Taxation and entrepreneurship in the traditional and collaborative economy

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“Taxation, investment and innovation: a triptych for balanced growth”
Panel on
“No collaboration without taxation”

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• What is entrepreneurship in the traditional and collaborative economy?

• Do existing tax practices discourage entrepreneurship?

• Can an appropriate tax design overcome the underprovision of entrepreneurship?

• Does the focus on the collaborative economy call for different answers to the above questions?

DG-Taxud Study on “Literature review on taxation, entrepreneurship and collaborative economy”

Dondena (Project leader), Institute for Advanced Studies (Consortium leader), CASE, IEB, PwC
What is entrepreneurship in the traditional and collaborative economy?

Two key joint determinants of entrepreneurship: - Innovation & Uncertainty

How to identify entrepreneurship in the traditional economy:
- Self-employment, small firms and start-ups
- Companies performing R&D
- High-impact entrepreneurial firms (HIEFs)

How to identify entrepreneurship in the collaborative economy:
- Digital Platforms: online intermediaries that connect providers with users and facilitate transactions between them. They enable precise, real-time measurement of spare capacity and have the ability to dynamically connect that spare capacity with demand
- Providers: they rent their spare assets, resources, time and skills. They offer access over ownership
Do existing tax practices discourage entrepreneurship?

- Impact of taxation on the decision to become an entrepreneur
  - Entrepreneurship in the TE, digital platforms and providers in the CE
- Impact of taxation on investment
  - Entrepreneurship in the TE and digital platforms in the CE
- Impact of taxation on access to financing resources and on capital structure
  - Entrepreneurship in the TE and digital platforms in the CE
- Impact of taxation on business location
  - Entrepreneurship in the TE and digital platforms in the CE
- Tax compliance and tax evasion
  - Entrepreneurship in the TE, digital platforms and providers in the CE
Do existing tax practices discourage entrepreneurship?
Focus on providers in the CE

- Outcomes potentially affected by taxation
  - Decision to become an entrepreneur
  - Decision to comply with tax
- Focus on P2P collaborative economy business model
  - Most distinct from traditional economic activity and most likely to give raise to novel implications for policy-makers
- Focus on transactions which involve a financial payment
  - Most relevant for taxation
Do existing tax practices discourage entrepreneurship?

Decision to become an entrepreneur

- Innovation and uncertainty hardly characterize activity of providers in the CE
- Micro-entrepreneur

<table>
<thead>
<tr>
<th><strong>Traditional entrepreneurship</strong></th>
<th><strong>Barriers to entry</strong></th>
<th><strong>“Micro” entrepreneurship</strong></th>
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</thead>
<tbody>
<tr>
<td>Higher overhead costs (office premises, capital investments)</td>
<td></td>
<td>Anyone with a skill or asset can start an enterprise overnight</td>
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<tr>
<td>Relationships and trust developed through face to face interactions</td>
<td>Nature of trust</td>
<td>Relationships and trust developed through online reputational scoring</td>
</tr>
<tr>
<td>You are an entrepreneur or you are not – you are dependent on work inflow</td>
<td>Nature of work</td>
<td>More opportunities to work flexibly and occasionally to top-up earnings</td>
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Source: PwC analysis
Do existing tax practices discourage entrepreneurship?

Decision to become an entrepreneur

- Income taxation
  - TE: Tax design (in particular, rates and degree of progressivity) and impact on risk-taking
  - CE: Tax design (in particular, rates and degree of progressivity) and impact on entry and employment (i.e. time devoted, frequency of activity, type of activities to be involved in)

- Strength of the tax effect as determinant of choice to enter the CE will likely vary according to jurisdiction, CE sector, type of provider
- Little evidence on whether taxation influences choices on employment
- Uncertainty on tax policy makes it harder to predict how (potential) providers subject their decisions to the tax policy itself
Do existing tax practices discourage entrepreneurship?

Decision to become an entrepreneur

- Social security contributions
  - TE: differential treatment of employees and self-employed has ambiguous effects on entry into self-employment
  - CE: similar trade-off
    - Flexibility of jobs within CE makes portability of social security benefits an important issue
    - Treatment of social security contributions impacts on the quality of jobs created in the CE
Tax design issues related to the CE

- **Definition of income**
  - Is an activity commercial or not?
    - E.g. ATO definition of income as an enterprise: regularity of the activity and view to generating profits
  - Does an activity generate income or is it simply cost-sharing?
    - CE has amplified the relevance of when cost sharing becomes income generation (e.g. sharing property may give rise to issues which are not present in traditional real estate rentals)
  - VAT threshold excluding the exchange of good and services from consumption taxes
    - CE has disaggregated economic activity and instances in which consumption tax liabilities disappear become more frequent
Tax design issues related to the CE

- Classification of income
  - Should the given income be classified as employment or self-employment income? (E.g. employment status of Uber drivers, workers of Homejoy)
    - Is it a matter of clarifying what characterizes the employee and the self-employed status or is there a need for a new definition for collaborative economy providers?
Relationship between taxation of the TE and of the CE

- Is it enough to say that all tax-related matters which originate in the CE should be treated analogously to the TE?
- Can there be tax-driven competition between TE and CE?
Is there an unintended differential tax treatment of the CE and TE?

• Potential unfair competition
  – Some sectors of the CE may not automatically be subject to the same regulation and taxes as their traditional competitors (e.g. tourist taxes): a lower tax burden may mean that these providers can offer lower prices.
  – Example: recent agreement of the Paris city authorities with Airbnb concerning remittance of a tourist tax justified on the grounds of recapturing lost tax revenue and creating a level playing field

  – Renting long term or short term via platforms
    • Home rental via CE is a way to underreport income
Do existing tax practices discourage entrepreneurship?

Decision to comply

- Can the tax system discourage participation to the CE?
  - Compliance costs (stability, simplicity, knowledge of tax rules): particularly relevant for providers with small incomes, working across more platforms, with no experience in paying taxes as self-employed
  - *Uncertainty* about the presence of a tax liability

- Can the CE make it harder to design a well-functioning tax administration system?
  - Amount of activity spread on a large number of providers generating potentially small incomes
Do existing tax practices discourage entrepreneurship?

The role of tax administration

- How to design tax administration?
  - Improvement of information available
    - E.g. information campaigns: US IRS; UK HMRC, ATO; online tax tutorials: Oei and Ring, 2015
  - Involvement of platforms
    - Third party involved in the reporting
    - Responsible of withholding (e.g. Airbnb withholds and remits tourist taxes in some towns; some examples of withholding also on income taxes – more difficult)
    - Is it simply shifting a burden from government and providers onto platforms? Can this discourage their entry or prevent their growth?
Do existing tax practices discourage entrepreneurship?

The role of tax administration

- Exploit technology (e.g. Estonia)
- Use of thresholds
  - Rationale: to avoid compliance costs of small providers
  - Evidence on the effects
    - Importance of VAT compliance costs for small firms: firms bunch at the threshold due to those costs. Firms avoid to become bigger: call for larger thresholds (Harju et al., 2016)
    - Evidence of evasion and avoidance responses, less so for start-up firms with higher input cost to sales ratio: call for smaller thresholds (Liu and Lockwood, 2016)
    - May make the system more complicated and increase rather than decrease compliance costs
  - Example: France
Can an appropriate tax design overcome the *underprovision* of entrepreneurship?

- Market failures can limit the provision of entrepreneurship
  - Externalities (which justify tax policies encouraging R&D)
  - Credit rationing (which justify tax policies to promote the development of venture capital)
- Likely to be relevant for digital platforms but minor for providers in the CE
- Favourable tax treatment for providers in the CE cannot be grounded on the same rationales as those identified for TE or CE platforms
Can an appropriate tax design overcome the *underprovision* of entrepreneurship?

- Economic and social rationale
  - CE could have the potential to involve demographic groups that have traditionally been more marginal in the labor market (e.g. women, low-skilled) or operators in rural areas or suburbs who would otherwise have fewer opportunities to generate income

- Environmental rationale
  - Hard to assess

Governments will need to carefully weigh up the various foundations on which a case for or against tax incentives might be made

  - An optimal regime is likely to be targeted (for example, in terms of sectors or types of providers)
  - The application of tax incentives should also take into account the country-specific context and the priorities of the government in question
Are our tax systems fit to face the challenges posed by the CE?

• Contrastings views
  – Existing tax law is already equipped with a conceptual framework sufficient to accommodate for CE modalities of business
  – Existing tax law inadequately addresses the rapidly developing technology exploited by the CE and may unduly constrain the economic activity based on it.

• Case studies (Estonia, France ad the UK)
  – Administrative costs for the government and compliance costs for providers are crucial elements
  – Level the playing field is a relevant goal
Are our tax systems fit to face the challenges posed by the CE?

- Solutions adopted or envisaged in most cases refer to tax administration
  - Improve information sharing
  - Reduce uncertainty in the definition of income
  - Involve platforms in information reporting
  - Exploiting the potential of the digital revolution to collect and match data to improve tax compliance

- Solutions adopted or envisaged in some cases refer to tax design
  - UK two tax-free allowances for individuals: not specific to CE but most likely to benefit micro-entrepreneurs
  - France: tax exemptions below an income threshold