SETTING TARGETS TO IMPROVE TAX COMPLIANCE FOR SMALL BUSINESSES

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ABSTRACT

We use a new dataset of the universe of Greek corporate tax returns to study a voluntary tax compliance program for small firms. This "self-assessment" program prescribed target taxable profit margins (the ratio of taxable profits to revenues) for different types of activities. Firms that reported profit margins above these targets in a given year were exempt from audits in that year. We find that the firms that take up the program report significantly larger taxable profits than non-eligible firms, with some evidence for longer-lasting effects on tax reporting. Firms that take up the program for more years exhibit stronger effects. We also find that firms can easily and substantially manipulate reported revenue (decreasing it by up to 40%) to help meet prescribed profit margins without paying more in taxes. Overall, the program increased tax revenues collected from small firms, but points to a very large level of baseline under-reporting of profits and the ease of manipulating reported revenues. In this self-assessment program for small firms, the government posts target taxable profit margins for different types of economic activities. If firms that engage in these activities reported profit margins at least as large as the guidelines in a given year, they were guaranteed to not be audited for that year. Thus, despite not being a typical amnesty program, this program represents a partial, temporary "amnesty" from audits for the year the firms take up the program.

Keywords: Corporate Tax, Tax Compliance, Tax Amnesty, Tax Avoidance, Taxation.

INTRODUCTION

Firms that participate in the self-assessment program are also subject to a VAT adjustment; whereby they pay an additional amount of VAT taxes applied to their cost of inputs see the exact formula for the additional tax. This clearly raises the cost of participating in the program and creates an incentive to decrease or manipulate the cost of inputs. At the same time, adjusting the cost of inputs down would increase accounting profits and potentially taxable profits (Stamatopoulos et al., 2017). The reduction in revenue we will document suggests that firms could have decreased their reported input costs. We do not have access to the VAT data or any measure of input costs, so we leave the VAT adjustment out of our analysis (Leuz et al., 2003).

The positive part of the distribution of pre-self-assessment profits is almost identical to that of accounting profits, which suggests that most of the adjustment is coming directly and simply from the self-assessment amount. To the contrary, for the many firms reporting negative accounting profits, pre-self-assessment taxable profits are reported as zero. This indicates an additional adjustment through reported costs and deductions for those firms with negative accounting profits (Zucman, 2014). These negative accounting profit firms first add back some

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expenses that are nondeductible expenses for tax purposes to get their pre-self-assessment profits to be zero, which explains the excess mass at zero (Christian et al., 2002). Negative profit firms may find it easier to respond by reporting higher non-deductible expenses since they have no tax benefit from not doing so, while positive accounting profit firms may under-report these non-deductible expenses. Still, these adjustments are not large. Self-assessing firms also used the tax loss carry forward deduction-one of the main avoidance tools-less than non-self-assessing firms. Thus, when accounting profits are negative, firms first adjust their accounting costs to bunch exactly at zero before applying the self-assessment payment. When accounting profits are positive, the main adjustment is through the self-assessment amount directly (Desai et al., 2004).

CONCLUSION

The use of a new dataset of corporate tax returns in Greece allows us to uncover firms' responses to a compliance program. This temporary "*self-assessment*" policy encouraged and guided firms to report higher taxable profit margins in return for immunity from audits in a given year. Our analysis shows that, in order to achieve the prescribed profit margins, firms increase their reported taxable profits (the response aimed for by the tax compliance program), but also lower their reported revenues (an undesirable response) by up to 40% to make meeting the target margin easier and decrease their tax burdens. While we are not able to distinguish between revenue reductions from reducing sales (avoidance) versus outright manipulation (evasion), the findings show a significant potential for a reduction in the corporate tax base. They thus highlight that it is very difficult to impose target margins when part of that target (revenues in the denominator) can be manipulated by firms.

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