

International Tax Dialogue (ITD) Global Conference on Taxation of SMEs

Closing Panel

Summary themes and examples

The unifying fact running through the discussions of the last 2 days is that every country, of every size and level of economic development, is at this moment very concerned with problems in the taxation of "SMEs", and all are attempting to come up with new answers to better deal with them. Many speakers referred to the fact that this issue is being seen in the context of their wider tax reform agenda. Beyond that, little seemed to constitute universal truth, and every rule had exceptions. Several general themes emerged, however.

(1) Almost every speaker noted the importance of the SME sector. In most cases, this importance was not deemed to stem from the potential tax revenue contributions of the currently small businesses, but rather to arise from the sector's role in the economy from a variety of perspectives. In this context, it is of course critical not to lose focus on the fact that in most countries--particularly those at lower levels of development and industrialization--the vast majority of tax revenue is derived directly or indirectly through the largest businesses, and thus managing those businesses is and will remain a staple of tax administrations' duties. But speaker after speaker brought out the contributions of SMEs to economic growth; their contributions to greater income equality (I think in particular of Professor Berry's articulate statement of this point in the opening plenary session)--or, at least, to reduction of absolute poverty by job creation; and their potential to contribute to innovation--and thus, again, to faster growth. But, on this as on all other issues, there were opposing views--Professor Slemrod led off by noting that there is in fact no intrinsic lesson of economics that would point to the importance of any one size of business over another.

In general, however, it was agreed by most speakers that "formalization" of small businesses within the economy is itself extremely important, revenue aside. Partly, this comes from the belief that employment within the formal sector will be of higher quality--broadly speaking; that formalized businesses will ultimately flourish better for a variety of reasons; and that formalization is important for reasons of political economy--that inclusion itself in the processes of government contributes to the quality of the civil environment.

Granting that the sector is of particular importance to countries' economies (and perhaps social structures), one opening speaker on the high level panel, framed the basic issue of the conference very nicely. He noted that this importance does not itself resolve the fundamental question whether there should be **special tax regimes** applicable to "the sector"--**Should small enterprises be treated the same way as larger, for tax purposes; should their compliance be facilitated to a greater degree than for other businesses by the tax system and/or the tax administration; and/or, should their tax burden itself be lower, as an**

incentive for their continued existence or expansion? He concluded--and I think that the universal sense of the conference was to bear this out--that due to their **intrinsically higher compliance costs** the second of these options--compliance facilitation--is critical. [**But--another generally accepted point--was that taxation was not the only, or even the most important, obstacle to the flourishing of SMEs.**]

Another observation which I, at least, took away from the conference is the relative dearth of **hard data** to support different solutions. There is a literature, theoretical and otherwise, on the role of SMEs in economic growth--though more remains to be done there. And there is quite a bit of data on compliance costs in OECD countries, now--again, needing more work in the developing country context. However, there appears to be a quite dramatic lack of data upon which to determine what approaches work better and worse to foster formalization, tax compliance, and efficient approaches to taxing the sector. **Clearly this is an area which will bear a great deal more detailed study.**

(2) Definition of "the SME sector" proved problematic. Almost every speaker, again, noted the heterogeneity of this concept. Some countries use formal definitions which result in 98 percent of businesses being deemed "SMEs". Even within a single country, such a broad range of enterprises clearly pose quite different management issues, and cannot be addressed as a block. But there was a lack of clarity in tailoring solutions even where subcategories--micro, small and medium--were specifically defined. In fact, most speakers, regardless of the definitions posed, implicitly or explicitly referred to micro and small businesses in discussing compliance and structural responses. And in some cases, "small" is viewed as nearly interchangeable with "informal". It might perhaps have been better to title the conference "Taxation of Micro and Small Enterprises" (MSEs??). In any event, clearly there is room to ask in most cases whether we are making the appropriate, and clear, distinctions in segmentation.

(3) Structural approaches in the tax system--special regimes. Use of "special regimes" differed greatly across countries--it would be very hard to generalize on the present status of this particular issue. Some countries--ranging from OECD countries to developing countries-- (we heard in detail the example of Spain) use a complex variety of regimes based around objective parameters, depending upon sector and other factors; other speakers, noted forcefully that such regimes cause distortions, and are not actually very simple. As someone said, "Simplified systems are extremely complex."

Some countries--for example New Zealand, the US--include small businesses within the 'regular' tax regime at all levels, but frequently use differentiated **administrative** approaches to the smaller businesses (more on this below). Other speakers documented a **move toward using turnover** as a criterion for application of a different regime **and** as the basis for tax under such a regime, noting that this was likely to be most efficient and simpler. Relatedly, several speakers noted the potential of using simplified taxes based upon cash accounting for

income, rather than upon full accrual accounting normally expected from companies keeping full books of account. In this context, it was universally agreed that simplification of the regular tax system is critical in general. (An interesting point was made by Minister B-G, in the broader tax regime context, when he described Egypt's elimination of special incentives and holidays, with a huge growth of foreign direct investment following on from that.)

What taxes are at issue? Some countries--for example, Brazil; Argentina--have developed quite elaborate single simplified regimes (the SIMPLES; the Monotributo) designed to substitute for all the major taxes, including social contributions, for relatively small businesses. Others have used a tax-by-tax approach in addressing substitution for the "regular" regime. Some countries, in that context, use a **high VAT threshold**, below which businesses only pay tax designed to substitute--more or less closely--for the income tax; others, including for example New Zealand, use a low VAT threshold and the Latin American countries frequently have no threshold. Where the VAT threshold is low, the problems of addressing small taxpayers can be exacerbated; it was pointed out by at least one speaker that such a choice should in part at least depend upon the capacity of the tax administration to handle a large volume of registrants--even if the long-run goal were for greater inclusion in the system.

Importantly, many speakers noted the complex problems posed by the need to collect **social contributions** for those employed in the micro and small business sector. *Indeed, full inclusion of those workers is one of the driving rationales for formalizing such businesses.* Again, a variety of approaches were mentioned with respect to this issue--ranging from the Brazilian SIMPLES through solutions involving administrative unification of collections with wage withholding--But this is **clearly another area where more study is needed.**

(4) Administrative approaches. All the countries represented were concerned about the administrative and compliance costs of addressing the needs of small businesses--whether for the purpose of collecting revenue from them, or to try to "formalize" them within the economy. Several themes emerged here:

* *Use of IT solutions.* Many speakers led off by discussing their increasing reliance on IT solutions to reach out to, manage, and assist, small taxpayers. This cannot be a panacea, where underlying tax structures and administrative systems are not well-designed for efficiency and effectiveness. But clearly technology is being thought of--and in some cases already being used as-- an ever more valuable **tool** for the management of small taxpayers. Many Latin American countries made this point extensively--Chile, Brazil, Argentina and Mexico. But many other OECD countries did as well, to varying degrees. An interesting issue is the extent to which such solutions may go beyond basic e-filing and payment, to taxpayer services of the traditional type--provision of tax information, say--to much deeper forms of facilitation of business, such as provision of accounting modules on line, provided free of charge either directly to small businesses (the Latin solution), or in

other cases (say, the US), through leveraging the private sector and tax practitioners. Another related theme in the positive provision of services was an increasing use of *pre-populated returns*, including in a few cases for VAT, but especially for individual income taxes, across a variety of countries.

* *Use of specialized offices.* Particularly in countries with less widespread availability of technological solutions, use of segmented offices is a developing trend. This approach is being adopted, for example, in Indonesia and Egypt. In all cases, country speakers noted the need to use differentiated channels of communication even within single country context.

* *Procedural change.* This of course, together with organizational reform, lies at the heart of tax administration improvement. One example that came up a few times was the failure of developing country tax administrations to properly *de-register* small businesses that close or cease activity. Such failure leads in many cases to those individuals moving out of the formal sector and into informal activity. *Use of third party withholding* was frequently mentioned as facilitating compliance and inclusion--at least of payment of taxes.

* *Use of tax intermediaries as allies in inclusion.* In OECD and more advanced emerging economies, administrations are seeking to leverage the private sector--tax practitioners--in their assistance to and management of small businesses. In several countries, administrations have evidence that 80 to 95 percent of very small businesses do employ tax assistance. This approach appears to be, understandably, far less prevalent in developing countries. And some countries are making the alternative choice to reach out directly to taxpayers without intermediation.

* *"Attitudes" are critical.* Many speakers outlined their attempts to change the attitudes of their **tax administrations**. As one speaker colorfully put it, the model must shift from that of **predator-prey**, to something a bit more collaborative. Quite interesting were the observations of a few speakers, that it is critical to change the attitudes of the **customers** of small (cash/informal) businesses. For example, in one Scandinavian country, it has been documented that while most informal small business persons are young, low-income males; most of their cash customers are middle-aged, high income males--a target group whose attitude toward saving money through cash transactions needs to be altered. Finally, an interesting example of survey data for one country produced the **behavioral result** that approximately 2/3 of individual entrepreneurs undertook their activities because they loved that particular activity--a craft, a trade, a hobby grown larger--or because they did not like working in large enterprises as an employee. The other 1/3 on the other hand simply wished to be business persons--they were truly entrepreneurial and were focused on growing their activity into a larger business over time. These two groups of people need different administrative approaches and services --and this was just one example of how seemingly homogenous subsectors really are not homogeneous at all.

Follow-up areas

The discussions have given us all an opportunity to learn from the experience of other countries and to reflect on how this learning can be used in a national context. For each of us this is clearly the most important follow-up.

The ITD will take steps to diffuse the ideas and continue the dialogue. We will continue to maintain a dedicated part of our website for SME issues. We encourage you to send related papers, for example outlines of new initiatives, reviews, and studies we can share via this network and via the site. Each of the ITD partner organisations will add the outcomes of their on-going work in this area. We will also revise the conference background document taking into account the discussion over the last few days. We would warmly welcome your feedback on that document we can incorporate in the revision process. To further address the gap in studies in this area, we will also work with the academic community to encourage further exploration in this important topic area.

The conference gives us a starting point for discussion. We would welcome your suggestions as to how the debate can continue.