

## **Small Business Tax Evasion, is There a Case of Internal Finance?**

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**Abstract:** As long as there are taxes, the incentive for evasion will exist as well. Studies for tax evasion are of interest in different fields like that of economics, public finance, personal finance, business administration, business finance, financial accounting, in the banking system etc. However, there are only a few studies about the internal causes and financial incentives that oblige decision-makers of small firms towards tax evasion. When we refer to business tax evasion, always brings to mind sensational cases of large businesses that evade taxes, but business tax evasion is a widespread phenomenon even to small firms. To be more competitive, small business must have a consistently entrepreneurial orientation, but limited financing prevents this, therefore the business savings from tax evasion is believed to be an internally funding path. The restrictions on small firms financing often make them orientate more toward internal generation of funds, which also has few alternatives. As a way to internal saving, firms often find tax evasion, which is not only a deviant and unethical behavior, but also puts firms into many difficulties in the long run. Consequently, the study aims to discuss the phenomenon of tax evasion in the managerial practice of small business in an Albanian region, as well as its financial cause as is perceived by the small business. The study findings report that the deviant behavior of businesses from taxes considers the need for internal financing as an important reason. The study concluded that savings from tax evasion is an alternative of internal financing primarily for small and early-staged firms, and that if entrepreneurs are capable of a good business model and competitive strategy, they will not need to make evasion.

**Keywords:** small business management; small business financial planning; owner-manager; developing country

**JEL Classification:** D92

### **1. Introduction**

Engelschalk and Loeprick (2016) stated that “Business taxation is at the heart of the relationship between the state and its economic constituents” (pp. 145).

Nyang’au (2016) remind us that:

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Tax evasion and avoidance is not a new practice. It has existed for centuries, dating back to two thousand five hundred years ago. During this period (two thousand five hundred years ago), while writing about tax evasion Plato said that the Ducal palace of Venice had a stone with a hole in it through which people would inform the state about those who evade taxes. In India, during the third century B.C., the state craft, arthashastra did advise the Mauryan kings to take good care of state revenues or else they be misappropriated by the people for their own benefit (Fjeldstad, 2006; ac cited in (Nyang'au, 2016, pp. 17))

In financial viewpoint, taxes are cash inflow for public finances as well as cash outflow for business finances, so they are obviously two opposing interests, as well as two different financial goals. If we put these two orientations versus each other, we can say that while one of the financial objectives of business is to minimize taxes that does not seem consistent with the objective of tax authority. However, a small business has a range of financial objectives that vary from those of a large company, and so do the sources of small businesses financing compared to large companies. If we refer to the characteristics of a small business operating in Albania, it generally turns out that they are privately funded and mostly by personal savings of their owners which are moreover limited to financing due to poor financial reporting, and often apart earning after tax or accounting profit it creates an informal saving through tax evasion. Although the study deals essentially with an unethical behavior of business not only for the damage that this phenomenon causes to public finances, but also because this is a very important issue for the financial perspective of the business as a phenomenon that appears in the financial management practice of small firms, as well as the fact that tax evasion is considered by the owner-managers of these firms as a rescue plan for financing business.

## **2. Review of Literature**

### **2.1. Issues of SMEs**

Small and medium enterprises are an important pillar for the economy of all countries. The importance of SMEs is already well known for the Albanian economy, according to the Bank of Albania SMEs account:

On average 99.6% of total enterprises in the country, a figure almost stable throughout the period 2006-2011. Micro enterprises, which employ an average of 1 to 4 employees, seem to be typical enterprises in Albania representing on average 91% of the market share of enterprises in Albania. While large enterprises constitute a very small part of the total enterprises, accounting for only 0.38% of their total (Bank of Albania 2013, pp. 134).

According to ITC (2012):

Tax evasion and avoidance are both phenomena that are probably as old as taxation itself. Wherever and whenever authorities decide to levy taxes, individuals and firms try to avoid paying them. Though this problem has always been present, it becomes more pressing in the course of globalization as this process extends the range of opportunities to circumvent taxation while simultaneously reducing the risk of being detected (pp. 7).

According to Ojeka (2011) one of the main problems faced by SMEs is the difficulty in access to capital in the short and long term too. According to La Porta and Shleifer (2014) businesses or informal firms account for nearly half of economic activity, although their impact on economic development is to be discussed. According to a report of McKinsey, Global Institute defined informal businesses as parasitic that compete dishonestly with tax compliance firms (Farrell 2004; as cited in (La Porta & Shleifer, 2014)), therefore informality should be banned. Formal and informal firms have such big differences, for example, owner-managers of formal firms are more educated and consider that it is more productive to have businesses slightly larger and formal, while entrepreneurs of informal firms are often uneducated and run businesses that trade poor quality products for low-income consumers (La Porta & Shleifer, 2014). According to Boka and Torluccio (2013) informality in Albania's economy has emerged since from the initial stages of the Albanian economy transition into a market economy, which is also affected by the slow progress of the institutional and political changes and of the economic austerity ongoing. Evasion and tax avoidance seem to be a problem that accompanies the economies of all countries and that cause to the governments of these countries even more loss (Greene, 2009; Choong & Wong, 2011; Ahangar, Bandpey & Rokny, 2011; Ross & McGee, 2011, as cited in Zakaria Ahmad, & Noor, 2013).

According to Greene (2009) a study proved that 25% of US taxpayers admit that they are not honest in reporting taxes, a problem that in European countries is even more frequent, and also in developing countries, too (as cited in Zakaria Ahmad, & Noor, 2013).

## **2.2. Issues of Small Business Internal Financing**

According to Lee (n.d.) extending small business does require investment, which will be realized only if the firm has adequate access to financing. Despite this, however, the external funders, moneylenders or potential investors are not very willing to finance small businesses, hence internal finance is the most accessible resource for small business investments.

## **2.3. Small Business Internal Sources of Finance**

According to Lee (n.d.) retained earnings of the company are one of the easiest accessible sources of financing and are automatically active because the owner instead of withdrawing the profit can use it for investment. Current assets include

cash or other assets that are more liquid, for example, inventory etc. However, given that this type of asset serves as a type of internal funding source, it should be regarded carefully because apart from that, their level should not be lower than current liabilities, for not risking financial failure of the company. Lee (n.d.) explains that fixed assets are not very liquid, so they cannot be a quick source of funding for the firm. However, a good case could be the sale of some fixed assets, such as a vehicle etc. in order to finance the purchase of new assets. The fact that personal savings of the owner are the main financing sources of small business is incontestable, especially in cases when the business is incapable of funding through the use of its assets. Personal savings can be used easily for business financing and they are a good alternative because assure a good way to keep business still under control (Lee, n.d). Empirical studies also show that a good part of the small Albanian firms are self-financed from internal resources, for example, according to the study of Lipi (2013) it is proved that the majority of firms, almost 84% of firms included in the study were financed by personal savings of the owner in the start-up stage and even during their evolution personal savings were one of the main sources of financing the SMEs.

#### **2.4. Issues of Taxation and Tax Productivity for Albania**

The World Bank (2014) report shows that tax productivity is determined by the tax collected as a percentage of the tax base (GDP or consumption) in proportion to the standard tax rate, so in terms of the VAT productivity, the basis is the total consumption.

While in regard to personal income tax and corporate income tax, the tax base in this case is the GDP. Logically related, productivity measures the length of tax base being taxed and the portion not being taxed because of the exclusion policy from tax, tax amnesties and tax subsidies that narrow the tax base, or due to problems in tax administration, corruption and collusion. The tax productivity, however, should theoretically be 100, considering the entire taxable base to be taxed, because theoretically there would be no exceptions or other spillages due to evasion. The report proves that (World Bank, 2014) VAT<sup>1</sup> productivity in the Albanian economy is 53%, while the productivity of this tax for Eastern Europe is 66%. In other words, for every 1 per cent of tax rate, VAT is collected only for about 53% of total consumption (the VAT base), as a result 47% of the base is untaxed. This performance is a consequence of the policy of exclusion of some sectors and transactions of the base, or due to problems of tax administration, tax evasion and corruption.

The productivity of PIT<sup>2</sup> and CIT appears lower, resulting 6% and 17% respectively, implying that only 6% of the base (or GDP) is taxed in terms of PIT, while the performance of CIT is presented somewhat better, while the productivity of Eastern

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<sup>1</sup> Value added Tax.

<sup>2</sup> Personal Income Tax and Corporate Income Tax.

European Countries in terms of CIT and PIT is on average 7% and 16% respectively. The report (World Bank, 2014) also notes that there is enough room to improve the collecting performance of the income tax and VAT as well, by reducing exemptions and amnesties as well as by improving the capacity of fiscal authority in the sense of being capable to detect evasion through data investigation and coordination of information from different sources. However, the chances of improving tax productivity are greater for the income tax than VAT, referring here mostly to personal income tax. According to a study about shadow Economy (Schneider, Friedrich, Buehn, & Andreas, 2007), informality in Albania is estimated at 35.1% of GDP with an approximate result to the average of Eastern Europe. According to Transparency International Corruption Barometer<sup>1</sup>, corruption in Albania is ranked as a major problem; even further World Bank in its report explains that the bulk of the informal economy, of the corruption and lack of efficiency of the institutions are associated with high levels of evasion and weak tax administration (2014).

### **3. Methodology**

This study is organized by a qualitative approach due to its objectives, its main aim is to describe and define perceptions, mind-sets, beliefs, attitudes, experiences and generate insights for other future quantitative or qualitative studies regarding such a sensitive issue for its impact on Albanian economy. An interview has been the main data collection instrument, which contained mainly open questions with carefully chosen words. After analyzing the empirical data, I have defined the patterns of the answers according to the topics of the interview in attempt to understand the behavior of firms in relation to tax evasion by the firm longevity, firm sector and legal form, or in connection with the use of savings from tax evasion as a funding source for the firm, and in respect to other motives that push business towards tax avoidance. Also another important question and an important objective of this study was to explore who is responsible and even who takes the decision for small business tax evasion behavior, aiming to investigate as well this behavior according to a humane perspective. So through the perceptions of the respondents is intended to understand, describe and discuss the behavior of small business in relation to tax evasion in an Albanian region, making the results of this study descriptive rather than predictive. To organize this research 30<sup>2</sup> small businesses of different sectors such as trade, services, and good manufacturing are included in the study, aiming a representative sample from various sectors of the economy. Interviews were addressed to the economists of these firms and not to their owner-managers, in order to provide an objective inquiry, given that this is a very sensitive topic for the owners who are the main decision makers of small businesses. The research data were collected in the

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<sup>1</sup> Transparency International Corruption Barometer 2013. Transparency International.

<sup>2</sup> A sufficient sample for the object of this study and the research approach.

region of Vlora during the first quarter of 2015<sup>1</sup>, and in the focus of the study were a group of small firms<sup>2</sup> operating in Vlora Region, representing so a sample of entrepreneurial firms from a developing country.

#### 4. Data Analysis and Study Findings

In the following are presented study findings after the research data haven been analyzed, referring respectively to the research questions or to the study objectives.

So referring to the question whether tax evasion can be stimulated by the need for cash and liquidity, results that all the respondents affirm that, and some of them imply that:

- The need for money is the main cause of evasion;
- Through tax evasion business enhance its income and thus maximize the firm's profits, or even the owner income;
- Businesses tend to save funds through tax evasion mainly when sales decrease.

However, despite the semantics of the answers of this question, almost 80% of respondents believe that tax evasion is so far largely driven by the business needs for financial resources.

Referring to the second question whether the savings from tax avoidance can serve as a source of internal financing, respondents generalize that although savings from tax evasion is a source of informal financing, it serves, however, as an important source of internal financing especially when the company is in the early stages; or when the business is small if we refer to its turnover of under 8,000,000 Lek and also when it operates as a sole Proprietorship.

Another question of the study is related to the impact that the firm age may have on tax evasion behavior, so I have chosen to describe their responses as follows, given that some opinions appear to be somewhat contradictory:

- The answers of this question result from several perspectives;
- If firms are older and more experienced, bigger is their incentive for evasion;
- Firms adapt better to fiscal requirements over the years;
- The incentive for tax evasion depends not only by the age but also by firms financial performance;

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<sup>1</sup> The action against informality by Albanian government started in September (which seems to have had no effect on the behavior and validity of the interviewees' opinion, given that interviews are made earlier than governmental action against informality).

<sup>2</sup> Classified according to the number of the employees based on law no. 8957, 17.10.2002, For small and medium business; small business have from 10 to 49 employees.

- Evasion is a phenomenon of all firms regardless to their age and longevity.

However, most of the respondents believed that stimulation or incentive for tax evasion is related to the firms' longevity, arguing that the greater life expectancy of the firm the greater the incentive for tax evasion is, and also becomes more difficult for the firm to convert into a tax compliance in the future.

Another question of the study intended to bring to light the behavior of tax evasion by various sectors. The answers of the respondents implied that in terms of business sector the firms with greater evasion incentive are the bakeries, restaurants, and cafes.

Respondents also figured out that commercial retail firms are more likely to evasion being also influenced by poor financial culture of their customers who generally do not require an invoice or a fiscal receipt, and also because their suppliers are mainly households, farmers, cattlemen or different craft manufacturers. The respondents indicate also that trading firms are more likely to avoid taxes perhaps due to the uncertainty and competition, to the low profit margins, and of the selfishness of their owner-managers to maintain the profit.

“Is there a connection between the phenomenon of tax evasion and legal form of the firm?” was another question raised in this study.

From the responses emerge some contradictory perceptions, such as:

- Evasion behavior is related more to the sector where firm operates rather than its legal form;
- The larger the firm the better it is organized by a legal perspective, apparently less oriented toward evasion (e.g. as in a limited company);
- The larger the company the greater the profit to be preserved (e.g. as in limited companies);
- The bigger the firm the stricter the tax audit is (e.g. as in limited companies), therefore there is less abuse (or tax evasion) compared to sole proprietorship firm.

Yet it is worth explaining that the legal form of the firm is often unfairly selected or it does not adjust to its size and age, so given that the legal forms do not fit in well with the firm's own organization; so firms often opt for tax evasion to compensate their legal costs.

Another issue or important insight discussed in the study is about the reasons, motivations, and incentives that push businesses to avoid taxes<sup>1</sup>. In table 1 are listed

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<sup>1</sup> This question is formulated based on previous studies.

a number of motives for which respondents have given yes or no answers based on their perception for these topics.

**Table 1. Reasons of tax evasion**

Are the following reasons incentives for tax evasion?	% Yes	% No
Culture of owners (such as lack of ethics or the ego to earn more etc.)	90%	10%
High costs of doing business	80%	20%
Higher taxes	80%	20%
Because others do not pay taxes too	76%	24%
To reduce cash outflows during difficult financial periods or during sales decrease	66%	34%
Higher interest and credit costs of financing	60%	40%
To reduce business costs and to be more competitive	60%	40%
Due to restrictions or refusal by banks for loan financing	30%	70%

Following the idea of the above question, another issue explored in this study questions: “Who is the most implicated decision-maker in tax evasion”? According to the empirical data, 100% of the interviewees testify that are precisely firm owners who orient the firm towards tax evasion behavior. They also mention other actors who through their action or inaction support this attitude such as the firm controller and public accountant, the manager, the salesperson, inventory specialist, cashier etc. (perhaps under the pressure of the owner itself).

## 5. Conclusions

As long as there are taxes, the incentive for evasion will exist as well. Studies for tax evasion are of interest in different fields like that of economics, public finance, personal finance, business administration, business finance, financial accounting, and also in the banking system. However, there are only a few studies about the internal causes and financial incentives that oblige decision-makers of small firms towards tax evasion (or fraud Taxation). Informality is a phenomenon that occurs to small firms and medium enterprises operating in all sectors of the Albanian economy. This phenomenon is reflected and implied in the statistics of the National Registration Center. According to this source only during January-October 2015 over 33,125 businesses were registered, about 122.3% more than the same period

during 2014<sup>1</sup>, assuming that some of these firms have exercised previously informal activity and due to considerate tax control they were later registered to run their activities formally. Also, if we refer to previous studies about tax evasion implications and funding sources results that:

When external sources of financing become more scarce or expensive, firms have incentives to avoid taxes. According to this reasoning, firms that depend more on external financing will have their tax avoidance activities more related to the external financing conditions. Hence, the more restrictive external financing conditions (the interest rate these firms face for credits) the greater tax evasion and avoidance (Troncoso & Vergara, 2010, pp. 10).

The study findings report that the deviant behavior of businesses from taxes considers the need for internal financing as an important reason. According to the findings of the study, although various and even opposing, has been defined that savings from tax evasion is an alternative of internal financing primarily for small and early-staged firms. In this way, the firm can increase the base of real earnings and internal funds, and thus minimize external financing and debt cost as well. So referring to the study objective it is recommended that policymakers must design a complete economic model to promote the formal economy for a simultaneous and harmonious benefit to all economic factors such as business, individuals, banks, society in general and public finance too. What we may conclude referring to the firms themselves is that if the entrepreneurs are capable to set a good business model and competitive strategy, they will need not to make tax evasion. It is also recommended that businesses, including small ones, must develop among other functions of the business especially the planning function<sup>2</sup>, making thus possible that the business have legal benefits from the performance of its marketing function, administrative and financial management function, and not through temporary and unethical incentives.

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<sup>1</sup> Accessed on 29 October 2015, from <http://acp.al/news/1359/in-10-months-over-33000-businesses-are-registered-in-QKR/>.

<sup>2</sup> Including tax planning and profit.

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