Tax Optimization for Small and Medium-sized Companies (SMCs). Perspectives from Agency, Transaction Costs and Game Theories

L'optimisation fiscale des Petites et Moyennes Entreprises (PME) à la lumière de la théorie de l'agence, des coûts de transaction et des jeux

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Abstract

Taxation is seen as an instrument or a tool of economic policy for the state, which is used in different manners. Taxation is also an instrument of SMCs management policy.

Previously, taxation was previously considered a burden and an obstacle that it was advisable to undergo passively, while now, in modern management and governance theory, taxation is recognized as a key parameter in business management. The choices made in the quest of optimization raise concerns about what can be accepted without negatively impacting public finances.

We intend to present a literature review that includes theories relevant to this issue, specifically the Theory of Agency, Transaction Cost Theory and the Theory of Games.

Keywords: SMCs (small and medium-sized companies) - Tax management - Tax optimization.

Résumé :

La fiscalité est perçue pour l'État comme un instrument de politique économique, pouvant être utilisé de plusieurs manières. La fiscalité est considérée parallèlement comme un instrument de la politique de gestion de la PME.

Considérée auparavant comme une contrainte qu'il convenait de subir passivement, la fiscalité est devenue un paramètre nécessaire de la gestion d'entreprise. Les choix retenus, dans le cadre de la recherche d'une optimisation légalement reconnue, posent la problématique de ce qui peut être acceptable sans nuire aux finances publiques.

Cet article présente une revue de littérature regroupant certaines théories mobilisées à l'égard de cette problématique, à savoir la théorie de l'agence, des coûts de transaction et des jeux.

Mots-clés : PME (Petite et moyenne entreprise) - Gestion fiscale - Optimisation fiscale.

Introduction

Currently, most studies on SMCs focus on their role in the economic and social development of a country. SMCs are effective tools for mobilizing human creativity and capacity.

The importance of SMCs stems from their fundamental assets and their ability to contribute significantly despite limited capital. SMCs promote innovation, generate employment, and drive development. Their attractiveness also enables more efficient production and cost reduction.

Recently, the taxation of SMCs has garnered significant attention in developed countries as a potential driver of development for several reasons. Therefore, our study on SMCs taxation offers several benefits.

The definition of SMCs in Morocco has evolved through various texts aimed at better defining this category, largely due to their small size and relative fragility. One such text is the General Tax Code (CGI).

The tax authorities can be viewed as a crucial shareholder who neither participates in the capital nor in the management (Desai, Dyck, & Zingales, 2003).

Moreover, the relationship between the tax administration and taxpayers is often strained due to the declarative system, which places the tax administration in a position of constant suspicion toward taxpayers. Additionally, the behavior of some taxpayers can be problematic, occasionally putting the tax administration in an adversarial stance.

SMCs represent over 90% of Moroccan production companies, highlighting the significant challenge of transforming the relationship with corporations from adversarial to collaborative.

The tax system has evolved from a topic of technical expertise to a major issue of social and economic responsibility for companies. However, SMCs demand greater transparency on this matter.

While some authorities do not recognize tax optimization, others view it as part of shareholders' responsibility, seeing it as a means to improve the relationship between management and shareholders.

This poses a challenge for SMCs: Should the tax system be viewed as a cost to be optimized or as a commitment to be upheld?

Due to the inability to conduct an empirical study, we intend to explore the issue through a literature review and the application of relevant theories, considering their potential applicability in Morocco. The key questions to address are:

I. What theories explain the relationship between tax administration and SMCs?

II. To what extent can these theories be applied in the Moroccan context?

1. The Theory of Agency

1.1. Business -Tax Authority Relationship

The agency theory, based on the principal-agent relationship, can be applied to analyze the interaction between SMCs and the tax authority. This relationship arises from the company's tax obligations. In this scenario, the tax authority (the principal) compels the company (the agent) to meet its fiscal responsibilities without a direct reciprocal benefit. The company aims to maximize its utility by minimizing its tax burden while remaining compliant with the law. This creates conflicting interests: the tax authority seeks to maximize national revenue through tax collections, while the company aims to reduce its tax expenses. To address this, the principal establishes a declaratory system based on financial statements, which encourages the company to fulfill its tax obligations by disclosing relevant information.

However, the company may prepare financial statements that minimize reported profits while adhering to accounting practices.

The tax management of results is a technique employed by companies to enhance their financial outcomes. According to Agency theory, Watts and Zimmerman (1978), pioneers of the politico-contractual theory, found that managers often select accounting standards that minimize reported profits for tax reasons. They also noted that this tendency is influenced by the nature of political pressures faced by the company. Their theory of political costs suggests that companies with significant political visibility--due to factors such as size, industry type, or profitability--contribute more to the state budget and are more susceptible to political pressures.

Thus, based on Agency theory, factors such as company size, industry type, and profitability can explain SMCs' tendencies to engage in tax management of results.

1.2. Tax Authority- Other stakeholders Relationship

Agency theory states that conflicts can arise in a company where ownership is separated from management, with shareholders (principals) and the company's executives (agents) potentially having differing objectives. According to Finet (2005), managers typically adopt a long-term perspective due to their desire to remain in their positions and maximize their compensation. In contrast, shareholders often focus on short-term gains, aiming to maximize the return on their investment as quickly as possible. This divergence in goals can lead managers to manipulate financial results to minimize tax liabilities and thereby maximize net income.

Extrapolating this theory to Moroccan SMCs, shareholders may prioritize minimizing accounting income even at the expense of employees, managers, or the overall company, to avoid a tax burden that could undermine their interests

2. The transaction costs theory

Initiated by Coase (1937), this theory addresses the fundamental question of why companies exist. According to Coase, the firm exists to reduce transaction costs (Charreaux et *al.*, 1987). Williamson supports this view, observing that transactions conducted within organizations differ from those conducted in the market (Chabaud et *al.*, 2008). Both authors argue that firms can substitute for the market by offering lower transaction costs compared to those of the market.

A transaction occurs when a good or service is exchanged across a technologically separable interface (Williamson, 1996). Transaction cost refers to the face-to-face price between two economic agents, whether individuals or groups, and it represents a source of behavioral uncertainty in economic exchanges (Charreaux et *al.*, 1987).

Several factors influence the formation of transaction costs, including the individual behavior of agents, such as their limited rationality and opportunism.

2.1. Limited rationality and opportunism

The concept of bounded rationality refers to the difficulties individuals face in reliably storing and processing information. It particularly highlights the challenges companies encounter when drafting contracts that account for all possible contingencies (Koenig, 1999). Individuals cannot anticipate every eventuality that may arise during a transaction. According to Williamson, bounded rationality arises from the limited cognitive capacity of individuals to process information effectively (Williamson, 1991). Consequently, contracts often remain incomplete, making transactions more costly as they require a legal framework to address potential disputes between parties.

The limited rationality of agents, combined with their opportunism, increases transaction costs. Demsetz (1972) defines opportunism as the tendency of individuals to act in their own interest, potentially deceiving others, through means such as deceit, trickery, or the provision of incomplete or misleading information. Opportunism is evident when an individual exploits a contractual loophole for personal gain (Williamson, 1998).

Bounded rationality and opportunism among agents consequently increase transaction costs, as individuals cannot fully anticipate future events and some uncertainty remains in each transaction. This uncertainty drives them to seek ways to minimize costs while considering the specific context (Kartochain, 2010).

2.2. Transaction Cost Theory and Fiscal Management Practices among SMCs

The world would be more manageable if economic exchanges were free from transaction costs. However, given the various ways of organizing economic activity, it is important to recognize that these organizational methods have tax implications (Scholes & Wolfson, 1996). Indeed, SMCs must work to reduce their transaction costs, including tax costs, while adhering to the specific provisions of the tax agreement with the authorities.

- **Minimizing tax costs**

Maximizing the company's value often involves optimizing or minimizing tax costs (Mayor, 2004). Taxes are a crucial factor in organizational decision-making. Policymakers generally aim to manage the tax implications of each transaction. By reducing their effective tax rate, companies can achieve substantial tax savings (Karyan et *al.*, 2002). According to Scholes and Wolfson (1996), to organize production with minimal costs, it is essential to consider the tax positions of all parties, both at the time of signing the contract and throughout its duration.

Transaction Cost Theory posits that every contract generates costs, and it is necessary to restore balance between the parties through arbitration, leading to situations where compromise is accepted (Mayor, 2004). To minimize transaction costs and enhance the firm's value, managers aim to engage in transactions that maximize overall value. If a transaction aligns with the company's strategic objectives, it may be accepted; otherwise, it should be avoided, even if it offers tax benefits, which are not the primary determining factors (Karayan et *al.*, 2002). According to Scholes and Wolfson (1996), an effective tax strategy must be evaluated in relation to its implementation costs. Generally, simpler tax strategies are more efficient than complex ones, which may only marginally reduce tax payments.

Generally, companies seek to minimize tax costs by restructuring transactions to achieve more favorable tax treatment. Tax experts may modify operations to convert non-deductible costs into deductible ones, in accordance with applicable regulations (Karayan et *al.*, 2002).

This reduction in tax costs increases net profit, offering a competitive advantage that can lead to lower selling prices and a greater market share (Karayan et *al.*, 2002).

This includes both actual and potential costs. Actual costs encompass fees paid to tax experts hired to secure tax benefits, as well as costs arising from potential challenges by tax authorities, including associated reputational damage (Holland, 2012). These costs arise from breaches of the tax regulations and any resultant disputes between the company and tax authorities.

- **The tax agreement for SMCs**

The financial contract established by SMCs is unique, differing from other types of contracts. As Scholes and Wolfson (1996) note, the tax administration is an involuntary party that imposes itself on all contracts. The tax authorities introduce a set of contractual clauses into their interactions with taxpayers. Unlike other parties, the tax authorities do not negotiate clauses individually for each transaction. In this context, the contract involves SMCs on one side and the tax authorities on the other. The terms of this contract are defined by the application of tax laws, particularly the general tax code. Companies must seek to identify the appropriate fiscal treatment for their transactions.

The tax agreement differs from other contracts because the relationship between tax authorities and SMCs is distinct from those with shareholders, customers, or suppliers. As Scholes and Wolfson (1996) explain, while the tax authority has a claim on the taxpayer's profits, it lacks voting rights or ongoing control to monitor whether the taxpayer complies with the contract's terms. This allows the tax authorities to conduct preliminary or comprehensive audits based on available information, including comparative data from other companies. The inherent ambiguities in the tax system often lead to disputes between SMCs and tax authorities. To address these issues, SMCs have two options: they can either seek advance guidance from the tax administration on the application of specific tax rules to clarify uncertainties before an audit (Scholes and Wolfson, 1996), or, if disputes arise after an audit, they can contest the tax administration’s assessments in court.

In Morocco, SMCs might seek the opinion of the tax authorities, specifically the Department of Studies and Tax Law, to confirm their compliance with tax regulations and ensure that their tax treatment will not be contested later. This practice, known as a ‘tax ruling’ in France, allows taxpayers to receive assurances about how tax laws apply to their specific situation.

Transaction Cost Theory, particularly its focus on minimizing tax costs and managing tax contracts, is relevant in the Moroccan context. On one hand, many Moroccan SMC leaders are focused on maximizing profits through expense reduction, including minimizing tax costs. On the other hand, these companies are governed by tax regulations that require legal compliance while also offering opportunities to reduce tax expenses. This theory captures a significant aspect of the dilemma faced by Moroccan SMCs. Finding a mutually agreeable approach with the tax authorities could help SMCs protect their interests.

3. Game Theory

Game Theory is a branch of mathematics that examines optimal strategies for decision-making. It aims to analyze games to determine the best moves, ideally those that lead to victory. This theory is applicable to real-life situations involving conflicts, where participants must make strategic decisions to maximize their benefits while anticipating their opponent’s actions. Game

Theory also helps identify equilibrium points (such as Nash equilibrium), which represent a stable state of play among participants. Consequently, Game Theory is a valuable tool for analyzing interactions between two key players, such as SMCs (taxpayers) and tax authorities.

This theory focuses on analyzing the auditing behavior of tax authorities in response to companies' financial statements. Early studies examined taxpayers' decisions to report only their taxable income (Reinganum & Wilde, 1986; Rhoades, 1999). More recent research has expanded to include decisions about disclosing additional information (Mills & Sansing, 2000; Zheng, 2002).

Graetz et *al*. (1986) were the first to apply Game Theory to the study of taxpayer and tax authority behavior. They proposed a novel theoretical framework to analyze fiscal non-compliance by treating it as an interactive system. In their model, they incorporated the tax authority as a crucial interactive component.

In Game Theory, the tax authority is viewed as a strategic actor. The auditing decisions made by the tax authority are based on the information provided by taxpayers. Consequently, levels of non-compliance, auditing, and penalties emerge from the interactions between taxpayers and the tax authorities.

Based on the fiscal result reported by the company, the tax authorities decide whether to conduct an audit. If the taxpayer is not audited, their reported statement determines their final tax liability. However, if an audit is conducted, the tax liability is recalculated based on the actual results, including any additional tax surcharges, fines, and interest on late payments.

In addressing the introduction of uncertainty into the fiscal game, Beck and Jung (1989) developed a model analyzing the interactions between taxpayers' reporting decisions and tax authorities' auditing policies within an environment of uncertainty and asymmetric information. Their main conclusion is that increasing penalties reduces the aggressiveness of taxpayers' result statements.

Regarding the inclusion of information in the fiscal game, Sansing (1993) explores how information that enables tax authorities to predict fiscal fraud impacts the game. The analysis reveals several key outcomes: first, the inclusion of such information may increase fiscal fraud as players attempt to anticipate each other’s actions. Second, it does not affect the expected level of gross public revenues. Third, it may lead to higher anticipated auditing costs. Lastly, the optimal level of investment in acquiring information does not change in a straightforward manner with variations in tax rates, penalty rates, auditing costs, or the extent of taxpayer losses. Additionally, Erard and Feinstein (1994) show that incorporating honest taxpayers into the model leads to improved empirical forecasts and introduces new, nuanced implications.

Erard and Feinstein (1994) find that public revenues for tax authorities increase only gradually with a higher percentage of honest taxpayers. They also determine that increasing the proportion of honest taxpayers results in a decrease in additional revenues from auditing.

Although the developed model provided theoretical insights into factors influencing companies to engage in fiscal risk, it did not identify the various sources of this risk. The model highlighted two external factors: the penalties prescribed by tax law and the auditing costs borne by the tax authorities.

Conclusion

Given the above, taxation emerges as both a financial constraint and a risk for SMCs. It is crucial for these businesses to understand the factors that drive their actions and to manage the risks associated with tax compliance and control.

Furthermore, the relationship between the tax administration and the taxpayer is often misunderstood. Each year, the tax code seeks to clarify this relationship by updating the legal framework that defines the rights and responsibilities of both parties.

In Morocco, 82% of revenue is derived from the corporate income tax paid by just 2% of the largest companies. Consequently, the relatively small contribution of SMCs is striking. This disparity can lead SMCs to feel unfairly treated by the tax system, as they may perceive that the services provided by the state are not commensurate with their tax contributions. As a result, tax evasion may appear to some SMCs as a means of adjusting for this perceived inequity.

Despite the criticism, fiscal charges are still viewed as a necessity because living in an organized society provides benefits, and society must therefore cover the costs.

Simplifying business administration, particularly for SMCs, is a significant concern. Reports frequently highlight that regulations in Morocco involve overly complex and slow procedures.

This bureaucracy creates additional costs, deters investment, and impacts the competitiveness of SMCs, which often lack the resources and expertise to manage tax risks effectively.

Indeed, at the end of each month, regardless of its financial health or the difficulty of revenue collection, a company must pay income tax, social security contributions, and other employee-related expenses. Many tax consulting firms report that their clients are reaching a point where they are unable to meet these tax obligations.

The state is well aware of the dire situation faced by SMCs, which often struggle to meet their tax obligations. It is imperative for the state to provide support by alleviating the tax burden on these businesses, allowing them some relief while they navigate through challenging times

Through this work, we have aimed to initiate a theoretical exploration of the antagonistic relationship between tax authorities and SMCs, as well as the decisions surrounding tax optimization. Like any scientific endeavor, this study is open to criticism and has its limitations, as it is confined to a review of existing literature on corporate tax management behavior. Nevertheless, it can serve as a foundation for future research, particularly within the Moroccan context.

It would be valuable to extend and deepen this study to explore how cultural, environmental, and sociological factors might also influence fiscal management behavior in SMCs.

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