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EQUALIZATION OF TERRITORIAL UNITS' INCOMES – A CASE STUDY OF POLAND

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Summary: This paper is part of a broader research project entitled: "Equalization of territorial units' incomes as a reflection of approach to regional development policy," which is performed with the objective of comparing approaches to equalization of territorial units' income in six European countries. The paper starts with a snap-shot description of Poland, giving a brief presentation of the situation in terms of socioeconomic development, inequality in terms of personal wealth distribution and approaches to equalization of personal incomes. The second part of the paper is devoted to describing in more detail the grant system and income equalization mechanisms. The final, third part of the paper presents examples of how equalizing measures work in relation to selected local governments which provide an overview of local governments of different income level prior to equalization.

Keywords: local government finance, grant systems, equalization mechanisms.

Streszczenie: Niniejszy artykuł podejmuje zagadnienie równoważenia dochodów jednostek terytorialnych w Polsce. Artykuł rozpoczyna się krótkim wprowadzeniem w sytuację społeczno-gospodarczą Polski, w szczególności w zakresie zadań wykonywanych przez samorządy, struktury i wielkości ich dochodów w relacji do PKB. Kolejna część artykułu opisuje system dotacji i subwencji oraz funkcjonujący w jego ramach mechanizm równoważenia dochodów pomiędzy jednostkami terytorialnymi. Ostatnia, trzecia część artykułu wskazuje przykłady oddziaływania mechanizmu równoważenia dochodów na wybrane jednostki terytorialne.

Słowa kluczowe: finanse samorządu, dotacje i subwencje, mechanizmy równoważenia dochodów.

1. Introduction

The last two decades witnessed an ongoing trend towards fiscal decentralization in Europe – sub-central governments have been given more responsibilities and greater shares in public spending [Bloechliger, Vammalle 2012]. The policy of decentralization brings with it a promise of an increased efficiency in terms of service provision and resource allocation on local and regional levels. The often unwanted consequence of decentralization is that growing taxing powers and financial autonomies given to territorial units are accompanied by growing disparities in terms of wealth and/or income distribution between local governments. Hence a need for fiscal equalization appears.

The overriding objective of fiscal equalization is to correct imbalances in fiscal capacity of territorial units resulting from sub-central autonomy and differentiation in terms of tax bases and to allow local and regional governments to provide their citizens with services of comparable quality and quantity. A recent study across eighteen countries (Australia, Austria, Canada, Denmark, Finland, Germany, Greece, Italy, Japan, Mexico, Norway, Poland, Portugal, Spain, Sweden, Switzerland, Turkey, and the United Kingdom) showed that fiscal equalization involves transfers varying from 0.5% to 3.8% of GDP [Bloechliger et al. 2007].

Depending on specific arrangements, equalization mechanisms may be in line with a chosen policy for development, supporting either territorially balanced development or placing emphasis on development engines. This paper, as a part of a broader research project which builds on notions of fiscal federalism and fiscal equalization to give a better view of approaches to income equalization between territorial units in six European countries, concentrates on the notions of fiscal decentralization and income equalization in Poland. The working hypothesis which is approached in this paper is that **Polish regulations favor the territorially balanced approach to regional development**.

2. Country background: Poland

Poland's economic development after the political and economic transformation of the early 1990s may be described as dynamic. The country's GDP *per capita* in purchasing power standards increased from just 43% of the average for the 27 EU Member States (excluding Croatia) in 1995 to 65% of the EU-27 average in 2011 [Eurostat 2012]. The Eurostat data shows that Polish GDP grew at a rate higher than that for the EU-27 for as long as the data on Poland has been collected (since 1995), with the exception of only 2001.

The convergence of Polish GDP with that of other European Union countries has not been accompanied by convergence in terms of internal personal wealth distribution and in terms of local governments' capacity for generating incomes. The GINI index increased from 0.267 in 1992 and 0.323 in 1993 to 0.341 in 2009, peaking at 0.359 in 2004, the year of accession to the EU [World Bank 2013]. Interestingly, the redistributive role of personal income taxation in Poland has been decreased in recent years.

Personal income tax (PIT) was introduced in Poland on January 1, 1992. It is, by definition, progressive with nominal tax rates increasing over set thresholds of income. A significant change in personal income tax was introduced as of January 1, 2009. Nominal rates of PIT amounted to 19%, 30% and 40% before that date, while only two rates (18% and 32%) remained after. Furthermore, there exists a small sum of income which is exempt from tax (this is approx. EUR 800 *per annum*), as well as numerous regulations which cater for preferential treatment of certain taxpayers (i.e. spouses who can pay their tax jointly), as well as for exemptions and reductions [Podstawka, Deresz 2012]. The real tax rates and fiscal burdens thus differ from person to person, allowing PIT to serve its dual function: fiscal and redistributive, although it may be argued that the strength of redistributive, equalizing mechanisms has weakened after the change which was introduced in 2009.

In terms of territorial self-governance Poland has many historical experiences, although modern day local governments (re)appeared in 1990. The Local Government Act of March 8, 1990 led to creation of self-governing territorial units on the communal level. Currently, Poland's administrative division is a three-tier division which was introduced on January 1, 1999. Apart from 2,479 communes, the organization of which has not been substantially changed by the last reform of administrative division, there are now 380 districts (or counties) as well as 16 regions [Piasecki 2009; Turała 2011].

Legislation specifies tasks which all these territorial units have to perform, emphasizing that activities of local governments on different levels need to be in line with the principle of subsidiarity. The tasks include, amongst others: spatial planning, environmental protection, public facilities and infrastructure, supplies of heat, gas and electricity, treating sewage, waste management, local public transport, health care, social welfare, education, culture and public order [Owsiak 2005; Stawasz (ed.) 2004].

The role of Polish local governments is best described by the amounts of their incomes and expenditures relative to the GDP of Poland. In 2011 Polish local governments collected incomes which amount to 11.25% of the GDP (including: communes and urban districts: 8.71%, districts: 1.55%, regions: 0.99%). This amount is comparable with state budget incomes which amount to 18.22% of the GDP (whereas the incomes of the entire public sector, including local government budgets and state budget amount to 39.67% of the GDP). On the other hand, local government expenditures amount to 11.92% of the GDP (including: communes and urban districts: 9.27%, districts: 1.58%, regions: 1.07%), while state budget expenditures and overall public sector expenditure amount to 19.87% and 43.33% of the GDP respectively [Central Statistical Office of Poland 2013].

The required incomes are provided through a mixture of sources, including own incomes and various grants. Communes were given the greatest financial autonomy [see: Oulasvirta, Turała 2009; Patrzalek 2010] – only they may collect local taxes and numerous local fees. Districts and regions, on the other hand, rely heavily on transfers from the central budget [Hanusz, Niezgoda, Czerski 2009]. Communes, which are the most autonomous territorial units in Poland and, at the same time, responsible for the greatest scope of tasks, receive (data for 2011) 29.5% of their incomes from local taxes, fees, incomes from property and other sources of own incomes. Further 16.0% comes from personal and corporate income tax shares awarded to communes, while 30.7% comes from general grants. The remaining 23.8% of communes' incomes comes in the form of targeted grants.

3. Income equalization mechanisms: Poland

Polish local governments on all levels are financed through a complex system of incomes which is composed of own sources of incomes (most notably: local taxes and fees as well as incomes from property) and transfers from the state budget (general and specific grants) [Owsiak 2005].

Given the significant spatial differentiation of socioeconomic development levels, wealth and taxation bases, the system of financing Polish local governments includes an equalization mechanism within the system of general grants – in the so-called "equalizing" and "balancing" parts of the general grant, to be more precise. Both these parts of the general grant system participate in the equalization mechanism, albeit differently. The detailed regulations on how to calculate the equalizing and balancing parts of the general grant are included in the Local Government Incomes Act of 2003 (Journal of Laws, no. 203/2003, item 1966).

The equalizing part of the general grant is designed primarily to protect the economically weaker territorial entities by providing them with additional incomes which are meant to compensate for the fact that their *per capita* incomes from chosen local taxes and fees as well as from shares in the personal and corporate income taxes are relatively low (in practice this means that every commune/city whose incomes from sources mentioned above are less than 92% of the national average receives this part of the general grant) [Strzelecki (ed.) 2008]. This part of the general grant system is financed from the state budget.

The equalizing part of the general grant is comprised of two components. The first of the two, referred to as or "primary" is received by those communes (cities) where the *per capita* incomes from six local taxes (property tax, rural tax, forest tax, tax on the means of transport, lump-sum income tax, tax on civil law contracts), chosen fees as well as PIT and CIT are less than 92% of the national average. The equalizing power of this component of the general grant is relatively great and may reach up to 80% of the difference between the average incomes from the mentioned sources and the actual incomes in a given commune or city. Figure 1 shows how significant this component of the general grant is in flattening the disparities in incomes from local taxes and fees between communes. It is enough to say that once applied, this mechanism ensures that communes have at least 81.57% of average *per capita* incomes from the said sources.

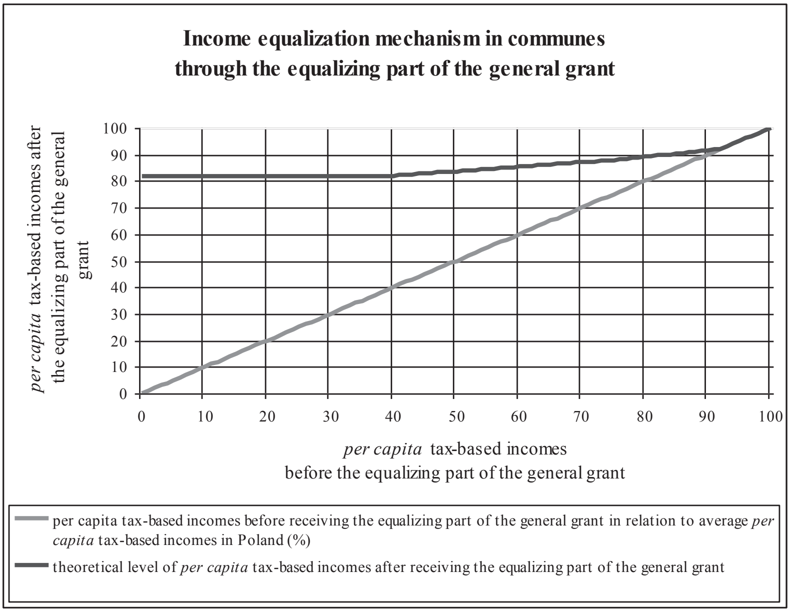

Figure 1. Income equalization in communes through the equalizing part of the general grant

Source: own elaboration.

On the other hand, the balancing part of the general grant serves the purpose of further equalization of income disparities between territorial units. What makes this part specific is that it provides a framework within which resources are redistributed between territorial units directly, i.e. territorial units which generate tax-based incomes which are significantly above the national average are supposed to contribute towards a fund which is then shared between the less wealthy territorial units. In other words – in order to increase the level of incomes of some territorial units, it is first necessary to reduce incomes of others. Figure 2 shows the strength with which the income equalization system affects the communes generating the above-average tax-based incomes through the contributions towards the balancing part of the general grant.

The role of general grants in financing local governments in Poland is significant. In 2011 the amounts of general grants transferred from the state budget to communal and urban district budgets and their share in total incomes of communes and urban districts were, respectively [Central Statistical Office of Poland 2011]: PLN 35.75 billion (26.94% of total incomes), including:

- equalizing part: PLN 5.99 billion (4.51% of total incomes);
- balancing part: PLN 0.97 billion (0.73% of total incomes);
- educational part: PLN 28.43 billion (21.43% of total incomes);
- other general grants: PLN 0.37 billion (0.27% of total incomes).

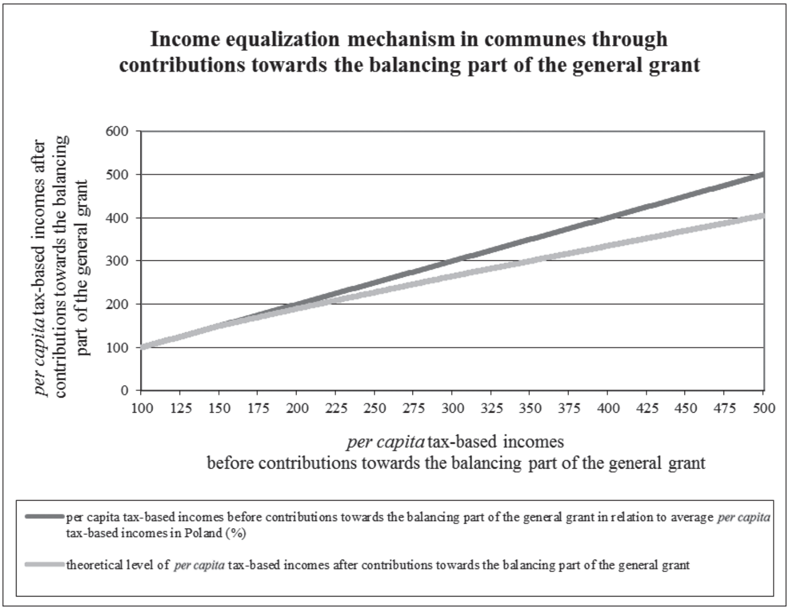

Figure 2. Income equalization in communes through the balancing part of the general grant

Source: own elaboration.

The grants transferred to Polish local governments are predominantly general, automatic and non-matching. Within this group, the balancing part and equalizing part of the general grant are income-based, while the educational part of the general grant is expenditure-based.

The general grants are mostly financed from the state budget – the educational part and the equalizing part of the general grant are transferred from the central government budget to local budgets. Only the balancing part of the general grant is redistributed amongst territorial units on all three levels of administrative division (communes, districts and regions).

In addition to general grants, Polish local governments participate in revenue sharing relating to the Personal Income Tax (PIT) and the Corporate Income Tax (CIT). Communes receive 39.34% of PIT revenue and 6.71% of CIT revenue, districts – 10.25% of CIT revenue and 1.4% and regions – 1.6% of PIT revenue and 15.9% of CIT revenue. Value Added Tax is not shared and remains in the central government budget in full. Formally speaking, these incomes are own incomes of local governments, even though their characteristics make them more similar to general grants. Communes and urban districts received as much as 20.62% of their total income from these tax sharing arrangements in 2011.

The remaining incomes are own incomes and specific grants. The data for 2011 shows that own incomes (apart from shares in PIT and CIT) amounted to 32.47% of total incomes in communes and urban districts. At the same time, specific grants gave 19.97% of the local governments' incomes.

4. Conclusions – strength of equalization

Polish local governments on all levels are financed through a complex system of incomes which is composed of own sources of incomes (most notably: local taxes and fees as well as incomes from property) and transfers from the state budget (general and specific grants) [Owsiak 2005].

Table 1. Strength of equalization in Poland, 2011 statistics

POLAND (2011) **Commune's name** (commune type) percentile according to tax-based income	**Tax-based income** (p.c., PLN)	**Tax-based income relative to average** (100 = average)	**Equalizing grant income** (p.c., PLN)	**Total: tax-based income + equalizing grant income** (p.c., PLN)	**Total: tax-based income + equalizing grant income relative to average** (100 = average)	**Other general grant income** (p.c., PLN)	**Total: tax-based income + equalizing grant income + other general grant income** (p.c., PLN)	**Total: tax-based income + equalizing grant income + other general grant income relative to average** (100 = average)	**Targeted current grant income** (p.c., PLN)	**Total: tax-based income + equalizing grant income + other general grant income + targeted current grant income** (p.c., PLN)	**Total: tax-based income + equalizing grant income + other general grant income + targeted current grant income** (100 = average)
1	2	3	4	5	6	7	8	9	10	11	12
Potok Górny (rural commune) minimum	283.4	**22.2**	872.2	1,155.5	**81.0**	758.7	1,914.2	**96.0**	609.3	2,523.5	**94.8**
Raków (rural commune) 10th percentile	520.0	**40.7**	629.9	1,149.9	**80.6**	773.8	1,923.7	**96.5**	671.9	2,595.6	**97.5**
Wyśmierzyce (urban-rural commune) 20th percentile	596.9	**46.8**	583.1	1,180.0	**82.7**	731.8	1,911.8	**95.9**	794.4	2,706.2	**101.6**
Janowo (rural commune) 30th percentile	672.9	**52.7**	536.2	1,209.1	**84.8**	644.8	1,853.8	**93.0**	880.5	2,734.3	**102.7**

1	2	3	4	5	6	7	8	9	10	11	12
Mikstat (urban-rural commune) 40th percentile	755.6	**59.2**	380.7	1,136.4	**79.7**	761.0	1,897.4	**95.2**	403.3	2,300.6	**86.4**
Zduny (urban-rural commune) 50th percentile	834.7	**65.5**	323.9	1,159.7	**81.3**	959.1	2,118.7	**106.3**	404.8	2,523.5	**94.8**
Borów (rural commune) 60th percentile	936.6	**73.4**	226.4	1,162.9	**81.5**	678.3	1,841.2	**92.4**	429.6	2,270.8	**85.3**
Malbork (urban commune) 70th percentile	1,052.7	**82.5**	125.8	1,178.5	**82.6**	508.4	1,687.0	**84.6**	406.3	2,093.3	**78.6**
Słubice (urban-rural commune) 80th percentile	1,202.9	**94.2**	53.8	1,256.7	**88.1**	407.7	1,664.4	**83.5**	431.6	2,096.1	**78.7**
Mińsk Mazowiecki (urban commune) 90th percentile	1,474.1	**115.5**	0.0	1,474.1	**103.3**	557.2	2,031.2	**101.9**	216.4	2,247.7	**84.4**
Kleszczów (rural commune) maximum	33,124.0	**2,595.3**	−9,143.2	23,980.8	**1,681.2**	998.8	24,979.6	**1,253.0**	256.5	25,236.2	**947.8**

Source: own elaboration.

Table 1 presents details of the equalization mechanism for 11 chosen communes in Poland – starting with the commune with the lowest *per capita* tax-based income, through a selection of communes with increasing values of *per capita* tax-based incomes and, finally, the commune with the highest level of *per capita* tax-based incomes.

Unsurprisingly, the strongest equalizing impact is made as a result of equalizing grants (equalizing part and balancing part of the general grant). In all the cases apart from one (highlighted in Table 1) the equalizing grants lead to strong convergence on income levels.

This impact is further strengthened (in all cases but the one highlighted) by the educational part of the general grant which is referred to as "other general grant income" in Table 1.

The impact of targeted current grants is more ambiguous. In some cases they lead to convergence of income levels, while in others their impact is to the contrary.

All in all, these cases show clearly that the strength of the equalizing system is significant, leading to major reduction of income level amplitudes thus supporting the working hypothesis. It may be concluded that Polish regulations indeed favor the territorially balanced approach to regional development, supporting local governments with relatively low income level at the expense of development engines characterised by greater levels of income – in particular through the balancing part of the general grant which redistributes incomes horizontally between local governments.

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