

# Tax penalties in SME tax compliance

ARTUR SWISTAK, M.A., M.P.S. PhD candidate\*

Review article\*\*

JEL: H26, H32, H83, K42

doi: 10.3326/fintp.40.1.4

---

\* The author is grateful to John Norregaard and Enrique Rojas (both IMF), and two anonymous referees for their valuable comments. All errors and omissions are the author's sole responsibility.

A previous version of this paper was presented at the regional conference: *Challenges of Tax Compliance by Small and Medium Enterprises* organized by the World Bank in Sankt Petersburg, Russia on September 20-21, 2012.

\*\* Received: September 25, 2015

Accepted: November 10, 2015

---

Artur SWISTAK

Warsaw School of Economics, al. Niepodległości 162, 02-554 Warsaw, Poland

e-mail: artur.swistak2@gmail.com

## Abstract

*Small business tax compliance requires special attention. On the one hand small businesses are often incapable of rigorously fulfilling their tax obligations, more vulnerable to external risks and tempted to exploit opportunities to be non-compliant. On the other hand, unlike larger businesses, they are usually sole proprietors or owner-operated businesses, hence highly responsive to personal, social, cognitive and emotional factors. These attributes pave the way to a better use of measures designed to influence their behavior and choices. This paper discusses the role and effectiveness of tax penalties in enhancing tax compliance in small businesses. It argues that tax penalties, although indispensable for tax enforcement, may not be a first-choice tool in ensuring tax compliance. Too punitive a tax regime is an important barrier to business formalization and increasing severity of tax penalties does not produce the intended results. To be effective, tax penalties should deter and motivate taxpayers rather than exert repressive measures against them.*

*Keywords: tax penalties, tax enforcement, SME's tax compliance, SME taxation*

## 1 INTRODUCTION

Small and medium-sized enterprises (SMEs) are an important part of the taxpayer population in any country around the globe. Their taxation usually poses a number of challenges. They are numerous but contribute relatively little to the state coffers, while often absorbing a large share of scarce tax administration resources much needed elsewhere in administering the tax system. Moreover, low levels of tax compliance are observed among SMEs, particularly among the self-employed, thus further reducing potential tax collections and increasing the tax administration effort (Engelshalk 2004; OECD, 2009; 2014). Many countries address these issues by adopting simplified tax regimes for SMEs and implementing dedicated compliance strategies (IFC, 2007; OECD, 2009; Crawford and Freedman, 2010). While the primary objective of a well-designed simplified tax regime is to improve efficiency of small businesses taxation, by reducing both compliance costs and tax administration effort, the compliance-enhancing strategies aim at the inclusion and more efficient use of different administrative instruments that allow more taxpayers to be brought into the tax net, encourage existing taxpayers to voluntarily fulfill their tax obligations, and ultimately to create a widespread culture of paying taxes.

There is a whole universe of measures that may be used to boost tax compliance. Presumptive taxation, less onerous tax obligations, including reduced frequency of filing and tax payments, use of third party information, IT solutions, and open communication with taxpayers are just a few examples (Thuronyi, 1998; Chen et al., 2002; Engstom et al., 2006; OECD, 2009; 2010; Swistak, 2015). Tax penalties also play a role – from deterrence to motivation and correction of improper behavior of taxpayers (Wenzel, 2004; OECD, 2010; Poppelwell, 2012).

None of these measures give satisfactory results if implemented alone. They are more efficient when used in a mix of complementary instruments. Tax penalties

may be, and usually are, a very important part of this mix (Devos, 2004; Popelwell et al., 2012). They may be powerful in influencing taxpayer behavior but never should they be seen as a primary or a stand-alone tool (Tyler, 2006; OECD, 2010). As noted by Matthews (2005) the myth of punitiveness has long been shattered. Tax penalties have the potential to work better if used as an auxiliary means of delivering and implementing a sound compliance strategy. It is thus important that policy makers and tax administrators have a good understanding of the nature of tax penalties. Otherwise their negligence or overuse may become commonplace.

Yet, it is not only the extent to which traditional tax penalties are used that defines the overall quality of taxation and behavioral responsiveness of taxpayers. Certain tax design features and tax administration actions may also be punitive for taxpayers. As such they become an important part of the discussion on tax penalties, or – to put it broadly – the punitiveness of the tax system (Wenzel, 2004; Kirchler et al., 2007; OECD, 2010).

Therefore, there are important questions to be answered: Does tax compliance in small businesses require special attention? If so, how important are tax penalties in enhancing and enforcing it? In what ways do they influence taxpayers' behavior? To what extent may they affect business informality? And, how punitive should the tax regulations be?

This article provides for a brief overview of the role of tax penalties in tax compliance in small businesses and aims to answer the above questions. First, it discusses the potential of tax penalties in driving tax compliance in SMEs. Then it discusses objectives and forms of tax penalties and follows with a brief elaboration on the severity of tax penalties and alternatives to their use. The final section offers concluding thoughts as well as a few practical guidelines for the effective use of tax penalties.

## 2 WHY PENALTIES MATTER IN SME TAXATION

Taxation of SMEs poses different challenges from larger businesses. There are several reasons why the size and structure of businesses matter in tax compliance. Small businesses, in most cases sole proprietors or owner-operated incorporated companies, may lack the capacity properly to fulfill their tax obligations, even more so if these are onerous (Evans et al., 2005; Engstom et al., 2006). Not many small entrepreneurs can or want to afford professional tax services and, instead, they rely on themselves. However, the low awareness of tax obligations<sup>1</sup>, coupled with relatively slower adjustment to tax law changes, commonly leads to mistakes

<sup>1</sup> Small businesses may lack not only understanding of specific tax obligations but also the basic nature of taxes. A value added tax is a primary example. Small businesses often perceive VAT as a tax on the profits they make, not as a tax on final consumption. Without in-depth knowledge of the VAT mechanism they may be inclined to avoid registering for VAT even if it would be beneficial for them. By “hiding” behind the VAT registration threshold they themselves add to evasion and – by breaching an invoice trail – provide further non-compliance opportunities to other businesses.

and delays in tax calculations, reporting and payment (McKerchar, 1995; Coleman and Freeman, 1997). The vulnerability of small businesses to changes in market conditions further increases the risk of involuntary non-compliance. Any exposure to trade shocks (e.g. a temporary ban on exports) or backlog of payments for supplied goods and services (e.g. delays in payments by a general contractor to its subcontractors) may easily result in a temporary cash flow-insolvency (Kitching, 2011; Ogawa et al., 2012). Since small businesses, unlike large companies, have also limited options in securing additional funding, e.g. accessing bank credit, they may be unable to pay their taxes promptly (Ayadi and Gadi, 2013; Darvas, 2013; ECB, 2013; Ozturk and Mrkaic, 2014).

The risk of voluntary non-compliance is also higher in the case of small businesses (Cowell, 2003; Slemrod, 2004; Crocker and Slemrod, 2005). Many SMEs, even if incorporated, are managed by the owners. Unlike professional managers or accountants in large companies, they do business using their own capital and have different interests in its use. Their personal risk-aversion may be lower as any gains arising from tax evasion directly accrue to business manager-owners. For this reason they are more sensitive to changes in the financial situation, unfair treatment by tax administration or simply tempted by existing opportunities. Unquestionably, there are more opportunities for small businesses to be non-compliant than for larger ones – they can use cash transactions, disguise their private consumption as business inputs, or hide actual wage payments (Cowell, 2003; Engstrom et al., 2006). By doing so they manipulate their sales, margins, profits, and even taxable wages paid to their employees. More importantly, it is easier for them not to be formalized at all. Specific tax concessions available for small businesses offer further avenues for tax abuse, e.g. hiding below the eligibility threshold in a presumptive tax (OECD, 2009).

Apart from penalties associated with non-compliance there are other risks that have an impact on small businesses. Unlike large enterprises, they are prone to abusive actions enforced by tax administration (e.g. excessive audits, lengthy and impeded tax procedures, unjustified certification requirements, corruption). Such actions although not strictly classifiable as tax penalties may be seen as penalizing in a broader sense and discourage compliance (McClellan, 2013).

Tax design also matters. Onerous tax obligations, multiple taxes, high tax rates and overall complexity of tax laws pose much of a challenge for small businesses. Even if these challenges give rise to the introduction of some special concessionary measures (e.g. less frequent filing and tax payments, cash flow accounting or presumptive taxation) not all risks are eliminated. Some measures are conditional (e.g. taxpayers in good standing only) and limited (e.g. turnover threshold, employment limits, exclusion of specific activities) so there is a need for a constant observance of eligibility criteria, adding to the existing risk of abuse (Thuronyi, 1998; IFC, 2007; OECD, 2009).

As pointed out above, the risks of being non-compliant are numerous. At the same time, small businesses due to their size and personal characteristic are more susceptible to corrective stimuli than large businesses. This suggests that behavioral measures, including tax penalties, are of great relevance for enhancing tax compliance in small businesses.

### 3 TAX PENALTIES AS A COMPLIANCE DRIVER

#### 3.1 ECONOMIC DETERRENCE MODEL

In many countries revenue bodies seem to rely on increased checks and severity of penalties as the main vehicle for enforcement of taxes. The established conviction of the effectiveness of this approach goes back to the economic deterrence model, developed by M. Allingman and A. Sandmo (1972).

The model assumes that rational taxpayers base their decisions purely on economic calculation. If they expect that costs of evasion are higher than benefits received as a result of it, they will comply. If the expected costs of evasion are lower than the expected benefits they have no incentive to be compliant. Therefore, it is enough to check taxpayers more frequently and impose more severe penalties to limit tax evasion. This approach, in its simplicity, seems to be very convincing. However, no tax administration has the capacity frequently to check all taxpayers and impose severe penalties. Rational taxpayers may well factor this into their calculations and choose to continue evading taxes. In addition, practice does not confirm the theory – there is much less tax evasion than the model would imply. Other factors, sociological and psychological, for instance, determine actual levels of tax compliance.

Therefore, revenue bodies should be compelled to shift from reliance on the classical economic deterrence model to a better understanding of taxpayer behavior and the provision of incentives for boosting tax compliance. This does not mean that tax penalties are no longer important. They are still necessary but need to be used in a well-informed way and supplemented with other actions and strategies. Tax penalties are just one of the many factors that drive taxpayer compliance. Other drivers include risk aversion, personal and social norms, opportunities, fairness and trust and economic factors (OECD, 2010). Reliance only on tax penalties is thus not effective. To achieve the best results, the knowledge of taxpayer behavior is critical, yet extremely complex. As is the relationship between tax penalties and tax compliance (OECD, 2010; Poppelwell et al., 2012).

#### 3.2 VOLUNTARY VS. NON-VOLUNTARY COMPLIANCE

It is important to distinguish between involuntary and voluntary non-compliance. Taxpayers already willing to comply are not likely to be motivated through tax penalties. In fact they may feel discouraged if unjustly punished. Voluntarily non-compliant taxpayers are also not a homogenous group – some of them cheat occasionally, some do it on a regular basis by taking advantage of existing opportunities, and some resort to permanent fraudulent actions. Ideally, they should be treated differently.

Different strategies are needed to foster voluntary compliance and enforce tax laws. Improving the climate of doing business and paying taxes does not require reliance on tax penalties whereas dealing with detected cases of tax offenses would be difficult without them. Elimination of excessive tax obligations, streamlining tax administration processes, support and trust are likely to give better results.

As mentioned above, the relationship between tax penalties and tax compliance is complex. Tax penalties may have both positive and negative impact on taxpayers. If tax penalties are fair and acceptable they strengthen taxpayers' compliance. If they are perceived as oppressive they are likely to create resistance and result in even more non-compliance.

Also, deterrence does matter. Not all taxpayers respond to this element in quite the same way. Recent OECD research (2010, 2012) found that tax penalties have greater deterrence impact on taxpayers who assess risk and severity of penalties as high, are not driven by a moral obligation to comply, and perceive the high social cost of non-compliance and notice that non-compliant taxpayers are being caught and punished. This underscores the fact that understanding personal characteristics of taxpayers and behavior patterns is a key challenge. It also calls for a strong and trustworthy tax administration that undertakes effective actions to create a sense of unavailability and fairness of tax penalties. If taxpayers see that those who are non-compliant are not punished it harms their morale. It is then important to penalize non-compliant behavior not only to deter and motivate a given taxpayer but also to convey a message to the general public that such behavior is not acceptable. The effectiveness of revenue bodies in this domain builds trust and creates a very important social norm, i.e. paying taxes is the right thing to do.

Dealing with experienced fraudsters requires a slightly different approach. Detection and punishment of a single tax offence may create an illusion of security – those taxpayers may believe that lightning never strikes the same place twice and continue their fraudulent practices. In such a case the deterrence of tax penalties is compromised and repetitive actions are required – up to fining those taxpayers out of business. As noted above, the consistency and effectiveness of the tax administration is crucial for the general perception of fairness and the creation of social norms.

### 3.3 TAX PENALTIES AND BUSINESS FORMALIZATION

Tax penalties may drive not only tax compliance of registered businesses but also be a barrier to business formalization. Naturally, there are other reasons for businesses to operate in the informal sector. Burdensome regulations, multiple and high taxes, labor law requirements, bureaucracy, corruption, etc. are traditionally cited as primary hurdles. Tax penalties just further add to this list.

The impact of tax penalties on business formalization is not uniform. Penalties may be seen at two extremes – as a barrier to formality or an invitation to informality. Tax penalties become a barrier if they are widespread, severe or abused by tax ad-

ministration. The number of tax obligations itself translates into higher risk of non-compliance and associated punishment. If this is coupled with a heavy reliance on penalties in tax enforcement actions a dire disincentive is created for business formalization. It becomes even bigger if penalties are unrelated to actual infringements or are used for purposes of corruption. Small businesses may choose to stay in the shadow to avoid any obligations and potential contact with the authorities. If they risk anything, it is the possibility of being detected and punished – but only once.

Tax penalties may also be seen as an encouragement to informality. This is due to poor design of tax penalties or poor performance of the tax administration. If the deterrence effect is not big enough or the tax administration is too weak to enforce penalties, businesses may prefer to stay in the shadow, not believing that they are in any danger.

A sound system of tax penalties should be therefore seen as one of the vehicles of incentivizing business formalization. It has a significant potential to influence taxpayers' choices, even more so if coupled with the removal of other barriers and adverse incentives (e.g. onerous tax obligations). The high efficiency of a tax administration in the enforcement of tax penalties is crucial, as is the support offered to taxpayers in their efforts to be tax registered and compliant. Without a strong trust in the tax administration and their conduct, including the trust in the fairness of penalties used, no incentives offered to small businesses to step out of the shadow economy are likely to be effective. Mutual trust helps in the building of strong social norms. Without those norms, no compliance strategy, which tax penalties are a part of, may give satisfactory results.

In designing a strategy for business formalization, lawmakers and tax administration should focus on a few core elements. Businesses ought not to be worse-off when formalized, there should be little or no risk that they will end up paying more penalties than when they are informal, the odds of being detected and punished must be very high and the penalties enforced need to be substantial as compared to those applied to businesses that are formalized but prone to making mistakes. To increase the deterrent effect and social acceptance, prompt and firm enforcement of tax penalties is also crucial. On balance, strong support should be offered to formalized business. Certain rewards (e.g. training, temporary forgiveness or well targeted concessions) are of additional benefit.

Yet, not all revenue bodies focus enough on the informal sector. Little research is done on country-specific reasons for a large informal economy, actual taxpayers' segmentation or existence and potential impact of social norms. Many countries lack comprehensive strategies, including studies on the possibilities of best employment of tax penalties in addressing business formalization and boosting tax compliance. Tax administrations, especially in emerging economies, find it easier to focus on known businesses, ignoring those invisible to them. Apart from fiscal costs there is a huge social cost attached to this – a culture of non-payment of

taxes becomes widespread and engulfs more and more businesses, even those potentially willing to be compliant.

The experience of Poland, although not exceptional, may be instructive by showing deficiencies in designing and delivering a sound compliance strategy for small businesses. Box 1 gives an overall picture of how much needs to be done to effectively tackle existing challenges, many of which have a historical and cultural background. Poland is a high-income country still strengthening its democratic traditions and the rule of law after the collapse of the Eastern Bloc. The troubled history and long-standing non-democratic regime, where one had to cheat, maneuver and avoid authorities to get by, greatly loosened once-strong social norms and imprinted a stigma on the culture of paying taxes (Majka, 2010). Even nowadays, non-compliant taxpayers are not condemned by society. In many cases they are seen as those who have the brains to play the system. It is the tax administration that is blamed for being oppressive even if its actions are necessary and justified (Debowska-Romanowska, 2008).

**Box 1: Poland – deficiencies in compliance strategy and use of tax penalties**

- No comprehensive research on taxpayers’ segmentation and behavior and impact of personal and social norms.
- No tax gap measurement, limited compliance data analysis, little data on informal economy size and structure.
- No comprehensive strategy on tax administration of SMEs (some scattered measures exist, e.g. limitation on length and number of audits).
- Little communication and few campaigns (though some distinct actions have been recently undertaken, e.g. the media campaign “Take a receipt”, promoting VAT compliance).
- No specific deterrence strategy.
- Heavy reliance on tax penalties, barely any alternatives are used.
- Fines keep increasing, currently up to USD 1,000 (though usually lower ranges are used).

*Source: Ministry of Finance’s documents ([www.mf.gov.pl](http://www.mf.gov.pl)); Action Plan for Improved Tax Compliance and More Effective Tax Administration: 2014-2017 ([http://www.mf.gov.pl/documents/764034/1161625/pakiet\\_dzialan\\_podatkowych.doc](http://www.mf.gov.pl/documents/764034/1161625/pakiet_dzialan_podatkowych.doc)); author’s analysis.*

Such a heritage, most likely relevant to other countries of the former Eastern Bloc, creates a great challenge for a tax administration and requires a tremendous effort to put tax compliance back track and match the levels observed in the developed world. A strong commitment to research and sound analysis of the current structure of compliance strategies, including the structure and use of tax penalties, is needed. Yet, in Poland, there is very little of this.

Such a phenomenon may only be partly explained by the tax authorities’ capacity constraints. The other factors entail insufficient awareness of the challenges, limited experience in applied behavioral economics, and more importantly – the lack of political will.



#### 4 OBJECTIVES AND FORMS OF TAX PENALTIES

A tax is a compulsory unrequited payment to general government.<sup>2</sup> It is unrequited in the sense that benefits provided by the government to taxpayers are not in proportion to the payments they make. Since there is no direct benefit, taxpayers are naturally resistant to the payment of taxes. The resistance differs amongst taxpayers but is largely commensurate with the overall tax burden and the quality of taxation and also the perception of government spending efficiency.

Unquestionably, the higher the acceptance of taxes, the easier the task for the tax administration to collect them. It would be too optimistic, however, to rely only on taxpayers' inner conviction that "paying taxes is a right thing to do". Legal coercion and sanctions are still necessary to enforce taxation. Obligations have to go hand in hand with sanctions (Ripstein, 2004). Otherwise they would become a classic *lege imperfecta*, an unimaginable approach in the public finance domain (Dębowska-Romanowska, 2008).

The critical question therefore is not whether sanctions should be used but what they should be like. Although there is no universal answer to it, two basic features emerge. First, a tax penalty should influence taxpayers' behavior – prevent non-compliance and induce compliant demeanor in the future. Second, it should be more painful than fulfillment of a given tax obligation, yet not repressive.

The preventive aspect of tax penalties lies mainly in deterrence (Wenzel, 2004; OECD, 2010; Majka, 2010). Taxpayers choose to comply with their tax obligations rather than paying more than the cost of obligation or losing potential tax benefits (e.g. tax concessions). However, it is only true if they know what the consequences of non-compliance are, find it unprofitable to cheat and believe they may be detected.

Tax penalties also motivate taxpayers. First, they may educate them, but only if tax penalties are fair and unavoidable. Certainty of being detected and punished is the prerequisite for taxpayer education (Frey and Feld, 2002; Torgler, 2007). The other is fairness of penalties applied. If they are too lenient taxpayers may find it beneficial to be non-compliant again. If they are too strict taxpayers may find them too oppressive and unacceptable and are likely to choose playing the tax system, even if they did not do it before. Second, tax penalties may contribute to the creation or promotion of social norms. If tax penalties are perceived as fair by other taxpayers they build up a sense of justice and reward those complying. At the same time a clear message is sent out – "paying taxes is a right thing to do", "taxpayers are honest – only those few non-compliant are punished". Such norms strongly motivate taxpayers, especially individual small businesses, to be compliant about their tax obligations (Torgler, 2007; Poppelwell et al., 2012).

<sup>2</sup> Although there is no common consensus on treatment of other charges, fees and social security contributions taxpayers are likely to perceive them as taxes, even if there is a direct benefit for these payments (e.g. service provided, license issued).

As noted above, tax penalties are not fair if they are too lenient. They are punitive only if taxpayers find them more painful than fulfillment of a given tax obligation. Therefore, in any tax penalty there must be a reasonable financial meaning – again, mostly to deter and motivate tax compliance. Tax penalties, unlike criminal penalties, should not aim at repression (Majka, 2010). The society still needs entrepreneurs to pay their taxes in the future – it should not be interested in severe penalties leading to business closure. This is naturally different in the case of fraudulent businesses. If serious crime is involved, tax penalties should lead to cessation of such an activity. For example, if small businesses register for VAT only to take advantage of fraudulent VAT refunds, the tax administration has a vested interest in the ultimate closure of such businesses. There are neither fiscal nor social benefits from allowing those businesses to operate. Severe penalties may be used in achieving this goal.

Tax penalties should not be imposed for revenue generation purposes (Debowska-Romanowska, 2008). The overarching goal of a well-designed and administered tax system is to create a situation where all taxpayers are compliant and no penalties are actually used. In this sense no government should count on the revenue from tax penalties. Any proceeds received are a mere consequence of imperfections both on taxpayers and the tax administration's side. They should be treated as a last resort measure to correct for those imperfections. By no means are tax penalties an effective revenue source. Increasing proceeds from tax penalties should be interpreted as an indicator of declining quality of taxation rather than of the effectiveness of the tax administration. It should encourage the government to undertake necessary actions to bring voluntary compliance and sound tax administration practices back on track.

Compensation is also not an objective of tax penalties (Majka, 2010). Any payment made by taxpayers to compensate the budget for loss of revenue (e.g. interest paid on tax arrears) is not a tax penalty. If compensation does not exceed the limits of the harm done (loss of revenue) there is no element of pain and it should be seen as a mere restitution, not a tax penalty. Yet, in many cases taxpayers may perceive it this way.

There is a whole universe of tax penalties – from standard fines administered by revenue bodies to more sophisticated measures like increased tax rates, additional tax payments, etc. Some other actions and solutions, even if unintended, may also be punitive for taxpayers.

The most commonly used form of tax penalties is fines. They are administered by revenue bodies, without courts' intermediation, whenever a case of non-compliance is discovered. They may be set forth in laws as fixed amounts or, less often, imposed in relation to taxpayer's income, profits, turnover, value of business assets, or any other easily observable factor. Seldom are they related to actual tax diminution. First, not every example of non-compliance results in understated tax

payment, e.g. lack or delayed notifications, deficiencies in tax accounts. Second, fines are typically administered immediately after non-compliance is detected, without unnecessary delay. It would require a thorough examination of every case for a tax administration to determine the amount of tax not paid as a consequence of non-compliance.

Other forms of tax penalties may involve increased tax rates and additional tax liabilities (e.g. additional VAT payment calculated as a percentage of under-declared tax). Incrementally increasing interests on tax arrears (depending on the ageing of outstanding payments) are also penalizing in nature – if they exceed regular interests on tax arrears.

Legal qualification of tax penalties may be irrelevant for taxpayers. They may perceive as a tax penalty any measure that is a consequence of breaching a tax obligation, resulting in a disadvantageous economic situation as compared with the situation where no such obligation was breached. Legal coercion is usually associated with sanctions. However, there may be sanctions where coercion is absent. Revocation of tax concessions and denial of certain rights illustrate this. If a taxpayer enjoyed a simplified form of taxation or accelerated depreciation and this is taken away from him there is certainly an element of pain, comparable to that stemming from a traditional tax penalty.

Traditionally only the measures that were enacted with a clear view to provide a degree of pain to non-compliant taxpayers would be recognized as tax penalties. Some measures, however, even if not intended to be punitive, are tax sanctions in effect.<sup>3</sup> There are numerous examples of tax design that either directly penalize taxpayers or induce non-compliance and make taxpayers vulnerable to traditional penalties. The first group may involve, for instance, lack of opt-in opportunities for small business choosing to be taxed under presumptive tax or lack of voluntary registration for VAT purposes. Small taxpayers may choose to be taxed under presumptive tax but after some time they may find it not beneficial to continue to do so (e.g. their margins drastically fall and taxation of turnover is excessive as compared to taxation of actual income under the general tax regime). If the election of presumptive taxation is fixed in time and switching to the general tax regime is not possible, small businesses are forced to pay higher tax. In this case it represents a penalty for them. Similarly, although the vast majority of small businesses find it beneficial to be exempt from VAT, some of them (e.g. exporters or those supplying mainly to VAT registered taxpayers) may be vitally interested in registration. If they are not allowed to do it they are penalized – they need to accept lower margins to remain competitive.

---

<sup>3</sup> It is not the aim of this article to discuss tax policy measures that may be punitive – intentionally, e.g. to discourage consumption of certain goods (excises on tobacco or alcoholic beverages), or unintentionally, e.g. by providing tax credits to married couples with children, single and childless taxpayers are punished or by taxing compound interest long-time savings are penalized, etc.

The second group of tax design solutions that may have a punitive impact on taxpayers encompasses excessive tax obligations and the quality of tax law. Excessive reporting requirements, short terms for fulfilling tax obligations, disproportionate conditionality of tax concessions are often not justified but add to compliance costs. In this sense they may be perceived as a penalty, even more so if contrasted with the option of staying in the informal sector. Lack of clarity of tax provisions and frequent changes of tax laws further complicate fulfillment of tax obligations. Such features of tax design and legislation may induce non-compliant behavior – if taxpayers are not aware of their obligations or have little time to act they are more likely to make mistakes and cause delays, exposing themselves to traditional tax penalties.

Improper actions of revenue bodies may be also seen as tax sanctions and a significant impediment to doing business (Silvani and Baer, 1997; IFC, 2007; McClellan, 2013). Incorrect tax decisions, faulty advanced rulings, lengthy tax appeals, frequent audits, delayed payments of VAT refunds, etc. add uncertainty and increase the costs of business. As such they are an indirect penalty. If no compensation is paid as a result of faulty actions of revenue bodies (e.g. interests on delayed VAT refunds, compensation for incorrect tax decisions, etc.) they become a genuine tax penalty – even more painful than traditional penalties.

Tax penalties may have a significant impact on business economics. They increase business operating costs not only by the amount of penalty paid but also by the associated costs of proceedings and appeals, if applicable. Since tax penalties, and rightly so, are not deductible for income tax purposes they affect the post-tax rate of return. Fixed lump-sum payments or penalties expressed as percentage of turnover or value of assets have different meaning for businesses with distinct profitability. If not adjusted properly they are regressive.

## 5 SEVERITY OF TAX PENALTIES

The probability of being detected and punished seems to be more of a deterrent than the sheer severity of penalty (Tullock, 1974; Majka, 2010; OECD, 2010; Poppelwell, 2012). If taxpayers see that it is more and more difficult to remain uncaught (e.g. due to risk-based and better targeted audits, or more sophisticated IT solutions) they may find it risky to continue evasive practices. If they can only observe increases in potential tax penalties they will not be more afraid than they were before. Indeed, there is not much difference between a 50, 70 or 90 percent penalty tax rate; or between a USD 5,000 and a USD 6,000 fine for a small entrepreneur. All those penalties seem to be equally in their deterrent effect or irrelevant for taxpayers. Their responsiveness to increased levels of potential tax penalties is not proportional.

Making tax penalties more and more severe has therefore no real impact on taxpayers' behavior. This is not to say that tax penalties do not require revisions. They do. Policy makers and tax administrators should have them on their agenda – first

a comprehensive review of the penalty system, then periodical reviews to make sure that the catalogue and levels of penalties respond to changes in business environment, economy, society and culture. The experience of the UK may be instructive. In 2008 HMRC embarked on a review of their sanctions for late or non-filing and payment, as part of their compliance strategy improvement (HMRC, 2008).

Tax penalties actually imposed certainly matter for taxpayers and society. On one hand they have to be painful enough to discourage non-compliant behavior. On the other hand they need to be acceptable, fair and not repressive. Limits for tax penalties are difficult to set (Debowska-Romanowska, 2008; Majka, 2010). Again, there are key roles for policymakers and revenue bodies to play in this exercise. They first have to design a proper catalogue, forms and limits for tax penalties. The latter have to pick the right penalty if there is some room left for the revenue body's discretion.

It is impossible to give a definitive answer to what a perfect penalty should be. However, some basic directives for effective penalties may be formulated.

First, they have to be painful enough to void any cost-benefit calculations on the taxpayer's side. Fulfillment of a tax obligation must be more advantageous for taxpayers than the option of being non-compliant. Taxpayers have to respect the financial needs of the government and predictability of its revenue streams. It is widely accepted that taxpayers may not use unpaid taxes as a source of revenue for financing their business activity. Interests on tax arrears are a primary instrument that prevents such situations and compensate the government for late payments. Tax penalties, e.g. fines and incremental increases in interest rate on tax arrears beyond the standard rate, are just an additional form of safeguarding due payments. It is the role of tax penalties to make non-compliance unprofitable and painful. Assessment of understated tax and payment of interest is not disadvantageous as this is only restitution of what should be paid and compensation for loss of time value of money.

Second, they may not be too harsh or destructive. Excessive repression never worked, not only in the area of taxation. Experience of the Eastern Bloc is instructive. Communist regimes imposed draconian penalties for any form of non-compliance, and yet evasion was widespread (Majka, 2010).

While setting up a fair penalty, a balance has to be struck between the desired painfulness and non-repressiveness. It means that a fair penalty has to take into account other factors. It has to recognize the type of non-compliance. It would be inaccurate to punish occasional mistakes and voluntary cheating in the very same way. The type of breached tax obligation also matters – late filing is different from underestimation of tax. Most importantly, however, a fair penalty has to be adjusted to taxpayer's ability to pay. A USD 100 fine has a different meaning for a blacksmith and a lawyer, as they are likely to operate in a different market and

have different margins. Similarly, a 10 percent penalty based on turnover would be a different share of the actual business' profitability largely varying across sectors.

The law needs to provide for a reasonable list of potential violations and indicate the range of a potential penalty or penalties. It does not have to be excessively casuistic, i.e. foresee every possible type of non-compliance and circumstances of violation. Indication of a fixed amount of fine is also not a good solution. A range or at least an upper limit, especially in case of fines expressed in amounts, not percentages, seems to be a good approach. It leaves a certain level of discretion for the revenue body with regards to both qualification of a given violation and actual penalty imposed, thus allowing it to choose a right and fair penalty in given circumstances. In countries where the tax administration is weak a positive indication of tax violations along with the limits of an applicable tax penalty allows confining – at least to some extent – the abusive actions against taxpayers.

The other challenge is the use of an IT system in administration of tax penalties. IT systems are an integral part of a modern tax administration and in fact they are indispensable for the efficient monitoring of taxpayer compliance. If used for verification of fulfillment of taxpayer obligations (e.g., late or non filing, required notifications, tax payments, etc.) they easily pick up non-compliant taxpayers. They may be programmed to impose a fine (or other penalty) automatically in every single case of non-compliance identified and notify taxpayers without any intermediation of the officials of the revenue body. This vastly speeds up administrative processes and reduces not only the amount of work otherwise to be completed by the revenue body's employees but also the risk of abusive actions on their part. However, such a process may appear to be "soulless" and contradict the idea of a fair penalty. Unless there is a "wise" algorithm in use, i.e., an algorithm capable of taking into account most relevant circumstances (e.g. a newly set up business, first late filing or payment), a verification of the penalty imposed is necessary – if not beforehand, then through a simplified appeal.

Escalating a tax penalty for a late fulfillment of tax obligations (e.g. filing) may partially add fairness to the system of tax penalties. If the purpose of a late-filing penalty is to encourage timely filing of a tax return, or at least to encourage its filing as soon after the due date as possible it seems equitable to gradually increase the penalty amount – the later the obligation is met the more unpleasantness taxpayers suffer. The actual design of such incremental penalties – a surtax on tax due or a flat amount – would largely depend on the capacities of the tax administration and taxpayers' responsiveness to tax penalties (IMF, 2004).

## 6 ALTERNATIVES TO TAX PENALTIES

Reliance on tax penalties in the enforcement of taxpayers' obligations is ineffective if not supplemented with other actions and measures. An increased severity of penalties is of no avail either. Therefore, there is a need for a comprehensive treatment strategy, a balance between the use of penalties and other actions that could

enhance tax compliance in less distortive and more supportive way. It is the old sticks and carrots dilemma – how much of each to use to have the best possible results. No easy answers may be offered; however, there are reasons to believe that the balance should tip to the latter. Even though this is challenging, some options do exist.

Tax authorities may find it beneficial to use indirect and direct alternatives to tax penalties. Indirectly, it may encourage tax compliance by providing more support to small businesses, especially start-ups, and by building trust through its professionalism, effective communication, training and technical support (Silvani and Baer, 1997; Hadler, 2000). This way the need for imposing penalties decreases and they may be used as a last resort, i.e., where other measures fail.

If non-compliance is detected a warning should be considered where possible, as a direct alternative to a tax penalty. Apart from deterrence, such warnings may exhibit a degree of support. On the one hand they signal to the taxpayer that tax authorities are watching and may take further actions if the case of non-compliance is not reversed corrected (detering effect). On the other hand they let a taxpayer know that a mistake was made and that it requires his attention (supportive effect). If the taxpayer neither takes corrective action nor seeks the tax administration's assistance in solving the problem, the tax administration has to be determined to use and be able to enforce a fair tax penalty.

The use of communications and spot checks is also deterrent in nature (OECD, 2010). Occasional communications via Internet website, e-mails, and other media on planned campaigns (e.g. verification of seasonal business in summer or winter resorts) may well discourage taxpayers from taking advantage of existing opportunities. Occasional checks in general may have similar effects to a tax penalty if used responsibly. Too frequent checks of a compliant taxpayer may be perceived as oppressive and give opposite results, i.e. lower levels of compliance. If a sanction is justified non-monetary penalties may be considered. They include a degree of unpleasantness but do not affect directly business economics – there is no payment involved. Publication of non-compliant taxpayers (“name and shame”), enforcement of mandatory compliance courses, or higher levels of the scrutiny may be just as painful and deterring as traditional tax penalties.

Lawmakers may also contribute to a lesser use of tax penalties. Apart from assuring transparency and simplicity of the tax law, balanced tax obligations and well targeted concessions for small businesses. they may consider adopting a number of “rewards in law”. These specific solutions motivate taxpayers to be compliant in order to get other benefits, e.g. deductibility of invoiced expenses only, clear tax records to participate in public procurement, renew business license or even to register a car, a good compliance record to benefit from accelerated VAT refund payments, etc. In all likelihood taxpayers will value those rewards more than a potential gain from being non-compliant.

## 7 CONCLUDING THOUGHTS

Tax compliance in small businesses requires special attention. On one hand they are often not able to fulfill all their tax obligations, more vulnerable to external risks (e.g. economic shocks, unfair competition, lack of transparency, and abusive actions) and tempted to use different opportunities to be non-compliant. On the other hand, unlike larger businesses, they are usually sole proprietors or owner-operated businesses, being thus highly responsive to personal, social, cognitive and emotional factors. These attributes pave the way to a better use of measures designed to influence their behavior and choices. Tax penalties are one of the behavioral measures that may be effectively used in addressing tax compliance challenges. Through deterrence, motivation, fairness and the creation of desired social norms they may drive taxpayers' choices and therefore play a significant role in encouraging business formalization and enhancing tax compliance.

To achieve this goal, lawmakers and tax administrators should be well aware of a few important attributes and challenges of tax penalties. The first to note is that tax penalties are important and still needed. They sanction improper behavior of taxpayers and facilitate enforcement and collection of taxes. However, they give best results if used as a supplement to other drivers of taxpayer compliance – the tax administration should not rely on tax penalties only. Too punitive a tax regime or administration is an important barrier to business formalization and a disincentive to tax compliance. Widespread penalties counteract creation of positive social norms and a culture of paying taxes.

Second, tax penalties should be designed to deter and motivate taxpayers, rather than repress or raise additional revenue. Tax penalties even if used for securing tax revenue should not be seen as source of revenue itself.

Finally, increasing the severity of tax penalties does not work – fairness and prompt enforcement is of much greater importance, also to reassure the compliant majority that the tax administration treats non-compliance seriously. Tax penalties, if necessary, have to be painful but not blind – they have to take into account an individual taxpayer's situation, at least type and reason of non-compliance, and taxpayer's ability to pay. Late notification of change of address should not be punished as much as under-declaration of tax. Also, a fixed lump-sum penalty has different meaning for businesses with distinct profitability. Other instruments may work better than tax penalties; lawmakers and tax administration – wherever possible – should make use of other deterrent instruments (e.g. checks, warnings, communications), non-monetary penalties and "rewards in law". Supportive actions and building trust in the tax administration may also foster tax compliance. After all, the effective use of tax penalties requires knowledge of taxpayer's segmentation, behavioral responsiveness as well as personal, social and cultural norms.



## REFERENCES

1. Allingman, M. and Sandmo, A., 1972. Income Tax Evasion: A Theoretical Analysis. *Journal of Public Economics*, 1, pp. 323-338. doi: 10.1016/0047-2727(72)90010-2
2. Ayadi, R. and Gadi, S., 2013. Access by MSMEs to Finance in the Southern and Eastern Mediterranean: What role for credit guarantee schemes?. *Technical Report*, No. 35/2013. Bruxelles: European Commission.
3. Chen, D., Lee, F. and Mintz, J., 2002. Taxation, SMEs and Entrepreneurship. *OECD Science, technology and Industry Working Papers*, 2002/09.
4. Coleman, C. and Freeman, L., 1997. Cultural foundations of taxpayer attitudes to voluntary compliance. *Australian Tax Forum*, 13(3), pp. 311-336.
5. Cowell, F., 2003. Sticks and Carrots. *DARP Discussion Paper*; No. 68. London: London School of Economics and Political Science.
6. Crawford, C. and Freedman, J., 2010. Small Business Taxation, in: S. Adam [et al.], eds. *Dimensions of Tax Design. The Mirrlees Review*. London: Institute for Fiscal Studies; Oxford: University Press.
7. Crocker, K. and Slemrod J., 2004. Corporate tax evasion with agency costs. *NBER Working Paper*; No. 10690.
8. Darvas, Z., 2013. Banking System Soundness is Key to SME Financing. *Bruegel Policy Contribution*, Issue 2013/10.
9. Dębowska-Romanowska T., 2008. Za co karać podatnika, a za co powinno odpowiadać państwo w stosunku do działających w dobrej wierze podatników? *Prawo i podatki*, (1).
10. Devos, K., 2004. Penalties and Sanctions for Taxation Offences in New Zealand: Implications for Taxpayer Compliance. *New Zealand Journal of taxation Law and Policy*, 10(3), pp. 212-244.
11. ECB, 2013. *Survey on Access to Finance of Small and Medium-sized Enterprises in the Euro Area* [online]. Available at: <<https://www.ecb.europa.eu/pub/pdf/other/accesstofinancesmallmediumsizedenterprises201404en.pdf??da920468528300ff549d8cc95522eb81>>.
12. Engelshalk, M., 2004. Creating a Favorable Tax Environment for Small Business in: J. Alm, J. Martinez-Vazquez and S. Wallace, eds. *Taxing the Hard-to-Tax: Lessons from Theory and Practice*. Amsterdam: Elsevier.
13. Engstrom, P. and Holmlund, B., 2006. Tax-Evasion and Self-Employment in a High-Tax Country: Evidence from Sweden. *Working paper Series of the Department of Economics*, No.12. Sweden: University of Uppsala.
14. Evans, C., Carlon, S. and Massey, D., 2005. Record keeping practices and tax compliance of SMEs. *eJournal of Tax Research*, 3(2), pp. 288-334.
15. Frey, B. and Feld, L., 2002. Deterrence and morale in taxation: An empirical analysis. *Working paper*, No. 760.
16. Hadler, S., 2000. *Best Practice in Tax Administration in Sub-Saharan Africa: A Handbook for Officials*. Cambridge, MA: International Tax Program, Harvard Law School.
17. HMRC, 2008. *Modernizing Powers, Deterrents and Safeguards. Meeting the obligations to file returns and pay tax on time*. London: HMRC

18. IFC, 2007. *Designing a Tax System for Micro and Small Businesses: Guide for Practitioners*. Washington DC: IFC.
19. IMF, 2004. How Should the Penalty for Late Filing of a Tax Return Be Structured? Available at: <<http://www.imf.org/external/np/leg/tlaw/2004/notes/eng/late.htm>>.
20. Kirchler, E., Muehlbacher, K. and Wahl, I., 2007. Why pay taxes? A review of tax compliance decisions. *Working Paper*; No. 07-30. Georgia State University.
21. Kitching J., 2011. *Adapting to a Fragile Recovery: SME Responses to Recession and Post-Recession Performance*. Available at: <[http://www.isbe.org.uk/content/assets/John\\_Kitching.pdf](http://www.isbe.org.uk/content/assets/John_Kitching.pdf)>.
22. Majka, P., 2010. Sankcje w Prawie Podatkowym. *Torunski Rocznik Podatkowy – Rocznik*, pp. 25-88.
23. Matthews, R., 2005. The myth of punitiveness. *Theoretical Criminology*, 9(2), pp. 153-174. doi: 10.1177/1362480605051638
24. McClellan, C., 2013. The Consequences of Poor Tax Administration: Collections, Growth, and Corruption. Dissertation. Georgia State University. Available at: <[http://scholarworks.gsu.edu/econ\\_diss/90](http://scholarworks.gsu.edu/econ_diss/90)>.
25. McKerchar, M., 1995. Understanding small business taxpayers: Their sources of information and level of knowledge of taxation. *Australian Tax Forum*, 12, pp. 25-41.
26. OECD, 2009. Taxation of SMEs. Key Issues and Policy Considerations. *OECD Tax Policy Studies*, No. 18. Paris: OECD.
27. OECD, 2010. *Understanding and Influencing Taxpayers' Compliance Behaviour Information Note*. Forum on Tax Administration: SME Compliance Subgroup. Paris: OECD.
28. OECD, 2012. *Right from the Start: Influencing the Compliance Environment for Small and Medium Enterprises Information Note*. Forum on Tax Administration: SME Compliance Subgroup. Paris: OECD.
29. OECD, 2014. *Tax Compliance by Design. Achieving Improved SME Tax Compliance by Adopting a System Perspective*. Paris: OECD.
30. Ogawa, K. and Tanaka, T., 2012. The Global Financial Crisis and Small- and Medium-sized Enterprises in Japan: How did they cope with the crisis? *Discussion Paper Series*, 12-E-012. Tokyo: Research Institute of Economy, Trade and Industry.
31. Ozturk, B. and Mrkaic, M., 2014. SMEs' Access to Finance in the Euro Area: What Helps or Hampers? *IMF Working Paper*; WP/14/78.
32. Poppelwell, E., Kelly, G. and Wang, X., 2012. Intervening to reduce risk: identifying sanction thresholds among SME tax debtors. *eJournal of Tax Research*, 10(2), pp. 403-435.
33. Ripstein, A., 2004. Authority and Coercion. *Philosophy and Public Affairs*, 32(1), pp. 2-35. doi: 10.1111/j.1467-6486.2004.00003.x
34. Silvani, C. and Baer, K., 1997. Designing a Tax Administration Reform Strategy: Experiences and Guidelines. *IMF Working Paper*; No. 97/30.
35. Slemrod, J., 2004. The economics of corporate tax selfishness. *NBER Working Paper*; No. 10858. National Bureau of Economic Research.

36. Swistak, A., 2015. West Bank and Gaza. Improving Taxation of SMEs: Design and Compliance Issues. *Technical Assistance Report*. Washington: IMF (unpublished).
37. Torgler, B., 2007. *Tax compliance and tax morale: A theoretical and empirical Analysis*. Cheltenham, U.K.: Edward Elgar Publishing Limited.
38. Tullock, G., 1974. Does Punishment Deter Crime? *Public Interest*, (36), pp. 103-111.
39. Wenzel, M., 2004. The social side of sanctions: personal and social norms as moderators of deterrence. *Law and Human Behavior*, (28), pp. 547-567. doi: 10.1023/B:LAHU.0000046433.57588.71