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# Overcoming the contradictions of the tax system and pension contributions

**Streszczenie:** Celem artykułu jest przedstawienie zasadniczych problemów występujących przy konstruowaniu systemu emerytalnego w Polsce. Pretekstem do podjęcia tematu była propozycja wycofania się z zapisu o limicie składek wpłacanych na ubezpieczenie społeczne. Posługując się argumentacją teoretyczną, przeglądem literatury i analizą podstawowych danych o bieżącym stanie finansów publicznych,

autorzy wskazują, jakie skutki powoduje manipulowanie zasadami określającymi funkcjonowanie systemu emerytalnego. O ile w krótkim okresie rezygnacja z limitu opłacanych składek poprawia saldo finansów publicznych i zmniejsza nierówności dochodowe, to w dłuższym okresie prowadzi do dodatkowych napięć w finansach publicznych i pogarsza wskaźniki spójności społecznej.

**Słowa kluczowe:** system emerytalny, nierówności dochodowe, stabilność finansów publicznych, progresja podatkowa

## Overcoming the contradictions of the tax system and pension contributions

**Summary:** The purpose of this article is to present the basic problems arising when constructing the pension system in Poland. The pretext to take up the subject was the proposal to withdraw from the limit on social security contributions. Using theoretical arguments, literature review and analysis of basic data on the current state of public finances, the authors

indicate the effects of manipulation in the principles of the functioning of the pension. While in the short term giving up the limit of paid contributions improves the balance of public finances and reduces income inequalities, in the long run it leads to additional tensions in public finances and worsens social cohesion indicators.

**Keywords:** pension system, income inequalities, public finance stability, tax progression

JEL H23, H55, H68, J32

The efficiency of any public finance system – tax collection, transfers and expenditures – must always be assessed in terms of the two fundamental functions that the system must perform. On the one hand, it is intended to foster social cohesion, which manifests itself in

a sense of social justice, wide access to public services, acceptance of economically justified inequalities in the distribution of income and wealth, integration of various socio-cultural groups, and mutual trust between the state and economic operators, both households

**and entrepreneurs. On the other hand, the system must foster capital formation, i.e. saving and investing, without which there is no development. It is not only about physical capital, including infrastructure, and financial capital, but also about human and social capital.**

There is no ideal situation in this respect anywhere in the world; after all, there are systems that are closer to it than what we have managed to shape in Poland so far. Improving the existing system (there are worse) is a permanent process (Kołodko, 2019b; Postuła, 2017). No wonder, then, that from time to time its various threads come to the fore. The same is true nowadays and that is why it is worth to pay special attention to some of them.

### Dispute over the 30-fold limit

The functioning of the pension scheme is extremely complicated, because apart from a typically conflicting situation that we have to deal with in the system of public finances (the stream of taxes paid and transfers received and public goods is different for individual entities and social groups), there is also the redistribution in time. So, not only does someone else pay contributions/taxes and someone else receives benefits, but there is also a shift of transfers by at least one generation.

It is worth recalling the basic arguments that prompted the legislator to introduce a limitation in the payment of contributions. The 30-fold limit was introduced together with the pension scheme reform in 1998 (Ustawa, 1998). It means that: *The annual calculation basis for retirement pension and social security insurance contributions* in a given calendar year may not be higher than the amount corresponding to the 30-fold amount of the forecasted average monthly salary in

the national economy for a given calendar year (ZUS, 2018).

By introducing such a limit, it was decided to opt for a defined contribution system where the future benefit is based on the amount of contributions paid throughout working life (Góra, 2001, 2003). In this respect, Poland has followed most of the member countries of the Organisation for Economic Co-operation and Development (OECD), where the defined contribution model became common, which has a number of advantages over the defined benefit system, where the amount of a pension depends on factors other than the sum of benefits paid. These may include seniority, last salary, or the nature of the profession.

The advantages of such a system are:

- A specific justice understood as: you get what you paid in.
- Limiting the grey market, because only when being officially employed and paying contributions you save in the pension scheme.
- Promoting longer working lives after reaching the retirement age, because the longer you work and pay contributions, the higher the future benefit.
- Some protection against demographic change, as extending life expectancy automatically reduces the current benefits that result from the quotient of accumulated contributions and the projected number of months of life that remain after retirement.

After all, one should remember about the limitations of the defined contribution model:

The pay-as-you-go financing of the system causes tensions when the next generation of employees is significantly less numerous than the previous generation, because the relatively large benefit stream resulting from the number of employees in the previous generation, and thus the

value of the paid contributions, will have to be financed by a much smaller number of economically active employees in the future.

By its very nature, the defined contribution system does not include a redistribution mechanism, i.e. income inequalities among employees automatically translate into the income structure of future pensioners.

The room for manoeuvre in manipulating basic parameters such as retirement age or current contributions only changes the structure of financial flows over time, but the degree of system balance does not change. Higher contributions paid today increase the income of the Social Insurance Fund (FUS), but at the same time determine higher benefits in the future.

The same applies to the case of increasing the retirement age. The current situation is getting better, because we work longer and pay contributions, while fewer people receive benefits. However, this means much higher expenditure in the next period. More deposited contributions – due to a longer period of professional activity – automatically translate into higher benefits, which are additionally increased as the retirement age is raised. This reduces the number of months of life left after retirement.

Being aware of these features of the defined contribution scheme, two important solutions have been adopted to limit its disadvantages:

- the institution of a minimum pension has been established, to which those who have worked a certain number of years (25 for men and 20 for women) are entitled, even if the quotient of accumulated contributions/the number of months in retirement gives a smaller amount than the administratively established minimum pension (Chłóń-Domińczak, Strzalecki, 2013);
- a mechanism of a 30-fold limit has been introduced.

The multiplier of 30 was set quite arbitrarily – it might as well have been 25 or 40, although the authors of this proposal took into account the consequences of its amount both for the state of public finances and the inequality in the distribution of income of different types of households. Contributions are, therefore, not so much state income, but a loan granted by the contributors, which has to be returned when the employee becomes a pensioner. While forcing such a solution, it was argued that high salaries should not be charged with contributions in order not to pay very high pensions afterwards.

The defined contribution system is capital-based (I get as much as I paid in), but it is financed on a pay-as-you-go basis, based on intergenerational solidarity. It is the current working and earning generations that contribute to the pensions currently paid out, which are obtained by those who once maintained the previous generation of pensioners in a similar way. So, if we were to increase the amount of contributions paid today and there were fewer workers than pensioners in the future – and this is what will happen as a result of the inevitable demographic processes – we would be giving our children and grandchildren a difficult future; the few working would have to finance numerous and, in the growing number of cases, high, sometimes very high, pensions.

Thus, while a departure from the 30-fold criterion would improve the public finance balance in the short term, additional tensions in the state finances would arise in the long term. Yet, we already have plenty of them. All these economic arguments were certainly taken into account in the government's decision to withdraw from the idea of abolishing the 30-fold limit, but essentially it was done for political reasons. Tensions within the ruling party caused the government to doubt that there were chances of passing

the already submitted bill in the Sejm. In total, it is good that this change has been abandoned, because the elimination of the existing rules would not only have positive effects but also many negative effects. Moreover, such important adjustments to the social security system should not be made in a hurry just because next year's budget already lacks several billion zlotys.

There were two objectives for the cancellation of the upper limit, beyond which contributions would not be deducted from remuneration. First, it was about additional revenues to the public finance system. If the total remuneration, regardless of its amount, is subject to contributions, the FUS records higher income from contributions paid by the employee and the employer; it is estimated that this would be about PLN 7.2 billion in 2020. Thus, the subsidy from the state budget to the structurally in deficit FUS automatically decreases. This operation has a positive effect on the balance of the state budget through lower expenditures rather than higher revenues. The revenues of central, local government and National Health Fund (NFZ) budgets are even decreasing, as social security contributions are deductible from income, so the contribution of all salaries reduces the basis for calculating the personal income tax and the health insurance contribution. It can be estimated that the state budget would gain about PLN 5 billion net in 2020, which is a combination of a lower subsidy to the FUS and lower revenues from the personal income tax, PIT.

Secondly, the 30-fold limit means that the Social Insurance Institution (ZUS), does not have to pay very high pensions to people who previously earned a lot. Currently, about 370,000 employees have income above this determined level. If they were to pay monthly social security

contributions from their, sometimes very high, income, over time they would also receive very high pension benefits, sometimes even several dozen times higher than the lowest benefits, with all the consequences both for the revenue side of the public finance system and for the increase in the scale of income inequality in society. While such situations can be tolerated in the case of private funded pension schemes, where too great an imbalance can be addressed by an appropriate personal income taxation system, they are more difficult to be accepted in relation to state schemes.

However, it should be remembered that the 30-fold level makes the tax and contribution system degressive. If the salary exceeds 30 times the average salary during the year, the monthly disposable income increases because the person no longer pays social security contributions. These contributions were deducted from taxable income, so now – when they no longer are – the progressive PIT burden increases. As a result, we have a system in which there is a range in which the more you earn, the lower the relative burden of the received salary. After exceeding the 30-fold limit (in 2019 it was PLN 142,950), contributions are no longer paid from the remuneration, and the remuneration is only subject to personal income tax.

Therefore, we have created a tax and contribution system that favours those who earn better. They are less taxed because they can choose self-employment with fixed nominal contributions paid to the ZUS and linear PIT, and when they are employed, they benefit from the 30-fold limit.

For earnings exceeding the 30-fold limit, the scale of personal income tax and contributions is decreasing and it is increasing again only in the case of much higher earnings, where progressive PIT is



**Table 1 Salaries of employees under employment contract according to the rules in force in 2019**

Annual gross salary	Annual net salary	PIT and contributions in % of gross salary
60 000	42 660	28,9
120 000	83 474	30,4
156 000	104 255	33,2
168 000	113 030	32,7*
180 000	119 970	33,4
240 000	158 370	34,0

\* decrease

Source: Own calculations based on applicable regulations..

becoming more and more important, i.e. cumulative income exceeds the highest tax threshold.

The entire fiscal system is degressive when we take into account indirect taxes, which burden the lower-income population to a greater extent, who spend on an ongoing basis a relatively large part of their disposable income (sometimes even the whole of it, because they are unable to save anything), each time paying the value added tax (VAT) or excise duty, integral to the expenditure. Studies taking into account the propensity to consume of various income groups confirm that the tax system in Poland is degressive. The scale of the relative burden with contributions and taxes – PIT and VAT – drops sharply, in particular, among self-employed people (Kuzińska, 2002; Tomkiewicz, 2016).

The cancellation of the contribution payment limit seems sensible at first sight, because it increases public revenues and reduces the degressivity of the tax system. However, a comprehensive look, with a longer time perspective of the analysis, shows that the situation is not so obvious. In the long run, the state of public finances could deteriorate.

By the way, it is also worth remembering about lower revenues of local governments (it would be about PLN 600 million in 2020) and the NFZ. Additional negative financial consequences for some

parts of the public finance system, the size of which is difficult to estimate, would also be:

- lower income tax revenues from the corporate income tax (CIT), and the cancellation of the contribution payment limit would mean a higher cost for companies, and thus a lower tax base;
- higher expenditure of public institutions related to wage costs incurred for hiring employees.

A similar problem, i.e. short-term benefits and long-term costs, exists in the case of income diversification. If the 30-fold limit is cancelled, income inequalities will fall in the short term, because high incomes would be subject to higher contributions, which would reduce the disposable incomes of people with salaries higher than this 30-fold limit. In the future, though, they would receive significantly higher pensions, which would imply significant inequalities, all the more so because at the same time those who worked part of their lives on the so-called junk contracts, would start to retire.

It is also worth noting that departing from the 30-fold rule would increase personnel costs as a result of increasing the amounts that employers would have to pay to the ZUS. This applies, in particular, to the costs associated with the employment of high-class, and thus, sig-

nificantly highly paid specialists. For this reason, well-managed companies would not go bankrupt, but their owners' profits would relatively decrease. It is difficult to determine clearly what would be the final effect of such a redistribution of income on investment in the entire national economy, since capital would be formed in other places and would also be invested elsewhere and by someone else. It is worth examining this aspect of the case further.

### Pillars of a good system

A good contribution and tax system must be based on several assumptions. Above all, it is necessary to take care of a long-term and dynamic socio-economic balance. Pensions are intended to allow for a decent living with relatively balanced public finances. People cannot be scared that the ZUS will go bankrupt, because it will not go bankrupt. This is legally impossible and politically unacceptable. It is possible, unfortunately, that a scenario will happen in which the majority of public funds will have to go to the pension system instead of education, science, culture, health and environmental protection. This would erode social cohesion and would be damaging to the accumulation of capital, which would slow down the overall pace of development and, consequently, hinder or even prevent the improvement of welfare. Therefore, on the one hand, the structure of public spending should be rationalised – for example, by moderating wasteful armaments spending or verifying poorly addressed social transfers – and, on the other hand, additional revenues should be sought that do not increase the state's liabilities in the future (Kołodko, 2019a).

The fundamental role of the public finance system is to collect and allocate funds necessary to finance public goods and services and to correct the market distribution of income, which leads to

socially unacceptable income and, over time, property inequalities (Tomkiewicz, 2017). This is not only an ethical issue, but it is also related to the effectiveness of management, against which excessive income inequalities turn (Fischer, 1999; Kołodko, 1999; Malinowski, 2016; Tanzi, Chu, Gupta, 1999). The tax system must be based on indirect taxes, especially the VAT, and the progressive personal income tax (PIT).

In the course of these considerations, several important issues must not be lost from sight. First of all, it is important how many thresholds we have and what are the tax rates, but no less important is to cover the vast majority of income groups with the system. The highest tax threshold is currently exceeded by only about 3% of taxpayers, which does not correspond to the actual income distribution. In other words, many of those who *de facto* earn relatively much money are not covered by the progressive tax. It is here, where additional public revenues should be sought. They should also feed the budgets of local governments, as the growing scale of their tasks requires growing revenues.

Secondly, there must be no illusion that the problem would be solved by the simultaneous cancellation of the 30-fold limit and introduction of a maximum pension. Such a solution is questionable from a legal point of view (the law does not have a retroactive effect; by taking up work and paying contributions, one has acquired the right to a pension based on the contributions paid). In addition, it would create chaos in the system, as different people would receive a benefit calculated in different ways. Income inequalities should be corrected by the progressive PIT and not by various manipulations that spoil the system.

Thirdly, the current income of the pension system must be ensured by making

it universal. So, “junk contracts” cannot be tolerated when actually the employee works full time. All salaries should be accompanied by contributions to the ZUS.

Fourthly, there is no economic justification for intentional measures to support entrepreneurship, such as the so-called small ZUS. After all, contributions to the ZUS are not only future pensions but also a share in financing current benefits. There is, therefore, no reason why entrepreneurs should pay less than employees. Above all, it is necessary to be aware that the part of the social insurance contributions paid to the ZUS by the entrepreneur is neither a tribute nor a charity, only a part of the payment for the employed labour force. It is an integral part of the wage, i.e. the price of the labour force, whose value in market economy conditions is determined by the cost of its reproduction throughout its life cycle, including the post-productive age.

And finally, fifthly, long-term savings must be supported. From this point of view, Employee Capital Plans (PPK) are a worthy institutional solution because they encourage the formation of an additional stream of long-term savings, which can be the basis for key investments. Of course, it is crucial to ensure effective public oversight and appropriate regulation of private funds managing the collected savings.

One cannot uncritically succumb to the view that the PPK system reduces the current disposable income of employees and employers. Yes, savings by nature constitute unconsumed income, but the PPK is a kind of justifiably enforced additional savings, since households are not willing to put off more of their own. Over time, these funds – with interest, if invested cost-effectively and in a dynamically sustainable economy this is what happens in the long run – will finance consumption, while immediately, in the national econ-

omy the willingness to save is increasing and the pool of funds that can be used to finance development is growing.

For years, it has been indicated that the Polish economy suffers from an accumulation rate which is too low in relation to development needs (EBRD, 2004; Hausner, 2013; Kołodko, 2007). The government is also fully aware of this fact (Strategia, 2017). Domestic savings and investments, which are almost equal (current and capital account balance is about 0.7% in 2019) at the level of about 18% of GDP, are much less than those of countries that have recorded a qualitative development leap. This applies to the already more advanced Asian economies (World Bank, 1993) and post-socialist transition countries (EBRD, 2019). In Poland also the investment rate was already much higher than nowadays, as both the relative level of domestic savings and the inflow of foreign investments were higher (Kołodko, Tomkiewicz, 2019).

### **Multilemma of 30-fold limit cancellation effects**

Hence, the problem is highly complicated, because we are looking for a creative compromise between conflicting interests: ourselves as current employees and future pensioners, employees and entrepreneurs, richer and poorer, those paying and receiving contributions, central and local budgets, public debt that is current and burdening future generations, immediate and prospective period.

There is no ideal answer here, because we are looking for a solution not so much to a mathematical equation – already complex enough anyway – but to an economic, social and political multilemma.

The neologism of the “multilemma” – as opposed to a simple alternative such as the dilemma of either-or, or the more complicated trilemma, where the choice of two out of three options excludes the

third one – is introduced here to emphasize the multifacetedness of the extended space of the selection made. Two trilemmas are particularly well known in economics – the obvious one of Robert Mundell's, which refers to the relationship between the exchange rate, interest rate and production (Begg, Dornbusch, Fischer, Vernasca, 2014) and the debatable one of Dani Rodrik's, which considers the relationship between democracy, advanced globalisation and the sovereignty of states (Rodrik, 2011). The multilemma discussed here requires taking into account several factors of different force of influence, in different time horizons, with various financial, economic, social, cultural, demographic, and political consequences. Economic policy preferences for the good sides of specific factors determine negative consequences for others.

For example, the simple cancellation of the previously binding 30-fold limit of the average wage as the maximum remuneration for work charged with the obligatory social security contribution to the ZUS has its good points in the form of a certain reduction of income inequalities and a certain improvement in the current state of public finances, but at the cost of an increase in these inequalities and a deterioration in the balance of public finances in the long run. Alongside, the position of local government budgets is deteriorating. The costs of entrepreneurs are also rising.

It is, therefore, necessary to avoid short-termism and selectivity – sometimes biased – in addressing this issue. Only a comprehensive and dynamic approach to the problem can provide a chance to solve it properly, which must be kept in mind when looking for the optimum in this matter. Looking for it, though it cannot be found. The thing is to get as close to it as possible. The contradictions that exist in this multidimensional space between

the various effects of actions taken can be presented collectively – see Table 2.

Of course, the above assessments are blurred and, thus, must be debatable. Will the indeed relatively lower incomes of highly paid professionals result, *ceteris paribus*, in the emigration of some of them and, consequently, in a relative decline in the supply of their services on the domestic labour market? Maybe so, but it does not have to be the case. It depends on a number of other factors, above all, whether, in the context of culture and family, they will want to leave and whether there will be a demand for their employment on better pay terms abroad. Will production costs, and consequently, inflation, actually increase?

It depends, because instead of pushing up the overall costs due to the increase in the costs of labour (and trying to pass this on to the increase in the prices of the products and services sold), the profits of businesses may fall. This, in turn, would result in an alternative: lower consumption of capital owners or smaller private investments? Within the framework of this multilemma, each and every answer gives rise to another question.

Therefore, it is worthwhile to discuss the target tax and contribution system seriously – with social concern, but also with technocratic responsibility, with political seriousness, but also with accounting precision. Many issues were successfully solved in Poland during the political transformation, often better than in other countries facing similar challenges (Kołodko, Tomkiewicz, 2019; Piątkowski, 2019; Kołodko, 2020), in which a relatively better starting point for a full-blooded transformation three decades ago certainly helped (Kołodko, Rutkowski, 1991). Unfortunately, this still cannot be said about the pension scheme. Due to changing social and economic conditions, in particular demographic

Table 2 **Multilemma of the cancellation of the 30-fold limit of the forecasted average monthly salary in the national economy as the basis for calculating pension and security insurance contributions**

Sphere of effects	immediate/short term	long-range/long term
balance of the state public finances	+	-
local government budgets	-	-
income of highly paid personnel	-	+
span of incomes	+	-
costs of production and providing services	-	n
inflation	-	n
supply of highly qualified labour force	n	-
social cohesion	-	+

+ beneficial change; – unfavourable change; n – neutral effect  
Source: own study.

and financial determinants, such a system cannot be rigid, fixed once and for all. It must be tested in practice and periodically reviewed to ensure that it fulfils its essential functions as well as possible – promoting social cohesion and capital formation. Yet, it cannot be changed too often, and certainly not hastily, under the influence of immediate economic difficulties and an emotional political impulse.

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