

Update, 28 June, 2002

On 25 June 2002, six days following the approval for publication of the Economic Survey of Poland by the Economic and Development Review Committee, the National Bank of Poland reduced its interest rates by a further 50 basis points, to 8.5 per cent. At the same time it revised its inflation target for 2002 from 5 per cent to between 2 and 4 per cent and its target for 2003 from "below four per cent" to between 2 and 4 per cent. The discussion of these issues in the third and final paragraphs of the Assessment and Recommendations and in the section on Monetary management in Chapter II do not reflect these developments.

ASSESSMENT AND RECOMMENDATIONS

GDP has slowed sharply, helping to bring down inflation as well as the current account deficit

1. The slowdown in economic activity that was already evident at the time of the previous *Economic Survey of Poland* has since intensified. GDP grew only 1 per cent in 2001, and unemployment reached about 19 per cent of the labour force. Since then the weakness of demand has persisted, with output expanding 0.5 per cent in the first quarter of 2002. In this environment, inflation fell to less than 4 per cent in 2001, and, as of May 2002, was 2 per cent. The driving force behind the slowdown has been a sharp fall in investment activity -- in response to very high interest rates following the slowdown in European demand and the pick up in inflation in 2000. In contrast, and despite a 3.5 per cent fall in employment, strong real wage growth and large World War II related transfers have allowed private consumption to increase. Overall, the weakening of demand closed the large positive output gap that had opened up following the fast growth of the 1990s and resulted in a substantial negative one by mid-2002. This helped to quell the inflationary pressures that emerged in 2000 and was reflected in the narrowing of the current account deficit to a still high 4 per cent of GDP.

Output is likely to remain weak in 2002 before picking up somewhat in 2003

2. The economy is projected to recover only slowly this year, with GDP growth then picking up to a moderate 2½ per cent in 2003. As a result, inflation should remain below 4 per cent. The turnaround in demand is expected to be led by stronger exports as world demand picks up. Along with the further easing of interest rates embodied in OECD projections, this should prompt an improvement in business expectations and investment activity during the second half of this year. Consumption should be a moderating force on domestic demand given slow wage growth and the absence of special factors serving to boost disposable income. Despite stronger export growth, the pickup in domestic demand should cause imports to expand even faster and, as a result, the current account deficit is likely to deteriorate once again, reaching about 5 per cent of GDP in 2003. The

failure of employment to increase during past periods of high growth, the concentration of joblessness among certain groups of individuals and persistently high regional unemployment rates, point to the increasingly structural nature of this problem. Without additional concrete steps to remove impediments to hiring, joblessness is projected to moderate only slightly.

Despite substantial rate cuts, monetary conditions remain tight

3. The tight monetary policy of 2000 and 2001 contributed to the substantial fall in investment activity and the welcome reduction in inflation. The challenge facing monetary policy now is to consolidate expectations at these low levels, so that the economy can reap all of the benefits of low inflation. At present, notwithstanding several cuts to policy rates, amounting to 1 000 basis points since February 2001, monetary conditions remain tight -- both because real rates, at about 6 percentage points, are high and because of the appreciation of the currency. Indeed, the current stance of policy seems consistent with a medium-term inflation objective of 2 per cent, well below the ceiling embodied in the National Bank of Poland's (NBP) rather vague "less than 4 per cent" medium-term target for end of 2003.

The Bank's medium-term strategy needs to be updated in co-operation with the fiscal authorities...

4. To increase transparency and improve its capacity to affect expectations, the Bank should move to make its medium-term objective more precise. Indeed, it needs to revise it on a more frequent basis. The existing one dates from 1999 and is increasingly looking like a short-term target. In revising it, the monetary authorities, who under current law are responsible for setting the objective as well as implementing the policies to achieve it, should nonetheless seek to define the objective in a way that is supported by the government. Such "buy in" on the part of the government would help preclude a repetition of the recent feuding between the NBP and the government. In so doing, it would improve the effectiveness of monetary policy and actually strengthen the Bank's operational independence. Similar results, and a more consistent Bank policy, could be expected if members of the Monetary Policy Committee were to serve overlapping terms instead of all being replaced simultaneously, as is currently the case.

...and its communications strategy improved

5. While such measures would improve the transparency and independence of monetary policy, given repeated failures to meet its targets, more needs to be done to improve the effectiveness and credibility of the Bank's inflation-targeting regime. In particular, the NBP's communication strategy needs to be strengthened through a more timely release of the *Inflation Report* and a clearer statements of the Bank's views concerning recent and future price developments. The report should include inflation forecasts, perhaps in the form of a point estimate and a surrounding confidence interval. Moreover, it should explain how recent events affect these forecasts, and how these developments are likely to impact the stance of policy and the Bank's operational targets. Not only would this help shape expectations, it would also make clearer the rationale behind interest rate policy.

A sharp relaxation of fiscal policy in 2001 contributed to the poor

6. In contrast to monetary policy, fiscal policy eased sharply in 2001, with the general government deficit rising from 2.1 to an estimated 5 per cent of GDP. About half of the increase reflected fiscally expansionary

policy mix, followed by a slight further easing

measures. This, and considerable confusion concerning the overall stance of policy during the course of the year, likely contributed to the reluctance of the monetary authorities to reduce interest rates more quickly. In contrast to 2001, this year's Budget incorporates prudent assumptions concerning inflation, output and revenues. Moreover, in a departure from past practice, the government proposed to follow a 1 per cent real growth expenditure norm for State Budget expenditures. If implemented to cover all central government spending, including that of the extrabudgetary funds, such a spending norm could help eliminate the procyclical bias imposed by the present system's deficit target. As passed the 2002 Budget did not apply the proposed norm. It included 2 per cent real growth in State Budget spending and explicitly procyclical provisions to increase expenditures even further if revenues prove higher than expected. Overall, this represents a slight further loosening of fiscal policy and appears to imply a cyclically-adjusted general government deficit of a bit more than 4 per cent of GDP.

Steps need to be taken to prevent medium-term spending pressures from threatening fiscal sustainability

7. The rise in the deficit and substantially lower privatisation revenues meant that the overall public sector debt rose last year after falling to 41 per cent in 2000. Based on the measures announced in the latest Budget, it is expected to increase further, reaching 47 per cent of GDP in 2002. As a result, there is a clear need to tighten fiscal policy in 2003. This can be achieved most usefully by extending the notion of some kind of expenditure norm to all of central government activity. The need for such a norm is all the more important because fiscal pressures are expected to increase in the future. As the low-interest loans of the so-called London and Paris clubs mature and are rolled over, total debt-servicing charges are expected to rise by about 1 per cent of GDP unless privatisation revenues both accelerate rapidly and are devoted to paying down debt. Moreover, the ageing of the population and accession-related costs will place further pressure on the public purse, notwithstanding expected EU transfers. Unless determined steps are taken to reduce government spending and increase potential output, the deficit will remain high throughout much of this decade, and the debt will keep rising towards its constitutionally-imposed maximum legal level of 60 per cent of GDP.

The authorities' proposals to foster capacity and employment growth may help,...

8. The containment of the debt ratio could be helped by the government's *Entrepreneurship-Development-Employment* plan (see below). It includes a number of measures aimed at increasing growth and employment, while containing spending and re-orienting resources away from personal transfers and towards growth-promoting programmes. Insofar as these objectives are achieved, the fiscal constraint should become less binding. However, to accomplish these goals, measures are needed to improve the ability of the authorities to control and reorient government spending. Indeed, improving the efficiency of public expenditure management (the topic of this report's special chapter) seems a critical element in achieving the growth objectives set by the government, and the following paragraphs present a range of reforms that should help in this regard. At the same time, more needs to be done to increase growth and employment through product and labour market reforms. These issues are taken up subsequently.

... but to improve budgetary flexibility the extrabudgetary funds need to be integrated into the State Budget...

9. As regards expenditure reform, a key objective should be to increase the comprehensiveness of the State Budget by abolishing the numerous extrabudgetary funds; eliminating their reliance upon earmarked taxes; and incorporating into the State Budget their programmes, revenues and expenditures. While such a step would not change the mandatory nature of their expenditures, it would serve to bring the level of political oversight of their activities on to a par with those of other government services and expose their programmes to competition with other spending priorities. Currently, only summary information on the activities of these funds is annexed to the budget and parliament has only limited power to alter them during the budgetary process. Recent measures to reduce the number of extrabudgetary agencies go in this direction but need to be greatly expanded. For example, the merger of the special farmers' pension system into the general one would have the advantage of making farmers' future pensions dependent upon their incomes and contributions, while income support during the transition period should be maintained through existing social assistance programmes. Moreover, such a reform would remove the current incentive to maintain small and economically inefficient farms, which is impeding agricultural restructuring. In this vein the integration of payroll tax information into the personal income tax system would help eliminate opportunities for tax evasion.

... and a more medium-term approach to budgeting should be adopted

10. Moving towards a multiyear budgeting framework would facilitate the integration of the funds into the State Budget by providing the ongoing programmes currently operated by them with a longer planning horizon. Furthermore, if coupled with a revised public-investment management system, it would help preclude the kind of delays and cost overruns that uncertain funding has yielded to date. Over time, a multi-year system could evolve into a fully-fledged, output-oriented, medium-term expenditure framework. The current practice of requiring new programme initiatives to include a three-year budgetary impact assessment goes in the right direction. However, more needs to be done to evaluate the effectiveness of government spending. "Sunset clauses" would help but, more fundamentally, programmes should increasingly be designed so that their impacts can be accurately measured, eventually giving policymakers the information they need to choose between competing programmes based on both their costs and their benefits (outputs). Moreover, the existence of such indicators should increase incentives within the bureaucracy to improve programmes, as opposed to simply preserving them.

Tax and benefit programmes need to be more carefully evaluated...

11. Failure to systematically evaluate the impacts of programmes means that those with perverse effects do not get re-examined and revised as they should. For example, although the zero or low VAT rating of a wide range of goods and services introduces significant price distortions and represents fully 6.5 per cent of GDP in foregone revenues, it has very little redistributive impact. A more efficient mechanism to fight poverty would see the standard VAT rate applied more uniformly and the additional revenues used to reduce payroll taxes, which would stimulate private-sector employment and income growth. Indeed, the recent decision to subject interest income to taxation works in this direction by widening the tax base. Similarly, evidence suggests that housing-related tax expenditures have

principally benefited the better off, while high social security benefits and regionally undifferentiated minimum wages are contributing to joblessness among the low-skilled. Moreover, rather than offering a personal income tax credit in the full amount of healthcare payroll taxes paid, both the credit and the payroll tax should be abolished, the current treatment having no budgetary impact.

... and reliance on non-transparent methods of financing reduced

12. In order to reinforce efforts to facilitate effective public expenditure management, the authorities need to avoid financing policy projects with loan guarantees except in cases where a clear market failure is identified. Moreover, rule-based limits should be instituted that stipulate the volume of new guarantees that can be issued as a share of GDP (or total revenues) and which simultaneously impose a separate risk-weighted ceiling on the total of outstanding guarantees. In addition, existing prudential rules should be applied to all state guarantees. The increasingly common practice of exempting guarantees from these rules may artificially understate government expenditure by keeping various forms of spending off-book. Left unchecked, such financing mechanisms, coupled with an optimistic evaluation of associated default risk, may be creating a significant hidden liability.

Meanwhile, more cooperation between local governments and better budgetary coordination with the centre is needed

13. The devolution of spending power incorporated in the 1999 regional reform has reduced the central authorities' ability to influence overall general government expenditure. While the rules governing sub-national governments' budgets include reasonable prudential limits on deficits and indebtedness, they focus too heavily on deficits and inadequately on spending limits. As a result, sub-national governments could contribute to a significant loosening of fiscal policy if they were to take greater advantage of the fiscal space provided for by the rules. While this need not endanger the sustainability of their own finances, it could destabilise the national economy. To guard against such an eventuality and to ensure that the authorities have all relevant fiscal information available to them when writing their budgets, the calendar for the preparation of sub-national budgets should be moved forward and the process better co-ordinated with that of the central government. In addition, the efficiency with which services are delivered at the local level could be enhanced by greater co-operation and joint delivery of services. While the legal framework for such co-operative efforts exists, so far few *gminas* (municipalities) have taken advantage of it.

Enhancing medium-term growth prospects requires structural reform across a broad front

14. While a reform of public expenditure management would help the government better control and orient its resources towards its priorities, a wide range of structural reforms need to be put into place if potential output, employment and incomes are to be improved. As noted, the government's *Entrepreneurship-Development-Employment* programme explicitly recognises this need. Thus, a reform of bankruptcy law proposes to reinforce creditor rights and to speed the transfer of resources from unproductive firms to healthy growing ones. These changes should help speed restructuring and aggregate productivity performance but would be more effective if creditors were given a more active role in the restructuring of debtor firms, with judges playing a monitoring rather than administrative role. Recent efforts to

reduce startup costs and ongoing administrative burdens facing small- and medium-sized enterprises (SMEs) should increase both their number and their success rates. The prospects of such firms and their access to credit could be improved further if the land registry were made more accurate, and the scope of the enterprise register expanded to include one-stop inscription of new firms. The authorities' plans to boost infrastructure investment are also welcome. However, the amount of resources allocated to promoting housing construction, which will do little to improve potential output, is disproportionate. In addition, care needs to be taken to protect against moral hazard by ensuring that default risk is borne by private-sector lenders and not the government, as in current proposals. Moreover, more resources need to be devoted to upgrading existing roadways as opposed to constructing new multi-lane highways.

Continued high unemployment and its concentration among vulnerable groups makes labour-market reform a priority

15. Elements of the government's plan also seek to respond to the critical policy priority posed by Poland's massive unemployment problem. The authorities plan to reduce the kinds of administrative burdens that impede the creation of small enterprises and associated jobs; to ease some of the more binding features of Polish labour law; and to introduce an age-differentiated minimum wage. These are all positive measures, which if introduced, would help to revive the labour market somewhat. However, they need to be reinforced if the rapid rise in structural unemployment is to be reversed. In particular, to make work pay for the low-skilled, in-work benefits should be introduced and both the level and high clawback rate of social benefits for the non-employed should be reduced. To fight the tendency for state-financed labour market withdrawal, access to, and eligibility criteria for, disability and early retirement programmes should be tightened. Budgetary savings could be used to help finance reduction of onerous social security taxes that contribute to joblessness among the unskilled. These efforts should go hand-in-hand with measures to upgrade workers' skills and a more "active" employment strategy, which would be supported by having the public employment service focus more closely on job-placement activities as opposed to benefit administration.

The independence of competition and sectoral regulators could be reinforced,...

16. While responding to a less pressing need, recent efforts to increase the flexibility of Poland's competition legislation may help promote innovation and growth by reducing impediments to some productivity enhancing forms of co-operative behaviour. At the same time, they may relieve the Office of Competition and Consumer Protection of some administrative tasks, allowing it to concentrate on its watchdog role. In this regard, there is scope for the office to take a more publicly critical position of government policies with which it disagrees. Elsewhere, the government has moved to combine some of its sectoral regulators. These mergers may well yield efficiency gains in terms of both reduced costs and improved information sharing. However, the replacement of the head of the Telecom, Pension and Insurance Fund regulators before the end of their terms is out of line with international practice and may raise questions about the authorities' commitment to the independence of these agencies. In the future, the government should avoid taking such steps, which can be perceived as eroding the effective independence of regulators.

... and the privatisation of large-scale firms needs to be accelerated

17. Although greatly reduced, the State continues to have an important ownership position in the economy, holding a controlling or larger stake in some 3 000 firms. In order for these companies and their workers to fully exploit their potential for job and output growth, they need to be privatised as quickly as possible. To do so, the authorities will need to eliminate some of the cumbersome processes and conditions attached to privatisation. In this regard, the government should rely much less on social and investment clauses which can impose excessive costs on firms, reducing the sale price or even scaring off potential buyers altogether. To the extent that such clauses are binding, they diminish the long-term ability of the enterprise to expand and provide sustainable jobs. Where significant labour market disruption is likely, this should be dealt with using standard social policy instruments. Indeed, most recently the government indicates it will be more rational in the social and investment conditions that it attaches to privatisation deals. In the case of direct privatisations, the State needs to take a more active role in seeking out buyers. Although it provides no direct support to most firms, their sheer number prevents the authorities from providing effective corporate governance and their management and employees tend avoid the kind of painful restructuring sometimes associated with privatisation. As a result, these firms pursue efficiency-enhancing measures with less vigour, pay substantially higher wages and under-perform those in the private sector. Moreover, those that are profitable fail to grow as quickly because they have limited access to private savings. The net result for the economy as a whole is slower growth, weaker employment and lower productivity.

Pursuing policy goals via state-owned firms is hurting economic performance

18. Problems with corporate governance extend to those joint-stock companies where the State has a majority or controlling stake. The recent highly visible replacement of State representatives on the supervisory boards of some of the most important state-owned firms suggests that the authorities are attempting to influence their commercial policy in directions other than those that maximise shareholder value. The government normally includes in privatisation deals a requirement that private-sector investors increase their stakes in partly-privatised firms. However, the record is mixed. On a number of occasions, the State has used its holdings to block efforts by its private-sector partners to invest in companies by expanding their stake in these firms, even putting into question a pre-existing contract to cede the remainder of its holdings in a particular firm. These actions risk worsening the environment for future privatisations, they appear to reflect a belief that the State can direct company policy more efficiently than private owners. Rather than seeking to use its holdings to force firms to pursue its industrial policy goals, the State should welcome its private-sector partners' initiatives to expand their stake and should seek to divest itself of its remaining holdings as rapidly as possible. To the extent that they wish to pursue industrial policy, the authorities should use less distorting and more transparent instruments such as subsidies and tax incentives. But even these should be used sparingly. Indeed, experience in other OECD countries indicates that the State has a poor track record in picking winning firms or activities. Poland's limited economic resources would be better used to create the overall conditions in which private firms could prosper.

An aggressive approach to restructuring and privatisation would help promote growth

19. Part of the torpor that has characterised the privatisation process derives from the authorities' desire to proceed with the restructuring of firms prior to their sale. Currently major restructuring plans continue to be executed in the coal, steel, and defence sectors. In so far as the goal of these plans has been to engineer a reduction in capacity and employment in these sectors, they have been successful. Unfortunately, the sectors remain money losing, with limited prospects for sales. The latest response of the authorities has been to bundle enterprises together in the hopes that additional economies of scale or monopoly power will help make them profitable. While such a solution may restore the sectors to profitability, it risks doing so by raising prices rather than lowering costs, thereby impoverishing consumers and making client firms less competitive internationally. A superior alternative would be to hasten their sale, leaving their eventual purchaser to decide the best way to proceed with their restructuring. Experience in other OECD countries suggests that, if the companies are relieved of their debt burdens and non-economic conditions are kept to a minimum, purchasers can generally be found with the expertise necessary to have a reasonable chance of successfully turning such firms around.

To sum up

20. *In sum*, notwithstanding the progress already made, substantial further efforts are required in order to achieve rapid rates of growth in incomes and employment. Indeed, the moderate pace of the projected recovery reflects the slow pace of restructuring and privatisation, widespread structural non-employment and the continued need for reform. To create the best conditions for sustained high growth, both structural reform and macroeconomic policies should be pursued in a coherent manner. In this regard, the macro policy mix needs to be adjusted through a combination of lower interest rates and tighter fiscal policy. Moreover, a clearer statement of medium-term targets by both authorities would improve the credibility and efficiency of macro policy in general. On the structural front, the government's *Entrepreneurship-Development-Employment* programme correctly focuses on reorienting spending away from transfers and towards growth-enhancing policies aimed at promoting the expansion of entrepreneurial firms, infrastructure development and reducing Poland's exceptionally high unemployment rate. To facilitate such a reorientation and in order to enhance the government's ability to manage the macro economy, the State Budget needs to be made more comprehensive by reintegrating into it the extrabudgetary funds. Such changes, combined with a more medium-term budgetary orientation and more comprehensive evaluations of spending programmes would make government expenditure more effective and improve democratic oversight. The government's programme would be even more successful and its employment impacts larger, if it reduced those personal transfers to the able-bodied that contribute to inactivity traps, and if the savings were used to finance a reduction in payroll taxes. This, plus steps aimed at increasing the efficiency of bankruptcy processes and reducing administrative burdens on firms and in labour markets, will help speed private sector restructuring and enhance productivity growth. To achieve similar benefits among the more than 3 000 firms in which the State still has a controlling stake and in order to better mobilise private-sector savings and expertise, the privatisation process needs to be accelerated. In this regard, the authorities should reconsider the current approach of restructuring firms

prior to their privatisation and should avoid using their ownership position to pursue industrial and social policy goals. Progress on all these scores is essential to further improving overall productivity performance and helping ensure a rapid and sustainable growth in living standards.