Incomes of Polish Households in the Context of 2005-2011 Tax and Benefit Reforms: A Pre-Election Analysis

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On October 9, Polish voters will decide who will form the new government. In an analysis of tax and benefit reforms introduced over the last two terms of Parliament, the independent Centre for Economic Analysis, CenEA, examines who gained and who lost on the implemented changes. The reforms that have been implemented since 2006 include significant tax reductions and important changes to family benefits, as well as a recent increase in the VAT. In the context of declarations made in earlier electoral campaigns, the actually implemented economic policies introduced, offer little guidance to the voters regarding the reliability of promises made during this current campaign.

The last two terms of office for the Polish parliament includes the period October 2005 till November 2007, and the current four-year term which followed a snap-election in 2007, and which will now come to an end with parliamentary elections scheduled for October 9.

During 2005-2007, the ruling coalition was led by the Law and Justice party (*PiS*) who then lost the 2007 elections to the Civic Platform (*PO*). This year, these two parties remain the main contenders for electoral victory.

The years since 2005 have been marked by a series of significant reforms with substantial influence on disposable incomes of Polish households. These reforms are analyzed in the first Pre-election Report recently published by the independent Centre for Economic Analysis, CenEA (Myck et al., 2011). This report analyses the extent of the most important economic reforms undertaken in the last two terms of office and their distributional consequences. The analysis is done using the Polish microsimulation model SIMPL based on a dataset from the Polish Household Budgets' Survey.

The report considers the following economic reforms:

1. reductions in disability rates of social security contributions (SSC) in 2007 and 2008,
2. introduction of a generous child tax credit (CTC) in the personal income tax system in 2007,
3. introduction of a two-rate (18% and 32%) instead of a three-rate (19%, 30%, 40%) system of personal taxation (PIT reform) in 2009,
4. a series of reforms to the means-tested system of family benefits (FB) in 2006 and 2009,
5. a VAT reform which increased the basic rate from 22% to 23% and changed the operation of lower rates at 5% and 8% instead of 3% and 7%.

Overall, the reform packages reduced the direct tax burden by about 9.2 billion Euros, which corresponds to around 2.8% of GDP, and substantially reduced the tax wedge on wages (see Table 1).[1] The government's income from social security insurance contributions fell by some 20% and the income from the personal income tax by about 12%.

Table 1. Effect of changes in Social Security Contributions, Personal Income Tax and Health Insurance on the balance of public finance in tax systems from 2005-2011 (year to year changes, in million euro)

	2006-2005	2007-2006	2008-2007	2009-2008	2010-2009	2011-2010	Total
Social Security Contributions	-110.7	-2 881.1	-3 154.7	-95.2	0.0	0.0	-6 241.6
Personal Income Tax and Health Insurance	388.8	-1 510.0	1 129.4	-3 285.2	-94.6	421.9	-2 949.8
Total	278.1	-4 391.1	-2 025.3	-3 380.5	-94.6	421.9	-9 191.5

Source: based on Myck et al. (2011), Table 4.

Annual values are given in Euros; differences in SSCs are computed as net changes accounting for changes in public sector's employer contributions. Exchange rate: 1 Euro = 4.3595 PLN.

While the big reforms grabbed the headlines, subsequent governments which oversaw their implementation, followed the policy of raising taxes and lowering expenditures through policies of freezing the value of tax credits and eligibility thresholds for family benefits. In the latter case, this generated a reduction in the number of children eligible to family benefits by 18%. At the same time, the value of benefits to those receiving them increased, on average, by 60%, with the net effect being a 7% increase in family benefit spending.

It is shown in our report that the reform package implemented in the 5th term of Parliament, and which included in particular the SSC reforms (2007/08), the CTC (2007), and a reform of the FB system (2006), has been distributed very evenly across different income groups. Households in income deciles 1-9 saw their incomes grow by about 4.5%, while those in the top decile gained about 3%.

[1] For analysis of changes in the tax wedge in Poland see: Morawski and Myck, 2010.

The implementation of the tax reform in 2009 brought about significant gains only to high income households. This tax reform was legislated prior to the financial crisis in 2008. The policy of freezing tax credits and benefit-eligibility thresholds, introduced in 2008 and 2011, resulted in losses for middle income groups, but meant that the bottom decile gained about 1%. This was largely through changes in the value of family benefits for families receiving them.

The entire 2006-2011 package of tax and benefit reforms, had a direct impact on households' incomes since it increased real disposable incomes, on average, by 5.4%. Here, the households in the top income decile gained the most (9.2%). The lowest gains were found in the 3rd decile (3.4%). Moreover, the poorest 10% of households gained, on average, 5.7% from the introduction of the entire package.

The nature of these reforms had an interesting distribution in terms of age and family type with the highest gains going to working-age individuals, in particular to married couples with children (10.2%). On the other hand, single pension-age individuals saw their income fall slightly as a result of the reforms (-0.3%), and only small gains have been seen for pensioner couples (0.5%).

In the report, we set the implemented policies against promises and declarations made by the principal parties during electoral campaigns and government goals declared in the Prime Ministers' *exposé*'s.

Out of the main policies implemented by the 2005-07 government, only the PIT reform of 2009 has been introduced in a form declared in the 2005 PiS electoral program. Its introduction was, however, legislated for 2009 and fell therefore under the current term of office. The introduced reductions in the rates of the SSC, one of the most costly reforms, were not mentioned in the electoral pledges. Moreover, the declared form of the CTC in the electoral program of PiS, was very different from the one introduced in 2007. The introduced program centered on the theme of a *"solidarity package"*, whereas the declared CTC was to be focused on low income families. The introduced policy, about 9 times as expensive as the declared one, transferred resources to low income families, but was most generous to high earners who pay enough tax to take advantage of the generous maximum amounts of the credit. The generosity of the CTC makes it the most costly "tax expenditure" item in the Polish system of direct taxes, with a value of 0.4% of GDP (Finance Ministry, 2010).

In terms of the PO's program and the Prime Minister Tusk's *exposé*'s, the report analyzes the focus on further reduction of taxes. In the midst of the financial crisis, the current coalition oversaw the introduction of the 2009 PIT reduction, but withdrew from implementing a 15% flat tax, one of its flagship policies prior to 2007. However, despite a reduction in the basic rate of tax from 19% to 18%, income taxes grew on average among low and middle income households (1-6th decile) because of the freezing of the tax credits. The net effect of income tax policies, in the current term of office, has meant gains for higher income households, with a substantial reduction in income taxes for those in the top decile group (on average 23%).

In the light of the growing level of the public debt, the current government implemented a VAT reform that raised indirect taxes by about 0.3% of GDP. The combination of an increased basic rate, with a reduction of lower rates on main food items, produced a proportional distribution of the tax burden.

Overall, the tax record of the current government is mixed. The implemented reductions were legislated already prior to its arrival, and the net result of the packages implemented in recent years hangs importantly on the level of households' income. On average, only the top three deciles of households have seen their tax burden fall.

Each of the coalitions, have their excuses for failing to deliver the promised policies. For the 2005-07 coalition, it is the early dissolution of Parliament. The current government, led by the Civic Platform, had to maneuver through the difficult years of the financial crisis and an economic slowdown. At the same time, one could interpret the policies implemented in the first two years of the 2005-07 Parliament as an expression of policy priorities, whereas the policies implemented during the current Parliament, can be confronted with their previous declarations to examine which groups of society they have prioritized.

In Poland, household income has grown fast in recent years. On the one hand, due to growing wages and earnings, on the other, due to introduced packages of tax and benefit reforms. Despite the financial crisis, the Polish economy has so far performed relatively well.

The reforms implemented in the last two terms of office, offer however little guidance to the credibility of electoral declarations on socio-economic policy. Even though the *Law and Justice* party (PiS), the leading party of the 2005-2007 government, legislated one of its key promises while in office (the PIT 2009 reform), it also implemented substantial reforms which were either not originally in their electoral program, or which took a very different shape and benefited other segments of the population. Even if the current government withdrew from the promises of further tax reductions when faced with the challenges of the financial crisis, it oversaw the implementation of significant tax cuts legislated in the 5th term of Parliament. Overall, however, the implemented policies increased taxes of lower income households.

To conclude, our results suggest that if Polish voters' decisions are to be guided by declarations in the area of socio-economic policy, they will face a tricky choice on the 9th of October.

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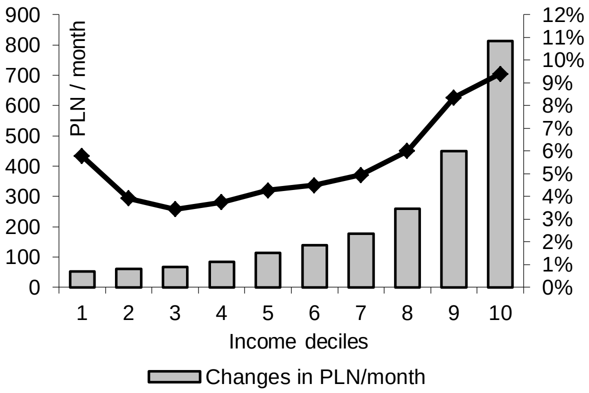
Figure 1. Changes in disposable incomes of Polish households as a result of tax and benefit policies implemented between 2006 and 2011, by income deciles.



Source: CenEA, Myck et al. (2011). Notes: average monthly values per household in a given decile group.

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