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The Polish Tax Reform

Patrick Lenain,

Leszek Bartoszuk

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by
Patrick Lenain and Leszek Bartoszuk

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ABSTRACT/RÉSUMÉ

THE POLISH TAX REFORM

The Polish tax system has commendable features, in particular a capacity to generate strong revenue on a continuous basis. But it also has a number of less desirable features, which could hamper growth in the future and come under increased criticism both domestically and internationally. The authorities have introduced in 2000 an ambitious tax reform package that addresses some of these weaknesses. The present working paper reviews the main features of the Polish tax system, the forces shaping tax policy, and the recently introduced reforms. It also suggests areas where further reform could be beneficial. One such reform relates to the personal income tax and to social security contributions, which are particularly high in Poland and lead, together with the rigid labour market, to a low employment rate and an oversized underground economy. Secondly, the paper argues that the various tax rates on capital incomes should be unified in order to reduce possible distortions in the allocation of savings and in the way investments are being financed. Third, the paper recommends putting property taxes on an *ad-valorem* basis in order to constitute a genuine local government tax base. Finally, the paper recommends introduction of VAT in the small scale agricultural sector, as required by EU rules, but in a gradual manner. Fast introduction of VAT in this sector would entail high compliance costs, would distract tax administration from more important priorities, and would raise virtually no new tax revenue.

JEL *classification*: H2

Keywords: taxation, Poland

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La fiscalité polonaise a beaucoup de points forts, en particulier une capacité à générer des recettes fiscales dynamiques de façon continue. Mais elle a aussi un certain nombre de points faibles qui pourraient peser sur la croissance à l'avenir et qui pourraient faire l'objet de critiques croissantes tant d'origine internes qu'internationales. Les autorités ont mis en place en 2000 une réforme fiscale ambitieuse qui vise à éliminer ces points faibles. Ce document de travail passe en revue les principales caractéristiques de la fiscalité polonaise, les forces qui déterminent la politique fiscale, et les réformes introduites récemment. Il propose aussi un certain nombre de réformes supplémentaires qui pourraient être bénéfiques. Le document suggère de réformer l'impôt sur le revenu des personnes physiques et les cotisations sociales qui sont particulièrement élevées en Pologne ce qui, dans un contexte de rigidité du marché du travail, conduit à un taux d'emploi particulièrement faible et à une économie souterraine développée. Deuxièmement, le document suggère d'unifier les différents taux d'imposition sur les revenus du capital de façon à éliminer les distorsions possibles dans l'allocation de l'épargne et dans la façon dont les investissements sont financés. Troisièmement, le document recommande de baser les taxes d'habitation sur la valeur des propriétés de façon à développer une véritable base pour la fiscalité locale. Finalement, le document recommande d'introduire la TVA dans le secteur des exploitations agricoles de petite taille, mais de façon graduelle. Une introduction trop rapide de la TVA dans ce secteur occasionnerait des coûts élevés de mise en conformité pour les exploitants agricoles, distrairait l'administration fiscale de tâches beaucoup plus importantes, et ne générerait pratiquement aucune recette fiscale supplémentaire.

Classification JEL : H2

Mots-clés : fiscalité, Pologne

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THE POLISH TAX REFORM

Patrick Lenain and Leszek Bartoszuk[1]

1. The Polish tax system has performed well in the last ten years. It has produced strong tax revenue on a continuous basis, helping to finance government spending and lower the budget deficit (Figures 1 and 2). With a well functioning tax system, Poland has been able to avoid the kind of fiscal crisis encountered by other transition economies. The tax system has also made an important contribution to the social cohesion of the country by providing the financing to ensure that vulnerable people -- especially old-age pensioners -- receive an adequate level of income and escape poverty. The tax regime does not appear to have been harmful to the business sector, which has been growing fast in the last ten years, and does not seem to have deterred foreign direct investors, who have entered the economy in large numbers.

(Figure 1. Key features of the tax reform)
(Figure 2. Evolution of tax revenue, 1991-98)

2. Unfortunately, these trends are unlikely to continue in the future. Poland's tax system has a number of features, which could eventually have undesirable effects:

- First, there is evidence that Poland's high labour taxes are harmful to employment[2]. The combined impact of social security contributions and personal income taxes creates a large wedge between labour costs and workers' disposable income. The gross average tax rate reached 42 per cent of the labour cost for the average production worker in 1999 and the marginal tax rate was 45 per cent (Figure 3). Such a high tax wedge raises labour costs, discourages to work in the official economy, and contributes to high non-employment in the working age population.

- A second significant problem of the tax system is its lack of neutrality with respect to investment decisions. The personal income tax encourages construction of new residential buildings, corporate tax incentives favour investments in certain sectors, and tax exemptions encourage location in Special Economic Zones. While there is no evidence that these incentives improve economic efficiency, it is likely that they encourage tax avoidance and lead to decisions purely aimed at taking advantage of a tax relief. Some tax incentives can also have international ramifications and be seen as harmful by other countries trying to implement neutral tax regimes.

- A third problem is that the tax system has become increasingly complex. The tax code contains a considerable number of allowances and reliefs, and requires that the majority of taxpayers file a tax return for small amounts of taxes. Concomitantly, enforcing compliance is becoming increasingly challenging for the tax administration.

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1. At the time of writing, the authors were economists at the OECD. The paper is a revised version of a special chapter that was originally produced for the OECD *Economic Survey of Poland* published in January 2000 under the authority of the Economic and Development Review Committee. The authors are indebted to Paul Atkinson, Chiara Bronchi, Andrew Dean, Rick Imai, Vincent Koen, Val Koromzay, Grzegorz Peszko, and Paul Van den Noord for comments and drafting suggestions, and to the Polish authorities for their assistance with obtaining the information necessary to prepare this paper. The authors are especially grateful for the assistance provided by officials of the Polish Central Statistical Office (GUS) in providing data on tax revenues at the level of the local authorities. Special thanks go to Roselyne Jamin for technical assistance and to Nadine Hofman and Doris Schombs for secretarial assistance.

2. Poland has a large problem of hidden unemployment, only one-quarter of the population aged 15-24 has a job, and most workers retire before the statutory retirement age.

Because of these problems, Poland's tax system could have a negative incidence on economic growth in the future, lead to an erosion in the tax base, and come under growing criticism both domestically and internationally.

(Figure 3. The labour tax wedge in Poland)

3. The Polish authorities are aware of these problems and have taken a number of steps to correct them. They have embarked on a comprehensive reform to establish a new tax system that would produce stable revenue without a negative incidence on economic growth. The present paper begins with an overview of the broad characteristics of the tax system, comparing Poland with other OECD countries. Next, a number of challenges facing the tax system are analysed. The tax reform recently proposed by the government and partially enacted is summarised. Finally, recommendations for future tax reforms are outlined.

The economic and social context influencing the design of the tax system

4. Poland has a high ratio of revenue to GDP (41 per cent of GDP in 1998), a legacy from the years of central planning when state and extra-budgetary revenues were large in relation to GDP. Although the level of revenue in relation to GDP is similar to the levels in European Union countries, it is higher than in the United States, Japan, and other OECD countries. The ratio of revenue to GDP has been stable over the last ten years in contrast to most other transition economies, where it has declined.

5. The level of tax revenue is largely explained by a history of high public spending, including through generous public pension schemes (Figure 4). Old-age and disability pensions have been heavy burdens since the early 1990s when generous indexation decisions were made and early-retirement schemes were provided to workers losing their jobs during the economic restructuring[3]. On average, workers retire five years earlier than the age stipulated by law. In addition, eligibility criteria for disability benefits are generous, and benefit levels are higher than in other countries of central and eastern Europe. As a result, approximately 9.5 million individuals received a pension in 1998, compared to about 7 million in 1990, of which about 4.8 million received a disability pension. Each pensioner is supported by 1.4 contributors, a low ratio by OECD standards. Retirement pensions were 67 per cent of the average salary in 1998, up from 53 per cent in 1989, and disability pensions were 51 per cent of salary. To finance these costs, social security contributions as a share of net wages were raised from 25 per cent in 1981 to 45 per cent in 1998. As a result, Poland devotes 14 per cent of GDP to pensions, well above the OECD average, compared to 6½ per cent in 1989. Disability pension expenditures alone correspond to 3½ per cent of GDP in Poland in 1998, compared for instance to 0.8 per cent of GDP in Germany in 1995. More public funds are spent on pensions than on education, research and development, and public investment (Cabinet of Ministers, 1999).

(Figure 4. General government total outlays, 1997)

6. Given the high share of revenues devoted to pensions, budgetary outlays in other areas that would help raise potential output are correspondingly limited. Social spending and pension outlays are important to cement the cohesion of the country and raise popular support for the reforms. But spending in the areas of education, public infrastructure, justice, and enterprise restructuring are also important in supporting long term growth in the economy. In addition, Poland needs to finance its accession to the European Union and to upgrade its military equipment to NATO standards. Because the tax burden can no longer be increased, solutions need to found to make room for these growth-enhancing outlays.

3. See OECD, *Survey of Poland* (1998).

7. Cutting and restructuring public expenditure has thus become an important objective of the government. The "*Strategy of public finance and economic development*" for 2000-10 recently outlined by the government makes proposals in this direction. The strategy aims at giving the priority to expenditure on research and development, modernisation of roads, investment in the railways system, agricultural development, and restructuring programmes. The strategy also aims at reducing the overall level of spending in order to generate larger government savings and establish the conditions for lower taxes.

8. A substantial part of output and income goes unreported in Poland, as in other transition economies. The size of the "unofficial economy" is estimated to be 15-20 per cent of GDP[4]. This costs the government tax revenue which it must compensate by higher taxes on the official economy or by reduced spending in areas that might be essential for economic growth. In addition to hidden output, there is also anecdotal evidence that firms under-report salaries in order to evade payroll taxes. This may take the form of undeclared payments of wages in cash and in kind.

Main characteristics of the tax system

9. The Polish tax system has undergone significant changes in the last ten years as it was modernised to become closer to European Union standards (Annex I provides a detailed description of the tax system, and Annex II provides an international comparison of tax systems). The system has made the transition from one which relied on transfers from state-owned enterprises to one which is based on the taxation of a wide range of private sector incomes. A number of changes were made in tax policy in the last ten years: the corporate income tax was introduced in 1989 and the personal income tax was introduced in 1992; VAT replaced the turnover tax in 1993 and the general import surcharge was cancelled in 1997.[5] In 1999, a new pension fund system was established, the health insurance act was enacted, and fiscal resources were provided to local governments in the context of the public administration reform. Following changes in recent years, general government revenue is based on three broad categories of taxes (direct taxes, indirect taxes and social security taxes) that each produce approximately one-third of total revenue (Figure 5). Most direct and indirect taxes are collected by the state to finance the general budget, while social security contributions are earmarked for large extra-budgetary social security funds (Social Insurance Fund, Health Fund, Pension Funds).

(Figure 5. Tax mix of selected countries, 1997)

10. The personal income tax is based on the world-wide income of resident individuals, but treats earned income and capital income differently (Table 1). As of 1999, earned incomes (other than financial incomes) are taxed at 19, 30 or 40 per cent, depending on the income bracket (down from 21, 33, or 45 per cent in 1996). The income brackets are very wide so that, given the relatively narrow income distribution, most taxpayers fall into the first bracket (Figure 6). Although they have been tightened recently, many income deductions are still allowed. In addition to an automatic fixed income deduction, individual taxpayers are authorised to deduct from income expenses incurred in building apartments for rents, social security contributions, expenses on the disabled, fees to organisations and donations to non-profit institutions. A tax credit can also be obtained for investment in housing, renovation of houses, health insurance contributions, education-related expenses, and some medical expenses. Spouses can file their

4. By comparison, the underground economy is estimated to range from 5 per cent of GDP (Scandinavian countries, Austria, the Netherlands) to 20 per cent (Italy and Greece) in the European Union, and to be about 40-50 per cent of GDP in Russia and Ukraine.

5. Poland maintained a general import surcharge of 6 per cent to generate additional revenue. This was gradually phased out and eventually cancelled in 1997 in line with Poland’s commitment under the GATS agreement to liberalise its foreign trade.

incomes jointly, in which case the tax rate is determined based on half the combined income. With a standard rate of 22 per cent, VAT has been brought close to the European Union standards with two notable exceptions: two reduced rates (4 per cent and 7 per cent) prevail on a broad list of goods and services, and agricultural production is not subject to VAT. The corporate income tax is based on the "classical" system under which corporate income is fully taxed and distributed profits (dividends) are taxed again by way of withholding. The corporate income tax rate is 34 per cent in 1999, down from 40 per cent in 1996, but still slightly above the rates observed among Poland's neighbours in central and eastern Europe. Corporate tax liabilities can be reduced by a fraction of investments made in certain sectors and firms that the government intends to support (export-oriented firms, start-ups, fisheries). Exemptions from the corporate income tax are also granted in Special Economic Zones. Social security contributions have been recently split between employers (17.9 per cent of gross wages) and employees (18.71 per cent). These contributions finance the first and second pillars of the old-age pension system, the disability pension regime, and other social benefits. Contributions are also due to the labour fund (2.45 per cent) to finance unemployment benefits and active labour market policies. A contribution equivalent to 7.5 per cent of taxable income was introduced in 1999 to finance the newly created health funds. This latter contribution is fully deductible from the personal income tax.

(Table 1. The tax system in a nutshell, 1999)
(Figure 6. Distribution of income and PIT tax brackets)

11. Several key features characterise Poland's tax system.

- *First*, tax revenue tends to rely more on social security contributions than on average in the OECD, a feature shared also by Hungary, the Czech Republic, and several Western European countries. This is in part a legacy from the communist system, but also a sign that Poland has found labour easier to tax in terms of tax administration (social security taxes are directly withheld at a fixed rate and no deduction is allowed). Labour is also less mobile than capital and therefore may not escape taxes easily.

- *Second*, the tax system is less diversified than in other OECD countries. Small taxes -- such as property, inheritance, or environmental fees and fines -- produce virtually no revenue. Other countries have diversified their tax system to spread the burden across a broader category of income and assets, and to avoid high tax rates on limited tax bases, but Poland relies on somewhat narrower range of tax instruments.

- *Third*, the bulk of tax revenue goes to the central government and to the social security institutions. Local taxes generate little revenue, and local governments receive only a very small portion of total revenue by OECD standards (Figure 7).

- A *fourth* specific feature of the tax system is the size of arrears on taxes and social security contributions (Table 2). At the end of 1998, total outstanding arrears amounted to Zl 15 billion (3 per cent of GDP), with the largest arrears stemming from state enterprises' late payments of social security contributions. Loss-making coal mines, steel mills, and the railway company were in particular all in arrears, with the implicit or explicit consent of the authorities. Social security contribution arrears were among the factors that triggered a liquidity problem at the Social Insurance Office (ZUS) in 1999.

(Table 2. Arrears on taxes and social security contributions)
(Figure 7. Tax revenue by level of government, 1996)

12. A *fifth* specific feature of the tax system is the generosity of tax exemptions, which results from numerous decisions made in recent years. For instance, the personal income tax law was amended more than 30 times and the corporate income tax law more than 40 times. As a result, the personal income tax contains about 125 tax reliefs, 10 types of income deductions, and 14 types of tax credits. The most costly for the budget are the income deductions and tax credits allowed for housing-related expenditures (Table 3). These deductions are popular among high income earners. Another deduction is for the purchase of educational material, which is interpreted rather loosely (*e.g.* video cassette recorders are often treated by families as such and their cost is deducted from income). Affluent taxpayers tend to benefit more from income deductions because they can afford to make the expenses required to benefit from tax allowances (such as housing investment). In 1997, only 39 per cent of taxpayers in the lowest tax bracket claimed an income deduction, compared with nearly 90 per cent for those in the highest tax bracket. This is because well-informed and skilled taxpayers in the high income tax bracket could afford to buy real estate and claim the corresponding deductions. The system therefore benefited affluent taxpayers disproportionately. A costly feature for the budget is the tax exemption granted to small entrepreneurs hiring disabled workers and who file their income under the personal income tax. Such a tax exemption is difficult to administer and, therefore, there is scope for abuse.

13. The impact of tax allowances is shown by the difference between the theoretical and the observed average tax rates. Based on the official tax schedule, the average tax rate on personal income (weighted by the number of taxpayer in each tax bracket) should have been 15.5 per cent of income in 1998. The Central Statistical Office (GUS) survey of households for 1998 shows, however, that households only paid 12.5 per cent of their income in personal income taxes on average. Although the latter number should be interpreted with caution, it suggests that households avoid taxes by using tax deductions, and evade taxes by hiding income and wage payments from the authorities.

(Table 3. Budget revenue losses from PIT allowances, 1996-98)

14. The corporate income tax also has generous exemptions. It has more than 40 investment allowances, 63 depreciation schedules, and investors enjoy 5-10 years of tax holidays in 17 Special Economic Zones. Although these exemptions cannot be cumulated, they are costly for the budget and make the tax system hard to understand and difficult to enforce. Similarly, a growing gap can be observed between the nominal rate of social security and labour fund contributions and the observed effective rate (Table 4). This is also to be interpreted with caution but reflects the use of loopholes in the existing legislation and the accumulation of arrears of contributions.

(Table 4. Social security taxes: statutory and effective rates)

Taxation and economic performance

15. This section reviews the incidence of Poland's tax system on employment, investment, capital income, the property market, and the environment. Additional sections review the tax regime for local governments and the status of tax administration.

Taxation and the labour market

16. An important consideration for the tax system is its impact on the labour market. It is generally agreed that the marginal tax wedge[6] on labour may affect labour supply, labour demand or both. The labour tax wedge is particularly high in Poland (Figure 8). For the average wage single-income earner, the average tax rate (personal income tax + social security contributions) is 42 per cent in 1999, and the marginal tax rate 44 per cent[7] (Table 5). In Poland, where social benefits are relatively generous and early-pension an easily available option, the labour tax wedge is likely to reduce labour supply. In addition, the elasticity of labour-supply to the tax wedge in the official economy may be higher in Poland than in other OECD countries because, for wage-earners and self-employed, work in the unofficial economy can be a close substitute. Given these two constraints, Poland should have a lower tax wedge than other countries in order to have a well-functioning labour market, rather than the higher tax wedge it has currently.

Box 1. How to make work pay more?

For people at the margin of the labour market, the combination of generous benefits and high taxes reduces the rewards from work. In Poland, for low-income and old age people, benefits are generous compared to wages. Unemployed workers receive a flat benefit for 6 to 18 months; low paid workers are eligible to benefits in the form of housing allowance and social assistance; and old-age workers have an incentive to leave on early-retirement or try to obtain a disability pension. On the other hand, taxes are high even for low-paid workers.

In these circumstances, the rewards from work can be limited. Returning to work, staying at work, or working more can be costly decisions. It is therefore not surprising that Poland has such a large pool of discouraged workers, in the form of hidden unemployment in the rural areas. It is also not surprising that workers are so attracted by early-pension schemes. The high tax rates explain why the wage-bargaining process is so difficult and why the Tripartite Commission often fails to reach agreement, as workers try to obtain higher real wages to compensate for the level of taxes. Overall, this reduces labour supply (mainly through hidden unemployment and early-retirement) and labour demand (because labour costs are higher than they could be).

OECD countries have experienced new policies to make work more rewarding. The United States has been using an Earned-Income Tax Credit (EITC) scheme since 1975 to offset the adverse effects of taxes on working poor families, and to provide incentives to work by increasing the after-tax income. The United Kingdom is using a Working Family Tax Credit (WFTC) that guarantees a minimum income to families with at least one working adult. France has reduced payroll taxes for the low paid since 1996. The rebate reduces the cost of labour by 12.6 per cent at the minimum wage level. In addition, health insurance contributions are no longer based on payrolls but on overall income, including income derived from financial investments.

There are good economic and long-term labour market reasons to introduce a scheme that would make work pay more in Poland, especially more than living on benefits. The first priority step in this direction is to cut the abuse of disability benefits, early-pensions, and sickness allowances. The generosity of such benefits and their lax administration encourages to leave the labour market or to work in the official economy. This would help promote labour supply and encourage workers to shift from the underground to the official economy. If this is not enough, consideration could be given to a more generous flat income deduction from the personal income tax than currently for families with at least one working adult. It could also take the form of a tax credit for workers at the minimum wage.

6. The labour marginal tax wedge is the increase in payments of income taxes and social security contributions associated with an increase in gross labour earnings (gross wages plus employers' contribution to social security and private pension plans).

7. The average and marginal tax rates would be even higher if indirect taxes were included.

(Figure 8. Tax revenue and tax wedge in 1997)
(Table 5. Estimated marginal and average personal income tax rates, 1999)

17. Poland provides social benefits to the unemployed, means tested benefits for children, and a minimum living standard for low-income people. For the unemployed, living on social benefits (such as social assistance, childcare, or unemployment benefits) is an interesting alternative to working at the minimum salary, losing benefits, and paying taxes. These benefits are in general lost as soon as individuals accept a job, work longer hours, or in any other way improve their income. Combined with high tax wedges, the loss of benefits makes working a costly decision for certain groups. Calculation of marginal effective tax rates net of cash transfers suggest that the increase in net taxes can be as high as 120 per cent of income for individuals moving from unemployment to a job paid at the minimum wage (Figure 9). This may help in understanding why, in addition to the large number of registered unemployed (2.1 million in mid- 1998), close to 1 million people are considered as "hidden unemployed" according to the 1996 survey of households and the agricultural sector. These are "discouraged" workers who have left the labour market, and fallen into the "unemployment trap", notably for a large number of redundant workers in the agricultural sector.

(Figure 9. Marginal and average net tax rates on individual incomes)

18. A first step toward reducing the pervasive effect of some benefits was taken in 1999 with the tightening of rules on sickness allowances. In Poland, as in other OECD countries, eligibility conditions for sickness allowances were often too lax and subject to abuse. The number of sickness benefit days has been rising in recent years, and related spending was more than doubled since 1995. In line with OECD recommendations, a new bill amending the current system of sickness benefits has been adopted by Parliament. The bill tightens eligibility criteria, mainly by reinforcing medical considerations. It includes a tighter control for the extension of the sickness benefit period, which must be provided only by a physician officially certified by the Social Insurance Office, and the creation of a central register of medical certificates. The bill came into effect on 1 October 1999.

19. Poland introduced a pension reform in 1999 which substitutes labour taxes with contributions to individual pension accounts, which are a form of compulsory savings and therefore makes work pay better in the long-run. Under the reformed first and second pillars, at any time employees know the amount of their accumulated contributions and are therefore likely to perceive their contributions, not as compulsory taxes, but more as a form of contribution to long-term savings. This should therefore encourage greater participation in the labour market, and notably encourage later rather than earlier retirement. If successful, the pension fund reform can have the effect of reducing the perceived tax wedge, make work pay more and encourage greater participation in the labour market. Assuming that pension contributions are saved incomes, and not taxes, the tax rate falls from 42 per cent to 27 per cent and the marginal rate from 44 per cent to 28 per cent for the worker paid at the average wage.

20. To be successful, however, the pension reform needs to be credible. Workers have to be convinced that their contributions to pension funds will guarantee benefits. The initial difficulties with the pension reform show that this credibility does not come easily. Measures need to be taken rapidly to correct the initial delays in registering contributors in the appropriate private funds, and to channel contributions to these funds.

21. The health insurance reform does not have the same positive impact. Health premiums are not related to benefits; working more does not provide entitlement to a more generous health treatment. In addition, the unemployed are eligible for the health insurance; deciding to work or not to work has no influence on the eligibility to health benefits.

Taxation and international investments

22. The tax system is often seen as a factor taken into consideration by foreign direct investors. It is believed that, before making an investment decision, investors look at the corporate income tax, the property tax, and customs tariffs as well as the tax reliefs that may apply to all those taxes. International tax competition has put national authorities under pressure in recent years to offer greater tax incentives to attract international investments, and the recent trend in central Europe has been to offer more tax incentives. Based on recent available evidence and studies (Easson, 1998), however, it appears that the tax system is only one factor among others taken into consideration by international investors. A market-friendly economic environment, a well-educated work force and a stable legal system are more important determinants. Because of the risk of introducing unnecessary distortions in the tax system, OECD countries have generally taken steps since the early 1980's to phase down special tax incentives for international investors. Poland, on the other hand, still has a tax regime with features to attract international investors. As noted, tax exemptions are offered to investors in Special Economic Zones, including full exemption from corporate income tax for five to ten years and other advantages. Anecdotal evidence also suggests that large foreign direct investors to Poland (such as foreign car manufacturers) also benefited from special tax incentives.

Capital income and taxation

23. Capital income is subject to different tax rates: under the corporate income tax, income is taxed at 34 per cent. But under the personal income tax, dividends are taxed at 20 per cent, interest income is exempt, and capital gains on shares are taxed as regular income. The marginal effective tax wedge therefore varies depending on the type of financing sources for a given investment, as shown in Table 6. Firms are encouraged by the tax system to borrow because they can deduct interest payments from their taxable income. In contrast, the withholding tax on dividends depresses the price of shares and therefore discourages the floatation of new equity. This works against firms that do not have access to bank lending because their size, collateral and level of development are not sufficient. This also tends to penalise start-ups that need to raise equity to finance their development. In contrast, the tax system favours large and established firms. It is not surprising, therefore, that large, foreign owned firms, and firms with strong cash positions have high levels of leverage in Poland (Hussain and Nivorozhkin, 1997).

(Table 6. Effective marginal tax wedge by funding sources)

Taxation and levels of government

24. Poland has inherited from the past a very centralised budget system, with the bulk of revenue going to the state and to social security administrations, and only 5 per cent of revenue going to local governments. Beginning in 1998, the authorities have allowed a greater degree of decentralisation, and steps have been taken to loosen central control over local budgets. Under the new system, local governments play a growing role for expenditure decisions. *Gminas* (communes) continue playing an important role in primary education, local roads, commercial services, and basic utilities. *Poviats* (counties) are called to play a role in secondary education and general health care. *Voivodships* (regions) are responsible for the regional economic development, co-ordinating the poviats and gminas they embrace. They also play a role in higher education and supervise the sickness funds.

25. Large financial transfers are made by the central government to local governments. In 1999, *gminas* are expected to get 45 per cent of their revenue from earmarked allowances and general grants distributed by the central government. *Poviats* are expected to rely even more on transfers from the central government, with 93 per cent of revenue coming under an earmarked allowance and a general grant from

the central government. *Voivodships* should receive 76 per cent of their revenue from the central government, with most of the remainder coming from a pre-determined share of the CIT. Altogether, local governments appear to have little autonomous power in making tax policy decisions and to rely heavily on central government transfers. In 1998, central government transfers did not play a role in closing the income gap between regions. These transfers were merely based on the size of the population living in each region, without attempting to reduce income distribution (Figures 10 and 11). In addition, these extensive transfers, while helping local governments match their resources with the expenditure they are responsible for, ran against the principle of delegating more powers to localities in their policy decisions and in their development strategy. Steps to delegate tax policies to regions are therefore necessary.

(Figure 10. Intergovernmental finances, 1998)
(Figure 11. Local tax revenue per capita, 1998)

Taxation and the property market

26. Several features of the Polish tax system have a potential impact on the property market. Under the personal income tax, individual taxpayers investing in rental flats can deduct a part of their investment from their taxable income and therefore considerably reduce their personal tax liability. Taxpayers involved in construction of single-family houses can take advantage of two tax credits, for the purchase of land up to 350 square meters, and for construction. Housing improvements and renovation are also creditable under the personal income tax. Based on the experience of other OECD countries, the elasticity of residential investment to tax deductions is likely to be high, because high-income taxpayers can take advantage of this exemption to reduce their tax liability and to reduce the cost of their investment. On the other hand, such an exemption may have a regressive impact because it benefits high-income taxpayers, without reducing the rental cost for low-income families. A different option to help low-paid families find affordable accommodation is to finance means-tested programmes that help purchase a first home. Public spending in mass transportation infrastructure and urbanisation of new areas may also be a more effective way to expand the availability of housing for low-income groups.

27. A stamp duty is imposed on housing transactions. Buyers of properties in the secondary market must pay a stamp duty amounting to 5 per cent of the value of the transaction. Purchasers of new properties and of co-operative apartments pay a stamp duty amounting to 2 per cent of the property value. Agricultural buildings are not subject to stamp duty. This tax is high by international standards and is likely to have a negative impact on the property market. It also reduces the mobility of the labour force inside the country. In addition, local governments impose property taxes based on the size of the living space in terms of square meters. The property tax is small and is unlikely to influence the property market.

Tax administration and enforcement

28. The Ministry of Finance is responsible for enforcing compliance with tax legislation and for collecting tax revenue through its local tax offices. Tax administration employees number about 50 000, at a cost equivalent to about 1½ per cent of state budgetary revenue.[8] The Ministry of Finance and the social security administration use common tax identification numbers (TINs) to identify individual taxpayers. About 24 million taxpayers[9] are currently registered with TINs. Tax administration has been successful in

8. By comparison, the cost of tax administration is equivalent to 1.6 per cent of tax revenue in France, 1.1 per cent in United Kingdom, and 0.5 per cent in the United States.

9. Farmers do not pay taxes and are, therefore, not registered as taxpayers. Poland intends to bring farmers into the tax net in 2000.

collecting a relatively high share of revenue in GDP. The tax administration system resorts to a number of tools to fight against tax evasion. Personal income tax and social security contributions are directly withheld and paid by employers to the tax administration, thus reducing the scope to hide income. The Tax Identification Numbers help to simplify tax administration and cross-check the accuracy of income statements with other sources of information. With the expansion of international financial flows, Poland has taken steps to reinforce its co-operation with tax offices in other countries in order to share information and provide mutual assistance for the recovery of claims.

29. Notwithstanding these strengths, estimates of the size of the underground economy (15 to 20 per cent of GDP) suggest that a significant amount of income is removed from the tax base. The limited uses of computers and information technology resources confine tax administration agents in manual-record keeping tasks and reduce resources available for tax auditing and tax control. The tax administration has poor information on taxpayers' individual assets. The lack of central registration of liens also prevents the verification of the accuracy of taxpayers' liabilities.

30. Compliance with the tax system is undermined by the high administrative burden imposed on taxpayers. Individual taxpayers must select among 24 different types of forms for filing personal income tax declarations, depending on the type of income earned, the time span of declaration, the family status of the taxpayers, and the exemptions and tax credits claimed for. The VAT legislation requires 75 types of information to be filed monthly, and the corporate income tax even more (128 lines). While Poland has introduced simplified tax filing status for certain categories of taxpayers (tax card and lump-sum status), this has met with limited success because even these simplified regimes still remain too complex.

Taxation and the environment

31. Empirical evidence suggests that economic instruments, including taxation, can be a powerful means to achieve certain environmental goals. In environment protection, OECD countries are gradually moving toward greater and more consistent use of economic instruments as a complement or a substitute to other policy instruments such as regulation. Since the 1970s, Poland has utilised a system of environmental fees in combination with regulatory instruments (limits on emission of pollutants or discharge limits) (Peszko, 1999). Fees are based on actual, self-reported emission of pollutants. Under the principles of "the Polluter Pays", the system makes polluters pay fees for their actual pollution. This gives an incentive to reduce the level of emission in order to reduce the fees. In addition, firms must pay environmental non-compliance fines when their level of emission or discharge exceeds the level allowed in the facility permit. Fees and fines are charged on air pollutants, solid and hazardous wastes, discharges of wastewater, surface and ground water extraction, and land clearing. Under the pre-transition regime, fee rates were quite low and did not have a noticeable effect on pollution levels. Since 1990, the fee rates have been increased dramatically. Environmental fees are levied by the Environmental Protection Departments of the Regional (Voivodship) Offices. They are normally collected once a year, but may be required on a quarterly basis from large enterprises. All revenue from fines and fees are earmarked. They are distributed to the National Fund for the Environment, 49 Regional Funds, and approximately 2 500 Municipal Funds. The funds disburse resources for environmental investments and other environmental activities (education, research, monitoring equipment). These resources are disbursed through a variety of disbursement mechanisms (soft loans, grants, interest subsidies, equity investments).

32. In view of the challenge of meeting EU environmental standards in the future, the tax system could do more to promote environmentally-friendly practices. Although fees and fines are high, they are not high enough to stimulate investment in pollution-reducing equipment. By some estimates, the cost of

such investments can be six times higher than the payment of fees[10]. The system of fees and fines has provided incentives for polluters to make low-cost investments in pollution-reducing techniques, but has not stimulated more drastic changes. Some taxes discourage progress towards stronger environmental protection -- for instance, excise taxes on unleaded and leaded gasoline are similar. The government also continues to subsidise activities that have a perverse environmental impact (such as subsidies to the coal sector). Finally, compliance with the fees is limited, notably in the coal sector. It is, therefore, not surprising that Poland produces one of the highest levels of carbon dioxide in relative terms among OECD countries, thus contributing negatively to climate change.

The tax reform

33. Poland's current tax system is young but has many commendable features. The authorities have been able to transform the previous tax regime based on transfers from state-owned enterprises to a system adapted to a market economy. Nevertheless, as of 1999, the tax regime had been weakened by numerous alterations introduced in the previous few years and, if left unreformed, this could have resulted in fiscal revenue shortfalls and have a negative incidence on economic performance. It was, therefore, more than time to enact a decisive tax reform.

34. In 1999, the authorities formulated tax reform proposals which were partially enacted (Box 2). The tax reform was part of an overall economic strategy to boost the long-run growth potential of the economy. It was designed to lower the tax burden on the economy, provide greater incentive for productive activity, and reduce the distortions between different sources of income. As in other OECD countries having implemented tax reforms, the focus was put on lowering tax rates while broadening the tax base. The tax reform was launched by the "*White Book on Taxes*" drafted by the Ministry of Finance in 1998 and distributed among political, business, and academic circles to spur a public debate with a view to forging a consensus on the future tax reform.

Box 2. A summary of the tax reform enacted in 2000

Corporate Income Tax

- 34 per cent in 1999.
- 30 per cent in 2000.
- 28 per cent in 2001.
- 28 per cent in 2002.
- 24 per cent in 2003.
- 22 per cent from 2004.
- Elimination of investment allowances.
- Rates for capital depreciation reduced to 10.
- No new tax exemptions in special economic zones starting in January 2000.

Value added tax

- Municipal services:	7 per cent starting in 2000.
- Construction materials and services:	7 per cent in 2000
	12 per cent in 2001.
	17 per cent in 2002.
	22 per cent subsequently.

10. According to Peszko (1999), the fees on SO2 and NOx were approximately $94 per ton at the beginning of 1997. However, the estimated marginal cost of investments to achieve a 30 per cent reduction (equivalent to new standards) in SO2 is approximately $600 per ton for large combustion sources.

Reform of the personal income tax

35. The government submitted to parliament proposals to reform the corporate income tax, the VAT, and the personal income tax laws. The first two draft proposals were passed into law but, due to a presidential veto, the personal income tax draft law was not enacted. The personal income tax reform aimed at broadening the taxable base while reducing the tax rates at the same time. Under the authorities' proposal, the tax rates would have been lowered from the schedule of 19, 30, and 40 per cent to 19, 29, and 35 per cent in 2000, 19, 28, and 35 per cent in 2001 and 18, 28 per cent in 2002 (the highest tax rate would be eliminated). At the same time, most income deductions and tax credits would have been eliminated in order to broaden the tax base. Income deductions for donations to charities would have been limited to 10 per cent of income. Income deductions for the purchase of health services would have been eliminated. Investments made by the self-employed would no longer have been tax-deductible (except for investments already started in 1999). The deductions for investment in rental apartments and housing construction expenses would have been repealed. Instead, a means-tested programme would have been introduced to help less affluent people build their first home.

36. In addition, income derived from gambling would have been subject to a flat 10 per cent tax when exceeding three times the average salary. Small businesses employing disabled workers would no longer have been authorised to exempt their income from the personal income tax; instead a new programme targeted to the disabled and based on the level of disability would have been introduced. The depreciation system would have been simplified for small businesses. Dividends would have remained subject to a flat tax rate of 20 per cent in 2000, but the tax rate would have been reduced to 15 per cent in 2001. Interest income derived from fixed deposits, treasury bills, and municipal bonds would have been subject to a 5 per cent flat tax starting in 2003. Capital gains realised on the stock market would have been taxed, starting in 2003, at a minimum rate of 18 per cent and would have been aggregated to individual incomes. Although the government's proposal was stopped by a presidential veto, the authorities intend to submit it again for consideration by parliament in 2000.

Reform of the corporate income tax

37. The reform of corporate income taxation was passed into law and becomes effective in 2000. It aims at lowering the tax rate, and broadening the tax base at the same time. The income tax rate will be reduced from 34 per cent in 1999 to 22 per cent in 2004. Simultaneously, investment incentives are eliminated in order to broaden the income tax base. Other aspects of the corporate income tax are reformed at the same time. The number of depreciation rates are reduced to 10 and the initial value of fixed assets are re-indexed based on recent inflation developments. Existing loopholes in the legislation are closed, with a clearer definition of taxable income being introduced. Steps are taken to avoid that income be filed in tax havens, or to avoid that international investors concentrate losses in Polish branches in order to reduce their tax liabilities.

Indirect taxes

38. The Polish government has proposed steps to harmonise the VAT and excise taxes with EU rules, in preparation for accession. These changes were accepted by parliament and become effective in 2000. Under the EU Sixth Council Directive, member countries must apply a common VAT scheme that spells out the basis for assessment, the tax rates to be applied, and the special arrangements that need to be put in place. The common regime establishes that a standard rate of at least 15 per cent must be applied to goods and services. Two reduced rates of at least 5 per cent are authorised for supplies of goods and services having a social or cultural purpose; the list of these goods and services is spelled out in Annex H of the

Directive[11]. In addition, standard exemptions from VAT are allowed[12]. Finally, a recent Council Directive authorises member countries to apply the reduced VAT rate to a specific list of services with high labour content (such as housing maintenance and renovation).

39. Like other central and eastern European countries, Poland has taken steps in recent years to come closer to the common VAT rules[13]. The standard rate of 22 per cent is well above the minimum rate of 15 per cent (but close to the rate actually used by several EU members), and the reduced rate of 7 per cent is above the minimum required. Most importantly, municipal services (public transportation, garbage collection, water) already are, or soon will be, subject to the appropriate VAT rate. Similarly, energy-related products (electricity, coal, heating, and hot water) are already taxed at the standard rate of 22 per cent. A number of deviations from EU rules are expected by the authorities for social and political reasons, for which they may request transition periods (in particular articles for children, construction material, new residential construction, legal services, and newspapers).

40. Bringing the agricultural sector into the tax net is the most important EU accession requirement in the field of tax policy that Poland faces. This presents an economic, social, and political challenge for the authorities. Poland has two million farms, most of which are small. Although the sector accounts for only 4 per cent of GDP, it provides 27 per cent of employment. This clearly indicates that productivity is extremely low in the agricultural sector and that, concomitantly, rural area incomes are also low. Because of the dominant social and economic impact of agriculture, Poland exempts agricultural production and trade in agricultural products from VAT. In particular, unprocessed food items (eggs, milk, meat, fish) are exempt from VAT. Moreover, a large number of agricultural inputs is zero-rated or taxed at the reduced rate, such as feed, seed, fertiliser, and machinery and equipment. Optional registration is available for farmers. However, *de facto*, the entire agricultural sector is zero-rated, except for a few purchases (electricity and building materials). All of these features are at odds with the Sixth Directive, which prescribes that agriculture should be included in the VAT base.

41. EU rules also require that excise taxes be maintained above certain minima. For most products, Poland has already taken measures to comply with EU rules, in particular for energy products and for alcohol. Legislative action is required, however, to put excise tax on cigarettes on an ad-valorem basis and raise the tobacco tax to the required level.

Assessment of the reform

42. The tax reform adopted by Poland is a courageous step which will decisively modernise the tax system, make it more equitable, and provide greater incentives. Regrettably, the personal income tax reform will not, for the time being, become effective. The authorities were right to aim at lowering personal income tax rates and broadening the tax base, as many OECD countries have done before with

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11. Annex H items consists of basic foodstuffs, other food products; luxury food items; water; pharmaceutical products; medical equipment; accessories for the handicapped; public passenger transportation; books; newspapers; periodicals; authors, composers, and artists; radio and TV broadcasts; cultural events; sporting events and facilities; social housing, hotels, boarding houses, and camping sites; agricultural inputs (except machinery and buildings); funerals; garbage collection; and waste treatment.

12. Standard exemptions consist of postal services; medical care; dental care; charitable work; education; non-commercial activities of non-profit making organisations; cultural services; radio and TV broadcasting; insurance and reinsurance; letting of immovable property; financial services; lotteries and gambling; supply of land.

13. OECD, 1998, "Value-Added Taxes in Central and Eastern European Countries - A Comparative Survey and Evaluation", OECD Centre for Co-operation with Non-members.

success. The proposed reform of the personal income tax would have eliminated the many debatable income deductions and tax credits, which benefit the most affluent taxpayers and therefore have a regressive impact on income distribution. The lowering of personal income tax rates would have been a step in the direction of increasing incentives. The reform of the personal income tax remains an importance piece of unfinished business. It should be resubmitted to parliament to ensure consistency with the reform of the corporate income tax. As they submit a new draft, the authorities could propose a larger flat income deduction or a larger flat tax credit, to make workers paid at or near the minimum salary tax exempt. This would contribute to making work pay more and would provide powerful incentives to participate in the labour market. The phasing out of the high income tax rate of 40 per cent would encourage those who are currently hiding income sources to comply with the tax system in the future.

43. The decision to comply with the EU Sixth Directive is also an initiative which will facilitate accession to the Union. Higher VAT taxes and excise taxes will generate the additional tax revenue needed to offset the losses stemming from the lower income tax rates. However, bringing the agricultural sector into the tax net carries particularly important political and social risks, with dubious benefits on the economy and on tax revenue. It is unlikely that Poland's two million small farms will be able to keep books of accounts and follow VAT rules in the near future. In any case, bringing the farms into the tax net would not generate new revenues because the VAT paid on farms inputs would be deducted from the VAT charged on foodstuffs. This would carry large administrative and compliance costs both for farmers and the tax administration. At this stage, Poland should introduce a threshold (based for instance of the size of the farming land plot) below which farmers would not have to register for VAT, keep books, and pay taxes. Demographic trends and EU integration will eventually lead to a restructuring of the agricultural sector in Poland. Overtime, this threshold should therefore be reduced to a level that is consistent with EU rules. A similar approach could be followed for the integration of the small scale farming sector into personal income taxation.

Scope for further reform

44. Despite the tax policy measures recently proposed by the government, there are other important measures that need to be taken (Box 3). The *first* priority is to make the tax regime more friendly for job creation. The large tax wedge created by the combined effect of social security taxes and personal income taxes has likely had a detrimental impact on labour supply and labour demand. Fortunately, the recent pension fund reform helps to make perceive pension contributions as a form of savings rather than just another tax. This may have a positive impact on labour supply, encouraging more people to work and thus raising potential output. It will also encourage workers to shift out of the underground economy to the formal sector, but may not, however, reduce labour costs immediately due to existing wage rigidities, especially at the minimum wage level. An overall reduction in ZUS contribution rates is necessary to boost job creation. There are several ways to finance this overall reduction: disability pension benefits should be made less generous by tightening eligibility criteria; the ZUS tax base could be expanded to cover fringe benefits, payments in kind, contractual work, and other kinds of incomes. The self-employed should assess their social security contributions based on actual income, rather than artificially low presumed income. Spending on sickness leave could also be reduced, as there is scope for abuse in the presently generous system.

Box 3. Further reform of the tax system: synopsis of recommendations for Poland

The following synopsis of recommendations draws on the experience of OECD countries and applies them to the specific economic and social circumstances of Poland.

Reduce the labour tax wedge to promote employment

- Resubmit the personal income tax draft law to parliament.
- High social security taxes, together with the personal income tax, create a large tax wedge and discourage employment. Lowering social security taxes could reduce the tax wedge. Tightening eligibility criteria for disability benefits, early pensions, and sickness allowances would reduce spending and enable lower social security contributions. Widening the tax base to include fringe benefits, contractual work, and wage payments in kind and closing existing loopholes would offset the tax cuts. The social security contribution of self-employed should be assessed on their actual income, not the existing low presumed income.

Eliminate distortions on capital income taxation

- Poland has different effective tax rates on corporate income depending on the source of financing, the legal form of the investor, and the residence status of the lender. This distorts investment decisions and incites companies to make decisions based on fiscal opportunities rather than on economic factors. Effective tax rates on various capital incomes should be aligned.

Harmonise VAT with the European Union directives

- In the context of its accession to the European Union, Poland will have to accept the obligations of the Sixth Directive on indirect taxation. Products currently exempt from VAT or subject to reduced tax rates should be brought in line with EU harmonisation requirements. This will most importantly affect the rate of tax on building materials, new apartments, articles for children, cultural services, books, magazines, and legal services. Excise taxes on tobacco need to be raised and calculated on an *ad-valorem* basis.
- Introduce a threshold (based for instance on the farming land size) below which small farms would not have to register for VAT purposes or keep books of accounts. Overtime, reduce the threshold to the level authorised by the EU. A similar approach could be adopted for the application of the income tax to the farming sector.

Introduce environmental taxes

- Introduce product charges on goods and services that damage the environment and contribute to climate change such as coal, electricity, packaging material.
- Raise VAT to the standard rate for all goods and services damaging the environment.
- Stop earmarking pollution fees and non-compliance fines and transfer these resources to the general budget of the central or local governments.

Improve and simplify tax administration

- Calculate and publish a tax expenditure budget, that is, identify the cost of the loss of tax revenue due to exemptions, deductions, and credits allowed by the tax code. This would be intended to make policy-makers, legislators, and the public aware of the revenue shortfall directly linked to tax allowances.
- Expand the use of information technology in tax administration.
- Rewrite unclear parts of tax laws, especially of the corporate income tax law, in close co-operation with groups of taxpayers.
- Begin the process of drafting a clear, simple, coherent, and comprehensive tax code covering all aspects, in co-operation with relevant parliamentary bodies and groups of taxpayers.

Bring the property market into the tax net

- As foreseen in the EU Sixth Directive, new apartments and houses should be made subject to the standard VAT rate.
- The property tax should be calculated on an *ad-valorem* basis, based on a new fiscal cadastre, and the revenue channelled to local governments
- The stamp duty on the purchase of apartments and houses should be repealed.

45. A *second* priority is to give more autonomy to local governments in formulating their tax policy. As shown by the experience in early 1999, large financial transfers from the central to local governments may have a destabilising impact on the central budget. Poland should instead allow local governments to build their own tax base with a range of tax instruments, rather than let them rely so heavily on transfers from the central government. In particular, local governments should assess the property tax on the value of properties rather than their size. Nonetheless, careful supervision of local budget operations is required to avoid slippage and possible fiscal crisis. Large borrowing by local governments with municipal bonds or other debt instruments should remain subject to monitoring and, if necessary, pre-approval at the central level because local debt service defaults would have an impact on the debt rating of the entire country. A "golden rule" -- limiting borrowing at no more than investment in infrastructure or buildings -- could be introduced. Alternatively, a system of "internal stability pacts" could be introduced.

46. A *third* priority is that the tax system contributes to a development that would be less damaging for the environment and for the world climate. A number of changes in the tax system could be introduced in the short-term to contribute to an environmentally sustainable development. The government could consider introducing charges (such as excise taxes) on products that contribute to pollution and to climate change. At present, product charges are nearly non-existent in Poland[14]. A higher excise tax should also be introduced on leaded gasoline in order to differentiate its price from unleaded gasoline, following the experience of other OECD countries. In addition, some goods and services benefiting from the reduced VAT rate are damaging to the environment. For example, pesticides, fertilisers, and chemical inputs to the feedstock are zero-rated under the VAT. Heat, electricity, coal, and gas are also subject to a standard VAT rate. Higher VAT rates and product charges would generate more environment-related revenues. The government could use these additional revenues to reduce the labour tax wedge. Finally, the authorities should stop earmarking the environmental fees and non-compliance fines. In general, earmarking tax resources reduces flexibility in the budget execution, leads to misallocation of fiscal revenue, may result in poor governance of public institutions and, in extreme cases, encourages bribery and corruption. Environmental fees and fines in Poland should be transferred to the general budgets of the central and local governments.

47. A *fourth* priority is to strengthen tax administration further, to boost revenue and prepare for European Union accession. Further simplification of tax declaration obligations and greater transparency in the tax interpretation would help maintain voluntary tax discipline in the future. This could be achieved by eliminating the need for most individual taxpayers whose taxes are withheld to file a tax return. Personal income tax liabilities are already directly withheld from wage payments. Similarly, income derived from financial sources could be subject to a withholding tax. This should cover a broad range of taxpayers once the government has eliminated most income deductions and tax credits.

48. A *fifth* priority is to reform property market taxation. At present, the construction sector and the property market largely escape the tax net. New residential construction is subject to 0 per cent VAT rate, rents are not taxed, construction materials are taxed at the reduced rate, and property taxes are low. The sector even benefits from indirect subsidies in the form of deductions from the personal income tax and tax credits. To bring residential construction into the tax net, Poland should start by applying the standard VAT rate to new apartments and new houses. Applying the standard rate is required by the Sixth Directive, is likely to generate additional revenues, and would not have a regressive impact because affluent individuals usually make new residential construction. Social housing could be taxed at the reduced rate, as permitted under Annex H of the Directive. In addition, as envisaged by the government, a means-tested program could help low-income families purchase a first principal residence. The property

14. Only one excise tax on plastic packaging has been introduced with an environmental objective in July 1995. There is also a deposit refund system on bottles.

tax should be based on the *value* of properties, rather than their size. *Ad-valorem* taxation of properties requires creation of a fiscal cadastre, registration of the value of housing transactions, and assessment of the change in the value of properties. This will take some time to put in place but, eventually, will help local governments build their own taxable base. In contrast, the 5 per cent stamp duty on the purchase of residences in the secondary market should be repealed in order to foster the real estate market and encourage mobility.

Table 1. **The tax system in a nutshell, 1999**

	1999 rates (%)	Tax base	Main allowances/exemptions	Revenue to GDP (%)[1]
PIT	19, 30, 40	All income of individuals	Housing investment, donations, pensions and other permanent burdens, purchase of educational equipment, medical expenses, joint filing of spouses	5.6
CIT	34	Income generated by legal entities and selected entities without legal capacity	Investment, advertising, and representation expenses, income of selected economic activities	2.5
VAT	22, 7, 4, 0	Sale of taxable goods and services with the annual turnover above the taxable Zl 80 000 threshold	Unprocessed agricultural products, selected services, apartment rental, sales of land	12.4[2]
Social security	36.6 per cent of gross wages	Income of individuals except farmers, judges and prosecutors	Exemptions limited to a few professions and activities. Self-employed assessed on presumed income	10.2

1. Ministry of Finance estimates.
2. Total indirect taxes, including excise taxes.

Source : Ministry of Finance.

Table 2. **Arrears on taxes and social security contributions**
In Zl million

	1995	1996	1997	1998
Taxes	5 196	5 271	4 922	6 723
of which:				
VAT	1 578[1]	1 384	2 006	2 888
Excise duty	139	202	287	289
CIT	1 337	1 178	1 197	1 085
PIT	1 217	1 437	1 513	1 812
Other	925	1 070	919	650
Social security contribution	4 207	4 759	5 859	8 323
of which:				
State enterprises	3 150	3 399	4 122	6 111
Private enterprises	1 057	1 360	1 737	2 212

1. Including outstanding turnover tax liabilities.
Source: Ministry of Finance.

Table 3. **Budget revenue losses from PIT allowances, 1996-98**[1]
In Zl million

	1996	1997	1998
Total PIT allowances			
of which: From income	28 101	6 414	9 054
From tax	57	2 823	2 961
Total budget revenue loss	**6 353**	**4 409**	**5 053**
of which: In per cent of PIT	24.28	14.73	13.78
In per cent of GDP	1.65	0.94	0.91
Housing expenditure			
Revenue loss	2 729	2 712	3 117
In per cent of PIT	10.43	9.06	8.99
In per cent of GDP	0.71	0.58	0.57
Average allowance claimed by taxpayer (Zl thousand)	0.47	0.41	0.48
Lowest income bracket	0.25	0.31	0.33
Middle income bracket	0.74	0.87	1.00
Highest income bracket	4.61	1.92	3.22
Donations			
Revenue loss	1 820	218	153
In per cent of PIT	6.95	0.73	0.44
In per cent of GDP	0.47	0.05	0.03
Average allowance claimed by taxpayer (Zl thousand)	0.29	0.13	0.10
Social insurance contributions			
Revenue loss	260	322	363
In per cent of PIT	0.99	1.08	1.05
In per cent of GDP	0.07	0.07	0.07
Average allowance claimed by taxpayer (Zl thousand)	0.53	0.57	0.59
Purchase of educational equipment			
Revenue loss	67	80	64
In per cent of PIT	0.26	0.27	0.18
In per cent of GDP	0.02	0.02	0.01
Average allowance claimed by taxpayer (Zl thousand)	0.10	0.11	0.14
Other			
Revenue loss	1 447	1 077	1 356
In per cent of PIT	5.64	3.60	3.91
In per cent of GDP	0.38	0.23	0.25
Memorandum items:			
PIT revenue	26 172	29 942	36 664
GDP nominal	385 448	469 372	555 100

1. In addition to these allowances, certain categories of income are exempt from PIT, e.g. income generated by employers hiring disabled workers.

Source: Ministry of Finance and OECD.

Table 4. **Social security taxes: statutory and effective rates**
In Zl million

	1995	1996	1997	1998
Social security contributions[1]	37 353	48 129	58 290	66 408
Gross wages and salaries[2, 3]	83 568	106 929	133 154	158 456
Statutory rate (in per cent of gross wages)	48.0	48.0	48.0	48.0
Effective rate (contributions/gross wages and salaries) (per cent)	44.7	45.0	43.8	41.9

1. Contributions to ZUS and the Labour Fund.
2. Includes monetary wages, payments in kind, fringe benefits and distribution of profits.
3. Excludes Ministry of Defence and Ministry of Interior and Administration which are exempt from social contributions and pay their own pensions.

Source: GUS and OECD calculations.

Table 5. **Estimated marginal and average personal income tax rates, 1999**
In per cent

	Minimum salary		Average salary		2 x Average salary	
	Marginal	Average	Marginal	Average	Marginal	Average
1) Personal income tax	15.4	8.2	16.1	12.6	24.4	14.3
2) 1 + Employee social security contribution	29.0	26.9	29.5	31.3	36.6	33.0
3) 2 + Employer social security contribution	44.1	38.0	44.7	41.7	51.7	43.2
4) 3 - Pension contributions	27.6	21.5	28.1	25.1	35.2	26.6

Source: OECD calculations.

Table 6. **Effective marginal tax wedge by funding sources**
Top personal tax rates

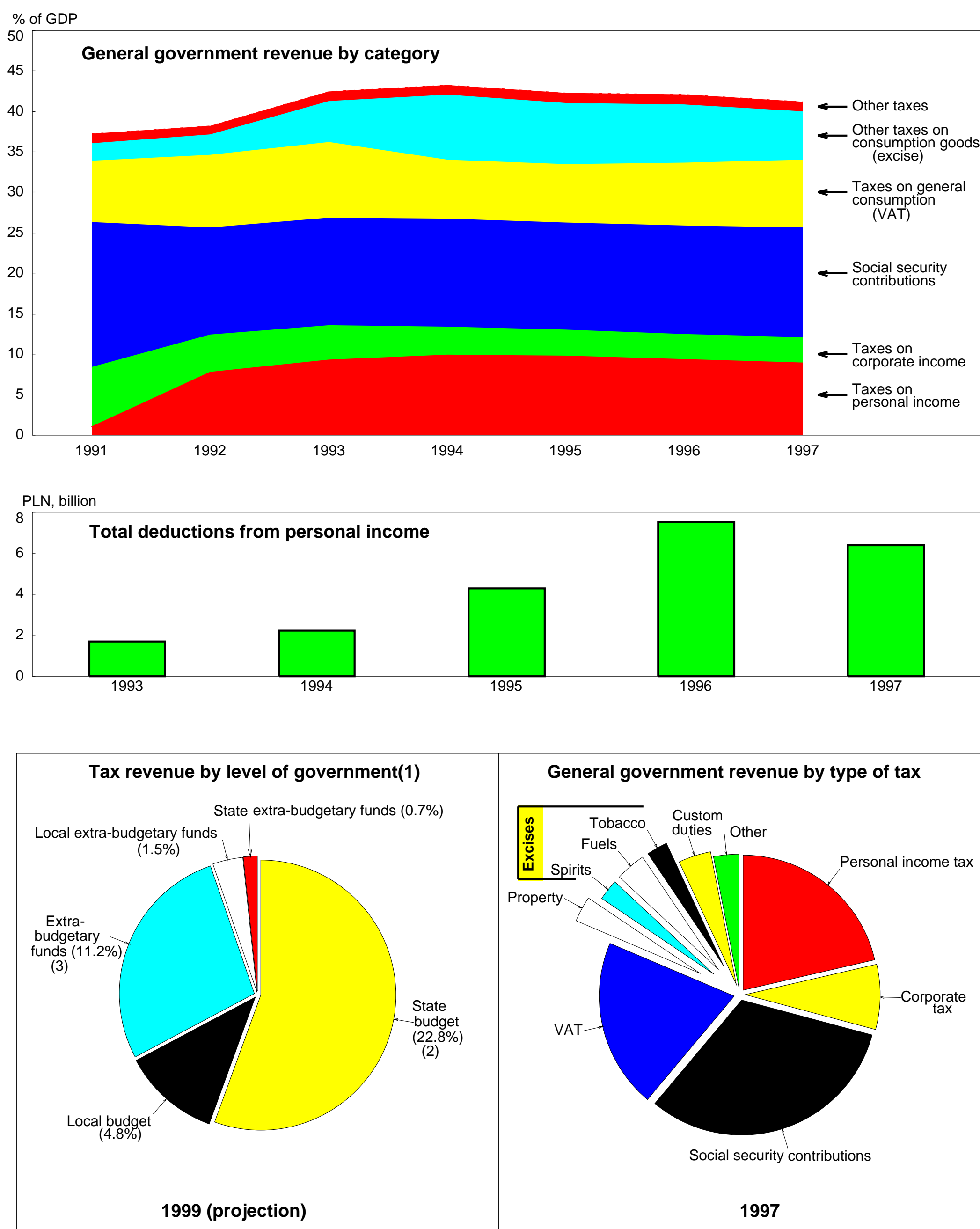
	Retained earnings[1]	New equity[1]	Debt[1]	Weighted average[3]
Machinery[2]	1.73	5.64	-3.74	0.21
Buildings[2]	3.59	8.45	-3.24	1.68
Inventories[2]	7.27	12.31	0.00	5.23
Weighted average[3]	3.47	7.89	-2.78	1.72

Note: Calculations based on King-Fullerton methodology.

1. Calculated using the following weights: machinery 50 per cent; buildings 28 per cent; inventories 22 per cent.
2. Calculated using the following weights: retained earnings 55 per cent; new equity 10 per cent; debt 35 per cent.
3. The weighted average uses weights indicated in footnotes 1 and 2.

Source: Gordon, Kathryn and Harry Tchilinquirian (1998), "Marginal effective tax rates on physical, human, and R&D capital", OECD Economics Department, Working Paper No. 199.

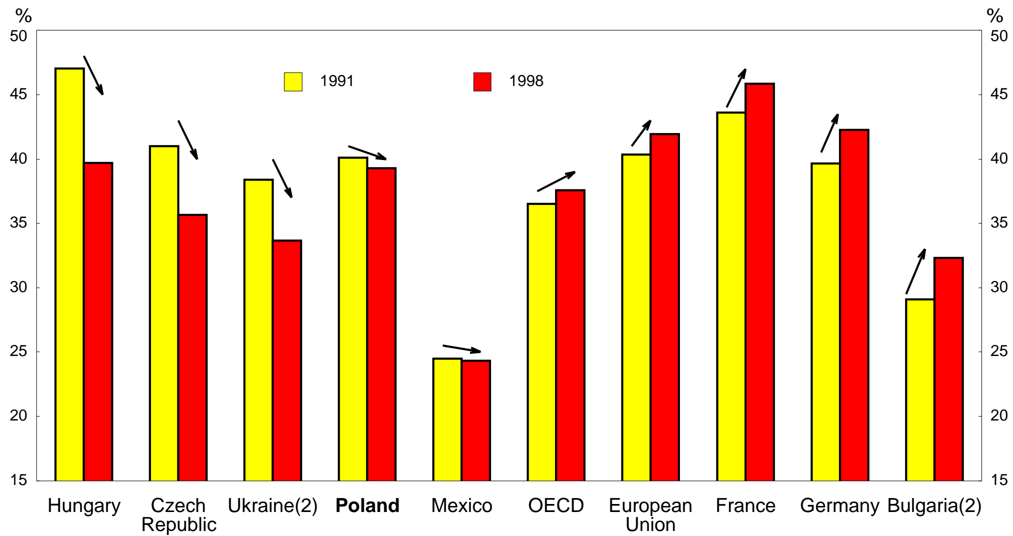
Figure 1. Key features of the tax system



1. Per cent of GDP. Including privatisation receipts.
2. Excluding transfers
3. Mainly ZUS, FUS and Labour fund.
Source: Ministry of Finance; OECD, Revenue Statistics of OECD Members.

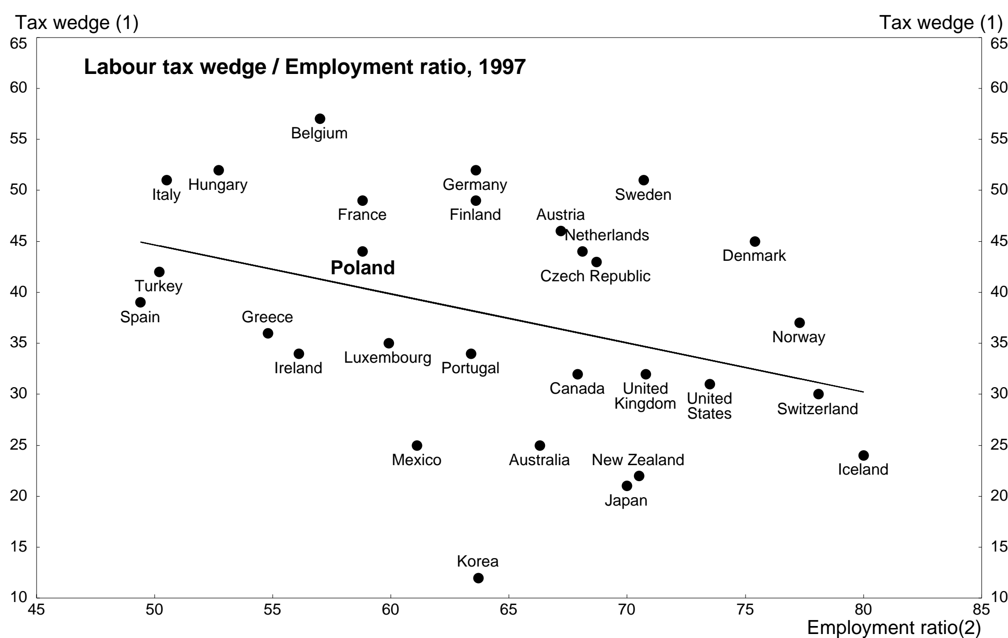
Figure 2. Evolution of tax revenue 1991-98(1)

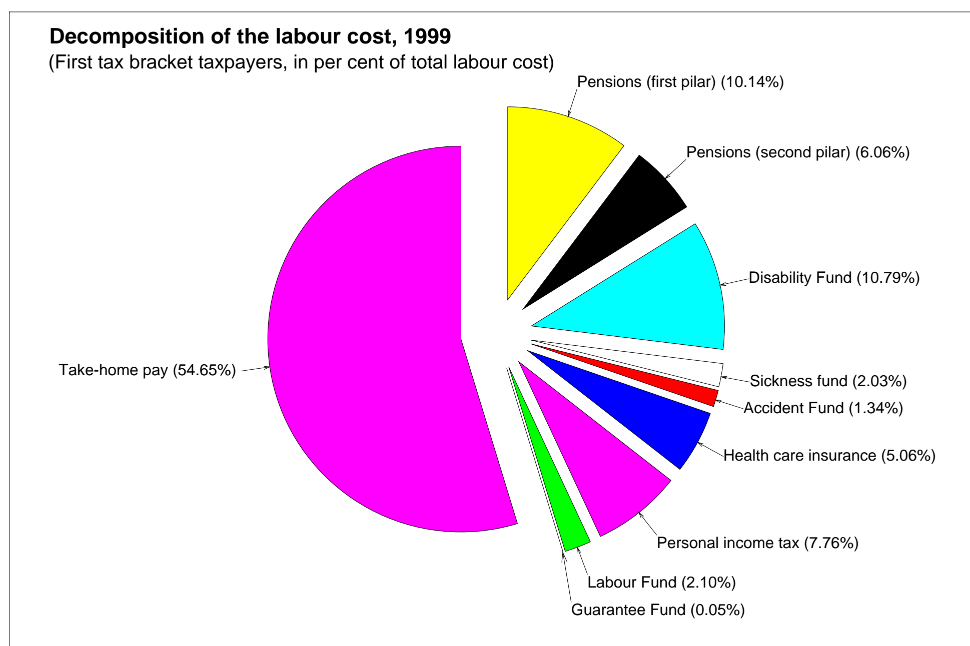
In percent of GDP



1. Direct and indirect taxes plus social security contributions. Unweighted average for OECD and EU.
2. 1991 data are for 1993 for Ukraine and 1995 for Bulgaria.
Source: IMF; OECD, National Accounts, and estimates.

Figure 3. The labour tax wedge in Poland

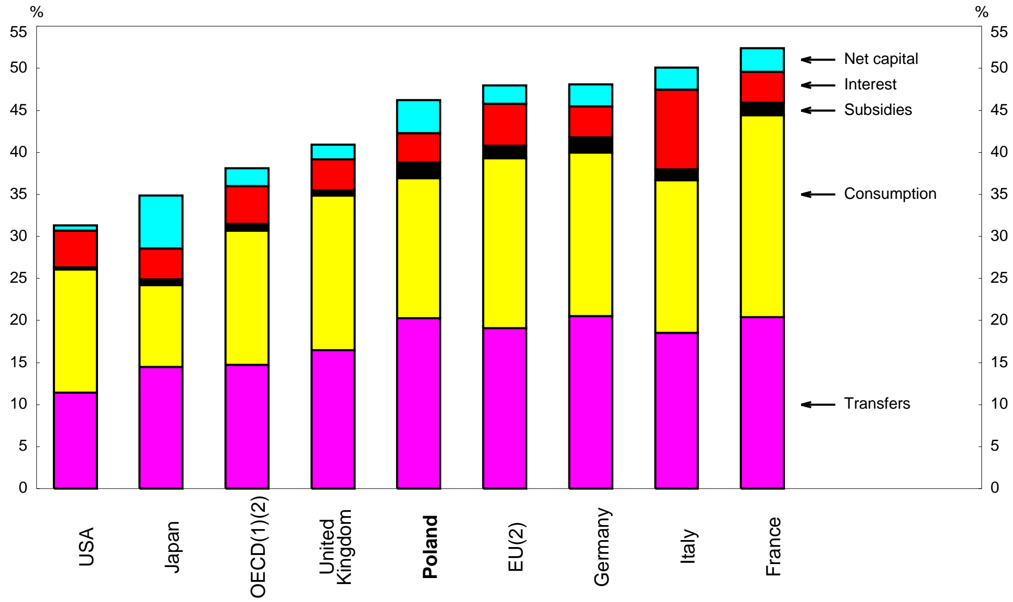




1. Income tax plus employees' and employers' social security contributions for single individual at the income level of the average production worker in percent of labour costs (gross wage + employers'contributions).
2. Persons aged 15 to 64 in employment or in the labour force divided by the working age population.
Source: Ministry of Finance and OECD, The Tax/Benefit Position of Employees and Employment Outlook.

Figure 4. General government total outlays, 1997

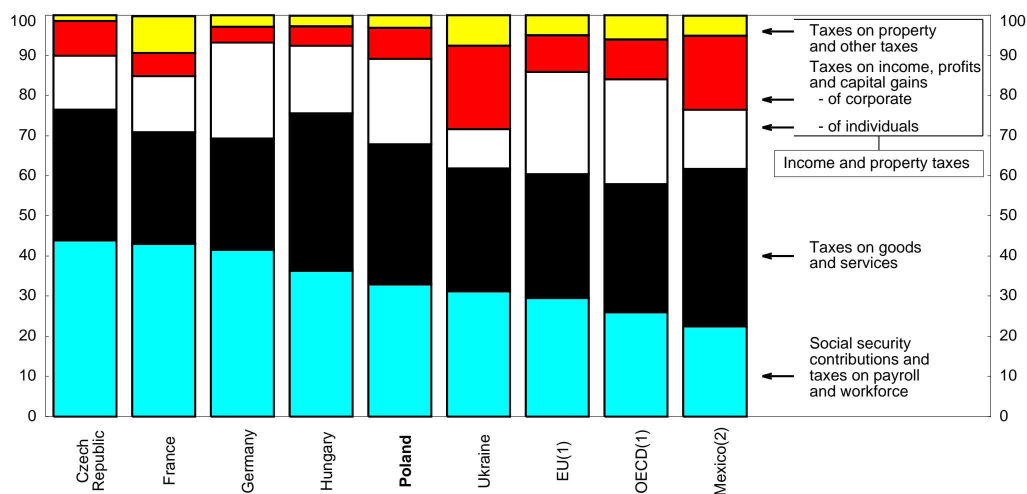
In per cent of nominal GDP



1. Excluding Hungary, Mexico, Poland, Switzerland.
2. Weighted average.
Source: OECD.

Figure 5. Tax mix of selected countries, 1997

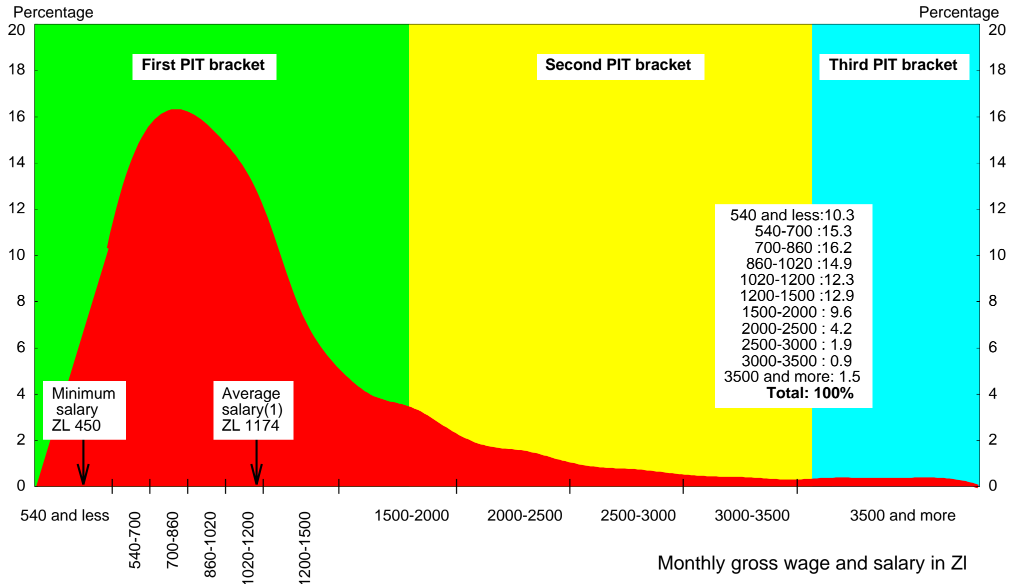
As a percentage of total taxation



1. Unweighted average.
2. 1996.
Source: OECD, Revenues Statistics of OECD Member Countries; IMF.

Figure 6. Distribution of income and PIT tax brackets

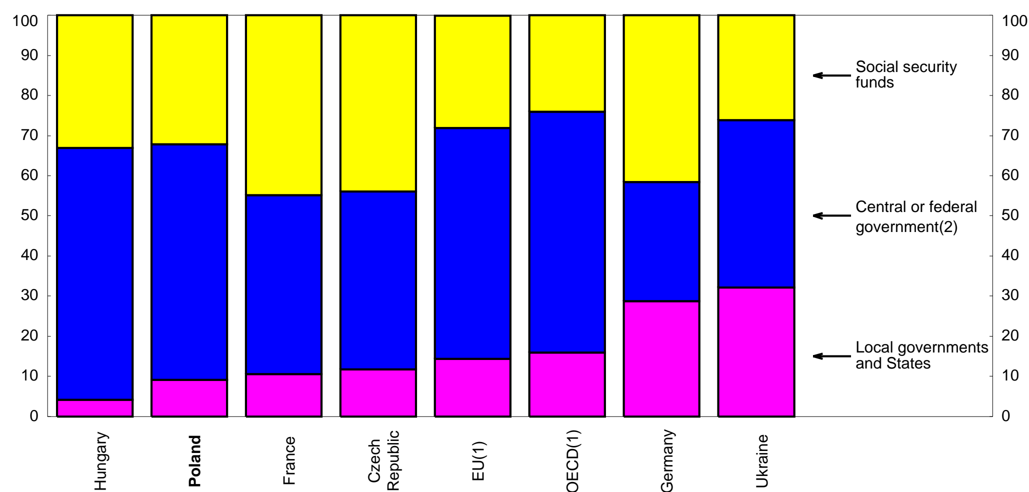
Percentage of wage-earners in each income group, September 1997



1. Average monthly gross wage and salary in the enterprise sector.
Source: Central Statistical Office and Ministry of Finance.

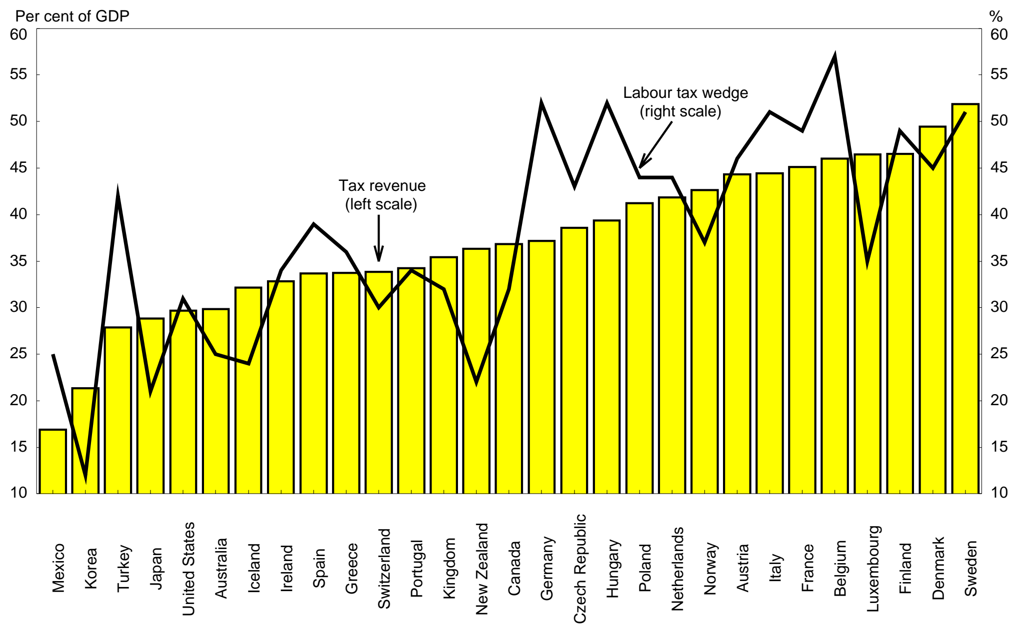
Figure 7. Tax revenue by level of government, 1997

As a percentage of total tax revenue



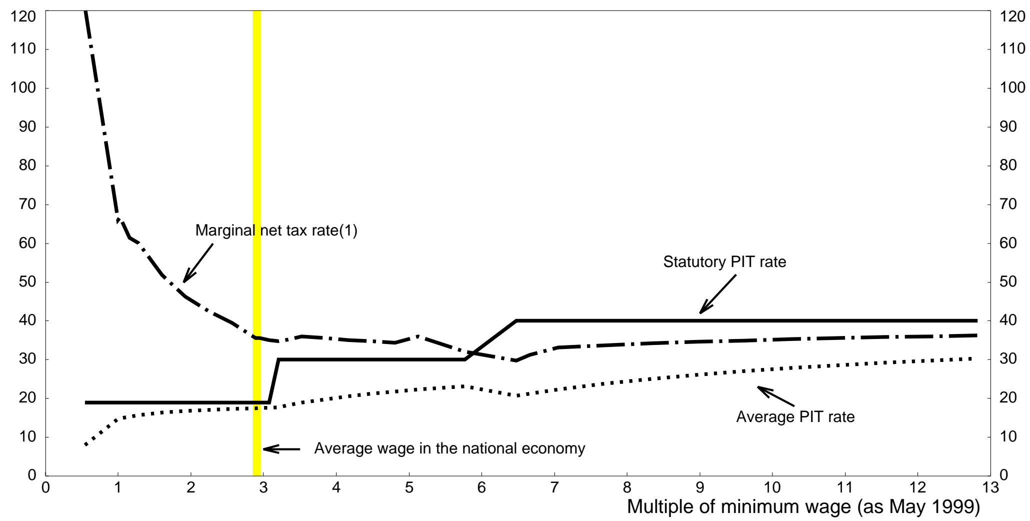
1. Unweighted average.
2. Including supranational taxes.
Source: OECD, Revenues Statistics of OECD Member Countries; IMF.

Figure 8. Tax revenue and tax wedge in 1997



Source: OECD, Revenue Statistics of OECD Member Countries and The Tax/Benefit Postion of Employees.

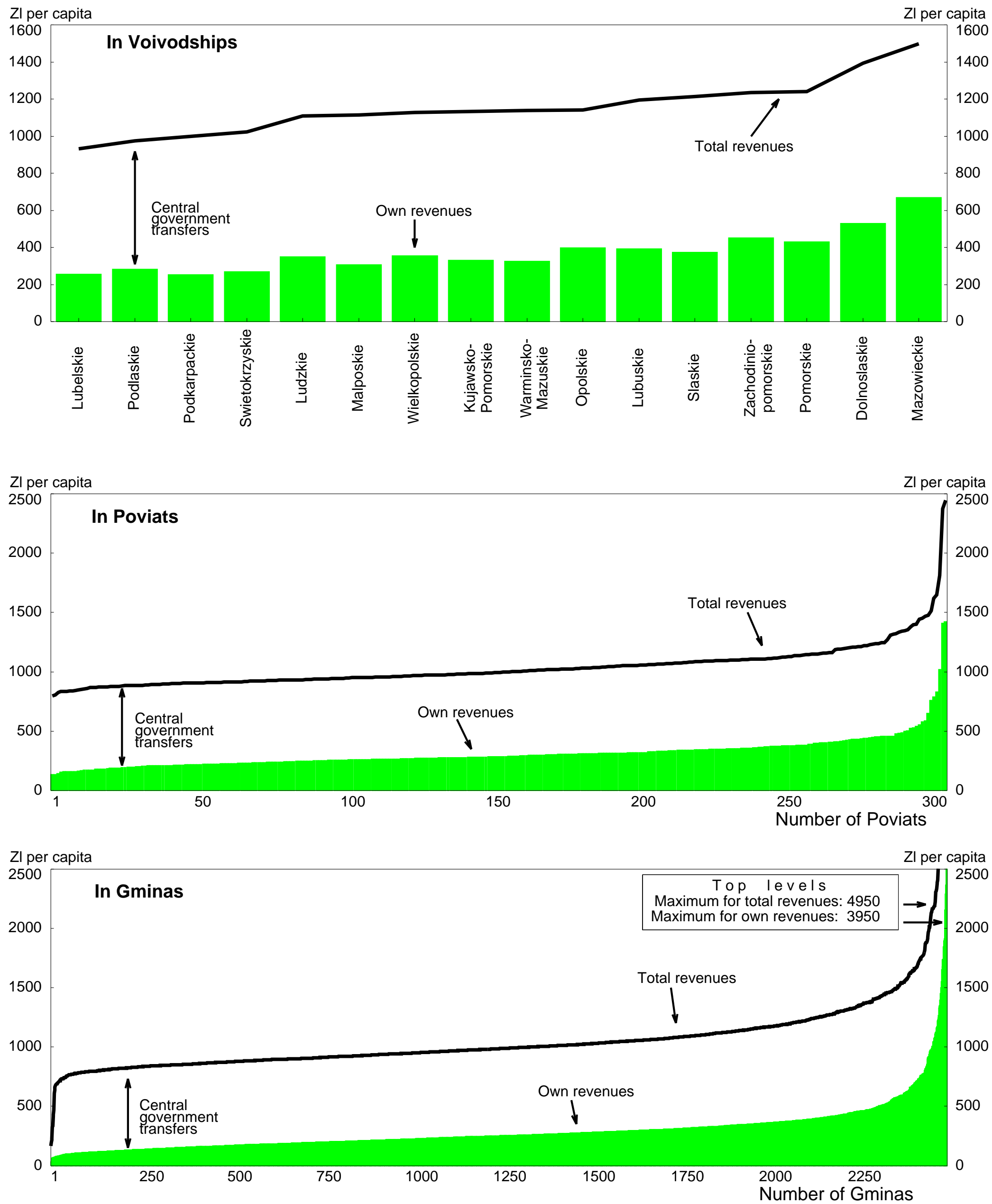
Figure 9. Marginal and average net tax rates on individual incomes



1. Net of benefits (welfare and child benefit); including employee's social security contributions; no deductions and allowances applied.
Source: Ministry of Finance.

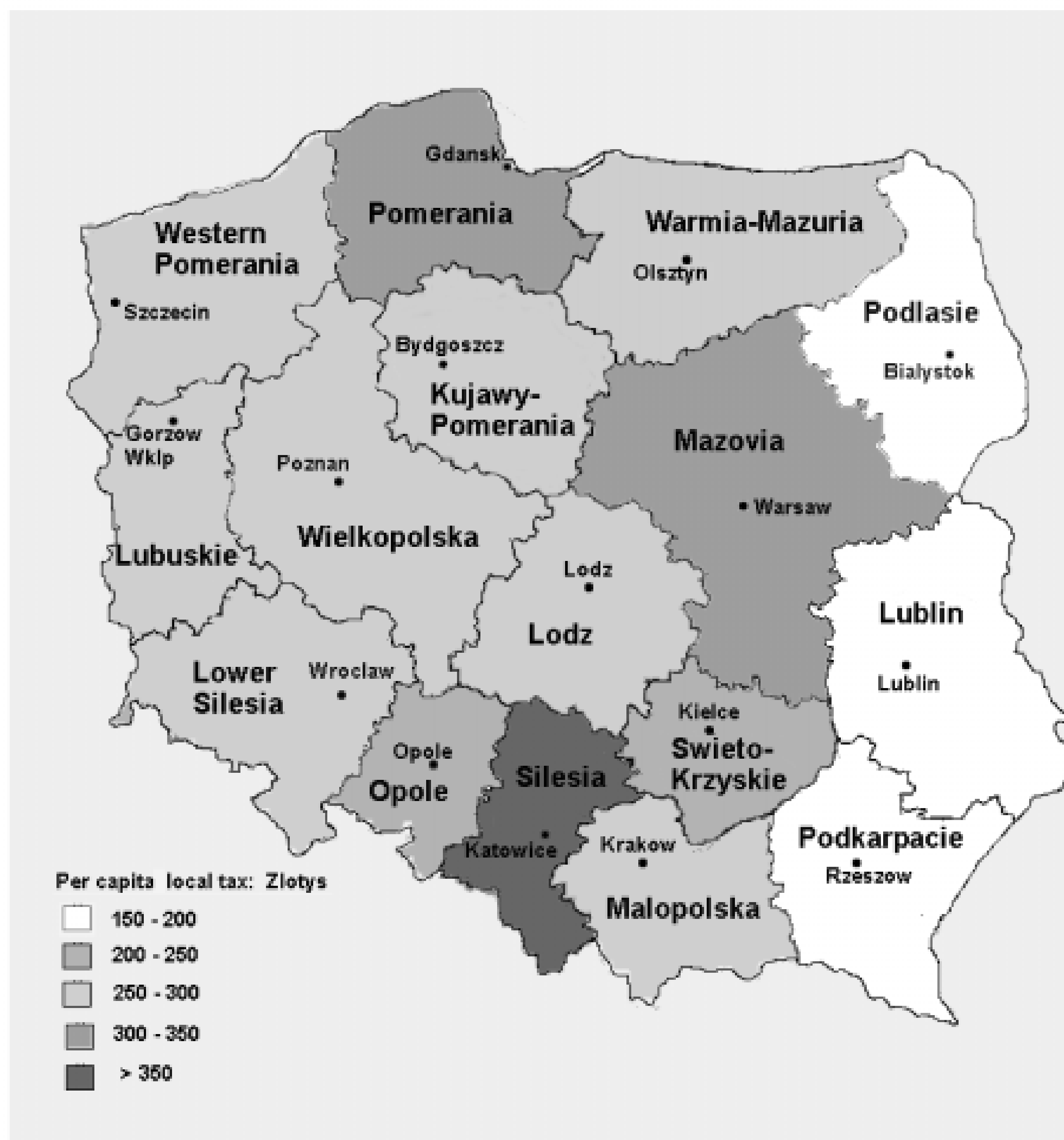
Figure 10. Intergovernmental finances, 1998

Own and total local government revenues per capita



Source: Central Statistical Office and Ministry of Finance.

Figure 11. Local tax revenue per capita, 1998
Regional distribution



Source: Central Statistical Office and Ministry of Finance.

ANNEX I

THE POLISH TAX SYSTEM AS OF JANUARY 2000

Value-added tax (VAT)

The VAT was introduced on 5 July 1993 to replace the turnover tax. The VAT applies to taxpayers that sell, import and export taxable goods and services in Poland. Taxpayers with annual turnover below Zl 80 000 are not obligated to register for VAT.

Nature of the tax: The VAT is a standard invoice style, consumption and destination-based tax. For imported goods, the tax base includes excise duties and customs fees. Imported goods are subject to the same level of VAT rates as similar domestically produced products.

Deductions and allowances: Unprocessed agricultural products, financial, insurance, educational, health, art and cultural, postal services, and apartment rental are exempt from VAT. Taxpayers paying income tax in tax card form are also exempt from VAT. The law provides for other exemptions, including the sale of unprocessed foodstuffs, financial services, educational, health care and social assistance services. VAT does not apply to some sales in duty-free zones. The Polish authorities took recently necessary action to enable VAT refunds to taxable persons not established within the country (such as foreign tourists).

Tax rates: The standard rate of the tax, applicable to most goods and services, is 22 per cent. Reduced rates are applied to some products: 7 per cent, 4 per cent and 0 per cent. The 7 per cent rate is applied to most processed foodstuffs, most construction raw materials, certain construction works (in particular those related to housing), long-distance passenger transport (by rail and coach), and medicines and pharmaceuticals. The zero per cent rate mainly applies to exports, books and magazines, and basic agricultural inputs (fertilisers, crop protection chemicals, feed, agricultural machines and equipment).

Excise tax

The excise tax was introduced in 1993. It applies to the importation and production of excisable goods.

Nature of the tax: Excise duty is charged on consumer products referred to as "excisable products", including alcoholic beverages, tobacco, fuel, passenger cars, luxury electronic equipment, gambling, salt, plastic packaging, furs, cosmetics, luxury yachts, sailboats. Taxes are not levied as exports. Excise duties do not apply to some sales in duty-free zones.

Tax rates: Tax rates on important excisable commodities sold in Poland are as follows as of 1 December 1999:

Spirits:
  Quality vodkas and alcoholic drinks up to 18 per cent;
  Zl 5 677/hl at 100 per cent spirit.
Wine:
  Fruit wine Zl 89/hl;
  Wine type alcohol drinks ZI 220/hl;
  Grape wines Zl 110/hl.
Beer:
  Per percent extract of beer base Zl 5.45.
Tobacco products:
  Cigarettes:
  Foreign brands Zl 97.40/1 000;
  Domestic brands with filter > 70 mm Zl 83.40/1 000
  Domestic brands with filter < 70 nun Zl 65.60;
  Domestic brands without filter Zl 63.70/1 000;
  Cigars Zl 97.40/1 000
Other tobacco products 60 per cent.

Fuel for engines:
  Leaded gasoline 94 Zl 1 219/1 000 l;
  Unleaded gasoline Zl 1 127/1 000 l;
  Diesel fuels Zl 806/1 000 l.
Passenger cars:
  Engine capacity > 2 000 cm^3 10 per cent,
  Others 2 per cent.
Electronic equipment (luxury amounts), 10 per cent. Gambling 15 per cent.
Salt:
  Without iodine, 15 per cent;
  With iodine, 7 per cent.
Plastic containers Zl 12/1 000.
Furs, 20 per cent.
Chewing gum, 20 per cent.

Corporate income tax

Corporate income tax (CIT) was introduced in 1989. The CIT is based on the “classical” system. Under this system, corporate income is fully taxed and distributed profits (dividends) are taxed once again by way of withholding. To reduce the impact of double-taxation, dividends are taxed at only 20 per cent. The taxable base consists of the annual worldwide income after deduction of business expenses. All legal persons incorporated in Poland are subject to corporate income tax. All legal persons incorporated abroad are subject to tax on Polish-source income. Income derived from agricultural activity and forestry is tax-exempt. Deductible business expenses include depreciation, expenditure on research and development, interest on liabilities, provisions for bad debts, donations, exchange rate losses, and mandatory social insurance contributions. The CIT rate is 30 per cent in 2000.

Deductions and allowances: Depreciation is treated as a tax allowable cost and can be calculated by means of the straight-line or declining method. For certain assets and in regions with structural unemployment, an extra allowance may be applied. There are currently 63 different depreciation schedules. Annual depreciation rates vary from 1.5 per cent to 30 per cent. The depreciation rates are: buildings 1.5-10 per cent; general machinery 10 per cent; ships, rail, aircraft 14-20 per cent; office equipment 14 per cent; road building machinery 8-20 per cent; road vehicles other than cars 18-20 per cent; and computers 30 per cent.

Various tax incentives apply to enterprises located in special economic zones (SEZs). Economic entities running their business in SEZs are eligible for tax allowances, preferential treatment and other benefits. Income of entities eligible for tax exemption can be totally exempt from CIT through a period equal to half of the period for which the zone has been established. After that time, up to 50 per cent of their income can be exempt from taxation. In the existing zones, total exemption from tax can be granted to entities whose investments exceed a certain threshold, characteristic of each zone, or investors, which create a certain number of jobs. Entities which do not enjoy income tax exemptions can be granted preferences in the form of the right to treat investment expenses related directly to their business in the zone as costs of the generated income, as well as the right to apply increased rates of depreciation.

Moreover, entities operating in the zone under a permit are exempt from local fees and charges, e.g. real estate tax. As from 1 January 2000 no new exemptions will be granted to companies operating in SEZs.

Tax incentives are offered to encourage investment in certain sectors of activity (such as scientific research, new businesses, and fisheries) and in export-oriented firms. When some conditions are met, the taxpayer may deduct the cost of investment up to 30 per cent of profit the first year, and up to 15 per cent of profit the second year

Personal income tax

The personal income tax (PIT) was introduced in 1992. The PIT applies to the worldwide income of resident individuals. Polish citizens are taxable on their income from foreign sources, unless bilateral taxation treaty applies. Foreign citizens are taxable on the income derived from Polish sources.

Nature of the tax: Taxable income includes income from employment, cash and fringe benefits, remuneration and benefits in kind, bonuses, retirement and disability pensions, income from non-agricultural businesses, income from leasing and renting for purposes other than agriculture, and income from financial investments. Several income sources are exempt from personal taxes, including income generated from agricultural activity (with some exceptions) and from forestry, inheritances, interest income, income derived from investment funds, capital gains, and disability and veteran pensions. However, income generated from the sale of stakes in companies, shares acquired outside public trading and shares acquired outside the stock exchange, as well as interest on deposits in bank accounts connected with performed economic activity, is taxable jointly with other income. Interest on dividends are subject to a 20 per cent final withholding tax.

Deductions and allowances: The current tax legislation, contains a comprehensive system of income deductions. These are social security contributions and other obligatory contributions, housing related expenses, pensions and other permanent burdens, spending on educational, equipment, expenditures for paid education of children, and medical expenses. Charitable contributions are deductible only if made for the benefit of legal entities. A flat income deduction ("cost of income generation") established by law at ZI 982.08 in 2000 is allowed. Married couples can reduce their tax liability by filing a joint tax return. Certain housing expenses and obligatory contributions to health funds are deductible from the PIT.

Tax rates: Taxable income net of income deductions is subject to a progressive schedule with there marginal tax rates. In 2000:

- 19 per cent for income of Zl 0 to Zl 32 736 (Zl 436.20 tax credit applies);
- 30 per cent (Zl 32 736-65 472);
- 40 per cent (above Zl 65 472).

Presumptive taxes based on turnover apply to certain small-scale entrepreneurs with turnover below Zl 400 000. These are taxed at three rates: 8.5 per cent of revenue from services; 5.5 per cent from manufacturing, construction and cargo transport; and 3.0 per cent on revenue from trade and catering. For most employed workers, the PIT is directly withheld by the employer from the monthly pay. Self-employed individuals pay the PIT on an annual basis.

Social security contributions

Contributions to the Social Insurance Office (ZUS). Contributions to ZUS are paid by the employer (17.9 per cent of gross wage) and the employee (18.71 per cent of gross wage). They are split between different accounts: old-age pension (19.52 per cent), disability pension (13 per cent), sickness insurance (2.45 per cent) and work injury insurance (1.62 per cent). An annual ceiling established at 30 times the monthly average salary is applied for employers' and employees contributions. Once the ceiling is reached in a given year, contributions are no longer due. Self-employed individuals must pay both the employer and employee contributions.

Contributions to labour fund and GESF. Obligatory premiums are paid to the Labour Fund. The contribution rate is 2.45 per cent of the payroll expenditures. The premium for Guaranteed Employee Services Fund for 1999 is 0.08 per cent of net wage.

Insurance premium to health funds

In January 1999, as part of the health insurance reform, a new mandatory health insurance premium was introduced to provide financial resources to the new Sickness Funds. The mandatory premium is calculated as 7.5 per cent of income. Employers or other providers of income must withhold insurance premiums and pay them directly to ZUS on a monthly basis. ZUS then channels these premiums to relevant Sickness Funds. Most income sources are subject to the health insurance premium, including salaries, self-employed income, farmers' income, pensions, and other social benefits. Income from financial sources (interest, dividends, and capital gains) is not subject to the health insurance premium. The health insurance premium is entirely deductible from personal income tax liability. Therefore, individual taxpayers can reduce their PIT liability by the amount of the health insurance premium.

Tax on inheritances and donations

Individuals who receive inheritances or gifts are liable to tax for the portion they receive.

Nature of the tax: The tax base consists of the market value of all property received by the beneficiary, after deducting debts and other liabilities. The tax rate is established in accordance with the taxpayer group to which the beneficiary belongs, and the value of the property received. Classification to a tax group takes place in accordance with the personal relationship of the acquirer to the person from whom the property has been acquired.

Deductions and allowances: The following are exempt from the tax:

- acquisition by inheritance of money or other valuables by a person classified to the first tax group, up to the amount defined in the Act, designated to be spent for housing purposes;

- acquisition by donation of rights to a savings account by a spouse, descendants, ascendants, siblings, and a person remaining in joint marital cohabitation with the owner of the savings account in a housing fund, on the condition that the funds accumulated in this account are designated to be spend for housing purposes;

- acquisition by inheritance, by persons classified to the first and second tax group, of objects of home furnishings, bed linen, clothing, linen and work tools appropriated for household use;

- acquisition by a spouse or descendants, by inheritance or donation, of a manufacturing, construction, trade or service establishment or its part;
- acquisition by a person carrying on economic activity, by donation, of machinery, equipment and tools received from abroad;
- acquisition by inheritance of the right to a living accommodation or residential house up to the equivalent of 110 m^2 (based on market prices), if it serves to satisfy own housing needs.

Agricultural tax

The tax obligation on this account was imposed by the Act of 15 November 1984 on the agricultural tax. This is essentially a property tax, assessed on the area of farm land and taking into account the type of land, the classes of farm land and the place where the land is located.

Deductions and allowances: The following land is not taxable:

- land under lakes and running water, land on which water reservoirs are located which are used for water supply for the population and land under flood dams;
- land recognised as wasteland;
- land entered in the register of monuments, on the condition that it is developed and maintained in accordance with the provisions on protection of monuments;
- land occupied for carrying on economic activity other than farming;
- land constituting infields of members of agricultural production co-operatives who have reached the retirement age or are invalids of the first or second group;
- land excluded for non-agricultural purposes on the basis of final administrative decisions.

Forest tax

Nature of the tax: The tax base for the forest tax is the number of conversion hectares, established on the basis of the area of the main tree species in the tree stand and classification of the tree stand for the main tree species -- resulting from the plan of arranging the forest, as of 1 January of the tax year.

The tax base: The forest tax on one conversion hectare is the cash equivalent of 0.200 m^3 of coniferous sawmill timber, calculated according to the price of sale of this timber acquired by forest superintendence.

Real estate tax

The real estate tax is an annual local tax paid by individual and business taxpayers. The taxable base is determined according to the floor area of the building. Tax rates are determined by Gimina councils, subject to certain ceilings.

Deductions and allowances: The property tax provides for various exemptions set out in the law, including property used for public purposes, property in special economic zones, and other real estate exempted on the basis of separate legislation. The following have been statutorily exempted from the real estate tax:

- real estate or their parts occupied for the needs of local governments;
- real estate being the property of foreign states or international organisations (on reciprocity basis), or turned over for perpetual usufruct to them, appropriated for the seats of diplomatic representations, consular offices and other missions enjoying privileges and immunities under statutory acts, international agreements or customs;
- public roads;
- public rail transportation, airports, sea and river ports;
- power plants, transmission and distribution electric power lines and lines of the distribution network of gas, heat, fuels and water, sewage systems, buildings or their parts directly connected with the process of water intake and purification;
- land under flowing water and navigation channels, with the exception of lakes and land occupied for water reservoirs or water power stations;
- utility buildings or their parts connected with forest activity, occupied for running special sections of agricultural production, and in farms, in the understanding of the provisions on the agricultural tax, utility buildings or their parts connected with agricultural activity;
- real estates or their parts occupied for the needs of conducting statutory activity by children and youth associations, in the field of education, upbringing, science and technology, physical culture and sports, with the exception of those used for carrying on economic activity, and land occupied on a sustained basis for camping sites and recreational areas for children and youth;
- buildings and land individually entered in the register of monuments, under the condition that they are maintained and preserved in accordance with the provisions on protection of monuments, with the exception of parts occupied for carrying on economic activity;
- buildings and land under the management of registered museums;
- real estates or their parts exempted from the real estate tax on the basis of separate regulations;
- land, structures and buildings located within a Special Economic Zone.

ANNEX II

INTERNATIONAL COMPARISON OF TAX SYSTEMS

Table A1. **Personal income tax**
Rates in percentage, 1998

	Highest and Lowest Marginal PIT Rates	Number of PIT tax Schedules	Zero-rated band	Tax credit	Unit of taxation 1995[1]	Average effective household tax rate 1991-96[2]
United States	15-39.6	5	Yes	No	Joint	14.4
Japan	10-50	5	Yes	No	Ind	10.8
Germany	..	..	Yes	No	Joint	15.8
France	10.5-54	6	Yes	No	Joint	9.8
Italy	18.1-45.5	7	No	Yes	Ind	15.9
United Kingdom	20-40	3	Yes	No	Ind	12.9
Canada	17.51-31.3	4	No	Yes	Ind	21.3
Australia	20-47	4	Yes	No	Ind	20.4
Austria	10-50	5	No	Yes	Ind	14.4
Belgium	25.75-56.65	7	Yes	No	Ind	19.3
Czech Republic	15-40	5	Yes	No	Ind	9.3
Denmark	8-29	3	Yes	No	Ind	39.8
Finland	6-38	6	Yes	No	Ind	29.5
Greece[3]	5-40	4	Yes	No	Ind	4.4
Hungary	20-42	6	No	Yes	Ind	12.1
Iceland	29.31-34.41	2	No	Yes	Ind	..
Ireland	26-48	2	Yes	No	Opt	17.7
Korea	10-40	4	No	No	Ind	5.6
Luxembourg	6-32	10	Yes	No	Joint	..
Mexico[4]	3-35	8	No	Yes	Ind	6.7
Netherlands	8.85-60	3	Yes	No	Ind	18.1
New Zealand	15-33	2/3	No	..[5]	Ind	25.4
Norway	18.8-32.5	3	Yes	No	Opt	19.2
Poland	**19-40**	**3**	**No**	**Yes**	**Opt**	**11.9**
Portugal	15-40	4	No	Yes	Joint	9.5
Spain	17-47.6	8	Yes	No	Opt	13.3
Sweden	25	1	Yes	No	Ind	30.9
Switzerland[6]	0.77-13.2	10	Yes	No	Joint	21.1
Turkey	25-55	7	Yes	No	Ind	..

1. Ind = Independent taxation of husband and wife; Joint = Joint taxation of husband and wife; Opt = Option different systems.
2. Taxes on income, profits, capital gains of individuals (including social security contributions) divided by wages and salaries plus property and entrepreneurial income of the self-employed.
3. For 1997.
4. In the case of Mexico, the tax on individual income is applicable to wage earners only; self-employed are taxed under the corporate income tax regime. Data for self-employment income and household property income are estimated from the 1994 household survey.
5. A rebate in the form of a tax credit is granted for those with low incomes. The rebate converts the statutory two step scale into a three step scale with positive rates.
6. Include all (private) medical insurance premiums in household taxation.

Source: The OECD Tax Data Base.

Table A2. **VAT**
Rates in per cent, 1996

	VAT standard rate	VAT in per cent of total tax revenue	VAT revenue in per cent of GDP	Productivity[1]	Effective VAT[2]	Example of zero-rated goods
United States	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Japan	5.0	5.3	1.5	50.5	2.6	None
Germany	15.0	17.6	6.7	44.7	11.6	None
France	20.6	17.2	7.9	38.2	14.3	None
Italy	19.0	13.0	5.6	29.6	9.6	Books, newspapers
United Kingdom	17.5	19.4	7.0	39.9	10.6	Food, books, children’s clothing
Canada	7.0	7.0	2.6	36.6	4.4	Medicine, exports, agriculture
Australia	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Austria	20.0	19.1	8.4	42.1	16.2	None
Belgium	21.0	15.2	7.0	33.4	12.5	Car for handicapped, newspapers
Czech Republic	22.0	19.5	7.2	32.7	..	n.a.
Denmark	25.0	19.5	10.2	40.8	22.1	Newspapers
Finland	22.0	17.1	8.2	37.4	17.0	Newspapers, vessels, international transport
Greece	18.0	22.7	9.2	51.2	10.9	None
Hungary	25.0	18.6	7.5	30.0	..	n.a.
Iceland	24.5	29.1	9.4	38.4	17.1	International transport, food
Ireland	21.0	20.9	7.0	33.5	15.5	Books, medicine, seeds
Korea	10.0	18.5	4.3	43.1	..	n.a.
Luxembourg	15.0	15.0	6.7	44.7	..	None
Mexico	15.0	17.7	2.9	19.2	4.4	Medicine, food, exports
Netherlands	17.5	16.1	7.0	39.8	13.0	None
New Zealand	12.5	23.6	8.5	67.7	15.3	Exports, fine metal
Norway	23.0	21.0	8.6	37.5	21.2	Books, newspapers
Poland (1998)	**22.0**	**20.8**	**7.8**	**35.4**	**11.7**	**Books, magazines, agricultural inputs**
Portugal	17.0	22.8	8.0	46.9	13.5	None
Spain	16.0	16.3	5.5	34.4	9.4	None
Sweden	25.0	13.5	7.0	28.1	14.1	Commercial aircrafts, medicine
Switzerland	6.5	9.5	3.3	50.6	5.5	None
Turkey	15.0	23.8	6.0	40.3	9.2	None

1. VAT productivity is VAT revenue in per cent of GDP divided by standard VAT rate.
2. Effective VAT rate is VAT revenue divided by base (consumption).

Source: OECD, *Revenue Statistics of OECD Member Countries.*

Table A3. **Central government corporate taxes**
Rates in per cent, 1998

	Type of corporate tax system[1]	CIT statutory tax rate 1991	CIT statutory tax rate 1998	CIT revenue in per cent of GDP 1996
United States	Classical	34	35	2.7
Japan	Classical	38	34	4.7
Germany	Split rate with full imputation	50-36	42-56	1.4
France	Full imputation	34- 42	33-36.7	1.7
Italy	Full or partial imputation	36	37	4.0
United Kingdom	Partial imputation	34	31	3.8
Canada	Partial imputation	28	28	3.3
Australia	Full imputation	39	36	4.7
Austria	Classical	30	34	2.1
Belgium	Classical	39	39	3.1
Czech Republic	Partial deduction of dividends paid	..	39	4.2
Denmark	Partial credit	38	34	2.4
Finland	Full imputation	23	28	3.2
Greece	..	46	35-40[2]	2.6
Hungary	Classical		18	1.9
Iceland	Partial deduction of dividends paid	45	30	0.9
Ireland	Partial imputation	43	32	3.2
Korea	Partial credit			2.7
Luxembourg	Classical	33	30	7.2
Mexico	Full imputation	..	34	2.3
Netherlands	Classical	35	35	4.1
New Zealand	Full imputation	33	33	3.5
Norway	Full imputation	27	28	4.3
Poland	**Classical**	**..**	**34**[3]	**2.8**[4]
Portugal	Partial credit	36	34	3.3
Spain	Partial deduction of dividends paid	35	35	2.0
Sweden	Classical	30	28	2.9
Switzerland	Classical	4-10	7.8[5]	1.9
Turkey	Partial credit	49	25	1.5

1. A classical system does not give shareholders credit for corporate taxes paid on dividend distributions. A full imputation system gives the shareholder a full tax credit for corporate taxes paid on dividend distribution (i.e. it eliminates double taxation of dividends). Partial credit systems retain some double taxation of dividends. Split rate systems impose different corporate tax rates on retained earnings than on distributed earnings (which may also be given full or partial imputation).
2. 1997.
3. CIT rate of 34 per cent in Poland is for 1999.
4. 1998.
5. The figure for 1998 is a net rate. The federal tax is deductible from its own base.

Source: The OECD Tax Data Base.

Table A4. **Social security contributions**
Per cent

	1997	1997	1994	1996	1996
	Employee's social security Contributions/ Labour cost[1]	Employer's Social security Contributions/ labour cost[1]	Use of income ceiling[1]	Social security contributions and payroll taxes / total tax revenue	Social security contributions and payroll taxes / GDP
United States	7	7	Yes	24.7	7.0
Japan	7	7	No	36.5	10.4
Germany	17	17	Yes	40.6	15.5
France	13	29	Yes	45.4	20.8
Italy	7	32	No	34.3	14.8
United Kingdom	8	9	Yes	17.3	6.2
Canada	5	6	No	16.3	6.0
Australia	2	0	No	6.7	2.1
Austria	14	24	Yes	41.1	18.1
Belgium	10	26	No	32.3	14.9
Czech Republic	9	26		42.0	17.0
Denmark	10	0		3.6	1.9
Finland	6	20	No	25.8	12.4
Greece	12	22	No[2]	31.4	12.8
Hungary	8	32		33.9	13.7
Iceland	0	4	No	8.6	2.8
Ireland	5	11	Yes	14.6	4.9
Korea	4	7		9.4	2.2
Luxembourg	11	12		26.6	11.9
Mexico	2	24	No	16.9	2.7
Netherlands	30	7	Yes	39.6	17.1
New Zealand	0	0	No	1.0	0.3
Norway	7	11	No	23.3	9.6
Poland[3]	**0**	**33[4]**	**No**	**31.8**	**13.4**
Portugal	9	19	No	25.7	9.0
Spain	5	24	No	35.9	12.1
Sweden	4	25	No	32.4	16.8
Switzerland	10	10	No	37.4	13.0
Turkey	9	13	Yes	15.8	4.0

1. Single individual at the income level of the average production worker.
2. 1993.
3. In early 1999, social security taxes were split between employers and employees.
4. Including labour fund contribution.

Source: OECD, The Tax/Benefit Position of Employees and Revenue Statistics of OECD Member Countries.

Table A5. **Taxation of interest income, dividends, capital gains and private pensions**

	Taxation of interest income from bank deposits 1998[1]	Taxation of interest income from Government bonds 1998[1]	Taxation of dividends 1998[1]	Taxation of capital gains (top rate of taxation)	Contributions to private pension funds	Pension fund annuities
United States	As ordinary income	As ordinary income[2]	As ordinary income	Taxed generally at 20 per cent	Deductible	Taxed
Japan	20 per cent WT	20 per cent WT	Depends on amount of dividend	For listed companies: 20 per cent plus 6 per cent local tax	Deductible	Taxed
Germany	31.5 per cent TC	31.5 per cent TC	As ordinary income or with 48.47 per cent tax credit	Generally exempt	Depends on type of pension	Taxed
France	15 per cent WT[3]	15 per cent WT[3]	As ordinary income or with 33.33 per cent tax credit	Flat rate of 26 per cent	Deductible	Taxed
Italy	27 per cent WT	12.5 per cent WT	12.5 per cent WT or as ordinary income with 10 per cent tax credit	Rate of 12.5 per cent on non-substantial holdings	Deductible	Taxed
United Kingdom	As ordinary income 20 per cent TC	As ordinary income 20 per cent TC	As ordinary income with 20 per cent tax credit	As ordinary income	Deductible with limits	Varies
Canada	As ordinary income	As ordinary income	Dividends are grossed-up by 25 per cent and treated as ordinary income with 13.34 per cent tax credit	Treated as ordinary income	Deductible	Taxed
Czech Republic	15 per cent WT	15 per cent WT	25 per cent WT	Exempt (securities held for more than 6 months)	Taxed	Taxed
Hungary	Exempt	Exempt	20-25 per cent WT	Generally taxed at 20 per cent	Deductible	Exempt
Poland	**Exempt**	**Exempt**	**20 per cent WT**	**Exempt**	**Varies**	**Varies**

Note: WT: Final withholding tax; TC: Withholding tax with a tax credit.
1. For resident individuals.
2. Except for tax exempt bonds.
3. Other taxes also apply.
Source: OECD tax database.

ANNEX III

INTERGOVERNMENTAL TRANSFERS

Poland has a budgetary system that entails large transfers from the central government to local governments, social security administrations, and extra-budgetary funds. By OECD standards, these transfers are large, reflecting the fact that most tax revenues are collected by the central government, in particular income taxes and indirect taxes. In 1998, one-third of central government revenue was spent on transfers to other levels of governments, the equivalent of close to 8 per cent of GDP. The main transfers are made to local governments, particularly communes (*gminas*), and to social security funds, particularly the social insurance fund (ZUS) and the farmers insurance fund (KRUS).

1. Transfers to local governments

In July 1998, under the Law on the Three-level Territorial Division of the State, Poland introduced an important reform of its public administration. The reform establishes three levels of territorial division in the country and decentralises policy functions to the level of government where these policies can be best implemented. By applying the principle of subsidiarity[15], Poland followed the trend of bringing policy functions closer to the people. The three administrative divisions consist of 2 489 gminas (communes), 373 poviats (counties or districts), and 16 voivodships (regions). The law establishes the main responsibilities of each level of local governments, along with its revenue.

2 489 Gminas	373 Poviats[1]	16 Voivodships
Resources	**Resources**	**Resources**
Property tax	Share in PIT (1%)	Share of PIT (1.5%)
Agricultural tax	Special purpose subsidies	Share of CIT (0.5%)
Forest tax	General subsidies	Leasing revenues
User fees	Education subsidies	Special purpose subsidies
Shares of PIT (27.6%) and CIT (5.0%)	Road maintenance subsidies	General purpose subsidies
Special purpose subsidies		Education subsidies
Education subsidy		Road subsidies
General purpose subsidy		Compensation grants.
Main expenditure	**Main expenditure**	**Main expenditure**
Elementary schools	Secondary schools	Regional economic development
Primary health care	General hospitals	Higher education
Land zoning	Fire stations	Environmental issues
Water management	Tax offices	
	Environment protection agencies	

1. Includes 65 urban poviats which assume both gminas and poviats functions.
Source: Ministry of Finance.

15. Subsidiarity, in the Polish context, is considered as "the division of public finances and administrative functions in such a way that the responsibility for every function is assigned to the lowest level of government capable of performing that function". From: Effectiveness, Openness, Subsidiarity – A new State for new Challenges", Chancellery of the Prime Minister of the Republic of Poland, September 1998.

Local governments receive the bulk of their revenue in the form of grants and transfers (hereafter "subsidies") from the central government. There are several categories of subsidies.

- **Special purpose subsidies** are to be spent only on pre-defined outlays. The list of spending categories for which these subsidies can be requested include social assistance, investment plans (such as sewage systems), and environmental projects. Central government co-financing cannot exceed 50 per cent of the cost of any particular project, except in some Gminas where it can reached 75 per cent, including territories previously used by the Soviet Army. Special purpose subsidies can also be received to finance mandatory administrative functions required by the law.

- The **education subsidy** is the largest subsidy. It finances the education system responsibilities of Gminas, Poivats, and Voivodships. The education subsidy allocates a fixed 12.8 per cent of planned central government revenue according to strict formulas. In 1999, out of Zl 16 billion paid under this subsidy, Gminas should receive Zl 9 billion. The education subsidy must be transferred up to the 25th day prior to the month when payments have to be made. In case of late payments, the law foresees that the central government must pay a penalty.

- The **general purpose** subsidy is intended to close the income gap between various Gminas. It is financed by a fixed 1 per cent of projected central government revenue combined with payments made by the richest Gminas to the poorest ones. The Ministry of Finance distributes the subsidy according to a rigid formula that allows for no discretion. The formula is based on the measured tax revenue per capita for each Gmina during the first six month of a given fiscal year. If the Gmina's tax revenue is less than 85 per cent of the national average, a subsidy is granted ; 1500 Gminas (out of 2200) are in such a case. The subsidy can cover 90 per cent of the difference between the Gmina's revenue and the national average. In contrast , Gminas that are above the national average have to make a payment to the central government ; 80 of them are in such a case.

- **Compensation grants** are given to Gminas to compensate them for the loss of revenue due to the cancellation of a tax or the loss of the tax base. For instance, Gminas are fully compensated for the loss of the transportation tax.

2. Transfers to social security administrations

The central government provides subsidies to cover the needs to social security funds and to finance specific programmes. FUS receives a subsidy to finance the reform of the pension system, in particular offset the losses due to the transfer of pension contributions to private pension funds under the second pillar.

Fund	Main functions	Subsidy foreseen in 2000 (1999) in Zl billion
Social Insurance Fund (FUS)	Payment of pensions and sickness benefits	14.4-(9.6)
Farmer's Social Insurance Fund (KRUS)	Payment of pensions to retired farmers	14.0-(13.4)
Alimony Fund	Payment of alimony benefits	0.84-(0.68)
Labour Fund	Unemployment benefits; labour market polices	0.74-(0.79)
State Fund for War Veterans	War veteran pensions	0.1-(0.1)

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