

Economic Survey of Poland, 2006

Has economic reform gone far enough?

Are monetary and fiscal policies on track?

How can further education reform improve labour market performance and human capital development?

How can tertiary education and adult training be improved?

Should more be done to make work pay and increase mobility?

How can the business framework for entrepreneurship and innovation be improved?

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Summary

Poland's growth performance since 2004 suggests that the process of catch-up with higher-income countries has been renewed. But an improved balance of macroeconomic policies and further efforts to improve structural policies are needed to sustain and accelerate convergence.

- Monetary policy may have temporarily been somewhat too cautious, but it would be easier for the central bank to relax if fiscal policy were put on a sustainable footing, with consolidation focused on social transfers, which have many adverse work incentive effects.
- Links between the education system and the labour market are still insufficient, and the financing of tertiary education is leading to both inequity and inefficiency.
- Weak performance on adult training, reliance on passive income support and too little attention to job-search or mobility requirements contribute to the high level of structural unemployment.
- Growth has been held back by poor framework conditions for entrepreneurship and innovation.

Seek a better balance of monetary and fiscal policies. The National Bank of Poland has acquired a reputation for inflation aversion. It may no longer need to be quite so cautious and could afford to do more in the future to test the limits of available capacity. Although the budget deficit improved in 2005, this was partly due to one-off factors. Clear expenditure priorities need to be defined and enforced, preferably within a multi-year planning framework. Social transfer payments absorb too large a share of public spending and GDP and should be better controlled.

Consolidate and extend the education reforms. Reforms of compulsory education have decentralised education management to local governments. Further steps are needed to align financial and management responsibility with accountability for performance and to ensure flexibility in allocating

This Policy Brief presents the assessment and recommendations of the 2006 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.

resources as needs change. Expansion of tertiary education has increased human capital formation, but it is inefficient to prevent public institutions charging fees; a concomitant reform of student grants and loans could increase equity and overall resources.

Boost employment with active labour market policies and by making work pay. Poland's very poor labour market performance is partly due to the costs of structural change, but many social transfer payments and the large tax wedge act to reduce employment. They need to be changed to strengthen incentives to work. The public employment service must increase its emphasis on job activation, making more use of adult training as well as job-search requirements for benefit recipients.

Raise investment and growth by reducing regulation and improving conditions for entrepreneurs. Sluggish investment and low innovation activity are related to Poland's high degree of regulation; this is due mainly to high public ownership, perceptions of an ambivalent attitude to foreign investment and a considerable burden of bureaucracy, though progress has been made in recent years. Without improvements in all these areas, measures to improve flows of finance and information to small companies and innovators will be less effective. ■

Has economic reform gone far enough?

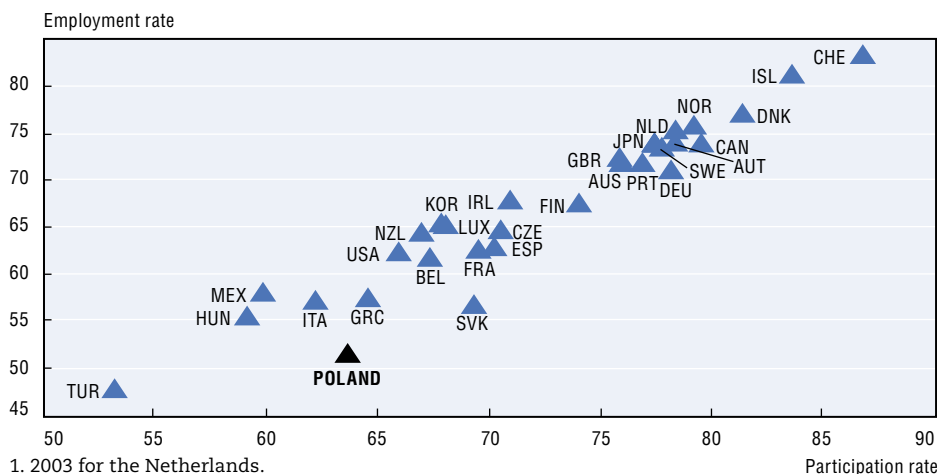
Entering the European Union in May 2004 gave an important boost to the Polish economy. GDP per head is currently under 45% of the EU average, but the long process of convergence has resumed. Although growth waned somewhat during 2005 when real GDP rose by only 3.2%, current prospects are for annual growth of 4½ per cent during 2006-07. EU funds will make an important contribution to improving public infrastructure and support policy in several other areas, provided they are used effectively.

However, numerous underlying economic problems remain. Employment rates are very low: the level of recorded unemployment is high, and there are substantial numbers of economically inactive people (although many of these may be active in the informal economy) even before population ageing really takes hold. In fact, labour market performance in Poland is arguably the worst in the OECD. Despite the need for faster capital accumulation if economic convergence is to continue, let alone accelerate, the share of investment in GDP has remained stubbornly low. Budgetary policy has been rather erratic, with something of a blow-out in 2004, followed by an unexpectedly large improvement in 2005 and uncertain prospects for 2006. These problems require the attention of policymakers, beginning with the maintenance of a strong and stable macroeconomic framework, for both fiscal and monetary policy. ■

Are monetary and fiscal policies on track?

Monetary policy has been criticised for excessive caution, as inflation has frequently undershot its target range. The National Bank of Poland (NBP) tightened policy in mid-2004, in a justifiable response to a surge in inflation; this prompt action, permitted by its independence and determined by its price stability mandate, played a part in preventing any second round effects from the inflation surge. Subsequently, the NBP maintained official rates at their higher level for several months after quarter on quarter inflation had subsided in late 2004 and waited until early 2006 before further cutting rates, although headline inflation was declining and core inflation low. The NBP was probably influenced partly by consumers' inflation expectations,

Figure 1.
EMPLOYMENT AND PARTICIPATION RATES IN OECD COUNTRIES
2004 or latest year available¹



1. 2003 for the Netherlands.
Source: OECD, Analytical database.

which tend to closely follow historical inflation with little relation to future outcomes. *The central bank should put more weight on genuine forward looking indicators, including its own inflation forecasts.*

The mandate, and even the independence, of the central bank has been under some threat recently. *The government should reaffirm the independence of the National Bank, and the autonomy of any new financial market supervision agency should also be clearly guaranteed. The credibility of monetary policy would also benefit from explicit government endorsement of the NBP's current objective of targeting inflation at the mid-point of the 1.5 to 3.5% range.*

However, inflation below the bottom end of this range may be a sign that monetary conditions have been too tight. While monetary reflation is not the answer to Poland's growth and employment problems, if inflation were to remain persistently below euro-area rates this would be likely to restrict output and employment unnecessarily. *The NBP should ensure symmetry in its approach to inflation targeting and be willing to probe the limits of the economy's supply responsiveness by cutting interest rates when inflation is below the target range, even if there is some probability that it may rise above 2.5% in two years' time.*

Movements in the exchange rate have had an important effect on monetary conditions. Joining the euro area would reduce this source of volatility and uncertainty. After three years of depreciation, the economy nevertheless weathered substantial appreciation in 2004-05, which accentuated the relatively tight monetary policy settings. EU membership requires eventual adoption of the euro, which has to be preceded by participation in the exchange rate mechanism (ERM II), but the current government is reluctant to commit to any target date for entry. With sound monetary policy, the cost of delay may be small, mainly in the form of an additional currency risk premium. Yet, a delay gives the government more time to improve flexibility in product and labour markets and put public finances on a sustainable footing; it is important that this time should not be squandered by putting off these necessary reforms.

Public finances are not yet in a sustainable condition: the current level of the general government deficit is too high, and the government's plans as described in its Convergence Programme are not very ambitious. General government debt is not excessively high (at the end of 2005 it was about 48% of GDP, according to national definitions), but it is increasing. *The government should work towards a declining target for the debt-to-GDP ratio.* The constitution contains strong debt limitation provisions, with mild constraints on policy kicking in when the share reaches 50% and a ratio over 60% requiring severe restraint. The force of these constraints was somewhat diminished by data revisions and methodological changes which recently reduced the official measure of the ratio. According to the January 2006 update of the convergence programme, the general government deficit – 4.7% of GDP in 2005, on the most appropriate definition (and recorded as 4.4% in recent revised data) – is planned to fall only to 3.7% by 2008; more progress than this should be feasible on the reasonable assumption of annual real growth averaging 4 to 5%.

However, revised national figures present a different picture, since the deficit was only 2.5% of GDP (and debt about 43%) in 2005. The gap is due to differences in the accounting treatment of contributions to open pension funds (OFE), after a major reform in 1999, which significantly improved public finances by both recognising implicit pension liabilities and taking steps to reduce them. But the reform would worsen the published deficit figure without a special temporary dispensation which, in the context of EU fiscal surveillance, treats contributions to OFE as government revenue. The dispensation expires in 2007. Therefore, despite the official deficit of 2.5% in 2005 and plans to cut it in the future, the EU Commission considers that Poland will have an excessive budget deficit, of nearly 4% of GDP, in 2007. The frustration for Poland is that few other EU countries have made such a pension reform, and, if they did, most would show deficits larger than Poland's. Yet the higher figure is a more realistic assessment of its budget deficit.

Nevertheless, underlying economic growth is likely to provide sufficient revenue for some combination of faster deficit reduction, moderate but well-targeted increases in growth-enhancing public spending and tax cuts over time. *The government should identify clear expenditure priorities within a multi year planning framework that includes limits on overall spending. Tax measures should be financed by paring low-priority spending, rather than slowing the pace of deficit reduction.* While the aforementioned pension reform improved the long-term fiscal position substantially, the gains have already been eroded by a concession to the miners. This was a step back which should not be repeated.

A large part of public spending is on social transfers, which are expensive, poorly targeted and have negative incentive effects on labour market behaviour, discussed further below. They have also proved politically difficult to change and, in the current fragile context for reform, may be even harder to amend. *Nevertheless, spending on social transfers should be reduced to make room for other priorities, such as health and long term care, child care and education, and active labour market measures.*

Sufficient spending restraint would permit reductions in overall taxation without compromising deficit reduction efforts. This Survey does not offer any detailed suggestions for such reform, but three principles should be followed, for both social security and general taxes: *the tax system should be simplified to increase transparency and reduce administration costs for both taxpayers and collectors; the tax base should be as broad as possible – i.e. special provisions and exemptions for particular groups should be curtailed – to keep tax rates low; and every effort should be made to whittle down the tax wedge, especially for low income-earners, so as to reduce disincentives to taking up employment.* ■

How can further education reform improve labour market performance and human capital development?

Sound fiscal and monetary frameworks will be needed to ensure that income per head can continue to grow more rapidly than in most OECD countries. This convergence will require many structural changes in the economy, if labour and capital resources are to move to areas where they are best used. For this process to accelerate, and for it to occur without too many people emigrating in the meantime, steps are needed to:

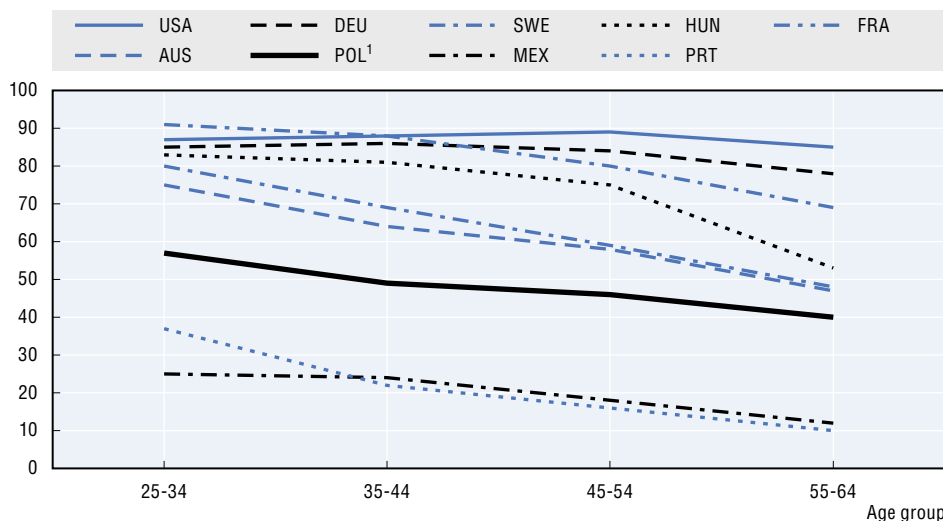
- improve labour market functioning, increasing internal mobility and raising Poland’s very low employment rate; and
- encourage Polish entrepreneurs to develop and expand their businesses so that innovation and investment flourish.

Pursuing these aims concerns many policies, and human capital development is vital to underpin them.

Important changes in many aspects of education were made in the 1990s. As far as compulsory education is concerned, performance (as measured by the PISA study) improved between 2000, when Polish performance appeared very poor relative to nearly all OECD countries, and 2003, when Poland moved into the group of middle ranking countries. This improvement can be at least partially ascribed to the effects of the reforms, notably the introduction of common national examinations and the change in the role of so-called basic vocational schools. A key motivation was to decentralise schooling to local government; *this new system should be further consolidated, with the emphasis on establishing clear lines of responsibility for the different agencies involved.*

An important component of successful education systems seems to be an appropriate balance between giving sufficient autonomy and responsibility to school principals and ensuring that they are pursuing the aims of national education policy. *Thus, principals should be given more administrative and financial autonomy to find ways to improve their schools’ results, monitored by an independent,*

Figure 2.
EDUCATIONAL ATTAINMENT BY AGE
Population that has attained at least upper secondary education
Percentage, by age group, 2003



1. Data for Poland do not include students who completed only basic vocational schools (Szkoła zasadnicza dla młodzieży), classified as ISCED 3C programmes.

Source: OECD, *Education at a Glance*, 2005

national, quality-control agency. Because not enough is known about what kind of education produces the best results in particular circumstances, there should continue to be room for experimental approaches. Measures of “value added” in individual schools should be calculated so that those responsible can assess the results of their policies.

Primary education currently starts at age 7, with one year of pre-primary education only recently made compulsory. In view of the increasing international evidence of the importance of early childhood education for social development and educational attainment, *priority should be given to increasing participation in pre-school education at even earlier ages; this would also help to raise female labour supply. For children over 15, vocational schools have become less popular, at the same time as employers continue to feel that many young adults finish school with insufficient skills. Both the general and the vocational streams must improve their responses to their graduates’ perceived difficulties on the labour market.*

Further improving the education system requires flexibility: some schools need to close, and some subjects or age groups need more teachers, others less. Falling student numbers should theoretically free up teaching resources that can be re-allocated. The Teachers Charter, as modified in 2000, improved the career structure for teachers, *but employment security aspects of the Charter should not be allowed to obstruct restructuring. Also, the government should ensure that schools have sufficient flexibility to vary teachers’ salaries according to teaching performance and recruitment needs.* ■

How can tertiary education and adult training be improved?

In 1991 there were about 400 000 tertiary students in under 90 higher education institutions (HEIs), all of which were in the public sector, but by 2005 there were 1.9 million students in over 400 HEIs, most of which are private. All private-sector students and part-time students in the public sector pay tuition fees, while the constitution prevents public HEIs from charging fees to full-time students. This asymmetry, especially in a period of budgetary stringency, makes it difficult for resources to be directed to where there is a need for public provision, and is a source of vertical and horizontal inequity. Many studies show that, although there are important social returns to tertiary education, the main benefits accrue to students themselves in the form of higher earnings. *Hence, an advisable reform would allow public HEIs to charge cost-related fees (not necessarily full-cost recovery) for all students, at the same time increasing the provision of grants to maintain accessibility. The student loan scheme should also be expanded, to be managed by commercial banks, but with the credit underwritten by the government and income-contingent repayment made through the income tax system.*

The growth in the number of private HEIs also left a gap in the accreditation and quality-control system. While the University Accreditation Commission concentrates on a relatively small number of elite institutions, the more recently established State Accreditation Committee (SAC) covers the rest. The SAC attempts to do more than simply verify compliance with technical requirements. Where a HEI receives direct budgetary support, SAC quality

assessment is important; for wholly private-sector institutions there may be less need for much more than certification of basic standards. *SAC assessments should be widely publicised and kept up to date to help potential students in their choice of course of study.*

Maintaining and improving teaching quality relies on adequately motivated teachers. In many public-sector HEIs career structures are opaque and do not depend closely on either teaching ability or research output. This is self-defeating for the institutions concerned and may also discourage the young and able from choosing this career or remaining in Poland. *Career structures in tertiary education should be based on open competition and transparent promotion criteria. To encourage high quality researchers, commercial links between HEIs and companies should be facilitated, including permitting flexible intellectual property rights arrangements.*

Polish companies do less training activity than those in most OECD countries, and a high proportion of it is financed by the employees themselves. This may be because, with the high level of unemployment, firms find they can generally recruit people with additional skills, or perhaps they do not appreciate the benefits of employee training for the company itself. Furthermore, a very high proportion of training is of people who are young and highly educated, suggesting a cleavage between a relatively small group of motivated people and the rest. Many international studies show that training leads to improved labour market outcomes. Hence, *public awareness campaigns to increase the take up of training would be useful*, although public subsidy or other incentives to train the employed in general may not be justified. Companies in Poland have nevertheless recently been given a small tax incentive to set up training funds for their workers, but this legislation is too recent for its impact to be assessed.

However, where Poland really stands out is in its meagre provision of training for the unemployed. This is one aspect of its more general under use of active labour market policies (ALMPs). Appropriately targeted training is an effective way to increase employability. *Training programmes for the unemployed should be enriched.* Many unemployed – those over the age of about 40 and with few skills or skills for which the demand has fallen drastically (in mining and steel, for example) – are vulnerable, because their low level of general education makes retraining more difficult and the economic return from training harder to demonstrate. *However, in order to try to minimise the extent to which a “lost generation” is created, more effort should be devoted to looking for ways to help these people develop skills that will allow them to re-enter the labour market.* This will depend in particular on stimulating local labour offices, who are responsible for training of the unemployed, to look for such solutions. *Pilot training projects should be encouraged and carefully assessed for their impact. ■*

Should more be done to make work pay and increase mobility?

While training will improve job prospects for many unemployed, they also need to have the right incentives to look for jobs. A large part of the population receives social transfers, some of which are generous relative to the average wage, with no job-search requirement. The disability pension scheme, which covers a significant share of the inactive, used to be a major culprit. Access has been tightened, and re-assessment of those previously given temporary pensions has succeeded in substantially lowering the stock of beneficiaries. However, nothing has been done to re-evaluate the condition of those who were previously given permanent pensions, even though many may be capable of some sort of work. *Recipients of disability benefits should be subject to regular monitoring of their work capacity. The right to social benefits for those who are able to work should be linked to the obligation to look for a job and to accept retraining when offered; for the longer-term unemployed, this may include willingness to move to another location where jobs are available.* These measures require a more active and responsible role for the public employment service (PES). *PES staff themselves should be better trained and be given incentives to improve performance.*

Access to other benefits, such as survivors' pensions, has not been touched, and pre-retirement schemes have grown rapidly, offsetting some of the positive impact of the reform of the disability scheme on labour supply; the average effective retirement age has actually fallen in recent years. *Pre- and early-retirement programmes should be fully phased out as previously intended.*

Other aspects of the social transfer system are also problematic for structural adjustment. The separate system of social security for farmers and their dependants (KRUS) is one of these. The high level of subsidy to KRUS creates a disincentive to leave the agricultural sector, despite its extremely low productivity. Even if farmers previously merited exceptional treatment, because of their low incomes or special position in society, this is no longer justifiable, particularly as subsidies from the EU Common Agricultural Policy are beginning to bolster agricultural incomes. *Farmers should receive treatment equal to, but no better than, those in the general scheme; in the longer run the two should be merged. At a minimum the fixed contribution approach used in KRUS should be replaced by a system of contributions proportional to income so that affluent farmers would pay more relative to their benefits.*

Neither employment protection legislation (EPL) nor the minimum wage are the major cause of high unemployment, but the popularity of short-term contracts and the probable extent of informal employment suggest that they can be obstacles for specific groups, such as the low skilled and older workers, to price themselves into jobs. Moreover, given the likely magnitude and pace of structural change, Poland cannot content itself with average labour market flexibility; it needs to be more flexible than most:

- *The government should consider further easing EPL on both indefinite and fixed-term contracts. The prohibition on dismissing workers within four years of retirement should be abolished, as it will serve to discourage employers from hiring older workers.*

- The minimum wage, which has fallen to around 34% of average wages over the past decade, will increase substantially under a new indexation rule. Even though it is unlikely to reach the long-term target of 50% of the average wage in the near future, any substantial increase, combined with the high tax wedge, will keep many low-skilled workers out of a job. *The government should revise the rule so as to avoid an increase in the cost of unskilled labour. The current exemption allowing some young workers to be paid less than the minimum wage could be extended to apply to other groups, notably the long-term unemployed.*

Though labour market incentives are crucial in encouraging geographical mobility, the cost of finding accommodation can offset even quite significant income incentives to move. In the past, rent controls, security of tenure legislation and limited supply of new housing in areas of growing demand meant that these costs were indeed high. Most rent controls have now been abolished, but security of tenure legislation and legal delays if a landlord wishes to take court action are still a disincentive for owners to rent out their property. *While reasonable protection against abusive landlord behaviour should be retained, the level of tenant protection should be reduced and treatment of disputes by the courts accelerated. New housing supply should be encouraged by allowing well planned urban development, not by subsidising mortgages, which will benefit mostly the already relatively well-off and further increase prices.* ■

How can the business framework for entrepreneurship and innovation be improved?

Previous Surveys have repeatedly criticised Poland for high levels of product market regulation (PMR) and other barriers to competition. Much has been done to improve the situation, especially in terms of reducing the costs of setting up businesses. Some of these changes were implemented after 2003 when the latest indicators showed Poland with the highest overall level of PMR, but it remains among the highest: the business environment is still not sufficiently conducive to entrepreneurship. The low share of investment in GDP is further evidence of a lack of confidence and obstacles to business activity. *Further reductions in regulatory and administrative barriers to entrepreneurship must be given priority.* Although corruption indicators do not form part of the PMR comparisons, Poland has the worst reputation for corruption among OECD countries on the more informal indicators published by respected non-governmental organisations. *The government should persevere with attempts to eliminate corruption, as it is a disincentive to both domestic entrepreneurs and potential foreign investors.*

OECD indicators show that Poland's product market competition suffers especially from the high level of public ownership. Privatisation policy has been dilatory in recent years, and a recently resolved dispute about a banking merger between two foreign owned banks has encouraged the view that the current government favours retaining a major State influence in this and possibly other sectors; this has unfortunately also created perceptions of an ambivalent attitude to foreign investment. *Privatisation should be pursued more vigorously, retaining public stakes only where there is a genuine public or security concern based on consumer welfare, not on protecting producer interests.*

Business expansion and technical progress are often thought to depend on high levels of research and development (R&D) expenditure, and indeed this is how the frontiers of technology are pushed out. R&D in Poland represents a smaller share of GDP than in any other OECD country. Not all countries with low shares of R&D grow slowly, however. Although, for a low-income country like Poland, targeting increases in R&D expenditure on basic research would be a mistake, studies show that R&D activity can help existing technologies to be absorbed more easily. But most Polish R&D is currently undertaken in the public sector, especially in specialised research institutes. *Public unconditional finance for these institutes should be reduced, and they should be increasingly required to finance themselves through competitive project selection and commercial joint ventures; similar methods should be applied to the research side of HEI activities.*

New ideas need not mean new technology; improvements can often be achieved with innovation in design, marketing or work organisation. In addition to investment in human capital that improves absorption and dissemination of innovative ideas, discussed earlier, this means ensuring that Poland is open to new ideas from abroad. *The government should re-affirm its commitment to the involvement of foreign enterprise on equal terms.*

Ideas also need to circulate freely within Poland, and the regional networks operated by or linked to PARP, the agency for enterprise development, are a good tool for giving access to information and advice to the many Polish SMEs. *PARP should be encouraged to develop its networks, and they should be co-ordinated or preferably merged with other similar networks – those related to agriculture, for example.*

The 2005 law on support for innovation has a number of useful ideas for improving the flow of finance to potential innovating companies. In putting it into operation, *the authorities should try to leverage private finance, involving venture capital companies, and take care to monitor different approaches for their effectiveness, retaining what works and discarding what does not.* ■

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Economic Outlook No. 78, December 2005.

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