Turnover Tax in Poland: Seduction by Simple Solutions

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ALEKSY PRZYBYLSKI

One of the most important problems of today's liberals and libertarians is how to translate the idea of liberty into a possible realization that would bring at least a bit of freedom. Nowadays, in a world of sophisticated systems of taxation and welfare states, it is very easy to make a mistake and thus roll over the first cube in this financial domino. As liberals working in such political, legal, and social environments, we are exposed to the risk of looking for easy recipes to expand freedom and to increase the pace of economic development.

One of the ideas that has recently gained the attention of the liberals in Poland is a turnover tax, which is presented as an ideal tax. Polish advocates of the turnover tax claim that it is cheap in collection, understandable and predictable to all, and tax optimization is almost impossible. However, few people realize what an economic tragedy it would be to try to simplify the tax system in a way, which is the result of relatively little knowledge of the current legal system and stems from common legal and economic myths.

WHAT IS THE TURNOVER TAX?

Revenue is proceeds received by an enterprise from, among others, sales, so if the enterprise sold 10 units of goods for EUR 100 each, its revenue is EUR 1,000. If the state imposes a turnover tax on enterprises – most often referred to as rates between 0.5% and 2.5% – in this situation, the tax due will equal 5-25 cash units. Let us assume a rate of 1.5%; the income after tax will be 985 units, and only from this amount we deduct the tax-deductible costs, i.e. salaries, machine rental or depreciation, property rental, purchase of materials or semi-finished products. In the end, we receive income that can be used for dividend payments or further investments. The amount of turnover tax paid is not affected by the amount of costs, the size of the margin, or whether the company made a loss. Another problem is when a company invests all its surplus funds all the time, which forces it to either credit itself to pay taxes, or slow down its investment.

> ” THE POLISH DEBATE TALKS ABOUT TURNOVER TAX AS AN ALTERNATIVE TO INCOME TAX

It is worth pointing out here that the Polish debate talks about turnover tax as an alternative to income tax. However, it was historically a substitute for VAT where it replaced the turnover tax in 1993. It is a popular tax, especially in the economies of developing countries, where a large informal economy exists.

Among the advantages of this tax, its supporters mention the enormous simplicity. This feature consists in the lack of deciding whether a given expenditure is tax-deductible or not, thanks to which, every entrepreneur is able to calculate what their tax liability is without any problems. As an advantage many people also point out that it is unavoidable, which, however, is not true and as such shall be proven later. Little knowledge about the possibilities of optimizing this tax probably stems from the fact that in Poland it exists mainly as an idea. It is only when it is translated into specific tax law regulation that we will be able to point out specific optimization possibilities. Still, we are already able to identify potential ways of its optimization.

WHAT IS INCOME TAX?

From a tax perspective, income is the difference between earned income and deductible costs. It should be emphasized that not every expense of an enterprise is tax-deductible, which depends on the law of a given country – tax-deductible costs may be defined differently by Poland and the United States. In general, a tax-deductible expense is any expense that contributes to the achievement of securing business revenue. Much depends on the purpose of the purchase; e.g. the purchase of a game console in the case of a grocery store will not be a cost, but if the activity of a given entrepreneur consists in being a gaming YouTuber, it is possible.

> ” NOT EVERY EXPENSE OF AN ENTERPRISE IS TAX-DEDUCTIBLE, WHICH DEPENDS ON THE LAW OF A GIVEN COUNTRY – TAX-DEDUCTIBLE COSTS MAY BE DEFINED DIFFERENTLY BY POLAND AND THE UNITED STATES

Moreover, governments can offer additional tax reliefs for investments. For example, in Poland, a decision on support can be obtained, thanks to which – once several conditions are met – a new investment can be exempted from corporate income tax for several years. The existence of such reliefs results in later accusations that Company X cheats on taxes. Unlike the turnover tax, the income tax provides one of the incentives for investments, and favors the tax shield effect in debt financing. This is because it becomes more profitable to reinvest profits than to pay dividends. Of course, this does not mean that the income tax is better than no income tax, because then other factors may gain importance.

It can be expected that if income tax would be replaced by turnover tax, various types of reliefs would also be introduced. This development, would, at the same time, contribute to complicating the tax system and open up additional opportunities for optimization.

It is worth noting that in the absence of income, enterprises will not pay income tax at all. What is more, the companies are able to reduce future income by losses achieved in an earlier period. This means that if in 2019 the company reached EUR 200 of loss and in 2020 it reached EUR 250 of income, the tax will be calculated only on the difference between them divided by two, i.e. on 25 cash units, because in Poland the enterprises can settle a maximum 50% of losses.

It should be emphasized that the lack of turnover tax is very important for low-margin industries, such as supermarkets, which operate on the effect of scale, as they make a small profit on individual goods, but sell so many of them that the business is profitable. In 2014 in Poland, the supermarkets were able to achieve a net margin of around 2%[1]. In 2018, Polish supermarket Dino, which is one of the fastest growing retail chains in Poland, was able to reach around 5.27% of net margin[2]. Meanwhile, Jeronimo Martins S.A. – the owner of Biedronka, the largest retail chain in Poland, and Hebe, a cosmetic chain – achieved a net margin of 3.9%, which was a growth by 0.63 p.p. compared to 2014[3].

Currently, non-financial companies pay income tax equal to approximately 0.8% of their revenues[4]. The median net margin for Polish companies listed on the Polish stock exchange between the third quarter of 2017 and the second quarter of 2018 was 6%[5]. Low-margin enterprises are not necessarily the least effective companies – sometimes they are even better than their competitors, because they produce the cheapest with the smallest margin, and achieve a high profit thanks to the effect of scale. It should be emphasized that every company – striving to maximize the return (profitability) on equity – would like to have the highest possible return on assets. However, since large profits (measured by the return on equity) attract competition, the consequence of a high turnover of equity is often accompanied by a low return on sales.

” CONSIDERING THAT, IN GENERAL, WESTERN COMPANIES HAVE A QUALITY ADVANTAGE, THIS IS NOT A GOOD SIGN FOR CEE ENTERPRISES

INCOME TAX EVASION

Many people accuse income tax that costs can be manipulated, making it easy to avoid. This is not entirely true, and much depends on specific tax regulations or the approach of local tax officials to entrepreneurs. The more complicated a tax code and unfriendly the tax administration is to the taxpayer, the greater the risk associated with any attempt at tax optimization. However, the more complicated the system is, the easier it is to optimize the tax. On the other hand, high risk means that the potential benefit must be high enough to compensate for possible tax penalties. It should be noted here that an aggressive tax administration may contribute to a reduction in tax optimization, but this is not a desirable feature of tax systems, as it simultaneously deters potential investors, which may lead to a a shrinking of the tax base. Of course, in a simple and friendly tax environment, entrepreneurs will continue to strive for

[1] https://mises.pl/blog/2015/06/24/zielinski-jaka-jest-rentownosc-biedronki/ [in Polish]

[2] Own calculations based on: https://grupadino.pl/raporty-gpw/raporty-okresowe/ [in Polish]

[3] Own calculations based on Emis Professional Database.

[4] https://www.money.pl/gospodarka/wiadomosci/artykul/podatek-przychodowy-cit-biedronka-lidl,66,0,2304322.html [in Polish]

[5] http://stockbroker.pl/marza-netto/ [in Polish]

optimization, but the incentives for relocation will be reduced.

In 2016, the anti-abuse clause definitively ended quite a popular practice to set up companies in the so-called "tax havens", then transfer, for instance, the company's brand or logo to a newly established company. The next step was to lend this logo for an appropriate fee to a company in Poland, which resulted in the transfer of profits from the company in Poland to the company in the tax shelter. Thanks to this operation it was possible to lower the taxation of income at the rate of the fiscal paradise

> THE LOWER THE MARGIN, THE GREATER THE SHARE OF TURNOVER TAX DUE ON THE INCOME

At the moment, such a transaction is very difficult to execute because of the anti-abuse clause, which prohibits actions where the tax advantage is one of the main benefits. Similarly, it is not easy to create costs from nothing, or to transfer a profit by means of a transaction of purchase or sale of goods at an increased or reduced price for two reasons: it must now be proved that such a transaction took place, and because of the provisions introduced – thanks to the OECD – transfer pricing documentation.

Under the transfer pricing rules, transactions with related parties must be made at market prices. There are several methods to determine this arm's length price, one of which is to compare it with similar companies. The Polish regulations contain several conditions that a given transaction must meet in order to be subject to the obligation to document and report such transactions.

What is the process of creating transfer-pricing documentation? If company A in Poland has a subsidiary B, and has concluded a commodity transaction for the amount of PLN 11,000,000, both companies must prove that the transaction was concluded on market terms, which means that the price for the given commodity corresponded to the price for which a similar transaction would be concluded with unrelated entities. While creating such documentation, there is some scope for manipulating market rates; however, at the same time, the tax authorities have the option to control and cancel the transaction. If the tax administration does not deny a transaction, it *de facto* approves it, thus it is difficult to talk *de jure* about a tax fraud.

IMPACT ON PRODUCTION

It is in the interest of individuals and of the state that the economy is as strong as possible. Individuals get wealthier, while the state increases its tax revenues. Therefore, it is worth considering which tax is the best – or, actually, the least harmful – for the economy. What will be the consequences for the economy of replacing the income tax with the turnover tax?

Imagine that you want to buy a table. There are two tables to choose from: foreign and domestic production. What will the supply chain and taxation look like?

Using the example of the foreign table, the case is as follows (the hypothetical value of the goods at a given stage is given in brackets):

> Wood from the Swedish forest (100) -> processed in a Swedish sawmill (300) -> furniture assembled in Germany (700) -> delivered to a wholesaler in the Czech Republic (800) -> delivered to a shop in Poland and sold in Poland (1000).

During such a transaction, the turnover tax will be levied once – on the income of the shop in Poland. At the rate of 2%, the tax paid in Poland will amount to PLN 20.

Now let us look at the taxation of one table production, which is 100% domestic production:

> Wood from the Polish forest (100) -> processed in a Polish sawmill (300) -> assembled in a Polish workshop (700) -> delivered to a Polish wholesaler (800) -> delivered to a shop in Poland (1000).

In this situation, five companies will be taxed. At the rate of 2%, the tax will amount to PLN 58. It will be borne in full by the Polish companies.

It is worth noting that it is not always possible to pass on the entire amount of the tax to the consumer. But let us assume that the entire amount of the tax will be passed on to customers. They will have to choose between a table for PLN 1,020 of foreign production, and PLN 1,058 of domestic production. The domestic product must be of such a higher value than the foreign one that it will compensate the higher price. Considering that, in general, Western companies have a quality advantage, this is not a good sign for CEE enterprises, as they will have to use their cost advantage even more. This, in turn, would affect employees and their budget.

We could also consider the example of a large corporation that is in charge of a whole supply chain:

> Wood from the company forest (100) -> processed in the company sawmill (300) -> assembled in the company workshop (700) -> delivered to the company store (1000)

In this case, the one transaction that will be taxed in the end is retail. All necessary processes took place inside the company. This gives the vertically integrated company an advantage over the chain of smaller companies.

> ” DUE TO THE RELATIVELY SHORT PERIOD OF CAPITAL ACCUMULATION BY COMPANIES FROM THE FORMER COMMUNIST COUNTRIES, THERE ARE FEW ENTITIES ABLE TO COMPETE FINANCIALLY WITH WESTERN GIANTS

WHAT DOES IT MEAN?

First of all, because of the turnover tax, the populist slogans that Poland is an assembly plant for the West will become reality. Thanks to this tax, there will be a strong incentive to move only assembly plants and distribution to Poland. It may turn out that there is no point in moving foreign customer service offices or departments of purchasing, accounting and finance, R&D, or even factories to Poland. Relatively popular Shared Service Centers do not supply any product to the external market; they exist only to serve the internal customer that is the parent company and other subsidiaries. Of course, SSCs achieve some revenue, but this occurs through transfers from affiliated companies in the form of payment for services, because the Centers have to pay their employees or office rent. Such a SSC will pay PLN 20,000 in tax for every PLN 1,000,000 of revenue, where PLN 1,000,000 is enough for an annual salary for about thirteen employees receiving an average salary[6].

Other operating costs of such a branch should also be taken into account – e.g. office rental or social contributions paid by the employer for each employee. And this is regardless of whether turnover tax will be introduced instead of VAT or income tax. Therefore, it may be a better solution to leave the market in Poland altogether or make it a place of purchasing the service of processing a given product – such as assembly of a ready-made table.

Moreover, it is worth taking a look at Tables 1-5, which contain several variants that differ in the margin achieved – from -1% to 10% – assuming the applicable tax rate of 2%. As you can see, with this seemingly low rate, a company must have a margin of ca. 7.9% so that the amount of the turnover tax due can be equal to the income tax due. It is worth noting that the lower the margin, the greater the share of turnover tax due on the income.

> POLISH UNIVERSITIES (MAINLY STATE UNIVERSITIES) PAY MINIMUM INCOME TAX OR NOT AT ALL, SO AFTER THE INTRODUCTION OF THE TURNOVER TAX THEY WILL HAVE TO PAY IT REGARDLESS OF THEIR INCOME

Companies create long supply chains through outsourcing of ordinary purchases of materials and semi-finished products on the market. This leads to a further specialization of companies, which is the source of development in the modern economy. The benefits of specialization are known thanks to the theory of comparative advantage. The benefit of such operations is the possibility to focus on providing their basic services or production and, if necessary, it is easier to leave the market. However, due

[6] In November 2019, it was PLN 5,229 gross, but the total cost of labor is PLN 6,300. See: https://stat.gov.pl/sygnalne/komunikaty-i-obwieszczenia/18,2019,kategoria.html [in Polish]

Tables 1-5: Comparison of profitability calculations for the income tax and the turnover tax

Assuming a profitability of 10%

Revenue	1000		Revenue:	1000
Turnover tax	20	2%	Salaries	-250
Salaries	-250		Materials	-140
Materials	-140		Depreciation	-210
Depreciation	-210		Estates	-300
Estates	-300		Income gross:	100
Income	100		Tax 19%	19
% of income = turnover tax	20.00%		Income net:	81

Assuming a profitability of 7.5%

Revenue	1000		Revenue:	1000
Turnover tax	20	2%	Salaries	-250
Salaries	-250		Materials	-140
Materials	-140		Depreciation	-235
Depreciation	-235		Estates	-300
Estates	-300		Income gross:	75
Income	75		Tax 19%	14.25
% of income = turnover tax	26.70%		Income net:	60.75

Assuming a profitability of 5%

Revenue	1000		Revenue:	1000
Turnover tax	20	2%	Salaries	-250
Salaries	-260		Materials	-140
Materials	-140		Depreciation	-260
Depreciation	-250		Estates	-300
Estates	-300		Income gross:	50
Income	50		Tax 19%	9.50
% of income = turnover tax	40.00%		Income net:	40.50

Assuming a profitability of 2.5%

Revenue	1000		Revenue:	1000
Turnover tax	20	2%	Salaries	-250
Salaries	-250		Materials	-140
Materials	-140		Depreciation	-285
Depreciation	-285		Estates	-300
Estates	-300		Income gross:	25
Income	25		Tax 19%	4.75
% of income = turnover tax	80.00%		Income net:	20.25

Assuming a profitability of -1%

Revenue	1000		Revenue:	1000
Turnover tax	20	2%	Salaries	-250
Salaries	-250		Materials	-140
Materials	-140		Depreciation	-320
Depreciation	-320		Estates	-300
Estates	-300		Income gross:	0
Income	-10		Tax 19%	0
% of income = turnover tax	-200.00%		Income net:	0

Source: Own calculations

> IN TERMS OF ATTRACTING NEW INVESTMENTS, THE INCOME TAX HAS A HUGE ADVANTAGE OVER TURNOVER TAX

to the turnover tax, it is rational to eliminate unnecessary intermediary entities imposing their margin. This is an incentive for companies to vertically integrate their supply chain – the dominant entity will seek to take over its suppliers and customers. Moreover, if there is no need to show costs in Poland, there is another incentive to outsource at least part of the operations.

Here we come to the next consequence directly related to vertical integration. Namely, due to the relatively short period of capital accumulation by companies from the former communist countries, there are few entities able to compete financially with Western giants. This is to say, the ability of local businesses to carry out this vertical integration is smaller than that of their Western counterparts. For this reason, Western companies will have an advantage in this respect, but also in the outsourcing of certain processes to developing countries, or simply having certain processes in the countries with similar operating costs, but without the turnover tax. Generally speaking, a company that already has factories in a given country has an advantage over a company that is just about to move production there. In addition, local companies will have increased operating costs compared to their Western competitors – a Polish table producer will have to devote extra work to finding savings, increasing productivity or quality of service to compensate for the tax increase of PLN 38 per piece.

Another distortion of the structure of the economy through the turnover tax is that it favors high-margin sectors over low-margin ones. This means that some parts of industry, agriculture, or services can shrink significantly and move to other countries, without there being significant advantages for the transfer of high-margin businesses. The result will be the need to create a comparable number of jobs in services, and the cost of training workers previously employed in shrinking sectors, which will not be 100% successful, because not everyone wants or is able to change their profession. This, in turn, may lead to higher costs for the welfare system in the welfare states by increasing the number of people taking advantage of any kind of benefit. This phenomenon will also increase the costs of hospitals and educational institutions.

Currently, Polish universities (mainly state universities) pay minimum income tax or not at all, so after the introduction of the turnover tax they will have to pay it regardless of their income. Thus, a Polish university with PLN 1,000,000,000[7] of revenue will have to pay PLN 20,000,000 of turnover tax, despite the lack of income. Of course, *de facto*, on the scale of the whole state apparatus, this is only an accounting

[7] For example, Jagiellonian University had PLN 1,209,138,300 of revenue in 2018. See: https://www.gov.pl/web/finanse/indywidualne-dane-podatnikow-cit [in Polish]

issue, but it shows well how extensive the effects of changes in the tax system can be.

TURNOVER TAX AND INVESTMENTS

In terms of attracting new investments, the income tax has a huge advantage over turnover tax. Namely, the income tax allows for deducting the cost of the investment – being a tax-deductible cost – from the tax due, which affects the calculation of the investment's profitability. If someone plans to make an investment, then in the case of the income tax they will not pay this tax and, what is more, they have to achieve income higher than the costs incurred to start paying. Of course, the government can keep the possibility of stimulation by introducing reliefs (e.g. exemption from taxation of income equal to X times the investment), but this will complicate the Polish tax system to some extent. It is important to remember that Poland, like other CEE countries, is a state with small capital resources. Therefore, if it wants to achieve the economic level of the West, the government should encourage investments even more.

The most important taxes in developed economies are quite similar to each other, so companies can assume that the income tax in Poland works quite similarly to that in Germany and differs only in details. Meanwhile, the introduction of a completely new tax may generate costs of modification or creation of a new accounting system and requires anticipating the costs of employee training. Especially, since a new tax often means uncertainty about the jurisprudence of administrative courts or tax authorities, which only arises with time. This is hardly an important argument against the income tax, but it is still a clear obstacle for companies.

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> A NEW TAX OFTEN MEANS UNCERTAINTY ABOUT THE JURISPRUDENCE OF ADMINISTRATIVE COURTS OR TAX AUTHORITIES

The order to pay the tax regardless of the profit made will be a huge threat to the health of the economy. In a period of prosperity, this is generally not a big problem. But during an economic crisis, companies' revenues fall and they are often forced to restructure by selling or liquidating unprofitable parts of the company, laying off employees, or making investments that could reduce operating costs.

In a country with income tax, companies that make a loss (those in need of restructuring) do not pay the tax, so they are able to devote more capital to improving their situation. In the case of entities subject to the turnover tax, on the other hand, it may turn out that the tax obligation will result in deeper cuts than in the normal situation, which may result in higher unemployment and slower recovery from the recession. Moreover, investors will be aware of this risk, which will increase the risk of investing in a country with such a tax. This means that investors will expect a higher rate of return on invested capital, leading to a situation when many projects may not be started.

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UNDER EUROPEAN UNION LAW, MEMBER STATES CANNOT INTRODUCE TAXES SIMILAR TO VAT

THE TURNOVER TAX VERSUS EU LAW

However, the most important obstacle may be a formal and legal issue – under European Union law, member states cannot introduce taxes similar to VAT. The settled case-law of the Court of Justice of the EU identifies four characteristics which must be met in order to establish an infringement of Directive 2006/112/EC: the general application of the directive, the fixing of its amount according to price, its collection at each stage of production and distribution, and the granting of a right of deduction from the tax due by the taxable person, with the result that the tax at a given stage applies only to value added tax and that the final burden of the tax is borne by the final consumer.

The turnover tax appears to meet the first three characteristics and the fourth partly, i.e. the passing on of the tax to the consumer, which is, in general, possible. According to the settled case law, failure to meet the fourth characteristic means that the tax does not infringe on the above-mentioned Directive. However, as indicated by the Jagiellonian Club, one can refer to the position of the Advocate General of the Court of Justice of the EU, who in his opinion criticized the line of interpretation adopted in the Hervis ruling, pointing to the narrow point of view of the case law[8].

HOW TO REDUCE HARMFULNESS OF THE TURNOVER TAX?

Attempts may be made to limit the harmfulness of the turnover tax by making the tax rate dependent on the amount of income, or the sector in which the company operates, or on the margin. Let us consider the characteristics of these criteria.

In the case of an industry-dependent rate, there is a problem with the classification of the company. While an enterprise dealing exclusively with coal mining is quite easy to classify, multi-branch entities will already be challenging. It is possible to go further and order companies to allocate revenues according to the sector in which it is obtained. In this case, part of the revenues will be taxed at a higher rate and part at a lower rate. However, we may fall into the dilemmas known from VAT in Poland, where, for instance, the VAT rate of a doughnut varies depending on the quantity of sugar and the shelf life[9]. In addition, this will require the involvement of specialists by the company to properly assign the goods or the company, and then officials will need to be involved to control what makes collection costs rise. Moreover, the industry-dependent rate will be a state interference in the structure of the economy – there may be a movement of capital from more taxed industries to less taxed ones. This, of course, will generate costs related to the training of employees, transformation of a given investment, etc.

The second solution is to make the rate dependent on the amount of income. It will not, however, really solve the problem,

[8] http://jagiellonski.pl/files/other/Podatek_od_sprzedaYy_detalicznej._Skutki_ekonomiczno-prawne_RAPORT_IJ.pdf [in Polish]

[9] https://poranny.pl/polskie-absurdy-podatkowe-paczek-a-stawki-vat-sa-az-trzy/ar/c3-13924873 [in Polish]

because companies that are most at risk are those with low margins, not low income – supermarkets have high revenues and low margins and will be the first victims. Lawmakers can go the other way – the higher the revenue, the lower the rate. Nevertheless, in such a situation, the legislators will favor existing large companies, which will be a factor that will encourage the largest ones to buy out other companies. This may lead to a partial monopolization of the economy. Especially as the lawmakers will hinder the development of companies with low incomes.

A third solution, seemingly the most effective, may not be the right one either. How is the tax office supposed to know what margin a company applies? It may be based on the company's declarations or documents, but how is an official supposed to verify that the taxpayer does not manipulate accounting data? Here comes to mind a market research of a given margin, which leads us to create transfer-pricing documentation related to the income tax.

> IN THE CASE OF AN INDUSTRY-DEPENDENT RATE, THERE IS A PROBLEM WITH THE CLASSIFICATION OF THE COMPANY

The most important disadvantage of the solution based on making the turnover tax "more detailed" by introducing different rates and criteria is that it diminishes the biggest advantage of this tax – its simplicity. The simplicity of not classifying costs as tax-deductible and other costs, and of not requiring additional effort on the part of officials in the control process, making collection costs very low.

TURNOVER TAX OPTIMIZATION

The simplest and most obvious method is to transfer factories, SSCs, warehouses, and, in extreme cases, even assembly plants or distribution points from Poland to a country with a better tax system. In the simplest way, management is informed about the planned changes, establishes a company in a foreign country and sells everything, then taxes the income and transfers the money to the new entity. Alternatively, they make a donation to the new entity and close the old company.

The second, equally simple, but much more costly and rather less beneficial, is the acquisition of other companies in the supply chain. The scale of the benefits depends on the final form of such a tax, but in the worst case the enterprises will reduce their revenues by eliminating the margin of intermediaries.

Small businesses may also not record actual sales, which also happens in the system with income tax. However, the turnover tax gives a stronger incentive to do so. The current Polish government is trying to fight this by introducing, among others, cash registers connected to the internet where all transactions are recorded and cannot be deleted.

The government may also encounter, as mentioned earlier, manipulation of the classification of goods or activities of the

> THE MOST IMPORTANT DISADVANTAGE OF THE SOLUTION BASED ON MAKING THE TURNOVER TAX "MORE DETAILED" BY INTRODUCING DIFFERENT RATES AND CRITERIA IS THAT IT DIMINISHES THE BIGGEST ADVANTAGE OF THIS TAX – ITS SIMPLICITY

company in case of introduction of multiple rates. If local tax offices classify the enterprises according to their activity, the former may encounter a division of the enterprise into production, service, and trade entities, between which prices for goods or services will be set so that the highest possible revenue will be achieved by the entity with the lowest tax rate. This is where market research of a given transaction, i.e. transfer pricing documentation will apply.

Alternatively, in the case of the criterion of the margin achieved or the amount of income, the entrepreneurs may divide the entity into several others, which then remain within the limit. Suddenly, instead of one company managing all the stores of a given brand, investors will have a separate company for each store.

It is also possible that companies will be established as brokers between the producer and the final customer. In such a scenario, the broker will not be the owner of the commodity and will thus earn commission on sales. Meanwhile, the actual selling party will be the producer or importer.

THE STORY OF BRAZIL

By now, it should become clear that whether or not to adopt the turnover tax should be based more on practice than theory. The world has been deliberately moving away from this type of taxation. Brazil is one of the examples.

Brazil, which in 2002 started the process of transforming two taxes calculated on revenue – *Programa de Integração Social* (PIS) and *Contribuição para Financiamento da Seguridade Social* (COFINS) – into VAT. The replaced tax was a contribution to a social inclusion programme, whereas the latter is a social security contribution. Before the reform, both contributions altogether amounted to 3.65%.

The case of Brazil was investigated in 2015 by Bruno Caprettini, currently associated with the University of Zurich, together with Antonio Ciccone, a researcher from the University of Mannheim, who published a paper on the subject within the Private Enterprise Development in Low Income Countries project. Using their findings, let us examine the effects of the reform[10].

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[10] https://pedl.cepr.org/publications/turnover-taxes-and-productivity-evidence-brazilian-tax-reform

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> BRAZIL, WHICH IN 2002 STARTED THE PROCESS OF TRANSFORMING TWO TAXES CALCULATED ON REVENUE INTO VAT

First of all, the biggest benefit for companies was the reduction of operating costs for all producers. What is important is that the distribution of this benefit was asymmetrical – the companies that bought more were much more taxed and, thus, after the reform they benefited most from it. In other words, the longer the supply chain, the greater the effect.

It has to be taken into account that, in general, longer supply chains have companies producing complex products – the shorter the supply chain will be for the production of tables rather processors – and these are usually the products whose production brings more value to the economy, and also bring with it R&D centers. Here we see what has been described above – complicated production becomes less profitable in the country with the turnover tax. According to the researchers, if a given good was the subject of a transaction twice, the benefit from the tax transformation was three times higher than in the case of a good being only once the subject of a transaction. This is because if a given good is exchanged twice, the tax affects two transactions, not one. The authors of the analysis also point to a reduction in productivity as a result of vertical integration, which they believe may be encouraged by the turnover tax.

What is more, the cost reduction allowed to lower the price and increase production – again, the higher the cost related to the turnover tax, the higher the price reduction and production increase. For example, Brazilian textile producers reduced the price by an average of 15.2% and increased sales by 11.6%. In Bruno Caprettini's other work, *Taxes, Misallocations and Productivity*, he indicates that, on average, employment in the industry increased by 2.71%, revenue by 4.13%, and sales by 4.14%[11]. Here it is worth highlighting Bruno Carpretitini's observation that some companies did not record all sales due to the turnover tax. The model developed by the authors of the publication showed that the elimination of the turnover tax in Brazil resulted in benefits equal to 3% of total tax revenues. This can be seen even in relatively short production processes.

CONCLUSIONS

The idea of abolishing income tax, much hated by friends of freedom, seems very attractive and right, but replacing it with the turnover tax significantly reduces the attractiveness of this change. The turnover tax leads to a distortion of the structure of the economy by promoting the construction of large corporations and discourages the production of complex goods. For many, this is an effective tax on multinational large corporations, but paradoxically, it will hit small, local, and independent enterprises, which, above all, do not have enough capital to compete effectively with

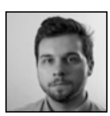
[11] https://pedl.cepr.org/publications/taxes-misallocations-and-productivity

> THE SUPPORTERS OF THE TURNOVER TAX FORGET THAT, IN GENERAL, WITH LESS REGULATION OF A GIVEN TAX, THERE IS ALSO A GREATER POSSIBILITY OF TAX OPTIMIZATION

corporations. As a result, the latter may lose their customers, i.e. the corporations in question.

The supporters of the turnover tax forget that, in general, with less regulation of a given tax, there is also a greater possibility of tax optimization as fewer operations are banned or controlled. A better solution seems to be to improve, for instance, by unifying the definition of the current taxes in Poland and working on improving the administrative and legal climate, rather than fighting for something that sooner or later will be regulated – like the income tax.

As mentioned at the beginning, liberals face the threat of looking for shortcuts in the fight for greater freedom or economic growth. The temptation is to reach for simple and, at first glance, effective solutions. However, the above example of the turnover tax shows that every proposal, even the most attractive one, requires an in-depth analysis to allow for a reliable assessment.



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ALEKSY
PRZYBYLSKI

Currently works for a consulting company. The co-author of comic books about Kapitalis