



Economic Survey of Poland, 2008

How to make the recent growth performance more sustainable?

How to increase labour mobility both across and within Polish regions?

How to achieve a better macroeconomic policy mix?

How to raise work incentives and economic efficiency?

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Summary

Poland has been catching up to the rest of the OECD more quickly in the past two years, thanks to strong growth performance. Substantial job creation has followed years of stagnation. Nonetheless, the economic boom has failed to draw inactive people into the labour market, and unemployment has plunged to below sustainable levels. The short-term outlook is clouded mainly by strong excess demand pressures and rising inflation, despite weakening activity abroad. In the medium term, the sustainability of the expansion is also threatened by adverse demographics and persistently low labour force participation.

- Monetary policy needs to tighten further to avoid a possible wage-price spiral and to facilitate the eventual adoption of the euro. The government should help by offsetting the fiscal loosening induced by recent budgetary measures.
- Further reductions in the labour tax wedge are needed to improve work incentives, but, tax reform should not endanger the deficit-reduction path presented in the up-dated Convergence Programme, so as to ensure the sustainability of public finances.
- The gaps in housing and transport infrastructures need to be addressed, not least to facilitate labour mobility, reduce regional disparities and ease the restraints on aggregate supply.

A tightening of macro policies is desirable from both short- and medium-term perspectives. The economy continues to grow at above-potential rates, further stoking capacity pressures at a time when headline inflation has already surged well beyond the official target. To prevent jeopardising hard-won credibility, the process of policy rate increases initiated already in April 2007 should be continued. Also, the release of additional information to markets about the Central Bank's expectations of future economic and interest rate developments should be considered insofar as it bolsters perceptions of its commitment to price stability in the medium term. The structural budget

This Policy Brief presents the assessment and recommendations of the 2008 OECD Economic Survey of Poland. The Economic and Development Review Committee, which is made up of the 30 member countries and the European Commission, reviewed this Survey. The starting point for the Survey is a draft prepared by the Economics Department which is then modified following the Committee's discussions, and issued under the responsibility of the Committee.

deficit narrowed in 2007, but the stance of fiscal policy is expansionary in 2008, complicating the task of monetary policy. With further tax cuts planned, the authorities need to provide a credible plan for containing spending so as to cut the deficit to sustainable levels.

Further cuts in the labour tax wedge would raise work incentives but should be funded. Cuts should be targeted on low-income earners so as to ensure cost effectiveness and can be partly funded by reforming early retirement pensions, but other sources of financing will need to be tapped. There is little scope for raising VAT or corporation tax. Yet, revenues from taxes on immovable property – one of the least distortive bases – are low, offering scope for some increase.

Better labour market outcomes would result from greater labour mobility. The first priority would be to overhaul housing policies. The supply of housing is hampered both by the absence of urban zoning plans and by regulatory barriers to the development of a rental market. This limits access to affordable housing, especially in major cities. The solution is to further ease controls on rent increases and enforce eviction of non-paying tenants. More efficient means to facilitate access to home ownership than subsidising borrowing costs should also be considered. For instance, eliminating stamp duties on house purchases would do so with less harm to labour mobility.

Future growth prospects are also darkened by several other barriers. Closing the gaps in transport infrastructure is a key to raising potential. A major challenge is to implement the ambitious spending plans sufficiently rapidly so that the substantial EU funds can be fully and efficiently absorbed without massive cost overruns. Access to the labour market for foreign construction workers should be further facilitated. Public procurement legislation should also be reformed, notably to limit the abuse of appeal procedures and to simplify the delivery of building permits and environmental impact assessments. Public-private partnerships should be given more consideration as they have the potential to enhance efficiency. Growth would benefit from efforts to strengthen competition so as to foster entrepreneurship and innovation. ■

How to make the recent growth performance more sustainable?

During the past two years, Poland has recorded its best economic performance since the late 1990s, with growth exceeding 6%. This was also the second-best performance among OECD countries, allowing for a significant narrowing of the income gaps vis-à-vis the average EU and OECD levels. Since Poland joined the European Union in 2004, GDP per capita has moved from 44 to 48% of the pre-2004 enlargement EU average. Furthermore, after nearly a decade of relative stagnation, employment has finally begun to contribute markedly to gains in living standards, rising by some 3% per year. Meanwhile, labour supply has shrunk, despite a still expanding working-age population. This further decline in labour force participation rates, to especially low levels for older workers and the least skilled, is of great concern. The result has been a spectacular decline in the unemployment rate, from nearly 18% in 2005 to 8½ per cent in the fourth quarter of 2007. At the same time, productivity gains have slowed from the growth rates recorded in the early 2000s.

The flip side of this strong performance has been increasing demand pressures, further abetted by the ongoing global food and energy price shocks, with all the risks that this pernicious combination entails in terms of a wage-price spiral, asset price bubbles and a hard landing further down the road. Thus far, these risks have not materialised to a significant degree, and the spill-over effects from the economic slowdown abroad may offset them. Real GDP is expected to slow to near 6% this year and 5% in 2009. Nevertheless, headline price inflation has already surged far past the 2.5% official target, and labour shortages have emerged in many sectors, causing real wage increases to outpace productivity gains throughout 2007. Meanwhile, a risk could arise that firms' capacity to absorb rising unit labour costs by squeezing margins approaches its limit implying upward pressures on prices. The public sector is also feeling the pinch, as wage demands by various groups have come to the fore, while administered prices are being raised substantially.

In this context, the best way for macro policies to help steer the economy to a soft landing is by taking appropriate action to ensure they are on track to achieve their medium-term objectives. In the case of monetary policy, this means bringing inflation down to its target with an appropriate tightening of monetary conditions. For fiscal policy, this implies providing a credible plan for a sustainable reduction in the general government cyclically-adjusted deficit to reach the 1% of GDP official target in 2011. As regards structural policies, the fact that excess-demand pressures have arisen in a context of still relatively high unemployment and stubbornly low participation rates for many groups is a symptom that the functioning of the labour market is being hindered by significant barriers. One of the key priorities is therefore to lift these barriers in order to fully exploit the substantial scope for boosting employment rates so as to sustain strong potential growth despite the imminent demographic reversal. Two policy areas deserve particular attention in this regard. One is the design of the tax and benefit systems: the high tax wedge on low-wage workers prices some of them out of the

labour market and leaves others with too few incentives to seek registered employment. And on the benefit side, a substantial share of older workers can withdraw from the labour force on favourable conditions well before statutory retirement age. ■

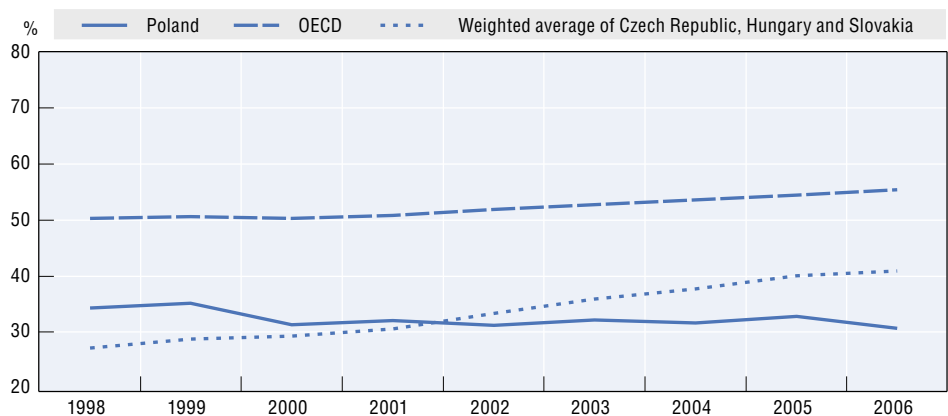
How to increase labour mobility both across and within Polish regions?

The second area concerns policies that impinge on labour mobility within Poland. In spite of widening discrepancies in economic activity across regions, there is little tendency for workers to migrate from high unemployment areas to those with many unfilled jobs (in major cities). The result is a high dispersion of employment rates, both across and within regions. Yet, the fact that a large number of Poles are prepared to move abroad to take job opportunities suggests that the low mobility observed inside the country is not so much a cultural phenomenon, but the result of specific hurdles. Indeed, access to affordable housing in fast-growing urban areas is limited. Housing policies may thus play a key role, not least as regards the persistent under-development of the private rental market. Another contributing factor is the lack of sufficient transport infrastructure, which makes commuting even over relatively short distances difficult. ■

How to achieve a better macroeconomic policy mix?

It is perhaps of limited surprise that headline inflation has risen from less than 1% per year in 2006 to 4% most recently, given the adverse food and energy shocks and the economy's growth performance. While the first factor was naturally unpredictable, excess demand in both labour and product markets has resulted despite a pick-up in potential growth to over 5% per year. The Monetary Policy Council began to raise official rates in April 2007. However, since inflation has risen faster than nominal interest rates, real ex post interest rates have actually fallen. Nevertheless, the real exchange rate has appreciated considerably, leading to a tightening of monetary conditions. Even so, unless this begins quickly to bear down on underlying inflationary pressures, the risk is that inflation expectations will jump and the National Bank of Poland's (NBP) hard-won credibility will be harmed, raising the cost

Figure 1.
THE LABOUR FORCE PARTICIPATION RATE OF OLDER WORKERS HAS BEEN FALLING
As a percentage of age group



Source: OECD, Employment Outlook database.

of bringing inflation down to the NBP's 2.5% target. Achieving the target will also most likely enable the EU price stability criterion for joining the euro area to be satisfied.

The NBP has gone a long way in providing more information to the markets in its periodic publications. Additional steps in that direction could involve the publication of one or more scenarios involving paths of interest rates that would – in the Bank's view – return the economy to the official inflation target over the forecast horizon. Above all, it should be clear that only the members of the Monetary Policy Committee have the authority to speak publicly on policy matters.

One clear benefit of the favourable conjuncture in 2007, and in particular of the sharp decline in unemployment, has been a substantial reduction in the general government deficit to 2.0% of GDP, down from 3.8% in 2006 and a peak of 6.3% in 2003. Both buoyant tax revenues and, to a lesser extent, savings on social security outlays have contributed to this better-than-expected outcome. Also, by bringing the deficit to such a level Poland has paved the way for the abrogation of the Excessive Deficit Procedure initiated by the European Union in 2004. This positive development notwithstanding, a further reduction in the deficit will most likely prove more difficult to achieve in the short run. Two factors point to a widening deficit in 2008 and, barring policy changes, beyond. *First*, when activity slows to a more sustainable level, the contribution from the business cycle to budgetary outcomes will become less favourable: the OECD estimates that this will cost the budget about 0.7 percentage point of GDP. *Second*, the 2008 budget contained measures that together imply a loosening of the fiscal stance (of around 0.8 percentage points of GDP). This makes the task of the NBP more difficult.

In March 2008, the government updated its Convergence Programme, which involves an increase in the deficit in 2008 and steady consolidation thereafter. In this context, the priority for fiscal policy is to stick to the deficit targets as laid out in the Programme so as to keep public finances on a sustainable path. This would result in a structural deficit of 1% of GDP in 2011, an objective that the government is committed to achieve. In the near term, this objective will be difficult to reconcile with the commitment to reduce income taxes in 2009, and the strong upward pressures on expenditures related notably to the co-financing of EU-funded infrastructure investments and the strong increase in public sector wages. Expenditure restraint could be exercised more easily if a multi-year planning framework that includes limits on overall spending were to be adopted. In addition, the government should renew its efforts to raise public sector efficiency, including by considering reductions in employment in the public administration in return for better pay. Beyond that, the authorities could eventually achieve substantial savings by completing the long-overdue final stage of social security reform, in particular the elimination of most of the early retirement schemes. A good step in this direction has been taken with the recently announced intention to shorten the list of professions eligible for early retirement.

A more complete reform would also involve the integration of the special pension system for farmers into the general regime. However, experience has shown that major changes in this sensitive area should not be introduced with a view to realising short-term budgetary gains, but should instead be motivated on efficiency and equity grounds. There may even be some costs involved in the short term, for instance if some form of compensation is offered to those who stand to lose most from reform. Nevertheless, the long-term budgetary gains can be substantial, as they arise not only from the savings on transfer payments, but also from an increase in tax receipts. Hence, such reform should not be deferred even if it increases short-term pressures on the budget. In fact, all measures that stimulate employment, including well designed measures on the tax side, will facilitate the task of the budgetary authorities, at least in the medium term. ■

How to raise work incentives and economic efficiency?

The tax wedge on labour income remains above the OECD average, despite recent reductions. It contributes to low employment rates in the official sector, especially among low-skill workers. To a large extent, this reflects high rates of social security contributions used to finance basic public pension regimes, which, combined with other income-support schemes (including early-retirement and disability benefits), lead to a low effective retirement age. Personal income tax is not particularly high, with the vast majority of taxpayers being in the 19% bracket. Against this background, a longer-term strategy for tax reform should be developed with a view to shifting the overall mix away from labour taxation and on to less distorting bases such as property and environmental externalities. Although a reduction in the overall tax burden would be desirable from a longer-term efficiency perspective, it should not be envisaged before public finances have been put on a clearly sustainable path. In any case, a cautious approach to estimating endogenous revenue gains from growth-enhancing tax reforms should be adopted.

Personal income tax (PIT) rates will be reduced for most taxpayers in 2009 in the context of a simplification of the tax structure. The number of brackets will be streamlined, leaving only two brackets, set at 18 and 32%, respectively. Following this, Poland will have one of the lowest top marginal tax rates in the OECD, both in statutory and effective terms. Nevertheless, the possibility of going one step further and adopting a flat tax – set at a rate similar to corporate income tax (though that might not yield enough revenue for current needs) – is being envisaged. A flat tax would have the advantage of discouraging tax avoidance and encouraging entrepreneurship, but it would provide less redistribution than the current progressive rate structure. Given that under the Polish system capital and labour income are taxed at different rates – consistent with a semi-dual income tax system – the desire to harmonise the top marginal rate with the 19% rate on corporate income is also understandable, at least in principle, so as to avoid creating fiscal incentives to incorporate. However, the gap between the two rates does not seem large enough for this to be a major concern. In any case, given the overarching objective of boosting employment, especially among low-skill

individuals, a higher priority is to reduce the tax wedge so as to enhance work incentives.

In order to maximise the cost-effectiveness of reductions in the tax wedge, cuts should be substantial, targeted at the bottom end of the wage distribution and focused on social security contributions. More specifically, their size should be highest at the minimum wage level and gradually withdrawn so as to be zero at around 70% of average earnings (which corresponds to 1.75 times the minimum wage). All components of social security contributions could be considered for a reduction, except old-age pensions in order to preserve the actuarial neutrality of that system. Targeted cuts would also help to raise the very low degree of progressivity of the tax system. Another pro-work measure that the government could consider is to introduce an earned-income tax credit. This would encourage labour market participation of marginal groups. However, to be most effective such a measure should take place in the context of a broader welfare-to-work strategy, with stronger emphasis on effective public employment services.

Further reform of the PIT should instead focus on broadening the tax base by eliminating a number of tax allowances. In this regard, the deduction for internet subscriptions has little justification and therefore appears as a prime candidate. Also, the recently introduced child tax relief should be reconsidered. In principle, another sensible measure to broaden the base would be to eliminate the PIT exemption granted to farming revenues. However, it may be politically difficult to reform or, better still, eliminate the special pension regime for farmers and subject their income to personal taxation at the same time. In such a case, reforming the pension regime should be seen as more pressing.

Even if the reform of the social security system were to create some room for the recommended narrowing of the tax wedge, it may not be sufficient to cover its cost, and therefore alternative sources of revenues may have to be sought. Even though statutory and effective corporate income tax (CIT) rates are among the lowest in OECD countries, they are comparable to rates observed in other central and eastern European countries, including those that have recently joined the European Union. Considering the high mobility of capital, raising CIT would be inappropriate to finance the reduction in labour taxation. On the other hand, further CIT rate reductions could be contemplated in the context of a base broadening that would leave the average rate largely unchanged *ex ante*. Another potential source is consumption tax, but both the main value-added tax (VAT) rate and excise duties are fairly high, thus limiting the scope for raising more revenues from these tax bases. VAT reform should focus on the simplification of procedures to reduce compliance costs for businesses. More generally, the tax code should be written more clearly so as to obviate the need for local legal interpretation of specific provisions and to reduce the vulnerability of businesses to arbitrary (and often conflicting) decisions by the two main tax-inspection bodies. The merging of these two agencies would eliminate the duplication of controls and generate useful savings.

One prime candidate for raising revenues is taxation on immovable property, which is low by OECD standards. This is one of the tax bases with the least adverse effect on economic efficiency. Poland is one of the few OECD countries without a full *ad valorem* (or cadastral) tax on property, even though the technical obstacles to such tax being implemented have basically been lifted. A move to such a tax would raise revenues for municipalities, allowing the central government to reduce its subsidies to sub-national administrations. Alternatively, local authorities could use the higher property tax revenues to eliminate stamp duties on housing transactions, thereby improving labour mobility. In order to facilitate the introduction of an *ad valorem* property tax, the rate should be set initially at a low level and be accompanied by measures to ensure that house-rich/income poor households can afford the tax without having to liquidate their property. ■

How best to stimulate the supply of affordable housing in major cities?

Another important advantage of an *ad valorem* tax would be to provide municipalities with stronger incentives to release zoning plans, given the prospects of higher revenues from new housing developments. By limiting the straightforward availability of land, the absence of such plans is currently contributing to the long-term shortage of housing, in addition to being a potential source of corruption. Their release should in any case be made compulsory. In the short run, however, the main housing supply constraint is rising construction costs owing to labour shortages in that sector. To ease the constraint, the government should enhance its vocational training programmes so as to raise the proportion of unemployed and inactive individuals that can be recruited to this sector. Even so, such measures may take time to bear fruit; in the meantime the authorities should provide easier access to the domestic labour market for all foreign workers, not only for those from its eastern neighbours, as has recently been done.

As in many other OECD countries, the Polish government has also introduced a number of initiatives to facilitate access to home ownership. The success of these measures in closing housing gaps has generally been mixed. One of them, the deductibility of mortgage interest payments has been repealed for new loans since 2007. This is appropriate, given that without taxation of imputed rents or capital gains, there was no justification for allowing interest costs to be deducted. However, another form of borrowing subsidy was put in place in 2006 whereby half of the mortgage interest costs are absorbed by the government for the first eight years of a loan. The programme is legitimately aimed at low-income households, but its design constraints are such that it squeezes out potential beneficiaries in large cities – due to high real estate prices – in favour of more affluent home buyers in rural areas. Although with some adjustments the programme could be made more equitable across regions, this could substantially raise its cost. Hence, in light of its limited usefulness, the programme should be reconsidered. A better approach would be to eliminate stamp duties on house purchases and to support the development of the mortgage market by increasing the availability of funding alternatives for mortgage institutions, including by allowing them to use a broader range of long-term financial instruments, with appropriate

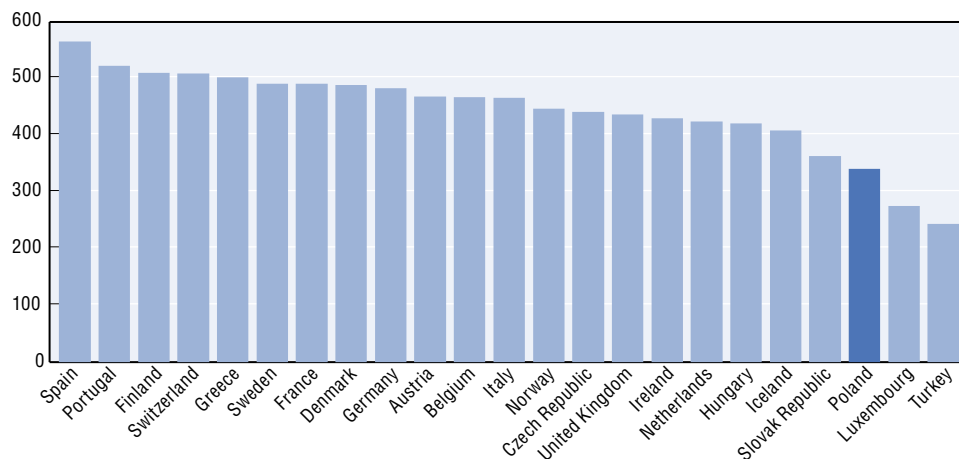
supervision. In addition, the introduction of escrow accounts would help protect buyers' down payments in case the developer goes bankrupt.

More generally, housing policies should avoid creating too strong a bias in favour of home ownership, not least because transaction costs hamper labour mobility in the case of a move. In this regard, a number of regulatory barriers stifle the development of a dynamic rental market in Poland, with adverse effects on labour mobility. For instance, the combination of controls on rent increases and eviction procedures that allow non-paying tenants to remain makes the expected investment return on rental housing relatively unattractive and may contribute to the prevalence of informal arrangements between landlords and tenants. The result is an under-supply of new rental facilities, a lack of modernisation of the existing stock and, in cases of informal letting, tenants with little or no protection. Furthermore, given that rents can generally be fully adjusted to reflect market conditions only when tenants leave, controls tend to reduce turnover, as tenants prefer to remain locked in at what become below-market prices. In this context, the best course of action would be to work towards further easing of the controls on rent increases but to consider introducing means-tested allowances so as to help low-income households cushion the impact of possibly steep increases in rents. In addition, although tenants must remain adequately protected from exploitation on the part of unscrupulous landlords, eviction should be enforced in the case of non-paying tenants. ■

How to improve transport infrastructure rapidly?

In the coming years, Poland will implement a vast programme of building and renovating transport infrastructure, financed through substantial EU and public resources. Yet the use of EU funds is subject to a limited time frame, and the deadline for completing many investments has been further advanced by the organisation of the 2012 European soccer championships. Thus whatever obstacles exist – such as labour shortages – have to be sorted

Figure 2.
THE DENSITY OF THE DWELLING STOCK IS ONE OF THE LOWEST IN OECD
 2006 or latest year available, units per 1 000 population

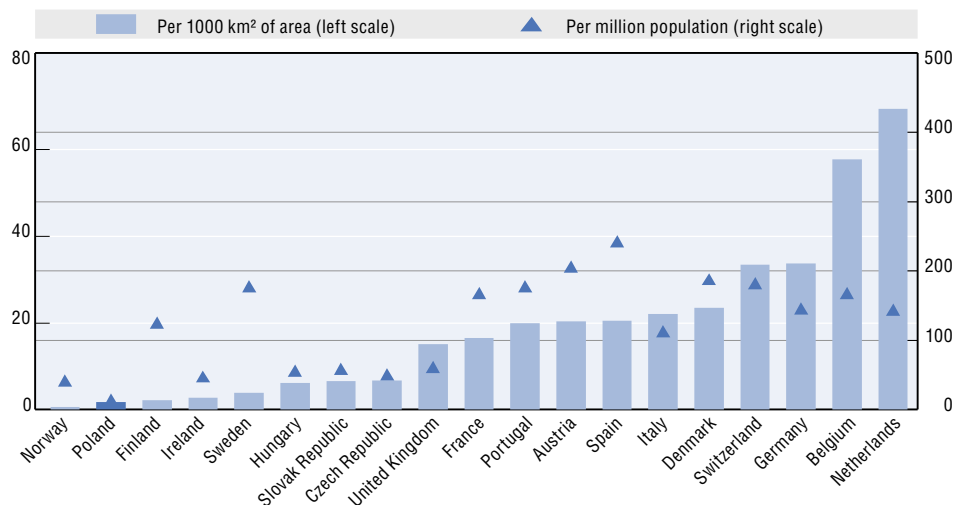


Source: European Mortgage Federation (2007), Hypostat 2006.

out rapidly. Maintaining a high vigilance over possible collusive behaviour among the suppliers of building materials and ensuring tendering procedures are as competitive as possible would be additional helpful steps. More generally, the legal framework needs to be streamlined in many areas, including public procurement (especially the ease with which multiple appeals can be launched), issuance of building permits, environmental impact assessments and archaeological research. Also, adopting a hedging strategy against euro/zloty exposure would allow the funding that is effectively available for projects to be safeguarded. Finally, the coordination among various Ministries and implementing bodies in channelling EU funds should be enhanced. The adoption of multi-year budgeting systems would help not only in this respect, but also in order to address the fiscal demands implied by co-financing.

Closing the transportation infrastructure gap should be guided by efficiency criteria. That is why it is crucial to design and publish a comprehensive top-down strategy based on careful cost-benefit analysis and that addresses long-term prospects and interrelations among the different modes. It must be recognised that, with predictable increases in income levels, several regions in Poland will probably lose their eligibility for EU funds beyond 2013. Therefore the authorities should already actively seek greater private-sector financial involvement in the process of building, maintaining and operating infrastructure, all the more so as the option of blending private and EU funds has not yet been explored. The use of public-private partnerships (PPPs) may in certain cases deliver better value for money and should be treated on an equal footing with public procurement schemes. Hence, the current PPP law should be streamlined. The creation of a central public unit responsible for the oversight and quality control of cost-benefit analyses could lead to the more widespread use of PPPs. In addition, it could help improve the business climate.

Figure 3.
THE MOTORWAY NETWORK IS FAIRLY SPARSE
Kilometres, 2004 or latest available year



Source: European Commission (2007), *Panorama of transport* and New Chronos database.

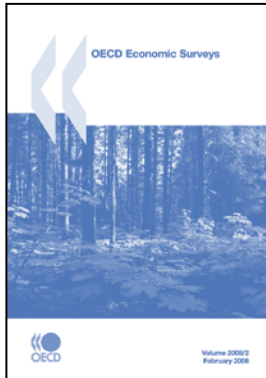
Market regulations and ownership structures should promote fair competition both between and within different transport sectors. Extending tolls to the entire motorway network but also charging passenger cars for using expressways would help to rebalance the modal split that is currently oriented toward roads, with all the implications for the environment and urban planning that follow. In accordance with EU guidelines, reforms in the rail sector require a clear ownership separation of infrastructure and operation in the public conglomerate (PKP Group), which should improve third-party network access. Coupled with a strengthening of the regulator's position, this would also make access-charging policies more transparent. In regional rail services, generalising competitive tendering procedures and creating independent system operators would reap efficiency gains. Finally, air transportation would benefit from the restructuring of the Polish Airports' State Enterprise and from further reducing airports' regional market power by introducing a fixed formula for calculating price caps on take-off and landing fees. ■

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