Taxation of Labor and Capital in Poland: Recent Trends and Challenges

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The majority of people around the world complain about taxes they have to pay. However, in the case of Poland, it is not only the size of the tax burden that poses a problem, but also complicated and unclear rules in place. In theory, particular levies can be easily classified as: taxation of consumption, of capital, or of labor. In practice, the distinction is often not so clear. Furthermore, official labels of different levies (in particular, taxes and social security contributions) are sometimes used in a misleading way. Such inconsistencies create serious problems for the Polish tax system, encouraging taxpayers to arbitrage, which provokes unnecessary disputes with tax administration. Therefore, the system needs to be reformed. The only question is: how?

> THE MAIN SOURCE OF PUBLIC REVENUES IN POLAND ARE INDIRECT TAXES (LEVIED MAINLY ON CONSUMPTION) AND SOCIAL SECURITY CONTRIBUTIONS (LEVIED ON LABOR)

OVERVIEW OF THE POLISH TAX SYSTEM

The main source of public revenues in Poland are indirect taxes (levied mainly on consumption) and social security contributions (levied on labor). In 2018, tax revenue in Poland amounted to 35% of GDP. This included:

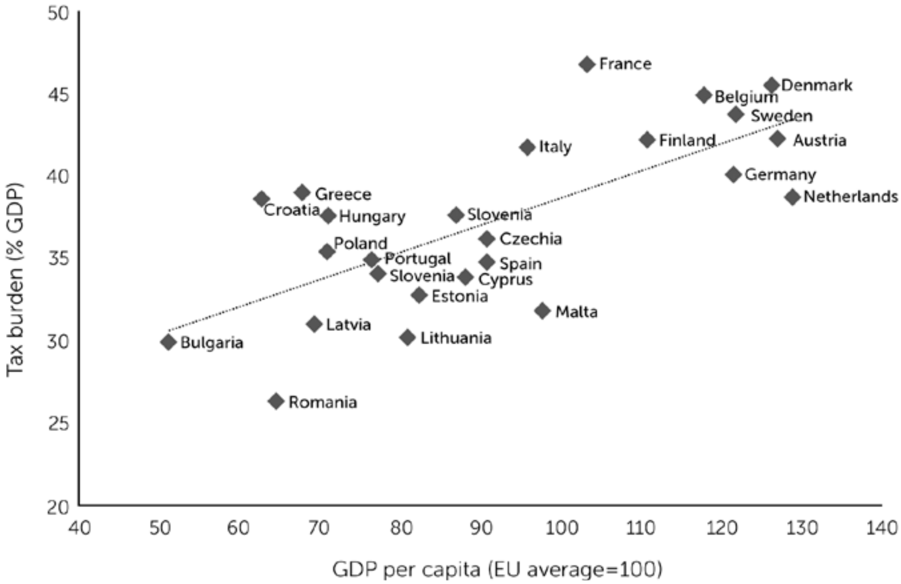
- **14.3% of GDP from indirect taxes.** The most important ones were VAT (8.1% of GDP) and excise (3.4% of GDP), both levied on consumption;
- **13.3% of GDP from social security contributions.** Formally, social contributions are divided between employer and employee, and some of them are even paid by pensioners (healthcare contribution, which is included in this category), but, in reality, in the long run they are paid by workers[1];
- **7.8% of GDP from direct taxes**, with PIT (5.3% of GDP) being by far the most important, followed by CIT (2.1% of GDP).

Overall, the tax burden in Poland is higher than in the majority of regional peers. Although it is below the EU average of 36.7% of GDP, it should be noted that more affluent countries with large government expenditure drive this result to a large extent. Poland, with its aspiration for faster economic growth, should be compared with its regional peers that are at a similar level of development.

Within the region, Polish taxes are well above average, substantially higher than in Bulgaria, Romania, Latvia, Lithuania, Estonia, and Slovakia.

[1] See: An overview of 52 empirical studies on this subject by González-Páramo and Ángel Melguizo (2012), who conclude that after market adjusts, nearly whole social security contribution is actually paid by workers. Available [online]: https://voxeu.org/article/who-really-pays-social-security-contributions-and-labour-taxes

Figure 1: GDP per capita and tax burden (including social contributions) in the EU (2018)



Source: European Commission

While relatively low reliance on direct taxes in Poland is growth enhancing, the high importance of social security contributions is more troubling. Several studies show that not only the size of tax burden, but also its composition, has a significant impact on economic activity and prosperity[2]. The main finding is that from the growth's perspective, the least harmful are taxes levied on consumption and real estate.

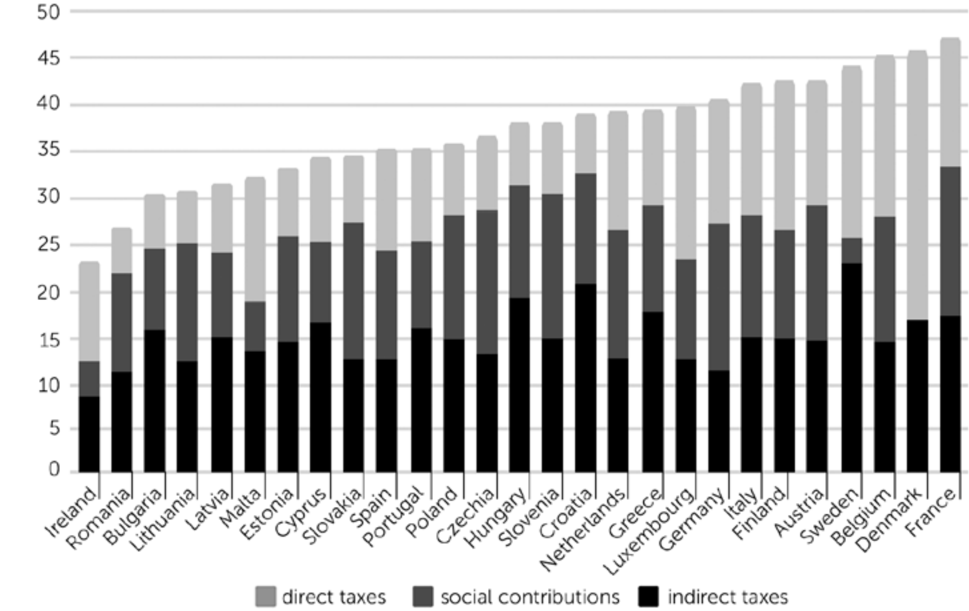
Such results are quite intuitive – in the long run, economic growth depends on input of labor and capital. So taxes and social contributions that lower monetary rewards for working and investing undermine growth potential. However, the taxes that make consumption and holding real estate more expensive have a much smaller impact on people's decisions about working and investing, and thus are more growth-friendly.

Looking at taxes in Poland from the growth's perspective gives a mixed picture. On the one hand, direct taxes constitute only 22% of total tax revenue (including social contributions) – well below the EU average of 30%, which is clearly growth-friendly. On the other hand, social contributions

> TAX BURDEN IN POLAND IS HIGHER THAN IN THE MAJORITY OF REGIONAL PEERS

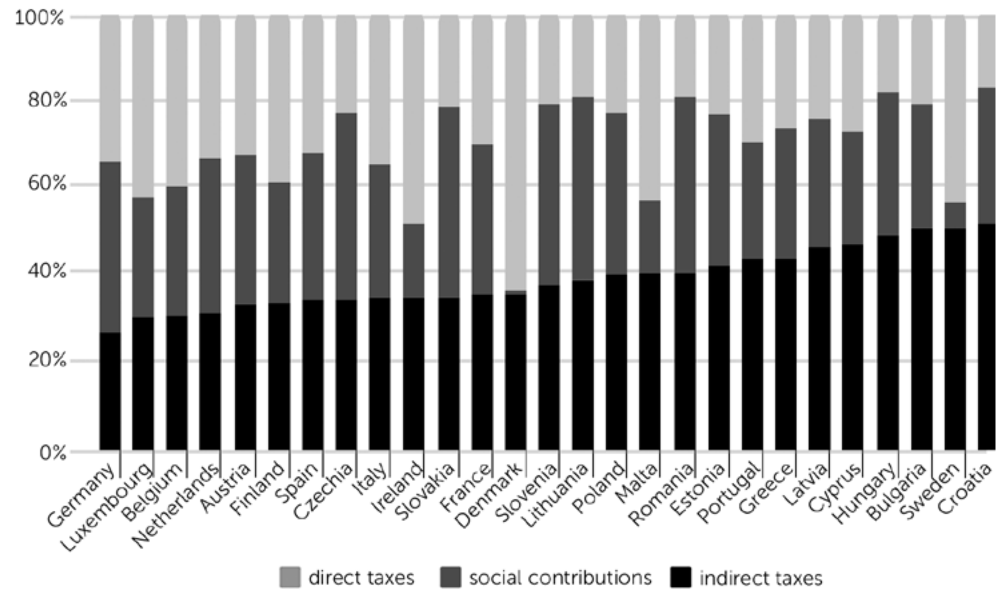
[2] For the impact of tax structure on economic growth see, for example: Johansson, Å., Heady, C., Arnold, J., Brys, B. and L. Vartia (2008) *Taxation and Economic Growth*, OECD Economics Department Working Papers. 10.1787/241216205486.

Figure 2: Taxes and social contributions as % of GDP (2018)



Source: European Commission

Figure 3: Structure of tax burden (2018)



Source: European Commission

represent over 37% of revenue – significantly above the EU average of 30%. The remaining part – indirect taxes – is in line with the EU average of 40%. So while relatively low dependence of public finances on direct taxes is beneficial, the huge burden of social contributions is something that government should work on by shifting more of the burden on to consumption.

SOCIAL CONTRIBUTIONS IN NAME ONLY

In Poland, the label of social security contribution obscures the economic character of several levies. According to the Eurostat's definition, social contributions *"(...) are contributions made by households to social insurance schemes to make provision for social benefits to be paid (...)"*. However, the strength of the link between contribution and the benefit varies significantly between different contributions.

On the one hand, there is sickness insurance – employee pays 2.45% of their wage and in case of illness receives sickness benefit equal to 80% of the wage. So the link between the base from which the contribution is calculated and benefit is straightforward. On the other hand, there are several contributions where such a direct link is missing – for example, although the rules governing healthcare contribution and its effective burden vary significantly between different professions, all of them are equally entitled to the public healthcare services.

> POLISH TAXES ARE WELL ABOVE AVERAGE, SUBSTANTIALLY HIGHER THAN IN BULGARIA, ROMANIA, LATVIA, LITHUANIA, ESTONIA, AND SLOVAKIA

In general, levies labeled as social security contributions can be divided into two broad groups:

- public healthcare insurance (NFZ);
- remaining social security contributions (ZUS and FP).

Healthcare insurance contribution is *de facto* another tax on labor. For the majority of taxpayers it is just another levy subtracted from their income: the rate is 9% and the base of contribution is nearly the same as for PIT – gross income minus ZUS (employee part), with the majority of it (7.75% out of 9%) being tax deductible. So while people usually think that income tax rates in Poland are 17% and 32%, in fact, they pay 18.25% and 33.25%, which can be divided into 9.25% or 24.25% PIT and further 9% of NFZ contribution. The only important advantage of a separate healthcare contribution is that it is a natural budget constrain on public health spending. In case that healthcare would be financed from PIT and become part of annual parliamentary budget process, there would be a serious risk of MPs voting for higher spending, without a link to revenue.

The way the NFZ contribution is calculated does not only obscure the effective tax rate, but also makes the calculations much more complicated. The base for NFZ and PIT is similar, but not the same: as regards PIT,

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the majority of taxpayers are entitled to a minor lump sum deduction (around EUR 15 monthly), which is not applicable to NFZ. Therefore, each levy must be calculated separately, making the process unnecessarily time-consuming.

Labor Fund contribution (*Fundusz Pracy*, FP) is a misleading name for an additional tax on labor. Contribution for FP is paid by the employer, thus the majority of taxpayers are not aware of this levy, which is equal to 2.45% of gross wage. The aim of the Fund was to finance labor market policies, but over time politicians started to use it as a piggy bank for programs ranging from scholarships for doctors, to support of mothers that decided to give birth to heavily disabled children instead of having an abortion. Clearly, the lack of connection between the contribution and the benefit is apparent, and such programs should be financed from general taxes.

Besides FP contribution, there is a much smaller contribution of 0.1% of gross wage, also hidden on the side of the employer. It goes to the Guaranteed Employment Benefit Fund (*Fundusz Gwarantowanych Świadczeń Pracowniczych*), which was set up in order to finance overdue wages of employees of bankrupt companies. However, as the number of bankruptcies went down, politicians have found other ways to use money from the Fund, once more breaking the link between contribution and benefit.

ZUS contributions together constitute the largest levy on labor in Poland. Basically, these include four contributions (old-age pensions, disability, sickness – paid voluntarily, and accident insurance) and in each case the strength of the link between contribution and benefit differs.

Formally, contributions in various proportions are divided between employer and employee, but as it was already stated, in the long run, their burden is effectively passed on to the workers. The base for all the contributions is gross wage; the rates are as follows:

- **19.52% old-age pension contribution**, with the annual base capped at 30 average wages in general, the link between contribution is straightforward: a pension is calculated as a sum of indexed contributions divided by life expectancy. But in 2017, the retirement age was lowered to 60 for women and 65 for men, the growing share of the population will not manage to pay contributions for anything more than guaranteed fixed minimum pension, which breaks the link between contribution size and amount of benefit;
- **8% disability pension contribution**, with the annual base capped at 30 average wages – it covers not only disability, but also survivors' pension; they are both linked to paid contributions, but formulas are more complicated than in the case of old-age pension contributions;

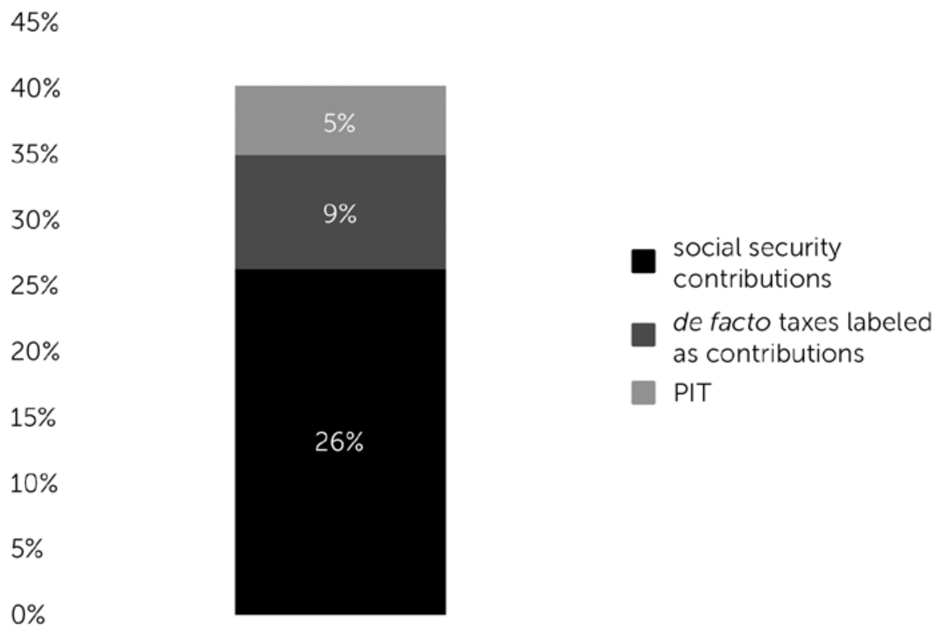
- **2.45% sickness contribution** – here the link is straightforward, as the sickness benefit is 80% of the same base as sickness contribution;

- **0.4–3.6% accident insurance contribution** – this contribution differs between employers; for companies where more accidents occur, they pay higher contributions, thus creating strong incentives for a safe working environment.

Altogether, social security contributions constitute 7/8 of the tax wedge in Poland, with the remaining 1/8 left for PIT. Box 1. presents how social contributions and taxes are calculated for a worker earning an average wage. However, by looking deeper into the character of subsequent contributions, it may be said that out of a 40% tax wedge, social security contributions amount to 26%, while taxes and *de facto* taxes amount to 14%.

> ZUS CONTRIBUTIONS TOGETHER CONSTITUTE THE LARGEST LEVY ON LABOR IN POLAND

Figure 4: Tax wedge for average wage in Poland as % of total labor costs



Source: Own elaboration

WHO SHOULD PAY SOCIAL CONTRIBUTIONS?

Heavy reliance of public finance on social contributions in Poland makes a distinction between income from labor and capital crucial. By definition, contributions are levied on income from labor, so they must be clearly separated from the income from capital. In the case of larger enterprises such a distinction is not very controversial, but the problem is much bigger when it comes to numerous microenterprises and the self-employed.

The self-employed and business owners in Poland have a range of options of how to pay social contributions and taxes. They pay social contributions calculated from a self-declared base, which (with some exceptions) must not be lower than 60% of average wage. A great majority of these entities choose to pay contributions calculated from the lowest possible base, turning them into a lump sum payment.

In the case of PIT, the self-employed can choose between a progressive tax with two brackets of 17% and 32% and many different tax breaks, and a linear 19% tax with a much more limited number of breaks. The idea behind a 19% PIT was to put it on an equal level as CIT, which is also 19%. This way, the proponents of such a solution argue, incorporated businesses and sole proprietors are taxed at the same rate. It is, however, only partly true, because owners of incorporated businesses also pay PIT from dividend payments. So their income from capital is taxed

BOX 1: HOW IS THE TAX WEDGE CALCULATED FOR AVERAGE WAGE?

In 2019, average gross wage in Poland was PLN 4,918. The total labor cost paid by the employer constituted of gross wage and social security contributions on the employer's side, and amounted to PLN 5,925. This is the sum of:

a) PLN 1,007 of **social security contributions on the employer's side**, which are calculated as percentage of gross wage (9.76% – old-age pension contribution; 6.5% – disability pension contribution; 1.67% – accident insurance contribution; 2.45% – Labour Fund contribution; and 0.1% – Guaranteed Employment Benefit Fund contribution);

b) PLN 4,918 of **gross wage**, which is further divided into:

- PLN 674 of **social security contributions on the employee's side**, also calculated as a percentage of gross wage (9.76% – old-age pension contribution; 1.5% – disability pension contribution; and 2.45% – sickness contribution);
- PLN 382 of **health care contribution**, calculated as 9% of gross wage minus social security contributions on the employee's side;
- PLN 353 **PIT**, calculated as 17.75% (in the 4th quarter of 2019, the rate was lowered from 18% to 17%, which gives an effective annual rate of 17.75%) of gross wage minus social security contributions and tax allowance, which gives PLN 682, but from this amount part of healthcare contribution (PLN 329) is tax deductible;
- PLN 3,509 of **net wage**.

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SOCIAL SECURITY CONTRIBUTIONS CONSTITUTE 7/8 OF THE TAX WEDGE IN POLAND, WITH THE REMAINING 1/8 LEFT FOR PIT

twice, which yield an effective rate of 34%[3], while sole proprietors pay only once, 19%.

Lump sum social contributions, coupled with linear PIT, make self-employment attractive for highly qualified employees. In theory, flat PIT was meant for income from capital, but in the case of the self-employed the distinction between income from capital itself and that from labor is blurred. The self-employed may well refer to a person renting apartments and outsourcing all the maintenance, which would mean that his income comes mainly from the capital. They can also be consultants, in which case their input will be mainly labor. Nonetheless, besides such clear-cut cases, there are many situations in-between – e.g. owners doing maintenance and marketing on their own, thus providing not only capital (apartment), but also their own work. Also, as was already mentioned, consultants can operate their own expensive equipment, thus their client will be paying both for labor (the consultant's work) and capital (equipment used by the consultant). Furthermore, self-employment is not the only exception in tax and social security contributions system. Incomes from different types of contracts are taxed in various ways, encouraging tax arbitrage [See: Figure 5].

Significant differences in effective taxation of different contracts make the tax system overly complicated, and are the source of conflicts between taxpayers and tax administration. Trying to tax similar actions or goods differently requires complicated rules – the Polish tax system is among the most time-consuming in the EU.

Furthermore, with huge discrepancies in tax rates, taxpayers have a strong incentive to dress their business in such a way so that they may apply the lowest rates, while the administration is trying to prove that higher taxed contracts should be used. For example, one company signed with workers "contracts of specific work" to dig a trench. For such a contract, a 9% tax rate should be applied. However, the administration pointed out that it should be a "contract of

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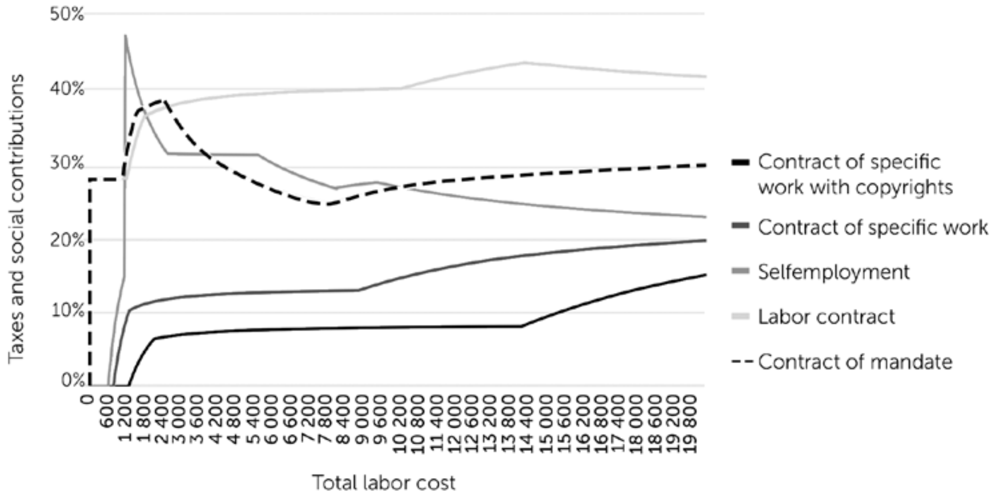
THE SELF-EMPLOYED AND BUSINESS OWNERS IN POLAND HAVE A RANGE OF OPTIONS OF HOW TO PAY SOCIAL CONTRIBUTIONS AND TAXES

[3] The effective tax rate can be lowered if the business is eligible for preferential CIT regime.

Figure 5: Effective taxation of income depending on the type of contract [taxes and social contributions as % of total labor cost]



Source: Own elaboration

mandate" and a usual rate of 40% should be applied. As everyday life is even more complicated than complex tax rules, such disputes are common. In the case of the abovementioned trench digging, the Supreme Court was needed to settle it eventually[4].

Unfortunately, instead of remedying old issues, the current Law and Justice government has further deepened the already existing problems with the Polish tax system. Instead of making the rules clearer and the differences between various contracts smaller, the authorities have introduced even more tax exemptions and special regimes, simultaneously increasing reporting requirements. As a result of these actions, the time needed to file taxes in Poland went up drastically.

[4] The Polish Supreme Court recommended revising the initial verdict and redirected it to the Appellate Court, stating that the type of contract in place should be a contract of mandate.

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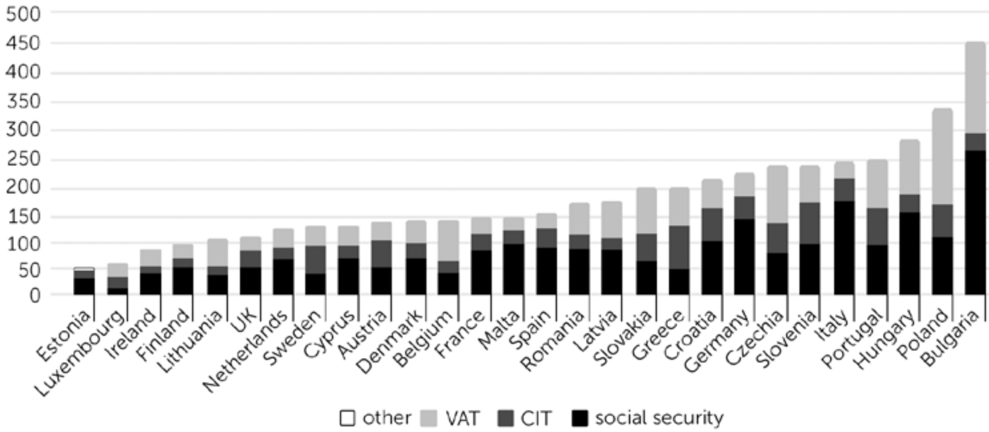
IN THEORY, FLAT PIT WAS MEANT FOR INCOME FROM CAPITAL, BUT IN THE CASE OFTHESELF-EMPLOYED THE DISTINCTION BETWEEN INCOME FROM CAPITAL ITSELF AND THAT FROM LABOR IS BLURRED

Figure 6: The annual time needed to settle taxes [year 2019, in hours]



Source: World Bank Doing Business

Furthermore, sanctions for different offenses went up, often out of scale when compared with European peers. Taking into account the complexity and instability of the tax code, running a business in Poland became even more risky. As a consequence of both tax incentives and increased risks, over the last four years Poland experienced a pronounced drop in the number of small and medium businesses. People either work for large companies, which are productive enough to pay full costs of labor contracts and have large legal departments to settle disputes with tax administration, or choose self-employment, which is taxed in a preferable way and thus often flows below the radar of the administration.

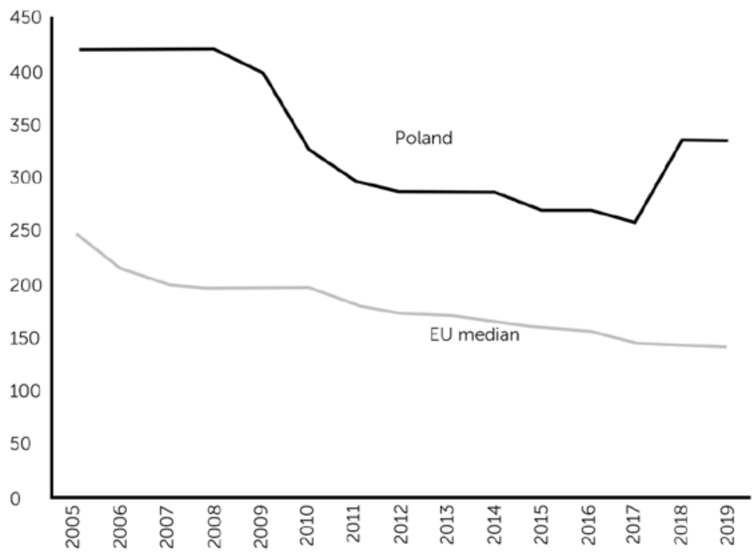
"WITH THE CYCLICAL SLOWDOWN STARTING IN POLAND, FURTHER CONFLICTS BETWEEN TAXPAYERS AND ADMINISTRATION CAN BE EXPECTED"

CONCLUSIONS

Looking at taxes alone in Poland tells us little about actual fiscal burden levied on labor and capital. The biggest part of the burden comes not in the form of taxes, but as social security contributions. The name is misleading, as part of them are *de facto* taxes, with no links between paid contributions and future benefits.

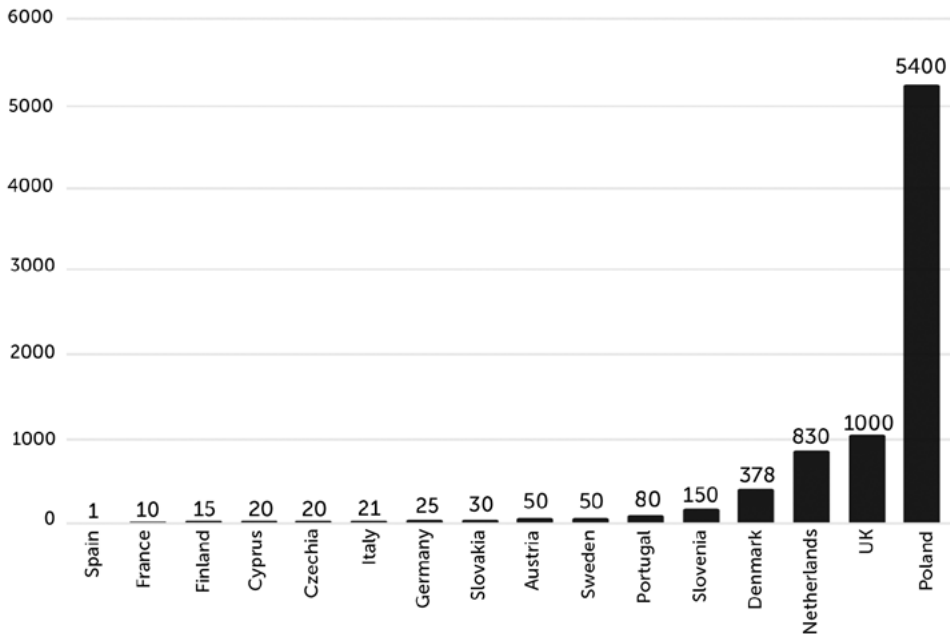
As contributions are levied only on income from labor, they create strong incentives for taxpayers to look for contracts where contributions are not applicable, or are at a lower level. The natural choice for them

Figure 7: Changes in annual time needed to settle taxes [2005-2019, in hours]



Source: World Bank's *Doing Business 2020*

Figure 8: Maximum penalty for non-compliance with the mandatory disclosure rules [EUR thousand]



Source: FOR, Own elaboration based on the data from the World Bank and a presentation by Adam Marianski entitled "Legislacja podatkowa w Polsce – Dokąd zmierzamy?" (October 1,2019)

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TAXATION OF LABOR AND CAPITAL IN POLAND NEEDS THOROUGH REFORMS

is self-employment, where the distinction between income from labor and capital is blurred, and thus the overall tax burden, including social security contributions, is lower.

With the cyclical slowdown starting in Poland, further conflicts between taxpayers and administration can be expected. With tougher market conditions, companies will be even more eager to look for ways of how to avoid high social security contributions and try to disguise labor costs, for example, as self-employed subcontractors. Simultaneously, slowing down the tax revenue stream will press the tax administration to search for taxpayer money even more forcefully. With complicated and unclear rules, it will be hard to say which side is pushing too strongly, and it will take years to settle cases in courts. Such conflicts will be a growing source of uncertainty further harming the business climate.

Taxation of labor and capital in Poland needs thorough reforms. In particular, in regards to the way in which social contributions are applied and levied on labor should be changed. These contributions that are just hidden tax, without any link to further benefits, should be simply merged into PIT, making the whole system more transparent. As for the remaining contributions, the right direction would be to lower the rates, while broadening the base, thus limiting the scope for arbitrage. In case of a broader reform, some of the burden could be moved from labor onto consumption, which would make the Polish tax system more growth friendly.

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