Poland's Public Finance Reform

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It is high time we reformed Poland's public finances. Without reform, we will not be able to tap billions of EUR from EU funds, accelerate economic growth to more than 5 percent annually, improve the investment climate, promote entrepreneurship and – as a result – substantially lower the unemployment rate. The current Byzantinean tax system fraught with various tax exemptions, deductions and allowances, inefficient spending of public money in extrabudgetary funds and agencies, and lingering bureaucratic barriers all combine to stifle business initiatives, constrain investment and lessen the predictability of the business environment. Now is the time to take hard decisions. The new program for Poland's Public Finance Reform recently presented by the Minister of Finance goes a long way towards tackling these challenges.

The first objective of this comprehensive, 13 point Program is to take advantage of PLN 62 billion that the EU will make available to Poland, as a new member of the Union, between 2004 and 2006. This significant inflow of money, earmarked in large part for badly needed investments in infrastructure, would undoubtedly contribute to acceleration in economic growth. According to some estimates, absorption of the EU funds can contribute an additional 0.7-0.8 of a percentage point to growth annually in the first three years of membership. The available funds, however, will not be tapped if Poland does not come up in the next three years with PLN 31 billion of its own funds needed to pay for the membership fee in the EU and other European institutions. Additional money will also be needed to co finance EU investments (typically own funds must amount to between 15 and 25 percent of the total project's value) and pre-finance agricultural direct payments. Hence, the reform of public finances aims to restructure public spending so as to free resources to finance our share in investments and thus maximize absorption of the EU funds. For every one PLN of our money we are likely to get an additional one PLN from the EU. This opportunity should not be wasted.

The reform of public finances also aims at streamlining and simplifying the tax system through elimination of all tax exemptions and breaks for both personal and corporate taxes. In personal tax law there are more than 127 various exemptions together with 14 tax breaks. Likewise, the corporate tax law – CIT – boasts of more than 70 exemptions. Such a panoply of holes in the tax system contributes to the system's complexity, awkwardness, and business unfriendliness, which is rightly pointed out by many businessmen as a potent barrier to promoting entrepreneurship. The reduction in the system's complexity would also go some way towards broadening the tax base and lessening the scope for corruption.

A widely shared myth maintains that taxes in Poland are high. Contrary to appearances, this is not true. According to the OECD, total tax revenue as a share of GDP in Poland in 2000 amounted to 34.1 percent, whereas the OECD and the EU average were 37.4 percent and 41.6 percent, respectively. Moreover, the combined tax rate on corporate income and dividend in Poland in 2001 amounted to 38.8 percent, which is much lower than the equivalent OECD and EU average of 48.8 percent and 50.1 percent, respectively.

Nonetheless, no one disputes that lower taxes would – sooner or later, to a lesser or a greater extent – contribute to increasing investment and enhanced attractiveness of Poland as a destination for foreign capital. In line with this thinking, the program promises – in return for the elimination of tax exemptions and breaks – **a general decrease in tax rates, both PIT and CIT**. Should the reforms be implemented, the CIT rate could decrease to 24 percent already in 2004 or 2005. The decrease in tax rates could be reckoned even deeper if one takes into account the amount of corporate savings on the decreased costs of processing taxes. Since every percentage point decrease in CIT tax rate lowers budget revenues by roughly PLN 500 million, the same amount saved by companies would then be equivalent to a one-percentage point lowering of the tax rate.

The third objective of the program is to limit increases in public spending by de-indexing the expenditure of the budget. In the current legislative framework, almost 70 percent of the central budget's expenditures increases automatically every year by a percentage indexed to either inflation, GDP growth, minimal wage or various other more or less sensible benchmarks. The value of this mostly socially oriented expenditure (pension payments, disability allowances, social subsidies) rises automatically irrelevant of the budget's capacity and changing preferences of the society. To cut this automated growth, all the 85 existing indexation mechanisms must be liquidated. This will constrain the growth of public spending and make any future increases in spending dependent each year on Parliament's decision.

In the current political and social situation it would be naive to expect that cuts in social spending are feasible – they are not. Both the Parliament and society at large are against any cuts in nominal spending. This can be understandable, particularly when viewed from the perspective of the impoverished part of society, which struggles to make ends meet in an environment of very high unemployment and ongoing economic restructuring. Nonetheless, even without explicit nominal spending cuts, the relative share of public expenditure to GDP can decrease as long as the rate of economic growth is higher than the rate of increase in spending. This is exactly what the program envisages: projected GDP growth rates of 3.5 percent this year, 4.9 percent, 5.4 percent and 6 percent in 2004, 2005 and 2006, respectively, will be much higher than the corresponding rate of increase in the central budget's expenditures.

Finally, the program announces the beginning of a serious battle against red tape and inefficient use of public money. This will be achieved through liquidation of nine extra-budgetary funds and two agencies of the state treasury, whose revenues and expenditures are as of now not subject to either governmental or parliamentary control and oversight. This lax supervision has bred inefficiency and poor use of available resources. The functions of these liquidated institutions will be transferred to the relevant ministries.

We will soon know more details of this ambitious program (more information is available at the Ministry of Finance's website www.mf.gov.pl). Fiscal consolidation through de-indexation of spending, simplification of the tax system, decrease in tax rates, stabilization of public finances and large inflows of EU funds should allow for an improved business environment and faster economic growth commensurate with Poland's potential and expectations. Political support will be the key to successful implementation of the program in its entirety. Because of its all-inclusive and inter-related nature, a piece-meal approach would fail the purpose. Without the reform of public finances, Poland's prospects will not look bright. The time for change is now.