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Reforming the Polish Tax
System to Improve its
Efficiency

Alain de Serres

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ABSTRACT/RESUME

Reforming the Polish tax system to improve its efficiency

The Polish tax system is characterised by high social security contributions for both employers and employees. As a result, Poland has one of the highest tax wedges in the OECD, despite relatively low personal income tax rates. This, combined with a relatively high minimum wage and generous early-retirement and disability benefit programmes, contributes to low employment rates, in particular among low-skilled workers. The system also relies heavily on consumption taxes, whereas relatively little revenue is collected from such bases as environment externalities, inheritances and, in particular, property. One of the key implications of the tax structure is that the system as a whole is one of the least redistributive among OECD countries. This paper reviews the main features of the tax system and explores options to improve its efficiency, including possibilities to broaden existing tax bases as well as to shift the tax burden from labour towards less mobile and distorting sources such as property.

JEL codes: H20; H22; H23; H24; H25

Keywords: Taxation; tax reform; labour tax wedge; property taxes; VAT; personal income tax; corporate income tax; polish tax system

Réformer le système fiscal polonais afin d'améliorer son efficience

Le système fiscal polonais se caractérise par des cotisations patronales et salariales de sécurité sociale élevées. Par conséquent, la Pologne compte l'un des coins fiscaux les plus élevés de l'OCDE, malgré des taux de l'impôt sur le revenu des personnes physiques relativement bas. Cette situation, associée à un salaire minimum relativement conséquent et à des indemnités généreuses de retraite anticipée et d'invalidité, contribue à la faiblesse des taux d'emploi, surtout parmi les travailleurs peu qualifiés. Par ailleurs, le système s'appuie massivement sur les impôts sur la consommation, tandis que les recettes provenant d'autres sources telles que les taxes sur les produits polluants, les droits de mutation et surtout les impôts fonciers sont relativement minimes. L'une des principales conséquences de cette structure fiscale est que le système est, dans son ensemble, l'un des moins redistributifs parmi les pays de l'OCDE. Cette étude examine les principales caractéristiques du régime fiscal polonais et envisage différentes solutions pour améliorer son efficience, comme l'élargissement des assiettes d'imposition existantes et le transfert de la charge fiscale du travail vers des sources moins mobiles et entraînant moins de distorsions, telles l'immobilier.

Classification JEL : H20; H22; H23; H24; H25

Mots-clés : Fiscalité; réforme de la taxation; coin fiscal; taxe foncière; TVA; impôt sur le revenu; impôt sur les profits; système de taxation polonais

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Reforming the Polish tax system to improve its efficiency

By
Alain de Serres¹

Introduction

The tax system put in place fairly rapidly in Poland at the start of the transition period in 1989 was initially successful in delivering revenues sufficient to cover the costs associated with the deep restructuring of the economy during the 1990s, allowing Poland to avoid the type of fiscal crisis seen in some neighbouring countries. However, excessive concentration of tax bases and their gradual erosion because of a proliferation of tax breaks or preferential treatments led the authorities to reform the system in the late 1990s. Following the trend observed in many countries, the changes went in the direction of lowering rates and broadening bases, not least as a means to cope with their increasing international mobility. This was particularly the case for corporate income tax, where the tax rate was cut in half to 19% between 1999 and 2004. In the case of personal income tax, a similar proposal for reform was vetoed by the President – and therefore never enacted – but a number of credits and allowances were eliminated, leading to some broadening of the base. Even though the reform was viewed at the time as a good step towards the modernisation of the tax system, improving both efficiency and equity, it was clearly not sufficient to fully address the main challenge identified at the time, and which is still relevant, namely to ensure that taxes do not excessively diminish the incentives to work so that labour supply decisions are not too distorted.

The key challenge is to reduce the heavy taxation of labour income. Tax wedges on labour are both among the highest and least progressive in OECD, penalising in particular the job prospects of low-wage earners. With personal income tax representing a relatively small proportion of overall direct tax revenues, this is mainly due to comparatively high social security contributions. Another broad challenge is to gradually shift the tax mix so as to rely on sources that are considered as less distortive owing to their low mobility. In this regard, a strong case can be made for raising property taxes, which yield comparatively little revenue in Poland. Although consumption taxes are also generally considered as less distortive than levies on productive factors,² VAT rates are already high, and revenues from various excise taxes account

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1. This paper was originally produced for the *OECD Economic Survey of Poland* (www.oecd.org/eco/surveys/poland) published in June 2008 under the authority of the Economic and Development Review Committee. The author is indebted to Andrew Dean, David Grubb, Chris Heady, Peter Jarrett, Rafal Kierzenkowski, Val Koromzay, Danielle Venn and Ann Vourc'h for their valuable comments. Special thanks go to Sylvie Foucher-Hantala for technical assistance and to Mee-Lan Frank for editorial support.
 2. This lies behind the preference of many experts for consumption rather than income as a tax base: it would provide stronger incentives to save and higher incomes in the long run.

for a share of total revenues that is similar to the OECD average. There is thus limited room to shift more of the burden towards these tax areas. However, environmental taxes remain under-developed in Poland and could provide one useful avenue for further diversifying the tax base. Finally, despite the steps taken in recent years to strengthen tax administration and reduce compliance costs, further simplification of the tax code remains a challenge, in particular in the area of the VAT where businesses have voiced numerous complaints about unnecessarily high compliance costs.

This paper provides an overview of the tax system in Poland and, based on international comparisons, reviews its main areas of strength and weakness. It begins with a review of the main forces that have shaped the current system. It then follows with an overview of the main features of the tax code and how they impact on economic performance. The taxation of productive factors (labour and capital) is first examined, followed by indirect taxation, with some emphasis on property taxes.

Factors that have contributed to shape the current tax system

Like most other Central and Eastern European countries that have moved from a centrally-planned to a market economy since the late 1980s, Poland entered the transition phase with a relatively high level of public spending, owing in large part to substantial transfers to provide income support to workers who were made redundant by the enormous industrial restructuring. The ratio of public spending on social benefits to GDP rose sharply in the early 1990s to peak at 25% in 1992, well above the OECD average of 18% and similar to the ratio observed in a number of high-income countries such as Belgium, Denmark and the Netherlands (OECD, 2007a). Even though the ratio fell somewhat thereafter, it remains above the OECD average. The major contributing factors are relatively generous disability and early retirement benefits, though spending on the former fell as a ratio of GDP following a tightening of eligibility conditions in 2003-04. The required funding of these social expenditures, traditionally based on a form of earmarked payroll contribution, has had a significant influence on the current design of the tax structure.

In parallel, the traditional sources of revenues – essentially taxes on profits, turnover and payroll of captive state enterprises – quickly eroded following the price liberalisation that marked the transition to a market economy, and which rendered many of these enterprises uncompetitive. Hence, the authorities faced the challenging task of quickly setting up a market-oriented system that would shift revenue collection towards new tax bases. Already in 1989, a major step was taken with the introduction of a uniform profits tax of 40% for both state-owned enterprises and private firms.³ A formal corporate income tax (CIT) was introduced in 1992, along with the personal income tax (PIT). Then a year later, the turnover tax was replaced by VAT and excise taxes. Hence, within a few years, the Polish tax code had acquired all the basic features of systems found in advanced OECD countries. On at least one important account, the rapid transformation of the tax system early in the transition phase was a success. Throughout the 1990s, the stream of revenues generated was sufficiently strong and continuous to help finance the adjustment costs induced by the deep restructuring of the productive sector, while preserving the State from the kind of fiscal crisis witnessed in other transition economies (Lenain and Bartoszek, 2000).

Nevertheless, the system suffered from major limitations, and these became more visible as the drive towards a full-blown market economy developed. For instance, the large number of exemptions, allowances and other special tax treatments that crept into the tax code created economic distortions and high compliance costs, raising incentives for tax evasion. Furthermore, the disproportionately high taxation of labour income contributed to the persistently high unemployment rate. Changes to the tax code were made regularly during the following years, but the first major reform to the new system took place in the late 1990s. Some of its objectives were to address the aforementioned limitations, but a number of factors

3. The profits tax introduced in 1989 was similar – even if not identical – to a corporate income tax (Schratzenstaller, 2005).

had major influences on their design. Most important in this regard were the preparation for EU membership, the process of fiscal decentralisation, and a change of strategy in the race with other CEE countries to offer attractive tax regimes for corporate and individual investors.

The proposed reform of the late 1990s focused essentially on lowering tax rates while broadening the tax base. This was particularly the case for the CIT, where proposals followed a relatively new trend which saw the authorities in emerging market economies opting for aggressive tax rate cuts rather than special exemptions in order to lure new businesses within their borders. The reform included phased reductions in the corporate tax rate from 34% in 1999 to 22% by 2004. In return, the authorities began to roll back some of the numerous *ad hoc* investment allowances introduced in previous years, and which most often lacked transparency. In addition, the number of depreciation rates was drastically reduced (from over 60 to 10). Similar objectives were pursued with the proposal to reform the PIT: moving to lower tax rates, simplifying the rate structure, and broadening the base through the elimination of a host of allowances. However, the draft law amending the PIT was vetoed by the president and therefore never enacted, leaving intact the three-rate structure (19%, 30% and 40%) which still prevails in 2008. On the other hand, the major reform of the pension and health insurance schemes in 1999 was accompanied by the introduction of employee social security contributions and by a corresponding reduction in employer contributions.⁴ This important change to the funding of the social security system had nevertheless only a minor impact on the overall labour tax wedge, which remained one of the highest in OECD.

In order to facilitate EU accession, another key element of the reform concerned amendments to VAT and excise-tax provisions so as to comply better with EU rules. In the case of the VAT, this implied mainly changes in the types of goods or services that could qualify for reduced rates or exemption, while the rate structure was kept largely unchanged.⁵ This process of harmonisation with EU provisions, which involved intensive discussions with the Commission and transition periods, culminated in 2004 with the adoption of a new VAT Act. Finally, the late 1990s marked the introduction of a new tri-level system of sub-national governments involving new arrangements for revenue sharing as part of a parallel reform of the structure of government. Even though the change implied a significant step towards fiscal decentralisation in terms of revenue allocation, the central government kept direct control of most tax instruments. In fact, only the lowest level of public administration (*Gminas*) exerts control over any tax instrument at all, namely the property tax.

Since the early 2000s, the most important changes to the tax system have concerned indirect taxes. Aside from the introduction of the new VAT Act in 2004, the excise system has been modified so as to divide goods subject to such tax into harmonised and non-harmonised excise goods, in line with EU regulations. As part of this process, new institutions were put in place, including tax warehouses, registered and non-registered traders, and the guarantee of excise payment. In another area, local tax administrations have been given more autonomy over real estate, agricultural and forest tax, notably in the determination of rates and exemptions, as well as over the management of stamp duties. As regards direct taxation, further measures were taken to broaden the base for CIT, whose rate was reduced to 19% in 2004, instead of 22% as originally planned. More recently, a number of changes have been made affecting labour taxation: social security contribution rates have been cut and, in 2009, personal income tax rates will be

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4. Before 1999, employers paid social security contributions equivalent to 48% of gross wage earnings. After the reform of the pension system and the health insurance scheme, contributions were split between employees (18.7%) and employers (20.4%). These rates remained basically unchanged until 2007.
 5. At the time of the introduction of the VAT in 1993, the standard rate was 22%, and there was a reduced rate of 7%. A second reduced rate of 3% was introduced in 2000 for agriculture products. Under the EU sixth Council Directive, the basic rate must be at least 15% and, aside from the few categories eligible for complete exemptions, only two reduced rates of at least 5% are allowed on specific goods and services. The 3% rate was allowed only over a (lengthy) transition period.

reduced and simplified. In parallel, a new allowance for children has been introduced while the deductibility of interest payment on mortgage loans is phased out.⁶

To summarise, few fundamental changes to the tax system have taken place since the major, albeit incomplete, reform of the late 1990s. And the changes made since have often taken place in a piecemeal manner, without a clear logic and/or well-defined objectives, thereby contributing to increasing the overall complexity of the tax code. To some extent, this illustrates the difficulties in carrying out comprehensive and coherent reform in this area. As a result, many of the shortcomings identified several years ago have remained unaddressed. The main characteristics of the tax system are reviewed in the next sections.

An international perspective on the size and structure of Polish tax revenues

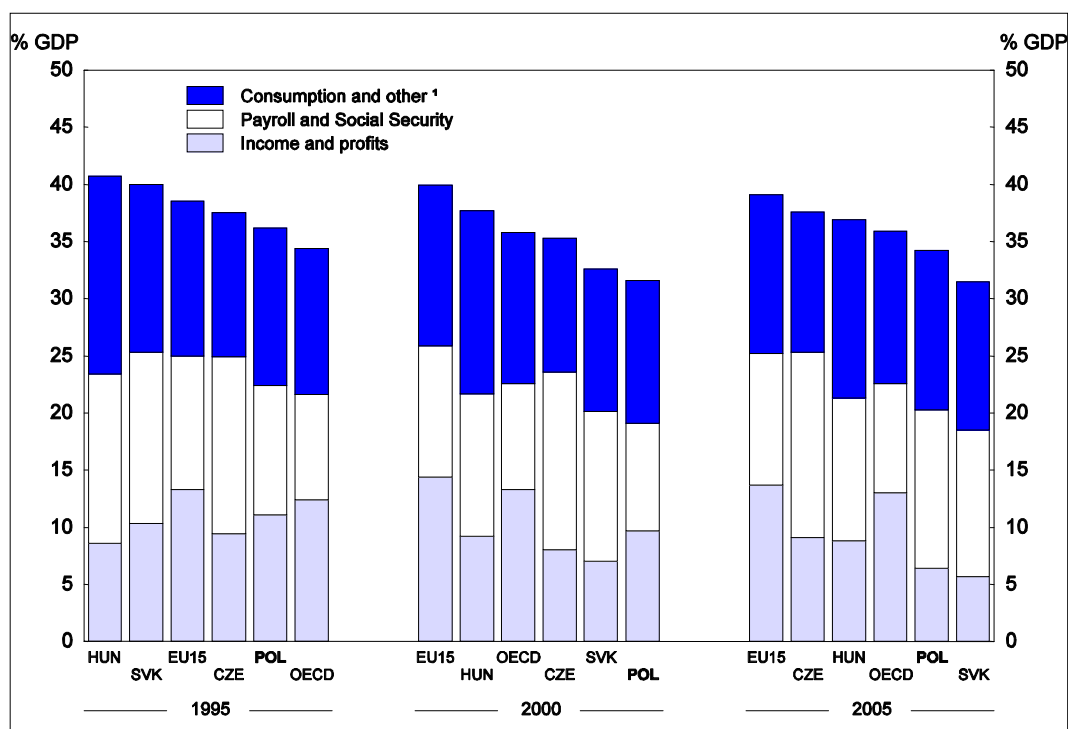
With total revenues amounting to around 34% of GDP in 2005, the overall tax burden is not particularly high (Figure 1). It is somewhat below the OECD average and well under the average of the pre-enlargement EU countries (EU15). Furthermore, the overall tax burden has fallen since the mid-1990s, whereas in most other OECD countries it has either remained broadly constant or risen. However, when compared with a narrower group of middle-income countries from Central and Eastern Europe, the overall tax burden appears not particularly low, either. Although a higher overall tax burden is found in Hungary and the Czech Republic, the tax revenue share of GDP is below 30% in the Slovak Republic, where it has fallen sharply since the mid-1990s, as well as in the three Baltic States (not shown). Indeed, considering that transition countries typically have narrower tax bases, owing in part to lower labour force participation rates (in the official sector), it has been argued by some that they should not aim for a tax revenue-to-GDP ratio of much more than 30% of GDP, otherwise too high tax rates would be needed (Mitra and Stern, 2004).

The structure of taxation, as measured by the share of total revenues raised by each specific tax category, has not changed fundamentally over the past ten years. In particular, there has been no tendency to move towards a more diversified tax base. Social security contributions and indirect taxes (VAT and excise taxes on goods and services) remain by far the largest sources of tax revenues, and their relative importance is not only well above that observed in the average OECD country, but they have even risen over time (Figure 2 and Table 1). In contrast, the share of total revenues raised from personal and corporate income tax has declined to below 20%, one of the smallest shares among OECD countries. Revenues from property tax have risen but remain modest in international comparisons, and other “small” tax bases such as or environmental externalities (see below) still generate little in the way of revenue.

In terms of revenue sharing between the different jurisdictions within the country, Poland is similar to the OECD average as regards the share of tax revenues that goes to local authorities (Figure 3). In 2004, they received 11.5% of total revenues, somewhat below the corresponding average figure across OECD unitary countries. In Poland, their main sources of revenues are transfers from central government and their share in centrally imposed income taxes. Not surprisingly, the share of total revenues dedicated to social security funds is much higher than the OECD average, leaving a smaller share in the hands of the central government.

⁶ It should be noted that the tax allowance being phased-out was only applicable on purchases of newly constructed properties (*i.e.* bought directly from property developers).

Figure 1. Overall tax revenues as a percentage of GDP

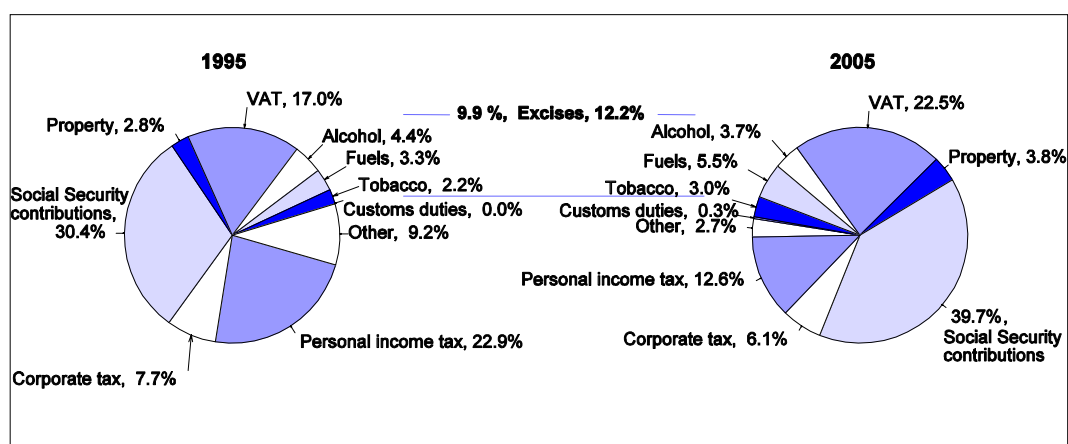


1. Including taxes on goods and services and property.

Source: OECD (2007), Revenue Statistics, 1965-2006, Eurostat, New Chronos database.

Figure 2. Structure of tax revenues

Per cent of total tax revenues



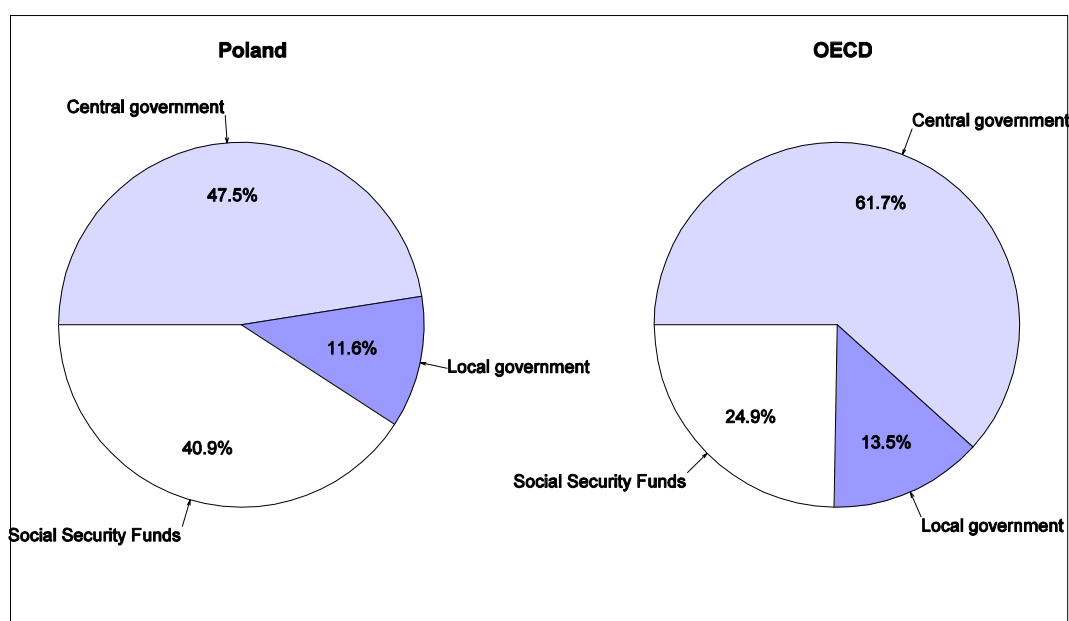
Source: OECD (2007), Revenue Statistics 1965-2006.

Table 1. **General government revenues by type of tax**Tax structure in selected OECD countries
(Per cent of GDP, 2005)

	Poland	CE-3	EU15	OECD
Income and social security	20.0	21.4	24.8	22.2
Personal income	4.3	4.6	10.2	8.9
Corporate income	2.1	3.1	3.4	3.6
Social security	13.6	13.5	11.1	9.3
Consumption	12.6	13.0	11.9	11.4
VAT	7.7	7.9	7.0	6.5
Excise and consumption	4.9	5.2	4.9	4.9
Property	1.3	0.6	2.1	1.9
Others	0.3	0.4	0.8	0.6
Total tax revenues	34.2	35.5	39.7	36.2

Source: OECD (2007), *Revenue Statistics database*.Figure 3. **Taxes by level of government¹**

Per cent of total tax revenues



1. Estimates for 2004. Central government includes supranational taxes (attribution less than 0.5%) collected on behalf of the European Union by its member states. The OECD figures are unweighted averages of unitary countries. The figures do not take into account the transfer of revenue from central to local government.

Source: OECD (2006), *Revenues Statistics 1965-2005*.

Although instructive about the main sources of revenues, the structure of taxation as presented above does not reveal much about the incidence of the tax system on economic behaviour and performance. An assessment of the latter requires a closer look at two dimensions of taxation: the influence of effective tax rates on economic agents' incentives and choices as well as the cost effectiveness of tax administration and collection. These are examined in more detail in the next section.

Taxes on labour and their negative impact on economic performance

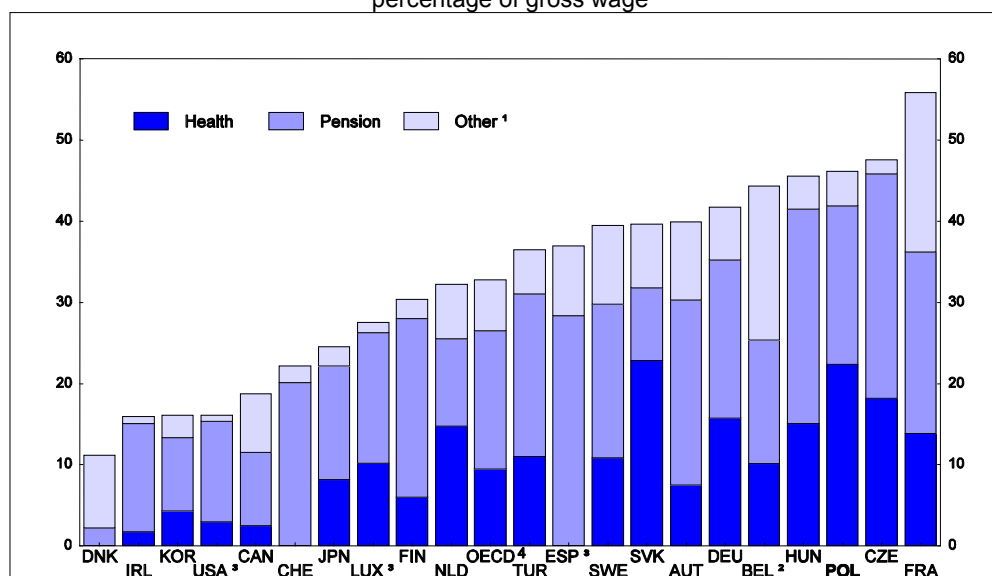
For the purpose of this analysis, taxes on labour comprise all those that are levied on the employment of, and/or income from, labour resources. It thus covers social security contributions and the provisions of the PIT that apply to labour income.

Social security contributions

As mentioned earlier, Poland has a fairly costly system of social expenditures, in particular for disability and old-age pensions (including pre-retirement schemes). Despite previous efforts at reforming such programmes (OECD, 2004 and 2006), their cost remains substantial, and they are mostly funded by social security contributions levied on gross wage earnings (Figure 4). The contributions, which are all earmarked for specific programmes, added up to 46% of gross wage earnings in 2006, slightly more than half of which were paid by employees. Given that the contributions are deductible from taxable income, the majority of workers recover close to 20% of the amount contributed through income tax savings.

Figure 4. **Structure of social security contributions, 2005**

Social security contributions for a single worker without children at 100% average worker wage, percentage of gross wage



1. The 'other' category mainly includes unemployment insurance and work-related illness and accident insurance.
2. The 'other' category includes family allowances (6%) and wage restraint (6.6%).
3. Pension includes disability. For Spain, it also includes health.
4. Average for countries shown except Luxembourg, Spain and the United States.

Source: OECD (2007), *OECD Employment Outlook*.

For many years, the rate structure has remained largely unchanged. In 2007 and 2008, contributions for disability pensions were reduced by 3 and 4 percentage points, respectively, in an effort to lower the tax wedge on labour income (see below). As a result, overall contributions have been lowered to slightly below 40% of average earnings, with the corresponding rate structure shown in Table 2. The cut in contributions has been partly offset by reductions in the costs of the disability programme. However, the shortfall in revenues is larger than the savings made, implying that a greater part of the funding for disability benefits will have to be covered by the general budget.

Table 2. **Employer and employee social security contribution rates in 2008**

By type of benefit (per cent of gross wage earnings)

	Total	Employers	Employees
Old-age pension and disability	25.52	14.26	11.26
Old-age pension	19.52	9.76	9.76
Disability/survivor pension	6.00	4.50	1.50
Insurance for sickness and maternity	2.45	–	2.45
Unemployment benefit (labour fund)	2.45	2.45	–
Guaranteed Employee Benefits	0.10	0.10	–
Insurance for accident at work and occupational diseases	1.57	1.57	–
Health insurance contribution ¹	7.11	–	7.11
Total	39.25	18.43	20.82

1. The rate of health insurance contribution is 9.0% but because it applies to earnings net of employee contributions, it is equivalent to 7.11% of gross wage earnings.

Source: OECD Taxing Wages (2007).

The extent to which employees perceive social security contributions as deferred benefits is difficult to assess. Since the 1999 reform of the pension system, benefits are much more closely aligned with lifetime contributions, reducing thereby the degree of redistribution embedded in the system. Indeed, a comparison of gross and net replacement rates from public pension regimes across OECD countries shows that Poland has one of the least redistributive systems (OECD, 2005a). Accordingly, contributions that are earmarked for pensions are likely to be perceived by workers as “forced” saving rather than taxes, at least to a larger extent than in other countries. On the other hand, this is much less likely to be the case for the other important components, such as disability pensions, or health insurance, where the link between contributions and lifetime benefits is much less clear.

The treatment of labour income under the personal income tax

Poland has a so-called *semi-dual income tax* system whereby different nominal tax rates apply to different sources of income (in this case mainly labour and capital).⁷ Capital income is taxed at one flat rate, whereas wage income is subject to progressive taxation, under a three-bracket structure (19%, 30% and 40%). Couples living together are free to choose between separate or joint declarations. In principle, Polish citizens living abroad are still subject to income tax in Poland, although the government has negotiated bilateral treaties with a number of countries in order to reduce the incidence of double taxation and encourage the return of expatriated workers (see Box 1). The issue has gained in importance in recent years due to the large number of Polish expatriates and the emergence of labour shortages in many sectors. Finally, earnings from farming activities are exempt from income taxation.

7. By comparison, in a pure *dual income tax* system, all net income (capital, wages and pension net of deductions) are taxed at a proportional rate but gross labour and pension incomes are also taxed at separate, progressive rates (OECD, 2006a).

Box 1. The tax treatment of Polish citizens working abroad

Poland's entry into the European Union has led to a sharp increase in the flow of Polish workers migrating to other member states. The United Kingdom has become a particularly favoured destination. Until 2007, the tax treatment of Poles working in this country was based on the so-called *proportional deduction method* (or credit method). According to this method, non-resident citizens – who spend at least half of the year abroad – would pay labour income taxes in their host countries, according to the personal income tax rules applied in this country. In addition, they would also remain liable to income tax in Poland. Income tax liability would therefore be calculated under the Polish PIT, on the basis of the income earned at home and abroad. However, to minimise double taxation, the amount of taxes paid in the host country would be credited against their tax liabilities.

Despite the credit, many expatriates still faced a substantial Polish tax bill, simply because the income earned abroad, in combination with lower tax-free income threshold, would place them in much higher tax bracket in Poland than in the United Kingdom. In order to ease the burden of double taxation, Poland entered in 2006 into a new double-tax agreement with the United Kingdom, according to which the *exemption method* applies to labour income earned by Polish tax residents in the United Kingdom. For income earned during the period 2002-07, the Polish authorities have indicated that a tax amnesty would be granted for taxes overdue in Poland and that those who have honoured their tax obligations over that period will be reimbursed.

In international comparison, the income threshold for the top bracket is not particularly low at over three times (gross) average earnings, and the marginal effective tax rate at that income level is substantially lower than the statutory rate (Figure 5). Even the second bracket rate (30%) only kicks in at an income level of around 1.5 times the average wage. And, if one considers in addition the deductions and credit for payment of social security contributions, the amount of gross wage earnings that would yield taxable income high enough to reach the 30% and 40% brackets are closer to 1.8 and 3.5 times average gross earnings. Partly as a result, a relatively small fraction (between 6% and 7%) of taxpayers who declare labour income are subject to those brackets. Nonetheless, these taxpayers provide 44% of total personal income tax revenues.

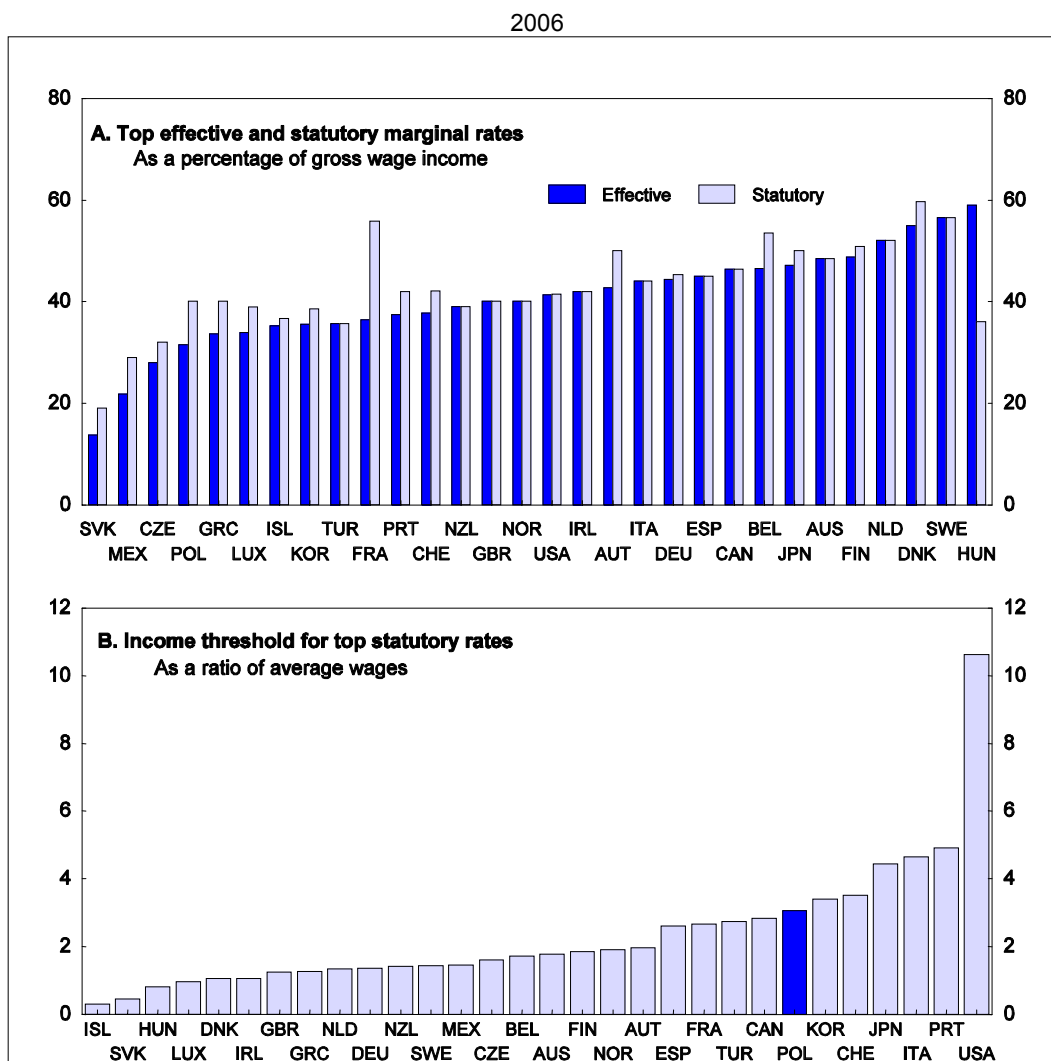
As in most OECD countries, the minimum earning threshold for paying income tax is also higher than zero, due to the presence of a deduction for work-related expenses and a basic tax credit which are both set as fixed amounts. In 2006, these two allowances combined were equivalent to a deduction worth about PLN 350 per month or 14% of (gross) average earnings.⁸ Considering the average cost for housing and basic food, this is clearly below poverty levels, even for single individuals. However, given the presence of a minimum wage, few earners would in practice face such a low income, and those who might (for example part-time workers or those living on old-age pensions), are most likely to receive additional income support from various social programmes. Furthermore, the marginal effective tax rate at that income level is quite low (9%).

Given that the PIT was excluded from the major reform in the late 1990s, the current rate structure and basic allowances have been in place for a decade. However, a substantial change is planned for 2009, with a reduction in the number of brackets from three to two. Under the plan, the first bracket rate will be lowered from 19% to 18% and the two higher rates will be replaced by a single rate of 32%. The income threshold for the second rate will be set at a level equivalent to around 2.6 times average earnings, which is only slightly below the income threshold for the third bracket under the current structure. Hence, the change is clearly set to benefit all income taxpayers and is therefore far from being revenue neutral. In fact, the size of the tax cut is estimated at 0.7% of GDP. Combined with the aforementioned reductions in social security contributions, the shortfall in revenues from these measures amounts to around 2% of GDP. The

8. This minimum threshold rises to about 30% of average earnings once allowances for social security contributions are taken into account.

taxpayers who will benefit the most are those in the two highest brackets, further reducing the overall progressivity of labour income taxation.⁹ Given the substantial loss of revenues that the coming change in the rate structure represents, and considering the need for further reductions in social security contributions, especially at the low end of the income distribution, moving to a flat tax should not be a priority (see Box 2).

Figure 5. Top marginal rates and corresponding income threshold



Source: OECD Tax Database.

9. Note that the degree of progressivity associated with the top bracket is less than the 10 percentage point difference in rates (40% percent as opposed to 30%). This is because the income threshold for the top bracket also corresponds to the income limit for payments of social security contributions. Hence, progressivity is in this case closer to 2 percentage points.

Box 2. The flat tax debate in Poland

Since the introduction of a flat tax in Russia in 2001, followed by Ukraine and the Slovak Republic in 2004, Georgia and Romania in 2005, and Bulgaria and the Czech Republic more recently, the authorities in Poland have been considering adopting such a tax. In most of these countries, the uniform tax rate has been set at a level close to the lowest-bracket rate of the tax structure in place before the reform. As a result, marginal tax rates for high-income earners have clearly fallen. Nevertheless, the impact of such reforms on overall progressivity is not clear cut as it depends on the tax-free allowance and the extent to which the reform is revenue-neutral *ex ante*.

There are several arguments in favour of the flat tax. *First*, its introduction is usually marked by a significant broadening of the tax base, which reduces distortions and improves efficiency. *Second*, reductions in marginal rates at higher income levels improve incentives to work and pursue entrepreneurial activities. *Third*, where a similar rate is set for personal and corporate income tax, the choice of a legal form to conduct business (corporation or unincorporated entity) is less distorted by tax considerations. Likewise, there is also less incentive for employees to turn themselves into own-account workers. *Fourth*, the simplification of the tax system and the greater transparency reduce compliance costs and, thereby, tax evasion. Indeed, following the success in Russia where revenues increased after the introduction of the flat tax (Gorodnichenko *et al.*, 2008), many countries in the region see such reform as an effective way to reduce tax evasion.

However, outside Russia the experience from the flat tax is more mixed. In all other cases where the flat tax rate was set at a level close to what was the lowest bracket in the previous tax structure, the reform has led to a reduction in PIT revenues (Keen, Kim and Varsano, 2006). Again with the exception of Russia, there is little evidence thus far that the flat tax has had a significant impact on work incentives, though it may be too early to judge in some of the more recent cases. While the simplification of the tax structure has clearly helped to increase tax compliance, the major source of complexity – numerous exemptions and allowances – could also be addressed in the context of a simple, multiple rate structure.

Before making a decision on the PIT reform to be introduced in 2009, the previous Polish government examined the potential impact of adopting a single tax rate for PIT. Two scenarios were compared at the time: a 15.4% rate with no basic allowance and a 20.5% rate with a basic allowance (OECD, 2006a). In both cases, the simulation showed that the change would have had only a small impact on the tax wedge, mainly because personal income tax accounts for a small portion of the wedge. Another reason is that, depending on the size of the tax-free allowance, only a modest proportion of taxpayers would have benefited from a significant reduction in PIT. Furthermore, the expected benefits would be limited insofar as Poland already taxes capital income at a lower rate under its semi-dual income tax system. Instead of a flat tax, the government opted for a reduction in the number of tax brackets, in the context of an overall reduction in PIT. While the rate structure is thus simplified, there has been no reduction in the complexities arising from the multitude of exemptions and allowances and thus any benefits in the form of reduced compliance costs and evasion have been foregone.

Efforts have been made to broaden the base by eliminating a number of tax reliefs in recent years.¹⁰ One of the most important concerns the deductibility of interest payments on mortgage loans. This is no longer allowed, though, with the change applying only to loans taken-out after the end of 2006, the positive effect on revenues will be only very gradual. Another substantial allowance eliminated in recent years was the deduction for the renovation of houses and apartments. Despite these efforts, several important exemptions and reliefs have remained in place at a non-negligible cost in terms of foregone revenues (Table 3). Allowances are often questionable from an equity perspective, since, with the exception of non-wastable tax credits,¹¹ they generally benefit higher-income group disproportionately. But even aside from equity considerations, the mere justification of some of the allowances is certainly questionable, not least those for Internet subscriptions. Eliminating such allowances would be all the more relevant to help

10. Throughout this chapter, “relief” and “allowance” are used as generic terms that can refer to either a deduction from taxable income or from the amount of taxes (tax credit).

11. With a non-wastable tax credit, individuals whose tax liability falls to zero before full exhaustion of the credit can still get the full value via a reimbursement from the government.

funding the new tax credit for children that was introduced in 2007, at an estimated cost of 0.5% of GDP. In 2008, the deduction from tax liabilities is a flat amount of PLN 1 173 for each child (or 3.7% of average earnings).

Table 3. **Budget revenue losses from PIT allowances and deductions in 2006**

PLN million (unless indicated)

Total PIT deductions	4 305
<i>of which: From income</i>	883
<i>From tax</i>	
Total budget revenue loss (result of allowances and deductions)	1 719
In per cent of PIT	6.11
Housing allowances	
Revenue loss	724
In per cent of PIT	2.57
Total average allowance per taxpayer (in PLN thousand)	0.52
In lowest bracket	0.45
In middle bracket	1.69
In highest bracket	2.77
Rehabilitation expenditures	351
Revenue loss	
In per cent of PIT	1.25
Total average allowance per taxpayer (in PLN thousand)	0.37
In lowest bracket	0.36
In middle bracket	0.64
In highest bracket	0.94
Internet expenditures	205
Revenue loss	
In per cent of PIT	0.73
Total average allowance per taxpayer (in PLN thousand)	0.10
In lowest bracket	0.09
In middle bracket	0.15
In highest bracket	0.22
Donations	71
Revenue loss	
In per cent of PIT	0.25
Total average allowance per taxpayer (in PLN thousand)	0.37
In lowest bracket	0.07
In middle bracket	0.19
In highest bracket	2.70
Other	368
Revenue loss	
In per cent of PIT	1.31
PIT revenue (state budget) in PLN million	28 125

Source: Ministry of Finance.

Providing allowances for dependent children is fairly common practice across OECD countries and is usually justified on the ground that raising children brings unavoidable expenses to the parents while creating benefits for the society as a whole, especially in countries facing adverse demographics. Furthermore, this is a case where the target is sufficiently general and easy to identify that it does not add much to the complexity of the system. However, considering that the tax rate cuts expected in 2009 will already offer substantial relief for high-income households, the case could be made for making the child tax credit more beneficial to those who most need them. To do so, the allowance should be turned into a

non-wastable tax credit and its size diminished in order to prevent the overall budgetary cost from rising further or even to lower the cost.¹² In such a case, however, the child benefit administered through the tax system may overlap with the family allowance delivered through the social assistance system.

The incidence of the tax wedge on labour costs and employment

The size and shape of the labour tax wedge

One of the key implications of the combined social security contribution and PIT structure is the substantial gap between the overall labour cost borne by employers and the net take-home pay received by employees. The average tax wedge on labour income is still well above OECD and EU averages across a whole range of family situations and income levels. Comparing the labour tax wedges for single earners, Poland was near the average in the case of higher-income workers but not for lower-income earners, where again it was relatively high (Figure 6). This reflects another singularity of the Polish tax wedge; that it is largely invariant across income levels. Indeed, when measured on the basis of a simple index that compares tax rates at high and low income levels, the Polish wedge schedule stands out as being the least progressive of all OECD countries' schedules. And to a large extent, this is because the PIT structure itself has relatively little progressivity.

Taking into account the reductions in social security contributions in 2007 and 2008, the new child allowance and the planned cuts in PIT rates in 2009, the combined reductions in the will vary from around 4 percentage points, for those who only benefit from the reductions in social security contributions, to over 10 percentage points for those who fully benefit from the child allowance and/or the PIT reductions (Figure 7). This is a considerable effort that will leave the tax wedge on average close to the current EU mean, albeit still significantly above the OECD mean. Whether or not this will be sufficient to give the much needed permanent boost to labour market participation and employment in the official sector depends on a number of factors, in particular on the responsiveness of labour demand and supply to the change in incentives.

Factors conditioning the influence of the tax wedge on employment

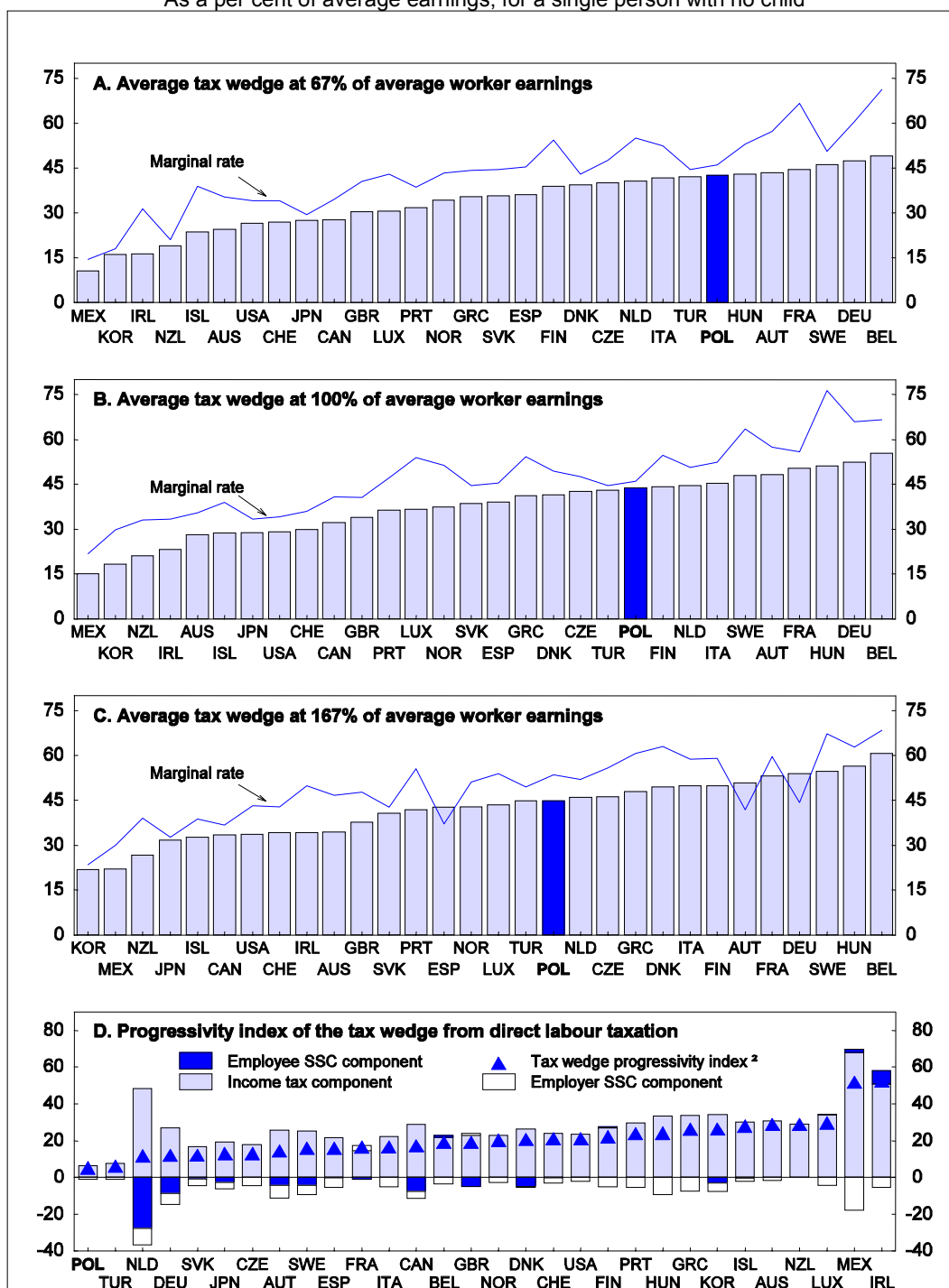
In general, the overall impact of the average tax wedge on employment depends to some extent on who ultimately bears its cost. Insofar as employers are able to shift the burden to employees through lower (pre-tax) wages the unemployment rate would be largely unaffected (at least in the medium term), and the magnitude of the effect on the employment rate would depend essentially on the responsiveness of labour-force participation to wage developments relative to "reservation wages". However, cross-country empirical studies often find evidence of a significant impact of the tax wedge on the unemployment rate, suggesting that pre-tax wages do not adjust sufficiently to prevent labour demand from falling relative to supply following a tax hike.¹³ According to recent OECD estimates, a 10 percentage point increase in the tax wedge would raise unemployment by nearly 3 percentage points for the average OECD country (OECD, 2007c). The negative impact on employment rates would be even larger, at between 3½ and 4 percentage points, indicating that participation rates would also fall.

12. If the tax credit were to be made fully refundable (non-wastable), it would generate a much larger reduction in the tax wedge for low-wage earners. For instance, the reduction for single-earner household (with two children) earning 75% of the average wage would be around 8 percentage points as compared to 3 percentage points under the current arrangement.

13. See Chapter 3 of OECD (2006b) for a review of selected empirical analyses.

Figure 6. Tax wedge across countries in 2006¹

As a per cent of average earnings, for a single person with no child

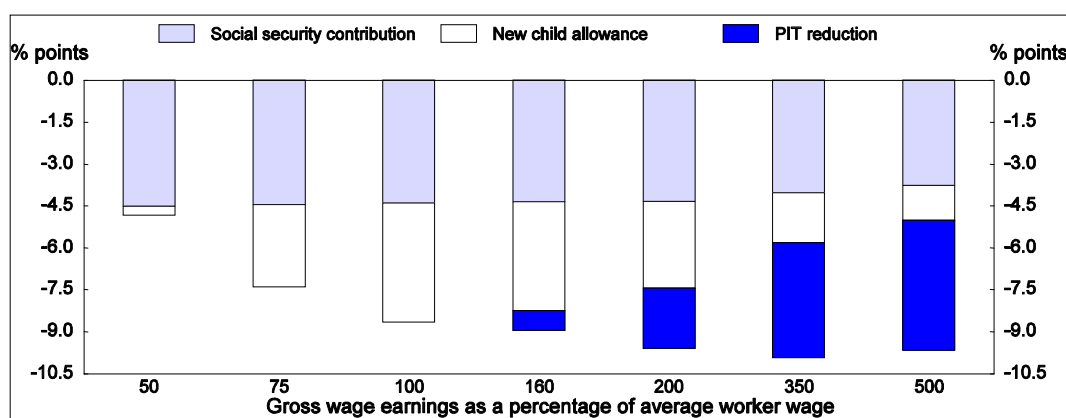


1. The average tax wedge is defined as the share of income tax and all social security contributions minus benefits in gross labour costs, marginal rates are defined as the increase in tax and all social security contributions minus benefits as a share of the related increase in gross labour costs.
2. The progressivity index of the tax wedge is calculated as $(TW_{167} - TW_{67}) / TW_{167}$, where TW_{167} and TW_{67} is the tax wedge for workers at 167% and 67% of average wage, respectively.

Source: OECD (2008), *Tax database*.

Figure 7. Magnitude and sources of reduction in the tax wedges by income level¹

Percentage points, single earner, married couple with 2 children



1. Each bar shows, for difference earning levels, the total reduction in the tax wedge resulting from three measures: *i*) the reduction in rates of social security contributions (2007-08), *ii*) the introduction of a child allowance (2008) and *iii*) the forthcoming simplification and cut in PIT rates (2009).

Source: OECD (2007), *Taxing Wages*.

As regards the effect on unemployment, the presence of a binding wage floor in the form of a statutory minimum wage is one factor contributing to this result, especially in countries where a uniform rate is set at a high level relative to the median wage (Bassanini and Duval, 2006). At an estimated 39% of the median wage in 2005, the minimum wage in Poland was not particularly high in international comparison. Its impact on employment is further mitigated by measures allowing enterprises to pay new entrants of any age only 80% of the minimum wage in the first year. Nevertheless, other evidence has shown that the proportion of workers paid at, or slightly above, the minimum wage varies substantially across Polish regions but can be particularly high for youth, especially those with low educational attainment (OECD, 2004).¹⁴ This is corroborated by data on the aggregate wage distribution showing a truncation at around the minimum wage level (Góra *et al.*, 2006). A particularly binding minimum wage in some regions may have contributed to the high overall unemployment for youth and the low-skilled (Figure 8). Furthermore, informal employment is also pervasive among younger workers (OECD, 2008), which could yet be another indicator that the high minimum wage relative to productivity is having adverse labour market outcomes. And, this effect may be exacerbated by the 20% increase in the statutory minimum wage that took place in January 2008, which would bring its level close to 43% of the median wage.

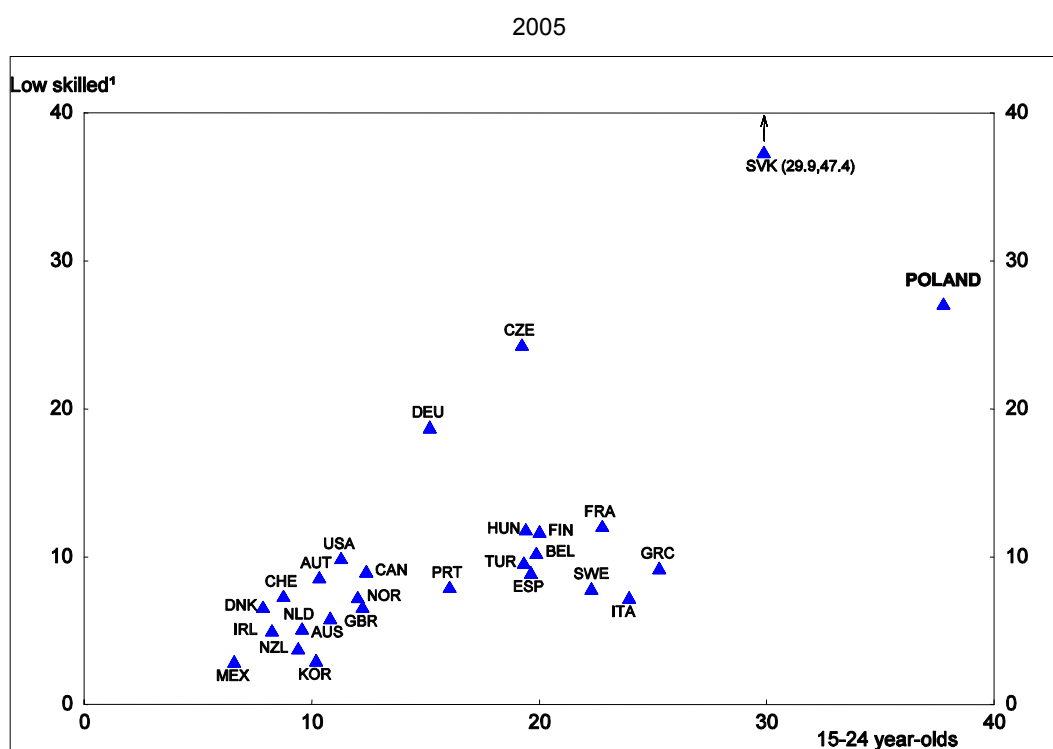
Aside from the presence of such floors, tax wedges can be a source of unemployment if employees have enough bargaining power to set wages persistently at above market-clearing levels (*i.e.* labour markets are not perfectly competitive).¹⁵ For instance, previous empirical analysis has found that the impact of tax wedges on unemployment can be particularly high in countries where strong union membership coincides with a low or intermediate degree of centralisation/co-ordination of wage

14. Calculations based on data for the year 2000 indicate that the share of employees paid at around the minimum wage was around 18% for all youth and 25% for those with less than secondary education. The latter proportion was 30% or more in four of the 16 voivodeships.

15. This condition is necessary but not sufficient. One other necessary condition is that workers must not perceive components of the tax wedge as deferred benefits (and accordingly must bargain purely for net rather than gross wages).

bargaining (Daveri and Tabellini, 2000). Poland no longer fits these criteria. While trade-union activism may have partly contributed to the steep rise in structural unemployment during the 1990s (Zientara, 2007), its influence on wage determination appears to have weakened significantly since then. Between 1990 and 2000, the share of workers represented by unions had already fallen from 30 to 15% (the fourth smallest proportion in the OECD; it has since edged down to 14%), and even then union representation is largely concentrated in specific sectors such as mining, shipbuilding and railways. Furthermore, a centralised form of social dialogue exists through the National Tripartite Commission, but the outcomes are more of a normative than of a binding nature and apply mainly to large state-owned companies or public-sector employees. Hence, private-sector wage determination is largely decentralised, with negotiations taking place at the company or plant level, without much higher-level co-ordination.

Figure 8. Unemployment rates for youth and the low skilled



1. Defined as population with no more than lower secondary education.

Source: OECD (2007), *Education at a Glance* and OECD (2007), *Employment Outlook database*.

As for the effect on participation rates, their sensitivity to net wage changes depends not only on workers' capacity and willingness to substitute leisure inter-temporally but also on the extent to which a change in the tax wedge affects the reservation wage and the market wage in different proportions. As the determinants of the reservation wage of a person outside the labour force include factors such as social assistance, family benefits as well as disability or retirement pensions – exempted for the most part from income tax and social security contributions—the reservation wage is likely to be much less sensitive to tax-wedge changes than is the market wage (Blanchard, 1999). This is even more the case if one believes income earned in the informal sector helps to determine the reservation wage, a factor particularly relevant in a country like Poland.¹⁶ In such a case, the elasticity of labour-force participation to tax-wedge changes

16. According to the methodology of the Central Statistical Office based on the commodity turnover statistics, the grey market in Poland is estimated to be approximately 13-14% of GDP, thus approximately

could be quite significant for workers with low earnings potential, given that their (pre-tax) market wage is often only marginally above their reservation wage and that they are the ones most likely to fall into inactivity traps.

Whether the impact of the tax wedge on Polish employment has come mainly through higher unemployment (*via* the interaction with the minimum wage) or lower participation is difficult to discern from empirical analysis. Even though, in principle, individual country estimates could be extrapolated from panel econometric analyses, such calculations are generally hazardous, especially since former centrally planned economies such as Poland are often left out from such estimations.¹⁷ What the evidence confirms, however, is that the impact seems to be much greater for lower-income earners. For instance, estimates based on micro data from the labour force survey in Poland indicate that the impact of a tax-wedge change on employment rates is four to five times larger for workers with less-than-median earnings than it is for those above the median (Góra *et al.*, 2006). The same study uses cross-country regression analysis over a sample that includes Poland and other CEE countries to show that the tax wedge has a large and statistically significant negative effect on the employment rate of low skilled, prime-age males, but not on that of high skilled individuals.¹⁸

Options for further reductions in the labour tax wedge

The empirical evidence reviewed above suggests that insofar as further reductions in the labour tax wedge would be deemed desirable to boost employment rates, they should be well targeted so as to lower the cost of labour and/or raise work incentives at the low end of the income distribution. Aside from the Poland-specific evidence cited above, previous experience and analysis have shown that targeted cuts in the labour tax wedge are generally more cost-effective in raising employment rates of specific groups than a broadly-based tax cut (OECD, 2007c). The budgetary cost would also be more limited and therefore easier to finance by expenditure cuts or increases in other tax bases. Targeted cuts can also be justified on equity grounds, given the low degree of progressivity in the Polish tax structure.

Two types of measures have generally been taken by OECD countries to raise the net take-home pay of low-income workers: in-work benefits and targeted cuts in payroll contributions. Many countries provide employment-conditional benefits in the form of means-tested cash transfers that top up the wages of low-income workers (OECD, 2005b). The most common type is the earned income tax credit (EITC), which is delivered directly through the PIT system. The EITC has been used since 1975 in the United States where it has become the largest anti-poverty programme for non-elderly individuals. Since then, similar schemes have been introduced, first in the United Kingdom (1999), and then in at least seven

PLN 150 billion. Measures based on social security coverage or tax returns suggest that informal employment represents between 5 and 10% of the workforce (OECD, 2008). This is comparable to what is observed in other Central European countries but much lower than in Korea, Mexico and Turkey.

17. For instance, the results reported above from OECD (2007b) are based on a sample excluding Poland. One more reason to be cautious is that the estimated coefficient on the tax wedge from panel unemployment regressions can vary substantially across country sub-groupings. For instance, Daveri and Tabellini (2000) find the impact to be largest in continental Europe, but insignificant for Nordic countries.
18. In this study, the low skilled are defined as those who have not completed upper-secondary education, while the high skilled have completed at least first-stage tertiary education. The authors find that a 10 percentage point increase in the tax wedge reduces the employment rate of low skilled prime-age males by around 5 percentage points, whereas the effect on high skilled prime age males is only one-third as large and not statistically significant.

other OECD countries.¹⁹ The main goal of EITCs is to boost labour supply by raising work incentives for low-skilled people, whose labour-market attachment is often tenuous, in part because their family situation further reduces the financial rewards of working relative to remaining inactive.²⁰ In parallel, a number of the countries (Belgium, France, the Netherlands and the United Kingdom) who provide an EITC also apply targeted reductions in employer social security contributions in order to reduce the minimum cost of labour and foster low-skilled job creation, in particular in the services sector. These countries thus act simultaneously on both sides of the labour market to boost employment.

According to earlier studies, both types of targeted incentives can be effective in raising employment rates among marginal groups, though this is generally under fairly specific conditions and not without some perverse effects on other groups or types of incentives.²¹ For instance, results from cross-country empirical analysis suggest that a 20% reduction in the financial disincentive to enter the labour market – through an EITC, for example – raises the probability of moving from unemployment to employment by 10% (from 45% to 49%).²² When the initial situation is one of inactivity instead of unemployment, the effect is somewhat stronger, but only statistically significant in the case of single women. Likewise, on the basis of country-specific monitoring, targeted reductions in employer social security contributions are generally seen as having significant effects on low-skilled employment, though the impact is difficult to quantify with any sort of precision and the associated deadweight losses can be substantial (OECD, 2007c, 2003; Rémy, 2005). However, previous analysis also suggests that in order to be successful in raising employment – and not just in redistributing income – both types of measures should be sufficiently well targeted so as to have a large enough impact on labour demand and/or supply, while limiting the cost to public finances.

As far as Poland is concerned, the effectiveness of either type of measure would be enhanced by the completion of the reforms of the disability and early retirement pension schemes, so that these programmes can no longer serve as an attractive alternative to participation in the official labour market. Integration of the special farmers' social security scheme (KRUS) within the general system (ZUS) should in this regard be seen as a priority.²³ It is also important to ensure that adequate resources are in place in the public administration in order to handle the added complexity that such measures entail. Beyond that, even though both should be considered, as they can be complementary, the case for reducing social security contributions seems to be more appealing. *First*, the combination of very high payroll contributions and a relatively high minimum wage creates the conditions for such a measure to have a significant impact on low-skilled job creation. *Second*, this measure may not be too demanding on additional administrative resources if it is introduced in the simple form of an exempted lower band as in the United Kingdom or Ireland. *Third*, EITCs have been found to work better in countries where tax rates and benefits for the

19. These are Belgium, Canada, France, the Netherlands, New Zealand and Sweden. Denmark also introduced an EITC in 2004, but it is not income-tested, and Finland has a similar scheme based on a deduction rather than a credit.

20. This is generally the case for lone parents whose return to the labour market often implies the loss of benefits as well as the need to pay for child care services.

21. Obviously, a narrow targeting in terms of income level implies a fairly rapid withdrawal of the measure as the wage level rises, reducing thereby incentives to work more hours or to invest in skill up-grading.

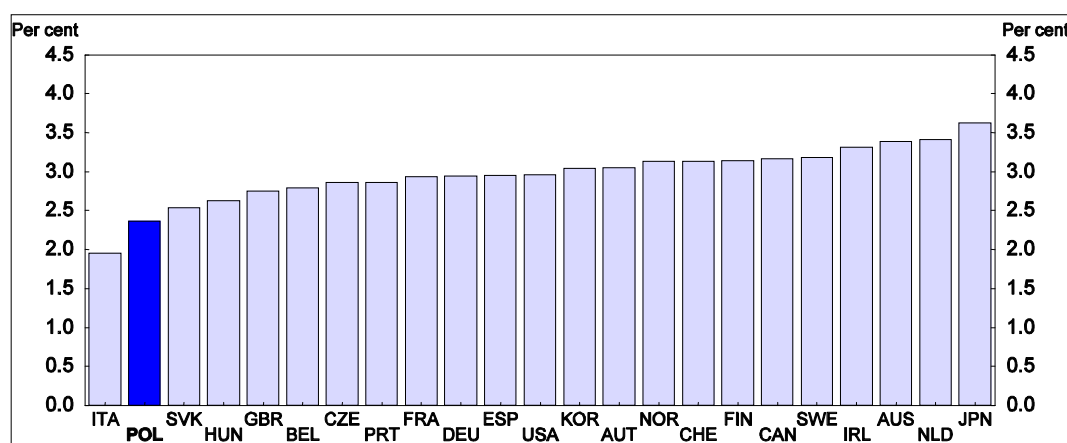
22. See Chapter 3 of OECD (2005b). The impact is strongest in the case of the unemployed partner of a person who already works, where the probability rises from 51% to 58%. The financial disincentive to return to work is measured in the form of a marginal effective tax rate that takes into account the resulting increase in income tax payments and social security contributions as well as the loss of social benefits resulting from the change in status (Immervoll, 2006).

23. Due to the loose eligibility conditions many participants who are not strictly farmers do benefit from the programme.

non-employed are relatively low (United Kingdom and the United States, for example), which is not really the case in Poland (Bassanini *et al.*, 1999).

More generally an advantage of payroll tax cuts is that a revenue-neutral reduction in the tax wedge for low-income earners can be more easily achieved by shifting some of the earmarked social security contributions towards income tax. This is because low-income earners (*e.g.* minimum wage earners) pay income tax only on a small portion of their earnings, if at all, and also because the base of personal income tax is generally broader (covering active and inactive residents as well as income from labour and capital). In fact, recent estimates indicate that a 5% reduction in social security contributions could be compensated in a revenue-neutral manner by an increase of less than 2½ per cent in personal income tax (Figure 9). In this regard, more ambitious reductions in the tax wedge at the low end of income distribution could also be envisaged if the planned reduction in the income tax rate were to be reconsidered or if some of the more costly allowances, in particular the child tax allowance, were to be rolled back. Alternatively, other tax bases could be considered as funding sources for offsetting genuine cuts in tax wedges. The scope for doing so is examined in the next sections.

Figure 9. Required increase in PIT rate to compensate for a 5% cut in employer social security contributions



Source: OECD (2007), Employment Outlook.

The tax treatment of capital income

This section covers the tax treatment of capital income, in particular regarding corporations, but also concerning small unincorporated businesses and the self-employed. The interaction between the corporate and personal income tax systems is also discussed.

Corporate income tax

As mentioned above, the Polish corporate tax system was the object of a much deeper reform than PIT, nearly a decade ago. The nature of the system has not changed fundamentally, but corporate tax rates were cut significantly and the base broadened to some extent, in line with observed international trends. The tax rate on corporate income was lowered from 40% in 1995 to 19% in 2004, where it still currently stands. All incomes earned by legal entities from activities carried out in Poland are liable for taxation regardless of residency. In principle, profits earned abroad by corporations headquartered in Poland are also subject to Polish taxation, but are in practice exempted for activity conducted in many foreign countries by virtue of international agreements. The income from a number of specific domestic activities

is also exempted, including that from agriculture, forestry and sea ports. Another major type of exemption concerns business activities in 14 Special Economic Zones, a measure adopted in the mid-1990s to stimulate (foreign) investment in less developed regions. Even though both domestic and foreign firms qualify for the exemption, it was still viewed as violating EU rules on state aid. Therefore, following negotiations on EU accession, no new exemptions have been granted since 2000. Also, these granted before 2000 are scheduled to be entirely revoked by 2017.

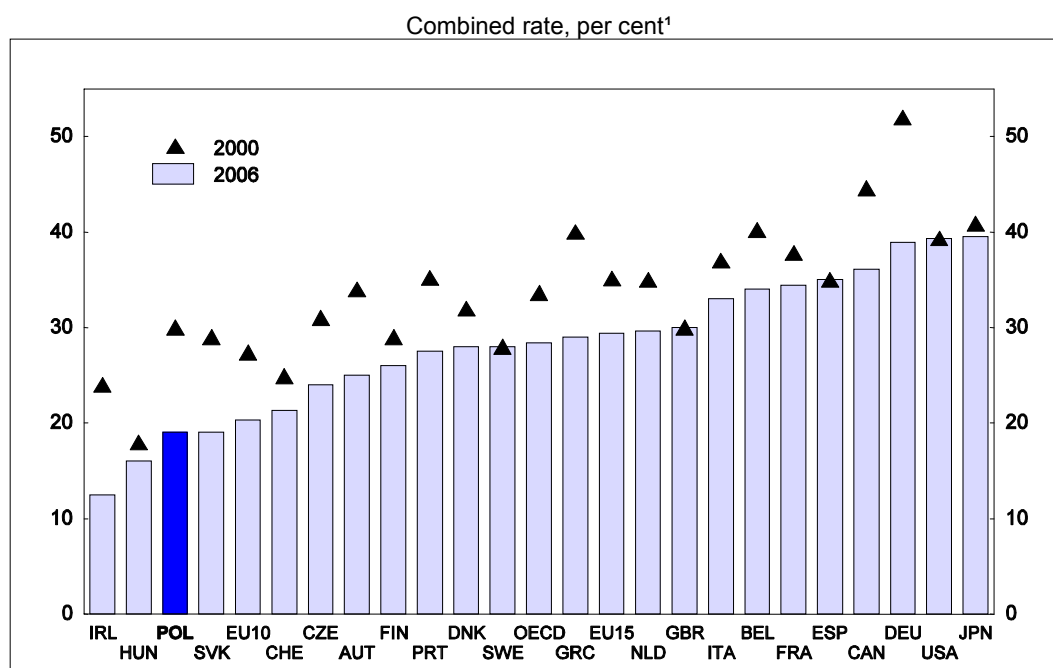
The tax base is fairly standard in that it covers any income, irrespective of the source of revenues (non-financial or non-equity financial) and where income is defined as the surplus of total revenues over the costs incurred in generating those revenues. The base thus includes the proceeds from sales of products and services, but as well the value of in-kind benefits or services received free of charge and various forms of capital gains upon realisation. Interests (upon receipt) on loans are included but not the proceeds from new share issuance. In return, expenses incurred to cover the cost of labour as well as for the purchase of materials and fixed assets, including interest payments on debt, are deductible from taxable income.²⁴ Losses can be carried forward and used as a deduction in the five subsequent years, although the deduction cannot exceed 50% of the loss in any year. Finally, spending on R&D can be fully expensed; but, in contrast with practice in many OECD countries, there is no significant additional tax relief provided for such expenditure.

As mentioned earlier, the interaction between the PIT and CIT systems combines the features of a *semi-dual income* tax with that of a *classical* corporate tax: profits are taxed at the corporate level and once again at the personal level when distributed in the form of dividends. To reduce the impact of double-taxation, dividends are subject to a final withholding tax at the personal level at a single rate of 19%. The same rate applies for interest income and capital gains.

Substantial cuts in statutory corporate income tax rates have left Poland with one of the lowest rate among OECD countries (Figure 10). In 2006 it was well below OECD average but comparable to those observed in the other EU member states that joined in 2004. However, statutory rates can mask differences across countries in tax bases and, given also that in parallel to cutting rates many countries (including Poland) have broadened the base, a more relevant comparison is provided by average effective tax rates (AETRs). In general, the Polish corporate tax code is more generous than that of most EU new member states but less so in comparison with the majority of older member states (Schratzstaller, 2005). AETRs have been calculated for most OECD countries on the basis of a common methodology.²⁵ Based on this measure, Poland is also one of the countries with the lowest rates of corporate taxation (Figure 11). The AETR has come down from 27 to 17% since 2000, a decline that is only slightly smaller than that found in statutory rates over the same period.

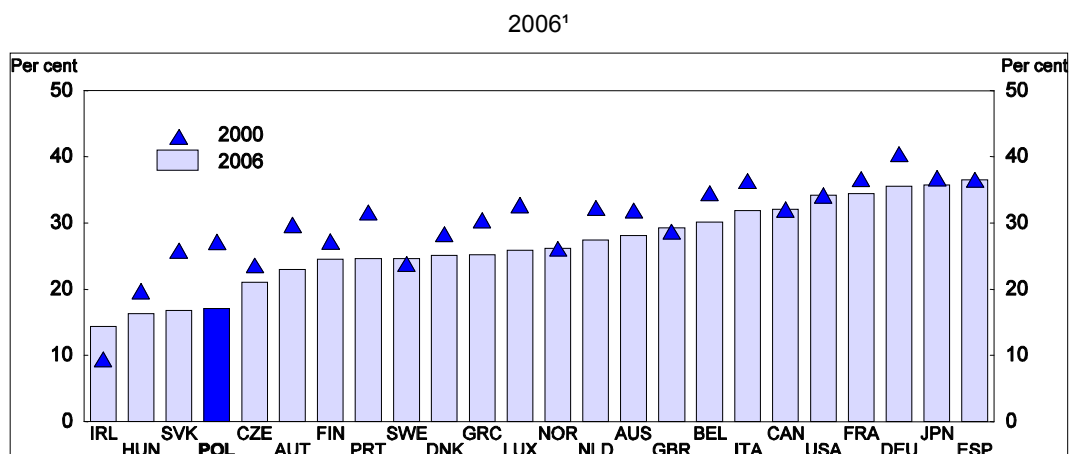
24. Capital depreciation is allowed under the straight-line methodology, and the rates of depreciation are 2.5% and 20% per year, respectively, for buildings and machinery.

25. The methodology, initially developed by Devereux and Griffith (1999 and 2003) has been extended to all EU countries (except Bulgaria and Romania) by the European Commission (CTPA/CFA/WP2(2007)14).

Figure 10. **Statutory corporate tax rates in international comparison**

1. Basic combined central and sub-central (statutory) corporate income tax rate. Aggregates are unweighted averages and EU10 covers the new EU member states.

Source: OECD (2007), *Tax Database*, www.oecd.org/ctp/taxdatabase and European Commission (2006), *Structures of the Taxation Systems in the European Union*.

Figure 11. **Average effective tax rates on corporations**

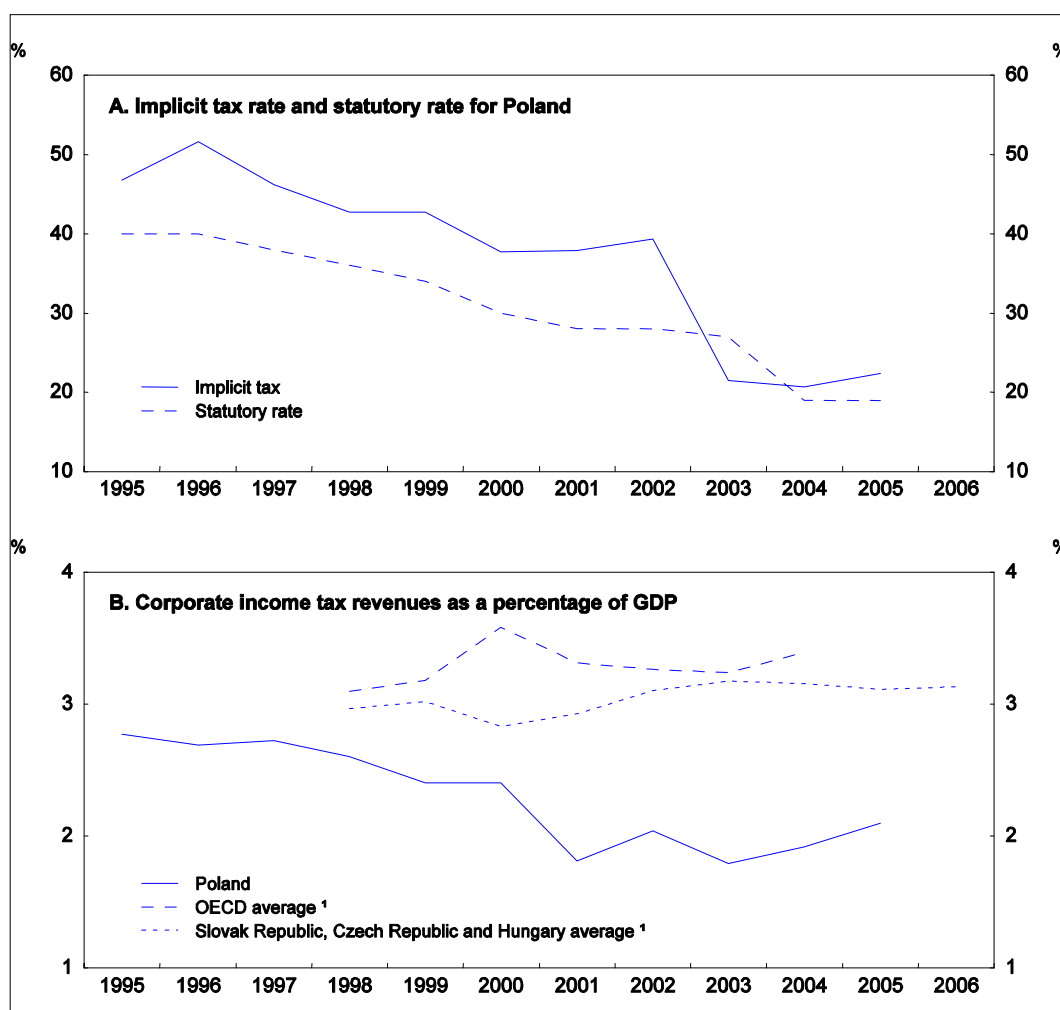
1. Data refer to 2005 for Australia, Canada, Japan, Norway and United States.

Source: CTPA/CFA/WP2(2007)14 and *International Financial Statistics*.

Taken at face value, this would indicate that the few measures taken to broaden the base have been too limited in scope to have a measureable impact on effective rates. Indeed, the small differential between the statutory and the effective tax rate suggests that allowances may not have been so generous in the first place. However, because they are based on a hypothetical investment situation involving a representative firm, theoretical constructs such as AETRs may not fully capture certain changes in the tax base, for

instance those that would lead a number of corporations previously exempted to be henceforth liable. An alternative consists of looking at broad tax ratios and implicit tax rates, which are based on the overall amount of corporate tax revenues collected in the economy as a whole. The two concepts are similar except that one normalises on GDP, whereas the other is based on a measure of taxable capital and business income from national accounts data on profits in the enterprise sector. One key difference is that the tax ratio will tend to increase automatically if the profit share of total income rises, whereas the implicit tax rate will not.²⁶ A look at implicit tax rates indicates a steep decline in corporate taxation since the mid-1990s. In fact, since 2000, the drop is largely in line with the decline in statutory rates, indicating again that, at least until 2005, there have been few significant measures to broaden the base (Figure 12, Panel A).

Figure 12. Implicit corporate tax rate and broad tax ratio



1. Unweighted averages. OECD average does not include Mexico.

Source: Taxation trends in the European Union and OECD (2007), *Tax database*.

26. For this reason, the implicit tax rate is considered a more appropriate way of measuring the effective tax rate, despite its own shortcomings.

In contrast, after falling steadily between 1995 and 2001, corporate tax revenues as a share of GDP picked up and by 2005 had moved closer to their 2000 level (Figure 12, Panel B). Not surprisingly, corporate tax revenues are particularly sensitive to cyclical developments, but in 2005 the economy was viewed as having returned to potential (according to OECD estimates of the output gap). This apparent paradox between falling tax rates (be they statutory or effective) and a steady share of corporate tax revenues in GDP has been noted before in a broader set of countries (Devereux and Sorensen, 2006) and is also consistent with the conclusion from a recent review of the impact of tax competition, suggesting that there is little evidence of a collapse in corporate tax revenues following the steep declines in rates (Nicodème, 2006). Furthermore, there are indications that reductions in corporate tax rates have been successful in attracting businesses to Poland and fostering investment. Inflows of foreign direct investment have risen sharply since the early 2000s. To some extent this is corroborated by the rise in the share of fixed capital formation in GDP.

Overall, while there is no consensus as to what the optimal corporate tax rate should be, there are reasons to believe that the current rate in Poland may be broadly appropriate. Put differently, it is difficult to make a strong case for significant changes in either direction. As shown above, corporate taxation has fallen substantially on most measures and is comparable to what is observed in many other transition economies from Central and Eastern Europe. Moreover, corporate taxation already accounts for a small share of overall tax revenues and, insofar as there are legitimate reasons for taxing business income, it is not clear that the benefits from further cuts might be worth the costs in foregone budgetary revenues. Hence, further reductions in the statutory corporate tax rate should be contemplated only as a compensation for broadening the base. At the same time, with capital being significantly more mobile than labour, taxation of capital income should probably not be considered as a potential source to finance the needed reduction in labour taxation. This is especially so since a rise in corporate taxation would send the wrong signal in the current international context of significant tax competition. For these reasons, future changes in corporate taxation should focus on addressing some of the distortions that characterise a classical system, not least the bias in favour of debt as a source of finance. Indeed, a number of options exist for removing this bias (OECD, 2007d). However, it could be risky for Poland to adopt a tax regime that deviates significantly from those in other countries given the potential implications for inward investment flows.

The tax treatment of small unincorporated businesses and the self-employed

Like many OECD countries, Poland offers a special tax regime for small unincorporated businesses and the self-employed, mainly in order to simplify their fiscal obligations.²⁷ Under the tax code, very small businesses earning income from non-agricultural activities are in principle liable to taxation on general terms, but they may choose (in agreement with the tax authorities) either to be taxed at the uniform 19% tax rate (general regime) or to pay a lump-sum tax under conditions laid down in the Lump-Sum Income Tax Act. The latter corresponds to the so-called presumptive tax regime that is common in developing countries but features of which are also applied in several OECD countries. The tax is based on turnover (registered revenues), which must be at least €150 000, but not exceed € 250 000, for a small business to qualify. The tax rate paid varies according to the nature of the business and in most cases, is below the CIT and PIT rates on capital income of 19%, but allowances are also much more limited. In comparison to the general regime, the main advantage for small businesses is the possibility to maintain a simplified register of revenues and expenditures.

27. The term self-employed generally refers to individuals owning and operating their own businesses and is commonly used to encompass both employers with employees (in small unincorporated businesses) and own-account workers. In Poland, self-employment accounts for around 20% of total employment, and nearly 80% of the persons considered to be self-employed consist of own-account workers.

The proportion of small firms adopting such regimes has fallen steadily to the point of becoming fairly marginal. In such a case, the authorities should perhaps reconsider the relevance of maintaining the lump-sum tax regime in place, or at least consider reducing the number of tax rates applied across types of activities in that regime so as to narrow the scope for tax avoidance or evasion. One advantage of the general regime is that, by allowing for the deductibility of wage costs, it raises incentives to declare employees, reducing thereby the incidence of informality. Insofar as the lump-sum regime is still viewed as needed, the possibility of allowing for deductibility of wages from turnover, while adjusting tax rates accordingly, should be explored.

As for self-employed individuals (also referred to as own-account workers or sole traders), they benefit from a favourable tax treatment relative to regular employees. Under the Personal Income Tax Act, their earnings are treated in the same way as capital income. Hence, they are entitled to a flat-rate tax of 19% on their declared income, as compared to the progressive rate structure applicable to labour income. More importantly, given the difficulties for the tax authorities in assessing their actual earnings, such entrepreneurs can basically choose to pay social security contributions on the minimum income level they are required to declare, which corresponds to 60% of the average wage. As a result, a majority of the self-employed in reality pay social security contributions effectively at a much reduced rate relative to regular employees. This favourable tax treatment may have contributed to the rise in self-employment since the early 2002 in many sectors such as manufacturing, construction, transport and trade.²⁸ This is also manifested in the ratio of tax revenues accounted for by the self-employed to GDP, which has risen steadily (from 3% in 2000 to 3½ per cent in 2005).

Strong growth in self-employment may be consistent with rapid changes in the industrial organisation of firms and the development of a business sector specialised in the provision of consultancy services to enterprises. Moreover, for many individuals self-employment may be the only real possibility to find work. A rising trend can therefore be generally regarded as a positive development, except when tax-induced distortions lead to an excessive use of the status. Anecdotal evidence suggests that this may have been the case in Poland (European Industrial Relations Observatory, 2006). For instance, reports indicate that firms have encouraged their employees to turn themselves into self-employed as there are also many advantages for employers. In addition to avoiding payment of social security contributions, firms also enjoy greater flexibility in the contracting relationship, in particular with respect to job-protection obligations in case of layoff. The benefit on the self-employed side in terms of higher net earnings is also substantial but comes at the expense of lower coverage of social benefits, in particular with respect to future pension rights. This could create problems further down the road if the trend were to persist.

In order to stem the development of fictitious self-employment, the government tightened the relevant eligibility criteria in 2007.²⁹ It is too early to tell how effective these changes will be. However, their impact may be magnified by the strong increases in nominal wages and the recent decline in the tax wedge. In this regard, further tax wedge reductions, even if concentrated on low-income individuals, would help to reduce the differential in the tax treatment of dependent employees and the self-employed, thereby reducing the incentive to choose the latter status solely for tax reasons. In the longer run, the government should nevertheless consider developing assessment tools that would allow the calculation of social security contributions to be based on a close estimate of actual earnings rather than on a notional income set at a low level.

28. Total self-employment has fallen somewhat since the early 2000s, but mainly due to the gradual shrinking of the over-sized agricultural sector.

29. The effectiveness is reinforced by the fact that reclassifications of self-employment contracts may now lead to heavy potential costs to the employer, since, in addition to liability to unpaid tax and social security contributions plus interest, a fine can also be imposed.

Indirect taxes

This section will treat three broad areas of indirect taxation: *i*) consumption taxes, which encompass both general taxes under VAT and taxes on specific goods *via* excise duties; *ii*) environmental tax; and *iii*) property tax.

Value-added and excise taxes

Compliance of the Polish VAT system with EU provisions, in particular those related to the Sixth Directive, was largely completed by the time of membership in 2004. Since then, several changes have been made to the relevant legislation, in part to further improve compliance with EU rules, but the rate structure and broad set of exemptions has remained largely intact. The main VAT rate is set at 22%, well above the minimum 15% required under EU rules, and there is one reduced rate of 7%, which applies to a broad range of products and services.³⁰ The main exemptions from VAT are for the most part fairly common and include financial, educational, health and other social or cultural services, the rental of apartments and the sale of a company (in whole or part).³¹ Also, small businesses whose turnover does not exceed PLN 50 000 are exempt from VAT registration, implying that they are not entitled to recover the VAT paid on their inputs. This threshold is relatively low by international standards.

The main VAT rate is among the highest in OECD, with only the Nordic countries applying equal or higher rates (Figure 13, Panel A).³² As a result, the amount of revenues collected through VAT as a percentage of GDP is also above the OECD average, albeit by a narrower margin. In fact, some countries such as Austria, the Netherlands and New Zealand manage to collect as much or even more VAT revenues as a percentage of GDP, despite having lower VAT rates, indicating that the base for the application of the standard rate is narrower in Poland (Figure 13, Panel B). The latter reflects the wider set of products exempted or subject to the reduced rate, but probably also a higher incidence of tax evasion. One summary indicator of the revenue performance of VAT can be obtained by taking the ratio of VAT revenues to national consumption, which is then divided by the standard VAT rate, and expressed as a percentage (OECD, 2006c). A high value indicates that the standard VAT rate is applied on a broad base, with few goods or services exempted, and that the incidence of tax avoidance is low. Calculations for OECD countries show that Poland has one of the lowest efficiency ratios, with a value well below 50% (Figure 14, Panel A). The cross-country comparison also points to a negative correlation between the standard VAT rate and the efficiency ratio, suggesting that countries with high VAT rates tend to narrow the base by moving many products to a reduced rate and/or are confronted with higher tax evasion (Figure 14, Panel B).³³

One aspect of the efficiency of the VAT revenue performance that is not captured by this type of indicator is the compliance cost that firms have to bear in order to fulfil all the procedures associated with their duty as tax remitters to the government. Polish firms have complained that the administrative burden

30. A 3% rate is also applied on most agricultural products. In December 2007, Poland was granted an extension of the possibility to maintain the 3% rate until end-2010, after which it should be abolished in compliance with EU rules stipulating that reduced rates (other than 0%) must be at least 5%.

31. Note that in conformity with EU rules a 0% rate is applicable to exports and intra-Community supply of goods as well as intangibles and international transport services. In contrast to the case of exemptions, the 0% rate allows for the VAT paid on inputs to be recovered.

32. Hungary has cut its VAT rate in 2007 and it is now lower than in Poland.

33. In the case of Poland, another factor possibly contributing to the low efficiency is the structure of household spending: Polish households spend a proportionally higher share of their income on food, which is taxed at a reduced rate.

associated with VAT procedures is not only generally higher than in other EU countries but that it is also unnecessarily cumbersome (see Box 3 below). Polish business representatives consider the simplification of VAT procedures as an even more pressing issue than a reduction in corporate taxation. To some extent, the claim is substantiated by data comparing the costs borne by businesses in various countries to comply with different types of taxes (Figure 15). The comparison shows Poland ranking particularly poorly in terms of the time required to comply with the VAT. The purpose of some of the criticised procedures is to prevent businesses from exploiting loopholes. However, with a VAT regime that is quite similar to those of other EU countries, it is not clear that concerns about potential tax evasion would justify the need for significantly more complex administrative procedures. A better approach in this regard, might be to simplify procedures and strengthen controls via random on-site inspection by the fiscal authorities. In this regard, the burden associated with controls would be greatly reduced if the fiscal control office were to be merged with the tax office. The duplication of such controls by two distinct authorities is not only raising administrative costs but also leaves businesses vulnerable to the possibility of facing different interpretations or judgments regarding specific tax compliance issues. One way to achieve simplification would be for the Polish government to exploit unused possibilities offered by EU legislation, which would allow domestic firms to adopt common EU practices (Box 3). Furthermore, it should be made much easier for firms to obtain legal certainty on specific provisions of the tax code whenever this is sought. Obviously, all this would be made easier with a simplification of the tax code, in particular with a view to reducing the need for seeking legal certainty.

Box 3. Simplification of VAT procedures

From the perspective of Polish business representatives, the cost of complying with tax regulation and collection procedures is currently a far bigger drag on business development and entrepreneurship than the overall amount of tax collected. Compliance costs are particularly burdensome in the case of VAT. Firms' complaints are centred on three aspects: administrative burden, tax non-neutrality and unexploited possibilities offered by EU legislation for simplified procedures.

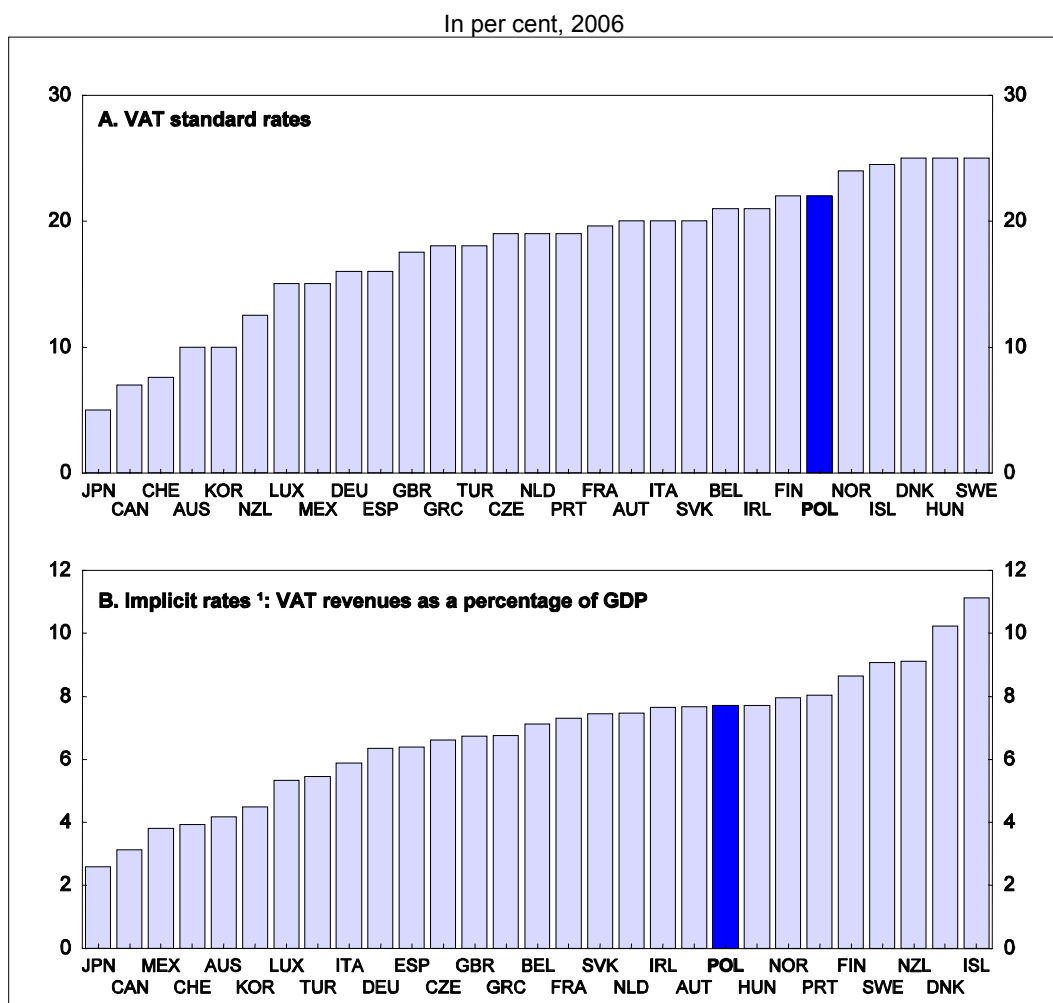
i) Transaction costs: Compliance with tax obligations necessarily involves administrative costs to businesses as a minimum of documentation and accounting requirements need to be fulfilled. However, in the case of Poland, the administrative burden is unduly increased by the complex application of specific provisions. For instance, in a given year, firms are allowed to claim VAT refunds only on the purchase of inputs on the basis of receipts produced (or received) during that same year. In the case of a delay in receiving receipts, firms can still claim the refund but must do so on the basis of a corrective form, which is burdensome. A simple adjustment would be to extend the period over which receipts are valid for refund claims.

ii) Tax neutrality: Even though in principle VAT payments should be proportional to the value-added at each level of production, significant lags between taxes paid and refunds lead to an additional "tax" being borne by businesses. A number of amendments would help to reduce this extra burden. For instance, firms should be allowed to apply the *postponed accounting* principle according to which the VAT payable in the case of imports from another EU country (intra-community acquisition) can be fully deducted in the same period thus cancelling the liability. In addition, efforts should be made to reduce the maximum delay for refunds, which currently can take up to 180 days.

iii) Scope for simplification under EU legislation: One way to simplify procedures would be for the Polish authorities to allow domestic firms to follow practices commonly used in other member states (and therefore that conform to EU legislation). For instance, the principle of *postponed accounting* has been adopted by several EU member states.

More generally, firms have also complained about the difficulty of obtaining legal certainty with respect to unclear provisions of the tax code. This concerns not only VAT legislation but corporate income tax as well. The government has taken action in this area in 2007 by centralising the issuing of tax rulings (four Bureaus of National Tax Information were established for that purpose in different parts of the country) so as to avoid the occurrence of conflicting rulings issued by different tax authorities, and they have also made rulings binding. Nevertheless, the quest for legal certainty imposes an extra burden, which could be diminished with a simplification of tax code.

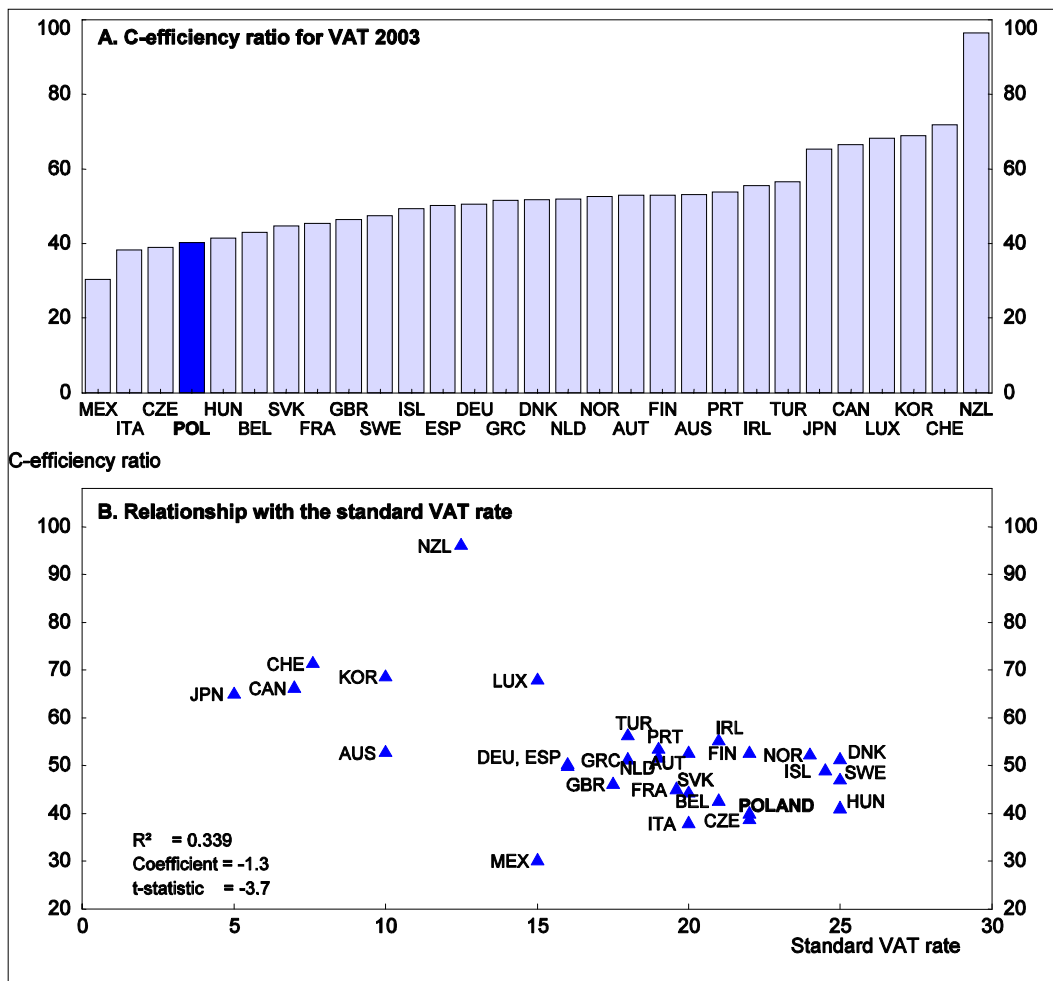
Figure 13. VAT rates in OECD countries: Statutory and implicit



1. 2005 for Australia, Belgium, Greece, Iceland, Ireland, Mexico and Poland. 2004 for Portugal and Italy.

Source: OECD (2008), Revenue Statistics database, March 2008, and OECD Consumption Tax Trends.

Figure 14. Revenue performance of VAT in OECD countries

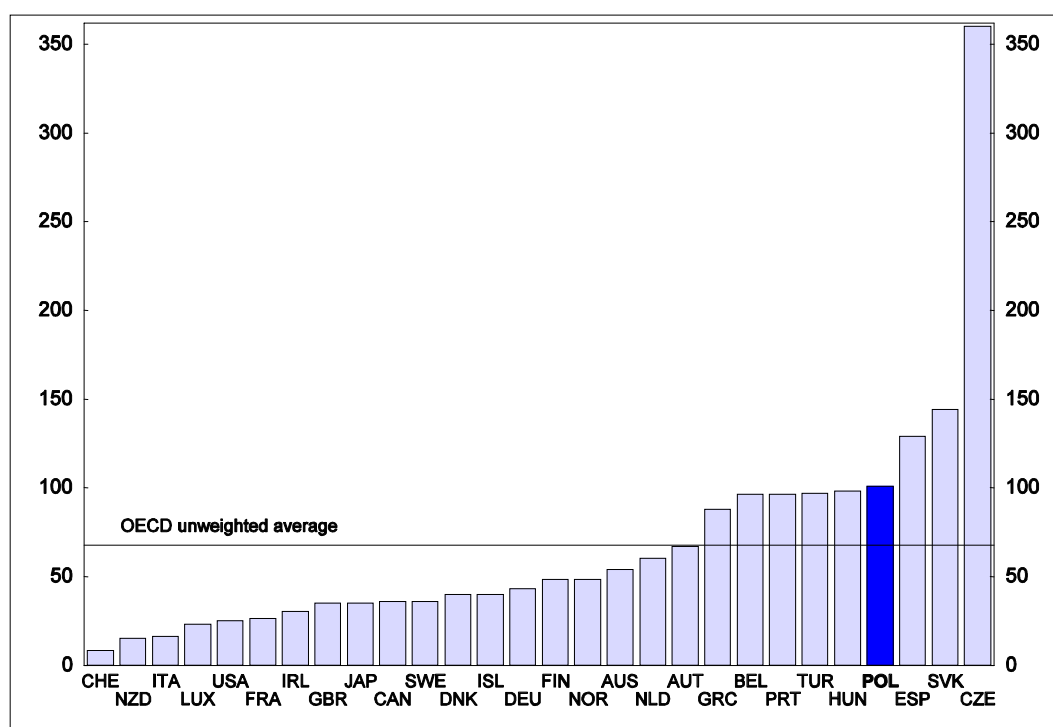


1. Measured as the ratio of VAT revenues to national consumption, which is then divided by the standard rate and multiplied by 100.

Source: OECD (2006), *Consumption Tax Trends*.

Figure 15. Time required to comply with VAT obligations

Hours per year, 2006



Source: World Bank (2008), *Paying Taxes: The Global Picture*.

In addition to a general VAT, Poland levies excise duties on the consumption of specific goods, including tobacco products, alcoholic beverages (including wine and beer), liquid gas and mineral oil products (liquid gas and oil used as motor fuel as well as heating oil), electricity and passenger cars. Most OECD countries impose excise duties on many of these goods, which are already subject to VAT, for Pigouvian reasons ranging from prevention of health hazards to encouraging energy conservation and preserving the environment. The fact that excise duties are typically charged on the basis of a volume, weight or even density in a particular component, makes cross-country comparisons somewhat delicate, especially as they can be influenced by market exchange-rate variations. These caveats notwithstanding, existing comparisons show that excise duties in Poland expressed in US dollars are generally below OECD average (OECD, 2006c). Furthermore, differentials in excise rates *vis-à-vis* neighbouring countries are generally not large enough to generate important cross-border trade flows (legitimate or illicit), except perhaps in the case of beer where the Polish duty is relatively high. Nevertheless, the amount of revenues from excise duties as a share of GDP is the same in Poland as in the OECD and EU15 average (around 5%, see Table 1). With the exception of tobacco, it is therefore not clear that higher revenues can be tapped from these sources. Policy should focus on simplifying procedures and eliminating the tax discrepancy between diesel used in vehicle engines and that used as heating oil.

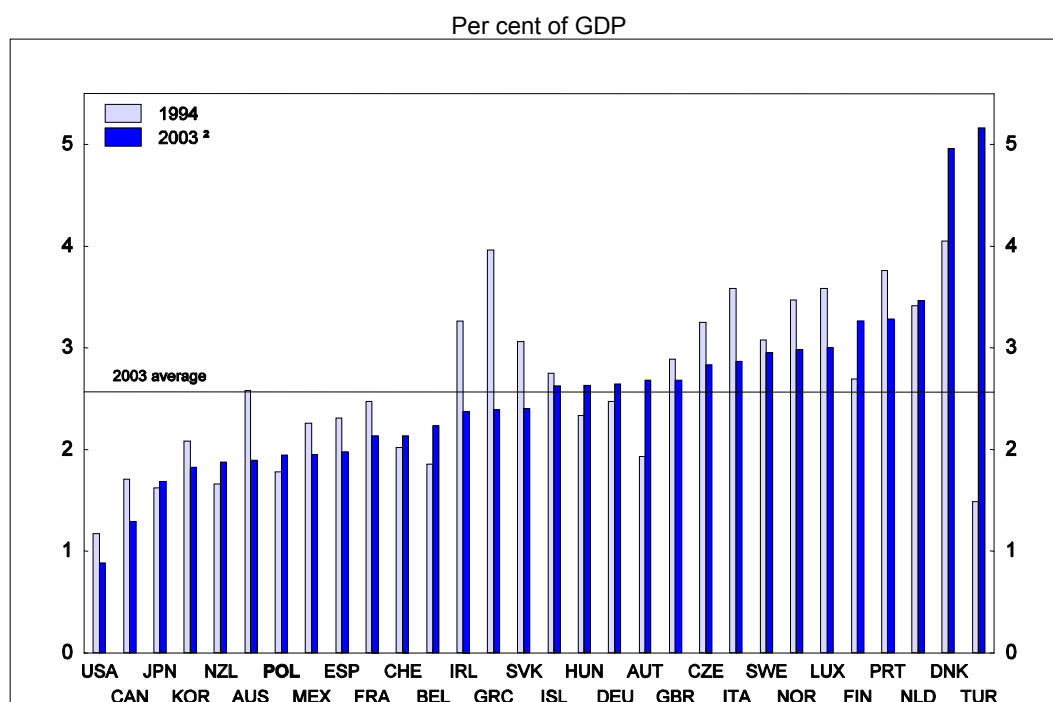
From an economic efficiency point of view, consumption taxes are considered as being preferable to the taxation of production factors. This is mainly because relative to the taxation of capital and labour income, they are more favourable to saving and labour supply, and hence on investment, work effort and

growth.³⁴ And this view has received some empirical support.³⁵ Based on these arguments, a number of countries are considering raising VAT rates to finance cuts in social security contributions, following the recent German example. In Poland, however, revenues from VAT and excise duties already account for a relatively high share of overall tax revenues. In addition, with the VAT rate being one of the highest, the pros and cons of a new hike would have to be weighed very carefully, especially considering the inconvenience of consumption taxes from a re-distribution or equity perspective. It could be argued that considering the relatively low efficiency of the standard VAT rate as shown above, more revenues could be collected *via* a broadening of the base or a strengthening of tax collection efforts. Indeed, the case for applying a reduced VAT rate is not entirely persuasive for all the products or services concerned; indeed, in some cases severe distortions result.³⁶ However, a move towards a more uniform VAT rate might be feasible only in the context of a reduction in the standard rate so that the change would be largely revenue-neutral. Likewise, insofar as tax evasion is significant – precise estimates are difficult to obtain – a strengthening of tax collection might be facilitated if the VAT rate were lowered somewhat. All in all, the scope for using consumption taxes to fund reductions in labour taxation appears limited. Better candidates in this regard would be environmental and property taxes, which are reviewed next.

Environmental taxation

In Poland, as in the majority of OECD countries, the bulk of revenues collected from what is considered as environmental tax comes from excises on the purchase or use of motor vehicles, fuels and electricity. Together, these amount to nearly 2% of GDP, somewhat below the OECD average of 2.5%. An alternative measure, calculated as the ratio of energy tax revenues on final energy consumption also shows Poland lagging most other European countries with respect to the burden of environmental taxation (Figure 16). Furthermore, while it has risen in the majority of EU countries since the mid-1990s, it has remained constant in Poland. These comparisons suggest that there is some scope in Poland for making greater use of taxation as a mean to reduce greenhouse gas emissions and air pollution, where little progress has been achieved in recent years. It should be said that, thanks to the re-structuring of the economy away from heavy industries, Poland is easily on track to meet its EU Kyoto burden-sharing commitments. However, it is still one of the OECD countries that release most greenhouse gases per unit of output, due largely to the prevalence of carbon-rich coal in power generation, and therefore it has more difficulties in meeting EU emissions criteria. Indeed, coal combustion represents by far the largest source of CO₂ and SO₂ emissions (Kiuila and Sleszynski, 2003).

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34. In the case of labour supply, the adverse effect from taxation comes primarily from the high marginal tax rates associated with progressivity, which discourages work intensity, investment in human capital and entrepreneurship.
35. In an international context, these effects are potentially reinforced by the fact that consumption taxes are levied on imports, but not exports (whereas the reverse is true for social security contributions), implying a favourable effect on competitiveness. However, in the longer run, this advantage will be offset by real exchange-rate adjustments. Nevertheless, real incomes would be higher.
36. A case in point is the dual-rate structure applied to the sale of new housing, with a reduced rate being applied to flats or houses no bigger than a certain floor area. Aside from technical complexities as to what the measured area is supposed to cover exactly, the dual rate is shrinking the market for larger premises. Fortunately, the measure will be abandoned in 2009 in accordance with EU rules, and all new houses will be taxed at the standard rate.

Figure 16. Revenues from environmentally-related taxes¹

1. Data refer to revenues from environmentally related taxes for pollution control.
2. 2002 for Australia and the Slovak Republic.

Source: OECD (2006), *Consumption Tax Trends*, 2006 Edition, OECD, Paris.

In this context, the authorities should consider introducing elements of a carbon tax, whereby the combustion of fossil fuels would be taxed according to their carbon content. A number of OECD countries have introduced some instrument that comes close to a carbon tax, including Denmark, the Netherlands, Norway, Sweden and the United Kingdom.³⁷ In all cases, the carbon tax was introduced as part of a revenue-neutral reform that included offsetting cuts in social security contributions or personal income tax. The shift in taxation was particularly large in Sweden and Denmark (well over 2% of GDP).³⁸ In the case of Poland, the main impact would be on the cost of coal combustion, implying a rise in electricity prices, which would then feed into the production cost of a whole range of (energy-intensive) industries, as well as into households' real disposable incomes. The negative impact on the latter and aggregate employment could be mitigated (or even more than offset) by simultaneous cuts in social security contributions. Obviously, insofar as the primary objective of a carbon tax would be environmental, the authorities need to examine the opportunity to use such an instrument against the main alternative based on an emission-trading system in the context of broader discussions on climate change at the EU level. In any case, the two instruments need not necessarily be mutually exclusive and in the case of Poland, an advantage of the tax would be to provide revenues that could be used to fund further reductions in the tax wedge, even though auctioning permits can also yield revenues.

37. Strictly speaking, no OECD country has a pure carbon tax in that they all have exemptions and non-uniformities.

38. However, no *ex post* evaluation of the impact of the reform in these two countries is available.

Taxes on immovable property

There are essentially three property taxes in Poland, which are all levied at the local level: on agriculture, forestry and real estate. Although the first two may represent an important source of revenues for some small rural municipalities, only real estate generates a significant amount of revenues at the aggregate level.³⁹ In the latter case, the tax applies to land (except those classified as forest or for agricultural use), buildings and building structures (related to an economic activity). The rates are set by local authorities, though with ceilings imposed by the central government. The ceilings as well as the actual rates are differentiated by categories and are several orders of magnitude higher on commercial buildings than on residential properties.⁴⁰ The system thus discriminates in favour of residential over business and industrial use. The amount of tax paid is based on the area of land and useable space. Hence, there is no value-based or cadastral tax.

As mentioned above, revenues collected from property taxes account for a relatively small share of total tax revenues in Poland. It is somewhat higher than in the majority of OECD countries (though below the average), but the fact is that in most countries property taxes represent an under-exploited source of revenues, except in Canada, the United Kingdom and the United States (Figure 17). Indeed, taxes on immovable property are largely considered as having the least distortive effect on the allocation of resources and therefore on economic efficiency. This is mainly due to the fixed nature of the base, which limits the scope for tax avoidance and evasion. In addition, because in the case of land it represents a tax on an economic rent, the impact on efficiency is much more limited than in the case of a tax on the normal return to labour or capital. In the case of Poland, as in many other OECD countries, another motivation for reviewing property taxation is the widespread bias in favour of owner-occupied housing.

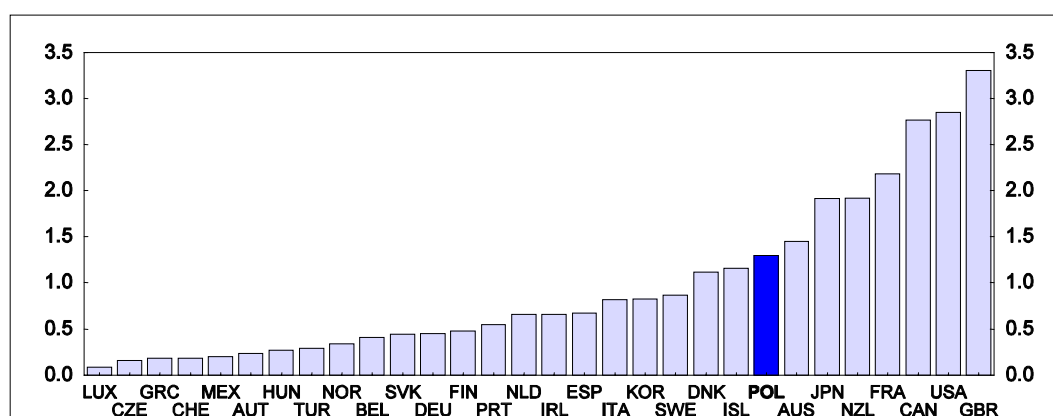
There are generally two main sources of this non-neutrality: *i*) there is no tax on the overall return to owner-occupied housing, *i.e.* neither imputed rent nor capital gains on principal residences are usually taxed; and *ii*) in many countries, interest payments on mortgage loans and, in some cases, renovation costs are deductible from income tax. The favourable tax treatment is often defended as a mean to facilitate home ownership, which in many countries is perceived by governments as a desirable objective. However, a strong bias in favour of home ownership may limit the development of a rental market and reduce labour mobility.⁴¹ Hence, moving towards neutrality *vis-à-vis* rental housing would involve either the introduction of a tax on imputed rent for owner-occupied housing along with taxation of capital gains, or the elimination of all related allowances from PIT. Given that rent imputation is difficult to implement in practice, the second option might be best, at least as a way to ensure some consistency. Poland has already made an important step in that direction with the phasing-out of the deductibility of mortgage-interest payments. As mentioned above the measure applies to new loans contracted since early 2007 and will thus be gradually phased-out until 2027.

39. Revenues from the agricultural and forest taxes represent only 0.3% and 0.04% of total tax revenues, respectively, as compared with 3.45% for real estate. However, 3.2 million taxpayers are subject to agricultural or forest tax, while 5.5 million pay the real estate tax.

40. For example, the ceiling rates were PLN 18.43 and PLN 0.56 per square meter in 2006 for commercial and residential buildings in comparable land areas.

41. The adverse effect of a high incidence of homeownership on labour mobility can be partly mitigated if transactions costs on buying and selling houses are kept very low. In this regard, the stamp duty on property transactions has been reduced from 5% to 2.5% in recent years.

Figure 17. Immovable property taxes

Per cent of GDP, 2006¹

1. 2005 for Australia, Belgium, Greece, Iceland, Mexico and Poland. 2004 for Portugal.

Source: OECD (2008), *Revenue Statistics database*, January 2008.

As regards rental housing ownership, the deductibility of mortgage-interest payments and renovation costs can be justified insofar as the return on the housing investment is in this case fully taxable. However, the return is only partly taxed, given that rents are subject to PIT but capital gains are currently exempted, provided the property is held for at least 12 months.⁴² The result is a fiscal bias in favour of investment in real estate as opposed to financial assets. In order to remove the bias, realised capital gains on rented properties should be made taxable under PIT similarly to capital gains realised on the holding of financial assets. More generally, the adjustments to the structure of property tax should be made in the context of a broader reform centred on the introduction of a land-value or cadastral tax. Aside from the advantages in terms of economic efficiency arising from taxing rents trapped in land value, a cadastral tax would be beneficial from an equity point of view in widening the tax differential between low-value and high-value properties. Likewise, basing taxation on property values would make explicit the huge differentials in effective real estate tax rates between business and residential uses, which would then facilitate a move to a more balanced structure.⁴³

The introduction of a cadastral tax has been on the agenda for many years. Most of the technical barriers related to such a tax – in particular the establishment of a cadastre – have been lifted, although putting in place a system for valuation of immovable property can be a challenging task. The main barrier is political. In order to ease its introduction, the tax should be initially set at a sufficiently low rate so as to be revenue-neutral. It could then be gradually raised so as to provide more revenues for municipalities, thereby allowing the central government to reduce transfers to local authorities. Furthermore, in order to avoid penalising house-rich/income-poor individuals or households, it should be accompanied by a mechanism that would allow people confronted with high tax payments relative to their income to be able to honour those payments without having to leave their property.⁴⁴

42. Until 2007, the property had to be held for at least five years for the capital gains tax exemption to apply.

43. For instance, stated in *ad valorem* equivalent, the effective real estate tax rates for business properties are 7.8% and 1.4% on buildings and land, respectively. For residential properties, the corresponding figures are 0.062% and 0.046%.

44. One possibility in this regard would be a reverse-mortgage system, but a simpler mechanism such as deferring the payment of tax liabilities until the sale of the property could also be envisaged.

Conclusion

The tax system in Poland has undergone several changes in the past few years. Many of these changes were driven by the need to comply with EU rules, in particular in the area of indirect taxation. In the case of direct taxation, efforts have focused on lowering the tax wedge, both via general cuts in social security contributions and, more recently, via reductions in PIT rates (to be mainly brought in 2009) and the introduction of a new tax credit. These efforts notwithstanding, the tax wedge remains well above the OECD average – especially at low-income levels – and, combined with a relatively high minimum wage, contributes to low employment rates in the official sector. Against this background, a longer-term strategy for tax reform should be developed with a view to shifting the overall mix away from labour taxation and on to less distorting bases such as property and environmental externalities.

In order to maximise the cost-effectiveness of further reductions in the tax wedge, cuts should be substantial, targeted at the bottom end of the wage distribution and focused on social security contributions. More specifically, their size should be highest at the minimum wage level and gradually withdrawn so as to be zero at around 70% of average earnings (which corresponds to 1.75 times the minimum wage). All components of social security contributions could be considered for a reduction, except old-age pensions in order to preserve the actuarial neutrality of that system. The currently very low degree of progressivity of the tax system leaves room for cuts to be targeted. Another pro-work measure that the government could consider is to introduce an earned-income tax credit. This would encourage labour market participation of marginal groups. However, to be most effective such a measure should take place in the context of a broader welfare-to-work strategy, with stronger emphasis on effective public employment services.

Further reform of the PIT should instead focus on broadening the tax base by eliminating a number of tax allowances. In this regard, the deduction for internet subscriptions has little justification and therefore appears as a prime candidate. Also, the recently introduced child tax relief should be at least turned into a non-wastable credit and its value significantly appropriately reduced to as to benefit low-wage earners while lowering its budgetary cost. Another sensible measure to broaden the base would be to eliminate the PIT exemption granted to farming revenues and port activities.

Even if the reform of the social security system were to create some room for the recommended narrowing of the tax wedge, it may not be sufficient to cover its cost, and therefore alternative sources of revenues may have to be sought. Even though statutory and effective corporate income tax (CIT) rates are among the lowest in OECD countries, they are comparable to rates observed in other central and eastern European countries, including those that have recently joined the European Union. Considering the high mobility of capital, raising CIT would be inappropriate to finance the reduction in labour taxation. On the other hand, further CIT rate reductions could be contemplated in the context of a base broadening that would leave the average rate largely unchanged *ex ante*.

Another potential source is consumption tax, but both the main value-added tax (VAT) rate and excise duties are fairly high, thus limiting the scope for raising more revenues from these tax bases. VAT reform should focus on the simplification of procedures to reduce compliance costs for businesses. More generally, the tax code should be written more clearly so as to obviate the need for local legal interpretation of specific provisions and to reduce the vulnerability of businesses to arbitrary (and often conflicting) decisions by the two main tax-inspection bodies. In this regard, the merging of these two agencies will help to eliminate the duplication of controls and generate useful savings.

One prime candidate for raising revenues is taxation on immovable property, which is low by OECD standards. This is one of the tax bases with the least adverse effect on economic efficiency. Poland is one of the few OECD countries without a full *ad valorem* (or cadastral) tax on property, even though the

technical obstacles to such tax being implemented have basically been lifted. A move to such a tax would raise revenues for municipalities, allowing the central government to reduce its subsidies to sub-national administrations. Alternatively, local authorities could use the higher property tax revenues to eliminate stamp duties on housing transactions, thereby improving labour mobility. In order to facilitate the introduction of an *ad valorem* property tax, the rate should be set initially at a low level and be accompanied by measures to ensure that house-rich/income poor households can afford the tax without having to liquidate their property.

Box 4. Main recommendations on tax policies

General

- Do not consider a further reduction in the overall tax burden until public finances have been put on a clearly sustainable path.
- Shift the overall tax mix away from labour taxation and rely more heavily on less distorting tax bases, in particular immovable property tax, but also environmental tax.

Labour taxation

- Further reduce the tax wedge on labour income by lowering social security contributions. The reductions should be both significant and targeted at the low end of the distribution.
- Consider introducing an earned-income tax credit to encourage labour market participation of marginal groups.
- Take the opportunity provided by the planned reductions in PIT rates to eliminate a number of tax allowances and to broaden the tax base. For instance, eliminate the deductions for Internet subscriptions and turn the recently introduced child relief into a non-wastable tax credit while lowering its value.
- Eliminate the special tax treatment of agriculture. Income from farming should be treated in the same way as that from other types of activities.

Capital taxation

- Consider further reductions in the corporate tax rate only in the context of a broadening of the base to make the change revenue-neutral *ex ante*.
- Reduce the tax bias in favour of the self-employed by basing their social security contributions on actual earnings rather than on a notional income set at a low level, while developing assessment tools that allow for such earnings to be better estimated.

VAT, excise and environmental taxes

- Simplify VAT procedures for businesses by letting domestic firms adopt practices commonly used in other EU countries. Concerns about potential VAT evasion can be better addressed through stronger controls, including random on-site inspections by fiscal authorities.
- Eliminate the tax discrepancy between diesel used as motor vehicle fuel and that used as heating oil.
- Consider introducing a carbon tax to achieve climate-change objectives at a minimum cost.

Property tax

- Replace the current residential property tax with an *ad valorem* system, and gradually raise rates so as to increase revenues collected and reduce central-government transfers to municipalities.
- Remove the personal income tax bias in favour of investment in real estate (as opposed to financial assets), by taxing realised capital gains on rented properties.

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