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INCOME IN A TRANSITION
ECONOMY: ISSUES RAISED BY
EXPERIENCE IN POLAND**

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Centre for Economic Policy Research

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ABSTRACT

The Taxation of Entrepreneurial Income in a Transition Economy: Issues Raised by Experience in Poland*

This paper considers the taxation of small business and entrepreneurial incomes in Poland. In both transition economies and existing West European market economies, the efficient taxation of entrepreneurial incomes presents particular difficulties, partly due to the absence of clearly defined 'borderlines', for example between labour and capital incomes, and between business expenses and private consumption. The treatment of income volatility, of social insurance contributions, and of inheritance by the tax system can easily have a non-neutral impact on the balance between entrepreneurial investment and other investments. The paper considers how these problems could be addressed, and outlines a number of issues specific to the taxation of entrepreneurs in transition economies.

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NON-TECHNICAL SUMMARY

What should tax policy in relation to entrepreneurial activities seek to achieve? Broadly, there might be two potential objectives, both of which are reflected in aspects of western practice.

The first is the achievement of neutrality in taxation between entrepreneurship and other activities and income sources; in other words, the tax treatment of entrepreneurs should be designed so as to cause as little damage as possible to the allocation of resources between different activities and types of organization.

The second is the active promotion of some aspects of entrepreneurial activity, such as small firms, to reflect and offset possible market obstacles to the efficient development of this type of activity.

The major conceptual issues arise in the definition of policies to achieve the first of these objectives. Such a 'neutral' system should in any case be taken as the baseline against which policies to promote entrepreneurial activities should be framed and assessed.

Even in established market economies the neutral taxation of entrepreneurial incomes presents particular difficulties. One source of difficulties is that small businesses combine functions which are separated in larger businesses, such as, for example, the provision of labour and capital. As a result, some of the 'borderlines' which are relevant in taxation are not clearly defined by transactions, and accounting documentation. Most tax systems make a distinction between labour and capital incomes, and between business expenses and private consumption. In the case of small businesses run by a self-employed proprietor, these distinctions are difficult to make and to enforce.

Other difficulties in the taxation of small businesses include the tax treatment of the volatile incomes earned by small businesses, definition of an appropriate level of social insurance contributions for entrepreneurs, and the tax treatment of small business inheritance. The way in which the tax system treats each of these issues can easily have a non-neutral impact on the balance between entrepreneurial investment and other investments.

These problems are magnified in transition economies by the rapid expansion of the small business sector, the fluidity of business structures and contractual

relationships, by the lack of established institutional relationships between government and business, and by the limited administrative resources of the tax authorities. At the same time efficient taxation of small businesses is of particular importance in guiding the development of the economy; tax factors may affect both the overall level of entrepreneurial activity, and also the structure and financing of small business.

The most severe transition difficulties concern the lack of good valuation evidence from market transactions. One practical implication of this is that floorspace taxes and other non-value measures should be preferred to real estate taxes wherever possible.

The shortage of administrative resources may also have implications for design of policy. In particular, scarce administrative resources should be concentrated on large revenue sources, leaving smaller firms subject to simply-administered presumptive and lump-sum taxes. In this respect the Polish authorities' introduction of the 'revenue lump-sum tax' appears to be particularly appropriate, although, if it is not to inhibit the development of small firms into larger firms, it will be important to ensure that it is set at broadly the same average tax burden as if the main tax system had applied.

Policy should also take account of longer-run objectives and constraints. The opportunity exists to make decisions now regarding the long-run structure of taxes on capital incomes and assets without the major adjustment costs that such decisions will involve later, once the private sector has adjusted to the existing tax regime. International competitive pressures (and the objective of EU entry) may dictate Poland's long-run tax system, but the form this will take is perhaps unclear. The most useful contribution to long-term efficiency in taxation which can currently be made is to avoid excessive discrimination in taxation between sectors or classes of activity. These tax privileges in West European economies have proved among the most durable features of the tax system, and similar tax privileges in Poland could later prove costly to reform.

Second draft, March 1995

**The taxation of entrepreneurial income in a transition economy:
issues raised by experience in Poland**

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London)*

This paper considers one aspect of tax policy in a transition economy - the design of taxation arrangements for small businesses and entrepreneurial incomes. The paper sets out the range of major issues involved in taxing entrepreneurial activities in transition economies, and considers how these problems have been addressed in Poland.

What should tax policy in relation to entrepreneurial activities seek to achieve? Broadly, there would seem to be two potential objectives, both of which are reflected in aspects of western practice. The first is the achievement of neutrality in taxation between entrepreneurship and other activities and income sources; in other words, the tax treatment of entrepreneurs should be designed so as to cause as little damage as possible to the allocation of resources between different activities and types of organisation. The second is the active promotion of some aspects of entrepreneurial activity, such as small firms, to reflect and offset possible market obstacles to the efficient development of this type of activity. The major conceptual issues arise in the definition of policies to achieve the first of these objectives. Such a "neutral" system should in any case be taken as the baseline against which policies to promote entrepreneurial activities should be framed and assessed.

Even in established market economies, the neutral taxation of entrepreneurial incomes presents particular difficulties, partly due to the absence of clearly defined "borderlines", for example between labour and capital incomes, and between business expenses and private consumption. The treatment of income volatility, of social insurance contributions, and of inheritance by the tax system can easily have a non-neutral impact

on the balance between entrepreneurial investment and other investments. These problems are magnified in transition economies by the rapid expansion of the small business sector, the fluidity of business structures and contractual relationships, by the lack of established institutional relationships between government and business, and by the limited administrative resources of the tax authorities. At the same time, efficient taxation of small businesses is of particular importance in guiding the development of the economy; tax factors may affect both the overall level of entrepreneurial activity, and also the structure and financing of small business.

The paper is in four main parts. Section 1 summarises available data on the growth and characteristics of entrepreneurial activity in the Polish economy, focussing principally on the characteristics relevant for tax policy. Then Section 2 sets out the general issues involved in efficient taxation of entrepreneurial activities, many of which arise in both market and transition economies. Section 3 considers aspects of the tax treatment of entrepreneurial incomes and small businesses which are specific to the position of transition economies. Section 4 discusses the treatment of entrepreneurial activity by the existing tax system in Poland, and the extent to which it has addressed the issues outlined in Sections 2 and 3. A concluding section summarises problems and possible solutions.

1. Scale and characteristics of entrepreneurial activity

1.1 Evidence of changes in private enterprise sector in 1989-1993 in Poland

One of the features of the planned economy in Poland - as in other countries in central and eastern Europe - was the small number of enterprises, and the highly-concentrated structure of production. Private firms, to the extent that they were tolerated, were restricted in their development, by rules which discouraged growth beyond a certain size. For instance, Polish private firms were not permitted to employ more than fifty workers per shift. Private firms which grew beyond this limit were at risk of nationalization. As a result the structure of enterprises consisted of a very small number of large state-owned enterprises, and, at the other extreme, some small private firms. The latter group was not very numerous, and was economically weak.

This structure of enterprises is unlikely to be consistent with efficiency in a market economy. The small and medium-sized enterprise sector is regarded as having considerable importance in a modern market economy, due to its potential contributions to innovation, flexibility, and employment growth[1]. In the transition of the Polish planned economy to a market economy, changes in the enterprise structure would be expected, in which the small and medium-sized enterprise sector would grow in relative importance.

The Economic Transformation Programme in Poland, which was launched with the "big bang" in January 1990, opened the economy to greater international competitive pressure, and freed the majority of prices. In some respects, the effects of the economic transformation programme have been different to those anticipated; the social costs of transformation have been higher, and the pace of privatisation slower, than previously expected (or, at least, than politicians had promised). However, the private sector responded quickly, and the number and economic activity of private businesses boomed.

This rapid growth in private business surprised both the statistical and fiscal authorities, and, as a result, official statistical and administrative data, especially that based on fiscal records, may not give an accurate picture of the current scale of the private sector in Poland. Due to the difficulties experienced by the fiscal authorities in controlling private sector business, many small firms have been able to under-record their profit margins, turnover and value added in order to pay less tax. Data on employment and the number of firms would appear to be the best available indicators of the development of this sector, whilst data on turnover, profits or value added is likely to be much more unreliable, especially where it has been derived from fiscal records.

[TABLE 1.1 NEAR HERE]

Evidence on the growth in the number of firms and employment in the non-agriculture private sector in Poland over 1989-93 is shown in Table 1.1. It shows very rapid growth, especially in the trade sector, which consists principally of firms engaged in wholesale

and retail trade and catering. Growth was much less rapid in manufacturing and construction. Overall, the number of firms in the private sector increased by 120 per cent over the period 1989-93, with especially rapid growth in the first year of the economic transformation programme. Employment in the private sector grew by some 48 per cent over the same period. In the trade sector, however, the number of firms increased roughly ten-fold between 1989 and 1993, whilst employment roughly doubled. The average size of firms in the private sector is, however, small, and has declined significantly since the start of the transformation programme, from 3.9 employees in 1989 to 2.6 in 1993.

[TABLE 1.2 NEAR HERE]

In order to explore these trends further, Table 1.2 presents details of the development of micro enterprises, defined in Polish data as firms with five employees or fewer. We can observe that the increase in employment in the microenterprise sector was higher than the increase for the private sector as a whole. Whilst employment in microenterprises grew by some 1.52 million between 1990-1993, employment in the total private sector grew by only 1.24 million. This suggests that the structure of the Polish private sector is evolving in an unbalanced way. Microenterprises employing less than 5 persons are growing rapidly, but medium-sized firms are not yet numerous.

1.2 International comparisons

A comparison of the structure of enterprises in Poland and in the European Union helps to bring out certain features of private enterprise development in Poland. Although European countries differ widely in terms of enterprise structure[2], the role of small and medium-sized enterprises is important in all sectors.

Table 1.3 shows data on employment in microenterprises in the EU, and similar data for Poland. It should be noted that the definitions of microenterprises are not the same in Poland and the EU, and the figures shown in Table 1.3 are not therefore wholly

comparable. Microenterprises are defined in Poland as firms employing up to 5 persons, whilst in the EU data, microenterprises are defined as firms employing less than 10 persons.

[TABLE 1.3 NEAR HERE]

Although the data for Poland and EU are not fully comparable, the evidence is clear that Polish trade sector consists of too many small firms, while Polish manufacturing and construction sectors better reflect European standards. Secondly, the trade sector definitely has changed its structure the most. This can be supported by the average size of trade firms in 1989 and 1993, which was 12.1 and 2.4 persons respectively.

[TABLE 1.4 NEAR HERE]

Although the size of the microenterprise sector may be close to (or, in the case of trade firms, exceed) west European standards, the position looks worse if the entire small and medium-sized enterprise sector in Poland is considered. Basic data on the small and medium-sized enterprise sector, as defined in EUROSTAT[3] are given in Table 1.4. By and large, employment in the small and medium-sized enterprise sector in Poland is still below European standards. This suggests that further reconstruction is needed, if the economic advantages of the small and medium-sized enterprise sector, in terms of flexibility to market needs, competition and innovation, are to be fully exploited.

In summary, during the first years of the economic transformation programme, the numbers and employment of small and medium-sized enterprises have changed relatively little in the construction and manufacturing sectors, whilst there has been rapid expansion of small and medium-sized firms in the trade sector. The above figures, however, suggest that the current position is one in which there are probably too many microenterprises in trade, and a shortage of medium-sized firms. The situation of

manufacturing and construction firms are different. Large construction enterprises dominate and probably they wait to be privatized and then they will split and reconstruct. Microenterprises in construction are, by contrast, already quite numerous. Manufacturing has better balance in microenterprise sector, but worse in the entire small and medium-sized enterprise sector than construction.

The average size of private sector firms in Poland is 2.6 persons per firm. This number, whilst lower than the EU average, is broadly similar to the average private sector firm size in EU countries with low levels of GDP per capita. There is a clear correlation between average private sector firm size and per capita GDP within the EU countries; the average firm size across all EU members is six employees, but only three for Greece, and four for Italy, Spain and Portugal.

A comparison of the enterprise structure of Poland and other Central and East European Countries can only be made on a very limited basis, due the lack of available data. Table 1.5 presents data on the number of private enterprises, both incorporated and unincorporated, for Hungary, Czecho-Slovakia and Poland.

[TABLE 1.5 NEAR HERE]

It may be observed that there are relatively more incorporated private firms in Hungary and Czechoslovakia than in Poland. Calculation of number of incorporated firms per 1000 inhabitant brought the following ratio: 1,4; 4,2; and 5.6 for Poland, Czechoslovakia and Hungary, respectively[4]. Presumably, incorporated firms are bigger and have better chances for development than unincorporated. This suggests that probably there are relatively more medium-sized firms in Hungary and Czecho-Slovakia than in Poland. This is however hard to prove due to the lack of data on employment of small and medium-sized enterprise sector. Some evidence of empirical surveys proved indirectly this hypothesis. In Czecho-Slovakia main competitor for private firms was state sector, in Hungary state and private sector, and for Polish firms it was private and informal sector[5]. Since state sector consists mainly of large enterprises, probably private firms competing with the state sector are bigger.

By and large evidence of Polish private sector development in the first years of the economic transformation programme proved that small and medium-sized enterprise sector has grown in microenterprises and their role increased the most. The gap of medium-sized firms is still significant. Trade sector exercised the biggest changes towards microenterprises. This is rather unexpected result of economic transformation. However trade sector was underdeveloped before transformation. Capital and skill requirements to start trade firm was low and it was easy to find a place on market in the first stage of the economic transformation programme. The question arises, did tax reform play any role in transformation of enterprise structure during the economic transformation programme?

2. Taxation of entrepreneurial activity - general issues

The tax system existing in Poland prior to the start of economic transition was not designed to tax entrepreneurs. Entrepreneurs were, in any case, unimportant. Also, those tax provisions which related to entrepreneurs in the old system reflected the previous negative view of their role in the economy, and taxed them punitively.

Careful design of the new tax system is necessary if an appropriate basis for entrepreneurial activity is to be created, in which the creative economic potential of entrepreneurs can be put to work, whilst at the same time the entrepreneurial sector does not simply become a refuge for tax evaders.

The start of a new tax system offers the opportunity to get things right in a way that existing market economies generally cannot. Business practices in market economies already reflect the tax systems in place; tax privileges and concessions may be capitalised into asset values, and reforms then lead to consequential capital gains and losses which may be undesired, and which almost certainly have a political cost. This is probably particularly true of the taxation of the small business sector.

But getting the taxation of entrepreneurs right is not an easy matter. There are a number of reasons for this, which are set out in the sections below. A number of these difficulties have in common that they concern "boundaries" between activities with different tax treatment - for example the boundary between labour and capital income, or between industrial inputs and private consumption. In small firms these boundaries are often much more difficult to observe, and, therefore, to draw than in larger firms;

fewer observable transactions occur, and the roles of manager, worker and supplier of capital are frequently combined in the same individual. Where "arms length" transactions occur between a large firm and, for example, its investors, these can generally be taken for tax purposes as an accurate reflection of the income flows accruing to investors; however, where no such transactions take place, they may have to be imputed for tax purposes, and such imputation is likely to be imprecise and unsatisfactory.

2.1 Labour and capital incomes.

The self employed and small businesses combine two factors of production - labour and capital - which are, quite often, taxed elsewhere in the tax system very differently from each other. Some countries levy higher taxes on capital incomes than labour incomes (eg the UK in the 1950s and 1960s); other countries levy lower taxes on capital incomes than labour incomes (eg the UK now). Because these two types of incomes are combined in the small business sector in a way which may be difficult to disentangle, small businesses will, almost inevitably, have to be taxed more favourably than the constituent factors would be, and the small business structure may become a route for evasion of tax on incomes more generally.

Moreover, like most businesses, small businesses have the option of manipulating their flows of capital income to their owners so that they are received in the form either of income or of capital gains. Many tax systems tax capital gains at a different rate (often a lower rate) compared to capital income. However, the potential for large businesses to make use of this by paying out profits in the most tax-efficient form may be limited by differences in the interests of different shareholders; small businesses can tailor the choice between income and capital gains in a way which suits the precise circumstances of their proprietor.

2.2 Transaction evidence and enforcement.

Quite apart from the problems of defining the appropriate boundary between capital and labour incomes, it is usually more difficult to enforce taxes on small business incomes than on other income flows. One of the ways in which the tax authorities can restrict evasion of taxes on incomes is by requiring both sides of the transaction to report the

payments; for evasion to work, both sides then have to be willing to make a false report, and large enterprises will usually be unwilling to do so. (A large enterprise which keeps false records to back up false reports to the revenue authorities will often find it difficult to prevent similar methods being used by its employees to defraud the company for their own gain). The proprietors of small businesses are able to control both sides of the information flow to the revenue authorities (ie payments to themselves, as owner or employee, and their receipt of these payments).

Employee taxpayers can be taxed through a deduction-at-source mechanism, which provides greater certainty of tax payment than if tax payments were made by the individual employee, on the basis of periodic declared statements of income. The system works because there are two parties to the deduction-at-source arrangements, the employer and the employee. For evasion to be possible, it would normally be necessary for both these parties to have an interest in the evasion. However, large companies, at least, are unlikely to wish to get involved in collusive fraud of this sort.

In the case of the self-employed, however, payments of income involve only one, rather than two, parties, and a deduction-at-source mechanism would contribute no improvement to the certainty of tax payment. Indeed, as argued above, the very notion of an income payment to the proprietor of a small business may often be blurred or meaningless; the "income" of the proprietor may be something that can only be ascertained as the result of detailed ex post accounting and audit.

2.3 Individual and business consumption.

It may also be difficult to define the boundary between individual and business consumption sufficiently tightly to prevent abuse. Many commodities which individuals consume are also used as business inputs, and some activities which can count as business expenses may often have a large consumption element (business entertaining, travel, etc). The tax authorities may often be unable to tell the difference.

Ideally, where business expenditures reflect consumption by individuals they should be subject to consumption and income taxes in the same way as if equivalent income payments were made to the individuals concerned, and consumption purchases were made out of this income. Also, it is desirable that business input uses of similar goods

should not be taxed (a reflection of the general rule of Diamond and Mirrlees (1971) that - under certain restrictive conditions - intermediate goods should not be subject to taxation).

2.4 Income and expenditure tax strategies and "borderline" problems in taxation of entrepreneurial incomes.

The problems which are posed for the attainment of a neutral treatment of entrepreneurial activities by the "borderline" problems described above vary depending on the underlying decisions made about the treatment of income, savings and consumption in the fiscal system. Depending on the general tax treatment of income, saving and consumption, some of the problems which arise because of the difficulty of distinguishing the boundaries between capital and labour income, and between business inputs and consumption, in entrepreneurial activities may be eased, although generally at the cost of accentuating the problems associated with other borderlines.

This may be illustrated by considering the choice between three general "philosophies" of the taxation of income, saving and consumption:

- a "comprehensive income tax" regime, in which both labour and capital incomes are taxed at the same rate, whilst individuals' investments are made out of taxed income.
- a "direct expenditure tax" regime, in which tax liability is based on income minus net saving in any period; individual investments are thus made out of untaxed incomes, whilst the returns to investments, in the form of capital incomes are taxed when consumed.
- a "deferred expenditure tax" regime, in which labour incomes are taxed but capital incomes are not; individual investments are made out of taxed income, but the returns to these investments are not taxed.

Broadly-speaking, most western countries have in the past operated systems closest to the first of these regimes; in this system, the tax system acts to discourage savings (a problem sometimes referred to as the "double taxation" of savings). The second and third systems avoid the double taxation of savings, in two different ways; in the case of the direct expenditure tax by allowing savings to be made out of untaxed income whilst

taxing the resulting capital incomes, and in the case of the third regime, by exempting capital incomes from tax. Direct expenditure taxes have rarely been applied (although extensively advocated in academic literature), partly because of the major transitional difficulties which would arise. On the other hand, in recent years many western economies have taken steps which have moved them closer to the third system, partly because increased international capital mobility has increased the pressure of international tax competition. The measures taken have included either reductions in the rates of capital income taxes, or the establishment of special regimes permitting certain investments to be made without taxation of the returns (eg PEPs and TESSAs in the UK).

The borderlines which matter in achieving neutral taxation of entrepreneurial activities depend on which of these regimes is in force.

- Under a comprehensive income tax regime, there is no need to try to distinguish the capital and labour incomes of business proprietors. Since both such incomes are taxed at the same rate, there is little to be gained[6] by changing the "mix" between capital and labour incomes in the incomes paid to the proprietor. There is, on the other hand, a strong incentive to misrepresent individual consumption as business expenditure, since by doing so it is possible to reduce income tax liability as well as any liability to consumption taxes.
- Under an expenditure tax regime, capital and labour incomes are again taxed on the same basis, and so the borderline between the capital and labour incomes of proprietors is not sensitive for tax purposes[7]. There is, however, a need to identify resources invested by the proprietor in the business, since, for neutrality with other forms of investment, these should be made out of untaxed income. This potentially creates particular difficulties with enforcement of the distinction between individual and business consumption; not only is it possible for business proprietors to avoid tax on their business incomes by channelling individual consumption through the business, but they can also avoid paying tax on consumption expenditures made out of earlier incomes, if money invested in the business is used to supply their personal consumption.

- Under the "deferred expenditure tax" regime, acute problems arise in achieving a neutral tax treatment of entrepreneurial activities compared to other forms of investment. Since capital incomes are untaxed, whilst the full burden of taxation is borne by labour income, there is a substantial gain to a business proprietor if most or all of the income from a small business can be treated as capital income. In this case, the tax exemption also, in effect, applies to (much or all of) the proprietor's labour income as well as capital income. On the other hand, the gain from misrepresenting individual consumption as business consumption is small, since it will only save any consumption taxes which would be levied on personal consumption but not on business inputs.

For these reasons, most countries which operate systems of this sort confine them to defined classes of assets; incomes from these assets only are exempted from tax, whilst other sources of capital income, including entrepreneurial incomes, remain taxed. However, whilst this is a solution to the problem of achieving neutrality between the labour and capital incomes of small business proprietors, it creates further possible non-neutralities between small and large businesses, if the shares or other sources of finance to large businesses can benefit from the capital income tax exemption. Large businesses then have access to tax-privileged sources of investment finance denied to small businesses, and the tax system may thus distort the enterprise structure in the direction of large businesses, financed from tax-privileged funds.

What conclusions should be drawn from this discussion for the design of the tax system? It would clearly be inappropriate for the choice between these fundamental bases for taxing consumption, savings and income to be made solely in order to facilitate tax enforcement amongst small businesses and independent entrepreneurs. Nevertheless, this is one consideration which would need to be evaluated in assessing the choice between, for example, comprehensive income taxation and its alternatives, and is, perhaps, one of the stronger arguments favouring comprehensive income taxation over systems which do not involve double taxation of savings. Where, however, these alternative systems are adopted, it is clear that particular difficulties will need to be addressed in designing tax systems for small business. In particular, countries which adopt regimes in which the returns from certain classes of assets are exempted from tax (PEPs, etc) will need to bear in mind that, because this treatment cannot feasibly be applied to own-capital investments in small businesses, the tax system will substantially

accentuate any existing distortions in the economic system against entrepreneurial activities. There will then be a strong case for substantial offsetting compensation, either in the rather rough-and-ready form of tolerating tax distortions in favour of small business elsewhere in the tax system, or in the form of explicit subsidy or support schemes.

2.5 Timing of tax payments

Tax payments by the self-employed are therefore usually made on the basis of an income statement ("tax return") to the authorities, as a result of which liability to tax is assessed, and payment demanded. In this process, tax payments need no longer be made at the same time as the incomes to which they relate. Payments might be made in arrears (ie in relation to incomes earned at some time previously), although estimated payments "on account" could be demanded earlier. There are a number of possibilities, and international practice varies. Where tax payments by the self employed are on average made later than tax payments by employees, there is a potential gain in terms of postponed tax payments, which can be made by being treated as self-employed.

2.6 Social security contributions

There are often issues about the social security taxes levied on the self-employed and small business proprietors. In principle, self-employed individuals should pay both the employer's and employee's element of social security taxes. However, given the combined rates at which such taxes are levied this may often prove impractical. Moreover, if capital income is not subject to social security taxes, such taxes may simply encourage small business proprietors to take as much income as possible in the form of capital income rather than labour income.

[TABLE 2.1 NEAR HERE]

On the other hand, there may be perfectly valid reasons for levying lower social security taxes on the self-employed. Since the concept of unemployment may be difficult to define for someone who is self-employed, it may be difficult to define circumstances under which the self-employed can be allowed to benefit from unemployment insurance. If - as in many western systems - the entitlements of the self-employed to unemployment benefits are severely restricted, it may then be inappropriate to require the self-employed to pay that part of social security taxes which represents a premium for unemployment insurance.

As Table 2.1 shows, rates of social security contributions paid by the self-employed in western Europe are generally substantially lower than the combined rate in respect of employees paid by employers and employees.

2.7 Restricting access to "self-employment".

If there are significant fiscal advantages to being taxed as self-employed rather than as an employee, it may be necessary for the fiscal authorities to control the ability of individuals to choose to be taxed as self-employed.

The UK system restricts eligibility for the self-employment tax regime tightly, and refuses the "privilege" of being taxed as self-employed to certain groups of taxpayers who, it is believed, wish to class themselves as self-employed purely for the purposes of evasion. The rule employed is one which confines the self-employed income tax regime ("Schedule D") to individuals who have substantial control and discretion over major aspects of the performance of their work[8]. Considerations such as the time and manner in which work is done, the location of the work, ownership of tools and equipment, and the extent of individual control are regarded as relevant in identifying genuine self-employment. Over and above this test, however, the UK tax authorities also require certain groups of borderline self-employed individuals to be taxed according to deduction-at-source arrangements equivalent to those applying to employees; such rules, for example, apply to labour-only subcontractors in the building industry, and to agency workers.

2.8 Income volatility

Entrepreneurial incomes are likely to fluctuate more widely than earned incomes, for two reasons.

Firstly, they may be more sensitive to the economic cycle and other aspects of business conditions. For example, in the United Kingdom, a comparison of annual percentage changes in aggregate employment income and aggregate self-employment income over the years 1970-90 shows considerably greater volatility in self-employment income. The standard deviation of the annual percentage change in aggregate self-employment income, adjusted for inflation, is 6.65, compared to 2.65 for the standard deviation of the annual percentage change in aggregate employment income. In addition to this aggregate volatility, reflecting the greater exposure of self-employment incomes to the overall macroeconomic situation, the self-employed tend to face greater individual year-on-year volatility in incomes, reflecting specific factors relating to each individual.

Ideally, the tax system should not penalise or advantage the self-employed simply because their incomes are more sensitive to economic conditions, and some system of income averaging would then appear appropriate. However, this may then create non-neutrality with employees who may not have opportunities for income averaging for tax purposes.

Secondly, entrepreneurial activity usually involves a period of initial investment, followed by subsequent receipts of income. Part of the initial investment may take the form of profits of the business immediately re-invested in the business (ideally, such incomes should be taxed in the same way that incomes which were paid to the proprietor and then explicitly reinvested would be, but this may be impractical). The time profile of individual taxable incomes may then be very uneven.

2.9 Impact of taxation on the incorporation decision

The tax system may be one of a number of factors influencing the choice of legal form - in other words, the decision whether to incorporate. In most countries, unincorporated small businesses are taxed through the application of the personal income tax system to the income of their proprietor, whilst a separate corporate tax regime applies to incorporated businesses. Depending on the relationship between the personal income tax and corporate income tax systems, there may be a fiscal incentive or disincentive to choose incorporation in preference to operating as an unincorporated small business.

Calculating the scale of the fiscal incentive to incorporate a small business is complex, and requires account to be taken of a number of factors, including:

- the "headline" rates of tax applied to profits earned in businesses of each legal form. Where the personal income tax is progressive, but corporate profits are taxed at a single percentage, the incentive to incorporate may differ depending on the income of the proprietor.
- the definition of taxable profits under each regime, including the basis of depreciation, and the types of costs allowable.
- the corporate tax system employed. This will determine the extent to which corporate profits taxes can be offset against the personal income tax liability of shareholders, avoiding "double taxation" of both company profits and shareholder incomes. The extent of such double taxation may vary depending on the source of business finance.
- the level and timing of taxation of capital gains earned by incorporated and unincorporated businesses.
- the availability of special tax regimes for small firms, in either incorporated or unincorporated form. To the extent that such special regimes may either reduce the tax burden, or the burden of tax compliance, they may influence the decision to incorporate.

In addition to tax considerations, other relevant considerations in deciding whether to incorporate a small business include the possible benefits of limited liability status which incorporated firms may obtain, implications for the proprietor's ability to maintain personal control, differences in administrative requirements and costs, effects on the availability of capital, and possible attractions of incorporation in easing the process of business disposal through sale or inheritance. Evidence on the extent to which tax considerations are likely in practice to influence the choice of legal form by small firms is mixed. As OECD (1994) discusses, even in countries where there appears to be a clear fiscal advantage to one particular legal form, not all businesses appear to select this form. However, there are also cases where fiscal incentives do appear to have influenced the

incorporation decision; for example, OECD (1994) cites the case of Belgium where the tax system provides strong incentives for incorporation, and where a high proportion of small businesses choose this form.

2.10 Beyond neutrality: arguments for active promotion of small businesses through the tax system.

Small businesses suffer a number of potential disadvantages in competition with larger enterprises in the economic system - for example, where economies of scale are significant, or where financial institutions only provide resources to small firms on less favourable terms than to larger businesses. However, as a recent discussion of the issue in OECD (1994) emphasises, the existence of these disadvantages is no immediate reason to provide a rationale for special treatment of small businesses, whether through the tax system or more direct assistance, since some at least of these disadvantages reflect genuine inefficiencies connected with small-scale enterprise. A case for intervention requires identification of market failures which impede efficient development of small business.

OECD (1994) identifies sources of market imperfection which could warrant government intervention. These include the possibility that small businesses may contribute to stabilisation or equity objectives, possible managerial limitations which could be addressed by centrally-provided management advice and information, financing obstacles, and government-imposed costs bearing particularly heavily on small businesses. The last two probably constitute the core of any justification for differential fiscal treatment to promote small businesses.

As regards access to finance, problems experienced by small firms include both problems of the availability and cost of finance. Financial resources may be rationed due to informational asymmetries between lender and borrower; for example, financial resources may not be available to small firms without collateral, whilst larger firms may be able to raise finance for the same project by using existing assets as collateral. Also, the cost of finance to smaller firms may be higher than to larger firms for a number of reasons. Whilst some of these reflect genuine underlying differences in situation which would imply differences in risk, small firms may be disadvantaged if the market takes an

excessively short-term view, or because of certain effects of the tax system on the relative cost of the sources of investment finance available to small and large firms (OECD, 1994).

As regards government-imposed costs, it is clear that the cost of tax compliance bears disproportionately-heavily on smaller firms. Data for the UK shows that the compliance cost of income tax for the self-employed rises less than proportionately with income; compliance costs are nearly 7 per cent of income for the lowest income band of self-employed ("Schedule D") taxpayers, but only 1.5-1.7 per cent of income for taxpayers in the top two income bands (Table 2.2).

[TABLE 2.2 NEAR HERE]

However, whilst the disproportionately-high compliance costs for small businesses would seem good grounds^[9] for some form of compensation, it should be noted that there may be possible benefits to small businesses from some of the requirements of the tax system, such as the need to keep proper accounts. These may in part compensate for the initial higher compliance cost burden.

There is clearly an issue as to whether any compensation for the disadvantages experienced by small firms should take place through the tax system, or should be provided in other ways. The forms of explicit promotion of small businesses which have been used in recent years in western countries have included lower tax rates on small companies, or capital gains tax exemptions for shares. The arguments for using the tax system in this way include the gains from using existing administrative apparatus, the automaticity of subsidies delivered through the tax system; arguments against include lack of transparency, poor targeting (direct payments may achieve greater "additionality" per dollar from the resources spent), and inability to aid unprofitable firms (some of which will be new firms most in need of the assistance).

3. Taxation of entrepreneurial activity - particular issues in transition economies

Some of the issues set out in the previous section arise in very similar form in transition economies and in established market economies. Others pose particular difficulties in the case of economies in transition. In addition, there are a number of considerations specific to the position of transition economies.

3.1 Problems of valuation evidence

Where the tax system requires valuations to be made of assets, either in the form of capital goods or stocks, transition economies may face particular difficulties in non-arbitrary tax administration, reflecting the lack of good market data on which to base valuations.

Market evidence on values may be deficient for either of two reasons. One is that in the early stages of transition, markets may be unusually thin (for example, if restitution disputes limit the amount of real estate with clear ownership title). In these conditions, it may be difficult to identify appropriate market valuations to use for tax purposes; there may be insufficient evidence based on genuinely competitive market valuations.

A second source of problems with valuation evidence is that during transition there may be substantial disequilibrium in markets, resulting in large temporary rents accruing to particular assets, goods, or individuals. These rents reflect lags in supply responses, either of a physical nature (eg the time required to build new transport or telecommunications infrastructure) or a non-tangible nature (the time required for individuals to acquire certain skills valued in a market economy). Over time these rents may be eliminated, but for a period during the process of transition the scarcity rents for particular assets may be substantial, and rapidly-changing over time. Current market values may thus be a poor guide to long run market values, and, if current values are changing rapidly, it may indeed be difficult to find uncontroversial evidence of the current level of market values in any period.

This suggests that transition economies should, as far as possible, avoid the use of tax systems requiring valuation evidence, and should be based as far as possible on tax bases which relate to current transactions values alone. Amongst the practical implications which might be drawn are that systems of business taxation based on assessed asset values - such as, for example, business rates, which are the largest single business tax in the UK - are unworkable and should be avoided during transition.

Better taxes - even though they might involve some inherent risk of inefficiency - would be taxes levied on unambiguous quantity bases, such as floorspace, rather than asset values.

A second implication of the unreliability of valuation evidence during transition is that it will generally be difficult to operate indexation arrangements for any system of business taxation. This perhaps points in the direction of cash-flow taxation of business enterprises, rather than taxation on the basis of inflation-adjusted accounting profit, although, as discussed in section 2.4 above, there are quite alarming risks associated with applying to small business proprietors a cash-flow consistent expenditure tax treatment for individual incomes.

3.2 Administrative limitations

One of the most severe limitations on tax policy in transition economies is the lack - and cost - of administrative manpower. Tax administration in a planned economy required few staff and little enforcement, and few existing trained staff are therefore available to operate tax systems in the new market economy. The financial skills and training required of newly-recruited staff are initially in short supply, but in strong demand in the new private sector; consequently a rapid build-up of an appropriately-staffed tax administration will be costly and difficult. The implication of this is that the tax system should be designed so that minimises the administrative resources required; initially at least, sophistication must give way to practicality. This is a particularly acute requirement in the context of the taxation of small businesses, which absorb a disproportionately-high proportion of the administrative resources consumed in operating income taxation in western economies.

A second, and somewhat distinctive, administrative limitation in transition economies is the "hangover" from past administrative traditions of extensive negotiation in taxation, in which taxes were simply one element in a wide-ranging bargain struck between production units and the state, over the achievement of both production and social objectives. As many commentators (including Gray, 1990; Bolkowiak, 1991) have observed, this tradition of negotiation introduced into the system an element of ex post taxation, which is incompatible with the requirement in a market economy that enterprises face hard budget constraints. To make a decisive break with this past

tradition, it is probably desirable that the tax systems employed during transition should involve the minimum possible ambiguity, so as to ensure that little scope is left for administrative discretion and negotiation to continue. Thus, over and above the arguments in Section 3.1 for avoiding valuation-based tax systems, these are probably amongst the most exposed to administrative flexibility, and should also be avoided for this reason.

3.3 Positive opportunities.

Whilst there are difficulties in operating a tax system in a transition economy which do not arise in existing market economies, there are also certain opportunities which are available to transition economies, which are in some respects unavailable in more established market economies. Initially, decisions regarding taxation begin - at least partly - with a clean sheet (albeit subject to constraints imposed by the expectations and past experiences of both tax administrators and subjects). Decisions regarding the tax treatment of assets can initially be made freely, without imposing the major capital gains and losses to existing asset holders which are one of the consequences of reforms to taxation affecting asset values in established economies. This freedom to make efficiency-improving changes without imposing arbitrary gains and losses on asset holders will diminish over time as private sector decisions adjust to the structure of taxation, and taxes are capitalised into asset values.

How far might tax policy towards entrepreneurial incomes in transition economies such as Poland be able to respond to this opportunity? Clearly, there are some potential gains from choosing, initially, a tax system which is expected to be durable in its broad structure. If initial policy can move immediately to the long run structure of taxation, then there will be reduced uncertainty about future taxation, and less need for subsequent reforms with arbitrary distributional effects. If, on the other hand, an explicitly transitional tax regime is chosen, there is a danger, either that the expected costs of later reform will deter efficient current behaviour, or that the reform will become permanent, as subsequent governments prove unwilling to accept the costly move from the transitional regime.

If it is possible to identify, therefore, an underlying "philosophy" to the intended long-run tax system which can be implemented at once, albeit subject in certain areas to ad hoc compromises to reflect particular difficulties during the transition, this may be expected to impose a lower long-run cost on the economy than choosing an initial tax system which will require costly reform later. This is of particular concern in the tax treatment of capital incomes and assets, both of which bear on the regime to be applied to small business and entrepreneurial incomes.

One way of approaching this issue is to identify the likely characteristics of the desirable long run capital tax system for Poland. Generally, this will involve the considerations relevant to such decisions in market economies more generally, such as the extent to which the efficiency arguments for an expenditure-tax-type system should be accepted, the degree of integration of corporate and individual income taxes, and the implications of increasing international capital mobility for the sustainability of any taxation at all on capital income. In addition, given Poland's declared intention of ultimately joining the European Union, it will be appropriate to select solutions - where a range of options exist - which are compatible with those adopted elsewhere in the EU.

The difficulty of this line of approach is that it provides relatively few practical guidelines. Certainly, a trend can be identified towards a reduced tax burden on individual incomes from capital. This may partly reflect the growing internationalisation of the capital market, but also probably reflects changing political preferences in many economies, and the role of the market pressures in leading to this outcome can perhaps be overstated. Beyond this, there is little observable international convergence regarding the basic philosophy of capital taxation in market economies. Foreseeing what the likely tax requirements for EU accession would be in 2000 or beyond is thus difficult, and subject to a large margin of error.

A better approach may be to try to design the tax system in a way which retains as much scope to accommodate future change as possible. Whilst the long-term European (or global) structure of taxes on capital is unclear, it may be reasonable to suppose both that it will continue to leave considerable scope for tax competition between countries (which, for political reasons, if not for efficiency reasons, may point in the direction of lower taxation on more "exposed" assets), and that it will involve relatively limited discrimination in the treatment of different assets and asset types (partly because major tax discrimination will be undermined by mobility, but also because both national and

international policy is likely to be based on some broad principles of neutrality). This, in practice, may well avoid the greatest pitfalls of badly-designed "transition" tax policy, since the unwinding of tax privileges given to specific sectors or assets (eg housing in the UK) is likely to prove one of the most difficult and costly obstacles to efficient long-run adjustment.

3.4 Transition compromises

In the shorter term, administrative constraints are likely to impose severe limits on the ability of transition economies to operate tax systems with the degree of complexity of those employed in the west. Some compromise of efficiency in the interests of administrative practicality is necessary if legislated taxes are to be collected, and the enforcement of the tax system is clearly desirable if long-run tax compliance is not to be undermined by a general acceptance of evasion. Short-term pursuit of the "ideal" system may be not only unrealistic, but from a longer run perspective, positively damaging.

The general principles for targeting limited resources are perhaps obvious - to concentrate on those revenue sources which can yield large amounts of revenue at low administrative cost per dollar raised. What should then follow is that other sources should either be exempted from tax, or should be made subject to special transition taxes which raise revenue without excessive administrative requirements.

In practical terms, it would seem appropriate to make the maximum possible use of VAT exemption, both through exempting sectors of economic activity which contribute low revenues per dollar of administrative input (the food sector would seem an obvious candidate), and through continued use of a high VAT registration threshold.

It would also seem appropriate to make the maximum possible use of presumptive and lump-sum taxes, set broadly in line with the average tax burdens that the activities covered would incur if taxed "properly". Such taxes are in general relatively easy to collect and enforce, and so long as they are not too far out of line with the provisions of the main tax system, may not severely distort competition between enterprises and activities subject to the presumptive tax, and those taxed under the main system. There will of course be some distortion; particular enterprises may find that they benefit, or lose, from the presumptive tax compared to the main system, and may therefore choose

to arrange their affairs so that they remain taxed under the more favourable regime. There is also likely to be some economic damage from heavy lump-sum taxes, which may push weak enterprises into bankruptcy more rapidly than would be desirable.

Nevertheless, taxes raising little revenue should not simply be discarded, without regard to the potential implications for other parts of the system. For example, capital gains taxes can play a beneficial role in maintaining the integrity of taxes on capital incomes, even if they, themselves, raise little revenue.

4. Tax policy in Poland, and the treatment of entrepreneurial activity.

4.1 Taxation of small and medium-sized enterprises in Poland after 1990

At the outset of the economic transformation programme, different taxation regimes applied to the private sector and to the state-owned sector. Turnover tax rates were set differently for the two sectors. The excess wage tax which was levied on enterprises in the state sector did not apply to private firms. Private firms were, however, subject to other taxes, not levied on firms in the state sector. Incorporated firms were subject to a Corporate Income Tax (CIT), levied at a rate of 40 per cent. Unincorporated microenterprises (with less than five employees) were subject to a "lump sum tax", at a level which depended on the type of activity, the number of employees, and the size of the town or city in which they were located.

As part of the economic transformation programme three major changes were introduced into the Polish tax system. Personal Income Tax (PIT) was introduced in January 1992, a new law on Corporate Income Tax was passed in 1992, and the Value Added Tax was introduced in July 1993.

Besides these changes to the general system of taxation, two other tax policy measures introduced by the Ministry of Finance have had a major impact on the fiscal treatment of small and medium-sized enterprises in Poland. In May 1990 the Balcerowicz government granted tax holidays for newly-established firms in the "trade" sector (mainly retail and wholesale trade and catering). In January 1994, as part of a modification of the personal income tax law, a new "revenue lump sum tax" was introduced, to apply to small businesses.

4.1.1 Tax holidays for trade firms

Conditions for the establishment and operation of small firms were liberalised from 1989, when the Law on Economic Activity was introduced. In May 1990 the Ministry of Finance granted tax holidays for unincorporated businesses. Firms in the "trade" sector were entitled to a 3-year exemption from income and turnover taxes, and a 2-year tax holiday applied to some services. This regulation applied only to firms established between May 1990 and the end of December 1990.

The tax holidays granted to private firms in the "trade" sector had the effect that most of the private sector was, in practice, exempted from taxation, since it created scope for relatively straightforward routes to tax avoidance. So-called "transactional prices" were used by non-trade firms (for example, firms in manufacturing) dealing with tax-exempt trade firms, to shift profits to the tax-exempt firm; the exaggerated profit recorded by the tax-exempt trade firm was then shared under-the-table with the non-exempt firm.

The number of unincorporated trade firms increased more than fivefold during the course of 1990, from 71,800 in December 1989 to 368,800 in December 1990. It seems probable that at least part of this rapid growth can be attributed to the decision to grant tax holidays to unincorporated trade firms. Certainly, it is generally believed that many new entrepreneurs were attracted by this regulation. However, although these tax holidays may have increased the number of small firms, they may at the same time have had a significant cost, in that they may have encouraged the development of informal economic relationships among firms, in order to take advantage of the opportunities for evasion which were presented by the differences in the tax treatment of firms in different sectors.

4.1.2 Personal Income Tax and Corporate Income Tax

The legislation governing the new Personal Income Tax (PIT) was passed in 1991, and the tax was introduced in January 1992. The personal income tax applies to personal incomes, including incomes from unincorporated business (except in agriculture which is exempted from the personal income tax). The marginal rates of the personal income tax were set at 20 per cent, 30 per cent, and 40 per cent for successive bands of income[10]. Taxable income was calculated as revenue minus costs, so there were incentives both to under-declare revenues and to inflate the costs of running a business,

for example by recording personal consumption expenditures as business costs. Surveys, such as that by Grabowski and Kulawczuk (1992), have shown that there was relatively little discontent amongst businessmen about the personal income tax, which suggests that they may have found it comparatively straightforward to find ways of manipulating the tax in order to reduce their tax liability.

The 1992 Act which sets out the Corporate Income Tax follows certain features of the previous regulation from 1988. As far as the small and medium enterprise sector is concerned, it is probably the least controversial tax in the present Polish tax system, despite the fact that its flat rate of 40 per cent is not low. It allows losses to be carried forward for three years, and accelerated depreciation. However, the Polish income tax system does not provide a deduction in the personal income tax for distributed corporate profits. This double taxation almost certainly discourages the development of small-scale incorporated firms.

4.1.3 Value Added Tax

The Polish VAT was introduced in July 1993, and is claimed to be a big success. Due to careful preparation work, the impact of the introduction of VAT on inflation was limited, and spread over time. Some turnover tax rates were increased to a higher level before VAT was introduced, thus avoiding a large, and perceptible, jump in prices as the time that VAT was introduced, and this strategy appears to have been successful in reducing the inflationary effect of VAT. There are three VAT rates, of zero, 7% and 22%. Several goods are exempt from VAT, including milk, meat, eggs, fish and domestic fruits.

The VAT has been introduced with a high turnover threshold for VAT registration, in order to limit the burden of administration; enterprises are required to register for VAT only if their annual turnover exceeds 1.2 bln zł, or about US \$50,000. In comparison, VAT registration is required from a considerably smaller turnover in most European Union countries. The registration limit in 1992 in France was the equivalent of \$12,200, in Germany \$15,900, and in Denmark only US \$1,500; in Italy all businesses, regardless of size, are subject to VAT (OECD, 1994). Whilst the registration threshold in the United Kingdom, the equivalent of \$66,300, was higher than in Poland, the maximum size of enterprise covered by the Polish concession was considerably greater than in the UK, given the very much higher wage rates in the UK than in Poland.

The high turnover requirement for registration has meant that about three quarters of small businesses in Poland are not registered for VAT. Detailed data on the number of VAT taxpayers in Poland and their structure are not available. However it can be estimated that there are about 460,000 private firms in the VAT system, some 25 per cent of the total number of private firms.

With effect from the start of 1995, the limit for VAT has been reduced by 50 per cent in real terms; this is likely to have the effect of doubling the number of firms within the VAT system, to a total of about 900,000 firms. This strategy, of introducing VAT with a high initial VAT registration threshold, and then decreasing the threshold over time, is in principle consistent with the severe administrative constraints in introducing VAT. It should keep the initial administrative burden of VAT within reasonable bounds, but, at the same time, avoid businesses becoming accustomed to VAT evasion. Initial enforcement resources can be concentrated on the largest firms, from which the bulk of VAT revenues would in any case be derived, whilst spending little time in the administration of the VAT system for smaller firms. The revenue foregone by not taxing smaller firms may be limited; whilst their output is not directly taxed, it may bear a certain effective VAT burden, since unregistered firms also forego the opportunity to reclaim the VAT paid on their purchased inputs. Questions arise however, about the appropriate pace at which the VAT registration amongst small firms should be extended. The decision to reduce the real threshold by 50 per cent after only a year of experience assumes that the learning process in the operation of VAT is very rapid.

Extending the coverage of VAT to include more small and medium sized firms will impose significant compliance costs on the firms concerned, as well as costs of administration on the fiscal authorities. Evidence on VAT compliance costs, discussed in OECD (1994), suggests that small firms experience higher compliance costs, in relation to turnover, than large firms. In the UK, firms with an annual turnover of between \$30,000 and \$75,000 (ie just above the VAT registration threshold) bear VAT compliance costs of the order of 0.8 per cent of turnover, compared to less than 0.05 per cent for firms with a turnover of \$1.5-15 millions. In Germany, VAT compliance costs are about 8% of turnover for firms with a turnover below \$20,000, compared to less than 1% of turnover for firms with a turnover of \$3 million or more (OECD, 1994, page 107; see also Cnossen, 1994).

4.1.4 Revenue lump sum tax

The limitations of the tax administration in dealing with a very high number of small taxpayers have also led to changes, enacted in December 1993, to the treatment of incomes earned in small businesses under the personal income tax. In order to reduce incentives to declare exaggerated levels of business costs, the "revenue lump sum tax" was introduced in January 1994. Its main goal was to levy a simple and moderate tax on small businesses, with low compliance costs to business, and relatively straightforward administration and enforcement. An entrepreneur with annual turnover below 1.2 bln zloty is liable to revenue lump sum tax, in place of the personal income tax (described above).

[TABLE 4.1 NEAR HERE]

Reflecting the objective of simplicity, the tax is levied as a flat percentage rate on turnover, although the rates levied vary according to the business sector. Firms in the retail trade pay revenue lump sum tax at a rate of 2.5% of turnover, whilst firms in manufacturing and construction pay 5%, and firms in the service sector pay 7.5%. Some services, including accounting and audit services, are excluded from the requirement to pay the revenue lump sum tax.

Unlike the taxes paid on income by larger businesses, the revenue lump sum tax takes no account of business costs in computing tax liability; the tax is levied on gross sales (turnover) rather than net income. However, the sectoral differentiation of the tax rate may be seen as a rough-and-ready reflection of the average cost structure of firms in particular sectors.

Table 4.1 shows the changes in the number of taxpayers subject to different taxes, and the average level of tax paid by different categories of taxpayer, following introduction of the revenue lump sum tax. At the end of 1993, just prior to introduction of the revenue lump sum tax, about 1.4 million businesses were subject to the personal income tax, paying on average 1.1 million zlotys per month in tax in 1993. Total revenue in 1993 from the personal income tax levied on entrepreneurs was some 19,700 billion zlotys

(Table 4.2). Following introduction of the revenue lump sum tax, the number of small businesses subject to the personal income tax fell by two-thirds, whilst the average personal income tax payment of those still subject to the personal income tax rose to some 4.7 million zlotys per month, a rise in real terms (after allowing for 30 per cent inflation) of some 300 per cent compared to the average payment a year earlier. The reform has thus successfully concentrated the administrative resources on larger taxpayers, accounting for the bulk of the personal income tax revenue; after allowing for 30 per cent inflation, the total revenue from personal income tax on small businesses in 1994 was in fact largely unchanged compared to the previous year. At the same time, significant additional revenues were derived from the new revenue lump sum tax applied to businesses with turnover below 1.2 billion zlotys. About one million businesses paid the new tax, with an average monthly tax payment of around 550 million zlotys, yielding a total revenue of 6,800 billion zlotys, equivalent to one quarter of the total yield from personal income tax paid by businesses.

Overall, tax revenues from small businesses subject to either of the two taxes are estimated to have risen between 1993 and 1994 by some 28 per cent, after allowing for inflation. Whilst the available data do not allow us to identify what proportion of the additional yield has been due to the larger payments obtained from taxpayers now subject to the revenue lump sum tax, and what proportion reflects an increase in incomes, and hence taxable profits, of businesses paying still personal income tax, the indications are that the reform has successfully targeted enforcement resources on the largest taxpayers, whilst also obtaining significant revenues through the administratively-uncomplicated lump sum tax.

[TABLE 4.2 NEAR HERE]

However, anecdotal evidence suggests that many businesses subject to the revenue lump sum tax have concealed part of their revenue, through collusive - and mutually-profitable - action between seller and buyer. This evasion not only reduces the level of tax revenues, but also prevents the evolution of larger firms and a more

concentrated business structure. Since collusive evasion of this sort requires tight control information flows in the business, entrepreneurs do not willingly delegate their jobs, and the growth of microenterprises into larger firms is thus inhibited.

5. Conclusions and policy implications.

The number of small businesses has grown rapidly in the past four years in Poland, with particularly rapid growth in the numbers of private restaurants and retail outlets; the number of small firms in manufacturing and construction grew much more slowly. However, it is unlikely that the current dimensions of this sector will prove a guide to its long-term significance in the economy; considerable further business restructuring is to be anticipated during the transition process.

Although very uneven, the level and pattern of small business activity in Western Europe may provide some guide to the direction of future trends in Poland and may therefore indicate the numbers likely to be involved, and the significance of the taxation of entrepreneurial activity for the economy as a whole. The small and medium-sized enterprise sector in Poland is still underdeveloped in European standards. Also, limited comparisons with other Central and East European countries suggest that both Hungary and former Czecho-Slovakia have a more balanced structure of private enterprise than Poland has. In particular, whilst microenterprises in the retail sector in Poland have developed at a high rate, the growth of medium-sized firms is still very weak.

Tax reforms for entrepreneurial income in Poland have affected the pace and pattern of growth of small business. The most important point is that tax holidays granted in 1990 for unincorporated firms in the retail sector were a major factor in the development of private retail trade firms, and in the structure of this sector. Different trade characteristics before the start of economic transition amongst the Central and East European countries do not explain why Polish trade firms are so numerous and smaller, than in other Central and East European countries.

The paper has set out the series of issues involved in taxing entrepreneurial incomes - many are common to policy both in western Europe and in transition economies, although transition involves both new difficulties and new opportunities. The most severe transition difficulties concern the lack of good valuation evidence from market transactions (which suggests that floorspace taxes and other non-value measures

should be preferred to real estate taxes, for example), and the shortage of administrative resources (which implies that resources should be concentrated on large revenue sources, leaving smaller firms subject to simply-administered presumptive and lump-sum taxes). In this respect the Polish authorities' introduction of the "revenue lump sum tax" appears to be beneficial measure in the context of transition.

Policy should also take account of longer-run objectives and constraints. The opportunity exists to make decisions now regarding the long run structure of taxes on capital incomes and assets without the major adjustment costs that such decisions will involve later, once the private sector, has adjusted to the existing tax regime. International competitive pressures (and the objective of EC entry) may dictate Poland's long-run tax system, but the form this will take is perhaps unclear. The most useful contribution to long-term efficiency in taxation which can currently be made is to avoid excessive discrimination in taxation between sectors or classes of activity. These tax privileges in west European economies have proved amongst the most durable features of the tax system, and similar tax privileges in Poland could later prove costly to reform.

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Table 1.1**The development of the non-agricultural private sector in Poland, 1989-1993.***thousands*

| | 1989 | 1990 | 1991 | 1992 | 1993 |
|-----------------------------|------------|------------|------------|---------|---------|
| Total private sector | | | | | |
| number of firms | 857.4 | 1,201.9 | 1,473.3 | 1,717.8 | 1,888.6 |
| employment | 3,360.7(*) | 3,738.1(*) | 4,161.9(*) | 4,675.3 | 4,977.0 |
| Trade | | | | | |
| number of firms | 77.8 | 382.3 | 609.6 | 654.5 | 795.0 |
| employment | 938.6(*) | 1,198.8 | 1,493.4 | 1,466.7 | 1,915.6 |
| Manufacturing | | | | | |
| number of firms | 291.2 | 346.1 | 363.6 | 364.7 | 363.3 |
| employment | 1,221.0(*) | 1,374.0 | 1,440.6 | 1,577.7 | 1,538.4 |
| Construction | | | | | |
| number of firms | 146.7(*) | 172.4 | 182.3 | 200.6 | 209.5 |
| employment | 414.4(*) | 459.8 | 628.3 | 775.3 | 638.1 |

Source:

- (1) Rocznik Statystyczny 1992, GUS Warszawa 1993, pp. XIV, XXII, XXIII, LI.
(1) Rocznik Statystyczny 1991, GUS Warszawa 1992, pp. XIV, XV, XX i XXI.
(2) Rocznik Statystyczny 1990, GUS Warszawa 1991, pp. 93, 96, 274, 312, 314, 290, 418, 419.
(4) Maly Rocznik Statystyczny 1994, GUS Warszawa 1994, pp 312, 313 and own calculations.
(5) Praca 1990, GUS Warszawa 1991, pp. 23, 31, 42, 48, 49, 54 and own calculations.

Remarks:

- (1) Private sector jointly with cooperative sector. The state statistical system included the latter in figures for the public sector until 1991, and thereafter in the private sector. There were 16,691 cooperatives in 1989, employing 1.85 million people; in 1990 there were 18,575 cooperative firms employing 1.73 million. At the end of 1993 there were 19,746 cooperatives, but their employment was not published.
(2) 296.000 persons worked in privatized enterprises by the end of 1993.
(3) Except where otherwise indicated, figures relate to December in each year.
(*) Average in the year

Table 1.2

Development of non-agriculture microenterprises in Poland in 1990-1993

thousands

| | 1990 | 1991 | 1992 | 1993 |
|----------------------|-------|---------|---------|---------|
| Total | | | | |
| number of firms | 636.4 | 882.1 | 1,131.6 | 1,382.0 |
| employment | 898.6 | 1,538.1 | 2,011.2 | 2,427.1 |
| Trade(**) | | | | |
| number of firms | 77.6 | 209.9 | 327.2 | 656.8 |
| employment | 115.7 | 445.3 | 639.0 | 1,335.2 |
| Manufacturing | | | | |
| number of firms | 260.4 | 314.8 | 321.4 | 265.1 |
| employment | 436.0 | 608.8 | 574.0 | 477.4 |
| Construction | | | | |
| number of firms | 134.9 | 159.1 | 173.7 | 157.5 |
| employment | 189.5 | 255.8 | 281.7 | 227.7 |

Source:

(1) Podstawowe dane statystyczne o dzialalnosci gospodarczej jednostek malych o liczbie pracujacych do 5 osob, GUS Warszawa 1994, p. 18 (Main statistical data on economic activity of small entities employing up to 5 persons)

Notes:

(*) Data are not fully comparable due to different definitions of microenterprises in different years. Microenterprises are defined throughout as firms with no more than five employees; however, in 1992 and 1993 the owner of the enterprise was counted as one of the employees, but not in the earlier years. The number of microenterprises recorded in 1990 and 1991 would have been lower if the criteria used in 1992 and 1993 had been applied. This implies that growth in the number of microenterprises is higher than the table suggests. Note, however, an offsetting effect for the trade sector in note (**).

(**) Trade data includes travelling salesmen in 1993 only.

Table 1.3

Employment in microenterprises(*) in the European Union and Poland as percentage of total employment, totals and sectoral breakdown.

| | EU (1988) | Poland (1990) | Poland (1993) |
|---------------|-----------|---------------|---------------|
| Total | 30 | 8(**) | 22(**) |
| Trade | 45 | 7.9 | 65.2 |
| Manufacturing | 14 | 9,9 | 13,2 |
| Construction | 44 | 17,4 | 27.0 |

Sources:

EU data: The European Observatory for SMEs, First Annual Report 1993, ENSR 1993, page 64. Poland: sources as in Table 1.2 and own calculations.

Notes:

(*) Data for Poland covers enterprises employing no more than 5 persons, and for EU enterprises employing less than 10 persons.

(**) Share of employment of microenterprises to total employment in non-agricultural sectors in Poland. Total employment in non-agricultural sectors in 1990 was 11.6 million and 10.9 million in 1993.

Table 1.4

Employment in the small and medium-sized enterprise[11] sector in the European Union and Poland

| | European Union | EU countries | | Poland | |
|---------------|----------------|--------------|-----------|--------|-------|
| | | poor(*) | large(**) | 1989 | 1992 |
| Trade | 86% | 96% | 84% | n.a. | n.a. |
| Manufacturing | 63% | 84% | 58% | 34% | 47,7% |
| Construction | 91% | 94% | 89% | 47,7% | 70,7% |

Source:

EU data: The European Observatory for SMEs, First annual Report 1993, page 64. Poland: Sources as in Table 1.1, and own calculations.

Notes:

(*) Portugal, Spain, Greece, Ireland.

(**) France, Germany, Italy, UK.

(n.a.) not available.

Table 1.5

Numbers of incorporated and unincorporated private firms in Poland, Hungary and Czechoslovakia, 1989-92.

thousands

| | Poland | Hungary | Czechoslovakia |
|----------------|--------|---------|----------------|
| 1989 | | | |
| incorporated | 11.7 | 4.5 | 0.2 |
| unincorporated | 813 | 186.3 | 86.8 |
| 1990 | | | |
| incorporated | 29.6 | 18.3 | 12.2 |
| unincorporated | 1,135 | 234.0 | 468.4 |
| 1991 | | | |
| incorporated | 45.1 | 41.2 | 39.0 |
| unincorporated | 1,420 | 300.0 | 1,175 |
| 1992 | | | |
| incorporated | 51.2 | 57.3 | 43.5 |
| unincorporated | 1,523 | n.a. | 1,262 |

Sources:

- (1) Webster, L. (1992b): Private Sector Manufacturing in Hungary: A survey of Firms, The World Bank.
- (2) Webster, L. (1992c): Private Sector Manufacturing in Poland: A survey of Firms, The World Bank.
- (3) Webster, L. (1992a): Private Sector Manufacturing in the Czech and Slovak Federal Republic: A survey of Firms, The World Bank.
- (4) Grabowski, M., Kulawczuk, P. (1992): Small and Medium-sized Enterprises in Poland - Analysis and Policy Recommendations, The Gdansk Institute For Market Economics.
- (5) Statisztikai havi Kozlemenyek - Dec 1992, Budapest 1993.
- (6) Biuletyn statystyczny 11/1992, GUS Warszawa 1992.
- (7) Short-term economic statistics Central and Eastern Europe OECD, Paris 1992.

Notes:

(1) Incorporated Firms defined as Limited Liability Companies and Joint Stock Companies, including privatized companies.

(2) Unincorporated Firms defined as sole proprietors and partnerships.

(3) Data on incorporated firms for Hungary refer only to limited liability companies. However, most limited liability companies are privately-owned, and most of joint stock companies are state-owned. In Hungary there are about 35 times more limited liability companies than joint stock companies.

(4) For Czechoslovakia, data includes state-owned incorporated firms. According to Webster (1992a page 13) about two-thirds of all incorporated firms are privately owned in Czechoslovakia, so the probable number of private incorporated firms in September, 1992 is some 33,000.

Table 2.1

Compulsory social security contributions as a percentage of pre-tax incomes of self-employed and employees compared, for income level of the average production worker.

| | Contribution of self-employed | Wage employment: employee contribution | Wage employment: employer contribution |
|-------------|-------------------------------|--|--|
| France | 41.5 | 18.0 | 38.0 |
| Germany | - | 17.8 | 17.8 |
| Italy | - | 8.5 | 50.1 |
| Netherlands | 17.3 | 29.1 | 11.5 |
| Spain | - | 6.0 | 30.3 |
| Sweden | 20.5 | - | 32.2 |
| UK | 5.5 | 7.7 | 10.4 |

Source: Employment Outlook, 1992, Paris: OECD

Table 2.2

Average income tax compliance cost for self-employed (Schedule D) taxpayers in the UK, 1983-4

| Income band | Mean compliance cost | Mean compliance cost as percentage of income |
|-------------------|----------------------|--|
| under £7,500 | £274 | 6.8% |
| £7,500 - £15,000 | £411 | 3.9% |
| £15,000 - £30,000 | £618 | 2.9% |
| £30,000 - £50,000 | £513 | 1.5% |
| over £50,000 | £1397 | 1.7% |

Source: OECD (1994), page 14.

Table 4.1

Entrepreneurs according to taxes (all numbers in 1000)

| | Number as in Dec. 1993 | Number as in April 1994 | Average monthly tax in 1993 | Average monthly tax in 1994 | Average tax increase 1994/1993 (&) |
|----------------------------|------------------------------|-------------------------------|-----------------------------------|-----------------------------------|---|
| Total | 1.854 | 1.871 | 1.004 | 1.569 | 156% |
| Lump sum tax(*) | 386 | 349 | 565 | 615 | 109% |
| Revenue lump sum tax(@) | did not apply | 1.043 | - | 545 | - |
| PIT on business(#) | 1.436 | 460 | 1.141 | 4.662 | 409% |

Source: Rzeczpospolita, July 2-3, 1994 according to Ministry of Finance

Notes:

(*) The "lump-sum tax" is paid by craftsmen, employing no more than 4 employees, operating in certain sectors. The tax due depends on the number of employees, size of city and profession, and is modified each year.

(@) The "revenue lump-sum tax" is levied on businesses with annual turnover less than 1.2 billion zloty (around US \$50,000).

(#) PIT (personal income tax) on business activity is levied on unincorporated firms with an annual turnover in excess of 1.2 billion zloty.

(&) The inflation rate for 1994 is estimated at 30%.

Table 4.2

Fiscal revenue from entrepreneurial income in 1993, and estimated revenues in 1994 (in billion of zloty)

| | Tax revenue in 1993 | Estimated tax revenue in 1994 | Percentage increase in tax revenue |
|----------------------|---------------------|-------------------------------|------------------------------------|
| Total | 22.337 | 35.201 | 158%(*) |
| Lump sum tax | 2.617 | 2.577 | 98%(*) |
| Revenue lump sum tax | did not apply | 6.817 | - |
| PIT on business | 19.668 | 25.749 | 1319%(*) |

Source: as in table 4.1

Notes:

(*) The inflation rate for 1994 is estimated at 30%

See also notes to table 4.1.

Endnotes

1. See, for example, Piore and Sabel (1984), Sengenberger, Loveman and Piore (1990), OECD (1989).
2. See *The European Observatory for SMEs*, First Annual Report 1993, ENSR 1993, pages 51-77.
3. See *Enterprises in Europe - Second Report*, EUROSTAT and EC Directorate General XXIII, 1992.
4. It is worth noting that the minimum capital required for a limited liability company was 100.000 KCS or approximately US \$3.900 in Czechoslovakia, 1.000.000 HUF or approximately US \$12.000 in Hungary and 40.000.000 PLZ or approximately US \$ 2.600 in Poland. This suggests that unincorporated Polish firms are smaller.
5. Compare Webster (1992a, 1992b, 1992c), Grabowski and Kulawczuk (1992).
6. As far as income taxation is concerned; in some tax systems, of course, there may still be tax reasons to channel labour incomes to the proprietor in a form other than direct income payments - for example as capital gains, if these are taxed at lower rates than income.
7. An expenditure tax has the further advantage of applying a consistent "cash flow" treatment to business incomes, which ensures greater neutrality between the tax treatment of capital gains and income. The difficult issue of whether "realised" or "unrealised" capital gains should be subject to taxation is sidestepped by making the test the timing of consumption. If unrealised capital gains lead to higher current consumption, they are taxed, but not if consumption remains unchanged.
8. The borderline is based on the legal distinction between a "contract of service" (the terms on which an employee is engaged) and a "contract for services" (the basis on which a self-employed individual supplies services to the purchaser of these services).
9. This may at least partly be an issue of equity or perceived fairness, rather than efficiency. Given the need to raise tax revenues, small businesses impose a cost on society, in terms of the high level of public resources devoted to collecting comparatively-small amounts of revenue. Efficiency considerations on their own might suggest that if there were fewer small businesses, the costs of tax collection and enforcement would be much reduced.
10. The rates have been increased in 1994 to 21, 33 and 45 per cent.
11. small and medium-sized enterprise is non-agriculture firm, which employs less than 500 persons.