

# Are Presumptive Taxes a Good Option for Taxing Self-Employed Professionals in Developing Countries?

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# Are Presumptive Taxes a Good Option for Taxing Self-Employed Professionals in Developing Countries?

Daisy Ogembo\*

## Abstract

Research on tax evasion by the so called ‘hard-to-tax’ in low and middle-income countries has largely focussed on farmers and SMEs; professionals are rarely considered in any discussion about the ‘informal sector’. Yet, considering their earnings, the absolute amount involved in evasion among professionals is probably higher than farmers and SMEs and they can cause serious damage to the tax systems of these countries. Researchers on tax in developing countries has almost exclusively focussed on multinational enterprises and challenges in the international tax system; but there is a growing realisation that domestic resource mobilisation is important and requires urgent attention. This paper makes use of qualitative data on tax evasion by lawyers and dentists in Kenya to argue that although presumptive tax regimes almost always exclude professional income, they can be a useful partial solution for taxing self-employed professionals *if* they are well thought-out, meticulously designed and rigorously monitored.

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\* DPhil Candidate, University of Oxford. This paper is part of a larger DPhil project investigating the reasons for tax evasion by self-employed professionals in low and middle-income countries, 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. 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 CIOT and the Oxford Law Faculty that facilitated this work.

## I. Introduction

The idea that the self-employed have greater opportunity for evasion than employees, whose salaries and wages are subject to employer withholding schemes, is well documented.<sup>1</sup> The scope for underreporting for high-income earners like doctors, lawyers, contractors and consultants is often considerable, particularly when they deal with cash transactions.<sup>2</sup>

In fact, self-employed professionals fall within a category of taxpayers known in the literature as the *hard-to-tax*, a term which also includes farmers and small and medium-sized firms.<sup>3</sup> These three types of taxpayers are described as hard to tax because they share the following typical characteristics:<sup>4</sup>

- 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 their accuracy;
- c. They are not prompt in filing tax returns;
- d. There is a significantly higher rate of tax evasion among them

The choice, in this research, to focus on self-employed professionals rather than farmers and small and medium-sized firms is motivated by the dearth of research on professionals,

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<sup>1</sup> Christoph Kogler, Stephan Muehlbacher and Erich Kirchler, 'Testing the "Slippery Slope Framework" among Self-Employed Taxpayers' (2015) 16 *Economics of Governance* 125; Kleven Henrik Jacobsen and others, 'Unwilling or Unable to Cheat? Evidence From a Tax Audit Experiment in Denmark' (2011) 79 *Econometrica* 651; Torgler Benno and Valev Neven T., 'Gender and Public Attitudes Toward Corruption and Tax Evasion' (2010) 28 *Contemporary Economic Policy* 554; Joel Slemrod, 'Cheating Ourselves: The Economics of Tax Evasion' (2007) 21 *Journal of Economic Perspectives* 25; Benno Torgler, 'The Importance of Faith: Tax Morale and Religiosity' (2006) 61 *Journal of Economic Behavior & Organization* 81; Vito Tanzi and Milka Casanegra de Jantscher, 'Presumptive Income Taxation: Administrative, Efficiency, and Equity Aspects' *International Monetary Fund* (August 7 1987) WP/87/54

<sup>2</sup> Gunther Taube and Helaway Tades, 'Presumptive Taxation in Sub-Saharan Africa' [1996] IMF Working Paper WP/96/5, 4. Michael Keen, 'Taxation and Development-Again' *International Monetary Fund* (2012) WP/12/220 <<https://www.imf.org/external/pubs/ft/wp/2012/wp12220.pdf>> accessed 10 February 2015.

<sup>3</sup> James Robert Alm, Jorge Martinez-Vasquez and Friedrich Schneider, 'Sizing' the Problem of the Hard-to-Tax' in James Robert Alm, Jorge Martinez-Vazquez and S. Wallace (eds), *Taxing the Hard-to-Tax: Lessons from Theory and Practice* (Emerald Publishing Limited 2005)

<sup>4</sup> Alm, Martinez-Vasquez and Schneider, in Alm, Martinez-Vazquez and Wallace (eds), *Taxing the Hard-to-Tax: Lessons from Theory and Practice* (Emerald Publishing Limited 2005) 3

particularly in the case of low and middle-income countries (LMICs). Past research on the hard-to-tax or informal sector in LMICs has focussed largely on farmers and SMEs. Keen argues that professionals are responsible for the most serious instances of revenue loss and damage to the fairness of the tax system particularly in developing countries; yet since they are so highly qualified and tightly regulated, it often appears unnatural to refer to them as ‘informal’.<sup>5</sup> He goes on to explain that, considering their earnings, the absolute amount involved in evasion among professionals is probably higher than any other group.

Farmers have been of interest in research on LMICS because most of these countries have relied on agriculture and/or cash crop farming for revenue through international trade. Cash crops such as coffee, tea, cotton, sugarcane and cocoa generated significant revenues for these countries in the past; in recent decades however, this has changed because of various factors including a significant drop in global prices for these crops, climate change, political instability, corruption, failure by these countries to mechanise and take advantage technological advancements in agriculture, and the global movement towards technology, innovation, service and e-commerce as leading sources of profit.

SMEs have also occupied much of the research space on the hard-to-tax because LMICs typically have large informal sectors characterised by small-scale traders, cottage industries and informal public transport enterprises. There has been significant donor support aimed at encouraging the growth and formalisation of these SMEs as well as researcher interest in government efforts (or lack thereof) to tax them.

As a result, professionals have not been extensively studied and this project seeks to close that gap. This research is important now, as all countries, not just developing ones, seek to expand their revenue base and close the tax gap to meet ever-expanding budgets and social

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<sup>5</sup> Keen, International Monetary Fund (2012) WP/12/220, 16  
<<https://www.imf.org/external/pubs/ft/wp/2012/wp12220.pdf>> accessed 10 February 2015.

needs. Global interest in taxation in LMICs has, in recent years, focused almost solely on tax avoidance and aggressive tax planning by MNEs to the extent that domestic resource mobilisation is at risk of being ignored or under-studied. This project turns the spotlight onto domestic resource mobilisation by searching for the barriers to compliance by self-employed professionals and how these can be overcome.

Terkper explains that professionals and SMEs in the informal economy ‘have genuine difficulty in keeping even simple records and make little or no use of banks and financial instruments’.<sup>6</sup> These businesses in the informal sector have poor management systems and financial structures; they are ‘usually controlled by owner-managers and a network of close family members, professional associates, friends and employees.’<sup>7</sup> In addition, because the operations of these businesses are highly simplified, their cost of tax compliance is much higher leading most of them to avoid compliance altogether.

Taxing self-employed professionals, and the hard-to-tax in general, in LMICs is even harder.<sup>8</sup> These taxpayers operate mostly in a cash-based economy and either do not keep proper records or the revenue authority has a difficult time extracting the records from them; when the revenue authority does succeed in doing so, it is difficult to ascertain the accuracy and validity of those records.<sup>9</sup> Since the hard-to-tax occupy a huge chunk of the economy of developing countries, revenue authorities are faced with a large number of individual taxpayers and the associated high cost of collection with the risk of minimal returns; consequently they will more often than not choose to pursue a small number of large taxpayers and largely ignore the large number of small taxpayers.

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<sup>6</sup> Seth Terkper, ‘Managing Small and Medium-size Taxpayers in Developing Economies’ (2003) 29 *Tax Notes International* 211, 212

<sup>7</sup> Terkper, (2003) 29 *Tax Notes International* 211

<sup>8</sup> Richard A. Musgrave, ‘Income Taxation of the Hard-to-Tax Groups’ in Bird & Oldman (ed), *Taxation in Developing Countries* (4th edn, The John Hopkins University Press 1990)

<sup>9</sup> Musgrave, in Oldman (ed), *Taxation in Developing Countries* (4th edn, The John Hopkins University Press 1990) 297-299

The inability to effectively administer and enforce taxes on self-employed professionals, and the hard-to-tax in general, has several adverse implications for the overall tax system. First, treating similar taxpayers similarly is one of the cornerstones of a good tax system; the considerable evasion opportunities that the self-employed enjoy lead to horizontal inequity because while these professionals can dodge their compliance obligations, their salaried peers whose taxes are withheld at source bear the full tax burden. Second, the widespread evasion by the self-employed seriously damages the tax morale of other compliant taxpayers who may begin to look for opportunities to evade as well; in addition, it may lead to distortions in the neutrality of the tax system-taxpayers may decide to move out of employment to self-employment for tax rather than efficiency reasons.

Third, while some studies question the positive effects of taxation on informal sector firm growth<sup>10</sup>, there is also a significant and growing amount of research suggesting that taxation may actually encourage firm growth by enabling those firms to access credit facilities, enjoy state protection, and benefit from government contracts.<sup>11</sup> Joshi et al discuss various studies including: a study in Mexico which showed that formalisation of firms through various means, including taxation, positively affected the profits of those firms and allowed them to reach their optimal size<sup>12</sup>; a study on SMEs in Vietnam showed that formalisation positively impacts their profits and investment<sup>13</sup>; and a study on micro firms in Bolivia indicated that registration for tax purposes increases the profits of medium sized businesses<sup>14</sup>. Weighing the

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<sup>10</sup> David McKenzie and Yaye Seynabou Sakho, 'Does it Pay Firms to Register for Taxes? The Impact of Formality on Firm Profitability' 91 *Journal of Development Economics* 15.

<sup>11</sup> Anuradha Joshi, Wilson Prichard and Christopher Heady, 'Taxing the Informal Economy: The Current State of Knowledge and Agendas for Future Research' (2014) 50 *The Journal of Development Studies* 1325

<sup>12</sup> Pablo Fajnzylber, William F. Maloney and Gabriel V. Montes-Rojas, 'Releasing Constraints to Growth or Pushing on a String? Policies and Performance of Mexican Micro-Firms' (2009) 45 *The Journal of Development Studies* 1027. They explored whether there was a difference in benefits to firms that began to pay taxes to access the benefits of formalisation and benefits to firms that began because they were caught out by the revenue authority. They found that paying taxes benefited all firms regardless of the motivation for compliance.

<sup>13</sup> John Rand and Nina Torm, 'The Benefits of Formalization: Evidence from Vietnamese Manufacturing SMEs' (2012) 40 *World Development* 983.

<sup>14</sup> McKenzie and Seynabou Sakho, 91 *Journal of Development Economics* 15.

different findings from the various studies they conclude that there is convincing evidence that ‘formalisation can drive broader economic gains, though there remains significant uncertainty about whether the smallest micro firms are likely to be beneficiaries’.<sup>15</sup> Thus for professionals owning small and medium-sized business, tax evasion and operating in the informal sector may well be holding them back from growth, formalisation and the resulting benefits.

This paper is part of a larger project looking at the major drivers of evasion among self-employed professionals in LMICs, using Kenya as a case study, and what steps revenue authorities and policy makers can take to increase compliance among them. While the larger project recommends a raft of legislative, administrative and policy changes, this paper focuses on presumptive tax regimes and whether they are a viable option for increasing compliance among self-employed professionals.

The rest of the paper is organised as follows: section II focuses on the nature of presumptive taxes as well as the opportunities and risks they present; section III explains how the empirical work for this research was conducted; section IV summarises the major findings of the research; in section V we consider the suitability of presumptive methods for taxing self-employed professionals in LMICs considering the findings of this research; section VI contains the conclusion.

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<sup>15</sup> Joshi, Prichard and Heady, (2014) 50 *The Journal of Development Studies* 1325, 1330.

## II. Presumptive Taxes?

### What are Presumptive Taxes?

Presumptive taxes are not new; in fact, present-day tax systems have evolved from presumptive regimes over time. In the past, tax was levied based on the value of land one held, one's lifestyle/standard of living, the number of windows/doors in one's home, the number of huts in one's compound (colonial British government hut tax) among other indicators of wealth.<sup>16</sup>

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....'<sup>17</sup> Presumptive taxation 'involves the use of indirect means to ascertain tax liability, which differ from the usual rules based on the taxpayer's accounts'.<sup>18</sup> In presumptive tax regime, 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.'<sup>19</sup> The presumption therefore replaces 'an entire tax base or at least a large portion of the base'.<sup>20</sup> 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<sup>21</sup>.

Thuronyi provides a helpful discussion on the various legal characteristics of presumptive taxation methods. The legal presumption that the taxpayer's income is no less than

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<sup>16</sup> Tanzi and Jantscher, International Monetary Fund (August 7 1987) WP/87/54

<sup>17</sup> Tanzi and Jantscher, International Monetary Fund (August 7 1987) WP/87/54

<sup>18</sup> Victor Thuronyi (ed) *Tax Law Design and Drafting* (Kluwer Law International 2000) 401.

<sup>19</sup> E. Ahmad and N. Stern, *The Theory and Practice of Tax Reform in Developing Countries* (Cambridge University Press 1991) cited in Thuronyi (ed) (Kluwer Law International 2000) 401.

<sup>20</sup> International Fiscal Association (ed) *Presumptive Income Taxation: Proceedings of a Seminar Held in New Delhi, in 1997 During the 51st Congress of the International Fiscal Association* (Springer Netherlands 1998) 1.

<sup>21</sup> Richard M. Bird and Sally Wallace, 'Is it Really so Hard to Tax the Hard-to-Tax? The Context and Role of Presumptive Taxes' in *Taxing the Hard-to-tax: Lessons from Theory and Practice* (2005) 2 <<https://www.emeraldinsight.com/doi/abs/10.1016/S0573-8555%2804%2968806-7>>

what is assessed using the alternative indicators *may or may not be rebuttable*.<sup>22</sup> Where they are not rebuttable- legally binding and not appealable- this should be clearly specified in the relevant legal instrument and defined precisely.<sup>23</sup> Where they are rebuttable, the revenue authority uses administrative approaches to reconstruct the taxpayer's income and the taxpayer is free to appeal and supply the revenue authority with evidence that their actual income, under normal accounting rules, is less than the income assessed using the presumptive method.<sup>24</sup>

Presumptive methods that are irrebuttable may be described as either *minimum tax* or *exclusive*. Where the minimum tax presumption is applied, the taxpayer's liability is no less than what is determined under the applicable presumptive rules.<sup>25</sup> If the tax liability would be higher under the normal rules, the taxpayer will pay tax according to the ordinary method of assessment. On the other hand, where an exclusive presumption is applied, the taxpayer's liability is determined solely using presumptive methods even if the usual rules would result in higher tax liability.<sup>26</sup> This type of presumption very simple to administer and does not create a disincentive to earn income particularly where the item upon which the presumption is based is in inelastic supply but they can lead to horizontal inequity.<sup>27</sup>

Presumptive methods may also be *mechanical or discretionary*.<sup>28</sup> Where the revenue officials have greater discretion, it is appropriate to use a rebuttable system otherwise it could lead to hardship, injustice or corruption. Mechanical methods are clearly described in the legal instrument such as where tax is based on turnover or assets; they may or may not be rebuttable.

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<sup>22</sup> Thuronyi (ed) (Kluwer Law International 2000)

<sup>23</sup> Thuronyi (ed) (Kluwer Law International 2000) 404.

<sup>24</sup> Thuronyi (ed) (Kluwer Law International 2000) 403.

<sup>25</sup> Thuronyi (ed) (Kluwer Law International 2000) 404.

<sup>26</sup> Thuronyi (ed) (Kluwer Law International 2000). Thuronyi gives the example of an agricultural tax based on the value of the land rather than crop yield. He explains further that this type of presumption results in a tax on the item used to determine the presumption rather than a tax on income.

<sup>27</sup> Thuronyi (ed) (Kluwer Law International 2000) 404, 405.

<sup>28</sup> Thuronyi (ed) (Kluwer Law International 2000) 405.

## Opportunities and Risks of Presumptive Taxes

Presumptive taxes have been used for a wide range of reasons in several countries; although they are found in some form in high-income countries like France, Germany, Belgium and Israel, they mostly feature in the tax systems of LMICs. In this section, we examine some of the opportunities and risks that presumptive methods present.

### Tax Simplification

In many LMICs, there are taxpayers who cannot comply with complex compliance requirements and therefore whose needs are best served by simplified book keeping and tax compliance rules. These taxpayers tend to run micro, small or medium sized businesses with modest turnover; subjecting them to the usual compliance burden places an onerous financial burden on them leading many such business owners to evade the compliance obligations altogether; this problem is magnified in environments where the tax paying culture is weak.<sup>29</sup> For example, such business owners are often unable to comply without engaging expensive professional help.

The literature confirms that even self-employed professionals who are highly educated keep very rudimentary, unreliable and inaccurate books of accounts that cannot be effectively utilised for tax assessment.<sup>30</sup> These costs, both in terms of time and money, are very burdensome for a business of this size.<sup>31</sup> In addition, in LMICs, there are numerous businesses of this size and the business owners will often not keep financial records for the business and when they do, they are often incomplete, inaccurate or deliberately misleading.<sup>32</sup> Revenue

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<sup>29</sup> Bird and Wallace, in *Taxing the Hard-to-tax: Lessons from Theory and Practice* (2005) 3 <<https://www.emeraldinsight.com/doi/abs/10.1016/S0573-8555%2804%2968806-7>>

<sup>30</sup> Taube and Tades, [1996] IMF Working Paper WP/96/5, 4.

<sup>31</sup> European Commission, *Simplified Tax Compliance Procedures For SMEs* (European Commission Enterprise and Industry Directorate-General 2007)

<sup>32</sup> Tanzi and Jantscher, International Monetary Fund (August 7 1987) WP/87/54

authorities, with their already limited budgets, will often struggle to audit them and instead focus their efforts on a small number of large taxpayers.

One of the primary goals of presumptive regimes is to cater to such taxpayers. In fact, all the other intended benefits of presumptive regimes stem from or are related to the goal of simplification. The anticipation of policy makers and revenue authorities is 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 (i) evade taxes because of lack of knowledge or understanding of their obligations and/or (ii) evade taxes because of the cost (financial or otherwise) of compliance is too high. Further, since the revenue authorities cannot ascertain the actual tax base because of poor record keeping, presumptive regimes allow them to come as close as possible to ascertaining the income of the business using presumptive methods.<sup>33</sup> 'From the tax administrator's point of view, the key motivation behind the use of presumptive taxation is thus to overcome administrative weaknesses that are endemic to many countries in Africa'.<sup>34</sup>

However, taxpayers engage in evasion for a diverse range of reasons including but not limited to these two reasons. Presumptive regimes will therefore not necessarily lead to increased voluntary compliance among all taxpayers; those who evade taxes because of dissatisfaction with or lack of trust in the government for example would not begin to comply simply because the process has been simplified.

In addition, striking the correct balance when it comes to simplification is not simple. In many countries, the simplified 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

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<sup>33</sup> Tanzi and Jantscher, International Monetary Fund (August 7 1987) WP/87/54, 4.

<sup>34</sup> Taube and Tades, [1996] IMF Working Paper WP/96/5, 11.

of abuse of the system by medium-sized enterprises is increases significantly.<sup>35</sup> Critics of presumptive regimes rightly argue that because most of these regimes are improperly conceptualised and poorly designed in the name of simplicity, they result in fragmentation of the tax system and are inconsistent with good tax administration.<sup>36</sup> In addition, presumptive regimes cannot be implemented in isolation and expected to resolve challenges posed by evading taxpayers; they work best when seamlessly dovetailed with other administrative efforts such as enforcement, taxpayer education and effective support services.

#### Enhancing Horizontal Equity

As briefly stated in the introduction, one of the principles of a good tax system is equity- both horizontal and vertical. Proponents of presumptive regimes are primarily concerned with horizontal equity, i.e., treating similar taxpayers similarly.

One of the goals of presumptive regimes is to encourage greater voluntary compliance among these hard-to-tax groups to reduce the ‘unfair advantage’ that they have, i.e., that they can 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.

Further, this horizontal equity is intended to lead to greater neutrality in the economy. The fact that the self-employed have greater opportunity to evade tax than salaried taxpayers can lead to distortions in the economy; taxpayers could choose to pursue self-employment instead of employment not because of efficiency considerations but because of the opportunity

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<sup>35</sup> Jacqueline Coolidge and Fatih Yilmaz, ‘Small Business Tax Regimes’ Viewpoint; No 349 World Bank, Washington, DC <<https://openknowledge.worldbank.org/handle/10986/24250>> accessed 23 May 2018.

<sup>36</sup> Bird and Wallace, in *Taxing the Hard-to-tax: Lessons from Theory and Practice* (2005) 4 <<https://www.emeraldinsight.com/doi/abs/10.1016/S0573-8555%2804%2968806-7>>

to evade tax. Neutrality is one of the corner stones of a good tax system and presumptive regimes are designed to level the play ground between the self-employed and employed.

Presumptive regimes have, however, been criticised for resulting in exactly the opposite- abuse of the law, unfairness, inefficiency and distortion in 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 if the regime is not well designed and monitored.<sup>37</sup> Presumptive regimes have also been accused of eroding vertical equity; for example, where taxpayers in a specified occupation or sector are subject to a lump-sum tax for example, all the taxpayers in that sector end up paying the same amount of tax regardless of their varying income, business expenses, or unexpected losses.

#### 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, and pay as you earn from those employed in the formal sector. The informal sector, despite making up a very significant percentage of the economy, contributes very little to the tax revenue collected by the government. This widespread evasion is a result of complexity of the law, high costs of compliance, poor record keeping and low probability of detection. The intention is that once the tax rules are simplified and the cost of compliance comes down, those in the informal sector who have previously been non-compliant will begin to voluntarily comply thereby expanding the revenue base.

Presumptive regimes, however, are not without their risks. There is a risk, for example, that taxpayers who are fully capable of complying with the ordinary rules will elect to shift to

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<sup>37</sup> Bird and Wallace, in *Taxing the Hard-to-tax: Lessons from Theory and Practice* (2005) 6 <<https://www.emeraldinsight.com/doi/abs/10.1016/S0573-8555%2804%2968806-7>>

the presumptive regime if the tax burden is lower. Thus, rather than expanding the revenue base, the presumptive regime would result in abuse of the tax system and erosion of the existing base. In addition, if the presumptive regime does not have an inbuilt sunset clause, businesses can manipulate their affairs to remain within the ambit of the presumptive regime year after year, denying the state valuable revenue. This calls for careful research and design of the regime to avoid such abuse.

#### Encouraging Formalisation and Firm Growth

Rebuttable presumptive methods give these taxpayers the opportunity to provide the revenue authority with documented evidence that their actual revenue is lower than the revenue assessed using the presumptive method. Apart from generating revenue, it is also anticipated that this opportunity to register with the revenue authority, keep simplified accounts and pay taxes will enable businesses that previously operated completely in the shadows to move towards formalisation of their operations. Thus, they may begin to enjoy the direct and indirect benefits of formalisation such as better access to credit facilities, better access to markets, better opportunities to negotiate and do business with other formal firms and government, better access to highly skilled and qualified workers etc.

Once again, the achievement of this goal is heavily dependent on the design of the presumptive regime. If the tax burden under the presumptive regime is significantly lower than the tax burden a firm would face if it grew and transitioned into the ordinary regime, there is little financial incentive to do so. As a result, firms will deliberately remain small or bunch at the tipping point into the ordinary regime to continue benefiting from the lower tax burden. This sort of distortion then defeats the goal of the regime and hampers efforts to ensure neutrality and fairness in the tax system. It is important to bear these considerations in mind when designing these regimes.

Rebuttable presumptions have also been criticised for introducing complexity rather than the simplicity because they require taxpayers to keep two sets of accounts for the different regimes to determine which one to use; on the other hand, irrebuttable presumptions can be legally and constitutionally challenged in many jurisdictions, particularly when they impose an onerous burden.<sup>38</sup> Revenue authorities must weigh both options and determine where the appropriate trade off lies, for their particular circumstances.

### III. Method

This research is based on data collected through semi-structured interviews with taxpayers, tax experts and senior government officials in Kenya. Kenya was selected for several reasons; first, it is classified as a lower middle-income country and therefore falls within the category of countries that this study is focusing on.<sup>39</sup> Second, Kenya possesses a significantly large number of hard-to-tax taxpayers; a 2007 study found that the underground economy in Kenya is about 20% of its GDP and has a tax potential of 4%.<sup>40</sup> In addition, 61% of Kenyans working in the urban areas are engaged in the non-agricultural informal sector and the informal sector employs over 80% of the Kenyan working population.<sup>41</sup>

Third, despite its significantly robust efforts at tax reform, Kenya has not managed to tax the hard-to-tax 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

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<sup>38</sup> Bird and Wallace, in *Taxing the Hard-to-tax: Lessons from Theory and Practice* (2005) 21 <<https://www.emeraldinsight.com/doi/abs/10.1016/S0573-8555%2804%2968806-7>> .

<sup>39</sup> World Bank, 'Kenya Data' <<http://data.worldbank.org/country/kenya>> accessed 20 May 2015.

<sup>40</sup> Shem Ouma and others, *Estimating the Size of the Underground Economy in Kenya* (Kenya Institute for Public Policy Research and Analysis 2007) p. 18.

<sup>41</sup> Debbie Budlender, 'Statistics on Informal Employment in Kenya' WIEGO Statistical Brief No 5 (May 2011) <<http://www.wiego.org/publications/statistics-informal-employment-kenya>> accessed 18 March 2015.; Institute of Economic Affairs Kenya, 'Economic Burden of the Informal Sector' IEA Kenya Number of the Week <[http://www.ieakenya.or.ke/number\\_of\\_the\\_week/economic-burden-of-the-informal-sector](http://www.ieakenya.or.ke/number_of_the_week/economic-burden-of-the-informal-sector)> accessed 11 July 2018.

both Budget Options 2013<sup>42</sup> and Budget Options 2014<sup>43</sup>, the Parliamentary Budget Office acknowledged that despite legislative reform, turnover tax has failed to yield significant revenue and its implementation ought to be rethought. These efforts at taxing the informal sector have focused on SMEs and farmers and excluded self-employed professionals; professional income is not covered by the turnover tax.

Fourth, Kenya's experience with corruption and its potential influence on the tax morale of taxpayers also makes it an important country to study. The Transparency International Corruption Perceptions Index 2016, ranks Kenya at position 145 of the 176 countries surveyed with a corruption index of 26 where 0 is attributed to the highly corrupt countries and 100 is attributed to the very clean countries.<sup>44</sup> Corruption negatively affects tax morale, destroys trust in government and revenue authorities and adversely affects the amount of revenue collected; studying the hard-to-tax in Kenya provides an opportunity to investigate how corruption in the country has influenced these taxpayers.

Fifth, the electoral processes of 2007, 2012 and, 2017 and the subsequent political and legal upheaval are also relevant. Kenya has faced tremendous challenges in its efforts to mount credible and fully transparent elections. Its electoral experience in the last 10 years and the view by a significant section of the population that the elections have not been credible has certainly influenced the perception of legitimacy of the government. Although this study does not specifically focus on the effects of the elections on tax morale in Kenya, it is expected that the political experience of the Kenyan taxpayer will inform and enrich the results.

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<sup>42</sup> Parliamentary Budget Office Kenya, *Setting the Pace for Sustainable Growth: Budget Options for 2013/14 and the Medium Term* (2013).

<sup>43</sup> Parliamentary Budget Office Kenya, *Keeping the Promise: Budget Options for 2014/15 and the Medium Term* (2014).

<sup>44</sup> Transparency International, 'Transparency International Corruption Perceptions Index 2016' <[https://www.transparency.org/news/feature/corruption\\_perceptions\\_index\\_2016#table](https://www.transparency.org/news/feature/corruption_perceptions_index_2016#table)> accessed 2 January 2018.

Finally, the researcher is Kenyan and therefore possesses a good understanding of the tax regime, the challenges that the revenue authority faces and has useful contacts at the revenue authority, treasury, tax advisory firms and the sectors that have been selected for the case studies. All these factors were instrumental in gaining access to key respondents during the fieldwork stage.

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 conduct an in-depth study of the sectors. The researcher settled on two professions; it was felt that conducting research on just one profession may not be sufficiently compelling or robust while research on more than two professions would be too time-intensive and costly considering the finite time and financial resources available to complete a DPhil. The two professions selected for this project were dentists working in the health sector in Nairobi, and lawyers working in private legal practice in Nairobi.

The data was collected through semi-structured interviews with 31 respondents-22 taxpayers, 5 government officials and 4 experts. 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 make generalised conclusions to the whole population; however, the goal of this research is to make use of the small samples to demonstrate tendencies that emerge within specific contexts. The small sample size provided an opportunity to conduct truly in-depth interviews and to tease out rich qualitative data. Doing so with a larger sample size would have required more time and financial resources than were available for a doctoral program. In addition, 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 data.

Dentists are an interesting case because of the highly informal nature of their engagements. The use of the term informal sector in developing countries 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 difficult to tax as other informal sector entrepreneurs. Many dentists in Kenya work informally for other dentists or for private hospitals or clinics on a *locum* basis; some dentists are in full time formal employment with the government but have part time informal *locum* engagements as well. *Locum* basically refers to the practice of temporarily covering for another dentist who may be on their off day, off-sick, or when the clinic or hospital is short-staffed. Other dentists are fully self-employed and the level of formality in these enterprises varies widely. Dentists on locum tend to earn much more than they would if they were on a fixed salary and it is therefore a very attractive option, financially.

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

Lawyers presented a good comparison. To begin with, it is reasonable to assume that lawyers have much better understanding of tax law and compliance requirements than dentists do; it was interesting to find out whether this would have any bearing on voluntary compliance. Second, the legal practice is much more formal than the dental practice. The concept of *locum* does not exist in legal practice in Kenya and lawyers in private practice are either self-employed or are 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 enterprises run by self-employed dentists, law firms tend to attract more corporate clients as the firm grows, thereby significantly decreasing the likelihood of cash payments and increasing the likelihood

of formalisation. Many large dental clinics however still receive a significant number of cash payments regardless of their stage of growth or size. Fourth, revenue officials in Kenya and across Africa with whom the researcher discussed this project were categorical in their view that lawyers evade tax more than any other profession. Whether this perception is anecdotal or fact-based is not particularly clear but it was an observation that further buttressed the decision to select the legal profession as the second case.

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

### *Snowball Sampling*

The dentists and lawyers who were interviewed were identified and selected using snowball or referral sampling; the respondents interviewed referred the researcher to acquaintances within their circles who would be willing to be interviewed. The first lawyer interviewed was known to the researcher through professional networks and that lawyer introduced the researcher to other self-employed lawyers. With respect to the dental profession, the researcher approached a dentist she knew personally but did not interview that dentist; instead, she was used to refer the researcher to dentists fitting the selection criteria.

This method was very useful in this context because of the nature of the topic. Potential respondents were understandably wary of being interviewed about tax compliance and a good number went to the extent of inquiring about the researcher'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 researcher was 'safe' and that her questions did not pose a risk to them. This made her work easier and she could gain their trust and gather even more sensitive data than she set out to collect.

Admittedly this sampling method has its disadvantages; for example, because of sampling bias, one could query whether the sample is sufficiently representative of the population. The initial respondents are likely to have referred the research to respondents who share their characteristics such as age, sex, level of education and size and nature of practice. There is a risk that respondents with different traits were not adequately represented and may present different and relevant responses. The counterargument in this case, however, is that the legal and dental professions in Kenya are not enormous. The differences in traits and characteristics are not likely to be so large as to render the snowball technique useless or redundant. In addition, the researcher took steps to try and vary the characteristics of the respondents interviewed to ensure that they did not all fall into the same category; an attempt was made to ensure that they varied in age, sex, and nature or size of their businesses or practice.

#### *Profile of the Government Officials and Tax Experts Interviewed*

The profile of the tax experts interviewed is as follows:

##### **a. Public Sector**

- A Senior Commissioner at the Revenue Authority (herein 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 has since been promoted from that position) (herein referred to as CM-KRA)
- A Manager at the Kenya Revenue Authority (herein referred to as M-KRA)
- A Director at the National Treasury (herein referred to as D-NT)

- 2 Senior Managers at the National Treasury (herein referred to as SM-NT)

#### **b. Private Sector**

- A former Finance Secretary now working as a private consultant (herein referred to as (FFS))
- A Senior Partner at one of the ‘Big Four’ audit and accounting firms in Nairobi (herein referred to as SP-B4)
- A Manager at on the ‘Big Four’ audit and accounting firms in Nairobi (at the time of the interview she was a Senior Tax Consultant but has since been promoted from that position) (herein referred to as M-B4)

#### **c. Academia**

- Dr. Attiya Waris- arguably the leading tax law academic in Kenya.

## IV. Major Findings

A selected number of the major findings of the research are presented below.

### Peer Perception: Social Influence Theory

*Proposition: Taxpayers who believe that other taxpayers are complying, are more likely to comply*

It is now generally accepted, in compliance literature, that taxpayer behaviour is influenced by social interactions. This view is premised partly on *social influence theory*, i.e., behaviour and attitudes of individuals is affected by the behaviour and social norms of that individual’s reference group.<sup>45</sup> Snavely argues that this theory applies in the field of taxation in the same

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<sup>45</sup> Merima Ali, Odd-Helge Fjeldstad and Ingrid Hoem Sjørnsen, ‘To Pay or Not to Pay? Citizens’ Attitudes Toward Taxation in Kenya, Tanzania, Uganda, and South Africa’ (2014) 64 World Development 828, 829.

way- the willingness to engage in tax evasion is influenced by one's social interactions.<sup>46</sup> If a taxpayer knows many people who are engaged in tax evasion in groups that are important to him -professional colleagues, family members and friends- he is likely to be more willing to evade as well.<sup>47</sup> In addition to the influence exerted by social groups, the fact that one's peers are also evading removes the fear of informal sanctions from peers if caught evading, a fear that may encourage compliance.<sup>48</sup> Existing research also suggests that taxpayers' perceptions about the probability of being detected when one engages in evasion can be influenced by social influences.<sup>49</sup>

The taxpayers interviewed for this research often repeated, using different words with the same meaning, their belief that other professional colleagues were engaged in evasion. In some instances, they had either witnessed the evasion or directly benefited from it; in other instances, it was premised on 'gut' belief and insider knowledge about 'the way things are done'.

All the lawyers believed that their peers are underreporting their income, filing nil returns, padding up expenses to pay little or no tax, keeping two sets of files, evading out of both ignorance and design, demanding payments in cash to avoid paper trails, demanding split payments or suppressing part of the payment as well as destroying physical evidence of evasion. ADV002 and ADV006 said they believed that the largest firms are engaged in the most evasion while ADV 003 suggested that the smaller firms are the worst offenders because they are invisible; generally, however, there is a belief that compliance within the profession is

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<sup>46</sup> Keith Snavely, 'Governmental Policies to Reduce Tax Evasion: Coerced Behavior versus Services and Values Development' (1990) [Springer] 23 Policy Sciences 57, 62.

<sup>47</sup> Odd-Helge Fjeldstad and Joseph Semboja, 'Why People Pay Taxes: The Case of the Development Levy in Tanzania' (2001) 29 World Development 2059, 2061.

<sup>48</sup> Margaret McKerchar and Chris Evans, 'Sustaining Growth in Developing Economies through Improved Taxpayer Compliance: Challenges for Policy Makers and Revenue Authorities' (2009) 7 eJournal of Tax Research 171, 178.

<sup>49</sup> O. H. Fjeldstad, C. Schulz-Herzenberg and I. Hoem Sjursen, *Peoples' Views of Taxation in Africa: A Review of Research on Determinants of Tax Compliance* (Chr. Michelsen Institute (CMI) 2012) 6.

low. Virtually all the lawyers admitted to some form of evasion, in the past or presently. A few confessed to keeping two sets of files and destroying tax related evidence and paper trail. Three respondents also spoke about 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 is that medics pad up expenses to pay less tax, small and large hospitals evade customs duties on medical equipment, medical institutions are also engaging in evasion, and that there is widespread underreporting of income among dentists. One respondent, DEN 002 spoke about a previous employer (a senior practicing dentist) who is well known within the profession as openly engaging in tax evasion; the senior practitioner treats his employees as independent contractors for tax purposes (even though the nature of their engagement is that of employer-employee), pays the 'employees' in cash only, accepts only cash payments for treatment, and pays off revenue officials to avoid audits and prosecution.

Overall, the respondents' responses painted a picture of taxpayers who (i) *believe* that majority of their peers are engaged in evasion and (ii) *know* many other peers who are engaged in evasion; in both instances, the evasion is believed to be successful because virtually all respondents (except DEN008 and ADV005) were aware of a professional colleague who had been successfully prosecuted. DEN002 argued that the law relies on a taxpayer's personal morality for compliance and felt that it is unfair for one to pay tax when others are evading. DEN003 said that he believes there is a lot of underreporting among dentists and there is also widespread avoidance among those who do not evade. DEN005 stated that he only knows one dentist who pays tax faithfully!

The perceptions of these taxpayers certainly seem to influence their choice to comply/evade; this was more so in the case of the dental practitioners who are emboldened by the fact that ‘everyone is doing it and no one has been caught’. Lawyers, perhaps because of their training, are more cautious about the risk of detection but are equally spurred on by the belief that other lawyers are engaged in the evasion game and it is simply just the way things are done. Tax evasion seems to have become part and parcel of the ordinary course of business of these professionals.

*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 them.*

The above passage contains the response of DEN002 when asked about his perception of the risk of detection. When the researcher asked him whether he believed that this was an accurate picture of the legal position, he responded that he believed her and felt no need to cross-check the legal position. This 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. It also corroborates the existing research that taxpayers’ perceptions about the probability of being detected can be influenced by social groups.

## Fiscal Exchange Theory

*Proposition: Tax compliance behaviour is positively correlated with the taxpayers' level of satisfaction with government provision of goods and services*

According to the fiscal exchange theory, government expenditure may motivate tax compliance.<sup>50</sup> In other words, tax compliance increases the extent to which taxpayers perceive that they are obtaining the benefits that they expect from the government.<sup>51</sup> Alm et.al. theorise that even in the absence of the risk of detection and punishment, some taxpayers will increase their compliance if there is an increase in the value of the goods that they receive from the government and will voluntarily comply so that they can receive government services.<sup>52</sup> Therefore, increased government expenditure may increase levels of compliance. They also explain that the results of their research suggest that that 'government can increase compliance by providing goods that their citizens prefer more by providing these goods in a more efficient manner, or by more effectively emphasizing that taxes are necessary for receipt of government services.'<sup>53</sup>

The basis for the fiscal exchange theory is the belief that citizens look at their relationship with government as a social contract; a quid pro quo arrangement in which they meet their end of the bargain by paying taxes and the government, in return, delivers services as expected.<sup>54</sup> In other words, in paying taxes, citizens surrender their purchasing power in the market, in exchange for government services.<sup>55</sup> Fjeldstad et.al., argue that the existence of positive benefits for the citizen would encourage voluntary compliance although that compliance is always varied and conditional on the government's 'performance, honesty,

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<sup>50</sup> Fjeldstad, Schulz-Herzenberg and Hoem Sjursen, (Chr. Michelsen Institute (CMI) 2012) 4.

<sup>51</sup> Ali, Fjeldstad and Sjursen, (2014) 64 World Development 828, 829.

<sup>52</sup> James Alm, Gary H. McClelland and William D. Schulze, 'Why do people pay taxes?' (1992) 48 Journal of Public Economics 21, 36.

<sup>53</sup> Alm, McClelland and Schulze, (1992) 48 Journal of Public Economics 21 34

<sup>54</sup> Fjeldstad, Schulz-Herzenberg and Hoem Sjursen, (Chr. Michelsen Institute (CMI) 2012) 4.

<sup>55</sup> Fjeldstad and Semboja, (2001) 29 World Development 2059, 2061.

attention to due process and other determinants of government reliability'.<sup>56</sup> Against this backdrop, tax evasion is then viewed as an attempt by an aggrieved taxpayer, who is dissatisfied with his terms of trade with the government, to alter those terms of trade.<sup>57</sup> When the system breaks down, the taxpayers will attempt to restore 'fairness' in their relationship with government by reducing or stopping their tax payments. When the taxpayer is satisfied with the government's performance, they are more likely to continue to fund it.

From the interviews, it emerged that corruption and poor service delivery by government have influenced the compliance attitudes of professionals. ADV007 was particularly categorical in stating that he views his relationship with government as one of reciprocal duties and responsibilities; the people have donated power and responsibility to the government as an organising entity and he, as a citizen has an obligation to financially support this body politic so that they can discharge the responsibilities donated to them. He further explained that in this relationship each side should meet its side of the bargain and right now, in his view, the political side has run amok and cannot account for how its resources are used since it is not providing services such as clean water, healthcare proper roads etc. He went on to explain that since the government is providing services at a lower level than obligated, citizens are well within their right to pay taxes at a lower level than obligated. One dentist stated that perhaps if Kenyans had other channels for holding the government to account, compliance rates might increase.

There was a general feeling among the lawyers that the tax collected by the government does not translate into service delivery and many repeatedly stated that they do not receive value for taxes paid. ADV001 explained that in her view, Kenyan citizens are cheated by the government because they do not know how their taxes are used; there is no transparency

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<sup>56</sup> Fjeldstad, Schulz-Herzenberg and Hoem Sjørnsen, (Chr. Michelsen Institute (CMI) 2012) 4.

<sup>57</sup> Fjeldstad and Semboja, (2001) 29 World Development 2059, 2061.

between the point of collection and use of taxes. Taxpaying was therefore viewed as a painful exercise of throwing money down a dark bottomless pit. ADV006 felt that while tax collection had improved vastly since the 80s and 90s under the President Moi regime, service delivery had not. ADV008 was categorical that corruption and failure to provide services really hinders compliance.

ADV007 also argued that the Kenyan government seems to be collecting more revenue than it can account for and that taxpaying at a rate that supports government wastage is unjustifiable. These comments were based on the Auditor General's report released a few months before the interview took place, suggesting that up to a quarter of Kenya's budget could not be accounted for.<sup>58</sup>

Several lawyers felt that the payment of 'facilitation fees' paid to a public servant (a bribe paid to a government officer to 'motivate' them to serve you) is a form of tax and that therefore corruption and taxation amounts to double taxation. In other words, these taxpayers have constructed bribery as a form of taxation and framed the payment of bribes together with the payment of tax as unfair double taxation. To remedy this perceived unfairness, the taxpayers then elect to evade tax since they cannot avoid corrupt officials if they want to receive services at government offices such as the Lands Office

The dissatisfaction with government service was a recurrent theme among the dentists as well. DEN001 explained that 'if we saw value for taxes, we would pay voluntarily. We do not see how paying taxes helps us. If we felt impact and saw changes and accountability we would be more encouraged to comply'. The dentists argued that the government does not provide the services it ought to provide using taxes, and the services most mentioned were

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<sup>58</sup> Edith Honan, 'Quarter of Kenya's State Budget Unaccounted for-Auditor General' (*Reuters*, 29th July 2015) <<https://af.reuters.com/article/investingNews/idAFKCN0Q31PZ20150729>> accessed 24 November 2017.

health care, sanitation, sewer and waste management and infrastructure. Several respondents stated that the failure of the government to provide these services causes taxpayer to incur extra expenses by engaging private service providers and causes undue suffering among those who cannot afford to do so. Paying privately for services like healthcare while also contributing towards taxes is perceived as unfair and painful; one dentist described it as ‘double taxation’.

These responses are an indication that the professionals are unable to see the link between their taxes and provision of public goods thereby making taxpaying ‘annoying’ as one respondent put it. All the dentists who had left public service for private practice explained that they did so because the public hospitals are under-financed, poorly equipped and working under such conditions became untenable. Because of their perception that the medical field is under-financed, they are extremely dissatisfied with the government. DEN008 described the Kenyan budget process as a sham. In his view, the system does not work and the government only makes false promises but never delivers and by evading taxes, the citizens are merely meeting the standards set by the government.

## Corruption

The relationship between corruption and tax morale has been explored in various studies showing that corruption severely damages tax morale.<sup>59</sup> Improving tax morale is difficult because it is tied to deeply rooted attitudes and perceptions; it can, however, be achieved. Prior to 2003, KRA would collect very little tax; they experienced a huge spike in revenue collection

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<sup>59</sup> Lars P. Feld and Bruno S. Frey, ‘Tax Compliance as the Result of a Psychological Tax Contract: The Role of Incentives and Responsive Regulation’ (2007) 29 *Law & Policy* 102, Bernard Fortin, Guy Lacroix and Marie-Claire Villeval, ‘Tax Evasion and Social Interactions’ (2007) 91 *Journal of Public Economics* 2089, Benno Torgler, ‘Tax Morale, Rule-Governed Behaviour and Trust’ (2003) 14 *Constitutional Political Economy* 119, Torgler, (2006) 61 *Journal of Economic Behavior & Organization* 81, Björn Jahnke, ‘How Does Petty Corruption Affect Tax Morale in Sub-Saharan Africa? An Empirical Analysis’ (*WIDER Working Paper, No. 2017/8*, 2017) <<https://www.econstor.eu/bitstream/10419/161573/1/877969116.pdf>> accessed 13 October 2017., Bernd Schlenther, ‘The Impact of Corruption on Tax Revenues, Tax Compliance and Economic Development: Prevailing Trends and Mitigation Actions in Africa’ (2017) 15 *eJournal of Tax Research* 217, Anja Baum and others, ‘Corruption Taxes and Compliance’ (2017) 15 *eJournal of Tax Research* 190.

after the 2003 national elections that were deemed the first free and fair elections in which the President Moi left power after 24 years paving way for a popular government.<sup>60</sup> Taxpayer attitudes changed and citizens were willing to support the new government through taxation. This view is supported by Wilson Prichard who explains that between 1998-2002, tax revenue in Kenya fell drastically from 20.5% of GDP in 1995-1996 to 15.7% of GDP in 2001-2002; he attributes this partially to the ‘declining legitimacy and popularity of the government’ with those opposed to President Moi deliberately withholding tax to frustrate and undermine the financial stability of his government.<sup>61</sup> In 2004-2005 however, tax collection hit a figure of 21.8% of GDP a remarkable jump from the 15.7%; this followed the election of Mwai Kibaki under a coalition government in 2002 which ushered in a period of public goodwill and faith in government which increased levels of compliance and little public resistance towards taxes.<sup>62</sup> Prichard adds that subsequent cracks in the coalition in its third year was accompanied by declining revenue collections in 2004-2005 and 2005-2006.<sup>63</sup>

In 2012 Uhuru Kenyatta and his deputy were elected on a change platform- they promised to inject fresh young leadership, innovative ideas, create jobs for the youth and most important to most Kenyans- to fight corruption. Unfortunately, President Uhuru’s government has instead been plagued with numerous mega corruption scandals widely covered in the media in the past six years and he has been accused of failing to push for prosecution of senior officials.

The professionals all expressed extreme dissatisfaction with government corruption and did not believe that enough has been done to stamp it out and they argue that this has

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<sup>60</sup> Interview with M-KRA on 22 March 2018.

<sup>61</sup> Wilson Prichard, *Taxation, Responsiveness and Accountability in sub-Saharan Africa* (1st edn, Cambridge University Press 2015) 131.

<sup>62</sup> Prichard, (1st edn, Cambridge University Press 2015) 134.

<sup>63</sup> Prichard, (1st edn, Cambridge University Press 2015) 134.

significantly affected tax compliance. However, not all respondents were of the view that corruption justifies tax evasion. There were three types responses to this question: one group felt that corruption justifies tax evasion, a second group felt that corruption explains and mitigates evasion but does not quite justify it, a third group felt that corruption does not justify evasion. Those who felt that corruption does not justify evasion had two main reasons: using corruption to justify evasion is unfair to other taxpayers, like the employed, who do not have that option; and secondly that professionals should not engage in such risky and illegal behaviour. Those who felt that corruption justifies evasion argued that the government does not promote honesty and paying taxes to a dishonest government is unjustifiable.

Despite different views on the justification of evasion, virtually all professionals agreed with at least one of the following: the government is corrupt, taxes are stolen or misused by government, taxpaying benefits those in government but robs the taxpayer, the existence of corruption discourages compliance and greater government accountability would encourage consistent honesty. Some lawyers felt that the government has marginalised and ignored or victimised professionals while the medics felt that the medical profession has been politicised and misused. Both groups viewed this as discouraging compliance.

The events that took place within the health sector in Kenya after the interviews for this research were conducted provide stark evidence of the tense relationship between professionals and the state. The dissatisfaction with the government was dramatically demonstrated by a 100-day nation-wide strike by all medical practitioners in Kenya on 5<sup>th</sup> December 2016. It was the longest strike by medics in the history of Kenya and paralysed over 2500 medical institutions. The strike was based on the refusal by the government to recognise a Collective Bargaining Agreement signed by the doctors' union and the government in 2013 under which doctors, dentists and pharmacists were agitating for improved working conditions, proper functioning

hospitals and increased pay. The government on the other hand argued that it did not have the funds required to implement the CBA. The strike was dubbed ‘Lipa Kama Tender’, a Swahili phrase loosely translated to ‘pay like a tender’; this slogan was intended to shut down the government’s narrative by suggesting that if President Uhuru’s government stamped out corruption, it would be able to deliver on the Agreement. The slogan was inspired by several major corruption scandals exposed in the media in which senior government ministers and officials allegedly benefitted from enormous questionable pay-outs under controversial government tenders, including allegedly corrupt deals under the Ministry of Health. There is a general perception in the country that government tenders are the quickest way to make wealth; the slogan therefore reflected the medic’s perception that the government is eager and quick to pay money under these tenders but not to provide health services.

The strike was long-drawn out and acrimonious resulting in the temporary imprisonment of the medical union officials which angered the medical profession to the extent that even medics working in the private sector joined the strike in protest and solidarity. It is against this backdrop that the responses of the respondents should be viewed.

The revenue authority is aware that when taxpayers see the people at ‘the top’ behaving with impunity and getting away with gross corruption, it lowers tax morale and creates a general culture of impunity in Kenya and other LMCs.<sup>64</sup> It is in a difficult position because it has no control over how taxpayer money is utilised yet it is difficult to obtain optimum level of collection without controlling corruption and restoring tax morale.<sup>65</sup>

The Ministry of Finance also acknowledges that the fact that taxpayers know they can bribe revenue officials if caught in evasion significantly damages tax morale; the option of a

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<sup>64</sup> Interview with SC-KRA on 10 September 2015.

<sup>65</sup> Interview with CM-KRA on 18 May 2016

bribe that would let one off the hook lowers the cost of non-compliance since the bribe would be much ‘cheaper’ than the penalties and other legal consequences for evasion.<sup>66</sup>

In conclusion, it can be said that corruption exacerbates evasion in Kenya; informal businesses are cash-based and always liquid and can therefore easily bribe. There is significant evasion by ‘consultants’ some of whom are professionals like lawyers, who participate in unscrupulous deals aimed at facilitating/securing construction permits and government tenders for their ‘clients’ many of whom are politicians or politically exposed and will use that political power to protect them.<sup>67</sup> The fact that one can ‘buy’ a tax compliance certificate defeats the whole purpose of the certificate and further erodes tax morale.<sup>68</sup> In addition, as a result of the political tensions centred around contentious elections in Kenya, there is socio-political discontent among various professional bodies and these professionals will not pay taxes if they do not support the government.<sup>69</sup>

#### Political Legitimacy: Public Perception of the Revenue Authority

*Proposition: Taxpayers who trust their government and view it as legitimate are more likely to comply with their tax obligations.*

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’.<sup>70</sup> This argument applies both at the national government level and at the level of government agencies such as the revenue authority; per Kirchler et.al., when citizens believe that the revenue authority is

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<sup>66</sup> Interview conducted with D-NT on 17 September 2015.

<sup>67</sup> Interview with SP-B4 on 13 May 2016.

<sup>68</sup> Interview with SP-B4 on 13 May 2016.

<sup>69</sup> Interview with FFS on 9 September 2015.

<sup>70</sup> Fjeldstad, Schulz-Herzenberg and Hoem Sjørusen, (Chr. Michelsen Institute (CMI) 2012) 7.

legitimate, i.e., trustworthy, just, fair and benevolent and aims to work for the good of all, they are more inclined to comply.<sup>71</sup>

Overall, the perception that the respondents have about the revenue authority is negative. One complaint shared by both lawyers and dentists is that the revenue authority does not understand the nature of their work and as a result its actions, rules and decisions are arbitrary, inconsistent and unfair. In addition, there is a general feeling that the authority is blind and aloof to the challenges that the self-employed or SMEs face that make it difficult for them to comply. They feel that the revenue authority is more interested in enforcement than supporting SMEs to comply.

The other recurrent theme was that the revenue authority is to be feared because it is aggressive, disrespectful, unreasonable, scary, and has a pre-conceived negative agenda. Most lawyers and dentists felt that the revenue authority intends to generate such fear and does not want to have a relationship with taxpayers. The tax sensitisation workshops often held by the authority were viewed by lawyers as ‘traps’. Most of the respondents view the revenue authority as an enemy to be feared and avoided. DEN006 said that she fears the revenue so much that she cannot go to their offices to collect some tax refunds that have been due to her for some years.

The taxpayers, particularly lawyers, feel that the revenue authority is more interested in cultivating relationships with multinational enterprises and High Net-worth Individuals because they help them realise their targets faster. The dentists also argue that the revenue authority is less interested in smaller boutique clinics and more focused on larger hospitals; one dentist said that revenue officials once came to his clinic and did not ask to audit any books of

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<sup>71</sup> Erich Kirchler, Erik Hoelzl and Ingrid Wahl, ‘Enforced Versus Voluntary Tax Compliance: The “Slippery Slope” Framework’ (2008) 29 *Journal of Economic Psychology* 210, 212.

accounts which were in shambles-they were more interested in seeing his licence to operate which was displayed on his wall. This perception has led the respondents to believe that there is either no or minimal risk of getting caught and created a sense of unfairness because they believe that the revenue authority exists only for the good of large taxpayers. They surmise that the revenue authority is more interested in meeting the needs and addressing concerns of these large taxpayers and ignores others.

The other public perception of the revenue authority held by both groups is that the revenue authority is more interested in collecting bribes than collecting taxes. The respondents generally all believe that revenue authority audits are merely meant to intimidate taxpayers and push them into paying over a bribe. Many respondents, particularly the lawyers, believe that if one is caught evading, one can always escape by paying a bribe. Dentists mostly believe that larger taxpayers pay bribes to the revenue authority to get away with evasion as well. Tax collection work is viewed as a tool to harass citizens and both groups construe the revenue authority's work as 'harassment', 'malicious', 'problematic' or 'interference'. One lawyer said that they came across a 'gentle' revenue officer, suggesting that revenue officers are believed to be either gentle or rough.

Finally, the revenue authority is viewed as inefficient. Lawyers, who regularly interact with the revenue authority believe that it is faster and more efficient to bribe revenue officers than to follow the proper channels which are viewed as slow, bureaucratic, inefficient and expensive; corruption is deemed to be faster and cheaper. The revenue authority is also viewed, particularly by the dentists, as not making sufficient use of technology. Both groups expressed dissatisfaction with the work that the authority does in sensitising and educating taxpayers about their tax mitigation options; taxpayers seem to view this as a critical component of the authority's work and one that it has failed to do.

## Low Levels of Financial and Tax Literacy

Lawyers spoke about the fact that financial indiscipline and disorganisation within the profession's self-employed, coupled with the nature of self-employment, has exacerbated the evasion problem. Most confessed that they tend to make haphazard withdrawals and do not prioritise taxable amounts thereby finding themselves without the funds necessary to meet their financial and tax obligations. ADV005 explained that the discipline of withdrawing money in a structured manner is difficult for sole proprietors and that he withdraws money monthly for his upkeep and occasionally makes large withdrawals when he receives an unusually large payment thereby making it difficult to plan for and pay his income tax.

In addition, they complained about their lack of knowledge and expertise in accounting and tax computation particularly when setting up their law firms; this was a recurrent complaint. All the lawyers interviewed explained that their transition to self-employment was difficult and shocking and they were not aware of just how much their tax obligations would change with the transition. ADV006 was of the view that lawyers jump into setting up law firms without requisite training and knowledge and with the mindset that the revenue authority is the enemy. ADV004 gave an example of an embarrassing argument with a client who withheld tax on payments according to the law but the respondent was not aware that this was a statutory requirement and therefore queried the action. Other respondents said that Withholding Tax and Withholding VAT took them by surprise and that overall, their total tax burden was more than what they expected when going into self-employment.

The accounting and tax illiteracy among lawyers coupled with what the respondents described as inaccessible tax information, leads to improper billing, inaccurate record keeping, and poor internal structures within their firms which then hampers compliance. SC-KRA found it difficult to believe that highly educated professionals, particularly lawyers, struggle with

financial and tax literacy; in his view, they should be the most informed group in society.<sup>72</sup> However, as ADV003 explained, although he knew what the law said, he was not familiar with the technical aspects of compliance. The revenue authority seems to be blind to this distinction.

The lawyers argued that when they moved into self-employment, they did not appreciate the difference between filing returns as an employed individual and filing returns as a self-employed individual running a business; they underestimated how different and difficult it would be. The response to these challenges, they say, is to simply cook up numbers on their returns or file nil returns. While they readily admit that there is a mix of both deliberate intent and ignorance when it comes to tax evasion among lawyers, they maintain that most evasion is inadvertent or because of ignorance.

It would appear, and was confirmed by the respondents, that most legal practitioners do not consciously develop their internal structures to enable or facilitate compliance. Those who cannot afford to engage a highly skilled accounting professional remain financially disorganised and find it hard to comply. Those lawyers who took steps to set up a proper fully functional in-house accounting department in turn kept proper financial statements and separate accounts for tax, and that encouraged and enabled compliance.

The lawyers felt that it is difficult or close to impossible to comply without expert help. Several lawyers stated that tax information is not readily available and that the revenue authority is not digitally accessible on email to assist. They strongly felt that there is insufficient information for tax compliance and that tax should be simplified and demystified. Based on the responses, it was evident that their solution to lack of knowledge or inability to interpret the system is to file nil returns.

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<sup>72</sup> Interview with SC-KRA conducted on 10 September 2015.

The dentists expressed very similar challenges; they explained that they lack the knowledge and skills required to run a business. Most dental clinics appear to lack financial accountability and proper internal financial structures resulting in widespread mismanagement, evasion and the collapse of many dental clinics. The medics say that accounting and management knowledge is not incorporated into their training program and that the Medical Board does not concern itself with ensuring or at least encouraging proper financial management structures and record keeping among its members' clinics.

Majority of the dentists were not aware of the correct amount of withholding tax due on their payments from clinics in which they locum. As a result, some were over-taxed by unscrupulous clinics and a majority did not receive or demand withholding tax certificates as proof that the amounts deducted from their pay were remitted to the revenue authority and not illegally retained by the clinic. In addition, many were not aware that they were obligated to pay income tax on the remainder of their income; some found out after several years of noncompliance and were either too afraid or not bothered enough to comply. Others only discovered this tax obligation during the interview for this research.

Many dentists felt that tax compliance is difficult, time consuming and expensive for SMEs. Almost all described the system as complicated and the revenue authority website as difficult to use. Majority were unable to comply without expert assistance which they say is expensive. One respondent stated that the many dentists who move into private practice would like to comply but are impeded by a difficult system which they cannot navigate without professional help; they also describe the process of filing tax returns as an employee as being vastly different from the process that the self-employed experience.

It therefore seems that financial and tax illiteracy coupled with the costs of compliance are a contributing factor towards evasion among professionals in Kenya, despite the scepticism

expressed by SC-KRA.<sup>73</sup> Not only are do these professionals struggle to comply without what they deem as expensive professional assistance, they lack basic accounting and management knowledge that is a requisite for proper record keeping and business management.

## V. Are Presumptive Taxes a Viable Solution?

In this section, we consider whether presumptive taxes would be a viable solution for taxing self-employed professionals in LMICs, considering the major findings of this research discussed in the previous section.

### *Simplifying compliance*

When properly designed, presumptive taxes can relieve taxpayers, like the many respondents interviewed, who struggle with record keeping and compliance. This then encourages the professionals to comply without incurring the costs associated with engaging expert help particularly when they are newly self-employed and earning below a pre-determined threshold. For taxpayers primarily evading because of illiteracy, this provides an excellent solution. To prevent abuse, however, the turnover threshold would need to be well thought-out to prevent taxpayers perfectly capable of absorbing the costs of compliance from moving out of the ordinary regime into the presumptive regime, thus depriving the state of revenue. Further, the presumptive tax ought to be designed with a sunset clause which ensures that when the taxpayer's business grows and they can handle the record keeping and compliance obligations of the ordinary regime, they graduate out of the presumptive regime. There should be a time-limit on how long a taxpayer can benefit from the presumptive method. The revenue authority's taxpayer education department ought to provide dedicated support and

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<sup>73</sup> Interview with SC-KRA on 10 September 2015.

education services to the professionals utilising the presumptive regime to prepare them for their exit.

The often-favoured turn-over tax, where the taxable income is ‘no less than a specified percentage of the gross receipts of the business’<sup>74</sup>, may be simple to administer but is likely to be ineffective among taxpayers whose gross receipts are easily hidden or manipulated such as self-employed professionals. Since the basis for the presumption is gross receipts, it is not an ideal solution for instances where the audit challenge is determining gross receipts. This method has however been adopted for taxing self-employed professionals in India. Prior to 2016, presumptive taxes did not apply to professionals in India, as is the case in most countries. Since the financial year 2016/2017, self-employed professionals, 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.<sup>75</sup> 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 but 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.<sup>76</sup> This presumptive regime is not mandatory and taxpayers are free to opt in and out from year to year without restriction. This amendment was introduced pursuant to the recommendations of a committee set up to consider simplification of income tax in India- Expert Committee on Tax Simplification chaired by Rtd. Justice Easwar. The committee recommended, based on the popularity of the presumptive regime among small

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<sup>74</sup> Thuronyi (ed) (Kluwer Law International 2000) 410.

<sup>75</sup> This covers professionals in the following sectors: legal, medical, architecture, accounting, interior design, engineering, information technology professionals, company secretaries, artists and technical consultancy.

<sup>76</sup> Income Tax Department Government of India, ‘Tax on Presumptive Basis in Case of Certain Eligible Businesses or Professions’

<<https://www.incometaxindia.gov.in/tutorials/13.%20tax%20on%20presumptive%20basis%20in%20case%20of%20certain%20eligible%20businesses.pdf>> accessed 29 May 2018.

traders, the expansion of the presumptive regime to include professionals.<sup>77</sup> The committee also recommended that professionals running small businesses should be alleviated of the burden of keeping audited books of account.<sup>78</sup> It is still too early to determine the success or failure of this presumptive regime and there is no academic literature documenting its implementation yet.

Presumptive regimes such as the lump sum method where taxpayers pay a minimum tax, a lumpsum, set at a very low threshold may be an option for sectors where the turnover method would not be beneficial. It relieves the tax authority of the burden of ascertaining a taxpayer's actual income through audits.<sup>79</sup> However, they can result in very low revenue and vertical inequity where the income within professions diverge widely. One solution is to create bands within the lumpsum to account for these variations to make the tax less regressive and increase revenue yield.<sup>80</sup> The disadvantage with this solution is that it compromises simplicity, and requires more detailed research into the income patterns and business expenses of the various professions, a process that cash-strapped revenue authorities may be hesitant to undertake.

### *Peer Influence*

Presumptive methods that target and encourage compliance by those who were prevented from doing so because complexity would have a 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, it is hoped that the social influence of the complying peers would lead to even more compliance. It is therefore a useful tool where

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<sup>77</sup> Expert Committee on Tax Simplification, 'Report (Containing First Batch of Recommendations to be put up in Public Domain)' <<http://taxsimplification.in/REPORT.pdf>> accessed 29 May 2018.

<sup>78</sup> Expert Committee on Tax Simplification, 19 <<http://taxsimplification.in/REPORT.pdf>> accessed 29 May 2018.

<sup>79</sup> Taube and Tades, [1996] IMF Working Paper WP/96/5, 14.

<sup>80</sup> Taube and Tades, [1996] IMF Working Paper WP/96/5, 15.

evasion is particularly rampant and the goal is to (i) reverse the pervading culture and establish one of compliance and (ii) the country faces a significant budget deficit problem and urgently needs to increase revenue collection.

Perhaps this was the idea behind the introduction of presumptive taxes for professionals as part of fiscal measures taken by Greece pursuant to measures required by Article 2 (2) of the ECOFIN Council Decision 2010/320/EU on 10 May 2010.<sup>81</sup> 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.<sup>82</sup>

To increase the effectiveness of this approach, the revenue authority perhaps in conjunction with industry representatives, would have to proactively communicate both the increased simplicity of complying and the increased levels of compliance within the occupation to influence the perceptions of those who have previously been non-compliant.

#### *Impact of Presumptive Methods on Public Perception of the Revenue Authority*

The current perception of the revenue authority by the taxpayers interviewed is, *inter alia*, (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 (iii) the authority does not understand the nature of their work and therefore makes arbitrary, inconsistent and unfair decisions.

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<sup>81</sup> European Commission, 'Communication from the Commission to the Council; Brussels, 19.8.2010 COM (2010) 439 final'

<[http://ec.europa.eu/economy\\_finance/economic\\_governance/sgp/pdf/30\\_edps/communication\\_to\\_the\\_council/2010-08-19\\_el\\_communication\\_en.pdf](http://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/30_edps/communication_to_the_council/2010-08-19_el_communication_en.pdf)>

<sup>82</sup> Nikolaos Artavanis, Adair Morse and Margarita Tsoutsoura, 'Measuring Income Tax Evasion Using Bank Credit: Evidence from Greece' (2016) 131 *The Quarterly Journal of Economics* 739

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 of compliance they face and taking steps to reduce this burden. Further, before introducing a presumptive method that would apply to a profession or several professions, the authority can 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 a relationship 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.<sup>83</sup> Trust in the authority is critical in encouraging voluntary compliance among taxpayers. According to the proponents of the slippery slope framework, both power and trust can be used to achieve tax compliance but the increased use of power results in *enforced compliance* while the increased use of trust results in *voluntary compliance*.<sup>84</sup> Thus while audits and fines lead to enforced compliance, trust and a good relationship between the tax authority and taxpayers including services that make compliance easier and more convenient lead to voluntary compliance.<sup>85</sup> Presumptive regimes provide an opportunity to make compliance easier and more convenient and are therefore worth consideration.

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<sup>83</sup> Kirchler, Hoelzl and Wahl, (2008) 29 Journal of Economic Psychology 210, 212.

<sup>84</sup> Kirchler, Hoelzl and Wahl, (2008) 29 Journal of Economic Psychology 210, 212. Although there is research showing that 'Severe sanctions increased compliance with the authority more than mild sanctions, but this effect was found only when authorities acted in a fair manner' Peter Verboon and Marius van Dijke, 'When do Severe Sanctions Enhance Compliance? The Role of Procedural Fairness' (2011) 32 Journal of Economic Psychology 120, 127..

<sup>85</sup> Aloys Prinz, Stephan Muehlbacher and Erich Kirchler, 'The Slippery Slope Framework on Tax Compliance: An Attempt to Formalization' (2014) 40 Journal of Economic Psychology 20, 21.

While presumptive methods present many positive opportunities for increased tax compliance, they are not a panacea for all ills. Simplified compliance procedures do not cure tax morale that has been damaged by corruption and poor performance by government. Taxpayers who believe that their social contract with the government has irretrievably broken down will not be motivated to comply simply because it is easier to do so. In fact, if these presumptive methods are not properly designed and monitored, taxpayers are more likely to abuse them even more to pay less tax. Where tax morale is low, taxpayers look for every opportunity to evade tax; a ‘cops and robbers’ situation as described by Kirchler.<sup>86</sup> A poorly thought-out and designed presumptive regime would provide the perfect opportunity for evasion thereby achieving the opposite of what its intended to achieve.

Therefore, presumptive tax regimes would not necessarily encourage greater compliance among self-employed professionals in LMICs if the primary motivation for evasion is dissatisfaction with government service delivery and corruption management. However, where there is a mix of reasons for high levels of evasion, presumptive methods *together with* overall efforts to improve service delivery and manage corruption are likely to be more successful.

In addition, some types of presumptive taxes are not suitable for countries with high levels of corruption and bribery like Kenya. The French forfeit method, for example, can be easily abused in such environments. It is a sort of ‘contract’ between the revenue authority and the taxpayer that involves an advance agreement between the revenue authority and the taxpayer on the estimated income that will form the basis for taxation for a fixed period, usually between 1-3 years. Since it involves negotiation and agreement between revenue officers and

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<sup>86</sup> Kirchler, Hoelzl and Wahl, (2008) 29 Journal of Economic Psychology 210, 211.

taxpayers it is susceptible to abuse where revenue officers are dishonest or corruption is a challenge.<sup>87</sup>

A better option for many low and middle-income countries would be the *tachshivim* used in Israel which was subsequently replaced by *tadrihim*; like the *forfait*, it 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’.<sup>88</sup> However since the objective of the *tachshiv* is to use other ascertainable factors to determine net profit, it would only be suitable for self-employed professionals whose turnover can be determined using external evidence.<sup>89</sup> A potential solution worth exploring in future research would be to use the income earned by similar professionals in government employment as an alternative base in such a regime.<sup>90</sup> In this approach, the revenue authority would determine what a professional with similar years of experience in government service would earn, and use that sum (with reasonable adjustments where the circumstances dictate) as an approximation of the self-employed professional’s income. A government salary would be a better alternative indicator than a private sector salary which is likely to be higher and could lead to injustice. The authority could decide to limit its application to professionals who are within 3-5 years of graduation and/or who have been self-employed for less than 3-5 years. It can also be designed to be rebuttable giving the taxpayer an opportunity to prove that their income would be lower if calculated under the ordinary rules. As stated above, rebuttable presumptive taxes introduce complexities of their own but the use of a government salary as a base is likely to be low enough to be deemed fair and not challenged but high enough to avoid abuse if well monitored and implemented.

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<sup>87</sup> Tanzi and Jantscher, International Monetary Fund (August 7 1987) WP/87/54, 13.

<sup>88</sup> Thuronyi (ed) (Kluwer Law International 2000) 424.

<sup>89</sup> Thuronyi (ed) (Kluwer Law International 2000) 425.

<sup>90</sup> This approach was inspired by a conversation with Professor Eric Zolt, Michael H. Schill Distinguished Professor of Law at UCLA Law.

## VI. Conclusion

The reasons behind non-compliance by self-employed professionals in LMICs are varied, complex and interconnected. There is no single solution that will address all the barriers to compliance and therefore a mixed-method approach is appropriate. This paper considered the suitability of presumptive tax regimes as a partial solution. While presumptive taxes regimes can simplify compliance, enhance horizontal equity, expand the revenue base and, in the long-term, encourage formalisation and firm growth, they can also be significantly abused and result in inequity and erosion of the revenue base if improperly designed and implemented.

Where presumptive taxes are well-thought out, backed by research, carefully designed and rigorously monitored, they can be of benefit to those 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 easier and cheaper.

Presumptive taxes would not, however, be useful in countries where the primary reason for evasion is the erosion of tax morale by government corruption and failure to deliver services. In addition, in countries where bribery is a big problem, some types of presumptive regimes that involve discretionary action by revenue officials can be seriously abused and are not advisable. However, since most evasion will be a result of a mix of reasons, presumptive taxes can be used, in addition to other measures, to encourage compliance. Careful attention must be paid to thresholds and the period for which a taxpayer can be subject to the presumptive regime before they are transitioned into the ordinary tax system. The tax should be designed with time-limits, encouraging the taxpayer to become increasingly formal and develop the

capacity to move into the ordinary tax system within a specified period to avoid abuse of the regime.

## ANNEX

<b>Identification</b>	<b>Nature of Practice</b>	<b>Level of Specialisation</b>	<b>Gender</b>	<b>Years of Experience</b>
Dental Practitioner 1	-Currently self-employed -Runs own practice -Has previous locum experience	Specialist	Male	More than 7
Dental Practitioner 2	-Currently self-employed -Informal employment working for a self-employed practitioner -Has previous locum experience	Non-specialist	Male	Less than 7
Dental Practitioner 3	-Formal employment (private) -Has previous locum experience	Non-specialist	Female	Less than 7
Dental Practitioner 4	-Self-employed -Runs own practice -Has previous locum experience	Non-specialist	Male	Less than 7
Dental Practitioner 5	-Formal employment (government) -Engaged in locum	Specialist	Female	7
Dental Practitioner 6	-Self-employed -Runs own practice -Engaged in locum	Specialist	Female	More than 7
Dental Practitioner 7	-Formal employment (government) -Engaged in locum	Non-specialist	Female	7
Dental Practitioner 8	-Self-employed -Runs own practice	Specialist	Male	Less than 7

Identification	Nature of Practice	Level of Specialisation	Gender	Years of Experience
	-Has previous locum experience			
Dental Practitioner 9	-Self-employed -Runs own practice	Specialist	Male	More than 7
Dental Practitioner 10	-Formal employment (government) -Engaged in locum	Specialist	Female	More than 7

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	< 3years	Male
Legal Practitioner 7	Sole proprietorship	> 10	> 3 years	Female
Legal Practitioner 8	Self-employed	< 10	N/A	Female
Legal Practitioner 9	Partnership	> 10	< 3years	Male
Legal Practitioner 10	Sole proprietorship	< 10	< 3years	Male
Legal Practitioner 11	Partnership	> 10	> 3 years	Male
Legal Practitioner 12	Sole proprietorship	> 10	> 3 years	Male

<b>Identification</b>	<b>Nature of Practice</b>	<b>Years of Experience</b>	<b>Age of Business</b>	<b>Gender</b>
	(previously run as a partnership)			

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