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Emerging Leader of the Tax Avant-Garde

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Emerging Leader of the Tax Avant-Garde: Poland's Proposal to Institute a Flat Tax on Individual and Corporate Incomes

ABSTRACT

In 1998, Poland's Minister of Finance Leszek Balcerowicz unveiled a plan to restructure the tax system. His flat tax proposal promises numerous benefits to individual and corporate taxpayers with significant reduction in tax rates for both groups. The new plan offers to further strengthen Poland's growing economy—a consequence that is especially significant in light of the country's aspiration to join the European Union. It provides a remedy for virtually every ailment plaguing the current tax system and, most importantly, the reform offers to finance itself. This Note argues that the plan should be adopted immediately for the following reasons: (1) Poland's weak middle class is not likely to oppose it; (2) the danger of harmful consequences to those who rely on the current tax laws is minimal at best; and (3) the reform will send a positive message to the citizens about the country's well-being ten years after its transition to a free-market economy.

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I. INTRODUCTION

Last year marked the tenth anniversary of Poland's first free parliamentary election since World War II.[1] Today, Poland's economic growth is the fastest in Eastern Europe, inflation is substantially limited and the investment spending is strong.[2] Two-thirds of all jobs are now in the private sector and real wages are on the rise.[3] A recent assessment by the International Monetary Fund characterized Poland's transition to the free market economy as "firmly on track."[4] It commended Poland for "its continued record of impressive economic performance, as reflected in the achievement of sustained strong economic growth with attendant gains in living standards."[5]

Credit for this continued achievement is largely due to one man—Poland's Minister of Finance, Leszek Balcerowicz. As Deputy Prime Minister in Poland's first democratically elected government, Balcerowicz delineated the course for Poland's transition from a centralized economy to a free-market economy.[6] His scheme, known as the Balcerowicz Plan, provided for rapid decentralization, elimination of price controls, and rationing of consumer goods.[7] He pushed for speedy privatization of large, state-owned enterprises[8] that, until 1989, had been operated as centrally controlled monopolies.[9] Balcerowicz reformed the banking system and pushed for creating mechanisms for channeling private investments.[10] He was instrumental in creating the Warsaw Stock Exchange and revising Poland's tax laws.[11] Due to his reforms, the Polish, trained by the former regime to refrain from making independent economic choices, have increasingly gained confidence in the new free-market

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1. *See* Howard A. Wolf-Rodda, Note, *The Support for Eastern European Democracy Act of 1989: A Description and Assessment of Its Responsiveness to the Needs of Poland*, 17 MD. J. INT'L L. & TRADE 107, 117 (1993).

2. *See IMF Annual Assessment of Poland's Economy*, 8 BNA'S E. EUR. REP. 310 (April 20, 1998) [hereinafter *IMF Assessment*] (the article contains the full text of the International Monetary Fund press information notice released March 30, 1998 at the conclusion of the Fund's annual consultation with Poland).

3. *See id.*

4. *Id.*

5. *Id.*

6. *See* Wolf-Rodda, *supra* note 1, at 118-19. The newly formed government was led by Prime Minister Tadeusz Mazowiecki. *See id.* at 118.

7. *See id.* at 118-19.

8. *See id.*

9. *See id.* at 117.

10. *See id.* at 119.

11. *See id.*

environment and regained their entrepreneurial spirits, providing fuel for economic growth.

Balcerowicz has been in and out of his office in the Ministry of Finance during the past decade, but today the veteran is back in the Cabinet with a new vision. In 1998, he unveiled his proposal to reform Poland's fiscal scheme and to institute a flat-rate tax on all corporate and individual incomes.[12] Balcerowicz promised greater economic growth, across the board fiscal fairness, and greater administrative efficiency.[13] He asked for nothing in return but a little trust from the Polish. By virtue of Balcerowicz's excellent track record and the shear attractiveness of his proposal, this trust is amply merited.

II. THE FLAT TAX AS A CONCEPT

Nobel Laureate economist Milton Friedman first introduced the flat tax in 1962.[14] Since then, legal scholars, economists, and politicians around the world have embraced the idea. While many variations exist on Friedman's theme, the basic concept behind the flat tax is simple: substantial broadening of the taxable base accompanied by a reduction of marginal rates.[15] Broadening the taxable base is accomplished by methodically eliminating exclusions, deductions and various tax credits.[16] Once the base has been broadened, the rates are converged and lowered to generate the same amount of tax revenues as would have been produced with the narrow-base-high-progressive-rates scheme.[17]

In practice, the flat tax is not quite flat. Most of today's flat tax proposals involve a progressive scheme of taxation where income, up to a certain amount, is not subject to withholding.[18]

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12. *See generally Switch to Flat Personal Income Tax Rate Proposed by Finance Minister Balcerowicz*, 8 BNA'S E. EUR. REP. 547 (July 27, 1998) (discussing reaction to Balcerowicz's proposal to adopt a flat rate for personal income tax, at either 17 or 18 percent, to be implemented by the year 2000).

13. *See* MINISTERSTWO FINANSOW, BIALA KSIEGA PODATKOW: ANALIYA OBECNEGO SYSTEMU PODATKOWEGO, PROPOZYCTE ZMIAN [MINISTRY OF FINANCE, THE WHITE BOOK OF TAX: ANALYSIS OF THE EXISTING TAX SYSTEM, PROPOSED CHANGES] 61 (1998) [hereinafter THE WHITE BOOK].

14. *See generally* MILTON FRIEDMAN, CAPITALISM AND FREEDOM 174-76 (1st ed. 1962) (discussing 23.5% flat tax in relation to the justifications for graduated taxation and the redistribution of income).

15. *See* Michael J. Graetz, *The 1982 Minimum Tax Amendments as a First Step in the Transition to a "Flat-Rate" Tax*, 56 S. CAL. L. REV. 527, 530 (1983).

16. *See id.*

17. *See id.*

18. *See* Richard P. Davies, Note, *A Flat Tax Without Bumpy Philanthropy: Decreasing the Impact of a "Low, Single Rate" on Individual Charitable Contributions*, 70 S. CAL. L. REV. 1749, 1780 (1997).

Thus, individuals in the initial bracket are taxed at a zero rate.[19] The government taxes all others at a single rate on the excess of their income over the generous tax-free amount.[20] At least two economists, Robert E. Hall and Alvin Rabushka, authors of the proposed reform of the U.S. income tax system, advocate this particular approach.[21]

Supporters of flat rate taxation cite a number of inherent benefits of the system. First, a flat tax would serve as an incentive for individuals to work by increasing the amount of post-withholding disposable income that, in turn, would raise the "total output," thereby improving economic performance.[22] Secondly, broadening the tax base would promote neutrality of the taxing scheme, which would reduce the impact of fiscal regulation on the allocation of resources and eliminate existing disincentives to engage in certain types of economic activity.[23] A broad tax base would also mean horizontal equity, a concept requiring that all persons in similar circumstances should pay the same amount of tax.[24] Most importantly, a flat tax fosters simplicity.[25] In their proposal, Hall and Rabushka predict a "postcard" would be a sufficient replacement for "the many pages of schedules the typical [American] taxpayer fills out today."[26]

Though not without inherent difficulties,[27] flat-rate taxation offers a number of benefits, particularly to a developing economy. Indeed, many of the difficulties associated with implementing the switch to a flat tax come in the transitional stage when the old tax system is replaced with the new.[28] This presents a great

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19. *See id.*
20. *See id.*
21. *See generally* Robert E. Hall & Alvin Rabushka, *The Flat Tax: A Simple, Progressive Consumption Tax*, *in* FRONTIERS OF TAX REFORM 27 (Michael J. Boskin ed., 1996).
22. *See id.* at 44. The authors discuss their proposal for the reform of the U.S. tax system and propose a 19% flat rate on all individual and corporate income. *See id.*
23. *See* Graetz, *supra* note 15, at 530.
24. Horizontal equity would be achieved by "eliminating provisions which allow some taxpayers to reduce their taxes because of either the source of their income or the type of expenditure." *Id.* at 531.
25. *See id.*
26. Hall & Rabushka, *supra* note 21, at 32. "All the taxpayer has to do is report total wages, salaries, and pensions at the top, compute the family allowance based on marital status and number of dependents, subtract the allowance, multiply by 19 percent to compute the tax, take account of withholding, and pay the difference or apply for a refund." *Id.*
27. *See generally* Graetz, *supra* note 15, at 535-43 (discussing some of the problems of a transition to a flat-rate tax).
28. One of the most significant challenges involved in the transition to the flat tax system in the United States would be protecting the expectations of taxpayers who have relied on existing law in making long-term financial decisions. *See id.* at 536. The magnitude of this problem would not be as great for a

opportunity for developing countries with young tax schemes. Because their tax laws are not fully crystallized, they are better suited to withstand the inconveniences of the transitional stage. One such developing economy—Poland's eastern neighbor, Estonia—has recently implemented a flat tax with great success.[29] It joined Denmark and Iceland as the third European state to use a flat rate taxation scheme.[30]

III. THE CURRENT STATUS AND THE PROPOSED REFORM OF THE POLISH TAX SYSTEM

A. *Evolution of the Polish Tax System Since World War II*

1. The Polish Tax System During the Communist Era: 1945-1989

During the communist era, when the state sector dominated the economy, the phrase "government money" accurately reflected Poland's lack of fiscal policy. State enterprise was managed according to a central plan, in which a "production unit" was the basic economic variable.[31] Producers were accountable for the quantity of items manufactured rather than income generated from production. Under such a system, fundamental concepts of tax law such as gain, cost, and expenditure had no meaning.[32] Only with respect to tax liability of privately operated ventures, a rarity at the time, were those definitions utilized in the very primitive Polish tax code.[33] It would be mendacious to describe Poland's fiscal regulations of the communist era as a tax system.

Following the end of World War II, Poland reverted to the tax system established during the period between World War I and

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developing country whose tax system is not yet reliable enough to create such expectations in the taxpayers. *See* discussion *infra* Part IV.B.2.

29. Since the flat tax was implemented, Estonia has enjoyed a 10% per year growth in its economy. *See* Jerzy Baczynski, *Linia Podzialu [The Dividing Line]*, POLITYKA, July 18, 1998, at 20; *see generally European Taxation, Estonia*, Int'l Bureau of Fiscal Documentation, June 15, 1998, *available in* LEXIS, INTLAW Library, IBFDEU File (providing a concise summary of Estonia's individual tax system).

30. *See* Jerzy Baczynski & Jacek Mojkowski, *Wielka rewolucja podatkowa Balcerowicza [Balcerowicz's Big Tax Revolution]*, POLITYKA, Sept. 5, 1998, at 3 [hereinafter Baczynski & Mojkowski].

31. *See* THE WHITE BOOK, *supra* note 13, at 10.

32. *See id.* The authors opine that any tax system not utilizing concepts of price, income, gain, and cost is a fiction. *See id.*

33. *See id.*

World War II.[34] Its most fundamental element was the comprehensive income tax scheme.[35] In 1945, an earned-income tax (*podatek od wynagrodzen*) was singled out and set aside from the scheme, marking the first major step in the tax restructuring process.[36] Within two years, the rest of the income tax section of the Code was repealed along with most other provisions, making room for a system that would better fit the needs of the newly centralized economy.[37] From 1948 to 1951, a new socialist policy emerged.[38] The foundation of that policy was the principle that tax liability depended on the form of ownership of the taxable unit.[39] Consequently, the system provided for three different groups of taxes: taxes imposed on individuals, taxes imposed on the private sector, and taxes imposed on the state-operated sector of the economy.[40]

a. Tax Treatment of Individuals

The chronology of the individual income tax in communist Poland begins with the 1945 imposition of the earned-income tax.[41] As a variation on the idea of a comprehensive income tax of the 1918-1939 era, it was the only tax to survive the sweeping changes of the late forties.[42] Effective for some thirty years, the earned-income tax was finally eliminated for public sector employees during the 1971-1975 period.[43] The government continued, however, to impose the tax on individuals employed in the private sector, self-employed taxpayers, individuals receiving income as a result of pursuing scientific careers, and those pursuing careers in the arts and education.[44] The tax remained in effect through the 1991 taxable year when the Polish tax system underwent an extensive overhaul.[45]

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34. *See* RYSZARD MASTALSKI, PRAWO PODATKOWE II-CZESC SZCZEGOŁOWA [TAX LAW II—PARTICULAR PROVISIONS] 31 (2d. ed. 1998).
35. *See id.*
36. *See* THE WHITE BOOK, *supra* note 13, at 10.
37. *See id.*
38. *See id.*
39. *See id.*
40. *See id.*
41. *See id.*
42. *See* MASTALSKI, *supra* note 34, at 31.
43. *See* THE WHITE BOOK, *supra* note 13, at 10.
44. Taxes on the incomes from such activities were assessed at flat rates of 20% on the income of private sector employees, 10% on artists' and scientists' incomes, and 20% on receipts of self-employed individuals. *See id.*
45. *See generally* Ustawa o podatku dochokowym od osob fizycznych [Personal Income Tax Statute] (July 26, 1991), Dz.U. z 1993 r. Nr 90, poz. 416 z pozn. zm. [1993 Journal of Legislation, No. 90, item 416, with subsequent changes], *available in* KODEKS PRAWNIKA 377 (Wydawnictwo Prawno-Ekonomiczne INFOR, 1998) [hereinafter PIT Statute].

In 1957, the government implemented the equalizing tax (*podatek wyrownawczy*).[46] The equalizing tax affected both public and private sector employees whose income exceeded the administratively established tax-free amount.[47] Under this scheme, the government allowed deductions for expenses such as building or renovating a house and for costs associated with raising children.[48] After the 1971-1975 changes, the equalizing tax was the only potential source of tax liability for public sector employees.

b. Tax Treatment of the Private Sector

Compared to revenues generated by the state-owned entities, the private sector's contribution to the Polish economy was only marginally significant. Still, the government imposed two types of taxes on privately owned enterprises: the operating tax (*podatek obrotowy*) and the income tax (*podatek dochodowy*).[49] The basis for the tax liability under the operating tax was the quantity of articles sold.[50] Under the income tax, progressive rates were applied to earnings generated by the privately owned entities.[51] One form of the operating tax was the so-called border tax (*podatek graniczny*), imposed on private importers.[52] The basis for liability under the border tax was the amount of goods transported into the country for the purpose of redistribution.[53] Both the operating and income taxes survived through the 1993 taxable year[54] when they were reformed as part of the comprehensive restructuring of the corporate income tax scheme.[55] The border tax lasted through 1994, when it too was replaced by the import tax (*podatek importowy*).[56]

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46. *See* THE WHITE BOOK, *supra* note 13, at 10. The equalizing, along with the uniform income tax lasted through the 1991 overhaul. *See id.*

47. *See id.* The equalizing tax scheme was a progressive one with marginal rates ranging from 10% to 50%. At no time was the effective rate to exceed 40% of taxpayer's income. *See id.*

48. *See id.* at 11. There was also an exception for income generated while in pursuit of a career in the arts. *See id.*

49. *See* MASTALSKI, *supra* note 34, at 31.

50. *See* THE WHITE BOOK, *supra* note 13, at 11.

51. *See id.*

52. *See id.*

53. *See id.*

54. *See id.* Corporate income tax underwent two changes at the end of the communist era. The first reform took place when the CIT Statute [Ustawa o podatku od osob prawnych] of January 31, 1989 was implemented. The statute was replaced three years later by the statute under the same name passed on February 15, 1992. *See* MASTALSKI, *supra* note 35, at 45.

55. *See generally* Ustawa o podatku dochodowym od osob prawnych [Corporate Income Tax Statute] (February 15, 1992), Dz. U. z 1993 r. Nr 106, poz. 482 z pozn. zm. [1993 Journal of Legislation, No. 106, item 482, with subsequent

The last years of the communist regime brought some significant changes to the tax treatment of the private sector of the Polish agricultural industry. Until 1984, land used by individuals for agricultural purposes was subject to the soil tax (*podatek gruntowy*).[57] Some other forms of agronomic enterprise, the so-called special sections were subject to the progressive equalizing tax.[58] The actual income of such enterprises was not reported; rather, tax liability was calculated on the basis of a centrally estimated norm fixed for each taxpayer and measured production units.[59] Starting in 1985, land hit with the soil tax as well as many of the special section activities became subject to the new agricultural tax (*podatek rolny*)—a modification of the soil tax.[60] Poland then eliminated the agricultural tax with respect to special section activities as a part of the radical restructuring of the Polish tax system during the 1991-1992 period.[61]

c. Tax Treatment of the State-Operated Sector

The taxing of state-owned enterprises during the 1945-1989 era underwent a progression typical of centralized economies.[62] The taxing scheme initially followed the classic approach of taxing entities based on their annual profit, but the government began to depart from this approach in 1955.[63] The new scheme utilized the practice of most centralized economies, whereby taxes are characterized as contributions to the budget and are in no way tied to the taxpayer's profit.[64] The pendulum began swinging back in 1982, when Poland passed the new tax law concerning state-owned enterprises.[65] While it significantly departed from the contributions-to-the-budget approach by utilizing the classic tax-based-on-profit approach, it did not come full circle.[66] The new scheme utilized progressive rates based on profit margins

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changes], *available in* KODEKS PODATNIKA 661 (Wydawnictwo Prawno Ekonomiczne INFOR, 1998) [hereinafter CIT Statute].

56. *See* THE WHITE BOOK, *supra* note 13, at 11.

57. *See id.*

58. *See id.* Special section activities included commercial production of flowers, fruits and vegetables, activities involving greenhouse production as well as poultry farming. *See id.*

59. *See id.*

60. *See id.*

61. *See id.*

62. *See* MASTALSKI, *supra* note 34, at 43.

63. *See id.*

64. *See id.* at 44.

65. *See id.*

66. *See id.*

rather than profits.[67] The 1982 law remained in effect until the 1989-1992 overhaul.[68]

The role of Polish fiscal policy on economic development during the communist era was marginal.[69] This lack of economic impact was largely due to the fact that the state generated its revenues without the fiscal event of change in ownership.[70] The scheme, lacking that fundamental event, had neither social nor economic stimulatory power,[71] and instead, the government was forced to apply economic pressure directly. It manipulated people's incomes through central imposition of price and wage controls.[72] Within this paternalistic model of governance, the state had unlimited discretion in disposing of "government money" and a citizen was but a passive client of the government apparatus.[73]

Corporate income tax, implemented in 1989, ended the forty-year period of dissimilar tax treatment of state-owned versus private entities.[74] The change was of great significance, as Poland finally recognized the two ideologically different sectors of the economy as equal in the fiscal sense.[75] That policy shift served as the foundation for building public finance mechanisms based on fiscal fairness. Implemented through the democratic process, the reforms of the early nineties "returned the country [and its money] back to the people."[76] These reforms began to repair the damage that forty years of bad governance had caused the Polish tax system.[77]

2. The 1989-1992 Reforms

The government began reforming the Polish tax system in the late 1980s.[78] The main objective of the reform was to build a scheme utilizing solutions developed by free-market economies of

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67. *See id.*
68. *See id.*
69. *See id.* at 32.
70. *See id.*
71. *See id.*
72. *See id.*
73. *See* THE WHITE BOOK, *supra* note 13, at 5.
74. *See* MASTALSKI, *supra* note 34, at 45.
75. *See* THE WHITE BOOK, *supra* note 13, at 5.
76. *Id.*
77. The free-market compatible tax system did not exist in the post-war Poland. The evolution of the Polish tax system, commenced in 1918, was effectively interrupted for forty years. Under the circumstances, the rebuilding of the Polish tax system, initiated in 1989, had to be started anew. *See* MASTALSKI, *supra* note 34, at 32.
78. *See id.* at 45.

the West.[79] The restructuring began with two fundamental legislative acts. First came the Corporate Income Tax Statute, enacted in 1989 and later replaced in 1992 by the statute of the same name.[80] The second major step in the reform process was the enactment of the Personal Income Tax Statute in 1991.[81] The 1991-1992 overhaul eliminated several key taxes remaining from the communist era. The losers included the individual earned-income, equalizing taxes, as well as the income tax of private sector enterprises and the agricultural tax imposed on special section activities.[82]

a. The New Approach to Taxing Individuals

The 1992 Personal Income Tax Statute was the fundamental legislative act regulating taxation of individuals on incomes generated from wages, self-employment, pensions, and alternative profit-generating activities.[83] The scope of that legislative act was intentionally broad, as it was founded on the principle of uniform tax liability among all individuals.[84] Thus, the statue affected all residents, and in some cases foreign taxpayers, who generated income from activities within Poland's borders.[85] It also presumed that all income was taxable, including value of any services received by the taxpayer.[86]

Despite the broad scope of the statute, some communist-era solutions remained in effect even after 1992.[87] Perhaps the most controversial was the punitive tax imposed on state employers who did not observe the administratively determined index of allowed pay increases granted to their employees.[88] Enacted in the early 1980s, this tax survived through 1996.[89]

79. *See id.*

80. The CIT statute was first enacted on January 31, 1989. It was replaced on February 15, 1992. *See id.*

81. The PIT statue came into being on July 26, 1991. *See id.*

82. *See* THE WHITE BOOK, *supra* note 13, at 11.

83. *See* PIT Statute, *supra* note 45, art. 3, para. 1.

84. *See* MASTALSKI, *supra* note 34, at 45.

85. *See* PIT Statute, *supra* note 45, art. 3, para. 1. The statute reached all residents of Poland as well as individuals whose presence in the country exceeded 183 days during a taxable year. The statute did not reach individuals who, while in pursuit of employment for a foreign company, were temporarily present in Poland during a taxable year. *See id.* para. 2.

86. *See generally id.* art. 10, para. 1.

87. *See* THE WHITE BOOK, *supra* note 13, at 12.

88. *See id.*

89. *See id.*

b. The New Approach to Taxing Legal Entities

The biggest changes in the Polish fiscal policy came with the enactment of the Corporate Income Tax Statute.[90] Tax treatment of legal entities under the 1989 statute was founded on the principle of fiscal equality, which served as the basis for many modern tax systems.[91] This new approach was a departure from the communist-era policy of different tax treatment based on the form of ownership.[92] The 1989 statute imposed a uniform income tax on all legal entities.[93] Though in practice it did not fundamentally change the way corporations were taxed, it did achieve a uniformity of construction between the corporate and the individual tax schemes.[94] It also brought the new Polish tax system closer to its Western European counterparts.[95]

3. Current Status of the Polish Tax System

Polish law defines tax as "any obligatory payment to the state budget which is not subject to repayment, is unilateral and is paid on the basis of a general law."[96] The Minister of Finance is the highest Polish tax authority.[97] The Ministry is authorized to promulgate orders and rulings to implement the resolutions of the Council of Ministers.[98] The Ministry also oversees the lower tax authorities, represents the treasury and controls the withholding of taxes levied on individuals and legal entities.[99] The Ministry has authority to abolish tax obligations and to defer or reduce tax payments.[100] Under Polish law, all individuals and entities with or without legal personality are subject to the filing requirement.[101]

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90. *See generally* CIT Statute, *supra* note 55.
91. *See* MASTALSKI, *supra* note 34, at 45.
92. *See id.*
93. *See id.*
94. *See id.*
95. *See id.*
96. Marek Waluga, *Taxation and Investment in Poland,* V Guides to Eur. Tax'n: Tax'n & Investment in Cent. & E. Eur. Countries (Int'l Bureau of Fiscal Documentation) § 4.1 (March 1998).
97. *See id.* § 4.1.
98. *See id.*
99. *See id.*
100. *See id.*
101. *See id.*

a. Current Tax Treatment of Individuals

The most fundamental tax imposed on individuals is the Personal Income Tax.[102] In 1997, it constituted 8.7% of the gross national product (GNP).[103] The Code provides a comprehensive list of the types of income subject to withholding.[104] It also contemplates that income, taxation of which would be administratively impractical, would not be recognized.[105] Gains from gifts and inheritances, treated in other sections of the Code, are not subject to the Personal Income Tax.[106] Final tax liability is determined by applying three progressive rates to the difference of gross income and deductions.[107] The tax rates in 1998 were 19%, 13%, and 40%,[108] and the tax-free amount was 1772 zloty.[109]

The Code thoroughly defines the taxable base. It includes, though it is not limited to, income from dependent and independent services, income from business and "special branches" of agriculture, gains from real estate transactions, rental income from real estate and income from money investments and property rights.[110] Capital gains are part of the taxable base under income from money investments, income from the sale of real estate or income from business.[111] In some cases, capital gains from the sale of buildings and flats may be exempt from withholding.[112] Otherwise, profits from the sale of real estate and property rights are taxed at a flat rate of 20%.[113]

The 1982-1992 reforms of the Polish tax system came early in the process of Poland's transition towards a free-market

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102. *See* THE WHITE BOOK, *supra* note 13, at 15.
103. *See id.* app. 1.
104. *See* PIT Statute art. 10, *supra* note 45.
105. *See* THE WHITE BOOK, *supra* note 13, at 15.
106. *See id.*
107. *See id.*
108. In 1994 the government first increased the tax rates from then applicable 20%, 30%, and 40% to 21%, 33%, and 45%. They remained at this level until 1997 when the government eliminated some deductions allowable to high-income taxpayers. The change allowed the tax rates to be decreased to 20%, 32%, and 44%. In 1998, those rates were lowered again to 19% for income up to 25,252 zloty, 30% for income between 25,252 and 50,504 zloty, and 44% for income above 50,504 zloty. *See id.* at 17.
109. *See id.* at 18.
110. *See* PIT Statute, *supra* note 45, art. 10; *see also European Taxation, Poland, Individual Tax Summary*, INT'L BUREAU OF FISCAL DOCUMENTATION, May 12, 1997, § 1.2, *available in* LEXIS, INTLAW Library, IBFDEU File [hereinafter *Individual Tax Summary*].
111. *See Individual Tax Summary*, *supra* note 110, §§ 1.2.1(c), (e), (f).
112. *See id.* § 1.2.1(h).
113. *See* THE WHITE BOOK, *supra* note 13, at 30.

economy.[114] Some sectors of the Polish economy could not keep up with the fast pace of the fiscal reforms.[115] As a result, the tax scheme required constant amendments in order to remain compatible with the economy that was still to a large degree centralized.[116] The byproduct of this race between the tax, and other reforms is a large number of exclusions and deductions, many of which are of social character.[117] Thus, exempt from withholding are disability pensions of war and military invalids and their families, child-care and childbirth benefits, and social assistance to foster families.[118] The government also does not recognize subsidies for individuals to purchase coal and prescription drugs as income.[119]

The Code likewise provides for a number of deductions.[120] Many of them appear to have been designed to either encourage taxpayers to incur certain expenses or influence particular taxpayer behaviors.[121] For example, the housing deduction[122] provides a tax incentive for individuals intending to purchase land for the purpose of constructing a house.[123] Certain expenses for the purpose of expanding, renovating, and repairing a building may likewise qualify as deductible.[124] Other tax incentives include deductions for certain charitable contributions, certain membership fees, social security and other obligatory contributions, as well as costs incurred by the taxpayer in connection with his employment.[125] A taxpayer may also carry forward losses in three equal parts and offset them against ordinary income over three years.[126]

Individuals who derive their income from independent, small business activities may fall under one of two exceptions to the ordinary individual tax scheme.[127] The so-called tax card is a relatively simple scheme of taxing privately owned, unincorporated enterprises.[128] The taxpayer is not required to

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114. *See id.* at 16.
115. *See id.*
116. *See id.*
117. *See id.*
118. *See Individual Tax Summary, supra* note 110, § 1.2.1(h).
119. *See* THE WHITE BOOK, *supra* note 13, at 16.
120. *See* PIT Statute, *supra* note 45, art. 21.
121. *See* THE WHITE BOOK, *supra* note 13, at 18-19.
122. *See id.* at 19. The authors of THE WHITE BOOK opine that the housing deduction has since its institution been ineffective. *See id.* During that period 42,278,000 zloty has been deducted under this provision yet the tax incentive has not revived Poland's housing industry. *See id.* at 21.
123. *See Individual Tax Summary, supra* note 110, § 1.4.2(a).
124. *See id.* § 1.4.2(e).
125. *See id.* § 1.4.2.
126. *See id.* § 1.5.
127. *See id.* § 1.6.3.
128. *See* THE WHITE BOOK, *supra* note 13, at 32.

conduct a regular accounting of his or her business, nor is he or she subject to the requirement of filing a tax return.[129] Factors such as location, type of enterprise, and number of employees determine the tax.[130] The tax authority communicates the amount of liability to the taxpayer through a private ruling.[131]

The second exception to the individual income tax scheme is the discounted reported income.[132] Persons conducting small-scale, independent business activities may take advantage of this exception, which provides for flat rate withholdings on their incomes.[133] One determines the discounted reported income liability from the individual's reported earnings without taking into consideration expenses incurred while generating that income.[134] Depending on the type of business activity pursued by the individual, either a 3.3%, 6%, or 9% flat rate applies.[135]

Under the current Personal Income Tax scheme, effective rates vary greatly among taxpayers in the same marginal tax bracket.[136] This effect is, to some degree, the result of the large number of exceptions and deductions specifically aimed at particular groups of taxpayers. In the bottom bracket, small manufacturers and free-lance workers enjoy the lowest effective rate of 11.15%.[137] Individuals, who derive their income from more than one source, are next with a 14.79% effective rate across the group.[138] Retirees are the first bracket losers.[139] Their average tax liability in 1997 was 15.16%.[140]

The trend reverses in the second and third marginal tax brackets. There, retirees enjoy the lowest effective rate of 23.65%.[141] Public and private sector employees are in the second place with 27.17%, and self-employed individuals are the most heavily taxed at a 34.55% effective rate.[142] In 1997, only 1.0% of all taxpayers landed in the highest marginal bracket, 4.42% were

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129. *See id.*
130. *See id.*
131. *See id.*
132. *See id.* Discounted reported income (*ryczalt od przychodow ewidencjonowanych*) came into being in 1994. An individual is eligible for the election under this provision if the earnings from his enterprise in the preceding year did not exceed the amount of 288,700 zloty. *See id.*
133. *See id.*
134. *See id.*
135. *See Individual Tax Summary, supra* note 110, § 1.6.3. In 1997, some 853,668 taxpayers took advantage of either the tax card or the discounted reported income exceptions. *See* THE WHITE BOOK, *supra* note 13, at 33.
136. *See generally* THE WHITE BOOK, *supra* note 13, at 27-29.
137. *See id.* at 26.
138. *See id.*
139. *See id.*
140. *See id.*
141. *See id.*
142. *See id.*

in the middle bracket, and 94.57% of taxpayers were taxed at the lowest marginal rate.[143]

Income from gifts and inheritances and increases in wealth from the acquisition of property by adverse possession are subject to withholding under the gift and inheritance taxes.[144] Polish citizens and persons domiciled in Poland are likewise subject to this tax if the received property is located abroad.[145] Gifts and inheritances of property located in Poland are not subject to withholding if the recipient is neither a citizen nor a taxpayer domiciled in Poland.[146]

Taxpayers are grouped under three categories based on the relationship with the decedent or the donor.[147] The applicable rates are determined by reference to those categories as well as the value of the gift or inheritance.[148] Generally, the more remote the relationship and the more valuable the gift or inheritance, the higher the taxable rate.[149] The most valuable gifts and inheritances are subject to rates of 7%, 12%, and 20% for the three groups respectively.[150] Property taken in adverse possession is taxed at a separate flat rate of 7%.[151]

There are a number of exemptions from the inheritance and gift tax liability.[152] Most notably, gifts and inheritances valued below a certain minimum amount are tax-free.[153] This minimum value varies for each of the three groups of taxpayers.[154] Inherited furniture and clothing items are likewise exempt.[155] Individual small enterprises are exempt where the recipient is a close relative of the donee.[156] Gifts from abroad are tax-free provided they are transferred to Poland through a bank or a Polish consulate.[157] The donee is obligated to pay the tax while

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143. *See id.* at 30.
144. *See Individual Tax Summary, supra* note 110, at 9.
145. *See id.*
146. *See id.*
147. *See id.* Group I includes spouses, children, stepchildren, sons and daughters-in-law, parents, brothers, and sisters. *See id.* Group II included nieces and nephews, spouses of brothers, and sisters. *See id.* All others taxpayers are in Group III. *See id.*
148. *See id.* at 10.
149. *See id.*
150. *See id.* Group I rates fall between 3% and 7% depending on the size of the gift or inheritance. *See id.* Group II and III rates are from 7% to 12% and from 12% to 20% respectively. *See id.*
151. *See id.*
152. *See id.*
153. *See id.*
154. *See id.* The minimum amounts for Groups I through III are 6100, 4600, and 3100 zloty respectively. *See id.*
155. *See id.*
156. *See id.*
157. *See id.*

the donor remains jointly and severally liable for the amount due.[158]

In addition to the personal income tax and the gift and inheritance taxes, individuals in Poland may, in certain situations, be subject to liability for additional taxes including agricultural taxes, stamp duties on the transfer of property, forest taxes, and other local taxes.[159]

b. Current Tax Treatment of Legal Entities

The Polish tax system employs a classical double taxation scheme with respect to corporate earnings.[160] A legal entity's income is fully taxed in the hands of the corporation, and the profits are taxed again upon distribution as dividends.[161] Taxpayers subject to withholding in this manner include state and cooperative enterprises and other entities with legal personality including those with foreign participation.[162] The system treats legal entities incorporated in Poland and companies whose boards of directors are located in Poland as residents.[163] Their worldwide income is subject to withholding in Poland.[164] Not within the scope of the double withholding scheme are Polish partnerships.[165] The individual partners are taxed separately upon distribution of the partnership's profits.[166]

The most fundamental of the taxes imposed upon entities with legal personality is the corporate income tax.[167] In 1997, its share of the GNP was 3.1%.[168] Corporate entities must withhold to the extent their income exceeds their business expenses.[169] Some of the deductible business expenses include depreciation, damage to assets, research and development expenditures, taxes,

158. *See id.*

159. For a discussion of value added and other indirect taxes, see discussion *infra* Part III.A.3.c. For a comprehensive overview of all taxes affecting individuals in Poland, see generally Waluga, *supra* note 96.

160. *See Corporate Tax Summary, European Taxation, Poland,* INT'L BUREAU OF FISCAL DOCUMENTATION, May 6, 1997, available in LEXIS, INTLAW Library, IBFDEU File [hereinafter *Taxation of Corporations*].

161. *See id.*

162. *See id.*

163. *See id.*

164. *See id.*

165. Exempt from the corporate income tax are also the National Bank of Poland (*Narodowy Bank Polski*) and the State Treasury (*Skarb Panstwa*). *See id.* § 5.1

166. *See id.*

167. In 1997, money generated by imposing this tax constituted over 13% of all government revenues. *See* THE WHITE BOOK, *supra* note 13, at 36.

168. *See id.* app. 1.

169. *See Taxation of Corporations*, *supra* note 160, at 2.

and charitable contributions.[170] Non-deductible items include, among others, the cost of earning tax-exempt income, interest on taxpayer's capital invested for profit, fines, and fiscal penalties.[171] There is likewise a long list of tax exempt categories of income. This list includes income allocated to the statutory objectives of corporations involved in charitable or educational activities, certain profits of trade unions and political parties, income from foreign sources pursuant to international agreements, and income of taxpayers employing disabled persons.[172]

The corporate income tax contemplates certain tax incentives. The most significant of those are investment allowances, tax holidays, and tax relief for companies investing in certain economic zones.[173] A company may benefit from an investment allowance when it incurs certain investment expenditures such as the cost of purchasing and assembling machinery and the cost of purchasing intangibles.[174] Likewise, when a company engages in business in certain predetermined economic zones, it may enjoy favorable tax treatment.[175] Under the special economic zones incentive, companies may even enjoy a total exemption from corporate tax liability.[176] Certain companies that participate in foreign markets and are capitalized from foreign sources may also enjoy income tax holidays.[177] All of those incentives share a similar objective of encouraging investment in the Polish economy, particularly in zones with retarded economic growth.[178] They are also intended to function as motivation for taxpayers to disclose their earnings.[179] Despite their attractiveness, in 1997, only 2% of taxpayers subject to the corporate income tax took advantage of those incentives.[180]

Capital gains of entities with legal personality are likewise subject to withholding.[181] Depending on their type, capital gains may be subject to corporate income tax, a 20% reduced rate, or exemption from taxes altogether.[182] Dividends received by corporate entities fall into the middle category.[183] Capital gains of non-resident entities from the sale of publicly traded stock

170. *See id.*
171. *See id.* at 3.
172. *See id.*
173. *See id.* at 4.
174. *See id.*
175. *See id.* at 5.
176. *See id.*
177. *See id.* at 4-5.
178. *See* THE WHITE BOOK, *supra* note 13, at 36.
179. *See id.*
180. *See id.*
181. *See Taxation of Corporations*, *supra* note 160, at 4.
182. *See* THE WHITE BOOK, *supra* note 13, at 36.
183. *See id.*

obtained on the Warsaw Stock Exchange may in some cases be tax exempt.[184] Poland has entered a number of treaties with other European partners to avoid the double taxation of capital gains. Pursuant to those treaties, the rates of taxation of such gains vary from 0% to 15%.[185]

c. Social Security, Payroll, and Transaction Taxes

Social Security and Payroll taxes impose a particularly heavy burden upon employers.[186] The social welfare system reform has been slow since the commencement of Poland's transition toward a free market economy.[187] The ghosts of the centralized economy, lurking everywhere, have continuously posed challenges to the budget drafters. It seems that the new tax system is not quite compatible with such communist era relics as the Polish archaic health care system.[188] One of the by-products of this situation is the high social security tax imposed on employers.[189] Employers are obligated to contribute 45% of each employee's salary to the Social Insurance Fund.[190] Additionally, 3% of the employee's wages go to the Labor Fund, which covers unemployment.[191] Finally, employers make a 0.18% contribution to the Fund of the Warranted Employee's Claims and in some cases an additional donation to the National Fund for Rehabilitation of Disabled Persons.[192] In sum, for each person in the lowest personal income bracket, the employer pays over 74% of the employee's net wages in social security payroll and income taxes.[193] For more qualified employees, this percentage increases to over 111% for persons in the second marginal income bracket, and in case of the highest paid employees, the contribution reaches an astonishing 146% of that employee's net salary.[194]

One of the most fundamental changes in the Polish tax system came with the addition of the value-added tax (VAT) in

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184. *See Taxation of Corporations*, *supra* note 160, at 4.
185. *See* THE WHITE BOOK, *supra* note 13, at 36.
186. *See generally* Waluga, *supra* note 96, at 59.
187. *See generally* Joanna Solska, *Inwalida w obrotach [Invalid's Ride]*, POLITYKA, Nov. 28, 1998, at 3.
188. *See* IMF Assessment, *supra* note 2, at 311. The report informs of the IMF Directors' encouragement of the Polish government to press forward with pension and health care system reforms. *See id.*
189. *See* Waluga, *supra* note 96, at 59.
190. *See id.*
191. *See id.*
192. *See id.*
193. *See* THE WHITE BOOK, *supra* note 13, at 50.
194. *See id.*

1993.[195] All individuals and entities with legal personality that, during the course of business, supply goods or services, are subject to the withholding of VAT.[196] This includes taxpayers who receive imported services.[197] Exempt, however, are those taxpayers whose turnover in the preceding year did not exceed a certain amount.[198] Also, those taxpayers filing under the tax card exception to the personal income tax are not subject to withholding of VAT.[199]

The VAT taxable basis is turnover.[200] In the case of imported services, the basis is the amount paid for the services by the importer.[201] One major exemption from VAT applies to the sale of an enterprise or an organized part of an enterprise.[202] Likewise dairy products, unprocessed meat and poultry, raw agricultural products, artistic products, postal, financial, insurance and health care services as well as services connected with science, development of technology, education, culture, art, and sport are exempt from VAT.[203] Although not exempt, a 0% rate also applies to books, maps and other publications, and the export of goods and services.[204] The applicable rates for the non-exempt transactions are a 7% reduced rate on certain goods and services, and a standard 22% rate on all others.[205] Value-added tax generated 8.3% of Poland's 1997 GNP.[206]

An excise tax is yet another recent addition to the scheme of fiscal regulation. The government brought back the tax as a part of the VAT Statute after almost fifty years.[207] Producers and importers of luxury goods,[208] including alcoholic beverages, tobacco products, salt, engine oils and fuels, cars, yachts, some electronic equipment, perfumes, playing cards, and equipment for operating games and mutual betting must pay the excise tax.[209] The tax is also imposed on producers or importers who

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195. *See generally* Ustawa o podatku od towarow i uslug oraz o podatku akcyzowym [The Value Added and Excise Tax Statute], Dz.U. z 1997 r. Nr 11, poz. 50 z poz. zm. [1997 Journal of Legislation, No. 11, item 50, with subsequent changes] (Jan. 8, 1993), available in KODEKS PRAWNIKA 147 (Wydawnictwo Prawno-Ekonomiczne INFOR, 1998) [hereinafter VAT Statute].

196. *See* Waluga, *supra* note 96, at 63.

197. *See id.*

198. *See id.*

199. *See id.*

200. *See id.*

201. *See id.*

202. *See id.*

203. *See id.* at 63-64.

204. *See id.* at 64.

205. *See id.*

206. *See* THE WHITE BOOK, *supra* note 13, app. 1.

207. *See generally* VAT Statute, *supra* note 195.

208. *See* Waluga, *supra* note 96, at 65.

209. *See id.*

excessively waste any excisable good during any stage of its turnover.[210] The export of excisable goods is tax exempt.[211]

The base for the tax is the turnover of the excisable goods.[212] The rates differ with respect to producers and importers.[213] For the former, rates vary from the standard 25% rate to 40% on cars and up to 95% on spirits.[214] Importers' rates are considerably higher[215] and reflect the government's protection of two major manufacturing sectors: automotive and alcohol industries. The standard rate and the rate on cars are 40% and 75% respectively.[216] It increases to 230% for wine products, beer, tobacco, and non-spirits alcohol products, 400% for fuels and oil and finally to a draconian 1900% for spirits.[217] In 1997, the excise tax generated 4% of Poland's GNP.[218]

Yet another element in the scheme of taxation of transactions is the game tax.[219] This tax came into being under the Law on Games of Chance and Mutual Betting enacted in 1992.[220] The tax is imposed on games and mutual betting activities and is a substitute for VAT and excise tax.[221] The tax rates vary depending on the kind of game or betting activity, ranging from 105% to 60%.[222] The game tax generated 0.1% of the GNP in 1997.[223]

B. *Proposed Changes*

1. Balcerowicz's Mid-Term Economic Strategy

In 1998, Poland's Finance Minister Leszek Balcerowicz pushed for an economic plan that would lead the country into the twenty-first century.[224] He proposed a so-called mid-term economic strategy, which encompassed the years 1999 through

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210. *See* THE WHITE BOOK, *supra* note 13, at 40.
211. *See* Waluga, *supra* note 96, at 65.
212. *See id.*
213. *See id.*
214. *See id.* Producers' rates on non-spirit alcohol products and fuels and oils are 70% and 80%, respectively. *See id.*
215. *See id.*
216. *See id.*
217. *See id.*
218. *See* THE WHITE BOOK, *supra* note 13, app. 1.
219. *See* Waluga, *supra* note 96, at 66-68.
220. *See id.*
221. *See id.*
222. *See id.*
223. *See* THE WHITE BOOK, *supra* note 13, app. 1.
224. *See Cabinet to Resume Consideration of Balcerowicz's Mid-Term Strategy*, 8 BNA'S E. EUR. REP. 322 (May 4, 1998).

2001.[225] The two main objectives that the Ministry aimed to achieve were the acceleration of privatization and the simplification of the tax system.[226] Although criticism continues to daunt Balcerowicz's plan, help from a large number of the Minister's supporters and the sheer persuasiveness of his arguments have fostered a gradual implementation of his strategy.[227]

Balcerowicz's plan seeks to speed the process of privatization by intensifying the government's effort to sell off state holdings in certain sectors such as the defense industry.[228] Additionally, the plan advocates the government's active involvement in increasing the number of companies listed on the Warsaw Stock Exchange.[229] As a final objective, the mid-term economic strategy seeks to simplify the Polish tax system by introducing single rate taxation on all corporate and individual incomes.[230]

2. Theoretical Underpinnings of the Government's Plan

In the White Book of Tax, the Ministry of Finance revealed the theoretical underpinnings of the proposal.[231] The drafters subscribe to the view that the effectiveness of a taxing system depends on four criteria. First, the scheme must reward taxpayers for engaging in activities that promote productivity.[232] Second, the scheme must be administratively efficient and simple in order to minimize both the burden of filing upon the taxpayer and the burden of collecting upon the taxing authority.[233] The third criterion is the explicitness of the scheme—the law must be precise and unambiguous.[234] Finally, an efficient tax system must be stable, allowing taxpayers to plan and implement their long-term financial strategies.[235] The Ministry recognizes that

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225. *See id.*
226. *See id.*
227. Bogdan Wyznikiewicz, Director of the Gdansk Institute for Market Economics opined that the Cabinet would likely approve Balcerowicz's plan. *See Link to Privatization Plan*, 8 BNA'S E. EURP. REP. 332 (May 4, 1998). He also expressed his view of Balcerowicz as "the most experienced policy maker in Poland, and possibly Eastern Europe." *Id.* He was likewise impressed with the strength of the Minister's arguments in the debate over the benefits of his mid-term strategy. *See id.*
228. *See id.*
229. *See id.*
230. *See* discussion *infra* Part III.B.3.
231. *See generally* THE WHITE BOOK, *supra* note 13.
232. *See id.* at 58.
233. *See id.*
234. *See id.*
235. *See id.*

stabilization of the tax system must be preceded by a reform that would ensure the achievement of the first three criteria.[236]

Designing a scheme that rewards productivity and taking initiative is, according to the drafters, a critical objective.[237] Fiscal regulation should play a role in ensuring that benefits associated with being employed always outweigh the attractiveness of remaining unemployed.[238] As a general rule, a taxpayer's income should correlate with his or her effectiveness and hard work.[239] Trying to earn more must always make financial sense.[240] The incentive must also be there for the taxpayer to pursue higher education.[241] Withholding at progressive rates defeats that objective, as higher education ordinarily corresponds with higher earnings and much greater tax liability.[242]

On the corporate side, the system must encourage employers to create jobs.[243] Poland must remain fiscally competitive in order to encourage both native and foreign businesses to operate there and hire local workers.[244] The tax system should also reward technological innovation.[245] This objective necessitates a more favorable treatment of capital gains over those from other types of financial investments.[246] Finally, as a general rule, the scheme must not favor consumption over saving.[247]

3. The Essence of the Proposed Reform

There are five core objectives that underlie the proposed tax system reform.[248] The first of these captures the most fundamental social and economic goals of the current government: to maintain the annual national economic growth above 6% over the next ten years and to create more jobs.[249] Second, the drafters aim to increase public trust in the taxing authority and to eliminate opportunities for abuse and manipulation of the system.[250] Third, the new tax system must

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236. *See id.*
237. *See id.* at 59.
238. *See id.*
239. *See id.*
240. *See id.*
241. *See id.*
242. *See id.*
243. *See id.*
244. *See id.*
245. *See id.* at 60.
246. *See id.*
247. *See id.*
248. *See id.* at 57.
249. *See id.*
250. *See id.*

ensure Poland's adaptability to the changing economic climate in Europe—it must be attractive to foreign firms and capital and remain friendly to foreign investors.[251] Fourth, the scheme should be able to adapt to future changes in Poland's economy, such as increased local autonomy and the anticipated reorganization of the health care system.[252] Finally, the new tax system must ensure Poland's compliance with the strict economic requirements of the European Union.[253] The reform plan submitted by the Ministry of Finance attempts to achieve all five of these objectives.[254]

The reform is to progress through four stages.[255] It will begin in 1999 with a reduction in the number of personal income tax brackets and an increase in the amount not subject to withholding.[256] The new marginal rates will be 22% and 32%, and the corporate rate will be decreased from 36% to 32%. In 2000, the personal income tax rate will be reduced to a flat 22%%, marking the second stage in the reform.[257] That same year, the corporate income tax rate will drop to 26% and the new comprehensive tax law, governing the taxation of all entities regardless of their form and income sources, will go into effect.[258] In the last two stages, the corporate rate will decrease to 24%, and finally, the asymmetry between the corporate and the individual rates will be eliminated by the year 2002 with the implementation of a flat 22% rate.[259]

One of the goals of the reform is to immediately lessen the tax burden on individuals with low income.[260] This objective will be achieved despite the initial increase in the lowest individual income rate from 19% to 22%.[261] To counterbalance the effect of that increase, the amount of income not subject to withholding will increase from 1772 zloty in 1998 to 3600 zloty in 1999.[262] These initial steps, according to the Ministry of Finance, will actually decrease the effective rate of taxation for low-income

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251. *See id.*
252. *See id.*
253. *See id.*
254. *See id.*
255. *See id.* at 63.
256. *See id.*
257. *See id.*
258. *See id.*
259. *See* Baczynski & Mojkowski, *supra* note 30, at 3.
260. *See* THE WHITE BOOK, *supra* note 13, at 62.
261. *See id.* at 63.
262. The tax free amount was, until 1998, expressed as a standard deduction to be subtracted from the final tax liability. This amount was 336.60 zloty in 1998, and it corresponded with 1772 zloty of income not subject to withholding. *See id.* at 18.

individuals from the current average of 14.97% to 13.46%.[263] Additionally, two favorable exceptions to the individual tax scheme for small businesses, the tax card and the discounted reported income, will likewise be utilized in the new system.[264]

An essential aspect of the reform is the elimination of most deductions and exclusions from the tax scheme.[265] This step is consistent with the reform's broad goal of achieving equality of tax treatment among entities irrespective of their form and the character of their enterprise.[266] More importantly, the elimination of those tax incentives will increase the taxable base, which will ensure that the reform process will not decrease the revenues generated by the government.[267] In fact, the Ministry of Finance expects the reform to finance itself.[268] Taxpayers currently taking advantage of certain tax incentives will continue to be able to do so under the new scheme.[269]

Yet another significant aspect of the reform is the change in tax treatment of agricultural enterprises.[270] The drafters clearly considered the diversity among the players in this industry. On the one hand, large enterprises will be subject to withholding under the same principles as all other corporations.[271] On the other hand, smaller enterprises will pay taxes in an amount based on the size of the farm.[272] These small producers will not be forced to keep track of their income and expenses for tax purposes.[273] This difference in treatment reflects the reality of the industry that many of the smaller farms are run by older, often under-educated owners.[274]

While the reform does not plan on bringing changes in the gift and inheritance tax schemes, the real estate value tax will replace the current real estate tax.[275] This new tax will also replace the forest and the agricultural taxes.[276] The basis for assessing liability under the real estate value tax will be an appraisal of the property and not, as it was under the former taxes, its size.[277] Assessment of the real estate value tax will

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263. *See id.* at 64.
264. *See id.* at 71.
265. *See id.* at 62.
266. *See id.*
267. *See id.*
268. *See* Baczynski & Mojkowski, *supra* note 30, at 3.
269. *See* THE WHITE BOOK, *supra* note 13, at 67.
270. *See id.*
271. *See id.*
272. *See id.*
273. *See id.*
274. *See id.*
275. *See id.* at 82.
276. *See id.* at 83.
277. *See id.*

require granting greater responsibilities to the local taxing authorities.[278] This will go hand in hand with the general decentralization of Poland's government—a process that is already under way.[279]

No fundamental changes are expected in either the value-added or the excise tax schemes, although the Ministry of Finance will be forced to address the issue of Poland's compliance with the European Union's requirements.[280] The Ministry will have to make the biggest adjustments with the value-added tax on raw agricultural products, building materials, books and magazines, and cultural and artistic services.[281] Certain adjustments will also affect the excise tax. Most notably, the government will raise the tax on gasoline to comply with the standards imposed by the European Union.[282]

IV. WILL THE FLAT TAX WORK FOR POLAND?

A. *Is There a Need for Change?*

That the Polish tax system is in need of reform is, to many, not immediately obvious. The fact that Poland's economy has been strong makes the task of convincing Balcerowicz's critics of the benefits of reform that much more difficult. Their argument—that the current tax system is not interfering with the economic growth—is not easily discounted without a thorough examination of the system itself. A closer look at the tax law reveals its weaknesses and provides strong counter-evidence to the argument of Balcerowicz's opponents.

1. Tax Burden Imposed on Employers

Perhaps the most obvious defect of the current system is the exorbitant tax burden on employers, in particular, those with legal personality.[283] First, corporations are subject to a high, 36% rate of withholding on their incomes.[284] Poland's CIT rate is significantly higher than that of its Eastern European

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278. *See id.* at 84.
279. *See id.*
280. *See id.* at 72. For an overview of EU's tax harmonization measures, see generally, Tracy A. Kaye, *European Tax Harmonization and the Implications for U.S. Tax Policy*, 19 B.C. INT'L & COMP. L. REV. 109 (1996).
281. See THE WHITE BOOK, *supra* note 13, at 72.
282. *See id.* at 80.
283. *See* discussion *supra* Part III.A.3.c.
284. *See* THE WHITE BOOK *supra* note 13, at 37.

counterparts where the rates fall between 18% (Hungary) and 29% (Czech Republic).[285] Secondly, Poland's employers contribute between 74% and 146% of each employee's net wages in social security, payroll, and individual income taxes.[286] Here again, Poland lands nowhere near the European average of 53%.[287] The negative impact of this arrangement on the Polish economy is self-evident.

The high tax burden imposed on employers is a tremendous disincentive to create new jobs.[288] The large number of individuals who work off the books is evidence that employers could create the positions if it made economic sense for the employers to do so.[289] Faced with the alternative of being able to save significantly by hiring employees illegally, employers often pursue that option.[290] Likewise, employees themselves have little incentive to increase their qualifications.[291] Knowing that they are more likely to be hired for entry-level, low paying positions, they are reluctant to pursue higher education. This arrangement creates a particularly destructive effect on Poland's high-technology industry by significantly slowing its growth[292]—a consequence that is unacceptable to a country trying to compete with highly-developed Western European economies.

2. Complexity of the Tax Code

Another major fault of the existing tax system is its complexity. The law is now replete with tax incentives, most of them added to the scheme during the 1993-1997 period.[293] In the personal income tax alone, 125 exclusions may be found in both the statute and the accompanying Treasury regulations.[294] Some twenty-nine deductions supplement the list of tax incentives for individuals.[295] Forty more exclusions apply to legal entities and an additional seventeen benefit value-added

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285. *See id.* at 50. The authors speculate both the Czech and the Hungarian governments intended for these low rates to stimulate reinvestment of capital. *See id.*

286. *See* discussion *supra* Part III.A.3.c.

287. *See* THE WHITE BOOK, *supra* note 13, at 50. For further comparison, U.S. and Japanese averages are 36% and 34%, respectively. *See id.*

288. *See id.*

289. *See* discussion infra Part IV.A.1, A.4.

290. *See* Baczynski & Mojkowski, *supra* note 30, at 3.

291. *See* THE WHITE BOOK, *supra* note 13, at 51.

292. *See id.*

293. *See* Baczynski & Mojkowski, *supra* note 30, at 3.

294. *See* THE WHITE BOOK, *supra* note 13, at 52.

295. Thirteen of those deductions are above the line and sixteen are below the line. *See id.*

taxpayers.[296] Finally, the tax authorities maintain broad power to waive income tax obligations, set up payment plans or even forego enforcement against taxpayers, on a case-by-case basis.[297]

This multitude of tax incentives has an inescapable consequence of creating an unfair advantage for taxpayers whose financial position allows them to make deductible expenditures.[298] In 1997, 81% of the second bracket and nearly 90% of third-bracket taxpayers claimed a deduction on their tax returns.[299] By contrast, only 39% of taxpayers in the first bracket benefited from such tax incentives.[300] Minimum amounts of expenditure and other qualifying requirements keep the deductions out of poor taxpayers' reach.[301] Complexity of the law only exaggerates the problem, as uneducated and elderly taxpayers are often unaware of their eligibility for deductions and cannot afford professional tax advice. This effect is evident in the first bracket in which retirees suffer the highest effective rates.[302]

The complexity of the tax system may also discourage taxpayers from reporting their incomes.[303] When the new personal income tax system was initially implemented in 1991, the drafters did not contemplate the large number of taxpayers who would opt to independently calculate their own taxes.[304] Since then, a growing number of tax incentives and continuous creation of new income sources have forced more and more taxpayers to fill out their own tax forms. Today, nearly 60% of all taxpayers tackle these forms, often devoting days to conquering the task.[305] As the complexity of the system increases, more and more taxpayers may decide to take their chances and abstain

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296. *See id.*
297. *See id.*
298. *See* Baczynski & Mojkowski, *supra* note 30, at 3.
299. *See* THE WHITE BOOK, *supra* note 13, at 20. The most popular of them—the housing deduction—has stimulated new home construction while the rest of the industry has for many years remained stagnant. *See id.* The retirement account deduction has benefited only the very few who can afford such accounts. *See id.* The deduction for expenditures on educational tools is reserved for those who can make the qualifying purchases. *See id.* at 21. Wealthy parents can also deduct their children's private school tuition. *See id.* at 22.
300. *See id.* at 29 tbl.15.
301. For example, the housing deduction has a minimum amount of expenditure requirement. *See id.* at 21. People who can afford to build their own home benefit greatly from that incentive. *See id.* On the other hand, those who merely renovate their living quarters often do not spend enough to qualify for a write off. *See id.* at 22.
302. *See* discussion *supra* Part III.A.3.a.
303. *See* Baczynski & Mojkowski, *supra* note 30, at 3.
304. *See id.*
305. *See id.*

from filing rather than spend endless hours trying to make sense of the law.[306]

Finally, the complexity and instability of the tax system are both detrimental to taxpayers' ability to formulate long-term financial plans. During the 1992-1998 period, Poland amended the personal income tax scheme on thirty separate occasions.[307] The corporate income and the value-added tax schemes have likewise changed numerous times during that period.[308] While most of the amendments have been implemented as legislative repairs of the faulty scheme, many of them were politically motivated and cannot be otherwise justified.[309] The effect has been a tax system in motion, with no predictable future. Taxpayers are unable to foresee the future consequences of their financial decisions with any degree of certainty, and in many cases, they forego the speculation. This harmful effect cannot continue if Poland is to compete with other European entrepreneur-friendly taxing schemes.

3. Ambiguity of the Tax Code

In addition to its overwhelming complexity, Poland's tax laws lack clarity. They are often poorly structured and written using language that promotes misinterpretations.[310] Each aspect of the fiscal scheme is a jigsaw puzzle in which the pertinent statute is but one of the pieces. To understand the personal income taxation scheme, a taxpayer must cross-reference the PIT statute, including its thirty amendments, with a few dozen Union statutes containing supplementing definitions, thirteen directives of the Ministry of Finance and nineteen directives of the Council of Ministers.[311] Then that taxpayer must analyze the tens of thousands of rulings issued by the tax authority each year, often with conflicting results on identical facts.[312]

Because of the ambiguities inherent in the tax laws, the taxing authority must endure tremendous administrative costs. The cost of researching and issuing the thousands of inter-

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306. *See* Stephen Moore, *The Economic and Civil Liberties Case for a National Sales Tax*, *in* FRONTIERS OF TAX REFORM 110, 112-13 (M. Boskin ed., 1996) (providing a discussion of the effort American taxpayers put into completing their tax forms); *see also* M. Scotland Morris, *Reframing The Flat Tax Debate: Three Not-So-Easy Steps For Evaluating Radical Tax Reform Proposals*, 48 FLA. L. REV. 159, 162 (1996).

307. *See* THE WHITE BOOK, *supra* note 13, at 53.

308. *See id.*

309. *See id.*

310. The authors criticize the drafters for using language "lacking legislative craft." *Id.*

311. *See id.* at 52.

312. *See* Baczynski & Mojkowski, *supra* note 30, at 3.

pretative decisions year by year is undoubtedly high.[313] Indeed, not even the White Book of Tax discloses the annual cost of executing the fiscal regulations.[314] One author has characterized this peculiar state of affairs, in which highly skilled tax specialists devote endless hours to unraveling the mysteries of the scheme, as "a waste of human energy and talent."[315] As if the interpretative costs were not enough, the taxing authority incurs significant expenses trying to enforce the ambiguous tax laws upon taxpayers who become misinformed or who otherwise misinterpret the Code entirely in good faith.[316] Ultimately, the administrative costs affected by the unnecessary complexity and ambiguity of the law are imposed on the taxpayer through higher taxes.

Ambiguity of the tax laws creates an incentive for taxpayers to defraud the government. Knowing that the administration is not sure how to interpret the Code, taxpayers often misuse tax incentives.[317] For example, it is not unusual for a taxpayer to claim the cost of an expensive vacuum cleaner as a medical deduction or write off the cost of a bicycle or a summer vacation under the physical education deduction.[318] When confronted with having to justify the deduction, taxpayers point to ambiguous Code provisions and employ the good faith mistake pardon.[319]

The consequences of this arrangement are troubling. On the one hand, the honest taxpayer suffers, as the government externalizes the tax abuse losses by increasing the rates. On the other hand, the reputation of the taxing authority suffers as a result of frequent confrontations with the taxpayers.[320] The latter consequence is particularly unwanted during Poland's difficult transition to a free-market economy, as the symbiotic relationship between the government and its citizens is a critical element of the reform's success.

4. Gray-Market

The expression gray-market refers to all forms of concealed tax evasion.[321] It captures conscious and purposeful efforts to circumvent the tax system, including deliberate non-compliance

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313. *See id.*
314. *See generally*, THE WHITE BOOK, *supra* note 13.
315. *See* Baczynski & Mojkowski, *supra* note 30, at 3.
316. *See id.*
317. *See id.*
318. *See id.*
319. *See id.*
320. *See id.*
321. *See* THE WHITE BOOK, *supra* note 13, at 53.

with formal requirements and refusing to discharge tax obligations.[322] It is estimated that in 1994, production of the gray-market sector of the economy constituted 18% of Poland's gross domestic product.[323] This statistic does not include taxpayers who openly refused to pay taxes, a phenomenon increasingly practiced by the remaining state-owned enterprises.[324]

Various inadequacies of the tax system are to blame for Poland's unusually large gray market. In particular, the high corporate income tax rate creates a tremendous incentive for corporations to understate their taxable incomes. They easily accomplish this by concealing their actual gains or overstating their operating costs.[325] Another common practice among many smaller firms is underreporting employees' incomes in order to avoid the high tax burden imposed upon employers.[326] Many corporations hire employees either off the books or as independent contractors in order to avoid this liability altogether.[327] Finally, it is not unusual for importers to conceal the value of their turnover in order to avoid value added or excise tax liability.[328] This is accomplished through false invoices that get "overlooked" by corrupted tax administration employees.[329] Amazingly, most businesses engaging in such activities are properly registered and otherwise law-abiding taxpayers. It is estimated that some 70% of the gray-market output may be attributed to such businesses.[330]

The second incentive for firms to engage in tax evasion is the low risk of getting caught. Here the complex, ambiguous tax law, the administrative inefficiency of the tax authority, and the primitive enforcement methods contribute to the problem. Individuals often choose to operate their enterprises in unregistered form, thereby remaining beyond the reach of the taxing scheme in order to maximize their profits. Indeed, over 30% of the gray-market output comes from unregistered enterprises that do not report their incomes at all.[331] In the end, the revenue loss generated by this group along with the losses

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322. *See id.*
323. *See id.* at 54. The organ that issued the report in 1994 noted the decreasing tendency of this phenomenon and predicted that the gray-market output would continue to diminish by 1% per year. *See id.*
324. *See id.*
325. *See id.* at 55.
326. *See id.*
327. *See id.*
328. *See id.*
329. *See id.*
330. *See id.*
331. *See id.* at 56.

attributable to the registered gray-market enterprises are imposed on other taxpayers in the form of higher taxes. One of the fundamental goals of the proposed tax reform is to minimize the gray market's contribution to the gross domestic product.

5. Political Nature of the Legislative Process

Since the 1991-1992 reforms, the tax system has become a political marketplace where wealthy interest groups buy tax incentives.[332] Indeed, most of them are byproducts of the political process and not effects of a planned economic strategy.[333] In a properly functioning tax system, deductions stimulate various economic behaviors.[334] They are "crafted in consultation with domestic interests," and incite the "individuals and companies to work toward perceived national goals."[335] In Poland, the misuse of tax incentives has become so pervasive that politicians today perceive the discussion of tax issues as nothing but a method of gaining voters.[336] National interests and economic goals are rarely a part of the legislative debate surrounding the passing of tax law amendments.[337] As one author pointed out, "to this day, in the Ministry of Finance documents, one will find neither the justifications for many of the deductions and exclusions nor the analysis of the fiscal consequences of their implementation."[338]

6. Progressive Tax Ill Logic

Poland bases its idea of fiscal fairness on the principle that wealthier taxpayers should pay more than the less fortunate ones.[339] The initial progressive rates of 20%, 30%, and 40% were

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332. *See* Baczynski & Mojkowski, *supra* note 30, at 3.

333. *See id.*

334. The proposition has received its share of criticism particularly from the proponents of the principle of neutrality. Indeed, one author opines that "the temptation to use fiscal instruments to achieve nonfiscal purposes is unlikely to be held down for long." Richard M. Bird, *Experience from a Century of Change*, *in* TAX POLICY IN THE TWENTY-FIRST CENTURY 17, 27 (Herbert Stein ed., 1988).

335. Lawrence H. Summers, *Taxation In a Small World*, *in* TAX POLICY IN THE TWENTY-FIRST CENTURY, *supra* note 334, at 64 (the statement particularly refers to the U.S. tax system).

336. *See* Baczynski & Mojkowski, *supra* note 30, at 3.

337. *See id.*

338. *Id.*

339. *See id.* Professor Michael J. Graetz believes that "multiple tax rates serve one of two purposes, (1) they enable the legislature to favor certain types of investment or consumption, or (2) they reflect a belief that fairness demands some progressive rates in a tax system." *Flat Tax: Hearings on the Flat Tax Proposal Before the Senate Comm. on Finance* (statement of Michael J. Graetz, Justus S. Hotchkiss Professor of Law), *available in* 1995 WL 306776. On the later point, he

designed to conform with that objective.[340] Yet the political reality has set the tax system on a different course. As the number of tax incentives has steadily increased over the years, and as many of such incentives benefited primarily the taxpayers in the higher brackets, the effective rates between the three groups began converging.[341] It became obvious that on a fundamental level, Poland's highly politicized multi-incentive approach and the progressive rates were irreconcilable, as the former destroyed what the latter had set out to achieve.[342] As the government's fiscal strategy became increasingly convoluted, the once critical idea of fiscal fairness slowly became a secondary concern in the debate over the tax system.

The complete lack of rhyme or reason in the tax system is evident from analyzing current statistical data. The fact that 5.4% of individuals contribute 33% of all personal income tax revenues[343] speaks volumes about the unfairness of the current scheme. Paradoxes likewise abound in the first bracket, in which retirees pay taxes at higher effective rates than do both sole entrepreneurs and individuals who derive their income from multiple sources.[344] The poorest first bracket taxpayers, those with income not exceeding 5000 zloty, are taxed at a rate 1.1% higher than the rest of the group.[345] Because the first bracket includes over 95% of all taxpayers,[346] its problems are not merely illustrative examples—they reflect the confused state of the entire tax system.

Poor fiscal planning, conflicting interests, and powerful political forces have, over the last decade, caused the scheme to slip deeper and deeper into chaos. Today's laws are too complex, too ambiguous and full of inconsistencies. They slow the growth of Poland's economy and promote fiscal inequality. Drastic steps must now be taken to set Poland's fiscal policy back on the right

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quotes the New York Times columnist William Safire: "Most of us accept as 'fair' this principle: the poor should pay nothing, the middlers something, the rich the highest percentage." *Id.*

340. For the chronology of PIT rate changes, see *supra* note 108 and accompanying text.

341. Between 1994-1996, effective rates in the three brackets steadily converged from 16.9%, 20.1%, 29.4% in 1994 to 15.8%, 16.8%, 29.2% in 1995 and 15.0%, 16.0%, 25.2% in 1996. *See* THE WHITE BOOK, *supra* note 13, at 23 tbl.5.

342 In practice, progressive rates and multiple tax incentives work against each other. *See id.* On one hand, progressive rates subject the wealthy to higher marginal rates. *See id.* On the other hand, tax incentives tailored to the wealthy lower their effective tax liability. See *id.*

343. *See id.* at 30.

344. *See* discussion *supra* Part III.A.3.a.

345. *See* THE WHITE BOOK, *supra* note 13, at 30.

346. *See id.*

course and ensure that the taxing scheme becomes responsive to the needs of the growing economy. Balcerowicz's proposal is a radical step toward achieving these objectives. His plan has the potential to be the rescue mission needed to save Poland's tax system from collapse.

B. *Will the System Overhaul Work Its Magic? An Optimist's Perspective*

Balcerowicz's proposal comes with a strong backing. Economists in the United States have for years strenuously argued the flat tax would benefit the American economy.[347] Likewise, many European scholars have given careful consideration to the feasibility of this option as a basis for tax and social security systems in the European Union, concluding that it could be the best way to proceed.[348] Furthermore, the recent success of Poland's neighbor, Estonia, whose economic growth has been a steady 10% since the country switched to a flat tax scheme,[349] demonstrates that Balcerowicz's proposal is worthy of careful consideration. The plan makes a good case for being the solution to the problems that currently cripple the tax system. For the reasons that follow, now is a great time for Poland to take yet another chance on Balcerowicz.

1. The Major Benefits of the Reform

a. Benefits to the Economy

The most important benefit offered by the flat tax is its stimulating effect upon Poland's economy. Improvement in the performance of the economy will come as a consequence of two fundamental changes: a radical reduction in the corporate income tax rate from the current 36% to 22% by 2002, and a comprehensive restructuring of the personal income tax scheme.

For nearly a decade, corporate taxpayers have argued that the existing system puts too high a tax burden on business income.[350] Balcerowicz's promise to reduce the CIT rate by 14%

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347. The two leading proponents of the movement, Professors Robert Hall and Alvin Rabushka, recommend the flat tax as a cure that would bring "drastic simplification" to the system. *See* Hall & Rabushka, *supra* note 21, at 53. They promise "the economy would thrive under the improved incentives that the flat tax would provide." *Id.*

348. *See, e.g.*, A.B. ATKINSON, PUBLIC ECONOMICS IN ACTION: THE BASIC INCOME/FLAT TAX PROPOSAL 154 (1995).

349. *See* Baczynski, *supra* note 29, at 20.

350. *See* THE WHITE BOOK, *supra* note 13, at 50.

over four years is an answer to those pleas beyond the taxpayer's wildest expectations.[351] The change would put Poland alongside its Eastern European economic rivals, Hungary and the Czech Republic, as yet another investor friendly country.[352] Indeed the tax break, along with other changes in the corporate income tax scheme, promises to procure a positive effect on capital formation.[353] Under Balcerowicz's plan, businesses would treat purchases of equipment and buildings as expenses[354] and according to flat tax proponents, the allowance for an immediate write-off of investment expenditures is "the ideal investment incentive."[355]

The tax reform will likewise reward entrepreneurial efforts by reducing the corporate tax rate. As it stands, the taxing scheme promotes "confiscatory taxation of successful endeavors and the tax subsidy for safe, non-entrepreneurial undertakings."[356] The latter effect is largely due to the interest deduction.[357] The former may be attributable to the high CIT rate and the practice of double taxation.[358] Balcerowicz's reform addresses this problem, on the one hand, by doing away with the interest deduction[359] and on the other, by reducing the tax rate[360]. As a consequence, the draconian 36% corporate income tax rate will no longer discourage investors from choosing a corporation as their income-making vehicle of choice. Flow of capital back into innovation and development will ensure the formation of new businesses and the creation of new jobs. Contribution to the economy from these emerging resources will be correspondingly high.[361]

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351. Commentators characterize the announcement as a "revelation." *See, e.g.*, Baczynski & Mojkowski, *supra* note 30, at 3.

352. Corporate income tax rates in both Hungary and the Czech Republic are significantly lower than Poland's 36% rate. *See* THE WHITE BOOK, *supra* note 13, at 50. The two economies may be characterized as investor friendly since lower rates encourage investment.

353. Because the Ministry's proposal is in most significant aspects indistinguishable from the model proposed in 1995 by professors Robert Hall and Alvin Rabushka, their conclusions provide a helpful analogy. *See* Hall & Rabushka, *supra* note 21, at 47.

354. This is a consequence of eliminating most of the existing tax incentives. *See* THE WHITE BOOK, *supra* note 13, at 66.

355. Hall & Rabushka, *supra* note 21, at 46.

356. *Id.* at 47. The authors admit that scholarly studies are not available to verify to what extent a fundamental shift away from this practice would generate economic benefits, though they speculate that such benefits "could be large." *Id.*

357. *See id.*

358. *See* THE WHITE BOOK, *supra* note 13, at 49-51.

359. This, according to the proposal would happen in the year 2000. *See id.* at 69.

360. *See* discussion *supra* Part III.B.3.

361. Hall and Rabushka estimated that if such reform were to be undertaken in the Unites States, it would generate a three percent increase in output from "added capital formation and dramatically improved entrepreneurial

The 14% reduction in the corporate tax rate closely correlates with the anticipated changes in the scheme of personal income taxation.[362] Existence of an asymmetry between the corporate and personal income tax rates would act as an incentive for an artificial attribution of income to the entity subject to the lower rate.[363] Thus, the plan contemplates finally converging the two rates as the last step in the reform.[364] This will proceed in stages to ensure that the diminishing revenues from the corporate income tax will not seriously destabilize the budget, and that the Ministry of Finance can compensate for the loss through continuous increase in the value-added tax rates.[365]

The second aspect of Balcerowicz's proposal—the reform of the personal income tax scheme—offers additional benefits to the Polish economy. Elimination of progressive rates is certain to improve incentives to work by increasing after-tax wages.[366] Economists almost universally agree that most taxpayers would respond to this added incentive by increasing their work effort.[367] A few workers may reduce their hours "either because the flat rate would exceed their current marginal rate or because reform would add so much to their incomes that they would feel that earning was less urgent," but the "majority would face much improved incentives" and respond accordingly.[368] The increase in taxpayers' work effort will, in the end, have a positive impact upon the economy by raising the overall output.[369]

This total output will likewise be affected by an increase in the stock of human capital that will come as a result of the reform.[370] High tax rates have, for years, served as a disincentive

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incentives." *See* Hall & Rabushka, *supra* note 21, at 48. (The authors also project a three percent increase in output "from increased total work in the U.S. economy").

362. *See* discussion *supra* Part III.B.3.

363. *See* THE WHITE BOOK, *supra* note 13, at 63.

364. *See* discussion *supra* Part III.B.3.

365. For an overview of how the reform will be financed, see discussion *infra* Part IV.B.2.

366. *See* Hall & Rabushka, *supra* note 21, at 44.

367. *See id.* at 45.

368. *Id.*

369. *See The Fairness of a Flat Tax: Hearings Before the House Ways and Means Comm.* (1995) (statement of Alan Reynolds, Director of Economic Research, Hudson Institute) *available in* 1995 WL 339763.

> By increasing the incentive to save, and to invest time and money in education and training, a flat tax would enlarge the economy's stock of capital and human capital, thus reducing the relative income shares of those who are already endowed with such assets, while increasing real tax receipts and enlarging national wealth in the process.

Id.

370. *See id.* at 11.

for people to invest their time and money in higher education.[371] "Steeply rising marginal . . . rates have [had] a demoralizing impact on those who might otherwise [invest in their training], thus making capital and skills artificially scarce and valuable."[372] Balcerowicz's reform promises to undo this effect by eliminating the progressive rates and lowering effective tax liability for 86.7% of all individual taxpayers.[373] Because the change in the stock of human capital is directly proportional to the variation in the tax rates,[374] an increase in this type of capital will likely ensue. This, in turn, will reduce the relative income share of the highly skilled individuals[375] and cause a significant increase in revenues.[376] Improved incentives for the highly educated will also limit the emigration of such individuals,[377] creating a competitive labor force that is sure to profit Polish businesses and attract foreign capital to Poland.

Poland's small businesses play a critical role in the country's economic development. The fact that the flat tax offers numerous benefits to this group of taxpayers is a powerful selling point of Balcerowicz's plan. Individual business owners themselves appreciate the impact the flat tax would have on entrepreneurs and small businesses by enhancing the benefits of working and risk taking.[378] "In terms of expanding the pool of available capital, lowering and flattening income tax rates, and tax simplification . . . small businesses will thrive under such reforms."[379] Symmetry between the corporate and personal income taxes further ensures that decisions to incorporate such

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371. Unskilled laborers ultimately suffer the consequences, as their productivity and, hence, their wages, are inherently connected with the economic well being of the skilled workers. *See id.* at 10.

372. *Id.* at 12.

373. *See* THE WHITE BOOK, *supra* note 13, at 65.

374. Economists have argued that for every increase in tax rates, the stock of human capital decreases proportionally with a much stronger effect if the rates are progressive. *See The Fairness of a Flat Tax: Hearings Before the Ways and Means Comm.*, *supra* note 369, at 11 (statement of Alan Reynolds).

375. Today, second and third bracket taxpayers (5.43% of all taxpayers) pay 33% of all personal income taxes. *See* THE WHITE BOOK, *supra* note 13, at 30.

376. *See The Fairness of a Flat Tax: Hearings Before the Ways and Means Comm.*, *supra* note 369, at 12.

377. This is referred to as the so-called brain drain. *See id.* at 11. The author notes further that "[t]alent may also be diverted from highly-taxed productive activity toward underground activities or rent-seeking (lobbying for government favors, such as import quotas)." *Id.*

378. In the United States, small businesses are one of the most powerful supporters of the flat tax. *See, e.g.*, *Impact of Flat Tax on Small Businesses: Hearings Before the Subcomm. on Taxation and Finance of the Comm. on Small Business, U.S. House of Representatives* (1995) (testimony of Raymond J. Keating, Chief Economist, The Small Business Survival Committee) available in 1995 WL 306659.

379. *Id.* at 5.

businesses will only be marginally influenced by tax considerations. In effect, Balcerowicz's plan creates an environment conducive to successful building and expansion of business enterprises.

b. Other Benefits of the Plan

A particular vestige of the communist era has not allowed many Poles to get a clear view of Balcerowicz's plan. Many of them are uneasy about letting wealth be controlled by market forces. They view fiscal regulation in the society as a method of controlling relative economic positions between groups of taxpayers and, to them, Balcerowicz's plan goes against that objective by attempting to surrender such control to the free market.[380] Yet, if they were to forego their fear momentarily, the flat tax would suddenly gain in appeal. Indeed, many commentators agree that a flat tax is fundamentally fairer than a progressive scheme,[381] because it is non-discriminatory, and it extends the base to all taxpayers.[382] It does not promote a punitive effect on wealthier taxpayers,[383] nor does it favor any sources of income over others.[384] Were Poland to adopt Balcerowicz's proposal, the uniform tax law would finally put farmers in the same category as other individual taxpayers.[385]

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380. *See* Baczynski, *supra* note 29, at 20. The same taxpayers, when asked whether they would like to see lower tax rates, elimination of tax incentives, simplification of the tax system, elimination of the "gray area," and whether they agree with the maxim that "one that works harder should earn more" in all cases have answered in the affirmative. *See id.* This psychological barrier then, does not seem to be insurmountable. *See id.*

381. *See, e.g.*, STAFF OF SENATE JOINT ECON. COMM., 104TH CONG., FLAT TAX: POTENTIAL FOR ECONOMIC GROWTH (1995) *available in* 1995 WL 306606 ("The flat tax, with its one low tax rate, would insure that all taxpayers pay their share. Tax breaks for special interests would be eliminated. The flat tax would provide fundamental fairness for all taxpayers.") [hereinafter SJEC Report]. *But see, e.g.*, *Flat Tax: Hearings Before the Senate Fin. Comm.* (1995) *available in* 1995 WL 306766 (prepared statement of Professor Sheldon D. Pollack, Dept. of Accounting, College of Business and Economics, University of Delaware) (describing the claim that a flat tax is a "fairer" tax as "invariably put forth without argument or reason, as if the proposition is another of those truths which we hold as self-evident.").

382. *See* THE WHITE BOOK, *supra* note 13, at 62-63.

383. *See supra* notes 341-44 and accompanying text.

384. Balcerowicz's proposal contemplates passing a comprehensive statute by the year 2002 that would regulate income tax liability of all taxpayers regardless of the kind or the type of income they receive. *See* THE WHITE BOOK, *supra* note 13, at 63.

385. *See* Baczynski, *supra* note 29, at 20. The author suggests that putting farmers in a separate category from the other individual taxpayers and subjecting them to different tax treatment makes them de facto citizens of a different category, and in that sense it is demeaning to them. *See id.*

Furthermore, elimination of tax incentives would insure that all income is treated equally.

Simplicity is the central feature of the proposed tax system. The reform offers to reduce the high administrative costs that the tax authority incurs year after year.[386] Passing Balcerowicz's simple tax laws would eliminate the need for countless rulings and administrative decisions.[387] Likewise, the cost of executing the laws will decrease as the number of incidents of non-compliance will undoubtedly drop and the money thus saved may be used to address the problem of Poland's gray-market or to combat criminal tax evasion. From the taxpayer's standpoint, the effort and cost of complying with the tax laws would likewise drastically fall.[388] This dramatic drop in the cost of tax advice would facilitate long-term financial planning, thereby increasing the success rate among small enterprises.[389] Finally, a simple, unambiguous tax system would bring greater confidence in the government and an increased cooperation between the taxpayer and the tax system.[390]

The new tax system offers to significantly limit the output of the gray market.[391] The two most pervasive practices of the gray-market taxpayers—mischaracterization of an employee's status and under-reporting of income[392]—may soon become too risky to pursue. As a result of savings in administrative costs brought about by the reform, the tax authority will allocate more resources to fighting these and other forms of tax evasion.[393] Furthermore, the benefit of pursuing such activities will diminish as a result of the reduction in tax rates and may no longer be justifiable to the taxpayer under the new law. As a result, the risk-versus-benefit analysis is likely to force many gray-market taxpayers into compliance.

As a final consequence, Balcerowicz's plan promises to eliminate politics from fiscal regulations. The continuous move towards a more politically driven legislative process in the tax area has had a significant negative impact on the law.[394] The

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386. *See id.*

387. *See id.*

388. As an appendix to THE WHITE BOOK OF TAX, the Ministry included a sample of a personal income tax form to be utilized under the new system. It resembles the IRS form 1040EZ. *See* THE WHITE BOOK, *supra* note 13, app. Form PIT-2000.

389. *See* Baczynski & Mojkowski, *supra* note 30, at 3.

390. "[C]omplex taxes diminish confidence in government, inviting a breakdown in cooperation with the tax system and the spread of outright evasion." Hall & Rabushka, *supra* note 21, at 29.

391. *See* Baczynski, *supra* note 29, at 20.

392. *See* THE WHITE BOOK, *supra* note 13 at 55-56.

393. *See* Baczynski, *supra* note 29, at 20.

394. *See* discussion *supra* Part IV.A.5.

increase in the number of tax incentives during the 1993-1997 era is in large part attributable to pressure from the wealthy interest groups.[395] Balcerowicz's plan offers to cure the consequences of that legislative fiasco by eliminating all exclusions and deductions from the tax scheme.[396] In place of the old scheme, the Ministry offers a new system that promises to equally represent all groups of taxpayers irrespective of their political influence.

2. Why Now is the Time to Implement the Flat Tax

"Economic progress, in capitalist society, means turmoil."[397] In no situation is the truth of this maxim more manifest than when a government undertakes to reform its tax system. It is one endeavor in which almost every citizen has a significant stake in the outcome, and none of them want to go through the battle unheard. This political process is almost certain to complicate even the most straightforward proposal.[398] It is then critical to the success of the reform that the government chooses the right way, and the right time to proceed with the undertaking.

Balcerowicz's introduction of the reform plan was highly effective. The White Book of Tax was unveiled to the members of the cabinet and the public only after the Ministry worked out the details of the proposal behind closed doors.[399] While opponents of the reform accused Balcerowicz of not subjecting aspects of the proposal to public debate;[400] he was by that time holding the final numbers and speaking of the benefits that the entire reform would bring to the taxpayers. He aimed to shift the public's focus from the lost tax incentives and higher value-added taxes toward lower effective rates for individual taxpayers, new jobs and gains to Poland's economy. He advertised the proposal in the popular media in the form accessible to the average taxpayer,[401] in an attempt to draw support from the major beneficiaries. The Ministry may have circumvented the political process and saved itself from having to compromise on particular aspects of the

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395. *See* Baczynski & Mojkowski, *supra* note 30, at 3.

396. *See* THE WHITE BOOK, *supra* note 13, at 62.

397. DANIEL B. BAKER, POWER QUOTES 57 (1992) (quoting Joseph Schumpeter, CAPITALISM, SOCIALISM AND DEMOCRACY).

398. *See* Hall & Rabushka, *supra* note 21, at 41.

399. *See* Jacek Mojkowski, *Fundament czy klajster na fasadzie [A Foundation or Putty on The Facade]*, POLITYKA, Sept. 12, 1998, at 16.

400. *See id.* Balcerowicz conceded that nothing would have been more disastrous to the reform than turmoil, demagogy and arguments based on numbers taken out of context that would have resulted from subjecting single aspects of the plan to public debate. *See id.*

401. *See, e.g.*, Baczynski & Mojkowski, *supra* note 30, at 3 (describing the essence of Balcerowicz's proposal).

proposed plan. If this approach proves as effective in practice as it does in theory, the Ministry will proceed with the reform not having "made concessions to the political pressures they may well [have] force[d] the nation to accept an improved tax system that f[ell] short of the ideal" that Balcerowicz had in mind.[402]

The timing of Balcerowicz's proposal is likewise impeccable. One of the challenges of reforming a tax system is honoring plans and commitments made by taxpayers in reliance on the old tax law.[403] Naturally, this reliance is a function of time; the older and more stable the tax system, the more likely these taxpayers' plans and long-term commitments involve, to some degree, considerations based on the existing tax laws. On the other hand, in a fluid tax system, taxpayers are less likely to consider tax implications in making their financial decisions since the consequences of their reliance would be uncertain. Because Poland's tax system has undergone a constant stream of changes and amendments in the last decade,[404] the number of taxpayers who rely on the old scheme and who would be hurt by the reform is presumably relatively small.[405] To those few that did expect to continue taking advantage of certain deductions, Balcerowicz's proposal offers to temporarily preserve these incentives.[406] Poland must take advantage of this favorable circumstance immediately, else there may never come a time when harmful consequences of a tax reform would be so limited.

Yet another motive for immediately undertaking the reform is the limited threat of political opposition from the Poland's middle class. Commentators have long been skeptical about the possibility of a flat tax's success in the United States because of its adverse consequence to middle-class taxpayers.[407] By all accounts, a flat tax substantially shifts the tax burden from high-income to middle-income households.[408] Indeed, Balcerowicz' proposal concedes that for some 13% of taxpayers, their tax burden would actually increase by an average of 0.6%.[409] Included in that group are second bracket taxpayers, whose tax liability would increase by some 1.3% under the flat tax

402. Hall & Rabushka, *supra* note 21, at 41.

403. Depreciation and interest deductions are a significant source of such reliance and in order for the tax reform to remain fair and impartial it must address the problem. *See id.*

404. *See* discussion *supra* Part IV.A.

405. *See* THE WHITE BOOK, *supra* note 13, at 67.

406. *See id.*

407. *See* Charles E. McClure Jr. & George R. Zodrow, *A Hybrid Approach to the Direct Taxation of Consumption, in* FRONTIERS OF TAX REFORM, *supra* note 21, at 72.

408. *See id.*

409. *See* THE WHITE BOOK, *supra* note 13, at 65.

scheme.[410] Indeed, were it not for the fact that the Polish middle class is in its infancy (second bracket individuals constitute 4.4% of all taxpayers),[411] Balcerowicz's plan would likely face strong political opposition. By undertaking the reform today, its chances of passing without having to make significant compromises along the way are strong. As the middle class continues to grow, that chance will gradually slip away.

After a decade of difficult transition to a free market economy, not all individuals have been equally rewarded. Though the economy has continuously strengthened, a large segment of the population has not yet seen any significant improvement in their standard of living. Lowering the tax burden for that group of taxpayers[412] offers them a small reward for enduring the painful transition at the time when they need it most. For many of them, lower taxes may constitute the only meaningful evidence that the economy is indeed doing well, and that the sacrifices they have made in the last decade have been wholly justified. The government would corroborate this evidence by not backing down from the proposal. By pursuing the self-financing reform, it would demonstrate, through action and not just on paper, its absolute confidence in the strength of the economy. The power of this message may never be stronger than on the tenth anniversary of the commencement of Poland's journey toward capitalism.

V. CONCLUSION

Ten years after Balcerowicz set Poland on course toward a free market economy, he deserves our trust yet again. His flat tax proposal promises numerous benefits to individual and corporate taxpayers with significant reduction in tax rates for both groups. It offers to further strengthen the economy—a consequence that is especially significant in light of Poland's aspiration to join the European Union. It contemplates a remedy for virtually every ailment plaguing the current tax system, and most importantly, the transition offers to finance itself. The time to set the reform in motion is now. The proponents must appreciate the favorable circumstances that exist today: lack of political opposition from the middle class, limited harmful consequences to taxpayers, and a positive message the reform will send. They must push for the reform, confident that in the end, the flat tax will prove to be just

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410. *See id.* at 66 tbl. 19.
411. *See id.* at 30.
412. *See* discussion *supra* Part IV.B.1.a.

what Poland needed to effectively compete on the European market in the twenty-first century.

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