THE IMPACT OF VAT ON SMALL AND MEDIUM ENTERPRISES (SMEs)

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ABSTRACT

The stimulants for the growth and spread of value-added tax (VAT) remains unclear both theoretically and empirically. small and medium enterprises (SMEs) are experiencing challenges with respect to complying with the VAT requirements. Unfortunately, there is little researches that have focused on understanding how VAT really affects the operations of SMEs. This study therefore sought to determine the factors that affect VAT compliance; identify the VAT collection methods; determine how VAT is affecting the operations and profits of the firms; and describe the status of VAT compliance among SMEs in this developed country which shall be referred to as country A. Structured survey questionnaires were distributed to conveniently sampled 50 owners and managers of the firms and a response rate of 76% was recorded. Results indicated that VAT compliance is affected mainly by characteristics of the individuals, features of the VAT system itself, and environmental factors such as political and socio-economic situation in this developed country. The non-compliance among most SMEs is a measure to survive the harsh economic conditions. The high costs of implementing such a complex system are so high for SMEs that an attempt to comply predict the folding up of that small business.

Small businesses are instrumental in ensuring economic growth that may lead to job creation. In this developing country, SMEs represent over 95% of enterprises that generate over 50% of private sector employment. Despite Small and Medium and Enterprises

(SMEs) being an important vehicle to address the challenges of job creation and economic growth, the SMEs sector is faced with multiple challenges among them financing and heavy tax burden. The SMEs, like any other business entities are expected to be compliant to the various tax systems in this 3rd would country, Value Added Tax (VAT) among them. The research study sought to explore the impact of VAT on small and medium enterprises in one developing country.

Keywords- *Value Added Tax, Small and Medium Enterprises, Compliance, Developed Country.*

INTRODUCTION

Increased Costs:

SMEs often operate on tight budgets, and the introduction of VAT can increase operational costs. These costs include the actual tax paid on goods and services, as well as expenses related to compliance, such as hiring accountants or investing in software to manage VAT records.

Cash Flow Management:

VAT can strain cash flow, as businesses need to pay VAT on their purchases while awaiting reimbursement through sales. This can be particularly challenging for SMEs with limited financial reserves, as they must ensure they have sufficient liquidity to cover these upfront costs.[1,2,3]

Administrative Burden:

Compliance Requirements: The requirement to comply with VAT regulations imposes an administrative burden on SMEs. Businesses must maintain accurate records, issue VAT-compliant invoices, and file periodic VAT returns. This necessitates a robust accounting system and, often, additional training for staff.

Increased Documentation:

VAT compliance requires meticulous documentation of all transactions. SMEs must keep detailed records of purchases, sales, imports, and exports, which can be time-consuming and may require significant changes to existing record-keeping practices.

PRICING STRATEGIES

Price Adjustments:

To maintain profit margins, SMEs may need to adjust their pricing strategies to account for VAT. This can be a delicate balancing act, as increasing prices could impact competitiveness and customer demand. SMEs must carefully consider how to incorporate VAT into their pricing without alienating customers.

Transparency with Customers:

Clear communication about price changes due to VAT is crucial. SMEs should ensure that customers understand the reasons for any price increases and how VAT affects the final price of goods and services. Transparency can help maintain customer trust and loyalty.

COMPETITIVE DYNAMICS

Level Playing Field:

For SMEs, VAT introduces a level playing field where all businesses, regardless of size, must comply with the same tax regulations. This can benefit SMEs by creating a more equitable competitive environment, particularly when competing against larger corporations that previously enjoyed a tax advantage.

Impact on Informal Sector:

The formalization of the tax system through VAT can reduce the size of the informal sector. SMEs operating within the legal framework may benefit from reduced competition from unregistered businesses that previously evaded taxes. [4,5,6]

OPPORTUNITIES FOR GROWTH

Enhanced Business Practices:

The need for VAT compliance can drive SMEs to adopt more rigorous accounting and financial management practices. This can lead to improved business operations, better financial planning, and enhanced decision-making capabilities.

Potential for Expansion:

With VAT being a common tax system internationally, SMEs that comply with VAT regulations are better positioned to expand into other markets. Understanding and managing VAT can facilitate smoother operations in countries with similar tax structures.

Strategies for SMEs to Navigate VAT Invest in Training and Resources:

SMEs should invest in training for their staff to ensure they understand VAT requirements and compliance procedures. Utilizing accounting software designed to handle VAT can streamline processes and reduce the risk of errors.

Seek Professional Advice:

Consulting with tax professionals or accountants who specialize in VAT can provide SMEs with the expertise needed to navigate complex regulations. Professional advice can help optimize VAT management and ensure compliance.

Monitor Cash Flow Closely:

Effective cash flow management is crucial under a VAT regime. SMEs should regularly monitor their cash flow, plan for VAT payments, and explore options such as VAT payment plans if available.

Engage with Industry Groups:

Joining industry associations or business groups can provide SMEs with valuable insights and support. These organizations often offer resources, training,

and advocacy on behalf of SMEs, helping them adapt to VAT requirements.

The introduction of VAT in the presents both challenges and opportunities for SMEs. While the financial and administrative burdens can be significant, with careful planning and the right strategies, SMEs can navigate the VAT landscape successfully. By investing in training, seeking professional advice, and adopting robust financial practices, SMEs can not only comply with VAT regulations but also leverage them to enhance their business operations and drive growth. [7,8,9]

DISCUSSION

A value-added tax (VAT) has been implemented in 160 countries because it is an efficient method of tax collection. VAT is perceived to be highly efficient in terms of tax turnover because it provides greater revenue collection and, at the same time, narrows deficits (Lee et al., 2013). VAT has a different effect on businesses, increasing both their start-up and ongoing operating costs; this effect is stronger for small and medium-sized enterprises (SMEs) (Evans et al., 1996, Gunz et al., 1995). VAT compliance activities consume a substantial amount of time for SMEs compared to other types of taxes, such as capital gains tax and income tax (Hansford and Hasseldine, 2012). SMEs are also more likely to rely on internal resources rather than external sources, such as external tax advisors, to comply with tax law (Eichfelder and Schorn, 2012, Eichfelder and Vaillancourt, 2012, Hanefah et al., 2002). One major impact of VAT on SMEs' internal resources is the adoption of VAT- compliant accounting systems, which tag transactions with specific codes that enable an accurate calculation of VAT amounts (including taxes firms have charged to their customers as well as the taxes charged by their suppliers). The difference between these two amounts is the amount of VAT that firms pay to, or claim as, refunds from the government. These tax compliance activities are facilitated by the accounting system. Prior literature (Eichfelder and Schorn, 2012, Halabi et al., 2010, Marriott and Marriott, 2000) has found that these tax compliance activities are a major reason behind SMEs' adoption of an accounting system.

One way to measure the amount of resources that a firm utilizes for tax compliance activities is to use the firm's tax compliance costs.

Tax compliance costs (Sandford et al., 1989) are defined as those costs incurred by taxpayers, or third parties such as businesses, in meeting the requirements laid upon them in complying with a given tax structure...For a business, the compliance costs include the cost of collecting, remitting and accounting for tax on the products or profits of the business and on the wages and salaries of its employees together with the costs of acquiring the knowledge to enable this work to be done including knowledge of their legal obligations and penalties [10,11,12].

Existing research on SME tax compliance costs has been primarily concerned with factors that influence compliance costs and how these costs can be measured effectively (Evans et al., 1996, Hansford et al., 2003). Hansford et al. (2003) found that firms using a computerized accounting system usually record higher tax compliance costs than those using a manual method. One possible reason for this is that firms allocate costs attributed to the computerized accounting system separately while costs associated with the manual method are included as part of the many roles performed by SME owner-managers. The researchers highlighted the need to examine the relationship between taxation and information technology (IT) adoption. Evans et al. (1996) indicated that SMEs incur relatively greater tax compliance costs than bigger firms and that a trend exists toward greater utilization of computers for tax purposes. These studies offer insights into possible links between tax compliance costs and accounting system adoption.

The current study contributes to the literature by empirically examining SMEs' perception of their tax compliance costs as an important factor in their accounting system adoption. Our study attempts to position tax compliance costs in the IT adoption framework for SMEs. In doing so, we provide a more comprehensive picture of the factors that affect SMEs' adoption of an accounting information system. In other words, instead of focusing exclusively on tax compliance costs as the sole factor in SMEs' adoption of an accounting system, we examine the influence of tax compliance costs as one factor in IT adoption. This

study also contributes to practice by providing managers and management teams with an understanding of the factors affecting accounting system adoption. This understanding enables managers to make informed decisions regarding integration and use of a tax-compliant system in their organizations' accounting system, particularly in the initial stages of the system's adoption.

We selected the technological–organizational–environmental (TOE) framework (Henderson et al., 2012, Kuan and Chau, 2001, Tornatzky and Fleischer, 1990) as an appropriate theoretical foundation for investigating this type of adoption among SMEs. A VAT-compliant accounting system not only facilitates the recording and calculation of tax returns, but also provides proper recordkeeping. We believe that a VAT-compliant accounting system improves the compliance and monitoring of companies' transactions in regard to VAT payments because of the requirement to map the VAT taxonomy to these transactions. Survey data from 401 SMEs were used to test the TOE framework. Based on partial least squares analysis, the results suggest that all the technological factors significantly influence the adoption of a VAT-compliant accounting system. Only the environmental variable, perceived coercive pressure, does not significantly influence the adoption of a VAT-compliant accounting system. In addition, the organizational variable, learning from external sources, does not significantly influence the adoption of a VAT-compliant accounting system. Tax compliance costs, as a measure of tax compliance activities, have a moderating effect on perceived comparability, learning from external sources, and perceived coercive pressure; these variables belong in technological, organizational, and environmental factors, respectively. Our study offers insights into the impact of the early stages of VAT implementation on SMEs. [13,14,15]

The paper is organized as follows. First, the background of the VAT system in is presented, followed by the literature review and theoretical background of the study and the hypothesis development section. Next, the methods and findings are presented. Last, discussion and implications of the study are presented.

RESULTS

In the wake of the Global Crisis, many governments turned to VAT to fill the hole in their public finances, either by increasing the standard VAT rate or by lowering the registration threshold. In the UK, for instance, VAT generates 21% of total tax revenue, ranking it behind only income tax and national insurance contributions as the largest source of tax revenue. Generally, registration involves an increase in tax liability for the firm and also compliance costs, which may not be trivial. In the UK, compliance costs for a firm with turnover at the VAT threshold are estimated to be around 1- 2% of turnover, and the cost may be higher in other countries.

Thus, a key question to inform policymaking is how VAT itself and, in particular, the registration threshold affects the behavior of small firms. We aim to understand the efficiency and welfare costs of VAT by analyzing three important, behavioral responses to the registration threshold: voluntary registration, bunching, and growth effects.

Voluntary registration makes VAT unique amongst all the major taxes. It refers to a situation where a firm registers for VAT even if it is below the turnover threshold, and thus is not required to do so.

This is likely to occur when a firm has large purchases of intermediate inputs, and/or they can pass most of the VAT on output onto the purchaser. In this case, it may be profitable to voluntarily register for VAT so the firm can claim back input tax, while passing some or most of the burden of the output tax on to the purchaser. In our comprehensive UK dataset, further described below, over 44% of companies in the UK with turnover below the threshold register voluntarily.

However, not all firms are in this position. A small trader selling services to households, such as a plumber or electrician, might have relatively small purchases of intermediate inputs and face elastic demand from purchasers, who themselves cannot claim back the VAT that they pay. In this case bunching occurs, where a firm keeps its reported taxable turnover just below the registration threshold either legally, by restricting the scale of its operations, or illegally, by misreporting sales. Growth effects are

related to bunching and occur when the firm restricts its growth in order to keep below the threshold and possibly also has a higher rate of 'catch-up' growth when it decides to register.

Several papers in the academic and policy literature have argued conceptually that voluntary registration, bunching, and growth effects might exist. For example, the ground-breaking VAT model by Keen and Mintz (2004) found bunching below the threshold and a hole above where firms do not locate. However, voluntary registration is never optimal in their model because none of the burden of output VAT can be passed on to purchasers. Brashares et al. (2012) discuss some of the possible determinants of voluntary registration and bunching in their calibration of the Keen-Mintz model to US data, but they are unable to test the predictions with data because the US has no VAT. To date, no work has yet established the extent to which these effects actually occur, their magnitudes, and their determinants for a country where VAT is in place.

To fill in these gaps, we develop a conceptual framework for studying the two key aspects of behavioral response to VAT, including voluntary registration and bunching, and we test this framework using UK firm-level data on tax returns and firm characteristics.

We show that voluntary registration is more likely in two scenarios: when the cost of inputs relative to sales is high, or when the proportion of business-to-consumer (B2C) sales is low.

In the first scenario, when input costs are important, registration allows the firm to claim back a considerable amount of input VAT. In the second, if most customers are VAT-registered, the burden of an increase in VAT can easily be passed on in the form of a higher price, because the customer himself can claim back the increase.

We show that the determinants of bunching at the registration threshold are the same as for voluntary registration, with the signs of the effects reversed.

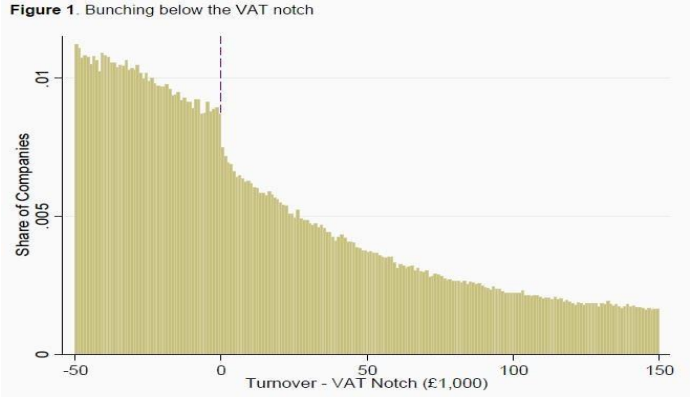
Specifically, bunching is more likely when the cost of inputs relative to sales is low, or when the proportion of business-to-consumer sales is high.

We also show that the elasticity of value added of registered firms with respect to the effective VAT rate can be recovered from an implicit function that relates the degree of bunching to the elasticity of value added. [16,17].

Finally, we show in the conceptual framework that the elasticity of value added can be related in a simple way to the deadweight loss of a small increase in the statutory rate of VAT, thus extending the well-known results of Feldstein (1999) and Chetty (2009) to an indirect tax setting.

We bring these predictions to an administrative dataset created by linking the population of corporation and VAT tax records in the UK, which includes 1,408,517 observations for 435,688 companies between 1 April 2004 and 30 March 2010. We show that the empirical pattern of voluntary registration is consistent with the theory. In particular, voluntary registration is more likely with a low share of business-to-consumer sales or a high share of input costs.

Quantitatively, the probability that a firm voluntarily registers for VAT is increased by 0.05 for a one standard deviation increase in the share of business-to-consumer sales, and by 0.02-0.05 for a one standard deviation increase in the input-cost ratio. We then look at bunching. To get a feel for the data, Figure 1 below shows a histogram of the distribution of firm turnover, pooling data across all years. To allow comparison across years, we measure turnover in deviations from the threshold in any given year. As Figure 1 shows, there is clear evidence of bunching at the VAT threshold, shown by the dotted line, which is mainly driven by growing firms. This is the first evidence, to our knowledge, that a VAT notch leads to bunching.



CONCLUSION

The next question concerns how firms bunch, that is, what are the mechanisms at work? One possibility is that they genuinely restrict their sales to stay below the threshold. If so, the distribution of the input-cost ratio should be smooth around the VAT notch. We provide some suggestive evidence that part of the bunching is driven by under-reporting of sales. Specifically, we find that the salary-inclusive input-cost ratio moves in parallel between the registered and non-registered group outside the bunching region, but starts to increase substantially for the non-registered companies just below the threshold. We interpret the large and sharp increase in the salary-inclusive input-cost ratio to be partly driven by the fact that it is costly to under-report salary expenses due to third-party reporting. [18,19].

In ongoing work, we are addressing the effects of the registration threshold on small firm growth. There is a vast empirical literature on the determinants of small-to-medium enterprise (SME) growth, but relatively little attention has been given to the role of 'tax notches' such as VAT registration. If we consider the analogue of Figure 1 just for firms that are growing, we see that bunching is much sharper, suggesting that the threshold might inhibit firm growth. We find that firms with a turnover below the VAT threshold that are not registered for VAT have a significantly lower growth rate than a 'control group' of firms below the threshold that are voluntarily registered for VAT (and thus do not have a tax cost of registration). Firms that cross the VAT threshold in a given year have a higher growth rate in that year than a control group of firms already above the threshold. Moreover, the closer the 'treated' firms are to the threshold, the stronger these effects are.[20]

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