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SMALL ENTERPRISES AND ECONOMIC POLICY

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ABSTRACT

Institutions such as strong property rights and the rule of law are important for both long-run economic performance and short-run volatility. Developing good institutions is generally viewed as a desirable goal, but there is no agreed road map for such changes.

This paper suggests that, at least for former communist countries, the right way to begin is by lowering the barriers to entry into the formal sector for small-scale entrepreneurs. Taxation, regulation, and establishing property rights must be taken together. A good way to cut this Gordian knot in one stroke is through moving to a low lump-sum tax on small business. Lower taxes have a positive direct effect and an additional indirect benefit of lowering regulatory burdens and corruption. Former communist countries that have implemented such taxes have quickly created a large small-scale business sector.

These policies have economic advantages, but their most important effect is to change the political equilibrium, creating a powerful force for further institutional improvement.

Recent experience in Eastern Europe, East Asia, and South America supports the idea that institutions—such as an effective judiciary, protection of property rights, and more specific laws—are key to both long-term economic development and recovery from crises.[1] The idea that institutions matter to some extent is well established and can be traced back at least to North and Thomas (1973), Jones (1981), North (1981), and Olson (1982), with key elements going back as far as Adam Smith. A great deal of empirical evidence now suggests that "better" institutions are a principal determinant of financial development (La Porta, Lopez-de-Silanes, Shleifer, and Vishny 1997, 1998), per capita income today (Hall and Jones 1999; Acemoglu, Johnson, and Robinson 2001), and growth over the past thirty years (Knack and Keefer 1995; Mauro 1995; Acemoglu, Johnson, Robinson, and Thaicharoen 2003; Johnson, McMillan, and Woodruff 2002). In addition, although there is no predetermination, institutions often persist for a long time (Acemoglu, Johnson, and Robinson 2002). In countries such as Argentina, weak institutions appear to be an important cause of economic volatility and repeated crises (Acemoglu, Johnson, Robinson, and Thaicharoen 2003).

The implications of these findings for policy are still being debated (see, for example, Frankel 2002). How can a poor country substantially improve its institutions? Does it have to take a long time, or can it be done all of a sudden? Certainly, we do not yet know enough to "unpackage" institutions and advise countries on what exactly to do or not do.[2] There is no magic bullet, nor is it likely that one size—or type of institution—fits all. This paper suggests, however, that there is one policy recommendation on which we may agree for postcommunist countries: lower the barriers to entry for new small businesses and the costs of running these firms by switching to a simple low lump-sum tax.

This paper compares the importance of small enterprises in various economies and discusses how countries can fall into a "bad" equilibrium with low official activity by small firms. It then scrutinizes the idea and practice of equal treatment of all kinds of enterprises and examines in more detail how governments impose costs on small firms. In the final sections, it explains how lump-sum taxes would work, considers the politics of small enterprise promotion, and discusses taxation and glass ceilings.

IMPORTANCE OF SMALL ENTERPRISES

Much of the world's economic production is very small scale: one or two people operating "under the radar" as individuals rather than as an organized business. A major problem for economic growth is how to persuade these people to invest, employ others, and, preferably, pay taxes. It is primarily

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the risk of expropriation by government and powerful individuals that constrains entrepreneurial investment and causes business people to stay very small scale and completely unofficial in many countries. This expropriation risk depends on taxation, regulation, and strength of property rights. At least in some countries, national and local bureaucrats intentionally make tax and regulation systems complicated to ensure that almost no one can fully comply, rendering entrepreneurs vulnerable to extortion and expropriation.

Small enterprises are of critical importance to the functioning of an economy and thus economic development. In the developed economies of the Organization for Economic Cooperation and Development (OECD), about 60 percent of gross domestic product (GDP) is generated by small enterprises, that is, enterprises with a maximum of 50 employees (OECD 2002). It is easy to understand why this is the case. A modern market economy consists of thousands of markets that require millions of enterprises to be reasonably competitive and efficient. A large number of small enterprises guarantee a high degree of competition, and the variety of economic activities is so great that as many enterprises as possible are needed in a modern economy. Semideveloped countries, such as in Latin America or the postcommunist region, have far fewer small enterprises, which is one of their major structural weaknesses (De Soto 2000; World Bank 2002).

The importance of small enterprises is probably not only strictly economic but also political. If a country has few small enterprises, its policies tend to benefit large enterprises and maintain the low number of small enterprises, which hampers the productivity of that country. Conversely, in countries with many small-scale entrepreneurs, their number stays large. There are few cases in which, once established, entrepreneurs have been persecuted—the notable exceptions of Soviet Russia in the 1930s and parts of Eastern Europe after 1945 are all the more extraordinary because they are so unusual.

The size of the small enterprise sector varies greatly within countries and even across regions within countries. Italy is a classic case with abundant small enterprises in the often communist-ruled Emilia in the north and a lack of entrepreneurship in the conservative south. Here, a standard argument is that historical differences in social capital exist (Putnam 1992), although the idea that areas with low levels of trust in the past can never experience cooperation, trust, and entrepreneurship in the future runs counter to the evidence (Locke 2002).

Under communism, Poland had many small private enterprises, whereas Czechoslovakia had virtually none. This was the case even though, between the world wars, Czechs had been famous for their small entrepreneurs and most small entrepreneurs in Poland were Jewish and were either exterminated or had emigrated between 1940 and 1950 (Åslund 1985).

A recent World Bank study (2002, 41) of transition economies notes that the postcommunist transition countries, all of which started with few small enterprises, can now be divided into two very different groups. One group (the Czech Republic, Hungary, Latvia, Lithuania, and Poland) obtains 50–60 percent of GDP from small enterprises, almost as much as in the industrialized West. The other group (Russia and Kazakhstan), on the contrary, generates only 20 percent of GDP from small enterprises.

These observations suggest three points. First, relatively small institutional differences can produce large differences in the size of the small enterprise sector. Second, if institutions do not change, the share of small enterprises can persist in being very different across otherwise similar economic areas for long periods of time. And, third, limited changes in economic policy can quickly change the size of the small enterprise sector.

ONE OPTIMAL AND ONE SUBOPTIMAL EQUILIBRIUM

It seems likely that there are two equilibria in the political economy game of postcommunist transition.[3] Several transition countries seem to have got stuck at a suboptimal equilibrium with about 20 percent of GDP coming from the small enterprise sector, whereas others have established an optimal equilibrium with around 50–60 percent of GDP.

These differing realities may be seen as two alternative equilibria: one optimal, the other suboptimal. The aim of government policy should be to move the economy from the suboptimal to the optimal equilibrium.

However, small enterprises are not likely to push for better conditions for small enterprises on their own. They are easily exposed to harassment by the authorities and unlikely to engage in collective action, as their costs are probably greater than their gains (Olson 1971). Perhaps even more important, small enterprises are quite comfortable when entrepreneurs are moderately repressed, because the monopoly rents they can extract due to the limited competition are likely much greater than the additional official costs and bribes they may have to pay.

At a critical threshold, however, small-scale entrepreneurs can no longer extract monopoly rents but have to accept being price takers, cutting their costs and lobbying for lower costs imposed on them by government. At this point, these small entrepreneurs will have become so politically influential that they cannot easily be persecuted. In moving from a suboptimal to an optimal equilibrium, the key issue is to raise the number of small enterprises above the critical level.

The World Bank (2002) suggests that the critical mass is reached when officially registered small entrepreneurs contribute around 40 percent of the officially registered GDP. This may be seen as the political "tipping point" for bringing small entrepreneurs into the official economy. If the level of tax-paying entrepreneurship rises above this level, small-scale entrepreneurs become politically much stronger and much harder to expropriate, and their behavior changes. But while small businesses remain below this level, they are politically vulnerable to expropriation, which, in turn, encourages them to stay small.

The logical conclusion is that affirmative action for small enterprises is to be recommended until the small enterprise sector is well above that threshold. This runs counter to one of the standard principles of good economic policy, namely, that all enterprises should be given equal treatment in regulation and taxation.

NATURE OF EQUALITY

This principle of equal treatment for all enterprises in regulation and taxation is quite dubious because it is very difficult to implement. In his novel *Animal Farm*, George Orwell made the point that "some animals are more equal than others." That is all the more true among enterprises.

A standard economic principle is that all enterprises should be treated equally through proportional taxation, but the same treatment by the government imposes very different costs on enterprises of different sizes, and the relevant equality is relative rather than absolute. More often than not, regulation and taxation involve great economies of scale. For example, statistical reporting requirements are similar for all enterprises, implying disproportionately greater overhead cost for small enterprises. Complex taxation is likely to benefit large enterprises, which can use more tax deductions than small enterprises. Regulation and inspection of enterprises do not rise in relation to size and thus imply economies of scale. Nor do legal costs rise with the size of an enterprise.

In fact, all OECD countries embrace this understanding of equality, as an OECD (1999) document puts it:

> All OECD countries apply special measures, including tax measures, intended to improve the economic and technological environment of small enterprises, and to facilitate their establishment and growth. The most important reasons cited for having such policies were that small and medium-sized businesses face proportionately higher costs; that there are market imperfections; that there are broader benefits to society going beyond the economic benefits; and that there are important social goals involved.

There are many reasons to presume that discrimination against small enterprises is greater in transition countries. Corruption is generally greater in less developed countries (Treisman 2000), and that is certainly true of transition countries (Transparency International 2002). Moreover, corruption is by no means equal in its treatment but aggravates the mistreatment of small enterprises. This is all the more the case in transition countries subject to serious "state capture," that is, politically powerful enterprises use the inequality of the state to gain benefits for themselves (Hellman 1998; Hellman, Jones, Kaufmann, and Schankerman 2000; Hellman, Jones, and Kaufmann 2000).

In reality, small entrepreneurs have been subject to massive discrimination in many postcommunist countries, as is clearly shown in a number of enterprise surveys of transition economies (EBRD 1999, 2002). In Ukraine in 1999, the International Finance Corporation (1999) found that small enterprises estimated their average tax load at a hefty 30 percent of gross sales.

There are, thus, strong reasons to believe that any regulation or taxation that is meant to be equal for all enterprises discriminates against small enterprises. Logically, the state should balance this bias against small enterprises, which is harmful to overall economic welfare, with affirmative action for small enterprises. The more corrupt the state, the stronger the affirmative action needs to be. Therefore, stronger affirmative action is needed in transition countries than in OECD countries.

Ironically, a major threat against small enterprise promotion is the international community of economists, which insists that affirmative action is wrong and that all enterprises should be subject to the same rules, even if they happen to be discriminatory. Unfortunately, both the IMF and the World Bank hold this view. Successful liberalization of small enterprises has typically occurred when and where common sense has dominated over traditional economic thinking.

The OECD, which is the international organization that has taken the greatest interest in small enterprises, fails to draw these conclusions itself. It has formulated policy recommendations for small enterprise development in transition countries that amount to a long laundry list of what should be done a little bit differently (OECD 1999).

COSTS IMPOSED BY GOVERNMENT

The costs that a government imposes on an enterprise can be divided into three major categories: taxation, regulation, and property rights. Taxation is the most easily understood and the most transparent cost of government. Regulation is the most elusive and includes restrictions on what enterprises are allowed to do (that is, administrative procedures, inspections, and sanctions if the restrictions are not observed). Property rights involve rules regarding the registration of property, including licensing, and the legal defense of property rights.

However, there is a great deal of overlap between these three categories. Penalties for violations of regulations also have a fiscal function, and licensing has a regulatory and fiscal function. The standard ambition is to simplify all three functions—a task that tends to be remarkably difficult. For instance, Russia has undertaken numerous legal changes to boost small enterprises, but so far the results are absent. When the authorities lose one lever of interference, they deploy another one more intensely, because their incentives have not changed (CEFIR 2002).

For instance, in Sweden, small entrepreneurs have dominated the southern forests for the last century, while the central forests have been dominated by company towns and have lacked small enterprises. The dearth of small enterprise in central Sweden appears to be primarily the result of one local act, namely zoning meant to reserve scarce labor for the big corporations. Without land for an enterprise, no tax relief will help.

In the stimulation of small enterprises, no link is stronger than its weakest link, and taxation, regulation, and property right defense are all connected. The crucial question is how to diminish all three government costs, preferably in one blow. The ambition should be to find one policy measure that excludes dangerous influences, is politically acceptable, and is tenacious enough to boost the small enterprise sector over the critical hurdle.

Regulatory costs appear proportionate to taxation. In a survey of new manufacturing firms in Poland, Romania, Russia, Slovakia, and Ukraine carried out in 1997, Johnson, McMillan and Woodruff (2000) found that the main concerns of entrepreneurs in Russia and Ukraine were taxes and court services. Although total tax collection as a share of GDP is higher in Central Europe, entrepreneurs there paid 16 percent of their sales in total taxes, whereas Russian and Ukrainian entrepreneurs paid 24 percent. Interestingly, the Russian entrepreneurs also paid 50 percent more bribes as a share of their turnover than their Central European colleagues, and the Ukrainian entrepreneurs paid 75 percent more. These results suggest that taxes and bribes are closely correlated. If this were generally true, corruption or informal regulatory costs would be best reduced through lower taxes.

Millions of entrepreneurs all over the world are stuck in the underground economy, being able to do little because they are deprived of legal property rights (De Soto 1989, 2000). With weak property rights, any investment is at risk; as such, entrepreneurs have no recourse in court. Nor can they borrow money from a bank or mortgage their assets. Because they operate illegally, they are also more vulnerable to organized crime and extortion.

Some experts formulate this problem very differently. Many focus on access to capital, but that is almost certainly a secondary issue, whereas property rights are primary (see Johnson, McMillan, and Woodruff 2002). After all, in the early transition the vast majority of all investment comes from retained earnings (EBRD 1999). The ambition should be to make the legal registration of an enterprise as simple as possible.

This can be described as the minimization of three separate costs of government:
c_t = taxation (costs), c_r =regulation costs, and c_p= property rights costs, that is,

$$\min f = c_t + c_r + c_p . \qquad (1)$$

However, we have already argued that,

$$c_r = kc_t ,$$

where k is a constant < 1. Ideally, the registration of an enterprise should be part of taxation, which means that c_p=0. Then (1) simply becomes

$$\min f = c_t (1+k).$$

LUMP-SUM TAX

If any interactions between state and enterprise cause corruption, these contacts must be minimized, and a low, fixed lump-sum tax appears to be the best solution. It exempts an enterprise from all regulations and inspections and also performs the function of enterprise registration.

Lump-sum taxes have been tested extensively. They boosted the private sector in Poland and safeguarded it in East Germany under communism (Åslund 1985). Leszek Balcerowicz's blanket liberalization of small entrepreneurship in Poland in 1990 allowed anybody to do any kind of business individually without paying any taxes, which gave an enormous stimulus to small-scale entrepreneurship (Sachs 1993). It has also worked well in Ukraine since 1998 (Thiessen 2001) and in Kyrgyzstan since 1998. Consequently, small enterprises have surged explosively in these countries, whereas less radical variants have had little or no effect in many other countries.

One example that shows both of these trends is Russia in 1992. The number of independent entrepreneurs skyrocketed with a blanket liberalization without any tax payments in January 1992, but this liberalization was undone by May 1992, and the development of small enterprises was capped (Åslund 1995). This failure can be given alternative interpretations. Local authorities in big cities reversed the liberalization because they were too strong and lacked financial incentives to support new small entrepreneurs. Established traders strongly opposed irregular competition, and the beneficiaries (both traders and customers) were mainly visitors to the big cities. The conclusion is that a critical mass of entrepreneurs is vital.

Successful lump-sum taxes have typically been limited to single entrepreneurs working with family members or a maximum of a couple of employees. For slightly larger enterprises of up to ten employees, a single low turnover tax has been applied. No bookkeeping is required, and the interaction with authorities is truly minimized.[4] These benefits must focus on microenterprises, or they will not be politically acceptable, and serious economic distortions may arise. By and large, state revenues from microenterprises will be a sheer addition, as these enterprises either did not exist before or did not pay taxes.

A lump-sum tax is regressive by its very nature. Most governments prefer progressive tax systems to ensure redistribution from rich to poor. Arguably, these progressive tax systems have some such effects in countries with high per capita income, but in most of the world, these tax systems are a major reason why poor people cannot build sustainable businesses. The illusion of progressivity in taxation must be sacrificed for the reality of development: Low lump-sum taxes *can* help the poorest people in poor countries.

This policy may be described as selective radical deregulation of microenterprises to counter state failure, which especially harms small enterprises. Much of small enterprise promotion, however, has focused on real or perceived market failures, notably in capital and credit markets, or amounted to sheer industrial policy. One case in point is the extensive small enterprise promotion in India, which has been characterized by protectionism, subsidies, and regulation. Small enterprises have been exempted from excise duties, but their taxation and regulation have not been simplified. They have been offered subsidized credits, a plethora of promotion programs, and the exclusive right to produce many products, but, as with most industrial policy, it has not worked (Mohan 2002). A criticism of such policies is no stricture of lump-sum taxation.

POLITICS OF SMALL ENTERPRISE PROMOTION

The main cause of resistance to small enterprise promotion is monopoly rents, benefiting existing enterprises and government officials, at the population's expense. The problem is overregulation and overtaxation, leaving state officials with powers too great and the public with powers too small. More competition can drive prices down and thus monopoly rents. Then corruption will shrink because entrepreneurs can no longer afford high bribe taxes. Small enterprise promotion is a major means of controlling corruption.

In many countries, local officials are the main beneficiaries from the maltreatment of small businessmen. In Russia, local officials have proved the most reluctant to lower barriers to entry for new firms: City and provincial bureaucrats of various kinds make good money from shaking down existing firms, and it is easier to extract more if limited competition keeps profits high (OECD 2002). But local government can be enticed into wanting small business development, as has been the case in South Korea and much of China.

A mixture of sticks and carrots can change the behavior of local officials. First, successful lump-sum taxation must be set centrally, because local officials easily drive up taxes to an excessive level (Åslund 1985). Second, local authorities have an incentive to support small enterprises if they receive part of the tax revenue they generate (Shleifer and Treisman 2000). Third, ideally, government officials should be prohibited from even visiting enterprises, to clarify the divide between state and enterprise and to reduce their opportunities to extract tribute. Fourth, the number of underpaid officials needs to be cut, resulting in fewer bureaucrats but with higher salaries. Fifth, the legal power of officials should be reduced, for instance, by decriminalizing tax violations, thereby depriving tax officials of the opportunity to arrest anybody at will.

The attitudes of businesses vary between small and large businesses, but the difference might not quite be the expected one. Recently, much has been made out of the idea of "state capture" (Hellman 1998; Hellman, Jones, Kaufmann, and Schankerman 2000; Hellman, Jones, and Kaufmann

2000). A frequently heard argument is that the big businessmen who have bought control of the state also want to block the development of small enterprises. Although their purchasing of the state is evident, their negative attitude to small businesses is not. Ukraine managed to liberalize its small entrepreneurs at the height of its oligarchic rule in 1998, and in Russia the oligarchic organization, the Russian Union of Industrialists and Entrepreneurs, is pushing for liberalization of small enterprise. The explanation is that small enterprises pose no threat to large self-confident corporations, whereas they need multiple domestic subcontractors. Big corporations and microfirms are too different to threaten one another. The largest firms are often exporters, for whom competition between domestic suppliers is helpful, which has been important for the success of companies such as Samsung in South Korea and Toyota in Japan.

A common idea is that small businessmen need to mobilize in support of other small businessmen, but small businessmen rarely defend one another when their numbers are few. One common explanation is the problems of organizing collective action (Olson 1971). However, a more fundamental problem is their actual interest. Businessmen never like competition, and the anticompetitive behavior of local officials benefits those who know how to manage them. In the Johnson, McMillan, and Woodruff survey (2000), total payments to officials as a proportion of sales in Central Europe were 10 percentage points lower than in Russia. At the same time, retail prices in Russia were at least 50 percent higher than in Central Europe (World Bank 2000), suggesting that existing small Russian businessmen were making substantial excess profits thanks to the difficult regulatory situation. Businessmen already operating in the official sector usually complain about their situation when asked, but they rarely organize public campaigns (unless extinction threatens, as in Belarus today). In many countries, the term *business lobby* is synonymous with large business.

Instead, reforms benefiting small businessmen typically come as top-down political measures. Somebody in power realizes that small enterprises are important and begins to look for radical measures to promote them. In Poland, such an understanding arose as early as 1956; in Russia, only around 2000. Breakthrough required that a significant policy community understand the need for affirmative action. However important small enterprises are, they are sufficiently insignificant to be independent of megatrends. They can be promoted when major deregulation appears impossible, but when they gain momentum, they change society.

The promotion of small enterprises has usually developed in steps. Initial measures have not had sufficient effects, but they have aroused negative reactions, which led to a trial-and-error policy. Private enterprise in Poland peaked in 1958 and 1969 before it started rising steadily from the mid-1970s (Åslund 1985, 230–1). The real takeoff, however, occurred when then-minister of finance Leszek Balcerowicz undertook a radical deregulation by decree in late 1989, with remarkable results (Johnson and Loveman 1995). Ukraine and Kyrgyzstan saw an accumulation of deregulation focusing on small enterprises until their takeoff in 1998. In Ukraine, a group of reformist ministers added one reform after another, and in Kyrgyzstan, President Askar Akaev decreed the necessary changes.

Gradual deregulation has not resulted in a linear process. A low number of small enterprises constitutes an underreform trap, and a shock is usually needed to break it. The shock can be general, as in Poland in 1990, or an accumulation of reforms crossing a crucial hurdle, as in Kyrgyzstan and Ukraine.

Rapid entry by many small new entrepreneurs quickly drives down prices, particularly evident in Poland (1990–1991) or in Ukraine (1998–1999), threatening and activating established small entrepreneurs. Initially, established entrepreneurs attack the privileges of the microentrepreneurs demanding more control of quality and taxes and so on. In Moscow, such a reaction ended a promising start of new small enterprises in the spring of 1992. However, if the initial attack from the business establishment is repelled, prices fall from the high suboptimal level. Realizing that the price change is irreversible, existing small businessmen will instead try to cut costs. Regulatory costs and taxation can be reduced quickly, prompting existing entrepreneurs to demand liberalization and lower taxes at long last. Then, a broad force for liberalization has been created, and the optimal equilibrium can be reached. Rather than being a persistent force for liberalization, established small entrepreneurs must be overwhelmed by both market and politics before they change their policy stance and behavior.

The political versatility of lump-sum taxation is truly amazing. In 1999, even state-dominated Uzbekistan introduced a fixed lump-sum tax for individual entrepreneurs, and these microfirms swiftly became the fastest growing enterprises in the country. By 2001, 428,300 microfirms were already officially registered in Uzbekistan (Jones Luong 2003, 15, 20).

TAXATION AND GLASS CEILINGS

Two remaining issues are tax revenues and “small enterprise traps” or “glass ceilings” in enterprise development.

One argument is that the number of small enterprises may rise, but they rarely exceed a certain size, for instance, about 20 employees in Russia (CEFIR 2002). Yet, the most dangerous borderline is if microenterprises do not enter the official economy, as Hernando De Soto (1989, 2000) has explained so well. Microenterprises on their own can easily comprise one-fifth of GDP, and their legal existence generates the necessary pressures, reducing market prices and therefore inclining established small enterprises to push for less costs from regulation and taxation.

A critical question is how high a lump-sum tax should be and who should set it. This has typically been determined through an iterative trial-and-error process. Gradually, the authorities have lowered the tax because of a lack of entrepreneurial reaction, reduced regulation, and standardized the tax centrally—and suddenly small enterprises have taken off. The best approach includes several elements: The lump-sum tax should be fixed for a long time and made payable only once a year; a lump-sum tax has more credibility if it is set by the national parliament; fewer classes of lump-sum taxes are preferable, but with some addition for each employee; and it is vital that bookkeeping is not required.

The rate should be low, around a few percent of presumed turnover of an average individual craftsman. Russia is now trying with a tax of 6 percent of turnover, and that is clearly too much, leaving the country with few legal microenterprises. The lump-sum tax must be less than the bribe tax to work. In addition, a risk premium must be added, which may be lower or higher in the underground than in the official economy. Lump-sum taxes are always controversial, because they go against the grain of modern taxation, being low and regressive. But their stimulative effect has proven to be huge, and if they are limited to people below a certain level of turnover, they pose no concern to income differentiation.

Lump-sum taxes are always accused of depressing tax revenues. Initially, this is hardly true, because successful lump-sum taxes convince underground entrepreneurs to join the official economy and economically passive people to start some economic activity, typically individual retail trade and craftsmanship. Bringing more people into the official economy is of great legal and social importance, although higher tax revenues might be unwarranted. Admittedly, many people working in larger organizations may strike out as independent entrepreneurs for tax reasons, but that is true of any economy with favorable conditions for small entrepreneurs and might even be a good thing. This was a big political issue in the early Czech transition (Johnson 1994), and a clampdown on small entrepreneurs there resulted in stifling the economy. Such complaints are now common in Ukraine, but the authorities have wisely refrained from taking action, and Ukraine has seen a substantial decline in corruption (EBRD 2002).

A more specific concern is that lump-sum taxation undermines value-added taxation, but no value-added tax (VAT) can be truly comprehensive. The positive effects of lump-sum taxation appear superior to those of VAT, which does not work well in any post-Soviet economy beyond the Baltics, and small-business men tend to be exempt in most countries.

The typical liberal response to criticism against lump-sum taxes is to introduce a simplified single turnover tax for slightly bigger enterprises, usually for enterprises with up to 10 or 20 employees. Currently, Ukraine has a simplified turnover tax for enterprises with a maximum turnover of $200,000 of 10 percent including value-added tax (VAT) (Thiessen 2001, 5).

The eventual response to a successful promotion of small enterprises would be deregulation and a lowering of the tax burden, which would not be possible without presumptive taxation, enhancing competition and changing the intellectual paradigm in the direction of the market. The first insight of transition economies must be that the marginal social cost of a higher tax burden is excessive. This is now dawning on many post-Soviet countries, after seven of them have seen their general government revenues fall to less than 25 percent of GDP (EBRD 2002, 62), but even so most transition countries still have high public revenues in relation to their level of economic development. Then, another kind of tax system is required, with broad tax bases and low flat rates. Five post-Soviet countries have now introduced flat income taxes at ever lower rates (Estonia, Georgia, Latvia, Russia, and Ukraine), and more are likely to follow (Åslund 2002). Similarly, corporate tax rates are being reduced, and more deductions are allowed. Estonia has taken the lead by abolishing the profit tax.

Rather than looking at a lump-sum tax as an aberration from normal tax rules, it should be seen as a facilitating device for the introduction of better taxation for the economy as a whole. Admittedly, it took as long as three and a half decades for lump-sum taxes to work through the economic system in the extremely adverse environment of communist Poland, but the country's large small-enterprise sector was a major reason why Poland got its economic policy right so early and why it worked so well.

If taxes are set lower than the corruption tax, the tax system becomes self-policing. Most single entrepreneurs want to be official and legal, and the state should facilitate such endeavors. Simplified taxes are arguably the strongest means against corruption.

Social security often complicates matters, but small-scale individual entrepreneurs should not pay for social security in poor transition countries. The key goal is to tempt them out of the underground economy, and any additional restriction will reduce the number surfacing into the legal realm. Social security remains a mighty incentive to move to normal, higher taxation when businesses have grown larger. Credit is another strong incentive for lump-sum taxpayers to move to formal accounts, because banks require bookkeeping to assess the financial state of the company.

Even so, large-scale lump-sum taxation may be seen as a temporary device to reduce corruption, excessive state intervention, and the underground economy. After these phenomena have been brought under control, which will take several years, lump-sum taxes will be reined in by political pressure. Yet, many individual activities may be subject to lump-sum taxes in any society, notably, minor individual artists, craftsmen, and retailers.

CONCLUSION

One view of economic development is that it requires investments by a wide range of people from outside the existing social elite. Such investments were key in both the rise of Western Europe after 1500 (Acemoglu, Johnson, and Robinson 2002a) and in the "Reversal of Fortune," through which relatively poor places became relatively rich during the nineteenth century and subsequently stayed rich (Acemoglu, Johnson, and Robinson 2002b). Investments by "new" entrepreneurs require that they enter the formal economy and put capital at risk. But how can this be encouraged when there is no rule of law, a weak judiciary, and less-than-ideal formal laws (Djankov, La Porta, Lopez-de-Silanes and Shleifer 2002)? This is a first-order issue in much of the world today.

We suggest the logjam can be broken, at least for former communist countries, by combining taxation, regulation, and licensing in one single measure—namely, a low lump-sum tax for small entrepreneurs. Anything that complicates the tax system leads to both more evasion and corruption. Strengthening the small business sector economically and politically is not a panacea, but in many countries today it would be a step in the direction of sustainable development. To cross the critical hurdle that may be around 40 percent of GDP, affirmative action is required to move the economy from a suboptimal equilibrium with few small entrepreneurs to an optimal equilibrium with 50-60 percent of GDP being produced by small enterprises.

There are significant economic benefits to be reaped from such a policy, but the main gains would be political. Encouraging small entrepreneurs into the formal business sector would greatly strengthen them politically and move former communist countries toward more stable, pro-property-rights policies.

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NOTES

1 For a good summary of the debate, see Frankel (2002).

2 For one early attempt to "unbundle" institutions, see Acemoglu and Johnson (2003).

3 For one economic model in which this is the case, see Friedman, Johnson, Kaufmann, and Zoido-Lobatón (2000). Some of the politics for postcommunist countries are discussed in Åslund, Boone, and Johnson (1996).

4 Health and sanitation, fire, construction, and police inspections are moot and often difficult to avoid, but that is quite different from the often almost daily inspections by scores of different government agencies in transition countries.

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