

TAXING SMEs



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This presentation—which draws on IMF and OECD surveys—reviews core issues:



- Background
- Tax design for SMEs when implementation is costless...
- ...and when it is costly
- Strategies for developing and emerging economies
- SMEs and tax administration
- Questions for the conference



BACKGROUND



SMEs in the economy and tax system



The increasing attention to SMEs reflects:



- Natural progression from focus on large taxpayers
- Growing emphasis on SMEs' importance to economic performance
- Close links with informality, especially in developing economies





The topic is very:

- Diverse—‘SME’ covers a wide range of enterprises, and practice varies greatly
- Difficult—policy and administration both key
- Neglected—rarely the centerpiece of tax debate, relatively little rigorous academic attention, and few generalized models



No single definition of SME suffices:



- An enterprise that is small by EU standards, e.g, could be in the LTU in a small developing country (so *relative* size matters)...
- ...but also true that largest enterprises large everywhere (so *absolute* size matters too)
- And highly heterogeneous within countries

Most difficult issues relate to ‘small’ businesses

The share of formal sector SMEs in employment and *GDP* is substantial...



...but their share of *tax revenue* is low

- In Africa and Middle East, for instance, largest 1 percent of taxpayers may remit over 70 percent of tax revenue...
- ...while micro/small, 80 percent of taxpayers, remit only 5-10 percent of revenue





These facts must be interpreted with care:

- Smaller companies may bear real incidence of taxes remitted by larger (e.g. VAT on inputs)—which may sometimes *benefit* them
- They reflect existing tax design decisions
- Potential revenue may be low, relative to implementation costs—though revenue should not be the only concern

Nevertheless, they suggest potential benefits from better inclusion of SMEs in tax system



TAX DESIGN FOR SMEs—WHEN IMPLEMENTATION IS COSTLESS



How persuasive are arguments for favorable tax treatment of SMEs?





Preferential tax treatment sometimes called for to address market imperfections/ equity concerns in SME sector:

- Difficulty accessing external finance
- Employment generation
- Innovation
- Self-employment as an active labor market program
- Compensating for other disadvantages
- Developing business skills





But:

- Many of these claims are open to question
- Some considerations point to preferential treatment of *larger* enterprises
- More fundamentally: Size-related tax interventions not likely to be the best response
- Important, however, to avoid tax distortions that harm SMEs



Example



To ease financing constraints for smaller enterprises:

- Set a reduced corporate tax rate? *But.*
 - This also benefits those not financially constrained
 - Start ups may have no taxable profits
 - This loses revenue or requires high marginal tax rates

- Additional/specific investment provisions? *But.*
 - Can also benefit the unconstrained and discourage growth

- Preferences at investor level? *But.*
 - Can create avoidance possibilities



Example (cont.)



Instead of distorting tax system:

- Address capital market imperfections directly
 - e.g. microfinance, development loans

- Remove tax distortions that worsen any underlying problem, by ensuring e.g. that
 - Dividend taxes do not unduly raise cost of new equity finance
 - Carry forward of losses is reasonable





TAX DESIGN FOR SMEs— WHEN COMPLIANCE AND ADMINISTRATION ARE COSTLY

*Practical concerns make differential treatment
inescapable*





Compliance and administration costs are proportionately greater for smaller firms

- but remember compliance has some benefits too
- Importance of size is as a practicable—though imperfect—indicator of implementation costs and potential revenue



Challenges—and responses—differ:



- If literacy, and access to technology/advice are good: simplify imposition of the same taxes
 - This is likely to be case for ‘medium sized’ firms
- Otherwise, may need to tax smaller firms on a different basis





Meeting these challenges requires:

- Choosing *thresholds* (generally size-based) to partition taxpayers into distinct groups for distinct treatment, and
- Determining what form of *special regime* should apply to each group, and for each ‘standard’ tax

Theorists have given this little thought—and practitioners have addressed it in many ways



Thresholds



- **VAT:** Implementation costs mean the best threshold is unlikely to be zero (though perhaps an ultimate objective)
- **Corporate income taxes:** Similar arguments
- **Personal income tax (PIT) and social contributions (SC):** Fairness requires applying same threshold to owners/employees of SMEs as to others





Special Regimes

- Are pervasive, even in higher income countries
- Range from modest simplification to presumptive taxation
- Are diverse: presumptive taxes can be:
 - Turnover (gross receipts) based
 - Cash flow (replacing the income tax)
 - Indicator-based:
 - Forfait
 - Standard assessment systems
 - Patente
 - Asset based



Special Regimes (cont)



Key considerations in choosing a special regime are that it be:

- Broadly equivalent in economic effect to the regime it replaces—with minimal further distortions
- Compatible with the compliance capacities and business practices of the target group, and with tax authorities' administrative capacity
- At an effective rate high enough not to discourage transition to the standard regime—but low enough to make informality unattractive
- Reasonably robust against opportunities for corruption/collusion
- and an open question: Should the special regime be “rebuttable?”



STRATEGY FOR DEVELOPING AND EMERGING ECONOMIES



What might be a coherent strategy for taxing smaller enterprises?





One possibility is to structure the tax regime around a reasonably high VAT threshold

The point being that those above should be able to comply with 'real' income tax, and with enough revenue at stake for it to be worth having them do so



And below the VAT threshold:



- **Micro businesses** (i.e. those unlikely to have income above PIT/SC thresholds)—exempt, or use simple patente
- **Business income tax**—Accounts-based special regime preferred, *turnover* being perhaps simplest but *cash-flow* also possible
- **VAT**—since the unregistered in any event pay VAT on imports and (some) purchases, is a replacement necessary?
- **Wage taxes and social contributions**—a tough and increasingly serious issue
 - Require those with employees to participate in standard regime



Where VAT thresholds are very low, on the other hand, an administrative strategy must focus on facilitating inclusion into the regular regime



One approach (proposed e.g. for Chile)

- Uses the tax administration to help formalize small businesses by providing accounting modules
- Employs intensive use of IT and the internet

This requires:

- A relatively advanced and credible tax administration;
- A relatively high level of technological penetration in country
- Intensive partnerships with private sector
- Adoption of simplified income tax for small enterprises





SMEs AND TAX ADMINISTRATION

*Appropriate responses should encourage
voluntary compliance*





Key challenges include:

- Large number of taxpayers
- High cost of administration
- High cost of compliance
- Informal economy
- Constantly have new SME taxpayers



Developing economies have additional challenges:

- Support available for SME's
- Strength of the banking sector
- Bartering
- Incidence of the informal economy





- Responses:
 - Risk management
 - Varied approaches to improving compliance
- Legislative framework:
 - Powers and penalties



Risk management

- Understand the context
- Identify and prioritise the risks
- Plan and implement the treatments
- Monitor and evaluate



Varied approaches to improving compliance



- Make it easy to comply and assist to comply
- Self help through use of technology
- Outreach and educational products
- Enquiry functions
- Telephone services
- Industry based approaches
- Life cycle approaches



Approaches to improving compliance



- Build up understanding and expertise
- Industry based approaches
- Issue based approaches
- Third party reporting and matching
- Prosecutions
- Visibility of the Tax Administration



Debt management

- Growth in debt
- Large number of small debt cases
- Small number of large debt cases
- Debt can grow rapidly especially GST/VAT and withholding taxes
- Need the correct mix of responses as well as specialist skills



Organisational responses



- Three models: tax-type, functional and client segment
- Good practices range along a continuum of functional and segmentation
- Recently, a few administrations in developing and emerging countries have developed integrated client-segmentation and policy reforms to better address SME compliance, building on function-based HQ and LTO models





Conclusions on administration:

- Administration challenges are significant
- Essential to have:
 - effective risk management; and
 - the right mix of strategies to improve compliance





QUESTIONS FOR THE CONFERENCE





- Should small enterprises receive preferential tax treatment?
- What general tax provisions are particularly important to SMEs?
- What have been experiences with VAT thresholds?
- And what experiences with special regimes for SMEs, and with presumptive taxes?
- How can SMEs best be brought into the formal economy?
- Is taxpayer segmentation a good model for tax administrations in dealing with SMEs?
- How can the challenges posed by the need to withhold PIT and SC from employees of smaller enterprises be met?
- Are there priorities for further research and analysis, and for follow-up to this conference?

