

Tax optimization in context of activity in the shadow economy

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Abstract

In this article, the author focuses on the tax optimization, which seeks to choose an entrepreneur's activity already on the verge of legality and illegality, i.e. in the shadow economy. The aim of the article is to try to determine the boundary between the legal and illegal pursuit of taxpayers to minimize tax burdens, as well as the impact of taxation on the development of the informal economy, including the process of globalization and tax competition. The conclusion is that although there are no clear and universal determinants affecting the existence and growth of the shadow economy, there are some dependencies, according to which the likelihood of shadow economy development is higher in countries with higher tax burdens. Certainly, the issue of defining the limits of taxation, and more importantly determining such limits, which do not cause negative implications in the sphere of the economy, is necessary, but unfortunately difficult to implement. It is very important to create an optimal tax system, limiting the possibility of escaping taxes or illegal tax evasion by moving to the shadow economy.

Keywords: tax policy, tax optimalization, shadow economy

JEL Classifications: H26, H32

1. Introduction

Conducting a business activity requires from the entrepreneurs, among others, the knowledge of tax law. Each tax system allows in many cases a certain freedom of shaping tax burdens by business owners. This is related to the choice of organizational and legal form, and thus the form of taxation. Undoubtedly, every rational entrepreneur will strive for optimization, and more accurately speaking, minimizing tax burdens, and thus for choosing such a method of taxing his business activity, which will be the most beneficial for him in the economic and organizational dimension. However, some entrepreneurs may, in the course of this optimization process, overcome a certain barrier, after which one can already talk about aggressive tax optimization, tax evasion and acting in the shadow economy, and even about tax fraud. Of course, the taxpayer has the right to optimization (e.g. cost) of his tax obligations, but the problem is to set the limits of these admissible activities, from those activities that we can identify as tax optimization result of abuse or circumvention of tax law.

It is natural that every corporation that has branches in many countries and bears other taxes in each of them, is tempted to show profits where the tax burden is the lowest. This is one of the methods of optimizing income taxation (tax planning). Such a procedure consists in finding the best solution (in relation to the established criterion), but from a set of permissible solutions, i.e. compliant with applicable law.

In other words, the optimization in question is the choice of such form and structure of the planned transaction, so as to pay the lowest possible public tax within the applicable tax law. However, other activities that are offenses, and thus go beyond the scope permitted by law, will be referred to as tax evasion, extortion, or even tax fraud, for which criminal and fiscal responsibility is legally contemplated. It is worth paying attention to a quite common case of tax optimization, when a powerful corporation operating in one country for many years without profits, is thriving on other markets.

However, it should be emphasized that the optimization of tax burdens is also made between entities related by capital or entities with their registered office in only one country. Therefore, the phenomenon discussed here has both a national and an international dimension. According to estimates, 40–60% of the global trade turnover takes place within multinational enterprises (Sojak, Baćkowski, 2003, p. 10).

Aggressive tax optimization is a problem for both the taxpayer and the state. It is also a matter of harmful tax competition in the international dimension, where entities using such optimization operate cross-border, both within the EU and outside it. Due to the fact that even in the EU there is no single tax policy, some of the countries conduct a fairly liberal policy in this area, which does not discourage taxpayers in tax avoidance.

The issues of tax avoidance and development of the informal economy, known as the colloquial shadow economy, are among the more important topics related to the implementation of fiscal policy. The shadow economy is located on the border of law and economics. Its size and the effects it has on the fiscal policy of the state are typical economic problems. In turn, the legal aspect of the shadow economy constitute, for example, legal regulations that stimulate or discourage activities in the informal economy. Undoubtedly, too little knowledge about it adversely affects the economic policy of the state. It is worth noting that the shadow economy is an inseparable element of the contemporary market economy, and its effects are felt in all areas of life, both economic and social. The existence of an informal zone causes distortions in the economy and requires a great deal of flexibility in the country's business operations.

Both public authorities and researchers strive to limit the scope of this phenomenon by creating a proper definition, measuring and detecting the reasons for its creation. Tax determinants contribute to the understatement by enterprises of pre-tax in-

come in order to reduce the amount of taxes paid (tax optimization). From the point of view of international economic organisms, the most advantageous option would be to accumulate all profits in an enterprise which headquarters are in a country with the most liberal tax system, so that due public taxes would be incurred to the smallest possible extent.

Economic entities operating in the “shadow economy” violate the rules of fair market competition, and their expansion is a serious challenge for the official sector (both its public and private segments). Informal economic activity also has some positive effects on the economy as well as consumers and households, including it is a kind of economic buffer that absorbs shocks and crisis phenomena in the official sector (e.g. through the offer of employment for the unemployed).

In the overall balance, however, the negative implications prevail, both in the macroeconomic dimension (smaller budget revenues), as well as microeconomic (losses of specific enterprises) and social (erosion of business ethics, moral norms, etc.). The occurrence and development of various forms of unregistered economic activity is therefore a major development challenge for many countries and requires undertaking various activities, including in the sphere of economic policy.

This study addresses the basic issues related to the problem of tax optimization in its legal dimension and the one that is against the law to evade taxes and act in the shadow economy.

The aim of the article is to try to determine the boundary between the legal and illegal pursuit of taxpayers to minimize tax burdens, as well as the impact of taxation on the development of the informal economy, including the process of globalization and tax competition.

2. The essence of tax optimization

The tax is a compulsory tribute, without direct, mutual benefit, intended to cover public burdens. More specifically, tax is a non-returnable, gratuitous and compulsory obligation of a basic and general nature, established and levied by the state or other public-law associations (Bouvier, 2000, p. 24; Głuchowski, 2006, p. 11). The reduction of income by tax results in specific reactions from the taxpayer, e.g. in the form of a reduction in the size of economic activity, changes in its type, reduction in consumption or changes in its structure. The state can deliberately shape the tax structure so that these reactions are consistent with its intentions. It takes into account such aspects as: protection of a certain minimum income level, the taxpayer’s family situation, the structure of his expenses, sources of income, etc. (Litwińczuk, 2008, p. 16). In this way, the state introduces – instead of a direct method of interference in the process of management or investment – parametric-economic methods of impact

on taxpayers, which ultimately leads to a decision to change the direction and amount of expenditure towards the taxpayers themselves (Andel, Haller, 1980, p. 124).

From a fiscal point of view, the tax for the state is treated as a way of financing its public tasks, which results in reaching to the economic source and making the amount of tax dependent on the financial result achieved by the taxpayer (Poszwa, 2007, p. 24). Therefore, taxes paid by enterprises have a significant impact on their net profits, and thus on earnings per share and the amount of the dividend. The tax payment is connected with its negative impact on the company's cash flow statement and deterioration of its financial situation. For this reason, rationally-operating enterprises will aim to reduce tax burdens as part of legally available legal instruments, which is often referred to as tax avoidance as opposed to illegal tax evasion.

Optimization of tax burdens includes actions consisting in making decisions concerning all spheres of economic activity, which involve specific tax consequences and aiming at achieving the optimal amount and structure of taxes encumbered by a given entity. This optimization is a resultant of activities that include both tax optimization and optimization of the tax structure. For this reason, tax optimization as an economic category can be explained as tax planning aimed at creating optimal tax and tax-related structures and solutions relating to specific economic activities undertaken by taxpayers, e.g. operational or investment (Gruziel, 2009, pp. 175–186). Tax optimization assumes the choice of a solution that avoids paying taxes or makes them payable in the lowest possible amount, thus these are actions aimed at minimizing tax burdens by choosing legal acts and selecting tax policy instruments that ensure a reduction of total tax burdens, thus maximizing net profit.

The most important tax optimization instruments include:

- instruments of fundamental importance, i.e. the choice or change of the organizational and legal form or the relocation of activities to a country with a more benign tax regime;
- comprehensive instruments, i.e. a change in the tax year, the choice of the depreciation method, the method of tax loss settlement or the choice of payment method for tax advances;
- current tax optimization instruments, i.e. control of the occurrence of the moment of tax revenue and tax costs, introduction of fixed assets to the records, forms of establishing an employment relationship with employees or selection of the form of investment financing.

A legally operating company may show income earned elsewhere, with a favorable tax regime in place where the company is registered, which means that the income will not be taxed. According to the OECD rule, if the income does not go where the business substance is, it is tax avoidance. It should be noted that taxpayers often fear that the actions they have taken or take, guided by the interest of the company and fi-

nancial effectiveness, will not be questioned by the tax authorities. At this point, the question often arises whether if, on the occasion of certain actions dictated by business needs (e.g. the division of a company or its transformation), a positive tax effect is achieved, the tax office will be able to ignore it and take the consequences (including fiscal penalties). Tax optimization has two sides: on the one hand, it can be understood as a collection of positive taxpayer behaviors, which aims to pay taxes honestly, by honest work and operation of the company, i.e. as much as it should. On the other hand, it is aggressive tax optimization, which aims to the situation in which the only goal of the action is to save taxes, to avoid taxation, to transfer funds to places in the world where the tax burden is much lower or it does not exist at all, which is an abuse or activity from the borderline of a tax offense.

3. Reasons for the existence of an informal economy

Accepting without great reservations the view that the informal economy is part of the general concept of “economy”, and the norms of law as the criterion for classifying the relationship of economic activities, the following definition can be used: the informal economy is a part of the economy which activity is not reflected in official reporting and formal contracts, using the criterion of the legality of a business operation. Below is the distinction of its four forms, the first two of which belong to the illuminated segment, and the remaining ones – to the shaded segment, i.e. the shadow economy (Stankiewicz, 2009, pp. 202–204):

- legal unofficial economy – economic activity not included in the reports and contracts, but not violating the legal norms and rights of other business entities, as in the case of the process of processing in a household;
- out-of-law economy – there is no violation of the right of other entities, but unrevised operations are carried out;
- semi-legal economy – activity in line with legislation in the scope of objectives, but sometimes going beyond its framework, using illicit measures (so-called grey markets), such as tax evasion, use of barter, operation without buying a patent and license, or without formalization, e.g. cash withdrawals;
- non-legal, criminal economy – unlawful activity that violates the law; it occurs on the so-called black markets, prostitution, drug trafficking, weapons, blackmail and extortion.

Another classification is the classification of the informal economy according to two criteria: the nature of motivation and the scope of registration. Taking into account the motivations, two types of economic activity are distinguished: hidden economy – when the activity is deliberately hidden from statistical and tax authorities; missing economy – activities not included in the reports due to incomplete

observation, lack of awareness and non-culpable mistakes of business entities (Stankiewicz, 2009, pp. 202–204). However, due to the scope of registration, we can talk about the next two types of informal economy: recorded economy – although not registered in the reporting of entities, but included in the statistics due to special estimates; unrecorded economy – falling out both from the reports and from the final statistical summaries.

In the shady economy or in the shadow economy, there are four basic types of hidden activities that create structures similar to those found in the illuminated sphere. One can distinguish here: enterprises conducting regular, unregistered business or unlawful activity; economic operations deliberately concealed in contracts and reporting; rental of labor force without formal contracts; income hidden from the tax office. Sometimes a fictional economy is distinguished, which is associated with a reflection in statistical reporting and in the accounting of non-existent business activities, such as transfer of money for undelivered production (Stankiewicz, 2009, pp. 202–204).

A number of reasons should be taken into account to facilitate the continuation or growth of the informal economy. First, the scale and intensity of state interventionism in the economy (over-regulated economy) and high dynamics of changes in world and regional labor markets, as a consequence of scientific and technical revolution and changes in the economic power system (increase in the importance of large corporations) and geopolitical, which results in undisclosed workplaces, illegal small businesses or the so-called self-employment. Secondly, the recently observed, even avalanche migration from third world countries and areas covered by local wars. Thirdly, the trend observed abolishing customs boundaries, barriers in the trade in goods, facilitating the transfer of capital and people, and thus enhancing competitive struggle, also between countries for markets and investors. The following main reasons for the occurrence and development of the informal economy can be found in the literature:

- tax burden and level of social security contributions – distortions of the general tax burden affect the choice of place of work and economic activity, they can stimulate labor supply in the so-called shadow economy (or grey zone) (Johnson, Kaufmann, Zoido-Lobatón, 1998, pp. 387–392; Schneider, 2005, pp. 598–642; Dell’Anno, Gomez-Antonio, Alanon Pardo, 2007);
- institution’s quality and corruption – are the key factors for the development of the informal sector (Teobaldelli, 2011, pp. 269–289);
- regulations – legal provisions are an important factor limiting the freedom (choice) of private persons in the official economy, especially when they concern the labor market or business transactions (Johnson, Kaufmann, Shleifer, 1997);

- public sector services – legal provisions are an important factor limiting the freedom (choice) of private persons in the official economy, especially when they concern the labor market or business transactions (Feld, Schneider, 2016, pp. 112–117);
- tax morality – public sector efficiency also has an indirect impact on the size of the shadow economy, because it has an impact on tax morality (Feld, Frey, 2007, pp. 102–120);
- the deterrence effect – the threat (the amount of penalties) is not unequivocally and sufficiently examined as a factor affecting the level of the shadow economy in the economy (Pedersen, 2003);
- official economy development – is another key factor in the development of the shadow economy, namely the higher the level of unemployment/lower GDP growth, the greater motivation to work in the shadow economy, *ceteris paribus* (Williams, Schneider, 2016);
- self-employment – the higher the self-employment rate, the more activities can be carried out in the shadow economy, *ceteris paribus* (Feld, Schneider, 2010, pp. 109–149);
- size of the agricultural sector – the larger the agricultural sector, the more opportunities to work in the shadow economy, *ceteris paribus* (Hassan, Schneider, 2016, pp. 309–339).

Summing up, the size of the informal economy is the resultant of many factors which significance is related to the historical, social and economic conditions of a given country. The habit of staying in the shadow economy is the effect of shaping certain processes over several decades, where current trends are only an additional stimulus that strengthens or weakens the development of the unofficial economy.

4. The international context of tax evasion and tax optimization

Globalization of economic processes, increasing degree of freedom in trade and progressing economic integration of individual countries are factors conducive to the creation of various forms of cooperation of companies that lose their national character, becoming international economic unions with ever greater economic and technical potential. Also, changes in the economic law of many countries and a favorable political climate create an incentive to create such transnational forms of economic activity.

The basic goal of these supranational economic organisms is – like most forms of economic activity – to achieve maximum benefits by making full use of the opportunities offered by the globalization of socio-economic life. In terms of their activity,

these enterprises also strive to optimize tax burdens, avoid taxation, usually by manipulating prices in turnover between their companies which headquarters are located in countries with different legal and tax systems (the transfer pricing phenomenon). In most developed countries, there are mechanisms that allow for quite effective control and elimination of the transfer pricing phenomenon, ipso facto shifting revenues to protect the tax base in individual countries where economic profit was created (Szarpak, 2006, p. 20).

Limiting informal markets in the era of globalization – as evidenced by the experience of developed countries – is not a simple matter. In the conditions of globalization, it is necessary to shape the tax system so that it encourages investment, innovation and creation of new jobs. From the point of view of international economic organisms, the best way would be to accumulate all profits in an enterprise which headquarters are in the country with the most liberal tax system, so that the due public contributions would be incurred to the smallest possible extent. International tax avoidance has become a complex and multifaceted phenomenon. It is no longer limited to aggressive tax optimization, but is also related to harmful tax competition between countries.

The tax competition is a phenomenon based on the use of such tax policy instruments by public authorities, which are designed to increase the level of attractiveness of a given territory as a potential or current location for business operations. Tax competition must be seen as a manifestation of a specific fight for potential investors and capitals for the development of a given country. Mobile production factors move from countries with higher taxation to countries with lower taxation (relocation), unless the level of public goods supplied is high enough in a given country that it compensates for high tax burdens.

Various stimuli, present in the tax system, may imply the formation of often persistent habits, and thus strengthen certain behaviors, including negative ones. These behaviors will usually reflect the fiscal policy pursued towards entrepreneurs and the reaction to it. The issue of the impact of fiscal burdens on economic activity, and thus on tax receipts of the state budget, has been the subject of research and analysis, among others of A. Laffer, who formulated the relationship between the level of the tax rate and the amount of tax revenue to the budget (Laffer, Miles, 1982). In a broader sense, the relationship described by Laffer curve raises the problem of tax optimization in the macroeconomic scale.

According to this concept, tax optimization comes down to achieving maximum tax revenues with the lowest possible tax burden on the taxpayers, which would not be a barrier to dynamic development of entrepreneurship and economic growth (Kulawczuk, 2004, p. 29). On the other hand, with the constant increase of tax burdens, a serious threat to the stable development of the country may also be the trans-

fer (relocation) of economic activity to countries characterized by low taxes. Economic activity as a gainful activity is aimed at making profits, and any tax burden means a reduction of the taxpayer's existing or future capital resources. The taxpayer's proceedings can be reduced to, among others, legal optimization of the level of taxation by using the flexibility of the tax structure or by relocation to countries with more lenient tax regimes. Alternatively, entities for which the costs associated with the migration of activity are too large try to operate in the shadow economy, hiding, in whole or in part, the source of their income from business activities, which is as unfavorable for a given country as the process of relocation or *transfer pricing*.

5. Conclusions

Undoubtedly, the issue of defining the limits of taxation, and more importantly determining such limits, which do not cause negative implications in the sphere of the economy, is not a simple matter. It is also difficult to expect that in the near future, the theory of economics and public finances will develop the universal, within the framework of certain economic and social conditions of a given country, methods of determining such a taxation limit. It is very important to create an optimal tax system, limiting the possibility of escaping taxes or illegal tax evasion by moving to the shadow economy. Optimal tax measures, e.g. in terms of choosing a legal form or choosing an entity that makes intra-group financing, should still be acceptable, and therefore undisputed, unless taxpayers resort to artificiality and taxes are not one of the elements determining specific actions. Unfortunately, there are no sharp, defined boundaries, each situation will be different, and the practice is just beginning to shape.

Therefore, it is worth considering a kind of internal tax policy that will be a balanced policy: it would balance the interest of the state and take into account the taxpayer's interest in such a way as not to introduce solutions that will be unfavorable especially for small and medium-sized companies. The functioning of each state requires that its organs have adequate financial resources, mainly obtained from taxes, and the obligation to pay public levies is one of the basic duties of citizens. Tax optimization carried out in a legal way usually does not jeopardize the interests of the state budget, because it gives the taxpayer a guarantee of protection of his interests, gives him certainty of action, stability and an incentive to pay taxes in a given country and build social well-being, while harmful tax competition, aggressive optimization or activity in the shadow economy will certainly threaten these interests of the state. One of the basic factors influencing the development of the shadow economy is the unacceptable tax system.

Tax-competitive countries usually have a smaller scope of the informal economy and greater development opportunities to reduce the distance to more developed

countries. The globalization of economic processes, and thus the internationalization of economic activity, makes it very easy to transfer investments between countries and tax optimization within the country, which in turn implies taking the game between the countries to attract investors for themselves. The process of tax harmonization limits tax competition, and thus may reduce the degree of competitive advantage and investment attractiveness of individual countries. Countries with higher tax revenues due to lower taxation, a smaller scale of legal regulations and more simple regulations, as well as a lower level of corruption, usually have a lower level of the informal economy, and entrepreneurs operating on their territory tend to have lower propensity to optimize taxation because the cost of such activities are too big in relation to the benefits obtained from unpaid taxes.

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Optymalizacja podatkowa w kontekście działalności w szarej strefie

Celem artykułu jest próba określenia granicy między legalnym i nielegalnym dążeniem podatników do minimalizacji obciążeń podatkowych, jak również analiza wpływu opodatkowania na rozwój szarej strefy w aspekcie globalizacji i konkurencji podatkowej. Choć nie ma jasnych i uniwersalnych uwarunkowań wpływających na istnienie i rozwój szarej strefy, istnieją zależności, zgodnie z którymi prawdopodobieństwo jej rozwoju jest większe w krajach o wyższych obciążeniach podatkowych. Z pewnością konieczne jest określenie granic opodatkowania, a co ważniejsze – takiego ich poziomu, który nie powoduje negatywnych implikacji w sferze gospodarki, jednak jest to w praktyce niezwykle trudne. Bardzo ważne jest również stworzenie optymalnego systemu podatkowego, ograniczającego możliwość ucieczki od podatków lub nielegalnego uchylania się od opodatkowania poprzez przejście do szarej strefy.

Słowa kluczowe: polityka podatkowa, optymalizacja podatkowa, szara strefa

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