SMEs AND THE TAX SYSTEM: WHAT IS SO DIFFERENT ABOUT THEM?

ALAIN JOUSTEN*

In most countries, tax policy is one prominent area where the legislator explicitly reserves a special treatment to small- and medium-sized enterprises (SMEs). The present article discusses some key tax policy issues relating to SMEs. In the face of a rather daunting array of issues that one encounters when thinking about SMEs, it opts for a broad, but still limited approach. This is reflected in the structure of the article. The first part outlines the contours of the concept of SMEs and positions it with respect to some theories of firm size and growth. In a second step, the article discusses the limits of some frequently cited reasons for special treatment for SMEs and evaluates their relevance for the determination of tax policy in a country. The conclusion is that tax compliance and administration costs are the main justification for a size-of-business related tax policy.

The concept of SMEs

Policy makers and the wider public alike have a strong perception that SMEs play a particularly important role in the economy. And indeed, at first sight, the concept of SMEs may look very clearly defined and their special roles appear rather obvious. One key reason for this observation is that almost every person, based on his or her own personal experiences, has a strong preconceived view of what constitutes an SME. Associated with it comes an equally strong belief that these SMEs are clearly "different" and thus deserve a special treatment.

When stepping back a little and thinking in a more structured way about what exactly are the criteria determining an SME, it rapidly becomes clear that the topic is much more complex than originally thought. To start, it is far from a "unidimensional" problem, as size of businesses can be measured in many different ways. The wide variety of size criteria used in the real world witnesses this in an extraordinary way. Legislators and institutions around the world rely on a multitude of criteria to determine what constitutes an SME. The number of employees, the ownership structure, the turnover, the balance sheet total, the capital base, the legal form as well as the type of activity are only some of the most commonly used indicators to determine the SME "nature" of a business. Depending on the context, the country and the author, businesses ranging from the (after-hours) one-man/woman enterprise up to companies employing several hundred people are frequently grouped under the same label of SMEs. As an illustration, the European Union uses a rather broad definition of the concept of SMEs for its policies ranging from the part-time self-employed worker to corporations employing up to 250 employees.[1]

The same issues relating to the relevant cutoff points and criteria persist when companies are subdivided into narrower groups of medium, small and micro enterprises – with inevitable policy problems ensuing. Table 1 gives a brief overview of the real world situation in a number of European countries and in the US. The data illustrate the importance of the different subgroups of SMEs and also show the major role they play in providing employment for the population. However, the data also illustrate a rather wide variety of outcomes in different countries, both in terms of composition, as well as in terms of employment.

* University of Liège and IMF. The views expressed herein are those of the author and should not be attributed to the IMF, its Executive Board, or its management.

[1] According to EU definition, a small business is defined as employing up to 50 employees and having an annual turnover and/or annual balance sheet total not exceeding EUR 10 million. A medium business is defined as having up to 250 employees and an annual turnover of less than EUR 50 million and/or an annual balance sheet total of less than EUR 43 million. A micro business is one that has less than 10 employees and whose annual turnover and/or balance sheet total do not exceed EUR 2 million. Additional restrictions apply for the case of non-autonomous companies.

Table 1

The role and size of SMEs

Country	Year	Structure of the SME Sector (% of all SMEs)			SME Participation in the Economy	
		Micro	Small	Medium	SMEs per 1,000 people	SME employment (% total)
Austria	2004	86,4	11,8	1,8	31,1	65,3
Belgium	2003	95,9	3,5	0,6	42,2	69,3
Bulgaria	2003	90,4	8,0	1,5	27,7	79,0
Germany	2005	91,1	7,3	1,5	38,3	
Spain	2005	94,1	5,2	0,7	73,0	
Estonia	2005	88,0	10,0	2,0	48,5	
Finland	2003	93,7	5,4	0,9	42,4	59,2
France	2004	93,3	5,8	0,9	43,3	
United Kingdom	2004	95,4	3,9	0,7	73,8	39,6
Hungary	2006	97,0	2,7	0,4	n/a	
Poland	2001	99,2		0,8	43,3	67,1
Slovak Republic	2004	80,5	15,1	4,4	13,1	
Sweden	2005	96,2	3,2	0,5	99,6	39,6
United States	2004	78,8	19,7	1,5	20,0	50,9

Notes: Micro 0–9 employees, except Austria 1–9. Small 10–49 except US 10–99. Medium 50–249 except Belgium, Spain and Sweden 50–199 and US 100–499.

Source: "Micro, Small, and Medium Enterprises: A Collection of Published Data", International Finance Corporation (IFC), Washington D.C. (2007)

Unsurprisingly, the results of both normative and positive analysis are very different depending on which part of this rather wide spectrum the discussion focuses on. Hence, one lesson to be kept in mind in any discussion of SMEs is that the reader and policy analyst should always be very explicit about the basis for and the applicability of any given result. In other words, it is important for intellectual and political honesty that policy recommendations and normative results should not be unduly generalized. They should be properly restricted to the categories and contexts that they were originally derived in. While insisting on the importance of precision, the presentation does not refer to specific cutoffs when classifying enterprises according to different criteria, as these cutoffs are a function of the economic and the institutional environment of any given country.

One important factor in shaping the view on SMEs is the perceived link with another concept, the "middle class". In casual discussions, some people would use these concepts almost interchangeably. This observation is true in the EU and other developed countries, but applies similarly to the context of the transition countries and the developing world. However, it is important to clearly separate these two notions. While the concept of SMEs relates to the operator of a business – in the EU context one refers to an entity engaged in an economic activity irrespectively of its legal form – the notion of middle class rather refers to individuals, families or households. Hence, while the concept of SMEs refers to the productive sector of the economy, the concept of middle class refers to the consumption sector of the economy.

This distinction between production and consumption spheres of the economy, which might at first sight seem unimportant or a question of detail, illustrates a point of major relevance for the discussion below. Indeed, the well-being of each consumer is an important factor contributing to the general welfare of a country. SMEs, on the other hand, are a pure concept related to the production side of the economy, and hence arguments related to their role and their specificities should be clearly separated from the ones relating to their owners or operators. Tax policy, as a discipline guided by the principles of optimal taxation, clearly has to recognize these important distinctions.

This article focuses on size-related issues regarding the business and not the owners thereof. This choice does not represent a judgment on the qualitative or quantitative importance of the different aspects. It merely reflects the need for a concise approach to a topic with wide-ranging issues involved. For example, in spite of their undoubted importance, the article does not discuss incorporation of businesses, nor does it discuss the related issues of the choice of self-employment over wage-earner status or the choice of remuneration by means of capital or labor income. Indeed, we consider these important decisions as not directly relating to the size of a company but rather applying to all workers in the economy. Similarly, we clearly recognize the key role that the ownership structure may play for capital mobility and thus the elasticity of the tax base. However, a full discussion of their interactions with increasing international capital mobility and informality is well beyond the scope of the present paper.[2]

Theories of firm size and growth

The starting point in this literature is Gibrat's law: if the distribution of businesses' growth rates is normal and independent of the initial size, then the limiting distribution of firm sizes in the economy is lognormal. While the result is simple and concise, it clearly suffers from a lack of realism given the strong assumptions taken. A more recent strand of the theoretical literature on firm size thus tries to use less mechanical explanations: for example, Cabral and Mata (2003) replicate Portuguese data by stressing the interaction of wealth and resource inequality as well as credit constraints that force some firms to operate as SMEs below their optimal size.

Lahiri and Ono (1988) illustrate another approach to explain the existence of SMEs, considering them as disciplining devices on an imperfectly competitive market. In this approach, productivity endowments of businesses are taken as exogenously given but different across firms. As a result, the less efficient a firm, the smaller it will be. The authors consider that all these companies with different efficiency levels and thus different cost structures sell their products on a market characterized by Cournot competition. They show that the presence of SMEs is ambiguous from an economic welfare point of view. On the one hand, they decrease welfare as they are less efficient if they were replaced by their bigger counterparts. On the other hand, they serve to decrease the market power of the more efficient colleagues, and thus have the potential to increase aggregate welfare. As the overall effect depends on the degree of market concentration and on the relative inefficiency of the smaller operators, this type of model can hardly be taken as a strong convincing argument for subsidizing small companies.

More recently, a new strand of the trade literature has emerged with interesting applications to firm size. The basis for this new literature was an empirical regularity observed in a wide array of countries – both in the developing and the developed world: even within very narrowly-defined industry categories major degrees of heterogeneity in firm size prevail. This finding was clearly novel, in the sense that it showed that a theory of firm size purely based on the life-cycle of a product or the relative maturity of an industry does not seem to be matched by the empirical evidence. The data further reveal that large degrees of heterogeneity exist not only in terms of firm size but are observable in the areas of productivity, job growth, wages, innovation, export performance, etc. within these same industry subgroups. Expressed differently, large degrees of heterogeneity are persistent and cannot be ignored.

These empirical findings clearly illustrate that any policy guided by the notion that there is some typical producer or entrepreneur for any given industrial sector can only end up making misguided choices. These heterogeneous-firm models often rely on rather realistic notions of sunk costs, exogenous shocks and monopolistic competition. In a typical result, Melitz (2003) predicts that it is only the more efficient/productive companies in any given sector that become exporters and operate on international markets. In the case of the most efficient businesses, they even go one step further and become multinationals physically operating in different countries. On the other extreme of the spectrum, the least efficient operators are limited to domestic production. These results have double policy relevance. First, they illustrate the importance of producer heterogeneity to be taken into account, even within very clearly and narrowly defined industry groups. In some sense it serves as a reminder that there is no such thing as the typical retailer, building contractor, etc. Large degrees of heterogeneity will inevitably remain, even in a steady state setting. Second, the predictions on the relative efficiency of exporters and purely national operators could again be seen as an argument against a privileged treatment of small operators, as those are the least efficient ones from a purely economic point of view.

[2] Based on this idea, Gauthier and Gersovitz (1997) find an inverse-U shape pattern of tax burden for Cameroon with medium companies paying most.

Differentiated tax policy?

In light of the above theories of firm size and growth, the key question from a (tax) policy perspective is whether there should be special emphasis on size as a determining factor for taxation. Expressed differently, it is not sufficient to observe that there are firms of different size in an economy, or to realize that these firms of different size are characterized by different productivity levels. The key policy question is to determine to which degree these differences are due to a situation that would justify a discretionary intervention of the government by means of a tax burden or a tax system that is differentiated according to the size of firms. If such a need for intervention is identified, a second step of the process would then require an analysis of whether these differences plead in favor of a differentiated tax burden within the same system or rather plead for a completely different tax system for SMEs. It is important to note that the case for special tax treatment does not necessarily imply the need for a preferential SME regime, nor for preferential rules regarding the tax rate, base, audit probability, etc. of the generally applicable tax system.

Politicians and citizens alike generally accept the need for preferential treatment of SMEs in the tax laws. A quick look at the data seems to speak a clear and unequivocal language. Administrative data from countries all around the world show a high degree of concentration of the tax payments in the hands of a small subgroup of taxpayers. Typically, less than 1 percent of taxpayers transfer more than 70 percent of tax revenues to the government, whereas the smallest two thirds of taxpayers generally contribute less than 10 percent of tax revenues. The fact that such numbers are usually derived by integrating all tax payments of a business to the government, integrating taxes withheld on behalf of other taxpayers (such as payroll taxes withheld in behalf of workers, value added tax withheld or reverse-charged, etc.) is not often fully appreciated. Furthermore, the basic lessons of tax incidence analysis are clearly applicable and imply that it does not matter – from a tax policy point of view – which economic agent transfers the money to the government, but it rather matters who effectively supports the burden of the tax. The latter observation hints at the need for partial equilibrium or even general equilibrium analysis of tax shifting.

As a result, SME policy is often presented under the form of common claims that are advanced to justify a special treatment. There is, however, surprisingly little scientific evidence supporting those claims. This clearly represents a challenge to politicians and researchers. From a normative point of view, it challenges all parties involved to find a solid theoretical basis for measures benefiting specific segments of the taxpayer population – sometimes at considerable fiscal cost. From an empirical standpoint, it also challenges researchers to scrutinize the data to understand the implications of the existing schemes and derive policy-relevant conclusions.

We discuss four of the most common claims. The first of these claims is that SMEs are particularly successful at generating employment. Davis, Haltiwanger and Schuh (1994) illustrate that the evidence on this point is rather unconvincing. Simple correlations and regressions of net employment growth and firm size often illustrate a strong employment effect of small companies. However, such results generally do not withstand the use of more robust analysis. For example, net growth is a misleading indicator, as it may add up to more than 100 percent of employment growth. Similarly, regressing on starting size of a business introduces a bias in favor of the result. When correcting for such errors, Davis et al. (1994) report no statistically significant effect of firm size on employment growth. Similarly, Biggs and Shah (1998) illustrated that in Sub-Saharan Africa large firms were the dominant job creators in the manufacturing sector.

The second claim holds that SMEs are particularly innovative, and thus spurring their growth leads to faster aggregate growth in the economy. The presumption is based on the observation that most big companies started small, and that some of the most innovative companies started as very small entities. The argument is, however, flawed. First of all, there is a large degree of heterogeneity in the taxpayer population such that all companies do not follow the same growth patterns. There are businesses that are small and will stay small for most of their existence, and others that are always large-scale operations on pure grounds of economies of scale. Similarly, even if a well-defined subgroup of growth-oriented companies could be identified, it is not obvious why the tax system should influence this growth process. In fact, such intervention, to the degree that it does not act in a lump-sum way, influences marginal decisions and as such has the potential to lead to excessive risk-taking and overinvestment. Empirical evidence seems to underpin these conceptual problems. For a sample of European companies, Pagano and Schivardi (2003) show that larger firm size is associated with faster innovation as larger firms are better positioned to exploit the increasing returns to R&D expenditures. Regarding the positive effect of SMEs on growth, the empirical evidence is equally unconvincing. While recognizing the positive correlation between growth and SME growth, Beck, Demirguc-Kunt and Levine (2005) do not find empirical support for a causal impact on growth using data from 45 countries. They further find no evidence that SMEs help alleviate poverty or decrease income inequality.

A third reason often advanced for preferential SME treatment is that they suffer disproportionately from credit constraints and from other forms of competitive disadvantages, which limit their ability to borrow in the same way their larger counterparts do. It is only to the degree that such differences in access to credit do not properly reflect the higher risk associated with their small scale that such limitations should be considered a discrete disadvantage. Any further government action beyond those limitations would lead to a socially dominated outcome as it would force an inefficient resource allocation onto capital owners. Even in the presence of a well-argued case for state intervention in the resource allocation process, it remains unclear why tax instruments would be the best possible tool to correct such a profoundly non-tax distortion. For example, the recent development of micro-credit institutions in developing countries can be seen as a policy tool that addresses the constraints of the poor more directly.

The fourth claim focuses on other non-tax disadvantages that SMEs face. Examples are disproportionately bigger administrative burdens, barriers to entry, problems of indivisibility of labor, as well as other fixed costs linked to their limited scale of operation. One other type of size-specific disadvantage is the presence of a large informal sector which can cause substantial explicit and implicit costs to an SME. Because of their type of activity and their size, SMEs are more exposed than larger entities to the informal sector as they are often directly in competition with informal operators both on the product and the factor markets.

Insofar as these explicit or implicit economic costs are due to excessive government intervention, a compelling case could be made in favor of rooting out such costs rather than handing out tax breaks. One of the key conclusions drawn on the basis of the Doing Business surveys conducted by the World Bank (see, for example, World Bank 2007) is that countries should implement reforms that simplify and ease the tax and non-tax regulatory environment for all businesses (and not only some sub-groups of the taxpayer population). However, such a case in favor of reducing fixed costs and barriers to entry is not an automatic one. Auriol and Warlters (2005) illustrate that in developing countries a tax revenue maximizing government may in a perfectly rational way want to increase barriers to entry for new entrants onto the market. The logic is that such protection would ensure market power in the hands of the selected few that are either explicitly or implicitly authorized to operate. In turn, this market power translates into economic rents that the government can then share in by means of taxation or other levies that it would impose on these large taxpayers.

Tax compliance and administration costs

The preceding discussions reveal the limited theoretical and empirical evidence in favor of a special SME regime on the basis of market imperfections. The case is even weaker for a preferential regime with such elements as a reduced rate or a favorable tax base, as some of the arguments discussed above would rather argue in an opposite direction on the pure basis of economic efficiency.

However, the tax system itself may well provide the most convincing arguments in favor of some differentiation of businesses according to size. Taxpayers face a whole series of explicit or implicit costs when complying with tax legislation. At the same time, the tax authority also sometimes incurs substantial costs as a result of the application of the tax rules and the administration of the taxpayer files. Empirically, because of fixed cost arguments, both average and marginal administrative and compliance costs seem to be negatively related to the size of a company, as expressed by different indicators such as the number of employees, sales, etc.

The Price Waterhouse Coopers and World Bank report "Paying Taxes – The Global Picture" gives some interesting insights on taxpayer compliance costs throughout the world. It clearly identifies tax compliance – measured in terms of formalities that a taxpayer has to comply with as well as the time spent on administrative matters related to tax compliance – as a major issue hampering business development. A tax system that succeeds in reducing the compliance burden for the taxpayers automatically reduces the fixed costs implied by the tax system and thus reduces both the justification for a preferential SME regime and the relative attraction of the informal sector. Expressed differently, streamlined tax administration procedures attenuate the calls for preferential tax policy regimes.

In the face of any remaining incompressible fixed costs, there is a potential role for tax policy to help alleviate the burden. Such tax relief for taxpayers could take the form of a lump-sum tax credit for administrative expenses applicable to all taxpayers. On the tax administration side, it could take the form of a different audit probability of taxpayers as a function of size to reflect their different importance and risk as compared to larger taxpayer units. There is, however, no doubt that any policy differentiation justified by fixed costs should not be linked to profits or other similar indicators, as they would only introduce an additional bias into the resource allocation problem faced by the business. In this sense, the many European systems providing progressive corporate income tax rates or preferential SME rates do not satisfy this criterion.

Another policy option is to explicitly recognize the costs when determining the scope of a tax system. Keen and Mintz (2004) show that in the presence of a fixed cost an optimal value added tax (VAT) has a threshold below which the taxpayer is not VAT-subjected. This means that SMEs would pay VAT on their inputs exactly like final consumers, while not charging VAT on their sales. It is possible to generalize this idea to a broader context: Whenever there are fixed costs to tax compliance and administration, it is generally optimal to have a simplified regime for the SME operators. Real-world examples are simplified income tax accounting rules or VAT exemptions. More radical alternatives use a presumptive tax basis, such as turnover, the number of employees, etc. Such regimes are the more plausible the more limited the administrative and compliance capacity of the tax authority and the taxpayer.

Simplified preferential regimes are, however, not without risks. First, any special SME regime replacing the VAT automatically poses the risk of tax cascading. This is particularly acute when the simplified regime is turnover based, given rise to strategic incentives to proceed towards purely tax-driven inefficient vertical integration of the corporate sector. Second, there is a risk that taxpayers will strategically take actions to influence the presumptive base rather than optimize the resource allocation of their business. Similarly, tax officials may be more tempted to "negotiate" the precise scope of the taxable tax base with the taxpayer. Third, under an overly generous simplified regime, the tax base for the payroll tax system – and with it the income distribution in the country – may be heavily affected. People can strategically re-label their employment into a self-employment relation this way affecting their tax liabilities, but also possibly their linked social benefit entitlements. The presence of a special regime thus creates new kinds of inequalities and a redistribution of the tax burden both among the current businesses as well as in the broader taxpayer population. Fourth, and most importantly, the design if the preferential tax system should be such as to minimize the effects of discrete jumps in tax burdens by attempting to provide for smooth and easily verifiable transitions from one regime into the other. The more limited set of tax instruments and/or control mechanisms applied under the special regime inevitably leads to the existence of discontinuities. As a result, there is a strong potential for perverse effects leading towards situations of lock-in (people not wanting to grow out of the strict limits of a preferential system), split-up (people splitting their business to qualify), and re-registration of taxpayers (if benefits are limited to some specific type of companies) to benefit from the more advantageous conditions.

Summing up

Preferential tax regimes for SMEs are generally seen as a common feature of a tax system. However, there are many reasons why such a special treatment may not be desirable from an economic point of view. The article argues that most common claims on the role of SMEs do not provide a solid basis for a different – let alone preferential – treatment of SMEs as compared to larger taxpayers.

One does, however, note that the existence of fixed costs related to tax compliance and administration can lead to two clear tax policy recommendations. First, there is a mandate for simplifying tax procedures for all taxpayers as much as possible in order to reduce the existence and the magnitude of these fixed costs. Second, there is a possible role for special regimes for the smallest taxpayers. They need to be simple to address the issues of compliance costs and informality in the most comprehensive way possible. However, these regimes are no miracle solutions. Special regimes will inevitably result in severe selection issues that may turn out to be very costly in terms of inefficient use of resources and even in terms of tax revenue.

The above discussion is clearly a partial one and has no claim of completeness. It focuses on the business unit and does not analyze the impact of the ownership structure on tax policy, which would require an explicit link with the ultimate beneficiary of corporate revenues. For example, some arguments in favor of special tax treatment of SMEs rely on the specific ownership structure and the behavioral characteristics of the owners rather than the SME itself. The present article thus calls for a complementary analysis of these other factors that are clearly related, but also separate issues.

References

Auriol, E. and M. Warlters (2005), "Taxation Base in Developing Countries", *Journal of Public Economics* 89, 625–646.

Beck, T., A. Demirguc-Kunt and R. Levine (2005), "SMEs, Growth, and Poverty: Cross-Country Evidence", *Journal of Economic Growth* 10, 199–229.

Biggs, T, and M. Shah, (1998), *The Determinants of Enterprise Growth in Sub-Saharan Africa: Evidence from the Regional Program on Enterprise Development,* RPED Discussion Paper, World Bank, Washington DC.

Cabral, L. and J. Mata (2003), "On the Evolution of the Firm Size Distribution", *American Economic Review* 93, 1075–1090.

Davis, S., J. Haltiwanger and S. Schuh (1994),"Small Business and Job Creation: Dissecting the Myth and Reassessing the Facts", *Business Economics* 19, 13–20.

Gauthier, B. and M. Gersovitz (1997), "Revenue Erosion through Exemption and Evasion in Cameroon, 1993", *Journal of Public Economics* 64, 407–424.

Keen, M. and J. Mintz (2004), "The Optimal Threshold for a Value Added Tax", *Journal of Public Economics* 88, 559–576.

Lahiri, S. and Y. Ono (1988), "Helping Minor Firms Reduces Welfare", *The Economic Journal* 98, 1199–1202.

Melitz, M. (2003), "The Impact of Trade on Intra-industry Reallocations and Aggregate Industry Productivity", *Econometrica* 71, 1695–1725.

Pagano, P. and F. Schivardi (2003), "Firm Size Distribution and Growth", *Scandinavian Journal of Economics* 105, 255–274.

Price Waterhouse Coopers and World Bank (2006), *Paying Taxes: The Global Picture,* World Bank Technical Report, Washington DC.

World Bank (2007), *Doing Business 2007: How to Reform*, World Bank, Washington DC.