



TAXATION OF SMALL AND MEDIUM ENTERPRISES

Background paper for the International Tax Dialogue Conference*

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* The paper has been prepared by staff of the IMF, with input from staff of the other organizations participating in the ITD (the Inter-American Development Bank, OECD and World Bank). The views expressed here should not be interpreted as the official positions of any of these institutions, however, but rather are those of the individual authors. It is intended to revise this paper after the conference. Comments are welcome, and should be addressed to the ITD secretariat via email (Rebecca.BREACH@oecd.org).

Table of Contents

I. Introduction	1
II. Background	3
A. The definition and importance of SMEs	3
B. Collection and incidence: SMEs in the wider tax system	7
III. Tax design for SMEs—When Implementation Is Costless	11
A. Tax policy arguments for differential treatment of SMEs	11
B. Lessons	17
IV. Tax Design for SMEs—When Compliance and Administration are Costly	18
A. Compliance, administration and tax strategies for SMEs	19
B. Partitioning: Thresholds and presumption	22
C. Strategies for taxing small businesses in developing and emerging market countries	33
V. Tax Administration for SMEs	39
A. Issues in administering SMEs—background	40
B. Administrative Methodologies	41
C. Tax administration organizational responses	48
D. Taxpayer inclusion as a path to modernization	50
VI. Concluding Remarks and Questions for discussion	52
References	54
 Tables	
1. Characteristics of Micro, Small, and Medium Enterprises	4
2. Concentration of Tax Revenues in Largest Enterprises, Selected Countries	7
3. Reduced rates of Corporation Tax for Small Companies, Selected Countries	12
4. Special Regimes in Latin America and Sub-Saharan Africa	27
 Figures	
1. Firm Size and Employment	6
2. Firm Size and GDP Share	6
 Boxes	
1. Social Security Payments under Presumptive Systems	39
2. Typical Tax Administration Organizational Structures	49
3. Algeria Case Study	50

EXECUTIVE SUMMARY

This paper provides an overview of key issues in the taxation of small and medium sized enterprises (SMEs), as background to the International Tax Dialogue conference on the topic held in Buenos Aires, October 17-19, 2007. It draws on surveys of country practice conducted by the IMF and OECD, the detailed responses being at www.itdweb.org

These issues are both topical and difficult. Their topicality reflects a growing sensitivity to the potential importance of SMEs for innovation, employment and growth, a commitment in many countries to build on reforms focused on the taxation of larger enterprises, and an increased recognition of the need to reduce the inefficiencies and inequities created by informality. Their difficulty stems from linkages between policy and administration concerns that are closer here than in perhaps any other area of tax design, and from the relative absence of serious analytical work.

A central theme of the paper is that recognizing the diversity of SMEs is critical to sensible tax design. A key feature of the SME sector is its heterogeneity. Within any country, it may include street sellers barely at subsistence level, highly paid professionals, and substantial manufacturing enterprises; and what one country would see as a small enterprise might in another find itself in the large taxpayer unit. It is also an important regularity, however, that SMEs generally contribute far more to output and employment than they do to tax revenue. This effect may be overstated by the widespread use of larger enterprises (and imports) as withholding points—illustrating too the important point that SMEs may be powerfully affected by taxes formally incident on others—and reflects choices made in designing and enforcing the tax system. This regularity suggests, nevertheless, some degree of untapped revenue potential—and an uneven playing field—in many countries.

A critical point for tax design is that the best response to market failures that may adversely affect SME is unlikely to be through size-related tax measures. Arguments are sometimes made for preferential treatment of smaller enterprises on pure policy grounds: if they have difficulty raising external finance, for example, a reduced tax rate on retained earnings, freeing more internal finance, may seem useful. The importance of this and other possible market imperfections in impeding realization of the full potential of SMEs remains unclear. The crucial points, however, are that size itself may not be closely associated with the relevant market failure (some smaller enterprises may face no financial constraints, for example), and tax interventions will often be dominated by targeted spending measures (such as development loans). Inadvertent damage to smaller enterprises from flawed tax design should be avoided, but the case for preferential treatment is far from clear.

There are strong arguments for tax design and enforcement that facilitates widespread inclusion of SMEs in the tax net. Size does matter as a proxy for the likely magnitude of compliance and administration costs, even though its relevance for choosing the optimal tax policy in the absence of such costs is debatable. There is no doubt that these costs are proportionately high for smaller enterprises, reflecting substantial fixed components. Account also needs to be taken, however, of benefits that compliance may bring the taxpayer (with formalization perhaps easing access to finance, for example), of further benefits that may also arise from incorporating an additional taxpayer into the tax system (strengthen the incentives for other firms doing business with it to comply, and fostering norms of compliance), and, not least, to the reduction in implementation costs associated with simplification of tax design. The key point is that variations in relative implementation costs and potential revenue may call for some size-tailoring of tax design and administration in order to achieve the goal of inclusion in the tax system, recognizing the danger of overburdening tax administrations with a very large number of small taxpayers contributing a relatively small amount of revenue. In this context, the VAT threshold—which varies widely across countries—may have an important role to play.

The key challenges in this context relate to small rather than medium-sized enterprises. The latter, in most countries, can reasonably be assumed able to comply with the requirements of the VAT and hence to income tax treatment based on books of accounts. And the revenue and potential distortions at issue are likely to be large enough for it to be worthwhile requiring them to do so. Some simplification—less frequent payment of the VAT for example—may be appropriate for these medium-sized enterprises. But presumptive tax regimes (using qualitatively quite different proxies for the standard tax base) are unlikely to be appropriate except perhaps as transitional measures, to be phased out as tax administration and compliance capacity are strengthened, enabling the reach of the standard tax system to be extended. In higher income countries, in particular, the appropriate scope for presumptive rather than merely simplified taxation will often be quite limited.

The paper argues that for small enterprises in lower income economies a single simplified regime in the form of a turnover tax or cash flow income tax is likely to be the best approach. In such lower income economies, there is likely to remain for some time an important role for presumptive taxation. Current practice in structuring presumptive taxes varies widely. However, a simple turnover or cash flow based income tax, resting on relatively simple accounting requirements, is likely to be preferable to indicator-based systems (along the lines of the classic French *forfait* or Israeli *takschiv*). These latter are not simple, and provide no path towards compliance with the standard tax system that should be the ultimate objective. Whether it is appropriate to impose on smaller enterprises some replacement for the VAT (perhaps a turnover tax) in addition to the income tax is less clear, largely because traders below the VAT threshold will nevertheless be affected by VAT charged on their purchases from VAT-registered firms and their imports.

Fundamental challenges for taxing smaller enterprises arise from the need to withhold payroll taxes and social contributions from employees. Simplification in this area is far from easy and may not be advisable, given the (increasing) importance of social insurance schemes for which some record of individual-level contributions is necessary.

In administrative terms too, it is small rather than medium-sized enterprises that pose the main challenges. Fostering voluntary compliance and self-assessment is as key for strengthening the taxation of smaller enterprises as it is for all others, with a number of countries developing innovative approaches to the distinct challenges they pose, including by fostering the use of information technology. Organizational responses may also be appropriate, including in the form of special offices for smaller taxpayers.

The paper concludes by extracting from the review a series of central questions for discussion at the conference:

Questions regarding the nature and role of SMEs:

- Are there any reasons, other than practical, why smaller enterprises should be taxed any differently from larger?
- How can SMEs best be brought into the formal economy? Are there any encouraging country experiences on this?
- To what extent should the tax treatment of SMEs seek the improvement of business practices as an objective in itself?

Questions regarding tax policy toward SMEs:

- What general tax provisions are particularly important to SMEs, and why do we observe considerable variation in their design?
- What have been countries' experiences in relying on special tax provisions for SMEs (whether at enterprise or investor level), in terms, for instance, of addressing perceived financing difficulties of SMEs and encouraging participation in the formal sector?
- What has been the experience with alternative forms of presumptive taxation? Can a 'single tax' work for SMEs?
- What has been the experience of countries in the use of thresholds for the VAT?
- What are the implications for the proper tax treatment of SMEs, if any, of the increasing use of offshore tax-planning by large corporations to lower their effective tax rate on investment?

Questions regarding compliance and administration for SMEs:

- What is the nature and extent of SME tax non-compliance in various types of economies? What lessons may be drawn from the differences, if any?
- Is taxpayer segmentation appropriate as an organizational model for tax administrations in dealing with SMEs? To what degree should the SME sector be further disaggregated by size in managing their tax compliance?
- What specific administrative methodologies have to date proven most effective in improving SME compliance?
- What challenges are posed by the need to withhold payroll taxes and social contributions from employees of smaller enterprises, and how can they be met?

Directions for future inquiry:

- What are the priority areas for further research and analysis, and for possible follow-up to this conference?

I. INTRODUCTION

The purpose of this paper is to set out, as background for the International Tax Dialogue conference of October 2007, key issues in the tax treatment of small- and medium-sized enterprises (SMEs). It draws on country surveys conducted by the IMF and OECD, but focuses on issues rather than description: the survey responses themselves can be found in the conference area of the ITD website, at www.itdweb.org.

The taxation of SMEs has come to attract increasing attention in recent years, in developed and developing countries alike. This reflects a range of considerations.

First, it is the natural next step after a strong focus in the last fifteen years or so, across industrialized, emerging and developing countries, on ‘large taxpayers’ as a separate group (Baer et al, 2003). This focus has a clear rationale in concentrating effort (of the taxpayer as well as the tax administration) where the revenue yield is greatest: moreover, in lower income countries in particular, the large taxpayer segment has frequently served as a focus for beginning overall revenue administration modernization. While this calculus remains valid, awareness of the dangers of inadequate attention to the taxation of SMEs has grown. It can lead, for example, to distortions of competition as a result of uneven tax enforcement, with incentives created to limit growth and to avoid tax through artificial splitting of enterprises. Not least, voluntary compliance by larger enterprises themselves, and by wage earners, may be undermined by the (correct) perception that their smaller counterparts, or better-off neighbors, are getting away with poorer compliance.

The increased focus on SMEs also reflects a growing emphasis on their potentially critical role in fostering innovation, employment and growth, not least in the service sector that is increasingly important in both developed and developing countries. Privatization and deregulation have spurred the development of the SME sector, most spectacularly in countries transitioning towards market economies: the number of small businesses in Russia nearly tripled between 1991 and 1994 (Engelschalk, 2004), for example, while the number of private SMEs recorded in China rose from zero in the early 1980s to around 40 million now (Hall, 2007). Their potential economic significance and vitality lends an importance to the tax treatment of SMEs that is potentially far greater than their contribution to revenue alone could warrant.

Not least, especially—though by no means only—in developing countries, the close link between informality (or the ‘gray’ or ‘hidden’ economy) and enterprise size, together with increasing concern with the distortions and inequities associated with a large (and perhaps

growing¹) informal sector, has led to greater focus on the tax treatment of SMEs as a key element in countering, or at least not aggravating, informality.

While there is considerable similarity in the broad concerns that countries bring to the taxation of SMEs, there are also very considerable differences both within the SME sector in any country—ranging from a single individual engaged in a part-time profit-making activity, to quite major corporations with several hundred employees—and across countries. The latter is perhaps especially marked: a ‘medium’ sized enterprise in an industrialized country might well be one of the largest businesses in a small, developing country; and while even the smallest enterprise in a developed economy can be presumed to have basic skills of numeracy and literacy, this may not be the case in low income countries.

Given such a wide variation in country circumstances, there can clearly be no single ‘best’ approach to the taxation of SMEs, applicable in all circumstances, and indeed practice in this area varies widely even across countries at roughly similar stages of development. The same point applies to many aspects of SME analysis: “It has...become something of a truism that the SME sector is so heterogeneous that little of universal value can be said of it” (Dannreuther, 2007). Greater segmentation is thus required in both analysis and practice. In much of this paper, the focus is on small, and micro, enterprises, which typically pose the greatest challenges to tax compliance and administration—rather than on medium-sized businesses, which, while smaller than the largest enterprises, should nonetheless be expected to comply with the regular tax regime even in developing countries.

The task of constructing tax regimes for SMEs is an inherently difficult one, mixing policy and administration considerations more intimately than perhaps any other aspect of tax design. There is as yet relatively little cross-country experience with generalized approaches to SME taxation, including on the part of multilateral agencies such as the ITD partner organizations. At a more academic level too, while there is a sizable literature on the challenges faced in designing tax regimes for SMEs, these have received far less analytical attention than many other aspects of tax design. And while tax systems have dealt with SMEs, in some way, for many years, they have rarely taken center stage in the discussion of tax policy and administration.

All this—the topicality, diversity, difficulty, and analytical novelties of the issue—make the taxation of SMEs an area with evident scope for fresh thinking and experience sharing. This paper, in setting out some of the key economic and practical concerns, and central features of current practice, is intended to set the scene for such discussion. It starts by considering what is meant by an SME, and sets out some stylized facts on this sector to guide the later discussion. Section III then focuses on pure policy issues, by considering how SMEs should be taxed if implementation were costless. The real difficulties are raised, however, precisely

¹ Schneider (2000 and 2002) reports evidence that informality has been growing, in most transition and all investigated OECD countries over the last decade; time series estimates are rarer for developing countries.

by costs of compliance (incurred by taxpayers) and of administration (incurred by the authorities); the design issues that these raise are taken up in Section IV, which suggests for consideration a possible generalized scheme based upon this analysis. Administrative issues are the focus of Section V. Section VI concludes, and provides some questions for discussion.

II. BACKGROUND

This section aims to provide some basic stylized facts to inform the subsequent discussion, on the nature of SMEs and their significance in both the wider economy (a more complete account being in Berry (2007)) and the tax system.

A. The definition and importance of SMEs

There are various criteria of size that might be used to define an SME (turnover, number of employees, capital base, profits, extent of imports and exports...), and various definitions have indeed been developed for application in a range of countries.²

For the purposes of this paper, however, no single definition is appropriate.³ For whether a particular enterprise appears for tax purposes to be large, medium or small differs very widely across countries, depending on their degree of development and the general scale of economic activity.⁴ A firm with turnover of less than EUR 10 million is categorized as ‘small’ in the European Union, for example, but in many developing countries would be

² The World Bank and the European Commission, for instance, define:

	World Bank (2004)	EU (Commission Recommendation 2003/361/EC)
Micro	10 or fewer employees, assets no more than USD100,000	10 or fewer employees and balance sheet total of no more than EUR 2m
Small	10 to 50 employees, turnover and assets between US\$100, 000 and US\$ 3 million	10 to 50 employees, and annual turnover and/or balance sheet total of less than EUR 10m
Medium	50 to 300 employees; turnover and assets between US\$3 to 15 million.	20-250 employees and turnover and/or annual balance sheet of EUR 10-50m

³ In Section IV.C, an implicit, practical, definition emerges, in which ‘small’ businesses are those with turnover below the VAT threshold, and ‘medium’ businesses are those above it but not eligible for inclusion among the largest taxpayers (those administered by an LTU).

⁴ Even within countries, differing definitions may be adopted for tax and other purposes (such as lending by development banks). Analysis of trends is also complicated by a tendency for definitions to change over time: that of the European Union has changed three times in the last fifteen years, and that in China four times since the 1950s.

included in the large taxpayer unit. There is thus some degree of relativism in the relevant notion of size for purposes of tax design: as noted by OECD (2004), “[t]he characteristics of a SME reflect not only the economic, but also the cultural and social dimensions of a country. Not surprisingly, very different patterns are used across countries and over time.” There is also, however, an inescapable absolute component to the notion of firm size: the very largest enterprises are large by the standards of any country, and the smallest—the street traders in developing countries, with income approximating some level of absolute poverty are also small everywhere. Indeed it will be helpful to refer to this latter group as a distinct category of *micro* enterprise.⁵

While there is thus no single definition of SMEs suitable for all countries and for all tax-related purposes, there is nevertheless some commonality of meaning that underlies much of the discussion in this area. In this spirit, Table 1 provides a sense of how these size classifications are used in this paper.

Table 1: Characteristics of Micro, Small, and Medium Enterprises

CHARACTERISTICS	MICRO	SMALL	MEDIUM
<i>Number of taxpayers</i>	Very numerous	Many	Moderate
<i>Type of taxpayers</i>	Individuals (small traders or non-specialized service providers); family-owned businesses.	Family-owned business with some employees; highly specialized self-employers	Legal entities with several employees; partnerships
<i>Ownership Structure</i>	Owner, employee(s) and manager are one and the same	Owner(s) are generally the manager	Owner is usually different from managers
<i>Type of transactions</i>	Mainly cash; high informality	Cash/bank; some informality	Bank; much more formal
<i>Place of business</i>	Frequently non-fixed	Fixed (but may be volatile)	Fixed
<i>Business administration</i>	Non-professional (family-run)	Some professional assistance	Regular professional advice
<i>Accounting Standards</i>	No or few records; very limited understanding	Some records, limited to partial compliance; limited understanding	Partial to good compliance and record-keeping
<i>Market reach</i>	Local	Local/Regional	National/International

⁵ Usage of the term in this paper thus differs from that in the World Bank and European Commission schemes in the earlier footnote.

<i>Life-span of business</i>	Very dynamic; rapid creation and dissolution	Dynamic; may disappear, stay small or grow	More stable (consolidated) business activities
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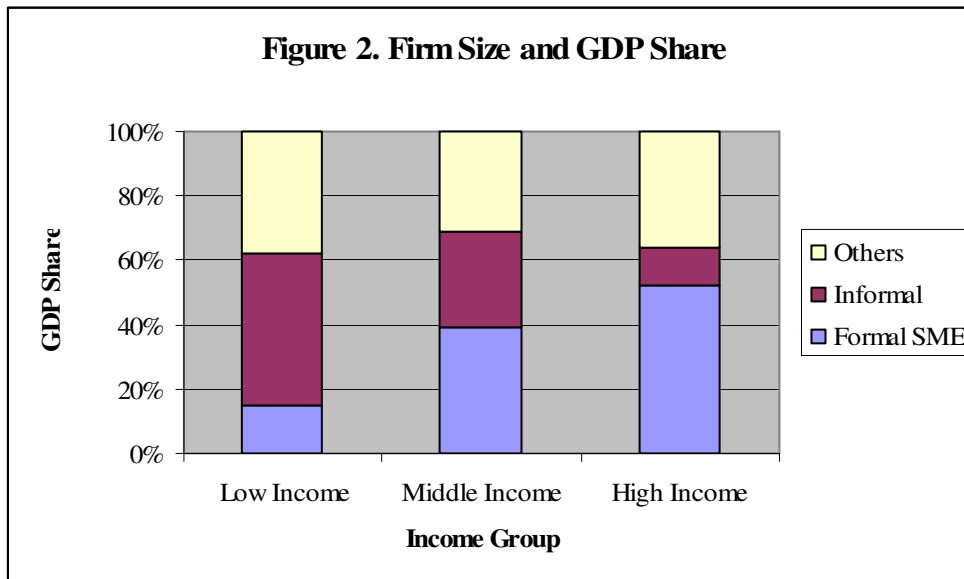
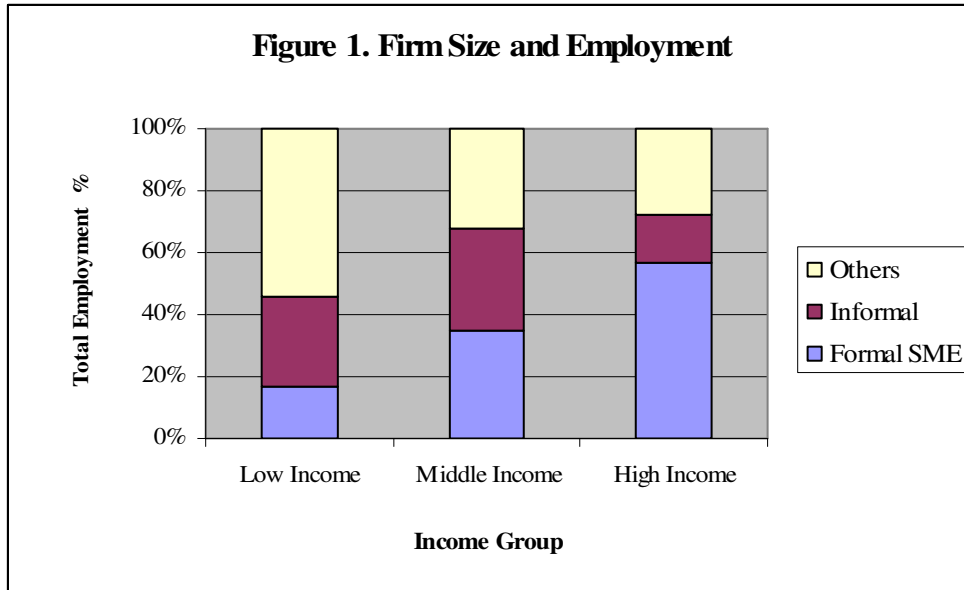
Source: IMF staff

Perhaps even more important is the substantial heterogeneity of SMEs within any country. They are likely to vary substantially in size itself, of course, from the small retail outlet to the substantial manufacturing enterprise. They are also likely to vary widely in their organizational form, which will typically include, for instance, sole proprietorships (with or without employees), small corporations (public or private), professionals, and partnerships. These latter differences may in turn carry differing obligations for record-keeping that affect the costs to the enterprises of complying with (and to the revenue authorities of administering) alternative possible tax obligations. Public corporations, for example, commonly have stronger accounting requirements than do sole proprietorships, and enterprises with employees may be subject to the full panoply of requirements associated with withholding labor income taxes and social contributions.

Internationally comparable data on the extent of economic activity conducted through SMEs are scarce. What is clear is that a large majority of enterprises, in both developed and developing countries, are SMEs. Over 95 percent of businesses in the OECD fall into this category, and they account for about two-thirds of total private employment (OECD, 2005a). Beyond this, Figures 1 and 2 provide an indication of their relative importance in countries at different income levels. These figures conceal significant variation in the importance of SMEs across countries at broadly similar income levels.⁶ Nevertheless, it emerges clearly that both the output and employment shares of formal sector SMEs increase with the general level of development (though Berry (2007) argues that this regularity may be weakening, in part because of the decline of large scale manufacturing enterprises in higher income countries).

The figures also show the important and well-known regularity that informality decreases as per capita income increases: Schneider (2003), for example, estimates the shadow economy at 18 percent of GNP, on average, for Western Europe but 41 percent, on average, in both South America and Africa. Importantly, Figure 2 suggests that in terms of GDP these two effects are largely offsetting, in that the combined share of the formal SME sector and the informal sector is broadly the same at all income levels, at around 60-70 percent of GDP. This is consistent with (though not in itself proof of) the presumption that in developing countries, informality is largely associated with smaller enterprises.

⁶As defined, respectively, by the World Bank and the EU (see footnote 3 above), SMEs account for around 70 (40) percent of employment in the EU-19, for example, compared to 50 (22) percent in the U.S. (Dannreuther, 2007).



Source: Ayyagari, M., T. Beck and A. Demirguc-Kunt (2003). This aggregates across a range of prior studies, augmented by estimates of informality.

B. Collection and incidence: SMEs in the wider tax system

Firm size and patterns of tax payment

An especially important aspect of the SME sector for purposes of this conference is that they account for a much smaller share of all tax revenues than they do of GDP or employment, and this is so in both developed and developing economies. This is the converse of the well-known empirical regularity that potential tax payments are typically very heavily concentrated in a relatively small number of enterprises.⁷ For example, typical distributions of revenue by firm size for African and Mid-Eastern countries would be: (1) for the largest—less than 1 percent of taxpayers and over 70 percent of revenues; (2) for the medium-sized—10-20 percent of taxpayers and 20-25 percent of revenues; and (3) for the small and micro enterprises—80-90 percent of taxpayers and 5-10 percent of revenues. Table 2 provides some examples from countries in various regions and development levels.

Table 2: Concentration of Tax Revenues in Largest Enterprises, Selected Countries

Country	Percent of taxpayers	Percent of tax revenues
Brazil	0.35	80.0
Argentina	0.1	49.0
Benin	1.0	90.0
Bulgaria	0.1	51.4
Kenya	0.4	61.0
Spain	0.1	40.2

Source: IMF staff compilation.

This stylized fact—heavy concentration of revenues in relatively few firms—needs, however, to be interpreted with caution:

One reason for this is that larger enterprises are to some degree used as withholding agents, so that part of the tax recorded as paid by them is intended as prepayment by smaller enterprises. As stressed by Slemrod (2007), it is, after all, a long-established principle of effective tax administration to collect tax at a few key nodes in the wider system—which often, and especially in developing countries, means larger enterprises and border points. For

⁷ There is some evidence that the distribution of firm size is even more unequal in lower income countries than in higher—reflecting a ‘missing middle’ in the former—with a greater concentration of potential tax payments among larger enterprises and smaller enterprises accounting for a larger share of output and employment (see for example Tybout, 2000).

example, many lower income countries, especially in Francophone Africa and South America, require large enterprises to withhold VAT and/or income tax in respect of their purchases from smaller firms (this tax then being creditable against those smaller firms' own liability). In one Francophone country for which data are available, taxes withheld in this way have been in the order of 8 percent of all profit tax revenue. Many lower income countries also make extensive use of withholding (against income tax) on imports.⁸

A second reason for caution is that the real economic burden of taxes remitted by larger enterprises may not be borne by them but rather passed on to (or through) SMEs. More generally, SMEs may well be powerfully affected by taxes that are the formal responsibility of, and remitted by, others: in this area of tax analysis as in others, what matters is the real incidence of the tax system—a point returned to below.

Despite the previous qualifications, that SMEs account for a far smaller share of tax payments than they do of GDP is certainly suggestive of relatively low effective tax rates on SMEs (at least for the sector as whole, though not necessarily for individual enterprises). This may, of course, reflect policy choices, since the distribution of tax payments itself reflects decisions made in designing and enforcing the tax system (both directly on tax remittances and indirectly, as discussed below, though effects on the underlying size distribution of firms).

Importantly, however, there is some evidence (at least for developing countries) that effective tax rates do not necessarily increase with firm size. Instead, studies for both Cameroon and Uganda—based on surveys that provide an unusual (if no doubt imperfect) ability to identify those evading tax—find an inverse-U shaped relationship (on average) between firm size and effective tax rates (Gauthier and Gersovitz, 1997; Gauthier and Reinikka, 2006). Smaller firms, it seems, reduce their tax payments by evasion and informality. Large firms, on the other hand, reduce them by securing legal exemptions (with corporate income tax (CIT) holidays or reduced rates, for example, on investments above some absolute amount);⁹ they may also have more access to tax-planning devices. The striking implication is that it is thus firms in the middle of the size distribution that pay the highest average tax rate.¹⁰

⁸ See for example Table 1 of Keen (2007).

⁹ Sri Lanka, for example, offers tax holiday schemes that increase in generosity with the size of the investment.

¹⁰ Implicit tax payments in the form of bribes may also follow this hump-shaped pattern: those with relatively low incomes have relatively little tax to evade and relatively little to be extorted from them, while those with relatively high incomes are less vulnerable to extortion from tax collectors in that they can more easily afford access to such appeals process as is available (Hindriks, Keen and Muthoo, 1999).

Tax incidence and SMEs

As stressed above, assessing the impact of the tax system on SMEs is not simply a matter of looking at statutory tax provisions. Allowance must be made for the impact of (and on) informality, and—still more fundamentally—difficult questions faced concerning the effective incidence of taxes formally imposed on other enterprises. For example:

- A small enterprise not required to register for the VAT may still be powerfully affected by the tax—and may even benefit from it. Even in the absence of VAT withholding of the kind described above, such a firm will bear unrecovered VAT on inputs that it purchases from VAT-registered firms or imports. If it cannot pass this unrecovered tax along to the buyer in the price at which it sells its product (perhaps because the demand for its product is highly elastic), the real burden of the tax must be borne by the owners or employees of the enterprise.¹¹ If, however, a VAT exempt firm is able to sell its product at the same price to final consumers as do enterprises liable to the VAT, then it is able to keep for itself as profit what VAT-registered companies must pay as tax on their value added. In this case, the VAT acts as subsidy to exempt firms.
- Calculated marginal effective tax rates (METRs)—indicating how the tax system affects incentives to invest—are built on some assumption as to the required after-tax rate of return to the final investor. For large enterprises, the conventional assumption is that finance is obtained on a world capital market, so that, for a small country, the required return can be taken as independent of its own tax policy: the burden of the tax cannot then be borne by capital, but rather the distortion of investment it implies will be felt in reduced payments to other less mobile factors. Moreover, since the marginal shareholder can then be taken to be non-resident, the METR is independent of personal tax rates in the country in which the investment is located. For SMEs, however, a more plausible assumption may be of domestic financing: in which case some of the real burden may be passed on in the form of a reduced after-tax return to investors, with a consequently diminished impact on investment; and, moreover, an important role may be played by personal tax parameters.
- For larger enterprises, attention often focuses as much on average effective tax rates (AETRs) as on METRs: to the extent that their earnings are independent of their location, they will tend to locate wherever the AETR is lowest. Smaller companies may have fewer such options, making the AETR less relevant. By the same token, simple changes in the statutory CIT rate may have less impact on the behavior of SMEs than on larger enterprises, with the latter more able to respond by using

¹¹ Or if the firm sells mainly to VAT registered firms then it has an incentive (compliance costs aside) to register voluntarily for the VAT.

transfer pricing and financial devices to shift taxable profit to lower-taxed jurisdictions.

One important dimension of incidence is the impact of the tax system on the size of the SME sector, and on the extent of informality. A heavy enforcement focus on larger enterprises, for example, may induce some enterprises to limit their size so as to remain below the threshold test for inclusion in any large taxpayer unit (LTU). Other discontinuities in tax treatment at particular size levels may have similar effects. For example, enterprises may choose to restrict their growth—or to artificially split their operations—in order to avoid a jump in their tax liability when they cross the VAT threshold.¹² Even in the absence of such threshold effects, tax structures may themselves systematically (even if unintentionally) affect the distribution of firm size. Perhaps most important, the choice between operating as an employee within a larger enterprise or as a self-employed entrepreneur—perhaps even performing the same tasks as contractor rather than employee—may be sensitive to a range of tax considerations (not only statutory tax provisions regarding the treatment of labor and capital income—including any tax privileges for forms of saving other than investment in ones own enterprise—but also opportunities for avoidance and relative compliance costs).¹³ Commodity taxation may also affect the distribution of firm size: ad valorem excises may tend to reduce the number of active firms, for instance (one of its effects being akin to an increase in the fixed costs that firms must cover in order to break even); specific taxation, in contrast, may tend to reduce industrial concentration (by in effect narrowing cost differentials across heterogeneous firms).¹⁴

Policy thus needs to be set bearing in mind the endogeneity of the size distribution of enterprises. In some cases, it should be noted, this may point to less favorable policy towards SMEs. The ease of collecting taxes from a relatively small number of large firms, for example, may give the authorities an incentive to facilitate such concentration by making it harder for smaller enterprises to do business (including perhaps by non-tax measures), a point developed by Auriol and Warlters (2005).

¹² Some countries adopt devices to avoid jumps in VAT liability.

¹³ Taxation may also powerfully affect the incorporation decision (as recently argued for the EU by de Mooij and Nicodème, 2006). This dimensions of effects is not considered here, however, since the decision made does not in itself affect the size of the enterprise. It remains true, of course, that a disproportionate number of small and micro enterprises tend to be unincorporated, so that tax measures that benefit the corporate form (such as a reduction in the effective rate of tax on dividends) tend to raise the tax payments of SMEs relative to those of other enterprises. For brevity, however, attention is confined throughout the paper, so far as possible, to measures that themselves are directly contingent on (not simply correlated with) some notion of size.

¹⁴ On this aspect of ad valorem taxation, see, for instance, Delipalla and Keen (1992). The claim on specific taxation, more precisely, is that a uniform specific tax reduces the Herfindahl index of concentration in homogeneous product Cournot oligopoly when firms are characterized by exogenous differences in marginal cost (and fixed costs are zero).

III. TAX DESIGN FOR SMEs—WHEN IMPLEMENTATION IS COSTLESS

It is useful to begin thinking about tax design for SMEs by imagining first that there are no costs to enterprises of complying with tax rules and none to the tax authorities in administering them. In the absence of such costs of compliance and administration—the two together being referred to in this paper as implementation costs—would there be any reason to tax SMEs any differently from larger enterprises?¹⁵

A. Tax policy arguments for differential treatment of SMEs

A first step in answering this is to understand the distribution of firm size itself: why is it so invariably the case that this is characterized by a relatively large number of small firms? This remains less than fully understood.¹⁶ Textbook explanations begin with Gibrat's law, which shows a skewed distribution of this kind to be the long-run outcome if the rate of firm growth is a random variable independent of initial size:¹⁷ this does not, however, appear to be the case (Sutton, 1997). More compelling approaches to the question draw attention to other possible characteristics of small firms that some may feel to warrant special tax treatment.

Financing constraints

Recent models of the size distribution stress the possibility that imperfections in capital markets may make it especially difficult for small firms to access debt or equity finance (Cabral and Mata (2003), Gill (2005)). This would then make them more reliant on retained earnings as a source of finance—which, for start ups in particular, may well be limited.

It is possible, it should be noted, that such imperfections could lead to the opposite outcome—that is, the theory also points to possibilities of over- rather than under-investment.¹⁸ Moreover, such as evidence as—such as that for Africa reviewed in Bigsten and Söderbom (2006)—does not always suggest that access to finance is a primary obstacle for the growth of small firms. And to the extent that these credit market constraints take the form of interest charges higher than are socially optimal, the deductibility of interest payments means that the tax system directly subsidizes part of these costs. Nevertheless, the

¹⁵ For further discussion of the issues addressed in this section, see, for instance, Holtz-Eakin (1995), Jouten (2007) and Slemrod (2007).

¹⁶ Some suggested answers to this question are non-economic in nature: there may simply be many people who prefer to work for themselves rather than within a larger organization.

¹⁷ More precisely, the proposition is that if the distribution of firms' growth rates is normal and independent of initial size, then the limiting distribution of firm size is lognormal.

¹⁸ Though underinvestment results have attracted particular interest, simple models of asymmetric information in financial markets can quite easily generate over-investment: see for example Boadway and Keen (2006).

perception of market failure in this area underlies, if only implicitly, a range of tax measures intended to ease any such financing constraint:

- A reduced rate of CIT might be charged on smaller companies (defined for example by turnover or capital level) or on lower levels of taxable profit, so increasing the internal finance available to them. Such measures are fairly common—a sample being in Table 3—though by no means universal (Australia, Austria, and New Zealand, for example, do not vary the corporate tax rate by size).
- Additional or specific investment allowances may be provided for SMEs (as is done, for example, in Canada, Japan, Poland, the United Kingdom, and the United States).
- Tax preferences for investment in SMEs may be given not at the level of the enterprise but at that of the investor, for example by providing favorable capital gains treatment for venture capitalists (exempted from capital gains tax on eligible venture investments in Australia, for example, and given a 50 percent deduction in the U.S.).

Table 3: Reduced rates of Corporation Tax for Small Companies, Selected Countries

Country	CIT Rates
Belgium	Standard rate: 33.39 percent, below a threshold: progressive 24.98, 31.93; 35, and 53 percent
Costa Rica	Standard rate: 30 percent; below a turnover threshold: progressive 10, 20, and 30 percent.
Indonesia	Progressive rates of: 10, 20 and 30 percent
Japan	Standard rate: 30 percent; below a certain capital threshold, progressive: 22 and 30 percent
Korea	Progressive rates: 13 and 15 percent
South Africa	Standard rate: 29 percent; below a turnover threshold: progressive 0, 10 and 29 percent
Spain	Standard rate: 32.5%; reduced rates depending on type of business or entity: 0, 1 10 20, 25 and 30 percent
United States	Progressive rates up to an income threshold: 15, 25, 34, 39, 34, 35, and 38 percent; If income is above threshold: flat 35 percent on all

Source: IMF staff compilation from published sources.

The difficulties with the first of these measures—a reduced rate of corporation tax for smaller enterprises—illustrate some of the potential difficulties that all are liable to face.¹⁹ First, it is poorly targeted: many SMEs may simply be unconstrained in their financing, so that a tax reduction for smaller firms foregoes revenue with little beneficial effect. Measures to reduce investment costs (such as the first year allowances for SME investment in plant and machinery provided in the U.K.) may be more closely targeted on enterprises with genuine growth prospects—but again much of the benefit may go to companies not facing significant financing constraints and, moreover, enterprises (not least in the service sector) using little physical capital will receive correspondingly little advantage. Second, either the reduced rate or special investment incentives for SMEs can actually create *disincentives* to growth: attempting to focus the benefit of a reduced CIT rate more sharply on smaller enterprises by clawing it back from larger, for instance, requires over some range a marginal rate that is above the higher ‘standard’ corporate tax rate. The METR is then likely to have the same inverse-U shaped as noted earlier has been observed for average effective rates in some developing countries. Third, since start ups are likely to be loss making in their early years of operation, a reduced tax liability provides them only limited benefit: although the losses can be carried forward, they generally do not attract interest and are unlikely to be acceptable as collateral for loans. (The same objection applies a fortiori, of course, to the tax holidays that some countries have offered to start ups). Providing the incentive at the level of the final investor can be a way to avoid this difficulty, but runs into yet a fourth difficulty: such schemes can become vehicles for tax avoidance, by companies artificially splitting²⁰ (or engaging in arbitrage activities) to exploit the progressivity of the tax system, or shifting taxable income towards enterprises subject to the lower marginal rate.

All these difficulties reflect a more general problem with the use of tax measures to overcome perceived market failures in relation to SMEs. As a general principle, the best response to a distortion is to act directly on the distortion itself.²¹ If capital market imperfections are a genuine concern, the wisest policy response is generally to act on that imperfection directly—perhaps, for example, by offering subsidized loans, grants and guarantees to such firms (and many countries do indeed operate such schemes, such as Canada, Japan, New Zealand, Spain, and United States; several developing countries also offer similar schemes, as shown in the IMF survey, including Algeria, Argentina, Brazil, Peru, and Trinidad and Tobago). The availability of alternative spending measures may vary across countries, however, and would be expected to be systematically greater in more developed countries—so that the case for special tax measures there is likely to be especially weak.

¹⁹ The difficulties discussed here are domestic ones; measures targeted at SMEs may also raise issues of international tax competition and coordination.

²⁰ Goolsbee (2004) shows that companies do separate to exploit the progressivity of the U.S. income tax.

²¹ Second best considerations mean that this principle is not a formal proposition, but a useful guide for policy given the difficulties and risks in identifying more finely-tuned corrective policies.

While the argument for active tax measures to mitigate capital market imperfections may be weak, measures that tend to create or amplify such distortions need to be avoided. In particular, incomplete integration between corporate and personal taxation may exacerbate any difficulty in obtaining external equity finance by in itself tending raising the cost of new equity finance.²² In this case action—reducing the additional tax on dividends—may be warranted not as a form of preferential treatment for start ups but rather as eliminating a distortion that happens to be especially damaging for them.

Employment, innovation and risk-taking

It is sometimes argued that small businesses play a particularly important role in employment generation, and in developing new ideas. To the extent that these generate significant positive externalities, the implication is that relatively favorable tax treatment is appropriate.

Simple correlations between net employment growth and firm size do often show an apparently strong employment effect of small companies. But regressions of this kind on starting size are biased by the tendency of small firms to be temporarily small, and hence to grow, and of large firms to be temporarily large and hence to contract. Controlling for this, Davis, Haltiwanger and Schuh (1993) report no statistically significant effect of firm size on employment growth. Similarly, Biggs and Shah (1998) find that in Sub-Saharan Africa, large firms were the dominant job creators in the manufacturing sector. As argued by de Rugy (2005), the common focus in popular discussion on the share of net job creation by smaller enterprises in economy-wide net job creation can also be misleading: this share can be more than 100 percent, for example²³ (and this can be so even if gross job creation is much larger in larger enterprises).

On the other hand, the World Bank has highlighted that in rural areas of some developing countries, small enterprises provide the only realistic employment opportunities. Similarly, the OECD (2005b) concludes that encouraging entrepreneurship is an effective means of job creation and poverty alleviation.

²² The (no longer so) ‘new view’ of dividend taxation stresses that taxing dividends at an unchanging rate does not affect the cost of retention finance—equity already in the firm is ‘trapped,’ in that the dividend tax must be paid either today (if profits are not retained) or in the future (if they are), and so do not affect value-maximizing decisions. Subscribing to new equity, however, means putting money into this trap, and so is discouraged by the taxation of dividends.

²³ De Rugy gives an example in which a small firms increase their net employment by 50 while of two larger companies one hires 2000 people and the other sheds 2000: the small firm accounts for 100 percent of net job creation, but only 2.4 percent of gross job creation. The point here is largely one of presentation: it is perfectly correct to say that ‘without’ the increased employment in small firms there would have been no increase in aggregate employment; but is also true that smaller enterprises made only a negligible contribution to the (over) replacement of jobs lost. The point, in any event, is not merely theoretical: on the net measure, for example, physician offices accounted for 174 percent of non-farm job creation in the U.S. between 2000 and 2001.

The suggestion that SMEs are particularly innovative, thus leading to higher individual firm and aggregate economic growth, is also not fully supported by econometric evidence. Though it is tempting to think of spectacular success stories—the big company that started as a small garage operation somewhere in the unspectacular suburbs of some city—not all companies follow the same growth patterns. There are firms that start small and stay small for generations; and there are others that are necessarily large-scale operations on pure economies of scale grounds. Empirical evidence seems to support this. Pagano and Schivardi (2003) show that for a sample of European firms, *larger* firm size is associated with faster innovation. Beck, Demirguc-Kunt and Levine (2005) do not find empirical support for a causal impact of the prevalence of SMEs on growth, using data from 45 countries. Some studies do though find that small firms may play a key role in diffusing new ideas and technology (Aps, Morck and Yeung (1999); Tether (1999)).

In any case, neither argument—employment creation or innovation—is persuasive as a basis for special *tax* treatment of SMEs. In each case, the same general principles as discussed above apply: better targeted instruments may well be available—public support for R&D, for example, and earned income tax credits to encourage employment, especially of the low paid. Even if there is no purposive role for tax policy in correcting market failures, however, care needs to be taken in setting tax policy to avoid unintended harm (by ensuring, for example, that risk-taking is not unduly discouraged by inadequate provision for loss carry forward).

Distributional considerations

Equity arguments arise in both developed and developing countries. Since businesses are not people, however, their impact on welfare comes only insofar as their owners or employees benefit from their activities. It is thus not clear from first principles, for example, whether large businesses employing unskilled labor at reasonable wages have any greater or lesser welfare impact than do small family-owned enterprises or subsistence self-employment. In the case of developing countries, the opportunity to create micro-businesses is often seen as an important route out of poverty, particularly for women. It is also important to remember, however, that the ‘self-employed’ often includes such people as high-earning attorneys and doctors, not obviously more deserving of support than are low wage employees. Whether SMEs help alleviate poverty or decrease income inequality appears to remain an open question: Berry (2007) argues that experience shows that a strong SME sector can be associated with relatively low inequality, for example, whereas Beck, Demirguc-Kunt and Levine (2005) find no evidence to that effect.

It may be that in some contexts small firms are created by those with few if any alternative employment prospects, and so might be seen as a form of active labor market program (to develop job skills and prevent the erosion of labor market attachment) and so warranting support comparable to that provided to such schemes. It might also be argued that small businesses form part of the foundation of local communities, contributing to social cohesion, as well as allowing the development of skills for the disadvantaged. Even if true, however,

this function may, again, be better provided through training and other services rather than by favorable tax treatment.

Inefficiency

One of the simplest ways to explain the co-existence in a single market of firms differing in size—and certainly one of the easiest ways for economists to model it—is by supposing the smaller of them to be less efficient, but able to survive because imperfections of competition sustain an equilibrium price in excess of their average production costs.²⁴ This does not mean that SMEs serve no socially useful purpose: depending upon the structure of the particular market, their continued existence may discipline abusive pricing by larger ones. It raises the possibility, nevertheless, that it may be optimal to impose systematically heavier taxes²⁵ on small firms than on large in order to shift production to more efficient firms (Lahiri and Ono, 1988). In a standard model of Cournot competition, Gersovitz (2005) shows that this will indeed be the case if the marginal cost of public funds (MCPF)—loosely speaking, the marginal social value of tax revenue—is not too high (specifically, is less than 2). At higher levels of the MCPF, however, it is optimal to tax larger firms more heavily than small: intuitively, the concern to use the tax system to raise revenue by soaking up rents is then greater, and these rents are concentrated in the larger (more efficient) firms. Again, then, the optimal tax policy toward SMEs from an efficiency standpoint is ambiguous.

Compensating for other disadvantages

It may seem tempting to offer special treatment to smaller enterprises to offset other cost disadvantages they may face. Apart from disadvantages related to size itself, which are sources of inefficiency of the type just described, these can be of broadly two types. There are those associated with complying with the tax system itself: the implications of these are the focus of the next section. The second is other policy-induced costs of doing business (and, often a particular concern, entering export markets) with a substantial fixed cost component: costs of registering a business, for example, or of meeting product standards.²⁶ If these are set inappropriately, however, the proper policy response is to change them, not to distort the tax system and in the process implicitly validate other policy errors.

²⁴ In this spirit, for example, the popular model of Melitz (2003) predicts that the most efficient companies in any given sector become multinationals, the moderately efficient ones become exporters from their home base, and the least efficient operators are limited to domestic production.

²⁵ The analyses referred to in this paragraph focus on production taxes, but broadly similar conclusions can be expected to apply for consumption or income taxes.

²⁶ As Berry (2007) notes, however, smaller enterprises may actually be in some respects less policy-hampered than large, for instance in relation to labor regulations.

International mobility

SMEs are likely to be less internationally mobile in their activities and financing than larger enterprises, being more likely to produce services that are hard to trade internationally (lawyers trained in one country, for example, may face restrictions on working in another), or to produce for local markets and preferences.²⁷ These firms may also simply not be able to realize sufficient economies of scale to operate in world markets.

This point should not be overstated—increased international trade in services, and facilitating SME exports, are often an important part of trade liberalization—and may be more true in developing than in developed countries. But any such difference in relative mobility has potentially important implications for tax design. Greater international mobility implies a greater sensitivity of the tax base to domestic tax conditions; and a higher elasticity of the tax base points towards setting a lower tax rate. Crudely, larger enterprises may choose to relocate abroad if tax conditions become less favorable than elsewhere, while immobile companies have no such choice. Optimal tax design requires recognizing this, with more mobile firms taxed at lower rates (Hagen, Osmundsen, and Schjelderup, 1998). And this means that, to the extent that they are less mobile, SMEs should on this account face relatively high tax rates. The decline in effective tax rates at the upper-end of the inverse-U relation noted earlier might, in principle, be a feature of good tax design.²⁸

If, on the other hand, larger firms are also more likely to be foreign-owned, this effect may be counteracted by the particular attraction of taxing foreigners rather than domestic residents. But this too has a counter-argument: many countries seem to attach particular value to foreign-owned investments, in the belief that these are especially likely to bring spillover benefits to the wider economy.

B. Lessons

Arguments clearly can be made, on pure tax policy grounds, for differential treatment of SMEs—and indeed they are made, often with some success. Whether they are compelling from an economic standpoint, however, is debatable.²⁹

²⁷ Hall (2007) reports, for example, that SMEs in the EU derive about 13 percent of their turnover from exports.

²⁸ From a national perspective, at least: from a collective perspective, the incentive for each country to set low rates on more mobile enterprises may leave all ultimately worse off. This raises wider issues concerning the costs and benefits of international tax competition that are not addressed here.

²⁹ Political economy considerations will of course also shape the treatment of SMEs in practice, though these may be complex. On one hand, the large number of individuals directly affected by the taxation of smaller enterprises suggests that they are likely to receive relatively favorable treatment, and indeed this group has clearly been powerful in many countries: Engelschalk (2004) gives the example of a tax-motivated strike of taxi drivers that achieved is led to the resignation of a Deputy Minister of Finance. On the other, the very heterogeneity of smaller enterprises may make it harder for their associations to represent more than their

(continued)

First, it is not even clear in which direction, on balance, they point. Perhaps, for example, SMEs do face capital market constraints that would be eased by tax measures increasing their potential retained earnings; but perhaps they are also less mobile, in which case efficiency requires that they be more heavily taxed than larger and more mobile firms.

Second, few of the underlying rationales for differential treatment relate to size as such. They relate rather to characteristics that may be correlated with size, but are not synonymous with it: access to capital markets, for example, or innovativeness or efficiency. These may be better proxied by some feature of an enterprise other than size, such as its age. While it would then be better to condition tax policy on these closer proxies—focusing support on start-ups, for example—effective implementation may prove difficult: reorganizations can make it all too easy, for example, to obscure an enterprise’s true ‘age,’ and differential treatment of enterprises inescapably creates scope for tax avoidance.

Third, and of critical importance to the analysis of this paper, the tax system is generally not the most effective way of influencing the aspect of behavior that might be of concern. Spending programs—subject to careful oversight, more closely targeted, and less subject to abuse and/or unintended side effects—will often be a better approach. Micro-credit schemes for the self-employed in developing countries, and job-training or similar schemes in developed countries, are good examples. There may be some cases, most likely perhaps in developing countries, in which such devices are unavailable, or subject to even more significant governance problems than tax measures. Even then, however, the difficulties associated with tax interventions noted above, combined with the generic weakness of the case for special treatment, are likely to create a presumption against tax differentiation on pure policy grounds.

While the case for active tax interventions to promote SMEs may thus be weak, it remains important that the tax system not create biases that distort the extent or operations of such enterprises. In this context, tax-induced preferences for operating as a self-employed contractor rather than an employee can cause particular difficulties, and distortions against equity finance and inadequate loss carry forward provisions, while also damaging to larger enterprises, may be felt especially keenly by SMEs.

IV. TAX DESIGN FOR SMEs—WHEN COMPLIANCE AND ADMINISTRATION ARE COSTLY

While policy considerations thus create no significant case for differential treatment of SMEs, practical concerns make it effectively inescapable for small and micro enterprises, particularly in developing and emerging countries. Size is often the best proxy for differences

broadest common interests—Dannreuther (2007) stresses that “it is very hard to find out what SMEs want”—and the smaller number and perhaps deeper pockets of larger enterprises has clearly in some cases made them relatively well-positioned to lobby for favorable treatment.

in compliance cost and revenue potential that are a key element in effective and efficient revenue raising—a very imperfect proxy, but often the best there is.

A. Compliance, administration and tax strategies for SMEs

Compliance and administration costs: evidence and significance

There is considerable evidence that the costs of compliance, relative to firm size, are greater for smaller firms. This has been widely documented for higher income countries: European Commission (2004), for example, reports survey results indicating that compliance costs for the VAT and corporate tax are around 0.02 percent of turnover for larger enterprises, but 2.6 percent for small businesses.³⁰ Emerging evidence for lower income countries points to similar conclusions: Foreign Investment Advisory Service (2007, Table 7), for instance, reports compliance costs in South Africa of around 4.6 percent of turnover for enterprises with turnover below R300,000, falling to 0.1 percent for those with turnover of more than R6million. These findings are no surprise, of course, since compliance is likely to involve significant fixed costs: the costs of registering for the VAT, for example, are likely to be largely independent of firm size. On the side of the tax authorities too, fixed costs in some aspects of administration—the time required for collection enforcement is largely independent of the amount due, for instance—mean that taxing smaller enterprises is relatively more costly.

Smaller enterprises may thus find paying taxes especially burdensome, while the tax authorities are likely to find it especially unrewarding to collect it from them. All this points to relatively low levels of both compliance and enforcement for smaller enterprises—consistent indeed with the focus on larger taxpayers that, as noted above, has been so marked in recent years. Viewed more positively, it points to potential mutual gains, to taxpayer and tax authorities, from the development of simple schemes for taxing small businesses.³¹

It is important, however, not to take too narrow a view of compliance and administration costs. For enterprises, there may be benefits of compliance to offset against the costs on

³⁰ Other studies reach similar conclusions. Pope and Rametse (2001), for instance, estimate the cost of complying with the Australian GST to be only about 0.04 percent of turnover for large businesses (turnover of around A\$2 million) but around 2 percent for smaller (at turnover of around A\$100,000). Pope (2001) reports similar figures for U.K. VAT compliance costs, ranging from 0.22 percent for large firms (turnover over 10 million Pounds) to 2.17 percent of turnover for smaller business (turnover between UKL 20,500 and 50,000). Crain (2005) presents estimates for the US based on the number of employees, which go in the same direction: the tax compliance costs for firms with less than 20 employees were estimated at US\$ 1,304 per employee, but US\$ 780 per employee for large firms (more than 500 employees).

³¹ It is crucial, however, that such schemes do not themselves create unnecessary complexity or distortions, either through their inherent structure or, importantly, through sheer multiplicity. One suggested response is provided in subpart C below.

which most studies naturally focus: a firm that produces accounts on which its tax liability is based may also find it easier, for example, to access finance or insurance. And for the administration too there may be benefits from including an additional taxpayer in the tax system beyond the additional revenue raised. These can include not only reduced economic distortions and increased future revenue, but external effects arising both from extending the social norm of compliance and by increasing the advantage to other firms of complying: if a firm chooses to register for the VAT, for example, then its suppliers also face an increased incentive to register.

Compliance and administration costs—net of associated benefits—may thus be lower than they may seem. And of course implementation costs also depend on the complexity of the tax being implemented: there is evidence, for instance, that VATs with a single rate are cheaper to implement than those with multiple rates. Nevertheless, there is an inherent regressivity in compliance costs that is likely to make informality—by which we shall simply mean substantial failure to comply with all tax and other regulatory obligations—especially attractive for smaller enterprises, resulting in both an erosion of revenues and a distortion of resource allocation, perhaps with an adverse impact on long-term growth (to the extent, for instance, that the decision to remain informal also impedes access to financial markets).

Coping with non-compliance and informality is thus a central part of tax design towards smaller enterprises, perhaps especially so in lower income countries. Importantly, it may shape the treatment of larger enterprises too—as with the use of withholding taxes by larger enterprises mentioned above—and motivate the use of other tax instruments, such as the withholding taxes levied on imports in many developing countries. Indeed the VAT itself can be seen as in part an attempt to ensure that informal operators bear at least some tax (on their inputs, so far as these are imported or purchased from VAT-compliant enterprises), and tariffs too may have value as a means of reaching those otherwise hard to tax.³² The focus here, however, is on the tax treatment of SMEs themselves.

Challenges

The nature of the challenges posed by non-compliance—and the search for simple tax regimes suitable for small enterprises—differs substantially across countries. At risk of caricature, a broad distinction can be drawn between two types of situation:

- That in which literacy and numeracy are nearly universal, there is good access to technology, the financial sector and professional advice and assistance, and a broad social norm that stigmatizes substantial tax evasion. In such circumstances, even relatively small taxpayers can be expected to maintain fairly complete and accurate

³² On the relative merits of the VAT, tariffs and withholding taxes in the presence of a large informal sector, see Emran and Stiglitz (2005), Keen (2007) and Munk (2007) .

books. Compliance costs (for any given set of tax rules) are likely to be relatively low, with most non-compliance likely to take the form of misreporting rather than wholesale concealment of economic activity.

- Those with the opposite features, and hence relatively high compliance costs. In particular, smaller taxpayers may have difficulty keeping books of any sophistication: or, at least, concealment of such books is widespread.³³ Informality is extensive, and many enterprises may simply be ‘ghosts’ operating without any effort at tax compliance (even though they may in some cases be compliant with basic registration requirements).

This dichotomy is overly sharp: in the early stages of transition, for example, many economies lay somewhere between the two, being characterized by high levels of literacy but also limited access to professional tax advice. And while many of the relevant features are of correlated with income levels, the link is far from perfect: wider governance and educational features, and established social norms, clearly have an important role to play.

Interpreted in a very broad fashion, the distinction nevertheless captures some important features of international experience. And it is tempting to draw from it a similar dichotomy between the appropriate strategies towards taxing SMEs. In the first set of circumstances it might seem, dealing with small enterprises is merely a matter of finding simpler ways to impose on them taxes that in their essential design features are the same for all taxpayers: paying VAT on the same basis, for example, but simply less frequently. For those in the latter, on the other hand, simplification may mean applying taxes on a significantly different base. This dichotomy does indeed seem to apply in relation to the taxation of business income under the personal income tax: in many OECD and emerging countries, the income tax treatment of small businesses tends to be more broadly similar to the general system; in developing countries, on the other hand, taxation of smaller enterprises on a substantially different base is commonplace (as discussed further below).

In all circumstances, however, the generic problem in taxing SMEs is the same: to partition taxpayers into distinct categories defined by some notion of size and determine in what form—and indeed whether—to impose on them each of the taxes levied on larger taxpayers. It is to the practice and principle in these matters that we turn in the next two subsections.

Before that, however, the stylized comparison between the two types of countries above raises one other general issue of some significance: To what extent should, and can, a country in the latter group seek to shape its tax system not only in recognition of that fact but, more purposively, to move itself to the former? There are two related but distinct aspects to

³³ Gauthier and Gersovitz (1997) report evidence for Cameroon that nearly half of the enterprises evading tax actually kept books of account.

this. One is the question of encouraging enterprises to move into the formal sector. The other is that of developing enterprises' business practices and capacities (even for those fully formalized). There are here potentially important trade-offs to be faced, in that the compliance costs which largely drive the decision as to whether or not to become fully tax compliant (and enter the formal sector), and/or on the business practices to adopt, can be reduced by the tax authorities incurring increased costs of administration (perhaps in education campaigns, or providing technical support). How much such public expenditure should be undertaken depends in large part on the externalities that are perceived to be associated with improved compliance or formality. Some such externalities relate to the operation of the tax system itself, as noted above. But there can of course be wider benefits: encouraging firms to keep proper records may provide a form of business training that enhances their productivity and growth prospects. As with the other policy objectives discussed above, a key question is whether there may be other instruments better suited to these non-tax ends. The view one takes of this potentially wider role of the tax system in promoting business development can have powerful implications for both tax design and tax administration (Toro, 2007).

B. Partitioning: Thresholds and presumption

There are two sets of decisions to be made in designing any tax regime for SMEs:

- A partitioning of the set of taxpayers into groups for distinct treatment, generally by the use of thresholds specified in terms of some notion of size; and
- Determining what form of special tax regime—if any—should be applied to each of size categories of taxpayer thus identified.

These decisions need to be made, it should be stressed, in respect of each of the taxes levied under the 'normal' regime on larger taxpayers, most notably the VAT, income tax (corporate and personal) on owners of the enterprise and the withholding from employees' wages of income tax and social contributions. Distinct considerations arise from the quite different purposes each is intended to serve.³⁴

It is also important to recognize that these two sets of decisions are (or should be) closely related, both vertically (within tax types) and horizontally (across them). With a high VAT threshold, for example, there is likely to be a stronger case for some kind of simple surrogate tax on those below the threshold. And simplification calls for some horizontal consistency in the reporting requirements and thresholds associated with the replacement regimes for, in particular, the VAT and real income tax regimes.

³⁴ In some countries questions arise in relation to other taxes too, including for example local property taxes, or in relation to the allocation of taxes across levels of government. These are generally fairly straightforward, in principle at least, and are not addressed here.

All this creates a highly complex problem—one that has received little attention from theorists, and which practitioners have addressed (if only implicitly) in very different ways.

Thresholds

Considering first the vertical dimension of the generic design problem, distinct considerations arise in setting thresholds under the main taxes.

VAT

The practical case for differentiating enterprises' tax treatment by size is clearest, and has been most fully analyzed,³⁵ in relation to indirect taxes on final consumption, the VAT of course being of particular practical importance.³⁶ If there were no implementation costs and efficiency were the sole concern, the optimal threshold for the VAT would be zero: excluding some enterprises from tax would simply distort competition to no social gain. All that changes, however when implementation is costly. Balancing the government's need for revenue (taking account of the costs they incur in collecting the tax) against the compliance costs that taxation imposes on taxpayers suggests—given the broadly regressive pattern of implementation costs—that it will generally be optimal to levy the tax only on taxpayers above some critical size, and entirely exclude from the tax all those below it.³⁷

Importantly, these considerations argue against the view that lower tax rates should be set on smaller enterprises on the grounds that compliance costs are more burdensome for them: intuitively appealing though that may sound, setting a lower tax rate in itself does nothing to

³⁵ See Keen and Mintz (2004), Zee (2005), and Dharmapala, Slemrod and Wilson (2006).

³⁶ The main excises are commonly collected from large enterprises, favored by economies of scale, that can be especially closely monitored—though there are exceptions, such as the Indian bidi.

³⁷ Suppose for example that some base B is distributed across taxpayers with density $f(B)$, that the applicable tax rate is τ and that the costs to the taxpayer of complying with the tax and to the tax authorities of administering it are $C(B)$ and $A(B)$ respectively. Denoting by δ the marginal cost of public funds—greater than unity to the extent that there is a social gain from transferring funds from private to public sectors—the social gain from bringing taxpayers with base B into tax is $\Delta(B) \equiv (\delta - 1)\tau B f(B) - C(B)f(B) - \delta A(B)f(B)$: the first term is the net social gain from the revenue raised, the second the compliance cost incurred, and the last the corresponding administration cost (weighted by δ , since it is paid for out of tax revenue). Under weak conditions, there exists a unique B^* , at which $\Delta(B^*) = 0$ and hence

$$B^* = \frac{\delta A(B^*) + C(B^*)}{(\delta - 1)\tau}, \quad (1)$$

such that tax should be charged only on those with base greater than B^* .

reduce the real resource costs involved in complying, but merely reduces the social value—tax revenue—that it creates. What these considerations do leave open is the possibility that some simpler tax, with lower compliance costs for taxpayers and cheaper for the tax authorities to administer, should be imposed below the VAT threshold (which in turn affects where that threshold should be).

Quite where the optimal VAT threshold lies depends on the urgency of the government's need for revenue, the tax rate, and the level of compliance and administration costs.³⁸ But this simple account ignores, of course, other considerations that affect the calculation of the appropriate VAT threshold. The simpler the VAT, in terms of the extent of rate differentiation and product-based exemption, the lower are implementation costs likely to be and hence the lower the optimal VAT threshold. Concerns to limit the scope for VAT fraud—which when especially widespread can be viewed as imposing particularly high administration costs—on the other hand, may argue towards restricting the set of VAT payers by leading to a relatively high threshold. Other important considerations include the impact that firms below the threshold will feel through VAT on their inputs, the consequent need to allow for voluntary registration (and revenue dilution that implies), and the potential distortions (and associated equity effects) that any such threshold creates (being, as noted above, likely to confer a competitive edge to enterprises exempted in this way from the VAT). While the balance of considerations is clearly complex, it may be that the threshold should fall over time as income levels rise and, more particularly, implementation becomes easier. This has indeed been the strategy in many countries (though it is notable too that many high income countries, such as the U.K. have continued to retain quite high thresholds). The important point remains, however, that practical issues mean that the optimal VAT threshold is almost certainly not zero and could be quite substantial, especially in developing countries.³⁹

Corporate income tax

Similar arguments might be made for the corporate tax. Compliance costs may in this case be relatively low, to the extent that books are required to be and—quite a different matter in

³⁸ Keen and Mintz (2004) derive a simple closed form for optimal VAT thresholds, specified in terms of turnover and denoted by Z^* , by supposing compliance and administration costs to be fixed and writing the ratio of value added to turnover as $v \equiv B/Z$, in which case (1) becomes

$$Z^* = \frac{\delta A + C}{(\delta - 1)\tau v}.$$

³⁹ These same considerations also suggest that it may be appropriate to set lower VAT thresholds for groups likely to be subject to lower administration and compliance costs, or to high mark-ups on material input costs (the latter likely to be the case in many services, for instance). Any such benefits would need to be weighed against the further complexities differential thresholds would introduce, for example in the treatment of enterprises with multiple activities.

many countries—actually are kept for other reporting purposes. Administration costs, however, may not be low (relative to the revenue at stake), and indeed some countries do impose special corporate income tax regimes for smaller enterprises. For example, incorporated business with total assets below one million Euros and net turnover below two million Euros are allowed to use simplified accounting in Spain. Other countries allowing simplified accounting for business below a certain threshold, including Denmark, Germany, Italy, United Kingdom, and United States. There are also examples of presumptive systems substituting for the income tax for smaller corporations, as in the case of Brazil and Portugal, where profit is estimated as a percentage (which differs across certain economic sectors) to turnover and then taxed at the standard CIT rates.

Personal income tax and social contributions

Quite different considerations apply for the personal taxation of unincorporated business income. Almost all personal income tax systems exclude some basic amount of income from tax, as a practically convenient way of lending some progressivity to the tax schedule. Excluding from tax personal business incomes above this basic amount, however attractive it might be on implementation grounds, runs foul of norms of horizontal equity. The choice of some simplified regime to be imposed on small business income above this basic amount is then effectively inescapable. The key question in this case is that of determining some level of size below which such a simplified form of business income taxation should be applied, rather than requiring the full panoply of the ‘regular’ income tax regime to be applied.

There is an important link to be made here with the VAT threshold. The ability to comply at reasonable cost with the VAT implies a basic capacity in record-keeping which in turn means that the taxpayer should be able to comply with a reasonably sophisticated accounts-based form of income taxation. Hence any fundamentally simplified form of income tax should apply, if at all, only to taxpayers below the VAT threshold, where such a threshold is set along the lines described above, based upon administrative and compliance costs.

Social contributions, and withholding of income tax on wages of employees

Broadly similar considerations to the personal income tax may apply to the levying of any social contributions on the business owner's income; while social contributions may also be subject to a (separate) exempt amount drawn largely in response to distributional concerns, any income estimated or presumed to be above that amount should be subject to social contributions. More complex problems arise in the case of small businesses with one or more employees. If wages paid exceed the personal income tax (and social contribution) threshold, there are few good alternatives to requiring the business owner/manager to comply with regular withholding requirements for such wages.

Special regimes: Simplified and presumptive taxes

With some small businesses excluded, by virtue of relatively high implementation costs, from operation of the ‘standard’ system for some tax(es), the issue becomes that of designing the regimes to replace them.

At this point, questions of terminology need to be confronted: the taxation of SMEs is an area in which terms are often used loosely, with consequent risk of confusion. For clarity, we refer to any tax intended to replace some levy under the standard regime applied to larger enterprises as a ‘special regime,’ with a further and looser distinction made within this category between ‘simplified’ and ‘presumptive’ taxes, with the former referring to ones that differ from the standard regime only in relatively minor matters of procedure or definition (such as frequency of payment or the use of cash rather than accrual accounting) and the latter indicating some quite different base.⁴⁰ This distinction between simplified and presumptive taxes is largely a matter of judgment, of course, but captures a potentially significant distinction.

Presumptive taxes in practice

Comparative information on presumptive regimes around the world is hard to come by, though the surveys conducted for this conference by the OECD and IMF go some way towards filling this gap.⁴¹ Three key features of international experience stand out.

The first is that special regimes are pervasive. More striking still is how common are regimes that, in the sense set out above, are clearly presumptive rather than essentially procedural simplifications. This can be seen from Table 4, which provides an overview of practice in Latin America and sub-Saharan Africa.⁴² Importantly, however, several OECD countries also have presumptive regimes, or some elements of them. Italy, for example, utilizes a system

⁴⁰ This usage differs, it should be noted, from an alternative and natural interpretation of presumptive taxes as those proxy for the ideal object of taxation. In this wider sense, as Slemrod and Yitzhaki (1994) stress, “[a]ll taxes are presumptive, to some degree.” The depreciation allowance claimed by the most sophisticated IFRS-compliant multinational for instance, is unlikely to be an exact measure of its true economic depreciation, and transfer-pricing adjustments in complex international transactions are in effect taxing by constructing a presumption on income streams. Indeed the minimum corporate or personal taxes found in many countries, at all income levels, are forms of presumptive taxes. More generally, most tax systems also provide for ‘best judgment’ tax assessments of liability when the taxpayer provides insufficient information for a normal assessment, or when that information appears inconsistent with external indicators of lifestyle. While presumptive taxes in this wide sense serve a number of roles (Thuronyi (1996) provides a review), the focus here is on their use as a routine form of final assessment for smaller enterprises.

⁴¹ The detailed responses are available at www.itdweb.org.

⁴² See also Engelschalk (2004) for an overview of special regimes during the transition period.

heavily based on sector studies, which required in its elaboration data gathering through questionnaires and cluster analysis in order to fix its various presumptive coefficients. The system's sophistication includes different coefficients not only by sector but also by geographical area. The system applies to taxpayers, regardless of their legal nature or accounting system, who declared *profits* below 7.5 million Euros.⁴³

Table 4. Special Regimes in Latin America and Sub-Saharan Africa

	Latin America	Sub-Saharan Africa
<i>Extent of presumptive regimes in the region</i>	Latin American countries have adopted a wide range of simplified regimes for SMEs. Of 17 countries, 14 have adopted some type of simplified taxation (Argentina, Bolivia, Brazil, Colombia, Costa Rica, Chile, Dominican Republic, Ecuador, Mexico, Nicaragua, Honduras, Paraguay, Peru, and Uruguay). Exceptions are El Salvador, Panama and Venezuela.	Pervasive: 25 out of 44 countries in the region for which data are available have special regimes for smaller enterprises (Benin, Burkina Faso, Burundi, Cameroon, Central African Republic, Chad, Comoros, Republic of Congo, Côte d'Ivoire, Gabon, Guinea, Kenya, Liberia, Mali, Mauritania, Niger, Rwanda, Senegal, Sierra Leone, Tanzania, Togo, Uganda, and Zambia). Almost half apply (usually creditable) withholding income tax on imports.
<i>Criteria for qualification</i>	Some countries use turnover as the principal criterion for qualification (Brazil, Chile, Dominican Republic); others use objective parameters as the primary criteria, such as physical area, electricity bill, number of employees, or number of vehicles as the main qualification, or use these as additional criteria (Argentina, Bolivia, Colombia, Costa Rica, Chile, El Salvador, Honduras, Mexico, Nicaragua, Paraguay, Peru and Uruguay); some countries prohibit certain economic sectors from presumptive taxation (e.g., Brazil).	Turnover is almost universally used as a qualification criteria, with the special regime generally linked explicitly to the VAT threshold.
<i>Existence of multiple regimes</i>	Some countries have two or more presumptive regimes (Argentina, Bolivia, Brazil, Chile,	Generally a single regime, though in some cases (Liberia and Uganda) with

⁴³ Portugal, to give another example, applies a simple regime based on a percentage of the turnover in order to estimate the tax base (20 percent for sales of goods and hotel/restaurant services; and 65 percent for other services under PIT – or 45 percent for other services under CIT). The qualification criterion is total turnover (less than 150 thousand Euros). Spain has a more complex system based on objective parameters, which take into account variables such as number of employees, physical area, electric power, number of tables in a restaurant, etc. This system covers nine different economic activities and utilizes several coefficients for fine adjustments (e.g., special activities such as taxis and transport, start-ups, temporary activities). Turnover (450 thousand Euros as a general case) and sector activity are used as parameters for qualification. Other OECD countries with significant elements of presumptive taxation are Austria, Belgium, France, Greece, Japan, and Spain.

	Latin America	Sub-Saharan Africa
	Mexico, Peru and Uruguay). These multiple regimes are used to tailor solutions for businesses of different sizes or specific economic sectors, such as agriculture, handicrafts, and transport.	structurally different treatment of the smallest taxpayers.
<i>Universe of taxpayers covered</i>	Some countries provide presumptive regimes for individuals, usually self-employed or unincorporated businesses (Argentina, Bolivia, Colombia, Chile, Dominican Rep., Ecuador, Mexico, Nicaragua, Honduras, Paraguay, Peru and Uruguay), while others also provide this for legal entities or incorporated businesses (Brazil, Costa Rica, Chile, Mexico, Peru and Uruguay).	Typically for unincorporated enterprises only, though in a few cases (such as Zambia) applies to corporations too.
<i>Tax calculation</i>	The main tax calculation methods are percentage of the turnover level (Brazil, Chile, Dominican Rep., Peru) and/or a patent or fixed quota (Argentina, Bolivia, Chile, Mexico, Nicaragua, Peru and Uruguay).	Most common methods are: fixed amounts varying across turnover bands (examples being mainly in Francophone countries such as Burkina Faso and Togo); percentage of turnover, either uniform or at multiple rates (such as in Rwanda and Tanzania respectively); fixed amounts varying across turnover bands (examples being Burkina Faso and Togo); and forfait/standard assessment methods (in Burundi and Gabon, for instance).
<i>Type of revenue covered (applied in lieu of taxes and/or social security contributions)</i>	Many regimes substitute for only one tax (Brazil, Colombia, Chile, Dominican Rep., Ecuador, Honduras, Paraguay, Peru) but others--even in the same countries-- include more than one tax, usually the income tax and the VAT (Argentina, Brazil, Bolivia, Costa Rica, Mexico, Nicaragua, Paraguay, Peru and Uruguay). In the case of Brazil, sub-national taxes are also included. Some presumptive regimes also substitute for social security contributions (Argentina, Brazil and Uruguay).	The presumptive schemes generally replace all other taxes.
<i>Turnover threshold</i>	A wide range: some countries define it at a low level to cover mainly micro and very small (usually unincorporated) businesses (below US\$ 50,000); Brazil is an exception with a threshold at US\$ 1,000,000 (in lieu of all taxes and social contribution) and US\$ 20,000,000 (in lieu of income tax only).	Commonly linked to the VAT threshold, which varies from around 12,000 USD to around 100,000 USD, but is commonly in the range 40-80,000 in Francophone countries and 30-40,000 USD in Anglophone countries.

Source: Inter-American Development Bank (2007) and IMF staff.

A second key feature of international practice—hard to document, and somewhat elusive—is a wide diversity in the normal tax that special regimes are intended to replace. Some countries, for instance, impose distinct special taxes specifically to replace distinct normal taxes; others seek to replace only some; and others have tried to use a single tax to replace all taxes. The concept of replacement here is somewhat elusive, it should be noted, in so far as it relates to the intention of policy makers. A single tax, for instance, could be rationalized either as replacing several or as replacing only one, with the others simply not being applied in any form to smaller taxpayers. Nevertheless, the notion of replacement is central to the coherent formulation of special regimes; it will be revisited below.

But the most striking aspect of experience is the sheer diversity in the form of the special regimes applied. Even within the OECD, a wide range of methods and qualification criteria are used (turnover, objective parameters, sector coefficients, estimation based on net worth, etc); some (such as those in Austria and Spain) apply only to unincorporated businesses, while others (in Italy, Japan and Portugal for example) reach incorporated businesses too; some countries allow opting-out (such as in Austria, Belgium, Portugal, and Spain), while others do not (as in Greece, Italy, and Japan).

Among the most common bases for presumptive taxes are:

- ***Turnover (or ‘gross receipts’)***. The appeal of this is that almost every business operator, no matter how small, will have a basic idea of their cash receipts, even if they cannot produce an accurate record of expenditures. The view that turnover is relatively easy to monitor presumably underlies, for example, its almost universal use as a threshold for the VAT, and indeed this link can be key in designing regimes for the treatment of smaller taxpayers, as discussed below. Cash receipts can also form a suitable bridge to the VAT and business income tax; for those small businesses that do grow, a properly designed presumptive regime based on cash receipts therefore eliminates some of the problems and disincentives associated with transition from the presumptive to the real regimes. Against this, of course, turnover taxation creates potential distortions through cascading (with consequent incentives to vertical integration, and loss of transparency in effective tax rates) the severity of which has been a primary reason for adoption of the VAT.

Even within the class of turnover-based taxes, a variety of methods can be found and/or conceived of. In some countries, for instance, tax is not levied directly on turnover but rather as a fixed amount within bands defined by turnover (creating discontinuities in tax liability, and to no very obvious benefit given that turnover has to be calculated in order to verify the applicable band). Or, as a replacement for the income tax, turnover can be taxed at progressive rates or, more systematically, used not as the tax base itself but rather as a means to proxy income, to which the normal tax schedule itself is then applied. And countries vary in the number of distinct turnover rates they apply.

- **Cash flow.** An alternative as a replacement for the income tax—much less common, though it has been used in Mexico and Poland, for instance (and the U.S. allows immediate expensing for smaller enterprises)—is to tax income on a cash flow basis: that is, using cash rather than accrual accounting and, still more important in economic terms, allowing immediate expensing of all investment spending (but no deductibility of financial costs). This has the appeal of providing a closer proxy to income (as normally defined) than does simple turnover, and of requiring only moderate sophistication in record keeping. And as a matter of economic principle, cash flow taxation has considerable attraction even for larger enterprises, and there is much to be said for taxing all enterprises on this basis. Even leaving that wider issue aside, taxing smaller enterprises on this basis has potential merit, as set out clearly by Conrad (2006), for example. If larger enterprises remained on the more standard form of income tax, issues would arise in relation to the transition from one regime to another (it being necessary, for instance, to deny depreciation deductions on assets acquired with immediate expensing, and to claw back appropriately on any subsequent asset sales). But such problems seem intrinsically no greater than those associated with the transition under other regimes.

- **Indicator-based** schemes use of range of characteristics of an enterprise and its activities—some perhaps based on accounts, others (perhaps all) based on physical attributes—as a basis for determining tax liability. These can take a number of forms, including:
 - Under the classic French *forfait* system (which had been in use for many decades before being abolished in 1998) liability was based on a range of indicators—purchases, sales, number of employees, number of cars owned by the taxpayer, and so on—with the sum due agreed between tax authorities and individual taxpayers, this amount then applying for two years.

 - *Standard assessment* systems use mechanical rules (unlike the taxpayer-level negotiation under the classic forfait, although perhaps drawing on industry-level negotiation) to assess tax on the basis of a range of indicators of activity (floor space, location....), often specified in great detail. The Israeli *tackshivim* system, officially in place until 1975, is the classic example. This covered the assessment of income in 130 economic branches, specifying within each the parameters to be used. Restaurants, for example, were divided between exclusive, fish, vegetarian..., with a further classification by location; revenue was then estimated per waiter (with rules not only on hours but on whether owners are to be treated as waiters) and income calculated by allowing proportionate reductions to allow for various costs (Yitzhaki, 2006; Engelschalk (2004) provides examples of similarly complex schemes from the transition experience). Evidently not all presumptive taxes are simple.

- A *patente* (or ‘fixed tax’) system simply charges a fixed fee—often varying with location and type of activity—and so is in a sense just a highly simplified form of standard assessment.
- *Asset based methods* impute income as a return on some measure of an enterprise’s assets. This is most appealing for small businesses that are dependent upon commercial assets with respect to which the government has good information and control. For example, in urban areas with good real estate cadastres, small businesses that operate from fixed premises could be taxed based upon imputed rents (a system that has been used with some success in Benin, for example); operators of transportation businesses with one or two vehicles could be taxed based upon the vehicles’ type and capacity.

General considerations in designing presumptive regimes

The relative merits of alternative presumptive bases will depend on the purpose they are intended to serve—in particular, the normal tax they are intended to mimic, a point discussed in more detail in the next subsection. Simplicity and transparency are evidently key concerns. Beyond this, there a range of considerations should guide the choice between them.

Clearly the presumptive base must be compatible with the compliance and book-keeping capacity of the target group, and with the implementation capacity of the tax administration (a point discussed in detail by Terkper (2007)). Full record keeping, commensurate with that necessary for full accrual accounting of large businesses, is beyond the reach of many, if not most, small and micro business operators in developing countries.⁴⁴ However, all but the very smallest operators in all countries do more or less know what their basic cash receipts are. A cash receipts journal is sufficient as a foundation for a simple presumptive regime suitable for most small businesses. Costs of administration also need to be borne in mind in choosing between presumptive regimes: developing (and keeping up to date) standard assessment tables, for example, can be a substantial undertaking.

Relatedly, the base should ideally be some rudimentary variant of that in the standard regime, with broadly equivalent economic effect. This can help ease the transition between regimes as firms grow, in particular minimizing discrete ‘jumps’ in tax liability as the taxpayer moves to the standard regime. It also helps preserve the economic coherence of the wider system. But this can be hard to achieve: some turnover-based tax may suggest itself, for instance, as

⁴⁴ In contrast, in most developed countries, it is to be expected that small businesses operating essentially at any level above that of the occasional small transaction should be able to keep records.

both a presumptive income tax and to substitute for the VAT—but it clearly cannot fully replicate the economic effects of two such different instruments.

A third set of considerations concerns the economic incentives created by the tax. Standard assessment methods, for example, invite enterprises to substitute away from the indicators on which liability is based: if the tax payable by a restaurant relates to the number of tables, for example, guests will soon find themselves sharing tables with a wide set of new friends; perhaps more seriously, use of employment-related indicators may discourage formal employment. Such distortions can clearly be costly: even though the enterprises affected may be individually small: there are, after all, lots of them. But it is also important to note that presumptive taxes can, in principle at least, actually have attractive incentive effects: to the extent that they capture potential rather than actual income, they in effect impose a marginal tax rate on the latter of zero: under an asset tax, for example, extracting higher returns from a given capital base has no impact on tax liability, whereas under an income tax it would. (Against this, however, asset taxes do raise the METR and so discourage investment). This raises deeper issues in tax design than can be addressed here: see Faulk, Martinez-Vazquez and Wallace (2006) for further discussion.

A fourth consideration is that the replacement tax be reasonably robust against corruption and extortion in its collection. This points to simple systems relying on minimal discretion by the tax authorities, avoiding excessive differentiation across taxpayers—with just a few distinct rates of turnover tax, or only one, especially if the general level is fairly low. When the regimes use a variety of enrollment criteria and assessments are made administratively, they may create undesirable scope for arbitrary decisions and collusion between tax officers and taxpayers. Difficulties created by negotiation and discretion were a key reason, for example, behind the decision in France to move away from the forfait and towards turnover-based methods in the 1990s.

Fifth, effective tax rates, relative to those in the standard regime, need to be high enough not to discourage transition to the latter, or encourage firms to hide their growth by underreporting income or splitting into multiple entities. Indeed one could argue that the statutory tax provisions should include a premium to claw back some of the associated compliance cost savings to smaller enterprises, so as not to discourage movement to the normal system. The balance is a difficult one to strike, however, since setting the presumptive tax rates too high may instead encourage outright informality. As Bird and Wallace (2003) note, there appear to be few if any careful studies of experience on the issue, but some sense that many countries may have erred in the direction of setting inappropriately low effective rates. One clear implication, also stressed by Engelschalk (2004), is that the success of a reform to some special regime is not to be judged by the increase in the number of taxpayers subjected to it, or even in the revenue it collects, since both can be increased by offering special treatment so attractive as to lead to migration out of the standard regime.

This last consideration raises the important question as to whether a presumptive tax should be rebuttable—that is, whether taxpayers otherwise subject to presumption should have the right to opt instead for treatment under the standard regime (subject, of course, to the associated bookkeeping and other obligations). There are strong arguments in favor, to the extent—as discussed above—that it is an object of policy to expand the scope of the standard regime. Moreover, some companies may wish to be subject to the normal regime in order for their parent overseas to access foreign tax credit; or they simply find it commercially advantageous to signal an elevated status by being subject to the normal regime. Against this, however, enterprises are evidently more likely to opt in when doing so reduces their tax payment, and, moreover, by doing so they are likely to add to the costs incurred by the tax administration. The government may thus find itself spending more to collect less (though the loss may be small given the concentration of tax payments in larger taxpayers). The desirability of allowing rebuttability thus depends to a large degree on the extent of the wider external benefits felt to be associated with inclusion in the standard regime, as discussed above. Where tax administration is strong, rebuttability—with limitations on the ability to move back to the presumptive regime and supplemented perhaps by a minimum tax—is likely to be appropriate. Where administration is weak, however, denial of rebuttability may be a coherent device for focusing limited resources on more important activities.

C. Strategies for taxing small businesses in developing and emerging market countries

The substantial variation across countries in the taxation of SMEs often seems to reflect traditional practice and occasional piecemeal reform rather than a fully articulated view of how this element of the wider tax system should fit into the whole. It is hard to resist the conclusion that current systems are all too often something of an after-thought, with little careful attention as to their proper role in the wider tax system. Yet one of the lessons from the introduction and reform of the VAT over the last decades, and increasing interest in reform of the income tax, is precisely that the strategy towards SMEs is a critical element of the overall tax architecture. There are, as will be seen, a number of forms such a strategy might take. This section briefly outlines one approach to the taxation of SMEs, variants of which are underway, or under discussion, in a number of non-OECD countries, that has significant appeal as a means to progressively broaden the tax system, reduce informality and, ultimately, expand the scope of the standard tax system—in the process minimizing impediments to the development of the SME sector.

This approach uses the VAT threshold—set based on the methodology described above—as an anchor for the partitioning of taxpayers into regimes for special treatment. It thus presumes that, in developing and emerging countries, the threshold is set at a fairly high level. In practice, many Latin American countries, and some others, do not have VAT thresholds—or rather have very low ones, hard to rationalize in terms of the principles set out

above.⁴⁵ This presents them with particular challenges in dealing with small and micro businesses, one manifestation of which is the development of such supplementary devices as widespread VAT withholding. We discuss later strategies that might be employed in such contexts. Here we focus on SME regime design when—as with many more modern VATs—the threshold has been set so as to exclude the majority of enterprises from full operation of the tax.

The importance of such a VAT threshold in designing a tax regime for SMEs is that any enterprise capable of complying with the normal VAT should be familiar with methods of self-assessment and able to keep reasonably sophisticated books. It should thus also be able—and required, given the revenue likely to be at stake—to comply with the real business income tax (meaning accrual accounting, depreciation of large investments, and so on). For purposes of this paper, given the costs-based methodology assumed to be used to set the VAT threshold, those above it would be considered ‘medium-sized’ businesses. By the same token, businesses that register voluntarily for the VAT should also be subject to the regular income tax: the choice to register should apply to both taxes or neither, not selectively.

What though of those enterprises that remain below the VAT threshold? These, in practice, will be small or micro, rather than medium-sized enterprises. Given such a partitioning, the key issues are how to treat these smaller enterprises in relation to each of the other main tax instruments: the taxation of business income, the taxation of sales, and the withholding of wage tax and social contributions on employees.

Micro enterprises

As the term is interpreted here, micro enterprises are those which can be assumed unlikely to have incomes above the personal tax threshold. It would make no sense to tax self-employed marginal workers when their counterparts earning the same amount but as wages from employment are not subject to personal income tax. Further, the potential revenue from subjecting them to other taxes, such as the VAT, is likely to be small relative to implementation costs. There is thus much to be said for simply excluding from explicit taxation all enterprises with turnover assumed to produce income below a level corresponding broadly to the personal exemption. The strongest argument for including them in the tax system is the view that this is important to securing participation in political processes and strengthening accountability of the authorities. This points to a simple *patente* system acting akin to a license fee.⁴⁶

⁴⁵ Although it is often said that many Latin American countries do not have VAT thresholds, this is not quite accurate; in some cases, businesses with lower turnover are subject to simplified or presumptive ‘VATs’ rather than the ‘full’ VAT.

⁴⁶ Frequently, such taxes are better implemented at local level.

Replacing the income tax

Businesses with turnover above the level identifying micro enterprises and the VAT threshold would be subject, as a presumptive income tax, to a tax based on turnover, set at levels that will generally approximate the tax burden that would apply to such businesses if they were subject to the real business income tax. Though not without its difficulties, turnover has the particular appeal in this context of being fairly well known to the taxpayer and resting on a simple form of accounts, so providing some link with more precise accounts-based methods.⁴⁷ This turnover-based regime could operate in either of the two ways noted above: either tax due or presumed income could be specified as some fixed proportion of turnover, with the regular income tax schedule then being applied in the latter case to determine liability. The two will be equivalent, of course, if there is only a single average rate of tax in the relevant range,⁴⁸ and the case for the latter approach (to be weighted against some loss of simplicity) is then stronger the more steeply progressive is the schedule at lower income levels. It is important to attempt to mimic under the presumptive regime the tax burden on profits arising under the real regime in the presumptive regime. This avoids the temptation to distort behavior or to hide true turnover that arises when the burden under the presumptive system is markedly lower than that in the real system. Such distortions are likely to arise most sharply, of course, in the case of businesses at or near the turnover threshold. Experience suggests, however, that it is unwise to adopt a large number of different rates based on industry sector or business type: this creates difficulties in relation to enterprises with multiple activities, and is vulnerable to game-playing and abuse. Two or three distinct rates are likely to be enough.

Depending to a large degree on precisely how high the VAT threshold is, there may be a case for a second cut-off point between the very low exemption level and the VAT threshold. Those in the lower part of this range would be treated as just described above, while those in the upper part of the range would be subject to a cash flow form of income tax, based on simplified cash accounting and immediate expensing of investment. These businesses would be expected to maintain not only the simple cash receipts journals needed by the smaller businesses subject to the simple turnover tax, but also records of cash based expenditures, including investments. The latter, somewhat more complex system, has the advantage of

⁴⁷ If the simplified cash flow tax option were adopted for the somewhat larger 'medium' businesses, as described above, a single tax rate should apply to their business profits calculated by that simplified method, and should approximate that used under the real income tax. If there are a series of rates under the latter, the appropriate rate can be derived using average profits based upon turnover at the VAT threshold.

⁴⁸ If the tax rate is 10 percent, for instance, then imputing income as 20 percent of turnover is equivalent to simply taxing turnover at 2 percent.

providing a smoother transition into the real regime than does the straight turnover based presumptive tax.⁴⁹

The question also arises as to whether such a presumptive income tax should also apply in respect of the corporate tax. In some countries, such as Kenya, businesses are not entitled to operate in corporate form unless they are able to maintain full accounting records and books. In such circumstances, even companies with turnover below the VAT threshold might be required to comply with the normal income tax; and this, it seems, is common though by no means universal practice. The case for proceeding in this way is not entirely clear cut, however. First, in many developing countries compliance with regulatory requirements may be weak. Second, policy needs to be decided with administration as well as compliance costs in mind: even if some enterprises can comply with more demanding requirements, it may be that the revenue at stake is so limited that it is wiser to save administration costs by treating them on a simpler basis. And third, differentiating tax liability by organizational form risks distorting the incorporation decision. Again country-specific circumstances must play a key role in policy design: but it should not be taken for granted that all corporations should be taxed under a real regime.

Substituting for the VAT?

There is little disagreement that smaller enterprises should pay some simplified form of income tax (subject to any generally applicable exempt amount). It is much less clear that some tax is needed to mimic the effects of the VAT for those below the VAT threshold.

To see why, note first that enterprises selling to VAT-registered firms will in any event want to register voluntarily. Any problem thus arises from exempted firms selling to final consumers. In the absence of any replacement tax, these will be placed at a competitive advantage relative to those required to pay VAT, distorting competition and eroding revenue. This is mitigated, however, to the extent that they will in any event bear some unrecovered VAT on their own purchases. Such implicit taxation of their sales weakens the case for explicit presumptive taxation in substitution for the VAT. However, the strength of this effect depends on the level of the threshold and the extent of informality: those wishing to supply to enterprises that are exempt—either because they are themselves below the turnover limit or because they are evading the VAT—have an incentive to avoid paying VAT themselves, leading potentially to chains of non-compliance (de Paula and Scheinkman, 2006).

The question of whether to replace the full VAT for smaller enterprises has received little attention. A reasonable conjecture, however, is that the case for doing so is likely to be stronger the higher is the VAT threshold and the greater is the degree of informality.

⁴⁹ It might be argued that such an interval is unnecessary, since a firm that can cope with a cash flow tax should be able to cope with a VAT. The greater (or at least more visible) opportunities for fraud under the VAT, however, may nevertheless rationalize excluding from it some such firms.

Supposing some replacement for the VAT to be under consideration, further questions arise as to the form it might take. Perhaps the most obvious candidate is a low rate turnover tax; the main difficulty with this, of course, is that, taken too far, the cascading effect of such a tax leads to all the problems that the VAT was intended to resolve. Other alternatives include: (i) a subtraction rather than invoice-credit form of VAT, which should be feasible for any enterprise subject to cash flow income taxation (but again can give rise to cascading when some enterprises remain subject to the invoice-credit VAT), and/or (ii) withholding taxes of the kinds mentioned earlier that are deliberately intended to reinforce the effects of the VAT in raising the input costs of smaller traders (which, however, raise their own administrative challenges: if crediting mechanisms do not work smoothly, they can increase input costs for large and compliant enterprises too).

This is clearly an area in which further thought and experience-sharing is needed. What is clear, however, is that the case for a presumptive tax to replace the VAT is weaker than that for a replacement for the standard income tax. Importantly, this would not mean excluding firms from the tax system: they would, recall—all but the very smallest—remain subject to the simplified income tax.

Withholding on employees: Payroll taxes and social contributions

Perhaps the greatest problem in dealing with small businesses is to determine how to handle social contributions and personal income taxes on employees, which are normally collected by employers. In the large and growing number of countries in which the social security system is accounts-based and provides retirement and/or health insurance schemes aimed at specific individuals rather than a simple support mechanism funded from general revenues, it is important to attribute collections to individual workers.⁵⁰ Subsuming this sometimes multiple set of social collections into a single presumptive tax regime is therefore impractical. Similarly, failing to account for and charge personal income taxes normally paid through employer withholding would create a distortion between those employed by small businesses and those employed by larger businesses or government. It would make little sense to require employees of the smallest businesses to take responsibility for filing their tax returns (or paying their own personal income tax); nor is it desirable to simply exclude them from tax. Thus there is little alternative to withholding on employees, potentially by quite small enterprises.

In the case of self-employed individuals operating at or near the subsistence level in developing countries—whose business income will likely fall below the proposed exemption

⁵⁰ As noted in the previous sub-section, social contributions for the sole proprietor or smallest business owners themselves should therefore, above whatever income threshold is normally applied, be accounted and remitted by them under the regular regime.

level equivalent to the personal income tax exemption, as described above—it may be sensible or necessary to provide an exemption from social tax collections, as well as from personal income taxes (though it would then be more sensible to exempt persons with similarly low employment incomes arising from larger employers from the social collections as well). For such people, there may in any event be some minimum subsistence support old-age scheme in place outside of the accounts based insurance scheme.

For those small businesses with one or more employees, exemption from either employee personal income tax withholding requirements or social collections is neither feasible nor desirable. They need to both pay social contributions on their own account and withhold contributions and taxes from any employees. This may of course lead to collusion between employer and employee to understate wages paid (a practice not unknown even in larger companies),⁵¹ to which some countries have responded by adopting minimum wages for purpose of payroll charged, leading to further distortions and potential inequities.

These are evidently difficult issues, and this may be the one area in which the structure of the business (that is, the presence of employee(s)), not simply its turnover, should determine at least a part of the tax treatment of the small business. Some countries have devised more complex presumptive systems that attempt to address this: see Box 1. But it is not at all clear whether this is superior to simply requiring that such businesses comply with the normal withholding requirements. These issues are likely to become increasingly important in many lower income countries as social insurance schemes are developed—and clearly require more discussion.

⁵¹ This consideration may in turn influence the choice of any special regime applied to owners: under a cash-flow tax, for example, but not under a turnover-based one, charges saved by overstating the wage bill are to some degree offset by increased income tax payments.

Box 1. Social Security Payments under Presumptive Systems

Brazil and Argentina have adopted presumptive systems that substitute for social security payments in addition to the major taxes. The rationale for these regimes goes beyond administrative simplification and aims at reducing impediments to job formalization. The solution is tailored for environments of high informality and low access to the social security network, the idea being that the tax base itself would be broadened as a result of the formalization process.

The Brazilian "*Simples*" was introduced in 1997 and cut the direct link between the *employer's* payment to the social security system and the value of the wage bill. Importantly, the *employee's* contribution continues to be charged under the regular system. Under *Simples*, eight different federal and sub-national taxes and social contributions are paid at once, calculated as a percentage of the business's turnover. The employer's contributions to the social security system become a function of the turnover, independent of the number of employees and the payroll. The greatest challenge is to maintain a balance between contributions and benefits, given that *Simples* employees keep the same rights to benefits as any other employee in the country. This was attempted through rate calibration and by restricting some labor-intensive activities from opting for this mechanism. However, there is an estimated tax expenditure of US\$ 2.5 billion for 2007 arising from foregone social security collections, showing that the regime does operate as a preferential system. The rates vary from 1.80 percent to 4.60 percent of turnover for businesses operating in commerce or industry. For the more labor-intensive service sector, the rates range from 2.42 percent to 7.83 percent. Some specific service activities, such as construction, are obliged to pay social security contributions under the normal regime (20 percent of the payroll) or are simply prohibited from opting for *Simples*. Naturally these needed differentiations add to the complexity of the system. The Brazilian social security system works under the PAYG method. Individual benefits are linked to earnings history, but there are no funded individual cash accounts in the public social security system.

The Argentine '*Monotributo*' has also been applied in lieu of social security contributions since 1998. It works under a patent system, whereby taxpayers pay a fixed quota which is a function of some variables (turnover, physical area, electricity bill). This regime replaces, in addition to the social payments, the income tax, the minimum tax on assets, and the VAT. The fixed quota varies from ARG\$ 92.44 to 564.44 per month, and also applies differently across economic activities. One of the major goals of the *Monotributo* was to include low-income taxpayers into the social security network, and a substantial amount of the revenue it raises is used to address the solvency of the social security system. As in the case of the Brazilian "*Simples*", the *Monotributo* produces a preferential rate relative to the regular system; the patent represents around 33 percent of what would be expected under the normal system.

V. TAX ADMINISTRATION FOR SMES

As discussed above, administrative and compliance concerns provide the most convincing rationale for size-tailored tax policies and administrative approaches, especially in the context of non-industrial countries. This section looks briefly at some of the underlying administrative issues in SME taxation; then describes some existing responses to the SME challenge, including administrative differentiation; and finally draws some preliminary conclusions.

It is critical to recognize that ‘SMEs’ are not, as discussed above, a uniform category in any country. Much of the discussion that follows in fact relates to small and micro enterprises. ‘Medium sized’ enterprises—which, depending on country context, could mean anything from businesses with 20 or more employees to those employing hundreds—should be, and generally are, treated in policy terms in the same manner as ‘large’ taxpayers. Administrative approaches to these taxpayers will also likely be more or less qualitatively the same as those applied to large taxpayers. The differences will come rather in the intensity of focus applied to each individual business, determined largely by a cost/benefit trade-off based on potential revenue at stake. Such medium sized enterprises often have some level of professional management, separate from or in addition to the business owners; they may have (indeed almost certainly will have, in industrial countries) professional accounting and legal advice; and it will be harder for such businesses to operate invisibly, in the informal sector, although that is not to say that avoidance and evasion will not occur. Thus, when the implementation problems of the ‘SME’ sector are mentioned, it is frequently small and micro enterprises that are being referred to, including the self-employed, small family run businesses, or informal partnerships. The term also generally implicitly refers to self-employed professionals.⁵² Many small enterprises, including these, may be quite profitable, with their owner/employees being high income individuals.

A. Issues in administering SMEs—background

Costs and benefits of compliance and administration

The basic problems in the tax administration of small enterprises stem, under any policy environment, from what is essentially a cost/benefit calculus. From the taxpayer’s standpoint, low risk of detection and penalization, coupled with high costs of compliance relative to income, provide poor incentives for voluntary compliance. This tax behavior is not homogenous, can be both intentional and unintentional, and is affected by SME characteristics. Unintentional noncompliance, for example, is commonly linked to limited understanding of the laws, poor recordkeeping, and the lack of professional tax advice—and is reflected in non-filing and mistaken underreporting. Intentional noncompliance stems from businesses operating in the informal economy with hard-to-trace cash and barter transactions which mask evasion (deliberate non-registration, non-filing, and under-reporting).

For all tax administrations, and particularly those in developing countries, a key objective is to reduce administrative and compliance costs per small taxpayer in such a way that more attention can be paid to them and risk and return more appropriately aligned. Conversely, and equally or more problematic, some tax administrations devote the vast majority of their staff time to small taxpayers, despite the relative lack of impact this has on revenue. This can result, in addition to the sheer number of SMEs, from antiquated methods of administration

⁵² This is also true in less developed economies, but the emphasis on and importance of that group is likely lower relative to small scale subsistence level economic activity, as a proportion of the total economic activity.

and organization, which may require administrative assessment, and/or are bolstered by a legal structure that requires, for example, audit of all VAT refund claims, or of all business income tax filings.

Successful tax administration means not simply increasing revenue, but rather increasing voluntary compliance. Solutions that are well suited for developed and some advanced transition economies (such as e-government) may not work well in countries with a much lower level of infrastructure development. And the critical issues will vary from country to country and even within a country over time. For example, countries with high levels of economic informality are typically more concerned with bringing unregistered small enterprises into the tax net; industrial countries, on the other hand, may find that a large portion of the small-enterprise tax gap arises from underreporting of income by registered businesses.⁵³

B. Administrative Methodologies

Modern tax administration depends upon taxpayer self assessment, which in turn depends on effective taxpayer service approaches buttressed by enforcement efforts directed at those taxpayers who are most likely to misunderstand or to intentionally avoid their obligations. Collectively, a risk-based and balanced service and enforcement strategy in the context of a self-assessment environment aims to maximize voluntary compliance and revenue mobilization within the law. These techniques must, as a practical matter, group taxpayers by a few major types of risks, picking visible characteristics as a proxy for underlying compliance behavior. Size is typically a starting point for this process, although multiple criteria are commonly used.⁵⁴ Indicators of risks posed by small taxpayers may include dynamic firm creation and dissolution; poor or absent record-keeping; cash or barter-based transactions; high participation in the informal economy; and many small retail transactions, which are particularly difficult to track in the service sector. For the tax administration, these pose a variety of challenges. Firm turnover, for example, puts a burden on the registration function, as well as on the service function. Poor records—a particular problem in developing economies where a portion of the self-employed and micro-business sector may not be fully literate—can undermine the self-assessment system by leading to the use of administrative assessments.

⁵³ See, for example, U.S. Department of the Treasury (2006): over 80 percent of the U.S. gross tax gap is attributable to under-reporting (by either understating income or overstating deductions and credits).

⁵⁴ In many large taxpayer operations, for example, individual compliance strategies for the largest taxpayers are further refined by industry sector to develop industry financial norms and staff expertise necessary to perform effective audits of complex multinational businesses. And specific targeting of groups within the small taxpayer population is also undertaken, particularly for categories of businesses that have been identified as posing compliance problems: for example, construction, food and beverage establishments, taxis, truckers.

Providing effective service

Tax administrations with limited resources often attach relatively little priority to a growing SME population, given a perceived low potential tax yield. This is particularly true where past or current practice is to evaluate tax administration performance largely on revenue yield. Successful self-assessment systems are based upon fair and impartial administration that includes transparent laws and regulations, access to clear information about tax obligations, assistance in meeting those obligations via telephone, counter, and correspondence, and appeal rights. Services designed to facilitate taxpayer compliance with the tax law are a complementary and integral part of a revenue administration. Further, though often hard to measure, it is arguable that in cost benefit terms, revenue mobilization from the provision of more effective service is higher than that from additional enforcement.⁵⁵ And tax administrations increasingly find that public expectations for service are growing as, more and more, comparisons are drawn between the performance of public sector organizations and that of the private sector.

The challenges of offering quality services to SME taxpayers, especially in developing countries, are significant: (i) these taxpayers are numerous and diverse; (ii) they typically have poor knowledge of tax laws and obligations; (iii) they tend to be less sophisticated and often have limited IT access and thus require costly face-to-face services and more extensive support through printed brochures and leaflets; and (iv) they are a “revolving clientele,” because their short business life cycle demands ongoing effort to educate newcomers.

To meet these challenges, tax administrations must understand the relative costs and benefits of the different service delivery options to support taxpayers (such as correspondence, public counters in local offices, telephone call centers, leaflets and booklets, leveraged services through others, and web-based options). In countries with established taxpayer service programs, the strategy is usually to manage costs by moving taxpayers to self-help options (web and e-based services, for instance, and automated telephone options). The tax administration lowers its overall costs by minimizing the need for direct services which are provided through more costly correspondence and counter services at local offices, and maximizing the use of telephones and encouraging web-based access to information.

For developing countries seeking to build a service program, a key design consideration is the degree to which SMEs have access to telephone service, media outlets, and the internet. In many countries, e-services and self-help options may currently have limited applicability. In such cases, even though these should be medium- to long-term goals, taxpayer services must necessarily be delivered more frequently through higher cost walk-in and telephone

⁵⁵ Because the revenue contribution of services is often relatively harder to measure, the operational budgets for taxpayer services are often under more pressure than for enforcement programs.

services. In these countries, outreach activities (community meetings and the like), tax education programs and media outlets are of great importance.

Services and products should be tailored to meet the transaction and life-cycle needs of SMEs and designed from their perspective. SMEs need clear and understandable answers to specific questions: How do I start a business? How do I file and pay my tax return? What records must I keep? What are my obligations as an employer? What income is reportable and what expenses are deductible? How do I dissolve a business? Simply providing access to the tax code or tax procedure law—however simple they are—will not meet the needs of a self-employed contractor who is about to hire an employee for the first time.

Many tax administrations now develop specialized advice for small businesses on an industry basis (such as construction, bars and restaurants, agriculture, retail, manufacturing). Often, tax professionals and industry groups assist in the development of these products; the role of tax professionals and others should be leveraged to increase SME service at low cost. Tax administrations should seek ways to help third parties help SMEs to meet their tax obligations. Recognizing the role of tax professionals in tax administration, a growing number of tax agencies develop tailored products and services such as specialized information alerts, call center services, internet portals, and seminars for these advisors. Partnerships with SME industry groups, small business associations, bankers and financial advisors are also very useful in providing information to their membership and clientele on general tax compliance topics and specific issues related to their field. Generally, advice and information received by SMEs through these sources has high credibility. Other governmental agencies with SME responsibilities (including those involved in registration, licensing, small business support) can be helpful and low cost distribution channels to reach the SME taxpayer.

Reducing the compliance burden

The heavy burden that many companies continue to face in terms of the time and expense involved in meeting their tax obligations have been powerfully documented in the widely cited *Paying Taxes: The Global Picture* (Price Waterhouse Coopers and World Bank, 2006). Simplifying these requirements can result in significant benefits to both the SME taxpayer and the tax administration. Key aspects include procedures to register, make and deal with inquiries, file and submit returns, pay taxes, complete an audit, and solve tax disputes. Given the limitations on SME's compliance capacities, tax administrations should streamline procedures, guided in this by four principles: (i) do not request more information than will be processed and used for the tax administration's purposes; (ii) provide simple and clear information on what, how, where, and by when actions should be completed, and clearly delineate record keeping requirements; (iii) standardize procedures nationwide in order to avoid different treatment across different offices; and (iv) operate with transparency and public accountability. All of these of course argue for the critical importance of simplifying

legislation, regulations, and forms. But clearly too this alone is not enough. Beyond this, prime areas for consideration in practice include:

- Registration practices are often needlessly bureaucratic (involving multiple agencies, and multiple crosschecks), complex (different laws, norms, documents and forms), expensive, and time-consuming. Delays in business registration, which often involves multiple government institutions including the tax administration, can be a significant impediment to business formation and particularly harmful to the small entrepreneur with limited start-up cash reserves. For example, in Australia and Canada a business can be opened within 2-3 days—elsewhere, it can take over 100 days in others (see 2007 *Doing Business* report). For the SME operating with limited capital and professional support, such start-up delays and increased costs raise the risk of failure. Best practices include adopting a single unique taxpayer identification number for tax and customs; coordinating efforts with other revenue administrations and agencies involved in the registration process, and integrating and streamlining procedures.⁵⁶
- Filing returns and paying taxes can be extremely burdensome, particularly if the forms are complex, the requested information hard to obtain, and return filing requires time-consuming visits to a local tax office in order to comply with tax obligations. For tax administrations, SME returns represent the bulk of forms received and processed and, unlike large taxpayers' returns, they have a disproportionate number of inconsistencies, missing information, and unintentional errors. The benefits are therefore very high for return simplification, plain language instructions, bank payment processing, reductions in filing and payment frequency, and e-filing and e-payment acceptance, when feasible.

Enforcement: Non-filing and under-reporting

Informality and non-registration

As noted earlier, in developing countries the extent of informality amongst smaller enterprises is one of the greatest problems faced by tax administrations. Registration is a major compliance problem in terms of base inclusion and reliable information—identification of unregistered taxpayers is extremely costly and typically requires efforts both in enforcement and education. For example, a recent pilot study in Mexico found that: (i) 24 percent of the active businesses (of which 93 percent were SMEs) were not incorporated in the tax register; (ii) 38 percent of the total active taxpayers had inaccurate addresses on file; and (iii) of those that had accurate address information, 71 percent of files were missing data

⁵⁶ Ideally, registration should be a one-stop service that minimizes multiple visits to different agencies. Given the importance of the TIN to the overall integrity of the tax system, proof of identity is a critical element of the registration process. For VAT, particular, care is needed to validate the business to protect against fraud.

(González, 2006). Non-registration (and non-filing) can, therefore, generate a significant component of the tax gap in some low-income countries.⁵⁷

Non-filers and underreporting problems

Unlike large businesses with strong internal controls, or the wage earner subject to withholding, SMEs with closer ownership/management linkages have greater propensity to underreport some or all of their income. Despite the strong foundation provided by the service and streamlined procedures discussed above, many SMEs exploit the openings afforded by, for example, single-owner operations and cash intensive businesses. The overall integrity of any tax system depends on public perceptions of its enforcement effectiveness through predictable and prompt enforcement action against non registration and following non filing and non payment, and through a balanced but risk-based audit program across all tax types and taxpayers. The administration therefore must aggressively pursue, at a minimum, medium-to-high-risk nonfilers and taxpayers who misreport.

Low cost approaches designed to target SME compliance issues often include: (i) requiring a taxpayer identification number to open a bank account; (ii) establishing proof of tax compliance for government contracts; (iii) prohibiting cash business transactions over a certain threshold; (iv) tying the issuance of business licenses and other permits, such as construction, to tax registration; and (v) offering easy validation of VAT registration for business-to-business and business-to-customer transactions.

Third-party reporting and cross-matching

Third-party information reporting can be an effective tool for tax administrations. The mandatory reporting of payments and payee information for some types of income by third parties is widely used, for example for salaries, interest and dividends. Some countries go further and require this for other types of income (such as non-employee compensation, capital gains distributions, real estate transactions, brokerage fees, government contract payments, international funds transfers). While it has generally not been seen as best practice, a few countries seek to increase VAT compliance by requiring submission of purchase and sale invoices to identify fake and falsified invoices, verify input credit entitlements, and ensure that invoiced taxable sales are reported in VAT returns.^{58 59}

⁵⁷ The proportion of non-compliance attributable to non-registration and non-filing may differ between developed and developing countries, and between individual countries. For example, in the United States, recent IRS research indicates that only about 7 percent of the overall compliance gap stems from non-filing, while 32 percent of the total gap comes from underreporting of business income.

⁵⁸ Of note, intra-governmental exchanges are also a very useful source of compliance information, e.g., national governments can secure information from local governments on assets (real property and business assets) and locally licensed businesses, while both can share enforcement results which may be relevant to identifying taxpayer underreporting of other taxes.

Information reporting is only effective if the data are cross-matched—which is difficult because the necessary document matching volumes can be exceptionally large. For example, the U.S. matched 1.56 billion documents in 2005-06, China cross-matched 409 million invoices representing 93 percent of the VAT revenue (2006), and Australia will match 48 million transactions (2006-07).⁶⁰ Consequently, effective data-matching programs are dependent upon electronic matching facilitated by a single taxpayer identification number. In developing countries, cross-matching of import and export data can be one of the more effective techniques. Done well, these matching efforts can be cost effective and the transparency afforded by third party information reporting does result in improved voluntary reporting. In the U.S., income subject to information and withholding is reported at an impressive 98.8 percent rate, and reporting of income subject to some information reporting falls only to 91.4 percent. On the other hand, reporting drops precipitously to an estimated 44.1 percent where the income is subject to little or no information reporting—as is typical of income earned by SMEs.

Industry-based compliance projects

These can be effective where there is persistent and widespread abuse (such as informal transactions or smuggling). These initiatives should contain education and enforcement components and be highly visible to the public to maximize their deterrent effect. Australia, through its cash/informal economy task force, has taken a holistic approach and developed a full range of strategies and tactical activities which begin with educating SME customers to the downsides of doing business with an unregistered taxpayer to the strongest enforcement actions.⁶¹

⁵⁹ Advanced tax administrations use selective cross-checking methods based upon risk assessment, which are less burdensome for taxpayers in general.

⁶⁰ 2006 Data Book, US Internal Revenue Service; State Administration of Taxation, China; and 2006-07 Compliance Program, Australian Tax Office.

⁶¹ The Commissioner of Taxation established the Cash Economy Task Force in November 1996. Its objectives are to examine the nature of the cash economy, determine what are the likely compliance issues, and develop a view about what additional steps can be taken by the Australian Taxation Office to address tax evasion in the cash economy (<http://www.ato.gov.au>).

Risk scoring

A more broadly applicable national system for risk-scoring taxpayers across major tax types, such as VAT and income tax, provides consistency and efficiency in the targeting of high-risk compliance workload. Risk scoring systems use the characteristics of taxpayers to identify and assess their risk of noncompliance. This allows appropriate prioritization of audit workload and allocates resources against the highest risks. Tax administrations in many countries use these systems to: (1) provide a comprehensive assessment of the risks of all taxpayers; (2) ensure that their compliance activities are directed to the areas of highest risks; (3) increase the tax revenues generated by their compliance programs; (4) reduce the burden of audit for compliant taxpayers; (5) provide information for compliance research, such as evaluating compliance strategies; and (6) deliver high-risk compliance workloads to local offices.

SME audits

Auditing an SME often requires using indirect methods and authority to secure third-party information, e.g., bank transactions, and purchases and sales. Determining the scope of off-the-books income requires skilled auditors to determine the amount of unreported income. There are several accepted techniques for this (retail mark-up method, proof of expenditures, analysis of bank deposits, and net worth analysis) but all require extensive information and analysis. The tax administration must have the legal authority to pursue the needed information, importantly including regarding bank accounts, (often requiring a summons) and make assessments based on indirect estimates. Tax administrations lacking skilled personnel and an adequate legal framework will be ill-equipped to tackle SME non-compliance. Potentially as challenging is the problem posed by the sheer number and variety of SMEs to designing an effective risk-based audit program in an environment when tax policy design is not reflective of taxpayer and administrative capacity, and thresholds for the formal system are set unrealistically low.

Debt collection issues

SME debt collection presents unique challenges: (i) although the individual cases may be small, collectively the debt is often substantial; (ii) many businesses operate with marginal cash flow and few distrainable assets; (iii) some have no formal place of business and are hard to locate; and (iv) others fail quickly leaving behind tax arrears that are hard to recover.

Tax administrations should implement a comprehensive SME debt management strategy based on risk management, legislative authority, sound debt collection policies, and debt management techniques. Important elements include: (i) streamlining the collection process to speed debt collection activity; (ii) risk-scoring each case based type of debt, age, amount owed, past payment history, asset information (from third-parties, for instance, such as

banks, credit bureaus, and other government institutions);⁶² (iii) using appropriate channels to communicate with taxpayers (letters, call centers, e-mails, in-person visits, as appropriate to the taxpayer's profile); and (iv) providing taxpayers with opportunities to resolve the debt by installment arrangement or full payment based on the situation.

Tax administrations should have appropriate legal powers to effectively recover SME arrears and manage collection inventories. Resolving SME tax debts often requires action against assets (with proper notification) held by the taxpayer (which may effectively end business operations) and third parties, such as bank funds and accounts receivable. Tax administrations should be able to exercise this authority without court approval. Often corporate officers can be held personally liable for failing to remit taxes that are collected by a business from its employees or customers on behalf of the government, such as personal income tax, social security contributions, value-added taxes, and excise taxes. Where assets have been transferred without due consideration, legal authority is needed to transfer the tax liability to the person receiving the assets.

When debts are determined to be uncollectible, the arrears should be written-off (with proper internal controls to avoid corruption and misuse). However, general amnesties should be avoided. While there may be a short-term revenue gain, they serve to undermine and weaken the compliance culture in the longer term (Baer and le Borgne, 2007).

C. Tax administration organizational responses

Organizational choices for tax administrations revolve around three basic models: tax type, functional, and client-segment: see Box 2. While each model has advantages and disadvantages, most countries have adopted, as the basic approach to domestic revenue collection, a functional organizational structure, including local offices responsible for all taxes and organized by function (registration, services, revenue accounting, returns/payments processing, collections enforcement, and audit). Within the overall function-based approach, a separate, full-service department, dedicated to large taxpayers has frequently been established in recognition of the revenue risks posed by these taxpayers.⁶³

Because the organizational structure is a tool to properly align the tax administration's work to SME risks, organizational responses to such risks have varied according to the specific needs of the country. For example, beginning the early 1990's, several countries developed tax administrations organized principally around customer segments: these included, for example, Australia, Denmark, Finland, New Zealand, Sweden and the U.S. It should be noted

⁶² This risk analysis may result in speeding collection action on newer and potentially smaller—but more collectible—debt, at the expense of larger debt with lower collection potential.

⁶³ For a further discussion of the organization of tax administration operations within OECD countries see OECD (2006).

Box 2. Typical Tax Administration Organizational Structures

There are essentially three types of organizational structures for revenue administrations.

Type of tax. One of the oldest structures is the tax-based model under which separate departments are set up to administer specific types of taxes. Each revenue department performs virtually all of the functions required to administer the taxes for which it is responsible. The main advantage of this approach is that it establishes clear accountability and control for each tax. The main disadvantages are: (1) high administrative costs; (2) high compliance costs for taxpayers (through having to deal with a variety of departments); and (3) vulnerability to collusion between taxpayers and tax officials (with fewer checks and balances as each department operates autonomously).

Function. Under this model, separate departments are established for each of the major administrative functions (e.g., processing returns and payments, auditing, and collecting arrears). The major advantages of this approach are: (1) improved taxpayers' compliance (through for example the ability to conduct joint audits for all taxes); (2) increased staff productivity; and (3) reduced scope for collusion between taxpayers and officials. The main disadvantage is that unique taxpayer service needs and compliance issues may not be adequately addressed.

Taxpayer segment. In this approach, the staff provides a full range of administrative services to designated group of taxpayers. The groups are usually based on the taxpayers' scale of operations and the corresponding risk to the revenue and service needs. The advantages of this approach include: (1) strengthened accountability for organizational outcomes; (2) allocation of resources based on risk to the revenue; and, (3) better matching of enforcement, service, and educational programs to types of taxpayers. Typically, these organizations have divisions responsible for large corporations, medium-size enterprises, and small businesses. A disadvantage is the added costs created by functional redundancy (processing returns and payments, auditing, and collecting arrears) that occurs within each taxpayer segment.

that these countries did not necessarily adopt the sort of office-type by segment organization which is typically meant in discussions of "segmentation" in developing countries. In New Zealand, for example, the segmentation was more programmatic, rather than physical. It is also of interest that some of these countries—including the US—have either returned to a functional alignment or reintroduced some functional elements because of concerns with cost and a desire to ensure consistent approaches to core activities (such as audit and arrears). And others—for example New Zealand, US, Australia, Canada, UK—have continued the evolution of their organizations, to take advantage of technological and telecommunication changes, moving to create organizational efficiencies and strategies (processing centers; modern 24 hour central call centers) for handling most taxpayers services and less complex compliance issues, while reserving more resource intensive one-on-one interactions for complex audit and collection activity, typically directed towards medium- and large-sized businesses and high wealth individuals.

Recently, a few tax administrations in developing and emerging countries, notably in Africa and the Middle East, have developed integrated client segmentation and tax policy reforms to better address SME compliance. Building on their function-based headquarters and large taxpayer office model, these countries have established special programs and, notably, special offices—medium tax offices (MTOs) and small tax offices (SMOs)—to deal with

their medium-size and small enterprises. The advantages of this approach include: (1) better allocation of resources based on risk-revenue considerations; (2) better matching of enforcement, service, and education programs to small and medium-size taxpayers' compliance patterns; and (3) strengthened accountability for outcomes, including clear lines of reporting to support SME compliance strategies. In these countries, MTOs typically handle enterprises with a turnover above the VAT threshold and SMOs, small and micro businesses with a turnover below the threshold. One such planned arrangement in Algeria is described in Box 3.

Box 3. Algeria Case Study

Since 2001, Algeria has been developing a tax administration reform strategy based on a major restructuring of its network of local offices and their operations. The purpose of the reform is to address a number of impediments to the modernization of the tax administration, including:

- Four levels of administration: headquarters, regional directorate (in 9 regions), departmental directorate (in 54 departments), and a fragmented network of about 1800 field offices.
- Weak management capacity at the headquarters level to supervise, and provide guidelines to, field offices.
- Lack of focus on taxpayer segmentation—large enterprises and medium-sized businesses were handled in the same offices as small and micro taxpayers.
- A complex *forfait* system for the taxation of small businesses.

The initial phase of the modernization strategy (2001–03) focused on (a) establishing a large taxpayer office (the *direction des grandes entreprises* or DGE) administering 600 large enterprises located in Algiers and its region, with a petroleum and gas unit dedicated to the control of those enterprises operating in this sector; and (b) strengthening the headquarters and the regional directorates.

The second phase (2004–06) focused on the preparations for the restructuring of the tax offices network, beginning with implementation of two pilot offices for medium-size taxpayers (*Centre des impôts—CDI*) in Algiers, and implementation of a pilot office (the *Centres de proximité—CDP*) for the administration of small businesses (meaning those with a turnover below the VAT threshold). During the same period, the authorities eliminated the *forfait* and adopted a presumptive tax regime for the small businesses.

Since January 2007, the authorities have embarked on the implementation of the CDIs and CDPs, beginning with Algiers and other important regions. The plan is to implement about 20 CDIs and 50 CDPs, initially in the four main regions. The vision for the longer term (5–6 years) is to replace the current network of 1,800 units by 60 CDIs for the medium-size taxpayers, and about 200 CDPs for the small and micro taxpayers.

D. Taxpayer inclusion as a path to modernization

The possible approach to taxing SMEs described in Section IV.C above presumed a fairly high VAT threshold, and suggested the application of a presumptive regime to most of those businesses falling below that threshold. However, regional circumstances differ. In particular, many Latin American countries which implemented a 'first-generation' VAT in the 1970s did not provide for a threshold. Under these circumstances, as noted earlier in the paper, a variety of second-best policy solutions have been adopted in many countries.

An alternative approach, based instead upon facilitating the inclusion of SMEs into the formal tax system, has been suggested for implementation in Chile (Toro, 2006). Well known for its highly successful tax administration reform of the late 1980s and early 1990s, Chile

now has a strong tradition of compliance and enforcement. Since the late 1990s, the administration has re-oriented its approaches to a more balanced use of programs of service to taxpayers, along with enforcement. Under these circumstances, it is perhaps not surprising that Chile is now giving particular focus to the provision of e-services to small businesses.

While acknowledging that many tax administrations are not yet ready to take on the full management of all taxpayers under the regular tax system, this model posits as the ultimate goal that as many taxpayers as possible should be ‘mainstreamed.’⁶⁴ Further, this approach advocates the use of the tax system to assist in the formalization of the small business sector. The strategy advocated under this proposal is to provide intensive focus on SME taxpayers through a service-oriented approach heavily dependent on advanced information technology (as opposed to through the adoption of special regimes). The aim would be to run an on-line tax life cycle in parallel with an on-line business life cycle for small taxpayers, ultimately resulting in universal electronic tax administration communication, registration, filing and payment.

Clearly such an approach would not be possible in many countries less advanced both technologically and in terms of the existing tax administration. And deep practical and logistical support to taxpayers, through the provision of hardware and software access, training, and taxpayer assistance, is required to make this work, as the approach acknowledges: in the case of Chile, this is to be undertaken in part through the development of public-private partnerships with private internet provider centers, building a network of 2,800 internet access points available for completing tax procedures on line.⁶⁵ The goal is to provide an accounting module to SMEs on line that would not only permit them to carry out their tax affairs electronically, but, importantly, would enable them to maintain their business records electronically, where otherwise they would be using paper records (if anything). Ultimately, one effect of the program, in terms of the threshold model discussed in Section IV.B, above, is that both administrative and compliance costs should be lowered.

Although it is obviously too early to assess the effectiveness of this comprehensive program of services, this ambitious approach has merits which could be considered—depending upon the level of development of both business and the tax administrations—in relevant countries.

⁶⁴ To some extent these two views do coincide, with the one described here acknowledging that, for example, the smallest taxpayers must fall under a simplified cash accounting system. A principal difference—in addition to the VAT threshold—would be in whether the smallest taxpayers were expected to maintain cash expenditure books as well as simple cash receipts. But the basic premise would use turnover as a basis for taxation, as suggested in part A above. Chile in fact presently has multiple simplified regimes.

⁶⁵ It is perhaps worth noting that Chile, like many other countries, has a number of rather burdensome procedures that would be made available electronically under this approach (e.g., mandatory issuance and tax authority certification of invoices for all sorts of transactions). To the extent that such procedures can be eliminated altogether, there would be less need for frequent interaction between the small taxpayers and the administration—electronically or otherwise—in order to ‘formalize’ their behavior.

While it would be unwise to lower VAT thresholds in countries with weak administrative capacity,⁶⁶ the taxpayer education and services programs developed in Chile may serve as an example of good practice when a cash flow system is implemented for the income tax.

VI. CONCLUDING REMARKS AND QUESTIONS FOR DISCUSSION

The tax treatment of SMEs is marked by wide variation in country practice and—perhaps linked—by a relative paucity of analytical work. But it is also attracting increasing attention in a many countries. This paper has sought to set out the key issues for both policy design and administration, and to draw some conclusions from experience.

The coverage in this paper is by no means exhaustive. A number of countries, for instance, use taxes on smaller enterprises as sources of finance for lower-level governments, raising further issue of fiscal federalism and administrative structures. The tax treatment of business transfers, including under the inheritance tax, is another concern in many countries that is not addressed here. Nor has the paper explored the potentially significant implications of the challenges faced in taxing SMEs for the design of the system applied to larger enterprises, but rather has taken the latter as given: if cash flow taxation is good enough for smaller enterprises, for example, why not—given its conceptual appeal—for larger enterprises too?

The core issues that have been raised here, nevertheless, clearly create much scope for discussion and further thought, and to this end the topics paper prepared for this conference provides a series of questions that might provide some focus for each of the sessions. Over-arching these is a series of fundamental issues on which the conference may shed light, including, but not limited to, the following:

Questions regarding the nature and role of SMEs:

- Are there any reasons, other than practical, why smaller enterprises should be taxed any differently from larger?
- How can SMEs best be brought into the formal economy? Are there any encouraging country experiences on this?
- To what extent should the tax treatment of SMEs seek the improvement of business practices as an objective in itself?

Questions regarding tax policy toward SMEs:

⁶⁶ And even some of the most advanced administrations—such as those of France and the U.K.—have raised their VAT thresholds.

- What general tax provisions are particularly important to SMEs, and why do we observe considerable variation in their design?
- What have been countries' experiences in relying on special tax provisions for SMEs (whether at enterprise or investor level), in terms, for instance, of addressing perceived financing difficulties of SMEs and encouraging participation in the formal sector?
- What has been the experience with alternative forms of presumptive taxation? Can a 'single tax' work for SMEs?
- What has been the experience of countries in the use of thresholds for the VAT?
- What are the implications for the proper tax treatment of SMEs, if any, of the increasing use of offshore tax-planning by large corporations to lower their effective tax rate on investment?

Questions regarding compliance and administration for SMEs:

- What is the nature and extent of SME tax non-compliance in various types of economies? What lessons may be drawn from the differences, if any?
- Is taxpayer segmentation appropriate as an organizational model for tax administrations in dealing with SMEs? To what degree should the SME sector be further disaggregated by size in managing their tax compliance?
- What specific administrative methodologies have to date proven most effective in improving SME compliance?
- What challenges are posed by the need to withhold payroll taxes and social contributions from employees of smaller enterprises, and how can they be met?

Directions for future inquiry:

- What are the priority areas for further research and analysis, and for possible follow-up to this conference?

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