# Executive summary

In most countries, small and medium-sized enterprises (SMEs) represent more than 95% of all firms. SMEs account for a large proportion of total employment and contribute significantly to national and global economic growth. They are also strongly heterogeneous: across and within industries and sectors; in their innovation behaviours; and in their profitability and growth potential. Importantly, SMEs also generate a significant share of all taxable business income in most economies.

SMEs are important for their contribution to employment, economic growth, innovation and the diversity and competition that they can bring to markets. As a large and important part of all national economies, SMEs often face challenges to their viability and growth, some of which are created by market failures, capital market imperfections and compliance costs.

This study examines the tax policy and tax administration arrangements affecting SMEs in OECD and G20 countries, drawing on the results of a questionnaire completed by 38 countries and on existing OECD databases. Based on the experiences of these countries, the study considers the influence that general tax rules and special tax measures can have on a number of economic margins, including the decision to enter self-employment, decisions over business form and whether to incorporate, the form of distribution of SME income, the size and growth of the business, decisions relating to investment, employment and finance, and compliance with tax rules.

Ideally, a country's tax system should be neutral with regard to its impact on business decisions, including the creation, form and growth of SMEs. However, the study finds that many of the tax systems examined provide incentives to incorporate and to distribute income in the form of capital, particularly as capital gains. In addition, certain features of the tax system may inadvertently disadvantage SMEs relative to larger enterprises. These features included the asymmetric treatment of profits and losses, a bias towards debt over equity and higher fixed costs associated with tax and regulatory compliance regimes.

The study notes that one of the most important issues affecting SMEs is the disproportionately high impact that regulatory requirements and the costs of tax compliance have on them. Even though many tax requirements may appear to be relatively "neutral" for businesses of all sizes, the significant fixed costs associated with compliance represent a higher cost for SMEs as a percentage of sales and income, and consequently have a greater adverse impact upon SMEs than larger businesses.

Another key issue affecting SMEs, which has been exacerbated since the financial crisis, relates to their limited access to finance for growth and expansion. With limited access to equity financing, SMEs also face considerable constraints in relation to debt financing. Availability of debt finance and the terms upon which it is granted to SMEs means that they are more finance-constrained and generally face greater costs in accessing finance than their larger competitors.

Against this backdrop, many governments provide support to SMEs through non-tax programmes, such as credit programmes, as well as through special tax rules, including both tax preferences and simplification measures for SMEs. This study presents details of the range and scope of special SME tax rules currently provided by governments. These measures include special small business corporate tax rates in fifteen jurisdictions; more generous tax deductions, tax credits or tax exemptions; preferences that apply directly to the owner or investor of the SME, providing relief for initial investment, ongoing income, or on disposal of the SME's assets; and special simplification rules, including special presumptive tax regimes for small enterprises reported in seventeen countries and special SME replacement taxes (presumptive or cash flow) reported in six countries.

While many of these special SME tax rules are designed to support the growth and profitability of SMEs, their design and introduction can have distortive impacts by giving businesses an incentive to remain small or to split up into different businesses to continue benefiting from the preferential tax treatment. These preferences need to be carefully targeted and designed to overcome the specific economic or tax difficulties identified or to provide support to companies providing positive spillovers to the economy.

After assessing some of the benefits and disadvantages of various approaches, the study highlights and identifies some principles to guide governments when developing and implementing measures to encourage the creation, growth and innovation of SMEs.

Some of the key findings include:

- SMEs often face higher tax compliance costs, in relative terms, due to their smaller size. When designing and implementing tax policies, governments should consider whether certain measures have a disproportionate impact on SMEs. Many countries provide special provisions and simplification measures that are designed to reduce the tax compliance costs of SMEs.
- The heterogeneity of the SME population means careful targeting is required to ensure that any government interventions, including tax preferences, achieve their stated policy objectives. With the exception of the disproportionately high compliance costs on SMEs, the size of a business alone may not be sufficient justification for government intervention in the form of special rules. Careful targeting of special tax rules can reduce their costs and potential distortions while ensuring that the intended goals are met.
- There may be a particular case for targeting preferences and simplification measures toward younger SMEs, who are most affected by finance and cash flow difficulties, face barriers to entry and growth from incumbent firms, are more likely to grow than older SMEs, face the highest compliance cost burdens and are likely to have higher spillover effects from innovation. Nonetheless, even within this group, measures should be carefully targeted to address the specific problem (e.g. access to finance, compliance costs) or particular objective (e.g. innovation). Young, small firms are also the riskiest and most likely to go out of business.
- Caution is needed to ensure that tax preferences or simplification measures do not introduce further distortions. These distortions can result in incentives to alter economic activity in unintended ways to benefit from special tax rules, horizontal inequities in the treatment of different firms or individuals depending on their characteristics, or the creation of additional barriers to SME growth owing to the creation of sized-based thresholds which provide incentives to remain under that threshold, whether artificially or by restraining growth.

- When introducing special tax rules for SMEs, care should be taken to ensure that these measures do not increase complexity. The costs associated with tracking eligibility, keeping specific records and interacting with the tax system for multiple different preferences or simplification measures can increase the complexity of the system. In this regard a simpler general tax system may be more advantageous to SMEs than a series of simplification measures.
- Process simplifications, particularly through targeted use of technology, offer many advantages in lowering compliance costs by streamlining and reducing the steps required to comply. They can, therefore, be a powerful tool to enhance compliance and reduce its costs.

The taxation of SMEs is an important issue given their importance to the economies of countries. Careful design of government programmes for SMEs, including special tax rules, can address market failures and the disproportionately high compliance burdens faced by SMEs. Consideration of the heterogeneity of the SME sector and the different challenges faced by SMEs and their owners need to be considered in the design of the taxation rules as governments endeavour to promote the creation, innovation and growth of SMEs.


**From:**
# Taxation of SMEs in OECD and G20 Countries

**Access the complete publication at:**
https://doi.org/10.1787/9789264243507-en

**Please cite this chapter as:**

OECD (2015), "Executive summary", in *Taxation of SMEs in OECD and G20 Countries*, OECD Publishing, Paris.

DOI: https://doi.org/10.1787/9789264243507-3-en