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Fiscal Policy in Poland: Growth Booster or Growth Buster?

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Fiscal Policy in Poland: Growth Booster or Growth Buster?

Summary

This paper presents major challenges for Poland's fiscal policy and strategic choices which have to be made in the area of economic policy in Poland's nearest future.

The space to manoeuvre in Polish fiscal policy is very narrow. The most important constraint is not the formal one (Polish Constitution, budget law, European Stabilization and Growth Pact) but the economic one. Huge budget deficit and growing borrowing needs of public sector can destabilize economy and hamper economic growth. Fiscal adjustment is needed but one has to distinguish between means and ends of economic policy. The most important goal of economic policy is always a long-term economic development.

1. Introduction

The situation of the Polish economy at the beginning of the 21st century is delicate. On the one hand, the economic transformation is still under way, which calls for the application of economic instruments adequate to the problems of the transitional phase between central planning and the market. On the other hand, Poland is joining the European Union, a group of institutionally mature market economies. It follows that the instruments of fiscal policy should be compatible with the market-economy standards.

Fiscal policy is one of the chief economic policy instruments at the disposal of the state. I understand here fiscal policy in a broad sense of the term, as activities undertaken to control the amount and structure of the state's revenues and expenditures. Fiscal policy has a manifold impact on the national economy, and the use of specific fiscal instruments triggers changes in its various areas. Notwithstanding the broad debate on the desired role of fiscal policy in stimulating growth (and the involvement of the state in the economy in general), it is an unquestionable fact that the scope and structure of the state's revenues and expenditures crucially affect the economic situation of the state and its development prospects.

Stimulating growth through fiscal policy is usually construed in terms of Keynesian support for economic growth by increasing internal demand, financed by an increased budget deficit. State finances do indeed play a highly significant role in creating aggregate demand, but at least equally important (particularly in the long run) is the impact of specific fiscal instruments on factors affecting economic activity. I include the following among these factors:

- macroeconomic stability;
- social and ecological equilibrium;
- conditions fostering rapid economic growth, especially investment in infrastructure and human capital.

Unfortunately, it may happen that fiscal policy not only fails to stimulate economic growth, but may even stand in the way of the pursuit and expansion of economic activity, inevitably affecting negatively the socio-economic development of a given country. If the state of public finances generates economic instability, if social inequalities reach excessive proportions while funds for public investment in infrastructure, environmental protection or human capital are lacking, then it is a fiscal policy which mainly generates problems, rather than growth.

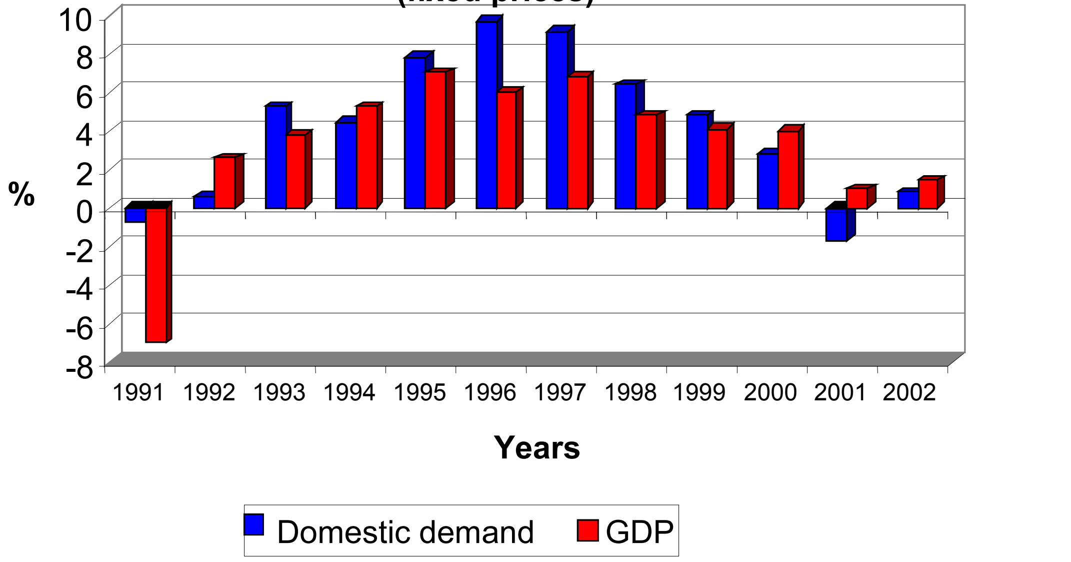
Membership in the European Union poses a challenge to Polish economic policy-makers – in particular, those responsible for fiscal policy. As Poland accedes to the EU, its public finances, already quite rigid, will become subject to further restrictions. It suffice to mention the need to pay the membership contribution or to meet the requirements on budget deficit and public debt, as stipulated by the Stabilization and Growth Pact.

The next couple of years will show whether we can manage to conduct a fiscal policy that despite the new restrictions will be able to act as a growth stimulant, avoiding economic destabilization which hinders growth.

2. Restoring Equilibrium in Public Finance

Economic practice has proved so-called Say's Law wrong; there is thus no doubt that global (internal and external) demand is essential for stimulating economic expansion. The recent economic history of Poland indicates that the dynamics of internal demand largely determines the rate of economic growth. As it became restricted in 1998–2001, growth dynamics took a rapid decline, with all the harmful consequences of this fact.

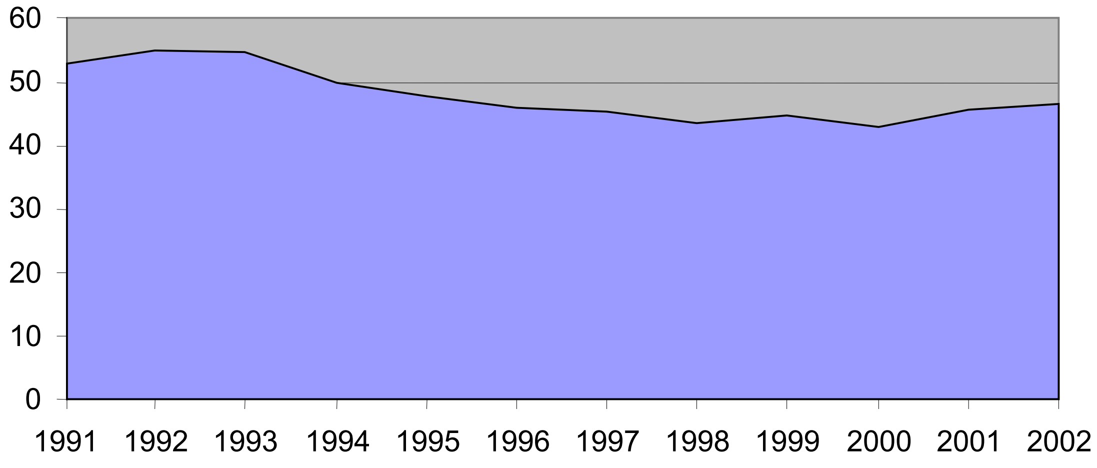
Figure 1. Domestic demand and GDP dynamics (fixed prices)



Source: Central Statistical Office (GUS), various years.

Public sector demand is an inalienable component of global demand. The state has a very important share in generating internal demand in Poland. Although the ratio of public expenditure to GDP has had a tendency to decrease throughout the transformation period, this trend has been reversed in the past couple of years. This does not, however, signify a deliberate increase of the state involvement in the economy, but, rather, the inertia of public spending, combined with a drop in GDP growth dynamics – in both nominal and real terms – which leads to an increasing public spending GDP proportion.

Figure 2. Public finance sector expenditure as % of GDP

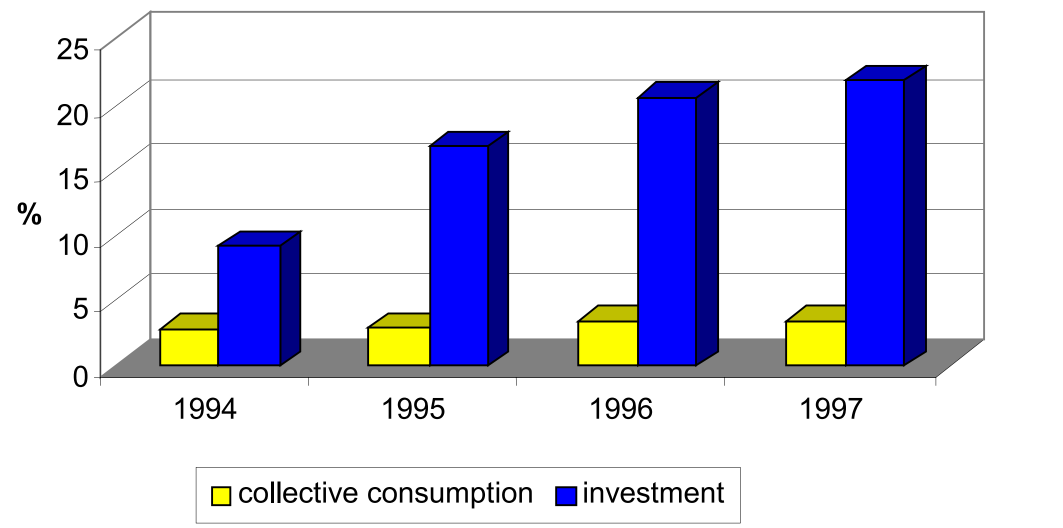


Source: OECD (2002) and the World Bank (2003).

Poland currently faces a highly complex macroeconomic situation. On the one hand, budget deficit needs to be curbed in the coming years, so as to stop the rapid increase of public debt, whose proportion to GDP is getting close to the constitutional ceiling, set at 60 percent.

At the same time, membership in the EU compels Poland to reduce the scale of fiscal imbalance, as we are required to comply with the EU regulations, which stipulate discipline in public finance. On the other hand, fiscal adjustment consisting of a reduction of deficit is tantamount to restricting the internal demand generated by the state. To avoid a situation when such a reduction of public consumption affects aggregate demand and, consequently, growth rate, the demand created by the state must be replaced with other components of global demand, such as private consumption, investment or exports. This is best exemplified by the experience of 1994–7. In those years, the ratio of state expenditures to GDP was being gradually reduced (collective consumption dynamics was far lower than real GDP growth), budget deficit was kept at a relatively low level, while a high rate of economic growth prevailed, based on the expansion of investment (Kolodko, Nuti 1997).

Figure 3. Collective consumption and investment dynamics (fixed prices)



Source: EBRD (2000).

The so-called non-Keynesian effects of restricting budget deficit, that is, the replacement of collective consumption with other elements, related mainly to global demand (especially investment), is possible, provided that the following conditions related to fiscal consolidation are met:

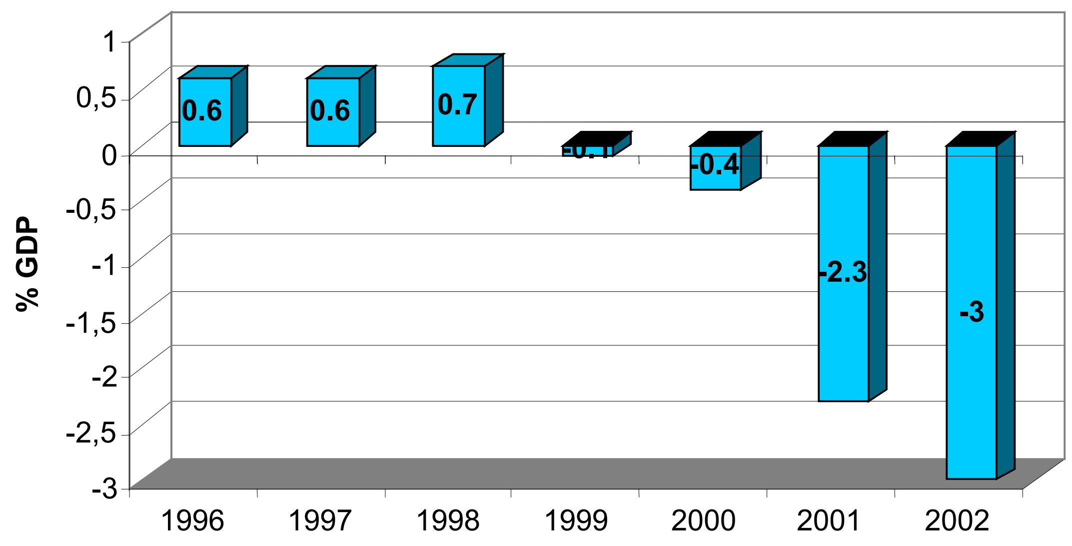
- macroeconomic risk decreases as budget deficit is curbed;
- the scope for possible monetary relaxation increases;
- market interest rates are going down (through a weakening of the crowding-out effect and a lower premium on macroeconomic risk);
- the risk of future tax increases is reduced, thus increasing the propensity to consume and invest (so-called Ricardo-Barro effect).

The necessity to reduce the scale of fiscal disequilibrium in Poland is related not only to the formal requirements imposed on fiscal policy (Constitution, Public Finance Act, Stabilization and Growth Pact), but first and foremost it is a consequence of the disadvantageous tendencies in state finances in the past few years.

First, in spite of the fact that the present state of profound disequilibrium in state finances is largely due to a major slackening of economic growth, which began to wane in 1998, bordering on recession in 2001, as a result of which the tax base shrank, the principal ailments of the public finance system in Poland are mainly of structural nature, while a poor economic climate only aggravates the existing problems (Coricelli, Ercolani 2002; World Bank 2003). The structural character of budget deficit restricts the possibility of actively using fiscal policy to stabilize the economic situation, since at a time of slowed-down growth, when fiscal incentives would be called for, they are practically unavailable because of the high dynamics of public debt, which approaches a level that puts macroeconomic stability at risk.

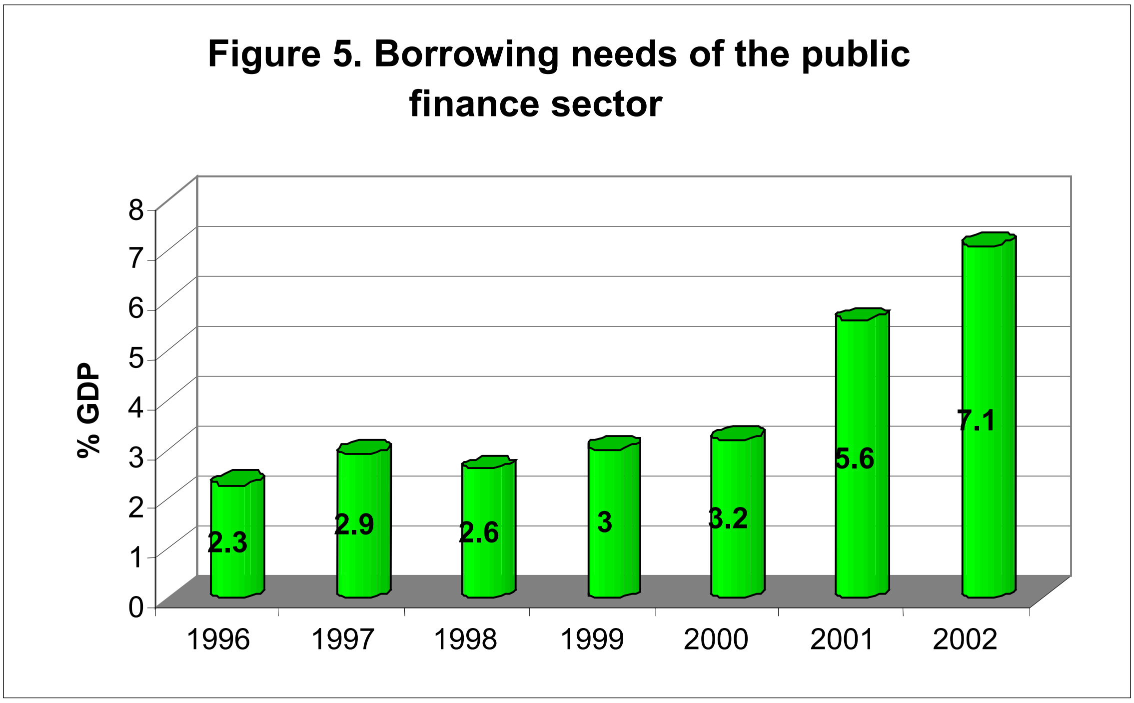
Second, a highly dangerous tendency has emerged in recent years, consisting of a drop in primary budget balance, that is, budget deficit calculated before the deduction of interest payments on public debt.

Figure 4. Primary deficit of the state budget



Source: World Bank (2003)

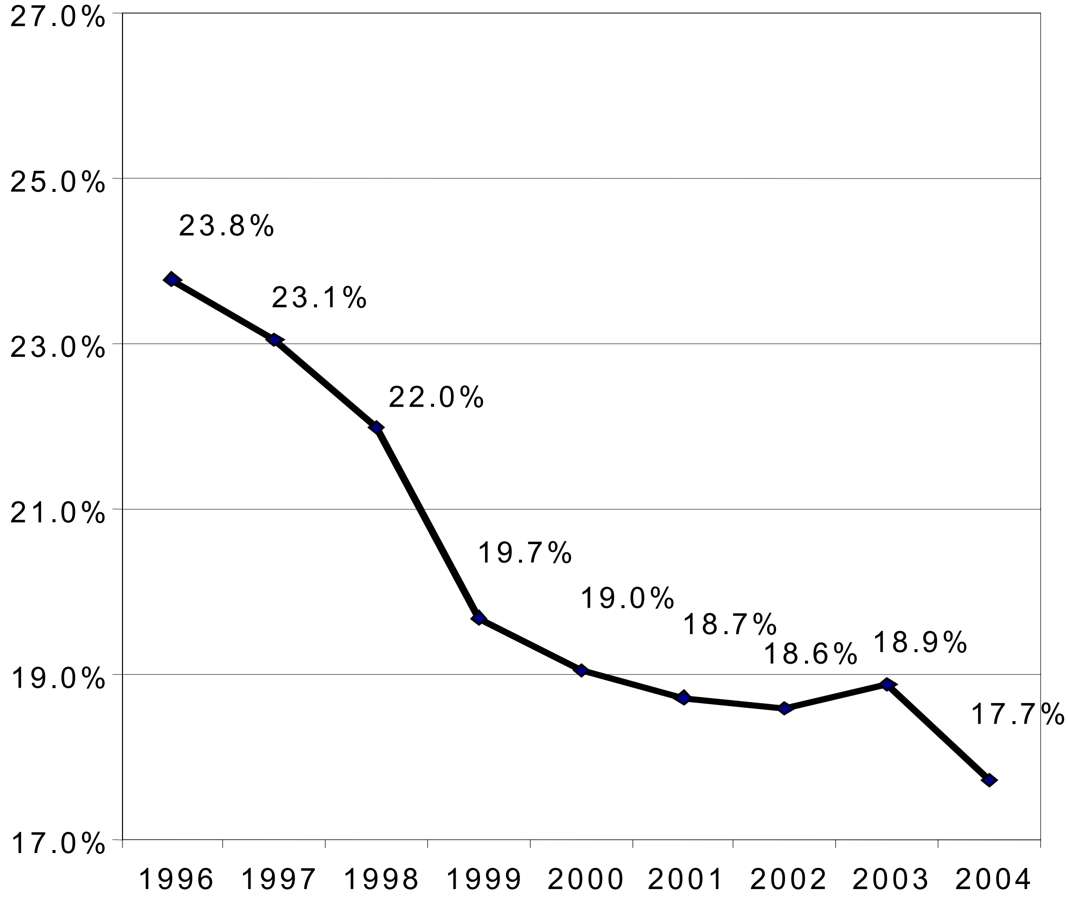
The primary budget deficit indicates that the current revenues generated by the budget do not cover the current expenditures, leading to a dangerously fast increase of public debt and add to the risk of insolvency (IMF 2003), all the more so since the low privatisation revenues mean that nearly all budget deficit has to be financed by loans incurred on the financial markets.



Source: World Bank (2003).

The need for fiscal consolidation in Poland is unquestionable. The debate should thus concentrate on *how*, rather than whether, to curb budget deficit. Generally speaking, budget equilibrium can be restored in two ways: by increasing revenues (higher taxes, larger tax base) or by decreasing public spending.

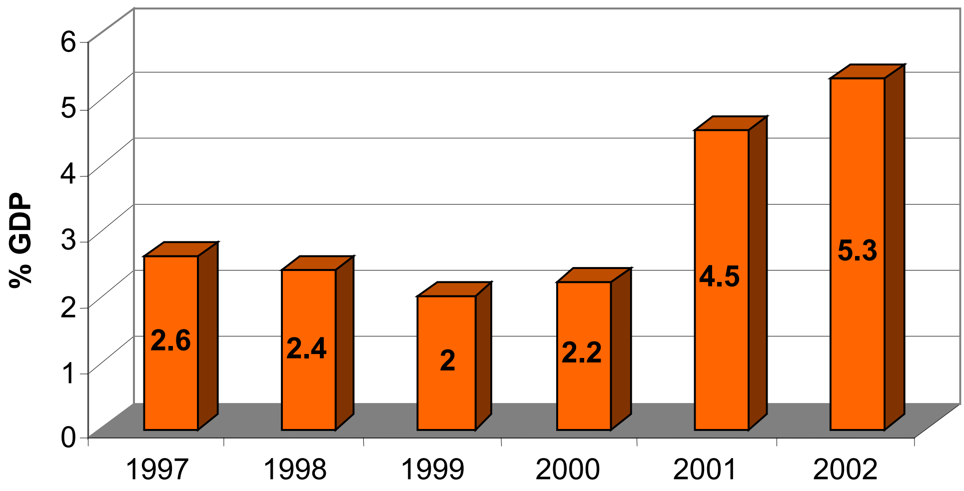
Figure 6. State budget revenue to GDP ratio



Source: *Uzasadnienie do ustawy budżetowej na rok 2004* [Justification for the 2004 budget].

Figure 6 indicates that the fiscal policy choice taken in Poland has been to reduce the tax burden. Unfortunately, the lowering of taxes was not matched by corresponding adjustments on the expenditure side. Lower taxes did not translate into faster growth, either, and even had an opposite effect. Growth dynamics was markedly weakened after 1997, causing the tax base to shrink, while the inertia of public expenditure resulted in a significant growth of deficit.

Figure 7. State budget deficit



Source: World Bank (2003)

In 2004, a further marked reduction of budget revenues was put into effect. This was not only a consequence of lower taxes (corporate income tax reduced from 27 to 19 percent, linear personal income tax for the self-employed), but also of changes in the financing of local governments. These changes mainly took the form of increasing the proportion of local government revenues financed from centrally levied taxes (CIT and PIT), which obviously reduces state budget revenues.

Considerations of international credibility of the country and consistency in fiscal policy reduce the scope for backing away from the already introduced tax cuts, and thus the brunt of fiscal adjustment has to be borne entirely by the expenditure side of the public finance system. In practice, the only possibility left on the revenue side is to abolish the system of excessive tax exemptions and benefits. Their elimination, proposed in the Public Finance Recovery Program, is being implemented, but the insufficient determination of the decision makers in this respect and the applicable legal restrictions (acquired rights) prevent achieving in this way an increase in public revenues that would be adequate to the needs of the budget.

Observation indicates that sectors which received support through the system of tax benefits, with respect to both indirect and direct taxes (for instance, housing construction) not only fail to expand dynamically, but are stagnant or may even be contracting. Assuming that a tax benefit only makes sense if a given form of economic behaviour would not take place without it, one is forced to conclude that the exemptions and benefits in the Polish fiscal system fail to meet this requirement. The system does, on the other hand, support sectors with a strong political representation or those which can effectively lobby for particularistic interests, at the expense of a considerable loss of budget revenues. According to the estimates of the OECD (2002), budget revenues lost in Poland through tax exemptions and benefits in 2000 amounted to as much as 8.5 percent of the GDP.

A strategy to reduce the scale of budget disequilibrium should be designed in a way that:

- prevents aggregate demand dynamics from stalling, which would negatively affect the rate of economic growth;

- does not impede the effectiveness of the state apparatus;
- fosters development-stimulating changes in the expenditure structure.

Thus defined conditions of fiscal adjustment indicate the strategic directions in the reform of the state fiscal system. In the first place, one should avoid a static approach to the financial reform of the state. Reasoning of the type: what cuts we must make in the coming year to avoid exceeding the ceiling on public debt, confuses means and ends. Fiscal adjustment should be an instrument supporting economic development and not an aim in itself. Reducing the expenditure of the state from year to year – whether at all politically feasible – may negatively affect the dynamics of internal demand, decrease the effectiveness of the state apparatus, and aggravate the inadequacy of the infrastructure.

A responsible fiscal adjustment strategy must be based on a dynamic analysis of specific fiscal components. Budget deficit cannot be significantly reduced from year to year without an adverse effect on the real sphere of the economy. A sensible method of stabilizing and then reducing public debt is to create mechanisms to ensure that public revenues increase faster than spending, gradually improving the balance of state finances. Such an approach to fiscal policy avoids the risk of collapsing economic dynamics and of the failure of the state to exercise its basic functions. Fine-tuning the economy to make sure that public revenues increase faster than expenditures, but slower than GDP, ensures that the fiscal burden on the economy is eased from year to year, while the scale of the disequilibrium of public finance is being reduced.

Attaining the desired relation between revenue and expenditure dynamics requires strategic economic decisions to be taken. Thus, first and foremost, the uncontrollable increase of state expenditures must be checked. To this end, the automatic indexation of specific categories of public spending must be abolished. An accumulation of indexation mechanisms in the area of public finances rigidifies the entire system. Outlays are growing regardless of the state of public finances, leading to an increased proportion of so-called rigid expenditures in the budget, which restricts the investment capacity of state.

Second, the revenues of the public finance sector may only be reduced if a reduction in expenditures on at least the same scale is achieved. What is particularly dangerous is a situation when, like in 2004, state revenues are significantly reduced without a corresponding adjustment on the expenditure side. In the current state of budget disequilibrium, it would be far more sensible to proceed in the opposite direction, that is, to lower taxes only after taking decisions that reduce the outlays or when the economy is growing at a rate at which lower tax rates do not entail a significant loss of public revenues. The pace at which public debt is increasing precludes tax cuts, which would translate into a further increase of the deficit. Instead, care should be taken to ensure a level of dynamics of budget revenues that exceeds the growth of expenditures. Within the tax system, the tax base needs to be consistently expanded by gradual absorption of the gray sector into the official – that is, taxed – economy. Apart from tightening the tax collection system (through the abolition of exemptions and benefits), one should also look for new sources of public revenue in the form of property taxes, including, especially, cadaster tax.

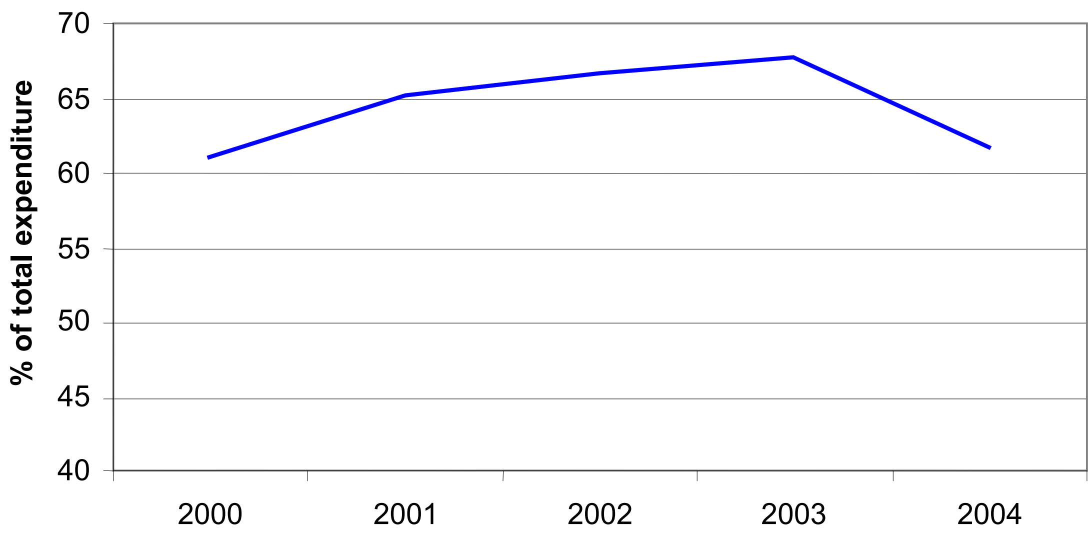
In the long run, it would be desirable to achieve a balanced budget or at least a large primary surplus. An improvement of the balance of public finance is necessary not only in view of the so-called Maastricht fiscal criteria. Stabilization of public debt at a secure level, achieved simultaneously with a structural equilibrium of public finances, allows the use of fiscal instruments (applied on an automatic or discretionary basis) to stabilize trade-cycle fluctuations. In combination with the so-called catching-up effect, this will allow the economy to maintain a high and fairly stable level of dynamics in the long run.

3. Growth-friendly Structure of Public Expenditures

The strategic principle that budget revenues should be higher than expenditures should not be taken to imply that the existing structure of expenditures and revenues is appropriate and there is no need for corrections. Such corrections are all the more necessary since a significant increase in development stimulating outlays is needed (especially in the form of investments in infrastructure and human capital). As comparative studies indicate (Conning 2000), the main obstacle to investment expansion (involving both domestic and foreign capital) is the quality of technical infrastructure, the creation of which must be mainly the responsibility of the state. Other obstacles, like high taxes or corruption, rank as less important. The necessity to increase outlays on the development of infrastructure is also substantiated by the estimate of the social rate of return, that is, the impact of particular types of public expenditure on the economic environment in which private economic entities operate. This highest levels of this indicator are achieved in the case of outlays on the development of infrastructure, particularly in less developed countries (Reinika, Svenson 1999).

The dynamics of the aggregate amount of public spending is limited by the high level of budget deficit, which necessitates changes in the structure of the outlays.

Figure 8. Rigid expenditure in the state budget



Source: *Uzasadnienie do ustawy budżetowej na rok 2004*.

A pro-growth fiscal policy (increasing the share of investment outlays) is hampered by the very high proportion of so-called legally determined expenditures in the budget. It is hardly possible to allocate more resources to investment, if nearly 70 percent of the total budget expenditures lie in practice outside the scope of political decisions. Therefore, room for shaping the fiscal policy is very limited.

The lower proportion of rigid expenditures in 2004 does not, unfortunately, signify the implementation of the necessary changes, but reflects the changes in the presentation of the budget, and in particular, the movement of the budget payments for the Open Pension Funds from the category of “expenditures” to “disbursements”. Since this item counts among rigid expenditures, its reassignment to another category results in a lower proportion of rigid expenditures in the budget. The lower share of rigid expenditures is also a consequence of the modified principles of financing local governments. The changes mainly consist in increasing the share of local governments in revenues from centrally levied taxes (PIT and CIT), which allows budget expenditures (in the form of subventions and subsidies paid to local governments) to be reduced. However, the decrease of rigid expenditure on the financing of local governments is tantamount to a drop in budget revenues, a greater proportion of which now goes directly to the communes (*gminy*), districts (*powiaty*) and provinces (*województwa*). Thus despite the lower proportion of rigid expenditures in the budget, the total amount in the budget available for flexible allotment has decreased.

From the economic point of view, the rigid component of public finances in Poland will increase, rather than drop, from 2004 onwards, since accession to the EU requires the payment of the membership contribution, financed by the state budget. However, the funds Poland may obtain the EU in the framework of the structural funds and Cohesion Fund, largely exceed Poland's financial obligations towards the Union and, therefore, the net result of integration with the EU is unequivocally favourable for the Polish economy. Yet access to the available EU funds depends on finding resources within the Polish system to co-finance the projects. Thus, from the point of view of public finances (and especially the state budget, responsible for the membership contribution) EU membership presents a considerable challenge, as it necessitates the provision of additional funds that will allow Poland to utilize fully the opportunities opened up by the EU accession.

The increased rigidity of public finance is, however, a beneficial change, as it necessitates restructuring the finances of the state by increasing the proportion of public funds (of domestic and EU origin) allocated to investments that foster development. An added benefit for the state finance system consists in the hard constraints that govern the utilization of EU funds. The requirements imposed by the process of preparation, verification and accounting for projects financed from EU funds will necessitate legal and organizational adjustments that will undoubtedly improve the efficiency of the public finance system in Poland.

The above-mentioned change in the financing of local government is an important step in the preparation of the Polish economy to the absorption of EU funds. The vast majority of these resources will have to be utilized by local governments. This means that the budgets of local government units will have to provide the funds necessary to co-finance EU projects. Equally important as the amount of local government revenues is their structure. The restructuring of these revenues to increase the share of income taxes therein, implemented in 2004 as part of the Public Finance Recovery Program, increases the flexibility of financial management at local-government level, since, in contrast to budgetary subventions and subsidies for local governments, earmarked for specific purposes, local governments now enjoy greater freedom in allocating their revenues. Accordingly, the potential for the absorption of EU funds increases.

Another significant argument in favour of the financing of local governments by means of a share in direct tax revenues is a stronger link created by this arrangement between the financial standing of communes, districts and provinces and the general economic climate. What matters here is not only the full participation of local governments in the fruits of rapid economic development, but also protection of the state budget in case of an unexpected economic downturn.[1]

[1] Let us recall the situation of 2001, when worsening economic dynamics resulted in budget revenues falling short of the assumptions, while the obligations of the state budget with respect to local governments could not be readjusted accordingly. As a result, an amendment to the budget became necessary.

Thus the necessity to change the structure of public expenditures by increasing the share of pro-development outlays in the state and local government budgets should not be called into question. Assuming, however, that the possibilities to increase the general expenditure level are limited, it is necessary to decide which group of budgetary expenditures should be cut down to free public money for investment purposes. The largest proportion of outlays in the public finance system in Poland of goes to social benefits, so it is mostly here that possible savings are sought that might be reallocated. But the structure of household income in Poland (GUS 2003) indicates, that rapid cuts in social expenditure might plunge large sectors of society into poverty.

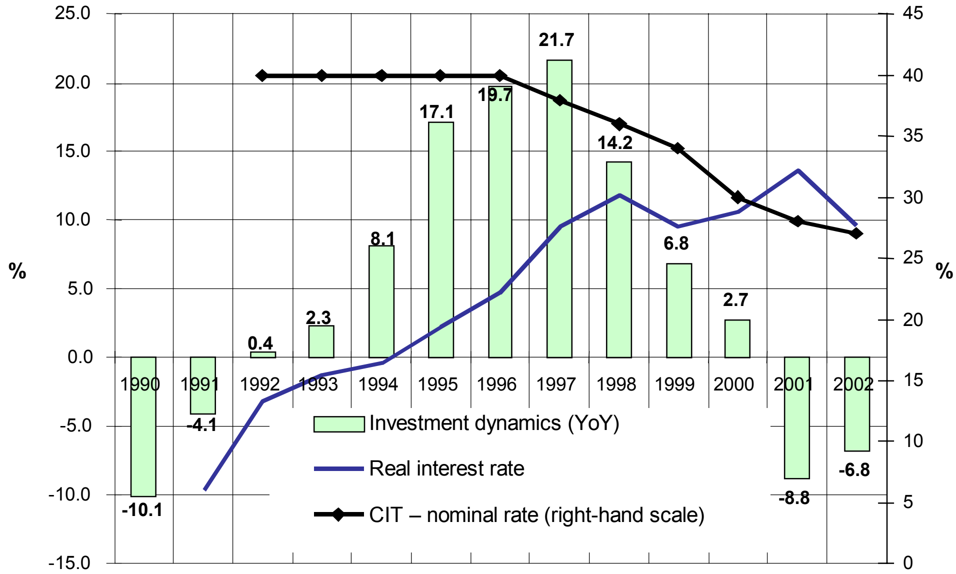
The above should not be taken to imply that obtaining social benefits under false pretences is a rare phenomenon. Such pathologies should be consistently eradicated, but not through a sudden, across-the-board cut in social expenditure. Restructuring public expenditures by reducing the share of social spending without bringing about a negative social impact is only feasible in a fast growing economy. Only than is it possible to rapidly create new jobs, thus reducing the unemployment rate, which in turn leads to changes in the structure of household income that allow social spending to be cut down.

The elimination of indexation mechanism in the sphere of social benefits also leads to a gradual improvement in the structure of social expenditure. The price stability attained in recent years seems to be secure in the coming years, and, therefore, even in the absence of automatic adjustment of benefits to changing prices and wages, the purchasing power of a given benefit will not perceptibly drop and hence will not lead to the impoverishment of a large part of society, which would be unavoidable under high inflation. Fixing a certain group of expenditures at a nominal level, combined with a positive dynamics of aggregate spending, will allow the proportion of investment outlays in the budgets to be gradually increased without adversely affecting the balance of state finances.

4. Fiscal Policy and Investments

Sound, long-term economic growth must be based on investment expansion. It is not enough that real GDP should grow while the demand gap (that is, the volume of unutilised productive capacity of the national economy) ought to shrink. It is also necessary to increase potential GDP – to expand the production potential of the economy. Building up this potential is effected by way of increasing the stock of production assets, that is, through investment. Fiscal policy has a number of instruments at its disposal (direct and indirect tax rates, tax benefits, special economic zones, investment subsidies etc.) to control the dynamics of savings (domestic and foreign) and their utilization (investment).

Figure 9. CIT rate, interest rates and investment dynamics in 1990–2002 (%)



Source: PNFR (Public Finance Recovery Program), p. 6.

A comparison of the figures and indicators presented above demonstrates that no simple correlation (of the type: the lower the taxes the higher the investment rate) exists between corporate tax rates and the propensity of enterprises to invest. In Poland, the recent years have witnessed a progressive reduction of the fiscal burden on enterprises and at the same time the investment dynamics has significantly decreased, reaching negative values in 2001 and 2002. Even so, another radical cut of CIT rates was put into effect in 2004: from 27 down to 19 percent. Such a radical reduction might have been justified by the need to create favourable conditions attracting foreign investment, stimulating the propensity to save and fostering the formation of domestic capital, had it been accompanied – or, better still, preceded – by an appropriate adjustment on the side of public spending, as proposed in the Public Finance Recovery Program. This, however, was not the case and so the tax reduction in 2004, as a move taken out of the context of a proper economic (not only financial) policy, appears to have been a mistake.

The experience of recent years indicates that investment dynamics depends mainly on the cost of capital acquisition (market interest rates) and the ability to sell the goods produced (internal and external demand). Investment expansion requires fiscal parameters which ensure a lasting capacity of the state for rapid capital formation, based predominantly on domestic sources. The need to increase public savings (reduce public finance deficit) and step up investment outlays financed from the budget has been discussed above. Fiscal policy should encourage an increase of private savings, to be channelled to finance effective projects through an efficient system of financial intermediation. At every stage of the capital formation process, it is possible to use fiscal instruments to promote specific types of behaviour.

Fiscal instruments can influence the dynamics of private savings through their impact on both the disposable income level (public expenditure, income taxes) and the propensity to consume (indirect and property taxes). The structure of liquid resource allocation can likewise be shaped by fiscal policy, which can differentiate the tax rates applicable to income from various types of savings instruments, thus affecting the attractiveness of various ways of investing liquidity surpluses in the financial markets.

The propensity of enterprises to invest and their preferences for specific types of investment can be shaped using the following fiscal instruments:

- income tax rates;
- indirect tax rates;
- public finance deficit level and its impact on market interest rates;
- investment benefits and incentives;
- regulations concerning depreciation allowances;
- subsidized interest payments on investment loans;
- co-financing of investments from public funds.

All these instruments must be used in ways that respect the principles of equal treatment of economic entities. Caution is especially indicated in cases involving public aid, that is, the use of public funds to support private entities.

5. Balanced Growth

Sustained economic growth must be balanced – in not only financial, but also social, territorial and ecological terms. Both environmental protection and the economic structure of society are influenced by the applied fiscal instruments.

Environmental protection requires both public investment and incentives for enterprises to act in ways that do not adversely affect the environment. Poland's accession to the European Union will necessitate the enforcement of appropriately high ecological standards. A large proportion of EU aid will be used to develop the environmental infrastructure. To some extent, this should ease the burden on Polish public finances in this respect. The adoption of the EU solutions in the field of fees and fines for the use of the environment[2] should likewise have a positive impact on the state of the environment in Poland.

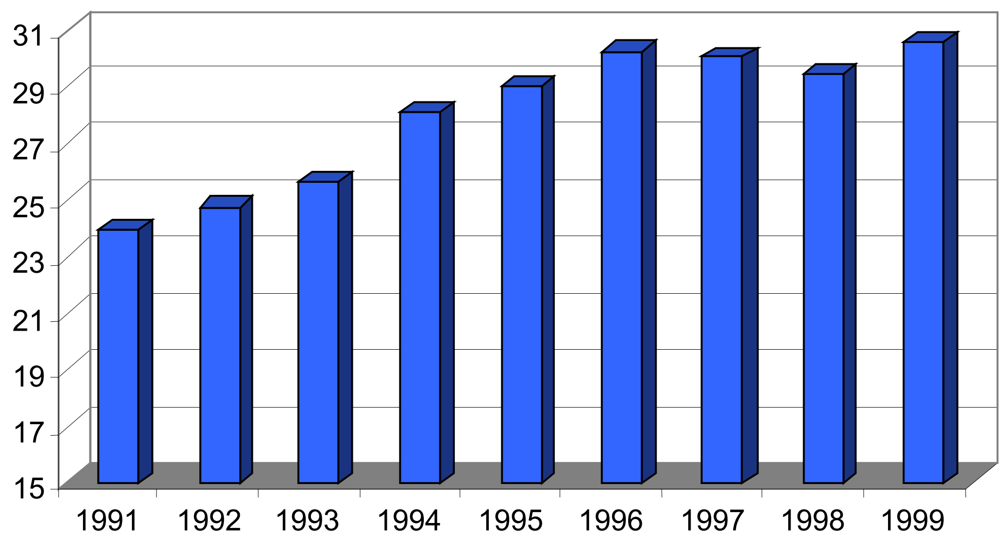
A balanced territorial structure of economic growth is necessary, if we wish to avoid excessive disparities in development level between particular regions. The differences in this respect between the richest and the poorest regions are enormous. Per capita GDP in the Warsaw Province is more than twice that of the Lublin Province (Szlachta 2003). The regional policy of the EU and the structural funds allocated within its framework may help overcome the backwardness of many regions of Poland. However, the possibility of utilizing the structural funds and Cohesion Fund depends on the capacity to gather a sufficient volume of own funds.

The new principles of local government financing clearly facilitate the absorption of EU funds, thus strengthening the regional development potential. A solution which deserves an unequivocally favourable assessment is the inclusion of a compensation mechanism in the local government financing principles. Such a mechanism will serve to reduce the large inter-regional income disparities (which would otherwise further increase, as the local government financing is now mainly based on a share in income tax revenues). It should also contribute to fuller participation of all regions in the benefits of economic growth, leading in this way to territorially balanced economic development of the whole country.

[2] Fees and fines are revenues of the state and thus count among fiscal instruments.

The economic transformation involves a whole gamut of socio-economic changes. One of the characteristic features of the post-socialist transition is the increase of income disparities in society.

Figure 10. Gini coefficient in Poland



Source: EBRD (various years).

Even though income disparities in Poland, as measured by the Gini coefficient, are not the greatest in comparison with other transforming economies, such disparities have increased over the past dozen or so years by several points.

Table 1. Gini coefficient in post-socialist countries

Country (year of study)	Gini coefficient
Armenia (2000)	48.6
Azerbaijan (2000)	50.6
Belarus (2000)	33.7
Bulgaria (2001)	31.9
Croatia (2001)	29
Czech Republic (2000)	27
Estonia (1999)	40.1
Georgia (1997)	49.8
Hungary (1997)	35
Kazakhstan (2001)	31.2
Kyrgyzstan (2000)	47
Latvia (2000)	33.7
Lithuania (1999)	36.8
Macedonia (2000)	27.7
Moldova (2000)	39.2
Poland (1999)	**30.5**
Romania (2000)	40.6
Russia (2000)	45.6
Slovakia (1996)	25.8
Slovenia (2000)	30.6
Tajikistan (1998)	35
Turkmenistan (1999)	26.5
Ukraine (2000)	46.2
Uzbekistan (2000)	26.8

Source: EBRD 2003 and WDI 2003.

While a certain increase of income disparities during the initial phase of the transformation is a natural phenomenon, their further rapid growth is a cause for concern. Rising disparities are particularly dangerous in times of slow economic growth or, worse still, recession. In such circumstances, one cannot speak about enjoying the fruits of growth, but, rather, about some social groups getting richer at the expense of others, which plunge into poverty. Excessive disparities in society no longer act as a growth factor (by rewarding higher efficiency in economic activities) and begin to threaten sustained growth (Kolodko 1998).

The rising support for populist parties in recent times indicates that Poland has reached a point when a further increase of income disparities may jeopardize the social stability of the country and thus become a barrier to economic growth.

By correcting the primary income structure in the economy (the redistributive function), fiscal policy is the principal instrument promoting a pro-growth, socially balanced structure of income distribution in society. If fiscal policy (especially in its tax dimension) is to avoid becoming an obstacle to growth, while leading to socially balanced development, it must be based on several fundamental principles:

- capital gains should not be taxed on preferential terms vis-à-vis labour income;

- progressive personal income tax rates should be retained. However, the progression should be modest, so as not to become a demotivating factor;
- correct proportions should be maintained between indirect and direct taxation;
- the role of property taxes should increase, which would also serve to verify the legality of the acquired possessions;
- consistent measures should be taken to abolish the system of tax exemptions and benefits, which lead to a redistribution of income to the detriment of poorer social groups. Where justified by social considerations, tax benefits should be replaced with subsidization mechanisms.

6. Conclusions

Fiscal policy must be designed, on the one hand, to be a factor stabilizing the economic situation of the state, so as to ensure the credibility (and hence stability) of the economy both in domestic and international contexts. On the other hand, the fiscal system should be flexible enough to allow the use of a whole gamut of fiscal instruments, so that quick and adequate economic responses can be made if and when problems arise.

Sound economic growth must be based on the rapid formation of domestic capital. High investment levels are impossible to achieve without an appropriate volume of domestic savings. Therefore, fiscal instruments should be used in ways that increase the propensity to save and encourages the efficient use of savings to finance investment.

Foreign investments are important (especially as a vehicle for the transfer of modern technologies), but should only be seen as a supplement to domestic capital. The role of fiscal policy is to create appropriate conditions to attract foreign direct investment, while protecting the economy from risks connected with uncontrollable flows of speculation capital.

In years to come, fiscal policy in Poland will be very carefully watched, as our country faces a series of key decisions that will shape the structure of its revenues and expenditures for years. The main problem nowadays is the massive disequilibrium of state finances; therefore, fiscal adjustment is now the most often mentioned problem of Poland. It is vital that the badly needed reduction of the deficit of state finances should not adversely affect the real sphere of the economy.

Watching the ongoing process of fiscal reform implementation in Poland, one fears that the worst-case scenario might become reality. That would happen if fiscal adjustment should fall short of preventing a crisis of state finance, but prove sufficient to trigger a political crisis and hence destabilize the national economy. Hopefully, this vision will not materialize.

In this paper, I have endeavoured to present some assumptions on which, in my opinion, fiscal policy in Poland should be based, if it is to foster rapid and sustained economic growth. Most of these postulates have been included in the Public Finance Recovery Program (2003). Fortunately, some of them have already been implemented (for instance the principles of local government financing), others wait to be put into practice. One should hope that, as we implement the strategy of fiscal reform, we will not lose sight of the long-term consequences of specific decisions, while resisting current pressures, which threaten to outweigh the multi-year perspective – for it is only through rapid and sustained economic growth that Poland can close the distance to the highly developed economies.

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