Tax Policy for SME Growth and Tax Compliance
(Proposal for 2008 WG3 meeting)

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Meeting of Working Group 3 (Tax Policy for Investment) of the MENA-OECD Investment Programme
19-20 June 2007, Cairo
Discussion points

- Widespread policy interest in SMEs
- Current OECD work on taxation of SMEs
- Analysis of possible tax impediments to:
  - business creation
  - business incorporation
  - external financing of SMEs
  - tax compliance
- Next steps
Policy interest in SME Sector

Contribution of SMEs to Employment, 2001

OECD work on taxation of SMEs

- Preparations for ITD global conference on *Taxation of SMEs*, 17-19 October 2007, Buenos Aires.
  - http://www.itdweb.org/SMEconference/
- SME tax questionnaire (OECD and non-OECD).
- Assess tax policy & administration impediments to:
  - SME development and growth
  - SME tax compliance
Tax impediments to business creation

- Comparison of statutory plus compliance tax burden under self-employment, versus dependent employment.

- Statutory tax burden comparison, factoring in:
  - progressive personal income tax (PIT) rate schedule
  - social security contributions (base, rates, incidence, benefits)
  - treatment of business losses (risk)
  - deductions for expenses in earning income
  - possibilities to evade tax, misreport income, expenses (evasion)
  - preferential treatment of certain savings vehicles
  - other taxes (e.g. inheritance/gift taxes, capital gains tax)
Tax impediments to business creation (cont’d)

- Compliance tax burden comparison, factoring in:
  - costs involved in understanding tax rules, maintaining records, filing tax returns
  - relatively low costs under dependent employment
  - relatively high costs for SMEs (especially new businesses)
  - various approaches to reduce SME compliance cost:
    - presumptive taxes.
    - VAT exemptions
  - compliance and statutory tax burden where business operates ‘underground’
Tax distortions to business incorporation

- Comparison of statutory plus compliance tax burden with unincorporated business, versus incorporated business.

- Statutory tax burden comparison, factoring in:
  - double taxation of corporate profit - possibly offset by:
    - integration of corporate and personal income tax
    - earnings retention (financing growth)
  - progressive PIT rate schedule
  - relatively low CIT rate
  - differences in determination of business profit
Factors in statutory tax burden comparison (cont’d):

- scope for owner/worker to mischaracterize labour income as capital income
- social security contributions (base, rates, incidence, benefits)
- treatment of business/corporate losses
- treatment of capital losses on SME shares
- possibilities to evade PIT/SSC (unincorporated business)
- other taxes (e.g. inheritance tax)
Tax impediments to SME financing

Important to address key policy questions:
• Under what circumstances does ‘market failure’ occur in the allocation of capital to SMEs? Where are the ‘capital gaps’?
• What structural features of tax systems are potentially impeding to equity financing of SMEs (i.e. in the absence of market failure)
Tax impediments to SME financing (cont’d)

- Certain structural features of tax systems may impede equity financing of SMEs:
  - classical taxation of distributed profits
    - increased cost of new equity finance (local investors)
    - corporate lock-in effects
  - classical taxation of capital gains
    - increased cost of retained earnings
    - capital gains lock-in effects (share of mature firms)
    - discouraging to venture capital financing
Other possible structural impediments:

- full corporate taxation of retained earnings
  - retained earnings key source of finance for SMEs
  - high CIT rate limits available retained earnings
  - preferential SME CIT may encourage SME growth – but only up to some threshold
  - certain advantages with targeting SME investment directly (target growth-oriented SMEs)
- Preferential taxation of alternative savings allocations:
  - principal residence
  - pension savings
  - offshore mutual funds
Tax impediments to high-risk SMEs

- Important to consider tax treatment of losses.
- Equity investment in innovative, high-growth SMEs typically high-risk.
- Risk-taking by entrepreneurs/investors may be discouraged if tax treatment of profits and losses is asymmetric.
- With symmetric treatment, government is equal partner in losses as well as profits.
Symmetric treatment requires:

- business losses deductible in full in the year incurred (or the equivalent) if profit taxed in full
- capital losses deductible in year incurred (or equivalent), at same inclusion rate as gains
Tax impediments to high-risk SMEs (cont’d)

- Policy concerns over symmetric treatment:
  - tax revenue loss (direct plus tax-planning)
  - characterization of consumption expenses as business expenses
  - deferral of tax on capital gains, current relief for losses

- Progressive PIT rate structure discouraging to risk taking
Tax impediments to SME tax compliance

- SME non-compliance (tax evasion) motivated by perception that tax burden is too high and other factors
  - undermines tax system, equity, efficiency, and impedes sustained economic development.
- Seek solutions that reduce compliance burden, increase tax revenue, avoid unintended distortions
- Ensuring tax compliance is difficult for SMEs
  - relatively high compliance burden (stronger incentive to evade)
  - costly to audit SME population
Tax impediments to SME tax compliance (cont’d)

- Tax evasion by SMEs may be curbed by:
  - reducing statutory tax burden on SMEs
  - reducing the compliance burden on SMEs examples:
    - Presumptive taxes
    - VAT exemption thresholds
    - increasing costs/fines for non-compliance
    - increasing probability of detection (audits)
- But such adjustments involve trade-offs.
Adjustments are not easy or straightforward

- relaxing reporting requirements for financial accounts, or relaxing auditing requirements (to reduce compliance costs) may also reduce compliance.
- lower statutory burden may feed perception that tax on employment is too high (SME creation to avoid tax)
- structural features facilitating evasion may be desirable (dual tax)
- general preference for reducing compliance burden as means to discourage evasion
Next steps

- Preparations for the ITD conference on taxation of SMEs (17-19 October 2007)
  - Finalize summaries of questionnaire responses (OECD and non-OECD countries)
  - Finalize background document for conference
- ITD conference and follow up (incl. preparation of summary report)
- Possible topic for 2008 meeting of Working Group 3 of the MENA-OECD Investment Programme