ARE PRESUMPTIVE TAXES A GOOD OPTION FOR TAXING SELF-EMPLOYED PROFESSIONALS IN LOW & MIDDLE-INCOME COUNTRIES?

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Abstract

The term 'hard-to-tax' (HTT), in tax evasion literature, refers to farmers, small and medium-sized enterprises (SMEs), and professionals. However, research on the hard-to-tax in low and middle-income countries (LMICs) has primarily focussed on farmers and SMEs. Professionals are rarely critically considered, despite the acknowledgement in the literature that, considering their potential earnings, the absolute financial amount involved in evasion among professionals in LMICs is probably higher than among farmers and SMEs. Further, while presumptive tax regimes have been widely used in LMICs to tax SMEs and farmers, professional income is almost always explicitly excluded in the eligibility criteria for these regimes. There is also a gap in the literature on presumptive taxes. Scholarly discourse on these regimes have primarily focussed on their suitability for farmers and SMEs; there is little discourse on their suitability for professional income. The author fills these two gaps by making use of qualitative data on tax evasion by lawyers and dentists in Kenya. The qualitative data suggests that professionals fail to comply because of (i) peer influence, (ii) low levels of financial and tax capability, and (iii) the damaged political legitimacy of the tax authority. This paper makes an original contribution to the literature on the hard-to-tax and presumptive taxation by proposing that although presumptive tax regimes ordinarily explicitly exclude professional income, these regimes can be useful partial solutions for taxing newly qualified, self-employed professionals *if* they are well-thought-out, meticulously designed and implemented, and rigorously monitored.

Keywords: Hard-to-Tax, Presumptive Tax, Tax Evasion, Taxing Professionals, Developing Countries, Taxation in Kenya.

INTRODUCTION

Objective

The objective of this paper is to discuss the suitability of presumptive tax regimes for hard-to-tax (HTT) professionals in LMICs. The literature on tax evasion by the HTT and on the use of presumptive tax regimes in LMICs has generally overlooked professionals. The taxation of SMEs and farmers has dominated the discourse in these two topics.

[1] The author has recently completed a DPhil in Law at the University of Oxford and is commencing a 3-year postdoctoral fellowship in Oxford, funded by the British Academy, in September 2019. This paper is part of a DPhil project investigating the reasons for tax evasion by self-employed professionals in low and middle-income countries (LMICs), and possible administrative, legislative, and policy solutions. Various aspects of this work have been presented at the following conferences and workshops: Addis Ababa (November 2015), Oxford (September 2016), and Oxford (June 2018). I am very grateful for the comments I received from the participants in those forums. I am particularly grateful for the invaluable comments and ideas I received from Professor Eric Zolt. Finally, I am grateful for the financial support from the Oxford Centre for Business Taxation, the Chartered Institute of Taxation (CIOT), and the Oxford Law Faculty that facilitated this work.

The qualitative data for this research is drawn from 31 semi-structured interviews, conducted in Kenya with dentists, lawyers, and a diverse group of tax experts. This paper does not purport to generalise the findings from the small sample size to the whole population. Instead, the qualitative data provides rich and nuanced patterns and trends in the professionals' attitudes towards tax compliance. The author then uses the data to inform the discussion on the suitability of presumptive tax regimes for HTT professionals in LMICs. The paper concludes by proposing that although presumptive tax regimes ordinarily explicitly exclude professional income, these regimes can be useful partial solutions for taxing newly qualified, self-employed professionals *if* they are well-thought-out, meticulously designed and implemented, and rigorously monitored.

The Hard-to-Tax

Professionals fall within a category of taxpayers known in the literature as the *hard-to-tax* (HTT), a category which also includes farmers and SMEs (Casanegra de Jantscher & Tanzi, 1987, p. 12; Musgrave, 1990, p. 299; Tadesse & Taube, 1996, p. 3; Alm, Martinez-Vazquez, & Schneider, 2005, p. 13-14). These taxpayers are described as hard-to-tax because they share the following typical characteristics (Alm et al., 2005 pp. 13):

a. They do not register themselves voluntarily with the revenue authority;
b. They do not keep proper books of accounts showing their income and expenditure, and, when they do, it is difficult to ascertain the accuracy of these accounts;
c. They are not prompt in filing tax returns;
d. There is a significantly higher rate of tax evasion among them.

Hard-to-Tax Professionals

This paper focuses on professionals, rather than farmers and SMEs, because of the dearth of research into professionals, particularly in LMICs. Prior research on the HTT has mainly focussed on farmers and SMEs (for example, Rajaraman, 1995; Terkper, 2003; Rajaraman, 2005; European Commission, 2007; Coolidge & Yilmaz, 2016). However, the scope for high-income earners, like doctors, lawyers, contractors and consultants, to underreport is often considerable, particularly when they deal with cash transactions (Keen, 2012, p. 16; Tadesse & Taube, 1996, p. 4). By focussing on professionals, this paper seeks to make a meaningful contribution to the literature on taxation of the HTT.

Furthermore, the author focusses on self-employed professionals. The self-employed have significantly more opportunities for evasion than employees, whose salaries and wages are subject to employer withholding schemes – this idea is well documented in the literature (Casanegra de Jantscher & Tanzi, 1987; Kleven, Knudsen, Kreiner, Pedersen, & Saez, 2011; Kogler, Muehlbacher, & Kirchler, 2015; Slemrod, 2007; Torgler, 2006; Torgler & Valev, 2010).

Professionals are an important group to study. According to Keen, they can be responsible for some of the most severe instances of revenue loss and damage to the fairness of the tax system, particularly in developing countries (2012, p. 16). However, since they are so highly qualified and tightly regulated, it often appears unnatural to refer to them as 'informal' (Keen, 2012, p.

16).[2] Keen (2012, p. 16) explains that, considering their earnings, the absolute financial amount involved in evasion among professionals is probably higher than in any other group.

Significance

This research is essential now, as LMICs, particularly in Africa, strive to improve tax collection in recognition of rapid changes in development funding and the urgent need to harness domestic resources to meet growing socio-economic needs sustainably. As a result, there is increasing awareness that domestic resource mobilisation is essential and requires more attention (Carnahan, 2015, p. 170).

LMICs record a higher number of HTT taxpayers than high-income countries. According to the table below, the informal sector – which has a high number of HTT taxpayers – is responsible for a significant share of the employment opportunities in urban areas, new jobs, and non-agricultural employment opportunities in developing countries. For example, in Africa, the informal sector provides 93% of the new job opportunities and 61% of the job opportunities in urban areas.

Table 1: Make-up of the Informal Sector in Latin America Caribbean, Africa & Asia (Chen, 2001, p. 72)

Informal Sector as a Percentage Share of:	Latin America-Caribbean	Africa	Asia
Non-agricultural Employment	57	78	45-85
Urban Employment	40	61	40-60
New Jobs	83	93	NA

Woodruff (2013, pp. 2–3) explains that in comparing the informal economy as a percentage of GDP and taxes as a percentage of GDP, the former is higher in developing countries while the latter is higher in many Organisation for Economic Co-operation and Development (OECD) countries. For example, according to the graphs below, taxes in Kenya are approximately 20% of the GDP, while the informal economy is approximately 40% of the GDP. The variances are even higher in countries such as Liberia, Honduras, and Georgia.

[2] Note that the term 'hard-to-tax' comprises taxpayers from the formal and informal sectors. Keen (2012, p. 16) argues that the term 'informality' is not always useful and has become quite loaded, while the term 'hard-to-tax' is 'much closer to the mark'.

Figure 1: Taxes and Shadow Economy as a % of GDP in OECD Countries (Woodruff, 2013, p. 2)

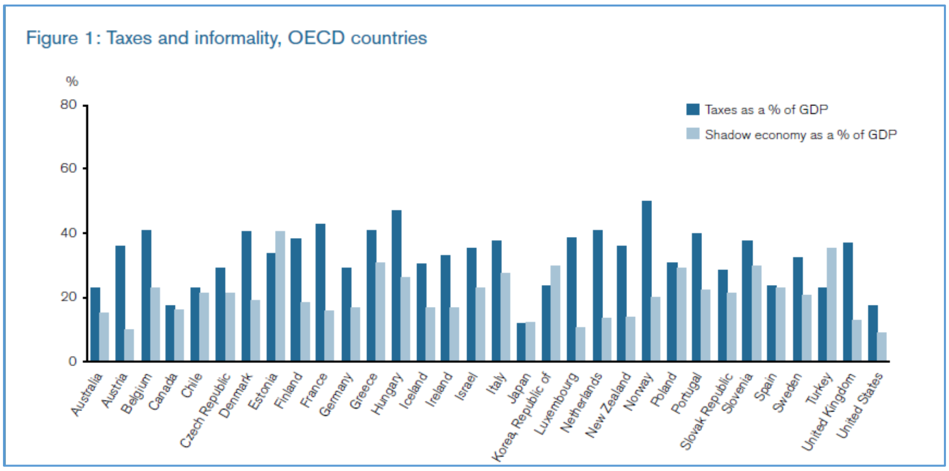
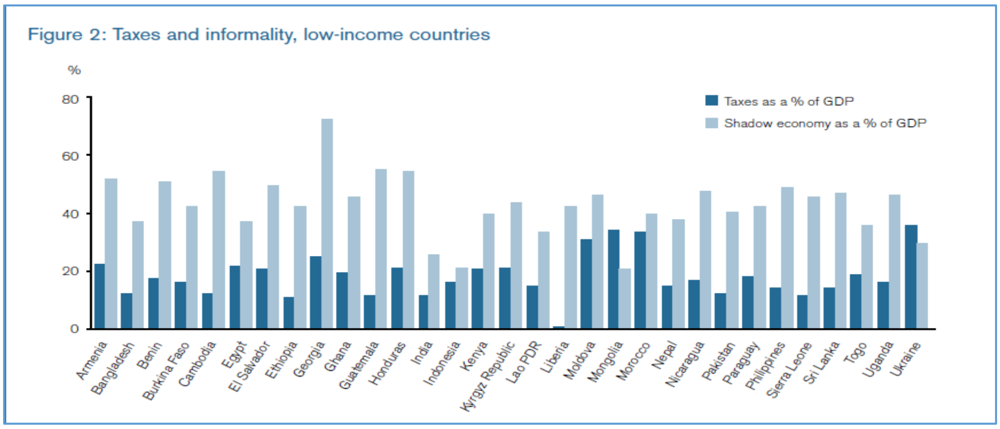


Figure 2: Taxes and Shadow Economy as a % of GDP in Low-income Countries (Woodruff, 2013, p. 3)



Thus, in LMICs, revenue authorities face dealing with a large number of individual taxpayers and the associated high cost of collection with the risk of minimal returns. In dealing with the HTT or 'informal sector', the default policy reaction seems to be to focus on the agricultural sector and SMEs with relatively low incomes, while ignoring potentially high income earning, self-employed professionals who operate in the informal sector and evade taxes. This professional class is growing in countries such as Kenya and the failure to effectively tax self-employed professionals appears to be unjustifiable. This paper advocates for a tax policy and administration shift, i.e. in policy and administrative efforts aimed at increasing tax collection from the informal sector, the taxation of professionals is a sensible place to start.

The inability or hesitance to effectively administer and enforce taxes on self-employed professionals has several adverse implications for the overall tax system. Admittedly, the revenue potential of these taxpayers is lower than the revenue collected from corporate taxes and PAYE; however, the importance of expending the effort and resources required to effectively tax the HTT stretches beyond revenue collection.

For example, effective taxation of self-employed professionals may promote the equal treatment of similar taxpayers, one of the cornerstones of a good tax system. The significant evasion opportunities that the self-employed enjoy may lead to inequity because, while these professionals can dodge their compliance obligations, their salaried peers, whose taxes are withheld at source, bear the full tax burden. It is inequitable to collect taxes from those who are 'easier' to tax, such as formal employees or larger corporations, while categorising other taxpayers – potentially earning comparable incomes – as hard-to-tax and pursuing the latter group less aggressively or leaving them out of the tax net altogether (Bahl, 2005, p. 343). Such inequity can have severe implications for the overall tax system (Bahl, 2005, p. 343; Bird & Wallace, 2005, p. 130; Musgrave, 1990, p. 299; Terkper, 2003, p. 4).

Second, widespread tax evasion by self-employed professionals can severely damage the tax morale of other compliant taxpayers, who may also begin to look for opportunities to evade. In other words, 'if taxpayers believe tax evasion to be common, tax morale decreases. Alternatively, if they believe others to be honest, tax morale increases' (Frey & Torgler, 2007, pp. 153-156). Thus, in order to promote fairness in the system and tax morale, it would be helpful to make a genuine effort to tax self-employed professionals.

PRESUMPTIVE TAXATION

What are Presumptive Taxes?

Present-day tax systems have evolved from presumptive regimes. For example, in the past, taxes were levied based on the number of windows or doors in one's home, or the number of huts in one's compound, i.e. colonial British government hut tax (for an interesting discussion on the colonial hut tax and further references on the topic, see Gardner, 2010).

In modern tax systems, the goal is to apply the tax rate to 'a well-defined measure of the income earned by taxpayers...in a given period....' (Casanegra de Jantscher & Tanzi, 1987, p. 1). Presumptive taxation 'involves the use of indirect means to ascertain tax liability, which differs from the usual rules based on the taxpayer's accounts' (Thuronyi, 2000, p. 401). In presumptive tax regimes, the ''desired' base for taxation...is not itself measured but is inferred from some simple indicators which are more easily measured than the base itself' (Ahmad & Stern, 1991, as cited in Thuronyi, 2000, p. 401).

The presumption, therefore, replaces 'an entire tax base or at least a large portion of the base' (Avi-Yonah & the International Fiscal Association, 1998, p. 1). In other words, where the revenue authority cannot ascertain a taxpayer's income, or cannot verify the accuracy thereof, presumptive regimes allow them to *presume* the amount of income based on alternative observable indicators, i.e. an alternative base determined by the revenue authority (Bird & Wallace, 2005, p. 124).[3]

Presumptive taxes have been used for a wide range of reasons in several countries. Although they have been used in some high-income countries, like France, Germany, Belgium and Israel, they mostly feature in the tax systems of LMICs. These regimes provide revenue authorities with various opportunities.

[3] For a detailed discussion on the various legal characteristics of presumptive taxation methods, see Keen (2012, pp. 401–405).

Tax Simplification

HTT taxpayers in LMICs face significant challenges when attempting to meet complex tax and accounting compliance requirements. Many HTT taxpayers run micro, small or medium-sized businesses with modest turnovers; subjecting them to the usual compliance requirements places onerous financial burdens on them, driving many business owners towards evading their compliance obligations altogether.

For example, small business owners are often unable to comply with their accounting and tax obligations without paying for professional help (Terkper, 2003, p. 219). The costs involved in this, both in terms of time and money, are burdensome for businesses of this size (European Commission, 2007, pp. 8-13). As a result, the owners of these businesses will often fail to keep financial records or will keep records which are incomplete, inaccurate, or deliberately misleading (Casanegra de Jantscher & Tanzi, 1987, p. 5). The literature confirms that even self-employed professionals who are highly educated can keep rudimentary, unreliable, and inaccurate books of accounts that are incapable of being effectively utilised for tax auditing purposes (Tadesse & Taube, 1996, p. 4).

One of the primary goals of presumptive regimes is, therefore, to cater to such taxpayers. Policymakers and revenue authorities anticipate that if the compliance burden is low and the rules are kept simple, taxpayers will be motivated to comply voluntarily. The target, in this case, is taxpayers who evade taxes because (i) of lack of knowledge or understanding of their obligations or (ii) the cost (financial or otherwise) of compliance is too high.

Since revenue authorities cannot ascertain the actual tax base in the face of poor record-keeping, presumptive regimes allow these authorities to come as close as possible to ascertaining income using presumptive methods (Casanegra de Jantscher & Tanzi, 1987, p. 4). Presumptive tax regimes are intended to simplify tax administration in LMICs and ‘overcome administrative weaknesses that are endemic to many countries in Africa’ (Tadesse & Taube, 1996, p. 11).

However, striking the correct balance is easier said than done. In many countries, the simplified tax regimes are still far too complex and burdensome for micro-enterprises; on the other hand, where the regime is too simple with little accountability, the risk of abuse of the system by medium-sized enterprises increases significantly (Coolidge & Yilmaz, 2016).

Enhancing Horizontal Equity

Proponents of presumptive tax regimes are primarily concerned with horizontal equity, i.e. treating similar taxpayers similarly. One of the goals of presumptive regimes is to encourage greater compliance among these HTT taxpayers. The intention is to reduce the ‘unfair advantage’ that they have, i.e. the opportunity to evade their tax obligations while those who are salaried bear the full burden of their obligations. Horizontal equity demands fairness in the distribution of the tax burden, and this is what presumptive regimes aspire to achieve.

Expanding the Revenue Base

The expansion of the tax base is an urgent need of many LMICs. These countries depend heavily on corporate income tax, value-added tax (VAT) and Pay As You Earn (PAYE) tax from the formal sector. Due to widespread tax evasion, the informal sector contributes very little to the tax revenue collected in LMICs, despite making up a very significant percentage of the economy. The rationale behind the introduction of presumptive taxes is that with simpler rules and lower compliance costs, previously non-compliant taxpayers will begin to comply voluntarily, thereby expanding the revenue base (Alm et al., 2004, p. 49).

Presumptive regimes have, however, been criticised for resulting in abuse of the law, unfairness, inefficiency, and distorted decision-making. Where the threshold for eligibility is too high, for example, larger taxpayers who are fully capable of keeping proper books of accounts and complying with ordinary tax rules can take advantage of presumptive regimes to pay lower taxes (Bird & Wallace, 2005, p. 6). Presumptive regimes have also been accused of eroding vertical equity. For example, where taxpayers in a specific sector are subject to a lump-sum tax, all the taxpayers in that sector end up paying the same amount of tax regardless of their varying income levels, business expenses, or unexpected losses. Such risks call for the presumptive regime to be carefully researched and designed in order to minimise the chances of distortions and economic instability occurring.

Presumptive Taxes & Professionals

Scholarly discourse on the use of presumptive taxes has mostly considered their suitability for SMEs and farmers (Bird & Wallace, 2005; Rajaraman, 2005; Terkper, 2003; Bird & Zolt, 2004; Erbas, 1993; Jaramillo, 2003; Pashev, 2006; Tadesse & Taube, 1996; Musgrave, 1990). Most of this literature either completely overlooks professionals or briefly mentions that presumptive taxes are not suitable for professionals. One apparent reason for this is that professionals are highly educated, so it is assumed that they are financially literate, tax literate, and sophisticated enough to keep proper financial records and comply with tax legislation.

In addition, tax policymakers and revenue authorities are perhaps hesitant to apply presumptive methods to this group because of the potential high earnings of professionals, and the challenges associated with factoring in the widely divergent incomes among professionals in the same sectors when designing the presumptive tax. There is a risk that high income earning professionals will abuse a poorly designed presumptive tax system in order to pay lower taxes.

However, these assumptions and fears are blind to several realities. First, in LMICs, a significant number of professionals run owner-managed small firms with modest incomes; these professionals run their businesses as informally as other HTT taxpayers (Terkper, 2003, p. 213). The data collected during the case study for this research, which is presented in the next section, suggests that the financial and tax capabilities of professionals within this group are not always as high as the literature often assumes.

Second, the blanket distinction between self-employed professionals and SMEs is problematic. Many self-employed professionals face the same compliance challenges that SMEs face, i.e. the ‘compliance costs or what it takes to meet tax obligations are also higher for small entities especially in relation to the amount of taxes they pay’ (Terkper, 2003, p. 213). While there are self-employed professionals who run large successful firms with significant turnovers and can afford professional accounting services, there are many self-employed professionals who struggle to cover their compliance costs on their modest incomes. For professionals running small firms, or recent graduates at the beginning of their careers, the typical costs of compliance are incredibly high and prohibitive, forcing many of them to evade taxes and operate in the informal economy. This category of professionals is ignored in the literature.

In practice, almost all countries that have some form of presumptive tax regime apply the regime to SMEs but explicitly make professional income ineligible through the language of the statute. Thus, self-employed professionals are usually unable to take advantage of presumptive tax regimes, even where they meet the other eligibility criteria. There are a few instances where countries have chosen to apply presumptive income taxation to professionals.

India

Before 2016, the income tax law exempted professional income from the presumptive tax regime. However, since the financial year 2016/2017, self-employed professionals in India whose total gross receipts did not exceed Rs. 50 Lakhs in the previous financial year can benefit from the presumptive regime under the new Section 44ADA of the Income Tax Act.[4] The taxpayer's income is presumed to be 50% of their total gross receipts for the year and, since a deemed deduction for all expenses is applied, no further deductions are allowed. The provision further relieves the taxpayer of the obligation to maintain proper audited books of accounts; however, the presumption is a rebuttable one and the taxpayer can produce audited books and receipts showing that their income was less than 50% of gross receipts (Income Tax Department, Government of India, n.d.). This presumptive regime is not mandatory. Taxpayers are free to opt in and out from year to year without restriction. The rate set for the presumptive tax, i.e. 50% of total gross receipts, is high and is likely to affect the uptake of the regime.

Greece

Greece has faced a significant problem with widespread tax evasion, especially among professionals; according to one study, 43-45% of self-employment income goes unreported and untaxed in Greece, and the primary tax evaders are professionals, like lawyers, doctors, and engineers (Artavanis, Morse, & Tsoutsoura, 2016, pp. 743, 763). Early attempts to increase enforcement on professionals in 2010 were unsuccessful, with Parliament voting down a proposed bill to that effect (Artavanis et al., 2016, p. 782). Greece introduced presumptive taxation of professionals as part of the economic and financial policies it adopted in response to the 2010 financial crisis; the regime was expected to raise 'at least EUR 400 million in 2011 and increasing returns in 2012 and 2013' (International Monetary Fund, 2010, p. 50). The presumptive tax regime applies to some categories of professionals but does not apply to liberal professionals, like doctors and lawyers (Ntoukaki, email correspondence, June 7, 2018). The exemption of liberal professionals is an interesting choice when viewed in light of the evidence that these groups are the primary tax evaders.

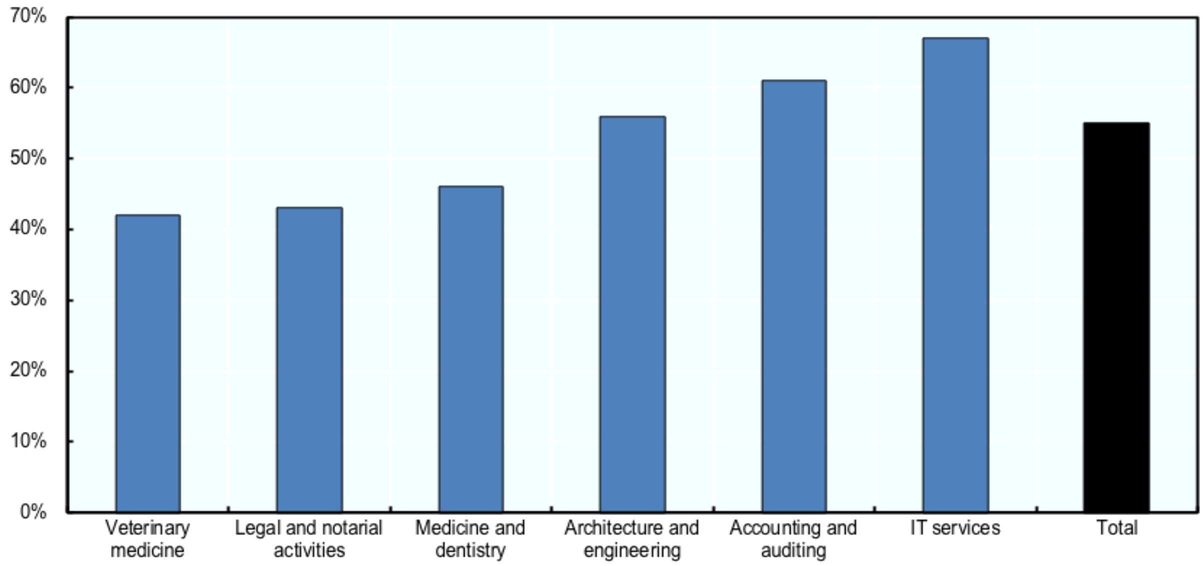
Costa Rica

In the 1990s, the presumptive regime for professionals applied to doctors, architects, engineers, lawyers, accountants, brokers, notaries, economists, and other technicians and professionals who failed to file their tax returns (Rajaraman, 1995, p. 1110). Costa Rica still faces widespread tax evasion among liberal professionals, including lawyers, architects, doctors, dentists, and accountants (OECD, 2017, p. 71). The receipt of professional fees in cash, for which these professionals do not issue receipts, allows them to underreport their income; they can also 'easily over-report deductible expenses or claim expenses that should not be claimed' (OECD, 2017, p. 72).

[4] This provision covers professionals in the legal, medical, architecture, accounting, interior design, engineering, and information technology sectors, as well as company secretaries, artists, and technical consultancy professionals.

According to the statistics below, in 2015, tax evasion was highest among professionals in I.T., accounting, and auditing.

Figure 3: Share of Taxpayers Declaring Zero Income Tax in Different Liberal Professions in Costa Rica in 2015 (OECD, 2017, p. 72)[5]



Furthermore, the statistics show that 55% of professionals declared zero income tax and, 'on average, this share remained relatively constant over the 2011-15 period at an average of 56%' (OECD, 2017, p. 71). The assets and gross earnings of most of the taxpayers in this group suggest that they are grossly underpaying taxes. 86% of the taxpayers in this group 'accounted for about 48% of assets and 30% of gross earnings of the total group while accounting for only 9% of total taxes paid' (OECD, 2017, p. 72).

Under the current presumptive regime, professionals who fail to file their tax returns and pay their taxes when due, as well as issue appropriate receipts, are presumed to earn an income that 'is either 250 or 335 times the basis (sic) salary depending on the profession' (OECD, 2017, p. 71). The higher presumption, i.e. 335 base salaries, is equivalent to approximately $242,000 (Quinones, email correspondence, October 28, 2018). This amount is significant in comparison to the GDP per capita based on purchasing power parity of Costa Rica, which is approximately $17,000 (The World Bank, n.d.-b). This disparity suggests that the policy motivation for the presumptive regime is to discourage tax evasion by compelling professionals to file returns and keep accurate records or face heavy tax burdens.

Guatemala

In 1987, Guatemala introduced a presumptive tax on professionals who failed to file tax returns as part of broader reforms on all aspects of individual income tax (Bahl & Martinez-Vazquez, 1992, p. 80). However, 'by 1990, most professionals would find it advantageous to pay taxes according to the fixed presumptive income assigned to their profession in the tax law' (Bahl & Martinez-Vazquez, 1992, p. 80).

[5] Data based on a 2015 report, Contraloria General de la Republica.

Guatemala still faces a significant problem with tax evasion among the HTT; its low tax to GDP rate (2011-2014) is a partial result of high levels of tax evasion (Kettle, Hernandez, Ruda, & Sanders, 2016, p. 2). 'For the income tax, the estimated average rate of tax evasion for individuals and firms in Guatemala is about 64 per cent…' (Kettle et al., 2016, p. 2).

Under the current presumptive regime, any professional who fails to register as a taxpayer, or who registers but does not file a tax return, is presumed to have earned an income of 30,000Q per month. If the professional graduated fewer than three years ago or is over the age of 60, that presumed income is reduced by 50%.[6] The tax due is then calculated by applying the relevant tax rate to the presumed income. The presumptive regime is a rebuttable one; the taxpayer is permitted to present evidence proving a lower income. However, the taxpayer would still face penalties for failure to file their returns and pay the tax promptly.

The presumed income of 30,000Q per month is the equivalent of $3,800. This figure is about 75% of Guatemala's annual GDP per capita, which is approximately $4,470 (The World Bank, n.d.-a). Once again, this disparity suggests that the policy motive for the regime is to deter would-be evaders and prod them to file their tax returns on the basis of their actual income.

Summary

These country-specific experiences tell us several things. First, presumptive taxation is not a very popular option with tax authorities dealing with the HTT; the uptake of these tax regimes for professionals is limited to very few countries and it is therefore difficult to carry out a comprehensive comparative analysis across countries.

Second, there is scant literature on the policy considerations that inform decisions to adopt presumptive taxes for professionals. In the Greek case, it is obvious that the decision was motivated by extraneous economic circumstances and external political pressure during the economic crisis. In India, the government introduced a presumptive tax regime for professionals in response to the recommendations of a government-mandated committee, which proposed its introduction based on the popularity of the presumptive regime among small traders (Expert Committee on Income Tax Simplification, 2016, pp. 9, 20). Apart from these insights, there is little scholarly discourse on the policy considerations that may underpin decisions to introduce presumptive taxes for professionals; the scepticism over their suitability for professionals seems to be generally accepted without critical consideration of any counterarguments.

Third, one could argue that the high tax rates associated with the presumptive tax regimes in Guatemala, Costa Rica and India suggest that the policy motivation for these regimes is to discourage tax evasion by compelling professionals to file returns and keep accurate records or risk facing unusually heavy tax burdens. In India, for example, the government openly acted in a manner contrary to the committee's recommendation that the presumed income should be 33⅓% of total gross receipts and, instead, introduced a much higher rate of 50% (Expert Committee on Income Tax Simplification, 2016, p. 20). Thus, while presumptive regimes for SMEs and farmers are framed as devices intended to *simplify and facilitate compliance*, governments seem to adopt a much more *punitive* stance with professionals.

[6] Decree 10-2012, Tax Update Law (Congress of the Republic).

This paper seeks to challenge these assumptions and stances by considering whether, and under what conditions, presumptive taxes may be *useful* rather than *punitive* devices for taxing professionals.

THE RESEARCH QUESTION

This paper seeks to answer the question: are presumptive taxes a good option for taxing self-employed professionals in LMICs?

In answering this question, the rest of the paper is organised as follows:

- Section II explains how the empirical data for this research was collected;
- Section III summarises the significant findings of the research;
- Section IV explores the suitability of presumptive methods for taxing self-employed professionals in LMICs in light of the findings of this research;
- Section V contains the conclusion.

METHOD

The empirical data was collected through semi-structured interviews with taxpayers, tax experts, and senior government officials in Kenya in 2015 and 2016.

Selecting Kenya

Kenya was selected for several reasons. First, it is classified as a lower middle-income country with a GDP per capita PPP of $3,2851.91 (The World Bank, n.d.-b). According to a recent survey, Kenya's tax-to-GDP ratio is 18.1% (2016); this is similar to the average tax-to-GDP ratio for 21 countries in Africa (18.2%) (OECD, the African Tax Administration Forum [ATAF], & the African Union Commission [AUC], 2018, p. 1). Thus, Kenya falls within the category of countries that this study is focussing on.

Second, despite its robust efforts at tax reform, Kenya has not managed to tax the HTT effectively. For example, with effect from January 2007, the government introduced a turnover tax with the intention of bringing the informal sector into the tax net. In Budget Options 2013 (Parliamentary Budget Office, Kenya, 2013) and Budget Options 2014 (Parliamentary Budget Office, Kenya, 2014), the Parliamentary Budget Office acknowledged that, despite legislative reform, the turnover tax had failed to yield significant revenue and its implementation ought to be rethought. Notably for this article, these efforts at taxing the informal sector have focussed on SMEs and farmers and have excluded self-employed professionals.

Third, Kenya possesses a significant number of HTT taxpayers; there is evidence that the underground economy in Kenya is about 20% of its GDP and has a tax potential of 4% (Ouma & Kenya Institute for Public Policy Research and Analysis [KIPPRA], 2007, p. 18). In addition, 61% of Kenyans working in the urban areas are engaged in the non-agricultural informal sector, and the informal sector employs more than 80% of the Kenyan working population (Budlender, 2011; Institute of Economic Affairs, 2016). While statistics on the overall informal sector do not explicitly capture the tax potential of professionals, the growing professional class in Kenya means that it remains a good choice to study.

Selecting Taxpayers

To better understand the tax compliance behaviour of self-employed professionals, it was necessary to focus on taxpayers drawn from one or two professions and to conduct an in-depth study of these sectors. The two professions selected for this project were (i) dentists working in the health sector in Nairobi and (ii) lawyers working in private legal practice in Nairobi. Kenya has more than 15,000 lawyers (The Law Society of Kenya, n.d.) and 1,300 dentists Shiundu, 2018).

Dentists comprise a compelling case because of the highly informal nature of their engagements. The use of the term 'informal sector' in LMICs typically conjures images of small-scale traders, roadside vendors, or public transport operators. This term is rarely associated with professionals such as dentists, yet the reality is that many of them operate very informally and are as challenging to tax as other informal sector entrepreneurs.

Many dentists in Kenya work informally for other dentists or private hospitals and clinics on a *locum* basis; some dentists are in full-time formal employment with the government but have additional part-time informal *locum* engagements. Other dentists are fully self-employed and the level of formality in these enterprises varies widely.

A total of 10 dentists were interviewed for this project. A table in the Annex sets out the profiles of the dentists according to their gender, the nature of their practice, their level of specialisation, and their years of experience.

Lawyers are an excellent group for comparison. First, it is reasonable to assume that lawyers have a much better understanding of tax law and compliance requirements than dentists; it was interesting to find out whether this would have any bearing on voluntary compliance.

Second, legal practice is much more formal than dental practice. The concept of *locum* does not exist in legal practice in Kenya; lawyers in private practice are either self-employed or in full-time formal employment. There are hardly any grey areas.

Third, although the level of formality in law firms run by self-employed lawyers varies just as widely as it does in enterprises run by self-employed dentists, law firms tend to attract more corporate clients as they grow. This transition significantly decreases the likelihood of cash payments and increases the likelihood of formalisation over time. However, many large dental clinics still receive a significant number of cash payments, regardless of their stage of growth or size.

Finally, revenue officials in Kenya and across Africa with whom the author discussed this project were categorical in their view that lawyers evade tax more than any other professionals. Whether this perception is anecdotal or fact-based is not particularly evident, but it was an observation that further buttressed the decision to select the legal profession for comparison.

A total of 12 lawyers were interviewed for this project. A table in the Annex sets out the profiles of the lawyers per the nature of their practice, their years of experience, the age of their business, and their gender.

Snowball Sampling

The respondents were identified and selected using snowball or referral sampling; the interviewees then referred the author to acquaintances within their circles who would be willing to be interviewed. The initial respondent from the legal profession was known to the author through professional networks, and that lawyer introduced the author to other self-employed lawyers and so on. With respect to the dental profession, the author approached a dentist personally known to her, but did not interview that dentist; instead, that dentist was instrumental in referring the author to other self-employed dentists.

This sampling method was beneficial in this context because of the nature of the study. Potential respondents were understandably wary of being interviewed about tax compliance and a good number of them went to the extent of enquiring about the author's relationship with the revenue authority. It was much easier to access the population through referrals by their trusted professional colleagues. Their colleagues assured them that the author was 'safe' and that her questions did not pose a risk to them. By taking this approach, the author was able to gather even more sensitive data than she set out to collect.

Snowball sampling does have its disadvantages; for example, because of sampling bias, it may not be clear whether the sample is sufficiently representative of the population. The initial respondents are likely to have referred the author to respondents who share their characteristics, for example, age, sex, level of education, and size and nature of practice. There is a risk that respondents with different traits were not adequately represented. However, the author took steps to vary the characteristics of the respondents to ensure that they did not fall into the same category; an attempt was made to ensure that their ages, sexes and the nature and size of their practices varied.

Profile of the Government Officials and Tax Experts Interviewed

Public Sector

- A senior commissioner at the Kenya Revenue Authority (hereinafter referred to as SC-KRA)
- A chief manager at the Kenya Revenue Authority – at the time of the interview, she held the title of manager but she has since been promoted from that position (hereinafter referred to as CM-KRA)
- A manager at the Kenya Revenue Authority (hereinafter referred to as M-KRA)
- A director at the National Treasury (hereinafter referred to as D-NT)
- 2 senior managers at the National Treasury (hereinafter referred to as SM-NT)

Private Sector

- A former finance secretary, now working as a private consultant (hereinafter referred to as FFS).
- A senior partner at one of the 'Big Four' audit and accounting firms in Nairobi – has since retired from the firm (hereinafter referred to as SP-B4).
- A manager at one of the 'Big Four' audit and accounting firms in Nairobi – at the time of the interview she was a senior tax consultant, but she has since been promoted from that position (hereinafter referred to as M-B4)

Academia

- Professor Attiya Waris – the leading tax law academic in Kenya.

Data Collection and Analysis

Most of the interviews were conducted face-to-face; four were conducted over the telephone. It is acknowledged that this is a small number of respondents from which it is not possible to generalise conclusions to the whole population. However, the goal of qualitative research is not to achieve sample representativeness in order to generalise findings to the whole population. The worth of the qualitative data obtained from the small sample size lies in the fact that the author was able to conduct truly in-depth interviews, each lasting one hour or more, during which she was able to tease out critical, analytical, and in-depth insights. In line with the theoretical underpinnings of qualitative research, the goal of this research is not to generalise the findings to the whole population, but to build deep, rich, and thick narratives and analysis regarding the perceptions, attitudes, and patterns of thought of these professionals. Besides, towards the end of the interview process with the taxpayers, the responses mirrored each other to such a significant extent that it is possible that further interviewing within the same professions would not have yielded widely varying information. The author analysed the data using a thematic analysis method; this ensured systematic data analysis, and allowed for objectivity and consistency in the identification of recurrent themes. Some major themes that emerged from the data are discussed below.[7]

MAJOR FINDINGS

Peer Perception

It is now generally accepted in compliance literature that social interactions influence taxpayer behaviour. This view is premised partly on *social influence theory*, i.e. an individual's behaviour and attitudes are affected by the behaviour and social norms of that individual's reference group (Ali, Fjeldstad, & Sjursen, 2014, p. 829). Snavely (1990, p.62) argues that this theory applies in the field of taxation in the same way – the willingness to engage in tax evasion is influenced by one's social interactions.

A common sentiment expressed by virtually all the dentists and lawyers was the belief that their professional peers were engaged in tax evasion. In some instances, the respondents had witnessed the tax evasion or directly benefited from it; in other instances, it was premised on 'gut instinct' and insider knowledge about 'the way things are done'.

All the lawyers believed that their peers evade tax and there was a general belief that the level of tax compliance in the profession is low. The lawyers mentioned various forms of non-compliance, including lawyers: underreporting their income; filing nil returns; padding expenses in order to pay little or no tax; keeping two sets of files; demanding cash payments to avoid paper trails; demanding split cash and bank payments to avoid declaring cash payments; and destroying physical evidence of non-compliance. The majority of the lawyers believed that the smaller firms are the worst offenders because they are invisible; however, according to ADV2 and ADV6, the largest firms are engaged in the most evasion.

[7] The lawyers are abbreviated 'ADV' and assigned numbers; the dentists are abbreviated 'DEN' and are similarly assigned numbers.

Virtually all the lawyers admitted to involvement in some form of tax evasion in the past or present. A few confessed to keeping two sets of files and destroying evidence of income to avoid a paper trail. Three respondents also spoke about a common practice of lawyers: hiding revenue in clients' accounts, which are protected by law from scrutiny due to advocate-client privilege.

The dental practitioners were even more categorical and clear that there is very little compliance in their field. The perception of all the respondents was that medics evade tax through padding their expenses to pay less tax, hospitals evade customs duties on medical equipment and practise other forms of evasion, and that there is widespread underreporting of income among dentists. DEN3 believed that the most common form of evasion was underreporting of income and DEN5 stated that he only knew one dentist who paid tax faithfully.

DEN2 told the author about his previous employer, a senior practising dentist, who is well known within the profession for openly engaging in tax evasion. The senior practitioner was known for treating his employees as 'independent contractors' in order to avoid paying PAYE, even though the nature of their engagement was that of employer-employee. To facilitate his non-compliance, the senior dentist remunerated the 'employees' in cash only, accepted only cash payments for treatments, and paid off revenue officials to avoid audits and prosecution.

Overall, the data from the dentists revealed that the dentists (i) *believed* that the majority of their peers were engaged in tax evasion and (ii) *knew* many peers who were engaged in tax evasion. In both instances, the non-compliance was deemed successful because all the respondents, except DEN8, were unaware of any professional colleagues who had been detected and successfully prosecuted.

This belief that their peers are mostly evading tax has affected the professionals' attitudes towards compliance. DEN2 argued that the law relies on a taxpayer's 'personal morality' for compliance and it is unfair for one to pay tax when others are evading it. The dental practitioners seemed to be emboldened by the fact that 'everyone is doing it, and no one has been caught'. Tax evasion, therefore, seems to have become part and parcel of the ordinary course of business for these professionals. When asked about his perception of the risk of detection, DEN2 answered:

> In my view, the consequences of not paying PAYE on my income are negligible. I was informed by someone who works as a self-employed research consultant that the fines payable if you are caught are so minimal that it is not worth complying. I believe her.

When the author asked him whether he believed that this was an accurate picture of the legal position, he responded that he believed his source and felt no need to cross-check the legal position. This response demonstrates the power of social influences, and the fact that a false narrative within a reference group can easily hold the force of law and influence the behaviour of members of the group. These findings support the theoretical argument that the knowledge that one's peers are evading tax removes the fear of informal sanctions from peers if caught evading (McKerchar & Evans, 2009, p. 178).

The findings also corroborate the existing research that social groups can influence taxpayers' perceptions about the probability of being detected (Fjeldstad, Schulz-Herzenberg, & Sjursen, 2012, p. 16). Lawyers, perhaps because of their training, were more cautious about the risk of detection, but were equally spurred on by the belief that other lawyers are engaged in the evasion game and it is merely the way in which things are done.

Low Levels of Financial and Tax Literacy

The lawyers agreed that financial indiscipline and disorganisation among the profession's self-employed, coupled with the nature of self-employment, had exacerbated the evasion problem. Most respondents confessed that they tended to make haphazard cash withdrawals and did not prioritise tax. They often found themselves without sufficient funds to meet their tax and other financial obligations. ADV5 explained that the discipline of withdrawing money in a structured manner is difficult for sole proprietors. In his case, he would make monthly withdrawals for his upkeep and, occasionally, make large withdrawals when he received unusually large payments. This approach made it difficult to plan for, and pay, his income tax.

In addition, the younger lawyers spoke about their lack of knowledge and expertise in accounting and tax computation, particularly when setting up their law firms; this was a recurrent complaint. These lawyers explained that their transition into self-employment was difficult and dreadful; they were entirely unprepared for the changes in their tax compliance obligations as a result of the transition. ADV6 was of the view that lawyers jump into setting up law firms without the necessary training and knowledge, and with the mindset that the revenue authority is the enemy. ADV4 gave an example of an embarrassing experience with a client who withheld tax on payments according to the law. The respondent was unaware that this was a statutory requirement and therefore queried the action, leading to an embarrassing discussion with the client. Other respondents explained that withholding tax and withholding VAT took them by surprise, and that, overall, their total tax burden was higher than they had expected when going into self-employment.

The accounting and tax illiteracy among lawyers, coupled with the existence of what the respondents described as inaccessible tax information, led to improper billing, inaccurate record-keeping, and inadequate internal structures within their firms. These shortcomings significantly hampered compliance. The tax authority found it difficult to believe that highly educated professionals, particularly lawyers, struggle with financial and tax literacy; in one respondent's view, they should be the most informed group in society.[8] However, as ADV3 put it, 'I was aware of the taxes but did not know how to calculate and remit them; I never learnt how to do that as an employee…I know what the legislation says, but I do not understand the technical aspects.' The revenue authority seems to be blind to this distinction.

The lawyers explained that when they moved into self-employment, they did not appreciate the difference between filing returns as a taxpayer whose only source of income is employment income versus filing returns as a self-employed individual running a business. The respondents explained that they were surprised by how different and challenging it was. Since they could not afford to pay for an expert or professional help, their response to these challenges, they said, was merely to 'cook up' numbers on their returns or file nil returns. While they readily admitted that there was a mix of both deliberate intent and ignorance in tax evasion among lawyers, they maintained that most evasion was inadvertent or a result of ignorance.

[8] Interview with SC-KRA, Senior Commissioner at Kenya Revenue Authority (Nairobi, Kenya, 10 September 2015).

The emerging trend from the data collected from these lawyers was that many legal practitioners did not consciously develop their internal structures to enable or facilitate compliance. Those who were unable to afford skilled, professional accounting services remained financially disorganised and found it hard to comply. Lawyers who chose, and could afford, to set up proper fully functional in-house accounting departments kept proper financial statements and separate accounts for tax. That level of organisation encouraged and facilitated compliance.

> I wish there was a starter pack for those starting to work in the private sector; for example, classes during the final year of university. We know how to treat patients, but we do not know how to run a business let alone how to pay taxes. [DEN1]

> Generally, medics lack business acumen. We are ignorant; I evaded tax purely out of ignorance. Clinicians should be trained so that they know…Money at hand is simply pocketed, and actually, this causes many clinics to shut down. [DEN5]

As evidenced by the statements above, the dentists mentioned very similar challenges to those mentioned by the lawyers. Most respondents explained that they, and most of their peers, lacked the knowledge and skills required to run a business. According to the respondents, most dental clinics lacked financial accountability and proper internal financial structures, resulting in widespread mismanagement and evasion. Several respondents explained that this financial mismanagement and illiteracy resulted in the collapse of many dental clinics. The medics blamed these failures on the fact that financial and management knowledge was not incorporated into their training programme. The medics also complained that the Medical Board did not concern itself with ensuring, or at least encouraging, proper financial management structures and financial record-keeping among its members' clinics.

Most dentists did not know the correct withholding tax rate due on their payments. As a result, some were overtaxed by unscrupulous clinics. The majority did not receive, or demand, withholding tax certificates as proof that the amounts deducted from their pay had been remitted to the revenue authority and not illegally retained by the clinic. In addition, many respondents were not aware that they were obligated to pay income tax on the remainder of their income; some found out after several years of non-compliance and were either too afraid or not bothered enough to comply. Some respondents only discovered this tax obligation during their interviews for this research.

The dentists were also unaware of the distinction between tax evasion and tax planning. Several dentists spoke about padding their expenses and including expenses that were not related to their work in order to reduce their taxable income. Those respondents referred to these actions as tax planning and believed that this was not criminal behaviour but 'legal tax avoidance'.

It therefore seems that financial and tax illiteracy is a significant contributing factor towards evasion among professionals in Kenya, despite the scepticism expressed by SC-KRA.[9] Not only do these professionals struggle to comply without what they deem expensive professional assistance, they also lack the basic accounting and management knowledge that is a prerequisite for proper record-keeping, business management, and tax compliance.

[9] Interview with SC-KRA (n 6).

Political Legitimacy: Public Perception of the Revenue Authority

Legitimacy has been described as 'belief or trust in the authorities, institutions and social arrangements to be appropriate, proper, just and work for the common good' (Fjeldstad et al., 2012, p. 7). Per Kirchler, Hoelzl and Wahl, when citizens believe that the revenue authority is legitimate, i.e. trustworthy, just, fair, and benevolent and aims to work for the good of all, they are more inclined to comply (2008, p. 212).

Overall, the respondents' perceptions of the revenue authority were negative. Only one dental practitioner and one lawyer reported positive experiences with the revenue authority; the rest had negative perceptions, shaped either by anecdotal evidence or personal experience. One common complaint across both professions was that the revenue authority does not understand the nature of their work. Consequently, its actions, rules, and decisions concerning taxpayers in the legal and dental professions are deemed to be arbitrary, inconsistent, and unfair.

There was also a general feeling that the authority is blind and aloof to the challenges that the self-employed professionals running small firms face, yet these challenges make compliance difficult and expensive. The professionals spoke about cash flow problems, the high cost of compliance, and the inability to keep proper records and understand their tax compliance obligations. The professionals felt that the revenue authority was more interested in enforcement than supporting SMEs.

The other recurrent theme was that the revenue authority was to be feared, because it is disrespectful, unreasonable, scary, and aggressive, among other adjectives, and has a pre-conceived negative agenda. Most lawyers and dentists felt that the revenue authority deliberately generates this fear and does not want to have a genuine relationship with taxpayers. The tax sensitisation workshops often held by the authority were viewed by lawyers as 'traps'.

Most respondents viewed the revenue authority as an enemy to be feared and avoided. According to DEN6, her fear of the revenue authority was so great that she was unable to go to their offices to process some tax refunds that had been due to her for some years.

The respondents, particularly the lawyers, felt that the revenue authority is more interested in cultivating relationships with multinational enterprises and high net worth individuals (HNWIs) because they help them to realise their targets faster. The dentists also argued that the revenue authority is less interested in smaller boutique clinics and more focussed on larger hospitals. This perception led to fairness concerns because the professionals believed that the revenue authority exists only for the good of large taxpayers. They surmised that the revenue authority is more interested in meeting the needs and addressing the concerns of large taxpayers, and ignores others.

Also common across both groups was the perception that the revenue authority is more interested in collecting bribes than collecting taxes. The respondents generally believed that revenue authority audits are merely intended to intimidate taxpayers and push them into paying bribes. Many respondents, particularly the lawyers, believed that if one is caught evading, one can always escape by paying a bribe. Most of the dentists believed that larger taxpayers pay bribes to the revenue authority in order to get away with evasion. There is evidence that such instances of petty corruption hurt tax morale and trust in the tax authority in sub-Saharan Africa (Jahnke, 2017).

Tax collection is viewed as a tool for harassing citizens and both groups construed the revenue authority's work as 'harassment', 'malicious', 'problematic' or 'interference'. One lawyer told the author that he once encountered what he described as a 'gentle' revenue officer, suggesting that revenue officers are believed to be either gentle or rough.

Finally, the revenue authority is viewed as inefficient; the lawyers, who regularly interact with the revenue authority on behalf of their clients, believed that it was quicker and more efficient to bribe revenue officers than to follow the proper channels. The proper channels were viewed as slow, bureaucratic, inefficient and expensive; corruption was deemed to be quicker and cheaper.

ARE PRESUMPTIVE TAXES A VIABLE SOLUTION?

Musgrave (1990, pp. 307-308) argues that presumptive taxes are unsuitable for professionals because they 'are fully capable of filing adequate returns, and their income levels fall within the middle or even upper ranges of the taxable income scale'. Others argue that the implementation of presumptive tax regimes for professionals would help to ensure horizontal equity (Casanegra de Jantscher & Tanzi, 1987). The tax experts interviewed as part of this research also expressed split opinions. The policymakers believed that it is 'absurd' to impose a 'primitive' presumptive regime on professionals who are highly educated and sophisticated.[10] Other experts expressed support for simplified tax regimes for some professionals.[11]

This paper proposes that *presumptive tax regimes can be a useful partial solution for taxing newly qualified, self-employed professionals if they are well-thought-out, meticulously designed, and rigorously monitored*.

Bird and Wallace (2005, p. 130) argue that, compared to farmers and SMEs, self-employed professionals are easier to track and find. They register with their regulators and associations, and their business premises are clearly marked. For this reason, Bird and Wallace (2005, p. 7) argue against presumptive tax regimes for professionals; instead, they advocate for more stringent enforcement.

Increased enforcement of tax law on hard-to-tax professionals is undoubtedly essential.[12] However, this paper also acknowledges that the reasons behind non-compliance by self-employed professionals in LMICs are varied, complex, and interconnected. The use of several complementary options, rather than solely relying on audits, would address the different barriers to compliance and compensate for any inadequacies in enforcement.

For example, tax authorities in LMICs are significantly resource-constrained, meaning that enforcement levels among individual taxpayers are often low. Ensuring a relatively high probability of audit and detection is a challenge for tax authorities in LMICs; they would

[10] Interview with D-NT, Director, National Treasury (Nairobi, Kenya, 17 September 2015); Interview with SM, Senior Managers, National Treasury (Nairobi, Kenya, 24 September 2015).

[11] Interview with SC-KRA (n 6); Interview with SP-B4, Senior Partner in a 'Big Four' Firm (Nairobi, Kenya, 13 May 2016); Interview with Attiya Waris, Professor of Fiscal Law, University of Nairobi, School of Law (Telephone Interview, 22 March 2018).

[12] The author has argued in favour of increased enforcement with regard to self-employed professionals in LMICs. Those arguments are available in the author's forthcoming thesis. 'Taxing the Hard-to-Tax in Low and Middle-Income Countries: An Examination and Kenyan Case Study' (2019), and in a forthcoming article, 'Trust or Power: How Should We Improve Tax Compliance by Self-Employed Professionals in Countries Dealing with Severe Government Corruption?' (2019).

require considerable financial resources and a large pool of skilled auditors, both of which are likely to be in short supply. While a country like Israel audits about 50% of the tax returns filed by the self-employed, most tax authorities in LMICs will use the few auditors they do have to audit large corporations, from whom they can collect much more revenue than from the HTT (Bahl, 2005).

While there are no reliable statistics on the exact outlay required for audits in LMICs, audits are expensive. The average estimated cost of audits in the UK is £2,500 per audit (Advani, 2017). This cost is a significant amount for most LMICs; even in the UK, one-third of the taxpayers selected for audit 'end up not being audited, largely due to resource constraints' (Advani, Elming, & Shaw, 2017, p. 9). Terkper explains that, while the cost of auditing a small or medium-sized taxpayer may not be high, the total amount required for auditing a satisfactory number of these taxpayers could be significant (Terkper, 2003, p. 221).

Audits also take up a significant amount of time; in the UK, 'the average time between when a return is filed and when the audit is concluded is 14.3 months but… for 10 per cent it is almost two years or more' (Advani et al., 2017, p. 11). The actual audits take an average of 5.3 months, with about 10% of audits running for 13 months or more (Advani et al., 2017, p. 11).

Audits also require significant human resource; one study estimates that audits take up 30% of a tax authority's professional and administrative staff (McKerchar & Evans, 2009, p. 195). While the threat of audit may successfully deter evasion in the short term, LMICs would have to follow through and carry out audits in order to have an impact on compliance attitudes. 'The existence of a penalty for noncompliance deters tax evasion but only in light of the probability that a penalty will actually be imposed' (Lederman, 2018, p. 15). Many LMICs will not have the sufficient number of skilled auditors required to carry out an adequate number of audits, given the cost, time, and workforce that audits take.

Furthermore, in LMICs with corruption problems, like Kenya, unscrupulous auditors may take the opportunity to extort or collaborate with tax evaders by turning a blind eye to evasion in exchange for a bribe.

In addition, many HTT professionals in LMICs engage in cash transactions. According to Tadesse and Taube (1996, p. 4):

> Small-scale businesses dealing with cash transactions are notoriously difficult to tax, and not just in Africa. Among professionals, including doctors, lawyers, building contractors, and consultants, the scope for underreporting of incomes is often considerable, even though they may be some of the highest income recipients in a country.

The reality of cash transactions among hard-to-tax professionals in countries like Kenya means that enforcement through audits is difficult. Without a defined basis for assessing income, revenue officials struggle to determine the amount of tax due.

Finally, from a policy perspective, it is difficult to justify permitting SMEs access to presumptive regimes but making professional income ineligible even when the professionals meet other eligibility criteria. Many professional firms in LMICs exhibit characteristics that are very similar to other SMEs. Indeed, many respondents often referred to their firms as SMEs during the interviews. The image of a large professional firm with an extensive portfolio of clients, significant income, and financial access to accounting and tax services is not an accurate representation of all professional firms in LMICs. There are professionals, particularly early career professionals, running small firms with modest turnovers. These professionals face the same compliance challenges that SMEs face, including the high costs of compliance and the inability to navigate complex compliance requirements. From a policy perspective, therefore, it is difficult to justify opting for a blanket ban on presumptive regimes for professionals.

Where presumptive taxes are designed in line with the characteristics of a good tax regime, they can be of benefit to LMICs where professionals evade taxes because of complexity, social influence, and low levels of financial and tax literacy. Presumptive methods can also improve the public perception of, and enhance trust in, the revenue authority if they are preceded by open dialogue and fair negotiation between the revenue authority and taxpayer representatives, and if they succeed in making compliance more manageable and cheaper.

Presumptive taxes are often criticised for being inefficient and inequitable in comparison to ordinary income tax regimes. However, overloading presumptive taxes with equity objectives, or other dissimilar and often competing or contradictory objectives, results in a presumptive regime that does not meet its prime aims. As pointed out in previous research, presumptive tax regimes cannot, and should not, compete with the standard tax regime; the two regimes serve very different purposes, with the former aimed at simplification, lowering compliance costs, facilitating cheaper enforcement, and ensuring that the self-employed also bear the tax burden (Pashev, 2006, p. 417). A presumptive regime is not a standalone or long-term solution; instead it is 'a complementary instrument that can help the tax administration in transition countries in the short and medium-run to handle the challenges of…the large hard-to-tax sector' (Pashev, 2006, p. 417).

This paper advocates for the limited and targeted use of simplified tax regimes for self-employed professionals who are newly qualified and just 'starting out' in self-employment; they face the most significant compliance challenges.

These taxpayers have weaker internal and accounting structures within their firms. They often make haphazard withdrawals of cash from their businesses, resulting in significant cash flow challenges, and have lower disposable income, thus inhibiting their ability to engage professional help for their accounting and tax affairs. The research data did suggest that lawyers naturally outgrow this phase over time, as they attract more corporate clients and begin to streamline their businesses. However, the extent to which this happens is likely to vary significantly, since not all firms will attract the same number and calibre of corporate clients. Dental firms did not exhibit a similar pattern and it is this latter trend that is likely to be replicated in most professions.

The professionals also spoke about the difficulty of dropping the bad compliance behaviour, and the long-lasting effects of the good compliance behaviour, acquired at the start of one's practice. Indeed, previous research has shown that new members of an occupation are 'tax novices' but soon adapt to the taxpaying culture within their occupation – be it one of compliance or one of evasion (Ashby, Webley, & Haslam, 2009, p. 217). Presumptive tax regimes for these newly qualified professionals would ensure that they begin their professional life engaging in good compliance behaviour which they can carry on demonstrating as they grow their firms.

Furthermore, if presumptive methods successfully encourage compliance by those prevented from complying because of complexity, the tax authority may also benefit from the knock-on effect on taxpayers who are influenced by the actions of their peers. Once simplicity encourages higher levels of voluntary compliance within the profession, the social influence of the complying peers may lead to even more compliance. It would, therefore, be a useful tool in professions where evasion is particularly rampant, and the tax authority's goal is to (i) reverse the pervading evasion culture and establish one of compliance and (ii) urgently increase revenue collection in a country dealing with a significant budget deficit. Perhaps this was the idea behind the introduction of presumptive taxes for professionals as part of the fiscal reforms taken by Greece, as discussed above.

To increase the effectiveness of presumptive regimes, the revenue authority, in conjunction with industry representatives, would have to proactively communicate the increased simplicity and levels of compliance within the profession in order to influence the perceptions of those who have previously been non-compliant.

The respondents' current perceptions of the Kenya Revenue Authority are, *inter alia*, that: (i) the authority is blind to the challenges that SMEs face in complying; (ii) the authority is not keen on cultivating relationships with small business owners and is more interested in large taxpayers, like multinational enterprises; and (iii) the authority does not understand the nature of the professionals' work and thus makes arbitrary, inconsistent, and unfair decisions. A presumptive method that simplifies the compliance process for some professionals may play a part in repairing the damaged legitimacy of the revenue authority. Taxpayers may begin to perceive the authority as understanding the costs and complexity that inhibit their compliance, and as taking steps to reduce these burdens.

Furthermore, before introducing a presumptive method that would apply to a profession or several professions, the authority should engage industry representatives in a public participation process; this would provide a platform for dialogue through which the authority can begin to better understand the unique needs and challenges of the professionals, and cultivate relationships with them. If properly managed, this process can demystify the revenue authority and build the trust of taxpayers, i.e. the taxpayers will begin to believe that the authority is benevolent and working for the common good, and increase the likelihood that they will voluntarily comply (Kirchler et al., 2008, p. 212).

How Should a Presumptive Tax for Professionals in LMICs be Designed?[13]

This, perhaps, is the most crucial question. This author does not claim to provide all the answers in this paper, but some useful ideas are suggested below.

Initially, it is necessary to determine which categories of income would be classed as 'professional income' and thus covered by the proposed presumptive tax. The tax should be restricted to professions in which self-employment is a ubiquitous employment option. In the case of Kenya – and most LMICs – this would probably cover lawyers, doctors, dentists, pharmacists, accountants, engineers, surveyors, architects, IT professionals, and consultants.

[13] I am extremely grateful to Professor Eric Zolt for the comments and suggestions that helped to shape this section.

The next significant action would be to identify the relevant professional association or regulator licensing each profession and make requests for third party data in the form of updated registers of members, including their business addresses, dates of admission to the profession, and personal identification numbers.[14] Keeping a regularly updated register or database of all professionals would be ideal. Without this information, it would be difficult to effectively design and implement a presumptive income tax, monitor its uptake, and prevent its abuse. This data would additionally assist the revenue authority in the monitoring of taxpayers who are subject to the regular tax regime.

It would then be necessary to conduct a study of the eligible professions in order to determine:

i. the level of financial and tax capability of newly admitted members, and whether and how this knowledge increases during their first seven years in practice[15];
ii. the revenue potential of newly admitted members during the first seven years;
iii. the amount of capital required to set up a business in each profession – for example, dentistry is much more capital intensive than accounting, and this determines how long the professional will wait to realise a return on their investment;
iv. the nature of clients that the various professionals tend to attract in the first seven years of practice (whether individual, corporate, or public sector) and how these trends change over the seven-year period;
v. the nature of transactions in the professions, i.e. cash or cashless, in the first seven years of practice;
vi. specific professional rules and regulations, if any, governing financial record-keeping and tax compliance within each profession.

Bearing in mind the resource limitations of the revenue authorities in LMICs, the tax authorities can take a phased approach, tackling one profession at a time.[16]

With this data, revenue administrators and policymakers will have a sound basis for designing a presumptive regime that takes into consideration the subtle differences in each profession. For example, some professions, like law, have professional rules and regulations governing the

[14] In addition to statutory powers underpinning requests for third party data, the success of such requests will depend on whether registration with the professional association or regulator is mandatory. Registration with regulators, particularly regulators established by statute, is almost always mandatory and this is perhaps the best source of data, since the professionals cannot opt out of registration for fear that the register is used for tax compliance purposes. Some professions self-regulate and membership to an association may be mandatory; such associations would also provide reliable data. Where registration with an association is optional, there is a higher risk that professionals will simply choose to withdraw their registration or membership, particularly if the other benefits of membership do not outweigh the risk of detection by the tax authority.

[15] The seven-year benchmark is not based on any particular scientific analysis; rather, it is intuitive and informed by the benchmarks applied in the legal profession in Kenya. Advocates who have practised for five years or fewer are deemed to be 'young advocates' and are entitled to certain privileges, including reduced practicing licence and continuing legal education fees. Such advocates are also prohibited from making applications to serve as notary publics. Furthermore, in order to be eligible for judicial appointments, advocates must have practised for a minimum of 10 years. In the author's view, the benchmark for eligibility for a presumptive tax regime ought to sit somewhere between those two benchmarks, and seven years appears to be a reasonable middle ground.

[16] See, for example, HMRC's approach to auditing professionals in the United Kingdom (www.gov.uk/government/publications/2010-to-2015-government-policy-tax-evasion-and-avoidance/2010-to-2015-government-policy-tax-evasion-and-avoidance).

keeping of accounting and financial records. A presumptive tax regime permitting taxpayers in such professions to keep simple books, or to keep no books at all, would have to be designed in consultation with the relevant regulator. The rules on simpler record-keeping should not result in the breaking of professional rules and standards; these things must coexist.

Eligibility for the presumptive regime should be based on the date on which one qualified to practice in the relevant profession and not when one chooses to become self-employed. This distinction would prevent abuse of the system by those fully capable of complying with the ordinary tax rules. For example, if Professional A was licensed to practice in 2010 but chose to go into self-employment in 2018, they are more likely to be capable of coping with the ordinary compliance requirements than Professional B, who qualified in 2016 but also went into self-employment in 2018.

The regime should contain a sunset clause that limits the number of years for which the taxpayer is eligible for presumptive tax, thus prodding the taxpayers towards self-assessment. The implementation should be accompanied by training and support from the revenue authority, thus preparing the eligible taxpayers for their eventual exit from the presumptive regime. The goal would be to inculcate a taxpaying ethos early in the taxpayer's career and encourage a fairly uniform path of growth towards formalisation for these small businesses, ensuring that none, or at least only a tiny number, are left behind.

The exit from the presumptive regime also needs to be managed appropriately to prevent taxpayers from slipping into evasion and the subsequent erosion of the gains made. Revenue authorities should work closely with regulators and professional bodies in determining how long taxpayers can be deemed to be 'newly qualified' and eligible for the regime. Revenue authorities would also have to determine whether or not there needs to be an 'intermediary' stage between eligibility for the presumptive regime and eligibility for the ordinary income tax regime, and what such an intermediary stage should look like.

Policymakers and tax authorities would also have to decide on the type of presumptive tax that would be suitable for professionals. The often-favoured turnover tax, where the taxable income is 'no less than a specified percentage of the gross receipts of the business', may be simple to administer, but it is likely to be ineffective among self-employed professionals whose gross receipts are easily hidden (Thuronyi, 2000, p. 410). This method has, however, been adopted in India, as explained above.

A presumptive regime, in which the taxpayer pays a lump sum amount, may be an option for sectors in which the turnover method would be unsuitable. Such a tax would operate as a 'maximum' tax, i.e. the taxpayer would have the option of producing books of accounts proving a lower income. This method would relieve the tax authority of the burden of ascertaining a taxpayer's actual income through audits and the taxpayer's compliance costs would be negligible. If the taxpayer chooses to keep proper books of accounts, their compliance costs will be no higher than they already are. This method has been criticised for resulting in vertical inequity, where the incomes within professions diverge widely, and proposed solutions have included the creation of bands within the lump sum in order to make the tax less regressive (Tadesse & Taube, 1996). However, as Pashev points out, overloading presumptive tax regimes with these equity objectives seriously undermines their effectiveness in achieving simplicity (Pashev, 2006). Some level of inequity is a trade-off that must be accepted in order to achieve the other goals of simplification, horizontal equity, and cheaper compliance and audit.

The French *forfait* and the Israeli *tachshivim* are examples of lump-sum taxation methods that may be considered. The *forfait* method is a sort of 'contract' between the tax authority and the taxpayer; they agree on the estimated income that will form the basis for taxation for a fixed period, usually between one and three years. Since this method involves negotiation and agreement between revenue officers and taxpayers, it is susceptible to abuse in countries where revenue officers are dishonest or corruption is a challenge (Casanegra de Jantscher & Tanzi, 1987).

In LMICs where corruption is a challenge, a better option would be to utilise the idea behind the *tachshivim*, which was subsequently replaced by *tadrihim*. Like the *forfait*, the *tachshivim* involves an advance 'agreement between taxpayers and the tax authorities' but, unlike the *forfait*, 'the agreement is on the tachshiv in general (being negotiated with industry representatives), not on its application to particular taxpayers' (Thuronyi, 2000, p. 424).

The in-depth study on average earnings among taxpayers in the different professions mentioned above would be vital in determining a suitable lump sum amount, since this would likely vary from profession to profession. A good starting point would be to determine the revenue earned by professionals with similar years of experience in government service and determine whether the average income of the self-employed professionals would be comparable.

Implementing a presumptive regime may inevitably result in a lower tax burden for these hard-to-tax professionals. One could argue that it amounts to an unjustified government subsidy for the decision to enter into self-employment. However, this is not necessarily an adverse outcome in Kenya's case and this may be true for other LMICs. With one million births a year, Kenya is experiencing a significant bulge in the number of youths in its population (United Nations Development Programme, 2013, p. 5).

However, the country also has high unemployment rates, particularly among the youth; nine in every ten unemployed Kenyans are aged 35 or below (Kenya National Bureau of Statistics, 2018). There are inadequate waged jobs in the formal sector; only two out of five waged jobs are formal and only 6 per cent of youths reaching the working age are securing modern waged jobs (The World Bank, 2012, pp. 29-30).

With the introduction of free primary education and an ever-increasing number of universities, there has been a significant increase in the number of graduates, but many graduates struggle to secure formal employment. One of the main objectives of the current Kenyan government is to increase income-generating opportunities for unemployed youths. A presumptive regime for newly qualified professionals would ease the pathway for graduates who are unable to secure formal employment; they would be able to set up firms, and enjoy the reduced cost and complexity of compliance for a few years to allow their firms to grow.

CONCLUSION

The reasons behind non-compliance by self-employed professionals in LMICs are varied; no single solution will address all the barriers to compliance and, therefore, a mixed methods approach is appropriate. This paper considered the suitability of presumptive tax regimes as a partial solution.

The literature on presumptive taxation has either overlooked professionals or automatically deemed the regimes unsuitable for them. In practice, most countries explicitly exclude professional income from eligibility for presumptive regimes in the language of the statute. Where presumptive taxes for professionals are introduced, they are used to punish non-compliance, rather than to support taxpayers and positively encourage compliance.

This paper makes two main contributions. It provides interesting qualitative data on the tax compliance attitudes of hard-to-tax professionals in a lower middle-income country, a group of taxpayers that have not been well covered in the literature on tax evasion in LMICs.

Second, the paper contributes to the literature on presumptive taxation. The author proposes that where presumptive taxes are well-thought-out, backed by research, carefully designed and implemented, and rigorously monitored, they can be of benefit to LMICs in which newly qualified professionals evade taxes because of complexity, peer influence, and low levels of financial and tax literacy. Presumptive methods can also improve the public perception of, and enhance trust in, the tax authority if they are preceded by open dialogue and fair negotiation between the authority and taxpayer representatives, and if they succeed in making compliance easier and cheaper.

Careful attention must be paid to thresholds and the period of time for which a taxpayer is eligible for the presumptive regime before they transition into the ordinary tax system. The tax should be designed with time limits, encouraging the taxpayer to move into the ordinary regime, and specific effort made to develop the taxpayer's capacity and financial sophistication during the period of eligibility.

However, policymakers and tax authorities should not be bogged down with the task of achieving maximum equity within a presumptive regime, as this will merely result in complexity; instead, the focus should be on simplicity, and reducing the costs of audit compliance and graduating the taxpayer to the ordinary tax regime within a reasonable timeframe.

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ANNEX

Table 3: Profile of Dentists Interviewed for the Project

Identification	Nature of Practice	Level of Specialisation	Gender	Years of Experience
Dental Practitioner 1	-Self-employed -Runs own practice -Previous locum experience	Specialist	Male	More than 7
Dental Practitioner 2	-Self-employed -Informal employment working for a self-employed practitioner -Previous locum experience	Non-specialist	Male	Fewer than 7
Dental Practitioner 3	-Formal employment (private) -Previous locum experience	Non-specialist	Female	Fewer than 7
Dental Practitioner 4	-Self-employed -Runs own practice -Previous locum experience	Non-specialist	Male	Fewer than 7
Dental Practitioner 5	-Formal employment (government) -Engaged as a locum	Specialist	Female	7
Dental Practitioner 6	-Self-employed -Runs own practice -Engaged as a locum	Specialist	Female	More than 7
Dental Practitioner 7	-Formal employment (government) -Engaged as a locum	Non-specialist	Female	7
Dental Practitioner 8	-Self-employed -Runs own practice -Previous locum experience	Specialist	Male	Fewer than 7
Dental Practitioner 9	-Self-employed -Runs own practice	Specialist	Male	More than 7
Dental Practitioner 10	-Formal employment (government) -Engaged as a locum	Specialist	Female	More than 7

Table 4: Profile of Lawyers Interviewed for the Project

Identification	**Nature of Practice**	**Years of Experience**	**Age of Business**	**Gender**
Legal Practitioner 1	Sole proprietor	> 10	> 3 years	Male
Legal Practitioner 2	Sole proprietor	< 10	< 3 years	Male
Legal Practitioner 3	Partnership	< 10	< 3 years	Male
Legal Practitioner 4	Partnership	< 10	< 3 years	Female
Legal Practitioner 5	Sole proprietor	< 10	3 years	Female
Legal Practitioner 6	Partnership	< 10	< 3 years	Male
Legal Practitioner 7	Sole proprietor	> 10	> 3 years	Female
Legal Practitioner 8	Self-employed	< 10	N/A	Female
Legal Practitioner 9	Partnership	> 10	< 3 years	Male
Legal Practitioner 10	Sole proprietor	< 10	< 3 years	Male
Legal Practitioner 11	Partnership	> 10	> 3 years	Male
Legal Practitioner 12	Sole proprietor (previously run as a partnership)	> 10	> 3 years	Male