

THE ROLE OF FISCAL POLICIES IN THE INNOVATION AND DEVELOPMENT OF SMALL AND MEDIUM ENTERPRISES

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Abstract

There are several factors that may represent an obstacle to development of SMEs; among them are relevant the fiscal policies, with regard to taxation and to administrative costs for tax payers. Taxation is a cost for enterprises which drains resources that could be employed in investing for development and innovation. Since fiscal policies play a fundamental role on the development of enterprises it is advisable that legislation shall provide a lower fiscal pressure and a simplification of fiscal procedures. The importance of a fiscal policy as a possible incentive to develop economic activities becomes even greater in the global market of today. In such a context a taxation system may become a factor of success for enterprises, either in a new establishment or in a development prospective. At present some countries such as Italy show a change of tendency in their traditional fiscal policies and is paying more attention to fiscal measures that may sustain development of SMEs. Such new tendencies must be strengthened in order to supply more effective means to innovation and development of enterprises specially small and medium.

1. Introduction

Among different obstacles to development of small medium enterprises, such as difficulties of access to credit, criminal constraints, lack of infrastructures and long period decrease of demand, fiscal duties play a major role.

As a matter of facts fiscal pressure seems to represent at present a major reason of involution of enterprises with reference both to birth of new ones and to their growth and innovation.

Taxes must be considered costs for enterprises and as such they drain precious financial resources that could be employed in development projects, either for plant logistics or for market expansion, and in innovation or evolution projects, both for processes and products.

2. Fiscal pressure on SME world-wide

Data in Table 1 show recent trends of fiscal pressure on enterprises in sixty countries.

Table 1 needs some explanation, First of all, it compares rates on companies profits in the period January 1998 - January 1999, so underlining fiscal drag on companies. However it should be noticed, in order to understand data correctly, that a simple comparison of rates is not sufficient to define fiscal drag on profits indifferent countries.

As an example as far as Italy is concerned the 41,25% rate is a resultant of two taxes, the so-called tax on juridical persons i.e. the companies better than the individual entrepreneur as a physical person (IRPEG) and the so-called regional tax on productive activities (IRAP). That means that only companies and not the many individual firms are taken into consideration.

Methodology used in Table 1 considers however the accounting differences in evaluating the companies profits subject to taxation and different criteria for definition of taxability.

Rates in Table 1 do not include neither taxes on salaries and wages and on socials security duties, nor fees for medical cares and accident assurances, taxes on property and other taxes different from income taxes.

For those reasons fiscal pressure as presented in Table 1 is only partially true but still is sufficient for scope of comparisons among different countries because exclusions regard all countries.

The investigation reveals that fiscal pressure increases a proportionally to economic level of different world areas: in OECD countries the average rate is 34.8%, in the Pacific countries, including the Far East and Australia, which are relatively less developed, taxation is a little lower (31.7% in the average). In Latin America is even lower (28.6%) which is an evidence of the fact that countries use fiscal benefits to attract capitals for investments.

Table 1 - Word's Enterprises Under Fiscal Pressure

<i>Country</i>	<i>January '98</i>	<i>January '99</i>	<i>% Gap</i>
Germany	56.66/43.60%	52.31/43.60%	-4.35%
Japan	51.60%	48%	-3.60%
Canada	44.60%	44.60%	*
Italy	41.25%	41.25%	
Belgium	40.17%	40.17%	
USA	40%	40%	*
France	41.66%	40%	-1.66%
Luxembourg	37.45%	37.50%	
Portugal	37.40%	37.40%	
Panama	37%	37%	
Israel	36%	36%	
Australia	36%	36%	
Greece	35/40%	35/40%	
India	35%	35%	
Mexico	34%	35%	1
Holland	35%	35%	

Vietnam	30/35%	30/35%	
Pakistan	30%	35%	5
Spain	35%	35%	
Sri Lanka	35%	35%	

Source: "International Tax centre" of KPMG consulting

*average rate

<i>Country</i>	<i>Jan. '98</i>	<i>Jan. '99</i>	<i>% Gap</i>
Argentina	33%	35%	2
Bangladesh	35%	35%	
Czech (Rep.)	35%	35%	
Columbia	35%	35%	
Fiji	35%	35%	
Poland	36%	34%	-2
Venezuela	34%	34%	
Austria	34%	34%	
Philippines	34%	33%	-1
New Zealand	33%	33%	
Turkey	44%	33%	-11
Brazil	33%	33%	
China	33%	33%	
Denmark	34%	32%	-2
UK	31%	31%	
South Korea	30.80%	30.80%	
Indonesia	30%	30.30%	
Iceland	30%	30%	

Paraguay	30%	30%	
Peru	30%	30%	
Thailand	30%	30%	

Source: "International Tax centre" of KPMG consulting

*average rate

<i>Country</i>	<i>Jan. '98</i>	<i>Jan. '99</i>	<i>% Gap</i>
Uruguay	30%	30%	
Costa Rica	30%	30%	
Ireland	32%	28%	-4
Malaya	28%	28%	
Norway	28%	28%	
Sweden	28%	28%	
Finland	28%	28%	
Guatemala	30%	27.5%	-2.50
Singapore	26%	26%	
Switzerland	27.80%	25.10%	-2.70
Honduras	40.25/30%	25%	-15.25
P-New Guinea	25%	25%	
Taiwan	25%	25%	
Bolivia	25%	25%	
Dominican Rep	25%	25%	
El Salvador	25%	25%	
Hungary	18%	18%	
Hong Kong	16.50%	16.50%	
Chile	15%	15%	
Ecuador	25%	15%	-10

Belize	n.d.	n.d.	
Source: "International Tax centre" of KPMG consulting			*average rate

Among those belonging to OECD, in 1998 several countries such as France, Denmark, Germany, Japan, Ireland, Poland, Switzerland e notably Turkey have lowered taxation on companies profits. Italy is at the forth position in the world list of countries with the higher taxation on enterprises; the investigation however does not take into account the possible application of a Dual Income Tax, which will be discussed later, which allows the companies to reduce the taxes they pay in a significant way.

Table 2 gives further relevant information on fiscal pressure on production in the European context, precisely in the European Union countries. In that table fiscal pressure, as the sum of taxes plus social security fees) is measured as a percentage of total public revenues with reference to gross domestic output.

Data of Table 2 would be veritable in the case all economic subjects should be perfect taxpayers. In reality pressure for taxpayers is even higher since contribution to GDO is also given by a number of activities which are partial or total tax evaders and which in those countries where such phenomenon is more extended are known as *submersed economy*.

Table 2 - Fiscal pressure in EU countries in 1997 (% of gross domestic output)

<i>Countries</i>	<i>Fiscal pressure</i>	<i>Social pressure</i>	<i>Total</i>
Sweden	38.9	15.1	54.1
Denmark	51.4	1.7	53.1
Finland	34.02	13.2	47.5
Belgium	31.6	15.0	46.6
France	27.1	19.3	46.3
Holland	27.0	18.9	45.9
Luxembourg	33.9	11.8	45.7
Austria	29.6	15.3	44.9
Italy	29.4	15.1	44.5
Germany	22.7	19.0	41.6
Portugal	25.9	12.0	37.9
Spain	23.2	13.0	36.2

Great Britain	29.3	6.7	35.9
Iceland	29.5	4.6	34.1
Greece	24.1	9.9	34.0
Font: Eurostat			

Submersed economy, made up of a large number of SMEs which get out or not even initiate the process of contribution legality and therefore don't fulfil fiscal obligations, is often a consequence of excessive fiscal pressure on enterprises.

Italy, taken as case in which submersed economy is a major problem, has never reacted to the issue of fiscal competition; while from the '80s on, all main countries, also as a response to Reaganian policies, have tried to modify their fiscal legislation in order to be more competitive, in Italy the continuous needs for increasing public revenues have pushed the legislation in the opposite direction, setting up a burdensome and distorted fiscal system, that discourages national enterprises and does not attract international investors.

Acts adopted by many developed countries within OECD have made levy on production factors, capital and labour, more onerous, in such way slowing down economic development and discouraging the start up of new initiatives.

To affect capitals and labour means to affect production. A consequence of that is a scarce birth of new enterprises, a reduced tendency of investors to allocate venture capitals in foreign countries, a modest will of companies to hire new personnel and to expand or renew.

But now, in the global market, in which venture capitals are free to move rapidly from a country to another on simple computers orders and enterprises fully engaged in the challenge for competition a wrong step in fiscal legislation may have dramatic effects.

Fiscal legislation, beyond the amount of revenues collected, obliges enterprises to face other additional costs the so called *administrative costs*.

As matter of facts enterprises are subject to two different burdens: a first one, of the substantial type, which consists of taxes to be paid, and a second one, of the formal type, which consists of the complex procedures enterprises must follow for fiscal reasons.

From single taxes and from the overall taxation system derive costs of different types. As administrative costs one could intend costs met by taxpayers or third parties, as enterprises, to meet the requirements of the laws of some fiscal system. Such costs are not proportional to their fiscal debts o to their taxable profits but depend on the activity of the taxpayer (Di Maio/Nocerino/Ceresa, 1997).

Such costs are particularly high for enterprises and continuous changes in tax legislation makes them even higher. Administrative costs are those an enterprise must face for fiscal consulting, invoice management, for keeping all sorts of official records and operating registers, for purchasing and operating complex management software, for fiscal updating, for defending in front of fiscal courts.

3. Some proposals for a fiscal simplification

From the framework of the previous discussion one can derive the importance that the fiscal imposition assumes in the economic context, mainly in the world of enterprises as a tool for boosting or not productive activities.

Only a correct use of fiscal imposition can settle fiscal legislation disputes in national, European and international relations, since quite often complexity of legislation in such relations is an obstacle to a correct evaluation of decision and choices of a strategic nature, not only for big companies, but also for SMEs.

In the European and world framework fiscal legislation play a role of booster or a deterrent to economic activities.

The legislator in the different countries is required to review rules and reduce fiscal pressure, thus attracting enterprises and investments and better distributing the reduced revenues among a larger number of economic subjects.

It is also important for those countries where the phenomenon of submersed economy or enterprises is relevant, to bring into fiscal legality such economy and enterprises through appropriate policies and incentives in order to re-establish transparency and sane competition in the market, to distribute among more enterprises and with more equity taxation burdens which achieve the same overall revenues, to avoid fiscal evasion and other phenomena of distortion in domestic and international development of enterprises. In particular, the chance of cancellation of previous fiscal debts given by some countries to the enterprises that get out of a submersed condition, can be successful only if accompanied by a serious and structural policy of reduction of fiscal costs for SMEs, that is excessive fiscal pressure and additional administrative costs for fulfilment of fiscal procedures.

As far as the last ones are concerned, beside simplification of fulfilment, which anyway reduce costs, there is a general need for simple, transparent and accessible fiscal rules thus eliminating laws of difficult interpretation and application, continuously amended or changed, that oblige SMEs to hire expert and costly consultancies for a safe fulfilment.

4. Fiscal measures to assist economic development: the case of the Italian legislation

In Italy an inversion of tendency has taken place with the so called Dual Income Tax, DIT, established by a legislative decree n.466/1997 (Pontolillo, 1999).

The government was delegated by a law passed by the Parliament to issue provisions under which to encourage capitalisation of enterprises taking into account needs for efficiency, reinforcement and rationalisation of the production system.

To sustain enterprises to seek more venture capital, the Italian Parliament had two alternatives: to impose only a partial tax allowance on passive interests, when the indebtedness ratio should pass a limit considered as physiological, or grant tax rebates as a function of unearned increments.

While other developed countries, as for example Germany, Spain and Japan, who were pursuing the same goals, adopted the first alternative obtaining that a pathological indebtedness, that above a certain limit to be considered as appropriate, be not tax allowed on passive interests, the Italian legislator has adopted the second solution. Such a decision has been more feasible for Italy being characterised by enterprises in financial disequilibrium due to heavy indebtedness (Cappelluti, 1998).

With the same objectives, but with completely different measures, the same Italian legislator has introduced a tax on the income of productive activities called IRAP from January 1st 1998 which has no comparison terms with similar taxes in other countries and which features no tax allowances on financial burdens which concur to make the taxable base, penalising the enterprises that apply more to short and long term borrowing.

DIT is a form of facilitated levy for enterprises both individual firms and partnerships, or stock and limited companies. In the last case the benefit consists of paying taxes on a 19% rate base instead of the usual 37% the part of the overall profit corresponding to the ordinary remuneration of invested capital as varied with respect to that existing at the end the fiscal year of reference (1996).

The importance and innovation of such provisions is in the introduction of a reduced rate of 19% on the taxable base of profits which have been reinvested in the same enterprise.

DIT is a tax that for the first time makes a distinction between profits to be consumed and profits to be invested to produce directly and immediately a further profit and which attempts to reduce financial disequilibrium of enterprises.

If it is true that a tax such as DIT in Italy has been an attempt to use levy to face financial weakness of those enterprises that are used to finance themselves by debts and to invest equity capitals, also produced by the enterprise activities, it is also true that the practical effects have been only slightly positive in the case of stock companies and null in the case of individual firms and partnerships. Many cases can be reported showing that only very high reinvestments can produce still minor tax savings.

Differently from stock companies for which any capital improvements may be considered for applying reduced tax rates with no reference to their allocation, for individual firms and partnerships, only improvements employed for reinforcement and rationalisation of the production system, or for productive investments or to balance internal and external financial resources may be considered for the reduced tax rate of 19%.

The Decree establishes that increases to be considered are:

- reduction of financial debts minus financial credits existing in fiscal year of reference (1996);
- value of new production goods, either purchased or leased starting from fiscal year after the reference one.

Application procedures of DIT could not be the same for individual or partnerships and for stock companies since they are subject to different fiscal regimes.

In order to take into account such difference the Italian legislator has adopted a separate taxation system for the amount of profits to be reinvested and therefore to be taxed by a 19% rate.

Nevertheless, for not creating inequalities between partners or owners of individual firms and stockholders, who must face their personal progressive income taxes after the 19% rate taxation, individual entrepreneurs are anyhow subject to an increase of their total taxation base in the domain of higher rates provided by a progressive taxation system.

As a consequence of that, at least in the present form of DIT, fiscal saving is a very minor one.

It is advisable that the application mechanism of a taxation such DIT be modified in order to better pursue the goals of balancing fiscal pressure on enterprises.

Other measures, still adopted in the Italian legislation, are grants of tax credits to favour development of some economic activities. In the last three years in Italy there have been several measures of that kind with different finalities but all featuring a sort of fiscal bonus to support and encourage some categories of activities.

As examples of such measures, one could report those to support the acquisition of production goods for enterprises in the field of detail trade, of sales of food and beverages, of hotels and tourism activities; to encourage research and development in industries, to support acquisition of software and hardware by service companies, to encourage hiring of new labour.

In all mentioned case, except labour hiring, fiscal measures provided a tax credit proportional to the costs of goods and services not including TVA.

Also with regard to administrative costs must be noted some legislation provisions aimed to simplify procedures. A fairly recent Government Decree (n. 241/1997) has introduced the unification of payments of different taxes giving the possibility of compensating fiscal debts and credits related to the different taxes, as well the possibility of paying taxes by credit cards associated to bank accounts and of submitting formats to Government offices by computer networks.

5. The European Union initiatives: suppression of fiscal barriers

The Treaty of Rome and subsequent modifications do not explicit refer to the need to harmonise income taxation systems in the member countries (Valente/Roccatagliata, 1997). Nevertheless, for an effective realisation of a common market that could permit a free circulation of persons, goods, services and capitals, since the '60s it was perceived the need for fiscal agreements especially for enterprise taxation. Later on several ad hoc study groups became aware that, considering multiplicity of factors to which are related structural different between fiscal systems and moreover to respect the levy autonomy of each country, any attempt to completely unify fiscal structure of member countries was politically not pursuable. Therefore to the firstly wished harmonisation a more realistic tendency to coordination and to alignment of fiscal policies.

In the early 90's the European Council has approved some transnational co-operation resolutions concerning:

- fiscal regimes to be applied to
 - amalgamations of companies of different member countries,
 - controlling and controlled companies established in different member countries,
- a procedure for arbitration in the subject of transfer prices (Iorio, 1998).

However the process under way is not leading to the elimination of differences existing in the various taxation systems nor it is pursuing the objective of avoiding the forms of a fair fiscal competition among countries, to which the Union recognises a determinant role as a factor of growth for economy and employment.

What can be wished to reduce difficulties determined by the divergences in the national fiscal systems and the community action intended to:

- eliminate discriminating provisions in the fiscal systems of the member countries;
- establish a minimum taxation system on enterprises a common rules to determinate taxation base and to limit the phenomenon of unfair competition,
- encourage the maximum transparency of fiscal allowances accorded by member countries to attract investors.

At present none of those actions has been implemented; as a consequence of that there are different taxation systems within the Union which implies different fiscal burdens on investing subjects in various countries.

Considering that such differences have a remarkable influence on the enterprises' decisions about innovating, expanding and investing, actual conditions favour allocation of investments in the areas at a lower taxation or in member countries where it is possible to obtain preventive official statements about fiscal matters or fiscal consequences of some activities by the Government offices through tax ruling.

However it has been approved by unanimity by the Council (Ecofin) in 1997 a *behavioural code* which is an engagement of member countries to eliminate all fiscal measures that could be dangerous for a fair competition and not to introduce new ones. It has been established an European Committee for the Behaviour Code. Such committee shall evaluate legislation of member countries in order to individuate fiscal regimes that generate unfair competition within the European Union. By means of the committee EU is monitoring fiscal measures in member countries that may be a cause of disequilibrium in allocation of financial resources.

From the first draft report of the committee France and Great Britain, followed by Holland and Portugal are at the first places in the list of countries which have adopted provisions that generate unfair competition. Italy is at the end of the list and it confirms its scarce tax appeal.

Thus for achieving an higher degree of co-ordination of fiscal policies within EU instead of a more utopic harmonisation every member country is called to review its fiscal rules to re-establish its taxation principles in the framework of national economy and to reset levy methods and procedures.

6. Conclusions

As a conclusion of the previous discussion the use of fiscal measures is a mean of sustain the development of SMEs both with a reduced taxation and with a simplification of procedures. It has been ascertained that tax allowances on SMEs profits imply to permit them a larger financial availability to be used for reinvesting in the enterprise activities for research and development as well as for domestic and international investments in production goods and know how. Introduction of taxes as DIT is a first experiment at the fiscal system aimed to sustain development of enterprises. It is a positive measure because it represents one of the few provisions by which the legislator does not pursue larger public revenues but the consolidation of enterprises by encouraging more venture capitals allocations, generally penalised by many existing fiscal systems.

Similar examples of taxation methods witness new tendencies in fiscal policies that take into account the need of consolidation, development and innovation in enterprises, especially small and medium, and are a must for economies which shall compete in the global market and therefore set up a fiscal framework in which to attract adequate financial resources.

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