of tax liability imposed should be affordable for the target group.
- If possible, consideration should be given to equity in the design of a presumptive tax regime.
- The design of the presumptive tax regime should facilitate and not deter migration into the standard tax system.
- The tax administration needs to reduce, as much as feasible, the opportunities for tax evasion and avoidance that the presumptive tax regime may give rise to.
- Good management of the presumptive tax regime requires co-ordination between institutions.

Table 4.1. Best practices in the design and administration of presumptive tax regimes

No.	Analytical framework	Best practice	Associated potential challenges or desirable conditions that should be met	Source
<i>The target group(s) will determine the design of the presumptive tax regime(s)</i>				
BP 1 Broad target groups and limited number of regimes	1. Target group 8. Interaction with the standard tax system	<p>The number of presumptive tax regimes will depend on the number and nature of the groups targeted for inclusion and whether those groups can be taxed under the same regime. Their common feature should be the difficulty they have in maintaining complete, up-to-date books and financial statements and complying with the procedures of the standard tax system. In general, broad target groups that include many activities with similar abilities to pay are preferable, resulting in a smaller number of regimes. Target groups per type of business activity should be avoided.</p> <p>A common practice across countries is to develop different designs of the presumptive tax regimes for two broad target groups: i) micro-businesses and self-employed with low incomes and ii) small and medium-sized enterprises (SMEs).</p>	Defining very narrow target groups that only include specific activities: i) increases the complexity of the tax system and its management, ii) might be a source of horizontal inequity between businesses which have similar incomes and abilities to pay but develop different activities and consequently are taxed under different regimes, and iii) can foster tax planning behaviours (where taxpayers shift from one regime to another solely to optimise their tax obligations).	

<p>BP 2</p> <p>Data-based design</p>	<p>All framework categories</p>	<p>The definition of the target group and the overall design of the presumptive tax regime should be based on a data-driven analysis of the hard-to-tax businesses operating in the country.</p>	<p>This analysis should allow the tax administration to examine which typology of businesses are under-represented in their registries; what kind of activities are likely to involve under-reporting of taxable income; what is the average business profitability by activity type and, preferably, by location; which indicators could be used to approximate taxable income of hard-to-tax businesses; what are the costs of complying with the standard tax system for micro and small businesses and what is the effective tax burden currently applicable to this type of business. For carrying out this empirical analysis, the tax administration needs to put information systems in place that allow for the collection of information on business activity and the characteristics of the businesses that are in scope, including those operating in the informal sector. This type of analysis can then also be used to lead tax auditing strategies, as it would allow for the identification of the businesses that declare less than their peers, which may signal tax non-compliance. However, accessing this information can be very costly and its management requires strong technical skills.</p>	
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<p>BP 3</p> <p>Defining the eligibility criteria</p>	<p>2. Eligibility criteria</p>	<p>Ensure that eligibility criteria exclude taxpayers that have high incomes and/or should be capable of bearing the compliance costs of the standard tax system (e.g., setting a turnover or income eligibility threshold above which businesses cannot register to the presumptive tax regime, will ensure that non-targeted businesses face the standard tax system).</p> <p>If the turnover or income eligibility threshold is set too high, it can have the effect of bringing too many taxpayers within the scope of the presumptive tax regime, which would leave few taxpayers in the standard tax system. On the other hand, if the eligibility threshold is set very low, it will prevent informal SMEs from entering the presumptive tax regime.</p>	<ul style="list-style-type: none"> • Information on the distribution of turnover or income across the population of businesses (including the self-employed) will be needed to determine the optimal eligibility threshold. However, this information might be difficult to obtain if many of the targeted businesses operate in the informal sector. • When the possibilities for income or turnover under-reporting are high, the eligibility criteria should be complemented with other indicators that correlate with income and are difficult to falsify (e.g., business or personal property, inputs, consumption or facilities' characteristics). • In a context of inflation, eligibility thresholds based on income, turnover, asset values, etc. should be indexed to ensure a consistent definition of the target group over time. • Where registered taxpayers are allowed to own more than one business, the eligibility criteria based on income, turnover or similar indicators should be applied globally to all the businesses owned. 	<p>(Engelschalk, 2005^[33]) (Thuronyi, 2004^[2])</p>
<p>BP 4</p> <p>Micro-businesses</p>	<p>1. Target group 3. Type of regime</p>	<p>For the target group of micro-businesses and self-employed individuals with low incomes (artisan or street vendors, etc.) facing significant tax compliance costs, it is preferable to set up a regime that is very simple and predictable, such as a lump-sum taxation method, with low and stable contributions, which does not discourage business growth. Additionally, these methods avoid the issues arising from turnover misreporting.</p>	<p>Payment of a lump-sum tax may create liquidity constraints for new businesses or for those who experience a drop in their economic activity. In circumstances where the risk of abuse from taxpayers is limited, these liquidity constraints could be smoothed by suspending the payment of the lump-sum tax for the period that the business is not operational.</p>	<p>(Thuronyi, 2004^[2]) (OECD, 2015^[9])</p>

BP 5 Small and medium sized businesses	1. Target group 3. Type of regime	Where the presumptive tax regime targets SMEs facing significant tax compliance costs, implement regimes that can better approximate the different abilities to pay within the target group (i.e., those that consider indicators of economic activity) and introduce simplified book-keeping requirements, as this will help taxpayers to transition into the standard tax system.	A significant difference between actual and presumed income might occur if the indicators used to estimate the presumed tax base are not defined carefully. Therefore, during the design phase of the presumptive tax regime, an analysis of the population of small and medium sized enterprises in the country, including those operating in the informal sector, should be conducted to be able to align the design of the regime with the characteristics and profitability of the target group. This type of assessment, though, can be costly and challenging if the available information is scarce.	(Engelschalk, 2007 ^[11]) (OECD, 2015 ^[9])
BP 6 Liberal professions	1. Target group	The liberal professionals are typically regarded as being highly educated, with high incomes, capable of keeping books and filling tax declarations and should not, on these grounds, be included in the same presumptive tax regime that targets micro and small businesses with a lower tax burden than the standard tax system and reduced compliance costs. However, because many liberal professionals provide services to households, their opportunities for income misreporting are very high, making the control tasks of the tax administration very costly. On these grounds, it might be justified that, instead of being taxed on reported income, liberal professions are taxed on a presumed tax base within the standard income tax. In this case, turnover is an inappropriate indicator of taxable income because it is associated with significant risks of misreporting. By contrast, indicators such as office size years of professional experience, and/or personal properties, may better reflect taxable income.	Identifying and defining the indicators that, while being difficult to manipulate, best capture professionals' income might be difficult. In general, the liberal professions are well organised and have significant political power, hence, if taxed under specific rules, discussion with the Ministry of Finance can arise.	(Ogembo, 2020 ^[34]) (Engelschalk and Loeprick, 2015 ^[14])

The design of the presumptive tax regime should evolve in line with improvements in the capacity of the tax administration to administer the regime

<p>BP 7</p> <p>Capacity of the tax administration to administer the regime</p>	<p>3. Type of regime</p> <p>6. Regime administration</p>	<p>The tax administration should have sufficient resources to implement, administer and enforce the presumptive tax regime and to reach a wide range of businesses from the target group.</p> <p>Where tax administration capacities to administer and enforce the regime are low, the regime can be initially framed as a lump-sum taxation method and gradually converted to a more complex regime (e.g. a turnover-based regime possibly complemented with other economic activity indicators) as administration capacities grow.</p>	<p>Adjustments should be driven by analyses of profit levels and tax evasion among the various groups of taxpayers, however, such an approach is difficult for tax administrations that are lacking analytical capacity and/or access to data.</p> <p>A balance must be achieved between the stability of the tax rules and adjustments so that they are not made too frequently.</p>	<p>(Engelschalk, 2004^[15]) (Engelschalk and Loeprick, 2015^[14]) (Engelschalk, 2005^[33])</p>
<p>BP 8</p> <p>Suitability of lump-sum taxation methods</p>	<p>3. Type of regime</p> <p>6. Regime administration</p>	<p>Lump-sum taxation methods: Implement these regimes, which involve low enforcement costs, where the tax administration has limited capacities to control turnover under-reporting and to monitor other indicators of economic activity.</p>	<p>The implementation of a single lump-sum, which is the simplest version of a presumptive tax regime, will involve vertical equity issues if the target group is large and covers a wide income band.</p>	
<p>BP 9</p> <p>Suitability of turnover-based regimes</p>	<p>3. Type of regime</p> <p>6. Regime administration</p>	<p>Turnover-based regimes: Implement these regimes, which can better approximate different abilities to pay within the target group and require businesses to comply with minimum accounting requirements, where administrative capacity is sufficient to control turnover under-reporting.</p>	<p>It can be difficult to identify sectors and businesses where under-reporting of turnover is less feasible (e.g., where clients are usually companies operating under the standard tax system or where electronic payment is more common and it is more difficult to manipulate the books).</p>	<p>(OECD, 2015^[9])</p>

BP 10 Suitability of other indicators of economic activity	3. Type of regime 6. Regime administration	Regimes based on indicators of economic activity other than turnover: <ul style="list-style-type: none"> • Are most suitable when the possibilities for turnover under-reporting are high and the tax administration has the means to monitor other indicators of economic activity. • Using complex indicators, such as fixed assets or wealth indicators, should be avoided in circumstances where the tax administration has limited auditing capacity. Consider indicators that are easy to verify, present a low risk of falsification, concealment and substitution, and show a sufficient correlation to actual income. It may be a viable approach to use input consumption (e.g. water/electricity) to calculate the tax burden because these indicators are difficult to falsify. 	Establishing a clear relationship between input consumption or facilities' characteristics and presumed income by sector requires strong technical skills from the tax administration. Where the indicator is water or electricity consumption, the tax administration must exchange information with the input supplier (i.e. third party reporting). Finding appropriate indicators of economic activity that correlate with actual income and are difficult to falsify will be easier for those businesses operating in a fixed establishment. However, it will be challenging to define indicators with low risk of falsification for those businesses operating in many different places (e.g., taxi drivers, electricians, plumbers, etc.).	(Engelschalk, 2007 ^[11]) (ILO, 2021 ^[10]) (Logue and Vettori, 2011 ^[3])
<i>The presumptive tax regime should reduce compliance costs for taxpayers and enforcement costs for the tax administration</i>				
BP 11 Need for clear rules	6. Regime administration	The rules of the presumptive tax regime must be simple, clear, straightforward and consistent. They should not be changed too often to provide tax certainty to taxpayers.	Changes to other taxes may require adjustments to be made to the tax rules of the presumptive tax regime.	(OECD, unpublished ^[35])
BP 12 Verifiable eligibility criteria	2. Eligibility criteria	The eligibility criteria shall be easily verifiable, ideally by using digitised data that reduce costly on-the-ground inspections and decrease administrative costs and the risks of corruption.	A lack of financial resources and/or capacity to develop and use digitised tax systems might hamper the control function of the tax administration.	(ILO, 2021 ^[10])

<p>BP 13</p> <p>Inclusion of taxes</p>	<p>5. Taxes covered</p>	<p>In order to reduce tax compliance costs:</p> <ul style="list-style-type: none"> • For micro-businesses with low incomes and very limited capacities to cope with the tax system, it would be preferable to levy a single tax under a presumptive regime that replaces as many taxes as possible (direct taxes, SSCs, VAT, etc.), as long as they are related to the economic activity. Including the VAT within the presumptive regime is an option that could be considered in the jurisdictions that do not implement a VAT registration threshold that releases micro-businesses from VAT compliance. • For small and medium-sized enterprises with limited capacities to cope with the tax system, it would be preferable to substitute by the presumptive regime as many direct taxes related to the economic activity as possible. With respect to indirect taxes and employee and employer social security contributions, it might be preferable to integrate the tax payments in the regime's tax filing, albeit being determined under the standard rules, when the standard filing procedures involve high compliance costs. 	<p>Substantial co-ordination is required in order to allocate tax revenues across the various recipient bodies (e.g. local governments, social security funds).</p>	<p>(Onias et al., 2014^[18])</p>
<p>BP 14</p> <p>Local taxes and local administrations</p>	<p>5. Taxes covered</p> <p>6. Regime administration</p>	<p>Including local taxes and fees in the single tax payment simplifies compliance costs. Sharing the corresponding tax revenues with local governments can encourage them to assist the tax administration (either central or local) in administering and enforcing the regime (by collecting and sharing information on taxpayers).</p>	<p>Securing cooperation across different levels of government can be challenging.</p> <p>Revenue-sharing difficulties may arise if there is insufficient co-operation between different levels of governments.</p>	

BP 15 Agreement between the tax administration and the taxpayer	3. Type of regime 6. Regime administration	Avoid implementing regimes based on an agreement between the tax administration and the taxpayer because of the substantial administrative costs they generate.		(Engelschalk, 2007 ^[11]) (Wei and Wen, 2019 ^[31])
BP 16 Simplified accounting rules and procedures	6. Regime administration	Establish simplified rules and procedures, especially in relation to accounting (e.g. authorise simplified book-keeping requirements, cash accounting), tailored to the difficulties faced by the target group in complying with the standard requirements.	Establishing simplified rules and procedures does not only require the introduction of specific regulations within the scope of the presumptive tax regime, but also adjusting the regulation of taxes that are not substituted by the regime and might affect registered businesses. To provide legal security to the regime's taxpayers, accounting requirements established beyond and within the scope of the presumptive tax regime must be coherent.	(Engelschalk and Loeprick, 2015 ^[14]) (Contreras, de Mello and Puentes, 2008 ^[36]) (Engelschalk, 2005 ^[33])
BP 17 Simplified tax filing procedures	6. Regime administration	Reduce the frequency of tax filing (e.g. single filing for taxes and social security contributions) and payments, and make the tax return simpler than in the standard tax system. The simplification of the tax filing should be tailored to the difficulties faced by the target group in complying with the standard requirements.	In the case of a single filing for central and regional taxes and social security contributions, administrative capacity is required in order to allocate tax revenues across the various recipient bodies.	
BP 18 One-stop shops	6. Regime administration	Implement one-stop shops to centralise administrative requests and procedures within one single public body to ease the administrative burden on taxpayers.	This might require legislative change, delegation of responsibility and redirection of funds to the recipient public bodies (e.g. national, regional and local authorities, or social security funds).	

BP 19 Digitised services	6. Regime administration	Offer digitised services to comply with the presumptive tax regime (e.g. filing tax returns or making tax payments through a mobile phone or the Internet).	This requires the tax administration to have technological capacity and taxpayers to be able to use digital tools. The latter may require additional investments in improving taxpayer knowledge and skills, hence, traditional tax payment methods should also be allowed.	(Loeprick, 2009 ^[5])
<i>The design features of the presumptive tax regime should provide an incentive to formalise</i>				
BP 20 Aim to improve tax compliance culture	4. Tax liability 6. Regime administration	<p>The main objective of the presumptive tax regime should be to develop an improved tax compliance culture over the long term, which encourages businesses to enter the regular tax regime as they grow.</p> <p>The introduction of the presumptive regime should not be driven by the objective of raising tax revenues in the short-term, as this would likely be counterproductive and hamper the entry of many taxpayers into the regime and the formal economy. Prioritising tax revenue collection in the short-term could also potentially lead to some cases of abusive practices in the tax administration, which would be counterproductive in building an improved compliance culture.</p>	It can be difficult to observe (and measure) improvements in tax compliance in the short and medium term, whereas increased tax revenues is a readily identifiable measure that can be tracked over time. The evolution and permanence of registered taxpayers in the regime could be used to evaluate tax compliance improvements.	

BP 21 Information and awareness campaigns	6. Regime administration	Implementing information and awareness campaigns to inform taxpayers about the presumptive tax regime can support the introduction and consolidation of the regime, and hence induce increased formalisation.	Because the target group is difficult to reach through the tax administration's traditional channels of communication (e.g. letters, emails, etc.), more inclusive channels can be considered (e.g. TV adverts, posters in the streets, radio programmes, etc.), perhaps involving local tax offices. However, these approaches can be costly, can take time and will need to be well targeted and administered to ensure value for money.	(OECD, unpublished ^[35]) (Engelschalk and Loeprick, 2015 ^[14]) (Bruhn and Loeprick, 2014 ^[37])
BP 22 Additional support instruments	7. Non-tax support instruments	Linking participation in the regime with access to additional support instruments (e.g., easier access to credit, accounting training, business development training) can strengthen the incentives to formalise.	This would imply: <ul style="list-style-type: none"> • Securing co-operation between key actors in the banking system and the tax administration, which may be challenging. • There will be costs arising from any bank guarantees provided by the State. • There will be costs arising from any training support provided by the administration. 	(ILO, 2021 ^[10])
BP 23 Gradual increase of the tax liability	4. Tax liability 6. Regime administration	The regime's tax burden can be set very low initially, when the taxpayer enters the presumptive tax regime, to incentivise registration, and increased gradually over time to reach the desired level of taxation.	Specific provisions will need to be included to avoid that taxpayers strategically enter and exit the presumptive tax regime to repeatedly benefit from the reduced tax obligations.	

<p>BP 24</p> <p>SSCs of the self-employed</p>	<p>5. Taxes covered</p>	<p>Including the social security contributions of the self-employed in the single tax payment might foster the business' registration in the presumptive regime, as the access to social protection might act as an incentive to formalise.</p>	<p>However, a number of conditions must be met, which can be challenging:</p> <ul style="list-style-type: none"> • The single collecting body (even where the payment is separated into a tax payment and a social security contribution) shall redistribute the funds internally among the various institutions (tax administrations, social security funds). • The government should provide sufficient co-financing under the general budget to finance the associated social protection benefits (and ensure their quality) or otherwise, the reduced tax burden will lead to a reduction in overall levels of social protection provided. This co-financing can be very costly. 	
<p>BP 25</p> <p>VAT voluntary registration</p>	<p>8. Interaction with the standard tax system</p>	<p>It is preferable to allow taxpayers under the presumptive tax regime to register voluntarily for VAT.</p>	<p>This would require excluding the VAT from the presumptive tax regime's single tax payment (the VAT could still be filed through the presumptive tax regime as a separate tax liability). If there is the will to release micro and small businesses from the standard VAT rules, a VAT registration threshold could be set below which businesses are not liable to VAT collection (and cannot deduct the VAT they have paid).</p>	<p>(OECD, 2015^[9]) (Bruhn and Loeprick, 2014^[37])</p>
<p>BP 26</p> <p>The number of employees is an undesirable indicator</p>	<p>2. Eligibility criteria 3. Type of regime</p>	<p>Using the number of employees as an eligibility criterion or as an indicator to calculate the tax burden is not recommended because it will discourage taxpayers employing staff and may encourage informal recruitment of workers.</p>	<p>The number of employees is often used as a criterion for defining a micro, small or medium-sized enterprise. A presumptive tax regime that targets this group therefore might implicitly use the number of employees as an eligibility criterion.</p>	<p>(OECD, unpublished^[35]) (ILO, 2021^[10])</p>

BP 27 Attitude from the tax administration towards registered taxpayers	6. Regime administration	The business' registration under the presumptive tax regime should not be used as an opportunity for the tax administration to start auditing procedures related to taxable events that occurred prior to the registration other than in exceptional circumstances, for example where there is a link to suspected criminal activity or fraud. A punitive or confrontational attitude from the tax administration will discourage registration.	While adopting a benevolent attitude to registered taxpayers, the tax administration still needs to ensure tax compliance and preserve the integrity of the tax system.	
<i>The level of tax liability imposed should be affordable for the target group</i>				
BP 28 Tax levels linked to businesses' profitability	4. Tax liability	The rules that determine the presumptive tax liability should be based on an analysis of the target group's profit levels. The more accurate the method for evaluating business profitability, the better and fairer the design of the regime.	<p>Lack of capacities within the tax administration to perform such analyses can make this difficult, especially because many of the targeted businesses are categorised as hard-to-tax and operate in the informal sector, making it challenging to access the relevant information.</p> <p>When actual income is not observable for all businesses, alternative indicators that are easier to observe and difficult to manipulate, such as location, type of activity and input consumption, should be used to approximate business profitability.</p>	(Loeprick, 2009 ^[5]) (Coolidge and Yilmaz, 2016 ^[38]) (Engelschalk, 2007 ^[11]) (Wei and Wen, 2019 ^[31]) (Logue and Vettori, 2011 ^[3])

<p>BP 29</p> <p>Need to consider the economic context</p>	<p>3. Type of regime</p> <p>4. Tax liability</p> <p>6. Regime administration</p>	<p>The business cycle must be taken into account when determining the amount of tax to be paid.</p> <p>Lump-sum taxation method: It is preferable to adjust the lump-sum amounts in the event of a major economic shock (e.g., a recession, pandemic).</p> <p>Regimes based on turnover or other indicators of economic activity: Where the regime includes pre-payments, those payments should not only be based on the turnover or the indicators of the prior year, but should be adjustable to take into account the projected turnover (or other indicators) of the current year.</p>	<p>Adjusting tax payments too frequently can give rise to large fluctuations in the tax liability payable, which can undermine tax stability.</p> <p>The Ministry of Finance may come under pressure to adjust tax levels frequently.</p>	<p>(ILO, 2021^[10])</p> <p>(ILO, 2021^[13])</p>
<p>BP 30</p> <p>Need to consider the taxes not covered by the regime</p>	<p>4. Tax liability</p> <p>5. Taxes covered</p>	<p>The taxes that are not covered by the presumptive tax regime but that businesses within the target group are liable to (e.g., local taxes and fees) should be taken into account when setting the regime's tax liability to avoid levying an excessively high tax burden.</p>	<p>The Ministry of Finance might face challenges gathering information on the complete spectrum of taxes and fees if they are highly decentralized.</p>	

If possible, consideration should be given to equity in the design of a presumptive tax regime

BP 31

Sectoral
differentiation

4. Tax liability

Where the regime applies to more than one sector, it is preferable to adjust the presumed tax base or the level of the tax liability according to the average profitability of each sector. This can be done, for instance, by applying sectoral coefficients to turnover or other indicators used to estimate the presumed tax base or by having differentiated rates or differentiated lump-sum amounts (higher for more profitable sectors).

Tax administrations may lack the resources and capacity to conduct the sector-based analyses of business profitability that are required in order to determine differentiated tax burdens.

Estimating sectoral coefficients can be complex. Coefficients should be updated on a regular basis, making the system more difficult for the tax administration to manage and more difficult for the taxpayer to comply with. On these grounds, business activity differentiation shouldn't be too detailed, as it would make the regime excessively complex, and it would be very likely that a single business belongs to more than one tax category.

It can be politically difficult to justify differences in tax burdens across sectors.

<p>BP 32</p> <p>Definition of differentiated lump-sum amounts or tax rates</p>	<p>3. Type of regime</p> <p>4. Tax liability</p>	<p>Where the regime levies differentiated lump-sum amounts or differentiated tax rates, the indicators used to categorise the tax schedule should not generate disproportionate increases in the tax liability arising from marginal changes in the tax base. This issue might arise, for instance, when lump-sum amounts or tax rates are differentiated across turnover bands. Examples of appropriate indicators for tax differentiation are categorical dimensions such as sectors of activity or number of years of operation of the business.</p> <p>Consequently, it is preferable to apply proportional/progressive rates on turnover-based regimes, rather than differentiated lump-sum amounts or differentiated tax rates based on turnover brackets, to avoid inducing bunching effects below turnover thresholds.</p>	<p>The categories set to differentiate lump-sum amounts or tax rates should be derived from differences in business profitability, which in turn requires an evaluation of the target group's profit levels.</p>	
<p>BP 33</p> <p>Suitability of progressive rates</p>	<p>4. Tax liability</p>	<p>When the target group is large (e.g., the regime's eligibility threshold is set at a high level), it is preferable to focus on progressive rates rather than on a proportional rate.</p>	<ul style="list-style-type: none"> • When business profitability does not increase with turnover, levying progressive tax rates on turnover will result in an increasingly high effective tax burden on less profitable businesses. • Tax payments will be more difficult to predict when progressive tax rates are applied, compared to lump-sum amounts or tax liabilities derived from proportional rates. 	

The design of the presumptive tax regime should facilitate and not deter migration into the standard tax system

<p>BP 34</p> <p>Specific transition provisions in the standard tax system</p>	<p>8. Interaction with the standard tax system</p>	<p>Under the standard tax system: Introduce specific and temporary tax provisions and administrative procedures to smooth the transition from the presumptive tax regime into the standard tax system (e.g., reduced rates, simplified accounting rules such as cash accounting, presumed cost deductions, less frequent tax filings and payments, etc.).</p>	<p>Maintaining such features on a permanent basis might bring some disadvantages such as bunching effects similar to what can be observed in presumptive regimes or artificial closing and reopening of business activities. It is therefore recommended to allow businesses to benefit from these tax provisions for a limited period of time and/or to tie them with a previous registration to the presumptive regime.</p>	<p>(Baurer, 2005^[26]) (OECD, 2015^[9])</p>
<p>BP 35</p> <p>Specific transition provisions in the presumptive tax regime</p>	<p>8. Interaction with the standard tax system</p>	<p>Under the presumptive tax regime: Include tax and non-tax provisions that facilitate and do not deter migration into the standard tax system. Some examples would be the following:</p> <ul style="list-style-type: none"> • Tax levels that converge to those in the standard system for taxpayers close to the eligibility threshold. • Requirement to satisfy simple accounting procedures. • Smoothing the transition between the presumptive regime and the standard tax system, by avoiding the abrupt withdrawal of regime eligibility where a business temporarily (e.g. for one year only) fails to meet the turnover or income eligibility threshold. In these circumstances, the business may be allowed to continue to benefit from the regime even if it temporarily fails to meet the eligibility tests so as to avoid the disruption of businesses entering, exiting and re-entering the regime on a regular basis. 	<p>These provisions make the design of the presumptive tax regime more complex and thus it requires a more developed administration capacity to ensure the enforcement of the regime.</p>	<p>(Coolidge and Yilmaz, 2016^[38]) (Engelschalk, 2004^[15])</p>

<p>BP 36</p> <p>Optional registration</p>	<p>8. Interaction with the standard tax system</p>	<p>It is preferable for the presumptive tax regime to be optional, allowing all eligible taxpayers to register under the standard tax system.</p>	<p>Allowing taxpayers who seek to minimize their tax liability to enter and leave the regime on a regular basis will increase tax administration costs without contributing to higher revenue collection. Thus where admission to the presumptive regime is voluntary, minimum periods of adherence might be required. Similarly, migration to the standard system could be linked to a requirement to remain within the standard system for a specified number of years.</p>	<p>(Engelschalk, 2007^[11])</p>
<p>BP 37</p> <p>Training support</p>	<p>2. Eligibility criteria 7. Non-tax support instruments</p>	<p>Provide supporting tools, including book-keeping training, to enable taxpayers to comply with the tax rules of the standard system, especially when businesses can remain within the presumptive regime(s) only for a limited period of time.</p>	<p>The provision of supporting tools is costly by the administration.</p>	<p>(Engelschalk, 2007^[11])</p>
<p>BP 38</p> <p>Comprehensive vision of the tax system</p>	<p>8. Interaction with the standard tax system</p>	<p>The impact of changes to the corporate income tax, the personal income tax and the VAT on the presumptive tax regime should be considered (e.g., possible distortions created).</p>	<p>An overall approach/vision to the existing tax system might be lacking.</p>	
<p>BP 39</p> <p>Interaction between the regime's threshold and the VAT threshold</p>	<p>1. Target group 2. Eligibility criteria 8. Interaction with the standard tax system</p>	<p>If the regime's target group is large and the VAT regulations include a VAT registration threshold below which businesses are not liable to VAT collection, setting the VAT threshold lower than the presumptive regime's eligibility threshold could help taxpayers in the regime to transition into the standard tax system.</p>	<p>There are no firm recommendations on determining the presumptive tax regime's eligibility threshold. Whether to align the VAT threshold with the presumptive regime's eligibility threshold will depend on many variables such as the size and characteristics of the target group, the complexities of the tax system and the administrative capacity of the tax administration.</p>	

The tax administration needs to reduce, as much as feasible, the opportunities for tax evasion and avoidance that the presumptive tax regime may give rise to

BP 40 Specialised unit	6. Regime administration 8. Interaction with the standard tax system	<p>The presumptive tax regime is regularly monitored and assessed, preferably by a specialised unit, in order to identify any anomalies arising from the design of the regime or from administrative rules.</p>	<p>The monitoring and assessment of the presumptive tax regime would require the construction and permanent update of a database that contains the register of taxpayers and as many other relevant information as possible.</p> <p>It is also key to track broad indicators such as the number of taxpayers registered, the average permanence in the regime or revenues collected.</p> <p>However, means to perform the specific monitoring/assessment can be lacking.</p>	<p>(OECD, unpublished^[35]) (IDB, 2009^[19]) (Loeprick, 2009^[5]) (Logue and Vettori, 2011^[31])</p>
BP 41 Penalties	6. Regime administration	<p>The presumptive tax regime's regulation should include fines and penalties for taxpayers who commit fraud.</p>	<p>Enforcing excessively high penalties might disincentivise registration in the regime. Hence, sanctions should be determined according to the severity of the non-compliance committed.</p>	
BP 42 Artificial self-employment arrangements	4. Tax liability	<p>To reduce artificial self-employment arrangements, it is preferable to establish a narrow tax differential between a self-employed taxpayer in the presumptive tax regime and an employee with similar characteristics (i.e., low income) in the standard tax system. Additionally, specific tax provisions to prohibit these arrangements should be legislated.</p>	<p>When assessing this tax differential, not only income taxes and social security contributions should be considered, but all the taxes covered by the presumptive tax regime.</p> <p>A monitoring of potential artificial self-employment arrangements is costly, as they might be difficult to detect, and hence it requires a developed administrative capacity.</p>	<p>(OECD, 2015^[9])</p>

<p>BP 43</p> <p>Interaction between turnover-based regimes and the VAT</p>	<p>2. Eligibility criteria</p> <p>3. Type of regime</p> <p>5. Taxes covered</p>	<p>If the regime is turnover-based and the contribution includes the VAT, the regime's eligibility threshold should be set low to cover a small target group because under-reporting of turnover becomes more difficult to detect, as there is no separate VAT compliance procedure.</p> <p>Alternatively, if given the characteristics of the businesses in the country and the complexities of the standard tax system it is not optimal to set the regime's eligibility threshold low, then – to limit the issue of turnover under-reporting – the VAT should be enforced independently from the regime and a VAT registration threshold could be set at a lower level (if this is optimal given the country-specific circumstances).</p>	<p>It is key to have sufficient administrative capacity to monitor and enforce a turnover-based regime. Detecting the under-reporting of turnover is challenging even where compliance with the VAT is assessed independently of the presumptive regime, especially in situations where transactions with households and cash payments predominate.</p> <p>On the other hand, where both a VAT registration threshold and the regime's eligibility threshold are enforced, setting their optimal level should be a coherent decision that will be determined by many interrelated factors specific to each country's context.</p>	
<p>BP 44</p> <p>Measures to restrict turnover under-reporting</p>	<p>3. Type of regime</p> <p>6. Regime administration</p>	<p>Where turnover is used to define the presumed tax base or as an eligibility criterion, implementing measures to restrict under-reporting may be needed (e.g., use of electronic cash registers, tax invoice lotteries or promotion of traceable payments).</p>	<p>Several challenges can be observed:</p> <ul style="list-style-type: none"> • The implementation and management costs of these measures can be substantial. • Specific difficulties in managing electronic cash registers can arise, which will increase taxpayer's compliance costs. The tax administration could provide tools to facilitate the implementation and management of these registers, however, this will involve additional funds. • Tax authorities might lack administrative capacity to use the data from electronic registers to identify fraudulent behaviour. 	<p>(Engelschalk, 2007^[11])</p>

BP 45 Combination of turnover and other indicators of economic activity	3. Type of regime	Where the possibility for turnover under-reporting is high (e.g., where the regime's single tax payment includes VAT or where the target group includes many small retailers or service providers to individuals), the regime shouldn't be based on turnover indicators solely, but on a combination of turnover and other indicators of economic activity which are difficult to manipulate.	Selecting and defining economic activity indicators that better reflect business characteristics and profitability and, at the same time, are difficult to falsify, can be challenging and might increase the complexity of the regime. Sufficient administrative capacity is needed to monitor multiple indicators of economic activity.	
BP 46 Conditional issuing of business licences	6. Regime administration	Where businesses targeted by the presumptive regime need a licence in order to pursue their activity, making receipt of the licence dependent on payment of the regime's contribution might be considered.	Good co-ordination between the public institutions involved will be necessary.	
<i>Good management of the presumptive tax regime requires co-ordination between institutions</i>				
BP 47 Functions to be developed by the Ministry of Finance	6. Regime administration	Presumptive tax regimes should be designed by the body responsible for tax policy, generally the Ministry of Finance. Support from other ministries may be required during the regime design and assessment phases (e.g. impact on formalisation and other relevant indicators in line with the regime's specific objectives).	For this to happen, it is crucial to identify who within the administration has relevant information and to ensure exchange of information within the administration.	(OECD, unpublished ^[35])

BP 48 Involvement of the local governments	6. Regime administration	It is preferable that local governments are not allowed to design the rules of the presumptive tax regime to avoid creating a source of local tax competition, but they can play an active role in monitoring and enforcing the presumptive tax regime.	Having local governments in charge of monitoring and enforcing the presumptive regime might lead to corruption risks.	
BP 49 Funds redistribution	5. Taxes covered 6. Regime administration	Either where social security contributions or regional taxes and fees are part of the regime's single tax payment, or where payments (taxes and social security contributions) are made separately to the same collecting body, that agency should have enough administrative capacity to redistribute funds on a pre-determined basis across the various institutions involved (tax administration, sub-central administrations, social security funds).		
BP 50 Harmonization of the SME definition	2. Eligibility criteria	There is a strong case for the definition of an SME used for the presumptive tax regime to be harmonised across the different institutions directly or indirectly involved in the regime (Ministry of Finance, statistical institute, other ministries, etc.).	Harmonising SME definitions can take time and can be difficult to accomplish politically. In such cases, administrations can, at a minimum, assess the consequences of the differences in definitions on the tax and non-tax treatments of taxpayers under the presumptive regime.	(Aditya, 2020 ^[17])

Source: OECD.

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