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A WORLD BANK COUNTRY STUDY

TAX REFORMS IN THE LIGHT OF EU ACCESSION

THE CASE OF POLAND

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ACRONYMS AND ABBREVIATIONS

AAD	Accompanying Administrative Document
CIT	Corporate Income Tax
CG	Corporation Government
EC	European Commission
ECOFIN	European Council of Economic and Finance
EEC	European Economic Community
ELO	Excise Liaison Office
EU	European Union
EUR	Euro
GDP	Gross Domestic Product
IMF	International Monetary Fund
IT	Information Technology
MoF	Ministry of Finance
OECD	Organization for Economic Cooperation and Development
PIT	Personal Income Tax
PZl	Polish Zloty
REED	Excise Exchange of Information
RR	Reduced Rate
SOEs	State-Owned Enterprises
VIES	VAT Information Exchange System
VAT	Value Added Tax
WTO	World Trade Organisation

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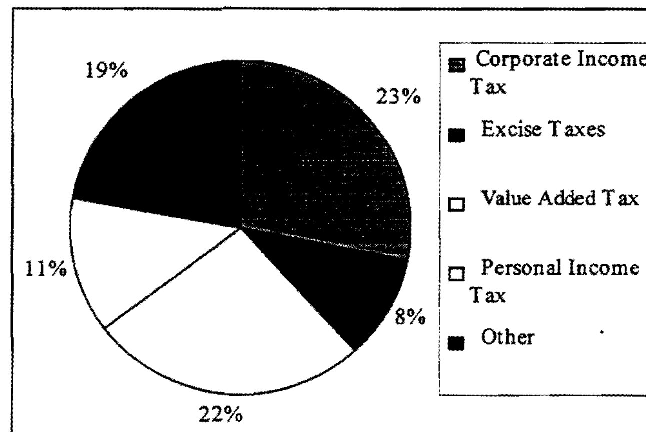
TAX REFORM IN THE LIGHT OF EU ACCESSION
THE CASE OF POLAND

Executive Summary

1. This report was prepared at the request of the Polish authorities as an independent assessment of the reforms in internal tax policy and administration needed to comply with EU directives. During the preparation of this report two other major reports were issued: the White Paper on Tax Reform and an IMF-World Bank report specifically dealing with tax administration. This report addresses similar issues, giving however a greater emphasis to EU requirements in each tax category and the options Poland faces in complying with these requirements.

2. The report's emphasis on understanding the implication of EU accession requirements for tax policy and administration is warranted because the accession provides opportunities and pitfalls. The harmonization of indirect taxes is key for allowing the smooth operation of the internal market, enabling companies to sell, purchase and invest across the Union without being subject to border controls and formalities. However, transitional arrangements may prove to be burdensome for small and medium enterprises (especially agricultural-based enterprises), creating new deterrents for trade. Also, indirect taxes subject to immediate harmonization (VAT and Excise) are important sources of revenue for the budget, accounting for over one-quarter of all sources of government revenue (Figure I). Any changes in tax policy to comply with EU directives need to account therefore for implications on government revenue and the tax burden on the private sector. Finally, tax harmonization has important implications for tax administration, creating additional demands for automation to register intra-Union transactions and establish a clearing mechanism for cross-border transactions.

Figure I: General Government Tax Revenues -1997 (% of Total Tax Revenue)[1]



Source: Polish Ministry of Finance. Department of Government Finance Statistics

[1] Other sources of general government tax revenues include: social security contributions, taxes on property, and taxes on international trade and transactions.

3. The focus on EU accession requirements still allows a certain degree of overlap with the government's tax reform proposal. The latter is summarized in the Ministry of Finance's White Paper on Tax Reform. It aims at reducing taxation levels, in particular direct taxation, while increasing and broadening the base for indirect taxation. The proposal also aims at increasing neutrality and transparency, revising many of the economic distortions introduced over the years through constant changes in tax legislation. Finally, the proposal addressees a variety of issues in tax legislation with important implications for tax administration. These include evasion and avoidance due to legislation complexity, and considerations about tax competition.

4. While the scope of the White Paper is much broader, the recommendations found in this report could help the government achieve some of the objectives set out in the tax reform proposal. This includes broadening tax coverage, and revising tax distortions introduced over the years through constant changes in legislation. For instance, the harmonization with EU taxation directives should provide the opportunity for broadening of the tax base by including agriculture and immovable assets under the VAT's umbrella, and by increasing excise rates on cigarettes, beer and mineral oil. Also, the selective increase in excise duties should open the opportunity to abolish several excise taxes where revenues collected don't cover administrative costs.

5. These changes in tax policy are expected to have important implications for tax administration. Indeed, following EU accession VAT collection on imports from EU countries (which is likely to account for the bulk of imports for domestic consumption) will no longer be collected by the Customs Administration at the border but instead by local tax offices from traders as part of their normal VAT liabilities. This implies a significant increase in the tax administration's workload, since, at present, the Customs Administration collects two-thirds of VAT revenues. Also, this increase in workload will compound additional demands for automation to register intra-Union transactions and establish a clearing mechanism for cross-border transactions.

6. The report is organised as follows. Chapter I reviews needed changes in the Value Added Tax (VAT) legislation and administration. These are among the most drastic changes, since it includes changes in the taxation of the agricultural sector and the taxation of immovable property, as well as border tax adjustments for the VAT. Chapter II considers measures to harmonise excises taxes on tobacco products, alcoholic beverages and mineral oils, and discusses the extensive administrative arrangements for these harmonised excise taxes. Chapter III examines options for harmonisation of taxes on capital income. This includes measures to mitigate the double taxation of dividend income, a more uniform taxation of capital income, and minimising some of the discriminatory effects of the corporate tax on inbound and outbound investment. The rest of this executive summary goes over the main points of each chapter.

A. Value Added Tax

7. Poland's VAT is modeled on the EU's Sixth Directive. It is levied at a standard rate of 22 percent, against an average of 19.3 percent in the EU. The main difference is the VAT exemption of agricultural products, and a zero rate that applies to a wide range of products and services. These include health products, new apartments, and agricultural inputs. A lower rate of 7 percent also applies to food products, medicines, various children's goods, essential building materials and passenger transportation.

8. Bringing agricultural products under the VAT's umbrella is the single most important challenge in complying with EU taxation directives. At present, agricultural production and trade are exempted, while a zero rate applies to feed, seed, fertiliser, machinery and equipment. The solution for taxing agriculture, yet not saddle the sector with additional tax obligations, is to adopt the Sixth's Directive's flat scheme under which purchasers are granted a tax credit equal to the average tax on farm inputs. In this case, feed, seed and fertiliser could be taxed at the lower rate, but machinery and equipment will need to be taxed at the standard rate.

9. The other areas where the VAT code will need to be modified to comply with EU indirect taxation directives include: immovable property, building materials, second hand goods, and the services provided by travel agents. The main recommendations are the following:

- Immovable property. Immovable property will need to be taxed more even-handedly to comply with EU requirements. New apartments will need to be taxed at the standard rate of 22 percent, rather than the current zero rate. The same applies to essential building materials and construction services that are currently taxed at the lower rate of 7 percent. Poland, however, should try to obtain derogation for the full taxation of the lease and sale of commercial property, since these are, in principle, exempted under the Sixth Directive.

- Stamp duties. Abolishing the anachronistic stamp duties might offset the increase in the VAT on immovable property. While this move would have important distributional implications, since the VAT revenue on immovable property would accrue to the central government, and the stamp duty is a local government revenue, it can still be accomplished for efficiency considerations by reassigning this increase in VAT collection to local governments.

- VAT exemption threshold for small businesses. In broadening the VAT tax base, Poland should aim at maintaining or increasing its small-business exemption. The present exemption threshold of PZl 80,000 is above the EUR 5,000 threshold defined in the Sixth Directive but not out of line with other EU member countries. The thresholds in countries with arguably stronger administrative capacity, such as France, Germany and the United Kingdom are much higher, while Austria recently obtained a derogation for a threshold of EUR 35,000 upon acceding to the EU.

10. In revising the tax rate structure, the Polish authorities need to avoid establishing a very broad range of rates, and setting lower than standard rates on certain goods and services to mitigate the VAT burden on the poor. The experience suggests that establishing a very broad range of rates only increases the costs of compliance, especially for small business, and raises the government's administrative costs of enforcing the tax legislation. Also, setting lower than standard rates for certain goods and services tends to be regressive, subsidising the consumption of higher income groups. The report recommends therefore that Poland tax all food products, whether for human or animal consumption, at the lower rate rather than be zero-rated. Other goods and services that should be taxed at the lower rate rather than be zero rated include feed, seed, fertiliser, pharmaceutical products, medicines, aids for the handicapped, newspapers, books, children's goods and building materials.

11. The most important administrative obligation associated with Poland's accession concerns the abolition of customs posts at borders with EU member states. The collection of VAT on imports will have to be shifted inland under the so-called transitional regime. To coordinate the VAT with other member states, EU-wide VAT identification numbers will need to be established. This in turn requires that Poland set up a VIES (VAT Information Exchange System) and a liaison office that informs seller VAT identification number of their clients in the country.

B. Excises

12. The revenue from major excise taxes (cigarettes, alcohol, mineral oil, and automobiles) accounts for about 10 percent of total tax revenues or 4 percent of GDP. Action in three fronts is required to bring these taxes in line with EU directives. First, the excise tax on cigarettes will need to include an ad valorem duty, in addition to the existing specific rate. This will double the tax receipts per pack of cigarettes. The report recommends therefore that, on revenue and social grounds, the specific excise rate be kept as close to the permissible limit of 55 percent of the total tax on cigarettes. Second, the excise tax on mineral oil will need to be increased substantially, with excise duties on leaded fuel increasing by 15 percent, and by 5 percent for leaded fuel. Also, large increases in excise taxes are required for gas oil, LPG, methane and kerosene. Third, the basis for the excise duty on beer will need to shift from hl/degrees of wort to hl/degrees of alcohol of finished product. This however is a relatively minor change.

13. The harmonisation of excise taxes should provide the opportunity for abolishing a number of excises on various luxury products, plastics, gambling equipment, salt and chewing gum. These taxes contribute with only 2 percent of total excise revenue, and are truly nuisance levies. The coverage of these excises is narrow, failing to achieve the desired progressivity. They only increase therefore administration and compliance costs. In doing away with these taxes however the Polish authorities need to find ways of levying higher taxes on pleasure boats, passenger cars, gambling, and hunting.

14. The implementation of this harmonised excise tax legislation will require at least two administrative adjustments. The abolition of border controls will require Poland to join the EU-wide warehousing system, allowing excisable goods to move from one member state to another member state under excise duty suspension arrangements. Also, various definitions and interpretations of the concepts of taxable persons, taxable and exempt supplies, time of supply and taxable value will need to be incorporated into the Polish excise legislation.

C. Taxes on Capital Income

15. The report identifies four main issues concerning the harmonisation of taxes on capital income: (i) options to mitigate the double taxation of distributed dividends at the shareholders' level; (ii) distortions arising from differences between the effective corporate income tax (CIT) and personal income tax (PIT) rates on capital income; (iii) the directives designed to reduce tax costs on operations between affiliated corporations; and (iv) tax incentives that could come under scrutiny during accession negotiations.

16. Poland levies a corporate income tax at the rate of 36 percent, taxing dividend income at a special flat rate of 20 percent to provide relief for double taxation of distributed profits. This flat-rate system is similar to the one found in the Czech Republic, Hungary, and 6 EU member

states (Austria, Belgium, Denmark, Sweden, Greece, and Luxembourg). The alternative to the flat rate is the imputation system adopted by some EU member states, including France, Germany, Italy and the United Kingdom. The imputation system, however, has much higher administrative costs, since it implies a complicated system of tax credits. The report recommends therefore that Poland keep its flat-rate system of dividend relief.

17. The second issue concerns the effective tax rates on various forms of capital income. In Poland, these tax rates differ widely from each other and from the ordinary personal income tax. The corporate income tax on retained profits is 36 percent. There is no on capital gains. The on distributed profits is 46.6 percent, and the on interest income is 20 percent. Finally the top rate for the personal income tax is 48 percent. The effective rate depends however on several important distinctions: (i) the legal form in which the investment takes place (corporate or non-corporate); (ii) the choice of financing of the investment (equity or debt), since interest payments are deducible, but dividends are not; (iii) the tax status of the domestic recipient of the return (taxable or exempt); and (iv) the place of residence of the recipient of the return (resident or non-resident). The differences in effective rates distort the economic behavior of entrepreneurs. In particular, they discriminate against small enterprises, stimulate debt finance and favour foreign and institutional investors over domestic individual investors. It is recommended that, in due course, Poland study the corporate tax systems of Finland and Norway that tax all capital income once and only once at the same flat rate.

18. The third and the fourth issues are, respectively, that upon joining the EU, Poland will have to incorporate the Parent-Subsidiary Directive, the Merger Directive in its tax legislation, and become a signatory to the Arbitration Convention. These directives have important implications for Poland future tax legislation. For instance, once Poland harmonises its legislation with the Parent-Subsidiary Directive, it would make little sense to lower the corporate income tax rate much below the rate prevailing in Poland's major treaty countries. Also, participation in the Arbitration Convention should help foreign investors concerned about double taxation in cases of transfer-pricing adjustments. Finally, Poland's tax incentive legislation will have to be reviewed in light of the EU's prohibition on state aids and the recently issued Code of Conduct for Business Taxation.

D. Tax Administration

19. These changes in tax policy are expected to have important direct implications for tax administration. EU accession requires a level of compliance consistent with compliance levels in EU-member countries. In addition, economic integration adds specific supranational tasks to the administrative activities. Tax arbitrage based on non-compliance is not admissible and, thus, the key importance of tax administration in the process of integration. Poland does not have a sustainable tax administration yet. To achieve a tax administration operation compatible with EU requirements is perhaps the most important task in the immediate future. This is a major managerial challenge that should include as term of reference the EU accession supranational requirements explained below.

20. The first and most obvious change in tax administration is that, following EU accession, VAT collection on imports from EU countries (which is likely to account for the bulk of imports for domestic consumption) will no longer be collected by the Customs Administration at the border but instead by local tax offices from traders as part of their normal VAT liabilities. This

implies a significant increase in the tax administration's workload, since, at present, the Customs Administration collects two-thirds of VAT revenues.

21. This increase in workload will be compounded by additional demands to set up a system to exchange information on VAT and excise tax obligations, and authorize and control the operations of tax warehouses. These obligations can only be met if the registration of intra-Union transactions is fully automated. Every taxable person will need to be issued an EU-wide applicable VAT-identification number. This VAT identification number must be listed on the bills of sales between parties to intra-Union transactions. Taxable persons then report quarterly on their intra-Union transactions, allowing the various VAT administrations to match intra-Union supplies and acquisitions by cross-checking the identification numbers and the amounts reported.

22. To control the validity of the VAT-identification numbers, Poland will need to establish a central liaison office that can inform sellers of the number of their clients in the country. Obviously, language training is essential to ensure the proper functioning of this office. The central liaison office will also have a role in informing traders of the type of invoice that has to be issued for each client, who may be a taxable person, a non-taxable person, residing in the country, in another member state or in a third country. Like in other member states, on-site review of procedures (through FISCALIS) will be essential to acquire the basic skills to run the liaison office. Indeed, long before the actual accession to the EU, it would be necessary to set up a hotline where information on the new rules can be obtained.

23. Finally, under the so-called horizontal directive, excisable goods should continue to be taxed on a destination basis, that is, in the member state of consumption. This will require the tax administration to authorize and control the operations of tax warehouses. These tax warehouses make it possible to move excisable goods free of excise from one member state to another member state under excise suspension arrangements. Also, a special document must accompany the movement of excisable goods, and the Excise Liaison Office (ELO) needs to administers the "movement verification system", taking care of the exchange of information with other member states.

CHAPTER I: VALUE-ADDED TAX

1. Poland introduced the VAT by Act of January 8, 1993. The tax, lastly amended by Act of November 21, 1996, is modeled on the EU's Sixth Directive. Nevertheless, Poland will have to make some drastic changes to its VAT to meet the EU's accession requirements in the field of taxation. The agricultural sector, currently exempted, will have to be included in the VAT base (albeit on the basis of a simplified scheme). Similarly, immovable property should be taxed more even-handedly and special schemes will have to be introduced for second-hand goods and travel agents. Furthermore, some important changes must be made in the rate structure, because the zero rate and the exemptions which apply to various domestically produced and consumed goods and services will have to be abolished. Last but not least, Poland will have to eliminate the border controls currently in place to impose the border tax adjustments for the VAT (to tax imports and to rebate the tax on exports). Henceforth, these border tax adjustments will have to be shifted to books of account. This chapter analyzes all these aspects in greater detail following a comparative survey of Poland's VAT and the VATs of various EU member states, the Czech Republic and Hungary.

A. Comparative Survey

2. The VAT adopted by Poland that is also the one used in the EU, is a multistage, comprehensive, tax credit type of destination-based, net consumption tax. It is multistage and comprehensive, because the VAT covers all stages of production and distribution and, in principle, includes all goods and services in its base. It is a tax credit type of VAT, because it eliminates cumulative effects by granting registered taxpayers a credit or deduction for the tax paid in respect of purchases from registered suppliers against their own tax payable on sales. It is destination-based, because goods and services are taxed in the country of destination or consumption, i.e. Poland, not in the country of origin or production. Finally, the VAT is a net consumption tax, because it purports to confine the tax to goods and services in consumer hands. All other tradable items, including inventories, are held free of tax.

3. As shown in Table 1.1, the Polish VAT is levied at a standard rate of 22 percent compared to a standard rate of, on average, 19.3 percent in the EU. Like most EU member states, Poland also uses lower rates, purportedly to mitigate the VAT burden on lower income groups. The Polish VAT is highly productive of revenue, contributing 17 percent of total tax revenue (inclusive of social security contributions) or 7.3 percent of GDP. By comparison, the VATs in the EU contribute 18 percent of total tax revenue – and 7.3 percent of GDP. In view of the broad exemption for agricultural products, which lowers potential revenue, this indicates that, on the whole, the Polish VAT is effectively administered.

4. Poland levies various reduced rates of VAT, including a zero rate (other than on exports). The zero rate applies to a wide range of products and services, including health products, new apartments, agricultural inputs, and some other items. The lower rate of 7 percent applies to food products, medicines, various children's goods, essential building materials, and passenger transportation. Similar reduced rates are found throughout the EU. Poland's VAT essentially differs from the VATs in the EU, however, in that it exempts a large number of agricultural products. This exemption makes the tax indeterminate in respect of these products. It is unlikely

that the EU will condone the exemptions. Furthermore, it tends to frown upon zero rates on items of domestic consumption.

5. In 1996, the number of registered persons under the Polish VAT was approximately 780.000, indicating a VAT density (inhabitants per registered person) of around 50. This is not unusually high compared with VAT densities in EU member states. The small-business exemption is PZl 80,000, which is the equivalent of US$ 23,600 or EUR 16,700. This exemption is higher than the corresponding exemptions in most EU member states. The relatively high exemption has the advantage that the VAT administration does not have to try and collect VAT from numerous small traders. The amount of revenue forgone should be small, because the exempt traders do pay VAT on their inputs purchased from registered traders. As in the EU, the small-business exemption is optional.

B. The Agricultural Sector

6. Bringing agriculture under the VAT is the single most important EU accession requirement in the field of tax policy for Poland. Agriculture is a highly distinctive feature of the country's economy and society. The sector accounts for 6.1 percent of GDP (down from 11.8 percent in 1989) and 25 percent of total employment. These figures indicate that incomes and productivity in the agricultural sector are low. This is partly attributable to the small size of most farm holdings, which, on average, is only just over 6 hectares. Of further interest is that of 4 million people employed in agriculture, only about a third is reported to have farming as the main source of income. The other two-thirds are part-time farmers, or pensioners with non-farm sources of income, including social security benefits.

7. Perhaps because of the sector's dominant social and economic impact, Poland exempts agricultural production and trade in agricultural products from VAT. Moreover, it zero rates a large number of agricultural inputs, such as feed, seed, fertilizer, machinery and equipment. Beyond that, agricultural extension services are exempted. Optional registration is not available for farmers. Therefore, the entire agricultural sector is zero rated, except for purchases of, say, electricity and building materials. All of these features are at odds with the Sixth Directive, which prescribes that agriculture (defined in Annex A of the Directive to include crop production, stock farming, forestry and fisheries) should be included in the VAT base.

8. Poland's approach raises at least three problems. First, the Sixth Directive does not permit the application of a zero rate or an exemption to agricultural inputs and produce (although Ireland and the United Kingdom obtained derogation when joining the EU). Instead, these items cannot be taxed at a rate lower than 5 percent. According to Article 12(4) of the Directive, the lower rate of tax should be set at such a level that as a rule refunds of excess credits do not have to be made. Second, the exemption of semi-processed farm produce, such as dairy products, honey, eggs, poultry, meat and fish discriminates against imports of similar products which are taxed at the lower rate. Third, it is difficult to zero rate inputs properly if they have various end-uses. While it should be feasible to zero-rate seed, feed, fertilizer and pesticides (although not permitted under the Sixth Directive), it is difficult to monitor the zero rating of farm machinery and equipment. A tractor can indeed be used on the farm, but it can also be employed in a factory or for private purposes. For these reasons, the Directive prescribes that, if so desired, the reduced rate can be applied to farm produce and agricultural inputs for the current production process, but that the standard rate should apply to farm machinery and equipment.

9. Two approaches are available for meeting the EU requirements regarding the taxation of agriculture: (1) full taxation and (2) 'flat-rate' taxation. Under full taxation, agricultural production units would become liable to VAT, just like any other business. The only relief available to these units would be the small-business exemption found in Article 24 of the Sixth Directive. This is the approach adopted by Denmark, the Czech Republic, Sweden and the United Kingdom (Table 1.2). Farmers with sales above the small-business exemption have to file returns and pay VAT. Alternatively, farmers above the threshold but too small to keep adequate accounts may be taxed under a presumptive tax on their turnover without the right to deduct the VAT on their inputs. Presumably, this alternative could apply to farmers whose turnover lies between PZl 190,478 (which is equivalent to the small-business threshold of EUR 5,000 prescribed in the Sixth Directive) and the current small-business exemption of PZl 80,000.

10. In view of the large number of (very) small farming units, however, Poland would be ill advised to follow this approach. The other approach available under Article 25 of the Sixth Directive is the 'flat-rate' scheme, which compensates farmers indirectly for the VAT borne on inputs without requiring them to meet any of the administrative obligations of the VAT. Indirect compensation takes the form of a presumptive tax credit granted to registered purchasers of agricultural products, approximately equal to the tax borne by farmers on their inputs. The purchaser is expected to pass that benefit on to the farmer who is not otherwise involved in the compensation procedure. Under this scheme, it is permitted to apply a reduced rate (not lower than 5 percent) to agricultural inputs, such as feed, seed and fertilizer. It is not allowed, however, to apply the reduced rate to agricultural machinery and equipment. These items attract the standard rate. The presumptive tax credit should be calculated by reference to the common method of calculation found in Annex C of the Sixth Directive.

11. The flat-rate scheme has two variants. Under the variant applied in Austria, Germany, and Hungary (see Table 1.2), as well as Ireland and Luxembourg, farmers add the VAT, calculated at a special rate to their bills of sale. The special rate is expressed as a percentage of sales so that the VAT charged to purchasers of agricultural produce are approximately equal to the VAT on inputs. Hence, farmers do not owe any net VAT to the Government. Under the other variant, the buyer (usually the processor) calculates the special-rate VAT on his purchases of farm produce. He can take a credit for the amount so calculated against the VAT on his sales that he pays to the farmer. This variant, which is the one recommended for Poland, is used in Belgium and the Netherlands, as well as Spain and Lithuania. Different flat-rate compensation percentages may be prescribed for forestry, fisheries, and for various kinds of agricultural activities. Exceptionally, the purchaser of farm produce can be compensated directly by the government if he cannot make use of the special tax credits.

12. Under both indirect compensation schemes, consumers will ultimately pay approximately the same tax as if farmers had been registered. The total amount of compensation is computed on the basis of macro-economic statistics on taxable inputs purchased by farmers falling under the flat-rate scheme. Subsequently, the amount is divided by the total output of all flat-rate farmers. Each farmer is then entitled to receive from the purchaser of his output an amount calculated as the product of his output, expressed, say, in kilograms, and the amount of input VAT calculated per kg of output.

13. Nevertheless, of course, only rough equal treatment is provided. Some farmers may be overcompensated, while other farmers may receive too little compensation. To mitigate the

impact of under-compensation, in all countries using the flat-rate scheme, farmers have the option of registration and payment of tax. This should be advantageous for large farmers and for producers whose output is exported. The option may be of little use to small farmers if the costs of complying with the VAT would be higher than the difference between the VAT on inputs and the amount that is reimbursed under the flat-rate scheme. But then it may be assumed that these small farmers use less input that are subject to VAT or that they sell their produce directly to consumers at the farm gate.

14. On the basis of these considerations, it is recommended that Poland should introduce the flat-rate scheme. Countries applying the scheme have found it to be satisfactory, since it does not introduce any new obligations for farmers. While the cost for farmers will not increase, the price of farm products will increase, however, because Poland cannot apply the zero rate to food products. The zero rate (other than on exports) is not permitted under the Sixth Directive. Food must be taxed at a positive rate, not lower than 5 percent.

C. Other Special Schemes

15. The flat-rate scheme for farmers is one of the four special schemes permitted under the Sixth Directive. The other special schemes, which require little discussion but which Poland will also have to review in connection with its accession to the EU, are for small businesses, second-hand goods, and travel agents.

16. *Small businesses:* To reduce compliance and administrative costs under its VAT, Poland exempts small businesses from the obligation to register and pay VAT. The compliance costs of small businesses, as a percentage of sales, are proportionately much higher than the compliance costs of large businesses. Also, the administrative costs of collecting VAT from small businesses, is relatively high in relation to the additional revenue (net of the VAT on inputs, which is paid anyway) raised from them. Accordingly, Poland has introduced a relatively generous small-business exemption of PZl 80,000, equivalent to EUR 24,000. Optional registration is available, but a minimum registration period of 1 year applies to prevent small businesses from moving in and out of the system at will. Small businesses that choose not to register for the VAT cannot take a tax credit for the tax on their purchases. As a result, this tax increases the cost of their purchases. On the other hand, they do not have to charge VAT on their sales and do not have to keep books of account for VAT purposes.

17. The Sixth Directive prescribes a small-business exemption of only EUR 5,000 or PZl 16,700. The use of this threshold in Poland would possibly double or treble the number of registered VAT-payers. This would put severe strains on the scarce administrative resources available to the Department of Indirect Taxes. The additional revenue, moreover, would be negligible and might well be negative if the VAT administration would break down under the additional workload. Accordingly, it is strongly recommended that Poland seek a derogation from the threshold requirement of the Directive. It might point out that the thresholds in Germany and the United Kingdom are much higher than EUR 5,000. Austria, moreover, obtained a derogation for a threshold of EUR 35,000 upon entering the EU.

18. *Second-hand goods:* Poland has thriving markets for second-hand goods that, having previously been sold to final consumers, return to the taxable trading circuit of the VAT. Motor vehicles, household appliances, various fixtures, works of art, antiques and collectors items are examples of goods that may be offered for resale after having been used by consumers. If these

goods would be taxed on the gross consideration, cumulative effects would occur. After all, the new tax would be in addition to the old tax for which no credit would be given. Thus, without good reasons, the VAT would deter the re-use of goods and would divert the trade in second-hand goods from taxable persons to private channels. In short, specialization would suffer.

19. Presently, Poland essentially ignores the trade in second-hand goods that are exempted from VAT. Previously, this approach was also used in Austria and Germany. The approach has much to recommend when a VAT is newly introduced, because it ignores the old tax under the old product tax regime. Furthermore, a large part of the trade in second-hand goods may not be affected anyway, because it is sold at auction on behalf of private vendors. In the event, only the auctioneer's commission would be subject to VAT as services rendered.

20. Now that more and more second-hand goods will have been taxed under the VAT, the time seems ripe to adopt the approach of the Sixth Directive under which only the gross margin of the registered trader buying second-hand goods for resale is being taxed. The margin is taxed by allowing the purchase price as a deduction from the sale price at the time that second-hand goods are resold by registered dealers. In other words, unlike other goods held in inventory, dealers cannot hold second-hand goods tax-free. Moreover, the dealer cannot pass on the tax on his trade margin, because he is not allowed to issue a tax invoice. On the other hand, any value added by consumers in the case of, say, antiques, is left out of the base. Article 26a, in conjunction with Annex I of the Sixth Directive, applies the margin approach to second-hand goods, works of art, collectors' items and antiques. Special arrangements apply to sales at public auction.

21. *Travel agents:* Poland has no special scheme for travel agents. As a result, Polish travel agents acting in their own name and using the supplies and services of other taxable persons providing travel facilities, may be confronted with foreign VAT on such transactions or, possibly, national VAT. Article 26 of the Sixth Directive also uses a kind of margin approach in taxing travel agents. It stipulates that the VAT should be levied on the margin of travel agents, i.e. on the difference between the payment of the traveler minus the costs of the supplies by other taxable persons for the direct benefit of the traveler. Furthermore, the VAT on the supplies and services of other taxable persons is not deductible. If and in so far the services of the agent relate to activities outside the EU, the agent's margin is zero-rated. The upshot of this arrangement is that the traveler pays the VAT, if any, on the supplies he purchases through his travel agent, at the rate of the country where the supply is subject to VAT. On the other hand, the services of the travel agent, whose value is represented by the agent's margin, is taxable in the country where the agent is established, unless the services relate to travel facilities outside the EU.

22. Nearly as important as the VAT treatment of agriculture is the treatment of immovable property. In most countries, expenditures on housing in the form of rents and rental values of owner-occupied property easily approximate 15 percent of GDP. Obviously, this is too large a sector to be ignored under a broad-based VAT that purports to be as neutral as possible. Immovable property, however, is one of the most difficult areas to deal with under a VAT. Article 13(B) of the Sixth Directive exempts immovable property, with the exception of short-term accommodation, parking space, the letting of permanently installed equipment and machinery, and the hire of safes.

23. In Poland, the construction, repair, renovation, renting, leasing and sale of immovable property are taxable as follows.

- As under the Sixth Directive, the renting of residential buildings is exempt, as is the use of owner-occupied property. Although, ideally, rents and rental values should be taxed, administrative considerations preclude the registration of all renters and owner-occupiers. Accordingly, as a second-best solution, the tax on new housing is taken as a proxy for the capitalized value of the tax that should have been levied on the flow of housing services. In this philosophy, which is followed in all EU member states and other countries with a VAT, sales of used residential property are also exempted. In the EU, Austria used to tax rents, but following its accession to the EU, it had to adopt the approach of the Sixth Directive.

- The exemption approach to the use or sale of residential property assumes that newly created residential property is fully taxed. Poland deviates from this philosophy by zero rating new apartments, but taxing dwellings not being apartments at the lower-than-standard rate of 7 percent. Presumably, the assumption is that lower-income groups generally live in apartments, but not the better off. In the EU, Ireland and the United Kingdom zero-rate the construction of new residential properties, but all other member states tax new housing at the standard rate, as required under the Sixth Directive.

- In contrast, the building, leasing and sale of commercial property is fully subject to VAT in Poland at the standard rate. Consequently, increases in the value of commercial building services are also taxed. This approach is superior to the exemption method of the Sixth Directive that exempts commercial property along with residential property, although users of commercial property, subject to specified conditions, can opt for registration and payment of VAT. As a result, cascading effects, inherent to all exemptions, are mitigated but not fully avoided. More importantly, perhaps, increases in the value of commercial building services rendered by exempt buildings are not taxed under the EU approach.

- A long list of essential building materials and appliances is taxable in Poland at the reduced rate of 7 percent, as are construction services. Thus, most repair and maintenance work done to apartments is taxed positively, as is work done to other dwellings. Repair and maintenance work to commercial buildings is also taxed at the lower-than-standard rate, but then time the tax credit for the purchaser of the materials and services would be correspondingly smaller. The application of the reduced rate to specified building materials and fixtures implies, of course, that materials and fixtures not on the list are taxed at the standard rate.

24. This approach to the taxation of the use, repair and sale of immovable property should be a considerable source of administrative complexity and an invitation to evasion. Most obviously, the treatment of immovable property under Poland's VAT is at odds with the Sixth Directive which permits the exemption of the rental or sale of used buildings (subject to optional registration and taxation of users of commercial buildings), but which does not permit the taxation of specified residential buildings at the zero rate. Instead, the Directive prescribes that

all new buildings, as well as all building materials, fixtures and construction services, should be taxed at the standard rate. The only exception is found in Annex H of the Sixth Directive which permits the application of the reduced rate to social housing.

25. Also, the zero rating of new apartments, other than as part of the government's social policy, will become increasingly difficult to justify. In the past, when most housing was allocated by the government, it may have been correct to assume that there was a high correlation between income level and type of housing, but over time this assumption will become less and less realistic. In the future, more and more well-to-do people will buy apartments, because they prefer the amenities that accompany these kinds of dwellings to the chores of doing gardening work, etc. themselves. This implies that the better policy seems to be to tax apartments on a par with other dwellings. Moreover, on the assumption that social housing is subsidized through the budget, the application of the reduced rate to such housing makes little sense. Application of the standard rate (which would cause fewer compliance problems and which would be less prone to evasion) along with an increase in the subsidy would achieve the same result.

26. Finally, the divergent treatment of various construction activities, such as the sale of essential building materials, the rendering of repair and maintenance services, and the creation of new buildings should cause numerous distortions and administrative difficulties. Thus, the delineation of essential from nonessential building materials should induce constructors to misclassify goods or undervalue the input of standard-rated materials. These forms of evasion are extremely difficult to detect. Similarly, constructors will be tempted to divert building materials from apartment building projects, where they attract the zero rate, to building projects for other types of housing.

27. On the basis of these arguments, it is recommended that Poland should tax all activities related to the construction, repair, and maintenance of immovable property at the same rate, i.e. the standard rate. There are no good arguments to apply a lower-than-standard rate. While housing is essential, it is less essential than is food. The Sixth Directive, moreover, does not permit the application of a lower-than-standard rate and it is unlikely that Poland will obtain a derogation similar to Ireland and the United Kingdom. It should be noted that the provision of social housing can be taxed at the reduced rate, but, as argued above, this does not make much sense. Furthermore, it is recommended that Poland should attempt to keep its approach to the taxation of nonresidential property. This approach is superior to the approach of the Sixth Directive, because it does not require a distinction to be made between exempt and taxable nonresidential property and conforms more closely to the neutrality criterion.

28. Attention should also be drawn to the stamp duties that are levied at 5 percent on the value of immovable property at the time of its transfer. By any standard, these duties are an anachronism. They yield very little revenue and inhibit the mobility of people looking for a job or another place of business in another city. Accordingly, it is recommended that the stamp duties should be abolished. The reduction in revenue would be offset by the increase in revenue from applying the VAT to all residential property in accordance with the requirements of the Sixth Directive.

- A case can also be made for taxing building materials and appliances at the standard rate along with all new housing. As Poland continues to grow economically, the demand for housing will rise. Particularly people with high incomes will build new houses. If so, the VAT on building materials and construction services will tend to have a progressive impact.

34. These recommendations are in conformity with Annex H of the Sixth Directive which confines the reduced rate to foodstuffs, water, pharmaceutical products, medical equipment, passenger transportation, books, newspapers, periodicals, admissions, social housing, agricultural inputs (other than machinery or buildings), short-term accommodation, funeral services, medical and dental care. The arguments provided above, however, indicate that it makes eminent sense to limit the application of the reduced rate as much as possible. Progressivity in tax burden distribution is highly important, but the right instrument, i.e. the income tax, should be used to achieve this goal.

E. Intra-Union Transactions: The Debate

35. The most important administrative change that Poland will have to make in the VAT area concerns the abolition of border controls which are currently used to effect border tax adjustments. Border tax adjustments have to be shifted to books of account under the so-called transitional regime. Since the definitive regime is still being discussed in the EU, this section elaborates briefly on the principles underlying the treatment of goods and services entering intra-union trade and trade with third countries.

36. As is well known, the member states of the EU, like Poland, administer their VATs on a destination basis, which requires border tax adjustments. Imports have to be taxed under the VAT to put them on an equivalent footing with domestically produced goods and exports should leave a country free of VAT. In the economics literature, it has been argued that border tax adjustments can be done away with by switching to the origin principle under which exports are taxed and imports enter a country free of VAT. Since imports are exchanged for exports, a tax on exports, it is argued, is equivalent to a tax on imports. Compensating exchange rate and price adjustments should restore the original position. Consequently, real trade (and investment) would not change. In practice, however, the origin principle cannot be administered, because exports must be valued to ensure that all domestic value added is included in the tax base and notional tax credits must be attached to imports to ensure that they are not taxed in domestic stages of production or consumption.

37. The destination principle is clearly the preferred choice for treating goods and services entering inter-EU trade. However, no definitive decision has yet been taken on how border tax adjustments should be effected without border controls, which were abolished in January 1, 1993. For the time being, the EU member states have agreed to tax cross-border trade between registered businesses on a deferred payment basis. Under this method, called the transitional regime, the mechanism of the VAT is relied upon to pick up the tax, previously imposed at the border, at the first inland production or distribution stage. The workings of the deferred payment system are identical to the reverse charge mechanism that Poland applies to services supplied from abroad. As under the reverse charge mechanism, the recipient of goods supplied from abroad is required to apply the VAT to his purchases and to take credit for that VAT, all in the same return. The system is backed up by special rules for cross-border mail order sales (subject

to VAT in the country of destination), cross-border purchases by exempt entities (obliged to file returns and pay VAT), and cross-border car purchases (subject to VAT in the country of use or registration). Last but not least, cross-border purchases by consumers are taxed on an origin basis.

38. In an EU context, however, the deferred payment system breaks the fractional VAT collection process, because intra-EU exports continue to be zero-rated. The EU Commission fears that a consequence of this approach may be that goods will be diverted to the untaxed underground economy. For this reason, the Commission seeks to replace the transitional regime by a 'definitive' regime under which exports by registered traders would be subject to the VAT of the member state of production, but a tax credit for an equivalent amount would be granted to registered importers by the member state of destination. The workings of the destination principle regarding transactions between registered traders would then remain intact if, subsequently, the member state of exportation would transfer the VAT collected on its exports to the member state of importation.

39. The drawback of this "clearing" system, however, is that importing member states have little incentive to check the accuracy of the tax credits claimed by their importers and that exporting member states might be slow in transferring the VAT remitted by their exporters to the importing countries. In other words, importing and exporting member states have an asymmetric interest in the system. In any case, it would not be possible to settle VAT payments on a transaction-by-transaction basis. Instead, some EU-wide form of macro-economic clearing mechanism, based on aggregate consumption statistics, would be required for settling VAT balances of member states that are net importers.

40. For these reasons, so far the member states of the EU have not agreed to introduce the clearing mechanism, but continue to cling to the deferred payment method. In the meantime, the EU Commission has issued a paper that heavily criticizes the differences in the design and operation of the various VAT systems in the EU, in the process casting doubt on the efficacy of the transitional regime. The transitional regime, according to the Commission, has three failings. First, the VATs are unnecessarily complex, as exhibited by differences in the place of supply rules, the rules applicable to non-residents which, although not having a nexus in some states, nonetheless are required to register and pay VAT, and the special schemes for mail-order businesses, motor vehicles, and purchases by exempt bodies. Second, in the Commission's opinion, the present methods of VAT operation rely too much on physical controls. Third, there are wide differences in the application of the common VAT between member states, such as special arrangements, options, temporary or transitional derogation which have not been repealed, shortcomings in transposition and differences in the interpretation of common provisions.

41. The Commission believes that the shortcomings of the current VATs can only be repaired by a complete overhaul of the common VAT system. Its proposal, referred to as the Common System of Value-Added Tax, has five main elements.

- Taxation of goods and services subject to VAT on the basis of the place of business establishment, instead of, as at present, the location of the transaction. Consequently, businesses involved in EU-wide trade would have to deal with the VAT system of one member state only.

Table 1.1: Comparative review of VATs

		Rates %			Revenue contribution (%)[3]	
Countries	Year of introduction	Standard	Lower[1]	Exemptions[2]	Total Tax revenue	GDP
Poland	1993	22	0/2*/7/17*	X	17.1	7.3
Austria	1973	20	10/12*	-	20.6	8.6
Czech. Rep.	1993	22	5	-	17.1	7.6
Denmark	1967	25	-	-	19.3	10.0
Germany	1968	15	7	-	17.8	7.3
Hungary	1988	25	0*/12	-	21.9	8.6
Netherlands	1969	17.5	6	-	15.8	7.0
Sweden	1969	25	0*/6*/12*	-	17.9	8.7
United Kingdom	1973	17.5	0/8*	-	19.1	6.6
EU Average		19.3			17.7	7.3

Source: Sijbren Cnossen, Global Trends and Issues in Value Added Taxation, International Tax and Public Finance, 5.

1. An asterisk (*) denotes special lower rates which apply to only one or two products.
2. Other than the standard exemptions permitted under the EU's Sixth Directive.
3. Revenue figures pertain to 1995 or 1996 and are for all levels of Government.

Table 1.2: Treatment of Farmers

Country	Type of concession	Optional registration	Treatment of inputs: Seed, feed	Fertiliser, pesticides	Machinery, equipment	Services	Treatment of output
Austria	Flat-rate scheme - agriculture: - other:	Yes	L	S	S	S	L
Czech Rep.	Small-business exemption	Yes	L	S	S	L or S	L
Denmark	Small-business exemption	Yes	S	S	S	S	S
Germany	Flat-rate scheme - agriculture: 11% - forestry: 5%	Yes	L	S	S	S	L
Hungary	Flat-rate scheme - animal husbandry: 7% - other: 12%	Yes	L	S	S	L	L
Netherlands	Flat-rate scheme: 4.5%	Yes	L	L	S	S	L
Sweden	Small-business exemption	Yes	S	S	S	S	S
Poland	Exemption	No	Z or S	L	S	L	Z, L or S
United Kingdom	Small-business exemption	Yes	Z	Z	S	S	Z

Note
S = Normally subject to the standard rate
L = Normally subject to the lower rate
Z = Normally subject to the zero rate
E = Normally exempt
Source: International Bureau of Fiscal Documentation, *Value Added Taxes in Europe* (Amsterdam: loose-leaf).

Table 1.3: Poland, VAT Rates

Exemptions other than standard exemptions (Appendixes 1 en 2)
Semi-processed agricultural products: dairy products, honey, eggs, poultry, meat, fish, cereals, breeding products Horticultural, forestry and hunting products Water Meals sold in canteens and snack bars (not open to the general public) Regenerative and preventive meals Incidental fringe benefits Washing, cleaning Cultural services, sports, films Agricultural, fishing and forestry services (including equipment leasing), except veterinary services Returnable packaging materials Specified legal services, real estate brokers, landscaping R&D activities Artistic handicrafts, works of art, collectors' items Second-hand goods\Municipal street maintenance services Irrigation, construction work Sewage services Camping services for children Municipal passenger transportation, taxis Warehousing Cleaning furnaces and chimneys Funeral services, coffins
Zero rate
Surgical appliances, hearing aids, braille products Newspapers, periodicals, books, maps, scores Printing New Apartments Feed, fertilizers, pesticides, peat Domestically produced agricultural machinery, equipment, tractors, trailers and spare parts (Appendix 3,1) Fishing nets Domestic air services Fire protection equipment
Two percent (Appendix 7)
Basic and supplementary medicines
Seven percent (Appendix 3)
Food products (unless exempted), except soft drinks, confectionery, spices, vinegar, mustard, alcoholic beverages Food services Children's goods, clothing (pun to 11), shoes, cosmetics, school stationery, skates, skis, sledges, bicycles, prams, baby goods, teaching aids, kindergarten equipment, playground facilities, toys, games Pharmaceutical products, medical supplies, lenses, orthopedic and prosthetic products, braille Essential building materials, basic appliances, construction services (Appendix 5) Passenger transportation (except taxis), retreaded tires Musical instruments and accessories Telecommunications Notary and attorney services Drilling services

CHAPTER II: EXCISES

1. Following an overview of the excise system in Poland and the EU requirements on excise taxation, this Chapter discusses the implications of accession regarding the 'harmonized' excises on tobacco products, alcoholic beverages and mineral oils. The extensive administrative arrangements that have to be implemented for the harmonized excises are also briefly described. The Chapter concludes with a brief discussion of the non-harmonized excises.

A. Overview

2. Poland has an intermediate system of excise taxation which covers the usual products related to smoking, drinking and driving, plastics, various luxury goods, as well as the age-old objects of excise taxation, such as salt and playing cards. Table 2.1 lists the various major excises and their revenue importance. Excises contribute nearly 10 percent of total tax revenue or 4 percent of GDP. This is broadly in line with the corresponding averages in the EU, although the composition of the excise receipts differs from that in various EU countries. Nearly 98 percent of total excise receipts, is accounted for by the harmonized excises on tobacco products, alcoholic beverages and mineral oils. As Table 2.1 clearly indicates, the non-harmonized excises on other products yield very little revenue. They can truly be qualified as nuisance taxes, because the cost of collecting and complying with them is extremely high in relation to the small amounts of revenue involved.

3. The excises on tobacco products, alcoholic beverages and mineral oils have been harmonized in the EU. Broadly speaking, minimum rates have been agreed on for uniformly defined products, as well as well as bands for the specific and ad valorem rates applicable to tobacco products. Equally important, uniform procedures have been adopted for the intra-EU movement of excisable products through a system of interconnected warehouses. In the EU, the imposition of non-harmonized excises continues to be allowed, subject to the proviso that they cannot lead to the reinstitution of border controls, i.e. the imposition of compensating excises on goods coming from abroad. This implies that non-harmonized excises discriminate against domestically produced goods. Consequently, they have been abolished by most member states.

4. Specifically, the harmonization of the excises in the EU is based on the following three sets of directives.

- Council Directive 92/12/EEC of 25 February 1992 on the general arrangements for products subject to excise duty and the holding, movement and monitoring of these products. The “horizontal directive” prescribes that excisable products moving under duty-free suspension arrangements between member states, must be accompanied by a special consignor-issued document.

- Three “structure directives” on the harmonization of the structures of the excises which are subject to the general arrangements procedures, i.e. manufactured tobacco (94/74/EEC), alcohol and alcoholic beverages (92/83/EEC), and mineral oils (92/81/EEC).

- Four "rate directives" on the approximation of the rates of duty applicable to cigarettes (92/79/EEC), manufactured tobacco other than cigarettes (92/80/EEC), alcohol and alcoholic beverages (92/84/EEC), and mineral oils (92/82/EEC).

B. Tobacco Products

5. Excises on tobacco can be justified to charge consumer for external costs, borne by non-smokers. Cigarettes smoking is a leading cause of lung cancer, of pulmonary emphysema, and is a major contributing factor to deaths from coronary artery disease. Moreover, smokers cause discomfort and imperil the health of nearby non-smokers and smokers. Hospital costs of treating smoking-related diseases are very high. Often it is alleged that premature deaths from smoking result in government savings on social security and pension payments, but of course this is a fallacy. Such payments are surely not to be considered as linked with negative externalities.

1. Excise rate structure

6. The EU excise rates on cigarettes and other products are shown in Table 2.2, along with the prevailing rates in Poland. Poland relies exclusively on a specific rate, i.e. a fixed amount of excise per quantity of cigarettes. In the EU, however, the ad valorem duty (expressed as a percentage of the retail price) also plays an important role. More specifically, according to the (harmonization) directive, the tax on cigarettes should comprise three elements:

(i) a specific excise, expressed as a fixed amount per 1000 cigarettes. Of particular importance is the fact that the rate directive prescribes a band for the specific rate, which currently is 5-55 percent of the total tax on cigarettes;

(ii) an ad valorem excise, levied at a fixed percentage of the retail price of the most popular price category, also referred to as the reference price; and

(iii) the VAT, also expressed as a percentage of the retail price, inclusive of the tax itself.

7. By definition, the specific excise does not vary with price. The manufacturer cannot influence the amount by changing the factory or trade price. This influence is possible, however, under the ad valorem excise and the VAT which, of course, are identical in effect. (Therefore, only the sum of the ad valorem excise and VAT, also called the ad valorem levy is relevant for the analysis.) According to the decision of the European Council of Economic and Finance Ministers (ECOFIN) of June 24, 1991, the total excise burden (specific and ad valorem) should be at least 57 percent of the retail price, while the VAT rate on cigarettes should be at least 15 percent (13.04 percent, inclusive of VAT).

8. The precise structure of the tobacco excise is an important bone of contention in the EU. Whereas the northern member states have a preference for the specific duty, the southern member states favor the ad valorem duty. A specific rate is more favorable to revenue and more effective in internalizing the harmful effects of smoking. Also, it does not influence the quality of tobacco products and seems to accord better with the aims of the internal market. On the other hand, an ad valorem rate protects the cultivation of inferior tobacco, but implies a less regressive distribution of the excise burden.

9. Table 2.3 presents an overview of taxes on cigarettes in various member states. The table presents some interesting information which is also relevant for the Polish authorities in deciding on the most appropriate rate structure when joining the EU.

10. The total tax burden (T) clusters around 75 percent of the retail price, or 300 percent of the retail price exclusive of tax. Few products are taxed so uniformly highly as cigarettes.

11. In the northern member states, the share of the specific excise in total tax (S) lies close to the upper limit of the agreed band of 5-55 percent. In the southern member states, in contrast, the share of the specific excise is close to the lower limit of 5 percent. The situation with respect to the sum of the ad valorem excise and the VAT is the other way around: on average, 37 percent of the retail price in the northern member states, as opposed to, on average, 68 percent in the southern member states.

12. Approximately equal relative total tax burdens, but large differences in the share of the sum of ad valorem excise and VAT in total tax, imply large differences in multipliers (M), i.e. the ratio of the difference in retail price to the difference in factory price. This multiplier increases the higher is the ad valorem levy. In other words, a small increase in manufacturing costs translates into a much higher increase in retail price. In the northern member states, M clusters around the value 1.9; in the southern member states, M fluctuates around 4.5.

13. In sum, although relative total tax burdens are close to each other, substantial differences occur in the absolute amounts of total tax burdens and retail prices. The northern member states levy, on average, 149 EUR per 1000 cigarettes (of which, 76 EUR from the specific rate) against EUR 75 by the southern member states (of which, EUR 5 from the specific rate). Not surprisingly, retail prices average EUR 194 and EUR 102, respectively.

2. What rate structure should Poland adopt?

14. Currently, Poland taxes cigarettes at a specific rate only. Poland will have to incorporate an ad valorem rate in its rate structure in order to meet EU requirements. However, it is strongly recommended that the country rely mainly on the specific rate in taxing cigarettes, i.e. Poland should aim for the upper range of 55 percent. As pointed out below, the reasons are revenue, proper internalization of external costs, as well as meeting EU competition policies.

15. *Maintaining revenue.* In considering the revenue implications of the choice between the specific and the ad valorem element of the EU excise on cigarettes, it should be noted that, per pack of cigarettes, revenue in the (southern) member states, which prefer the ad valorem rate, is only half of the revenue in the (northern) member states which prefer the specific element of the duty. At first sight, it may be thought that this has nothing to do with the nature of the rate. At a retail price of, for example, PZl 3, a specific rate of PZl 1.50 raises as much revenue as an ad valorem rate of 50 percent. This equality, however, holds only if all characteristics of the product, except volume, are the same and price before tax is determined exogenously. The characteristics of tobacco, however, are not the same nor is there a pure monopoly. It is the interaction between the ad valorem rate and quality with detrimentally affects revenue. In contrast to the specific rate, the ad valorem rate will induce manufacturers to decrease the price of their product by lowering its quality. Not surprisingly, southern member states with high ad

valorem rates market cigarettes of lower quality at lower prices. At a given volume of consumption, this means less revenue for the excise office.

16. A disadvantage of a specific rate is that, unlike an ad valorem rate, its revenue does not fluctuate in tandem with movements in the price level. In case of inflation, the real revenue of a specific rate that is not adjusted will be eroded. To avoid this effect, the specific rate can be adjusted periodically for increases (decreases) in the price index of tobacco or for changes in the general price index. The general price index is favored, because the issue concerns the maintenance of the real level of revenue, not the level which fluctuates with the price of tobacco. Moreover, if the specific rate has been chosen in order to internalize the external costs of smoking, then these costs are obviously more likely to vary with the general price level than with the price of tobacco. Incidentally, logic also dictates the use of the general price index. After all, if the specific rate is indexed for movements in the price index of tobacco, then the result is an ad valorem rate.

17. In passing, it of interest to note that if the Government would solely be interested in revenue, presumably it should wish to keep the retail price as low as possible under a specific regime, so as not to depress sales volume. Under an ad valorem regime, on the other hand, the Government would have an interest in keeping the retail price as high as possible. This suggests that there is a combined rate at which revenue is independent of retail price. This situation occurs if the share of the ad valorem levy in total tax is equal to the price elasticity of demand. If the price elasticity equals 0.5, an empirically derived figure, then the ad valorem rate and the specific rate should each generate one half of revenue.

18. *Paying for social costs.* Furthermore, a specific excise is a better instrument to internalize the external costs of smoking than is an ad valorem levy. After all, a specific excise directly hits the cause of the costs, i.e. tobacco (similar to the spirits excise, which is based on the strength of alcohol). The specific excise has a price effect which cannot be avoided by the manufacturer and the consumer. It is also important to note that a specific excise does not tax other items, such as wrappers, which do not contribute to the generation of external costs and whose value, therefore, should not be included in the excise base. Incidentally, a specific excise, based on the weight of tobacco is a better internalization instrument than is the specific excise prescribed by the EU which is based on the number of cigarettes. A rate which is based on the number of cigarettes also taxes the ingredients, such as the filter, which mitigate the effects of smoking. Interestingly, current excise duties in Poland also discriminate against filter cigarettes - clearly an odd policy if the Government wishes to reduce the harmful effects of smoking.

19. The reason why filterless cigarettes are taxed lower in Poland is, of course, that they are mainly consumed by lower-income groups. In other words, the lower rate reduces the very regressive impact of the excise. It should be emphasized, however, that internalization issues logically take precedence over tax burden distribution issues. (The alcohol content of blood at which the license of a driver is confiscated also is not weighted with the income of the drunken driver.) Finally, an important question is whether the tobacco excise restrains the consumption of tobacco. It should because the price elasticity of cigarettes is less than (-) 1, but higher than 0. In other words, the quantity consumed decreases, albeit less than proportionally, with an excise-induced increase in price (particularly among young smokers).

20. *Meeting EU policies.* Finally, a specific excise accords better with the free competition policy of the EU than does an ad valorem excise. Trade diversion can only be prevented (without resulting in large-scale legal and illegal cross-border purchases and sales of cigarettes) if price differentials are not too large. In fact, while differences in price excluding tax are relatively minor, differences in price including tax are enormous. And, of course, the latter differences determine how advantageous it is to buy cigarettes across the border or to trade cigarettes illegally. To illustrate, Table 2.3 indicates that prices excluding tax range from EUR 59 per thousand in the United Kingdom to EUR 25 in Italy, a difference of EUR 24, or EUR 0.48 per pack of 20 cigarettes. Retail prices, on the other hand, range from EUR 193 in Ireland to EUR 99 in Italy, a spread to the tune of EUR 1.88 per pack.

3. Example of a new rate structure

21. Table 2.4 illustrates the new tobacco excise duty structure compared with the current structure. The calculation is based on the assumption that the most popular price category of cigarettes is sold at PZl 3.20 per pack of 20 cigarettes. The specific excise is PZl 60.6 per thousand pieces or PZl 1.20 per pack. Furthermore, the VAT of 22 percent, which is imposed on the retail price excluding VAT, translates into a tax-inclusive rate of 18.03 percent. Following the alignment of the tobacco excise, it is assumed that the VAT on cigarettes will be reduced to 15 percent (the minimum standard rate in the EU) or 13.04 percent of the retail price. The current trade margin is assumed to be 12 percent of the retail price and to drop to 9 percent under the new regime (which still implies an increase in absolute earnings of the trader).

22. As Table 2.4 shows, the sum of the specific and ad valorem rate is 54 percent of the retail price (not quite enough). Furthermore, the specific element is 50 percent of the total tax. While the ad valorem excise is 20 percent of the retail price.

23. If consumption changes little on account of the imposition of the new excise regime, the table indicates that tax receipts should double per pack of cigarettes following the alignment of the excise duty structure. The increase might be phased in over a number of years. Following the alignment, the retail price of the most popular price category of cigarettes would increase by 50 percent. Nonetheless, this price would still be competitive compared with prices prevailing in, say, Germany and Austria.

C. Alcoholic Beverages

24. The harmful effects of excessive alcohol consumption are also well known. Society must compensate for alcoholics' absenteeism on their jobs and for the damages of social properties caused by violent behavior. Releasing inhibitions, excessive alcohol consumption may bring about homicide by violent acts, cause traffic accidents and industrial accidents. In all countries the revenue collected on the sale of alcoholic beverages is only a fraction of the total social costs caused by excessive consumption.

25. Table 2.5 shows the excise rates on alcoholic beverages in Poland along with the minimum rates prescribed by the EU. Across the board, the duties are much higher in Poland than the minimum rates in the EU, although it should be noted that they are still lower than the rates in most of the neighboring EU member states. In any case, the changes that Poland will have to make in this field are less dramatic than the changes in the tobacco excise. Poland will have to adopt the CN classification, however, and the definitions used in structure Directive

F. Non-Harmonized Excises

34. Excises may also be imposed on nonessential or luxury products considered proxies for taxpaying capacity. The most obvious examples are expensive cosmetics, perfumery, jewelry and furs, but passenger cars and pleasure boats also fall in this category. Table 4.7 shows the luxury products which are subject to excises in Poland. Before the abolition of border controls at the end of 1992, many EU member states also used to subject various luxury items to separate excise duties (Denmark, Sweden) or impose higher-than-standard VAT rates instead (Austria, Belgium, Portugal). Some countries (France, Italy) even employed both approaches. The only notable exceptions to the differentially higher taxation of luxury items were Germany, Luxembourg, and the Netherlands. In the EU, however, all higher-than-standard VAT rates were abolished in 1992. Similarly, with the abolition of border controls for consumer purchases, most member states abolished the separate excises as well.

35. The EU member states realized that the case for luxury excises is weak in industrial countries where there are no major constraints on administrative capacity. If progressivity in the tax burden distribution is desired, it should be achieved through the income taxes which are more comprehensive in coverage and more adaptable to the individual circumstances of the taxpayer. Separate excises should not be used for that purpose for the following reasons.

- Class-differentiated consumption patterns that are helpful in tax design for imparting progressivity have ceased to exist or have become irrelevant. Admittedly, higher income groups often buy more expensive varieties of particular products, but price-related rate structures, indicated to achieve progressivity, cannot be administered properly.
- The coverage of luxury products is extremely narrow, hardly comprising more than one or two percent of consumption expenditures. Consequently, the effect on progressivity or revenue of higher rates on perfumery, cosmetics and fur products is negligible. These excises are truly nuisance levies.

- Separate excises add to the costs of administration and compliance. The definitional refinements that are required to tax luxury items higher usually give rise to numerous, casuistically natured disputes on interpretation that must often be settled before the courts. Audio-visual equipment is an example. Cheap items and spare parts are difficult to exempt and must therefore be taxed along with expensive items.

36. Accordingly, it is strongly recommended that Poland abolish the excises on luxury products. A good case can be made, however, for retaining the purchase excises on passenger cars and pleasure boats. The collection of these excises should be tied to registration requirements based on residence.

37. The excises on plastic products (see Table 4.7) can be justified on environmental grounds. Plastics degrade hardly at all and society incurs costs in removing plastic items from streets, parks, etc. However, the question is whether the excise has an appreciable effect and whether better instruments are available. Experience elsewhere indicates that the effect is hardly measurable. Moreover, imposing higher excises on the raw materials from which plastics are made, i.e. mineral oils, probably is a better way to account for the external costs. Finally, the excises on playing cards (with the usual exemption, in Poland, of playing cards for children!),

salt and chewing gums really are not worth the cost of collection, while the excise on slot machines, roulette tables and hunting rifles should be subsumed by the license fees which are levied in connection with the use of these products.

38. In sum, it is recommended to abolish all non-harmonized excises, but to find alternative ways to levy higher taxes on passenger cars, pleasure boats, gambling and hunting.

Table 2.1: Poland, Excise Duty Receipts, 1997
(in millions of Zloty)

Products	Duty Collections				
	Domestic	Imports	Total	Percent of Total	Percent of GDP
A. Harmonized Duties	**15,379**	**2,144**	**17,523**	**97.8**	**3.9**
1. Tobacco Products	4,521	43	4,564	25.5	1.0
2. Alcoholic Beverages	6.224	153	6,377	35.6	1.4
- Spirits	4,710	81	4,791	26.7	1.1
- Beer	1,177	5	1.181	6.6	0.2
- Wine	338	68	405	2.3	0.1
3. Mineral Oils	4,634	1,1949	6,582	36.7	1.5
B. Non-harmonized Duties	**145**	**251**	**396**	**2.2**	**0.1**
1. Cars	48	138	187	1.0	-
2. Other	96	112	209	1.1	-
C. Total Receipts	**15,524**	**2,395**	**17,919**	**100.0**	**4.0**

Source: Department of Indirect Taxes, Ministry of Finance

Note: Figures may not add due to rounding.

Table 2.2: Poland, Harmonized Excise Duties on Tobacco Products, 1999

EU Classification	Rates in Poland		Minimum EU Rates
	Domestic	Imports	
1. Cigarettes	PLN 92.80-60.60 per 1000 pcs depending on brand origin, filter and length of filter	PLN 92.80 per 1000 pcs	Specific & ad valorem duty at least 57% of retail price of most popular price category
2. Cigars and Cigarillos	97.40 per 1000 pcs	97.40 per 1000 pcs	5% of retail price or EUR 7 per 1000 pcs
3. Smoking Tobacco			
- Fine cut	60%	150%	30% of retail price or EUR 20 per kg
- Other	60%	150%	20% of retail price or EUR 15 per kg

Source: Poland –Ministry of Finance; EU-Directives 95/59/EC, 92/79/EEC and 92/80/EEC

Table 2.5: Poland, Harmonized Excise Duties on Alcohol, 1998

EU Classification		Rates in Poland in Zlotys (EURs)		Minimum EU Rates (in EURs)
Products	CN Code			
		Until August 31	As of September 1st	
1. Spirits (Strength)				
- > 1.2%	2207, 2208	5433 (1393) per hl of pure	5677 (1456) per hl of pure	550 per hl of pure alcohol at 20%C. Reduced rates on small
- > 22%	2204, 2205, 2206			
- potable spirits				
2. Beer				
- > 0.5%	2203, 2206	5.20 (1.33) per hl/degree of wort	5.45 (1.40) per hl/degree of wort	0.75 per hl/degree Plato or 1.87 per hl/degree of alcohol. Reduced rates on small distilleries (200.000 hl per year) not lower than 50% of standard national rate
3. Wine				
- Still Wine	2204, 2205	63-210 (16-54) per hl depending on type of wine: fruit, grape, mead, lee	66-220 (17-56) per hl	0 per hl
- Sparkling wine	2205			0 per hl
4. Other Fermented Beverages		Not separately classified		0 per hl
5. Intermediate Products	2204, 2205, 2206			45 per hl

Sources: Polish Ministry of Finance.

Table 2.6: Poland, Harmonized Excise Duties on Mineral Oils, 1999

EU Classification		Rates in Poland in Zlotys (EURs)		Minimum EU Rates (in EURs)
		Domestic	Imports	
Products	CN Code			
Leaded Petrol	2710-0026/34/36	1476 (378) per ton	1476 (378) per ton	337 per 1000 liters
Unleaded Petrol	2710-0027/29/32	1357 (348) per ton	1357 (348) per ton	287 per 1000 liters
Gas Oil	2710-0069			
- propellant		604-644 (158-169) per ton	604-644 (158-170) per ton	245 per 1000 liters
- stationary motors, tractors		exempt	exempt	10 per 1000 liters
- heating		exempt	exempt	18 per liters
Heavy fuel oil	2700-0074-78	Exempt	exempt	13 per 1000 liters
LPG and methane	2700-0074-78, 2711-2900			
- propellant		90 (24) per 1000 liters	90 (24) per 1000 liters	100 per 1000 kg
- stationary motors, tractors		exempt	exempt	36 per 1000 kg
- heating		exempt	exempt	0 per 1000 kg
Kerosene	2710-0051/55			
- propellant		exempt	exempt	245 per 1000 liters
- stationary motors, tractors		exempt	exempt	18 per 1000 liters
- heating		exempt	exempt	0 per 1000 liters

Sources: Poland – Ministry of Finance. EU-Directive 92/82/EEC

Table 2.7: Poland, Non-harmonised Excises, 1998

Products	Rates (percent)	
	Domestic	Imports
1. Passenger cars (>EUR 7,500)	10	15
2. Pleasure boats (>EUR 2,400)	15-20	25
3. Luxury products		
- perfumery, cosmetics, glues	20	25
- fur skins	20	25
- fur garments	15	17.7
- audio-visual equipment	10	11.1
4. Plastic products	zloty/pc.	zloty/pc.
- cans, boxes	0.01	0.01
- jars	0.02	0.02
- bottles	0.03/0.05	0.03/0.05
- canisters	0.40	0.40
- balloons	0.50	0.50
- cases, crates	0.75	0.75
- barrels	5.00	5.00
- drums	6.00	6.00
- vials, tubes	1.00/1000	1.00/1000
5. Gambling and hunting equipment		
- playing cards	25	33.3
- slot machines, roulette tables	15	17.7
- hunting rifles, gas weapons	20	25
6. Salt	7-15	17.7
7. Chewing gum	20	25

Source: Appendixes 1 and 3 of Finance Minister's Ordinance, 5 January, 1998.

CHAPTER III: TAXES ON CAPITAL INCOME

1. In the field of direct taxes, tax harmonization and coordination in the EU has not proceeded as far as in the field of indirect taxes. The treatment of cross-border dividend payments by subsidiaries to parent companies, cross-border mergers, transfer pricing issues, and the exchange of information are the only areas in which some progress has been made. The major issues, i.e. the tax entitlement rules, the structure of the corporate income tax (CT), and the rules for determining taxable profits so far have not been the subject of joint decision-making by EU member states. This does not mean, of course, that taxes on corporate profits and other capital income in anyone member state are not profoundly affected by what goes on elsewhere in the EU and, indeed, the world. This Chapter starts therefore by placing Poland's CT in a broader perspective comparing it with the CTS in various EU member states. Subsequently, the effective tax rates on various forms of capital income are calculated and the ensuing distortions discussed. More can be done to tax capital income more even-handedly. The Chapter concludes with an overview of the measures that the EU has taken to mitigate some of the discriminatory effects of national CTS on inbound and outbound investment.

A. Comparative Survey of Corporate Tax Systems

2. As indicated in Table 3.1, Poland's 34 percent CT rate is not out of line with the rates in EU member states. Furthermore, it will become even more competitive in case the government's proposal to reduce the CT rate to 28% in 2000, and then gradually to 22% by 2003, is approved by Parliament. The table also shows that Poland's CT is not a major source of revenue. In 1995, it contributed 7.7 percent of total tax revenue or 3.3 percent of GDP, when total tax revenue was 42.7 percent of GDP. Nonetheless, Poland's CT is more productive of revenue than the CT systems of the EU which, on average, contributed 6.9 percent to total tax revenue or 2.9 percent of GDP. In Poland and elsewhere, the yield of the CT, of course, depends not only on the rate, the method and degree of dividend relief, but also on the extent of incorporation. Without further analysis, a comparison of inter-country yields, therefore, makes little sense. Even if the CT does not yield much revenue, however, corporations are still subjected to all its complexities, attendant compliance costs, and distortions.

3. In interpreting the data in Table 3.1, it should be noted that CT systems are commonly distinguished depending on whether and to what extent they are integrated with the personal income tax (PT) of shareholders. In the absence of some form of integration, corporate equity income would be taxed twice: once at the corporate level and, if distributed, again at the shareholder level. If, in Poland, corporations would be regarded as entities entirely separate from their shareholders and taxed as such (classical system), distributed corporate profits would be taxed at an effective rate of 36 percent CT plus 48 percent PT (assuming that the dividend falls in the highest rate bracket) over 64 percent of profits net of CT, resulting in a total effective rate of 66.7 percent. Prima facie, this should distort financing and investment decisions in favor of debt and risk-averse projects.

4. Poland has chosen to mitigate the double taxation of distributed profits at shareholder level. Dividend relief is provided by taxing dividend income at a special, flat, PT rate, lower than the top PT rate. The special PT rate can be imposed at the level of the shareholder, but it can also be levied as a final withholding tax at corporate level and this is what Poland does. At corporate level profits are taxed at 36 percent and upon distribution dividends are taxed at a flat

rate of 20 percent. Thus, the total effective tax rate on distributed profits is reduced to 48.8 percent, i.e. 36 percent plus 20 percent of profits net of CT. As shown in Table 3.1, Poland has this system in common with the Czech Republic, Hungary, as well as 6 EU member states. The flat rate is positive in Austria, Belgium, Denmark and Sweden, zero in Greece (because dividend income is exempted at shareholder level), and half the ordinary PT rate in Luxembourg (because only half of dividend income has to be included in taxable income).

5. Most other EU member states also mitigate the double tax at shareholder level, but prefer to effect his through an imputation system. Under such a system, dividend income is grossed up (either partially or fully) by the CT which can be attributed to it. Subsequently, the grossed-up amount is included in the taxable income of the receiving shareholder (and thus taxed at his marginal rate). The shareholder is given however a tax credit for the CT with which the net dividend was grossed-up in the first place. As shown in Table 3.1, a full or partial imputation system is found in 6 member states, including the largest states, France, Germany, Italy and the United Kingdom, which together account for some 80 percent of the EU's total product. Finland provides full relief; other member states with imputation systems provide less than full relief. The relief is also less than 100 percent in Germany and Italy if the local, non-creditable, CT is taken into account. In passing, it may be noted that Portugal and Spain have crude forms of imputation systems. Portugal permits a credit for the underlying CT without gross-up of the net dividend and Spain does so without ensuring that the underlying CT has indeed been levied.

6. Which system is the preferred choice? To begin with, imputation systems systematically reduce the double CT/PT burden on profit distributions; in other words, the relief is proportionate to the marginal PT rates of shareholders. Under the flat-rate schemes, on the other hand, dividend income is de facto taxed at a proportional rate (as indicated above, in Poland this rate is 48.8 percent). Consequently, the relief tends to be distributed regressively with respect to income: higher-income groups are under-taxed when the CT+PT on dividend income is compared with their marginal PT rate, but lower-income groups are overtaxed. This regressive impact can be mitigated, as is done in Austria and Belgium, but not eliminated, by permitting low-income bracket PT-payers, whose marginal ordinary PT rate is lower than the special rate, to opt for classical double taxation of their dividend income at shareholder level (with credit for the PT withheld at source). To reduce the regressive impact of the flat rate, Denmark taxes small amounts of dividend income at a lower PT rate of 25 percent (compared with the ordinary flat rate of 40 percent) on the assumption that the amount of dividend income received by lower income groups tends to be smaller. Also, a drawback of the flat-rate system is that dividends distributed out of exempt profits are taxed only at the special PT rate.

7. An imputation system does not have these shortcomings, but it tends to be more complicated than a flat-rate scheme. First, a proper imputation system requires a compensatory tax at corporate level on dividends paid out of earnings that are wholly or partially exempt from corporate income tax. Consequently, rules must be provided for the sequence in which profits are presumed to be distributed. Generally, profits that have been taxed at the highest rate are assumed to be distributed first. Second provision must be made for the treatment of dividends received by domestic corporate portfolio shareholders. Should they also be entitled to a tax credit for the underlying CT against their own CT, or should inter-company dividends be exempted (with the necessity of providing for a pass-through to individual shareholders at a later stage)? Third, foreign shareholders must be dealt with. International practice is to extend imputation

credits to portfolio shareholders but not with respect to foreign direct investments. Whatever the case, this implies that double tax treaties have to be renegotiated—always a tedious exercise.

8. In evaluating the choice of dividend relief system at shareholder level, the effect on foreign investors should also be considered. In this connection, it should be pointed out that in small open economies, the prices of shares (and other financial assets) are largely determined by foreign investors. Hence, any increase in the CT on dividend income for foreign shareholders under, say, imputation or flat-rate systems will be reflected in lower share prices which tends to increase the corporate cost of capital. Consequently, investment in the corporate sector is dampened. Moreover, the relative preference of domestic investors for shares over bonds increases. In a small open economy, only double tax relief at the corporate level or, more directly, investment incentives at corporate level, would lower the cost of capital of domestic investment relative to foreign investment, because foreign shareholders would also benefit from the relief.

9. In view of these considerations, it is recommended that, for the time being, Poland should stick to the flat-rate system, provided it ensures that corporate profits are taxed comprehensively. A change to the imputation system is not advisable, neither is an increase in the flat rate on dividend income. Poland should follow developments in the field of capital income taxation elsewhere rather than blaze new trails itself. In the long-term, as argued more closely below, Poland should probably take a closer look at the dual income tax system in the Nordic countries under which all capital income is taxed once and only once at a single, uniform (CT) rate.

B. Effective Tax Rates on Capital Income

10. As the previous section implied, CT and PT should be taken into account in the calculation of effective tax rates on the return of an investment (financed by equity and/or debt). Although corporations are separate legal entities, both taxes enter the wedge between the before-tax return (the financing costs) of a corporation and the after-tax return (the savings premium) that must be paid to the shareholder or debt-holder to induce that person to put up his or her capital. At the margin, this wedge determines whether an investment will or will not be undertaken.

11. Table 3.2 indicates that effective total tax rates on various forms of corporate earnings differ widely in Poland and in most other countries. Retained profits (the return on old equity) are taxed at 36 percent, distributed profits (the return on new equity) are taxed at nearly 49 percent, interest (the return on debt) is taxed at 20 percent, and the return on the capital invested in a proprietorship or partnership is taxed at a rate that may reach 48 percent. More generally, the overall effective tax rate on the undifferentiated return of an investment, depends on the legal form in which the investment takes place (the corporate form or the non-corporate form), the choice of financing of the investment (equity or debt—interest being deductible, but not dividends), the dividend policy of the corporation (profit retention or distribution), the tax status of the domestic recipient of the return (taxable or exempt, such as pension funds), and the place of residence of the recipient of the return (in the absence of a withholding tax, nonresident debt-holders are not subject to the national CT or PT).

12. As a result of these arrangements, effective tax rates on the return of one and the same investment may range from 0 percent to 49 percent in Poland. By the same token, required

returns may be expected to vary. The corporation, for instance, which has to pay a PT-liable investor an after-tax return of 6 percent, must earn a before-tax return on the investment of 18 percent {6/(1 – 0.36)(1 –0.48)} if it is obliged to finance the investment with equity and all profits are distributed. However, the required before-tax return drops to 12 percent {6/1 – 0.48)} if the corporation is able to attract debt provided by a PT-liable investor, and to 9 percent {6/(1 – 0.36)} if the investment can be paid for out of retained profits. Last but not least, a before-tax return of 6 percent is sufficient if the loan capital is put up by an exempt pension fund or a (nontaxable) non-resident debt-holder.

13. As Table 3.2 indicates, similar divergent effective tax rates are found in other countries. Indeed, Poland does a better job in taxing capital income even-handedly than most EU member states. Its system of capital income taxation closely resembles that of Austria which also imposes a flat PT-rate on dividend income and which has a moderate final withholding tax on interest. Ireland and the United Kingdom are other countries which tax capital income more or less at the same effective CT/PT rate. Clearly the best approach is found in Finland which taxes all capital income once and only once at the CT=PT-rate of 28 percent.

14. In considering the effects on investment of the CT and the PT, it should be noted that the absolute size of the CT/PT wedge reduces the incentive to invest because it raises capital costs. This is the price that must inevitably be paid if it is considered desirable to tax the return on an investment. Such is not the case, however, with respect to differences in the size of wedge. By letting the size of the wedge depend on the business form, the source of financing, the corporation's dividend policy, and the tax regime of the recipient of the return, the CT/PT system violates one of the market's most fundamental rules, which prescribes that economic considerations instead of tax motives should determine the behavior of entrepreneurs.

15. Specifically, the following forms of distortion and discrimination should be noted.

(a) If, as in Poland, the CT+PT on profit distributions is higher than the CT (plus capital gains tax, if any) on retained profits, then dividend-payout and investment decisions will be distorted. Corporations will be induced to retain profits which will not become available on the capital market and will not be able to seek their most profitable return. To be sure, the tax literature has questioned the effect of the double tax on mature firms. Under the 'new view,' it is argued that the potential PT on dividends is capitalized in lower share prices. Hence, the PT on dividend income does not affect the effective rate of taxation on investments financed with retained profits. Most empirical studies, however, tend to support the 'traditional view.' They show that dividend-payout ratios respond to changes in the CT/PT on distributed profits. Hence, profits cannot be retained without raising the cost of capital. Whatever view is adopted, taxing dividends twice always harms investment by new and emerging firms, which have to rely on new share issues to provide for their equity needs. The discrimination of new equity under Poland's CT, moreover, contributes to the concentration of market power by discouraging the entry of new corporations.

(b) If, as in Poland, the PT on interest is lower than the CT (plus capital gains tax, if any) on retained profits and/or lower than the CT+PT on profit distributions, then debt financing will be stimulated and corporations unable to obtain debt (typically,

fledgling enterprises) will be discriminated against. This effect will be exacerbated by the growing internationalization and liberalization of capital markets, because it increases opportunities for evading or avoiding the PT (or the CT) on interest income. Whereas retained earnings are taxed at source through the CT, the tax authorities cannot be sure that cross-border interest payments are reported and taxed. In addition, the tax-exempt status of institutional investors, such as pension funds and life insurance companies, facilitates the preferential tax treatment of the return on debt. On balance, this means that little interest is being taxed. Although Table 3.2 shows positive PT rates on interest, generally, interest withholding rates are reduced to 0 percent (or at least 5 percent) when paid to residents in treaty countries. In short, the favorable tax treatment of interest distorts economic efficiency and horizontal equity by stimulating debt finance and by favoring foreign and institutional investors over domestic individual investors.

16. In view of the growing mobility of capital and increased opportunities for tax arbitrage, some countries, particularly Finland (and Norway) have radically changed the treatment of various forms of corporate earnings and other types of capital income. Finland has transformed its CT and PT into a dual income tax, under which capital income is treated separately for tax purposes from labor income. All capital income is taxed at a uniform, flat rate, i.e. the CT rate (Table 3.2), while labor income continues to be taxed at progressive rates. Double taxation of equity income is prevented through full imputation. Alternatively, and more in line with Poland's present CT, dividend income might be exempted in the hands of shareholders. Interest payments should be subject to a source withholding tax, which would not be refunded or reduced when the interest would be paid to exempt entities or non-residents. In short, basically, all capital income would be taxed once and only once at source at the same, proportional CT rate.

17. The proportional, in rem taxation of all corporate earnings would obviate the need for thin capitalization rules. Manipulation of transfer prices by transnational corporations would still be possible to influence the allocation of profits (and thus CT revenues) between countries, but a minimum CT rate of 30 percent, as proposed by the Ruling Committee, for instance, should reduce the incentive for this form of tax arbitrage. In this connection, it should be emphasized that approximation of statutory tax rates seems more important than approximation of effective tax rates. Differences in statutory rates are important for exploiting opportunities for tax avoidance (transfer prices, thin capitalization). Effective tax rates, on the other hand, affect the determination of taxable profits (depreciation, inventory valuation) with respect to less mobile physical capital. Tolerable differences in effective tax rates would leave countries more tax independence.

18. The uniform taxation of all capital income, regardless of source (debt or equity, corporate or non-corporate business form) or by whom received (resident individuals, exempt entities, nonresidents) is a goal worth pursuing by Poland. While much more can be done in the domestic context, such as lowering the CT/PT burden on distributed profits and increasing the tax on capital gains and interest, it would not be advisable, however, to raise the withholding rate on interest payments to nonresidents without EU-wide agreement. In fact, Finland also does not impose a withholding tax on interest paid to residents in major treaty countries for fear that it would discourage inbound investment.

19. The foregoing analysis provides a context within which domestic and international capital income tax issues can be discussed and decided on by Poland. The main ingredients are the following:

- the application of the CT rate to all capital income, broadly defined and including capital gains;

- the elimination of all forms of double taxation, preferably by taxing capital income at source and exempting it at the level of the recipient; and

- the imposition of source withholding taxes on all corporate earnings, including interest and royalties, but only after agreement has been reached with Poland's main capital suppliers.

C. Tax Harmonization

20. The tax harmonisation measures of the EU are mainly concerned with the promotion of cross-frontier cooperation between enterprises. The aim is to remove the influences the tax systems may have on locational decisions, as well as, more positively, to promote EU-wide cooperation between industrial enterprises. The legal basis for tax harmonization is found in Articles 100 and 101 of the Rome Treaty, as amended, that prescribes approximation of direct taxes, among others, as directly affect the functioning of the internal market. The directive is the instrument and the Council has to act unanimously. In this context, the Parent-Subsidiary Directive and the Merger Directive have been adopted. In addition, the Arbitration Convention has been adopted, but this measure is based on Article 220, which requires member state to enter into negotiations with each other for the purposes of abolishing double taxation.

1. Parent-Subsidiary Directive (90/435/EEC)

21. The aim of the parent-subsidiary directive is to reduce the tax costs of cross-border operations between affiliated corporations, called parent-subsidiary relations. Double taxation would occur if the profits of a subsidiary company would be taxed again in the source country upon distribution to the parent company or if the dividend would be taxed in the resident country of the parent company. Accordingly, the directive prescribes that no withholding tax can be levied on dividends paid to parent companies situated in another member state. In addition, the country of the parent must grant relief from double taxation, either by exempting dividends received from the subsidiary company or by granting a foreign tax credit for the underlying corporate income tax paid by the subsidiary. A parent-subsidiary relationship exists if the parent company holds at least 25 percent of the capital of the subsidiary company, but member states can relax this criterion. The directive applies only to payments between companies (that take one of the forms listed in an annex) that are considered to be resident in the member state in question (to be determined according to the laws of the state from whose taxes exemption or relief is being claimed), and that are subject to one of the corporate income taxes listed in the directive without the possibility of an option or of being exempted.

22. The directive implies that dividends, called, somewhat more widely, distributions of profits (in other words, not management fees or charges for services), between related companies can flow freely throughout the EU, reducing the need for treaty shopping and re-routing profits

within the EU within groups of companies. This should reduce tax competition between member states for holding companies and intermediate companies of multinational groups. At the same time groups of companies having their top holding outside the EU will find it easier to locate their Euroholding in a member state which exempts both incoming dividends and capital gains on substantial holdings and which does not levy a withholding tax on outgoing dividends to third countries.

23. Poland will have to incorporate the parent-subsidiary directive in its corporate income tax law. The implications are that it will have to abolish the 5 percent withholding tax that it still levies on dividends paid by Polish subsidiaries to parent companies in most EU member states. This should benefit parent companies located in EU member states which exempt foreign dividends from tax, but not parent companies whose countries apply the indirect tax credit method and whose corporate tax rate is higher than the Polish rate. After all, these countries will simply have to permit a lower tax credit and, in effect, will collect the withholding tax which Poland has abolished. In this connection, it is highly important that Poland give due consideration to the level of its corporate income tax rate. It makes no sense to lower this rate much below the rates prevailing in the EU member states which invest in Poland. Since Poland also applies the indirect tax credit method, the absence of withholding taxes in EU member states will have little consequence if its corporate tax rate is the same or lower as the rates in those member states.

2. Merger Directive (90/434/EEC)

24. The principal aim of the Merger Directive is to remove the tax costs of establishing cross-frontier mergers. These costs are caused, among others, by the taxation of capital gains when the assets of a company in one member state are transferred to a company in another member state. Most member states provide relief from immediate taxation in the case of corporate reorganization of domestic companies. In the event, potential capital gains on assets transferred to other companies can be rolled over so that the immediate tax liability is deferred. Before the directive, however, this had not been possible for transfers of assets to non-resident corporations, because member states feared that the potential tax would be deferred indefinitely or that it would be impossible to recover the associated tax liability. Essentially the directive provides a similar concession for cross-border mergers, while preserving the ability of the member state of the transferring company to impose its tax in the event of any subsequent disposal of the assets transferred.

25. The scope of the directive is rather limited, however, since it applies only to mergers, divisions, transfers of assets and exchange of shares in which corporations of two or more member states are involved. On the other hand, the directive extends the relief to the recapture of tax-deductible reserves and to the carry forward of losses to the corporation acquiring the assets. Moreover, it is not clear whether the directive extends to the situation in which a corporation increases its controlling interest in another corporation. Furthermore, there is some doubt whether the exchange-of-assets provisions apply to a subsidiary in another member state and its permanent establishments. The requirement of a permanent establishment was expected to lead to a revival of the branch form of business operations in the EU. This did not happen, however, for both tax reasons (more uncertain tax treatment than subsidiaries) and commercial reasons (vaguer corporate image). So far, companies in the EU seem to follow the well-trodden path of takeovers through cash purchase or exchange of shares (accompanied by a dividend access plan).

3. Arbitration Convention (90/436/EEC)

26. The arbitration convention, which is based on Article 220 of the EEC Treaty (and thus not subject to the jurisdiction of the European court of Justice), seeks to element the double taxation that may occur between related enterprises (parent companies, subsidiaries, branches, two associated enterprises) in different member states. In accordance with the separate accounting principle, these enterprises have to conduct their transactions at arm's length. These transactions are subject to scrutiny by the tax authorities, of course, but in the absence of the convention an upward or downward correction in one member state might not necessarily involve a corresponding adjustment in another member state. As a result, double taxation would occur. The convention provides for procedures to seek redress through an advisory commission, which gives a binding ruling. Poland will have to sign the convention. It is unlikely that the convention will generate a large number of proceedings, because its preventative effect may be greater than its actual application.

4. Proposed Interest/Royalty Directive (COM (90) 571 final)

27. The proposed interest/royalty directive purports to apply the same treatment to interest and royalty payments as the parent-subsidiary directive does to dividend payments, namely exempt them from withholding tax. The difference is that the exemption applies to payments made in both directions – from subsidiary to parent and vice versa. The qualifying relationship is defined in the same way as it is in the parent-subsidiary directive. The directive is mainly meant to reduce administrative costs. After all, interest is deductible from company profits and a credit is available to the receiving entity. As has been proposed for Greece and Portugal, Poland could apply for a derogation on the ground that it is a significant importer of capital and technology and hence might stand to lose substantial revenue from abolishing all withholding taxes on outgoing payments of interest and royalties. Abolishing the withholding taxes would mainly benefit the treasuries of EU member states from which the capital and technology is provided. A drawback of the proposed directive is that it applies only to parent-subsidiary payments and not to payments made by smaller enterprises. This might distort competition in favor of large multinational enterprises.

5. Proposed Directive on Intragroup Losses (COM (90) 595 final)

28. An important deterrent to foreign direct investment is that parent companies cannot offset the losses of its foreign subsidiaries against its own profits (unlike the profits of its branches if it is taxed on worldwide income). The loss directive makes this possible for subsidiaries, provided that the parent holds at least 75 percent of the shares of the subsidiary. For subsidiaries the "deduction method with re-incorporation of subsequent profits" must be used. This means that the parent company can deduct the subsidiary's losses from its own profits, but must clawback the loss when the subsidiary later makes a profit. For branches the "credit method" can continue to be used. Under this method branch profits are taxed as if they had been made by the parent, but a credit for the foreign corporate income tax is allowed against the parent's own corporate income tax bill. The directive does not specify how losses are to be computed. Poland should be interested in the adoption of the directive, because it will make investments by EU member states less risky from the tax point of view. As in the case above, one factor to be weighed in the decision to adopt this directive is that Poland, at present, has no form of group relief for domestic

company groups. Adopting this directive might therefore distort competition in favor of multinational enterprises.

6. Ruding Committee Report

29. Mention should also be made of the Report of the Committee of Independent Experts on Company Taxation, issued in 1992, and commonly referred to as the Ruding Committee Report. The Ruding Committee was appointed by the European Commission to examine the need for company tax harmonization in the EU. Specifically, the committee was asked to investigate three issues: (a) do differences in corporate income taxes distort the workings of the internal market? (b) if so, would market forces or tax competition eliminate these differences? And (c) if not, which measures would be necessary to eliminate or mitigate the distortions?

30. According to the Committee's report, the answer to the first question is affirmative. A survey among 6,100 business firms in the EU indicated that the corporate income tax plays a major role in decisions regarding the type of finance (equity or debt), the source of finance (the local bank or the parent company), and the form in which a business is carried on (subsidiary or branch). Furthermore, the corporate income tax affects the way in which profits are allocated between parent company and subsidiary, as well as the form in which corporate source income is repatriated (e.g. as dividends, interest, or royalties. The answer to the second question, according to the Committee, is mainly negative. Although rates of corporate income tax converged in the 1980s, wide differences remain in the rules for ascertaining taxable profits. However, revenues increased in the period under review.

31. As regards the third question, the committee favors retaining the traditional way of ascertaining taxable profits. These profits should continue to be taxed in the source state, while the residence country upon repatriation of those profits should apply the exemption or tax credit method. Interest and royalties should continue to be taxed by the residence country. The Committee favors a minimum rate of corporate income tax of 30 percent and a maximum rate of 40 percent. Furthermore, if the recipient does not provide appropriate tax identification, the source country should subject distributed profits to a dividend tax of 30 percent in order to prevent tax evasion. Finally, the Committee lists a large number of *de minimus* rules with respect to depreciation, inventory valuation, tax-free reserves, the deductibility and attribution of business costs, and other matters relating to the corporate tax base. The Report continues to influence discussions of corporate tax harmonization in the EU. In the meantime, however, some member states continue to offer very favorable tax regimes to foreign investors, which erode the tax base of other member states. In other words, the limelight has shifted from tax harmonization to tax competition, as discussed in the next section.

D. Tax Competition

32. In view of the large number of tax incentives which Poland has enacted to attract foreign investment, the government should also be interest in the "Code of Conduct for Business Taxation" adopted by the European (Ecofin) Council that at the end of 1997. Although the resolution has no immediately binding implications, it will increase the political pressure on member states whose tax laws offer generous tax benefits in attracting investment from other member states. The Code covers any business measures, which affect or may affect in a significant way the location of a business activity in the EU, including activities conducted within a group of companies. The Code defines potentially harmful tax measures as those which

result in a significantly lower effective level of tax than that generally applicable in the member state in question. Moreover, member states are required not to introduce any new measures falling within the scope of the Code's criteria and are committed to review their laws and practices.

32. The Code lists the following characteristics of potentially harmful tax measures:

- whether particular benefits are given only to non-residents of the member state in question, or are given only in respect of transactions carried out with non-residents;
- whether benefits are otherwise ring-fenced from the domestic market of a member state so they do not affect the national tax base;
- whether benefits are available without there being any real economic activity;
- whether the basis of profit determination in respect of activities within a multinational group of companies departs from internationally-accepted principles, notably those agreed upon within the OECD;
- whether the measure lacks transparency, including where statutory rules are relaxed at administrative level in a non-transparent way.

Poland has two kinds of tax incentives that may have to be reviewed in the course of its accession negotiations.

1. Special capital investment allowances introduced in the Act on Income Tax of 1993. These provide for the following deductions: (a) up to a maximum of 20 percent of taxable income for the year, for investment in a new activity exceeding EUR 2 million; (b) up to a maximum of 40 percent of income if the taxpayer's revenue from exports exceeds 50 percent of its total revenue for the year, or EUR 8 million; and (c) up to a maximum of 50 percent (and in some cases 75 percent) of income for investment in specified regions of high unemployment.
2. Tax holidays for investment in designated special economic zones (i.e. nearly every region) introduced by the Act on Special Economic Zones of 1994. Generally, these zones are established for a period of 20 years. A complete tax holiday is granted of ten years and the tax is reduced by 50 percent during the remaining ten years. Furthermore, as noted above, certain investments may be expensed immediately and accelerated depreciation of fixed assets is allowed.

33. It is possible that these tax incentives have to be reviewed under article 92 of the EU Treaty which prohibits the granting of any state aide which distorts or threatens to distort competition by favoring certain undertakings or the production of certain goods, insofar as trade between member states is affected. An exemption, however, is permitted if the aim is to promote the economic development of areas where the standard of living is low or where there is serious unemployment. Furthermore, the incentives may be scrutinized under the Code of Conduct,

although they apply equally to both foreign and domestic investment, and are directed towards genuine economic activities.

Table 3.1: Corporate income taxes in Poland and Selected CE and EU Countries, 1998

Countries	CT Rate[a]	Dividend Relief	Revenue Contribution (%)[b] Total tax	GDP
		A. Flat-Rate Systems		
		PT-Rate		
CE Countries				
Czech Rep.	39	25[c]	12.3	5.4
Hungary	18	23	4.8	1.9
Poland	36	20	7.7	3.3
EU Member States				
Austria	34	22	3.7	1.6
Belgium	40.2	25	6.7	3.1
Denmark	34	40[d]	4.1	2.1
Greece	35	0	6.2	2.6
Luxembourg	40.3	½ PT rate	17.5	7.7
Sweden	28	30	6.1	3.1
		B. Imputation Systems		
		Tax Credit[e]		
EU Member States				
Finland	28	7/18	5,3	2,5
France	36.7	½ (basic CT)	3.7	1.6
Germany	56/42[f]	3/7 (CG/CT)	2.8	1.1
Ireland	38(10)[g]	23/77 (1/18)[g]	8.5	2.9
Italy	53.2	37/63 (CG/CT)	8.7	3.6
Portugal	39.6	60% of CT	8.0	2.7
Spanje	36	40%	5.5	1.9
United Kingdom	33	¼	9.5	3.3

Notes

a. Including surcharges, surtaxes, and local income taxes.
b. Revenue figures are for fiscal years 1995 as reported in OECD *Revenue Statistics*.
c. 50% of the final (withholding) tax is creditable against the CT.
d. Share income not exceeding DKR 33,800 (DKR 67,600 for married couples) is taxed at 25%.
e. As fraction of net dividend paid.
f. The lower rate applies to distributed profits.
g. The rate (fraction) between brackets applies to manufacturing and processing activities.

Source: International Bureau of Fiscal Documentation, **European Taxation** (Amsterdam: loose-leaf). Abbreviations have the following meaning: CG= Central Government; CT= Corporate Income Tax; GDP= Gross Domestic Product; PT= Personal Income Tax. Some information may be incomplete or out of date.

Table 3.2: Effective Total CT+PT Rates on Various forms of Corporate Earnings, 1998

Countries	Retained Profits			Distributed Profits[c]	Interest	Ordinary
	CT Rate	PT on Capital Gains[a, b]		(CT+PT)	(Top PT)	Top PT
		Ordinary Shares	Substantial holdings			
CE Countries						
Poland	36	-	45	48.8	20	48
Czech Republic	39	-	-	46.6	25	40
Hungary	18	10[d]	10[d]	40	0	48
EU Member States						
Austria	34	-	25	48.5	22	50
Belgium	40.2	-[e]	-[e]	55.1	15[f]	60.6
Denmark	34	40	40	60.4	61	61
Finland	28	28	28	28	28	57.5
France	36.7	19.4	19.4	61.5	19.4	60.2
Germany	56	-	rr[g]	64.4	57	57
Greece	35	-	-	35	15	45
Ireland	38(10)[h]	40[i]	40[i]	58,1 (50,6)[h]	42	48
Italy	53.2	15	25	58.7	12.5	51
Luxembourg	40.3	-	25.6	55.6	51.3	51.3
Sweden	28	30	30	49.6	30	56
United Kingdom	33	40	40	49.8	40	40

a. Capital gains are adjusted for inflation in Ireland, Italy, Luxembourg, and the United Kingdom. Alternatively, short-term and long-term gains are taxed at different (effective) rates in Denmark, France, Spain, as well as Ireland. Various countries exempt small amounts of capital gains.

b. Usually, capital gains realized by corporations are subject to CT at the normal rate; generally, the tax is deferred if the gain is reinvested.

c. Calculated as [CT + (1 - CT) PT] minus any tax credit, if available. Under the dual income tax in Finland, the top PT rate on capital income equals the CT rate. In countries with flat PT rates on dividend income, obviously the flat rate is taken as the top PT rate on distributions.

d. Capital gains are exempt if shares are held in an approved capital account.

e. Capital gains on shares held less than 3 months are taxable.

f. The PT rate is 25% on interest paid on bonds issued before March 1, 1990.

g. Capital gains up to DM 30 million on substantial holdings (more than 25% of the share capital) are taxed at reduced rates.

h. The percentages between brackets apply to manufacturing and processing companies.

i. The capital gains tax rate is 27% on the disposal of shares in unquoted trading companies held for at least 5 years.

Source: See Table 1. CT= Corporate Income Tax; PT= Personal Income Tax; rr= reduced rate. Some information may be incomplete or out of date.

CHAPTER IV: TAX ADMINISTRATION ISSUES

A. Introduction

1. This chapter reviews key tax administration issues in Poland. The success of the Polish tax administration, as elsewhere in the world, will depend largely on its ability to implement its tax policy framework. Tax administration in Poland is in transition both to EU accession and to a modern tax administration. As such it confronts numerous challenges, chief among which is the improvement of its executive management capacity. Much of what follows is related to the ability of the agency managers to guide the transition process to address EU accession harmonisation as well as to take into account factors that characterise tax administration modernisation efforts world-wide.

2. The EU mandates identified in the first three chapters addressed specific issues like exchange of information for VAT and excise tax control, warehouses to help control excise taxes, coordination and liaison requirements to deal with the extended markets. Underlying these specific EU requirements is the more global one of building a working-automated tax administration. This work is currently being supported by the EU following the mandate of document "Enlargement – Pre-accession Strategy for Taxation" DGXXI/2131/97. Tax administration modernisation will be supported by the EU through a multilateral action to be implemented through the Intra-European Organization of Tax Administrators. Given that developments of tax administration fall into the subsidiarity principle, the discussion below provides the necessary elements to think of an EU complaint tax administration. The discussion expands and provides country background specificity to the study, "Definition of Pre-Accession Technical Assistance Program for the Tax Sector in Poland",[2] which proposes a managerial framework for meeting EU accession requirements.

3. The main message of this chapter is that the executive challenges will need to be systematically met before Poland's tax administration can improve. This is particularly true in the following areas: compliance, enforcement, procedural transparency, and information technology applications. The evidence and analysis reveals that these areas generally lack adequate executive management oversight, coordination, accountability, and strategic vision. These areas are discussed in following sequence followed by a set of recommendations. Section B provides a review of executive management and organization. Section C examines what has come to be called the business side of tax administration. This includes improving the environment for compliance and building-up enforcement capacity. Section D considers automation development. It argues that a "project" approach would be the best way to confront the range of tax administration issues facing Poland today. This would strengthen system executive management as well as help advance EU accession efforts. Some alternative organizational designs are provided in Annex I.

[2] Prepared for the Ministry of Finance by Desmond Walsh under the auspices of the EU.

B. Executive Management and Organization of Tax Administration

4. Executive management and organization are basic to the successful implementation of a modern tax administration. Arranging the right management structure and putting together the proper executive team are essential to launch the institutional process of reform. Once management is operating efficiently, organizational design and reform pertaining to the business and IT side would need to be specified. The executive management and general organization will now be discussed.

1. Executive management

5. The executive management issue is the first step in tax administration reform. Strategic vision, a business plan, operational concepts, strategic IT development, interim solutions, and management of change--all form part of the global strategy that will require managerial alignment (structural) and practices (organizational behavior). In Poland the functional division of work at the executive level--policy, administration, and fiscal control--does not promote the development of a global management vision. It also does not take into consideration the crucial *tax administration policy* function. The consequence is that information on organizational performance at any level is extremely difficult to obtain.

6. Tax administrations, as systems, must deal with numerous taxes that may be defined in contradictory or partial ways, and interpreted and complied with differently by individuals, taxpayer groups, or third parties. The performance of a tax administration must be balanced and comprehensive with respect to taxpayer compliance.[3]

7. Tax administration is one of the largest, most complex operational environments of a country. In a sense, tax administrations are like a bank dealing with multiple debit and credit accounts but for taxpayers. It is also an investigative force dealing with evasion of tax obligations and corruption. Another function is to provide a parallel administrative court system dealing with taxpayer appeals. In addition to rationalising tax administration generally, the executive management challenge for Poland also incorporates several EU issues. These include VAT and excise taxes, intra-community trade, information exchange and internal functions, such as implementing the fiscal decentralisation initiatives of the government, and, in general, defining a sound organizational platform.[4]

8. The executive management functions most critical in Poland will now be discussed as follows: operations management, tax system management, technology and organizational framework, human resources, and resource allocations.

9. *Operations Management.* The implementation of the tax system remains unfinished business in Poland. The gap between the tax obligations explicit in the tax laws and taxes actually paid is still wide. This may be the result of a limited awareness that the legal design

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[3] Annex II provides an overview of executive management functions used in the discussion below.

[4] To have an idea of the magnitude and complexity of tax administration institutional development, recent developments in the US IRS are revealing: the US investment in its tax administration system will be between $5 and $7 billion during the next ten years. The IRS considers this project the single biggest systems integration project ever undertaken.

must not exceed the administrative capacity of the tax agency. Strategy development focused on, inter alia, internal organization, automation, evasion, the informal sector, and audits was not a high priority on previous management agendas. As a consequence, ad hoc policy development is not uncommon, and tasks and services performed by local tax offices are inadequate. Indeed, an operational strategy that defines workflow at all levels of the tax administration is needed to provide performance benchmarks. In addition, operations management includes the responsibility for public dissemination of information about tax system requirements and obtaining and interpreting taxpayer feedback on their perceptions and expectations of the tax agency.

10. The contrast between the design and operation of VAT and that of personal income tax (PIT) is indicative of inconsistent managerial approaches in the definition and application of these taxes. The political decision for the enactment of the nearly *universal* PIT--with a large number of refunding requests of taxes withheld--assumed an administrative capacity that could smoothly implement the legal decision. The legal framework was designed without considering whether the tax agency could operationally process the PT requirements. For this reason, the tax has never worked as embodied in the tax code, despite its outstanding revenue performance, which reflects more the ability to capture the taxpayers and not the good functioning of the tax administration. Since the MOF is not in a central tax policy-making position (lacking the capacity to carry out this responsibility), the design of all internal operations as a derivative of PT returns became, de facto, the domain of local tax administrations. This led to diverse accounting, registration, and tax rebate procedures across Poland. In contrast, five years later, a *non-universal* VAT was designed and introduced with more comprehensive managerial standards, even though the automation was rudimentary. VAT shows a clearer record of good performance with less administrative problems.

11. Performance indicators reflecting operational efficiency and effectiveness are now emerging in the field of tax administration derived from world experience. They include:

- Improved distribution of the effective tax burden (i.e., after agency's intervention)
- Improved revenue performance through increased compliance[5]
- Decreased tax arrears, tax evasion, and tax avoidance
- Improved transparency and integrity of the revenue administration system
- Reduced compliance costs.

12. Several sets of data would be needed based on operational information to gain a perspective on performance. Interpretation of some indicators might be problematic, as performance encompasses many variables exogenous to the tax administration. Together with good or even bad managerial efforts, economic conditions and the general perception of government by taxpayers are mutual determinants of tax system performance levels. Nevertheless, as the data are produced, there will always be interpretive possibilities. What is

[5] An efficient revenue system fosters voluntary compliance, reduces evasion, and paves the way for a gradual reduction of tax rates.

important is the establishment of indicators as part of the basic measurement of system effectiveness and efficiency.

13. Operations management also includes the responsibility for public dissemination of tax system concerns. This responsibility emerges from the need to provide consistent interpretations in and outside the tax administration. It is also a means to ensure improvement in formal compliance. This involves determining needs for external communications and deciding what media to use. This is clearly requires a corporate perspective, mentality, and decision-making.

14. Generally, modern management practices require obtaining and interpreting taxpayer feedback on the performance and expectations of the tax agency. Together with internal surveys, this provides a powerful tool for improving quality in operations.

15. Finally, the issue of corruption is an endogenous and undesirable by-product of many tax operations. It always needs to be considered systematically and controlled. Modern management addresses the issue of integrity by developing solid risk analysis and management systems, together with promoting high ethical standards among staff and the right incentives, especially adequate wages and a spirit of professionalism.

16. *Tax System Management Issues.* Tax administration should (i) be an input in the (national and international) definition of the tax system and (ii) arrange global tax administration transactions—such as general bank collection procedures and arrangements, integration with public and private databases, and private sector support.

17. Tax system management has always been in the forefront of tax developments in Poland. Laws and international treaties have evolved to level of sophistication that will require concerted efforts by several tax agencies to accommodate. Legal steps to improve the "tax social contract" need to be devised through structured dialog with clients, which is a crucial first step in developing a sustainable system. The law governing tax advisors, mirroring continental practices, and legally enacted committees for continuous private-public sector dialog, are positive signs as well.

18. There is an increasingly international dimension to defining tax systems, in recognition of managerial concerns about international trade and financial transactions. For the EU, the legal framework of a country should be developed along the lines of the Acquis Communitaire. Verification of appropriate legislation is the Commission's domain, as the main guardian of the Treaty conditions.

19. The proposals of the White Paper are a major contribution to aligning what is desirable and what is feasible. A broad-based, lower-rate tax system would clearly be better accepted by the community. It would also be easier to control and harder to avoid. If approved, the proposed tax reform would substantially lighten the operational demands of current tax laws, given the increase in generality and the gradual reduction of the rates.

20. Still pending are legal changes to simplify tax administration, such as reducing the number of taxpayers by introducing the PAYE system, and eliminating the declaration of millions of taxpayers by increasing the PIT threshold to declare, and adjusting it for inflation. The tax agency's legal capacity will need to be matched with any increase in the taxpayers' technical capacity, i.e., when there is electronic filing and computerised accounting.

21. *Technological and Organizational Setting.* IT definitions combine technical appraisals of the suitability of automation solutions to solve a business-side problem with financial soundness and feasibility. It also includes following the technological developments of IT and taxpayer IT practices as a guide to system investments. In the end, the result of this managerial effort is the definition of the organizational design and human resource mix of the system under the adopted IT strategy.

22. Coordination needs careful definition. Defining functional, regional, inter-institutional and third party requirements to promote the smooth flow of information and communications necessary to fulfil tax administration functions. Networking, in the IT context, is a derivative of operational functional design and coordination efforts. Issues of cost and ease of implementation are the most important determinants of the type and level information.

23. Arranging operations in a way to optimise private sector participation as a possible partner or collaborator should be a strategic priority. A constraint that could immediately be removed is the IT development of fiscal control functions, which, as a consequence of the bottleneck in developing compliance administration, does not appear in the current Polish IT strategy. Experience in Nordic countries, and in countries at similar stages of development, should prove useful in defining the next steps for simultaneously developing the business and IT sides of tax administration.

24. *Human Resources and Training.* Human resource development does not appear to be an executive management concern at the moment. As with IT investments, operational training has not been a priority nor has human resource development employing an incentive policy linked to performance. The authorities on different occasions considered the establishment of more structured training projects; however, given the uneven results to date, and the lack of attention to follow-up, this area needs to be structured in the context of a multi-year human development program.

25. The human aspects are particularly important because the bulk of the work done by tax administration is mediated by individual employees, even if IT applications are pervasive. The transformation of institutions and the adaptation of legal systems need be assimilated, accepted, and managed by people. The human part of change management is perhaps the most difficult part of reforming tax administration. Institutional change brings with it a redefinition of staff profiles and necessarily, clarifies mismatches between the supply and the demand for desirable skills, educational levels, training, and ethical behavior.

26. A first set of questions with respect to human resources deals with the adequacy of the system's incentives to the individual staff for the achievement of the goals of the administration. In this context, stability, salary levels, career paths and job satisfaction become a major issue. The second set of issues deals with the adequacy of the existing professional profiles to execute the redefined set of functions and a completely transformed operational environment. The fact that over fifty percent of the current labour force in Poland's tax administration are paper movers or manual record keepers is revealing not only of the failure of the earlier IT strategy but also of the implications of change.

27. A modernisation strategy combining simplification and electronic filing would substantially change the manpower requirements and their spatial distribution. The

establishment of a target based audit system would probably require also a staff mix that combines a relatively small group of highly qualified and specialised group of inspectors and a large group of base auditors guided, in principle, by the system itself. Finally, the risk of corruption is in the end a product of organizational climate and expectations. Corruption problems and the design of anti-corruption institutional capacities and human resource policies are at the core of global tax administration reform management.

28. *Resource Allocation.* Underlying all of managerial actions is resource allocation. Executive managers generally do not have complete control over the parameters that define their responsibilities. Salaries are fixed by central government policies, and are often embedded in rigid civil service regimes. Budget allocations are usually beyond their control once salary allocations are made. Non salary expenditures are or may be amended as part of fiscal adjustment without the participation of the tax administration. Depending on the degree of autonomy, executive tax administrators have circumscribed ability to managing resources. When they are subject to strict budgetary rules and unexpected changes, their decision-making capacity becomes marginal.

29. Within these limitations, current expenditures dominate resource allocation, with almost no strategic investments or planning as a part of the agency budget. A short-term perspective of tax administration clearly prevails. Substantial improvement in the decision-making mechanisms governing the allocation of resources could occur through a multi-year strategic plan and accompanying business and IT plans and programs. This will be a necessity to bring the management of tax administration in Poland in line with EU accession requirements--and can provide a useful yardstick by which to measure progress toward achieving this goal.

30. IT investments per year have been erratic but decreasing commensurately, as shown in Table 4.1

Table 4.1: Ministry of Finance's Information Technology Expenditure, 1993-1997

IT INVESTMENT		IN PERCENT OF TAX ADMINISTRATION:	
MILLION PZl.		TOTAL EXPENDITURE	INVESTMENT
1993	36,000	6.1	58.5
1994	26,100	3.1	33.9
1995	28,700	2.8	55.8
1996	42,050	3.2	62.1
1997	25,300	1.7	35.3

2. Overall Organizational Design

31. After executive management, the general organizational design is the next crucial issue to confront during general tax administration reforms. Poland is currently implementing a major fiscal and administrative decentralisation reform of its tax administration based on a well prepared plan that in some respects is more advanced in concept than the current reorganization of the Polish State.

32. Organizational design is fundamental to improving tax administration efficiency. This is because in modern systems, organizational redesign flows from reengineered business processes

(based on an implementable legal framework) and subsequent automation. Business plans should incorporate ongoing tax and public administrative reforms. In the ensuing discussion, organizational improvement is viewed from several perspectives: possible integration of the collection function through merger of (customs and tax) agencies, collection and fiscal control functions, the definition of fiscal control, the possible involvement of the private sector in tax administrations, administrative autonomy, and EU linkages.

33. The first element is assessing the possibility of *integrating the collection function* of different agencies. Poland is now contemplating the merger of customs and tax administration. Integration of the collection function, a world-wide phenomenon, brings all (or some) of the agencies dealing with tax collection under a common organizational umbrella. Internal taxes, social security, customs and local taxes collection can theoretically be collected by the same agency and funds then distributed based on prescribed guidelines. Canada, Denmark, Hungary, Latvia and the Netherlands are examples of this trend. The integration of collection agencies leads to a reduction in taxpayer compliance costs, and the rationalisation of State functions. Taxpayers' costs are reduced when instead of two or three declarations one multi-tax form is submitted. State functions are rationalised because the cost of tax collection in the national budget would likely be reduced through integration. In addition, and in some cases most important, the absorption of social security collection by the central administration eliminates moral hazard--lack of incentives to collect and audit by the social security agencies--given the probability of a central government in case a deficit occurs.

34. A second major element is the *definition of fiscal control.* Currently, fiscal control includes tax evasion, expenditure management and administration, and tax administration staff behavior. Unbundling these may improve the efficiency and integrity of the control system generally. Each is a special function but must reinforce the other two. Taxpayer control should not be merged with the ethical oversight of staff responsible for the control. This would be a conflict of interest, as auditors would have to review each other's work.

35. A third major element is the possible *involvement of the private sector* as a partner of tax administrations. Unbundling selected services and functions based on comparative advantages of the private sector could improve the flow of information and effectiveness of the system. Western tax administrations are a good example of gradual and increasing participation of the private sector in supporting the tax system. Generalized withholding at the source, payment of taxes in banks, production and distribution of tax forms, third-party reporting, execution of audits by private auditors, outsourcing of arrears collection, and contracting out of software development, data capture, and processing are candidates for private sector participation. Recent legislation allows the use of tax advisors and accountants as promoters of accuracy in taxpayer records and returns.

36. A fourth issue is the decision regarding *administrative autonomy* of the tax administration. In Poland, tax administration units are organizationally linked to the Ministry of Finance. If adopted, a decentralized tax agency would need to be provided with sufficient managerial, technical, and financial resources and capacity to effectively implement its mandate. The current system is perceived to be too open to be manageable. This is because: (i) the budget is a political process outside the purview of tax executives; (ii) staff appointments also are outside their jurisdiction; (iii) salaries are below those of the private sector for equivalent

positions; (iv) procurement is done by other administrative units; and (v) management of automation is outside tax agency control.

37. From the point of view of the Ministry of Finance, this may seem appropriate. An autonomous tax administration combines much responsibility that they may be unable to manage properly. Typically budgets, contracting, and appointing officers is outside the control of those responsible for tax administration management.

38. Administrative autonomy is difficult to achieve under any circumstances and may not be useful for Poland to contemplate, given the basic array of issues the tax administration now confronts.

39. Finally, *EU specific functions* should also be considered part of the organizational design. The EU Commission is developing a road map for tax administrations based on specific requirements, such as VIES (VAT Exchange System) and REED (Excise Exchange of Information), that need to be incorporated into the new organizational design of the tax agency. Also a special unit to follow EU developments seems called for at the executive level of the organization.

C. The Business of Tax Administration

40. The business of tax administration involves two administrative functions: compliance administration and enforcement. Tax administration functions begin with the way procedural laws define rights and obligations of taxpayers, as well as the powers and obligations of tax officials. In modern tax systems, similar to those Poland hopes to emulate, specific operations emerge from the legal implications of compliance and enforcement for tax procedures (see Box 4.1). In addition, given the inherent risk, containment of corruption is part of the tax administration "business".

BOX 4.1: Legal Implications of Tax Compliance and Enforcement

COMPLIANCE		ENFORCEMENT
Registration	*Collection*	*Enforced Collection*
Declaration	*Tax Rebates*	*Audit and Fiscal Control*
Taxpayer Support and Orientation		Administrative Review (Appeals) Judicial Review

41. With the exception of audit and fiscal control, all tax administration functions should be performed in response to *all* taxpayers' actions. The audit function is thus inherently discretionary.

1. Compliance Administration

a. In general

42. Compliance is the outcome of taxpayer behavior based on signals provided by tax administration and the perception of the State in general (Annex III delineates reasons for

taxpayers non-compliance and its origin). To a large extent, the *sustainability* of a tax system rests on the capacity of a tax administration to achieve and maintain high compliance rates.

43. As a general principle, voluntarily achieved compliance is the most economical way to collect taxes--both on the taxpayer and the administrative side. The Polish tax system is based on taxpayer and third-party voluntary compliance to pay, collect and declare/report tax obligations. Poland developed an innovative means to ensure VAT compliance. In 1994, VAT implementation began with an "awareness" campaign, and included incentives to comply. These included financing cash registers especially for VAT that could be deducted by businesses from their VAT returns. Such incentives may explain in part the initial success of VAT in Poland.

44. Compliance is an EU issue because EU policies break down if taxes are not even-handedly enforced. The whole system rests on the capacity of tax administration to achieve and maintain high levels of compliance. In most transition economies, initial compliance rates seem high--perhaps based on the fear of taxpayers that have lived in formerly totalitarian States. As democracy settles, this fear may diminish, and, if allowed, more and more taxpayers may attempt to get away with lower compliance thresholds.

b. Compliance issues: The taxpayer side

45. Taxpayers face several compliance constraints in Poland: complexity and instability of the legal framework, frequency of tax return submissions, and arbitrary penalties--all of which occur in an environment of limited information.

46. *Complexity and instability of legal framework.* The White Paper addresses in some detail the complexity and instability of tax laws. All taxes are inherently complex: some, like income taxes, are supposed to discount and allocate time in different taxable periods and deal with distortions engendered by inflation; others, like VAT, are supposed to keep track of the whole set of transactions of the business community. In addition to inherent complexities, Polish policy-makers have permitted exemptions and tax holidays that engender administrative difficulties due to interpretations and lack of generality. Also, multiple rates used in transaction taxes create a harder-to-administer environment.

47. Interpretation is a shared responsibility in compliance based systems. If laws are unclear and/or unfinished, interpretation becomes difficult. Some progress has occurred in consistency of interpretations, as reflected in recent high-court rulings. The Government is empowered to issue rulings. However, according to tax advisors, it often avoids this responsibility. The law was recently changed to require rulings in all cases; however, the change also eliminated the obligation of the tax administration to follow these rulings. This debilitates the system and decreases taxpayer confidence in the application of tax laws. On the other hand, to make everything subject to ruling fosters a parallel legal capability that may not be desirable in the long run.

48. Tax declaration forms are a good indicator of tax system complexity. In addition to reflecting an official interpretation of tax laws, they denote what the tax agency would like to know about taxpayers--sometimes beyond legal requirements. Forms may never be simplified if the legal framework remains overly complex.

49. Poland uses 24 types of forms for filing personal income tax declarations. Numerous forms must be filled out, depending on type of income earned, time span of the declaration, exemptions, and even the family status of the taxpayer. The VAT form requires as many as 107 types of information (lines) provided monthly. This is clearly too many entries for such frequent declarations, and is much longer than the VAT declarations of most EU countries. The same is true for forms (up to 128 lines), filled in monthly, as well as the forms issued to payers choosing more simplified methods. (Further study into data processing methods could also provide a clearer picture of whether this is a problem as well.)

50. Poland established a simplified personal income tax system based on a tax card issued to taxpayers. This simplified system covers a variety of activities. In general, countries establish this type of system to cover the majority of taxpayers. This is not the case in Poland. Initially only about 2% of taxpayers participated, and currently less than 1%. This suggests that the system is either too expensive or too complex to encourage its use. Although at first glance this method could overburden the taxpayer, it could be viable if the tailor-made forms require only the basic data from designated taxpayer categories.

51. The Polish tax system is so new there are still many compliance issues to analyse. However, as the market economy expands, businesses necessarily become more complex in their tax profiles, creating tax situations not contemplated in the original laws, and compelling legal changes, interpretive flexibility or both (e.g., Internet trade and international financial transactions, loans to subsidiaries). This also complicates simplifying the tax system in the absence of analyses of such issues and their tax treatment internationally.

52. *Frequency and coverage of tax declarations.* Complexity is compounded when tax declarations are universal and required very frequently. Over half the population is obliged to register for and declare the income tax. Monthly declarations are required for a large group of taxpayers. While for some, complexity of forms and frequency of filing are distinct administrative aspects, they are clearly related: frequent complex forms can represent a large and unnecessary compliance cost and should be used to report on a long enough period that is relevant in terms of enforcement. Frequent forms should be used for provisional payments.

53. Poland requires an annual income tax return from virtually all income earners--regardless of the importance of the tax paid. Income tax declarations in Poland are required on a monthly basis for business taxpayers. Monthly declarations are a necessity in countries where high inflation causes a significant loss in real collection caused by the time lag between the accrual of taxes and their payment (Tanzi-Oliveira effect). If this is not the case, what is needed is routine (e.g., quarterly) payments based on estimates of the tax base for the payment period, not a full declaration of tax bases. The transaction costs both to taxpayers and tax administration under current arrangements is notably excessive.

54. In contrast, VAT was designed with a higher threshold to declare. VAT differs from income tax because the payer is a "tax collector" transferring revenue to the government. Monthly or bimonthly declarations are a common way of securing the flow of VAT revenue collected. However, if the design of VAT is such that it generates a substantial percentage of

payers requesting refunds, monthly declarations may create a processing backlog for refund requests.[6]

55. Tax forms in Poland generally are difficult to interpret and their contents unnecessarily long. No effort has been made yet to reduce the number of entries. Information requested generally should be related to the frequency and use by the tax administration and should consider taxpayers accounting systems and compliance costs. Given the high frequency of collections, the amount of information being requested in tax declarations is beyond the administrative capacity to capture. Many forms call for repeating the same data several times.

56. The recently enacted law on the practice by tax advisors and the statutory mandate of having a joint public-private sector forum on tax issues is an auspicious sign for the development of more consistent application of tax laws. Such communication will reduce uncertainty, administrative appeals, and the perceived inefficient of judicial reviews.

57. *Arbitrary penalties.* The statutory Treasury lien (or hidden unregistered mortgage), a unique Polish institution, is perhaps the hardest and most controversial penalty-institution to protect the Treasury's interest. Under this system, the right of the Treasury pre-empts all other claims, whether secured or not. By hampering the development of secured credit markets, this institution is perhaps more costly to the economy than beneficial to the public finances.

58. In addition, although the problem has largely subsided, penalties are still perceived arbitrary when applied in situations of uncertain interpretation. Also, formal errors have been penalised very strongly in the past by the use of implicit penalties like the rejection of deductions based on the their occurrence. According to tax control officials and tax advisors, this practice has been reduced in the recent past. Also, the level of the penalties has been reduced.

59. Penalties are a major deterrence mechanism for fostering voluntary compliance. As part of the built-in incentive-to-comply, penalties have to be carefully designed to achieve the compliance objective without, if applied, damaging the economic agent beyond what is really needed. There is room for improvement in Poland.

c. Compliance Issues: The Tax Administration Side

60. Poland has substantially increased the understanding of taxpayer behavior and improved its service as much as it is possible with limited IT resources. However, Poland has had major difficulties in responding to taxpayer's compliance. Registration has been achieved. In contrast, taxpayer services dealing with declaration (and all its consequences) are still inadequate because of the high volume of transactions. With over 25 million taxpayers, and monthly processing of complex declarations, the volume of data to be processed has been beyond the IT capability since the establishment of the PT. In fact, in 1995/96, the automated processing of tax declarations collapsed and a manual system had to be reactivated. The enormous processing burden not only

[6] In some countries have many small taxpayers (e.g., Hungary), VAT returns are filed quarterly for only a specified number of small taxpayers. This caused the volume of paper work to decline sharply, from over 4.5 million declarations annually in 1994 to just over 2 million by 1996, though the number of taxpayers remained relatively constant at approximately 500,000.

includes the loading of information in the systems, but also the processing of subsequent transactions, mainly comprising tax rebates and keeping accurate and timely individual accounts.

61. As tax compliance consists of submitting the tax form and making the required payments, the tax administration functions dealing directly with compliance are passive. The key compliance forms are registration/declaration (return), payment receipt, and rebate request. The tax administration deals with the universe of taxpayers in the compliance transactions by:

- Receiving and storing tax declarations
- Receiving money and issuing a receipt for payment
- Providing tax refunds
- Dealing with taxpayers in arrears.

62. All these transactions are registered in the fiscal accounts. The record keeping and accounting of each individual event, or transaction, affects the situation of the Treasury. Such record keeping is the framework for the aggregate accounting of state revenues, and, if adequately designed, the archive of transaction data on all taxpayers individually. If this is the case, the administration should be able to know who declared and paid, who declared and did not pay, who overpaid according to her/his declaration, and who did not declare. The control functions then ensure the accuracy of this information through audit and enforcement.

63. All these functions can be substantially automated and that was the initial objective of Polish authorities when it decided to implement the POLTAX program in the early nineties. However, POLTAX was not defined properly and a system that addresses all compliance (teller and accounting) issues is still not in place. (The automation problems are discussed in paragraphs 87-104).

64. *Availability and dissemination of information.* The availability to taxpayer-on-request outstanding balances, as facilitated by a comprehensive and timely taxpayer account, is basic to encourage compliance, since it facilitates compliance, i.e., actual payment of the tax obligation. Currently, the Polish tax administration is unable to provide this information to all taxpayers on all taxes, either due or refundable.

65. In addition, taxpayers need orientation about how to meet their tax obligations. While there are private tax practitioners that provide advisory services, many taxpayers do not require such advice, only orientation. In this sense, tax advisors can increase compliance costs to society. In Poland the administration is considered establishing taxpayer customer services to improve the quality-at-entry of forms provided by taxpayers.

66. General information requirements greatly expand during EU pre-accession/accession efforts. Awareness campaigns about EU-driven changes and their implications become mandatory for tax administrations. In general, EU member states operate on the assumption that information is a civic right.

2. Enforcement Policies and Management

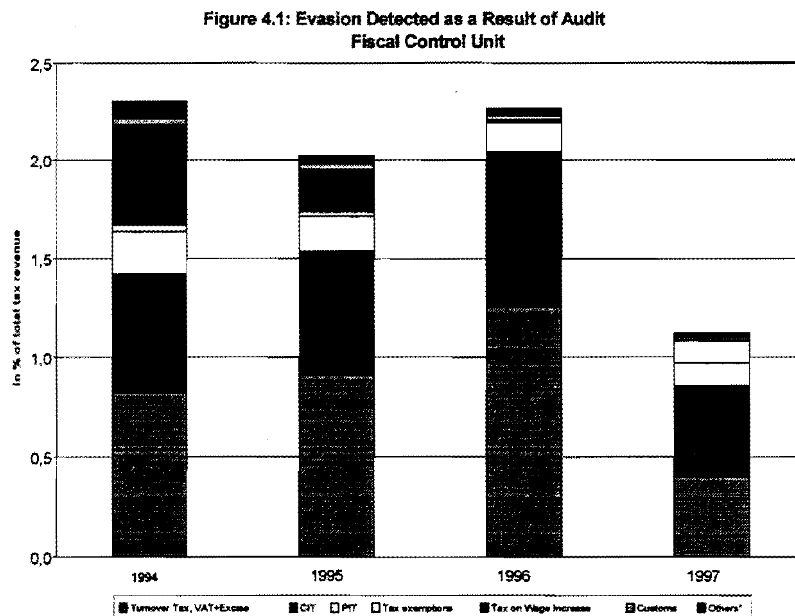
67. Enforcement policies comprise deliberate efforts of the tax administration to (a) reduce avoidance and evasion through fiscal control and audit strategies, and (b) minimise arrears. These two enforcement functions are discrete. The first deals with unknown obligations of both known and unknown taxpayers, while the second addresses outstanding balances of known taxpayers.

a. Evasion and Control

68. Currently, two administrative units, Fiscal Control and local tax offices, are responsible for evasion and control activities. This arrangement emerged in the mid-1990s when the control of smaller taxpayers in a growing informal (grey) economy was included, as part of the local office functions (*powiat* level). Fiscal Control theoretically focuses on large taxpayers and tax fraud. Under ideal coordination arrangements, the 16 regional Fiscal Control offices would perform audits of large taxpayers, whereas local offices would specialise in small taxpayers. This operational arrangement was a move in the right direction. Presumably, large taxpayers have countrywide and possibly trans-national operations, which require high audit skills and countrywide audit. Local tax offices are better positioned to know about and audit small taxpayers. However, this division of work (with separate heads to deal with audit and investigations) may create duplication of, at least, the administrative efforts. In addition, it disallows the possibility of productively structuring audit work based on modern auditing techniques of selecting probable evaders.

69. Fiscal control is a central function of the Ministry of Finance and extends beyond taxation. It includes auditing and monitoring activities of all ministries in the area of financial management, and involves tax and expenditure interventions. However, tax-related interventions comprise the bulk of these activities. A breakdown by tax of the results of fiscal control units is presented in Figure 4.1.

Figure 4.1: Evasion Detected as a Result of Audit
Fiscal Control Unit



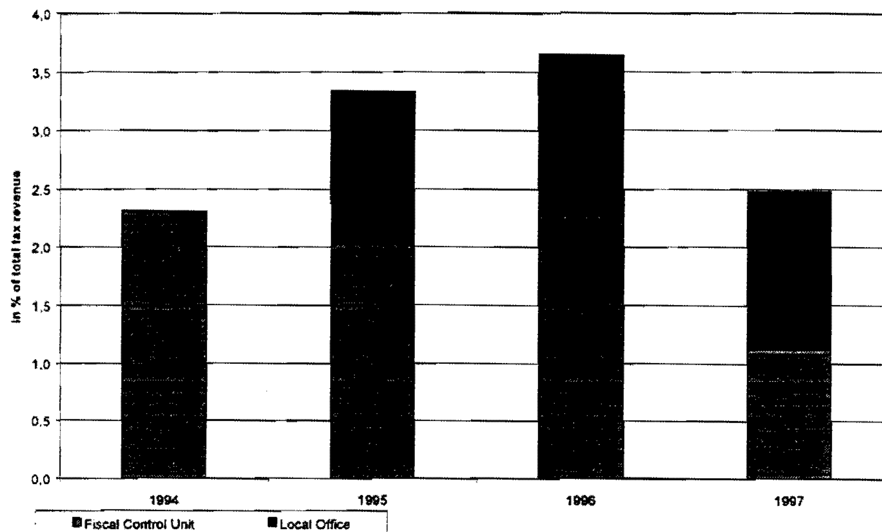
* includes: local duties and taxes, treasury duties, inheritance taxes and tax on donations, turnover tax on imported goods, dividend tax

Source: WB staff calculations based on Ministry of Finance Treasury Control Department data

70. The combined audit results of fiscal control units and tax offices are presented in Figure 4.2. In the absence of a fiscal control plan with a clear targeting strategy, these results suggest that evasion may be generalised: evasion is found wherever is looked for. The results should be viewed with care because the results show additional tax accruals and not additional tax collections. Complaints by tax advisors about the quality of the additional tax assessments indicate that they may be exaggerated.

72. Could the results have been any better? The lack of prior structured risk analysis and definition of an audit strategy, with prosecuted quantitative results, makes it impossible to pass judgement on prior efforts. Even so, the mere presence of tax administration seems to have maintained existing compliance levels and brought in some percentage of the informal sector. In retrospect, all efforts have been useful by developing and maintaining some citizen respect for tax law compliance. In addition, tax auditors reportedly, are exercising restraint. Inquires of public accountants indicate that tax auditors from the fiscal control unit were geared towards detecting formal errors of taxpayers rather than re-construing a firm's actual tax bases and obligations. According to the same advisors, audits seldom obtain additional money[7] but represent a high cost to taxpayers. Alternatively, they may occasionally obtain unwarranted amounts of money, based on arbitrary rules, like the norm that states that the lack of an invoice adds to the taxable base, or some of the 52 non-deductible items in the CIT law.

Figure 4.2: Evasion Detected as a Result of Audit
Local Office and Fiscal Control Unit



Source: WB staff calculations based on Ministry of Finance Treasury Control Department data

73. Any audit strategy quickly shows diminishing returns. If judged by the 1997 results, this seems to be the case of the present strategy. Taxpayers learn the rules of the game, so an on-going renewal of the strategy is needed to keep pace with the dynamics of non-compliance. Risk analysis is generally needed. Poland needs to improve the tools of audit selection and perhaps reduce the presence of tax administration while making it more effective. Both compliance and administrative costs increase substantially when verifications are made on tax compliers and

[7] A notion consistent with the relatively low aggregate results of audit interventions.

there is an opportunity cost in the allocation of scarce audit resources. Under evasion and control there is a need to expand on auditing strategy which should have three key components: (i) priority efforts—on probable evaders as a function of expected return from audit; (ii) quality control effort—based on statistical sampling (perhaps 3 to 5% of taxpayers); and (iii) automatic effort—100% of detected cases of evasion not in (i) or (ii) through automatic notification (for example all stop-filers, all non-filers).

74. In addition to generating efficiency to the tax administration, the use of profiles supported by evidence-in-principle (i.e., obtained from computerised cross-checking), is the way to achieve equity in delivering tax administration control. Taxpayers are not viewed individually but in relation to sets of population characteristics and behaviors, which engenders more objectivity and more equitable treatment. As the use and application of such techniques increases, taxpayers gain more protection from possible arbitrariness by tax officials that otherwise might select them arbitrarily. Under a well-conceived and equitable system of selection, the transparent procedures would apply to those selected for audit. This signifies that: the criteria signalling possible evasion (risk analysis) are the trigger and guide for the audit.

b. Arrears Management

75. The nature of tax arrears makes it appear as a relatively small problem when compared to fiscal control. However, in terms of revenue impact, arrears may be a large or even larger problem than evasion.

76. Tax arrears are the outstanding balances derived from private returns or official reassessments. In theory, most of these balances should be collected as soon as they surface. However, since there is no individualised tax account in Poland, relatively easy routines to identify and collect arrears are not possible. The present system only constructs and quickly reports to the Ministry of Finance an aggregate arrears account by tax.

77. In addition to having individual balances available, modern collection systems comprise information systems that trigger computerised "reminder" letters based on a specific business strategy to deal with collection of bad debts. Upon persistence of arrears, the system signals collection staff to start personalised motions and keeps record of their interventions following an established workflow. The basis for all these options is the accuracy of and access to taxpayer accounts.

78. Although, in principle, all outstanding debts should be collected, managing arrears includes difficult decisions regarding old debts that would probably never be paid and should be written off. In the case of transition economies, the SOEs are perhaps the largest debtors. In particular, they have a large amount of old debts with the Treasury that will probably never be paid. The debt of the carbon sector in Poland is an obvious example.

3. Anti-Corruption Policies

79. Poland's tax administration is not perceived as a generalised corrupt institution. In contrast to several countries in the region, where corruption is identified as a major institutional problem, complaints about this problem were minimal. They referred mainly to the exercise of discretion by MOF officials in granting exempt status. The opportunity for this type of

corruption would be greatly reduced if the White Paper recommendations dealing with base broadening were adopted.

80. Discretion brings in the risk of corruption when discretion is exercised without accountability, as may be the case for exemptions granted on an individual basis and when auditors are in the field defining what to include or exclude in their assessment of the taxpayer situation. There is no accountability when auditors are left to their own initiative to detect tax evasion. When they have unaccountable power they may try to negotiate with, extort and/or blackmail taxpayers. Many times tax administration advisors advocate some sort of automatic checking mimicking the close model of traditional accounting. This can (and should) be done whenever possible, often through automation. It is, however, not possible in complex tax situations that involve making judgements during an investigation and deciding on whether to continue or not. In these situations, the area of fiscal control needs a relatively high degree of discretion that should be accompanied by close monitoring. A system in which taxpayers consistently maintain general and auxiliary ledgers is less likely to lend itself to corrupt practices than a system in which taxpayers do not maintain accounting books and records.

81. The risk of corruption is endogenous to many other tax administration actions. In the compliance management function, the risk of corruption emerges from the soundness and transparency of the fiscal accounting system. An accounting that consistently maintains general and auxiliary ledgers is likely to be corruption-proof. The risk of fraudulent entries is virtually eliminated. In Poland, the system is unable to reconcile the dairy by tax and the taxpayer ledgers, which lends itself to fraudulent entries. Precisely because of the inability to reconcile accounts, corrupt entries may never be detected. Also, aggregate outstanding arrears may never be enforced (and paid) simply because the individual taxpayer's account reports them as paid based on the fraudulent entry.

82. Annex IV presents different instances where tax and tax administration issues are permeable to corruption.

D. Information Technology for Tax Administration

83. Automation is one of the most crucial issues for the development of tax administration in Poland. Crucial decisions that have been delayed and postponed need to be made. Allocation of the required financial resources to conclude the automation efforts initiated in the early 1990s (postponed thereafter) will be necessary for systems development and compatibility with EU practices. Automation is a stated fundamental issue for EU accession as: (a) revenue administration regimes of EU members are increasingly automated, and (b) member need to interact with each other, particularly regarding the auditing of intra-European cross-border transactions.

84. At the outset of implementing its new tax system, Poland viewed automation of operations as a key objective. Substantial investment was made to automate the tax administration process in the early 1990s; however, neither its approach nor its technical content were satisfactory. The situation has lapsed without a definite solution.

85. Today, automation remains fragmented and limited in application. A part of the reason is that Poland initially—early nineties—decided to obtain the POLTAX system, a turnkey solution from a hardware vendor to automate its tax administration. Software development was supposed

to be supplied by the vendor as well. At that time there was no clear concept of what operations to be automated first and why. The business circle was not able to establish its needs and requirements in a structured and prioritised way. Users were not made part of the definition of needs. As a result, tax offices were flooded with equipment that seldom was used, eventually becoming obsolete because of the lack of well-defined, tax administration-specific software applications.[8]

86. Automation of Poland's tax administration is clearly a priority for several compelling reasons additional to EU accession:

- the volume of information generated by taxpayers every time they declare is impossible to process without the support of automation or without increasing staff considerably

- there is a need to create an environment that controls fully taxpayer liabilities to the level of individual taxpayer accounts and that implements thorough accuracy and auditability for all tax administration transactions.

- there is a need to create an environment that supports the fiscal control function. Sophisticated computerised accounting now generally available to the private sector can increase the potential for evasion unless matched by equally or more sophisticated auditing capacity in the tax administration; and,

- better taxpayer services service is needed: taxpayers are increasingly managing their accounts using IT applications. In a very short time, a tax administration, such as Poland's, without the capability for electronic filing will become a source of inefficiency for businesses and will increase both compliance and processing costs to the State and increase the potential for evasion. In addition,

1. IT System Considerations

87. Technology is a major force defining organizational design and the dynamics of tax administrations world-wide. Historically, tax administrations were not quick to adopt technological change because of a number of different constraints, including staffing limitations (no training or human resource capacity), inability to pay near market professional salaries, budget uncertainty, and procurement complications. Nonetheless, as part of the "systems paradigm" that governs contemporary societies, tax systems now confront major technological decisions. Delays in making decisions are always costly and lead to low efficiency levels. On the other hand, as in the case of Poland, applying information technology improperly can lead to major implementation problems and inefficiencies resulting from waste and fraud.

88. *IT Investment.* The cost of the investment depends on the legal definition of taxpayers and internal services. Obviously, there are differences in level of application and system capacity, with budgets usually a deciding factor. For this reason, a "project" approach, which includes feasibility studies, evaluation, implementation, and planning can be the most cost-

[8] Decentralized VAT registration and limited declaration processes were done. Also, users benefited from the exposure to data processing.

efficient way to implement information technology systems. For Poland, given budget constraints, the losers of non-systemic decisions turned out to be a tax (PIT) and a function (audit). Thus, two of the most important operations of the agency show the lowest automation level.

89. In automation projects, one key cost determinant is the response time and the comprehensiveness of the system. To make a system able to respond in a fraction of a second would increase exponentially the amount of hardware required plus related automation costs, compared to strategies geared to respond in minutes or hours. For this reason, retrieval requirements for each transaction must be scrutinised carefully.

90. The development of specific software applications is always difficult and time-consuming. After its earlier experience with a hardware supplier that agreed to provide the required software applications, Poland decided on an in-house development path based on the system the contractor supplied and what could be done using its own limited resources. Under the specific circumstances of Poland, this led to incomplete and inefficient IT applications. Although in-house development does not have to be inefficient, in Poland this has not been the case because of reasons outside the IT responsibility: (1) confuse administrative environment, (2) complex and unstable legal and regulatory environment, (3) weak strategic planning based on partial requirements often linked to the then "most urgent" problems, (4) insufficient and erratic allocation of budget resources.

91. Many countries decide to contract-out major software developments. Moreover, there is the possibility of upgrading or retooling, through adaptation, of software developed and imported from other tax administrations. This approach could be tried in Poland if tax simplification proposals are approved. The current complexity and unique nature of the Polish system may not lend itself to this alternative.

2. IT in Poland

92. The initial concept of software applications in the Polish tax system had four weaknesses: (a) it focused on a limited (and short-sighted) concept of the tax declaration--collection processes; circumscribed to VAT (b) it did not include any major process reengineering to rationalise the operations; (c) it put aside completely the automation of fiscal control to detect evasion; and, (d) given (a) through (c), no meaningful tax management information system could evolve. The enormous demand of data entry--2.5 million declarations per month—eventually could not be entered into the computers because of inadequate storage and data capture capacity in 1995.[9] While focusing first on a tax has been the observed practice to do automation in many countries to trigger the development of automation, this approach neglects the overall system integrity and makes its expansion costly and expensive as the Polish case itself demonstrates.

93. The original system was based on the centralisation of the accounting function to provide timely aggregate data on collection by tax. Although, as conceived, the system contemplated a self-contained accounting module for local tax offices, it overlooked local taxpayer service needs

[9] A situation of collapse is one in which the flow of information to be processed automatically cannot be entered into the computers because of inadequate storage and for data captive capacity.

and the structure of individual taxpayer accounts, which are the backbone of the collection function.

94. In addition, automation was to be implemented by function (registration, declaration, payment, accounting, and refunds) as software developments evolved. This approach followed an IT production logic not appropriate for tax administration "business" logic. The lack of a balanced approach lead to a one-track mind set that in turn lead to uneven efficiency and effectiveness in tax collection. At the local level, the system engendered enormous differences in service quality, i.e., fast registration but all other processes slow. Many transactions related to the personal income tax were put aside, even though this tax had the largest volume of declaration, payment, and refund transactions. In short, the system was neither set up to serve the taxpayer, nor to facilitate operations at the local level. It was geared instead to serve limited information requirements of a centralised system and to implement VAT.[10]

95. Recently, the tax IT Department has defined an integrated information management system covering a substantial number of functions, and the most important taxes. The IT environment has evolved from one of abundant hardware without specialised software applications, to one where the required software applications are either specified, available, or being developed and, there is insufficient or inadequate equipment to run these applications. In light of the 1995 system failures, caution has been exercised by executive management in defining discrete and relatively small hardware procurements required by the tax administration to process declarations.

3. Toward Unified IT Applications

96. A renewed automation effort will require detailed analysis of the basic storage and retrieval of information because this time major reengineering of processes should lead the automation efforts. In addition, automated support of fiscal control should be made part of this effort. To date, automation plans reiterate their vocation towards collection, i.e., registration, declaration, and payment and debt control. They persist in postponing the automated support of the fiscal control function.

97. Consolidation of data processing leads to cost savings and organizational changes that can shorten the time for and improve the quality of PIT refunds. Developing information packages for taxpayers starting business and providing specialised seminars, training, and receiving sector feedback should improve taxpayer compliance. Selection criteria for fiscal and tax audit would be a first step towards the automated support of audit.

98. Currently, Poznan is rationalising its tax processes through a pilot project under the auspices of the US Treasury. The pilot has been programmed in close collaboration with the IT Department and may be used as the catalyst to expand and refine the automation concept through further business process reengineering. The pilot encompasses the consolidation of data processing from PT declarations, the improvement of taxpayer services, and introduction of targeted auditing. It also includes training requirements associated with its implementation.

[10] This type of development parallels that in Hungary and Croatia, where strong data centers--geared to integrate statistics--have had a harmful effect when automation is viewed from a taxpayer perspective.

99. In contrast to the earlier IT approach, the Poznan pilot has the advantage of cutting across tax administration functions to assure a balanced development of local and central offices. As such, it represents a substantial improvement over the present IT hierarchical approach, i.e., first registration, then declaration, and finally accounting.

100. Understanding the relationship between the tax authorities and the taxpayers will be essential for successful automation. This is perhaps the most important of all perspectives and has so far been absent in recent IT developments. The notion of efficiency should include both reduction of administrative costs to the tax institution and compliance costs of taxpayers, as well as tangible improvement of services. Businesses are computerising their accounting systems. This trend is not widely acknowledged by policy makers when they are drafting the laws--even when they represent the taxpayers' interest. The key lies in: (i) the definition of general accounting standards and practices that satisfy tax administration requirements, and (ii) the use of this accounting design in the interest of tax administration. Technology provides a very powerful tool to do this. Annex V provides an inventory of systems required for supporting or executing tax administration operational functions, identifying required outputs and training needs and those available in Poland currently.

E. Conclusion

101. With no integrated management approach, there have been three clear losers in the business of tax administration: the PIT payers, the audit function, and the local tax offices. As a consequence, voluntary compliance has suffered.

102. Despite some notable improvements, like VAT implementation and control of the informal economy-- management of the tax system has not been consistent. The management of tax administration, embracing both IT and Business sides, has to organise itself to improve internal governance and to increase the overall effectiveness and performance of tax administration.

103. Although tax legislation and automation received substantial attention at the beginning of the tax system's implementation,[11] the design of a business plan and the structuring of an investment program have been absent from the managerial perspective. Furthermore, the organizational design does not take into account important connections among the managerial, operational and IT functions. Moreover, the fiscal control approach makes it difficult to discriminate among various control functions. And in the absence of an integrated systems approach and systematic data gathering about taxpayers, decisions regarding individual or groups of taxpayers cannot be made (e.g., whether to audit, status of current account, etc.). Differences about the taxation itself and tax administration have caused local offices and certain taxes to lose out because of an overly centralised approach to tax reform.

104. In most developing countries, the incapacity of tax institutions has crippled the development and implementation of OECD type tax policy and administrative standards. Poland is a case in between. It operates a tax system much more complex than some that have emerged in other latitudes as a result of a trade-off between its tax system and the limited capacity of its tax institutions. On the other hand, the administrative system did collapse, as it was unable to

[11] After the failure of the Poltax project, the Ministry of Finance showed some skepticism regarding proposed investments, regarding the IT side of tax administration.

process the tax documents it received and continues failing in the delivery of many functions. In addition, malfunctions occur because audits are not based on the optimal use of resource allocation based on structured targeting of evasion or because there is no way to know quickly who is in arrears, which limits the assessment of penalties.

F. Recommendations

105. The Polish tax system may be improved substantially by a combined policy of simplification of tax obligations, structuring of executive management functions, reorganization and automation of tax functions and the establishment of a set of incentives propitious to administrative effectiveness. In addition, the management of change will need to be built into the management concept of tax administration.

106. The Ministry of Finance cannot continue to be a set of loosely co-ordinated departments covering tax administration. Managerial efforts should tackle tax administration as an enterprise, in particular, the business side, which has been developed unevenly. Completion of the automation of the compliance functions and developing enforcement applications will be important (PT, the second most important revenue item and the audit functions need to catch-up). This would improve local tax office capacity. The dual functions of tax auditing and expenditure monitoring needs to be re-examined in light of the specialised nature of taxation and technical staffing requirements. In addition, gains made in the area of compliance should be maintained by specially addressing managerial policies that should include simplification, policy dialogue with taxpayers, massive dissemination of taxpayer information and special effort to clarify laws, regulations and interpretations.

107. To do this, the development of a more sophisticated IT support is required and the automation efforts should be framed around the needs of tax administration concretely expressed as IT requirements. The current IT policy arbitrarily persists in keeping the audit function away from automation, crippling the long-term development of tax administration.

108. Based on the foregoing analysis, the following agenda is suggested for action by the MOF and the tax authorities in Poland:

In general

- Set the proper executive management layer to direct change;
- develop a strategic vision for tax administration five years hence;
- evaluate the role and responsibilities of executive management in the tax agency;
- review the legal framework and propose laws that create incentives for compliance (like better penalties design, improved procedures) and reduces current incentives for non-compliance (like closing loopholes as proposed in the White Paper);
- harmonise tax policy, organization, administration, and automation requirements;
- reduce the number of PIT filers by excluding a large segment of labor income payers from the obligation to file a return and increasing thresholds;
- simplify and reduce the number of tax forms;
- eliminate the Treasury lien or make it compatible with legislation dealing with the security of credit transactions.
- define an change implementation plan and management strategy; and,

- allocate the required resources for a multi-year implementation of the strategic vision and plan.

With respect to organizational design, merger and fusion:

- establish operational parameters of the tax administration (Box 4.2);
- assess how the private sector can support routine tax administration activities;
- carefully design the inter- and intra-level relationships;
- segregate tax issues from other fiscal control issues;
- analyze carefully the possibilities and implications (in particular, the transition effects on operations and morale) of merging customs at this stage;
- weight the alternative of integrating data while maintaining the personality of the institutions (customs, social security);
- prepare a built-in integrity and anti-corruption strategy.

With respect to operations-cum-automation:

- define improved services through the inclusion of alternative interactions of taxpayers with tax administration;
- define a re-engineered set business requirements for all tax operations;
- define and adopt a yearly fiscal control plan;
- improve the current automation of PT to deal with excessive withholding;
- define performance measurement indicators and methods and systems for data collection;
- develop organizational and IT parameters to bring consistency in the eyes of civil society;
- structure a top-middle management organization-communication with the full range of managerial functions and internal coordination mechanisms.

With respect to automation:

- adopt a uniform five-year automation strategy to implement business requirements throughout the country;
- analyze technological choices of going about automation;
- contract out software developments if in house capacity is not consistent with plans;
- define the investment and incremental costs of implementation of strategy.

With respect to human resources

- establish adequate salaries and performance incentives for agency staff;
- understand and define a strategy to deal with the implications of change;
- define the investment and incremental costs of implementation of strategy.

Box 4.2

PARAMETERS OF A TAX ADMINISTRATION INVESTMENT PLAN

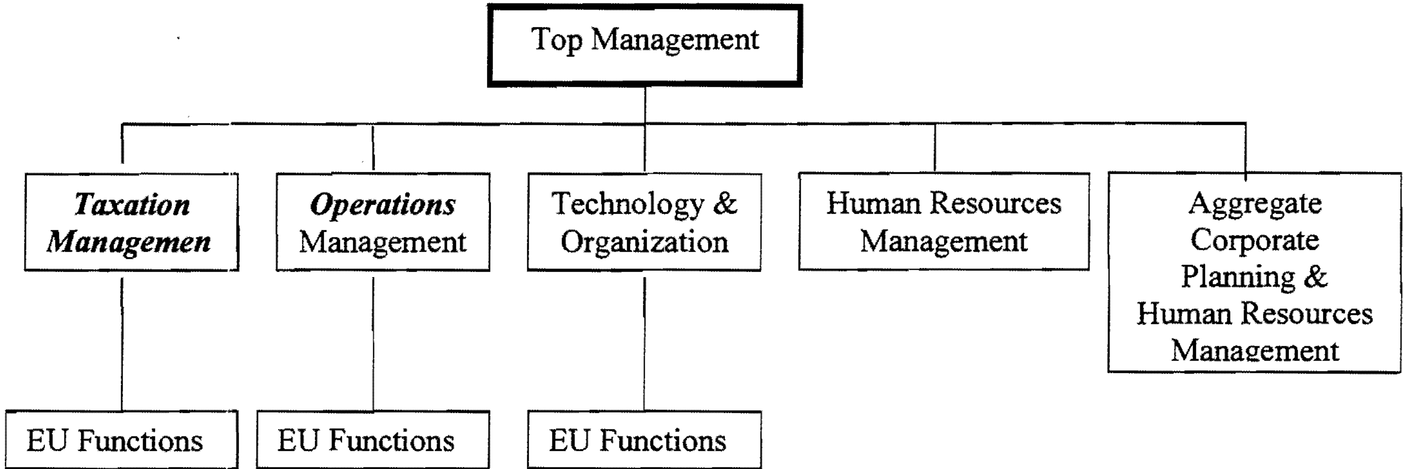
When viewed as an investment, a tax administration modernisation plan requires a long term vision and a clear mid-term strategy to achieve a set of objectives, and implementation plans prepared by the managerial team of the tax institution undergoing change. The strategy should be expressed measurable outcomes to be obtained from the investment, rather than inputs required. To a large extent, this exercise would list and define the services to be provided (a minimum required set of transactions between the taxpayers and the tax administration) and the desirable parameters for operations to be achieved when providing the selected services. Examples of norms defining taxpayers' services include:

- Taxpayers should be able to declare on paper and/or electronically on-line or using other magnetic media.
- Taxpayers should be able to determine their outstanding balances *x* days (hours, minutes, seconds) after their last declaration, assessment or payment.
- Taxpayers should be informed of missing declarations, and late and missing payments, *y* days after they become due.
- Hidden transactions should have *x, y* or *z* probability of being detected.
- Cross-checking of information should cover *u, v* or *w* % of transactions.
- Tax refunds should be given after cross-checks with information from beneficiaries of payments
- Tax refunds should be completed in *z* days (hours, minutes) after the agency receives the refund request.
- Discretion should be automatically monitored in complex cases.
- Managerial reports should be ready in *s* days (hours) at the conclusion of the evaluation cycle (day, month, semester, year)

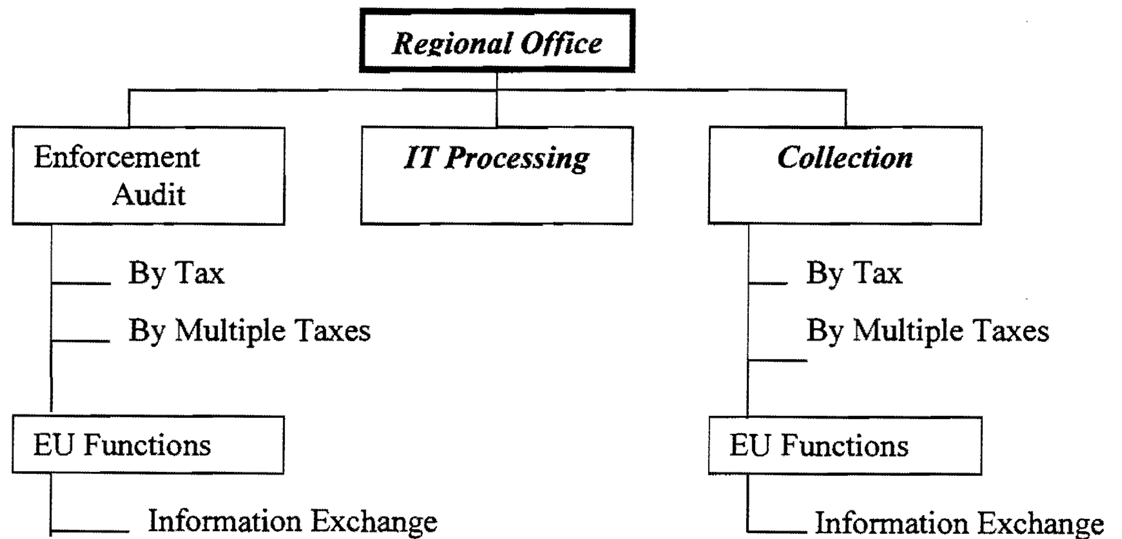
POLAND: ALTERNATIVES OF ORGANIZATIONAL DESIGN

Variant 1: One Organizational Unit for all Tax Administration Functions

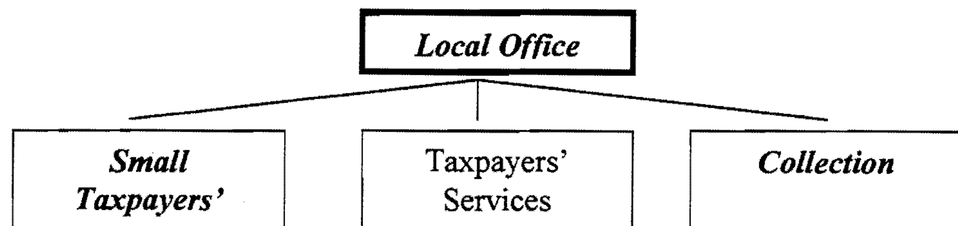
First Organizational Layer by Managerial Function



Regional Organizational Layer by Operational Functions

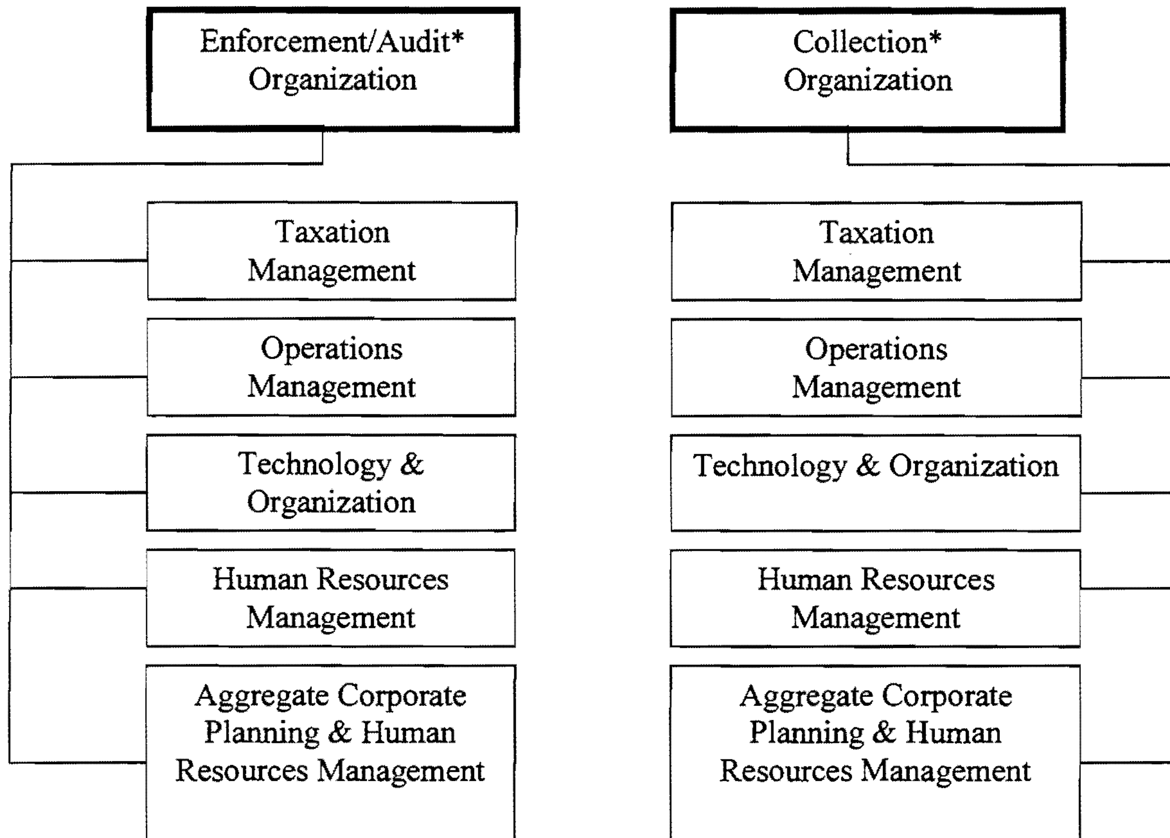


Local Organizational Layer by Operational Functions

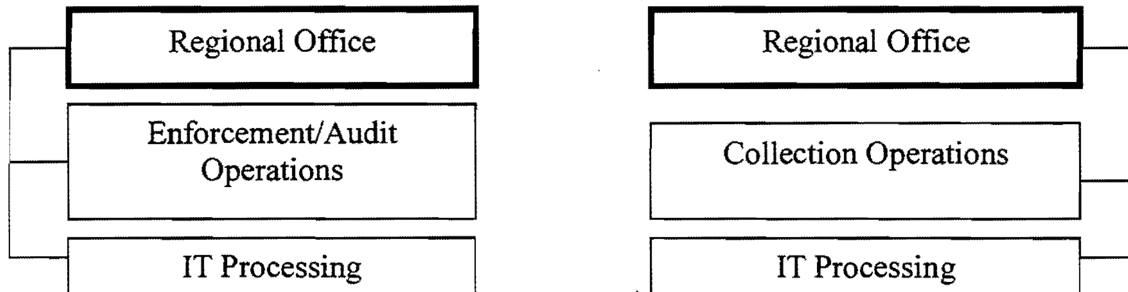


Variant 2: Two Parallel Organizational Units

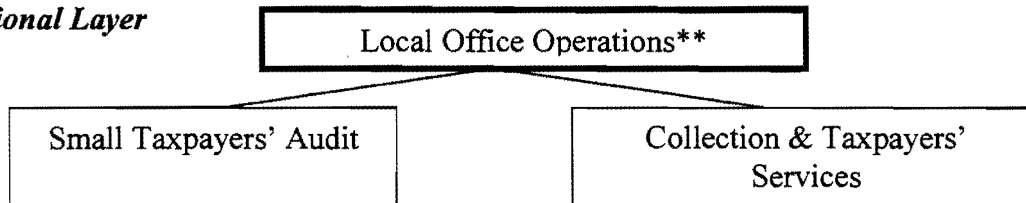
Maximum Autonomy



Regional Organizational Layer



Local Organizational Layer

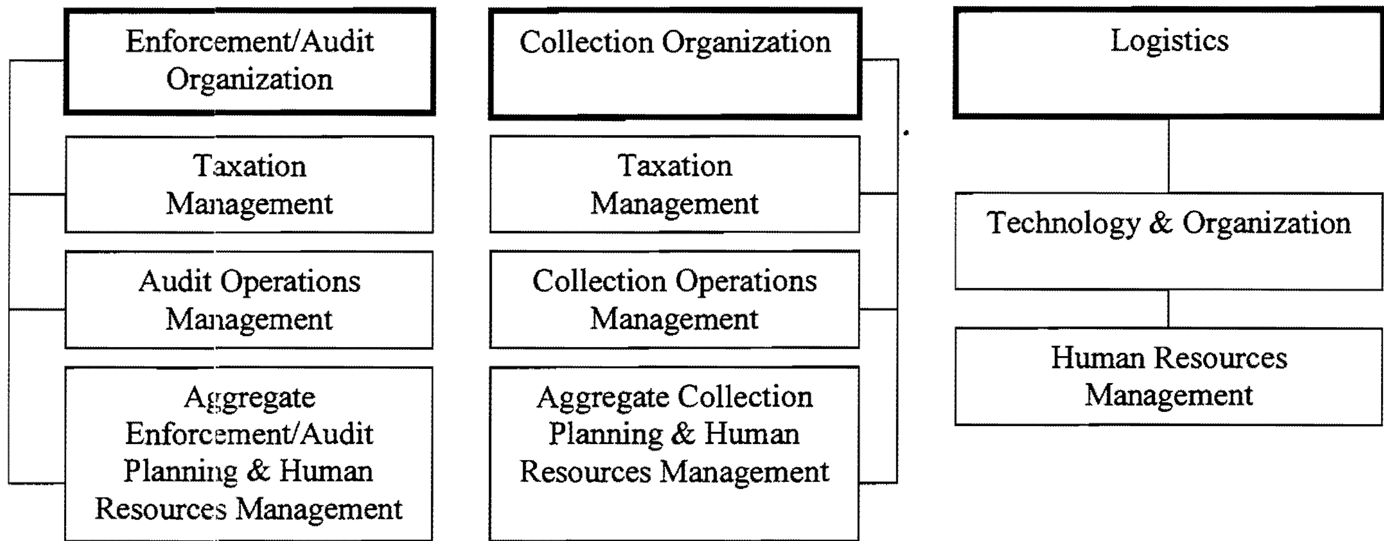


* Would include Social Security and/or Customs if integration is decided.
** Local Office should be joint.

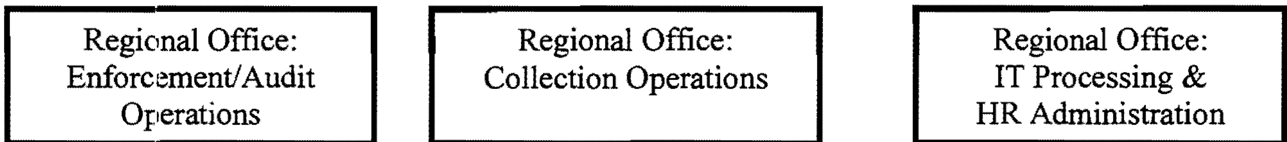
Variant 3: Two Parallel Organizational Units + One Logistics Unit

Restrained Autonomy: Technical Tax Aspects

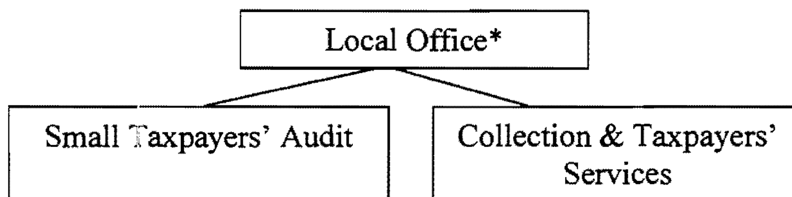
First Organizational Layer



Regional Organizational Layer



Local Organizational Layer



*Due to scale, Local Offices should subsume both operations.

POLAND: OVERALL VIEW OF TOP LEVEL MANAGERIAL FUNCTIONS OF A REDEFINED TAX ADMINISTRATION

	TAXATION MANAGEMENT		OPERATIONS MANAGEMENT		TECHNOLOGY AND ORGANIZATION		HUMAN RESOURCE MANAGEMENT	AGGREGATE CORPORATE PLANNING AND RESOURCE MANAGEMENT
FUNCTION	NATIONAL	INTERNATIONAL	BUSINESS PLANNING	PERFORMANCE EVALUATION	INFORMATION TECHNOLOGY DEVELOPMENT	ORGANIZATION AND COORDINATION		
OUTPUTS	Strategic Legal Agenda Strategic Regulatory Agenda Definition of tax administration official interpretation of tax law Re-engineering of tax laws	Implementation of Tax Treaties Strategic Position on International Relations	Corporate Plan Audit Strategy Arrears Collection Strategy Integrity Development Strategy	Definition of System of Performance Measurement Actions based on performance measurement	Strategic IT Development Plan	Organizational Strategy Functional Regional Inter-institutional Third parties Networking Integration	Human Resource Management Plan Recruitment and Selection Training Compensation and Benefits Career path Ethical Code	Corporate Plan Audit Strategy Arrears Collection Strategy Integrity Development Strategy
STRATEGIES	Development of consistency and completeness of tax laws Systematic analysis of loopholes in tax laws and procedure laws Assimilation of technological change into the tax laws	Participation in the development of country's position for entering into tax treaties. Convenience analysis of treaties from a tax administration perspective	Integrate top and middle management views into a multi-year corporate plan Refine action plans for Headquarters and operational units	Define units of performance measurement: - Organizational units - Regional offices - Programs - Individuals Determine performance criteria for - organizational units - programs - management staff - operations staff	Monitoring IT developments to improve performance Maintaining updated the institution's concept of operations Following up IT requirements of new legislation Developing interfaces with other systems Re-engineer business processes	Define functional coordination requirements Define regional interfaces and coordination requirements Define inter-institutional relations and required coordination Define coordination requirements with third parties Explore feasibility of networking Analyze benefits and costs of integration	Establish salary comparators from relevant labor markets Establish clear entrance and exit rules for staff Make recruitment policy objective Define a training master plan Issue a behavior code for tax administration staff	Integrate top and middle management views into a multi-year corporate plan Refine action plans for Headquarters and operational units

THE DILEMMAS OF TAX CONSCIOUSNESS AS POLITICAL AND ADMINISTRATIVE PROBLEMS

I DON'T PAY BECAUSE	PROBLEM	LEVEL OF THE PROBLEM		SOLUTION TO THE PROBLEM	
		Political	Administrative	Political	Administrative
I don't benefit from my payment	Expenditure Inequity	The distributional design of public expenditure is unacceptable for some	Inadequate operational planning of public expenditure	Try to apply benefit principle to a level that is feasible politically and administratively	Follow-up on who actually pays when designing coverage of public services
My neighbors (the rest of the population) don't pay taxes	Tax inequity	Exemptions and special regimes imply excess burden on other social groups	To tolerate evasion implies uneven application of collection and tax inspection empowerment	Try to widen tax bases to all taxpayers. Reduce tax rates	Define tax inspection and collection programs with horizontal equity criteria
It is too much	Excess burden incompatible with private efficiency	The level of rates is incompatible with private efficiency		Reduce tax rates and the number of taxes	
They steal the money	Corruption in expenditure management	Legal design--procurement, budget, accountability -- defines a legal environment which facilitates corrupt acts	Public administration is incapable of controlling corrupt acts emergent from the administrative process.	Simplify and introduce instruments of fiscal and administrative accountability much effective and simpler	Establish expenditure control systems that allow targeting administrative, fiscal and financial controls
I don't know how to do it	Tax Information and Taxpayers Services	Legislation does not establish basic rules of the game	Tax administration has not assumed a role for facilitating compliance by taxpayers	Integrated definitions of procedures and rules of the game	Define specific strategies--individual and collective-- of support to compliance
I tried to pay but I could not	Tax Collection Management	Tax procedure legislation and/or regulation is complex and hard to comply with	Tax administration has not assumed a role for facilitating compliance by taxpayers	Simplification of procedures defined by the laws	Define specific strategies--individual and collective-- of support to compliance Taxpayers services
If they catch me, I'll fix it	Corruption in tax administration	Tax procedure legislation and/or regulation is complex and gives disproportionate discretion to tax officials	Tax administration is perceived as corruptible	Increase accountability by law	Define tax inspection and collection strategies to permit transparency of the process Provide productivity incentives
Nothing happens if I don't pay	Institutional Incapacity of Tax Administration	Enforcement legal powers maybe weak	There is no administrative strictness for noncompliance	Review possible loopholes in law	Establish computerized monitoring systems that signal management presence and understanding of tax administration operations

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EFFECTS OF CORRUPTION IN TAX SYSTEM

CORRUPTION RISK	SITUATION	RESULTS
Definition of legal system Government lawyers Government officials Legislators	**Risk of introducing loopholes into tax laws:** drafting tax law proposals reviewing these proposals enacting laws	• Reduced tax base, reduced collection • Legal inconsistencies • Legislation deliberately sheltering vested interests • Higher rates for all other taxpayers potential • Complex, unmanageable tax system • Increased vulnerability to fraud and corruption
General interpretations Tax administrations Courts	**Risk of more loopholes being introduced**: Executive power exercising regulatory and/or interpretive capacity Judiciary power exercising regulatory and/or interpretive capacity	• Reduction of individual tax base or tax payment • Inequitable application of tax laws • Unequal competitive conditions among taxpayers leading to revenue losses. • Regulation /judicial decisions deliberately sheltering vested interest
Individual interpretations Tax administration Courts	**Risk of taxpayers requesting or receiving official but discretionary interpretations from for their own tax situation from general tax laws**	• Fragmentation of interpretation and application of the law. • Unequal competitive conditions among taxpayers • Revenue losses. • Generalized environment of corruption
System Administration Document management IT processes	**Risk from vulnerability of national accounting system of the Treasury.** Fraudulent payments introduced. Massive deletion of outstanding balances and other taxpayer debt data.	• Permanent loss of already-accrued revenues. • Permanent loss of revenue due to widespread fraudulent IT transactions.
General Administration Procurement	**Risk of fraudulent procurement activities.** Excessive payment for procurements. Misallocation of resources due to corruption incentives guiding decisions.	• Unsustainable procurement to carry out business plans. • No achievement or expensive achievement of institutional objectives.

POLAND: SUPPORTING SYSTEMS FOR TAX ADMINISTRATION OPERATIONAL FUNCTIONS

FUNCTION	Registration	Taxpayers Services	Collection Function	Fiscal Control Function	Management Function
OUTPUTS	➢ All taxpayers have a valid ID number. ➢ Updated information on all taxpayers.	➢ Reduced taxpayers' compliance cost ➢ Proactive program of consultation with taxpayers	➢ Collection ➢ Payments and returns registration ➢ Administrative enforcement actions	➢ Management of data on tax bases (return data, third party data) ➢ Improved Compliance by optimization of selection of taxpayers	➢ Maximize the impact of the organization's activities on compliance ➢ Overall management of system supporting functions ➢ Performance evaluation ➢ Comprehensive evaluation
SOFTWARE DEVELOPMENTS TO SUPPORT FUNCTION	APPLICATIONS TO: ➢ *issue and control tax ID#s* ➢ *monitor ID# related functions* ➢ *make cross-checking possible* ➢ *retrieve information when performing other functions* ➢ *develop interfaces with other registration systems*	APPLICATIONS TO: ➢ optimize private-public automation capacity - *data capture* - electronic filing - payment in banks - third-party data ➢ benefit from Internet e.g. access to tax rulings ➢ selectively disseminate tax rulings and information ➢ establish automated voice response system	APPLICATIONS TO: ➢ keep taxpayers' current account ➢ *detect and action nonfilers* ➢ monitor taxpayers in arrears ➢ enforce collection of arrears ➢ manage withholders current account ➢ monitor aggregate collection function ➢ review overall effectiveness of area and cost effectiveness ➢ update fiscal accounting	APPLICATIONS TO: ➢ target tax evaders - perform crosschecks - define evaders profiles ➢ address specific sectors audits ➢ monitor income of State officials ➢ program audit work ➢ manage audit casework ➢ support field audits ➢ monitor audit/inspection functions ➢ review overall effectiveness of area and cost effectiveness	APPLICATIONS TO: ➢ review overall, regional, local, individual and area performance ➢ resource allocation on audits ➢ follow the performance of the individual taxes ➢ monitor coordination of functions ➢ support policy formulation ➢ support strategic planning ➢ manage human resources ➢ bolster budget and procurement management
TRAINING FOR THE FUNCTION	CURRICULA ON: ➢ identification technologies ➢ input data to the database	CURRICULA ON: ➢ human relations ➢ specialized tax issues ➢ applications dealing with taxpayers support	CURRICULA ON: ➢ human relations ➢ tax arrears management and control (OECD, US IRS) ➢ applications dealing with collection operations	CURRICULA ON: ➢ human relations ➢ targeting ➢ sectoral analysis ➢ statistics ➢ international business practices, transfer pricing ➢ applications dealing with audit/inspection operations	CURRICULA ON: ➢ other tax administration practices (Field trips of managers to several tax administrations) ➢ management seminars and courses (US IRS, OECD)