

On the Development and Tax Burden of SMEs

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Abstract

China's small and medium-sized enterprises (SMEs) are shouldering a heavy tax burden which falls a foul of the economy's shift toward a domestic demand-driven growth path. The SMEs play an import role in promoting the economic growth. Among theoretical research and empirical studies at home and abroad, the development of SMEs has always been a focus area of research, and the tax burden is a key factor for the development of SMEs. Rather than large state-owned enterprises and enterprises under the central government, SMEs and township companies are the driving force promoting the sustainable growth of the Chinese economy and the sound development of Chinese society. How should the government effectively adjust the taxation mechanism, and how should SMEs get to know tax risks and learn to develop the ability to resist tax risks are the focuses of this research.

Key words: SMEs; Tax burden; Tax risk

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INTRODUCTION

Chinese SMEs and non-public enterprises makes up 99.8% of the overall quantity of all companies in China, contributing to 60% of the national GDP, 50% of all taxes nationwide, 75% of the national labor force, 69%

of Chinese imports and exports, and over 82% of newly developed products. From the perspectives of the three factors that drive the economic growth-investment, consumption and export, SMEs have evolved into a key factor promoting the sustainable development of Chinese economy and society. The *Law of the People's Republic of China on Promotion of Small and Medium-sized Enterprises* has been adopted at the 28th Meeting of the Standing Committee of the Ninth National People's Congress on June 29, 2002 and brought into effect on January 1, 2003. The law lays down general provisions on funding, support for the establishment of enterprises, technological innovation, market development, and public services to promote the development of SMEs. This is a move to set out special rules for SMEs, signifying the great importance attached to SMEs by the Chinese government.

1. LITERATURE REVIEW

It is found from the literature review that most domestic scholars and researchers blame SMEs problems on the capital chain such as financing and loan borrowing and believe that funding sources are the most fundamental problem. However, only few studies touch on the taxation of SMEs.

In terms of development of SMEs and foreign policy support for SMEs, Chen (2004) analyzed the 2003-2004 Yearbook data and studied the development status and some common problems of SMEs in Midwest and coastal areas of China. He proposed to implement SMEs laws, deepen the financial reform of SMEs, and lower the policy threshold for SMEs. Yang (2005) discussed the preferential tax policies of Japan and the U.S. for Chinese SMEs and their enlightenments for China's policy making. To establish a tax policy system for the development of Chinese SMEs, Yang proposed to improve tax-related laws and regulations, upgrade the level of tax laws,

adjust the tax rate, formulate a reasonable tax incentive system, and encourage SMEs to expand production, thus promoting the overall development of SMEs. Hou (2009) analyzed how the tax incentives of Italy, France and Japan aid for the development of SMEs. As the tax burdens and risks caused by external and internal factors, Luo (2012) expounded the underlying reasons, and through experimental studies probed the fundamental reasons for different levels of tax burden, incomplete tax mechanism and heavy tax burdens among local SMEs. Research methods, such as information asymmetry theory, bounded rationality theory, game theory as well as other related theories in the field of economy, management and psychology, were employed to study the tax risk formation mechanism and classify the tax risks of SMEs, eventually developing a set of tax risk mechanisms and systems with effective monitoring and management.

1.1 Development of SMEs

This paper collects data from the Yearbook of Chinese Small and Medium Enterprises from 2003 to 2008, and selects the national GDP and the general output, assets, taxes and employment of SMEs as the basic indicators. During the six years, SMEs gained rapid development.

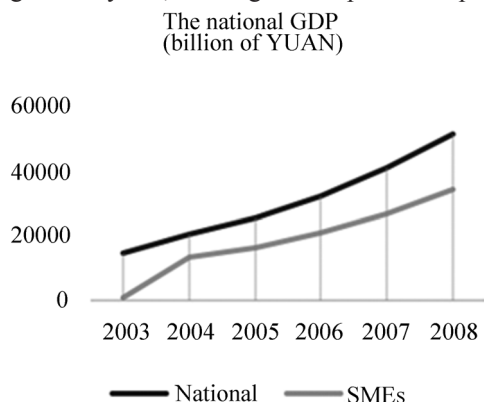


Figure 1
The National GDP

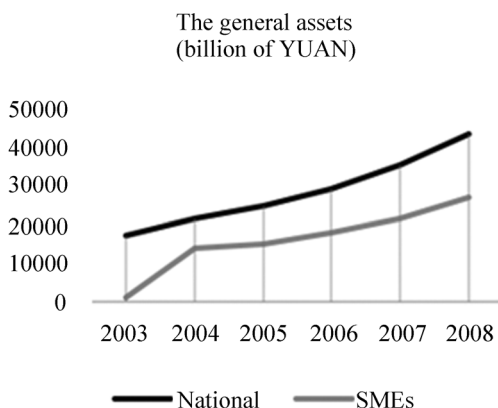


Figure 2
The General Assets

From Figures 1 and 2, the national GDP and general assets grew at a relatively high rate from 2003 to 2008,

of which SMEs contributed 65% and 60% respectively. It should be pointed out that the amount of output and assets of SMEs was very small in 2003, accounting for less than 3%. After the defining of SMEs development and the policy reform in 2003, SMEs made improvements significantly in all aspects.

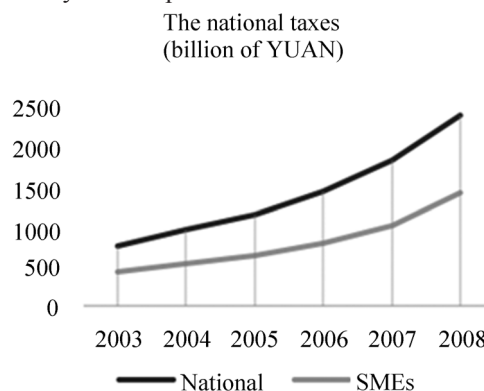


Figure 3
The National Taxes

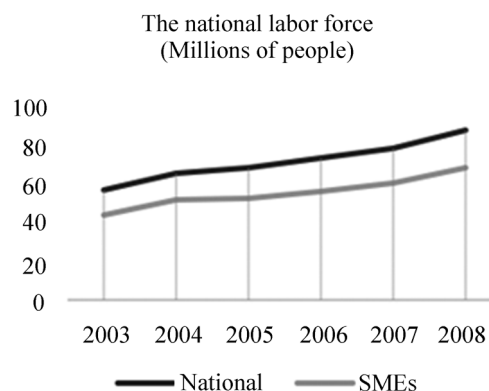


Figure 4
The National Labor Force

From Figures 3 and 4, SMEs contributed to 54%-59% of national taxes, very close to 60%, and recruited about 77% of the national labor force. In terms of social contribution, SMEs played an important role and a significant part in increasing the state revenue and improving the employment rate. Analysis of other data indicated that the current development of SMEs was manifested not only in the increase of asset value, local GDP and employment figure but also in the diversification of economic indicators, the number of professional enterprises, the innovation efforts, and the flourishing of all other aspects. The vitality of SMEs represents the level of economic activity of a nation.

1.2 Status Quo of Tax Burden of SMEs

Chinese SMEs plays a dominant role in the entire national economy. However, the overall tax burden is still heavy. Premier Wen Jiabao pointed in the executive meeting of the State Council on November 12, 2011 that some small and micro enterprises were faced with business operation troubles, financing difficulties and heavy tax

burden and other major problems, to which great attention must be attached. It is also specified in the *Twelve Five-Year Growth Plan for SMEs* released by the Ministry of Information that we should seriously implement existing tax incentives for SMEs, and further increase the support of fiscal policies for small and micro enterprises; should further continue to optimized the tax collection process and improve the tax service quality; should move on to clear up various charges related to SMEs, and regulate administrative feeds and management service fees to reduce the tax burden of SMEs. Therefore, we can see that the heavy tax burden of SMEs has become a significant barrier hindering the development of SMEs, which however has got the attention of the state.

1.2.1 Heavy Nominal Tax

On the Fourth China SME Festival in 2010, Chief Engineer Zhu Hongren from the Ministry of Industry pointed out that China had launched an avalanche of support policies and measures for SMEs, the problem of heavy tax burden still lingered, making it very urgent to alleviate the tax burden of SMEs. Take the data of a small enterprise in 2009, whose annual revenue added up to 3.0 million yuan, including 1.5 million yuan costs, 180,000 yuan wages for five employees, 320,000 yuan fees, and 1,000,000 yuan profits. The detail tax items included 255,000 yuan for VAT, 250,000 Yuan for income tax, and 21,250 yuan for income tax increase, and 25,500 yuan for city maintenance and construction tax and additional tax of education, all of which added up to a total of 551,750 yuan, accounting for more than 50% of corporate profits. Nevertheless, small taxes such as stamp duty, property tax, and urban land use tax and vehicle tax were not yet included. Moreover, the enterprise needed to pay administrative fees to departments of industry and commerce, environmental protection, quality control, public security, health and the like, adding additional burdens to the enterprise. In the National Macro-economic Strategy Seminar held in March 2011, some experts found after investigation that the business condition and environment of SMEs had been remarkably deteriorated, especially by the heavy tax burden, which had become a main problem faced by SMEs. According to an investigation on Chinese Entrepreneurs Survey System, over the first quarter of 2010, 36.1% medium-sized enterprises and 49.5% small-sized enterprises were operating at a profit-making level lower than normal; and 15.7% medium-sized enterprises and 17.6% small-sized enterprises were running at a loss. Another survey indicated that over the first quarter of 2010, 49.9% of SMEs regarded heavy taxes and social insurance and other burdens as main obstacles obstructing their business development. Such burdens were second only to the increase costs in labor force, energy and raw materials. It can thus be seen that the heavy nominal tax burden on Chinese SMEs has constituted a direct threat to the survival and development of SMEs.

1.2.2 Actual Tax Heavier Than Nominal Tax

Due to flaws in China's enterprises tax collection and management mechanism, there is still a large gap between nominal tax rate and the actual tax rate for SMEs. Even though nominal taxes of many SMEs were generally lowered than those of large enterprises, SMEs indeed pay more actual taxes than large companies do because they could not enjoy the value-added tax deduction or preferential tax policies. According to relevant statistical data in 2010, taxes of Chinese SMEs accounted for 6.81% of the burden rate of sales revenue, higher than the national average level of 6.65%.

The heavy actual tax burden on SMEs is primarily reflected in the higher actual tax rate of VAT. SMEs are mostly small taxpayers. Although the actual tax rate for VAT is 3%, but they could not enjoy the deduction of input tax, thus paying the same level of taxes with large companies that can enjoy the deduction of input tax but pay taxes at a rate between 13% and 17%. Secondly, service-oriented SMEs provide a large number of employment opportunities, and are required to pay the business tax at a rate between 3% and 5% in accordance with Regulations on Business Tax. However, due to incomplete account books & vouchers or nonstandard accounting systems of SMEs, relevant taxation authorities always find it impossible to check accurately the actual business turnover of SMEs and have to resort to tax payables, as well as urban construction fees, additional tax of education, corporate income tax and so on, making it unbearable for many small low-profit enterprises in the start-up stage and the growth stage and thus impossible for them to carry out effective profit accumulation and reinvestment. Besides, as specified by the Corporate Income Tax Law, general enterprises should pay the income tax at a rate of 25%, and only small low-profit enterprises and high-tech companies can enjoy the 20% and 15% preferential tax policies. Despite of a certain degree of decline from the previous 33%, there were two 27% and 18% preferential tax rates, and most SMEs were indeed taxed by these two rate levels. Even though small low-profit enterprises are taxed at a preferential rate of 20% in accordance with the new Corporate Income Tax, there is an increase of 2% in comparison to the previous 18%. Many medium-sized enterprises are not able to enjoy preferential tax policies and must make tax payments at a rate of 25%. Coupled with little deductible tax items and small profits, tax burden on SMEs seems heavier than before.

China promotes the reform of VAT. The reform can alleviate the burden for enterprises and increase their investment enthusiasm in the short term; and can stimulate investment, expand domestic demand and encourage cooperation with the structural transformation of the market economy, playing an important role in reviving the economy and boosting public confidence. The policy has an impact on corporate accounting statements and

financial indicators, and under the same production and management conditions helps enterprises to reduce the tax amount and the debt burden and improves the overall competitiveness and profitability within the industry. There is a wide range of preferential policies for business tax items. Taxable items cover almost the entire third industry. There are specific taxable details and tax rate differences for each tax item. Financial personnel need to make a detailed analysis and classification of tax items according to their business types and effectively categorize and check business activities between different tax items, between different tax rates, between internal and external labor services, and between tax relief and tax collection, which is of great importance to reduce the tax burden, cut down unnecessary tax expenditures and increase profits. As the second largest tax, income tax becomes increasingly important in state tax revenue, an important tool for the state to regulate the economy and adjust income distribution. The new Corporate Income Tax Law and tax preferential policies continue to make improvements under the taxation reform ideas of “simplified taxation, broad tax base, low tax rate, and strict collection and management”. To make clear the difference and docking between old and new tax laws is of great importance to increase corporate profits and explore new taxation plans. Since 2011, relevant departments have been attaching great importance to the reduction of tax burden for SEMs. The Ministry of Finance and the Development and Reform Commission have both issued a notice to cancel the collection of fees for 31 administrative services offered by national and central departments and units. By the end of September 2011, the Ministry of Industry and Information mentioned in the *Five-Year SMEs Plan* to continue the cancellation of various fees for SMEs and regulate administrative charges and management service fees, so as to reduce the burden on SMEs. On May 12, the State Council issued the *Opinions on Further Support for the Sound Development of Small and Micro Enterprises*, making clear the aim to step up taxation support for SMEs and alleviate financing difficulties. While investigating the financial work, Director Xie Xuren of the Ministry of Finance proposed to deepen the fiscal and taxation reform, implement and improve the structural tax reduction policy, put various tax incentives into practice, and increase the fiscal and taxation support for enterprises, especially small and micro ones.

2. ANALYSIS OF CAUSES FOR TAX PROBLEMS

Both citizens and companies are legally obliged to pay taxes in accordance with the law. However, rights entitled to citizens and enterprises are not clearly specified, causing enterprises’ ignorance of due rights and taxation

authorities’ negligence of duties. There are internal and external causes of tax problems of SMEs. External reasons are mainly due to the ineffective implementation of national tax policies, while internal reasons are ascribed to the limitations of SMEs themselves that lead to development hindrance.

2.1 External Causes

External reasons, including tax legislation defects, tax collection and tax law changes, give rise to corporate tax risks, which are related to changes of national policies. Tax problems and burdens are thus generated by these external factors, which are manifested in the following aspects:

2.1.1 Low Effectiveness Level of Tax Laws and Regulations

There are now 21 kinds of taxes in China’s taxation system. In addition to *Corporate Income Tax Law*, *Personal Income Tax Law*, *Vehicle and Vessel Law* and some other tax laws, and *Tax Administration Law*, which are enacted by the National People’s Congress, other 18 kinds of taxes are promulgated by the State Council in the form of provisional regulations and stipulations, which are not laws in the strict sense. Other tax laws are issued by the Ministry of Finance or the State Administration of Taxation in the form of departmental regulations. The release of plentiful regulations of taxation departments every year will render taxpayers especially SMEs at a loss. If failing to learn about new tax regulations timely, many SMEs will continue to make tax payments in accordance with old tax regulations, giving rise to less tax declaration, less tax payment and late payment and thus leading to penalties imposed by taxation authorities. Especially for SMEs that lack a professional tax management department and staff and whose financial personnel are less qualified, understaffed, too busy and characterized by high turnover rate, costs for learning new tax laws are rather high. Therefore, many SMEs begin to know about a new tax policy only several years after its release, which constitutes one of the most important reasons for the heavy tax burden of these SMEs.

2.1.2 Common Problems During the Collection of Administrative Departments

2.1.2.1 Arbitrariness of Law Enforcement by Taxation Authorities

Tax authorities do not exercise the discretionary power for the purpose of safeguarding national interests and public needs but for personal interests of the tax authorities themselves or tax officials. They perform unreasonable tax-levying behaviors even aware that their discretionary behaviors go against the spirit of tax legislation, and turn the discretionary power into a tool to satisfy personal interests of tax authorities and personnel and into an invisible sword determining the fate of SMEs. On the other hand, with discretionary power endowed by tax laws and regulations, some tax authorities and officials fail to implement standards strictly during law enforcement.

Those that should be punished are not punished, those that are subject to heavy penalties are not heavily fined, and those that are subject to small fines are fined too heavily, all of which will increase the tax risk of SMEs. For instance, the Article 65 in the *Tax Administration Law* specifies that

If a taxpayer who fails to pay the tax due prevents the tax authorities from pursuing the payment of the tax in arrears by means of transferring or concealing his property, the tax authorities shall pursue the payment of the tax and the surcharge thereon and shall also impose a fine of not less than 50 percent but not more than five times the amount of the tax in arrears.

This gives a huge discretionary power to tax officials, with two penalty extremes at 50% and five times, so tax officials have the power to impose far too different penalties on different taxpayers, which bring uncertainty to SMEs.

2.1.2.2 Lack of Impartiality During the Law Enforcement by Tax Authorities

Tax authorities do not appropriately exercise the discretionary power within the scope prescribed by the law, leading to evident injustice and irrationality and harm the legitimate rights and interests of taxpayers. Most importantly, they result in some tax risks for small and medium-sized enterprises. For instance, on the one hand, tax authorities regard the cost-saving tax planning behaviors of SMEs as arrears in tax payments or tax evasion, or even request enterprises to pay taxes in advance to fulfill the tax plan. In 2008, the National Audit Office investigated offices under State Administration of Taxations (SAT) in 16 provinces (including autonomous regions and directly-controlled municipalities). It was revealed that 62 tax offices at county level in 13 provinces collected illegal taxes, a total of 2.34 billion Yuan, from 169 enterprises in the forms of taxes in advance and surcharges to fulfill their taxation tasks. In 2010, the National Audit Office conducted an audit investigation on national taxation systems in 18 provinces and municipalities. It was found that 103 SAT offices in 9 provinces and municipalities collected illegal inter-annual taxes, a total of 3.357 billion yuan, in the forms of taxes in advance and surcharges, including 3.033 billion Yuan in 2009 and 324 million Yuan in 2010. To maintain the applicability and continuity of tax laws, legislative bodies should employ some specific terms and legal jargons when formulating tax laws and endow tax authorities with rights to interpret these terms and legal jargons. When enforcing the law, if tax authorities can accurately and appropriately interpret these provisions, it will be beneficial to compensate for the limitations of tax laws; but if tax authorities deviate from the legislative purposes of tax laws, and even interpret tax provisions in violation of socially accepted rules, especially willfully enlarging or narrowing the interpretation of flexible legal terms, which is likely to misguide SMEs.

2.2 Internal Reasons

Due to the undesirable quality of personnel, SMEs have no professional staff and departments to deal with tax issues. Therefore, they pay less attention to policy changes than large enterprises. The lack of attention to tax problems due to limitations of SMEs has become an internal factor constraining their development, which is manifested in the following aspects.

2.2.1 Deficiency in Financial Management

Recently, most SMEs in China lack a complete and systematic financial management system. The most prominent problem is the insufficient financial accounting mechanism. The reliability and authenticity of accounting materials ensure the economic value of financial information, but many SMEs, at their discretion in financial accounting, do not establish a rigorous financial accounting system and fail to perform indispensable accounting procedures such as account checking and voucher checking. The reliability and authenticity of accounting materials can not be guaranteed, leading to the phenomenon of distortion of accounting materials. In addition, many SMEs pay little attention to the seriousness and coerciveness of financial disciplines and lack a complete position management system, assessment mechanism and other supporting financial management mechanisms. Therefore, during production management, it is difficult to accurately identify financial problems, to effectively supervise and assess financial management personnel, and to motivate the working enthusiasm of employees.

2.2.2 Vague Understanding of Corporate Businesses

SMEs in different industries attach most attention to their sales departments, and their sales managers pursue only the amount of sales for the sake of work performance but ignore how salespersons handle the work. Tax authorities collect taxes only based on accounting statement data and invoices. Nevertheless, the actual sales of enterprises are less than what are stated in accounting statements. Such phenomena are particularly serious among SMEs in the service sector. Salespersons ignore the impact of corporate tax to pursue sales performance, which will eventually lead to unnecessary losses of SMEs. Thus, the favor of the sales department toward overall corporate interests is one of the causes leading to the tax burden.

3. POLICY SUGGESTIONS

3.1 Tax Incentives for SMEs

3.1.1 Make Amendments to Define Different Scales of Enterprises and Broaden the Main Body of Smes Entitled to Income Tax Preferential Policies

All SMEs are entitled to preferential income tax rates, which can encourage the sound development of SMEs. Therefore, we should step up efforts in preferential

policies: firstly, further reduce the tax rate from the current 20% to 15%; secondly, exempt the income tax or reduce the tax rate within a certain period for newly-established SMEs; thirdly, in addition to preferential tax rates, offer more favorable tax policies for SMEs in terms of depreciation deduction and other preferences for general enterprises.

3.1.2 Enrich and Improve the Scope of Tax Incentives

There are huge differences in industrial structure and regional development status between coastal areas and midwest areas. Therefore, the State should work out different policies for SMEs in different regions within the overall taxation framework, so as to strengthen the orientation of preferential tax policies and focus on encouraging the industrial upgrade, technical innovation and reinvestment of SMEs. The State should also encourage the establishment of SMEs by offering tax breaks, investment tax credit and other tax incentives. The State should help to reduce costs and risks and thus increase the profits of SMEs by investment tax credit, income tax exemption in case of losses and carry-over, and address funding difficulties and encourage investments on SMEs by means of reinvestment tax credit and tax reimbursement.

3.1.3 Strengthen and Improve the Legality of Tax Incentives for Smes

Strengthen the legality of tax incentives for SMEs, set up the maximum preferential quota, classify appropriately different rates for small-sized and medium-sized SMEs, stipulate the right of SMEs to choose their tax status, and strike a balance among taxation fairness, taxation legality and social policies. Standardize tax incentives, introduce the concept of tax expenditure, management and regulate tax incentives, establish a scientific evaluation mechanism for tax incentives, and improve the level of standardization of tax incentives.

3.2 SMEs Resist Tax Risks

3.2.1 Establish a Set of Tax Risk Forewarning Systems

On the one hand, SMEs lack an adequate internal management and control mechanism during the production and management process and thus have a lower capacity for preventing and bearing tax risks than large enterprises. On the other hand, financial statements of SMEs are more clearly specified, and data come from simpler sources, which offer a more direct representation of hidden tax problems. Therefore, it is necessary to consider from the perspective of quantitative evaluation of tax risks and establish a risk forewarning system according to internal task risks of SMEs. The forewarning system is used to predict the severity of the overall tax risks of SMEs, ensure that SMEs can identify tax risks in advance, facilitate SMEs to make a reasonable evaluation and analysis of hidden tax risks in advance, and hence manage tax risks more effectively.

3.2.2 Hire Tax Professionals to Implement Special Management

This mode is usually suitable for small companies or new start-ups. Because of the small number of employees, the small business scale and the small tax-related workload, it will be a huge cost to arrange professional staff for tax risk management. Some SMEs are staffed with tax officers who can basically handle some routine and simple tax affairs. However, tax officers will find themselves incompetent to implement effective control and evaluation of tax risks in case of complicated tax affairs, especially those new to them. Therefore, enterprises can hire experts as tax consultants, who will carry out special evaluations of risk tasks regularly according to businesses of the enterprise, and offer tax consulting service and assistance to help address tax problems faced by the enterprise. This is an effective and economical way to implement tax risk management for SMEs.

SUMMARY

Tax is an important but not decisive factor affecting corporate development, so enterprises should still lay the emphasis on their development. In terms of financing, it is reflected in the difficulty of credit rating. Many SMEs can not satisfy the requirements for loan issuance. Therefore, banks should take the lead to offer more innovative financing products for SMEs and establish an effective financing supervision mechanism, allowing SMEs to obtain the development seed. In comparison to larger enterprises, small enterprises have an incomplete, unscientific understanding of taxation and have a lower degree of risk awareness and a lower ability in tax risk management. It should be noted that foreign-invested SMEs have a better sense of tax risks and construct a better tax risk management mechanism than domestic-invested SMEs, which to some extent explains the urgency of implementing tax risk management in SMEs. The definition of taxes is very important to the development of SMEs. However, a good policy should be implemented by an effective tax authority that is the core of local finance. Unfair, opaque and willful tax collections from SMEs will inevitably lead to corruption and hence hinder the development of local economy. However, enterprises themselves should strive for development and achieve scientific management and scale economy, contributing to the local development and the macro economy of the country.

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