

Taxation of SMEs and Sustainable Economic Development

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Collection from businesses

- Collecting taxes from businesses, rather than individuals, makes use of the economies of dealing with a smaller number of larger units, many of which have sophisticated accounting systems.
- It is *more* costly, as a fraction of revenue raised, to collect taxes from SMEs compared to larger businesses.

The Tradeoff

- Raising taxes from SMEs entails high collection costs per revenue.
- Collection costs include both administrative and compliance costs, but the former should be weighted more heavily.
- But taxing SMEs preferentially creates inefficient incentives for resources to flow to them (where they are difficult to tax).
- Thus, *economizing on the costs of collection may exacerbate the distortion costs of taxation.*

Types of distortions

- Example: a size-related exemption discourages businesses from getting big, a production inefficiency.
- It also favors goods and services whose production technology involves small businesses, a consumption inefficiency.

Cost-benefit considerations

- The potential collection costs savings and the distortion costs depend on to which tax the SME preferences apply, and on the nature of the preferences.
- Special treatment can take many forms, including exemption, a lower rate schedule, a simplified base, and relatively lax enforcement.
- Key question: what about a tax system delivers lower collection costs?

Poverty alleviation

- Assessing equity issues requires careful consideration of the ultimate incidence of SME tax policies.
- Both tax liability and compliance costs can be shifted away from the apparent beneficiaries via market adjustments.
- For example, SMEs are not necessarily owned by people with small incomes.

Summary

- Special tax regimes for SMEs may be appropriate policy instruments for minimizing the cost of collection.
- The objective should be to achieve collection cost savings while minimizing the revenue loss, disruption to the economy, and the inequity and capriciousness of the tax burden.

Closing thoughts

- Many of the issues apply to regulation, too, because of the fixed costs involved.
- Other policies can address the informal economy, such as subsidies for business use of financial institutions.
- Many large businesses are MNCs, so that special tax regimes for SMEs tend to target domestically-owned businesses, for better or worse.