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# The Recent Trends in Personal Income Taxation in Poland and in the UK

Beata Heimann

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Hrsg. von
Andreas Knorr, Alfons Lemper, Axel Sell, Karl Wohlmuth

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Beata Heimann
pawlowsk@uni-bremen.de

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und Internationales Management
Universität Bremen
Fachbereich Wirtschaftswissenschaft
Postfach 33 04 40
D- 28334 Bremen
Telefon: 04 21 / 2 18 - 34 29
Telefax: 04 21 / 2 18 - 45 50
E-mail: iwim@uni-bremen.de
Homepage: http://www.wiwi.uni-bremen.de/iwim

**Abstract**

Income taxation raises complex and interesting issues as it may affect individual's savings, work and attitudes towards risk-taking; it also affects the distribution of incomes after tax and before tax - all these questions that are central to the design of tax systems. The concern about the design of the tax system is the same concern that underlines the discussion of striking the correct balance between equity and efficiency, and in particular the problem of minimising excess burden while achieving a socially desirable redistribution of income.

In this paper I seek to use economic analysis to examine the Polish and British personal income tax in the last two decades. I try to do this by comparing each part of the tax and examine them using theoretical analysis. In spite of the fact that the personal income tax structures in Poland and in the UK were constructed and developed under different economic conditions, the aim of this paper is to identify some common trends in the personal income taxation in both countries on the example of the reforms introduced in the past and some governmental proposals for the future changes in Poland and in the UK. I also try to answer the question whether the reforms in the personal income tax in Poland and in the UK in the past have provided for equity, certainty, convenience and efficiency.

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**LIST OF ABBREVIATIONS**

CIT – Corporate Income Tax

CGT – Capital Gains Tax

CPE – Centrally Planned Economy

CTC – Children's Tax Credit

DPTC – Disabled Person's Tax Credit

GDP – Gross Domestic Product

ISA – Individual Savings Account

LEL – lower earnings limit

MCA – Married Couple's Allowance

MITR – Mortgage Interest Tax Relief

NI – National Insurance

PAYE – Pay-As-You-Earn

PEP – Personal Equity Plan

PIT – Personal Income Tax

PT – primary threshold

p.w. – per week

SERPS – State Earnings-Related Pension Scheme

ST – secondary threshold

TESSA – Tax-Exempt Special Savings Account

UEL – upper earnings limit

UK – United Kingdom

VAT – Value Added Tax

WFTC – Working Families' Tax Credit

ZUS – Zaklad Ubezpieczen Spolecznych (Social Insurance Office)

£ - British pound

## 1. Introduction

Public sector economics is a rapidly developing sphere of inquiry and taxation is one of the more challenging areas of that subject. Income taxation raises complex and interesting issues as it may affect individual's savings, work and attitudes towards risk-taking; it also affects the distribution of incomes after tax and before tax - all these questions that are central to the design of tax systems. The concern about the design of the tax system is the same concern that underlines the discussion of striking the correct balance between equity and efficiency, and in particular the problem of minimising excess burden while achieving a socially desirable redistribution of income.

In this paper I seek to use economic analysis to examine the Polish and British personal income tax in the last two decades. I try to do this by comparing each part of the tax and examine them using theoretical analysis as regards to the economic effects of taxes and in a practical way by looking at real day-to-day problems of the Polish and British personal income tax.

The reason for choosing the British personal income tax as a subject for comparison with the Polish one was the general similarity of the institutional arrangements, such as income tax structures in both of the countries, which contributes to the clearness and transparency of the analysis included in the paper. The following factors seemed to be of great importance for the selection of the British tax system: the approach to defining income is very much alike as in the Polish personal income tax and the amount of tax rates in the UK is the same as in Poland as well as the fact that both of the countries provide for a system of tax deductions and reliefs. However, while comparing the Polish and British income tax, one cannot ignore the differences in matters of historical, economic and social nature, e.g. mentality and tradition of compliance with tax regulations, which result in dissimilarities between Poland and the UK as regards personal allowances and the system of collecting income.

Much of the material in my paper concern the evaluation of the economic effects of personal income tax by looking at how actual taxes in the UK and in Poland differ from the theoretical tax. The

reason for doing so is that much of the complexity of the tax systems derives from the absence of any clear view as to what principles should underlie the construction of the tax. Therefore, I try to examine each part of the personal income tax and answer the question: what are the underlying principles of taxation? The main objective of the paper is to answer the following questions:

- Taxes should be chosen so as to minimise interference with economic decisions in otherwise efficient markets. To what extent the Polish and British personal income tax imposes 'excess burden' that should be minimised?
- What matters in this context is not only the impact point at which the tax is imposed but its final resting place. How is the problem of incidence in the personal income tax solved in both of the countries being compared?
- Everyone should be able to pay his or her fair share. Is the distribution of the tax burden equitable?
- In what way does the tax structure in both of the countries facilitate the use of fiscal policy for stabilisation and growth objectives?

I would like to pursue in this paper the question of whether the reforms in tax systems in Poland and in the UK in the past have provided for equity, certainty, convenience and efficiency.

In examining the issue it appeared logical to divide the work into four parts: principles of taxation, the recent trends in the personal income taxation in Poland since the tax reform in 1992-93, the recent trends in the UK since 1978-79 and the comparison of the personal income tax in Poland and in the UK for the year 2001 and 2001-02 respectively where attempts will be made to assess the advantages and disadvantages of particular institutional arrangements in the light of the principles discussed. The following issues are scrutinised while analysing the income tax structure in the UK and in Poland: the income tax structure, taxable income, deductions and reliefs and tax rates. Next, I pursue the subject of the national insurance contributions as a form of tax. It will be followed by the presentation of the tax collection system. Finally some conclusions will be drawn.

## 2. Principles of Taxation

From Adam Smith on, ideas about what constitutes a good tax system have been discussed by economists and social philosophers. Among them, the following are of major importance:

- Interference with economic decisions in otherwise efficient markets should be minimised as shown in chapter 2.1.
- The problem of incidence, explored in chapter 2.2, must be allowed for.
- The distribution of the tax burden should be equitable, a matter to be dealt with in the following chapter 2.3.
- The tax structure should facilitate the use of fiscal policy for stabilisation and growth objectives, a topic dealt with in chapter 2.4.

### 2.1. Taxation and Efficiency

A fundamental concept in the context of taxation and efficiency is that of Pareto efficiency. Economists consider an arrangement efficient if resources are used in a way which does not leave a possibility of alternative arrangements under which somebody could be better off without anyone being worse off.[1] In practice, because most economic changes make some people better off and some people worse off, the concept of efficiency may be modified so that the requirement is that the gainers gain more than the losers lose. In other words, efficiency would be enhanced if, as a result of a change, the gainers were able to compensate the losers by the amount of their loss, and still be better off.

Taxation naturally imposes economic costs on society. These costs of taxation can be classified into three groups: the first category is the excess burden of taxation, the second, administrative costs, which covers the burden to the public sector of administrating taxes, and the third group embraces those costs incurred by the private sector in obeying (or not obeying) the requirements of the tax system; that is the compliance costs.

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[1] S. James and C. Nobes, *The Economics of Taxation*, Prentice Hall International (UK) Ltd, Herfofdshire, 1992, p.17.

### The Excess Burden of Taxation

Taxes transfer spending power from the taxpayer to the government and there arises the income effect of taxation. It means that with imposing or increasing a tax, the taxpayer's spending power is reduced. Income effects do not themselves precede economic efficiency. In addition to this transfer of resources, taxes may distort consumers' choices between goods or activity, and lead to the substitution of one form of consumption or activity for another - this kind of phenomenon is represented by the substitution effect of taxation. The substitution effect of taxes can, therefore, influence economic efficiency and impose an excess burden on the community because they interfere with consumer choice. The actual burden of a particular tax is determined by a large number of factors, such as the rates and coverage of particular taxes.

As far as the income tax is concerned, it is said that it may influence the allocation of resources and thus impose an excess burden on the community. The excess tax burden may result in tax evasion. Some incomes avoid taxation by adopting particular types of employment which afford opportunities to avoid tax. That means the change in the allocation of labour and interference with the market. The similar effect may occur as a result of tax deductions which makes one form of income less taxed than the other. [2]

Some deductions allow particular items of expenditure against income and that may influence the consumer choices by encouraging particular form of expenditure. Tax expenditure as a form of fiscal advantage bestowed on a group of individuals, or a particular activity relates directly to the topic of taxation and efficiency. Tax concessions allow the government to favour certain groups or activities and therefore they impair the economic efficiency of the market mechanism. The loss of economic efficiency may also occur in the situation when some types of income suffer discrimination. It happens so when income is taxed more than once, e.g. when an income earned abroad is subject to income tax both in the foreign country and at home. In another case even though all types of income are taxed once and only once, some may be taxed at higher rates than

[2] *Ibid*., p. 27.

others. The obvious contrast is that between a proportional income tax, where the tax taken is a constant proportion of income received and on the other hand a progressive income tax, where the proportion taken rises as income increases. The existence of progressive income taxes not only implies taking larger percentage slices away from the higher income groups in any one year, but may even mean taking more from people whose earnings fluctuate from year to year than from those whose earnings are constant over time.[3]

### Administrative and Compliance Costs

Administrative and compliance costs are the costs of operating a tax system imposed on the public and private sectors respectively. Administrative costs include therefore the wages and salaries of staff, the full cost of the accommodation and materials used by staff and services received but not paid for from other departments. In comparison to the excess burden of taxes and with compliance costs administrative costs are easy to measure. One of the proposals regarding taxation system, including administrative costs, made by Adam Smith says:

> *Every tax ought to be so contrived as both to take out and to keep out of the pockets of the people as little as possible, over and above what it brings into the public treasury of the state*.[4]

The costs of complying with the requirements of a tax include money spent on accountants and tax guides and also taxpayers' time spent in completing returns. According to Adam Smith, the mental costs to taxpayers of any anxiety suffered as a result of the operation of the tax must also be included. He wrote:

> *By subjecting the people to the frequent visits and the odious examinations of the tax-gatherers, it may expose them to much unnecessary trouble, vexation and oppression, and though vexation is not, strictly speaking, expense, it is certainly*

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[3] A. R. Prest, *Public Finance in Theory and Practice*, London, 1985, p.41.
[4] A. Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations (1776)*, E. Cannan edt, Methuen & Co. Ltd., London, 1925, Book V, Ch. II, p.310.

> *equivalent to the expense at which every man would be willing to redeem himself from it.*[5]

While considering the subject of taxation and efficiency the following questions arise : which sector - public or private should perform the administrative tasks in order to carry out the work in the most efficient way, how complex the tax structure should be (as the more complex tax system seem to be the higher administrative and compliance costs occur) and finally whether better compliance should be secured by higher penalties.

As this brief discussion suggests, tax administration and enforcement offer interesting problems in policy design and trade-offs, not only for administrators but also for economists.

## 2.2. Taxation and Incentives

### Effects on Work Effort

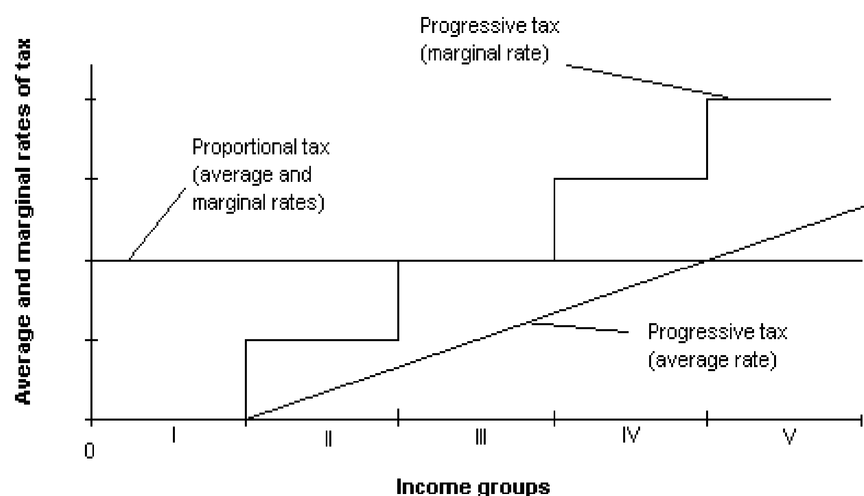
The effects of the income tax on work effort are distinct. The tax generates two effects, namely 'income effect' which results from the fact that the taxpayer is made worse off than he would be without imposing or increasing the tax on his income and 'substitution effect' which describes the effect on a person's choice between work or leisure as the marginal benefit from either or both changes as a result of the tax and in that way as a result of the income decrease. These effects generally work in the opposite directions as normally when a higher tax is imposed one should expect the income effect to encourage the taxpayer to work harder so he can attain the former level of the income after tax while the substitution effect will discourage work effort because if the rate of income tax rises so that the marginal benefit from work falls, a person may choose to substitute some leisure for some of his working time. The net result depends on which of these two effects is stronger.

This type of analysis can be applied to the very substantial question while constructing tax system, particularly what kind of income tax - proportional, regressive or progressive should be used. The definition

[5] *Ibid.*, p.312.

of a proportional income tax is that the marginal and average rates of tax are equal. With the progressive income tax the marginal rate of tax exceeds the average rate of tax. This means that the progressive tax has a stronger substitution effect and therefore is likely to be more adverse to individual work effort than a proportional tax. On the contrary, a regressive tax is more likely to be favourable to individual work effort than a proportional tax since the regressive tax will have a lower marginal rate and therefore a weaker substitution effect than the progressive tax (See Figure 1). Given the equal yield the income effect in all of these examples will be much the same.

Figure 1. Progressive and proportional taxes.




*Source: S. James and C. Nobes, The Economics of Taxation, Prentice Hall International Ltd, 1992, p.48*

The comparison between the effects of proportional and progressive taxes on the community as a whole is more complex. It is not possible to predict on purely theoretical grounds what the overall effects of a more progressive tax would be on the work effort of the particular

groups of the community, given that the community is divided into the groups according to their level of income. The net result would depend on the strength of the opposing income and substitution effects and the number of people, in each group.

The analysis so far has ignored many of the practical considerations which may influence the total supply of labour. The first one would be the existence of a standard working week which prevent changes in taxation from influencing the  supply of labour. The second practical consideration is the quality of the work done as the discussion so far has assumed that each hour of work is equally productive. Taxation, however can influence the level of productivity by affecting the willingness of individuals to acquire more productive skills or of moving to a more productive job in the strive for promotion.[6]

### Effects of Taxation on Private-Sector Saving

While examining the likely effects of the income tax on the level of saving two effects must be taken into consideration, namely: income and substitution effects. The substitution effect operate on the rates of return to saving while the income effects mainly involve the relative burden of the income tax on different sections of the community. Taxation effects on saving may result in the reducing the net rate of return on saving, thus it lowers the rate at which the household can substitute future for present consumption. The degree of the substitution effect is difficult to assess. Those who believe that savings are highly elastic with respect to interest rates will expect a greater responsiveness to a given differential than those who believe savings to be interest inelastic.[7] The income effect means that the taxpayers' income is reduced and clearly taxes reduce significantly the income when the double taxation occur in form of imposing tax when the income is first received but also when the income is saved through the taxation of any interest.

Given the assumption that marginal propensity to consume declines as income rises and thus the level of spare income that could be saved increases, savings will generally be discouraged more by a

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[6] S. James and C. Nobes, *The Economics of Taxation*, *op.cit.,* p.57.
[7] A. R. Prest, *Public Finance in Theory and Practice*, *op.cit*., p. 84.

highly progressive income tax than by a less progressive tax of equal yield.

The income tax can be designed to favour saving. An income tax that exempted investment income would avoid the 'double taxation of savings'. Incentives in form of tax-deductible saving may favour some methods of saving such as consumer credit or mortgage finance.

### Effects of Taxation on Enterprise and Risk Taking

Saving is a necessary condition for capital formation but it is not a sufficient one. Investors must also be willing to invest, and taxes once more enter into this decision.
People are generally averse to taking risks and they will only be induced to do so if they expect to receive some sort of return. Therefore, the response of investors to take risk and thus the level of investment would depend very much on these returns, which are influenced by taxation. When the income tax does not allow losses to be offset against gains in the calculation of taxable income it means that the return to investment would decrease but it would also reduce the amount of risky investment associated with that return. On the contrary, if losses are allowed to be set off against profits, the consequence of that would be the situation when tax revenue falls and the level of risk-taking in the community grows. The combined effect on society as a whole, therefore, may be the increased amount of risk-taking.

## 2.3. Taxation and Equity

Taxes are supposed to be fair. The importance of fairness in taxation rests particularly in the desire of the governors and governed for justice. While it is easy to agree on the statement that the tax system should be equitable, it might be less easy to find agreement as to what 'fair' means. One can distinguish two separate concepts of fairness: horizontal equity and vertical equity. Horizontal equity means that people with equivalent circumstances should be treated equally, while vertical equity is concerned with fairness between

people with differing circumstances.[8] Horizontal equity is concerned with fairness between persons with the same income and wealth, however there are great problems to decide who is equal to whom and what equal and differing circumstances mean: does it mean the same income, expenditure, wealth, total utility, benefit gained from the expenditure of the tax-raising authority or some combination of these factors? To answer this question equity criteria need to be examined.

## Equity Criteria

### The Benefit Approach

The benefit principle of taxation has its roots firmly established in the voluntary exchange or price theory of public finance, and examines the costs and benefits of public sector activities that face individual citizens. The prescription to achieve fairness is that each individual's tax contributions should be based upon the benefit received from consuming public goods.[9] The benefit principle is, in fact in some taxation systems, applied to highway taxation, where road building is paid by earmarked highway-user taxes, set aside in separate accounts from which they cannot be 'diverted' to other purposes. The principle is sometimes also applied in the local services field, such as the construction of sewers and streets, which can be partly financed out of special assessments levied on the residents who will be served.[10] The benefit principle has obviously a number of drawbacks as it is difficult to theorise which groups in society receive the most of the government expenditure, particularly those concerning public goods like defence, justice and law and order. Furthermore, there are types of government expenditure which are designed to be some form of redistribution of income towards those in need and would be unfair to call for the tax contribution based on the benefit approach.[11]

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[8] C. V. Brown and P. M. Jackson, *Public Sector Economies*, Oxford, Basil Blackwell, 1990, p.298.
[9] *Ibid*., p.298.
[10] O. Eckstein, *Public Finance*, Prentice-Hall, inc., New Jersey, 1973, p.54.
[11] S. James and C. Nobes, *The Economics of Taxation*, *op.cit*., p.69.

### The Ability - to - Pay Approach

Rather than basing and individual's tax liabilities on how much benefit the individual received from public spending, the ability-to-pay principle prefers to levy taxes on how much the individual could afford to pay. The ability-to-pay approach has its foundations in the writings of Adam Smith, who wrote :

> *The subjects of every stage ought to contribute toward the support of the government, as nearly as possible, in proportion to their respective abilities; that is, in proportion to the revenue which they respectively enjoy under the protection of the state. (...)*
> *It is not very unreasonable that the rich should contribute to the public expense, not only in proportion to their revenue but something more than that proportion .* [12]

John Stuart Mill also supported the ability-to-pay approach. In his *Principles of Political Economy* he pointed out that:

> *Government must be regarded as so pre-eminently a concern of all, that to determine who are the most interested in it is of no real importance... As in a case of voluntary subscription for a purpose in which all are interested, all are thought to have done their part fairly when each has contributed according to his means, that is, has made an equal sacrifice for the common object.* [13]

According to the principle, unequals should be treated unequally (vertical equity) while equals were to be treated equally (horizontal equity). But what is meant by the equality of sacrifice? There are three distinct interpretations:[14]

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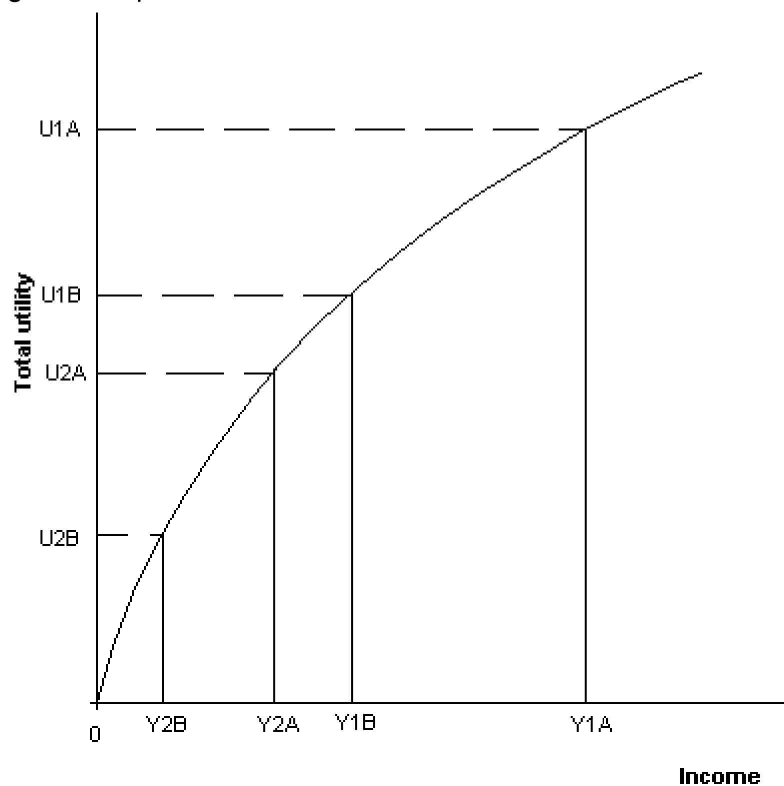
[12] A. Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations (1776)*„ *op.cit*.,p.310.
[13] J. St. Mill, *Principles of Political Economy*, Longmans, Green and Co., London, 1896, Book 5, chapter II, P.485.
[14] C. V. Brown and P. M. Jackson, *Economics*, Public Sector, *op.cit*., p.301

*Equal absolute sacrifice* (Figure 2) which says that due to taxation of income each individual experiences the same loss in total utility. The assumption has been made that the marginal utility MU of income declines - as income rises total utility rises but at a decreasing rate. In order to achieve an equal absolute sacrifice of utility a higher amount of tax should be imposed on a higher income and then

$OU_{1A} - OU_{2A} = OU_{1B} - OU_{2B}$.

However, nothing conclusive can be said about whether or not the tax should be progressive because this will depend upon the rate of decline in the marginal utility of income.

Figure 2. Equal absolute sacrifice.



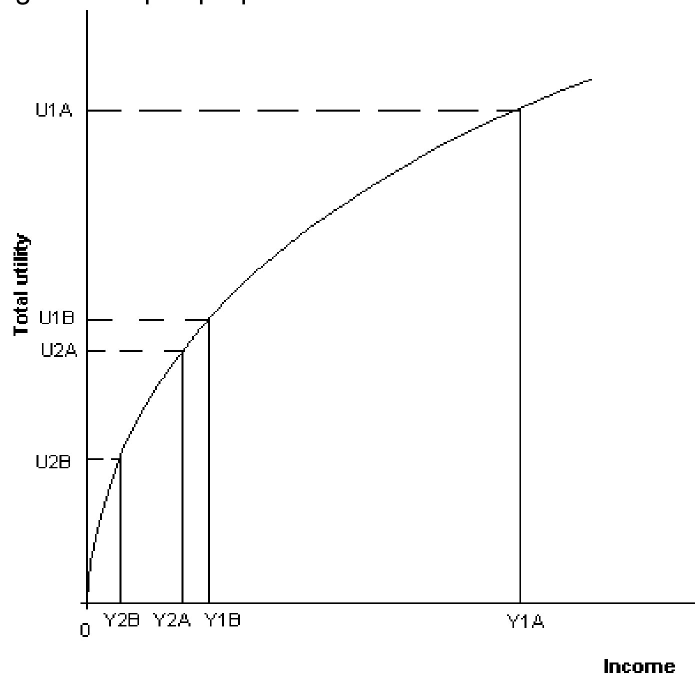

*Source: C.V. Brown and P.M. Jackson, Public Sector Economics, Blackwell 1994, p.302.*

*Equal proportional sacrifice* (Figure 3) suggests that the ratio of the utility lost to total utility should be equal for each individual. Using the same assumptions as in the equal absolute sacrifice rule, it means that each individual loses utility in the same proportion and then

$OU_{1A}/OU_{2A}=OU_{1B}/OU_{2B}$.

It implies that in the case of a falling straight-line marginal utility MU of income function requires progressive taxation. However, if the MU of income function is not straight line the result is inconclusive and will depend on the level and the rate of change in the MU function in addition to the amount of tax revenue that has to be raised and the initial distribution of income.

Figure 3. Equal proportional sacrifice.




*Source: C.V. Brown and P.M. Jackson, Public Sector Economics, Blackwell 1994, p.302.*

*Equal marginal sacrifice* (Figure 4) claims for the situation when taxation will reduce income to the point that the marginal utility of income is equal for all, for each individual. Thus if individuals are to have equal marginal utility, they must be at the same point on the utility curve where

$OY_{2A}=OY_{2B}$.

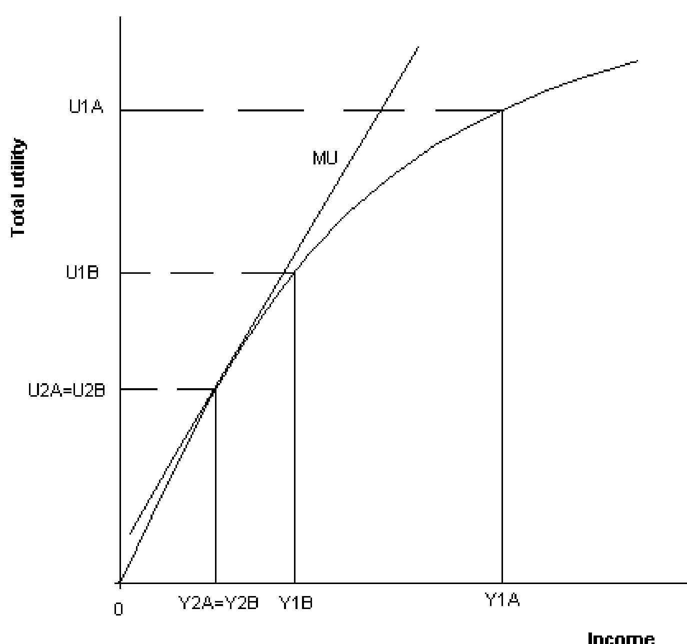
If the tax is used to redistribute incomes, to the point of making incomes equal, then this would call for maximum progression. If, however, the objective of the tax is to finance public expenditures, then the degree of progression will depend upon how much revenue is to be raised so as top incomes are reduced until the amount of the tax revenue is achieved.

It is seen from this brief discussion that the ability-to-pay rule is ambiguous and inconclusive with respect to whether or not progressive taxes are required. The result will depend upon the precise definition of equal sacrifice chosen and the properties of the utility function which is used, i.e. the shape of the MU of income function. Therefore, the main critique of the ability-to-pay approach focuses on the following assumptions.

Income has been the most widely accepted measure of ability to pay approach mainly because it is easy to build progressiveness into income taxation, however the income is not unanimously considered to be the ideal determinant of utility. Furthermore the definition of income is not precisely limited - the question is whether it includes different than earnings mixes of income like capital gains and gift received or not. Nor is it all clear that the law of diminishing marginal utility applies equally to income as it does to commodities. It is difficult to say that marginal utility of income is known and declines as income increases. It is also ambiguous to measure the individuals' relative utilities by differences in their incomes and there is doubt among 'new welfare economics' whether the interpersonal comparisons of utility are allowed.[15]

[15] *Ibid*., p.304

Figure 4. Equal marginal sacrifice.




*Source: C.V. Brown and P.M. Jackson, Public Sector Economics, Blackwell 1994, p.303.*

**The Effects of Inflation on Equity**

Inflation may cause inequity of taxation system for two reasons, particularly when the income tax system is progressive. Unless special adjustment are made to a progressive rate structure, inflation pushes earners into higher rate bands without increasing their real gross incomes. Moreover, as prices rise, the real value of exemptions and allowances declines. As a result, the level of real income at which the tax begins to apply falls. Thus income tax liability increases more rapidly than do prices, i.e., they increase in real terms.

**Administrative Fairness**

Equity of taxation system can be perceived in relation to administrative fairness which should provide the coherence of the tax

system and the reduction of evasion. If the tax system is to be clear for taxpayers the general attitude of the Inland Revenue in its dealings with the public by letter, telephone and face-to-face is important. Also, explanatory leaflets easy to understand should be provided. The existence of an appeals system as well as some provision for postponement or cancellation of assessment is a further example of administrative fairness.[16]

**Avoidance and Evasion**

Avoidance is an individual's manipulation of his affairs within the law so as to reduce his tax liability. Evasion is illegal manipulation to reduce tax liability.[17] The main causes of avoidance and evasion include high tax rates, imprecise laws, insufficient penalties, and inequity.

Avoidance and evasion become more rewarding as rates of tax become higher. Therefore, it is worth spending more money on advice, performing more complex manoeuvres and taking great risks. Imprecise law resulting in the loopholes can be used to avoid paying taxes. However, increasing legal complexity (which is necessary to maintain equity and to reduce avoidance) has the unfortunate side effect of reducing comprehensibility. Moreover, mild and insufficient penalties compared to the benefits can result in the increase of the tax avoidance. Also, if the system is commonly regarded as being inequitable this will lead to an increased desire to avoid or evade tax, and these activities will become increasingly socially acceptable. The ease of success with avoidance and evasion by other people encourages others to do the same.

Avoidance and evasion involve the taxpayer's time and consequent adjustment to his affairs and also sometimes involve the time and resources of expert advisers, and all this effort makes up the costs in terms of reduced economic welfare.

There is also another aspect of tax avoidance and evasion. It is said that income and wealth are redistributed towards those who

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[16] S. James and C. Nobes, *The Economics of Taxation*, *op.cit.,* p.88.
[17] *Ibid*., p.88.

successfully commit avoidance and evasion, and away from those who do not. This comes about not only because the avoiders and evaders pay less than they otherwise would, but also because the rates of taxation have to be increased in order to raise a predetermined amount of revenue from other taxpayers. This is clearly inequitable and, as has already been mentioned, the perception of this will lead to further avoidance and evasion. All these costs and disadvantages suggest that effective effort put into the reduction of avoidance and evasion would be well worth while.[18]

### 2.4. Taxation and Stabilisation

It is well known in macroeconomics that if economic activities are not sufficiently well co-ordinated the result is a general disequilibrium, which can show up in a number of possible ways, each having an undesirable effect, e.g. unemployment, inflation or an imbalance on the country's external trading account. The failure of the market system to co-ordinate all activities and to come into equilibrium provides the justification for macroeconomic policy, which uses two principal, interacting to each other weapons: monetary and fiscal policy. While fiscal policy refers to changes in governmental tax and expenditure policy, monetary policy involves changes in the level of the money supply. While the Keynesian approach to stabilisation stresses the importance of fiscal policy, the monetary approach strongly supports the monetary policy. However, as taxation is an instrument of fiscal policy, the following discussion will refer to the fiscal policy. The main dilemma faced when using the stabilisation policy is the decision whether discretionary of automatic changes should be used. Discretionary change refers to programs which involve explicit public decision making, e.g., transfer-expenditure programs, public works, varying tax rates cyclically.[19] Automatic change, on the other hand, refers to change which is 'built-in' to the system in some way - either into the tax structure itself, or in the system of unemployment compensation or in the way of people's behaviour. An increase in tax revenue as a result of inflation is therefore an example of automatic change.

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[18] *Ibid*., p.91.
[19] P. A. Samuelson, *Economics*, Mc Graw-Hill Book Company, London, 1976, p.359.

The use of discretionary measures has been the subject of criticism. The importance of lags in the theory of stabilisation has been stressed by Friedman (1947 and 1948) who pointed out that fiscal policy can involve considerable time lags. The classification recognises three types of lag: the recognition lag, the implementation lag, and the response lag.

The recognition lag is the delay from the time the need for action arises until that need is actually recognised by the government. Much of the recognition lag exists because of the time taken to collect and analyse economic data. The delay could be very small or even negative if it were possible to forecast future levels of economic activity. However, forecasting is never precise. The implementation lag is the delay between the decision to take action and the implementation of that action. The delay occurs because, naturally, it takes time to carry out policy changes. The response lag refers to the time between the implementation of a policy measure and the time it finally influences the economy.[20]

The theory of the political business cycle (Kalecki 1943) said that using discretionary powers by a government which is influenced by the effort to win the next election more than by the interests of long-term economic stability can be itself an originating source of cyclical instability.[21]

One method of reducing the possible disadvantages of discretionary policy is to design a system of government budgeting which automatically responds to changes in the level of economic activity. For the tax system, this implies that tax revenue should rise and fall as national income rises and falls. This feature of a tax system is usually referred to as 'built-in-flexibility'.

The most important example of built-in-flexibility is the progressive income tax. Progressivity means that income tax receipts change proportionately more than any original change in national income. The main advantage of built-in-flexibility is that it avoids the recognition lag. Nonetheless, built-in-flexibility has its limitations as a

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[20] S. James and C. Nobes, *The Economics of Taxation*, *op.cit*., p.103-104.
[21] P. A. Samuelson, *Economics*, *op.cit*., p.259.

stabilising device. First of all, it cannot cope with large exogenous changes. Secondly, built-in-flexibility cannot eliminate cycles; it can only reduce them. The third limitation is that while built-in-flexibility undoubtedly cushions the effects of economic depression, it also impedes recovery.[22]

Automatic stabilisers help to reduce upward and downward movements in national income. However, in the situation when the economy begins to recover from a recession and unemployment, the automatic stabilisers would act as a drag on the expansion. This is known as a 'fiscal drag'.[23] Unless indexation is implemented the automatic stabilisers like e.g., a progressive tax system, the magnitude of the recovery is reduced. However, indexation impairs the built-in flexibility of a progressive tax system.

## 3. The Recent Trends in Personal Income Taxation in Poland

### Introduction

The Polish tax system has been subject to a number of changes and tax reforms over the last two decades. The main tax reform was introduced in 1992-93 after the collapse of the communist regime and was a result of the change in the political and economic system in Poland. Until then, the structure of taxation system in Poland reflected the basic assumptions of the centrally planned economy, where the prices, taxes and subsidies as policy instruments were administered in a selective way.

In a planned economy individuals were taxed by four kinds of tax: tax on salaries, equalisation tax, agricultural tax and income tax. The main aim of taxation was to flatten the level of wages in order to prevent people from having a permanent surplus over the current consumption expenditures. Private saving was actively discouraged in a planned economy, which was consistent with the prevailing emphasis on the central role of the State in financing capital accumulation.

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[22] S. James and C. Nobes, *The Economics of Taxation*, *op.cit*., p.107.
[23] J. Sloman, *Economics*, Prentice Hall, London, 1991, p.633.

After the collapse of the communist regime in 1989, Poland introduced a completely new tax system, which was fully implemented in 1992 and 1993. It included: the unified personal income tax (PIT) in which the taxable income included all kinds of income of a particular taxpayer, the unified corporation tax (CIT), and value added tax (VAT).

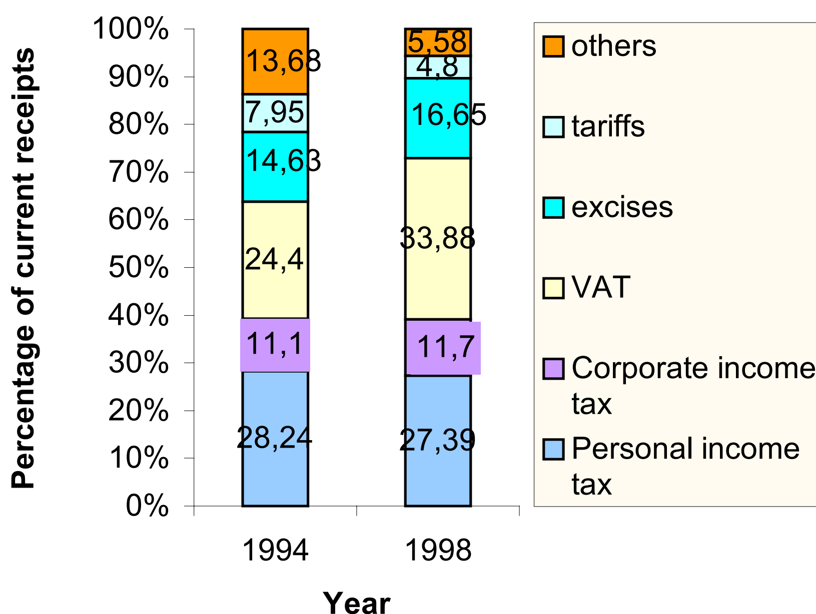
The reform of the Polish tax system resulted in a rise of the allocation neutrality of the tax structure as unified regulations of the tax system were implemented. It also increased the transparency of the tax system. The new tax system became a useful device of the economic governmental policy in strive for stabilisation and growth objectives, mainly by the relevant tax incentives and allowances.

In order to provide a general picture of the changes in the Polish tax system over the last nine years since the Tax Reform in 1992-93, first their effects on the composition of aggregate government revenue will be presented. The share of particular taxes in total budgetary revenues has been changed gradually in favour of indirect taxes. The share of indirect taxes (VAT, excises, tariffs, etc.) grew from 51.64 per cent in 1994 to the level of 55.71 per cent in 1998. [24] The VAT share in total budgetary revenues alone grew from 24.4 to 33.88 per cent. At the same time the share of direct taxes (PIT and CIT) in total budgetary revenues decreased slightly from 39.34 per cent to 39.09 per cent respectively (see Figure 5).The changes are consistent with the tendency in the world as indirect taxes are considered as more efficient than direct ones (they are believed to be less distortionary than other types of taxes). In comparison to other taxes VAT is easier to collect and that means it requires less extended system of tax authorities. It is more difficult to avoid VAT than any other taxes. A shift towards indirect taxes is of particular importance for Poland for the following reasons: the general personal income tax as well as corporate income tax was implemented only in 1992, at the beginning the Polish tax authorities faced some technical obstacles, e.g. lack of electronic service and computer skills, moreover there was no tradition to comply with tax law regulations before, which explains partly why tax avoidance and evasion has been so popular in Poland

[24] *Reforma Podatkow*, Ministry of Finance, Warsaw, August 1999.

(in contrast to the UK where the Inland Revenues is well-organised and has got long practical experience and taxpayers are used to paying the income taxes).

Figure 5. The structure of budgetary revenues in Poland in 1994 and in 1998 in percentage.




*Source: Reforma podatkow, Ministry of Finance,Warsaw, August 1999, p.11.*

As far as the personal income tax (PIT) is concerned the Tax Law on 26 July 1991 established a general and unified tax system that replaced the previous incoherent regulation based on the system which differentiated the various elements of income from different sources by the means of different rates and different legal rules.[25] Instead of five different kinds of income taxes, namely: wage tax, tax-on-salaries, equalising tax, income tax and farm tax, the uniform

[25] J. Fiszer, 'Nowa ustawa o podatku dochodowym od osob fizycznych', *Orzecznictwo gospodarcze*, Nr 3/1991, s. 81-84.

personal income tax was introduced in 1992, which covered all incomes generated by natural persons irrespective of where the sources of income are located. The reform provided also a more equitable distribution of the tax burden by introducing a progressive system with three nominal tax rates (20%, 30%, 40%). In order to simplify the tax collection the first tax bracket was extended to cover income up to three times the average wage in the year preceding the given fiscal year. Such a very wide spread of the first bracket was supposed to cover the vast majority of earned incomes, so that it did not discourage higher productivity by reduction of the marginal tax rates and it facilitated tax assessment as collection costs were limited. The personal income tax had broad political effect in the sense that a lot of people started to think with the mind of a 'taxpayer citizen', and the requirement for more information about budgetary expenditure has increased considerably. As a result of the tax reform the framework of the market economy became more clear.

Over the last nine years, the personal income tax in Poland has been subject to many amendments, of which the most important are: the change of tax rates, broadening the tax base, and abolition of many deductions and relief. Also, the system of social security contributions was reformed.

### Tax Rates

Although the tax rates in the year 2001 do not differ much from the tax rates of 1992 when the personal income tax was introduced in Poland, we can observe significant fluctuations in the tax rates over the last nine years. The variation margin for the highest tax rate was up to 5 percentage points and for the higher rate up to 3 percentage point. The basic rate was relatively stable and changed up and down only by one percentage point in relation to the tax rate of 1992 (see Table 1). In 1998 the suggestion to implement the flat income tax in Poland was made as it was believed that the flat income tax would provide for horizontal equity (where people under similar circumstances bear equal tax burden) and would be less distortionary than the progressive tax. The flat tax rate of 22 per cent was planned to be introduced in the year 2000. However, for political reasons this proposal as well as the government's proposal of the PIT reform in

1999 suggesting introduction of two tax rates 18 and 28 per cent in the year 2001 and later, failed to be accepted by the Parliament.

Table 1. Personal income tax rates in Poland, 1992-2001.

| *Fiscal years* | *Basic rate* | *Higher rate* | *Highest rate* |
|---|---|---|---|
| 1992 to 1993 | 20 | 30 | 40 |
| 1994 to 1996 | 21 | 33 | 45 |
| 1997 | 20 | 32 | 44 |
| 1998 to 2001 | 19 | 30 | 40 |

*Source: Biala Ksiega Podatkow, Polish Ministry of Finance, Warsaw, 1998.*

The income amounts falling under the various brackets has been readjusted yearly since 1994, in line with the increase in the retail prices index for the previous three terms preceding the tax year. Thus the equitable aspect of taxation in relation to inflationary pressure was taken into consideration.

The total number of income taxpayers in 1997 in Poland totalled 24,611,000, of which there were 94.57 per cent basic rate taxpayers, 4.42 per cent higher rate taxpayers and 1.01 per cent taxpayers paying the highest rate (Table 2). The above figures imply that in Poland the basic rate encompasses the vast majority of the taxpayers (23,274,623), particularly pensioners or old age pensioners with very modest pension benefits. This group of taxpayers amount for 36 per cent of all taxpayers paying the basic tax rate. That category of taxpayers relatively rarely claim any deductions and reliefs so in that case no other adjustment at the end of the tax year is required. That means that the tax assessment is greatly facilitated.

However, the long basic rate band has some negative implications for equity between taxpayers. The long basic rate band results also in the fact that 33 per cent of all taxes in Poland in 1997 were paid by merely 5.43 per cent of taxpayers (those paying high or the highest tax rate (Table 2). Such a high progression of the Polish tax system may often be perceived by well-off people as inequitable and thus lead to tax avoidance or even evasion.

Table 2. Number of income taxpayers in Poland in 1997.

| Number of income taxpayers, 1998 | Number (thousands) | Percentages | Taxpayers share in total income tax receipts |
|---|---|---|---|
| Number of individuals paying tax | 24,611 | 100.00 | 100.00 |
| Basic rate taxpayers | 23,275 | 94.57 | 67.02 |
| Higher rate taxpayers | 1,088 | 4.42 | 13.21 |
| Highest rate taxpayers | 248 | 1.01 | 19.77 |

*Source: Biala Ksiega Podatkow, Polish Ministry of Finance, Warsaw, 1998.*

### Treatment of Marriage

In Poland spouses are taxed separately unless they apply for joint taxation. However, in the year 2001 the option for joint taxation was reduced significantly (it is not possible to apply for joint taxation if one of the married couple pays tax in a lump-sum form). There have been already proposals to abolish the option as the practice has shown that it was abused in order to lower the taxpayers' tax burden. The example for it is the fact that the amount of couples who applied for joint taxation for 1997 grew in Poland from the level of 1996 by 9.3 per cent.[26] Such a drastic change can be explained by the fact that in the year 1997 new rules applying to deductions and reliefs in the Polish tax system were introduced. Before 1997 deductions were allowed to offset only against income, (from 1997 also against calculated amount of tax) which made joint taxation not that lucrative as far as the reduction of the tax burden is concerned.

### Deductions and Reliefs

Generally, according to the efficiency principle, the reform of the tax system in Poland in 1992 aimed at the reduction of majority of the exemptions and reliefs, so common and used extensively in the tax system under communist regime. However, some provisions were made for the four specific categories of exemptions:

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[26] *Biala Ksiega Podatkow,* Polish Ministry of Finance, Warsaw, 1998.

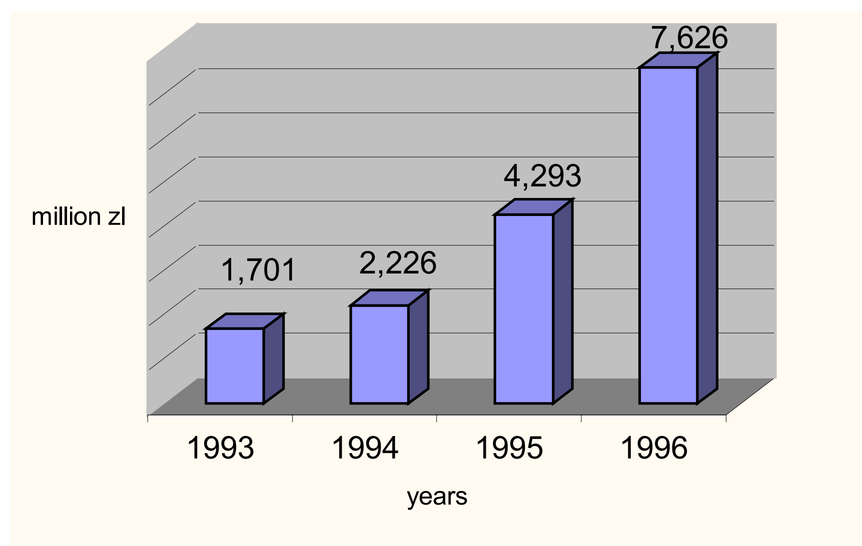
- the revenues that are not related to earning of income e.g., social benefits,
- exemptions of social reasons e.g., compensation payments,
- exemptions of specific reason e.g., incomes from games of chance and lottery winnings,
- exemptions of stimulating character e.g., incomes on sale of the house of flat in order to build or purchase another one, incomes on capital gains e.g., sale of company shares, stock and other securities, interest earned on bank deposits and accounts as well as on bonds, with the exception of dividends.[27]

The two former exemptions were made under the influence of the equity postulates saying that it would be unfair to call for taxation of the redistributional payments, the two latter were made in respect to the incentive aspects of taxation and represented the active fiscal policy consistent both with the budgetary revenue policy and social and economic policy, of which proclaimed goals was to introduce the market forces. The incentives alone, though implemented for good reasons, impaired the economic efficiency by interfering the economic decisions and at the same time provided for inequity between the taxpayers with the same taxable capacity by exempting only the particular kinds of income. This led to various forms of distortion in the allocation of resources and manipulation or tax avoidance. The problem arises when the given tax exemptions do not reach the primarily assumed final resting place. For instance, in Poland the exemption of income on sale of the house or flat in order to build or purchase another one was aiming at promoting the development of the housing market and thus reduction of the number of people with difficult housing circumstances, in particular young married couples. However, it was questionable if the tax exemption had major impact on the fall of the prices in the housing market and resulted in the increased number of flats purchased or new houses built. Instead other taxpayers who could afford the purchase of a flat or house benefited from the tax exemption, which made the tax system perceive as inequitable.

[27] *Ustawa z dnia 26 lipca 1991 o podatku dochodowym od osob fizycznych.*

In evaluating tax deductions and reliefs, it is important that all costs and benefits are taken into account in evaluating their cost effectiveness. The direct benefits may be measured by the increased level of the desired activities. The direct cost to the government are its revenues foregone in lower taxes. In Poland as a result of the deductions the budget acquired smaller revenues. It is estimated that in Poland in 1996 all deductions and reliefs cost the budget the whole amount of zl 7.626 million, which is £1.407 million (according to the exchange rate on the 9 June 2001)[28] (see Figure 6).

Figure 6. Income tax deductions in Poland in 1993-1996.




*Source: Biala Ksiega Podatkow, Polish Ministry of Finance, Warsaw, 1998.*

However, revenues foregone very often exceeded the effect of desired activities and as shown in practice, the deductions and reliefs rarely reached the primarily assumed final resting place, they were more often used by the taxpayers to lower their tax burden. More than 80 per cent of the taxpayers who paid higher rate in 1997 and more

[28] Exchange rates *at: http://www.gazeta.pl*

than 89 percent who paid the highest rate took the opportunity to deduct the allowable expenditures. (Table 3). The significant result of this was the reduction of the effective tax burden (i.e. tax burden after deductions and reliefs) of all taxpayers by 2.11 percentage points. It benefited mostly the taxpayers who paid the highest rate by 5.58 percentage points (Table 4).

Table 3. Number of taxpayers who deducted allowable expenditures in Poland in 1997.

| Tax bands | No of taxpayers | No of taxpayers who deducted allowable expenditures | % (3:2) |
|---|---|---|---|
| 1 | 2 | 3 | 4 |
| I | 22,210,454 | 8,606,610 | 38.75 |
| II | 1,038,069 | 839,546 | 80.88 |
| III | 237,206 | 212,246 | 89.48 |
| Total (I+II+III) | 23,485,771 | 9658,402 | 41.12 |

*Source: Biala Ksiega Podatkow, Polish Ministry of Finance, Warsaw, 1998.*

Table 4. Average tax burden in different tax bands in Poland in 1997.

| Tax bands | Nominal tax burden | Effective tax burden |
|---|---|---|
| I | 16.40 | 14.97 |
| II | 21.59 | 18.26 |
| III | 36.47 | 30.89 |
| Total | 19.24 | 17.13 |

*Source: Biala Ksiega Podatkow, Polish Ministry of Finance, Warsaw, 1998.*

Not only did the extended system of deductions and reliefs milden the progression of the tax system but also often created the situation when well-off people benefited more than those with relatively minor income, though deductions and reliefs were directed generally to all taxpayers. Thus the perception of fairness of the tax system was impaired.

Moreover, the efficiency impact of tax reliefs was relatively minor. The above tax reliefs were to serve as the incentives for the developing Polish housing sector. However, though in years 1993-97 in Poland zl 42.278 million (which is £7.800 million) was deducted in form of

housing expenditures (Table 5), still the housing sector in Poland has been experiencing regress since many years. Only in 1997 the amount of zl 2.448 million (which is £452 million) was deducted in computing total income and zl 1.775 million (which is £327 million) offset against total income.[29] The number of single-family dwellings has been indeed increasing but the number of flats in multi-family dwellings for people with relatively minor income is still in Poland unsatisfactory. Most of the taxpayers could not even afford spending the required sum of money that entitled to deductions on house modernisation. The second biggest deduction were expenditures on donations to socially worthy causes (in 1997 it totalled zl 837 million (which is £154 million)). However, tax authorities reported the phenomenon of the growing black market in certifications of donation to institutions, e.g. churches.

Table 5. Deductions on housing expenditures in Poland in 1993-1997.

| | Amount of deductions in mln zl | As a percentage of gross income |
|---|---|---|
| 1993 | 4,099 | 5.09 |
| 1994 | 4,932 | 4.51 |
| 1995 | 7,208 | 4.89 |
| 1996 | 11,817 | 6.42 |
| 1997 | 14,222 | 6.35 |
| Total | 42,278 | × |

*Source: Biala Ksiega Podatkow, Polish Ministry of Finance, Warsaw, 1998.*

As shown above on the example of the Polish tax system direct costs of allowable deductions and reliefs in the form of the reduction of budgetary revenues could not be underestimated. There were more direct and indirect costs than the reduced revenues to the government. These included a less efficient allocation of resources, the need for other taxes and/or rates to be higher to compensate for the foregone revenues, the increased complexity of the administration of and compliance with the tax system, the reduced perception of fairness of the tax system, and the lessened reliability of the tax system in raising revenues for supporting government programmes.

[29] *Biala Ksiega Podatkow,* Ministerstwo Finansow, op.cit.

These latter costs well exceeded the costs traditionally measured by economists.

Another two negative features of the tax system in Poland distorted its well-functioning: the instability of the tax system and its complexity. The frequent changes in the tax law in the past made the tax system unforeseeable for the future and discouraged both savings and investment. Indeed, it was calculated that until the year 1999 the tax law on personal income tax was changed 38 times.[30] The frequent changes made the tax system even more complicated as the parliament tried to tighten the loopholes in the tax law in order to provide for expected budgetary revenues. The frequent tax amendments together with the harmful system of tax relief and deductions resulted in the fact that the tax system became difficult to understand for both the average tax-payer and tax officers. The correct interpretation of the tax legislation became a problem even to tax authorities; in 1998 one quarter of all tax authorities decisions in litigious cases between the taxpayer and the tax authorities were repealed.[31] The consequences were that administrative and compliance costs increased significantly.

### Social Security Contributions

Until 1998 social security contributions in Poland were still the remains of the old communist system. The global reform of the social security system came into force from the beginning of the year 1999.

Until 1998 social security contributions in Poland were paid by the employers in form of the payroll tax with a marginal rate of 48.15 per cent, including 45 per cent as the national insurance contributions for the account of the Social Insurance Office (*Zaklad Ubezpieczen Spolecznych (ZUS)*), 3 per cent for the Labour Fund (*Fundusz Pracy*) that dealt with the unemployment benefits and 0.15 per cent for the Guaranteed Employee Services Fund (*Fundusz Gwarantowanych Swiadczen Pracowniczych*), that could be claimed in case of for

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[30] *Reforma Podatkow, op.cit.*

[31] *Ibid.*

instance a lack of liquidity or liquidation of the employer.[32] The lower rate was assigned to the agricultural sector for which the rate for national insurance contributions was equal to 38 per cent. If the employer employed more than 20 workers he returned one declaration and paid the contributions for the account of the Social Insurance Office (*Zaklad Ubezpieczen Spolecznych*) in monthly instalments. Otherwise, the employer was obliged to prepare a declaration for each of the employers by name in 10 days from the date of employment. Self-employed paid the same rate as employers on the wage bill, that is 48.15 per cent. Their contributions were related to the profits level. Until 1999 the Social Security contributions could be qualified as a kind of tax imposed on employment. The burden was immense but the revenues were often not sufficient to meet the claims. It was because the social security contributions system was the relics of the Polish economy in the communist period and was not a reservoir of accumulated contributions from which today claims will be met. Today's claimants were still dependent on what today's taxpayers paid.

Two factors contributed to the global reform of the social insurance system in Poland in 1999: high unemployment in Poland and the growing number of people reaching pensionable age, which made the reform indispensable. The Reform of the National Insurance Contribution System in Poland was assessed as successful. The social security schemes are viewed by most of the younger population as an element of savings for the future and as insurance rather than another tax. It is believed that the reform is going to have a positive impact both on labour supply (people will be willing to work more in order to be entitled to receive a higher insurance premium in the future) and on labour demand (employers will try to shift their part of contributions onto employees and they will accept wage reductions in exchange for employer contributions).

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[32] *Rozporzadzenie Rady Ministra z dnia 29 stycznia 1990 w sprawie wysokosci i podstawy wymiaru skladek na ubezpieczenia spoleczne.*

## 4. The Recent Trends in Personal Income Taxation in the UK

### Introduction

The British tax system including the personal income tax have been subject to various structural changes over the last two decades. The most visible changes in the composition of aggregate government revenue have resulted from a shift away from indirect taxes levied on specific goods towards general consumption taxes such as VAT (see Figure 7), which mirrors the trend in other developed countries. There has been a slight reduction in the revenues from personal income tax, while the percentage contribution of National Insurance remained unchanged (although the radical structural changes have been introduced). Corporation tax provides a larger share of total revenue in 2000-01 than in 1978-79, though much of this reflects the stage of the business cycle in those years.[33] Despite the large growth in VAT, the change in the balance between direct taxes and indirect taxes is little (the VAT rise is offset by the fall in excise duties and the fall in personal income tax is offset by the rise in corporation tax). The shift from direct to indirect taxes, the latter are believed to be more equitable and less distortionary, which was a part of the declared strategy of the 1979-97 Conservative government, has not been achieved.

Total government receipts are forecast to be £375.6 billion in 2000-01, or 39.6 per cent of UK GDP.[34]

The most important changes concerning the personal income tax since 1979 in the UK were: the reform of the rate structure, introduction of independent taxation, reduction of many distortionary tax relief affecting saving and capital gains tax was set at income tax rates. As far as National Insurance contributions are concerned, which are very often perceived as a tax rather than contribution, some major changes relating rates and structure have been introduced.

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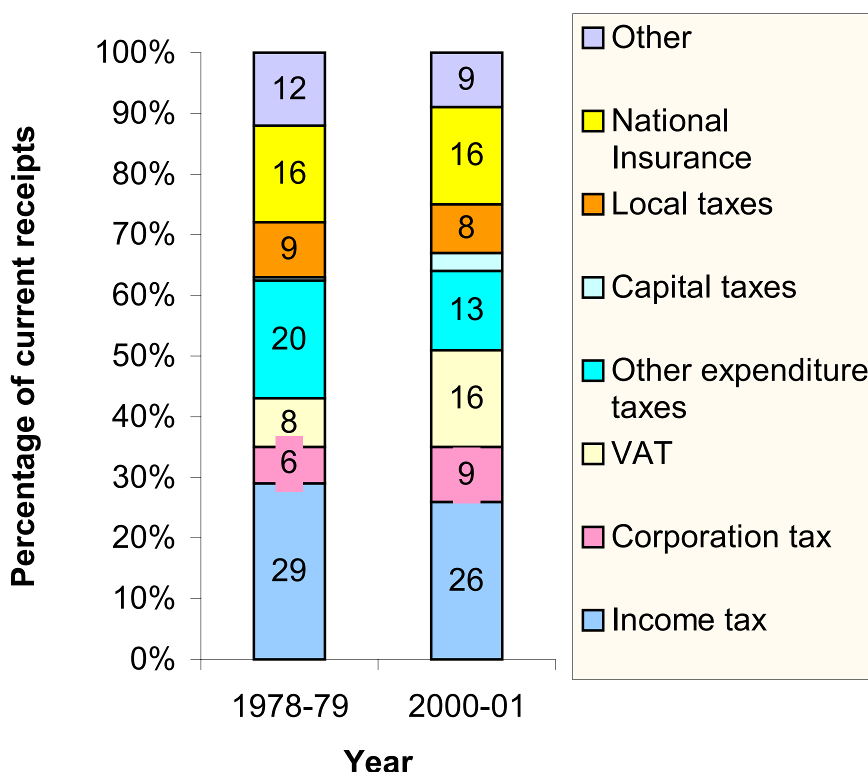
[33] Chennells, L., and Dilnot, A., and Roback, N., *A Survey of the UK Tax System,* The Institute for Fiscal Studies, Briefing Note, No.9,, p.17.
[34] *Ibid.*

Figure 7. The structure of general government receipts in the UK, 1978-79 and 2000-01 in percentage.




*Source: Chennells, L., and Dilnot, A., and Roback, N., A Survey of the UK Tax System, The Institute for Fiscal Studies, Briefing Note, No.9,, p.17.*

The most dramatic change to personal income tax has been the reform of the rate structure; the tax rates were reduced, the attempt to reduce the number of tax rates was made and the tax base was broadened.

**Tax Rates**

Whereas in 1978-79, there were three tax rates with the higher rates ranging from 40 per cent to 83 per cent, already in 1988 the top tax rate was cut to 40 per cent (see Table 6).

Table 6. Income tax rates on earned income in the UK, 1978-2002.

| *Fiscal years* | *Lower rate* | *Basic rate* | *Higher rates* |
|---|---|---|---|
| 1978-79 | 25 | 33 | 40-83 |
| 1979-80 | 25 | 30 | 40-60 |
| 1980-81 to 1985-86 | - | 30 | 40-60 |
| 1986-87 | - | 29 | 40-60 |
| 1987-88 | - | 27 | 40-60 |
| 1988-89 to 1991-92 | - | 25 | 40 |
| 1992-93 to 1995-96 | 20 | 25 | 40 |
| 1996-97 | 20 | 24 | 40 |
| 1997-98 to 1998-99 | 20 | 23 | 40 |
| 1999-00 | 10 | 23 | 40 |
| 2000-01 to 2001-02 | 10 | 22 | 40 |

*Source: Chennells, L., and Dilnot, A., and Roback, N., A Survey of the UK Tax System, The Institute for Fiscal Studies, Briefing Note, No.9,, p.18.*

In addition, until 1983-84 an investment income surcharge of 15 per cent was applied to those with very high investment income, leading to a maximum income tax rate of 98 per cent. In the tax year 1979-80, the basic rate of income tax was reduced to 30 per cent and the top rate to 60 per cent. In the next year the lower rate was abolished which resulted in the fact that over a decade there were only two tax rates and through the mid-1980s the basic tax rate was reduced to 25 per cent. In 1988, the top tax rate was cut to 40 per cent and the basic rate to 25 per cent (which covered almost 95 per cent of taxpayers). In 1992, the lower tax rate of 20 per cent was re-introduced, which was further reduced to 10 per cent in 1999 by the Labour Party in fulfilment of a pre-election promise.

The total number of income taxpayers has remained fairly constant for the last two decades, however, the number of higher-rate taxpayers has grown substantially, from less than 3 per cent of the taxpayers in 1979-80 to nearly 10 per cent in 2000-01. The reasons for this are various: in some years the tax bracket for the higher tax rate has not been raised in line with price inflation; incomes on average have grown more quickly than prices; the dispersion of incomes has grown over the period, with especially rapid increases in the incomes of high-wage earners, pushing them into higher-rate income tax liability.

The number of lower-rate taxpayers rose in the years after 1992 as the width of the lower-rate band was increased, but fell sharply in 1999-00 as the new 10 per cent rate was introduced, which covered a much narrower range of income than the 20 per cent rate before. It is interesting to notice that a large part of the total amount of income tax is paid by taxpayers facing the higher tax rate; in 1999-00 the top 10 per cent of income taxpayers paid half of all the income tax paid, which says much about a redistributive character of the income tax in the UK. These shares have risen dramatically since 1978-79, despite the reduction in the higher tax rates (see Table 7).

Table 7. Shares of total income tax liability, 1978-2002.

| *Fiscal years* | *Top 1% of income taxpayers* | *Top 10% of income taxpayers* | *Top 50% of income taxpayers* |
|---|---|---|---|
| 1978-79 | 11 | 35 | 82 |
| 1981-82 | 11 | 35 | 81 |
| 1986-87 | 14 | 39 | 84 |
| 1990-91 | 15 | 42 | 85 |
| 1993-94 | 16 | 44 | 87 |
| 1996-97 | 20 | 48 | 88 |
| 1998-99 | 20 | 48 | 88 |
| 1999-00[a] | 21 | 50 | 89 |
| 2000-01 [a] | 21 | 51 | 89 |
| 2001-02[b] | 21 | 51 | 89 |

[a]*Provisional.*
[b]*Projected, in line with the March 2001 Budget. These projections are not within the scope of National Statistics.*
*Source: Inland Revenue, at:http://www.inlandrevenue.gov.uk*

### Treatment of Marriage

Prior to 1990, married couples were treated in the UK as a single unit for income tax purposes. In the late 1970s a suggestion to introduce a new system, neutral in its treatment of men and women was raised. However, the issue whether the tax system should provide for equal treatment of married and single people was not easy to agree upon. In the late 1980s a system of transferable allowances was introduced: according to this system, unused allowances could be transferred between spouses. In 1990 independent taxation of husbands and wives was put into practice, though a married couple's allowance (MCA) was available to either husband or wife. Since 1993, the MCA was reduced in value continuously by reducing the tax rate at which it can be claimed and it was finally abolished in April 2000. Those over 65 and claiming the allowance at that date will continue to be able to do so. In addition, other similar reliefs and allowances have also been abolished. The revenue from reduction of the MCA has been channelled into increasing child benefit, and from 2001-02, to fund a new children' tax credit, which will provide support for children directly through the tax system.

It can be said that due to the changes in the last decade the British tax system has become neutral as far as the treatment of married and single people is concerned, but on the other hand, it lost its neutrality as it provides financial support to those with children and discriminates those without children.

### Taxation of Saving

Over the last two decades in the UK efforts to reduce the tax system distortions to the return on different savings vehicles were made. Confronted by the increasing mobility of capital, there have been a series of reforms that have reduced the tax advantage of previously highly tax-privileged savings, and others that have removed tax disadvantages of other forms of savings. In general it all led to a more equal tax treatment of saving.

In 1984 life assurance premium relief was abolished, which had given income tax relief on savings in the form of life assurance. The mortgage interest tax relief (MITR), which until 1974 was available on

any size of loan and later up to a certain ceiling, was abolished in April 2000.

In 1988 tax arrangements for equal treatments of individual-based pensions and employer-based occupational pensions was introduced and provided for tax relief on contributions, no tax on fund income, tax on withdrawals apart from a lump sum not exceeding 25 per cent of the accumulated fund. Another extension of relatively tax-favoured saving were the Personal Equity Plan (PEP) and the Tax-Exempt Special Savings Account (TESSA) introduced in 1987 and 1991 respectively. The PEP was a vehicle for direct holding of equities and it was reformed later to allow holdings of pooled investments such as unit trusts. The TESSA was a vehicle for holding interest-bearing savings accounts. Saving into PEP or TESSA was not given any tax relief, but there was no tax on income or gains within the fund and there was no tax on withdrawals. The PEP and TESSA have been replaced by the Individual Savings Account (ISA), which is similar in most important respects.

All these reforms led to the situation when at present for housing, equities and cash saving, saving is out of taxed income, there is no tax on returns and no tax on withdrawals, while, for pension, saving is out of untaxed income, fund income is untaxed but withdrawals are taxed. These two regimes produce the same effective tax rate of zero on the real return to saving. The one obvious exception is the existence of the tax-free lump sum in pensions, which makes the effective tax rate on the return to pensions saving negative. In addition, employers' pension contributions are particularly tax-favoured since they are not subject to either employer or employee National Insurance at the point of contribution or at the point of withdrawal.[35]

Capital gains tax (CGT) was introduced in 1965 and is levied on gains arising from the disposal of assets by individuals, personal representatives and trustees. Prior to 1982, CGT was charged at a flat rate of 30 per cent on capital gains taking no account of inflation. Indexation for inflation was introduced in 1982 and amended in 1985,

[35] Chennells, L., and Dilnot, A., and Roback, N., *A Survey of the UK Tax System, op.cit.,* p.22.

and then in 1988 the flat tax rate of 30 per cent was replaced by the individual's marginal income tax rate. Individual capital gains tax was reformed in 1998 by the introduction of a taper system and removal of the previous indexation allowance. The taper system reduces the amount of capital gains tax paid the longer an asset is held.

In general, it can be stated that the tax reforms in the UK in the last two decades provided for a more equal tax treatment of saving.

**National Insurance Contributions**

The National Insurance (NI) system has its roots in 1911, and until 1961 it continued as a weekly lump-sum payment by employers and employees to cover the cost of certain social security benefits, in particular the flat-rate pension, unemployment benefits and sickness benefits. Since 1961, it has steadily moved closer and closer to being simply another income tax. The link between amount of contributions made and benefit entitlement, which was once close, is now almost entirely gone. National Insurance contributions are perceived very often in the UK as a separate tax. Its main features are: complexity, distortional character and horizontal inequity with the income tax system. However, substantial progress has been made in integrating the tax rate structure and the tax base with those of income tax (e.g. by the extension of the NI system to cover benefits in kind). Most of this progress has come in the last 15 years. The main changes include: the increase of the employee rate from 6,5 per cent to 10 per cent, reduction of employer rate from 13,5 per cent to 12,2 per cent, abolition of the ceiling for employers (whereas there continues to be an income level beyond which no further employee contributions are due, the income level for employers was abolished in 1985), cuts for low earners (in 2000-01 for employees no NI contributions were payable on the first £76 per week (p.w.) of earnings, while for employers liability did not begin until £84 p.w. (which was equal to the income level at which income tax starts to be paid). The two rates have been equalised at £87 p.w. for employees in 2001-02.

## 5. The Comparison of the Personal Income Taxes in Poland and in the UK

### 5.1. Introduction

The purpose of the chapter is to compare different tax systems between two countries with different economic condition and background. This chapter will examine the subject in different aspects of principles of taxation (efficiency, incentives, equity and stabilisation) and it will involve an analysis and discussion of the following elements of the personal income tax: income tax liabilities, deductions and reliefs, rates of tax, National Insurance contributions and tax collection system - in terms of principles of taxation described in Chapter 1.

One of the most noticeable characteristics of the tax system is that it is subject to continual change. This paper describes the tax legal status for the year 2001 for Poland and for the year 2001-02 for the UK. The principal Act in Poland concerning income tax is Ustawa z dnia 26 lipca 1991 o podatku dochodowym od osob fizycznych with certain later amendments. The principal Act in the UK is the Income and Corporation Tax Act 1988, but certain amendments have been made in subsequent yearly Finance Acts, which are preceded by Budget statements and Finance Bills. These statutes are supplemented by case law which interprets some of the finer points.

### 5.2. Income Tax Liabilities

The definition of income can be analysed in terms of the principles described in chapter I. In particular, there are implications for both economic efficiency and equity.

Poland and the United Kingdom (UK) adopted a similar approach to defining income. The Tax Law lists a variety of types of receipts that are defined as income and are subject to tax. Any class of receipt not listed is thus legally not income and as such escapes tax.

Personal income tax in Poland covers all incomes generated by natural persons. Taxable income includes income from employment (cash and fringe benefits, remuneration and benefits in kind,

bonuses), income from old-age pensions or disability pensions, profits from a business, income from non-agricultural businesses, income from leasing and renting for purposes other than agriculture, and income from capital gains (income on sale of shares, stakes in companies, dividends, interest income) and property rights.

Specific items of income are not aggregated but are taxed separately at flat rates by a lump-sum form as follows:

- 20% on loan income, income on interest and disposal of stocks,
- 15% on dividends,
- 75% on income from non-revealed sources of income or those which are not covered by the revealed sources of income.

The main kinds of income on which tax may be payable in the UK are income from employment, profits from a business, occupational pensions, interest from building societies and banks, dividends on shares, and income from property. Tax is also payable on some social security benefits such as the state retirement pension, widow's pension, jobseeker's allowance and incapacity benefit, but not on others such as income support, or child benefit.

For tax purposes in the UK, income is classified by reference to the source from which it arises. The various sources which give rise to a charge to tax are grouped under Schedules (See Table 8). There are four extant Schedules (Schedule A, D, E and F). It is worth mentioning that the treatment of expenses under Schedule D and E for the purposes of income tax, and also National Insurance contributions (the matter of discussion in the following chapters), relatively favours Schedule D taxpayers (broadly the self-employed) as compared to Schedule E taxpayers (employees). As discussed in the chapter 1.1. economic *efficiency* suggests that it is usually inefficient for behaviour to be caused by tax consideration alone. In this case there is an artificial incentive for individuals to become self-employed even when it might be economically more efficient for them to work as employees. This disturbs economic efficiency and may lead to avoidance or even evasion.

Table 8. Classification of income for tax purposes in the UK for 2001-02.

| Schedule | Case | Description |
|---|---|---|
| Schedule A | Rent and other receipts from land and buildings | |
| Schedule D | Case I | Profits of trade |
| | Case II | Profits of profession or vocation not dealt with under any other schedule |
| | Case III | Interests and annual payments |
| | Case IV | Income from overseas securities |
| | Case V | Other income, other than employment income, arising abroad |
| | Case VI | Any other income, in particular occasional profits not chargeable under Case I and II |
| Schedule E | Income from offices, employments and pensions | |
| Schedule F | Dividends and other company distributions | |

*Source: Inland Revenue, at: http://www.inlandrevenue.gov.uk*

In terms of *equity*, in so far as employees see the differential treatment as unfair, it may lead to a loss of 'tax-morale' and a reduction in the willingness of taxpayers to comply with the requirements of the tax system. This in turn could have implication on the fact that more money should be spent by Inland Revenue on prevention.

In the British tax system dividends and majority of savings income are taxed separately. The rates of tax for dividends are 10 per cent for income up to the basic rate limit (£29,400 in 2001-02) and 32.5 per cent for income above the basic rate limit. When an individual has savings income in excess of the starting rate limit (£1,880 in 2001-02) he/she will be taxed at the lower rate of 20 per cent up to the basic rate limit (£29,400) and at the higher rate of 40 per cent for income above the basic rate limit. The 10 per cent starting rate of income tax includes savings income.

As shown above, Poland and the UK adopted a schedular tax system where different tax rates apply to different income sources (earned income and capital income is taxed at different tax rates). In times of international mobility of both fixed investment and financial investment there is a growing tax competition among countries as far as capital income is concerned. Responding to capital-market integration and taking into consideration different tax elasticities of different income sources many countries apply a lower tax rate on capital income than on other income in order to attract capital and thus move away from the concept of 'global income' where all sources are taxed with a unified tax rate. The concept of 'global income' in contradiction to the schedular system makes no distinction among income components, and hence provides for equity and efficiency in the tax system.

### 5.3. Deductions and Reliefs for Income Tax

There are various deductions and reliefs to which an individual is entitled or which are available for the purposes of income tax generally both in Poland and in the UK. These can be categorised as: tax exemptions, deductions and personal reliefs.

### Tax Exemptions

In Poland in 2001 several income sources (105 items) are exempt from personal taxes and those include: veteran pensions, social benefits, compensation payments, income on interest and discount of government securities and of local government bonds and of bank deposits (except from those linked to performed economic activity), income from national games of chance and lottery winnings. From the year 2002 on, the income on interest and discount of government securities and of local government bonds and of bank deposits are going to be taxed at the rate of 20 per cent.

The following tax exemptions are provided in the UK for 2001-02: some forms of social security benefits such as income support, or child benefit, interests received from certain National Savings products such as National Savings certificates, income of charities, or first £ 30,000 of payments on termination of employment.

Both in Poland and in the UK some of the social benefits are exempted from tax for either reasons of justice or for social reasons. These types of government expenditures are designed to be some form of redistribution of income towards those in need and therefore it would be unfair to call for the tax contribution.

The categories of income that are exempted from tax such as government securities and local government bonds in Poland and National Savings certificates in the UK are of stimulating character and are directly related to the governmental economic and social policy and work as a kind of *incentive*, e.g. increase savings.

The category of incomes from the national games of chance and lottery winnings in Poland may sound controversial but the taxation of such incomes would reduce the interest in participation in these games and that would result in lower revenues for the budget.

**Deductions and Reliefs**

Both Poland and the UK have shortened the list of allowable reliefs and deductions in the last few years.

The Polish Tax Law for the year 2001 provides for:

1. *income tax deductions* that are deductible in computing the taxable income, and
2. *income tax reliefs* that are deductible from the calculated amount of tax.

1. The taxable income is calculated after deducting the following expenditures (*income tax deductions*):

- contributions to old-age pension fund, disability pension fund, sickness insurance fund and work injury insurance fund,
- expenditures on donations, but only for the benefit of corporate bodies, to socially worthy causes, e.g. in support of science, education or culture,
- expenditures on rehabilitation .

2. In 2001 *income tax reliefs* provide for deduction a set percent of the expenses from the calculated amount of tax. The following income tax reliefs are allowed, e.g.: compulsory health insurance

premium (7.5 per cent of taxable income), expenditures on supplementing the taxpayer's education, expenditures on educational equipment, expenditures to purchase a building ground, expenditures on housing (the time limit for the deduction of the last two expenditures has been limited to 4 years and the tax relief for expenditures on housing will be abolished in 2002).

The following items are deductible in computing income in the UK in 2001-02: approved occupational or personal pension schemes, approved profit sharing schemes, Individual Savings Accounts, etc. The new individual savings account (ISA) started on 6 April 1999. This provides a tax favoured environment for savings, building upon the experience of TESSAs and PEPs.

No new TESSAs could be taken out after 5 April 1999, but TESSAs taken out by 5 April 1999 are able to run their full five year course under the current rules (interest and bonuses earned are tax free, provided the savings are left in the account for 5 years, no capital my be withdrawn during 5 years without losing tax exemption but interest may be withdrawn at any time less the equivalent of basic rate on savings income, at the end of 5 years, the account will automatically cease to be exempt from tax and any further interest will be taxable in the ordinary way). In addition no subscriptions to PEPs may be made after 5 April 1999, but savers holding PEPs will be able to continue holding them under the current rules (i.e. for the new individual savings account, a 10 per cent tax credit will be paid on dividends from UK equities until 5 April 2004).

The ISA can include three components: cash, stocks and shares and life insurance. The main features are: annual subscription limit is £7,000, of which no more than £3,000 can go into cash and £1,000 into life insurance, the account is completely free of income and capital gains tax, there is no statutory lock-in or minimum subscription, and the account is guaranteed to run tax free for at least ten years.

As shown on the example of the Polish tax system (see Chapter 3) direct costs of allowable deductions and reliefs (the reduction of budgetary revenues) cannot be underestimated. However, there are more direct and indirect costs than the reduced revenues to the

government. These include a less efficient allocation of resources, the need for other taxes and/or rates to be higher to compensate for the foregone revenues, the increased complexity of the administration of and compliance with the tax system, the reduced perception of fairness of the tax system, and the lessened reliability of the tax system in raising revenues for supporting government programmes. Therefore, the tendency to limit the system of deductions and reliefs in both countries is the right step in the direction of the *efficient* and *equal* tax system.

### Personal Allowances

The structure of income tax in the UK operates via a system of allowances and bands. All individuals have a personal allowance which is deducted from total pre-tax income in order to derive taxable income. Allowances refer to income that is tax-free regardless of the individual's pattern of expenditure or the source of his income. They therefore include the personal allowances shown in Table 9. The allowances act as a zero-rate band of income which takes large numbers of potential taxpayers out of the 'tax net' as well as contributing to the progressivity of the tax.[36] Personal allowances in the UK are mainly introduced for *efficiency* reasons and social reasons as the use of them generally facilitates the tax collection in the way that it does not involve tax authorities in situations when tax revenues are relatively law compared to the costs of tax assessment and collection.

The personal allowance of £4,535 for 2001-02 is available to each taxpayer resident in the UK. The individual may deduct this amount from his total income, along with any other deductions to which he may be entitled, and will then be taxed on the remainder. If the individual earns less than the personal allowance to which he is entitled for that year, he will not be liable to income tax.[37] Other allowances are available to blind people and elderly people. The age allowance is granted instead of the ordinary personal to single people aged 65-74 years (£5,990) and to married couples if either partner is

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[36] S. James and C. Nobes, *The Economics of Taxation*, *op.cit*., p.129.
[37] Inland Revenue, at: *http://www.inlandrevenue.gov.uk*

born before 6 April 1935 (£5,365). A higher age allowance is granted to single people aged 75 and over (£6,260) or where at least one of the spouses has attained that age (£5,435). However, age allowance was intended to benefit only those on modest incomes and is restricted if income exceeds a certain amount (£17,600 for 2001-02). Then the allowance becomes subject to a taper of 50 per cent which gradually reduces it to a minimum level equal to the personal allowance for those under 65. The rate of relief for the continuing married couple's allowance and maintenance relief for people born before 6 April 1935 is 10 per cent and the minimum amount of married couple's allowance is £2,070. The main personal allowances are required to be increased annually in line with the increase in the retail prices index for the previous calendar year. Changes in allowances have to be rounded up to the nearest multiple of £10. Despite these provisions for indexation, lower increases can be made, provided approval is made by the Parliament.

Table 9. Income tax allowances in the UK for 2001-02.

| ***Income tax allowances*** | ***2001-02*** **(£)** |
|---|---|
| Personal Allowance | 4,535 |
| Personal allowance for people aged 65-74 | 5,990 |
| Personal allowance for people aged 75 and over | 6,260 |
| Income limit for age-related allowances | 17,600 |
| Married couple's allowance for people born before 6 April 1935 | 5,365 |
| Married couple's allowance-aged 75 or more | 5,435 |
| Minimum amount of married couple's allowance | 2,070 |
| Children's tax credit | 5,200 |
| Blind person's allowance | 1,450 |

*Source: Inland Revenue at: http://www.inlandrevenue.gov.uk*

In addition to the tax allowances there are some tax credits, such as Children's Tax Credit (CTC), Working Families' Tax Credit (WFTC) and Disabled Person's Tax Credit (DPTC). The Children's Tax Credit is payable to all families with one or more children aged under 16 living with them. It takes the form of an allowance (£5,200 in 2001-02) for which relief is given at 10 per cent against income tax owed. The credit is gradually withdrawn if the taxpayer's income exceeds the basic rate limit.

Another major reform to the allowance system is the introduction of the new Working Families' Tax Credit, which replaced family credit from October 1999. It is available to working families with children (under 16 or under 19 if in full-time education up to A-level or equivalent standard) on low or middle incomes where one adult work at least 16 hours per week and have savings of £8,000 or less (see Table 10).

The WFTC is made up of several elements. There is a basic tax credit (one per family) of £59.00 p.w. (from 4 June 2001), various tax credits for each child depending on the age of each child (£26.00 p.w. for a child under 16 and £26.75 for a child aged 16-18) and an extra tax credit of £11.45 p.w. for working 30 hours or more per week. In addition there is a childcare tax credit, worth 70 per cent of actual childcare costs up to £200 p.w. (£135 p.w. for families with only one child). If a family's net income (after tax and National Insurance contributions have been taken off) exceeds a weekly threshold (£92.90), then WFTC is subject to a taper of 55 per cent on net income (i.e. the amount payable is reduced by 55 pence p.w. for each £1 of net weekly income above the income threshold.)

The Disabled Person's Tax Credit is a tax credit available to people in work with an illness or disability which puts them at a disadvantage in getting a job, and who work at least 16 hours per week, have one number of qualifying benefits for disability or were receiving one of them up to 182 days prior to the date of application and have savings of £16,000 or less.

Table 10. Tax credits in the UK for 2001-02.

| **Tax Credits** | **£ p.w. from 4 June 2001** |
|---|---|
| Working Families' Tax Credit (WFTC) | |
| Basic tax credit | 59.00 |
| 30-hour tax credit | 11.45 |
| Child tax credits under 16 | 26.00 |
| 16-18 | 26.75 |
| Disabled child tax credit | 30.00 |
| Enhanced Disability Tax Credit (lone parent/couple) | 16.00 |
| Enhanced Disability Tax Credit (child) | 41.05 |
| Maximum eligible childcare costs allowed – 1 child[1] | 135.00 |
| Maximum eligible childcare costs allowed – 2 or more children[1] | 200.00 |
| Income threshold | 92.90 |
| Disabled Person's Tax Credit (DPTC) | |
| Single person basic tax credit | 61.05 |
| Lone parent/couple basic tax credit | 91.25 |
| 30-hour tax credit | 11.45 |
| Child tax credits under 16 | 26.00 |
| 16-18 | 26.75 |
| Disabled child tax credit | 30.00 |
| Enhanced Disability Tax Credit (lone parent/couple) | 16.00 |
| Enhanced Disability Tax Credit (single person) | 11.05 |
| Enhanced Disability Tax Credit (child) | 41.05 |
| Maximum eligible childcare costs allowed-1 child[1] | 135.00 |
| Maximum eligible childcare costs allowed-2 or more children | 200.00 |
| Income threshold-single person | 72.25 |
| Income threshold-lone parent/couple | 92.90 |
| Children's Tax Credit (CTC) | 5,200 |

*[1]Childcare tax credit is 70% of eligible childcare costs allowed.*

*Source: Inland Revenue at: http://www.inlandrevenue.gov.uk*

As described above, the British system of allowances and tax credits was constructed in such a way that for social reasons it supports those in need and takes form of an *active policy stimulation* via so called in-work benefits in order to get low skilled workers into work. In-work benefits in form of tax credits are designed to counter the low wages and high implicit tax rates faced by those individuals on welfare. These in-work benefits are designed to stimulate work and remove individuals and families from the poverty trap (the poverty trap occurs when traditional systems of low income support, which are designed to relieve poverty, make it difficult for individuals to take work because there is no return and there could be losses of in-kind benefits from taking employment). When individuals start to earn, the withdrawal of benefit income creates an implicit tax rate of close to 100 per cent. In addition, in-kind transfers like free medical services, free dental care, free medical prescriptions, and subsidized housing are often lost with a move into employment. Thus, some instruments of the welfare system, although support individuals on low incomes, they reduce the economic incentives for workers to seek work. Therefore, in-work benefits are interesting solutions to *induce* a reasonably large and *positive increase in labour market participation* of low skilled workers in a way that in-work benefits encourage the welfare recipients to take jobs and leave welfare.

Blundell *et al.* seek to estimate *incentive* effects of the introduction of the WFTC in the UK and use the discrete choice structural labour supply model. [38] They consider two target groups: single parents and married couples with children. They come to conclusions that the WFTC reform influences in a positive way the work incentives of those with low potential returns in the labour market, however it affects those two target groups in a different way. As far as single parents are concerned, the WFTC does increase the incentive to work; there is a strong incentive to move into work for a non-participant. However, there is also an incentive to reduce hours of work among those single parents working full time. The balance between these two effects is purely an empirical matter although it is suggested that the positive participation effect will dominate. For

[38] R. Blundell, A. Duncan, J.Mc Crae and C. Meghir, The Labour Market Impact of the Working Families Tax Credit in: *Fiscal Studies*, 21 (1), 2000, pp.75-104.

couples, however, the incentives created by the WFTC lead to lower participation in the labour market as the WFTC is based on family income. There is an increase in the effective marginal tax rate for those who become eligible for WFTC and this group face an increase in their marginal tax rates from 33 per cent (produced by income tax and National Insurance) to just under 70 per cent (produced by the interaction of the 55 per cent WFTC taper on post tax income). A proportion of women whose low earning partners are eligible for the WFTC have no incentive to work. The generosity of the tax credit relative to the previous system of Family Credit has increased household income. This increase in income is lost if the woman in the household worked. And for those women currently in the labour market, the WFTC increases the income available to the household if she were to stop working. The effects for men and women with non-working partners imply an increase in overall participation.

In order to evaluate *efficiency* of the in-work benefits via tax credits the issue of the longer-run payoff to labour market attachment for low skilled workers must be considered. The in-work benefits will have positive effects on increase in labour supply when through tax credits and the progression of wages, workers become more attached to the labour market and get themselves out of a low income group. This will mean that they will not receive any income assistance or any form of tax credits any more. On the other hand, if the payoff is relatively low, then these individuals are likely to remain the tax credits recipients and my be stuck continuously in this part of the welfare system. Blundell states, though, that this dynamic payoff for low skilled workers remains an open question.[39]

In terms of *equity*, the WFTC creates inequity in a way that it discriminates those in need without children against those with children who are entitled to the tax credit.

As far as the personal allowance in Poland is concerned there is one general personal allowance provided, though the allowance is not literally granted by the Tax Act. Instead a set amount is deducted from the tax calculated on taxable income, which does not contribute

[39] *Taxation, Welfare and the Crisis of Unemployment in Europe*, edited by Marco Buti, Paolo Sestito, Hans Wijkander, Edward Elgar Publishing Limited, Cheltenham, 2001.

to the transparency of the tax system. The personal allowance can be calculated using the following formula:

$$a = \frac{d \times 100\%}{r}$$

a - allowance
d - deduction in the first tax band set by the Tax Law
r - tax rate

In 2001 the personal allowance totals zl 2,596.42 (which is £479.04 according to the exchange rate on the 9 June 2001)[40].

$$2{,}596.42 = \frac{493.32 \times 100\%}{19\%}$$

In other words, the calculated amount is a tax-free level of income. If the individual earns less than the personal allowance to which he/she is entitled for the current year, he/she will not pay the income tax. However, as the withholding of tax from wages and salaries is undertaken by employers on a non-cumulative basis in monthly instalments starting from the moment when the income arises, it means that the tax collection involves tax authorities also in the situations when no tax is due. This produces *inefficiency* as far as tax costs of tax assessment and collection are concerned. Therefore, it is suggested that the personal allowance should be set directly by the Polish Tax Law and tax should be withheld only when income exceeds the amount of the personal allowance in order to make the taxation system clear, simple and cost effective.

Although for the first zl 2, 596.42 no tax is due, the marginal effective tax rate net of cash transfers can be as high as 120 per cent of income for individuals moving from unemployment to a job paid at the minimum wage. An individual who accepts a job at the minimum wage will immediately lose all social benefits and start paying social

[40] Exchange rates *at: http://www.gazeta.pl*

security contributions and taxes. This may help to understand why almost 1 million people have fallen into the 'unemployment trap' and were considered as 'hidden unemployed' in 1996.[41] The size of the 'unofficial economy' is estimated to be 15-20 per cent of GDP and it may be a close substitution to the official economy for the discouraged workers who left the labour market.

In order to encourage workers who are active in the grey economy to surface in the official economy as well as to combat the high unemployment (the unemployment rate is expected to grow untill 19,3 per cent until 2003 according to the European Commission) Poland should follow the British example and introduce some form of the employment-conditional tax credits.

A number of empirical studies suggest that tax credits increase the labour supply, but only in terms of the number of people working, with overall hours worked remaining broadly unchanged.[42] However, even if the number of hours worked increases slightly due to offseting effects, the positive externalities resulting in the reduction of the hidden unemployment in Poland and bringing more and more individuals into the official labour market cannot be underestimated. The employment-conditional tax breaks could be revenue-neutral in Poland as the pre-tax income distribution is wide (there are sufficient low-paid jobs available) and there is a binding minimum wage which ensures that take-home pay would increase.

### 5.4. The Rates of Tax

The rates of income tax and the bands of income in Poland are set by the Minister of Finance (Chancellor of the Exchequer) while in the UK they are fixed each year by Parliament and announced at the time of the annual Budget. In both of the countries, in Poland and in the UK there are some anti-inflationary provisions made. In Poland the income amounts falling under the various brackets are readjusted yearly, in parallel with rising average wage levels in the period of

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[41] P.Lenain, L.Bartoszuk, *The Polish Tax Reform*, OECD, March 2000, Economics Department Working Papers, No.234, p.10.

[42] P.van den Noord, C.Heady, *Surveillance of Tax Policies: A Synthesis of Findings in Economic Surveys*, OECD, Economics Department Working Papers, No.303, 2001, p.68.

three terms in the year preceding the tax year. In the UK the tax rate bands are subject to statutory indexation and are linked to the retail prices index unless Parliament determines otherwise.

In Poland the basic rate which is set at 19 per cent for 2001 is the appropriate rate for the vast majority of taxpayers as the basic rate limit which is set at zl 37,024 (which is £6,831) (See Table 11). For 2001 the higher rate is 30 per cent and the limit is zl 74,048 (which is £13,662). Income above that limit is charged at the highest rate 40 per cent.

Table 11. The Rates of the Personal Income Tax in Poland in 2001.

| Tax Yield (zl) | | Tax |
|---|---|---|
| **over** | **to** | **Amount** |
| | 37,024 | 19% of tax yield minus zl 493.32 |
| 37,024 | 74,048 | zl 6,541.24 + 30% of surplus above zl 37,024 |
| 74,048 | | zl 17,684.44 + 40% of surplus above zl 74,048 |

*Source: Rozporzadzenie Ministra Finansow z dnia 21 listopada 2000 roku w sprawie skali podatku dochodowego oraz wysokosci kwoty przychodu podlegajacego opodatkowaniu zryczaltowanemu (Dz.U.Nr 101, poz.1090).*

An individual in the British tax system has a tax-free level of income provided through the personal allowance system. A starting rate applies to the first slice of an individual's total income (income above any personal allowances), i.e. up to the 'starting rate limit', which is set at £1,880 for 2001-02 (See Table 12). The starting rate for 2001-02 is 10 per cent. For 2001-02 the basic rate is 22 per cent and the basic rate limit is £29,400. Income above the basic rate limit is charged at the higher rate which is 40 per cent.

The 10 per cent starting rate of Income Tax includes also savings income. Where an individual has savings income in excess of the starting rate limit they will be taxed at the lower rate of 20 per cent up

to the basic rate limit (£29,400) and at the higher rate of 40 per cent for income above the basic rate limit.

The rates of tax for dividends are 10 per cent for income up to the basic rate limit and 32.5 per cent for income above the basic rate limit.

Table 12. The Rates of the Personal Income Tax in the UK for 2001-02.

| **Band of Taxable Income (£)** | **Tax Rate** |
|---|---|
| 0 – 1,880 | Starting rate 10% |
| 1,881 – 29,400 | Basic rate 22% |
| Over 29,400 | Higher rate 40% |

*Source: Inland Revenue at: http://www.inlandrevenue.gov.uk*

The common thing for the British and Polish personal income tax is the very long basic rate which provides for *simplicity*. It is the appropriate rate for the vast majority of taxpayers in the UK as well as in Poland. For instance, it is estimated that for 2001-02 that in the UK there will be 27,600 thousands individual income taxpayers of whom 2,930 thousands will pay the starting rate (10 per cent), 21,000 thousands will pay the basic rate (22 per cent) and 2,840 thousands will pay tax at a higher rate (40 per cent). In other words, over 76.09 per cent of taxpayers paid tax at the basic rate (Table 13). The main reason for the long band in the UK has been that it allows tax to be deducted at source very accurately from the investment income and from any second and subsequent employment of most taxpayers. All that has to be done is to set the rate at which tax is deducted from these sources of income to that appropriate to basic rate taxpayers. The only adjustment then required after the end of the tax year are those for the relatively small proportion of individuals who do not pay tax at the basic rate. There is also an advantage in having the long basic rate band and just one higher rate because almost all taxpayers are aware of the marginal rate of tax they pay. This would, of course, be much harder to establish if there were a more graduated rate scale.

Table 13. Number of income taxpayers in the UK, 2001-02.[1]

| Number of income taxpayers, 2001-02 | Numbers (thousands) | Percentages |
|---|---|---|
| All taxpayers | 27,600 | 100.00 |
| Starting rate taxpayers | 2,930 | 10.62 |
| 'Savers' rate[2] | 810 | 2.93 |
| Basic rate taxpayers | 21,000 | 76.09 |
| Higher rate taxpayers | 2,840 | 10.29 |
| Single people | 11,610 | 42.07 |
| Married men | 9,280 | 33.62 |
| Married women | 6,690 | 24.24 |
| Taxpayers aged under 65 | 24,070 | 87.21 |
| Taxpayers aged 65 and over | 3,510 | 12.72 |

*[1]Projected, in line with the March 2001 Budget. These projections are not within the scope of National Statistics.*
*[2]Taxpayers with a marginal rate at the 20% lower rate for savings income or the 10% ordinary dividend rate from an extra £1 of earnings.*

*Source: Inland Revenue at: http://www.inlandrevenue.gov.uk*

Also in Poland the basic rate encompasses the vast majority of the taxpayers; in 1997 there were 94.57 per cent basic rate taxpayers (see Chapter 3 and Table 2).

However, the long basic rate band has some negative implications for equity between taxpayers. It means that individuals on very low incomes pay tax at a high marginal rate (22 per cent in 2001-02 in the UK and 19 per cent in 2001 in Poland). It also means the same marginal rate of tax whether he or she earns in the UK as £6,416 or as much as £33,935 (taxable income plus personal allowance) or in Poland zl 2,596.42 (which is £479) (taxable income) or zl 34,427.58 (which is £6,351) (the basic rate limit minus personal allowance).

The long basic rate band results in the UK in the fact that although only 10.28 per cent of income taxpayers face the higher rate they pay more than a half of the total amount of income tax paid. Also in Poland 33 per cent of all taxes in Poland were paid in 1997 by merely 5,43 per cent of taxpayers (those paying high or the highest tax rate).

Such a high progression of the British and Polish tax system may often be perceived by well-off taxpayers as *inequitable* and thus in case of Poland lead to tax avoidance or even evasion.

As far as the issue of *efficiency* is concerned, the long basic rate band affects also work incentives. The final effect, however, depends on the reactions of taxpayers to the marginal and average rates of tax. It seems that individuals in Poland and in the UK who are just over the threshold are subject to considerable disincentives. In Poland the high marginal income tax rate together with high social security contributions result in the fact that the marginal tax rate at the level of the minimum salary amounted in 1999 for 44,1 per cent, at the level of the average salary: 44,7 per cent and at the level of 2 x the average salary: 51,7 per cent.[43] The high tax wedge discourages employment and reduces both labour demand and labour supply and at the same time encourages creation and growth of the underground economy.

In contrast to the British tax system the Polish basic tax rate (19 per cent) is at the same time the starting tax rate, which means that individuals on low incomes are faced with exceptionally high marginal effective tax rate. Calculation of marginal effective tax rates net of cash transfers suggest that the increase in net taxes can be as high as 120 per cent of income for individuals moving from unemployment to a job paid at the minimum wage.[44] It has *negative efficiency implications*; it damages considerably the work incentives and results in the fact that many people have fallen in the 'unemployment trap' when the costs of leaving unemployment exceeds the benefits of taking up a new job.

Therefore, it would be reasonable that Poland follows the British example and either the starting rate should be introduced or the basic tax rate should be reduced in such a way that the effective marginal tax rate will be reduced, in particular for those taking up a job for a minimum salary. It would increase labour supply of lower-income workers and encourage them to leave the unemployment trap.

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[43] *The Polish Tax Reform*, OECD, p.25, *op.cit.*,

[44] *Ibid.*

### 5.5. Taxation and Marriage

In Poland, spouses are taxed separately unless they apply for joint taxation, in the latter case the tax would be assessed at twice the amount of tax which falls due on half of their joint income. In 2001 joint taxation is not any more available for the couples where one of the married couple pays tax in a lump-sum form.

Since 6 April 1990 in the UK both husband and wife have been taxed independently on all their income (and capital gains) and the married man is no longer responsible for his wife's tax affairs. There is a personal allowance available to anyone, male or female, married or single, which can be set against all forms of income. However, the tax system does not provide complete independence since there is also the married couple's allowance for elder people and married women reduced rate of the Class 1 national insurance contribution.

The tax treatment of married couples, as opposed to single people and those cohabiting, can be analysed in terms of principles: equity and efficiency.

The *equity* issues involve horizontal equity between different family types and vertical equity. As horizontal equity is concerned, some people say that two single people, each working and each with their own tax allowance when they marry each other they should pay more tax because their cost of living will have been reduced. Others argue that the government should encourage marriage and reduce their tax burden. However, there is a large body of opinion that says that the tax system should be neutral to marriage. It implies that the spouses should be taxed separately, just as if they were not married. Such an approach often has the additional advantage of eliminating patriarchal aspects of the tax system. However, it should be noted that separate taxation can allow the tax system to favour marriage if the individual allowances are larger for people who are married.

Turning to vertical equity, there are objections to separate taxation on grounds that it benefits richer couples. This is particularly true in tax systems where the tax rates increase strongly with income, because then the separation of the two incomes moves the couple onto lower tax rates. This often seems particularly indefensible in the case on non-labour income, where the allocation of income between spouses

is often arbitrary and can be manipulated by the rich to minimise their tax burdens. On the other hand, joint taxation may produce the same result in case of the progressive tax system and when one of the married couple receives no income or his/her income is significantly lower than the partner's income and taxed with the lower tax rate. Thus, the joint taxation, reduces the tax liability of the couple.

The *efficiency* impact of taxation is relatively minor. As mentioned above, separate taxation can lead to reduced tax payments and reductions in the tax on additional incomes. On the other hand, joint taxation may reduce married women's labour supply.

As shown above, the treatment of marriage in a tax structure is a case of conflict between vertical and horizontal equity.

### 5.6. National Insurance Contributions

The National Insurance scheme is a system for protecting members of the population of the nation who fall upon hard times. It is appropriate to treat National Insurance contributions under the general heading of taxation because most types are compulsory and are not always related to entitlement to National Insurance benefits.[45]

In Poland the global reform of the social security system came into force from the beginning of the year 1999. The new social insurance system has been divided into three pillars and national insurance contributions are earmarked for large extra-budgetary social security funds.

*First pillar*

The old national insurance contribution of 45 per cent of the payroll tax paid by the employer was divided into two parts: one that is equal to 22 per cent paid by the employer, the other of 23 per cent paid by the employees themselves. In order to let the employee pay the contribution his/her income before tax is grossed and thus is increased by 23 per cent. The employee's contribution goes to three new different funds: old-age pension fund (12 per cent), disability fund (8 per cent) and sickness insurance fund (3 per cent). The employee

[45] S. James and C. Nobes, *The Economics of Taxation*, *op.cit*., p. 135.

pays the contributions through the offices of the employer. Additionally, the employer pays the rest of the contribution (22 per cent), which are treated as labour costs and are offset against profit. The employer's contribution includes contribution to old-age pension fund (12 per cent), disability fund (8 per cent) and work injury insurance fund (the amount of which is differentiated but at average equals to 2 per cent).

All the contributions are withheld out of the wages or salaries before tax. The employee's income after deduction of all contributions is taxed.

An employee and employer pay contributions on their monthly earnings if the employee's earnings fall between the 'lower earnings limit' and the 'upper earning limit' which is set at the level of the amount of thirty times the monthly average salary. Once the ceiling is reached for a given year, contributions for the old-age pension and disability funds are no longer due. However, the employee will still keep on paying for sickness insurance fund (3 per cent) and the employer for work injury insurance fund. In this case the employee's income will increase by additional 20 per cent of his/her earnings. This will be liable to income tax. Also the employer will keep the contribution of 20 per cent, which he/she can use at his/her discretion.

*Second pillar*

A part of the contribution paid by the employee in the first pillar goes to the second pillar, i.e. to one of the open old-age pension fund chosen by the employee himself/herself. That part totals 9 per cent of the earnings before grossing and 7,3 per cent of the gross income. However, this is an obligatory pattern only for young people at the age of up to 30. Individuals aged 50 or more follow the old rules and that means that all of the employee's contribution of 23 per cent is paid for the account of Social Insurance Office. Individuals between 30 and 50 need to use his/her own choice which pattern they wish to follow.[46]

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[46] A. Fandrejewska, Z metryka w ubezpieczenia in *Rzeczpospolita,* 22 June 1998, 144 (5004).

The contributions for the first and second pillar are withheld out of the income before tax. They are not taxed. However, all the benefits paid out of the fund to the employee are liable to tax.

Future pensions rights are linked to the salaries or wages previously earned (and this means the benefits depend on the period for how long the employee paid his/her contribution and its monthly amount) as well as to the life expectancy at the retirement age. As a result, the new system creates stronger incentives to continue work after the minimum retirement age than the old system, as the accumulated capital increases and life expectancy decreases.

In the new system, the old-age pension is calculated according to the following formula[47]:

$$P_n = \frac{\sum_{i=k}^{n} \{ c_i \prod_{j=i}^{n} (1 + r_j) \}}{G_n}$$

$P_n$ – old-age pension at age *n*

$c_i$ – contribution in year *i*

$r_J$ – rate of return in year *j*

k – age of entering to social security

$G_n$ – average life expectancy at retirement age in the calendar year of retirement

*Third pillar*

Third pillar consists of the employee's old-age pension schemes, premium funds, etc. Third pillar contributions are voluntary and derive from the income after tax. The future benefits will not be liable to tax.

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[47] *OECD Economic Surveys Poland 1999/2000: 2000 Edition*, Paris, January 2000, p.82.

The National Insurance scheme in the UK resembles commercially based insurance in only limited respects, in practice, payments from and receipts into the fund bear little relation to each other for any individual contributor. In the National Insurance system, current contributions finance current benefits, with the fund merely being a device to prevent cash-flow problems.[48] Although called insurance in the UK is not funded on a true insurance basis in many ways it is like income tax. There is a National Insurance Fund as a separate entity within the government accounts, but it only ever contains enough money at any point to pay out benefits derived from it for between two and four months. Generally, it is a system of a cross- generational transfer, in that contributions of the current working population are used mainly to pay current State pensions, the balance being used to fund other current benefits. The term contribution is, in effect, a substitution for tax. The main differences are that it is paid on earned but not on unearned income; in case of employees it is not paid on income above the upper earnings limit (UEL); and is levied on weekly and not annual income, which affects the liability of people with fluctuating incomes.

There are four classes of contribution: Class 1 contributions are levied in respect of employees, Class 2 and Class 4 contributions are levied on the self- employed and Class 3 contributions are voluntary (Table 14). Class 1 relates to employees and is paid by both the employees and their employers. It is withheld at source from salaries and wages and the Inland Revenue is responsible for collecting it as well as income tax.

Employees pay contributions on their weekly earnings (or monthly or yearly equivalents) if their earnings fall between the lower earnings limit (LEL) and the upper earnings limit (UEL) which are £72 and £575 respectively in 2001-02. Employees only pay National Insurance contributions if their weekly earnings exceed the primary threshold (PT), which in 2001-02 is £87. Those earning above the PT pay a rate of 10 per cent on earnings between the PT and the upper earnings limit (UEL), of £575. For income above the UEL, no employee

[48] Chennells, L., and Dilnot, A., and Roback, N., *A Survey of the UK Tax System, op.cit.,* p.6.

contributions are paid. Employers also pay National Insurance contributions for each employee who earns over £87 per week (equal to the income level at which income tax starts to be paid, which is known as the secondary threshold (ST)). Above the level, they pay National Insurance at a rate of 11.9 per cent on the difference between earnings and the ST (see Table 14).

When employees are contracted out of the state earnings related pension scheme both employees and employers pay a lower rate of contribution on earnings between the lower and upper earnings limits. National Insurance contributions are lower for those who have contracted out of the State Earnings-Related Pension Scheme (SERPS) and instead belong to a recognised pension scheme. The reduction depends on the type of pension scheme that an individual has joined. For defined benefit pensions, the percentage levied on earnings between the LEL and UEL is for the year 2001-02 reduced by 1.6 percentage points for employee contributions and by 3 percentage points for employer contributions.

Class 2 contributions are payable by the self-employed and are levied at a flat rate which, in 2001-02 was a £2.00 per week. This contribution is payable if income from self-employment exceeds a small earnings exception, currently £3,955 per year. In case when profits of a self-employed individual exceed the lower profits limit, which for 2001-02 is £4,535 the self-employed is liable to Class 4 contributions which are related to their level of profits. For the year 2001-02 the rate was 7.0 per cent on profits between £4,535 and £29,900 per year.

Class 3 contributions are voluntary, and payable either by the non-employed, who wish to preserve their entitlement to benefit; or by the employed of self-employed who wish to increase their entitlement to benefit or by UK citizens living abroad in order to maintain their entitlement to benefits when they return. Class 3 contributions are payable at a flat rate (£6.75 per week in 2001-02).

Table 14. Classes of contribution in the National Insurance scheme in the UK for 2001-02.

| **Class 1** | |
|---|---|
| Lower Earnings Limit | £72 |
| Upper Earnings Limit | £575 |
| Primary Threshold | £87 |
| Secondary Threshold | £87 |
| Employee's contributions | 10% of £87.01 to £575 |
| Employee's Contracted-out Rebate | 1.6% |
| Married Women Reduced Rate | 3.85% |
| Employer's Contribution Rates | 11.9% on earnings above £87 |
| Employers' contracted-out rebate, salary-related schemes | 3% |
| Employers' contracted-out rebate, money-purchase schemes | 0.6% |
| **Class 2** | |
| Self employed Contribution | £2.00 |
| Small Earnings Exception | £3,955 per year |
| Special rate for share fishermen | £2.65 |
| Special rate for volunteer development workers | £3.60 |
| **Class 3** | |
| Voluntary Contribution | £6.75 |
| **Class 4** | |
| Upper Profits Limit | £29,900 per year |
| Lower Profits Limit | £4,535 per year |
| Contribution Rate | 7% |

*All figures are weekly unless shown otherwise.*

*Source: Inland Revenue at: http://www.inlandrevenue.gov.uk*

To sum up, there are two main differences between the structure of National Insurance contributions in Poland and in the UK, mainly for historical and economic reasons. First, the new social security system in Poland provides for a closer link between individual's contributions and future pension benefits (in case of young people) whereas the British National Insurance scheme is a system of a cross-generational transfer where there is no relationship between amount of contributions made and benefit entitlement. Second, it seems that the Polish new social insurance system is more distortionary than the British one. Despite the positive element of the reform which makes contributions perceived as savings for the future rather than another tax, the rates of the social security contributions in Poland are significantly higher than in the UK, which seems to have negative effects on the labour market. Social security contributions together with personal income tax create a high tax wedge, which leads to unemployment, as it reduces both the labour demand and labour demand and gives *negative incentives* to seek for employment in an unofficial economy. The gross average tax rate (personal income tax and social security contributions) reached 42 per cent of the labour cost for the single individual at the income level of the average production worker in 1999 compared to 30 per cent for the UK in 2000.[49] One-third of the tax wedge in Poland falls on the employer's social security contributions (twice as much as in the UK), which are expected to have stronger adverse employment effects than other forms of labour taxation. In order to remove impediments to job creation in Poland social security contributions need to be reduced, in particular the employer's social security contributions.

[49] P.Lenain, and L.Bartoszuk, *The Polish Tax Reform*, *op.cit.,* p.4

### 5.7. System of Collecting Income

In Poland the withholding of tax from wages and salaries is undertaken by employers on a non-cumulative basis in monthly instalments: 19 per cent from the income received in the given month if the accumulated income throughout the tax year did not exceed the upper limit of the first tax band, 30 per cent from the income received in the month after the month when the accumulated income throughout the tax year did exceed the limit and 40 per cent from the income received in the month after the month when the accumulated income throughout the tax year did exceed the upper limit of the second tax band.[50] The instalment is reduced by the one-twelfth of the deduction in the first tax band set by the Tax Law and by a health insurance premium. It means very often that the amount of tax withheld is imprecise because it does not include other allowable tax deductions and relief. Nevertheless, withholding too much tax by the tax authorities provides a substantial incentive for taxpayers to complete their returns promptly and accurately in order to get their rebates back as soon as possible. To assist taxpayers the revenue services organise instructions and advice that appear on television, the radio and in the press. Although the new system was introduced fully only in 1992 in Poland it seems as if the taxpayers already got accustomed to completing a return every year, mainly due to the publicity that is concentrated in the appropriate period. Each year every taxpayer has to complete a return by a specified date (in Poland the deadline is the following 30 April). If the final tax liability exceeds the amount of tax that has already been withheld or otherwise paid, he or she should pay the difference. If, on the other hand, he or she is owed tax, a rebate is paid as soon as possible after the return is submitted. Next, they are subject to a check for arithmetical errors by the tax authorities. A small proportion is selected for a more detailed audit.

The UK has a system of collecting income tax by the Pay - As - You - Earn (PAYE) scheme and parallel due to the recent changes since

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[50] *Ustawa z dnia 26 lipca 1991 roku o podatku dochodowym od osob fizycznych*, Art.32 ust.1 pkt 1-3.

1996-97 also by self-assessment system for particular kinds of income while in Poland only self-assessment is practised. Most income tax in Britain is collected through PAYE. Other tax is paid directly by the individual after, or at the same time as, details have been supplied in a tax return (from 1996-97 the self- assessment tax return). Until 1996-97 fewer than 10 per cent of the adult population filled in tax returns each year, with tax returns concentrated on those self-employed and with higher incomes and a greater probability of multiple income sources. In 1996-97, the UK began a move towards greater self-assessment, with 9 million tax returns being issued in that first year, covering almost 20 per cent of the adult population.[51]

The two systems (PAYE and self-assessment) differ considerably from each other. PAYE system attempts to collect precisely the correct amount of tax each pay period (e.g. every week of every month) and it puts the main burden of calculating the amount of tax due on the Inland Revenue. In the self-assessment system it is the taxpayer who is primarily responsible for calculating tax liability and paying it rather than tax authorities.

PAYE is the mechanism by which income tax is deducted at source from employment income (that is Schedule E). In principle it covers all income from nearly all forms of employment and so covers pensions as well as wages, salaries, and fees paid to directories.

PAYE system is operated on a cumulative basis and therefore the weekly deduction of tax vary with weekly fluctuations in income. As a result it avoids over-withholding tax so the taxpayer does not have to repay it after the end of the tax year. Under the cumulative system a taxpayer's allowances and pay are accumulated throughout the tax year. This means that the actual amount of tax deducted in any pay period depends on the income already received in the tax year as well as the income received in the current period. Consequently, a cumulative system is capable of deducting the correct amount of tax throughout the tax year and at the end of the tax year the total amount of tax collected should equal the taxpayer's liability. The effect of accumulation is to divide the taxpayer's allowances by the

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[51] Chennells, L., and Dilnot, A., and Roback, N., *A Survey of the UK Tax Syste, op.cit.,* p.6.

pay periods in the tax year. When the taxpayer's income falls in one week the system can generate a rebate at time because the tax paid in earlier periods is taken into account.

The first stage of the PAYE system is that the taxpayer provides details of his personal circumstances to the Inland Revenue by completing a tax return. Most employees are not required to complete a return each year. The allowances that the employee is entitled to claim are than translated into a code number. The taxpayer's code number is then sent to the employer. At the end of the tax year (5 April) every employer is required to send to the tax office a list of his employees, together with details of their pay and tax withheld. The figures for each individual are then checked. Provided that the code number has been fixed correctly, and the PAYE system operated properly, no further adjustment should be necessary.

The most important advantage of a cumulative PAYE system is that tax is withheld very accurately from employment income and no end-of-year adjustment to most employees' tax payments are required. The other advantage of PAYE system is that when a taxpayer's entitlement to allowances increases during the tax year, the code can be increased so that he receives the benefit at once. If the taxpayer becomes entitled to a tax rebate this also means that it can be paid during the current tax year, rather than after the end of the year.

There is also a technique which is sometimes known as 'coding in'. This is used where a taxpayer has, for some reason, paid insufficient tax on his earnings at the end of the year. Instead of demanding immediate payment, the Inland Revenue may recover the outstanding tax slowly (and less painfully) over later years by reducing the taxpayer's code number by the appropriate amount.

In certain circumstances, it is not practical to operate the cumulative element of PAYE accurately. This occurs, for example, with higher rate taxpayers who have more than one job. The problem is that if each job were treated separately, PAYE would tend to withhold too little tax. The reason is that too much income would be subject to tax at the basic rate, and too little at higher rates. The problem is dealt with by setting the taxpayers' allowances against one job ( or possibly more than one ) and allocating a D code prefix to any further jobs.

D codes are operated on a non-cumulative basis and, when a D code is issued, the employer must withhold tax at the appropriate rate on all payments to the employee. Although the D code system improves the accuracy of PAYE in these circumstances, errors remain because of the non-cumulative element. For instance, if the taxpayer's income from his main job changes, the D code in force on second and subsequent jobs may cease to be appropriate and an end-of-year adjustment becomes necessary.

It could be argued that a system which demands little effort from taxpayers is the simplest possible one for most individuals. PAYE avoids the need for most taxpayers to complete a return every year. This, however, has its disadvantages and can easily lead to the wrong amount of tax being paid. It is also possible that, without an annual return, taxpayers may not be aware of their entitlement to certain allowances and expenses, nor that it is up to them to claim.

It can also lead to difficulties when something affecting a person's tax affairs changes and the taxpayer is then forced to deal with a system with which he or she is largely unfamiliar, e.g. when he/she becomes a self-employer or worked abroad and then self-assessment system is required. It can also lead to extra administration and compliance costs arising from enquiries to the Inland Revenue and others made by taxpayers who are unfamiliar with the mechanism of the tax system.

In the self-assessment system a taxpayer is required to compute his own tax liability. This involves adding up several sources of income, then deducting various allowances in order to compute taxable income. The tax due is then found by consulting tax tables. In the UK taxpayers can send their returns back to the Inland Revenue by 30 September each year, for the Revenue to calculate the tax owed (given the information on income sources and expenditure provided by the taxpayer). Alternatively, for those wishing to calculate their own tax bills, the deadline is the following 31 January, which is also the deadline for payment of the tax. Fixed penalties and surcharges operate for those failing to make their returns by the deadlines or for underpayment of tax.

The basic arguments in favour of self-assessment are based on the efficiency ground and it is said that the costs of tax collection are saved, the tax structure is more flexible and it leads to greater understanding of the tax system on the part of taxpayers. The arguments against self-assessment are that it increases private sector costs. Another argument from the *equity* point of view says that self-assessment can lead to a greater variance of tax actually paid by taxpayers in identical circumstances. It is because some forms of income may remain hidden due to the lack of a universal annual return and also some taxpayers are unaware of allowances and reliefs to which they are entitled. A tax system may benefit only those who have the ability or the resources to take advantage of its complications, even if designed to be equitable.

Concluding, the two systems of tax collecting (PAYE and self-assessment) differ significantly from each other and therefore it is difficult to estimate the supremacy of either of the systems. However, neither of the system is perfect and in order to suggest what system should be used the discussion on efficiency and equity principles is required. If the system is supposed to be cost-effective in terms of budgetary expenditures it is said that self-assessment system would be superior. However, if the main aim of the tax system is to provide with the equity among taxpayers PAYE system meets the requirements more precisely than self-assessment system.

Nevertheless, the final argument for self-assessment system and against PAYE is that the PAYE is used exclusively in Britain while self-assessment is practised more commonly in the European as well as in the world tax systems.

### 5.8. Summary

The comparative discussion of taxation of personal income in Poland and in the UK conducted in this chapter lead to some conclusions regarding evaluation of the particular elements of the personal income tax in view of *efficiency, equity, incentives and stabilisation.*

The analysis on taxable income concluded with the statement that none of the tax systems in Poland and in the UK provides for the total efficiency and equity of the taxation. The reason is that both countries

offer great number of exemptions and the preferential treatment of capital gains. This may be considered as *inequitable* and lead to distortions in the market *efficiency*. The similar conclusion relates to the favourable treatment of the allowable expenses under different schedules in the British tax system and to the system of National Insurance contributions in the UK that favours only some group of taxpayers.

The analysis that was carried out further on concerning the tax rates is one of more challenging areas of the subject presenting extremely complex question of conflict between efficiency and equity. The solution that was adopted both in Poland and in the UK results in a very long basic rate that provides for *efficiency* in the sense that administrative and compliance costs are reduced and it does not result in the misallocation of resources, however it has negative implications for *equity* between taxpayers. The similar problem between efficiency and equity arises in the domain of taxation and marriage resulting in the fact that neither Polish nor British tax system provide for neutrality of marriage as both of the countries allow either joint taxation of spouses (in Poland) or married couple's allowance for elder people (in the UK).

The subject matter that we were dealing with while describing reliefs and deductions is a conflict between incentives and efficiency and equity of taxation. It is often repeated that *incentives* in form of tax deductions and reliefs rarely reach primarily assumed final resting place and do not stimulate the primarily assumed action. As a result they prove to be *inefficient* as they produce more economic costs than benefits and on that basis it is postulated that their number should be limited. Tax incentives also create *inequity* between taxpayers as the beneficiary is often a limited group of taxpayers.

However, both, Poland and the United Kingdom provide for a number of deductions and tax credits, mainly because they are often useful devices of the governmental *stabilisation* policy in the economic and social field. The WFTC in the UK and tax exemptions (e.g. National savings ceritificates in the UK and government securities and bonds in Poland) as well as tax reliefs (mainly housing expenditures in Poland) have been introduced to the tax systems as instruments of the active fiscal policy in fight with undesirable phenomena in the

economies of both countries. With the introduction of the WFTC the UK is trying to reduce the level of unemployment and improve the financial situation of parents with children, whereas Poland makes efforts to increase the level of investment in the housing sector by means of tax reliefs. Both countries attempt to increase the level of domestic savings through the relevant tax exemptions. The scope of the fiscal stabilisation policy with the help of the tax system is determined in both countries by historical and economic reasons and relates to different views on the role which government should play in the economy in Poland and in the UK.

The issue of tax collecting and administration and enforcement was examined as regards to efficiency and equity principles and it seems that British PAYE system emphasises *equity* between taxpayers. In terms of *efficiency*, the self-assessment system is regarded as more *efficient*.

## 6. Conclusions

The analysis in this paper has tried to single out some common trends and provide the comparative evaluation of taxation of personal income in Poland and in the UK. The discussion on that subject was to contribute to the discussion of the principles of taxation underlying the process of designing the tax system.

In the light of *efficiency* principle, there are some issues in the Polish and British tax system that raise concern in this respect and these are:

- the different treatment of expenses under different schedules and national insurance contributions in the UK that relatively favour self-employed taxpayers,
- the preferential treatment of capital gains in both countries, which distorts the neutrality of allocation of resources and results in the loss of the market efficiency,
- high social security contributions in Poland which have a negative impact on the labour market.
- high complexity and costs of the PAYE system in comparison to the fairly transparent and low cost self-assessment system.

In the view of *equity*, there are some practical problems common for both countries. On one hand the basic tax rate in Poland and in the UK provides for efficient tax collection, on the other hand it makes the tax burden less equitable. Moreover, the taxation of marriage adopted in Poland and in the UK cannot be regarded as completely fair because it discriminates non-married taxpayers.

As far as the problem of *incidence* is concerned, the conclusion from the discussion presented above is that the rates of the Polish personal income tax together with the rates of the social security contributions create a high tax wedge which seems to be adverse to work and need to be reduced. Tax incentives in form of tax deductions and reliefs have proved to be inefficient as they rarely reached primarily assumed final resting place and should be abandoned. In order to encourage workers who are active in the grey economy to surface in the official economy as well as to combat the high unemployment Poland should follow the British example and introduce some form of the employment-conditional tax credits.

In terms of *stabilisation* there are some tax provisions in both countries, which influence a socially-desirable income distribution and stimulate economic stability and development. Both countries attempt to stimulate the particular economic phenomena (e.g. the level of employment, investment and savings) by means of tax credits, tax exemptions and tax reliefs.

Finally, one need to remember the fact that the personal income taxes in Poland and in the UK differ from each other because they were constructed and developed under different economic conditions and in different background.

Some positive common trends in both countries may be observed on the example of the reforms introduced in the past and some governmental proposals. These include:

- the shift from direct taxes to indirect taxes as the main elements of the budgetary revenues as the VAT is believed to be more difficult to avoid and evade than other taxes and therefore is less distortionary for the effective allocation of resources,

- reductions in the top rates of personal income tax in order to reduce the incentives for tax avoidance by using tax loopholes to reduce the tax liabilities,
- flattening of the income tax by making the tax less progressive (fewer rates and lower marginal tax rates) as it is believed that lower progression enhances the work productivity and creates incentives for individuals to acquire more productive skills or to move to a more productive job in strive for promotion; it also encourages the increase in the demand for well-qualified labour as the marginal labour costs are reduced,
- broadening the tax base by the removal of a number of tax deductions, which distort consumption, savings and investment decisions and by including such income sources as: fringe benefits, contractual work and wage payments in kind into a taxable income.

It is expected that these trends will be intensified in the future in both countries, which should provide for more efficiency in the tax system and more equitable distribution of the tax burden.

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