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**The Polish tax system – What has been achieved
thus far? What should be done in the future?**

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Abstract

The paper briefly discussed the main parts of the Polish tax system underlining its important bad points and problems. After almost 15 years after introduction of main taxes, PIT, CIT, VAT and Excise, there is a need for some kind summary in these fields. The huge scope of subject allows only for general deductions and recommendations, but seems to be a good starting points for further discussions. The paper begins with a brief analysis of public economics theory in the field of taxation. Next it describes historical changes in the Polish tax system and present public finance situation in Poland. It is impossible to put aside a size of public spending when realistic and significant tax changes are analysed. Afterwards, in theoretical and practical context main taxes are described in more detail. The final paragraph presents conclusions and formulates some recommendations for further changes.

Even though the significant changes in taxations began in 1992 (introduction of PIT and CIT) the analysis mainly covers years from 1995 to 2005, with some exceptions for 2006 and 2007 when data available. More detailed descriptions concerns last 3 years to embrace most up-to-date problems.

1. Objective restrictions and achievements of public economics theory as a framework for every tax system

Prior to beginning the discussion of possible solutions when designing any tax system, there is a need to underline the significance of common restrictions accompanying a democratic state. These are stages and conditions of public sector finance evaluated by its indicators (see Table 1), which arose due to features of modern society and economy. The nature of the welfare state in most European countries, including Poland, is something inseparable from the evolution of democracy and cannot be reformed overnight. The vast scope of public spending generally accompanying contemporary democracy requires large public revenues, the main source of which is taxes. Other sources of government income include customs duties and other revenues¹; however, these provide rather insignificant income.

The second most important source of government revenue is the budget deficit. The budget deficit, in the context of public finance, is essentially future taxes to be paid. However, it is necessary to note that taxation is limited and can only be increased to a certain level. Excessive budget deficits may lead to high public debt, which can lead to a public finance or currency crisis². Essentially, the main, or even singular, method of financing public sector spending in the long term is taxes.

Likewise, the goal of every government throughout the world is to promote the development of their economy. Public spending is an important instrument for regulating global demand, but, as previously stated, its source is primarily taxes. Despite the fact that through public spending the government has the ability to reallocate incomes which can stimulate activity in some sectors of the economy or fulfil the needs of the welfare state, very careful attention should be paid to the level of public expenditure and to the design of the tax system. High public spending generally necessitates high taxes which hamper business activity and result in high compliance costs for the economy as a whole, often causing more harm than good. In most cases, we come to the conclusion that the government should

¹ For example: dividend, foreign revenue, a share in the central bank's profit or public sector units' revenue.

² For more about the problem, see also Stern (1999), p.9.

collect the necessary revenues³ only through taxation. The problem to be analysed is how to design an adequate tax system.

Theories of public finance provide some recommendations and principles (James and Nobes (2002), p. 3-113, Rosen (1999), p. 255-334). However, varying results of optimal taxation can be achieved if different assumptions are made concerning the operation of the economy or agents' behaviour. Nevertheless, there are three primary fields which must be considered in the context of taxation: efficiency, incentives and equity. The analysis of each of these fields may bring different recommendations, but it is helpful to formulate general rules which should be followed and applied in every tax system. The list of rules may be limited by making assumptions about the goals to be attained by the tax system. The reader should be aware that here we provide merely an overview of this interesting and complex topic before presenting some recommendations.

To examine the issue of taxation and efficiency the concepts of excess burden⁴, administration and compliance costs, and tax expenditures⁵ are particularly useful. The cost of taxes should be viewed more broadly than as simply the amount of money which the taxpayer must pay to the tax collector. Every imposition of a tax distorts price relations⁶ between goods⁷ or factors. If a consumer's choice between goods changes after taxation it often means that he is worse off because the tax has induced him to consume a different bundle of goods, which is likely to be less desirable than the previous one. The cost of that change is known as the excess burden of taxation, which is intangible, but an important factor in tax design.

More tangible costs of taxation are administrative and compliance costs. Administrative cost amounts to the money spent on tax administration, whereas compliance costs are essentially the estimated time taxpayers must devote to completing the necessary tax paperwork. Multiplying the time spent by the average wage results in an approximation of the compliance costs of taxation for an economy. How can these costs be minimised? The simpler the tax, the lower the excess burden of taxation, as well as the lower the administrative and compliance costs. In reality, most tax issues are associated with the tax base calculation. The final computation of taxes due is not typically a problem, even when

³ Level of public spending is beyond the scope of this article and will not be elaborated on. The level of public spending is taken as given.

⁴ A loss of welfare above and beyond taxes collected; also known as the dead – weight loss due to taxation or welfare cost (Rosen (1999), p. 531).

⁵ A fiscal advantage conferred on a group of taxpayers, or in respect of a particular activity, by reducing tax liability rather than the payment of a cash subsidy (James and Nobes (2002), p. 267).

⁶ Except for a lump- sum tax, which is seldom, if ever, used.

⁷ Work and leisure are also goods.

there are several different tax rates. However, the existence of various exemptions or allowances greatly complicates tax calculations. This is due to the need to verify the legitimacy of an exemption by the tax administration, and the fact that the taxpayer must know and prove his eligibility for the tax exemption. Thus, exemption verification constitutes a significant source of hidden costs, which are essentially subsidies known as tax expenditure.

In addition to the inconvenience, widely understood tax allowances often result in a number of disincentives. Taxpayers measure their tax burden based on the marginal tax rate, while in reality they pay an average (effective) rate of tax, which generally remains unnoticed. High marginal tax rate may constitute a disincentive for taxpayers to comply with the tax policy. This is the case particularly under progressive tax structures, where marginal tax rates seem to be very high, when in fact the average rate is much lower. The average rate, however, is not easily computed before the end of the tax year. The more tax allowances and exemptions in the tax schedule the bigger difference between the marginal tax rate and the average rate.

The question to answer is: how to find the optimal tax rate(s)? An interesting rule was presented by the Meade Committee which states that *“as a general principle (i) average rates of tax should be high on high incomes and low on low incomes, but at the same time (ii) marginal rates of tax should be exceptionally low at both the bottom and the top ends of the income scale.”* (Meade Committee 1978, Chapter 14; in James and Nobes (2002), p. 62) Every government considering the implementation of a progressive tax system to meet equity criteria should remember this principle. The trade-off between incentives and equity can be minimised by approaching the marginal and average rate. In fact, administrative and compliance cost should be lowered at the same time. How far tax systems must meet equity criteria remains a political decision, but even a progressive system cannot be overly harmful if the number of allowances and exemptions are limited.

According to the previous discussion, an adequate tax system should follow a few rules:

- administrative and compliance costs should be minimised, which guarantees that the cost of running the tax system is low (Rosen (1999), p. 326-327). This means that taxes should be as simple as possible. However, a simple tax does not mean a one rate tax. The method used to calculate the tax base determines how complicated the tax is. The fewer exemptions from taxation and fewer tax rates the better;
- the lowest tax rate(s) possible is ideal, since the lower the tax rate, the lower the benefits from tax evasion. Further, every tax causes a dead – weight loss of taxation.

The higher the rate of tax, the larger the distortion. It is better to have several lower taxes than one very high tax (Rosen (1999), p. 294; Stern (1999), p. 11);

- horizontal equity⁸ should be maintained, meaning that people should pay taxes proportional to their income or wealth. Likewise, the market of goods or production factors should be taxed in a comparable fashion. Decisions of investment in a given factor or acquisition of a good should not be influenced by taxes (Owsiak (1997), p. 152; Rossen (1999), p. 323-326);
- the stability rule holds: “a good tax is an old tax” (Owsiak (1997), p. 151; Stern (1999), p. 12).

The list quoted above is not complete and undoubtedly imperfect. However it is a useful and necessary framework. Every country should supplement and adjust it to its specific economy and citizens.⁹ In practice, adjustments, such as creating a new type of tax, are limited. Experience shows that only a very narrow range of taxes is applicable at the government level. According to quoted rules, implementation of a new type of tax can be difficult and costly. In the age of globalisation, countries, particularly developing countries, should use a tested, systemic tax solution rather than experiment with a new one. The expansion of the VAT is a useful example. In 1965 only two countries used the VAT while 135 countries were using it as of 2005.

Implementing an entirely new tax solution at the national level exposes the economy to isolation or additional costs. The most favourable solution is to adjust worldwide, proven systems to the specific needs of the country, particularly since the present shape of these taxes is a result of the evolution of the economics of taxation theory and everyday compliance¹⁰. It is not surprising that the various taxes used on the central government level are very similar in Europe.¹¹ Conversely, local taxes often vary between countries.

⁸ The similar treatment of individuals in similar economic circumstances (James and Nobes (2002), p. 264).

⁹ Structure of population (e.g. increasing population share of the elderly) and level of the social consciousness should be considered during the design of the tax system.

¹⁰ The harmonisation process in the field of taxation within the European Union is very popular, especially in a field of capital taxation (Haufler (2001), p. 13-20), and will probably grow.

¹¹ It does not mean that applied taxes are the same. Systems are similar but differ in details.

2. The main features of the Polish tax system and potential changes

Prior to describing the Polish tax system, the primary public finance indicators in Poland should be considered. Table 1 shows how the tax system and public finance have evolved since 1995. As was previously mentioned, the public expenditure level is one of the determinants of taxation. Taxes cannot be low when public expenditures are high. In such circumstances, it is possible to apply low rate taxes only in the short term, which generally result in higher levels of public debt. Due to the high level of public debt¹² and stable public sector deficit¹³ in Poland, we cannot consider low taxes to be an option now or in the near future. Public revenues should at least remain stable, the result of which is that all changes in the tax system will have a neutral effect. It seems that the first step to be taken by the Polish government is to cut unnecessary public expenditure, which will make space for cutting taxes. At present, only minor changes that will lower the cost of the tax system and remove disincentives to taxpayers should be considered.

Table 1. Public Finance in Poland, 1995 - 2005

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
	PLN million										
Public finance revenue (general)	136 830.5	170 473.8	206 563.3	227 283.3	253 343.3	272 094.1	289 105.6	296 955.4	325 259.8	357 270.3	384 502.6
Public expenditure (general)	142 121.3	178 706.5	213 585.4	241 584.7	273 257.1	292 969.1	327 102.5	343 263.3	369 045.3	399 303.4	409 820.0
Public sector deficit	-5 290.8	-8 232.7	-7 022.1	-14 301.4	-19 913.8	-20 875	-37 996.9	-46 307.9	-43 785.5	-42 033.0	-25 317.4
Public debt (end of the year)	167 266.7	185 602.8	221 649.7	237 399.9	273 383.5	280 321.8	302 106.7	353 843	408 640.5	432 284.4	467 806.0
Central budget revenue	83 721.7	99 674.5	119 772.1	126 559.9	125 922.2	135 663.9	140 526.9	143 519.8	152 110.6	156 281.2	180 406.6
Central budget tax revenue (general):	68 975.2	83 864.5	98 688.5	113 949.5	112 776.9	119 643.9	119 101.3	128 750.9	135 227.6	135 571.3	156 432.3
VAT	20 666.9	28 014.9	36 914.5	42 868.6	48 811.6	51 749.8	52 893.1	57 441.7	60 359.5	62 263.2	75 930.4
Excise	12 139.9	15 524	17 890.2	21 068.5	25 208.1	27 312	28 860.5	31 489.8	34 387.7	37 964	39 479.1
CIT	8 837	10 730.3	13 264	14 809	15 060.4	16 867.7	13 219.7	15 008.4	14 108	13 071.7	15 785.2
PIT	23 511.8	26 171.9	29 941.5	34 664	23 115.2	23 088.6	23 444.2	24 139	25 674.9	21 506.2	24 444.1
Other revenue	14 746.5	15 810	21 083.6	12 610.4	13 145.3	16 019.3	21 425.6	14 768.9	16 883	20 709.9	23 974.3
Central budget expenditure	91 169.7	108 841.7	125 674.9	139 751.5	138 401.2	151 054.9	172 885.2	182 922.4	189 153.6	197 698.3	207 901.2
Budget deficit	-7 448	-9 167.2	-5 902.8	-13 191.6	-12 479	-15 391	-32 358.3	-39 402.6	-37 043	-41 417.1	-27 494.6
Public sector revenue (as % of GDP)	41.5	41.1	41	38.6	38.8	37.6	38	38	39.9	38.7	39.2
Public sector expenditure (as % of GDP)	43.1	43.1	42.4	41	41.9	40.5	43	43.9	45.3	43.2	41.8
Public sector deficit (as % of GDP)	-1.6	-2	-1.4	-2.4	-3.1	-2.9	-5	-5.9	-5.4	-4.6	-2.6
Public debt (as % of GDP)	50.8	44.8	44	40.3	41.9	38.7	39.7	45.3	50.1	46.8	47.7

Source: www.stat.gov.pl

¹² It is about 50 % of GDP depending on: economic cycle, exchange rate and adjustment of public accounting to European accounting standards.

¹³ In 2004, the European Commission began the Excessive Deficit Procedure against Poland, which still is not canceled.

As a European country and a member of the European Union, Poland has a tax system similar to other European countries. It was not necessary to implement a new tax solution, e.g. a tax on enterprise assets or a general turnover tax, since the Polish economy and society are closely tied to other European countries through commercial relations and culture. Furthermore, similar tax solutions and legislation are important factors for investment, and Poland has needed to boost its economy.

From January 1, 1992 the Polish parliament implemented the PIT and CIT, followed by the VAT and excise tax on July 1, 1993. The introduction of these taxes has been the most significant and complex tax reform to date. Since then, the Polish tax system has been permanently altered but within the applied tax limits. Depending on political needs or economic position, different rates or exemptions have been used. Amendments incorporated into the tax laws made the system very complicated and far from transparent. However, the volatility of tax rates was not as harmful as the legislation changing the tax base¹⁴. This issue will be discussed in-depth further in the paper, when each tax is analysed separately.

Nevertheless, since 1995, general public finance revenue and different tax revenue have been growing although there was a significant decrease in PIT revenue in 1999 (see Table 1), when public administration and pension fund system reforms were introduced. Also, the CIT revenue fluctuated from 2000 to 2004 due to certain features of the economic cycle and the gradual CIT rate decrease. In general, the Polish tax system has produced strong tax revenue on a continuous basis (Bartoszuk and Lenain (2000), p. 4-6). On March 1, 2002, a tax on gains from savings (capital) was introduced, which removes the asymmetry between taxation of capital and taxation of the labour factor. As a result, Poland possesses the entire spectrum of taxes in use in other European countries, with the exception of the cadastre or property value tax¹⁵. Its introduction seems unavoidable in the future however, particularly due to its advantages, importance and universality as a part of the modern tax systems of Europe (Almy (2001), p. 8-16).

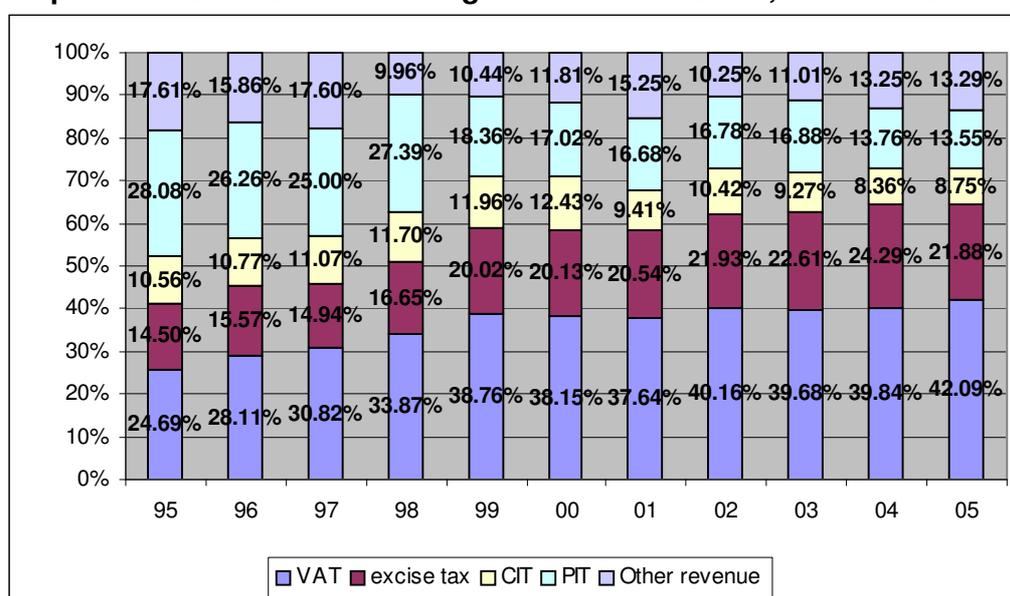
Graph 1 shows the structure of central budget revenue during the last 11 years. Despite growing budget revenue, the growth rate of separate taxes has changed. We have

¹⁴ There is a substitution between a tax rate and tax base; the wider the tax base, the lower the possible tax rate.

¹⁵ Besides that, there are a lot of objective obstacles to overcome, the most important of which is lack of a computerized database of fiscal cadastre, which counts as a tax base. Also, there is no political will for the implementation of a cadastre tax in the near future. The Polish Ministry of Finance has worked on its implementation, but now there is no official information about further preparatory work.

observed an increased significance of indirect taxes simultaneously with a decreased share of direct taxes in budget revenue. One explanation is that indirect taxes are politically easier to administer because it is harder to identify the relationship between the wealth of taxpayers and the amount of tax payable. It is not astonishing that indirect taxes (VAT and excise) play a primary role in contributing to budget revenues across Europe. Poland is not an exception. Other reason for this is due to globalisation and the increased mobility of capital, which has led to international CIT tax competition, thus decreasing its rate and the revenue collected as a result. Another factor increasing the significance of indirect taxes is the common trend to decrease labour costs, which results in lowering PIT rates and PIT revenues, thus making revenues collected through indirect taxation more important.

Graph 1. Structure of central budget revenue in Poland, 1995 - 2005



Source: GUS, own calculations.

Tax systems, as a whole, determine the scale of the public revenue burden on a country's citizens. How this burden will be redistributed among society depends on the structure of taxes applied by a government or a parliament. Tax systems can be progressive, proportional or regressive. The more progressive the tax system, the smaller the tax burden placed on lower income citizens. Every single tax has its own character with regard to proportionality¹⁶ which can be intensified by implementing specific solutions. One should remember this whenever changes are made. Politicians, in particular, should be aware of this, since their decisions are crucial in determining the level and shape of taxation. Final

¹⁶ Every tax has its inherent feature e.g. as experience shows VAT is mainly regressive. This can be attributed to lack of personal tax allowance in VAT (similar to PIT) or greater proportion of poor consumers' income spent on taxable goods. Of course, PIT and CIT are mainly progressive or proportional.

results of the shape of a tax system are a political decision influenced by voters and different lobbying groups and often have nothing in common with economic efficiency. Therefore, social education about taxes and public sector operation should be at the centre of public interest, which may help to minimise the number of rent-seeking politicians.

2.1. Personal Income Tax – PIT

PIT, because of the amount of taxpayers, is the most common tax that can be easily influenced by a political factor. Any planned reforms are widely discussed in political circles, but generally remain in the initial phase of the project. Most significant changes are prepared by the Ministry of Finance and these bills are presented to Parliament, which typically passes them without major amendments¹⁷. Personal income taxes are regulated in two Acts¹⁸ and have a wide subjective scope. Both employees and employers are subject to PIT. In 2006 there were four forms of PIT payment:

- 1) Flat, 19% rate PIT without any deductions or allowances.
- 2) Progressive PIT with 19, 30, 40% rates with some deductions and allowances¹⁹.
- 3) Lump sum tax for small entrepreneurs e.g. barbers, shoemakers.
- 4) Special tax calculated as % of recorded turnover²⁰ from 3 to 20% (all-around amount tax).

Despite that the construction of lump sum and all-around taxes are different from one another, they are all applicable to personal incomes. The second alternative, progressive PIT, is universal and every taxpayer is subject to it. If one is an entrepreneur for example, an alternative tax may apply under certain conditions. The simplest option is a lump sum tax used by specific entrepreneurs listed in the annex to the PIT Act. This tax varies by region and type of activity. Although the list of entrepreneurs is limited, the lump sum tax is a rather favourable solution, particularly for small enterprises in which commercial accounting practices may be difficult or inconvenient.

A more complicated alternative is the all-around amount tax. Tax duties are calculated based on the turnover recorded in the cash register or paid invoices. In that case,

¹⁷ Experience shows that this is usually the case as a result of numerous negotiations between parties and the government, preceding final voting. Of course, there are no rules without exceptions.

¹⁸ These are: PIT Act from July 26, 1991 and Act from November 20, 1998 – concerning simple forms of taxation for personal income gained from specific sources.

¹⁹ Every employee, who works on the basis of an agreement for work, is subject to that form.

²⁰ Limit of the turnover which lets to select this form is 250,000 Euro for previous tax year. The most popular activities here are: small services e.g. taxi, small restaurants, other transports, renting etc.

costs do not influence the amount of payable tax. For taxpayers who have high costs or whose retail prices are very high, it is not worth choosing any of these forms. In the first case, taxable net profit is small and common PIT probably brings lower tax burdens. In the second case, high retail prices may generate high turnover and so a high tax burden. Of course, the existence of simple forms of taxation should be considered as possible alternatives and therefore, an advantage. Unfortunately, the number of taxpayers is decreasing due to rather high tax burdens generated by these forms comparable to the other one. Costs are the most important factor when making a decision on which form of taxation to select²¹.

The progressive PIT is the most common form. Its main features are shown in Table 2. In 2005, yearly earnings below 2,790 PLN were free of tax²². Non-taxable earnings, lump sum costs and the joint yearly tax declaration with a spouse are the most important allowances in the system. There are some other deductions that make PIT less progressive, e.g. spending on renovations or building a house²³, donations, obligatory medical insurance, using the internet, and interest from mortgage, all of which can be deducted from the payable tax or income. Because of the widening tax base²⁴, many deductions were cancelled at the beginning of 2006 e.g. spending on education or computers. This can be considered as a continuation of an downward trend begun a few years ago (Table 3). For example, the Ministry of Finance was searching for additional revenue, such that in 2004, a flat tax was introduced as an option to PIT but the level of public deficit could not increase. In spite of the motivation for such an action, there are some advantages, such as the convergence of marginal and average rates in PIT, lower tax expenditures, or a decrease in compliance and administrative costs.

²¹ The amount of taxpayers decreased in all-around amount tax from 1.2 million people in 1994 to 0.6 million in 2004 (Neneman and Piwowarski (2004), p.38-41).

²² The Ministry of Finance updated thresholds for 2007. See Annex 1.

²³ It was valid until the end of 2006.

²⁴ The tax base can be broadened in two ways. The first is to increase the number of taxpayers and the second is to increase the amount of taxable income.

Table 2. Main characteristics of PIT taxpayers in 2004 and 2005

Yearly earnings in PLN	Taxpayers (as % of all)	Marginal rate in %	Effective rate in %	Effective rate without medical insurance in %	Taxes paid (as % of budget revenue)
From 2,790 to 37,024	22 361 536 (94.77%)	19	13.52	6.16	59.51
	22 356 919* (94.46%)		13.55*	6.12*	57.48*
From 37,024 to 74,048	1 033 311 (4.38%)	30	18.57	11.80	20.27
	1 102 502* (4.66%)		18.70*	11.73*	20.94*
above 74,048	201 188 (0.85%)	40	28.74	22.57	20.22
	208 327* (0.88%)		29.66*	23.09*	21.58*

Source: Ministry of Finance.

*2005

Table 3. Tax deductions in PIT in 2000 – 2005 (in 1000 PLN)

	2000	2001	2002	2003	2004	2005
Tax deductions from income	8 069 562	5 694 616	3 842 988	4 601 766	2 607 680	3 201 583
Tax deductions from paid tax	4 991 975	5 289 759	5 048 438	5 250 943	4 041 185	3 899 021
All	13 061 537	10 984 375	8 891 426	9 852 709	6 648 865	7 100 604

Source: Ministry of Finance.

Tax deductions are regarded as a reduction in tax liabilities or tax expenditures. A decreasing number of applied tax exemptions should be positively considered both theoretically and practically. A detailed cost of every deduction should be published so as to evaluate it efficiently and to allow for an estimation of the progress of the tax system. However, this issue does not appear in a flat tax structure.

The flat PIT was introduced in 2004 and can only be selected by entrepreneurs²⁵ who fulfil certain conditions²⁶. The Ministry of Finance opposed application of the flat PIT for all individuals, and instead decided to limit its introduction to entrepreneurs on an optional basis as a compromise between employers' unions and the government. Because of the high tax burden on entrepreneurs in the progressive PIT, the government decided to create this form of taxation to facilitate investments. Small firms are not able to finance their investments on the financial market due to the high expense. In general, the higher the interest rate or bank services costs, which are still relevant in Poland, the lower the tax rate should be in order to leave larger net profits in the hands of firms to encourage investment²⁷.

Further, the CIT was lowered to 19% in 2004 which contributed to the introduction of a flat PIT following pressure from the public and employers' associations. A 19% tax rate seems to be theoretically more attractive than 30 or 40%. However, only 200,168 taxpayers in 2004 and 260,999 in 2005 selected this form of payment²⁸. When taxpayers choose the flat tax form they lose all easily accessible allowances and deductions from the progressive PIT. The tax burden from the progressive and flat PIT amounts to approximately 42,000 PLN per year after deducting costs²⁹. For taxpayers from the first threshold, as well as for some from the second threshold, this is not optimal. This should be considered not as a marginal rate but as an effective one (Table 2). The effective rate in the flat PIT equals the marginal rate, thus, it is only beneficial to change the form of PIT payment for taxpayers who now pay the effective rate above 19%. This solution clearly shows that the implementation of a flat tax for all taxpayers would increase tax burdens for low income individuals. To avoid such a situation, the government should apply a very low flat tax. However, a low flat tax rate would not bring in enough public revenue, which is the reason that the common flat PIT is an idea that surfaces in political debates rather than in official government documents.

More light has been shed on the problem after analysing budget revenue from the last three years (Table 4). Since 2004, the Ministry of Finance has divided PIT revenue into the flat and progressive taxes.

²⁵ Excluding agricultural business activity.

²⁶ As an example, self-employed managers cannot select this form and nobody who is now self-employed and has done the same type of work as an employee for his previous employer.

²⁷ For more see Zee, Stotsky and Ley (2002).

²⁸ Beside the fact that the relative increase in the number of flat PIT taxpayers is high (about 30 %), nominal numbers remain small compared to all PIT taxpayers.

²⁹ Considering the average gross monthly salary in Poland of about 2,500 PLN, this amount is quite large.

Table 4. PIT revenue in 2003, 2004 and 2005, in PLN million**

PIT	2003 Progressive PIT (only)	2004 and 2005			
		Progressive PIT	Flat PIT (19 %)		Total
			For entrepreneurs or self employed persons	Tax on the profits from stock exchange	
Revenue	29 868	28 733 29 833.4*	5 723 6 797*	536 766*	34 992 37 396.4*
Revenue increase (in %)	2004/2003 17		2005/2004 18.8	42.9	6.9

Source: Ministry of Finance.

*in 2005

** differences in PIT revenue between Table 1 and Table 3 are due to that part of revenue transferred to local administrative units. Table 4 contains the entire PIT revenue and Table 1 contains only the central budget revenue.

As we can notice PIT revenue increases every year from 2003, and this can be explained as follows:

1. A tax on the profits from shares traded on the Warsaw Stock Exchange was introduced in 2004 and constitutes another source of PIT revenue. The number of taxpayers (about 250,000) was stable and growing revenue is due to high economic growth.
2. Additional revenue in 2004 came from cancellations of many deductions and allowances e.g. the aforementioned spending on education or computers. This was about 1.2 billion PLN. The process continued in 2005, with the amount of tax deductible allowances decreasing by about 150 million PLN.
3. PIT revenue increased by 17% in 2004 and 6.9% in 2005. In published information from 2004, the Ministry of Finance considered the implementation of the flat PIT as another source of higher budget revenue, but it was cautious about this implementation. It was hard to judge whether it was due to a widening of the tax base due to decreasing tax evasion, essentially an increase in the number of taxpayers, or if it was simply due to high economic growth. A comparable situation appeared in CIT, where revenues were higher due to fast growth and high profitability of many companies. Another reason identified for this increase was a decrease in the likelihood of overstating costs. After the introduction of the flat PIT, the risk was too high in comparison with the potential profit. However, considering the problem in the

context of the data from 2005, it is difficult to judge if this hypothesis is true. Still, relatively high increases in the flat PIT revenue in 2005 can be attributed to the increase in the amount of taxpayers, approximately 30%. At the same time, the average tax decreased from 28,589 to 26,042 PLN, meaning that the tax burden per taxpayer is lower. This could be a result of lower incomes of taxpayers joining the flat PIT or more successful and widespread tax avoidance³⁰.

4. The rate of the widening tax base, approximately 30%, in the flat PIT was higher than the increase in revenue of 18.8%. Besides the increase in tax revenue, the average tax decreased, which could be proof that people chose the flat PIT option in order to lower their tax burden.
5. The positive effects of the introduction of the flat PIT thus far should be carefully considered. This tax was applied only to entrepreneurs, who cannot be compared to employees and it should be recalled that firms and their profits are different from employees' earnings. Nobody can say with certainty that the implementation of the flat PIT for all taxpayers would have no effect on budget revenues. Various studies, using assumptions about budget revenue to remain stable and static analysis, have shown different evaluations for the rate of the flat PIT for Poland. The Entrepreneurs Council (2003) offered the rate between 18 and 19%, most likely 18%, with a 4,000 PLN tax allowance. One of the largest Polish political parties, Civic Platform (Platforma Obywatelska) introduced a 15% flat PIT without any allowances and deductions after winning the elections in 2005. The Ministry of Finance calculated estimates for the flat rate PIT ranging from 15.4 – 20.5%, depending on the number of allowances and deductions. A 15.5% rate without any tax relief was calculated by Neneman and Piwowarski (2004). At present there are no wider discussions about the flat PIT, but its implementation should be seriously considered in the long term, particularly in the context of cadastre tax implementation.

2.2. Social security contributions

Social contributions are inseparable from PIT as they are paid from gross salary.

There are five types of insurance:

- pension scheme 19.52% (half paid by employer)
- critical illness coverage 13.00% (half paid by employer)
- sickness coverage 2.45% (half paid by employer)

³⁰ One year of experience of the flat PIT compliance is an important factor and should be considered. More detailed analysis is needed to assess if the flat PIT appeared to be a good instrument to combat overstated costs in one –person businesses.

- accident coverage 0.90 to 3.60% (paid only by employee)
- obligatory health care (medical) insurance 8.75%, paid only by employee (but only 7.75% is tax deductible)

Employees' social contributions are deductible from gross salary and the tax is paid afterwards; thus, we can call them quasi-costs. Employers' social contributions are costs for firms. The tax wedge is the difference between an employee's net salary and the cost of taxation for the employer³¹. Social contributions are a significant source of the high cost of employment in Poland, while the role of the tax is rather small. (Graph 2)

Social contributions for self-employed persons are independent of income. Their minimal level depends on the economic indicators published by the Polish National Statistic Office (GUS)³². In most cases, entrepreneurs chose only the minimal level of social contributions which is considered an ineffective solution in the context of horizontal equity. The result is that new or low income entrepreneurs incur a high quasi-fiscal burden as the minimal social contribution is a lump sum which is paid irrespective of entrepreneur revenues. High social contributions can be a serious obstacle to overcome when a firm is in its infancy and revenues are low, or when it must invest. Conversely, there is no economic justification for high income tax payers, who often pay the flat PIT, to pay lump sum social contributions simultaneously. (Graph 3) Their tax burden is then relatively very small. It is hard to find economic arguments for such unequal treatment of taxpayers whose incomes are the same. Taxpayers who are employees have lower net income, or salary, than taxpayers who are self-employed. (Graphs 2 and 3)³³

The monthly, minimum levels of obligatory social contributions for self-employed persons in October 2006 were as follows:

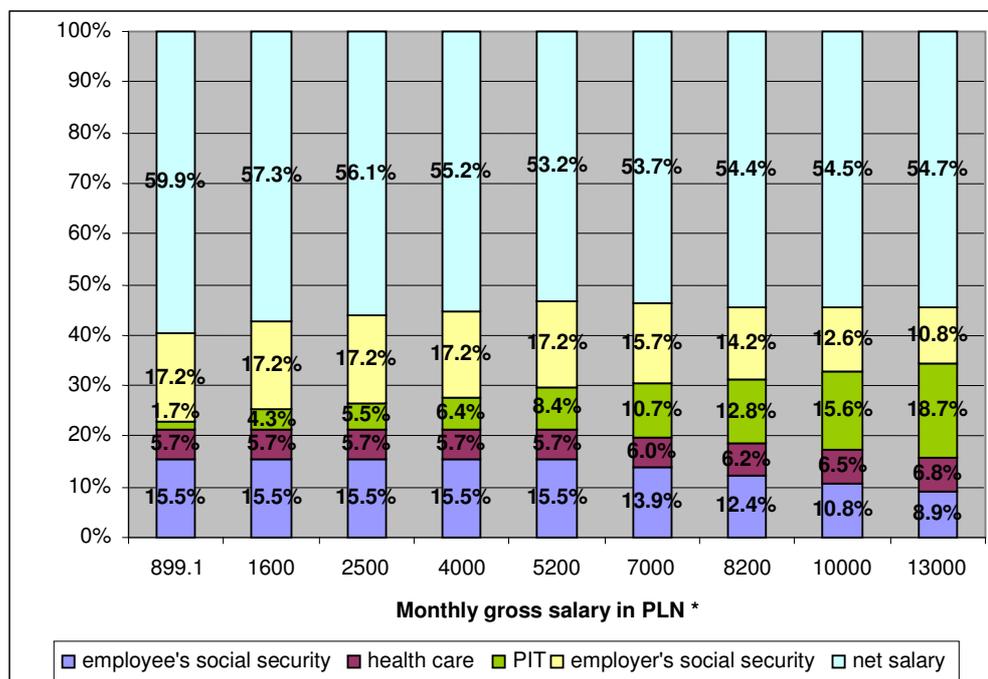
- pension scheme – 284.28 PLN;
- critical illness coverage – 189.33 PLN;
- sickness coverage – 35.68 PLN (voluntary);
- accident insurance – (1.8 %) 26.21 PLN;
- payroll – 35.68 PLN;
- obligatory health care (medical) insurance – 169.47 PLN.

³¹ The gross salary plus his part of the social contributions.

³² Minimum level of social contribution is obligatory. The increase over the minimal level is voluntary for this group of entrepreneurs.

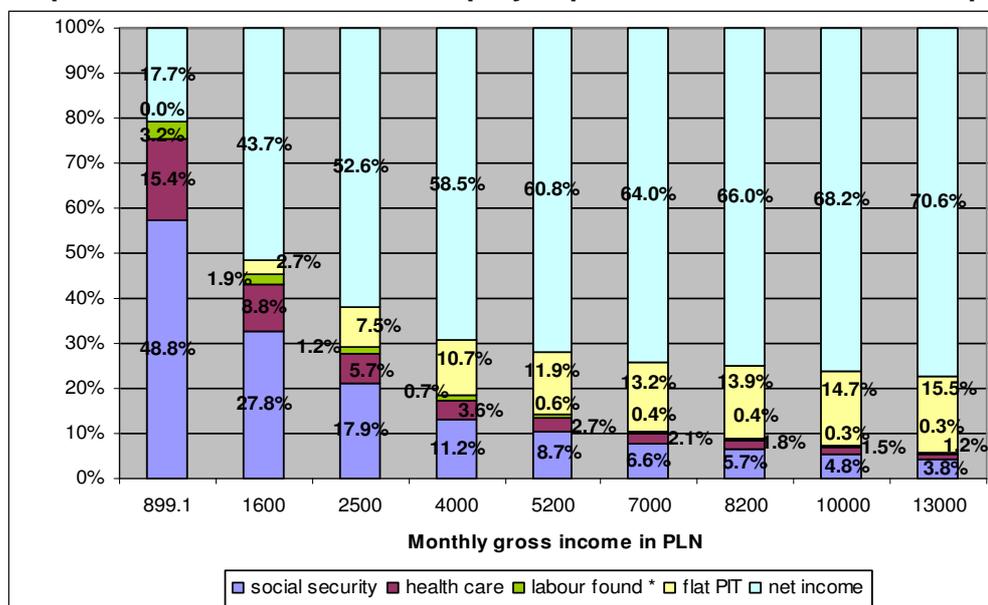
³³ Numbers can change and become more equal, when a self-employed taxpayer decides to pay higher social contribution. The lower the pension scheme payments, the lower the pension in the future. It is his decision. Nevertheless, employed taxpayers do not have such a choice.

Graph 2. Labour cost per employee



Source: own calculations for 2006.
 *Whole payments constitute 100%.

Graph 3. Labour cost of a self employed person – under the flat PIT option



Source: own calculations for October 2006.
 * Special fund created for self employed person when becomes unemployed one.

Social security contributions are the most significant element of the tax wedge in Poland. Not surprisingly, the Polish Government decided to reduce employee critical

sickness coverage by 3 percentage points, from 6.5% to 3.5%, or 13% to 10% in total, as of July 1, 2007. The next reduction, of approximately 4 percentage points, may be applied in 2008 or 2009. These changes should be positively evaluated following their implementation.

2.3. Corporate Income Tax – CIT

Historically, CIT was the most important source of budget revenues³⁴ but recently, its importance has been relatively small and decreasing. (Graph 1) Free movement of capital causes the CIT rate to become an important factor for investors to consider. A country that wants to attract new investments must take part in a worldwide tax competition. Poland is one of the leaders³⁵ in this area with a basic nominal CIT rate of 19%³⁶, and a much lower effective rate. (Table 4) Although the Polish government has removed many exemptions and deductions, some remain. Companies can still deduct losses from previous years, or deduct expenditures connected with its status activity. There is also a list of revenues which are excluded from taxation and many other special deductions which are included in the CIT Act. Poland also has special economic zones where companies can obtain further tax allowances that make a difference between nominal and effective rates.

Table 5. Nominal and effective corporate income tax rates, 1992 - 2005

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Nominal rate (%)	40	40	40	40	40	38	36	34	30	28	28	27	19	19
Effective rate (%)	35.9	36.7	31.3	32.6	31.0	30.9	30.8	29.7	26.8	25.2	24.7	23.7	16.9	16.7

Source: Ministry of Finance.

As the Ministry of Finance data indicates, there were 264,017 CIT taxpayers in 2005 (249,345 in 2004) and 179,893 of them made a profit (164,286 in 2004). However, only 56,728 of these people paid tax (52,016 in 2004) or 21.48 % in 2004³⁷. Further, 84,124 taxpayers (85,059 in 2004) made a zero profit or carried losses. The need for an increase in budget revenues accompanied by a cut in the tax rate resulted in the government

³⁴ In 1990 it accounted for close to 45% of the budget revenues (see Misiąg and Malinowska, (2002), p. 102-103).

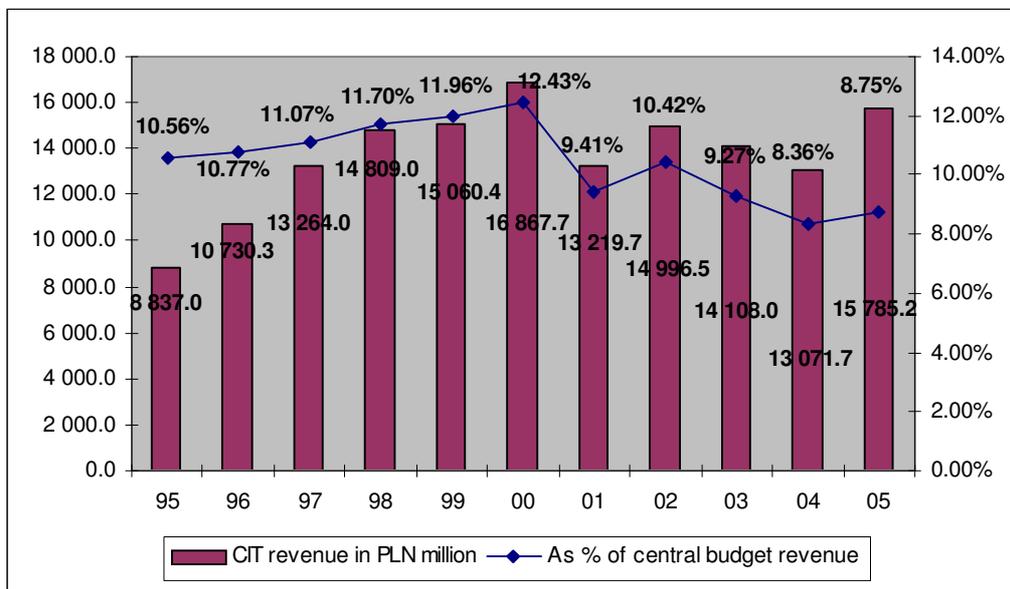
³⁵ Despite the low 19% CIT rate in Poland, there is strong tax competition in the region e.g. Lithuania 15 or 13%, Latvia 15%.

³⁶ The same rate is applied to dividends.

³⁷ One can explain such a low percentage of CIT payers as a result of applied tax deductions, existence of special economic zones in Poland and in the likelihood of overstating costs.

simultaneously broadening the tax base. The number of taxpayers slightly increased from 2004 to 2005 and as a result, we can observe stable budget revenues with its fluctuations mostly attributed to the business cycle.

Graph 4. CIT revenue*, 1995 - 2005

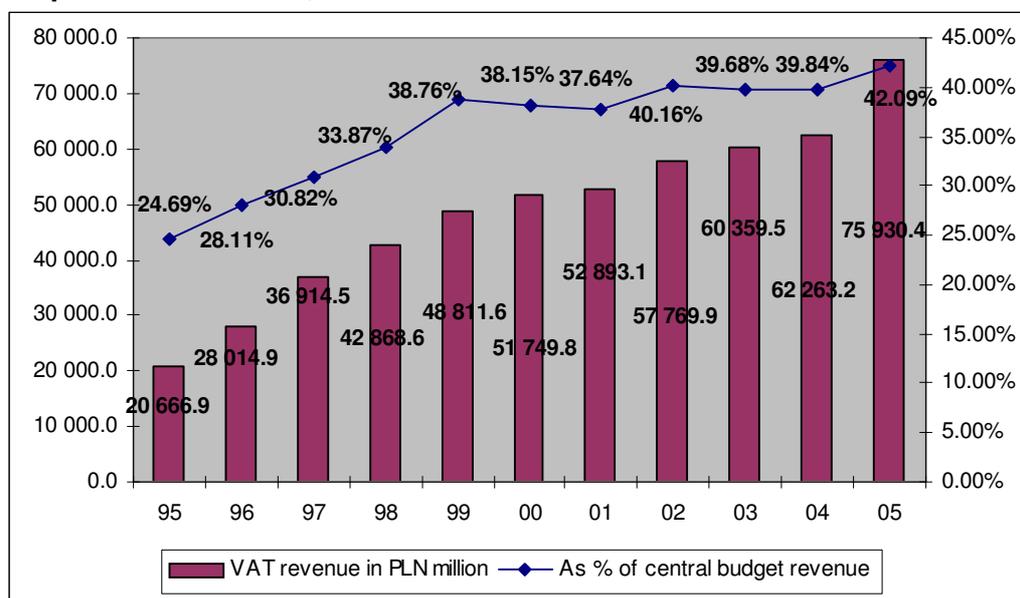


Source: GUS, own calculations.

* CIT revenue less transfers to local administrative units.

2.4. Value Added Tax – VAT

Graph 5. VAT revenue, 1995 - 2005



Source: GUS, own calculations.

The VAT has been the most important tax for budget revenue in Poland since 1996. (Graph 1) Its basic rate is 22%, which is one of the highest in Europe. The other rates used are: 0% (for export, public education, public services and a limited number of others), 3% (for food, agriculture services), and 7% (also for food, and newspapers, construction services). In general, the VAT in Poland is harmonised with the VI Directive and any vagueness can be solved before the European Court of Justice. The government attempts to shorten the list of goods and services taxed by lowering rates, but it is sometimes impossible due to the effective opposition of various lobbying groups. The shorter the list of exemptions the better, as it makes VAT compliance more transparent. Fraud in VAT usage is complex in its nature and its roots lie primarily in informal agreements between companies. Fictitious³⁸ invoices for goods or services are very difficult to recognise, resulting in the need for double monitoring in many transactions e.g. Poland has implemented a troublesome and often a very costly solution for companies regarding delivery of goods and services within EU countries. Companies can apply a zero VAT rate under the condition of receiving the confirmation of receipt.

However, even if the government was able to apply only one rate of VAT, there would be still numerous problems to solve. The main and arguably most insolvent issue is the

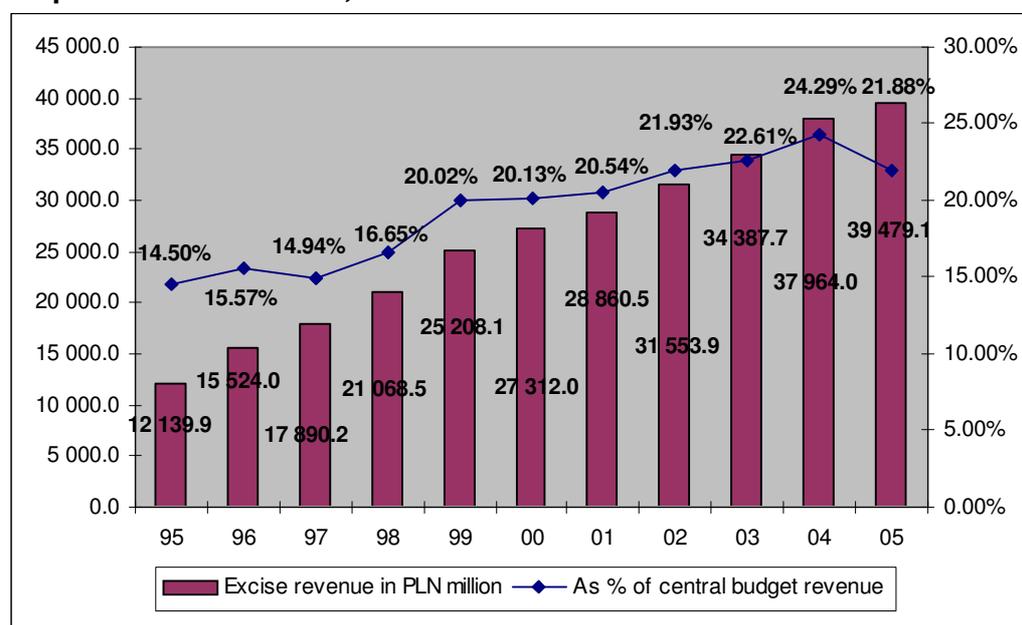
³⁸ Invoices which were produced only for generating non-existent costs.

feasibility of deducting the paid VAT from the due VAT. The neutrality of the VAT as its main feature works only theoretically. In reality there are several limitations, which increase the tax burden³⁹.

The annual threshold for entrepreneurs to apply VAT is only 10,000 EUR. Even if in the next tax year the taxpayer does not reach a threshold, he is still subject to the VAT⁴⁰. This causes a lot of problems and abuses; tax evasion is a common activity that results in unregistered services and sales. Reaching the 10,000 EUR threshold generally results in higher compliance costs. The small entrepreneur in particular, who uses the simplified form of PIT and exceeds the threshold for VAT, loses all advantages connected with that form of income tax payment. The need for keeping commercial books, which means generally higher costs, makes the use of a simple form of PIT questionable.

2.5. Excise

Graph 6. Excise revenue, 1995 - 2005



Source: GUS, own calculations.

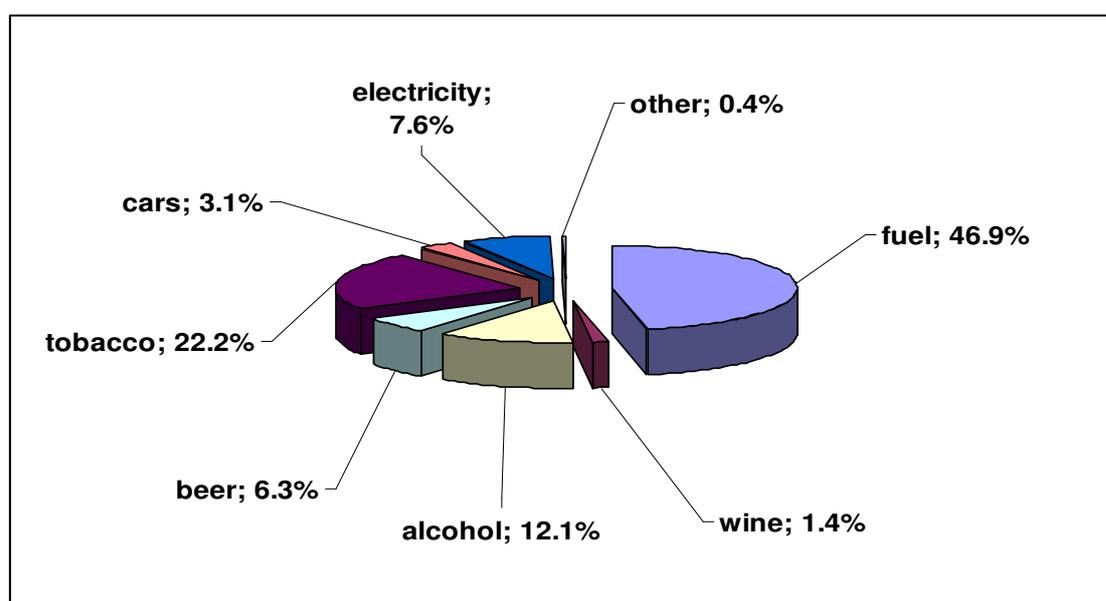
The excise tax has been the second most important tax for budget revenue since 1999. The construction and rates of the excise are generally harmonised within the European

³⁹ When the due VAT cannot be deducted, the total amount of the invoice is, in most cases, the cost for income tax purposes. However, this solution only reduces the tax burden of the VAT.

⁴⁰ Three years after reaching a threshold the taxpayer is eligible for a VAT exemption.

Union Common Law. The differences can be found in solutions when excise becomes chargeable (chargeability of excise). The Polish budget revenue and obligations to harmonise rates mean that they are relatively high, which contributes to many abuses. Cigarettes and alcohol smuggling, for example, is a huge problem in Poland and lowering excise rates is one of the ways to decrease the scale of the problem. However, this is sometimes impossible due to the Common Law⁴¹. The same issue, as well as different rates in use, appears in the petroleum market. There is only a small space for lowering rates because their level is near the obligatory minimum of the EU and the requested number of inspections makes excise compliance a huge cost. Harmonised goods constitute the majority of revenue from the excise. (Graph 7)

Graph 7. Composition of excise revenue in the first half of 2005



Source: Ministry of Finance, own calculations.

2.6. Other taxes

Other taxes include:

- gambling tax
- property tax
- agriculture tax
- forest tax
- means of transport tax
- heritage and gift tax

⁴¹ The Polish government can use lower rates on cigarettes till 2008.

- tax on dog possession
- conveyance tax
- tax on profits from savings
- tax on exchange dealings
- dividend tax

These taxes are primarily municipal but revenues from these taxes are insufficient for municipalities and must be subsidised by the central government. (Table 6) An increase of the share in PIT and CIT would bring more financial independence for local governments. The cadastre tax implementation would probably be another source of revenues that would strengthen the autonomy of local units. At present, the property tax revenue is important for local budgets, despite that it is a quantitative tax and depends on the location and class of the land.

Table 6. Local government revenue in the first half of 2006

Executed local government revenue in 10,000 PLN	
All	56 357 214.2
Own revenue*:	27 691 687.1
Share in CIT	2 814 403.7
Share in PIT	8 406 917.2
Property tax	6 157 779.1
Agriculture tax	447 759.9
Forest tax	80 810.1
Means of transport tax	372 930.9
Lump sum PIT	47 875.2
Heritage and gift tax	126 584.5
Tax on exchange dealings (PCC)	669 691.6
Other revenue	8 566 934.9
Purpose grants	8 579 613.4
Subsidies	20 085 913.8

Source: Ministry of Finance.

* These are e.g. local fees and charges, incomes from property or estate.

3. Conclusions and proposals for further reform

The Polish tax system is not optimal in the context of the rules listed at the beginning of this paper, but it does contain modern and up-to-date solutions. These are achievements in public economics theory and tax compliance experience gained by developed European, or OECD, countries. The PIT, CIT, VAT and excise taxes constitute the core of the Polish tax

system and bring stable revenue. However, a wide range of tax exemptions make the system complicated and costly. Costs of tax administration and compliance must be lowered. This can be done by cutting rates and widening the tax base simultaneously. Additionally, a better understanding of the tax system, both by the administration and society, should contribute to the development of fiscal institutions. For developing countries, simpler tax solutions work better. Developed countries can afford to apply intricate tax mechanisms, because their fiscal institutions are better prepared for it and are able to bring enough tax revenue (Tanzi (1998), p. 51-57).

PIT is intricate and should be simplified⁴². High administration costs of PIT are the results of many allowances and deductions which make the PIT very complex. It is not useful to implement one rate in PIT and leave the other things the same. Administration and compliance costs would not decrease. If costs are to be minimised, the government should apply a common flat PIT without any deductions. Then, yearly complicated tax declarations can be cancelled and the tax return and payment may be easily carried out. This type of system is easy to inspect and can be fully computerised. The level of the flat PIT rate must be a compromise between bringing in enough budget revenue and acceptable tax burdens for low salary citizens. The introduction of a cadastre tax can be considered as a factor which would bring balance to the budget revenue when the applied flat PIT rate is very low. This solution should be widely discussed.

Undoubtedly, the flat PIT appears to be a good instrument to lower compliance costs. In this respect, its introduction would bring more transparency to the tax system and may contribute to an improvement of relations between taxpayers and the state. Unfortunately, inseparability of PIT from social security contributions means that any change in one part should be considered in conjunction with the other. The present solution, which joins the flat PIT for self-employed taxpayers with lump sum social security contributions, is inefficient in the context of horizontal equity. It decreases the majority of the burden from high income taxpayers, transferring it to low and average income taxpayers. Taking into account the huge cost of the implemented pension system reform, any unjustified losses in revenue from social security contributions could result in serious issues for the government in the future. Some changes in the social security contributions system are immediately needed and should be discussed. Planned decreases in critical illness coverage will lower the tax wedge and is a move in the right direction.

⁴² The announced implementation of two rates in progressive PIT in 2009 (18%, 32%) will not simplify the tax system.

The CIT rate is low and its compliance has improved, but the dividend tax should not be overlooked. This solution is often considered as double taxation which should be changed. Some economists say that the CIT rate should be zero, leaving only the dividend tax. The Ministry of Finance has considered the zero rate for reinvested profits⁴³, but now this seems to be an issue only for further discussion.

Due to the process of harmonisation, there is not much space for changes in the VAT, except lowering its basic rate. Key political parties have offered one rate in VAT, ranging from 15 to 19%. Every proposal which lowers compliance costs is favourable and worth considering.

Different rates of excise taxes for petroleum products are a significant source of fraud. The Ministry of Finance tried to equal their rates but did not manage to do it. It is a prime example of the importance of the political factor in any changes. Nevertheless, these rates should be minimised and equalised.

One can say that tax reform is an element in every political campaign. Unfortunately, what is said by politicians is not necessarily implemented. It seems as though there has not been a political party in Poland which has a complex, coherent and feasible project for tax reform. It is believed that taxes should be simple and low, but considered in the context of the budget revenues required by the government, discussions of this issue are much simpler than implementation of possible changes. There is no basis on which one can assume that something will change this situation in the coming years.

The fact is that the Polish Government, namely the Ministry of Finance, because of the Excessive Deficit Procedure implemented against Poland, must lower the public debt/GDP and budget deficit/GDP ratios, and therefore cannot afford to lose any revenues. The most probable scenario is an abolition of tax allowances and exemptions wherever possible in order to widen the tax base. This should also be done to minimise administrative and compliance costs, but this may be difficult to conduct in Parliament. Bringing the marginal and effective rates of tax closer together is an effective solution. Nevertheless, this solution is economically viable but may be not implemented because of political parties and lobbies existing within the present Polish government.

⁴³ The solution would be a copy of Estonian one.

Polish democracy is still young and it is very hard to broaden political consensus about important economic issues, particularly since the Polish economy is in good condition, which does not create unfavourable political conditions. However, due to the abandonment of public finance reforms, when the economic situation is good, the Polish economy and society may pay a higher price in the future. There is certainly a lack of a long-term vision for the evolution of the tax system, which can be accomplished by all governments independently of political options. Such a vision may include the implementation of the flat PIT scheme combined with cadastre tax implementation and adequate projections of social security contribution arrangements. Of course, a sudden implementation of the common flat PIT is rather impossible.

The evolution of the present system, with the tendency toward the removal of tax allowances and exemptions seems to be the way to reach the flat tax. Nevertheless, without public acceptance of the flat PIT, neither the parliament nor the Ministry of Finance is able consider its implementation. Higher tax burdens for low income taxpayers will be major obstacles to overcome. Despite this issue, this solution has many advantages, which should be stressed and widely discussed. The present Polish tax system creates a good basis for such changes. The analysis conducted and arguments presented in this paper should be considered as a starting point in the discussion of the long-term vision of the Polish tax system.

Annex 1.

Table 7. PIT brackets in 2007

Yearly earnings in PLN	Marginal rate in %	Tax paid in PLN
from 3,015 to 43,405	19	19 % less 572.54 tax allowance
from 43,405 to 85,528	30	7,674.41 + 30 % of income above 43,405
above 85,528	40	20,311.31 + 40 % of income above 85,528

Source: Ministry of Finance.

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