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A TAX REVOLUTION IN POLAND?

The New Economic Polish Deal policy of the Morawiecki Government and its implications for investors

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Issues & Sectors	Polish Parliamentary Elections 2023, Taxation, Digitalization, Infrastructure
Stakeholders	Parliament, President, Government, Business Associations, EU Institutions

Poland's ruling United Right coalition is hoping 2022 will be a year of economic transformation for the country, stimulated by the politically controversial Polish Deal, the Government's landmark package of sweeping economic, tax and social policy reforms. The reforms outline significant changes for Polish households, businesses, multinational corporations and local governments, with strategic goals leading up to 2030. Coming into force on 1st January, 2022, the policy package – also known as the PND (Polish New Deal) – looks set to become one of the main drivers of Poland's post-pandemic recovery and a major contributor to creating jobs and attracting inward investment.

At the same time, the forthcoming plan has been subject to fierce criticism from Polish business communities over its alleged punitive impact on SMEs and the middle class through increased tax liabilities. The political debate around the PND was one of the main catalysts of the break-up of the Polish governing coalition earlier this year and the policy package remains politically controversial, with critics claiming it is designed to bolster support among the ruling bloc's low-income electorate ahead of the 2023 parliamentary elections. Alongside this controversy, the introduction of the PND comes at a difficult time for the country's ruling bloc as the Government, led by PM Mateusz Morawiecki, remains embroiled in a long-running dispute with the EU over rule-of-law issues and is struggling to secure crucial recovery funding from Brussels.

As the main tax provisions of the PND will enter into force from January, Aretera takes a more detailed look at this flagship economic and social policy, its implications for current and potential investors present in CEE's largest market, as well as the turbulent relations between Warsaw and Brussels.

This memo will cover:

A MAJOR ECONOMIC DEVELOPMENT PACKAGE

On 15th November, Polish President Andrzej Duda, a key ally of the country's four-party United Right coalition, signed a number of amendments to the Polish taxation system into law, effective from January 2022. The reforms constitute the most integral part of the New Economic Polish Deal (Połski Lad), an ambitious socio-economic program that is expected to have a profound impact on Polish households and individuals, as well as domestic companies and foreign investors.

Introduced earlier this year by the Government of Prime Minister Mateusz Morawiecki, the program is billed as a multi-faceted support program for Poland's post-pandemic economic recovery and social development up until 2030. Also known as the Polish New Deal (PND), the program outlines an astonishing 651.6 billion PLN (close to €140 billion) spending program for the next decade, with an annual average spending of 72.4 billion PLN (more than €15.5 billion) to modernize the Polish economy and improve living conditions.

In addition to the state budget, the program will be financed through the Multiannual Financial Framework (MFF), the EU's annual budget for 2021-2027 and the NextGenerationEU scheme, the European bloc's €750 billion-strong post-pandemic economic recovery package. Poland is set to receive €36 billion under the EU's recovery scheme, however the European Commission is yet to approve Poland's National Recovery & Resilience Plan (NRRP), a necessary step to receive the funding. The EU executive body is currently blocking the funds over the Polish Government's alleged breaches of the rule of law concerning a number of judicial reforms.

The PND was introduced with five strategic objectives:

1) lowering taxes for 18 million Polish citizens (in a country of 38 million),

2) drastically improving the country's healthcare system,

3) making housing more affordable,

4) providing tax reliefs for pensioners,

5) creating at least 500,000 thousand new jobs across several key industries.

New Tax Rules

By far the most significant policy area of the PND is a tax reform package expected to drastically alter the country's entire taxation system and aimed at reducing discrepancies in taxation levels for various social groups (and so reduce the high tax burden on earnings in Poland). Most importantly, the Morawiecki Government will increase the tax-free income allowance from 3,000 PLN (€660) per annum to 30,000 PLN (€6600), while the threshold for the higher income tax category will rise to PLN 120,000 a year from the current PLN 85,000 – with a higher tax rate of 32% instead of the previous 17%.

The program also includes the abolishment of personal income tax for working seniors and old-age pensioners receiving an annual pension of up to PLN 30,000 (€6600), while the system of healthcare contributions will also undergo significant changes. Among other adjustments, there will be a gradual increase in non-tax-deductible healthcare social security from 4.9% in 2022 to 9% of income in the

coming years – except for the self-employed, where this rate will increase to 4.9% after criticism that a higher rate would hurt Polish SMEs.

Among the changes awaiting large corporations, including foreign investors, the introduction of the so-called minimum corporation tax rate is among the most significant. Introduced to cover potential budgetary shortfalls from the overall package, the new tax would amount to 0.4% of company revenues, plus 10% of expenses used for tax optimization purposes.

Main Policy Areas

Alongsjde the tax reforms, the PND includes significant policy and regulatory changes to a number of strategic sectors, most notably healthcare, digitalization and infrastructure. Responding to the COVID-19 crisis, the Government has prioritized healthcare, with PLN 127 billion (close to €28 billion) allocated up to 2030. Besides reforming the healthcare contribution system, the Polish Government aims for raising the country's healthcare spending to 6% of the GDP within two years and to 7% by 2027, also envisaging new mechanisms and institutions such as a centralized System of Medical Information and an online Patients Services Centre.

In addition to several proposals to digitalize the healthcare sector, a significant aim of the Polish Government is to digitalize all public services until 2024 and introduce mechanisms for small business to employ cloud technology. Additional measures within the tax reform package are proposed tax reliefs in the robotization sector and for employees working in R&D and innovation.

Furthermore, the economic plan hopes to attract considerable investment, more than PLN 200 billion (€44.4 billion), into infrastructure. Related measures include developing regional trade routes, establishing a regional transportation hub and modernizing the country's railway system.

The PND & Its Key Provisions

Policy Area/Industry	Main Policy Initiatives
Taxation	raising the tax-free income limit from PLN 3,000 to PLN 30,000 gradually increasing non-tax-deductible healthcare contributions to 9% introducing a minimal tax for large corporations
Pension System	tax-free pensions of up to PLN 2,500 abolishing PIT for working seniors
Digitalization	digitalizing all public services until 2024 providing tax relief in robotization and for employees working in innovation
Healthcare	raising healthcare spending to 6% of the GDP in 2023 and 7% up to 2027 digitalizing all public health services creating an online Patients Service Centre and a centralized System of Medical Information

Infrastructure	➢ developing cargo and trade and cargo routes as part of China's New Silk Road Project ➢ establishing a transportation hub for the whole CEE region in central Poland ➢ doubling the number of interregional expressways by 2025 through projects such as Via Baltica, Via Carpathia and accomplish important rail route Rail Baltica
Energy	➢ construction of a new nuclear power plant ➢ further developing hydrogen technology and renewable energy capacities
Housing	➢ abolishing special permissions to build a single-family house up to 70 m2

POLICY RESET IN A CONTESTED POLITICAL ENVIRONMENT

Given the huge levels of spending outlined within the PND, the reform package has been the focus of heated political and public discourse ever since it was first unveiled in May. Morawiecki's flagship program, which was set to be a continuation of the socio-economic measures of the previous PiS-led governments, was met with mixed reactions, not only from other political parties but from Polish society and representatives of the business communities.

The Polish Government's National Recovery and Resilience Plan (NRRP), required in order to receive EU recovery funding and therefore a crucial element of financing the Polish New Deal, was expected to be approved by the European Commission in August, while the tax bill related to the PND was planned to be voted upon in September. However, the tax provisions of the PND came under heavy scrutiny from the Accord Party, one of the four members of the governing coalition, with Accord leader and former deputy PM Jaroslaw Gowin fearing that the new tax policies would essentially plunge the country's middle class and SMEs into unnecessary financial difficulty. Despite numerous efforts in August, the coalition partners could not resolve their differences.

Division inside the Polish governing bloc, led by the senior ruling Law and Justice party (PiS), had been rumbling on since 2020, and disagreement over the PND was the final straw, leading to the break-up of the four-party coalition in early August when PM Morawiecki dismissed Gowin from the Government. In return, Gowin's party left the ruling bloc, leaving it with a minority in the Sejm[1], the lower house of the country's bicameral parliament. (With some Accord MPs defying Gowin, the ruling United Right bloc currently has 228 of the 460 seats in the Sejm.) Nevertheless, PiS managed to secure a parliamentary majority with the assistance of confidence-and-supply parties and independent MPs for the PND's tax bill, which was eventually approved by the Polish parliament in October.

HIGH EXPECTATIONS, MIXED REACTIONS

Following the completion of the legislative process in Parliament, Polish President Andrzej Duda – also a key ally of the main ruling PiS – signed the relating tax amendment bills into law on 15th November,

with the vast majority of its provisions now on course to be enforced from 1 January, 2022, which commentators say leaves taxpayers little time to adjust. Duda's endorsement comes after multiple calls for the President to veto the legislation from several economic and business associations. The Polish Entrepreneurship Council, which represents the country's nine largest business organizations (including the Polish Bank Association, the Federation of Polish Entrepreneurs, the Union of Entrepreneurs and Employers, the Polish Business Council, the Lewiatan Confederation and the Polish Chamber of Commerce), called the structure of the new corporate minimal income tax "flawed" and have claimed the proposed changes will "deepen the inconsistencies of the tax and social security system" and facilitate the growth of the grey zone in the Polish economy.

Furthermore, the quality of the public consultation process announced by the Polish Finance Ministry and the hastiness of the legislative process (which leaves two months for companies to prepare for the new tax regime) have been major concerns, with business leaders feeling completely left out of the consultation phase. The question of the real tax burden falling upon Polish SMEs and the middle class remains a key concern, particularly for entrepreneurs using the Polish flat income tax model of 19%, with critics arguing the effective tax for entrepreneurs will increase to 23.9%.

Although not scrutinizing the tax cuts, criticism from the opposition parties has also mounted on the Morawiecki Government. Critics point out that the PND primarily improves the conditions of those communities most supportive of the ruling bloc, claiming it is a thinly-veiled political move ahead of the 2023 parliamentary elections which blatantly disregards the interests of small businesses and the middle class.

On the political side, local governments are expected to be the main losers of the PND tax policies. While the Morawiecki Government announced and approved a considerable subvention program for local governments in October to compensate for the expected losses of local governments caused by the tax cuts, Fitch Ratings said in a recent report that the Polish Deal will cut personal income tax revenues for local governments by 11% in comparison with their expectations for 2021, potentially forcing local governments to raise local taxes and service fees.

While most of the immediate concerns are rather microeconomic in nature, the danger of a growing inflation rate also looms large should the PND tax reforms be adopted. In recent months, inflation in Poland was one of the highest in the EU: in November, the country's Central Statistics Office reported a 7.7% increase year-on-year, the highest-ever this century, and concerns are growing that a set of reforms aimed at stimulating further spending could see it climb even higher.

To ease overall inflation pressure on the Polish economy (and respond to increasing prices on the energy market), the Morawiecki Government recently announced a separate, €10 billion-worth package of tax cuts that is likely to mitigate at least some of these concerns. Among other initiatives, the measures, most of which will be introduced in January, include reducing VAT on electricity to 5% and on gas to 8% from the current 23% for three months, abolishing excise duties on electricity for households and cutting excise tax on petrol to the minimum allowed by the EU for five months (from 20th December), while Polish households will receive compensation for the energy price increases in two installments in 2022.

Among the main PiS arguments in favour of the Polish Deal are its potential to maintain Poland's economic growth trajectory as the country looks to recover from the COVID-19 crisis. The National Bank of Poland estimates the PND will add 0.3% to the country's GDP growth in the next two years by boosting consumption, with the Polish central bank expecting a 5% growth rate in private consumption in 2022 and 2023. Taking the effects of the PND into account, the European

Commission's latest forecast expects GDP growth at the level of 4.9% this year and at 5.2% in 2022, while EBRD economists predict 4.9% in 2021 and 4.8% next year. Furthermore, the Morawiecki Government claims the new tax policies will save taxpayers an estimated PLN 16.5 billion annually.

Finally, the PND – combined with similar strategic objectives from the NRRP – offers a comprehensive vision when it comes to digitalization. Already one of the most digitalized countries in the CEE region, the Morawiecki Government is clear about continuing Poland's investments in the field and attracting leading global tech companies in order to become a "Silicon Valley" of the region. Recent moves in this direction include up to $2 billion in investments from Google that established a regional cloud data hub for the CEE region in Warsaw and an investment of $1 billion from Microsoft earlier this year to accelerate the innovation and digitalization of the Polish Digital Valley project.

CRUCIAL EVENTS PLAYING OUT ON THE EU LEVEL

The implementation of the PND, which relies on receiving European Union funds, comes at a difficult time for the Polish Government as it has been struggling to secure crucial EU funding for months. Under the EU's recovery spending scheme, Poland is entitled to receive €24 billion in grants (constituting almost 5% of the Polish GDP) and an additional €12 billion in loans, however the European Commission has delayed any approval of the funds over Poland's alleged breaches of the rule of law.

Tensions have escalated between the two sides after the Polish Constitutional Tribunal (PCT), which critics say is controlled by close-to-government judges, declared certain elements of the EU's founding treaties incompatible with the Polish constitution in October, essentially questioning the primacy of EU law. The crisis took another turn when the European Court of Justice (ECJ) in October imposed a daily fine of over €1 million for not suspending a controversial disciplinary body in the country's judicial system.

The Polish Government initially reacted by vowing not to pay the fines and it remains to be seen whether the Government will comply. This was followed by other court rulings from the PCT and the ECJ in November that deepened the crisis further. Simultaneously, Poland also awaits a crucial decision from the ECJ that is due to decide about the so-called rule of law conditionality, a sanction mechanism approved by the EU Council but yet to be confirmed by the EU Court, but which could suspend the use of EU funds under the 2021-2027 MFF over rule of law concerns going into 2022. In a recent letter to the Polish (and Hungarian) Governments, the EU Commission indirectly signalled its intention to use the sanctions mechanism as early as 2022.

A lack of agreement with the EU institutions could significantly disrupt the PND's implementation process, posing a considerable risk to our forecast. According to an earlier forecast from the EBRD, EU funds could add 0.4% to the country's GDP growth annually, while delays constitute the main risks for Poland's economic path. Although a number of its policies have been disputed, both the PND and the Polish NRRP offer a comprehensive stimulus for the development of certain sectors, particularly digitalization, an already advanced field of the country's economy, in which Poland aims to become a regional leader.

CONCLUSION

The reactions of Polish society and businesses to the Polish New Deal are yet to be seen as the Polish Government, now greenlighted by both the parliament and President, prepares for the implementation of a socio-economic development program of massive proportions. Going into 2022, the PND's tax revolution is expected to be a key source of tension between the Morawiecki Government and the business community. However, the overall performance of the policy program depends on its impact on the economy and the targeted social layers. The implementation of the PND offers numerous opportunities for businesses, yet a delay in receiving EU funds could pose challenges for the economy, with the lack of an agreement between Poland and the EU being the greatest risk. Despite the tension with the EU, the past few months have seen no significant changes in terms of public support for political parties. According to our estimates, the PND remains, so far, unlikely to impact Government stability. At the same time, pressure facing the Government on its tax and societal provisions, as well as from other issues combined, could mean a more challenging political environment next year, with elections due in 2023.

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