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Grzegorz W. Kolodko

STRATEGY FOR POLAND

PACKAGE 2000

Growth • Stabilization • Competitiveness

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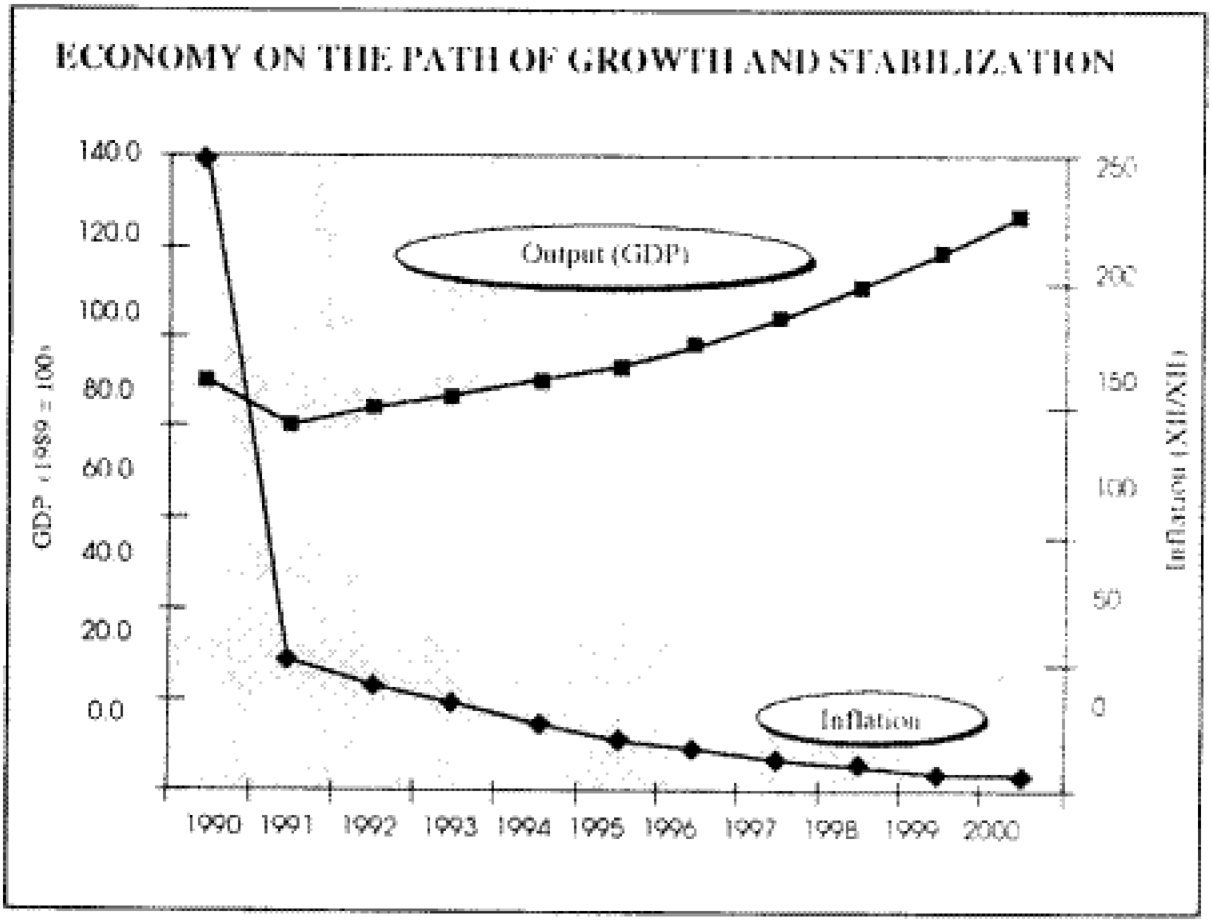


Warsaw 1997

Contents

In order to preserve the character of the present publication originally given to it by its Author, the "Package 2000" is presented here in its initial version, as was submitted to the Council's of Ministers approval in March 1996. In April 1996, the Council of Ministers approved the program in slightly modified form. The finally accepted version changed the presentation mode of data underlying the macroeconomic prognoses for the period till 2000. Further, in the chapter on fiscal policy, the Council of Ministers, following the debate, adopted a compromise solution on the pace and scope of transformations to be implemented. This regarded, in particular, the personal income tax. Transitions to 20, 30 and 40 per cent rates was to be divided into two steps (1997 and 1998). Corporate income tax allowances for investment were limited to a smaller degree than originally proposed. A number of personal tax allowances, originally suggested for elimination, were maintained.

Furthermore, with respect to the value–added tax, the mildest option of passage from zero rate to preferential rate (7%) was adopted. These amendments and modifications, however, did not infringe on general principles and rules of the "Package 2000". (Editor's note).

INTRODUCTION

"Strategy for Poland" – the economic programme of the SLD–PSL (Democratic Left Alliance and Polish Peasants Party) coalition government brings the expected results. **In 1994–1995, the Polish economy proved to be one of the world's most dynamic economies.** A record rate of economic growth and increase in exports were achieved. Inflation and unemployment fell considerably There was a real growth in the population's incomes and consumption Those favourable trends have been noticed by Poland's international partners, this resulting in a rise in our ratings and in an increase in foreign capital inflow.

But economic growth has not been given to us forever. A lot of conscious endeavour and effort is necessary to advantageously consolidate those trends. Especially much, though not everything, will depend on the quality of the Government's economic policy. This policy must avail itself of new circumstances in an active and creative way and should efficiently eliminate, or at least minimize, the emerging threats.

The debate on PACKAGE 2000 has proved that, in the presence of new challenges, a more detailed specification of the "Strategy for Poland" is needed and expected, especially by the economic circles. Despite a great number and variety of detailed remarks, **premises which constitute the Package have gained support.** Due to amendments and supplements suggested by various organizations and institutions the programme has gained clarity and become more specific.

The PACKAGE 2000 is not a replacement for the "Strategy for Poland" but develops it in new conditions brought about, on the one hand, by our economic success and, on the other hand, by the already near perspective of Poland's accession to the European Union. The PACKAGE recommends measures related to only two streams of economic policy, i.e. macroeconomic and fiscal policies. So it vitally concerns both employers and employees, producers and consumers. Its implementation will defuse political tensions and conflicts about the present economic policy, thus reducing the risk of economic destabilization.

The aim of the PACKAGE is not to set detailed economic tasks but to **set up fundamental objectives.** Objectives which are difficult, ambitious and mobilizing, but at the same time feasible and indispensable. That is the PACKAGE should not be perceived as a different form of a five-year plan. **The PACKAGE is a projection of problems which are feasible and must be achieved and consolidated.** Its success, will, in general, permit Poland's joining the EU, the latter being the key element of the Polish reason of State at the turn of the century.

The PACKAGE 2000 is a proposal for response to three basic problems of the Polish economy, illustrated by the following questions:

- how to cope with the challenge of the integration with the EU in about 2000?
- how to consolidate the strong upward trend of 1993–1995?
- how to combat the economy destabilization threat resulting from the now growing group claims pressure?

Thus, the PACKAGE defines the way in which to cope with challenges, take advantage of opportunities and combat threats facing Polish economy.

As far as challenges are concerned, the PACKAGE is a set of objectives conducive to macroeconomic consolidation of the Polish economy in a perspective of Poland's joining the European Union. It means that Poland not only has to meet criteria laid down for the Union's members. Our condition at the moment of our accession to the Union and our position within it, will depend on the extent to which we meet these criteria.

As far as opportunities are concerned, the PACKAGE should be perceived as a set of means aimed at consolidation of the hitherto achieved high rate of growth. This is a prerequisite of our achievement of all our plans and intentions – social, economic and political. Without a high and sustainable rate of growth over a long period, Poland will not be able to effectively solve the problems facing it or will do it only partially, irrespective of which kind of political force will be in power.

Finally, **as far as threats are concerned, the PACKAGE is a set of rules** expected to protect the economy from destabilization. The fact that the economy has unexpectedly well survived the recent several month's period of political upheaval witnesses to durability and depth of structural and systemic changes going on in the economy and confirms the rightness of the adopted policy of sustained, systemic reforms which are gradual, acceptable to people, instead of reforms forced against their will.

However, the threat of destabilization is a result not only of very acute political tensions but first of all of a growing pressure to consume the achieved fruits of the economic growth as well as of the fight over their distribution. We can avoid destructive developments of this fight only by protecting the economy with adequately stable and tough rules of macroeconomic and fiscal policy. Those rules, while protecting the economy against populist threat, will make it predictable for all participants of the economic game by creating natural encouragement to innovation and initiative as well as to inflow of foreign capital.

The above–mentioned set of objectives, means and rules proposed for the macroeconomic and fiscal spheres does not mean pushing aside the structural reforms which make the core of the "Strategy for Poland". Just the opposite,

- **without** reform of the economic Centre,
- **without** reform of the social security system,
- **without** further, well–considered but insistent privatization of the public sector,
- **without** measures aimed at economic stimulation of underdeveloped regions and restructuring of strategic sectors of industry,
- **without** persistent investing in human capital,
- **without** legal protection of the sphere of economic avtivity and without obstinate effort to „civilize" it,

consolidation of the premises of Poland's long–term development will not be possible. All efforts already started in these fields will be continued and accomplished by the third government of the SLD—PSL coalition.

1. MACROECONOMIC POLICY. OBJECTIVES • MEANS • RULES

Macroeconomic part of the PACKAGE 2000 defines **the most important social objectives, basic means and tough rules** of economic policy.

1

The point of reference, and axis which orients the economic policy for the next few years prior to Poland's joining the Union **are two primary social objectives**:

- to reduce the level of unemployment, and
- to maintain a socially perceptible real consumption growth rate.

2

In order to reduce the level of unemployment to the target level of about 10% by 2000 (Figure A), it will be necessary to create about 800 thousand new working places for those now unemployed, plus about one million places for the new age groups that will enter the labour market. It is a very difficult objective requiring a consistent and sustainable economic policy in the following four fields:

- stimulation of economic growth,

regional development policy aimed at gradual removal of existing disproportions,

- multifunctional development of rural areas aimed at gradual restructuring and consolidation of agriculture without adverse impact on the level of unemployment,
- big infrastructural projects, especially construction of new motorway networks without which Poland will be doomed to stay on the periphery of Europe.

3

The main instrument of economic policy in the above-mentioned fields will be maintenance of high rate of capital investment which will bring about increment in new working places, thus neutralizing the effects of the processes which tend to increase the number of unemployed, namely:

- restructuring and modernization of industry which must lead to eliminationn of excess employment,
- expiry of negotiated periods of guaranteed level of employment in privatized enterprises.

4

An additional but very important factor in reducing the level of unemployment (as well as in reducing this statistically high, but often fictitious, level to its real dimensions) will be absorption of the underground economy sector. According to estimations of GUS (Central Statistical Office) and PAN (Polish Academy of Sciences) employment in the underground economy is a permanent source of income for about 800 thousand persons. A considerable part of them are registered as unemployed and draw unemployment benefit. The Government will aim at legalizing this employment through:

- appropriate fiscal policy (inter alia, reduction in indirect tax rates, improvement in tax collection efficiency),
- making the total duration of employment a more important factor in assessment of the old-age pension,
- broadly understood reform of the social security system aimed at the reduction in indirect labour costs.

5

In order to increase the number of permanent work places, a systemic reduction in unit labour costs must be made. This means that in 1996–2000, the rise in real wages, together with other costs indexed upon wages, will have to be kept below the productivity growth. Meeting this requirement will permit to maintain the international competitiveness of the domestic production.

6

Apart from efforts in the real sphere, measures will be taken to clear the unemployment statistics of fiction, thus bringing the statistical dimension of the problem closer to its real dimension.

7

Increase in consumption (Figure B) will be achieved **mainly** as a result of an increase in the population's real incomes, especially incomes from employment. Also, an important factor of income growth and improvement in the households' financial situation will be the policy of unemployment reduction.

8

Efficient implementation of social objectives will be conditioned by a successful progress in economic processes. To reach these objectives, the Government attributes a fundamental role to **three lines action:**

- maintenance of a high rate of economic growth,
- maintenance of a high rate of growth in exports, fast growth in investments.

9

In order to achieve the most important social objectives, a steady and fast economic growth is necessary, leading to cumulative increase in gross domestic product by about 1/3 by 2000. This means that over that period average annual rate of GDP growth should not be less than 5.4 per cent (Figure C).

10

It is also important to keep the growth rate rather constant over successive years. It will permit to plan reformatory moves in a rational and long–term way and to augment the resulting social advantages.

11

Exports will remain the principal factor of the GDP growth. Its forecasted average annual 10% growth is high but possible. Factors which will enable high dynamics of exports include:

- improvement in competitiveness of Polish products, being i.a. a result of implementation of technological innovations,
- changes in the structure of Polish exports in favor of processed goods,
- reduction of protectionist barriers within the World Trade Organization,
- normalization of trade with countries of the Commonwealth of Independent States and with the Baltic Republics,
- development of export credit insurance, in particular with respect to Treasury–guaranted insurance of medium and long–term export credits,
- active exchange rate policy having a long–term anti––inflationary and effectiveness–promoting effect,
- subsidies to investment export credits,
- corporate income tax allowances for exporters,
- refund of value–added tax and custom duties levied on imported manufacturer's goods intended for the purposes of export production,
- right of domestic economic bodies to hold foreign currency account with a bank.

12

At the same time, in 1996–2000, factors of strong pressure towards growth in imports will be present. The most important of them will be:

- unilateral reduction of tariff rates by Poland (the EU countries have done it already before),
- reduction in import tax rate in 1996 and its total abolition beginning with 1997,
- strong economic growth and the resulting increased investment suction,
- growth in foreign direct investments which, however, will, at the same time, be a factor of balancing the current account, and in a longer perspective – of stimulation of exports and reduction in import of producer goods.

13

In 1996–2000, the Government's policy in the sphere of economic relations with abroad will be aimed at atopping the deterioration in the trade balance; this means that the **rate of the import growth should be approximate to the high rate of export growth.** One of the instruments of protection against a substantial fall in foreign exchange reserves will continue to be the exchange rate policy allowing changes in the exchange rate within a determined band of fluctuations in accordance with current situation in the foreign exchange market.

14

Proper relation between exports and imports (Figure D) will make less onerous to Poland gradual discharge of its external debt, scheduled by accepted agreements mainly for the beginning of the 21st century. Owing to regular repayments, the country's creditworthiness in international markets will improve, thus resulting in an increased inflow of foreign capital which, in turn, will further stimulate the economic development.

15

Apart from the exports, investment growth will be another factor dynamizing the economy. It should rise by about 11 per cent on annual average (Figure E). Investments will strengthen the competitiveness of the Polish economy and lay solid foundations of its further growth in the future.

16

Investment growth will be promoted by the following economic policy measures:

- introduction of sectoral restructuring and modernization programmes,
- regional programmes of competitiveness promotion, support for multifunctional development of rural areas,
- construction of motorway networks,
- housing development projects,
- stimulation of development of small and medium business sector with the help of an adequate central bank's interest rate policy as well as through development of the institution of credit guarantees.

17

The main limiter of the policy of economic growth stimulation by means of investment will be search after balance of trade equilibrium. Improved equilibrium, in turn, will permit to continue the anti--inflationary policy of moderate devaluation of zloty against foreign currencies. In this case, however, an additional instrument of stimulating investment should be gradual reduction in interest rates in accordance with declining rate of inflation.

18

In pursuing the policy of economic growth stimulation which will permit to implement the most important social objectives, it is absolutely necessary to observe certain rules being a prerequisite of success in all the areas outlined above. The Government identifies **four** such **firm rules:**

- gradual reduction in inflation,
- gradual reduction in the level of budget deficits,
- gradual reduction in the level of public debt,
- gradual limitation of the State budget's redistributional function.

19

The task of steady reduction of inflation (Figure F) is a prerequisite for keeping Poland on the path of sustainable economic growth, for social peace as well as for reaching European standards in the socioeconomic sphere. At the moment of joining the EU, Poland will have to meet the requirements of the Maastricht Treaty and give evidence of one-digit rate of increase in prices. That is why **by the end of December 2000 our annual inflation rate**

must not be higher than 5–7 per cent. Such an objective is feasible and should be set by the Government as a proof of its determination in combatting inflation and as a factor of curbing the inflationary expectations.

20

After a period of anti–inflationary destruction of the economy in 1989–92 and the following period of the economy–restructuring policy accompanied by further reduction in inflation, continued fight against inflation requires to–day application of a more and more complex package of coordinated fiscal and monetary instruments as well as effective control of demand i.a. through creation of appropriate encouragement of investment and savings, targeted both on enterprises and for households.

21

Increase in savings in the corporate sector will be promoted i.a. by:

- creation of structural conditions for growth in profits and for high accumulation as the only mechanisms which can secure firm market position for companies,
- maintenance of tax allowances for investment, while making them conditional on the level of profitability,
- increase in the importance of depreciation in the process of reproduction of assets.

22

Struggle against inflation will now be carried out in conditions of growing complexity of the economic environment, characteristic of a developing market economy. Economic policy aimed at securing a high and equilibrated growth as well as deep restructuring and modernization of the industry will generate conflicting impulses which will either curb or objectively feed inflation. **Thus, the efficiency of this policy will depend, first of all, on a proper balance between the means that stimulate and those which curb inflation.**

23

Among factors apt to generate rise in prices over the next few years, the following ones are particularly worth mentioning:

- the need to raise prices of energy carriers in order to rationalize their consumption and accumulate financial resources for the indispensable, expensive modernization of the power industry,
- the need for gradual adjustment of VAT rates to EU standards,
- maintenance of protectionistic agricultural policy, indispensable for the restructuring and modernization of the Polish agriculture,
- reappraisal of fixed assets which will have to be done in 1998.

24

Whereas the main factors which tend to reduce inflation will be:

- consistent demonopolization of the economy,
- reduction in the number of permanently non-profitable enterprises,

- policy of production capacity growth promotion with respect to sectors and firms capable of coping with the challenge of international competition,
- creation of conditions for conclusion of stable, long-term wage settlements between employers and workers' representations,
- consistent but flexible monetary policy of the central bank,
- increase in the labour productivity and reduction in unit production costs,
- reduction in custom tariff rates on industrial goods till their complete abolition by January 1, 1999 (except rates on imported passenger cars),
- abolition of import tax from 1997.

25

When starting negotiations about joining the EU, Poland should be prepared for a scrutiny of its economy by the European Commission from the point of view of meeting the Maastricht criteria. Such a scrutiny is likely to take place in 1998 already. It will be particularly detailed with respect to the level of budget deficit and public debt, as the EU has been applying similar procedures to its member countries since 1994 already. So, Poland can not count on any preferential treatment in this respect and must continue to further reduce the deficit and the debt.

26

As to the policy of financing the budget deficit, the fact has to be taken into account that the EU regulations forbid financing the deficits with loans contracted with the central bank and prohibit privileged access of the public sector to financial institutions . This restriction can, in a longer perspective, mean the necessity to eliminate budget deficits.

27

Thus, the **second** important **rule** of economic policy in 1996–2000 **will be gradual reduction in the level of budget deficit.** Thanks to the high rate of economic growth, the budget deficit to GDP relation must decline each year so as to become in 2000 by at least one percentage point lower than in 1995 (Figure G). The reduction in budget deficit will be obtained, in the first line, through:

- effective restructuring of the economy, in particular of permanently loss–bearing sectors and firms which now must be supported by the budget in one way or another,
- privatization of the public sector resulting in accelerated development of privatized enterprises and, consequently, in increase in their tax effectiveness,
- limitation of the underground economy sector and, consequently, enlargement of the taxpayer base,
- reform of the social security system in order to rationalize the State's expenditure in this field.

28

Simultaneously with the policy of gradual reduction in budget deficit, **reduction in the level of public debt** in relation to GDP will go on (Figure H). It will be a result of both strong economic growth and Poland' s efficient fulfilment of agreements concluded with the London and Paris Clubs. Due to these developments, the international credibility of the Polish economy will be strengthened which, in turn, will be a substantial factor of stimulating the growth.

29

In 1996–2000, the fourth tough rule governing the Polish economy will be gradual limitation of the redistributional function of the budget (Figure 1). This will become possible due to further improvement in the condition of the Polish economy and in the population's standard of life, and at the same time will set a standard the compliance with which will secure us a suitable position among the most developed nations of the contemporary world.

30

The budget-related tasks formulated above (gradual reduction in deficit and redistributional function of the budget) require rational changes in the sphere of public expenditures, the more so because the Government firmly intends to gradually reduce the tax burdens on individuals and firms. At the same time, effective economic policy will produce a steady and perceptible growth in budget expenditures which will enable implementation of important structural reforms and better satisfaction of social needs.

Projection of macroeconomic indicators for 1996-2000

Specification	1995	1996	1997	1998	1999	2000	Average rate 1996-2000
growth rate in percent age							
1. Gross domestic product (GDP)	7.0	6.0	5.5	5.3	5.1	5.1	5.4
2. Consumption	4.4	4.5-4.7	3.2-3.6	3.2-3.6	3.1-3.6	3.1-3.6	3.5-3.8
3. Gross investments	19.0	10.5-13.0	9.5-14.0	9.5-12.5	10.0-10.5	10.0-10.5	9.9-12.1
4. Imports	21.1	11.5-14.6	8.0-13.0	7.0-10.4	6.5-8.6	6.5-8.3	7.7-10.5
5. Exports	17.0	13.4	12.4	10.0	8.4	8.3	10.5
in percentage							
6. Unemployment rate	14.9	13.6	13.1-13.4	12.0-12.4	10.7-11.3	9.4-10.2	x
7. Inflation rate (XII/XII)	21.6	17.0	12.0	8.0-10.0	6.0-8.0	5.0-7.0	x

Projection of State budget revenues and expenditures for 1996-2000 (in percentage points)

Specification	1995	19967	1997	Average rate 1996-2000
Increase in expenditure - real	3.6	2.3	1.8	2.0
Increase in revenues - real	3.5	2.3	1.9	2.3
				Level 2000
Share of expenditures in GDP	32.9	31.8	31.2	29.9
Share of revenues in GDP	30.2	29.1	28.5	28.2
Deficit in relation to GDP	2.8	2.7	2.6	1.7

Figure A

FALL IN INFLATION RATE

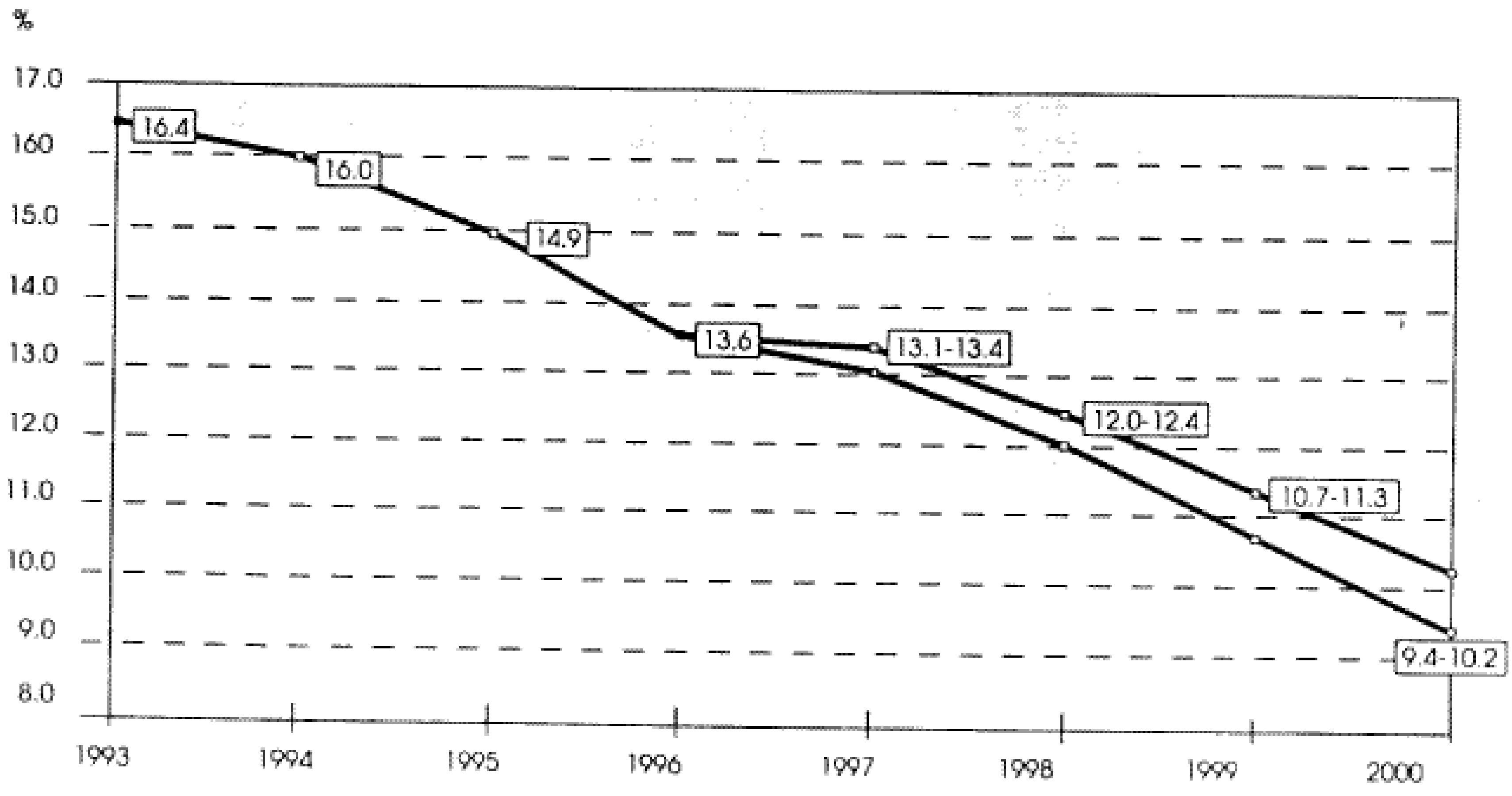


Figure 8

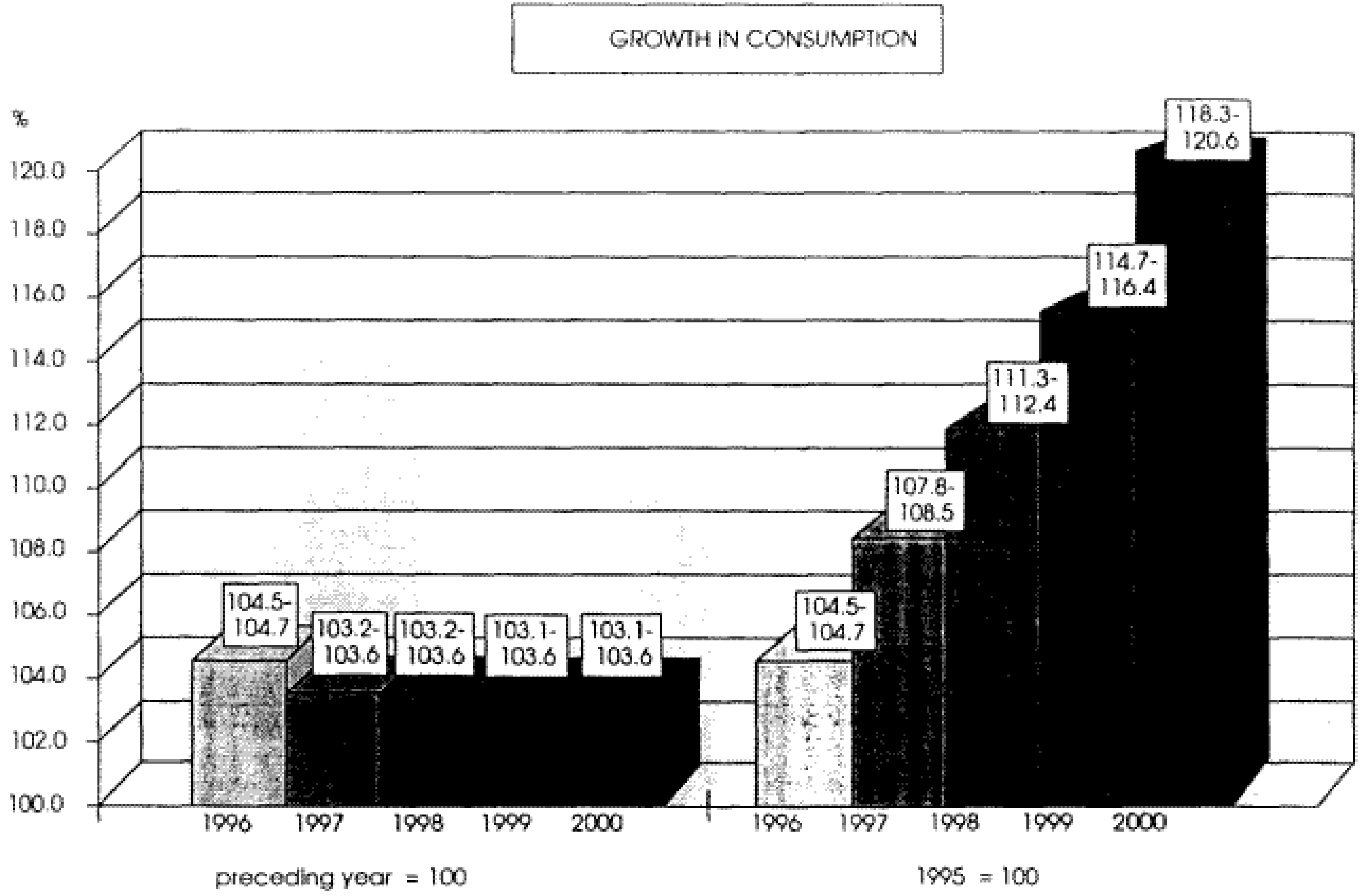

GROWTH IN CONSUMPTION
%
120.0
118.0
116.0
114.0
112.0
110.0
108.0
106.0
104.0
102.0
100.0
104.5-
104.7
103.2-
103.6
103.2-
103.6
103.1-
103.6
103.1-
103.6
104.5-
104.7
107.8-
108.5
111.3-
112.4
114.7-
116.4
118.3-
120.6
1996
1997
1998
1999
2000
1996
1997
1998
1999
2000
preceding year = 100
1995 = 100

Figure C

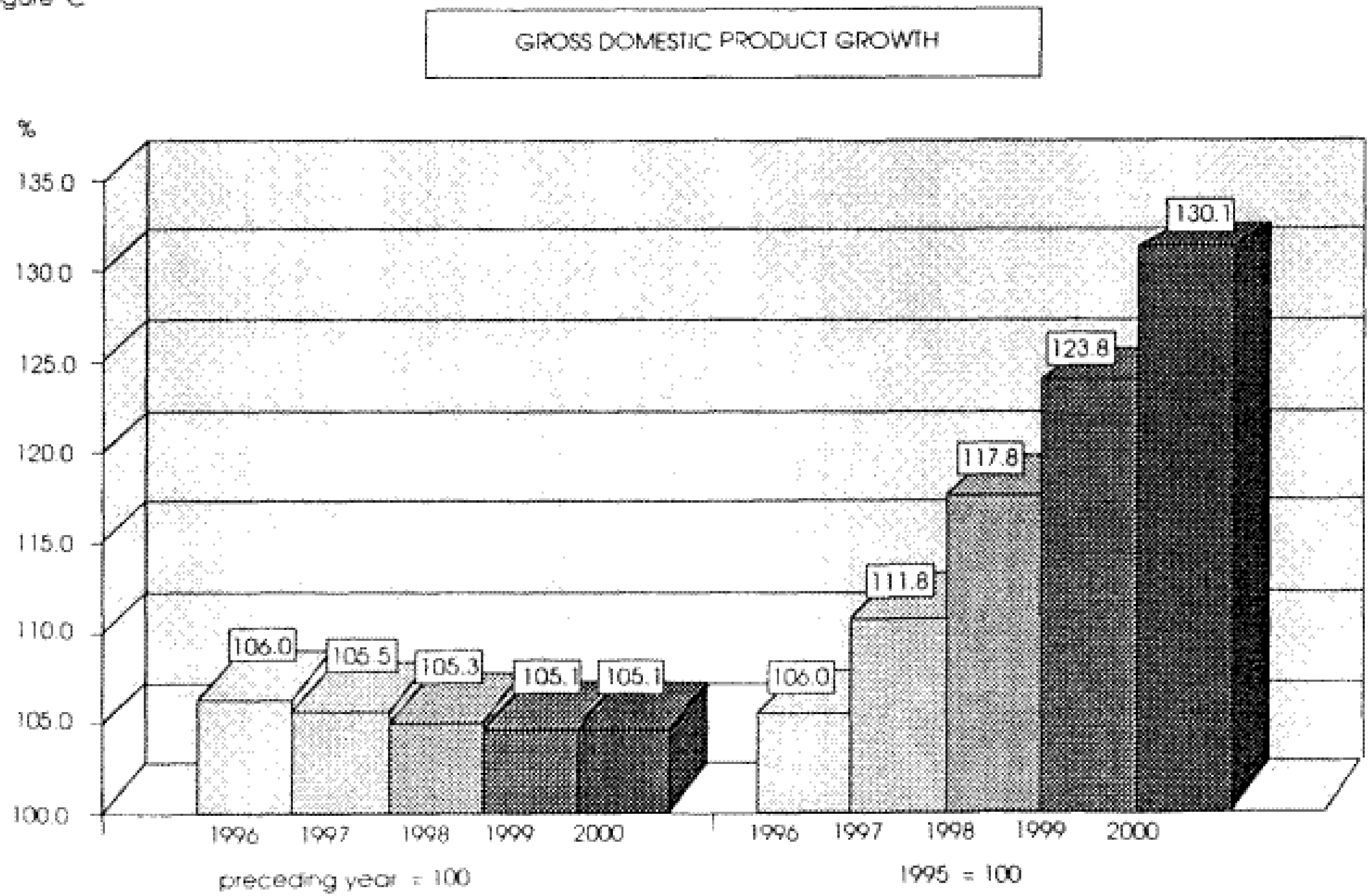

GROSS DOMESTIC PRODUCT GROWTH
%
135.0
130.0
125.0
120.0
115.0
110.0
105.0
100.0
106.0
105.5
105.3
105.1
105.1
106.0
111.8
117.8
123.8
130.1
1996
1997
1998
1999
2000
1996
1997
1998
1999
2000
preceding year = 100
1995 = 100

Figure D

INCREASE IN FOREIGN TRADE VOLUME

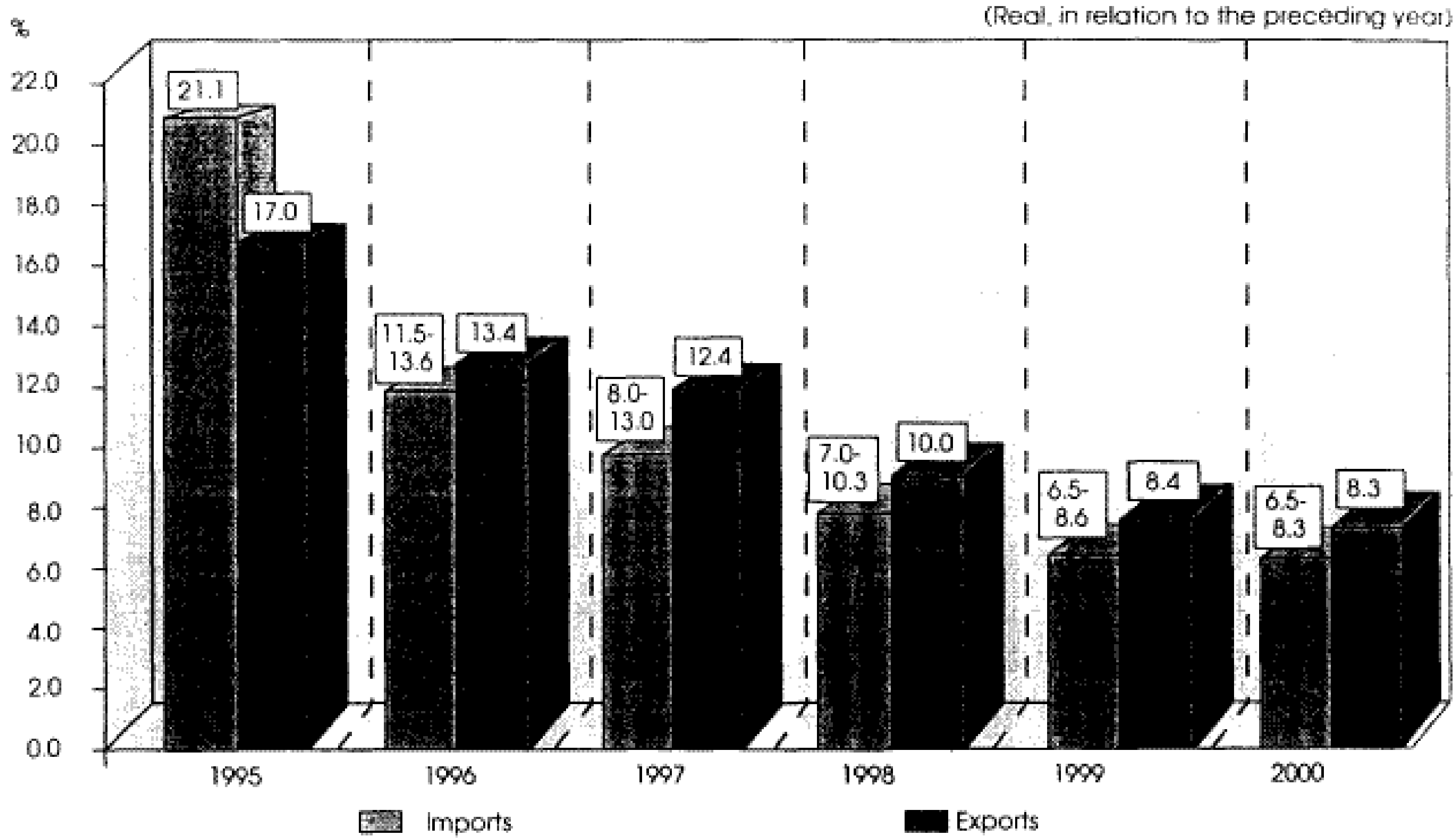


Figure E

INCREASE IN INVESTMENT

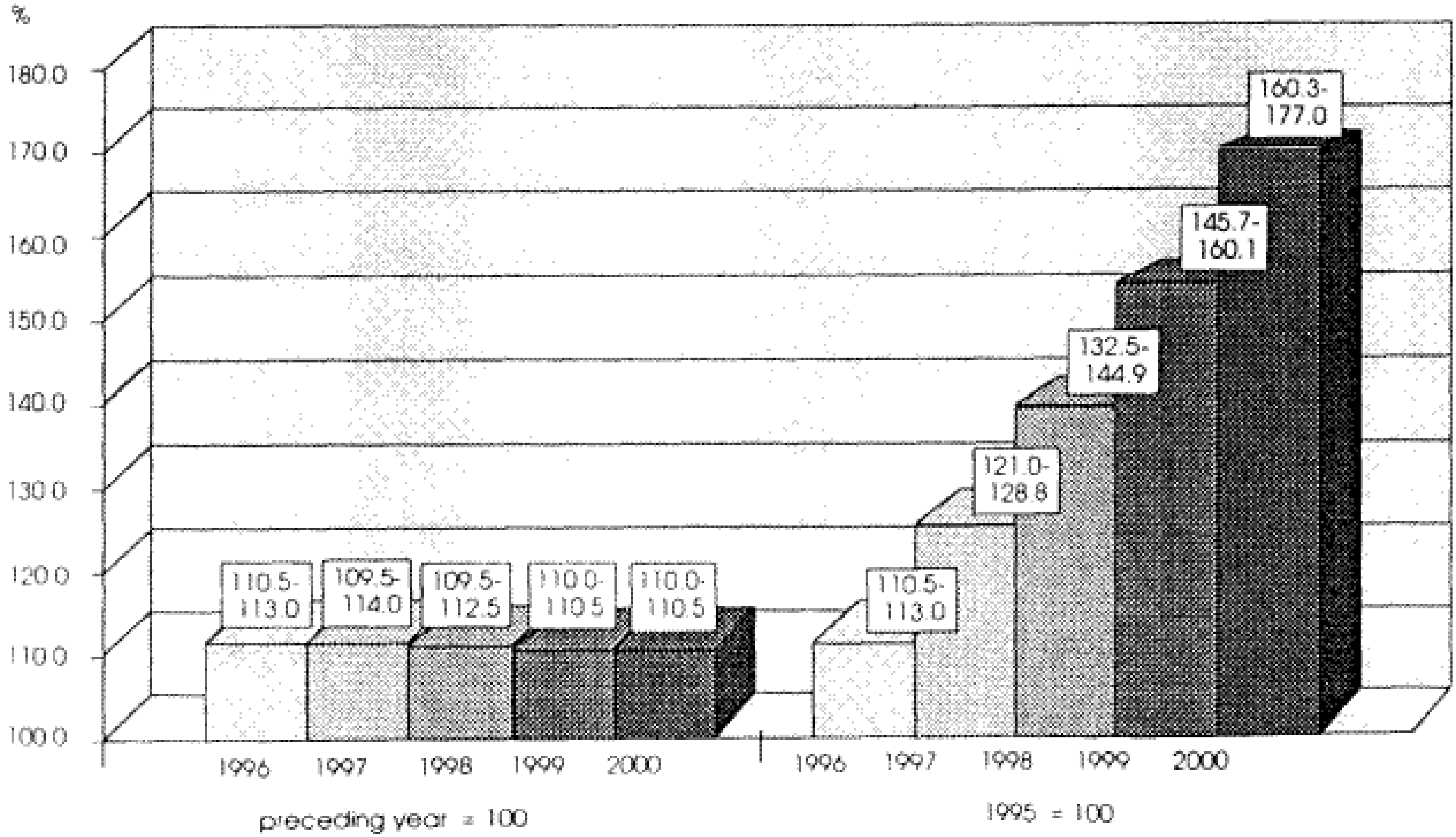


Figure F

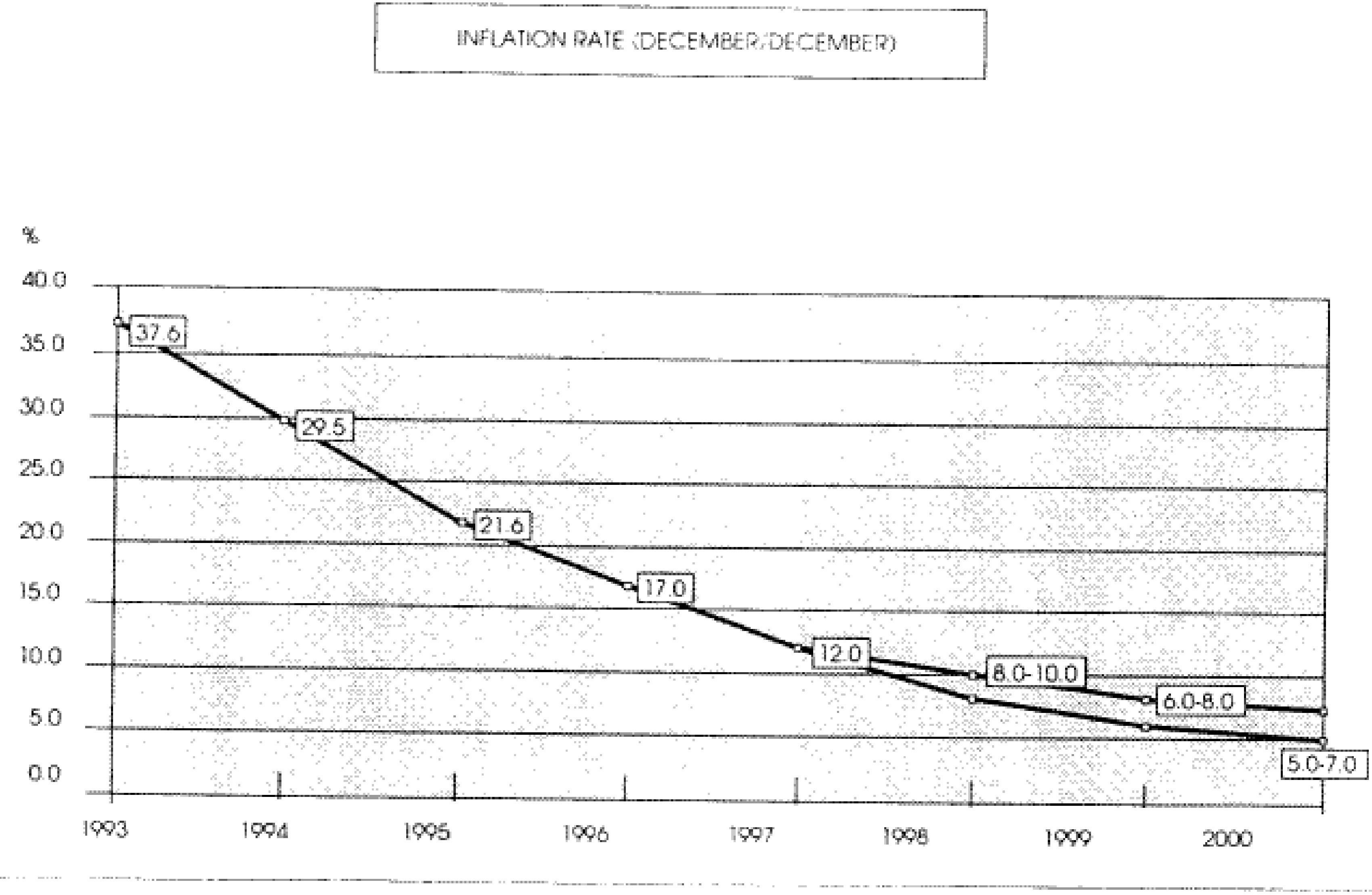
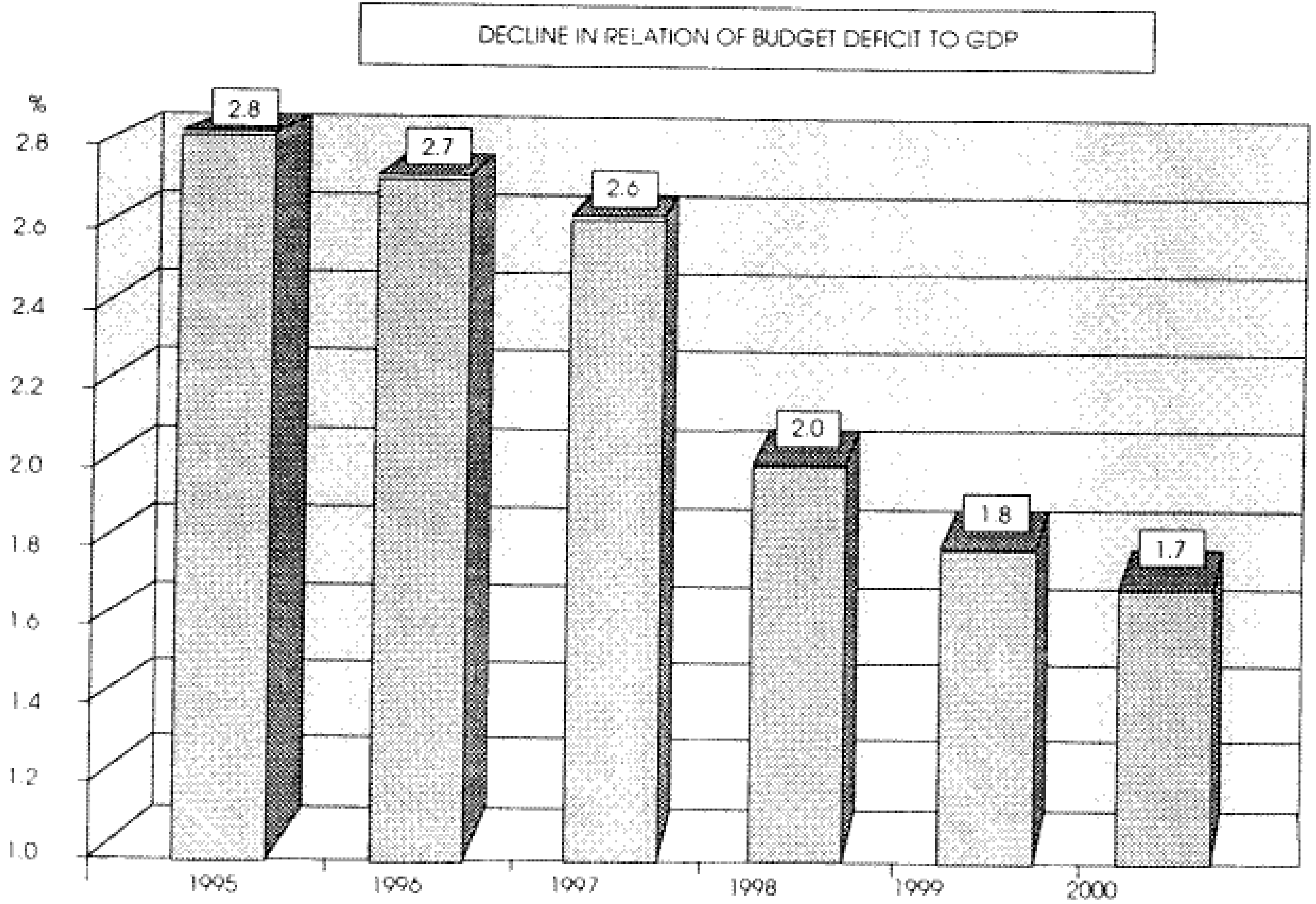

INFLATION RATE (DECEMBER/DECEMBER)
%
40.0
35.0
30.0
25.0
20.0
15.0
10.0
5.0
0.0
37.6
29.5
21.6
17.0
12.0
8.0-10.0
6.0-8.0
5.0-7.0
1993
1994
1995
1996
1997
1998
1999
2000

Figure G



DECLINE IN RELATION OF BUDGET DEFICIT TO GDP
%
2.8
2.6
2.4
2.2
2.0
1.8
1.6
1.4
1.2
1.0
2.8
2.7
2.6
2.0
1.8
1.7
1995
1996
1997
1998
1999
2000

Figure H

DECLINE IN RELATION OF PUBLIC DEBT TO GDP

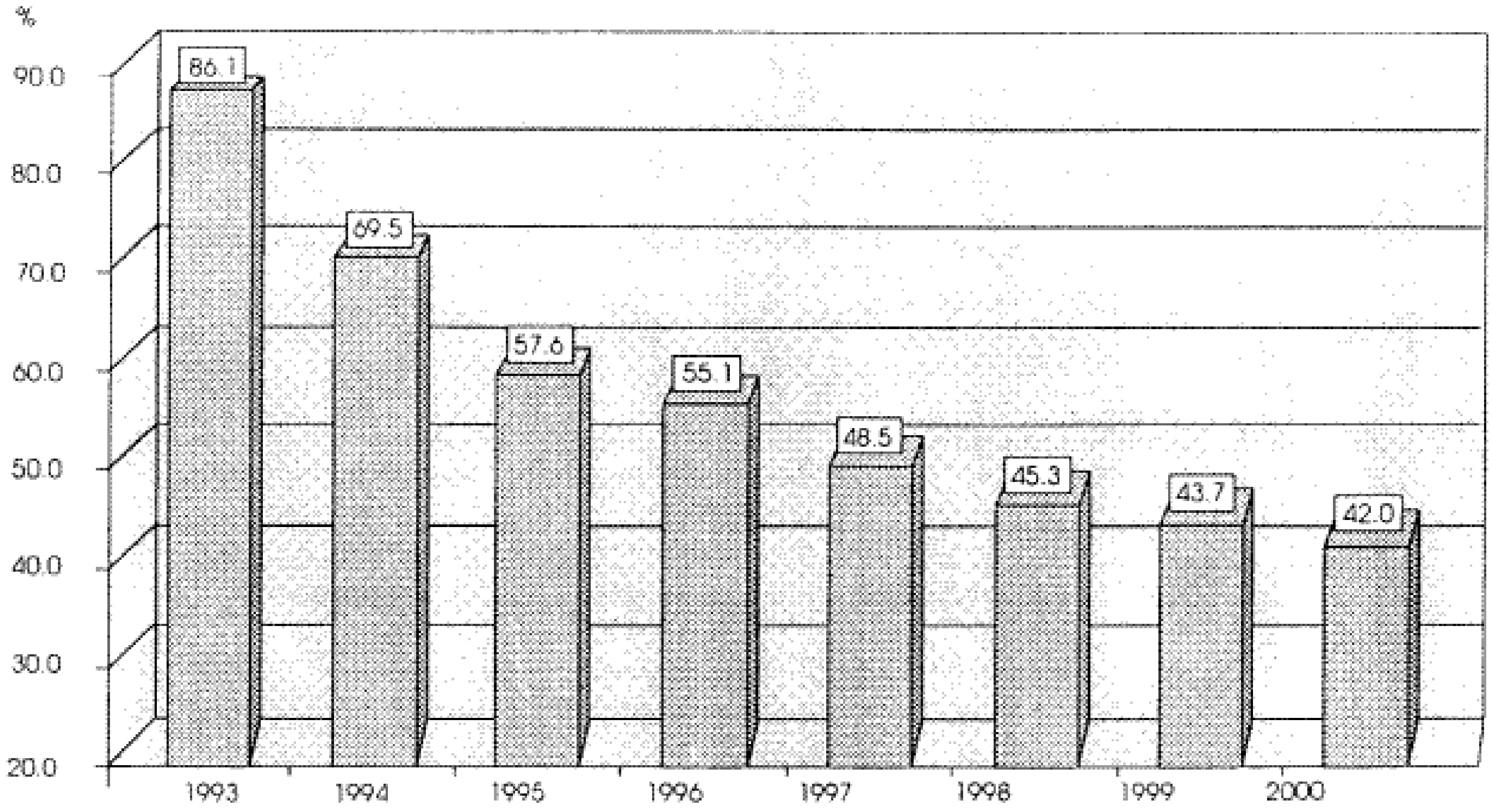
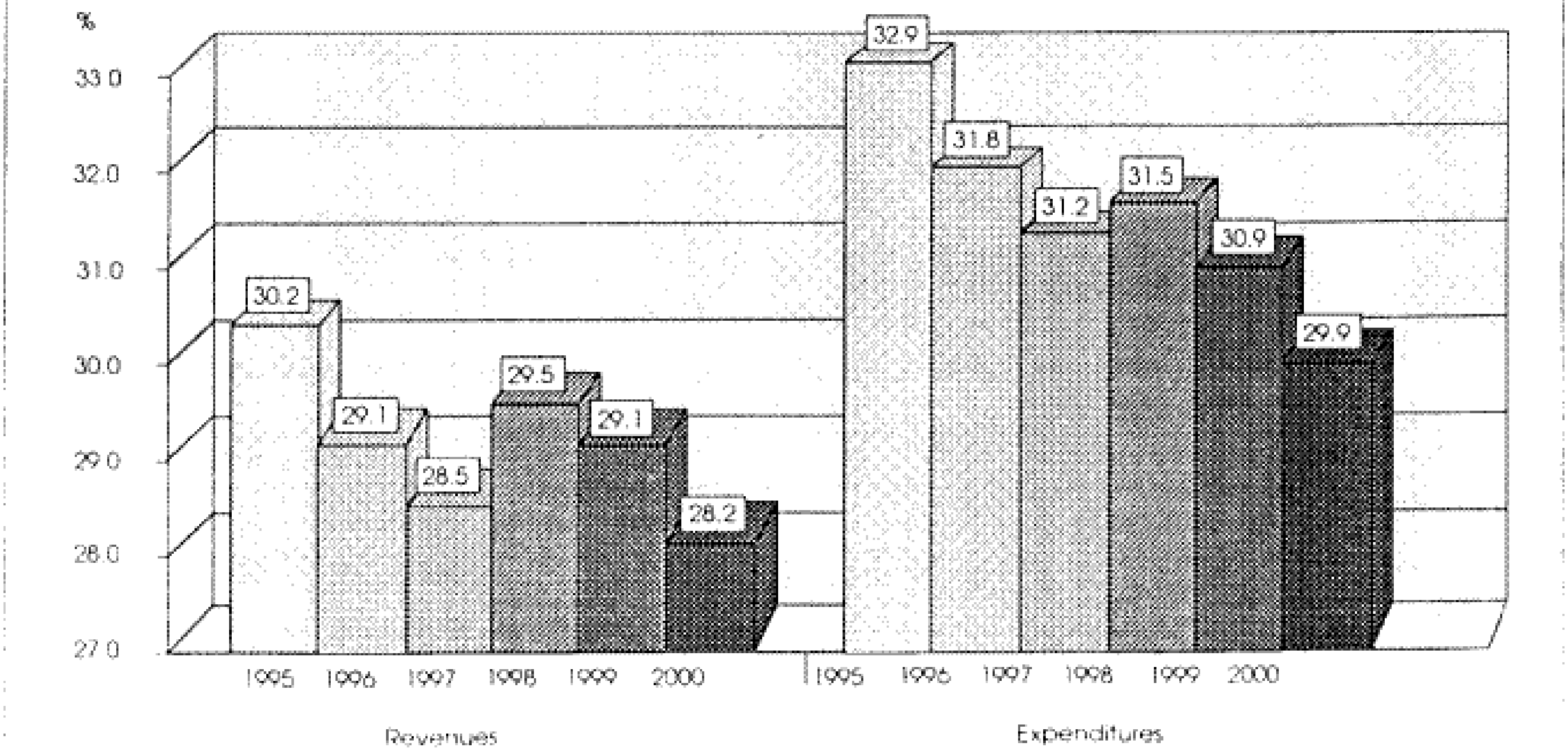


Figure 1

DECLINE IN RELATION OF BUDGET REVENUES AND EXPENDITURES TO GDP



2. FISCAL POLICY, DIRECTIONS OF CHANGES IN TAX SYSTEM

The primary **objective of changes** in the tax system, suggested in the PACKAGE 2000, **is such a formulation of regulations that they be comprehensible to taxpayers and easy to comply.** This will make tax system cheap and readable.

Precise definition of the scope and schedule of changes in the tax system till 2000 will secure stability and predictability of the level of tax burdens. It will bring about increase in the safety of economic operations and household keeping and will contribute to rationalization of behaviour of all the participants in the economic life.

Suggested changes are also aimed at making all the fiscal solutions as far as possible neutral from the point of view of economic competition. Therefore, tax burdens should be common, while possible allowances must be available to all entities clearly fulfilling well-defined criteria which exclude discretional interpretation.

An important objective of introducing the PACKAGE 2000 is a general reduction in tax burdens which will be a stimulus to development and will enable reduction in the redistributional function of the State budget. High yield of fiscal revenue sources, necessary for efficient functioning of the State, should be, to a higher and higher degree, derivative of economic effectiveness and universality of burdens rather than of their high rate. Together with stimulation of savings and investment, this will induce a strong growth in domestic product.

Changes which are now being initiated have to take into full account conditions and requirements of our membership of international organizations, in the first line the World Trade Organization (WTO), Organization for Economic Cooperation and Development (OECD) and the European Union (EU).

Suggested changes give an opportunity to set in order the whole system of tax law and to eliminate a number of revealed inaccuracies, errors and gaps. As their global result, the changes will lead to further absorption of the underground economy sector i.e., on the one hand, to reduction of the scope of tax avoidance practices and, on the other hand, to a considerable increase in the effectiveness of tax collection.

Although the PACKAGE 2000 does not directly touch upon these issues, it is obvious that introduction of its fiscal part is tightly linked to implementation of key structural reforms and, at the same time, conditions them. This mainly concerns the social security and health insurance reforms, the reform of the local self–government finance and of financing of non–profit organizations.

2.1. Tax law

The Government's draft proposal for Tax Law is now subject of parliamentary proceedings expected to be completed by mid–1996. **Such a code of tax proceedings will reduce the scope of interpretation in assessing taxes and granting allowances~ will make tax avoidance more difficult and improve tax collection.** It will, thus, contribute to limitation of the underground economy, while, at the same time, protecting the interests of law-abiding taxpayers.

In the amended general fiscal law, the scope of the rights and obligations of all the parties to tax proceedings i.e. taxpayers, tax withholders, tax collectors and tax authorities alike, will be defined in a precise way. Principles of their mutual relations, clearly defined by the law, will minimize the possible conflits in the taxpayer budget (State budget or local budget) relation.

Under the new law, payers and collectors of taxes will be given additional rights which will induce all the participants of tax proceedings to behave in accordance with the law. Fiscal authorities will be equipped with instruments permitting them effective assessment and collection of taxes from persons or companies reluctant to meet their fiscal obligations towards the State or the local budgets.

2.2. Tax consultancy

In the first quarter of 1996, parliamentary proceedings on the Government' s draft proposal for Tax Consultancy Act are expected to come to an end.

Creation of institution of tax consultancy will make it possible to taxpayers to avail themselves of qualified advice in meeting their tax obligations. Eligible for performance of tax consultancy will be exclusively persons or institutions having appropriate qualifications and being in possession of sufficient funds which guarantee coverage of loss suffered by a taxpayer through the consultant's fault.

2.3. New system of real estate taxation

The main objective of the planned reform is to create a stable and effective revenue source for local budgets. Owing to it, the system of local government will be able further to develop in Poland.

Taxation of real estate on the basis of its value is a solution generally applied in EU countries and used as a source of local government or local administration financing. The new tax, being an exclusive local budget revenue, will strengthen the autonomy of local self-governments, this being consistent with directives of the European Local Government Charter ratified by Poland.

The main **principles** underlying the introduction of the new real estate tax are as follows:

1) the new ad valorem tax on real estate is intended to replace three types of taxes which are now in force: real estate tax, rural tax and forest tax;
2) revenues from the new tax will continue to be the revenues of local budgets, while the State budget will have no share in them;
3) under the new tax system the scope of allowances and exemptions will be very limited. It will not be enlarged either compared to the current one or to that provided in separate draft bills now being subject of parliamentary proceedings. But as a result of enlarged taxation base an increase in revenues from real property taxation will take place without increase in unit tax burden;
4) for objects on which the tax has already been levied on the basis of their value (buildings used for economic purposes) the tax amount will remain on the same level;
5) local self–governments will have the right to set the tax rates, allowances and exemptions. Allowances and exemptions introduced by local self–governmenmts will be neutral for the State budget, as they will not create ground for claiming any additional subsidies;
6) at least till 2005, institutional solutions concerning taxation of agricultural and forest lands will not be substantially changed; the target form of the taxation system of agricultural and forest activities (VAT, income tax and real estate taxe), will depend on the pace and the scope of changes in the agrarian structure, resulting from implementation of the agricultural policy.

The Government proposes the following schedule of steps leading to introduction of the new real estate tax:

1) formulation and adoption by the Parliament of a set of laws introducing an ad valorem tax on real estate – 1997,
2) formulating and issuing executory ordinances – 1997,
3) introduction of new institutions related to taxation and registration of real estate (general appraisal of real estate, establishment and launching of property cadastre – 1998,
4) creation of organizational structures needed to administer the new real estate tax – 1998–99.

Tasks mentioned under 1) to 4) will be carried out gradually and their scope can be modified as a result of decisions made in the course of legislative proceedings. The deadline for implementation of the new real estate tax throughout the country is scheduled for after 2000. However, possibility of earlier voluntary introduction of the latter tax by local governments will be foreseen, provided they are prepared for it.

2.4. Indirect Taxes

At present, the following indirect taxes are in force:

- import tax and custom tariffs,
- value added tax (VAT),
- excise tax.

A

Import Tax

It was introduced in December 1992, at 6 per cent ad valorem rate and was levied on all imported goods. In 1995, the import tax rate was reduced to 5 per cent, and in 1996 – to 3 per cent. **From 1997, the import tax is to be abolished.**

Abolition of this tax is an important factor of reducing inflation. Imports of investment and manufacturers goods will become cheaper. Pressure towards rise in consumption prices will be weakened. On the other hand, competition will become sharper for Polish producers. However, graduality in abolishing the import tax has left some time for domestic producers to adjust to more severe competitive environment. So, eventually, the abolition will contribute to increase in competitiveness of domestic production, which is one of the prerequisites of adjustment of the Polish economy to conditions of a liberalized market. Thus, abstention from levying the import tax is also a necessary step on Poland's road to OECD and the European Union. In spite of the fact that abolition of this tax can for a short time affect the State budget revenues, the Government considers it to be an investment in development instead of being a budgetary cost.

B

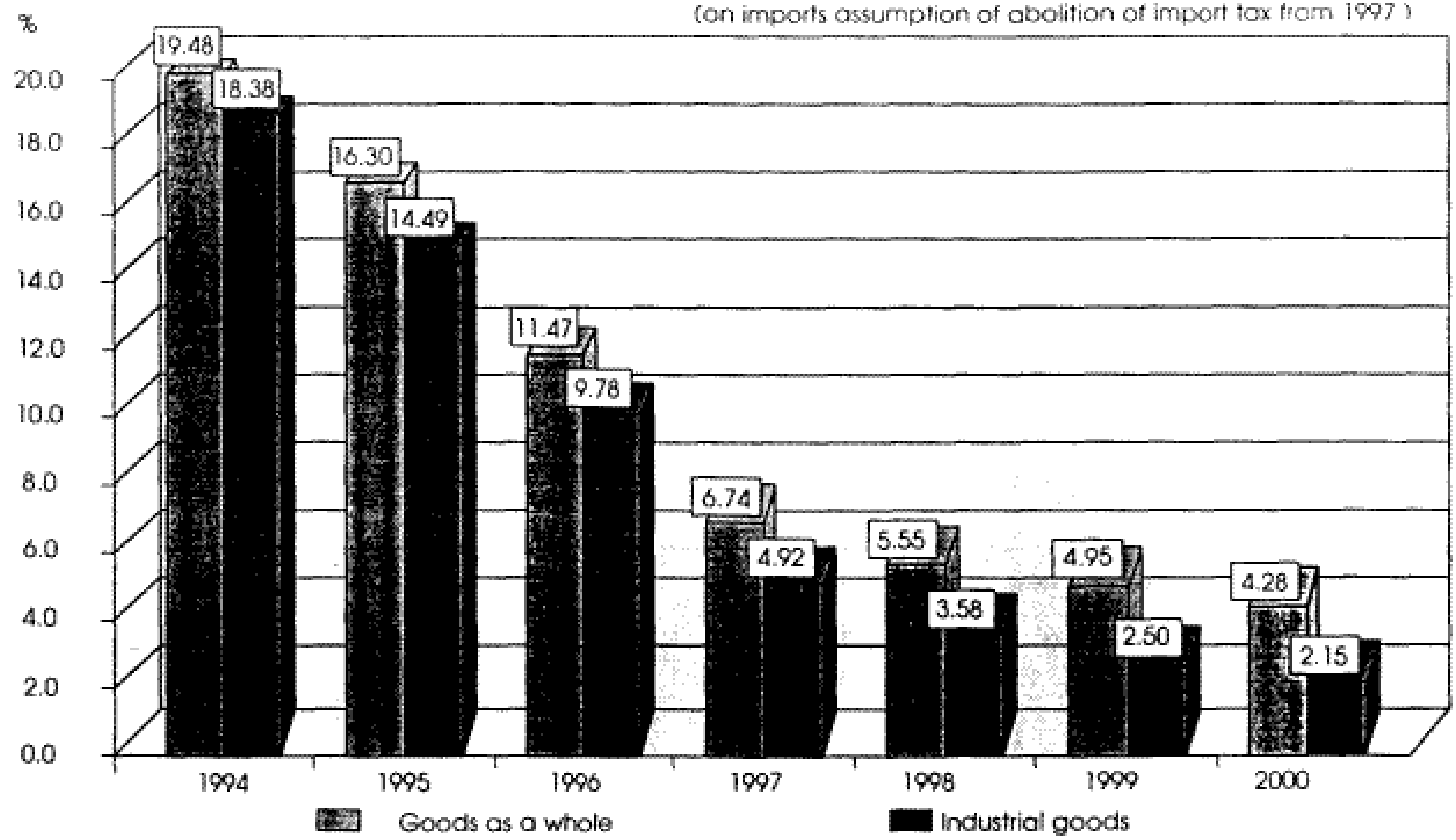
Custom Tariffs

Successive reductions in custom tariff rates should be perceived in a similar way (Figure J).

Customs policy is predominantly determined by Poland's agreements signed with the EU, CEFTA and EFTA countries, but first of all by the WTO agreements. In virtue of them, custom tariffs on industrial goods are to be gradually reduced beginning with January 1, 1995, each year by 20 per cent. Custom tariffs on industrial goods are to be totally abolished by January 1, 1999, except on imported cars; here the tariffs will be abolished by 2000. The reduction in custom tariffs on imported agricultural products is to be carried out at a slower pace. As far as this group of goods is concerned, reduction in tariffs started on July 15, 1995, and has been taking place at the pace of 10 per cent annually.

Figure J

AVERAGE BURDEN (TARIFF AND IMPORT TAX)



C

Tax on goods and services (VAT)

The several years' period since the introduction of VAT has revealed the weak and strong points of the adopted solutions. Errors which have been noticed in regulations and in practice must be corrected, while at the same better adjusting our solutions to the EU standards.

Changes within VAT belong to more important and delicate adjustment processes awaiting the Polish economy. The most important of them are:

1. Abolition of zero tax rate on domestic sale of goods and services, since such a rate is contrary to EU directives. At present, zero rate is applied to medicaments, books, newspapers and magazines, means of production for agriculture such as farm tractors, farm machines and equipment, fertilizers, feeds and pesticides.

   Three options for passage from zero to 7 per cent taxation rate on medicaments, books, newspapers and magazines have been proposed for consideration (rates in per cents):

Year	Option I	Option II	Option III
1997	7	2	3
1998	7	4	5
1999	7	7	7

Permanent preferential (7%) VAT rate on the above--mentioned goods will be consistent with accepted priorities of the socioeconomic policy and will be an indirect form of subsidizing production and consumption of these goods.

2. Sale of unprocessed agricultural products will continue to be tax-exempted at least till 1998, since abolition of the exemption must be preceded by establishment of appropriate institutions making settlement of the tax possible for the farmers. In order to strike a balance it will be necessary to maintain zero VAT rate on means of production for agriculture, as well. Dilemmas of the system of agricultural products have to be overcome, at the latest, prior to Poland's joining the European Union; otherwise the Polish agriculture will be barred from the Union funds needed for the indispensable restructuring and modernization.
3. Till 2000, preferential rate (7%) on building materials and services will be maintained.
4. **In accordance with EU directives, VAT levied on goods bought and exported by foreign tourists should be refunded.** Introduction of this solution in Poland requires:
   - to define the minimum purchase value which will entitle a tourist to ask for VAT refund;
   - to work out a mechanism for handling this fiscal operation, as at present the tax offices operating in the border areas would not be able to provide an efficient service in this respect to many millions of tourists crossing the frontier each year (an alternative could consist in handing over this operation to a specialized firm or to customs offices);
   - to introduce solutions protecting against tampering with sale documents which entitle to have VAT refunded.

An undoubtful advantage of the introduction of VAT refund for tourists will be reduced attractiveness of operating and buying in the underground economy sector and, consequently, a push towards legalization of that sector. The resulting taxation of firms hitherto operating in the underground sector will compensate for the gap in budget revenues caused by VAT refund to tourists.

5. In the EU countries, the tax on insurance is levied on revenues of insurance companies from premiums. Rates of this tax are very differentiated. The lowest ones are applied to life insurance and rural insurance as well as on maritime and air transport insurance. In Poland, revenues of insurance companies are exempted from indirect taxes, whereas the insurance intermediation is taxed. The latter taxation should be abolished as soon as tax is imposed on insurance companies, such a solution being in accordance with that adopted in the EU.

2.5. Direct taxes

A

Corporate income tax

In 1997–2000, the rate of this tax will be gradually reduced, with simultaneous limitation of the whole range of existing tax allowances and exemptions, in particular those for investment. As a result, the amount of funds left at the disposal of investors and available for investment will in principle remain unchanged, while the budget revenues from this tax will not be reduced. Investment allowances will be equal for all the economic entities, including those operating in areas threatened with high structural unemployment.

In order to enlarge the number of economic entities eligible for investment allowances aimed at accelerating increase in the number of new working places in high–unemployment areas, a reduction from 8 to 4 per cent will take place in the income–to–proceeds ratio being the eligibility condition for the allowance. Within the above context, the following schedule of changes is proposed:

Year	Corporate income tax rate in force	Maximum amount of investment expenditures deductible from taxable income (in virtue of Council of Ministers Ordinance of January 25, 1994), as percentage of taxable income. Reduction in maximum deductible amount from the present level of	
		25	50
		to	
1996	40	25	50
1997	38	20	40
1998	36	15	30
1999	34	10	20
2000	32	10	20

Introduction of these changes will require amendment to the existing law and issuing in 1996 of a new Council of Ministers ordinance on investment allowances, effective from 1997. Under this ordinance:

- the system solutions provided in the Council of Ministers, Ordinance of January 25, 1994 on deduction of investment expenditures from taxable income and on reduction in income tax rates will be maintained;

– the following ordinances of the Council of Ministers will be rescinded (while respecting vested rights):

* the above-mentioned Ordinance of January 25, 1994,
* Ordinance of January 24, 1995 on deductions of investment expenditures from taxable income and on reductions in income tax in localities threatened with exceptionally high structural unemployment.

At the same time, **tax privileges provided by the Special Economic Zones Act will be respected.**

In addition, the following measures are suggested:

– till the end of 2000 – successive harmonization of regulations on corporate income tax with EU directives;

– from 1998 or 1999 – change in the definition of the subject of taxation for taxpayers obliged to keep account books. The subject of taxation will be gross profit and not income as it is today. Profit will be evidenced on the basis of orderly kept books, and will be diminished by incomes from non-taxable or tax-free income sources and augmented by costs and expenditures other than costs of earnings the income (in the understanding of Coprporate Income Tax Act).

B

Personal Income Tax

1. **Beginning with 1997, the rates will be reduced to 20, 30 and 40 per cent,** with preservation of the principle of indexation of the costs incurred in earning income from employment contract or similar contracts as well as of the generally applied income-deductible amount.

2. The mode of application of legally provided income deductions will be modified.
3. Some deductions and allowances will be abolished according to the following criteria:

- in order to eliminate abuse, the amount of allowances will have to be documented with receipts for payment and/or with VAT invoices;
- allowances and deductions which have lost their economic importance or those which can not be properly controlled and, at the same time, are abused by taxpayers will be annulled;
- till the end of 2000, the following incomes will continue to be tax–exempted:
  - * from the sale of shares in companies established (in virtue of provisions of the Act on Privatization of State–Owned Enterprises) in order to take over – against payment – exploitation of an enterprise or of an organized part of its assets,
  - * from the sale of Treasury bonds issued after January 1, 1989,
  - * from the sale of shares admitted to public trading, purchased through public offer or at stock exchange, and
  - * from sale of shares in trust funds;
- the mode of making use of allowances for donations and expenditures on housing investment, renovation and modernization will be modified. The existing mode should be replaced by right to tax deductions uniform for all the tax–schedule brackets; with respect to renovation and modernization expenditures, the limit on deductions will be set for three years' periods;
- the rules of making use of investment allowances related to economic activities will be changed in the

same way as described above with respect to corporate tax;

- till 2000, the existing level of lump sum costs of earning the income from copyrights and short work contracts will be maintained; whereas from 1997 lump sum costs of earning income from similar rights will be reduced from 50 to 20 per cent; however, taxpayers who draw incomes from these rights will be able, when determining taxable income, to deduct costs actually incurred, provided they can prove them;
- from 1998 or 1999, incomes obtained from commercial, general and limited partnerships will be taxed in the same way as incomes falling under the Corporate Income Tax Act.

2.6. Schedule of changes in tax systems

Lp	Name of regulation	Date of adoption by the Ministry of Finance	Date of approval by Council of Ministers	Date of passage through Parliament	Date of becoming effective
1	2	3	4	5	6
1.	Tax Consultancy Act		adopted and forwarded to Parliament	till mid-1996	6 months after promulgation
2	Tax law		as above	2nd/3rd quarter of 1996	January 1, 199
	Property taxes				
3	Real Estate Act	2nd quarter of 1997	3rd quarter of 1997	4th quarter of 1997	January 1, 200
4	Land Cadastre Act	2nd quarter of 1997	3rd quarter of 1997	3rd quarter of 1997	60 days after promulgation
5	Act on obligatory associations of communes, on cities and on self-governmental local-tax and cadastre offices	2nd quarter of 1997	3rd quarter of 1997	4th quarter of 1997	60 days after promulgation
6	Act on conditions for earlier introduction of real estate tax	2nd quarter of 1997	3rd quarter of 1997	4th quarter of 1997	14 days after promulgation
	Indirect taxes				
7	Act on amendment to the Value-Added Tax and excise Tax Act, providing i.a. for: 1) cancellation of zero rate on some goods and services 2) specification of some regulations and changes in the application of sanctions for faults in VAT settlements	March 1996	May 1996	September 1996	January 1997
8	Insurance Tax Act	January 1997	March 1997	June 1997	January 1, 199

	2	3	4	5	6
9.	Act on amendment to Value-Added and Excise Tax Act comprising introduction of VAT refund to foreign tourists	January 1997	March 1997	June 1997	January 1, 1998
10.	Act on amendment to Value-Added and Excise Tax Act, comprising taxation of agriculture	March 1998	June 1998	December 1998	January 1, 2000
	Direct taxes				
11.	Act on amendment to Personal Income Tax Act, concerning i.a.: 1) change in tax schedule, 2) change in definition of tax allowances - from deductibility from taxable income to deductibility from tax due; 3) adjustment of Act provisions to changes mentioned under 1) and 2), 4) redefinition of some other provisions	March 1996	May 1996	September 1996	January 1, 1997
12.	Act on amendment to Corporate Income Tax Act, including i.a.: 1) change in tax rate, 2) amendment to provisions on transfer prices, in order to harmonize them with OECD directives	March 1996	May 1996	September 1996	January 1, 1997

	2	3	4	5	6
13	Council of Ministers Ordinance on deductions of investment expenditure from income and on reduction in income tax, including in particular: 1) change (reductions) in the limit of deductions and reductions in connection with change in tax schedule of personal income tax and in the rate of corporate income tax 2) allowances for economic entities operating in areas threatened with high structural unemployment	June 1996 (after the adoption by the Council of Ministers of the draft laws mentioned in points 11 and 12)	October 1996 (after passing the laws by Sejm)		January 1, 1997
14	Corporate Income Tax Act (new Act which will i.a. provide for 1) change in taxation subject (from income to gross profit) which will lead to considerable modification to the hitherto existing act; 2) harmonization with the EU legislation (adjustment to EU directives)	June 1997	3rd quarter of 1997	first half of 1998	January 1, 1999
15	Revised Personal Income Tax (as above)	June 1997	3rd quarter of 1997	first half of 1998	January 1, 1999

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