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OECD ECONOMIC SURVEYS

POLAND

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CENTRE FOR CO-OPERATION WITH EUROPEAN ECONOMIES IN TRANSITION

OECD ECONOMIC SURVEYS

POLAND

1992

ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

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Poland, the Czech and Slovak Federal Republic, and Hungary participate in the OECD programme "Partners in Transition". This Economic Survey was carried out in the framework of this programme, which is managed by OECD's Centre for Co-operation with the European Economies in Transition.

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BASIC STATISTICS OF THE REPUBLIC OF POLAND, 1991

THE LAND

Area (sq. km.)	312 680
Arable land (sq. km.)	143 600

THE PEOPLE

Population (thousands)	38 305
Projected population growth rate (1990-2000)	0.5
Urban population (percentage of total)	62
Rural population (percentage of total)	38
Employment (thousands, end-year)	9 553
Employment (percentage of total):	
State agriculture (and forestry)	6
Industry	35
Construction	8
Services	18
Government and other	33

Population of major cities, June 1991 (thousands):	
Warsaw	1 655
Katowice area	2 136
Lodz	847
Gdansk area (incl. Gdynia and Sopot)	763
Cracow	751
Labour force (percentage of total):	
Under 40 years of age	65
With technical and occupational training	53
Private farms (thousands)	2 138

THE PARLIAMENT

Bicameral Parliamentary system	
Sejm membership (lower house)	461
Senate membership (upper house)	100
Number of political parties in Sejm	29
Share of seats in Sejm held by 9 main parties	90

PRODUCTION

GDP (trillion zlotys, current prices)	823.8
GDP per capita (U.S.$, official exchange rate)	2 036.8
Consumption (private, percentage of GDP)	60.5
Gross fixed capital formation (percentage of GDP)	18.4

PUBLIC FINANCE

State budget deficit (percentage of GDP)	3.8
General government revenues (percentage of GDP)	25.6
Government debt (domestic, percentage of GDP)	15.9

FOREIGN TRADE AND FINANCE

Exports of goods and services (percentage of GDP)	16.4
Imports of goods and services (percentage of GDP)	16.3
International reserves (months of imports)	6.1
Total external debt (bn U.S.$)	48.4
Total external debt (percentage of GDP)	62.0

THE CURRENCY

Monetary unit	zloty
Currency units per U.S.$:	
Average, 1991	10 559
March 1992	13 443

This survey was prepared by the OECD Secretariat in the context of the Partners in Transition programme.

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Its contents were discussed in a Partners in Transition meeting of the Economic and Development Review Committee on 21st May, 1992.

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This survey is published on the responsibility of the Secretary-General of OECD.

I. Reconstructing the Polish Economy

The Economic Transformation Programme of Poland, adopted in January 1990 by the Solidarity-backed government that came into power in September 1989, was both bold in its conception and path breaking in its objective: in a short time to reconstruct Poland from a "planned economy" into a market economy. Market institutions were to be established and the economy privatised over a period of several years; those changes which could be introduced by decree were made at once – most notably the liberalisation of domestic prices and of foreign trade. The programme included an immediate stabilisation package, viewed as crucial not only to bring the serious macroeconomic imbalances inherited from 1989 under control, but also to make zloty convertibility credible. For the longer term, the aim was to provide a stable policy environment conducive to the development of a market economy. In particular, during the process of structural change inflation was to be held on a steadily declining path through tight fiscal and monetary policies.

This economic survey, the first for Poland under the Partners in Transition Programme with the OECD, aims to assess how this process of transformation has unfolded in the two years since its inception. Because the transformation is as yet incomplete – with the heritage of the old system continuing to weigh heavily on economic performance while the new, dynamic forces of the market are not yet dominant – there are two different approaches to making this assessment. The first would be to focus on the distance that has been covered already. The second, and the one generally followed in this survey, is to measure what has been accomplished thus far against the full achievement of the objectives that were set for the Economic Transformation Programme. This approach, which has the possible merit of highlighting issues for the future, runs the risk of seeming to pay insufficient attention to the extraordinary efforts and accomplishments of the Polish authorities in moving forward on a very ambitious and difficult endeavour.

This is far from the intention. Indeed, it is difficult to find examples in economic history where so much has been accomplished in such a short time as has been the case in Poland over the past two years – a time, furthermore, when Poland also had to deal with large external shocks.

The achievements are striking:

- The legal basis of the economy has been irreversibly transformed: in areas ranging from property rights and competition law to trade, banking, and labour law, the premises of central planning have been swept away, and new market-oriented laws put in place.
- New economic institutions have developed both inside and outside government: a social safety net has been established, as has a system of unemployment compensation; new commercial banks, private insurance companies and other financial intermediaries have become actors in the economy; private enterprises have expanded in number, in size and in the range of their activities.
- Market-oriented instruments for managing the economy have been created: price signals rather than administrative measures are now the fundamental regulators of economic activity; a modern tax system is being put in place; budget processes have been made much more transparent; instruments for indirect control over the money supply have been developed and are being strengthened.
- Finally, the opportunities for individuals to make economic choices have expanded dramatically: shortages have disappeared and the range of available consumer goods and services has increased; and entrepreneurial possibilities have opened up for many.

Nevertheless, major problem areas remain. The assertion, often found in the Polish press, that the economy is in a state of crisis is perhaps overstated. But two features of the situation prevailing at the beginning of 1992 are worrying:

- First, popular support for the reform path taken has eroded over time. Since in a democratic society, such support ultimately sets the limits for what economic policy can accomplish, this erosion needs to be contained. The reasons for diminishing support are numerous. In part, it reflects what were no doubt unrealistically optimistic expectations on the part of many people at the start of reform concerning the speed with

which economic reform would translate into increased production. But there is no doubt that the transition has also entailed real social costs: output has fallen sharply, and with it unemployment has risen. For many, near-term job insecurity must appear a more pressing reality than the more distant opportunities for better jobs in new activities. While aggregate consumption levels during the past two years have fallen less than output, different households and social groups have been affected quite differently by the economic transformation, so that many are – or perceive themselves to be – worse off. In these conditions, the priority the government now attaches to stabilising output in 1992 is fully understandable because indicators that the most difficult part of the transition had been passed would provide a strong basis for renewing popular will to go further.

– Second, the early months of 1992 were characterised by the coming to light of an increasingly precarious financial situation made up of three interrelated phenomena. First, both the profits and the balance sheets of the state-owned enterprises deteriorated markedly during the course of 1991, and signs of an improvement are not yet visible. Second, the banking system has become very fragile due to the build-up of claims on a growing number of unviable borrowers. The share of non-performing assets in many banks' portfolios has risen sharply over the past year. Finally, reflecting declines in tax revenues from the enterprise sector, but also certain legislated expenditure programmes and debt interest obligations that threaten to grow explosively, the budget deficit has widened, and there are risks that it will get out of control.

Addressing these financial problems constitutes an immediate challenge for the government, and indeed the policies announced by the authorities for this year are directed towards containing them. However, the challenge for the government is also a deeper one insofar as these indicators of financial fragility are themselves symptoms of the incompleteness of the overall structural reform process: it is to contain financial instability, while continuing on the course of economic transformation – and carrying along popular support for this course.

The economic transformation programme and its background

The choice, in adopting the Economic Transformation Programme, to embark on structural transformation rather than more gradual reform reflected a long experience in Poland with ineffective attempts at reforms throughout the 1970s and 1980s. While a full analysis of the various efforts of the previous regime to "improve" the central planning system during this period is out of place here, some elements of direct relevance for the economic situation at the end of 1989 can be summarised briefly. During the 1970s, these reform efforts emphasised raising productivity through large scale importation of technologically sophisticated investment goods from the West. For a time this yielded some successes, but rising import dependence was not matched by growing exports and external debt steadily accumulated, reaching $24 billion in 1976 at the peak of the expansion, and grew further in subsequent years even as domestic output stagnated, culminating in the balance-of-payments crisis of 1980 and a resulting forced compression of consumption.

During the 1980s Poland remained subject to a tight external constraint. Trade surpluses were necessary to finance external debt and such surpluses were generally realised, though debt service could not be fully maintained and gave rise to reschedulings in the Paris Club in 1985 and again in 1987. There was limited scope for new borrowing, but capitalisation of interest steadily pushed external debt higher, to over $40 billion by 1989. In these constrained circumstances, domestic reform efforts concentrated on decentralising decision making by increasing the autonomy of enterprises both in terms of setting prices and allocating inputs. Few visible positive results were achieved: productivity growth remained weak, shortages remained pervasive, exports did not grow sufficiently to sustain debt-service and wage and price inflation continued creeping upward.

Nevertheless, as a result of these reform efforts, Poland by 1989 was very far from the typical idea of a centrally planned economy, and was often characterised as having "neither plan nor market". The share of material inputs subject to central allocation had decreased from 45 per cent in 1986 to 22 per cent in 1988, and a number of prices were subject to only limited controls. Firms, while nominally state-owned, had become "autonomous self-financing units". They were not self-financing in practice, however, and this led to serious problems. Firms were dependent on a variety of state subsidies, which in 1988

amounted to around 16 per cent of GDP. Moreover, there was generally no clear commitment to repay debts, while bankruptcy – though theoretically possible – had never been enforced. Enterprises were indeed autonomous, to a considerable extent by virtue of the strong influence of Employees' Councils. These Councils did serve an important role in preventing the re-centralisation of power over enterprises into the hands of the planning authorities. But economic results were poor, with an intensification of efforts by enterprises to secure higher wages for their workers, since these could be automatically passed through into prices. For many in Poland, the fundamental reason for failed reform prior to the 1990 programme was that it did not address the question of ownership nor lead to the introduction of genuine markets.

The immediate backdrop to the Economic Transformation Programme was the rapidly deteriorating macroeconomic situation in 1989. 1988 had ended with a wage explosion that carried over into 1989. By the end of the first quarter, wages were up by 120 per cent over a year earlier and prices (still substantially administered) by 76 per cent. High inflation was then locked in by full wage indexation. Budget expenditures also soared and the budget deficit exploded. The financing of this deficit by the monetary authorities in turn gave rise to a surge in the money supply. As a result of these developments, excess demand conditions became acute; shortages worsened as a scramble for goods developed, intensified by an acceleration of money velocity as people sought to reduce cash holdings. This incipient de-monetisation of the zloty was reflected in the widening of the gap between the official and free exchange rate for the dollar from 270 per cent in early 1988 to 440 per cent by mid 1989. All these elements indicate that the conditions for hyperinflation were developing, and this became clearly visible after August when meat prices were liberalised. By October 1989, the annualised rate of inflation exceeded 16 000 per cent.

In fashioning its response to these critical developments, while at the same time creating conditions for a market economy, the new government that came into power in September 1989 faced a problem of sequencing its actions which had no solution in economic theory. Strong immediate measures were clearly essential in view of the hyperinflation threat. In practice, the government opted to combine a strong stabilisation package with immediate liberalisation of prices and trade, while developing a broad agenda of structural reforms that – it was recognised – could only be implemented over time. This implied that, initially,

stabilisation and liberalisation measures would impact on an economy that in other respects remained stuck in the heritage of central planning. The dynamic tensions created by this were surely powerful, and their consequences for economic performance were at the time unknowable.

As regards those elements of the transformation programme that could be implemented quickly, the basic logic consisted of three elements. First, in order to gain control rapidly over both inherited inflation and the additional inflation stemming from price liberalisation and zloty devaluation, two nominal ''anchors'' were to be introduced: nominal wage controls and a convertible zloty pegged, at least for a time, to a fixed value in terms of foreign exchange. Second, to allow these nominal anchors to hold, tight monetary and fiscal policies were to be put in place. Finally, both to counteract inflation and to promote a rationalisation of the relative price structure in the face of pervasive domestic monopoly possibilities, most restrictions on trade were abolished so as to ''import'' competition. Specific measures were set out:

- Fiscal policy: the aim was to reduce the budget deficit from an expected 6-7 per cent of GDP in 1989 to around 1 per cent in 1990, using both expenditure and revenue measures. The expectation was that this deficit would be financed by treasury bonds and loans from commercial banks, without recourse to the National Bank of Poland.
- Monetary policy: the intention was to eliminate the system of rationing credit at sharply negative real interest rates and to install the interest rate as the main instrument for restricting credit demand. The new interest rates were to be applied to both new and old debt, although a part of the increased interest payments on old debt were allowed to be capitalised.
- Exchange rate: having already been devalued several times by large amounts in 1989, it was decided to devalue the zloty by a further 31.6 per cent on 1 January 1990. With the support of a $1 billion stabilization loan, the government committed itself to maintaining the rate for at least three months. Although enterprises were henceforth not permitted to keep their export receipts in foreign exchange accounts, currency was available on demand for current transactions.
- Wage and price policy: a strict tax-based incomes policy was introduced with the twin aims of *i)* preventing a wage-price spiral and *ii)* effecting an unwinding of the real wages increases that occurred in 1989. Along-

side the liberalisation of most prices that had not already been freed, there were large corrective price increases for energy and other products remaining under administrative control.

- Trade policy: all domestic and foreign trade monopolies were abolished and quantitative trade restrictions lifted. An import tariff averaging just under 20 per cent was established as the principal measure to influence trade.
- State owned firms: pending privatisation, the control of state owned firms was to be achieved via increased foreign competition and tight budget constraints which would be enforced through bankruptcy.

The results achieved from these measures, as well as from subsequent policy adjustments and their interaction with the structural elements of economic transformation that were inevitably on a slower track, are discussed in the following chapters of this survey. There is no doubt that in some major respects developments diverged sharply from those expected or hoped for when the programme was launched – but given the vast uncertainties that must have surrounded any estimates of how such unprecedented measures would work, this is hardly surprising. It is also clear that new, difficult problems have surfaced. But in making an assessment of all this, the only point that is really clear is that scholars will be busy for years analysing what has happened and why. Poland must move forward in its transition along a still unblazed trail.

II. Macroeconomic Developments and Policies

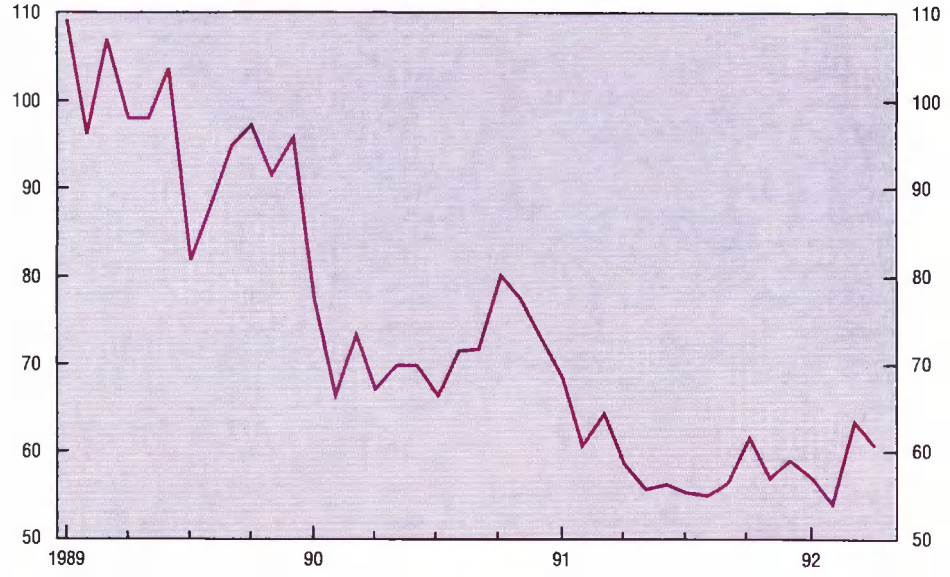
The course of the Polish economy during 1990-1991 was a very bumpy one, influenced both by the dramatic reforms inaugurated at the beginning of the period and – though to a lesser extent than some other countries of the region – by the collapse of the market in the former USSR. Inflation fell markedly during this period, though it still remains high. Output fell more or less continuously though at a diminishing rate. It is almost impossible to disentangle "demand-side" and "supply-side" influences on economic performance since the two are interrelated and, after the fact, output is the main available indicator of both supply and demand. There are nevertheless grounds for seeing the development of output as being heavily determined on the supply side, with changes in demand being reflected more in the external balance and inflation than in changes in production. Thus, in reviewing macroeconomic developments, this chapter focuses on supply-side performance.

Macroeconomic developments

Output and its uses

Following the introduction of the economic reform programme, GDP fell by an officially estimated 11.6 per cent in 1990 and by a further 8 per cent or more in 1991. The structure of the decline has varied over this time, pointing to the emergence of different underlying factors. This is most apparent in industry which accounts for a large percentage of GDP. The steepest decline in sales[1] of industrial products occurred in the first months of 1990, coinciding with the liberalisation of prices and their associated surge[2]. Sales by state-owned industry fell by 30 per cent from December to February. Clearly this fall in output must be seen in part as the counterpart to the systemic shift from an economy of shortage to one where output needs to respond to demand. From June onwards, industrial

Chart 1. **INDUSTRIAL PRODUCTION**
Dec. 1988 = 100



Source: Polish Central Statistical Office.

output recovered for a time, but then a further contraction started in October which continued until the second half of 1991 (Chart 1). Some pickup has been evident since then, but it is uncertain how securely based this is. Developments in aggregate output are reflected differently at the sectoral level: in the first half of 1990, the declines in output were generalised across industrial sectors, but in 1991 the sectoral differentiation became much greater[3], with the engineering and metallurgy sectors bearing the brunt. In contrast to industry, the service sector has continued to grow strongly over the period.

Most sectors experienced a fall in output but sometimes, as in transport, this was due to necessary rationalisation[4]. In some sectors, output falls resulted from plant closures for environmental reasons. In contrast to other sectors, agricultural production declined by only 2 per cent. This was accompanied by a much diminished use of inputs such as pesticides and fertilisers following increase of

Table 1. **Sources and uses of output, 1989-1991**

	1989[1]	1990[1, 2]	Estimate 1991[2, 3]
	Bn zlotys	Rate of growth	
Total GDP produced	9 994.3	–11.6	–7
Material sectors	8 570.9	–13.4	
Non-material sectors	1 423.4	–0.4	
Consumption	7 050.2	–11.7	
Personal consumption	6 311.0	–13.1	
Paid from personal income	5 421.5	–15.3	8
Paid from public funds	889.5	0.7	
Public consumption	739.2	0.2	
Gross fixed investment	2 114.5	–10.6	–5
Stockbuilding	680.3	–68.9	
Total domestic demand	9 845.0	–15.4	
Net exports	149.3	243.1	
Exports of goods and services	–	15.1	–4
Imports of goods and services	–	–10.2	33
Total GDP used	9 994.3	–11.6	

1. In constant prices of 1984.
2. Percentage change with respect to previous year.
3. In constant prices of 1990, figures are approximate.

Source: Statistical Yearbook 1991 and Informacja o sytuacji spoleczno-gospodarczej kraju 1991, Polish Central Statistical Office.

their prices; yields were not seriously affected by this so that while gross output decreased, value-added increased (see Annex III). However, the economic situation of farms worsened, especially the large state cooperatives. Farmers' real incomes were squeezed by low commodity prices and by high interest payments on previously accumulated debt, although the situation eased slightly towards the end of the year.

Movements in domestic absorption have likewise exhibited important fluctuation in composition: in 1990 final domestic demand fell by about 10 per cent. Falling real incomes, resulting from a decline of real wages by around 32 per cent in the socialised sector, led to a measured decline in real personal consumption of about 13 per cent. Gross fixed investment fell by about 9 per cent overall, and by more than that in the socialised state sector. Stockbuilding, which had

been large in 1989, fell very sharply as enterprises adjusted to real positive interest rates and to the fact that they no longer needed to hold precautionary raw material inventories to manage supply irregularities. The decline in stockbuilding may have contributed some 5 percentage points to the decline in total domestic absorption. Indeed, in the first half of the year substantial de-stocking occurred, contributing both to the collapse in production and to strong exports as excess inventories were converted into cash[5]. The decline in domestic demand as well as the devaluation of the zloty in January 1990 spurred exports and restrained imports, so that large trade surpluses were registered both in convertible and non-convertible currencies. As a result, real net exports made an overall positive contribution to GDP growth of the order of 6 percentage points.

Estimates for 1991 point to a smaller decline in domestic absorption than in 1990 but to a substantial negative contribution to output growth from net exports. In sharp contrast to 1990, household consumption grew, with consumption paid from personal income[6] estimated to have risen by around 8 per cent[7]. This rise in consumption was supported to some extent by real wage increases of 2 per cent, but also reflected a decline in household savings. Other components of domestic demand continued to decline. Public consumption fell slightly as a result of tight expenditure controls. Aggregate investment declined by a further 5 per cent, in both the state and private sectors, and was most marked in agriculture. Investment in construction, however, declined by 22.5 per cent, following a steep decline in 1990. Modernisation of buildings only partly offset a virtual halt in building of new structures[8]. The number of apartment units begun has been steadily diminishing, despite the general shortage of housing.

On the external side, the real appreciation of the exchange rate contributed to lower the growth of exports to market economies (exports to the EC grew only 26 per cent in 1991 after a 65 per cent expansion in 1990). In combination with the collapse of the CMEA market (a 43 per cent drop in exports), the overall volume of exports of goods and services declined by around 4 per cent[9]. By contrast, the volume of imports of goods and services surged 33 per cent with respect to 1990, with the growth concentrated in the first half of the year. Reflecting the strength of total private consumption, this rise in imports was associated with a markedly changed commodity composition. Consumer goods imports were twice as high as in 1990: the share of consumer imports in total

imports amounted to about 34.7 per cent, compared with 21.5 per cent in 1990 and 17.5 per cent in 1989.

Supply response

In seeking to clarify the factors shaping these macroeconomic outcomes it is essential to differentiate between the private and the state sector, the latter comprising predominantly state-owned industrial enterprises.

Private sector activity

In 1990, private sector output increased 17 per cent, while output in the state sector declined by about 20 per cent[10]. As a result, the private sector share of GDP grew from 28 per cent in 1989 to 35 per cent in 1990[11]. The trend of a rising private sector share apparently continued in 1991, though full economy estimates are not yet available. In industry, the output of private firms grew by around 25 per cent and the share of the private sector in total industrial output (in current prices) increased from 17 per cent to 27 per cent. The share of employment in the private sector continued to increase in parallel with these trends, and private enterprises (including private farmers) at present constitute over 50 per cent of total employment. Outside agriculture around 37 per cent of people employed in the "material sphere" are working in the private sector.

The share of the private sector in production and employment, and consequently its contribution to output growth, may in fact be considerably higher than indicated by these figures since private activity has expanded rapidly in the service sector for which statistics may be less reliable. Thus, the share of private shops in total retail trade has grown to over 80 per cent, and the share of private firms in foreign trade has grown rapidly: recorded private exports accounted for 19.8 per cent of total exports in 1991, and recorded private imports for 46.1 per cent of total imports. The share of private firms in total freight transport now accounts for 32 per cent. To the extent that official statistics fail to capture such developments, the level and growth of overall economic activity, as well as the share of private enterprise in it, are underestimated.

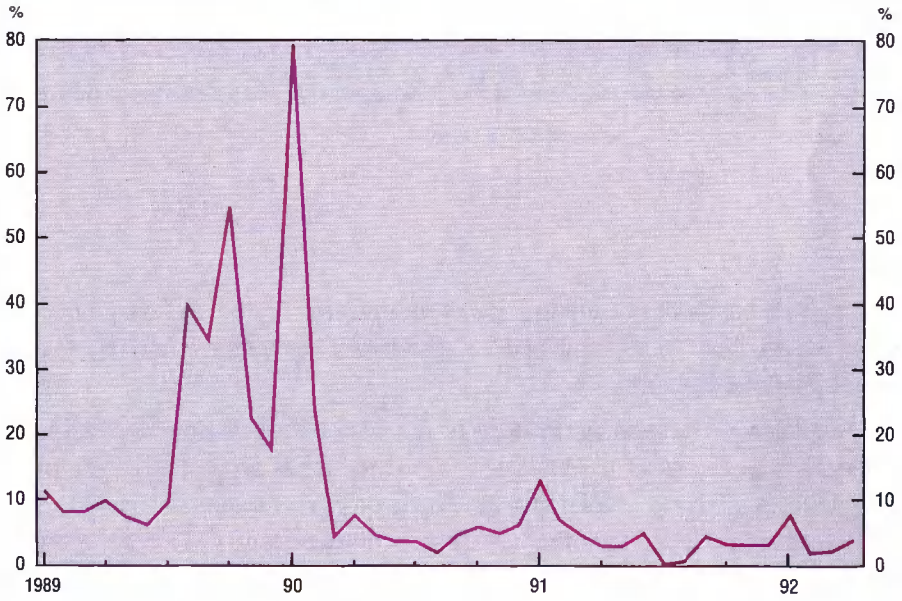
The supply response of state enterprises

Output declines in the state owned industrial sector have to date been larger than output increases in the private sector. While the latter has grown rapidly, it

began from a small base. Price and wage developments over the period in the face of changing nominal demand have been a major factor behind the continuing output declines in the state sector[12].

The price liberalisation introduced in January 1990 was followed by a generalised explosion in prices in January and February, but in March the situation changed. In the face of rapidly falling real demand, enterprises curtailed or reversed price increases, while also cutting production sharply to limit inventory build-up. Thus inflation came down quickly from March onwards (Chart 2). Wage behaviour during these months reinforced disinflation. Until mid-year nominal wages (i.e. enterprise wage bills) remained significantly below norms (Chart 3) so that real wages declined sharply: by over 50 per cent relative to the peak in the third quarter of 1989 (Chart 4). As a result of these developments, enterprises finished the first half of 1990 with high profits. These were boosted

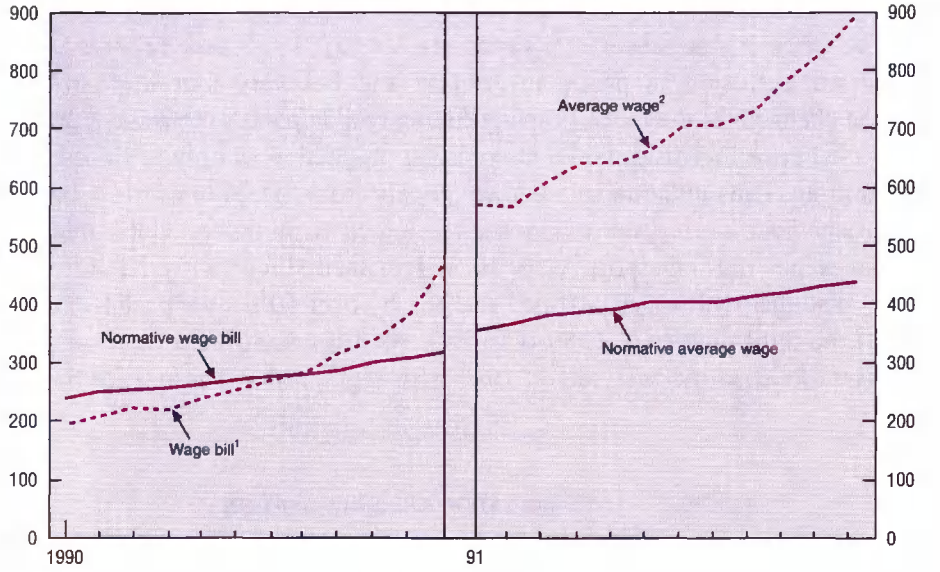
Chart 2. **HYPERINFLATION AND STABILISATION**
Month-on-month consumer price changes



Source: Polish Central Statistical Office.

Chart 3. **NOMINAL WAGES AND THE WAGE NORM**

Sept. 1989 = 100



1. Wage bill paid by enterprises covered by the Central Statistical Office's survey of enterprises (F01), excluding payments from profits.
2. Average nominal monthly wage in the six main sectors of the economy (i.e., material sectors and municipalities), excluding payments from profits.

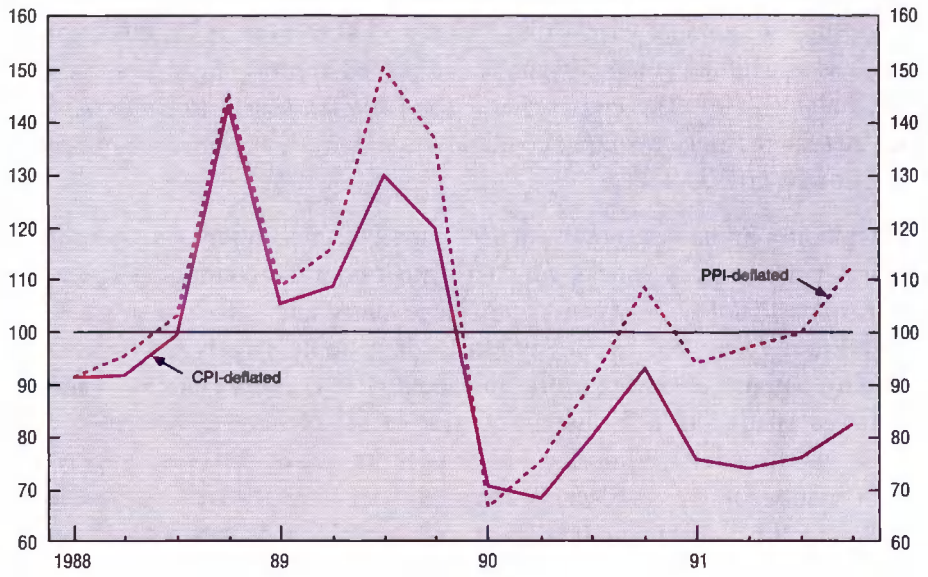
Source: Polish Ministry of Finance, Central Statistical Office.

further by the realisation of holding gains on inventories and on foreign currency deposits when they were subjected to mandatory conversion into zloty at the National Bank of Poland.

The situation changed again from June onward. At that time, at least in part in reaction to policy adjustments that seemed to signal an easing of the overall stance, nominal demand accelerated and, for a time, real output recovered. But of more lasting significance than the output recovery was renewed strong growth of wages. Not only was the room that had been built up earlier under the wage norms quickly exhausted, but even the relatively easy norms that had been established for the second half of the year were increasingly exceeded. This

Chart 4. **AVERAGE REAL WAGES IN INDUSTRY**[1]

Average real wage 1988-1991 = 100[2]



1. Excluding profits.
2. Average of CPI- and PPI-deflated wages.

Source : Polish Central Statistical Office.

process continued, and indeed accelerated during 1991 as state enterprises apparently lacked the incentives to resist above-norm wage increases despite the penalty taxes that this entailed (Chart 3).

While initially these wage increases and even the penalty taxes they gave rise to could be covered out of the high enterprise profits that had been built up earlier, this could not last. Profit margins started to come under pressure, more and more pronounced over time. By the second half of 1991, after-tax profits of the state-enterprise sector were negative in aggregate.

In responding to declining profits, state enterprises failed to address the fundamental problem of costs. Cost-cutting measures, such as more aggressive laying-off of redundant labour, that might have preserved competitiveness, were

not taken. Nor did resistance to wage increases stiffen noticeably. Instead, enterprises raised prices, so that inflation, which had continued to decelerate until August, began to rise again. However, in the face of an exchange rate that was held constant in nominal terms from January 1990 to May 1991, this implied a steady loss of external competitiveness, and indeed imports began to surge in the second half of 1990. The consequent loss of market shares to imports in turn meant that the recovery in output could not be sustained, and production began to contract again after October.

Beginning in the last months of 1990, the Polish economy was subjected to two further deflationary shocks which, together with the continuing squeeze on enterprise profitability between rising wage costs and prices that were constrained from rising because of external competition, largely account for the continuing output fall during 1991. In January 1991, energy prices to industry were raised sharply in a further instalment of the phased adjustment of these prices to world levels. While the inflationary impact of this was quickly contained (because of the fixed exchange rate), cost competitiveness was further eroded since the associated (short-lived) fall in real wages was not sufficient to offset higher energy costs. Of greater significance was the loss of markets in the ex-USSR[13]. Overall, the shock impact of the collapse of intra-CMEA trade in 1991 may have amounted to about 2 per cent of GDP, heavily concentrated on the machinery sector. The overall effect on GDP growth stemming from this shock may well have been exacerbated by multiplier effects, even though increased exports to the west provided a substantial offset. It would probably be inaccurate, however, to regard the collapse of the CMEA market as a purely ''exogenous'' shock: the shift to world-market pricing in CMEA trade would have exposed many of the industries engaged in this trade to a severe cost-price crisis independently of the collapse of the USSR market.

Economic performance improved somewhat in the second half of 1991. While industrial production continued to show year-on-year declines throughout this period (and in January-February 1992 was still some 14 per cent below year-earlier levels), monthly movements were no longer systematically downward. This may be accounted for in part by the passing through of the impact of the CMEA trade collapse. Also, the devaluation of the zloty by 15 per cent in May 1991 served to ease cost-price pressures somewhat. (And the shift in October to a crawling-peg whereby the zloty is devalued at a steady rate of 1.8 per cent per

month goes in the same direction). However, the situation remains fragile, in particular because real wages resumed their upward trend in the second half of 1991, with no indications that productivity growth in the state enterprise sector is picking up. This creates the risk that the more flexible exchange-rate policy now in place could serve only to intensify a wage-price spiral rather than contributing to improved competitiveness.

In assessing the overall performance of the state enterprise sector during the 1990-1991 period, three considerations – cutting in somewhat different directions – can be noted:

- First, the problem of wages was made much more difficult to handle throughout this period by the fact that consumer prices rose much more rapidly than producer prices. For instance, between December 1990 and December 1991, consumer prices rose by 60.4 per cent, but producer prices for industrial goods by only 35.7 per cent. Thus, nominal wage increases that, for workers, tended mainly to compensate them for higher consumer prices, represented a sharp increase in real labour costs for enterprises whose output prices were rising more slowly. These divergent price movements, which reflected a combination of external terms-of-trade deterioration and internal terms-of-trade deterioration of industrial goods versus domestic services (and distribution services in particular) needed to be absorbed somehow. In the event, given the workings of wage policy, they were absorbed by the state sector enterprises rather than the labour force in industry.
- Second, it is probable that the relatively good performance of the economy in the spring of 1990 generated unduly optimistic expectations about how the economic transition would proceed. Many of the factors sustaining profits were temporary and due to be reversed; and surely some part of the initial real wage decline had to be recouped. But perceptions that conditions were not as difficult as had been feared initially may have eroded popular willingness to proceed with tough adjustment, and so contributed to making difficulties more severe.
- Finally, it may be that in these conditions, the policy package announced by the government in June of 1990, prematurely "eased the pressure". This package, comprising a further cut in the refinancing rate, a temporary increase in the wage indexation factor to 1.0, an initiative to resolve

inter-enterprise credit problems by discounting enterprise bills and a new program of support to agriculture was modest in itself and could hardly be seen as an abandoning of the stabilisation strategy. Nevertheless, it could have altered expectations in the enterprise sector, and shifted the centre of gravity from adjusting to "waiting" for future government support.

Unemployment

Since the beginning of the transformation programme, unemployment has steadily increased from 0.3 per cent in January 1990 to 6.1 per cent at the end of 1990 and 11.4 per cent at the end of 1991[14]. The rise in unemployment, though large in absolute terms, has been small relative to the decline in output: state industrial firms in 1990 cut employment by only 14 per cent in response to an output decline of 25 per cent[15]. Thus, if widespread views that Polish state enterprises were over-manned before have any substance, the problem has worsened[16]. The pattern of sluggish adjustment of employment continued in 1991. Failure to reduce employment as output has fallen has been a factor, along with wage and energy price increases, in the increasingly difficult financial situation of state enterprises. Mass layoffs accounted for only about 23 per cent of the unemployed at the end of 1991, although they are becoming more common. The relatively small share of unemployment accounted for by mass layoffs reflects the comparative lack of bankruptcies, the slow pace of fundamental restructuring of potentially viable enterprises, and high severance costs for such layoffs[17]. It is likely that the level of unemployment will increase further, even if total output begins to recover as enterprises adjust with a delay to past output declines and undertake restructuring.

The geographical pattern of unemployment in Poland reflects the absence of a national labour market. Unemployment is lowest in the Warsaw area (4-5 per cent) and highest in the North-East (17 per cent)[18]. One reason for the regional segmentation of labour markets[19] is low mobility aggravated by housing shortages[20].

Unemployment is concentrated in particular groups: as in many OECD countries, women and young people are especially affected. Women make up more than half of the total number of unemployed[21]. There is also evidence that

some youth unemployment is becoming long-term. If this indeed represents a trend, its reduction will depend to a large extent on the effectiveness of retraining and on whether the education system responds to labour market needs[22].

Income distribution and poverty

The fall in output raises questions about the impact on aggregate economic welfare, but particular concern attaches to the incidence of poverty. Issues of the distribution of income and economic welfare are notoriously difficult to assess and even more so in Poland for two different reasons. First, parallel markets appear to be especially important. Income distribution measures derived from Polish household surveys certainly under-record income from such activities. Second, it is almost impossible to measure what happened to the real standard of living between 1989 and 1990. Although recorded real wages fell 30 per cent in 1990, at the same time shortages were eliminated and access to many goods became available for the first time. Direct measures of real consumption are very difficult to obtain. Some calculations, although extremely crude, point to a decline of less than 5 per cent in the aggregate[23]. If this is correct, and the results are disputable on several grounds, then by the end of 1991 real consumption levels in aggregate were back up to the levels prevailing at the end of 1989. On the other hand, a preliminary estimation by the Central Statistical Office found that for four major income groups, real consumption had declined by 5 to 41 per cent between 1989 and 1991.

Nevertheless despite the statistical caveats it is undoubtedly true that particular groups (notably small farmers and the unemployed) have experienced increasing economic hardship and a number have certainly fallen beneath any normal measure of poverty. As structural adjustment in particular firms and regions gets under way, others may be hard hit. Informal activities can be a means of avoiding the worst of poverty by many, but some will not be able to cope. This will be all the more so if unemployment reaches very high rates and informal markets become saturated. At the same time, increased charges for rent, heating, power and hot water to reflect economic costs will affect a wider circle of people with marginal incomes. It is therefore essential to have in place a comprehensive, but cost effective, safety net.

External constraints: the balance of payments and external debt

The evolution of Poland's balance of payments in convertible currencies since 1989 is shown in Table 2. Both the shift of the current account into surplus in 1990, and its subsequent move back into deficit in 1991 were largely driven by trade flows, which developed very dynamically over the period. Especially noteworthy was the 43 per cent rise in dollar receipts from exports in 1990, while imports grew slowly, so that a large trade surplus opened up. Exports continued to grow in 1991, by a healthy 17 per cent (though receipts peaked at mid-year, and have drifted downward since then). Import payments, however, surged by almost 50 per cent, so that the trade surplus largely disappeared.

Table 2. **Balance of payments in convertible currencies, 1989-1991**[1]

Mn current U.S.$

	1989	1990	1991
Trade balance	240	2 214	51
Exports, f.o.b.[1]	7 575	10 863	12 760
Imports, f.o.b.[1]	7 335	8 649	12 709
Non-factor services balance	–3 315	–3 479	–2 627
Net interest	–3 087	–3 329	–2 863
Unrequited transfers	1 656	1 981	1 217
Private	1 144	1 676	308
Official	512	305	909
Current account	–1 419	716	–1 359
Net medium- and long-term capital	–2 834	–4 153	–4 472
Net short-term capital	112	–2 740	–1 155
Capital account	–2 722	–6 893	–5 627
Other financial items, valuation changes, errors and omissions	–178	360	–771
Exceptional financing	4 578	7 755	6 569
Overall balance	259	1 938	–1 188
Change in reserves (increase –)	–259	–1 938	1 188

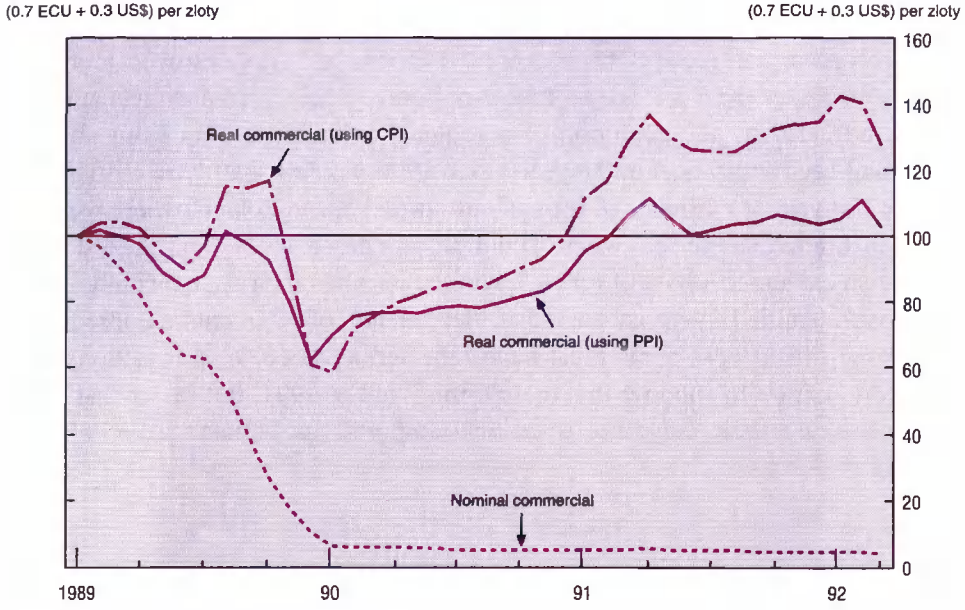
1. On cash basis.
Source: National Bank of Poland.

Trade developments as recorded in the balance of payments, based on settlements, are qualitatively consistent with the customs data that are discussed in Chapter V. It is likely, however, that merchandise imports have in fact been under-recorded, and receipts from exports of goods and services even more so. Some support for the existence of substantial unrecorded foreign exchange earnings is provided by the evolution of unrequited private transfers from abroad, which had been substantial in the years up to 1990, but fell sharply in 1991. 1990 was the last year of existence of foreign-currency shops in Poland, where western goods in limited supply elsewhere could be purchased for dollars. The dollars that Polish citizens got hold of for such purchases, when their source could not be otherwise identified, were accounted in the balance of payments as unrequited transfers. In fact, these sums must have reflected a variety of transactions and there is no reason to suppose that these diminished in 1991, but rather that such earnings found their way into additional imports (or perhaps accumulation abroad).

The development of trade flows during this period no doubt reflects many factors, including the massive trade liberalisation undertaken at the beginning of 1990, but at least in a qualitative sense the movements appear well correlated with movements in the real exchange rate. Chart 5 shows the evolution of the real effective exchange rate for the zloty, calculated by the OECD Secretariat on the basis of both relative consumer prices and producer prices. The most striking feature of the Chart is the speed with which Polish competitiveness eroded following the large depreciation of the zloty in 1989. This is especially the case for the index of relative consumer prices, which had risen above the 1989 base before the end of 1990, and has since continued to appreciate. The real exchange rate in terms of relative producer prices has risen less, and remains below the peak reached prior to the devaluation of the zloty in May 1991 – in part, no doubt because Polish producers have been constrained by foreign competition from raising their prices. While judgements on whether the level of a real exchange rate is appropriate are always difficult to make – and all the more so in a country like Poland undergoing rapid structural change – there would nonetheless seem to be a serious risk that present levels will not sustain a strong trade performance. But the Chart also makes it clear that nominal depreciation can provide only a very temporary boost to competitiveness because the gains are quickly eroded in

Chart 5. **NOMINAL AND REAL EFFECTIVE EXCHANGE RATES**

Jan. 1989 = 100



Source : Polish statistics and OECD calculations.

the absence of measures to limit the pass-through from resulting higher import prices into domestic wage costs.

Viewed more globally, the convertible currency balance of payments continues to be very significantly shaped by Poland's external indebtedness. Net interest due is recorded in the current account on an accrual basis (and similarly, in the capital account, scheduled amortisation is treated as an outflow). Poland, however, has not been able to fully service external debt for a number of years, and the substantial "exceptional financing" shown in the table reflects the various mechanisms – reschedulings, arrears, deferrals and capitalisation of interest – that were employed to deal with this problem. In this respect the situation in 1991 is quite different from that of earlier years, because in April 1991 agreement was reached in the Paris Club that Poland's debt to official creditors in the West (amounting at the time to some $32 billion, or over 65 per cent of total

Polish external debt) would be written down by 50 per cent in present value terms. The principal features of this debt-forgiveness operation are as follows:

i) 30 per cent debt write-down would be effective immediately, with the remainder coming in April 1994 on condition that the International Monetary Fund completes its review of Poland's extended fund programme by the end of 1993.

ii) Poland undertook not to provide more favourable terms to non-Paris Club creditors (including in particular private banks) than had been agreed with the Paris Club creditors. Western banks have generally not been satisfied with this condition, and in the resulting impasse Poland is continuing not to service its bank debt. (In fact, Poland had stopped payment on this debt in 1989.)

iii) Paris Club members agreed that the forgiveness would be structured so as to assure that Poland would not need to repay principal for five years, and that interest payments for the first three years would be limited to no more than 20 per cent of interest due on the whole stock of debt before any debt reductions. Beyond this, individual creditors and the Polish government were to decide bilaterally on the precise modalities through which the 50 per cent present value reduction was to be achieved (e.g., whether by debt write-down, reduced interest rates, or interest deferrals). As a result, and because not all bilateral agreements have been concluded, it is at present very difficult to translate the debt reduction package into balance of payments terms. The recorded Polish current account deficit in 1991 could well be fictitious to a large extent, since substantial amounts of ''exceptional financing'' takes the form of interest forgiveness or deferral, that could equally well be accounted ''above the line'' as a reduction in interest due.

The ''bottom line'' of the Paris Club agreement is that at least until 1994 it will substantially ease the external constraint on Poland compared to what would have been the situation otherwise. Interest obligations over these years will average less than $500 million per year – substantially less than what Poland owed in interest in previous years, though rather more than what was actually paid. Nevertheless, Poland remains debt-constrained: access to normal commercial borrowing (with the exception of short-term trade credit) is precluded, at

least until agreement on a debt relief package can be reached with the commercial banks. Even thereafter, banks are likely to remain extremely cautious in lending to Poland for a number of years. In these conditions there are serious constraints on the extent to which any further weakening of the trade balance could be financed, unless foreign direct investment picks up sharply. The situation is not critical: substantial commitments by the World Bank and other international institutions, plus a number of bilateral credit lines with foreign governments, insured by them through their export-credit insurance agencies, are in place; and it should be possible to accelerate disbursements through these channels to some extent[24]. In addition, foreign exchange reserves, though down from 1990, tended to stabilize in the latter months of 1991 and remain adequate. In spite of this, Poland clearly needs to ensure continued strong trade performance, and generate an export-led recovery of output, if it is not to fall back into a damaging debt-trap in future years.

The balance of payments in non-convertible currencies became largely irrelevant in 1991, as the value of transactions denominated in transferable roubles (TR) declined to very low levels. Up until 1990 Poland had accumulated TR debts within the CMEA system. At end 1989, Poland had TR debts of about 5 billion TR *vis-à-vis* the USSR, as well as dollar-denominated debts of $1.8 billion resulting from assistance to the previous Polish regime from the USSR in 1981-1982. In 1990, however, Poland ran very large TR trade surpluses so that by mid-1991 Poland had accumulated gross claims *vis-à-vis* the Soviet Union in the CMEA clearing accounts to the amount of about 7.5 billion TR. The Russian authorities have posed difficulties about netting these claims against older liabilities. Negotiations concerning the settlement and conversion of mutual claims and liabilities have been launched, but remain inconclusive (see Chapter V).

Macroeconomic policy

The principal immediate goal set for macro-economic policy at the start of 1990 has been realised. Zloty convertibility has been maintained and, through this means, inflation expectations have been contained if not eliminated. Even so, the implementation of macro-economic policies was hampered in 1990 and 1991 by inadequate instruments. Fiscal control has proved difficult owing both to the sharper-than-expected decline in output, and hence tax revenues, and to the need

to rely on a narrow and fragile tax base as tax reform was delayed. The effectiveness of monetary policy has been hampered by a lack of instruments to control the money supply, as well as by the absence of structural conditions favouring a smooth transmission from monetary restraint to inflation outcomes. Wage policy has been burdened both by the need to make frequent adjustments to the parameters and by compliance problems. In addition, lack of accurate data and knowledge of behavioural relationships has contributed to difficulties in implementing policies. This section examines these issues.

Fiscal policy

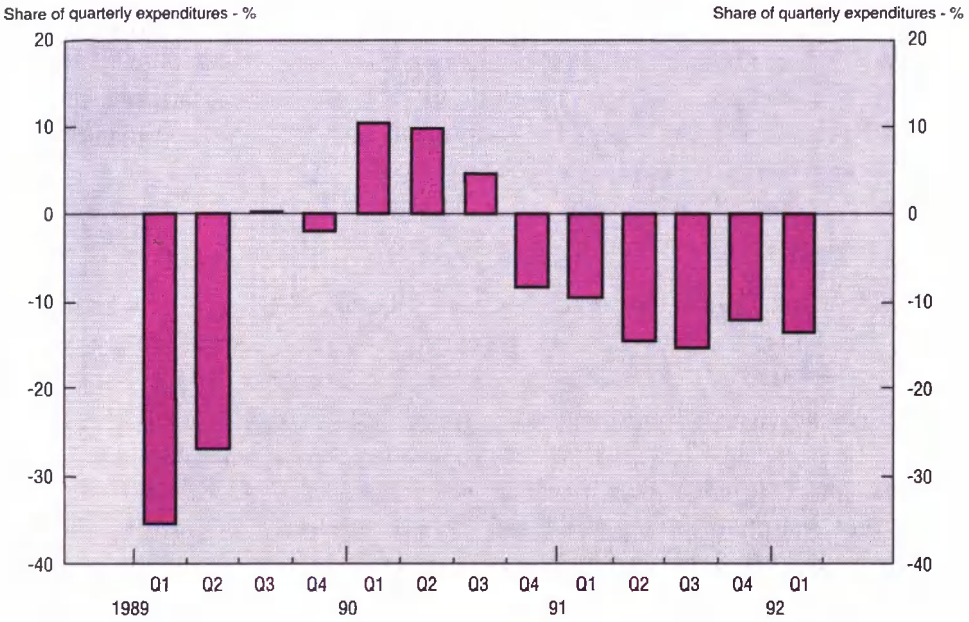
In 1990 and 1991 budget outcomes were wide of objectives – with an initial swing into budget surplus that was stronger than programmed, followed by slippage back into a deficit that was larger than expected. The evolution of budget deficits (scaled by government expenditure for lack of quarterly GDP data) is presented in Chart 6. Emergency measures taken in the last quarter of 1989 had put the budget deficit, which was 6 per cent of GDP for 1989 as a whole, on a sharply declining trend, and this was reinforced by further expenditure cuts at the beginning of 1990. In consequence, and also reflecting bouyant tax receipts, the budget rapidly moved into surplus. For 1990 as a whole the budget was in surplus by 2.7 per cent of GDP, although slippage occurred from the third quarter onward, and by the fourth quarter the budget was back in deficit. The deficit widened further through the first three quarters of 1991, and for the year as a whole it is estimated at 3.8 per cent of GDP.

Following the substantial expenditure cuts in late 1989 and early 1990, real government expenditures were kept broadly unchanged over the following seven quarters, though with quarterly variations[25]. Since social expenditures were under a strong upward pressure, this performance entailed substantial cuts in other expenditure components. From this perspective, the re-emergence of deficits ought to be seen mainly as a problem of declining revenues in real terms, and not as a failure to exercise reasonable control over expenditures.

The immediate cause for declining real tax revenues in 1991 was sharply declining corporate profits and hence lower profit taxes. Turnover tax receipts were also relatively weak despite higher rates for some items; and increases in other taxes – such as the excess wage tax and import duties – were insufficient to offset the revenue losses from the corporate tax. An additional significant factor

Chart 6. **GOVERNMENT BALANCE AS SHARE OF EXPENDITURES**

In current prices



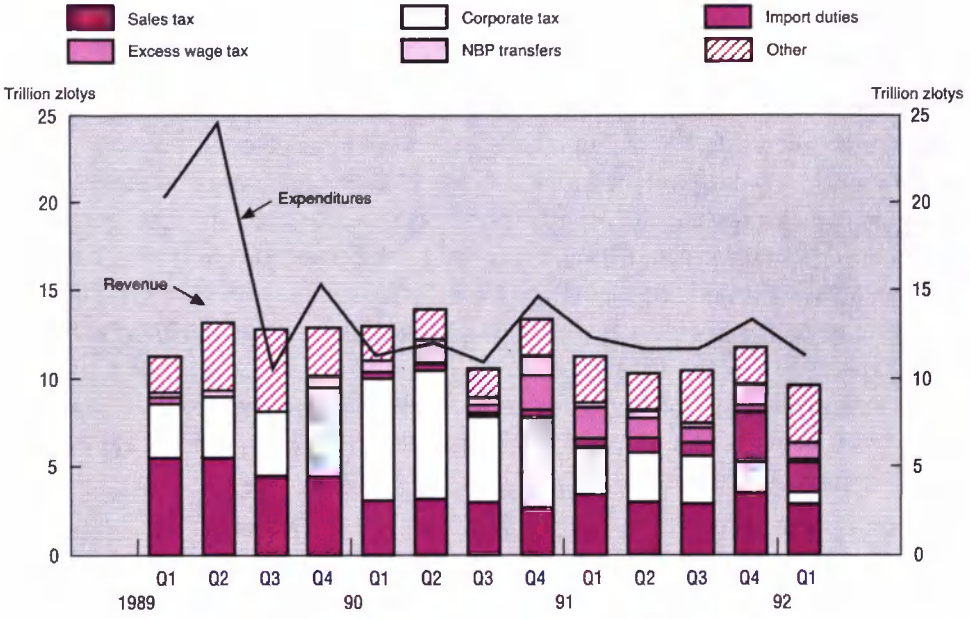
Note: In 1989-1990, the central budget and all local budgets are included; in 1991, due to classification changes, the central budget and only part of the local budgets (the voivodship budgets) are included.
Source: Polish Ministry of Finance.

was the increasing incidence of tax arrears. This is the primary reason for the fall in excess wage tax receipts despite continued violation of the wage norms. There were also mounting arrears in the capital tax or ''dividenda''. Although the private sector expanded dynamically throughout the period, tax breaks and low tax compliance meant that contributions to central budget revenues from this source grew only marginally in both 1990 and 1991.

As further discussed in Chapter III, a large number of measures were taken in 1990 and 1991 on both the revenue and expenditure sides of the budget. In 1990, subsidies to both consumers and producers were substantially reduced from 10.5 per cent of GDP to 7.0 per cent. A number of distortions in the tax system were eliminated: private and state firms were put on an equal footing; the

Chart 7. **REAL BUDGET REVENUE AND EXPENDITURES**

In constant prices of Dec. 1989



Note: The 1989-1990 data cover only the central budget; in 1991, due to classification changes, only the state budget is covered — i.e. previous central budget plus part of the previous local budgets (the voivodship budgets).

Source: Polish Ministry of Finance.

number of turnover tax rates were substantially reduced; exemptions or subsidies were streamlined or eliminated; and preparations were put in hand for the introduction of a personal income tax and VAT. In addition, two taxes were strengthened not solely on account of fiscal considerations but with the objective of stabilising wages and controlling state enterprises: the excess wages tax (Popiwek) and the capital tax (dividenda).

Budget policies were further reinforced at the beginning of 1991. In particular, thirty-odd extra-budgetary funds were eliminated, and a comprehensive overhaul of local government finance was undertaken, making municipalities more self-financing and devolving onto them greater spending responsibilities. In addi-

tion, tight monitoring of expenditures resulted in reduced spending – during the first half of the year only 37 per cent of outlays planned for the year as a whole were undertaken. On a less positive note, the introduction of a personal income tax was delayed in Parliament so as to come into effect only in 1992, and the value-added tax was postponed, probably to 1993.

Despite these efforts, the slide of the budget into deficit was not arrested. By mid-1991 it exceeded 13.1 trillion zloty (the initial target for the year had been 4.3 trillion zloty) and partly as a result, the IMF programme was suspended. Exceptional measures and a revised budget were introduced in October 1991: energy subsidies were trimmed, and the requirements to qualify for unemployment benefits tightened. Substantial savings were achieved by abolishing the indexation of budget sector wages to industrial wages (saving 20 trillion zloty in the last quarter). On the revenue side, higher tariff rates – though not implemented specifically for budgetary reasons – resulted in the average duty increasing from 9.6 per cent to 13.5 per cent. Despite these actions, the end-year deficit reached around 31 trillion zloty.

Overall, the record of fiscal policy during 1990-1991 indicates persistent efforts by the government to maintain control over the budget deficit, though it was hampered in this by delays in reforming the tax system, and expenditure cuts largely had to take the form of underfunding, rather than reforming expenditure programmes to make them durably less costly. From this perspective, and in view of the sharp declines in output, containing the budget deficit within 3.8 per cent of GDP in 1991 can be considered a significant achievement. Nevertheless, the budget inheritance from 1991 casts a serious shadow over the future: certain expenditure programmes – pensions and housing in particular – contain within them powerful expansionary pressures; interest payments on accumulating domestic debt will rise sharply; and Poland must look forward to substantially greater foreign debt service beginning in 1994. Further strong measures on both expenditures and revenues are thus likely to be necessary in 1992 and beyond.

Monetary and exchange rate policy

The task for monetary and exchange rate policy in the stabilisation programme was to create a stable monetary environment for decision making and to reduce deep-seated inflationary expectations. This was not an easy objective: in 1988 and 1989 the zloty was falling into disuse as many important transactions

were in foreign currency and people sought to hold their wealth either in goods or foreign exchange. Inflationary expectations, after several years of high and accelerating inflation, were deeply entrenched. The credibility of official institutions and of government commitments were low.

Under these circumstances the authorities decided that the operational goal for monetary policy was to establish convertibility for the zloty at a fixed nominal exchange rate as a nominal anchor for price expectations. In the prevailing circumstances, this decision was surely the right one: in view of the pervasive uncertainties associated with economic transformation, and the unknown relationships that would prevail in the new environment between money growth and inflation, other strategies would have failed to provide the clear signals needed to bring hyperinflation under control. The exchange rate has remained central to the formulation of monetary policy throughout 1990 and 1991, even though the strict nominal anchor approach was eventually modified.

The initial commitment of the government in January 1990 was to keep the zloty fixed against the dollar for a period of three months. In fact, market pressures on the zloty were substantially weaker than had been feared. The $1 billion stabilisation fund that had been established to support convertibility did not need to be drawn on; it proved possible to stabilise the kantor rate within a narrow band of the official rate; and official reserves grew throughout 1990. Under these conditions it proved possible to keep the zloty fixed for substantially longer than had been planned originally. The zloty was finally devalued in May 1991 by 15 per cent – less on account of severe pressure on reserves than in order to ease the competitive pressures on enterprises that had arisen from the large real appreciation of the zloty over the preceding 17 months. At this time too, the peg was changed from a dollar peg to one against a basket of currencies. Exchange rate policy was again changed in October 1991, when the fixed peg was abandoned in favour of a crawling peg, whereby the zloty is depreciated at the rate of 1.8 per cent per month. This crawling peg continues to operate, though an additional 12 per cent devaluation was super-imposed on this in March 1992. Even with this relaxation of exchange-rate policy, the zloty has continued to appreciate in real terms, and is continuing to act as a constraint on enterprises' ability to raise prices.

The priority assigned to the exchange rate goal carried with it an important implication: zloty interest rates would have to be permitted to adjust accordingly.

In Poland, holdings of foreign currency, both in cash and in bank accounts are important: at end 1989 they accounted for 64 per cent of M2 money supply. Moreover, given commitments to limit movements of the zloty in the parallel market for private transactions relative to the commercial rate, Polish residents have ample scope to shift their asset holdings between zloty and foreign-currency accounts. In these conditions, forestalling a loss of confidence in the zloty and the risks of a run on the currency and rekindled inflation required an interest-rate policy that makes zloty deposits attractive relative to foreign-currency deposits. The controversial decision by the government[26] to pursue a goal of maintaining positive real interest rates must be understood in this context: it is not only to increase saving, though this is surely important in a medium-term context, but also to attract funds into zloty deposits.

To underpin zloty convertibility it was essential to contain the growth of money and credit within limits that would enforce a steady decline in inflation. Failure here would, sooner or later, have resulted in a build-up of excessive liquidity and made the nominal anchor strategy unsustainable. In pursuing the goal of controlling money and credit, the NBP has been hampered by a rudimentary banking sector and limited financial markets, which together have restricted the range and efficiency of policy instruments (see Annex IV for more details). Instruments are largely lacking for indirectly controlling the money supply through open-market operations, and instruments such as rediscount limits often proved ineffective. Reserve requirements under conditions of high bank liquidity have generally not proved to be an effective constraint on credit expansion, while in the absence of a money market, interest rates have played only a secondary role in influencing the money and credit aggregates. Consequently, since October 1990, the NBP has used administrative credit controls as its principal instrument, implemented both by moral suasion and by some formal agreements with the state-owned banks.

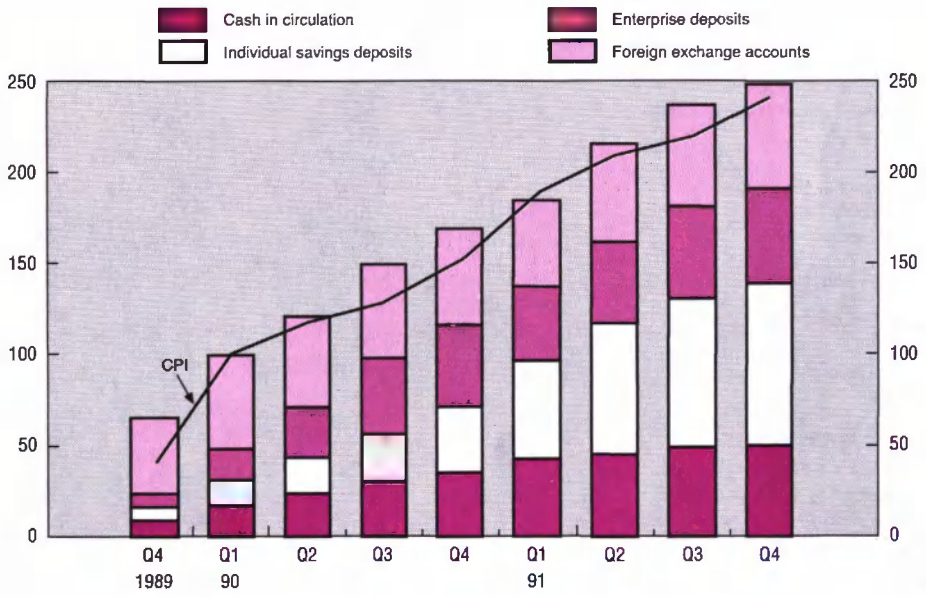
Monetary developments 1990-1991

As a result of the ''corrective inflation'' that began in the summer of 1989, the real money supply and real domestic credit fell sharply. Indeed, they fell by more than half from January to March 1990. This dramatic monetary contraction was the means for absorbing the ''monetary overhang'' that had built up in the Polish economy over previous years and that had as its counterpart the chronic

shortages in goods markets. By March, the price level had adjusted sufficiently to bring money holdings into line with available goods' supply and so permit equilibrium in the goods markets to become established. In considering monetary developments during 1990 - 1991, this paper thus takes the "equilibrium" situation at end March as the benchmark[27].

The evolution of broad money (M2) from March 1990 to the end of 1991 is shown in Chart 8, together with the consumer price index. For the period as a whole, M2 growth has exceeded the rise in consumer prices by a small margin. In view of the concomitant falls in output, this implies a substantial deceleration of money velocity that could in part reflect a rising demand for money as inflation rates came down. In addition, true velocity would not have slowed as much as suggested in the numbers to the extent that burgeoning private sector activity not captured in the GDP accounts has meant that real activity has been better

Chart 8. **STRUCTURE OF MONEY DEMAND**
End-of-quarter, March 1990 = 100



Source: National Bank of Poland.

maintained than is supposed. Even so, however, the chart does not suggest that monetary policy has been unusually restrictive during this period as a whole.

Considering movements during the period, the features that stand out are: first, the relatively rapid growth of money in the second half of 1990, perhaps associated with the rapid rise in net foreign assets resulting from trade surpluses with both the hard currency and rouble areas; second, the fall in real money balances in the first quarter of 1991 as money growth slowed and inflation

Table 3. **Consolidated banking system, 1989-1991**
End-of-month, current trillion zlotys

	1989Q4	1990Q4	1991Q4
Total money	73.9	190.6	280.9
Domestic currency	26.4	130.8	215.5
Cash circulation (excl. cash in bank vaults)	9.9	39.3	56.4
Cash issue	12.8	48.1	68.3
Cash in bank vaults	2.9	8.7	11.9
Individuals' savings deposits	8.6	40.5	100.4
Demand,	1.4	11.0	20.9
of which:			
Savings-settlement accounts	0.7	3.0	6.0
Savings deposits,	7.2	29.6	79.5
of which:			
Interest and bonus accounts	2.2	7.2	14.4
Enterprise funds	7.8	50.9	58.7
Foreign exchange accounts	46.9	59.6	65.4
Individuals' accounts	31.4	55.5	62.7
Enterprise accounts	15.5	4.1	2.6
Dollar-denominated Bank Pekao SA coupons	0.6	0.2	0.1
Assets			
Foreign reserves	10.6	74.3	71.3
In mn U.S.$	1.6	7.8	6.5
Domestic assets, net	63.3	116.3	209.7
Credits for businesses and individuals	32.6	118.2	191.8
Credits for socialised sector	30.6	99.6	145.6
Credits for private sector and individuals	2.0	18.6	46.2
Credit for the budget, net	6.5	–9.2	32.0
Balance of other items	24.2	7.2	–14.1

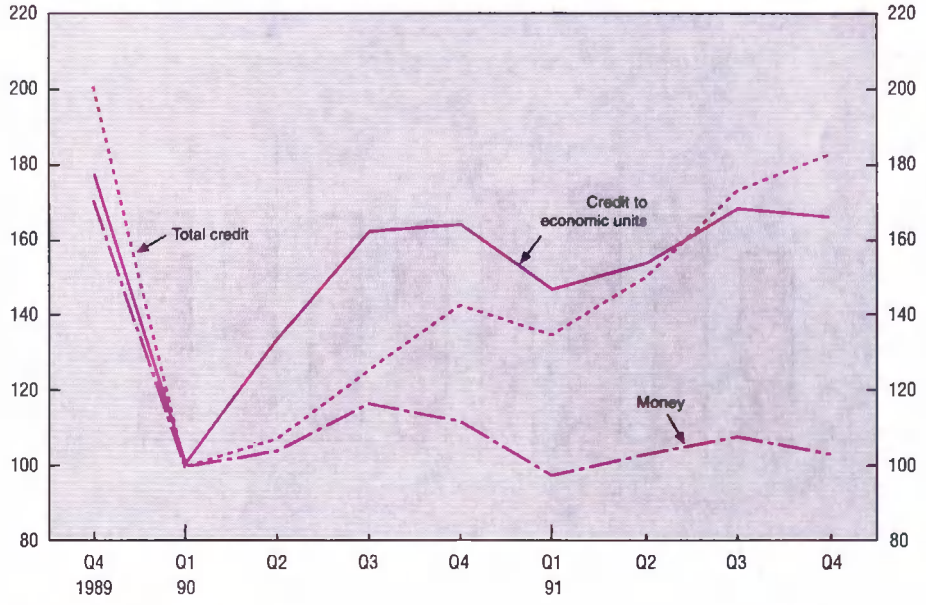
Source: National Bank of Poland.

accelerated; and finally, the resumed growth of money in real terms during the remainder of 1991. Overall, real money supply fell in 1991 by 8 per cent.

Over the same period (March 1990 to December 1991), total domestic credit grew substantially faster than the money supply, as increases in net foreign assets (which other things equal would tend to reduce domestic credit expansion relative to money growth) were relatively small, and were more than offset by shifts in "balance of other items" of the monetary survey (Table 3).

The composition of credit growth has undergone substantial shifts during this period. During 1990, with the government budget deficit shifting into surplus, credits to businesses and individuals expanded strongly in real terms (even more rapidly than total credit). During 1991, credit to businesses and individuals was roughly unchanged in real terms as overall credit growth slowed somewhat, and government pre-emption of total credit increased (Chart 9)[28].

Chart 9. **GROWTH OF REAL MONEY AND CREDIT**
End-of-quarter, March 1990 = 100, CPI-deflated

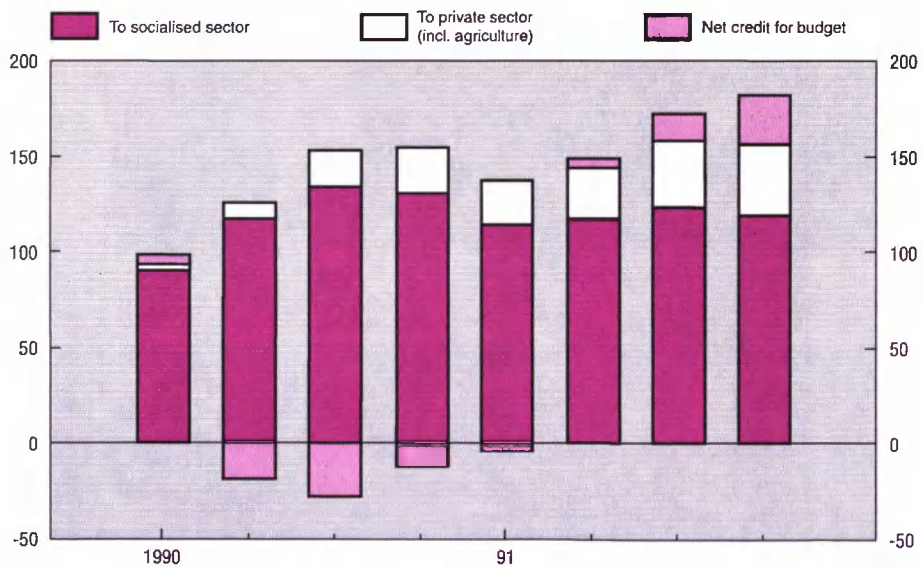


Source: National Bank of Poland.

The evolution of the structure of domestic credits in real terms is shown in Chart 10. What stands out, in addition to the growing share of domestic credit accounted for by government, is the relatively rapid increase in credits for housing construction and the private sector (which – importantly – includes agriculture). Credits to the socialised sector have fallen in real terms in 1991.

It is probable that the trends in money and credit described above have been to some extent at least determined by the demand for credit (and the availability of credit-worthy borrowers for the banks to lend to), as well as to its supply. Indeed, anecdotal reports strongly suggest that interest rates were considered by many enterprises to be prohibitively high. Establishing the truth of this conjecture is not straightforward, since "real" interest rates are difficult to measure, especially in a period when inflation is high and very volatile month by month.

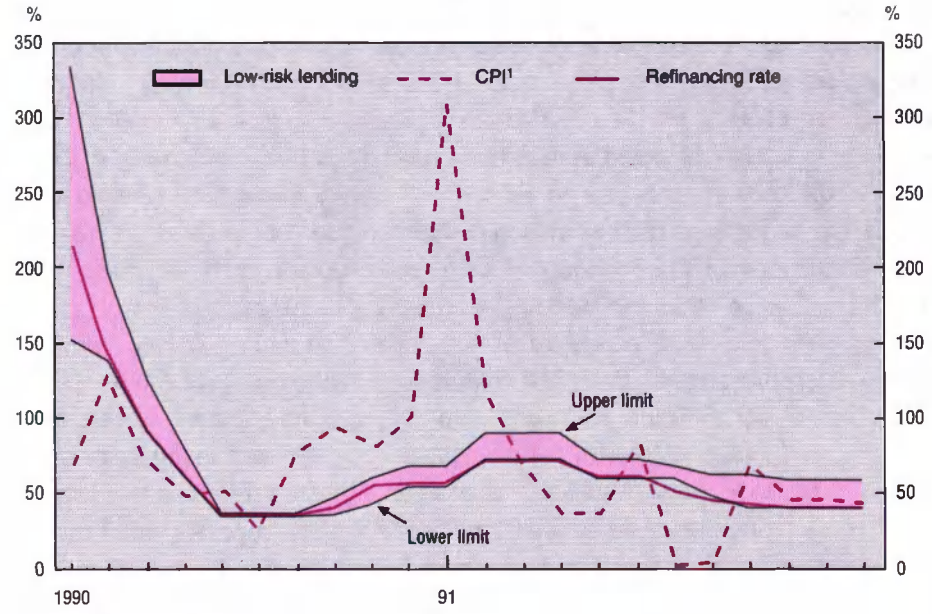
Chart 10. **STRUCTURE OF REAL CREDIT**
End-of-quarter, March 1990 = 100, CPI-deflated



Source: National Bank of Poland.

Chart 11. **INTEREST RATES AND INFLATION**

Per annum



1. Month-on-month annualised rate.

Source : OECD calculations and National Bank of Poland.

Chart 11 provides one rough indication of real interest rates by comparing annualised monthly inflation rates to the NBP refinancing rate, which appears from the chart to serve as an anchor for bank lending rates in Poland.

It is clear that at the beginning of 1990, real interest rates were indeed very high (after having been strongly negative during 1989). Thereafter the picture is less clear: real interest rates appear to have been negative during the second half of 1990 when inflation began to accelerate, but then to have become strongly positive during much of 1991 as inflation came down. Such a pattern of real interest rates moving inversely with inflation is in line with what is generally observed in other countries.

Assessment

Questions such as "how tight is monetary policy?" are difficult to answer in any economy, and almost impossible to judge in the case of an economy like Poland that is undergoing rapid structural change. Judged by results – the bringing down of inflation and the absence of speculative pressures on the zloty during the past two years – it would appear that monetary policy was broadly effective. There would, however, appear to be serious limitations on the extent to which monetary policy can be used as an anti-inflation instrument without giving rise to costly distortions in the economy. Two specific points might be cited in this regard. First, as in other transforming countries of the region, efforts to restrain credit growth are to some extent offset – at the level of enterprises – by increases in inter-enterprise arrears. The NBP estimates that the volume of inter-enterprise credits is on a magnitude comparable to the banking systems' credit to the economy: in September 1991 the official statistics report outstanding liabilities of around 200 trillion zloty. While this is of course a gross figure, and in addition not all of it corresponds to involuntary lending, the scope for enterprises to compensate for reduced access to bank credit by not paying their bills is clearly a problem. Second, the capacity of the NBP to restrict credit is limited because the resulting allocative effects are very costly: since credit to government by the banking system cannot be effectively controlled, and since a variety of preferential credit arrangements cannot be squeezed when overall credit conditions tighten, overall credit restraint impacts primarily on unprotected sectors – and especially the private sector. Thus, the improvement of the scope for monetary policy to serve as an instrument for stabilisation will require not only a strengthening of instruments, but also continued structural changes in the banking system, the enterprise sector, and budget-financing techniques. Some of these issues are addressed in subsequent chapters.

Wages policy

Wage policy in the state sector was established in part for structural reasons, but also as an additional stabilization tool. It is this latter aspect that is considered here.

The instrument of wages policy during 1990 and 1991 was an excess wages tax (Popiwek) which had, in various forms, been in use throughout the 1980s. The growth of nominal wages is regulated by taxing at penalty rates any wage

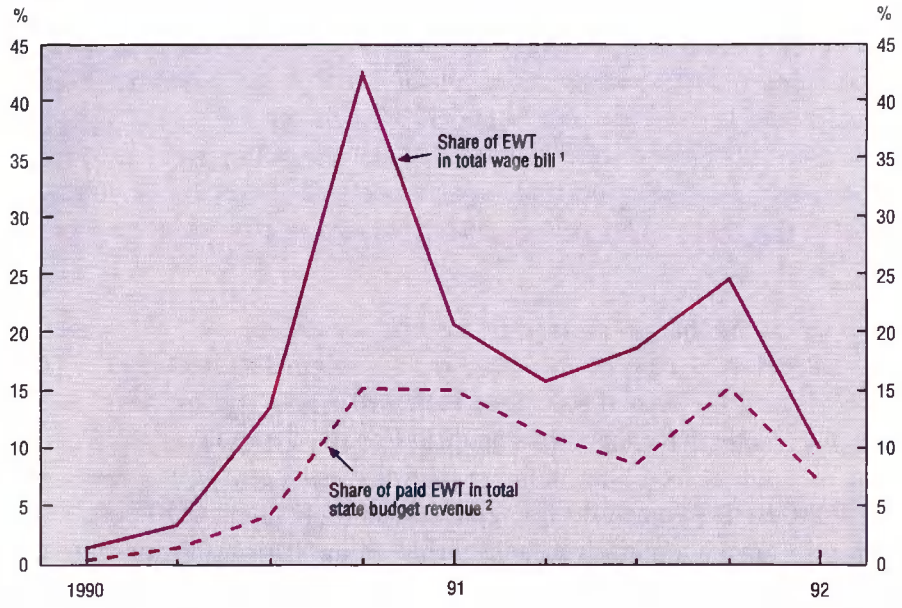
awards above an indexed ''norm''. The norm is specific to each state enterprise and is adjusted monthly by a given fraction of inflation[29]. Any ''unused' potential for wage increases can be carried forward and no penalties are incurred if this results in wage payments exceeding the norm in later periods. The penalty tax[30] is therefore based on the cumulative excess of actual wage payments over the calculated norm. In 1990 the total wage bill was chosen for control as a pragmatic measure since there were expectations that the policy would not stay in place very long: the employment inhibiting aspects of controlling the total wage bill and the risk that employment might be reduced to pay for wage increases were accepted.

It is estimated that on average in the first six months of 1990, wage bills stayed well below the norms resulting in the accumulation of unused wage increases. During the second half firms increased wages and by November, on average, they were above the norms and had to pay penalty taxes – or decrease nominal wages. An increasing number of firms had been paying taxes since August 1990. By December, declining profits and tight credit conditions led the government to make a number of adjustments to the norms, thus pushing them above the level warranted by partial indexation. This brought the norm and nominal wages together in the first months of 1991 and resulted in a substantial decline in the share of tax payments in the wage bill. However, the change undoubtedly damaged the credibility of the government's policy and thereby directly contributed to the rapid increase in tax liabilities later in 1991 (Chart 12).

The system was amended in several important respects for 1991:

- The average wage rather than the wage bill was subject to ceilings. However, the average wage could be increased without incurring tax penalties under several circumstances[31].
- Commercialised firms were entitled to varying degrees of exemption depending on the level of state ownership.
- Wage increases based on enterprise-level profitability ''indicators'' were exempt.
- The definition of total wages was modified to include all payments (including overtime) and benefits (monetary or in-kind) paid out from the resources of the firm[32]. Payments from the social and housing funds exceeding a certain limit were taxed.

Chart 12. **EXCESS WAGE TAX**



1. Excess wage tax owed by enterprises covered by the Central Statistical Office's survey of enterprises (F01); for 1992Q1 the net wage bill has been estimated (gross wage bill minus 20% personal income tax) for consistency with previous years.
2. In 1990 as a share of central budget revenue; in 1991 as a share of State budget revenue; the 1991 State budget consists of the previous central budget plus part of previous local budgets (those of the voivodships).

Source : Polish Ministry of Finance, Central Statistical Office, OECD calculations.

Despite these changes, actual wages exceeded the norm rather quickly and tax liabilities increased throughout the year. Although arrears mounted steadily, the tax became rather perversely a major source of fiscal revenue. This development was possibly facilitated by a further deterioration of credibility: on two occasions the government increased the level of the minimum norm to provide a tax relief for firms that had offered excess wage increases and subsequently incurred the popiwek. On these two occasions low wage industries were involved and it was argued that they should be regarded as special cases. But, as with any

incomes policy, effectiveness is rapidly eroded when exemptions and exceptions start to be introduced.

In principle, and in other circumstances, tax-based incomes policies of the sort exemplified by the popiwek scheme would seem to be preferable to direct wage controls as a means of keeping aggregate wage growth under control, because they allow for an essential flexibility at the margin to deal with necessary wage changes. The increasing ineffectiveness of the excess wage tax in Poland results not so much from problems in the way it is designed (though improvements are certainly possible, particularly in the direction of strengthening the incentive for enterprises to remunerate workers through bonuses related to profits rather than through higher straight wages). Rather, the unsatisfactory results may be due to too frequent adjustments in the parameters. Such adjustments inevitably cause a loss of clarity in the basic objectives aimed at, and lead to anticipatory behaviour. More fundamentally, the problem has been that state enterprises do not see themselves as clearly bound by hard budget constraints, and hence have been far too ready to pay wage increases that could not be afforded.

Short-term prospects and risks

The priority objective identified by the new coalition government that came into office in December 1991 was to arrest the decline in output, while keeping inflation under control. Official projections developed early in 1992, which are to some extent normative, are for zero growth of GDP in 1992, and for inflation to slow to 45 per cent year-on-year, compared to 70 per cent in 1991, implying an inflation rate of 36.5 per cent from December to December.

One key to achieving outcomes along these lines is to keep the budget deficit under control. In this regard the government has faced a particularly difficult challenge. Initial prognoses by the Polish authorities suggested that inertial forces in the budget would cause the budget deficit to balloon in 1992 to well over 10 per cent of GDP – a clearly unsustainable development. To counter this, actions to increase the efficiency of government programmes and reduce their costs, and to increase revenues through new tax measures and more effective collection were clearly required. The previous government, which remained in office in a caretaker role after the October elections until a new government could be formed, decided to present to Parliament a budget covering only the first

quarter of 1992. This three-month budget was set in the framework of a budget objective of keeping the deficit for 1992 as a whole below 5 per cent of GDP; and the projected 17.6 trillion zloty first-quarter deficit was judged compatible with this objective. Parliament voted this three-month budget in February. (In fact, the budget out-turn for the first quarter was better than expected, with a deficit of only 8 trillion zloty.) The new government submitted a revised budget for the whole year on 23 March. It reaffirmed the 5 per cent deficit target, implying a borrowing requirement of about 65 trillion zloty, 50 trillion of which would be met by the banking system and 10 trillion by sales of bonds to non-banks.

The new budget involves substantial tightening measures on both the revenue and expenditure side, while also carrying over the measures that had been introduced in the first-quarter budget. The most important changes proposed on the revenue side involve increased turnover tax rates and excises, together with a broadening of coverage, in anticipation of the introduction of a VAT in 1993. These measures are expected to raise 25 trillion zloty. The share of corporate tax accruing to the communities (Gminas) was cut from 5 per cent to 2 per cent, without a corresponding reduction in the programmes the communities are mandated to carry out[33]. Some increased revenues are anticipated from improved tax collection – in particular it is assumed that tax arrears will not increase this year (except for the popiwek, where some increase in arrears appears inevitable). Also the personal income tax introduced as of January 1992, though initially programmed to be revenue neutral with respect to the taxes that it replaced, is expected to become a more dynamic source of revenue over time. There are also some tax losses projected: in particular from the reduction of the tax rate on fixed assets (dividenda) from the current 22 per cent to 10 per cent from mid-year.

On the expenditure side, a number of programme modifications were proposed to reduce expenditures. Pension eligibility rules were tightened and the frequency of indexation reduced; family allowances were subjected to a means test; and unemployment compensation rules were tightened to eliminate benefits for those who are in fact working. Education programmes were modified by increasing the hours taught per teacher (with a compensating rise in teachers' salaries); by introducing fees for postgraduate and night courses; and by replacing state scholarships with loans. Health care programmes were tightened by more stringent management of the distribution of subsidised medicines; by introducing fees for certain services; and by a more efficient system of procurement

for medical equipment. The budget also proposes to abolish the automatic indexation of public sector wages to those of the enterprise sector.

Nevertheless, to achieve the budget objective will require finding solutions to the problem posed by the fact that – contrary to the budget assumptions – Parliament has failed to overrule (by the required two-thirds majority) two controversial rulings made last year by the Constitutional Tribunal. The first of these rulings overturned a government decision to suspend indexation of civil service wages to those in the enterprise sector for the last quarter of 1991. The second ruling was that the government's 1991 reform of the pension system – which raised a number of pensions but lowered others – could not stand on the grounds that no pension could be cut. The precise implications are still somewhat unclear. Initial estimates had been that these two rulings might, together, add over 5 percentage points of GDP to 1992 budget expenditure. But the recent Parliamentary votes leave the government some flexibility and may permit less expensive solutions. Present government estimates are that the public sector wage reimbursement may cost some 10 trillion zloty, and the pension adjustments 15-20 trillion zloty. Furthermore, the government has been given six months to present to Parliament proposals on how these adjustments are to be implemented. It may be possible to find ways of offsetting these costs; and in addition the time delays implied suggest that much of the actual expenditure would be deferred until 1993.

Associated with the planned budget is a monetary programme that foresees, in broad terms, an expansion of money by about 127 trillion zloty during the year, or by about 6.1 per cent in real terms. Domestic credit could grow by about the same amount, with credit to government rising by about 50 trillion zloty, of which 20 trillion zloty would be absorbed by the NBP and 30 trillion zloty by the banking system. Credits to the economy could then rise by 80 trillion zloty. Of these, about 30 trillion are likely to be pre-empted by credits for housing, central investments and agriculture, leaving 50 trillion for state and private enterprises – a real growth in this category of 1-2 per cent. While indirect instruments of monetary control will be used to support these targets to the extent possible, primarily reliance will again have to be placed on administrative ceilings on credit expansion applied to the individual banks. In this regard, passage of the new Banking Act has eased the task of the NBP, since it now has formal authority to impose such limits on all banks, and not just the state-owned ones.

The intention as regards interest rates is to keep the refinancing rate "slightly positive". Other interest rates will be determined primarily by market pressures; in this regard the need of the government to sell bills to the public may tend to push market interest rates up.

Two further assumptions of the programme need to be noted. The first concerns the exchange rate. As a technical assumption for preparing the economic programme, it was assumed that there would be no further devaluations in 1992 beyond those implied by the crawling peg mechanism. Taking into account the 12 per cent devaluation in March, this implies that on a December to December basis the zloty would depreciate by about 37 per cent relative to the currency basket – roughly in line with projected consumer-price inflation. The second concerns wage developments, where it is assumed that real wages relative to consumer prices will remain unchanged over the year. No new instruments for wage control have, however, been introduced; the excess wage tax will be maintained. Given these parameters for prices and wages, it would be possible for enterprise profits to recover somewhat to the extent that productivity could be increased by reductions in overmanning. However, this possibility could only be realised if enterprises resisted wage increases that entailed substantial excess-wage tax liabilities.

Assessment of the risks

It has to be recognised that the coherence of the programme is a fragile one. Uncertainties begin with the budget. Even setting aside the 25-30 trillion zloty "hole" in the budget that has resulted from the failure of Parliament to overrule the Constitutional Tribunal's decisions on civil service wages and public pensions, achievement of the deficit target will require Parliament to enact a large number of regulations – many of them contentious – in order to make the proposed programme changes feasible. In addition, some elements of the draft budget might be considered somewhat artificial. For example, the holding gains of the NBP on its foreign reserves following the last zloty devaluation (amounting to some 4 trillion zloty) are treated by the government as additional profit to be transferred to the budget. But it is unlikely that such a transfer could be affected without a corresponding reduction in other profit remittances from the NBP. As another example, the cut in the corporate tax share allocated to the Gminas may not in the end improve the general budget picture. The Gminas are

under strong pressures to increase social spending, and while they may respond to some extent by raising local taxes, this may not cover the gap. While recent indicators suggest that the Gminas are continuing to run budget surpluses, there is a risk that this will not continue. Should the Gminas move into deficit, their borrowings from the banks would add further pressure to the monetary plan. Finally, it might be noted that 10 trillion zloty in privatisation receipts are included in the budget revenue estimates. This would represent a dramatic increase in receipts relative to 1991 and it is not clear what entities to be privatised could be expected to generate such sums. Furthermore, OECD accounting practices would regard such receipts as a financing item, rather than revenue, because they represent an absorption of private savings by the government.

There is no scope for significant overruns on the deficit target. Such overruns would place severe pressures on the other elements of the programme: a larger deficit would further reduce credit available to enterprises, if credit expansion targets are to be maintained, and this in turn would make the output projection quite unrealistic. Indeed, the limited growth of credit to enterprises is one of the pressure points even within the present financial programme. Faster domestic credit expansion, however, would almost certainly be inflationary since it would entail higher money growth unless foreign capital inflows were to strengthen substantially more than seems likely now. Even at present, the money growth projection appears high relative to likely demand for money. Of course, because of the very limited alternatives to money holdings as a means of financial saving by the population, demand for broad money balances may be expected to increase if household savings increase; and some part of the projected increase in money arises from the re-evaluation in zloty terms of foreign exchange deposits due to zloty depreciation. Households may regard such increases as different in kind from the accumulation of zloty holdings. But at the same time, households are expected to acquire substantial amounts of assets outside the banking system (10 trillion through purchase of government bonds and substantial purchases of privatised assets) – though some portion of the 10 trillion zloty in projected privatisation receipts will come from foreign investors. On balance, therefore, the projected growth of money may exceed the demand for it and thus accentuate an inflation risk.

Of course, the exchange rate policy continues to provide a certain limit to actual inflation so long as it can be sustained. But the credibility of the crawling peg may have become harder to sustain to the extent that it is geared to broadly accommodating expected inflation rather than to actively pushing the inflation rate down. The dilemma here is a familiar one in high inflation countries, and it has to be noted that there are no easy solutions to it. A strict exchange-rate policy can control inflation, but only at the cost of putting severe pressure on the tradeables sector of the economy through reduced competitiveness, and hence a growing trade deficit. A policy of preserving competitiveness through exchange-rate depreciation, however, makes inflation control very difficult to sustain. In such circumstances strict wage discipline and actions to raise enterprise efficiency may be the only way out.

In sum, the macro-economic programme of the government represents a serious attempt to find a workable balance between competing needs in a very difficult economic situation. With strong implementation, outcomes along the lines projected by the authorities might be achievable – though further budget measures seem likely to be required. Prospects for this could be strengthened substantially by an acceleration of structural reform in certain key areas: in the banking sector to assure that scarce credit is better allocated to those enterprises that can use the funds most productively; in accelerating privatisation, and particularly encouraging greater foreign participation in this process as foreign direct investment would serve not only to accelerate structural adaptation, but contribute directly to increasing the savings available to the economy; in the budget sector, by reforming pension and housing programmes in particular, so as to reduce their excessive claims on national savings; in enterprises and in labour markets so as to generate more efficient wage outcomes and tip the balance of incentives more strongly towards increasing productivity and profits. These structural issues and others are taken up in the following chapter.

III. Strengthening the Structural Framework for Growth: Progress and Priorities

A great deal of progress in structural reform to build a market economy has been achieved over the last two years. However, while some features have proven straightforward to introduce more or less at once (e.g. price liberalisation) other essential features require either legislation (including deregulation), new institutions or indeed both. These are proving much more difficult and time consuming to implement than at first expected[34]; in some instances they have simply been overlooked under the pressure of competing political and macroeconomic stabilisation issues. It is inevitable, because some things take longer to do than others, that progress will be uneven. But this creates a risk that gaps or deficiencies in one area (e.g. the tax system) impact in a negative manner on behaviour more generally (e.g. fiscal policy and enterprise behaviour). Thus a vicious cycle can threaten to the extent that poor macroeconomic performance resulting from uneven progress in structural reform in turn slows down the reform effort. This must be avoided.

It is impossible, in the course of one study, to deal with the entire range of structural reform issues facing the Polish economy. This chapter focuses on four areas that are of systemic importance: defining property rights; developing a banking system; establishing a labour market; and reforming tax and social security systems. Subsequent chapters address the restructuring of the enterprise sector and foreign trade.

Establishing a framework for property rights

Establishing the legal and institutional framework for a market economy is a major undertaking. At the most basic level, it requires the freeing of barriers to entry and exit from economic activities so that efficient competition can develop;

defining and liberalising access to real property and resources; and establishing rights and resposibilities on the use of property through, for example, competition law and provisions on the enforcement of debt. Some of the requirements were handled quite quickly and effectively. Thus on 29 December 1989, the Polish Constitution was amended to eliminate the socialist property classifications and to treat all types of property equally[35]. Moreover, the administrative allocation of resources was ended in the latter part of 1989 and prices covering about 90 per cent of commodities were liberalised in January 1990. By contrast, other important elements are either not yet effective or have been delayed. For example, the Law on Privatisation was not passed till July 1990 and implementation is proving slow. The first two versions of the Law on Foreign Direct Investment had major shortcomings and an effective law did not come into force until July 1991. Above all, enforcement has proved to be a major problem in most areas.

Rights to real property

The definition and enforcement of real property rights in Poland threatens to become a major bottleneck in the transition to a market economy. The constitution now includes a general guarantee of private property but the laws and regulations on which effective property rights are ultimately based appear to create considerable uncertainty. This is not just a question of the number of laws involved (on one estimate there are around 50 ranging from laws governing agricultural land transfer to urban land taxation) but also to institutional weaknesses, which are discussed in the following paragraphs. Unless investors are reasonably assured of ownership, use and transfer rights in property, they will simply not invest, preferring instead either consumption or holding foreign assets.

Most land and other property formerly under ''state ownership''[36] now lack clear title and are therefore unavailable for sale or long-term lease. There are two aspects: the allocation of property rights to units of government and restitution (often termed in Poland ''reprivatisation''). The basis for allocation of property rights to various state entities was established in 1989 by an amendment to the Civil Code. This was complemented in 1990 by amendments to the Land Use and Expropriation Act which gave these entities the right to sell land outright, rather than being limited to granting only rights of usufruct. Under the legislation, state

enterprises could become owners of the land and buildings they previously administered. However, as of early 1992, the enabling regulations for the provision of titles to these enterprises had not been enacted. Adding to the difficulty, the Act on Local Autonomy re-established some 2 500 communes (gminas) and foresaw the transfer to them, without payment, of certain state property which had been under their operational administration – including most urban land, the housing stock, public utilities, and certain enterprises. This process has now stalled, in part because of conflicts between local governments and state enterprises due to the latter being awarded their own grounds[37].

Restitution (or reprivatisation) is an unresolved issue in Poland. Its early resolution is essential to reduce uncertainty[38]. Even in the absence of a legal framework, by the end of 1991 10 000 applications to have property restored had been received by three separate Ministries. A draft Reprivatisation Law (1991) sought to clarify the situation by proposing compensation in the form of capital vouchers convertible into shares of privatised enterprises. In this draft, which has yet to be debated and voted in Parliament, enterprises, land and housing are treated separately since the legality of the measures by which these assets were initially nationalised varies[39]. However, the draft law in its present formulation fails to be sufficiently clear on the compensation principle. Thus, it also foresees that a previous owner would have priority in purchasing shares or assets with the vouchers. In addition, entitled individuals (the current draft applies to citizens of Poland or their descendants resident in Poland who will have a year to lodge claims) can also be given compensation in kind "mainly as far as small, improperly utilised enterprises are concerned or in case of property separated from the enterprise"[40]. If the experience of other countries is any guide, such lack of clarity could place an intolerable burden on an already fragile registration and court adjudication system. Until the reprivatisation issue is settled, little land with clear and indisputable title will be available and a number of assets will also be encumbered with claims.

A well functioning registration system is fundamental for any real property system and is also essential for the development of financial intermediation. Poland's registry system is in a state of disarray: many transactions have not been recorded and a number of registers are missing or incomplete. Moreover, the notarial system is slow and expensive[41] although a positive step has been the privatisation of notaries. The courts have now taken over the maintenance of the

registration system but they are not well equipped to administer them and restitution issues will add to the problems. A solution does not only entail committing more resources to the system but in investigating ways in which it could be simplified[42].

Many controls on the use of real property remain narrow and unclear. In this area, clarification and simplification of the existing regulatory system is urgently required since the communes have neither the administrative capability nor the experience to administer the present system. Three areas are particularly important: land use regulation; building standards; and regulation concerning the respective rights of owners and tenants in the case of residential property. Lack of a suitable regulatory framework[43] in the latter area will inhibit the development of mortgage lending and will therefore constitute an unintended barrier to the formation of small and medium scale enterprises where collateral is important.

Company law and bankruptcy procedures

The current company law in Poland is the Commercial Code of 1934[44]. In general, it is flexible enough not to restrict the development of the private sector[45], though no doubt adjustments will be needed in the future as the conditions of doing business evolve. Both forms of corporate organisation permitted by the Law (limited liability and joint stock) allow considerable flexibility with respect to majority and quorum rules, voting rights and distribution of profits. These provisions enable control to be more concentrated than ownership, which could be useful in addressing the Polish concern for widespread ''ownership'' being combined with strong corporate governance. This flexibility does imply that the ''rules of the game'' may not be clearly defined *ex ante*. This is particularly so with the joint stock form which follows German practice in establishing a two tier board[46]. In view of the allocation to labour interests of up to one third of the seats on the upper or supervisory board (in the small number of cases so far), a great deal of the ownership and control issues will revolve around how the respective powers of the two boards evolves.

This favourable assessment does not extend to bankruptcy procedures: although an efficient bankruptcy procedure is crucial for a market economy, the Polish system is hardly functional. For state-owned firms, there are two separate procedures (Article 19 of the Law on State-Owned Enterprises and the Bank-

ruptcy Law). These are often contradictory in law and in practice. Moreover, the general bankruptcy procedure remains a shell: few bankruptcies have been carried out. The current bankruptcy law stems from the Bankruptcy Act of 1934. It appears reasonable in broad terms (it resembles most bankruptcy legislation in continental Europe) providing general procedures for both liquidation and reorganisation under the control of a receiver appointed by the court. Under the law, bankruptcy is overseen by a tribunal of the local court. If a petition is accepted, the tribunal appoints a judge, who then appoints a trustee (receiver). The new trustee manages the company with the mandatory co-operation of the original managers who lose their management rights.

The procedure is, however, complicated and further stretches the already limited court capacity and training. While special economic courts have been established in Warsaw and some other big cities, the procedures may overwhelm smaller generalised courts. A serious problem is the limited availability of receivers who by law must not be associated with the creditors in any way; nor may creditors propose to the court a specific receiver. These requirements are limiting given that many cases in the future could concern state-owned firms. All these factors contribute to the desire on the part of many creditors to avoid the procedures, but another is also important: the lack of priority creditors. The Act does allow for secured creditors but forty years of central planning has meant that few loans are secured in this manner. Thus, new and old loans are treated in a different way. It may be necessary to consider some form of transitionary regulation if the effectiveness of bankruptcy procedures is to be improved.

The Bankruptcy Law may be too strongly biased toward liquidation as opposed to reorganisation and therefore poorly adapted to the restructuring needs in Poland (see Chapter IV). Prior to the war, the bankruptcy law was complemented by a frequently used procedure promoting the "amicable" settlement of debts between an on-going enterprise and its creditors: the Law on the Procedure for Mutual Agreement, 1934. This law is still on the statute books but not used. The main differences with the bankruptcy procedure is that only the debtor can bring a mutual agreement case and the trustee does not have the power to remove the management and take over the enterprise (in this respect it is similar to Chapter 11 in the United States), though he can place the firm into bankruptcy. Given the restructuring problems facing Polish state-owned enterprises, any provisions to make more flexible the procedures for reorganisation (including

financial restructuring) are pressing but must be formulated against the background of limited administrative capacity. In this respect, reorganisation procedures, with the management in a more active role, but under the oversight of a receiver, could be a useful complement to the Polish bankruptcy regime.

For state-owned firms there is an alternative bankruptcy procedure under Article 19 of the Law on state-owned Enterprises. Failure to pay the tax on capital (''dividenda'') constitutes the criterion for insolvency, at which point the founding ministry *may* initiate liquidation proceedings. These proceedings are extremely unclear: firms enter the procedure but seldom appear to be closed, tax payments are simply rescheduled and the ranking of creditors is not transparent. In many respects it resembles an informal receivership with the Industrial Development Agency and ad hoc groups of experts from the ministry in the role of receivers. Being unclear, the procedure has not contributed to an understanding of the new ''rules of the game'' on the part of management.

Competition policy: legal provisions and enforcement

One of the most difficult problems in the transition to a market economy is the promotion of competitive behaviour. It requires both changing peoples' and enterprises' attitudes toward competition and establishing the institutional conditions under which competitive behaviour may develop. Forty years of state ownership and socialist doctrine created widespread sentiments, in the population at large and in the views of many managers, that competition is wasteful. Competition was simply not part of the previous system. Under central planning, co-operation between firms was the norm and non-competitive behaviour was further reinforced by widespread, chronic shortages. With such conditions prevailing at the start of the reform programme, the authorities correctly viewed the promotion of competition as a systemic issue to be pursued by a combination of trade liberalisation, privatisation, restructuring of state enterprises and financial market reforms, as well as in the enforcement of competition law.

The Antimonopoly Act of February 1990 (complemented in 1992 by the Act on Unfair Competition) established an independent Antimonopoly Office[47] for investigation and enforcement of competition law (either in response to complaints filed by individuals and firms, or on the Office's own initiative) and gave it wide formal powers with respect to both industrial structure and anti-competi-

tive behaviour[48]. Moreover, it established the possibility of appeal to a special antimonopoly branch of the Warsaw district court.

The definition of anti-competitive behaviour is far-reaching. A rule-of-reason approach[49] is adopted in many instances but the wording implies that named practices are presumptively illegal: the burden of proof lies with the company to show that the practice is not harmful to competition[50]. The Act specifies a number of ''monopolistic practices''. The most important include:

a) imposing onerous contract terms which yield undue benefits;
b) conditioning a contract on the performance of the other party of unrelated services it would not otherwise perform (''tie-ins'');
c) limiting market access of third parties;
d) direct or indirect price-fixing among competitors;
e) geographical or product specific market-division agreements among competitors;
f) restriction of output, sales or procurement.

Moreover, if a ''dominant position'' exists, the definition of ''monopolistic practices'' additionally covers market division, price discrimination, resale price maintenance, refusal to deal, and predatory pricing. A ''dominant position'' is defined as one where a firm does not encounter substantial competition on the home or local market; an enterprise is presumed to have a dominant position when its market share exceeds 40 per cent[51], and this situation applies to many Polish firms. Where the dominant position is ''monopoly-like'', certain practices such as cutting output, suspending sales to increase prices or imposing ''blatantly high prices'', are deemed illegal *per se.*

The Antimonopoly Office also has wide-ranging powers to control industrial structure which go far beyond the usual rights to investigate and control mergers and acquisitions. Thus Article 12 states that ' state enterprises, cooperatives and companies of commercial law having a dominant position on the market can be divided up or liquidated when they permanently limit competition or conditions of its existence'. Moreover, all proposals for the conversion of state enterprises into joint stock companies (''commercialisation'') and for their privatisation must be cleared with the office.

Under the difficult conditions of transition, the competition authorities have to allocate their efforts between two objectives: enforcing the development of a

more competitive industrial structure and curtailing anti-competitive behaviour. As regards the former objective, the issue is to what extent market forces resulting from import liberalisation, privatisation and spontaneous divestitures prompted by efficiency considerations can be counted on to promote an adequately competitive industrial structure; and to what extent an active structural competition policy is required. This is an important issue in Poland which is still characterised by a high level of concentration in goods markets: at a detailed product level (581 product lines), 80 per cent of goods markets are characterised by producers with a market share in excess of 30 per cent (excluding imports) and for a number of products, two state-owned firms each had a market share in excess of 30 per cent[52]. It is not clear, however, whether such concentration figures provide a meaningful indication of durable market power as they exclude imports and do not take other factors into account, such as the possibility of new entry.

Up to now, the Office has opted for an active monitoring role. The office reviewed 1100 requests for transformation of state enterprises (corporatisation and "liquidations" – see Chapter IV) of which around 10 per cent were revised or blocked. In particular, 60 out of 200 requests for change of status to joint stock company were delayed in 1991 pending divestiture or reorganisation of the company concerned. Reservations with respect to about a 100 state enterprises eligible for mass privatisation were also submitted to the Ministry of Ownership Changes and they were accordingly withdrawn from consideration. Finally, the office has also been active in conjunction with founding Ministries in dividing firms. In 1990, 188 enterprises were divided into 771 firms, while in the first half of 1991 the corresponding figures were 84 and 190.

The competition policy grounds for deconcentration are not always apparent. Lower concentration need not coincide with the needs of competition policy: sustained competition may require that the firms in the market be sufficiently large to exploit economies of scale and scope. Further, as mentioned above, higher concentration does not necessarily correspond with durable market power. Whether concentration presents a problem often depends on trade policy. From this perspective, close coordination between the Antimonopoly Office and those responsible for trade policy could make an important contribution to strenghthening competition. Unfortunately, such co-ordination has tended to decline in the course of 1991. For example, in 1991 tariffs were increased on some commodi-

ties which the Antimonopoly Office had previously identified with non-competitive domestic markets. Even under circumstances where both vertical and horizontal restructuring would be warranted (and in the former case it is far from evident), the information demands placed on the office are very great indeed. In practice these are even greater given the low threshold for defining dominant position and the need to review practically all corporatisation and privatisations. Clearer guidelines and a higher threshold may be necessary.

In the circumstances of structural transformation it was also necessary to decide which types of behaviour would be regarded as anti-competitive, and therefore subject to penalties, and which behaviour would simply be regarded as ''normal'', albeit under extreme conditions and more amenable to other policy measures. In other words, there has been a continuing question about whether a cause should be addressed or only the symptom. During the first two years of operation, the Office has taken a rather wider interpretation. In the period January to June 1991, the office considered 209 cases concerning monopolistic practices – of which 83 went forward for decision. The most typical monopolistic practices considered covered (a)-(c) from the list presented above as well as price discrimination and reduction of supply to raise price. However, cases dealing with the ''imposition'' of onerous contract terms and with the control of ''excessively exorbitant prices'' have tended to decline over time as market competition has increased and enforcement practices have evolved with experience.

Experience gained over the first two years of enforcing competition policy under conditions of structural transformation point to several areas requiring closer consideration. Fundamental for policy with respect both to industrial structure and to anti-competitive behaviour is the way in which the concept of dominance is implemented. A low threshold for presumed ''dominance'' together with an extensive list of behaviour which constitutes ''abuse of dominant position'' creates a risk that actions are taken for which there is no need from the competition point of view. This is particularly the case if the relevant market for assessing dominant position is defined too narrowly. For example, in the case of a domestic car producer, the authorities excluded from the measurement of the relevant product market new and used cars which were being imported into Poland as substitutes for domestic production. Further, even where proper definition of the relevant market yields a large market share, the authorities must then go on to test whether in fact the market share conveys market

power. Factors which the authorities need to examine in this context include the possibilities for supply substitution, entry from other geographic markets and new entry.

The Polish law considers both price discrimination and any form of differential treatment to be abusive when practised by a dominant firm. While these practices may indeed harm competition when the dominant firm has a near monopoly position, this is not the case when there are several large firms in the industry (a typical situation in Poland). In such cases the primary effect of the law could be to discourage aggressive price rivalry – by precisely the size class of firms which could otherwise be most likely to engage in it, and where the danger of informal contact is greatest.

In the Polish situation, horizontal agreements and understandings carry particular dangers. Polish law, however, only partly distinguishes between horizontal agreements (i.e. agreements between competitors) and vertical agreements, which do not involve competitors[53]. However, in implementation a clear distinction is necessary. Competition laws in market economies, e.g. those of the EC and the United States, likewise do not distinguish between horizontal and vertical restraints but sharp distinctions have arisen through court decisions, enforcement guidelines and block exemptions. Prohibitions on vertical agreements, even in an economy such as Poland's, could be more likely to slow the development of competition than to increase its extent and effectiveness[54]. While vertical restrictions (such as agreements on exclusive dealing, territorial division or resale price maintenance) may reduce intra-brand competition, they will generally act to increase competition between brands and can serve to facilitate new entry[55]. It is fortunate that the Polish law, unlike laws in some other post-socialist countries, does not include a requirement for contract notifications or authorisations, which could unnecessarily burden the Office with notifications of vertical agreements. In addition, it is welcome that the Office has undertaken to develop regulations or guidelines for specific and distinct treatment of some of the most common vertical and horizontal agreements.

Such regulations or guidelines or, better still, changes to the law itself (currently under consideration), are crucial to the development of a well-focused enforcement policy and to shield the Office from having to deal with numerous complaints related to vertical practices unlikely to harm competition. Further, changing the law itself would permit the creation of a harsh, *per se* prohibition

for horizontal agreements very likely to harm competition, e.g., agreements between competitors on prices, output, products and market division. At the same time, a revision should establish a more lenient, case-by-case review for vertical agreements and include in this latter provision a threshold related to market power below which agreements would benefit from presumptive or *per se* legality. This would have the additional effect of freeing scarce resources for areas which should be dealt with more intensively. Among the latter must be counted closer scrutiny of horizontal conduct, barriers to entry and exit and trade policy measures such as quota allocation and anti-dumping regulations. It is crucial to clearly establish knowledge about the new competitive "rules of the game" and for this focus is often useful.

The development of the banking system

A sound banking system plays a key role in a market economy by, *inter alia,* providing a reliable payments mechanism and promoting the efficient allocation of credit. As in other areas of structural reform, important measures have been taken to develop the Polish banking industry, beginning with the creation of a two-tier banking system in 1989[56]. There has been an ongoing process of "learning-by-doing" both on the part of new banks themselves and in the development of regulatory and supervisory instruments; and further progress can be expected. Nevertheless, certain aspects of the present situation give grounds for concern. First, still-limited changes in the commercial environment of banks and in their practices, together with the important share of preferential credit and old ties between state-owned firms and the banks, has meant that much credit continues to be allocated inefficiently. Second, delays in establishing a regulatory framework, shortcomings in banking supervision and, above all, the inability to enforce financial discipline on state-owned firms, are threatening the soundness and viability of the banking system.

The allocation of credit

In assessing the efficiency of credit allocation, there are encouraging as well as negative indicators. In 1990 the new commercial banks faced a major challenge in establishing credit policies: it takes time to develop a "banking culture" and the capacity to make professional credit evaluations. In practice, the ten-

dency was for most banks to continue to lend to those state-owned enterprises that they inherited as clients, without adequate discrimination among them. The continuing practice of capitalising large amounts of interest, while an understandable response to high inflation, has been a further deterrent to the development of vigorous credit assessment. But efforts by the banks to strengthen management practices are under way; new lending is increasingly based on collateral[57]; and banks have been successful in diversifying their client base to some extent – though "lock-in" effects with regard to very large debtors remain a serious constraint on this.

Development of a more efficient allocation of bank credit depends not only on actions by the banks themselves, but also on the environment within which they operate. At its inception, the Polish banking system was characterised by regional concentration and a lack of effective competition. In January 1989 the National Bank of Poland (NBP) was subdivided. It retained for itself the traditional central bank responsibilities, while nine state-owned commercial banks were created out of its regional (voivodship) branches, taking over their deposit and credit operations[58]. The banks received some branches outside their region as well, but still remain concentrated in their own areas. The decision to create regionally based banks may, in retrospect, appear unsatisfactory (industrial sectors are also regionally concentrated) but was taken at the time to avoid telecommunications and management problems. The new banks were permitted to determine their credit activities and interest rates, while loans and relations with enterprises became discretionary. While commercial banks are in general universal banks (the scope of their powers depends on their statute and licence), only a relatively narrow range of services are at present provided, although this is now starting to change.

The major tool adopted by the government to encourage competition in the banking sector was the liberalisation of entry by new banks[59], including ones with non-state capital. This led to a rapid growth in the number of banks: at the end of 1991 there were 75 banks (of which 30 had a majority private share). In addition, 104 co-operative banks seceded from the agricultural bank (BGZ), while 1 562 small co-operative banks remained affiliated to it. There are seven banks with foreign capital involvement, but so far the influx of foreign capital into the Polish banking sector has been low.

Competition among the banks remain limited. The nine commercial banks are still largely dominant within the regions where they operate. The new banks remain generally very small, and concentrate their lending activity within particular niches where the commercial banks have not sought to develop their activities. Nevertheless, a few new banks have emerged that are large enough to compete with the smallest of the commercial banks, and it can thus be expected that competition in credit markets will develop. On the liability side, competition for funds has remained restricted to particular term deposits, in large part because the banks have tended to be quite liquid over much of the past two years, and also because credit ceilings applied to the state banks have limited their need to bid aggressively for funds. Competition for depositors first became evident in 1990, as access to refinancing credit was reduced.

Preferential credit and administrative guidelines

Preferential credit has absorbed an important share of credit expansion (about 34.8 per cent in 1991). Prior to 1990, credit for certain activities, mainly housing construction, agriculture and central investment, had been provided at low fixed interest rates and the banks could refinance them at a low preferential refinance rate. At the start of 1990, a new system was introduced whereby part of the interest was paid by the borrower, part via a budgetary subsidy and the rest was capitalised[60]. Arrangements have since been modified several times, but the main features remain. In the case of agriculture, special lines of credit were approved throughout 1990 and from July of that year open-ended credit was made available for buying agricultural products at a fixed rate of 20 per cent, through rediscounting of agricultural bills of exchange, which led to their rapid increase. The rediscounting is limited by the amount earmarked in the Budget for subsidising the interest rate applied to them. In 1992, with the passage of a new Bank Act, a special agricultural fund has been established, financed from the interest payments due on banks' reserves (see Annexes III and IV).

In the case of credits for housing construction, the pure subsidy element for new loans was removed as of 1992, but income-related limits on the amounts that borrowers are required to pay imply a very substantial automatic capitalisation of interest due, and 70 per cent of such capitalised interest is in turn rediscounted in the budget. A fuller discussion of this issue is given in Annex V. For 1991 as a whole, over a third of total credit growth for the non-state sector has been pre-

empted by agriculture and housing. But since much of this took the form of capitalisation, little new credit has in fact been available for housing or agriculture.

Central-government investment projects, i.e. important investment undertakings relating to the development of the infrastructure or the production of energy, benefit from a government guarantee to the lending bank. Such loans are, in addition, automatically eligible for refinancing from the NBP and generally carry the refinancing interest rate. In some cases the loans are at preferential rates and in these cases the difference between the lending rate and the NBP refinancing rate is covered by the budget. The banks grant such credits for long periods, with interest not being collected during the grace period, but capitalised, and repayable only after the completion of the project. The banks receive a 2 per cent commission for managing these loans.

The NBP has also sought to influence the allocation of credit through administrative guidelines and advice. To a some extent this has been in reaction to the evident bias of the commercial banks to lend to their old clients. Thus from 1990 onwards the central bank has urged state banks to devote 50 per cent of the growth of credits for private firms. Results have, however, been disappointing: only around 20 per cent of credit growth has been to the private sector. It is unclear whether this has been due to a lack of demand by private firms to borrow at high interest rates or to credit rationing on the part of banks[61].

The financial condition of banks

At the time of their audits by Western consultants in early 1991, the nine dominant commercial banks were apparently sound both from the point of view of the capital base and the quality of the loan portfolio. Moreover, during 1990 and early 1991, the banking sector as a whole, and the commercial banks in particular, had registered very high profitability. Despite the high level of mandatory reserves imposed on them, the profit margin[62] measured by the ratio of profit to costs was relatively high, amounting to an average of 127.5 per cent for the nine state banks and an average of 65.6 per cent for all the banks taken together (in 1989 this ratio had been 74 per cent): the high profits thus enabled the major commercial banks partly to recapitalise. New private banks were less profitable due to high start-up costs. This high level of profits can be attributed to several factors: lack of competition; low labour costs (although the level of

wages has been quickly rising as banks compete for qualified staff); large spreads between deposits and lending rates; high charges and commission for banking services; the benefits accruing from the sale of NBP bills and the high share of deposits in foreign currencies, bearing a much lower interest than zloty deposits[63].

Although the nine major banks were quite comfortably above the 8 per cent BIS capital ratio norm[64] at the end of 1990, the proportion of bad and doubtful loans increased dramatically[65] throughout 1991. Profit margins declined to 24 per cent for the banking sector as a whole and to 40 per cent for the nine state banks. The stock of irregular credit increased sharply – in June 1991 it was 8 per cent but by August it had risen to 12 per cent. However, this understates the need for provisioning. In mid-1990 the need for provisioning was estimated at 15-17 per cent which was then well within the reach of the banks. By the end of the third quarter of 1991 the situation had deteriorated, mirroring the worsening situation in industry. Indeed, after allowing for more realistic provisions, the NBP assessed that a very significant recapitalisation was needed for the system as a whole. To gain a sense of the amounts involved, the outstanding loan portfolio to the state-owned enterprises from the banking system was around 140 trillion zloty in early 1992 (or about $10 billion). Some knowledgeable observers estimate that as much as half of this portfolio should be regarded as bad or doubtful and therefore requiring provisions, though other estimates are somewhat lower.

The deterioration of bank portfolios is primarily attributable to the deteriorating financial position of state-owned enterprises and the failure of banks to sufficiently alter lending policy. The practice has not been one of supporting old debt but old debtors; old debt was generally wiped out in late 1989 and January 1990. But banks have often chosen to prolong a credit, usually granted for a three-month period, and to convert the unpaid interest into principal, rather than place an enterprise which is experiencing payment problems into bankruptcy[66]. This approach is of course not necessarily unwarranted. Not all doubtful loans prove to be bad, and work-outs are a normal part of banking practice. There is indeed some evidence that while the stock of doubtful loans has continued to grow, the composition of this stock has been changing, with some doubtful loans becoming performing once again, and other loans that were previously performing becoming impaired. This is indicative of some success in dealing with doubtful loans. Nonetheless, a more aggressive approach to initiating bankruptcy

for truly insolvent borrowers is probably needed. One reason why this is not being done is that – due to the government's reluctance to let insolvent state-owned enterprises go bankrupt – banks have come to expect that failing firms will be bailed out. Moreover, the lack of experience and experts in the liquidation procedures[67], the virtual absence of collateral on old loans and the unclear ranking of banks as creditors in the bankruptcy of a state-owned enterprise have all contributed to a reluctance on the part of banks to initiate bankruptcy.

Another reason why banks may have preferred roll-overs and interest capitalisation to stopping credit to insolvent firms is that tax treatment was unfavourable to provisioning. Tax offices tended to allow banks to deduct provisions from pre-tax profit only in cases where the loans were fully written down. The situation in this regard has been improved, with instructions from the Ministry of Finance to the tax offices to allow the establishment of reserves from pre-tax income against doubtful loans.

The deterioration in the portfolio quality has been as rapid, if not more so, in private banks as in state banks, i.e. ownership *per se* has had little impact on the quality of loan assessment, although banks with foreign capital have tended to do better. The very uneven peformance of private banks could partly be blamed on a shortcoming in the licensing procedure: the required capital base for issuing licences was in many cases too low; and after the initiation of operations there was no follow-up on the qualifications of the owners or credit officers. In addition, the influence of local interests has been particularly pervasive in private banks, and represents an important problem.

Policy response

One requirement for improving the functioning of the banking system is to develop the regulatory framework, particularly with respect to bank supervision. The authorities are taking measures to improve the system and, following the recommendations of auditors, are now preparing a set of guidelines for internal controls. Until recently the NBP has had only a very narrow range of powers. Amendments to the 1989 Acts should have come into force on 1 January 1992 but the Law was vetoed by the President on other grounds so a legal vacuum prevailed until the revised Law was approved in March 1992. The new law attempts to fill the existing legal gap, giving the President of the NBP relatively wide powers in supervisory matters; most changes are in line with EC regula-

tions. The amendments establish wider powers for the banks while at the same time establishing clear prudential limits. Article 35 introduces in Poland for the first time the concept of ''large exposure'': 10 per cent of equity is the threshold for one loan and 15 per cent is the limit to the exposure of a bank to one client or group of financially connected clients[68]. A new legal framework will eventually be put into place, with a new Banking Law, a new Act on the National Bank, and one on Banking Supervision and Deposit Protection, though there have been delays in preparing this legislation.

While it is necessary to recapitalise the banking system, solving the stock problem will not be enough: as the main problem arises from loans to the large state-owned enterprises, it will also be necessary to solve the flow problem through reforms in the way these firms function (Chapter IV). While no decisions have yet been taken, there are several possibilities to recapitalise the banking system. One method is for the state to intervene by issuing bonds to the banks in exchange for some portion of the bad debts, thus taking these off the balance sheets of the banks. A second approach being considered is to leave the bad loans within the banking system, but to segregate them in special collection departments that would operate to restructure, write down, or otherwise deal with these loans. In itself, this would not resolve the solvency problem of the banks, but if coupled with other forms of capital assistance from the government and an active provisioning policy, might make it possible for the banks to ''grow'' out of their present situation along a sort of ''critical path'' to progressive recapitalisation.

Debt/equity swaps have been proposed as an instrument for dealing with bad debts, but according to the new law the equity holdings in one firm will not be able to exceed 25 per cent of own capital. Also, the acquisition of packages of shares beyond certain limits will have to be expressly authorised by the President of the NBP. Debt/equity swaps, moreover, must be approached with considerable caution. The experience of many countries is that such swaps have only led to increased ties between firms and banks, impairing competition and causing banks to extend further credits to firms in trouble in order to defend both their interest and their dividend income: a path fraught with risks.

As part of the overall development of the banking system, there are plans to privatise the nine commercial banks. In order to pave the way for privatisation, the Government and the NBP took the step of transforming the nine banks into joint-stock companies[69]. This was followed by in-depth diagnostic studies of each

of the nine banks. In a more recent step, each bank has been encouraged to enter into a co-operation agreement with a leading Western commercial bank, which would assume the role of strategic partner. At some stage it could hopefully acquire a large equity position in the privatised bank, thus playing an active role in the bank's management – overseeing, modernising, and bringing the Polish bank up to the standards of western financial institutions.

The objective of privatisation is to establish commercial criteria in decision making; enhance competition; reduce government interference – rendering the bank operations independent from political pressures as well as accelerating the development of capital markets; extend share ownership, and raise revenue for the state treasury. The process is well under way for two of the nine banks, Wielkopolski Bank Kredytowy in Poznan and Bank Slaski in Katowice, which are already involved in the preparatory stages of privatisation. It is envisaged that these two banks will be privatised during 1992; the privatisation of the remaining seven commercial banks should be completed in two to three years. However, the rapid deterioration of the balance sheets of the banks and the rising cost of adequate provisioning raises questions as to the feasibility of the privatisation, unless decisions are taken to deal decisively with the bad loans.

The development of capital markets

While a well-functioning banking system is the essential core of any financial system, the development of capital markets can contribute importantly to improving the intermediation of funds, to creating more effective competition, and to the diversification of risks. The Polish authorities took important steps in 1991 to promote the development of capital markets, beginning with the passage of the Act on Public Trading in Securities and Trust Funds in March; and the opening of the Warsaw stock exchange in April. The general approach pursued by the authorities has been to move first to assure that regulatory safeguards meeting international standards were in place in such areas as disclosure and prospectus requirements, flotation procedures, licencing of brokers and centralisation of supervisory authority in a Securities Commission. This may have slowed the development of markets somewhat, but assures against the risks inherent in the unregulated development of securities markets.

The markets are still in their infancy. Only fourteen authorisations for initial public offerings of shares in privatised enterprises have thus far been granted,

and 12 of these enterprises are now listed on the Warsaw stock exchange. Total capitalisation of this market is about $130 million, with monthly turnover of about $6 million. There is no bond trading as yet. The potential for growth is clearly large, however, and the institutional infrastructure for expansion is in place: 26 brokerage houses have been established, and 131 brokers' licences issued. A fully computerised trading system for the Warsaw stock exchange will become operational in May 1992, with a capacity to handle much larger trading volumes that at present. Linked to the stock exchange is a National Securities Depository Institution through which clearing and settlement for all securities transactions can be completed in a maximum of five working days.

Rapid growth in the Polish capital markets can be expected from two sources in particular; the development of a market in government securities as a counterpart to the growing need to finance the budget deficit; and an increase in equity trading and issuance as a result of privatisation – with mass privatisation in particular holding promise of a quantum jump in the size of the market.

Establishing a labour market

Reforms to establish a labour market have a vital role to play in facilitating the restructuring of the economy along market lines, as well as supporting the stabilisation programme. Three sets of measures are particularly important: creating a legislative and institutional background which supports labour mobility; establishing a framework for wage formation; and dealing with unemployment, including the long-term unemployed. This section briefly examines progress and outstanding issues in these areas.

Creating an institutional and legislative framework

A number of reforms have been implemented in the last two years which serve to facilitate labour mobility and enable firms to restructure. With respect to the latter, job security has been eliminated and provisions have been introduced for both individual and mass lay-offs[70]. In both cases trade unions have an important statutory but "consultative" role (see Chapter IV). Mass layoffs can be particularly expensive for the enterprise and for the Labour Fund: until March 1992 it was mandated that compensatory payments had to be made in certain

cases for up to six months to employees who took up new employment with a lower remuneration[71]. These compensatory payments have now been abolished. Severance pay varies according to previous earning and length of service. On occasion, mass layoffs have resulted in the bankruptcy of the enterprise. It is therefore hardly surprising that enterprises have preferred a gradual reduction of employment mainly through natural attrition and early retirement[72].

In the restructuring process, experience elsewhere has shown that it will often be necessary to alter the work conditions for individuals (e.g. the nature and organisation of their job). While it is difficult to form a clear judgement, it would appear that the Polish approach to individual labour contracts will make such flexibility difficult to achieve. In addition, the provisions for short-time working appear to be, by international standards, very restrictive. The Labour Code, which dates from 1975, is in urgent need of revision.

Labour mobility has been facilitated by the provision of unemployment compensation. Some important mistakes were made in the provisions enacted in 1989 which discouraged job search, but many of these have been rectified during 1990 and particularly in early 1992 (see below). Retraining has been emphasised in the legislation but in practice the scope – and the success – of retraining programmes has been limited. With around 2 million unemployed at the end of 1991, there were only about 18 000 funded training positions. Experience has been that less than 40 per cent of workers find new jobs following re-training, perhaps reflecting the difficulties in identifying the type of re-training needed to maximise employment possibilities in a period of rapid economic change. Thus in practice labour market policy has emphasised passive rather than active measures.

The greatest barrier to the development of a labour market and to labour mobility remains the shortage of housing and an ineffective housing market. Regional mobility has been steadily declining throughout the 1980s while the disparities in regional unemployment and vacancy rates have further increased in 1991.

Wage formation

An important aspect of the labour market is the process by which the wage structure is determined: the level of wages, inter-enterprise distribution and occupational structure. In most countries this is usually a matter for negotiation

between the social partners (and sometimes arbitration) but in Poland collective bargaining legislation has yet to be implemented. In the meantime, industrial relations and wage setting are both governed by laws drafted prior to 1990. These appear to constrain the room for free bargaining (e.g. alteration of contract terms) and therefore to inhibit the development of market oriented institutions – particularly in the private sector. However, of greater overall significance are the relations between employees' councils, unions and management in state firms, but particularly the state sector wages policy, discussed in Chapter II.

The excess wage tax on state-owned firms is not only a macro-economic policy instrument but has a pervasive effect on the functioning of the labour market. From the point of view of minimising distortions in the labour market, it is unclear whether the shift in the tax base from the total wage bill to the average wage in 1991 represented an improvement: while it eliminated the potential ''pro-unemployment'' bias of the previous system and ensured a firm's ability to expand and hire more workers if it were profitable to do so, it could also have the undesired effect of stimulating the dismissal of better paid and presumably more skilled workers. Furthermore, the control of the average wage, in combination with high tax rates might make it difficult for enterprises to restructure wage relativities[73]; these are highly compressed allowing little room for work incentives. What is clear is that the excess wage tax, in any form, reduces the efficiency of wage setting and is thus undesirable from a micro-economic point of view, whatever its justification as an instrument for macro-economic control.

Linking the permitted growth of average wages to some extent to profit or other measures of firm level performance, as is now partly the case, is perhaps warranted in present circumstances, to the extent that it provides incentives to workers in state enterprises to increase efficiency. But as labour markets develop further, this approach would become less and less relevant. In well-functioning labour markets, the level of wages and the change in them are *similar* for all firms. This means that a successful state enterprise with high productivity should not distribute these in the form of wages but employ more workers and expand. The benefits to the whole economy will eventually come in the form of lower relative prices for these products[74]. Moreover, if rising productivity in some enterprises were to be translated fully into higher wages, this could via demonstration effects lead to wage increases in other industries and therefore to their contraction, financial losses, and decreased employment.

Following the lines of this argument, it should be noted that widely different wage levels between the state and private sectors, with little visible tendency to converge, is *prima facie* evidence that the labour market is not yet operating effectively. This is not an argument for extending the current wage policy to the private sector, or indeed for dismantling all controls on the state sector. Rather, the structure of the wage policy will have to be re-examined in the broader context of economic development if a dualistic labour market is to be avoided.

Measures directed towards the unemployed

Anticipating the prospective growth of unemployment, a new Employment Law came into force in December 1989. Employment offices were reorganised and given new tasks, providing unemployment benefits, facilitating job search, and providing start-up loans and re-training. Unemployment benefits were to be provided by a newly created Labour Fund financed from central budget transfers and a 2 per cent payroll tax paid by the employer. Anyone without a job was entitled to benefits; as a consequence, the number of ''voluntarily unemployed'' soared. In September 1990, eligibility was made subject to the requirement that the recipient had worked for at least 180 days in the previous year and that no suitable job could be found. Exceptions comprised mass layoffs and school leavers. The minimum benefit was 95 per cent of the minimum wage[75], but for individual redundancies, the benefit was generally 70 per cent of the individual's previous wage for the first three months of unemployment, 50 per cent for the next six months, and 40 per cent thereafter with unlimited duration[76].

With growing unemployment, expenditures by the Labour Fund rose sharply, but payroll contributions did not keep pace. As a result, the Fund became increasingly dependent on budget subsidies: in 1991 transfers from the budget contributed 61 per cent of revenue, and the payroll contribution 34 per cent. On the expenditure side, unemployment benefits and social insurance payments to the unemployed took up 82 per cent of the Fund's expenditures in 1991. Given overall budget constraints, this has meant that other labour market measures such as training and start-up credits were crowded-out. Moreover, there were grounds for supposing that the system did not adequately stimulate job search.

To deal with some of these problems, since March 1992 unemployment benefits are set at 36 per cent of the average wage in the economy in the previous quarter for a period of 12 months: they are flat-rate and not income-related. This

new set of rules creates better incentives for job-seeking, is simpler to administer and less of a strain for financing. On the other hand, since benefits are related to the previous quarter's average wage, a strict wages policy could quickly reduce the real value of unemployment benefits, thereby forcing some families below the poverty line; they would thus become eligible for social assistance. At the other extreme, an unchecked increase in real wages would increase unemployment benefits along with the number of unemployed, but because the employers' contribution to the Labour Fund remains unchanged in real terms, higher subsidies from the budget would be necessary.

Social policies

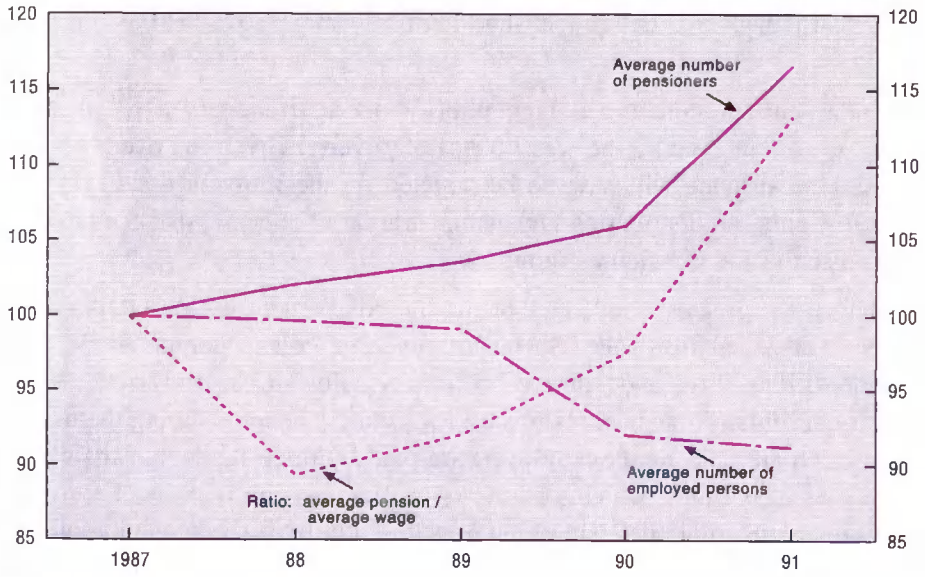
In addition to establishing support for the unemployed, the reform strategy has also emphasised the establishment of a more general social safety net. Much has been accomplished towards this end, although the system remains a heterogeneous collection of both inherited and reformed schemes. Partly as a result, social security expenditures are growing rapidly and the programme might be financially unsustainable, even in the short term. A major overhaul is therefore required[77].

Under current conditions, high priority needs to be given to measures directed toward alleviating the worst forms of poverty. Given the overall budget constraints, assistance will have to be targeted on the most needy. In order to further this aim, the distribution and administration of social assistance has been decentralised to the communes (gminas).

One of the greatest challenges facing the government is to establish sound financing for social insurance. Social insurance in Poland comprises pensions (retirement, disability, and survivor's), family allowances, and sickness and maternity benefits. These benefits (except for sickness benefits during the first six weeks which are paid by the employer) are paid by three funds, but mainly the Social Insurance Fund, which operate on a pay-as-you-go basis. Enterprises contribute a standard 43 per cent of the wage bill, but from the beginning of 1992 this has been increased to 45 per cent in response to growing pension expenditures[78]; employees do not contribute. Deficits of these funds have been increasingly covered by transfers from the central budget.

The main reason for the rapidly escalating cost is the generosity of pensions. Especially since 1990 there has been a growing number of pensioners as a result of liberal regulations regarding disability allowances and early retirement (Chart 13). Particularly important has been early retirement in the case of mass layoffs. The other factor contributing to higher costs is the increase in pensions relative to average wages. There are two principal grounds for this: the wage explosion in 1988 and 1989, which led to higher pensions since earnings over the last two years of employment determine the entitlement; and the introduction of quarterly indexation of pensions to the average wage. At the same time, there has been a decrease in revenues due to both a lower level of employment and an increased number of unemployed whose contributions are related to unemployment benefits.

Chart 13. **THE STRUCTURAL PROBLEMS OF PENSION FINANCING**
1987 = 100



Note: All calculations exclude individual farmers.
Source: Polish Ministry of Labour.

In response to increased budgetary subsidies, a number of steps have been taken. Indexation was postponed in the second half of 1991, and the government proposed that revisions should only occur twice a year. In January 1992 the parliament established indexation three times a year, but only if during the preceding four months the average wage in the economy increased by 10 per cent. However, of most significance has been the introduction of a new method for calculating pensions[79].

For 1992 all pensions were recalculated according to the new system taking into account pensioners' earnings in the last three years before retirement[80]. The highest pensions were limited to 250 per cent of average wages. After these changes around 60 per cent of pensioners were to receive higher pensions than previously but around 40 per cent were to have them lowered. However, the Constitutional Tribunal declared that decreases in pensions were unconstitutional. This ruling failed to be overturned by a two-thirds majority in the parliament: in the absence of further offsetting measures the budget liabilities would be increased by an estimated 18 trillion zloty.

The new system has a number of positive features, such as the longer period taken into account when calculating the level of pensions, and relating the level of pensions to the number of working years, thus creating better work incentives. Moreover, the new formula should in due course lower the ratio between average pensions and the average wage. However, there are equally a number of negative features which will make early reform inevitable. Costs remain very high while there is the risk that many pensioners on the minimum pension will fall below the poverty line. In the medium term, the government may need to foster the creation of private pension funds to complement a generalised, but substantially trimmed, public pension scheme.

Progress and issues in establishing a new tax system

The government has from the beginning of the Economic Transformation Programme recognised the necessity of establishing an efficient, equitable and securely based tax system. To this end, the strategy called for a shift of taxes from enterprises to households, and from direct to indirect taxes. In line with experience in other countries[81], the intention was to widen the tax base, lower

marginal tax rates and to shift the burden of taxation towards consumption rather than saving.

Against such ambitious objectives, the installation of the new system has been hindered by the enormous legislative workload and by the need to create new institutions and to reform existing ones. Legislation to introduce a Value Added Tax (VAT), and a new personal income tax (PIT) were submitted to the Sejm in 1990. The intention had been to introduce the new taxes in January 1991. However, the PIT was not finally approved until July 1991, and the VAT law has still not been approved. The PIT and a new corporate income tax came into force in January 1992 but it is unlikely that the VAT will be implemented before 1993. Problems in implementation have also been encountered. These principally relate to the lack of trained tax-collectors and the relatively wide discretion of the tax administration.

Personal income tax

The PIT came into force in January 1992, replacing a 20 per cent tax on gross payrolls, previously levied on enterprises, and four other taxes which had been paid by individuals[82]. The rationalisation of these separate taxes was an important step forward: nearly all income now receives equal treatment regardless of source or person. Exemptions are limited to social welfare benefits in kind, some allowances and interest on household savings accounts and government securities[83]. By contrast, dividends are subject to tax. Apart from special treatment for receipts on the sale of owner occupied housing, when reinvested within one year, and for profits on financial assets, capital gains are taxed as part of normal income. To foster the development of capital markets, in 1992 and 1993 the profits from trading financial securities will not be taxed. The tax schedule is progressive: there are three brackets (20, 30, 40 per cent). Married couples are in principle taxed individually, thereby reducing dis-incentives for wives to take up employment; but under certain conditions couples can choose to be taxed jointly, paying double the tax due on half the joint income. There is no minimum taxable level for income but a threshold is established since Zl 864 000 per annum is deducted from tax liabilities so that an individual with an annual income of less than Zl 4 320 000 pays no tax). The overall tax burden is expected to amount to around 17 per cent of personal income. Tax collection is on a monthly pay-as-you-earn basis but at the basic 20 per cent rate. Taxpayers are

required to file annual returns at the end of each year and adjustments to tax liabilities are then made.

Enterprise income tax

The most radical change in the enterprise income tax system was introduced in 1989 when income tax for legal persons was made non-discriminatory, at a flat rate of 40 per cent[84]. During 1990, a confusing series of exemptions were introduced[85] but in the course of 1991 these have been rationalised: tax relief for newly created firms was abolished; investment relief was restricted to the agricultural and food processing sectors and; the statutory exemption for joint ventures with foreign partners was revoked (see Chapter IV)[86]. In general, equal tax treatment for foreign and domestic companies is now stressed. At the same time, provision for loss carry-over was introduced: they can be carried forward for three years on a linear basis. Revisions to the CIT passed by the Sejm in January 1992 makes revenue from dividends taxable at a rate of 20 per cent but also creates provisions for some tax offset. Thus the system is principally classical with only a small relief from the double taxation of dividends[87].

Of considerable importance for assessing the effective tax rate on firms (and therefore the cost of capital) is the determination of the tax base. The rules for depreciation are relatively conservative: straight line with rather low rates for buildings. Historical cost has, however, been indexed for inflation on a yearly basis[88], and this provision has not been extended for 1992.

Indirect taxes

Since 1990 the distortionary effects of the old turnover tax system have been substantially reduced by widening the number of products and services subject to the tax and by reducing the number of rates from several hundred to a few[89]. Nevertheless, there have been numerous exemptions and revenue is highly dependent on several items[90]. In particular, enterprises producing semi-manufactures, components and raw materials have not had to pay sales tax. The distortionary effect of the present sales tax system has paradoxically been one of the factors influencing the delay: with the introduction of a VAT it is expected that relative prices will shift significantly, with prices for food and housing construction rising substantially[91]. In order to prepare for the eventual introduction of a VAT, the coverage of goods was substantially extended in the 1992 budget: the

5 per cent turnover tax that already applied (since January 1992) to practically all services has been extended to processed foods and building materials. In addition, a 1 per cent tax on retail trade has been established. Present plans for a VAT envisage three rates: 22, 7 and 0 per cent. These measures should help to minimise the transition costs which could arise during the introduction of the VAT.

Special state sector taxes

In addition to the normal corporate tax, state-owned enterprises are also subject to two other taxes which have become an important source of government revenue: a capital tax (dividenda) and the excess wages tax (Popiwek, discussed in Chapter II). The capital tax, in particular, has been widely criticised as excessive and inequitable. Taken together, these two taxes have increased the fragility of tax revenues since they rely on the liquidity of the state-owned enterprises.

The original intention of the capital tax (dividenda) was to prevent the decapitalisation of the state-owned firms through excessive wage increases and other misuse of assets: the tax was to replace the missing ''advocate of capital'' in safeguarding the firms present value. This role was reinforced through non-payment being the primary criteria for bankruptcy. The intention was not strictly one of raising revenue in an efficient manner. The role of the tax in influencing behaviour is discussed more fully in Chapter IV; only some financial aspects are discussed here. The tax is a fixed charge payable irrespective of profits. The tax base is often stated to be ''assets'' but is in reality a carry-over from socialist accounting: tax is levied on the ''initial fund'' which is ''capital transferred to the enterprise in the past in the form of the assets needed for engaging in economic activity''[92]. While the base refers to notional assets, they have not been depreciated[93] but have been revalued occasionally to account for inflation. Moreover, the tax base does not include the ''enterprise fund'' which is, broadly speaking, retained earnings. In comparison to western accounting concepts, the tax base is akin to issued capital which has been indexed. The tax rate has been reduced from 32 per cent in 1990 to 22 per cent in 1991, and is likely to be 10 per cent as from July 1992. As enterprise profits have decreased in 1991, more and more firms are recording losses after paying the tax. In addition, more firms are recording before-tax losses; it is therefore not surprising that arrears have

increased rapidly in the course of 1991. The state has not enforced payment through an effective threat of bankruptcy.

Assessment

Over the last two years, the Polish authorities have significantly improved the transparency of the tax system and have moved towards introducing uniform treatment for taxpayers. In addition, most extra-budgetary funds have been liquidated and the quasi taxes related to them (e.g. import levies paid to FOZZ) abolished. An important achievement has also been the establishment of a system of local government financing based on shares for gminas (communes) of the CIT and PIT as well as their own taxes and levies, although local authorities continue to have little authority over their revenue sources. Overall the system is now clearer and simpler, more adapted to a market economy.

Implementation delays, which have arisen for both legislative and institutional reasons, have been extremely costly. This is most apparent from the collapse of revenues in 1991, which might have been controlled had a VAT and household income tax been in place. Moreover, although some features of the tax legislation have sought to simplify the system so as to promote effective implementation, this has not always been given the priority it could deserve. However, of perhaps even greater importance has been the uncertainty created for investors, domestic and foreign alike, by drawn out tax reform. For example, one firm of business advisors noted 22 major changes to tax regulations between December 1989 and January 1991. Reform of course means change, but the need to settle the tax system quickly and to establish well defined and stable "rules of the game" is equally vital.

Particularly severe problems remain which will lead to continuing fragility of budget revenues. Above all, the budget still depends heavily on the state-owned enterprise sector for revenues, and particularly on its continuing profitability and ability to pay. Yet there appear to be few incentives for state-owned firms to strive for profits and financial soundness. Solving this problem will require governance reforms in the sector itself, discussed further in the following chapter. However, the taxes themselves are far from ideal. In particular, the capital tax is levied on a narrow tax base with little regard for the constraints facing the enterprise.

Aside from the capital tax, it appears that the enterprise income tax may be associated with a high effective tax rate and therefore a high cost of capital. This would serve to discourage investment. A shift to indirect taxes, which is well under way with the 1992 Budget would not only reduce this effect but also support saving. Double taxation of dividends is another feature that may discourage saving as well as the development of mutual funds, while tax-free bank interest will further reduce the incentives to acquire shares in privatised companies. The present system of indirect taxes, even though it has been reformed, still remains inferior to a value added tax. It is difficult to assess the level of tax burden in the private sector. Taxing it more effectively will be facilitated by a shift to indirect taxes, but the need for a more effective tax administration will remain paramount.

IV. Fostering Restructuring in the Enterprise Sector

Two years after the launching of economic reform, large parts of the enterprise sector are in a critical situation. The difficulties are concentrated in the state sector: at the end of November 1991, a third of the 8 200 state-owned enterprises reported a before-tax loss while 41 per cent reported after-tax losses[94]. Of 1 800 firms under the supervision of the Ministry of Industry, 718 were in a desperate or difficult financial position; 250 firms employing more than 500 people could have been declared bankrupt in line with the law on state-owned enterprises while another 300 were expected to be in a similar situation in the near future. In most branches output has continued to decline although at a slower rate in 1991 than in 1990, while mass layoffs have started to add significantly to unemployment. By contrast, the private sector has continued to expand, though possibly not at a rate sufficient to offset the decline of the state sector. Even so, private firms also face obstacles to their development: cash-flow is being squeezed as the result of involuntary of credits extended to state-owned firms; access to capital from financial institutions remains limited and its price high; consequently, private investment activity is weak[95].

The problems of the enterprise sector result primarily from the difficulty of enterprises to adjust adequately to the radical changes in the external conditions facing them. Far-reaching changes in relative prices and costs, large shifts in the goods demanded by consumers following liberalisation of the domestic and external trade regimes, and rapidly evolving international market conditions – in particular, the collapse of the Council for Mutual Economic Assistance (CMEA) – have meant that *most* enterprises need to alter their product mix, organisation, focus and technology. This is as much a restructuring in business culture as it is one of technology and capital. Successful restructuring would mean that some existing enterprises expand while others contract. Many new

enterprises would need to be established, and a number cease to operate. Scarce resources would be re-employed in the process.

Inadequate adjustment partly reflects the fact that adjustment takes considerable time. When one considers the many years required for OECD countries to adjust fully to the 1973 oil shock, it is hardly surprising that Polish enterprises are still struggling now, some two years after the much larger shock of opening up the economy to world prices. Slow adjustment also reflects the difficulties of overcoming the structural rigidities inherited from the period of central planning and the inevitable delays in establishing the legal and institutional framework for a market economy including privatisation of enterprises. Finally, as regards the state sector, it also reflects distorted incentives within enterprises because there is no effective "representative of capital" to enforce decisions; and budget constraints that would force enterprises to adjust are not perceived by them to be truly binding.

To accelerate adjustment requires that the scope for market forces to guide the decision-making of enterprises be enlarged as quickly as possible: through privatisation in the first instance and, where this is not immediately possible, through the development of better incentive structures for state enterprises. (After all, even on the most optimistic estimates, state enterprises will still account for 50 per cent of industrial output in 1994.) In this sense, the test of an effective microeconomic strategy is whether it is helping or hindering market adjustment processes. When assessing policy alternatives, this criterion needs to be kept clearly in view since "adjustment policies" are often put in place to shield particular enterprises from market processes, in favour of the short run interest of specific regions, groups of workers, managers or owners. The consequence is a sacrifice of growth possibilities.

The first section of this chapter analyses the major changes in the environment facing Polish enterprises and the consequent adjustment pressures; the second reviews strategies and instruments to foster enterprise restructuring[96].

The scope and nature of the restructuring challenge

The introduction of a market economy through the abolition of quantity and price controls and the opening of trade has created a number of pressures and

incentives for enterprises to adjust; at the same time it has highlighted a number of previous unseen barriers and inherited weaknesses.

Pressures for adjustment

With price liberalisation and the opening up to world trade in 1990, relative prices changed significantly, energy prices rose dramatically and interest rates increased to positive levels. While some enterprises were no doubt well-placed to develop their activities in these new circumstances, many risked becoming unviable if they did not sharply adjust their use of energy and labour; and a few clearly could not survive at all. To give one example, prior to 1990 Poland was a major exporter of tropical flowers. As a result of the higher energy prices, this industry has disappeared.

Changed relative prices

The freeing of most prices in 1990, the substantial reduction of subsidies (including large increases in remaining administered prices) and the introduction of convertibility resulted in a significant change in relative prices. Table 4 suggests that relative price movements for industrial goods have been large. The relative prices of clothing, textiles, precision equipment and electronics have fallen (in some instances even halving in comparison to 1989) while the relative prices of fuel and power, food and non-ferrous metals have increased[97]. Such changes have not been confined to industry: within the consumer price index, the relative price of goods has fallen and that of services has increased.

Although the change in relative prices has been great, there is every reason to expect that the process has some way still to go. First, the continued high growth in imports of particular goods, and financial losses by some industrial branches, indicate that a sustainable relativity of domestic to world prices has not yet been reached. This is particularly so for firms heavily tied to trade with the NIS. Second, many service prices are still artificially low, especially those provided by local government such as rental accommodation and local heating.

Policy changes implemented during 1990 have not only influenced broad sectoral price developments but also the costs of particular enterprises. Prior to 1990, the Polish budget distinguished between product specific and enterprise specific subsidies. While the latter were fairly small in aggregate[98], the tax/subsidy system was in fact operated in an enterprise specific manner so that loss

Table 4. **Changes in relative prices, 1987-1991**[1]

% of overall price index

	1987	1988	1989	1990	1991
CPI / PPI	100.0	100.3	112.5	106.7	122.8
Consumer prices-total	100.0	100.0	100.0	100.0	100.0
Goods	100.0	99.6	103.4	99.6	93.4
Food	100.0	93.3	111.6	110.0	94.2
Services	100.0	102.1	78.7	100.2	137.5
Producer prices-total	100.0	100.0	100.0	100.0	100.0
Energy	100.0	106.5	81.1	116.0	146.5
Coal	100.0	105.6	62.9	87.0	122.6
Fuel	100.0	110.2	95.8	132.5	147.3
Power	100.0	101.6	89.1	132.9	173.5
Metallurgy	100.0	104.8	111.5	136.4	110.2
Iron and steel	100.0	99.7	114.0	136.3	109.2
Non-ferrous metals	100.0	113.4	108.7	137.0	113.6
Electro-engineering	100.0	97.3	94.3	85.3	79.3
Metal products	100.0	97.1	97.7	94.0	84.6
Engineering	100.0	95.5	86.5	77.0	70.7
Precision equipment	100.0	95.3	83.5	60.7	52.8
Transport equipment	100.0	98.1	99.7	98.6	100.8
Electronics	100.0	100.2	100.2	83.7	71.2
Chemicals	100.0	101.5	95.7	102.8	97.7
Mineral products	100.0	97.8	94.2	94.7	92.7
Building materials	100.0	95.9	86.8	90.8	88.9
Glass	100.0	102.4	110.4	106.6	104.0
Earthenware/ceramics	100.0	104.6	122.4	103.4	104.6
Wood and paper	100.0	92.8	98.7	90.1	87.0
Wood	100.0	91.6	98.5	83.3	85.2
Paper	100.0	96.1	100.1	106.3	86.9
Light industry	100.0	98.4	101.9	71.7	66.4
Textile	100.0	98.7	100.0	74.7	65.9
Clothing	100.0	95.1	93.9	57.4	56.5
Leather	100.0	100.8	115.3	79.4	73.5
Food	100.0	98.5	123.1	107.0	110.1
Other industrial categories	100.0	99.6	88.9	79.1	81.3
Animal feed	100.0	120.0	99.5	67.4	56.3
Printing	100.0	93.9	81.0	73.4	90.5
Miscellaneous	100.0	95.4	89.0	86.2	84.1

1. Including state units, co-operative units and units of political organisations and trade unions.
Source: Polish Central Statistical Office (GUS).

making *enterprises* were systematically bailed out. Indeed, there was often a negative relationship between operating losses and profits after taxes and subsidies[99]. The elimination of enterprise-specific subsidies thus intensified adjustment pressures.

A major energy price shock

Until 1990, government policy held energy prices significantly below the cost of indigenous supply, and even below the low prices of energy imports from the CMEA. Since January 1990, Polish enterprises have faced enormous increases in the real price of energy (Table 5), a shock much greater than that

Table 5. **Increases in nominal energy prices since January 1990**

	Date price increase implemented							
	January 1990	May 1990	Sept.-October 1990	January 1991	Overall increase Jan. 91/Feb. 90	May 1991	January 1992	March-April 1992
	Preceding period = 1.0							
Hard coal								
Industry	5	1.3	– "free prices" –		1.5			1.06
Household	7	1.5			1.5			
Lignite	2.5	–	– "free prices" –		1.5			1.07
Natural gas								
Industry	2.5	–	–	1.6	1.6		1.1	–
Household	5	2	–	1.8	3.6	1.4	1.7	1.04
Heavy fuel oil								
High sulphur	4.3							1.37
Low sulphur	4.1							1.37
Light oil (diesel)	1.9	– several times –			2			1.35
Gasoline	2	– several times –			1.7			1.19
Electricity								
Industry	3.8	–		1.15	1.15	1.25	1.15	1.1
Household	5	1.8		1.2	1.2	1.1	1.2	1.12
Memorandum item:								
Producer prices	2.1	1.01		1.1	1.4	1.02	1.03	n.a.

n.a. Not available.

Source: International Energy Agency, Energy Policies-Poland, Paris, 1990, p. 13 and data provided by the Polish Central Planning Commission.

experienced in either 1973 or 1979 by OECD countries, which had the advantage of developed markets. Even so, Polish energy prices still remain below the levels prevailing in Western Europe. The objective is to adjust energy prices for enterprises to world market levels by the end of 1992, which implies continued pressure. Not only are fuel prices generally below equilibrium levels relative to other prices, there also remain significant distortions in relative prices for different fuels.

The importance of the energy price increase is compounded by a concentration of the Polish industrial sector on energy intensive goods, as well as a generally high level of energy consumption. Thus the estimated Total Primary Energy Requirement/GDP ratio is almost twice the OECD (IEA) average[100]. The pressure on Polish enterprises to adjust is illustrated by calculations of how value added might have evolved had only energy and commodity prices changed, with wage costs remaining at pre-reform levels: under these conditions 27 per cent of manufacturing output would have immediately operated at losses while a further 15 per cent would in all likelihood have also incurred losses depending on the level of the real exchange rate[101].

Sharply higher interest rates

In addition to changing energy and product prices, enterprises have also had to adjust to much higher interest rates and the unaccustomed restriction of credit. Given high and variable inflation, it is difficult to judge whether the level of interest rates has been high in real terms. However, borrowing rates must have appeared very expensive to enteprises whose own output prices were rising only slowly or not at all, as was the case in many sectors. Interacting with high interest rates was the random distribution of debts from the past. While the high rate of inflation at the end of 1989 and in January and February 1990 extinguished a substantial amount of old liabilities, sectors and enterprises were not all equally affected. Those with foreign currency balances (i.e. old exporters) or whose goods rose particularly rapidly in price clearly benefited, but others did not.

A need to adjust labour costs

Prior to liberalisation, labour costs (measured in foreign-currency terms) were high relative to international prices in many industries[102]. The shift to world prices and liberal trade thus entailed a need to reduce these costs, and this was

intensified by the sharp rise in the price of commodity inputs and energy. The sharp devaluation of the zloty in 1989 and January 1990 for a time achieved this cut in labour costs measured in foreign currency, but subsequent increases in nominal wages eroded this (see Chapter II). Furthermore, declining output not matched by comparable reductions in employment has meant that, during the period from 1990 to March 1992, labour costs per unit of output have risen much faster than wages. Thus substantial changes either in wages measured in foreign-currency terms or in labour productivity remain necessary to establish adequate competitiveness.

Structural factors intensifying the pressure to restructure

The need for the enterprise sector to react and to restructure in the face of changed relative prices and opportunities has highlighted a number of structural weaknesses.

Age of capital stock and technology, size distribution of enterprises

The capital stock in Polish industry is comparatively old and poorly allocated across enterprises. The former point is illustrated in Table 6 which shows that the proportion of equipment under five years of age has been steadily falling and is low in comparison to other ex-socialist countries and to market economies[103]. To the extent that technology is embodied in the capital stock, the level of technology in Polish industry is also correspondingly lower[104]. Indeed, other

Table 6. **Age structure of equipment in industry**[1]

% share of assets under five years of age

	1975	1980	1985	1988
Poland	42	35	17	19
CSFR	31	32	25	23
GDR	30	30	26	29
Hungary	41	41	28	29
FRG[2]	–	39	–	40

Sources:

1. United Nations Economic Commission for Europe, Economic Survey of Europe in 1989-1990, New York, 1990, p. 13.
2. Years 1980 and 1989, Statistisches Bundesamt, Fachserie 18; Volkswirtschaftliche Gesamtrechnungen, Reihe 1.

indicators suggest that a large share of installed technology dates from the mid-1970s. Moreover, anecdotal evidence from many observers points to the fact that new capital equipment is distributed more or less at random across enterprises, pointing to considerable efficiency gains if a market in equipment could be established.

Under central planning, there was generally a strong bias towards concentrating production in large, vertically integrated enterprises[105], whereas in market economies small and medium-sized enterprises have tended to play the dominant role in many sectors. While Polish industry was somewhat less characterised by giant enterprises than other countries of central and eastern Europe, it was still characterised by a marked lack of small and medium sized enterprises in comparison to market economies (Table 7). Moreover, this pattern is not a function of the overall specialisation of the economy toward heavy industry: Table 8 indicates that the lack of SME's in the 1-100 category is important in just those sectors in which they often dominate in market economies (i.e. engineering, light industry, food, other branches).

Table 7. **Distribution of employment according to firm size, international comparisons**

Number of employees/firm	Industry		Number of employees/firm	All industrial enterprises				
	Poland 1989	GDR[1] 1988		Japan 1972	UK 1979	Hungary 1981	Yugo-slavia 1981	USA 1977
	% share of total			% share of total				
1-100	1.4	1.0	5-75	90.9	81.3	7.0	22.4	76.7
101-200	18.2	2.5	76-189	6.1	10.8	18.7	32.1	12.4
201-500		8.7	190-243	0.8	1.5	9.2	12.0	3.8
501-1 000	15.0	12.2	243+	2.1	6.9	65.1	33.5	7.1
1 001-2 500	43.1	25.9						
2 501-5 000		22.6						
5 000 +	22.3	27.1						
All firms	100.0	100.0	All firms	100.0	100.0	100.0	100.0	100.0

1. Excluding apprentices.

Sources: Poland – Polish Ministry of Industry (Promasz); GDR – Statistisches Bundesamt (1990) DDR 1990, Zahlen und Fakten, Stuttgart, Table 8, (reprinted in OECD Economic Survey of Germany), July 1991; Japan, UK, Hungary, Yugoslavia, USA – World Bank memo.

Table 8. **Distribution of state-owned industrial enterprises by employment and sector, 1988**[1]

As percentage of total

No. of employees/firm	Total manuf. industry	Metallurgy	Engineering	Fuel & energy	Light industry	Food	Chemicals	Wood & paper	Mineral products	Other branches
1-100	1.4	0.3	1.4	0.0	1.4	1.6	1.4	5.8	2.0	2.9
101-250	18.2	2.3	17.8	0.9	24.1	28.4	18.3	25.7	28.7	42.3
251-500										
501-1 000	15.0	3.1	15.5	2.3	16.4	28.2	12.0	15.1	30.7	26.9
1 001-5 000	43.1	38.8	42.3	43.5	54.2	37.7	39.6	50.8	35.3	27.9
> 5 000	22.3	55.5	23.0	53.3	3.9	4.2	28.7	2.6	3.2	0.0
All firms	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Memorandum item:										
Total no. of employees	4 017 124	203 975	1 272 366	660 672	632 832	410 103	276 598	210 228	205 998	144 352

1. Manufacturing industry only (minus mining and construction).

Source: Polish Ministry of Industry, "Memorandum on Industrial Restructuring", July 1991.

Dispersion of effort and product quality

Polish industrial enterprises carry out a substantially wider range of tasks than is typical in market economies thereby reducing managerial efficiency. In some areas vertical integration when not undertaken for clear economic reasons, may have saddled enterprises with complex management problems in co-ordinating different levels of production. Business services in Poland have traditionally been provided in-house. Under market conditions these could be more efficiently provided by specialised service firms. Finally, enterprises have been and are still responsible for a wide range of social activities such as housing, recreation and health which add to costs and spread the decision making abilities of the firm[106].

Generally speaking, in exporting to European markets, Polish industrial products have a relatively low unit value compared with those of competing producers (Table 9). Such a price discount is suggestive of lower product quality. While this does not in itself constitute a need to restructure, it does nevertheless set the parameters within which Polish firms must compete internationally. It is accordingly important that exchange rate and wage developments remain compatible with competition at this end of the market.

Table 9. **Indicators of product quality, 1977 and 1987**

Relative price gap[1]

	Mechanical Engineering		Electrical Engineering	
	1977	1987	1977	1987
Poland	0.586	0.545	0.551	0.726
Federal Republic of Germany	1.0	1.0	1.0	1.0
Czechoslovakia	0.639	0.527	0.423	0.629
Hungary	0.667	0.670	0.488	0.776
Italy	0.982	1.020	1.083	1.083

1. The relative price gap is a trade-weighted index of import prices in the European Community relative to the market leader, mostly Germany. In mechanical engineering 480 products are included; for electrical engineering 254 products.

Source: M. Landesmann and I. Székely, "Industrial restructuring and the reorientation of trade in Czechoslovakia, Hungary and Poland", CEPR Discussion Paper 546, April 1991, London.

Level of infrastructure and regional dispersion of industry

Of direct significance for industrial restructuring is the level and distribution of communications and transportation infrastructure. Reflecting the egalitarian emphasis of central planning, infrastructure is generally well spread but the overall stock is low and not adapted to the needs of a market economy. Thus the density of local roads and railways is relatively high but the density and length of motorways is quite low[107]. The number of telephones per capita is only some 10-20 per cent of what is typical in OECD European countries although this is now growing quite quickly.

Industry is also geographically widely spread in Poland. Though the two conurbations of Warsaw and Katowice account for a large share of total production, sizeable industrial enterprises are scattered over much of the country. This gives rise to the phenomenon of "one big firm in a small town" [108]. In many cases this will make the community or regional dimension of industrial adjustment extremely difficult and places a premium on workers' geographical mobility.

The comparative development of the service sector and heavy industry

Comparing the sectoral distribution of GDP in Poland with what is typical in OECD countries, it seems clear that service activities are relatively under-represented; and that industry accounts for an unusually large share of total output (Table 10)[109]. Industry, moreover, is dominated by heavy, capital intensive and resource intensive lines of production. It cannot be concluded *a priori* that this specialisation is misdirected; but the fact that the development of heavy industry was largely subsidised (it was regarded as strategic and therefore given priority) during the planning period, and also that chronic conditions of excess capacity persist in a number of heavy-industry sectors at the global level, suggest that particularly difficult adjustments lie in store here. Finally, insofar as heavy industry is often a major source of pollution, and Poland faces severe environmental problems in a number of industrial regions (Annex VI), extensive rationalisation of production in heavy industry would seem to be a requirement on this score as well.

Table 10. **Sectoral distribution of GDP, 1988**

	Poland	Range in OECD countries	
		Lower	Upper
Agriculture[1]	13.1	1.3	16.3
Industry[2]	58.0	24.3	41.2
Services	28.9	46.9	68.7

1. Including forestry.
2. Includes mining, manufacturing, construction, transport and communication.
Sources: Poland: Rocznik Statystyczny, 1991, Table 3 (195) p. 112; OECD statistics.

Factors facilitating restructuring

While changed relative prices and inherited structural distortions have created an urgent need for enterprise restructuring, Poland nevertheless has considerable resources which can, under appropriate market conditions, facilitate the process. Three in particular stand out: human capital, geographical location, and a potentially large internal market.

While it is difficult to document, a very large number of sectoral consultancy reports point to a high level of technical skills in the Polish work force – in contrast to a shortage of many managerial skills. Moreover, such human capital is inexpensive by international standards making Poland an attractive manufacturing location. In addition, the Polish work force is comparatively well travelled, a factor which should increase its flexibility and motivation.

Poland is geographically well situated to exploit market opportunities in both the European Community and EFTA – market access permitting. Transport and communications costs from Poland to these regions are potentially well below those facing countries that are further away. Over the longer term, geographical proximity to and knowledge of the market in the ex-USSR is also a significant advantage.

Poland represents not only a promising location for industrial exports but is also, with 38 million citizens, a potentially major market. This, of course, can be supplied from abroad, but under appropriate market conditions enterprises pro-

viding a wide range of goods and services to consumers could be expected to develop their activities in Poland.

Strategies and instruments: progress and outstanding issues

At the risk of over-simplification, the strategy developed in 1990, and which remained in force throughout 1991, viewed the development of the private sector as the primary means for restructuring the enterprise sector. The development was to be accomplished by measures to facilitate the creation and growth of new private enterprises, and through the privatisation of state enterprises. It was recognised that many state enterprises would need to be transformed before they could begin to function as viable entities in a market context; but only limited efforts were made to begin this restructuring process. Restructuring was viewed as requiring major resources and especially new investment; but without new, commercially oriented owners (i.e. representatives of capital), state-owned enterprises could not be trusted with major investment decisions – and Ministry officials even less so. As a result, the strategy was *de facto* one of privatisation before restructuring[110]. Not all firms could be made viable or attract private investors, however. For these, liquidation was foreseen which would release physical and financial resources for other uses. Pending privatisation, discipline over state-owned enterprise was to be exercised via taxes (an excess wage tax and a capital tax, "dividenda"), and by a reformed and commercially oriented banking sector which would ensure a hard budget constraint.

In line with the transformation strategy, the private sector has indeed expanded, vigorously so in some areas (e.g., trade, transport and construction). But implementation of privatisation has proved difficult, particularly with respect to larger enterprises, and less has been achieved thus far than had been hoped. A central problem has been to find a politically acceptable balance between achieving speed in privatisation and the need for the process to be perceived as "fair". After numerous set-backs and delays, a flexible multi-track programme has evolved which, as described below, has a number of strengths though it remains burdened by institutional difficulties, confused lines of authority and unresolved restitution issues. In particular, there are 60 "founding organs"[111] which are the nominal owners (although this term has somewhat limited meaning), but often a

privatisation will involve numerous ministries and levels of government in addition to the Ministry of Ownership Changes.

Perhaps the biggest problem for the strategy has been the failure to provide an adequate operating environment for state-owned enterprises prior to their privatisation. In practice, it proved impossible to impose hard budget constraints fully[112], or to put non-viable firms into bankruptcy on the scale which would have decisively signalled a new policy. And because the enterprises themselves lacked both the means and the incentives to adjust (as well as to assess and manage risk) their balance sheets deteriorated steadily. As it became apparent that privatisation would be slower than expected and tight restrictions on state enterprises were difficult to maintain, additional policy measures were called for. The following paragraphs first examine the issues relating to the development of the private sector and privatisation, and then turn to the question of how the problems of the state enterprises are to be addressed.

Developing the private sector

The development of the private sector – privatisation in its broadest sense – has been fostered through a number of policy initiatives. Legal barriers to entry have been eased, taxation reformed and property rights created (Chapter III) although significant impediments still remain with respect to real property. Important opportunities have been created: trade has been extensively liberalised (Chapter V) and the realisation of ensuing commercial opportunities facilitated by currency convertibility. Moreoever, the possibility for responding to the new opportunities has been enhanced by the sale of state-owned assets: privatisation.

The overall response by the private sector to the new opportunities is to some extent a matter of surmise since many activities are known to be under-recorded. However, even on the basis of what is actually measured the general strategy has been quite successful: the number of private firms increased from 11 693 in 1989 to around 41 450 by the end of September 1991, while the number of individual establishments rose from 813 000 to about 1.4 million. During 1991 the importance of private firms has increased relative to businesses run by individuals. This may signal a process of consolidation of Polish small and medium-sized enterprises, which would be a healthy development. It may also reflect the increasing impact of privatisation. The share of GDP accounted for by the private sector increased from 28 to 35 per cent in 1990 (Table 11)

Table 11. **Share of the private sector: main indicators, 1989-1991**

Percentage

	1989	1990	1991
GDP[1]	28.4	35.0	–
Employment			
Including private agriculture[2]	44.3	45.8	50.6
Excluding private agriculture[3]	29.5	30.9	36.7
External trade			
Total	–	8.6	36.2
Exports	–	4.9	21.9
Imports	–	14.4	49.9
Investment	35.3	41.3	–
Material production			
Industrial production	16.2	17.4	24.1
Construction[4]	33.4	32.2	55.2
Trade	59.5	63.7	82.8
Transport	11.5	14.2	23.7

1. In constant prices of 1984.
2. As share of total employment.
3. As share of non-agricultural employment.
4. Building and construction.

Source: Polish Central Statistical Office (GUS).

although some observers place the figure much higher. More dramatic is the rise in the share of foreign trade accounted for by the private sector although, especially in this area, the development is significantly under estimated. The strong performance of private firms founded before 1990 is particularly noticeable (Table 12).

These tables only partially document a very important point: the private sector has shown flexibility in adjusting to the new circumstances. The switch to a market economy in 1990 created as many problems for the existing private sector as it did for state-owned enterprises. However, field research indicates that they responded by seizing new opportunities and redefining their strategies[113]. Entry and exit patterns are indicative of this. Between January and August 1990, a large number of firms in production and services either suspended their activity or were liquidated: the gross outflow was 27 257 and 15 506 enterprises respectively[114]. Some closures were attributable to older owners not being able to adjust

Table 12. **Composition of gross domestic product: real growth rates, 1990**

Percent change over 1989[1]

	Total	Public	Private	Former private
Total	–11.6	–19.6	8.7	19.7
of which:				
Material production	–13.4	–23.5	11.2	19.4
Industry	–22.0	–25.1	0.4	7.5
Construction	–14.5	–15.5	–11.9	–7.5
Agriculture and forestry	–1.9	–13.2	1.9	3.8
Transport and communication	–12.6	–10.9	–20.8	–0.8
Trade	0.7	–35.4	57.5	118.7
Other material	–10.9	–7.0	–15.5	7.9
Non-material production	–0.4	2.4	–8.8	32.6

1. In constant prices of 1984.
Source: Polish Central Statistical Office (GUS).

to the new conditions of a market economy, but higher rents and the increased costs of energy are reported as most important[115]. Many entrepreneurs, however, simply saw better profit opportunities in the trade sector and shifted their activity accordingly. The relative attractiveness of this sector was reinforced by tax exemptions for small traders beginning in June 1990[116], growing availability of suitable premises as state-owned shops were sold-off, and high interest rates that made other lines of activity relatively less attractive[117]. Thus between January and August 1990 the net inflow of enterprises into trade was 118 882. Adjusting to changing circumstances, private firms restructured by shifting product focus and sector so as to pursue new opportunities and avoid losses.

Improving conditions for foreign direct investment

In addition to fostering the growth of the private sector in general, the restructuring strategy also foresaw an important role for foreign direct investment. However, it has taken time to implement an appropriate regulatory framework. The foreign investment regulations which were in force up till July 1991 – although they provided generous fiscal incentives and permitted full foreign ownership – created a number of impediments that served no useful purpose. Among these, foreign investors have cited: a lengthy and bureaucratic approval and registration process (approval was needed for acquisitions above 10 per

cent); a minimum investment amount; the lack of loss carry-forward provisions in the tax code; and, most importantly, limitations on repatriation of profits generated in local currency.

The new Foreign Investment Law of July 1991 addressed most of the major impediments, in addition to providing far-reaching guarantees from expropriation and nationalisation. Above all, after-tax profits of a foreign partner can be converted and repatriated, as can capital gains on the sale of assets. Investments in only a few sectors now require government approval, firms in all other areas simply need to register. No minimum capital is required, which will facilitate investment by people of Polish origin living abroad. In addition, the administration of the legislation has been simplified: responsibility for regulation and management has been moved from the Ministry of Foreign Economic Relations (Agency for Foreign Investment) to the Ministry of Ownership Changes (State Agency for Foreign Investment). This makes a lot of sense considering that privatisation of state-owned enterprises and acquisition by foreign investors will often be tied together in one transaction. Privatisation is already difficult enough without introducing a further dispersion of closely-related powers.

The current regulatory framework emphasises the principle of equal tax treatment for foreign and domestic companies: loss carry-forwards and accelerated depreciation are now available to all investors. Generous tax relief is only granted to companies making large investments with government approval, rather than automatically, and in priority areas of the economy. However, it is important to make criteria for tax relief transparent, and not to bias the selection of projects to particular prestige areas. By and large, the experience with selective tax incentives to encourage foreign direct investment is not promising: in many countries the incentives have simply led to budgetary losses since the projects were in any case commercially viable. Recent pronouncements regarding policy intentions with respect to foreign investment would seem to indicate a limited move toward linking approvals of joint ventures to industrial policy considerations – emphasising such criteria as technology transfers and export development. International experience suggests that such targeting efforts run the risk of discouraging foreign investment overall, if only because of inevitable increased delays in processing and agreeing on applications.

In response to the policy changes, the number of joint venture companies operating in Poland has continued to grow rapidly: by the end of September

1991, 3 512 joint ventures were reported as operating, more than double those at the end of 1990 (another 1-2 thousand companies had been established but had not commenced operations). Altogether, joint ventures and direct acquisitions of Polish firms amounted to around $670 million by October 1991 – of this $280 million was associated with four contracts in June 1991. Although the number of operating joint ventures has grown rapidly, the average size remains small: the average initial investment has been well under $200 000 and many joint-ventures started with the minimum capital requirement ($50 000) which was enforced until July 1991. The generally disappointing level of foreign direct investment may be attributable to a number of factors. Up till July 1991 the regulatory framework was a hinderance although macroeconomic conditions and political developments were also certainly important. However, uncertainty about the privatisation programme and the time taken for it to start to gather momentum have also been important.

The privatisation process

The Polish privatisation programme, which formally began in August 1990 when the Privatisation Law came into effect, has had to develop strategies and instruments almost from scratch: there was only very limited experience to follow. Consequently ''learning by doing'' and institution building have characterised the first two years of the programme. Although many wish that more could have been achieved over this period, the formidable difficulties in this uncharted area, both economic and political, cannot be underestimated.

Despite these problems, much has been achieved. A summary of the overall state of privatisation is difficult, but some indicators are given in Table 13. These exclude the ''small privatisations'' of retail shops where Poland has been particularly successful relative to other reforming countries. The most notable and encouraging feature shown by the table is the acceleration of privatisation in 1991 relative to 1990.

- *Concepts and institutions*

The privatisation programme has had to develop within strictly defined political and social boundaries. Two factors are especially important: the voluntary nature of the process and the absence of centralised ownership. As discussed below, ''state-owned'' enterprises are in fact self-governing with an important

Table 13. **Summary of progress in privatisation**

	31.12.90	30.6.91	31.12.91	30.3.92
Total number of state-owned enterprises	8 453	8 591	8 228	8 273
Small/medium enterprises privatised by liquidation:	59	343	950	1 123
Under Article 37[1, 2]	37	170	416	488
Under Article 19[3]	22	173	534	635
Companies converted to joint-stock companies awaiting privatisation	159	162	244	504
Capital privatisation	1	13	26	32
including:				
Leveraged buy-outs	1	1	2	2
Public flotation	–	6	8	8
Trade sales	–	5	16	22

1. Of which approximately 90 per cent through leasing.
2. In 1991 including industry (85 firms), trade (79), construction (185).
3. In 1991 including industry (170 firms), trade (47), construction (86).
Source: Dynamika Prywatyzacji, Ministry of Ownership Changes, Warsaw, Nos. 6 and 8, 1992.

role for employees councils. In consequence, it has been considered crucial that privatisation remain, so far as possible, voluntary. This overriding political and social condition has importantly influenced institutions and procedures. Moreover, up to the present, it has been considered neither desirable nor possible to establish centralised ownership of state-owned firms. Formal ownership has therefore remained with the 60 founding bodies but with a Ministry of Ownership Changes to oversee and coordinate the process. As a result, responsibilities and decision making powers are quite diffused.

Concern with the need to establish "real owners" with a financial stake in the enterprise has characterised the Polish programme from the beginning. In common with other ex-socialist economies, the privatisation process was viewed from the outset as likely to be hampered by a lack of savings. Nevertheless, there was firm opposition to give-away programmes and simple employee ownership schemes. More generally, the Polish programme has emphasised effective control over ownership transfer and in this manner has sought to support the restructuring strategy.

In view of these goals and constraints, a flexible multi-track procedure has had to develop. Small scale establishments are handled by one procedure (small privatisations)[118] while for enterprises there is the possibility of privatisation by one of two routes: ''liquidation'' or the ''capital'' method. In the future there will be a third: the ''mass privatisation'' programme. These techniques and more detailed aspects such as valuation procedures are discussed in the following sections.

To oversee and control the multi-track programme, the Ministry of Ownership Changes has gradually evolved a sectoral perspective for privatisation (sometimes misleadingly termed sectoral privatisation). The essence of the approach is that it is necessary to have a sectoral information base which clarifies not only the relative positions of enterprises in the domestic market (e.g. their relative strengths and weaknesses) but also in the world market. In other words, it seeks to provide industry information which is routinely collected by companies and marketing research in developed market economies. Such an information base has been found necessary to:

i) improve the bargaining position over sales price, in particular with foreign investors;

ii) determine which privatisation path might be appropriate for a particular company; and

iii) encourage further privatisation in an industry with a view to promoting competition and industrial restructuring.

To date, 34 such sectoral studies have been undertaken for the Ministry. The results have been disseminated to state-owned enterprises in order to further encourage privatisation and rational decision making.

- *Small privatisation*

The privatisation of small scale trading establishments, transport and construction firms has progressed rapidly in the past two years. By the end of September 1991, 75 per cent of trading firms, 45 per cent of construction firms and around 80 per cent of trucking were in private hands. Many of the privatisations were carried out by the communes which showed a clear preference for selling to existing employees. The decentralised approach was associated with a

marked variability of procedures and methods of valuation which, although subject to some criticism, nevertheless facilitated a speedy process.

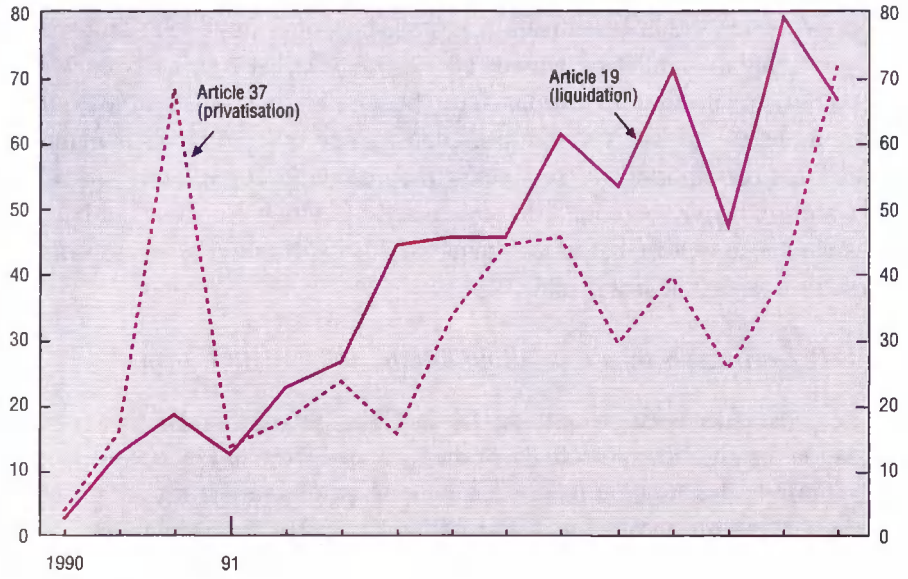
While changing the face of most Polish cities and the quality of everyday life for the better, trade privatisation has raised some quite particular issues. Shops were mainly rented or leased, but in many cases rights of renewal are weak thereby restricting investments to those with a short-term pay-off. In addition, property rights have often been constrained by communes demanding a guarantee that certain kinds of services will continue to be provided. As relative prices stabilise, it may be hoped that this practice (which constitutes a barrier to entry as well as to exit in that it constrains the ability of entrepreneurs to move to the most profitable lines) will fade.

- *Privatisation through "liquidation" of the state firm*

The most successful technique to date has proven to be the so called "liquidation" path under Article 37 of the Law of Privatisation: applications for privatisation via this method have been running at an average rate of around 40 enterprises a month throughout 1991 (Chart 14). By this technique, a state enterprise (usually a small or medium size firm) can be wound up as a legal entity in one of three ways: sale of assets; contribution of assets and liabilities to a joint venture with a domestic or foreign partner; sale of assets and liabilities to a new firm established by management and workers (buy-out). The latter method, which usually involves a transitional leasing arrangement, has accounted for around 90 per cent of liquidations and contributions to joint ventures for the remainder. Straight sale of assets has in fact not been employed often.

Privatisation through liquidation, as practised, involves the management and employees council first deciding to privatise the enterprise and choosing the preferred path. Simplifying considerably, a business plan is developed by the enterprise and a valuation prepared, often with consultants. The plan is submitted to the relevant founding body for comment and approval. The founding body may object either to the valuation or the chosen method. The application must also be submitted to the Antimonopoly Office which can exercise a veto as well as make recommendations. Final approval must be obtained from the Ministry of Ownership Changes which may raise objections to any aspect including valuation. However, of particular significance for the Ministry is the chosen method: whether the joint venture route is appropriate or simply a way of avoiding

Chart 14. **APPLICATIONS FOR PRIVATISATION THROUGH LIQUIDATION**
Number of applications per month



Source : Polish Ministry of Ownership Changes.

competitive bidding associated with the "capital" route; or whether a worker/management buyout should be preferred to the alternative of direct sale. These issues are considered further below. Finally, as a new firm will also take over the old liabilities, approval is necessary from the creditors and especially its banks.

The worker/management buy-outs are closely controlled, the principle concern being to establish effective interested owners[119]. The law requires that, in a buy-out, more than 50 per cent of the employees should be shareholders and to meet this condition two months is provided. If after that time the required number has not been met, or the general assembly of workers has voted to overturn the rule, outside parties can be introduced into the process. Outside investors are in any case often necessary since, in the usual case of sales through leasing, the new firm must have a paid-up capital equal to at least 20 per cent of the capital of the

former enterprise. This requirement has three purposes. First, the new firm is ensured start-up capital. Second, it establishes a commitment on the part of the new owners and therefore lends credence to the business plan – which is in any case practically impossible for bureaucracies to check[120]. Third, it facilitates the extension of easy purchase terms, through leasing. This is one of the strong points of the programme serving to lessen the constraint of low savings while at the same time avoiding undesirable give-away schemes. Generally speaking, the contracts extend over 5-10 years, at the end of which the firm in nearly all cases will become owner of the assets in question[121]. Interest, which is tax deductible, is capped at either 30 per cent or 75 per cent of the refinancing rate set by the National Bank of Poland, whichever is lower. In order to support firms over a transitionary period, during the first two years only 30 per cent of due interest may be paid but in the third year arrears must be cleared.

The most difficult issue in liquidation is the valuation of the assets to be sold or leased. Purchase by insiders not subject to competitive bidding always runs the risk of give-away sales, but it is not obvious how this risk can be avoided without falling into the opposite problem of seriously slowing down the whole process. Initially, asset valuation was on the basis of estimated cash flow. However, there have been cases where the ''management'' has contained the operation of the enterprise in order to reduce cash flow and thereby obtain a lower purchase price. In response, a less specific notion has been introduced: market value of assets plus goodwill. This criterion has some advantages over a mechanical but easily manipulated criterion. In particular, it is more suitable for financial restructuring since, *ceteris paribus,* a high level of financial liabilities will be associated with a lower sales price. However, it leaves the Ministry of Ownership Changes, and especially founding bodies, exposed to charges of favouritism or corruption. In Poland there are many cross checks, one of which is the employees' councils which to some extent may represent a countervailing influence to management. Any form of privatisation, spontaneous or not, will always be confronted with the difficult trade-off between speed and certainty of valuation, and thereby fairness problems.

The ''true liquidation'' of unviable state firms (i.e. ones not paying taxes) under Article 19 of the Law on State Enterprises has also resulted in the transfer of real assets from the state to the private sector. Unlike the Article 37 method described above, liabilities are not taken over by the new firm, only assets are

purchased. Initiation of the procedure can be either by the founding body or on application by the management and workers council. A committee of ''experts'' is then appointed to evaluate the enterprise and make a recommendation concerning liquidation which is then reviewed by a committee that may include creditors as well as representatives of the founding body. The committees' decision is then either ratified or rejected by the responsible minister (or, in the case of founding bodies that are not ministries, the senior person). A liquidator is then appointed whose role is to sell off assets and apportion the receipts among outstanding creditors: unpaid wages and severance payments have first claim, followed by other creditors although there is uncertainty about the ordering of claims.

A serious problem with the liquidation process under Article 19 is that it is very lengthy, and the costs of delay are likely to be even higher than in Article 37 privatisation. During the ''vacuum'' period between the initiation of the procedure and the appointment of a liquidator, management and workers have an incentive to ''asset strip'' the enterprise, defer payments to creditors, and appropriate as income for themselves as much of the cash flow as possible. The result is that the final indebtedness of the enterprise to be written off is thereby increased.

Privatisation through liquidation has shown itself to be an effective method for shifting firms to the private sector in a way that also encourages restructuring. Its potential could be substantially enhanced by simplifying the process, clarifying the legal status of property and reducing bureaucratic delays. As the primary cause for complexity is the question of valuation, simplification would involve controlling valuation more with an eye to avoiding outright fraud or abuse, than to finding the ''right price'', which will in any case be almost impossible to establish beyond doubt.

- *Capital privatisation*

Privatisation by the ''capital'' path involves several distinct methods: the flotation of the enterprise by public share offering, buy-out, and direct sale to, for example, a foreign investor. In all cases, the essence of the programme has been up till now that it is voluntary: management and employees' councils apply to the founding organ to be privatised. If the capital path rather than liquidation method is approved, a business plan is prepared (usually by consultants), which includes a valuation. This part of the process has, as in other countries, proved expensive

and controversial. The enterprise must next be converted into a joint stock company owned by the Treasury. At this stage of the process the employees' council ceases to exist although a third of seats on the supervisory board are chosen by employees. After conversion to a joint stock company, there is a two year period within which to privatise the firm by one of the three methods. (This condition was incorporated into the original legislation in order to prevent a *de facto* re-centralisation by the state.) At the time of sale, employees are entitled to purchase up to 20 per cent of the shares on concessional terms. Sale proceeds accrue to the budget.

With respect to public offering, flotation costs have been high and there has been considerable investment in "learning by doing". The selling strategy has changed over time. The first flotations sought to encourage widespread share ownership but this proved difficult to achieve as interest appears to have been quite restricted in several cases[122]. In the course of 1991, in reaction at first to poor sales but later out of concern for governance issues, interest has shifted to finding strategic partners (i.e. shareholders with a large enough stake to take an active and effective interest in the management of the enterprise). Given the inherent limitations of the technique in the Polish context, it will probably remain a smaller part of the programme than at first envisaged.

The most important method has to date proven to be direct sales (i.e. trade sales) to investors, mainly foreign (Table 13). In these cases competitive bidding is required by law although, on occasion, this has been waived by the Council of Ministers. Competitive bidding in some instances can deter foreign direct investment but overall it appears to have improved both the sales price and conditions, as well as attracting more potential investors. In stimulating and controlling the process, the results of sectoral studies have proved useful. Finally, it is worth noting that maximising the sales price is only one criteria for completing a trade sale. Other conditions such as investment intentions are also taken into consideration – a practice which although widespread, does nevertheless lead to decreased transparency and slows the overall process.

- *Mass privatisation: the Polish variant of the voucher scheme*

Following lengthy deliberations and experience gained in early flotations, the Polish approach to "mass privatisation" has emphasised corporate governance objectives over simple transfer of ownership: the scheme being developed

by the Polish authorities seeks to avoid the dispersed ownership of firms that would result from a general distribution of shares along the lines that are being implemented in the Czech and Slovak Federal Republic. Although the scheme is not yet in operation, many of the major features are already decided. Privatisation will occur in two phases: allocation of companies to trust funds followed by distribution of shares giving ownership rights in the funds to the public. The first phase is to last through the autumn of 1992 and will involve around 400 medium size, financially sound firms (representing about 10 per cent of total industrial output and 7 per cent of industrial employment[123]) for which ''privatisation plans'' and financial data are available. The shares in these firms (which will already have been corporatised) will be initially allocated as follows: up to 10 per cent to the employees in a free distribution; 30 per cent to be held by the government for either sale at a later point or allocation to a proposed pension fund; and 60 per cent to around 15-20 National Investment Funds (NIF).

The creation of these National Investment Funds lies at the heart of the programme. The Funds will be established as joint stock companies and will operate as closed-end investment funds. Fund management will be contracted-out to management firms through a tender offer open to both Polish and foreign firms. It is expected that most management firms will have both Polish and foreign professional partners. Compensation, a key element on which the success of the programme depends, will comprise a fixed fee, determined by competitive bids, and an incentive fee tied to the performance of the fund. The performance fee will be 1.5 per cent of the equity of the fund payable in shares each year for 10 years. At first, each fund will receive an equal portion of a first block of 27 per cent of the shares of all companies; after examining the prospects for each firm, the funds will then select in turn specific companies so as to obtain a 33 per cent block of shares in them. Thus each fund will end up with about a 33 per cent ''strategic stake'' in some 20 to 30 companies, the remaining 27 per cent being spread among other funds. This distribution could then change following further trading among shareholders, with certain restrictions to ensure that no companies are abandoned. This is to be encouraged as a way of deepening capital markets.

The success of the programme will depend on the selection of managers, the detailed conditions of the management contract, and whether 33 per cent will not only constitute an active interest but also convey effective control. At the time of writing these details are not available. Nevertheless, the scheme seems promis-

ing. It should be noted that the firms slated for privatisation through this route are all regarded as "good", so a judgement must be made as to whether this form of privatisation is preferable to other possibilities, such as direct sale to a foreign strategic partner. The key issue in this regard is which route offers the greatest potential for expansion, which is turn may hinge on the extent to which the funds will be able to raise new capital for these firms, directly or indirectly. The problem firms must still be addressed.

The second phase of the process will involve the distribution of shares in the funds to the population. Details have not yet been finalised and several variants are under consideration including some that involve nominal payment as in the Czech and Slovak Federal Republic. What has been agreed is that the shares will not be tradeable until the first yearly results for each fund have been released.

Assessment

Development of the private sector in Poland is clearly proceeding. It is already large in comparison to the other countries of the region (accounting for around 35 per cent of GDP), and the comparison remains true if agriculture (which has always been largely in private hands) is excluded from the calculation. Over time, the private sector can be expected to carry a steadily growing share of economic activities. As discussed both in this chapter and in Chapter III, impediments to private sector development nevertheless remain. Measures can be taken to remove these and otherwise accelerate the process of shifting resources from the public to the private sector. In particular, the incentives to voluntary privatisation can be improved in ways which do not encourage excessive expectations. As the private sector matures, it will also become increasingly important to establish a regulatory and tax environment that minimises distortions to private decision-making. Both the tax laws and their enforcement need strengthening to assure that emerging private sector activities do not develop a "black economy" character.

Defining a policy toward state-owned firms

In view of the time needed for privatisation, the effectiveness of policy toward the state-owned enterprises, including the institutional conditions under which they operate, must be reassessed. The approach adopted to date has been termed situational[124]: it assumed that state-owned enterprises would respond to

circumstances and adapt to opportunities and dangers as they emerge. In practice, however, two necessary conditions for this have not been put in place. First, the opportunities and dangers of the transition period have not been effectively "brought home" to the enterprises. This has led to a lack of credibility and limited behavioural change. Second, the complex property rights and incentive structures within the firms have not been adequately addressed. Taken together, these two problems account for a good part of the observed behaviour of the state-owned enterprises, and represent the starting point for reassessing policy with regard to these enterprises.

Creating a credible budget restriction

Imposing hard budget constraints on state enterprises was considered an essential element of the overall strategy. The threat of bankruptcy combined with a commercially oriented bank lending subject to tight overall credit ceilings was agreed as crucial in this regard. During the first six months of the programme, enterprise studies[125] point to this threat being taken seriously by managers and workers alike. In corroboration, wages were often below the allowed norms; credits were at first repaid from the high windfall profits associated with price liberalisation; and employees' councils in a number of cases replaced directors with those who offered a future plan (i.e. a survival plan). In the second half of 1990 and extending throughout 1991 there are indications that the threat of bankruptcy became less and less effective. For example, despite falling profitability and a high marginal excess wages tax, many firms paid the tax and increased wages. The number of firms making losses rose continuously, as did non-performing loans. Moreover, firms increasingly called on the government for assistance, invoking arguments typical of the past: good personnel, high technology production, unrest among the work force, exports.

There are a number of inter-related reasons why the hard budget restriction may not have been credible. First, bankruptcy and liquidation procedures for state-owned firms were non-transparent and were easy to avoid[126] (see Chapter III). In particular, liquidation does not clearly result in the closure of the firm: many firms are in so-called liquidation, but few have been closed. More importantly, the threat of bankruptcy was not carried out soon enough and clearly enough to establish credibility and thereby to change behaviour. Second, the government has often been accommodating in re-scheduling tax arrears, thereby

giving conflicting signals: the major test of solvency has been made negotiable. Third, despite efforts to redirect new lending, banks have continued to lend to non-viable enterprises, rolling-over loans and capitalising interest, in the expectation of ultimate government assistance. Where banks have sought to restrict credit to particular enterprises, moral suasion by the government has sometimes been used to support further lending[127]. Credit for other more promising enterprises has consequently been reduced even as the credibility of hard budget constraints for weak state enterprises has been undermined. Fourth, the sheer scale of the restructuring problem facing large firms in particular, and the lack of flanking adjustment policies, have reinforced the belief that firms would eventually be bailed-out. The issue of firms "too big to be let go" has not been resolved.

An unresolved fundamental issue has lain behind these difficulties: what are to be the criteria for liquidating an enterprise? Initially, the criterion promulgated was that firms unable to pay taxes (in particular the capital tax) would be liquidated. This has not been enforced; and indeed the economic rationale for this criterion is weak. Similarly, financial criteria relating to the capacity of the enterprise to service its debts are inappropriate for deciding liquidation (in the conventional sense), all the more so because the debt structure of Polish enterprises is to some extent a random inheritance from either the past, or mistakes made by enterprises during the difficult early transition period, and only partly reflects present and past operating conditions. However, financial insolvency in this sense does indicate the need for financial restructuring and, as further discussed below, bankruptcy (which ought to be seen as quite different from liquidation) may constitute an efficient way of achieving this.

In theory, firms should be closed down if they cannot cover their variable costs or, somewhat more stringently, if the profits they earn excluding taxes, interest charges and depreciation are less than what could be obtained by selling-off the assets of the enterprise. The rationale for this criterion is that so long as firms earn a profit in this sense, they have the means to contribute *something* to servicing their liabilities, whereas in case of closure there is nothing.

In the present situation in Poland, this general criterion is modified by two countervailing considerations. First, because labour is very immobile, it can be argued that firms should be kept open even if they fail to cover costs, because closure would imply releasing workers who could not find alternative employ-

ment and would have to be supported through unemployment compensation. This argument has merit, but cannot be pushed too far. Rather, it implies that wages in the enterprise should be reduced to the point where the enterprise can cover its variable costs. If wages cannot be cut, liquidation may be preferable to continued operation at a loss, because the subsidies needed to keep the firm in operation are costly. Second, attention has to be paid to ''moral hazard'' problems. There are enterprises that could perhaps earn a profit but don't, because they have inadequate incentive to do so. Refraining from liquidating firms further reduces incentives for others to become profitable because the liquidation threat ceases to be credible.

The balance of considerations suggests that what is needed is certainly not a wholesale liquidation strategy; but rather a selective, visible and prompt closure of a certain number of the worst performing enterprises so as to encourage others to try harder to become profitable.

A distinction needs to be made between keeping firms open and restructuring them through new investments. In some cases firms that earn operating profits should be allowed to run down and eventually be closed, rather than being restructured. New investment is justified only if it can be expected to earn a required rate of return. Of course, by its nature this is a highly subjective measure based on expectations of what can be achieved. It is therefore of fundamental importance who makes this decision and subject to what motives. Someone with a financial interest or directly responsible to owners will judge the situation differently from an official with no such interest or responsibility. In this respect, the strategy of privatisation before ''real'' restructuring (i.e. restructuring involving substantial new investments), has much to recommend it.

Where the need is for financial restructuring, in some cases this too can reasonably be deferred until privatisation. If certain debts are written off at that time, the sales price of the enterprise to be privatised would be correspondingly higher. However, the risk of exploding debt through deferred and capitalised interest suggests that in many cases it is better to admit that debts are unpayable and to recognise the resulting losses without waiting for privatisation if this will take considerable time. Bankruptcy proceedings, along lines developed in market economies, provide a way of doing this on a case-by-case basis that has the advantage of being able to associate the financial restructuring with a certain number of ''real'' measures to improve efficiency. For this to be effective,

however, the implementation of bankruptcy proceedings will have to be strengthened considerably, as discussed in Chapter III. A more generalised forgiveness of debt, in the context of recapitalisation of the banking system is another approach to be considered. It is essential, however, that this not be done unless incentives or constraints facing the enterprises are such that they do not consider debt forgiveness simply as an invitation to run-up new debt without clear expectations that these new debts can be serviced – which would have additional negative macroeconomic consequences. The following paragraphs deal with the central issue of incentives in greater detail.

Clarifying property rights and establishing efficient incentives

To address the issue of incentives, it is necessary to understand the interests operating within enterprises. ''State-owned'' firms in Poland are a misnomer: they are a complex coalition of three interests (unions, employees' council, management). Such a state of affairs evolved over the 1980s in response to the political situation and the uneven nature of economic reform. Increased powers were devolved to the enterprise in line with the decline of central planning and the move to autonomous, ''self-financing'' firms. However, an incentive system representing the ''interests of capital'' was not established. Rather, a balance of power was sought within the firm involving management, the employees' council and the trade unions. Employees' councils were given the right not only to elect directors but also to ''adopt the enterprise's annual plan, to take investment decisions, to allocate the enterprise's income to the various funds it maintains, to take decisions on merging the enterprise or splitting it up, and to change the profile of its operations''[128]. The Ministries and other intermediate bodies were at first to exercise countervailing power but this only occurred to a limited extent. Rather, the granting of individual, discretionary relief on corporate income tax, changes in the proportional allocation of the depreciation fund between enterprises and the Treasury, and the granting of subsidies all worked in favour of increasing the powers of employees' councils *vis-à-vis* management, and indeed often uniting their interests *vis-à-vis* the government.

Legislative changes in 1990 further increased the powers of the employees councils with respect to ''management'' while blurring the distinction still more. The Privatisation Law of 1990 and the State Enterprise Law gave substantial blocking power to employees' councils in the area of corporatisation, privatisa-

tion and restructuring of firms, as for example when an operating division is to be sold. Formal power and its exercise are two different things, but some evidence does point to its application. For example, in the first nine months of 1990, 275 managers were reported to have been dismissed by employees' councils – as opposed to 44 in 1989 and 6 in 1988. By the end of 1990, 20 per cent of all managers had been replaced[129]. Moreover, the councils have been effective both in opposing *and* supporting plans for restructuring including privatisation. To make the situation more opaque, in some cases the unions have been in opposition to the councils.

The exact structure of property rights and therefore incentive structures represented by the ''autonomous, self-financing'' firms appears to vary across enterprises (in particular between large and small enterprises) and indeed over time[130]. In part this may be reflected in the wide intra-sectoral dispersion of profits (Table 14). However, generally there has been a tendency for the firms to behave as if under ''labour management''. Thus in combination with the non-credible budget constraint, there has been a pattern of wage increases even in firms suffering large cash flow deficits. This was particularly the case during 1991 when capital consumption or ''hollowing-out'' became evident. At the same time, there has been little incentive for firms to invest and this would not alter if budget restrictions were tightened. While such behaviour has been observed elsewhere as a common feature of labour managed firms, in Poland the situation is somewhat different[131] because of privatisation arrangements.

Since privatisation is generally voluntary, the incentive structure for entering privatisation is important. The direct incentives at present are the removal of the excess wages tax (as well as the capital tax, the ''dividenda'') at the time of privatisation, and the offering of shares on concessional terms to employees. The former provision was intended in part to induce workers to agree to the termination of the employees' councils, but it also reflected the assumption that, after privatisation, wages would be subject simply to effective negotiation. The inherent contradiction between these two points of view has generally not been appreciated, and privatisation projects have been accompanied by exaggerated promises and expectations[132] of high wage increases. The other incentive, share offerings on concessional terms (workers are entitled to purchase 20 per cent of the equity at a discount), appears to be of limited overall value. Pending privatisation, there is no incentive to invest or to carry out painful restructuring

Table 14. **Dispersion of before-tax profitability among enterprises in industrial sectors, 1990**

	Sales	Shares in sectoral sales						
		Enterprises with losses			Enterprises with profits			
		Total	Losses > 5%	Losses < 5%	Total	Profits < 5%	Profits = 5% – 10%	Profits > 10%
	Bn zlotys	Percentage						
Industrial sectors[1]								
1. Total industry	310	19	13	6	81	14	14	53
2. Fuel and energy								
Coal	22	51	33	18	49	22	9	18
Liquid fuel	23	–	–	–	100	5	44	51
Energy	23	42	26	16	58	25	9	23
3. Metallurgy								
Ferrous metal	15	10	6	4	90	18	26	46
Non-ferrous metal	5	4	4	–	96	18	26	52
4. Engineering								
Metal goods	12	16	6	10	84	14	14	56
Machinery, non-electrical	26	6	5	1	94	3	8	83
Precision instruments	3	19	15	4	81	12	5	64
Transport means	14	18	14	4	82	23	7	52
Electric equipment	13	24	21	3	76	10	16	50
5. Chemistry	31	11	6	5	89	9	10	70
6. Mineral products, non-metallic								
Building materials	13	45	43	2	55	6	6	43
Glass	3	13	11	2	87	15	7	65
Ceramic products	1	14	14	–	86	4	7	75
7. Wood and paper products								
Wood	10	15	8	7	85	26	25	34
Paper and pulp	4	8	8	–	92	32	22	38
8. Light industry								
Textiles	11	34	24	11	66	24	12	30
Wearing apparel	5	21	14	7	79	16	18	45
Leather products	4	33	21	12	67	35	10	22
9. Food industry	60	11	7	4	89	12	10	67
10. Other branches	13	18	16	2	82	8	5	69

1. Polish industrial classification system.
Source: Polish Ministry of Industry (Promasz).

that would increase the value of the firm, because that would also increase the cost of the shares to be bought even at a discount. The longer the privatisation process lasts, the greater the incentive to disinvest. Better from the point of view of creating incentives both to privatise and to operate the firm efficiently[133] in the meantime, would be to give the employees a percentage of the sale price or to give them an option to purchase shares at a fixed price[134].

Proposals for systemic reform measures

Reform proposals have focused on the issue of corporate governance. Most schemes would abolish the employees' councils through corporatisation of the enterprise, which would then come under the direct control of the central authorities (e.g. Ministry of Industry or a State property agency). The authorities would then be in a position to exercise control through appointing the supervisory board. This, it is said, would clarify the position of management and allow enterprise restructuring to proceed. Whether such reforms would succeed in achieving the desired objectives depends importantly on how well they deal with two points; principal/agent issues and industrial relations.

By itself, the re-centralistion of ownership in the state may not improve the performance of the state-owned enterprises and could make it worse unless other incentive mechanisms are introduced and budget restrictions seriously enforced. Removing the power of the employees' councils to appoint directors and replacing this with the state will certainly change incentives but in a manner which is not evident from the viewpoint of efficiency and restructuring. In particular, it is essential that the responsible government departments be in a position both to espouse and to implement the appropriate objectives as owner. Maximisation of present value or the achievement of a target rate of return may be unlikely to be chosen in the political process; employment maintenance, wage increase or even no economic objective at all could emerge[135]. Under these conditions little would be gained as compared with the existing system. Even if objectives were appropriate, the state as principal would still have difficulty in making the management (the agents) fulfil these goals without a new incentive system. Moreover, given that the owner will be the state, the greater danger may be a tendency to return to old patterns of dependency on Ministries for decisions and for the provision of financial assistance. Indeed, several enterprise studies have detected just such a tendency on the part of both management and unions. The dangers have been

multiplied by the failure to address the implementation of credible budget restrictions, as discussed above.

Alternative management incentive systems have been developed in Poland, and these could be more widely extended. For example, the management/restructuring contract (in January 1992 there was one such contract) extends up to three years with the objective of privatising the firm at the end of the period. Compensation for the manager is based on the increase in net worth over the period and includes the possibility for the manager to buy the firm at a prearranged price. In addition, there is the example of the fund management contracts developed for the mass privatisation scheme discussed above. Both schemes, suitably modified, warrant further attention for the bulk of the state enterprises.

A potential weak point with the reform proposals is the presumption that employees' councils have at all times been a barrier to efficiency and to restructuring: the evidence is in fact not all on one side, though admittedly the anecdotal evidence is that over time the councils appear more often than not to have become advocates of higher wages and employee benefits, rather than agents of broader enterprise reform. However, even if councils appear to be a barrier to more effective management, it does not follow that abolishing them is preferable to modifying their status so that they clearly represent workers' interests in negotiations with management whose interest correspond to those of owners – that is, employees' councils could become the basis for an enterprise-based system of collective bargaining. A functioning industrial relations system is crucial to restructuring, which will not be painless – and especially so in Poland where the possibilities for most workers to move to new jobs in other firms will remain low for the foreseeable future. Indeed the experience in OECD countries is that limited enterprise-based industrial relations systems have generally facilitated structural adjustment and improved performance. Abolishing employees' councils would tend to speed the development of a sectoral-based industrial relations system which may not be desirable in the present conditions where enterprise flexibility is necessary.

Preferential finance

The provision of preferential credit and loan guarantees has been advocated as a systemic reform measure for the state-owned enterprises – although these instruments can also be used for sectoral industrial policy more generally. There

is no doubt that restructuring is a far-reaching undertaking necessary for both state enterprises and private firms alike, and that it will involve considerable funds: for new investment, for closing operations, or for financial reorganisation. Moreover, given the shortage of funds it is clear that tight lending criteria will be necessary and that under the circumstances, some "preferential" terms might be included. It is therefore essential that reforms to the incentive system be *first* put in place to ensure efficient use of any funds which are to be deployed.

In this respect the experience of the Industrial Development Agency (IDA) in its financial operations is instructive. Founded in January 1991 as a joint stock company with a largely advisory role, it has also functioned as the restructuring agency of the Ministry of Industry[136]. In this role, it very quickly became involved in numerous enterprises by taking on financial commitments, in some cases large ones, through loans that were either granted on preferential terms, or foresaw the option of future debt/equity swaps. The likelihood that these loans will be repaid appears to be low. As of January 1992, the IDA had trouble meeting even its current commitments[137]. Two lessons might be drawn. First, enterprise incentives were not reformed and budget constraints tightened: indeed the assisted firms were typical of those which expected support rather than attempting to initiate difficult restructuring on their own resources. Second, no clear criteria of rate of return or future profitability appeared to guide the loans.

One immediate issue with preferential credits is why they should be intended only for the state enterprises. Presumably the funds could also be used, and perhaps with greater returns, by the private sector. In fact, the schemes appear to be intended simply as a substitute for a lower real rate of interest. This cannot, however, simply be decreed: it is largely determined by the level of savings. In countries such as Korea where large scale "preferential" loans have been granted (Germany and Japan in the 1950s were also similar), the rate of savings and of profitability were also high – and kept that way through consistent policy measures. Given the evident overall limitations on credit volume for such programmes, it has been suggested that preferential loans be made contingent on undertaking specific tasks such as increased exports and the introduction of new products or technologies. Such proposals often fail to meet the test of promoting market-based restructuring since they discourage rational decision making on the part of management based on alternative rates of return. Earmarked schemes

based on ''physical'' criteria also prevent a comparison of alternative uses of funds[138].

Many in Poland argue that the government needs to involve itself to a larger extent in credit allocation because the banks are unable to make credit decisions on economic criteria. As noted in Chapter III, the banking system is indeed beset by serious structural weaknesses. Incentives to redirect credit flows toward ''sound'' enterprises are blocked by heavy exposure to unsound enterprises and resulting ''lock-in'' effects, as well as by the presumption that large unsound enterprises (and their creditors) will in the end be bailed out so that it is not necessary to enforce the conclusions of credit assessment. The technical capacity to assess the profitability of investments when making credit decisions is, furthermore, still rather undeveloped, although the situation is improving. Finally, very high levels of economic uncertainty relative to situations typically experienced in OECD countries mean that even well-functioning banks would make many mistakes. That being said, and accepting that certain government credit programmes will inevitably play a role in the transition programme, it would be perverse to further weaken the potential for development of the banking system by making its credit-allocation function subservient to government decision, rather than to address the problems of the banking system directly so as to make it more able to carry out its job.

Supporting measures

It is clearly not sufficient simply to tighten budget constraints and improve incentive structures within the state enterprises, though these are necessary: the overall policy and institutional environment must also be appropriate. In this respect both the macroeconomic policy issues discussed in Chapter II and the structural issues addressed in Chapter III are directly relevant. Only the key points concerned with overall direction and consistency of tax policy need be drawn together here. As noted in Chapter III, the state enterprises are governed by a separate taxation system (capital tax and excess wage tax, Popiwek) which has often led to charges in Poland that these enterprises are being ''destroyed''. The evidence does not lend support to this argument. Firms in the state sector have deteriorated financially because of a failure to adjust to new circumstances; that is why the taxes in question appear to have had perverse effects (i.e. Popiwek has become a major source of revenue; many firms are making losses even before

paying the capital tax, which in any case should be encouraging output not reducing it[139]).

This does not imply that the taxes are efficient and do not need to be reformed, quite the contrary. Assuming that the general governance reforms discussed above are implemented, what overall objectives could govern tax reform? First, although privatisation is of overriding concern, it may not be necessary to use the tax system as an incentive to this end. As was discussed above, a stake in the sale price for employees is a better instrument and stimulates improved performance in the meantime. Second, although the original purpose for the introduction of the excess wage tax is still valid (i.e. lack of ''true owners'' for bargaining purposes), so that some form of wage control may still be necessary, it could be better directed to encouraging cost minimisation behaviour and to fostering a restructuring of the wage system[140]. Third, the objective of the capital tax was originally to avoid capital consumption, but it has not been notably effective in this regard. A dividends policy *vis-à-vis* state-owned enterprises is clearly needed, but it should be more flexible[141] than the present tax and geared to the specific opportunities and constraints facing the enterprise, while emphasising the principle that equity has an opportunity cost and is not free. In sum, the tax system should be used to support the governance reforms through more clearly seeking to replace those market elements which, failing privatisation will remain absent. At present the tax structure contains a number of crude instruments that are inconsistent with the governance structure and incentives actually in place.

Possibilities and limits of sector specific industrial policy

The expectation that *particular* enterprises are to be supported in some manner (as opposed to enterprises in general) has been growing, nurtured by unclear policy statements. General or horizontal policies towards the state enterprises, although their precise form is subject to debate, are clearly required. More controversial is whether sectoral policies are also necessary in Poland. Two distinct arguments have been advanced: special policies are required for particular problem industries; and specific policies are desirable for industries with potential (''picking the winners''), especially those that export. The two arguments need to be dealt with separately. In addition, there is a variant which argues that it is necessary to decide which sectors need to be scaled back and

which need to be supported. The basis for such a sectoral triage policy is questionable although the process of privatisation will implicitly answer the question of which existing sectors are most promising, as more firms in some sectors find willing owners than in others. Within each sector, however, there are profitable enterprises (Table 14) and product niches which a sectoral approach will tend to overlook.

Under any set of policies, certain large scale, regionally concentrated, capital intensive industries such as iron and steel, coal mining and probably shipbuilding will pose major problems. In western European countries, regardless of ownership, restructuring of these industries (usually in response to long-standing pressures) has often used large amounts of public funds. However, the benefits from such intervention have often been judged to have been marginal. In Poland, funds to be employed in these sectors are very scarce, so that the rationale and instruments for any intervention have to be considered carefully.

In western Europe two arguments for specific policies *vis-à-vis* such sectors have usually been put forward, and these are also applicable to Poland. The first argument is that these industries are heavily concentrated and to some extent non-divisible (i.e. there is a restricted margin for changing the scale of operation). In practice, however, it has turned out to be more effective to develop regional economic and support policies rather than to support the enterprises themselves. Successful adjustment by OECD economies in these sectors (also with respect to defence industries) has more often been achieved by encouraging the growth of new industries and activities and ensuring that the labour force has access to the requisite retraining rather than supporting the old enterprises. This is not always a question of state funds but often one of local initiative[142] which must be further developed.

The second argument for specific support policies for these industries is that, since they are large scale and capital intensive, any adjustment to new factors such as higher energy prices usually requires large amounts of new investment. Local externalities and "imperfect" capital markets[143] could justify some direct support measures in these circumstances[144]. However, neither is a compelling reason for abandoning a rate of return test on the funds to be employed. To be effective, the terms and conditions for support also have to be carefully specified and made compatible with the profitability objectives. In particular, they should not be allowed to become an indirect support for wage increases.

The Polish authorities, as elsewhere, are coming under intense pressure to introduce sector specific industrial policy[145] in support of industries and firms with "potential" – or indeed to make use of capacities which are thought to exist. While there are some circumstances under which clearly defined and structured policies may be desirable[146], such a course of action is hazardous and is often an ineffective substitute for more general policies. Sector specific policies are appealing for they give the impression that "something is being done" to promote new employment and output or to safeguard particular jobs and capacities. The policies, it is argued, are needed since Polish firms are uncompetitive (but given time and protection, will become so); and they will be successful as evidenced by Korea, Taiwan and recently Malaysia.

These arguments for sectoral intervention are dubious on several grounds. First, such policies have not often been evidently successful in achieving objectives worth their cost, in either industrialising countries or the OECD area[147]. Where they appear to have been successful, the policies were tightly focused on profitability considerations, there was a credible timetable for their termination and they were accompanied by far reaching general measures. Given such a general policy environment, the sector specific policies may well have been effective, though only marginally[148]. Where they have clearly failed has been in the areas of most interest to Poland: large state-owned industrial firms[149]. Moreover, the situation in Poland is quite different from that in countries like Korea: it is a restructuring not an industrialising country[150]. Third, while the new employment generated by sectoral support measures may be easy to point to, it is not the same as a net increase of employment. Other enterprises and factors are invariably taxed even though the effects are spread out and thereby less noticeable. This is particularly the case with trade policy. Fourth, the political economy of rent seeking behaviour cannot be underestimated: firms will learn how to exploit the industrial policy and this is likely to be politically destructive in the absence of clear cut, overriding economic goals. Finally, the pressure for sectoral policies has often arisen as an enterprise or sector response to more general problems, e.g. lack of competitiveness. These problems are best solved by appropriate macroeconomic instruments and general policies. When the macroeconomic setting is appropriate and the general policies and institutions are in place, there is only weak justification for sectoral industrial policy: the "winners should select themselves". This is not a naive policy of relying on the "invisible hand".

Sectoral policies are often implemented through trade intervention. As noted in Chapter V, there are some indications that Poland is beginning to move in this direction. Two general questions arise: what are the possibilities for Poland to use tariff policy for industrial purposes? And how should a tariff policy be structured to be at all effective? The possibility for using tariffs to pursue industrial goals is rather constrained. Although Polish tariffs are not yet bound in the GATT, the Association Agreement with the EC constrains tariff increases while generally phasing out existing tariffs after 1995. In the agreements there are, however, important exceptions. In particular, Article 29 of the Association Agreement allows Poland to increase tariffs insofar as they "concern infant industries, or certain sectors undergoing restructuring or facing serious difficulties, particularly where these difficulties produce important social problems". Any increase in tariffs for these purposes must be accompanied by a schedule providing for a phasing out of these duties starting at the latest two years after their introduction at equal annual rates. The whole measure must not exceed five years. These are sensible rules and, more important, they have behind them the credibility of international agreement[151]. Indeed, if there is to be an industrial policy, then this is the best form: one that contains within it clear-cut and credible rules to assure that it is temporary. What must be decided by the Polish authorities are the criteria for judging an industry to be in serious difficulties, and whether it would in any case make sense to introduce protective measures. The criteria for such a decision will have to take account of the cost to other industries and the economy as a whole rather than the cost to the particular industry or to the budget. In making such decisions many countries have found it useful to create independent institutions with powers to investigate claims.

Assessment

To a large extent, the critical problems of the state enterprise sector have been perceived as requiring financial restructuring to alleviate debt burdens, and new credits to fund re-structuring via investment. Shortage of funds (in the budget due to the precarious budgetary situation, and in the economy more generally due to low domestic saving and limited access to foreign capital) have been seen as the principal constraints. This perception does have an important element of truth. But the review undertaken in this chapter suggests that other issues may in fact be of higher priority: creating appropriate incentive structures within state enterprises for them to minimise their costs of production and to

maximise their market value for privatisation is a clear precondition for financial support, if the latter is not simply to be dissipated. The credible threat of bankruptcy for insolvent firms is another precondition; and indeed a well-designed bankruptcy process can accelerate financial restructuring without necessarily dissipating the assets of an enterprise. Liquidations are clearly also required; and where this is the case, it is best to move quickly rather than to allow non-viable firms to continue running-down assets. In general, and with only limited exceptions, getting the ''flow'' conditions right (that is, getting firms in the state sector to the point of either covering their operating costs or, failing that, closing down) must accompany actions to deal with ''stock'' problems of unsustainable financial structure.

V. Strengthening Poland's Integration into the World Economy

In 1990 Poland introduced sweeping reforms which, at one stroke, changed the nature of its trade system and set the stage for strengthened integration into the world economy. The package comprised three major elements. First, the system of compulsory import and export licences was abolished and with it the state monopoly of foreign trade[152]. At the same time, other discriminatory treatment among enterprises was eliminated: uniform application of corporate and domestic turnover taxes was established, and a far-reaching removal of domestic price controls and subsidies (including export subsidies) implemented. Second, current account convertibility of the zloty was introduced. This meant that convertible currencies required for imports of goods and some services were directly available from Polish banks at the official exchange rate while convertible currencies earned on export transactions had to be surrendered to the banks (also at the official exchange rate). Finally, nearly all quantitative restrictions on exports and imports were lifted. Thus foreign trade was put on a footing which was liberal by any standards.

By way of comparison, prior to 1989 Poland was, in economic terms, largely insulated from the world economy. Trade flows were regulated by pervasive licensing of both imports and exports, and by the administrative allocation of foreign exchange. Relative prices played little part in decisions, because differences between domestic and world prices were systematically offset by taxes and subsidies. To facilitate control and administration, trade remained the sole purview of prescribed state trading organisations for both CMEA and western trade.

Set against these bold reforms, the response by OECD countries has been measured. A number of quantitative restrictions on Polish exports have been lifted and market access considerably improved. However, in areas of vital importance to Poland such as textiles and agriculture, market access is still

limited and hedged with such restrictive conditions that business development will suffer from the associated uncertainty. Faced with such asymmetry, the Polish authorities have come under increased pressure from interest groups to "adjust" the liberal trade policy stance.

The first section of this chapter describes the development of Poland's trade regime and its trade relations with the market economies, as well as problems encountered in shifting CMEA trade onto a market footing; the second assesses how Poland's trade performance has responded to the changed environment.

The liberalisation of trade and the development of trade relations

Relationship with the GATT

The restructuring of Poland's trading relations and its liberalisation programme more generally are taking place within the context of GATT. Despite Poland's strong economic and trade links with CMEA partners, it acceded to the GATT in 1967 on the basis of a Protocol of Accession. The Protocol provided for an undertaking by Poland to increase its imports by not less than 7 per cent annually from Contracting Parties (CPs), an annual review process of trade developments, and a discriminatory safeguard provision allowing CPs to restrict Poland's exports which cause or threaten serious injury to domestic producers (i.e. "specific" quantitative restrictions). These specific provisions were included in the Protocol because the Working Party which examined Poland's request for accession noted "that the foreign trade of Poland was conducted mainly by state enterprises and that the Foreign Trade Plan rather than the customs tariff was the effective instrument of Poland's commercial policy. The customs tariff at that time ... was in the nature of a purchase tax rather than a customs tariff"[153].

Immediately following the implementation of the Economic Transformation Programme, Poland requested in January 1990 the establishment of a Working Party for the re-negotiation of its GATT Protocol of Accession. Under this process, GATT Contracting Parties were invited to submit tariff binding requests to Poland and to raise any questions about the compatibility of Polish trade policies with the provisions of the General Agreement. At the meeting of the Working Party in February 1992, the Polish Delegation reiterated that Poland was prepared to abide by all existing GATT obligations and that, from their point

of view, no specific commitment or undertaking was justified for inclusion in the revised Protocol of Accession.

Securing improved market access for Polish exports

The immediate purpose of trade liberalisation was to "import" relative prices and competition into an economy that was heavily monopolised and lacking a tradition of competitive behaviour. There was also a systemic consideration: by deepening the commitment to the world trading system, domestic reforms would gain in credibility by appearing irreversible. At the same time, there were specific goals concerning the trade regime with market economies. In particular, an important aim was to secure and improve market access through the elimination or reduction of barriers against Polish exports. This was seen as not only important in its own right, allowing Poland to better participate in the world division of labour, but also to make Poland a more competitive location for attracting foreign direct investment.

At the beginning of the Polish liberalisation programme, exports to OECD countries were subject to extensive import barriers. To illustrate, only seven of Poland's top 100 export products in 1989 did not confront any non-tariff measures (NTMs) in the OECD area. Poland has sought to improve its terms of market access and to make these more predictable and transparent, and in this has been moderately successful: GSP treatment, although possibly of limited value, has been obtained from most OECD countries and a number of non-tariff barriers have been eased.

The most significant improvement in market access has been that achieved *vis-à-vis* the European Community (EC). In 1989, the European Community and Poland had concluded a co-operation agreement on trade, commercial and economic matters in which the EC undertook to remove gradually, over the period to 1995, all quantitative restrictions maintained specifically against Poland that were not in conformity with Article XIII of the GATT, i.e. the quantitative restrictions applied on the basis of the EC State Trading regulation, termed specific restrictions. On 1 January 1990, the EC eliminated these "specific" quantitative restrictions in advance of the agreed deadline. The EC also suspended until 31 December 1991 the application of non-specific quantitative restrictions with the exception of those maintained by Spain and Portugal. The importance of this

suspension can be gauged by the fact that in 1987, 11.6 per cent of Polish exports to the EC were covered by non-specific restrictions[154].

Important barriers for Polish exports remain. In the case of the co-operation agreement with the EC, the GSP is limited by contingents and quotas (coal and steel were excluded from the GSP) and the Commission has not shrunk from increasing tariffs when the quotas have been exceeded. In 1990, 14 out of the top 50 Polish exports to the EC exceeded their GSP contingents[155]. In addition, the suspension of non-specific quantitative restrictions is in many cases conditional on "difficulties" not being encountered in EC Member countries, particularly in the area of textiles. Polish agricultural products confront significant barriers in all OECD countries. Secretariat estimates place the *ad valorem* equivalent level of protection facing Polish agricultural goods at around 100 per cent.

Many barriers are not specifically aimed at Polish exports but are international in scope. Consequently, increased market access for many Polish products will be integrally linked to a successful conclusion of the Uruguay Round and continued world-wide trade liberalisation. Poland has been pursuing the objective of further improving market access, and more generally integrating the Polish economy into the world trading system through both bilateral and multilateral negotiations. The principal initiatives in this regard are briefly described in the following paragraphs.

Association Agreement with the EC

Of fundamental importance for securing long run market access to the EC is the Association Agreement (AA) signed in December 1991, though it has yet to be ratified by members of the European Community and by the Polish Parliament. The treaty (like those concurrently negotiated with Hungary and the CSFR) is wide ranging (see Annex I for details), going well beyond trade issues to such matters as the movement of workers and capital, rights of establishment, current payments and competition policy – though in most of these areas it will take some years for the relevant provisions to become operational. The treaty fixes a timetable for the progressive establishment of a free trade zone, and points toward possible full membership of Poland in the EC.

The provisions of the treaty that are of most immediate relevance relate to the phased reduction of trade barriers in an asymmetric manner. While the EC has immediately eliminated barriers on some Polish exports and will extend

adjustment of others over a five-year period, Poland will only liberalise the majority of its markets from 1995 onwards. Upon entry into force of the trade aspects of the Agreement on 1 March 1992, the EC eliminated tariffs on about 50 per cent of Poland's industrial exports and introduced a gradual reduction on the remaining tariffs on a schedule extending over five years, as specified in relevant annexes[156]. Preferential tariffs granted in 1989 under the General System of Preferences (GSP) on some 480 tariff lines will be gradually phased-out to duty free levels over a five-year period through tariff ceilings. Quantitative restrictions applied on industrial goods by both the EC and Poland were eliminated on 1 March 1992. Poland eliminated tariffs on about 27 per cent of EC industrial exports and the remaining tariffs will be phased-out over a five year period starting on 1 March 1995.

Undoubtedly the Agreement significantly improves market access for Polish goods and services, and will also increase competitive pressures on Polish firms to adjust to world market conditions. However, the value of the agreement to Poland has been diminished in two areas: sensitive products and rules of origin. So-called "sensitive products" are covered in the Agreement though, not surprisingly, the timetables for fully liberalising access in such sectors as iron and steel, coal, textiles and agriculture are among the longest, and in the case of agriculture, numerous special provisions (which are not always transparent) as well as a general safeguard clause are retained. Liberalisation is limited to food processing. At the same time, the Agreement also permits Poland to implement temporary and conditional measures in derogation to the Agreement for industries and sectors undergoing restructuring (steel is specifically mentioned), or facing serious difficulties. Rules of origin, which are crucial in determining market access, appear to be rather restrictive: although it is difficult to summarise, there is a general local content rule of 60 per cent but imports from the EC can be included in meeting this criterion. The protocol also specifies numerous technical operations which must be performed in Poland for goods to be classified as Polish.

European Free Trade Association

While EFTA represents a considerably smaller market than the EC it is nevertheless significant. In June 1990, EFTA countries, Poland, Hungary and the Czech and Slovak Federal Republic signed the Gothenburg Declarations which

provided, *inter alia,* for each of the three countries to jointly examine conditions for gradually establishing a free trade area. An agreement which is being drafted by the joint EFTA-Poland Committee is in an advanced stage and includes provisions about public procurement, intellectual property rights and rules on competition.

The proposed agreement offers many similarities with the trade section of the Association Agreement concluded with the EC. The Agreement provides for an asymmetric implementation of tariff and non-tariff barrier reductions, and enables Poland to introduce temporary safeguard measures to protect its industries and sectors undergoing restructuring. However there are notable distinctions: the EFTA Agreement covers only industrial and processed agricultural products, while agriculture will be subject to bilateral negotiations for improving respective market access.

Upon entry into force of the prospective Agreement, EFTA countries would eliminate tariffs on all items except where individual EFTA countries have decided to phase tariff reductions for specific products over the implementation period. These exceptions include coal, steel products, textile and clothing, and some specialty chemicals. EFTA quantitative restrictions will be eliminated upon entry into force of the Agreement except for those affecting textile and clothing (Norway) and lignite coal (Austria). Poland will abolish a number of tariffs upon entry into force of the Agreement and eliminate the remainder over a five-year period from 1 January 1995. Its remaining quantitative restrictions will be eliminated gradually.

Trade with the ex-CMEA

With respect to the CMEA, the aim in 1990 was to negotiate the dismantling of the pre-existing state-trading arrangements and to establish trade in convertible currencies at world prices on the basis of direct dealing among enterprises. While it was foreseen that such a sea-change could entail substantial terms-of-trade losses for Poland, these costs were judged worth incurring in order to establish a coherent, unified trade regime based on market principles. Not foreseen when this approach was adopted was the subsequent collapse of trade with the Soviet Union that resulted from the latter's inability to finance imports in convertible currency. This development prompted a generally unsuccessful search for interim mechanisms to preserve some amount of bilateral trade.

Up until 1990, trade among CMEA countries was based on bilateral protocols negotiated at government level that specified the goods to be delivered by each country and their prices in transferable roubles. Enterprises providing the agreed goods were credited through the Foreign Trade Bank with the zloty counterpart of their export deliveries, valued at the artificial zloty/transferable rouble exchange rate (though taxes and subsidies were adjusted so as to assure that the price that an enterprise received would be about the same for exports or for domestic sales). The transferable rouble claims that thus accrued to the Trade Bank were settled through clearing accounts held in the Moscow-based International Bank for Economic Co-operation (IBEC) against transferable rouble liabilities arising from imports. While in principle trade was to be bilaterally balanced, this was not always the case in practice so that substantial net positions in IBEC were built up.

In January 1990, participating members of the CMEA decided to abolish this system effective 1 January 1991, and that thereafter trade would be conducted among enterprises in convertible currencies[157] at freely negotiated prices. 1990 was seen as a transition year, during which negotiated product lists would continue to be used (though they would be regarded as "indicative", rather than binding). The transition year was also to be used to work off accumulated imbalances in the IBEC or, failing that, to have such balances converted into hard-currency obligations.

These transition arrangements posed some problems for Poland, in particular in its trade with the USSR, because the latter increasingly fell short in its indicated deliveries (and indeed, deliveries of energy in particular were increasingly forthcoming only in exchange for hard currency). On the other hand, many Polish enterprises found it advantageous, in view of falling domestic demand, to increase their deliveries beyond the amounts specified in the lists. A large transferable rouble surplus thus opened up. In mid-1990, the Polish authorities sharply decreased the zloty/TR rate for exports in excess of plan from 2 000 to 1 000 zloty/TR (and in August even to 500 zloty/TR), in order to make such sales unprofitable; but later in the year this was partly reversed as concern regarding falling industrial output mounted.

By 1991, trade between Poland and the CMEA countries of central and eastern Europe other than the USSR had been put essentially onto a commercial footing, and could no longer be seen as being different from trade with market

economies (though at substantially lower levels of trade than had existed previously). In the case of the Soviet Union, however, it was recognised that a similar arrangement would not work, because of the inability of Soviet enterprises to enter into trade contracts on their own accord (or at least to obtain the foreign exchange needed to honour them). New indicative lists were thus negotiated with the USSR for 1991, with balances to be settled in hard currency, as a means of preserving some amount of trade[158]. In fact, with the disintegration of the USSR, these lists played only a minor role. Poland's indicative exports for the first 11 months of 1991 reached only 36 per cent of the anticipated value. Imports from the former USSR were somewhat better maintained – but only because energy was purchased for cash.

In response to the severe squeeze on those Polish enterprises that traditionally exported to the USSR, the Polish government has made several attempts – thus far unsuccessfully – to negotiate special clearing arrangements with the former republics of the USSR[159]. Economic and co-operation agreements of uncertain value have been signed with the Republic of Russia, Ukraine, Belorussia and Latvia. More recently, Poland has sought to promote the linkage of aid to the republics of the former USSR from western donors with purchases by these republics from eastern European countries: so-called triangular agreements, but little has matured to date.

Overall, the problem for Poland of how to maintain or re-establish trade with the former USSR is one for which no solution has yet been found; and indeed it seems unlikely that much can be accomplished until the basic political and economic situation in this region stabilises. The adjustment costs imposed on Poland (as on other countries of the region) by this predicament are severe.

Tariff policy

Since the beginning of 1990, when nearly all quantitative restrictions were eliminated, the customs tariff has been the primary instrument of Polish foreign trade policy. Tariff adjustments have, in fact, been made frequently, in part reflecting the fact that Poland's tariffs are not bound in the GATT and could therefore be raised unilaterally. The tariff framework prevailing when the reform was launched had been established in 1989. It provided for a uniform application of duties for all imports regardless of origin and status of the importers[160]. Preferential treatment was granted by Poland within the Generalised System of

Preferences (GSP)[161]. The average tariff rate (frequency weighted) was 18.3 per cent, although Polish authorities estimate that the trade-weighted average tariff was 10.0 per cent in 1989, presumably because imports were concentrated on commodities with lower tariff rates.

In a legal sense, these tariffs remained in effect during 1990. However, in order to lower the price of machinery imports needed for restructuring (the zloty was undervalued in the first half of 1990) and to promote competition, the government chose to suspend many customs duties in part or in whole. Thus, in March 1990, tariffs on 143 items were suspended and in August 1990 this suspension was extended to about 60 per cent of all tariff items. This resulted in the weighted average tariff declining from 18.3 to 5.5 per cent. The total suspension of duties applied primarily to goods not produced in Poland whereas the partial suspension applied to goods produced in Poland by highly concentrated industries. Originally introduced for a short period, the suspensions were renewed to the end of July 1991.

In August 1991 most of these suspensions were allowed to lapse (though they were extended for a limited selection of goods until the end of February 1992)[162], and at the same time the tariff schedule itself was revised[163]. These actions resulted in an increase in the weighted tariff rate from 5.5 per cent to 18.4 per cent, very similar to that at the start of the transformation programme. There was also a shift in the sectoral distribution of tariff levels, both with respect to 1990 and 1989, tending in general to reduce the sectoral dispersion in tariff rates and to reduce spikes in the schedule (Table 15)[164]. Concerning sectoral averages, the most important change in comparison with 1989 was the increase in tariffs on agricultural goods. Beyond this, reductions in tariffs on the plastic, wood and paper, and machinery sectors more than offset increases for the mineral, chemical, and fur and leather sectors.

Tactical considerations may have played a role in tariff adjustments. The free-trade negotiations with the EC and the European Free Trade Association (EFTA) required the harmonisation of tariff nomenclature and an agreed and fixed basis of tariff levels as a means of assessing concessions. The relatively high average tariffs of 1989 presumably appeared to be a more suitable base than the lower tariffs of 1990 since, with the coming into force of the EC Association Agreement, a number of duties were to be decreased immediately and others phased down over a fixed period. Thus, with respect to these trading partners, the

Table 15. **Comparison of Poland's customs tariffs, 1989-1991**

	January 1989	August 1990 to August 1991	August 1991
Harmonised System trade categories[1]			
Agricultural	17.2	4.0	26.2
Mineral	7.8	3.4	8.9
Chemical	13.5	3.9	14.1
Plastic	19.9	5.5	15.0
Fur and leather	17.2	5.1	25.7
Wood and paper	18.7	7.4	13.4
Textiles, footwear, clothing	22.2	9.7	20.6
Industrial mineral and metal	15.4	4.2	14.7
Machinery, transport equipment, precision instruments	21.9	3.9	16.1
Jewelry, arms, art objects, miscell.	19.9	11.6	19.1
Total categories	18.3	5.5	18.41
Memorandum items:			
Average rate incl. agriculture	18.3	5.5	18.4
Average rate excl. agriculture	18.7		16.3
Variance[2]	275.1 (86.4)		84.6

1. Over all categories: averages calculated on a frequency-weighted basis.
2. Lower variance shown for 1989 excludes the 999.9% rate.
Source: Polish Ministry of Foreign Economic Relations and OECD calculations.

promulgated tariff schedule is to some extent illusory. However, the present higher tariffs will remain in effect for those countries not included in bilateral arrangements[165] and could even be further increased before being bound in the GATT.

General protective effects were also taken into consideration at the time of the tariff adjustment. In August 1991 the authorities were concerned at the level of the real exchange rate and saw an increased overall level of tariffs as a partial compensation. This was one reason for the tariff schedule being relatively flat

across broad sectors: rates of effective protection probably do not differ greatly from the nominal tariff rates[166]. However, it should be stressed that tariff protection, even when by and large uniform, is no substitute for changes in the exchange rate since exports are generally taxed by tariff increases[167].

There are some indications that tariff policy is being adapted to achieving sectoral domestic objectives. A clear case in point is the increase on duties for trucks and motor vehicles from 15 to 35 per cent on 1 January 1992, in order to attract foreign investment into this sector. Subsequently duty-free import quotas permitted in the AA were granted to selected EC car producers to encourage them to invest in the domestic automotive industry. In addition, components may be imported duty-free up to 90 per cent of the value of production. Taken together, the effective rate of protection is now considerably higher than 35 per cent. Increased agricultural tariffs (in April 1991 and again in August) are another instance. To the extent that in this case the action reflects the pressure to protect domestic producers from the subsidised exports and other forms of agricultural support undertaken by trading partners, the use of countervailing duties rather than straight tariff increases might have represented a more effective approach.

While Polish trade policy has thus far relied primarily on tariffs, certain quantitative measures remain in place. The customs law specifies instances where import and export licences may be required[168]. Import prohibitions and quotas may be imposed for the instances which are broadly consistent with the relevant sections of the General Agreement of the GATT[169]. Export quotas may be established to comply with international obligations, such as those relating to the Multi-Fibre Arrangement (MFA), and to avoid shortages in the domestic market[170]. In general, the reach of quantitative restrictions on trade is limited. The most important ones are those needed in order to comply with the trade policies of other countries, notably with respect to the MFA. Beyond this, on the import side, quotas apply principally to certain alcoholic products. The administration and allocation of quotas fall within the purview of the Ministry for Foreign Economic Relations and a Commission was established to carry out these responsibilities. The rules followed by this Commission in allocating quotas follow Polish administrative procedures and are published but transparency is still an issue: the allocation of quotas takes a large number of considerations into

account. Efficiency could be improved by auctioning quotas rather than distributing them administratively.

Overall, trade policies have up to now been generally consistent with the objective of reducing distortions to trade and encouraging market forces to operate. Pressures to adopt a more activist trade policy in pursuit of sectoral objectives, or to provide protection from foreign competition to domestic enterprises in difficulty, are rising, however, and the government has indicated an intention to move at least some way in this direction. Certain instruments now being developed, such as anti-dumping procedures, represent legitimate approaches to dealing with some problems but are also capable of considerable abuse. But the long-run costs to Poland of a shift towards highly interventionist trade policies would surely exceed, by a large margin, whatever perceived short-term gains could be achieved by such a shift.

Assessing trade performance

The two years following liberalisation of the trade regime have been marked by extremely dynamic development of Polish trade, characterised above all by a major reorientation of trade flows away from the CMEA area towards the market economies, and the EC countries in particular. Moreover, the share of the private sector in exports and imports has increased from 8 per cent and 22 per cent in 1990 to 25 and 50 per cent respectively in 1991. The first part of this section describes these developments in aggregate terms, and relates them to the broader macroeconomic developments that have conditioned trade performance. Integration into the world economy is not simply a matter of increasing levels of trade. The shift to a market economy will entail profound changes in the structure of trade as competitive pressures replace previous administrative decisions regarding what goods to import and to export. Experience has shown that it is practically impossible to identify in advance the goods that are ultimately selected by market forces as the ones in whose production a given economy has comparative advantage, and the past two years are clearly too short a period from which to assess the directions in which Polish trade structure will evolve; nevertheless, an examination of the present Polish export structure does suggest that further large changes in the composition of trade have to be expected. The second part of this section addresses this issue.

Aggregate trade developments

For any discussion of Polish trade developments, a cautionary word concerning trade statistics is necessary. Available statistics are subject to a number of biases and distortions. It is likely that a growing share of imports and exports have been under-recorded, as private transactions that slip through the customs net have developed. OECD partner data suggest higher levels of trade than do Polish sources. Price data on private imports have not been collected in 1990 and 1991, so that volume measures are likely to be severely distorted. Finally, the problems of sensibly aggregating CMEA and non-CMEA transactions remain insuperable because of the artificiality of the rouble/zloty exchange rate. But even keeping these transactions separate is no simple matter. Thus, up until 1989 the distinction between rouble-denominated and non-rouble denominated trade was relatively clear and corresponded broadly to trade with CMEA and the rest of the world respectively. But already in 1990 an increasing number of CMEA transactions were being carried out in hard currency so that this mapping began to break down. Trade volume statistics are however only available on a rouble/non-rouble split until 1991, and only on a geographical basis thereafter. This accounts for the presentation in Table 16, which summarises recent trade developments.

The most striking feature of Polish trade has been the strong growth in exports to the west, and the EC in particular. In 1990 this led to a healthy overall rate of growth of exports despite a decline of exports to CMEA; in 1991 overall export volumes were broadly sustained despite a further fall of over 40 per cent in exports to CMEA. For state enterprises, the fall in export volumes to CMEA exceeded 50 per cent.

While this performance is impressive, some of the underlying conditions supporting export growth have clearly deteriorated over the period:

- The sharp devaluation of the zloty in January 1990 created strong incentives to sell goods for hard currency. But since then domestic production costs have been rising rapidly and, correspondingly, the real exchange rate has appreciated so that the initial competitive advantage has been eroded or even reversed.
- Linked to this, the profitability of exporting appears to have diminished sharply. Direct information on this point is hard to obtain, but it is strongly suggested by anecdotal evidence, and supported by several

Table 16. **Summary of trade developments, 1988-1991**

	1988	1989	1990[1]	1991[1]
	Exports (excluding services)			
Volumes	9.0	0.2	13.7	–2.4
Geographical area				
EC	16.5	6.9	65.1	26.4
Others	–	–	–	–7.8
CMEA	7.1	–0.5	–	–42.9
Currency zone				
Rouble	8.0	0.1	–13.3	–
Non-rouble	10.1	0.3	40.5	–
	Imports (excluding services)			
Volumes	9.0	1.5	–17.9	37.8
Geographical area				
EC	23.1	15.1	12.2	76.1
Others	–	–	–	73.2
CMEA	1.0	–3.7	–	–31.9
Currency zone				
Rouble	1.9	–3.4	–34.1	–
Non-rouble	18.3	6.4	–2.9	–
Terms of trade (1985=100)	108.5	126.4	105.8	96.5

1. Including private sector.
Source: Informacja o sytuacji spoteczno-gospodarczej kraju, Rok 1991, January 1992.

indirect indicators: export prices to the EC rose by only some 8 per cent in zloty terms in 1991 – far below any index of domestic input or labour costs. The general dramatic decline of profitability in the state enterprise sector, furthermore, points in this direction: there is no indication that exporting firms, as a group, are earning significantly above-average profits.

– These developments suggest that to an increasing extent, exports are being driven by "distress sales", as enterprises seek to maintain production in the face of sharp declines in domestic and CMEA demand for their products. This is a normal development in market economies in times of cyclical downturn, but it is not sustainable for very long.

The slowing of export growth between 1990 and 1991 may reflect these worsening conditions, though slowing growth in the west has also been an important factor. On the more positive side, the initial strong growth in exports to the EC, although predominantly spontaneous, did push against import barriers for a number of goods. The further improvements in access resulting from the coming into force of the Association Agreement with the EC may thus serve to give exports a new boost.

A major geographical shift also occurred in the sources of imports: imports from the CMEA fell by a cumulative 50 per cent over the period from 1989 to 1991 while imports from the rest of the world (primarily Western Europe) rose by over 55 per cent. The time pattern was however very different than for exports, with the growth in imports from the west heavily concentrated in the last quarter of 1990 and the first half of 1991. While falling output and incomes no doubt contributed to keeping import demand low in 1990 despite trade liberalisation, the low exchange rate must also have been an important factor. The sharp rise of imports in 1991 is the more remarkable in that it occurred despite further falls in production, which might have been expected to restrain intermediate imports.

A breakdown of imports by end-use categories may shed light on this. Between 1989 and 1991, the share of intermediate goods in imports declined from 57 per cent to 53 per cent, while that of consumer goods surged from 18 per cent to 30 per cent. This is as might be expected on macroeconomic grounds, since (as noted in Chapter II), overall consumption rose despite falling output. Even so, intermediate imports grew in absolute amount despite a 14 per cent fall in industrial production. Substitution of imported for domestic goods in both production and consumption has clearly been occurring on a large scale. The same is true with respect to investment: imports of investment goods rose despite sharply falling investment.

Such substitution is not in itself a cause for concern. To the extent that it reflects a shift to ''quality'', economic welfare is clearly improved; and in the context of investment and intermediate goods, such imports can also strengthen domestic production capabilities. But despite changes in the exchange rate in October 1991 and again in March 1992 relative price incentives now strongly favour imports over domestic production, so that domestic production costs and output prices need to be brought down relative to those prevailing abroad.

The structure of Polish trade

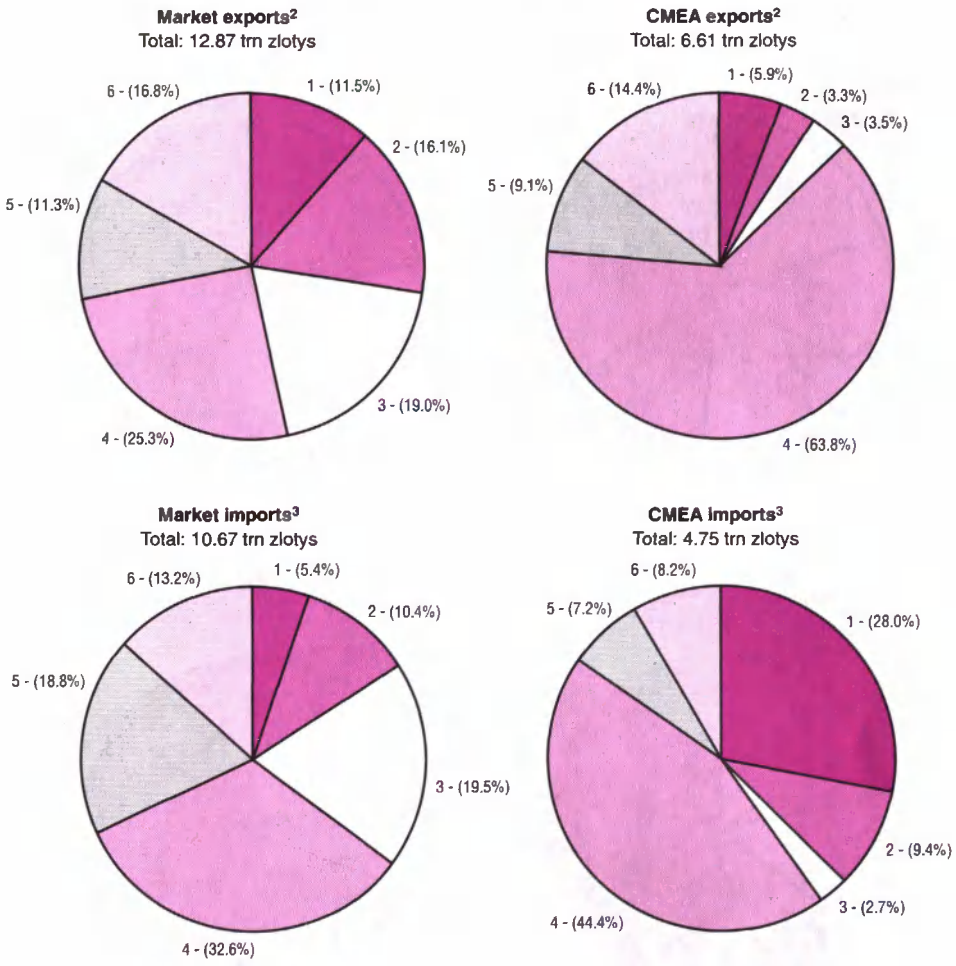
The structure of Polish trade by major product categories prior to liberalisation is summarised in Chart 15. The most striking point is the very different composition of trade as between the CMEA and the rest of the world. CMEA trade, on both the import and (especially) the export side was very concentrated in electrical engineering products. Energy imports from the CMEA region were also quite important. In trade with the rest of the world, there is much less evidence of specialisation, with the six broad commodity groups identified in the Chart all accounting for a roughly equal share of exports. Imports were also quite evenly spread across product categories, with only fuels accounting for a relatively low share.

As discussed above, the last two years have witnessed a very dramatic change in the geographical pattern of trade, with the relative importance of the CMEA market falling drastically (Chart 16). At the broad level there has been substantially less change in the commodity composition of trade with each of these two groups of countries, as shown in Chart 17, which replicates Chart 15 for 1991. Perhaps most noteworthy is the rise in the share of mineral and metal exports to the west. However, within broad commodity groups there have been significant changes in the goods both exported and imported.

As a result, the principal pressures for adjustment have clearly fallen on the electrical engineering sector, which was unable to compensate for the decline in CMEA exports by increasing their sales to other markets. As shown in Chart 18, the share of this sector in overall exports fell by almost half, from 38.4 to 22.7 per cent of the total.

Perhaps not too much should be made of these numbers, certainly at this level of aggregation. It can be expected that the restructuring of trade to reflect comparative advantages is a lengthy process. In the short run, Poland will be largely constrained to export those goods for which history has given it large productive capacity, so long as this can be done at all profitably. A more difficult question is the extent to which changes in export structure can be expected in the longer term. Table 17 below provides a comparison of Polish export structure with that of Germany on the one hand and five so-called Dynamic Asian Economies (DAEs) on the other, where goods are classified by the input they utilise most intensively. It should be noted that the categorisation into labour-intensive,

Chart 15. **COMMODITY COMPOSITION OF POLISH TRADE WITH CMEA AND THE REST OF THE WORLD, 1989**[1]

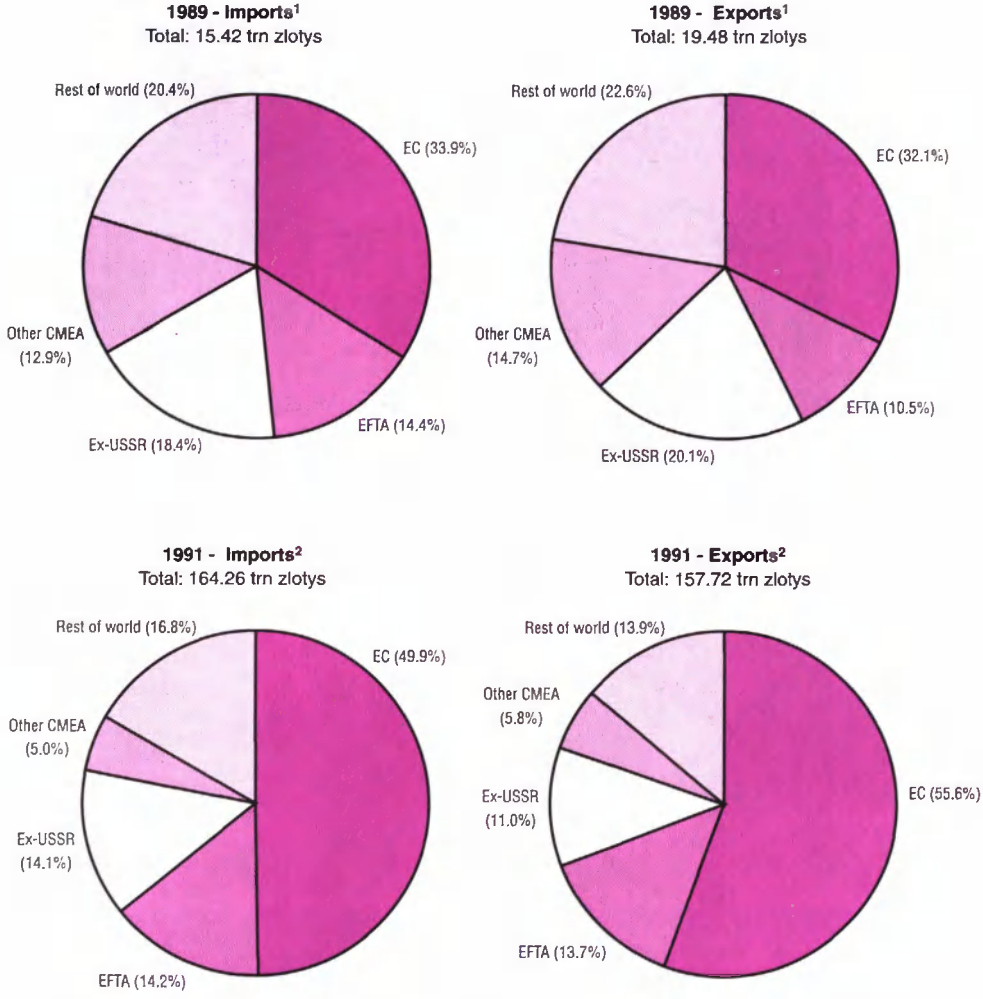


1. Fuels
2. Minerals and metals
3. Food and agriculture
4. Electrical engineering
5. Chemicals
6. Manufactures (includes wood and paper products, textiles, wearing apparel and leather goods, construction, forestry and other industries)

1. Polish nomenclature; refers to state enterprise trade only.
2. f.o.b.
3. c.i.f.

Source: Polish Central Statistical Office.

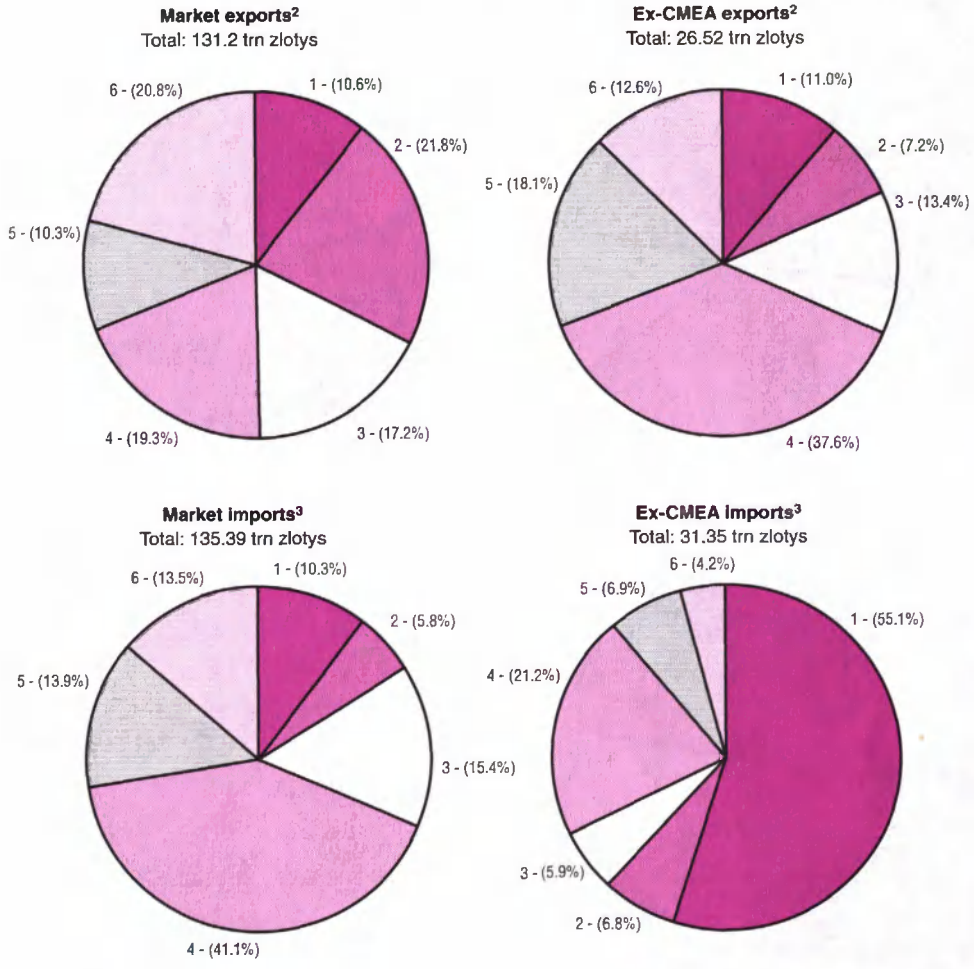
Chart 16. **REGIONAL DISTRIBUTION OF POLISH TRADE**



1. Refers to state enterprise trade only; imports c.i.f., exports f.o.b.
2. State and private sector trade; imports and exports f.o.b.

Source: Polish Central Statistical Office.

Chart 17. **COMMODITY COMPOSITION OF POLISH TRADE WITH EX-CMEA AND THE REST OF THE WORLD, 1991**[1]

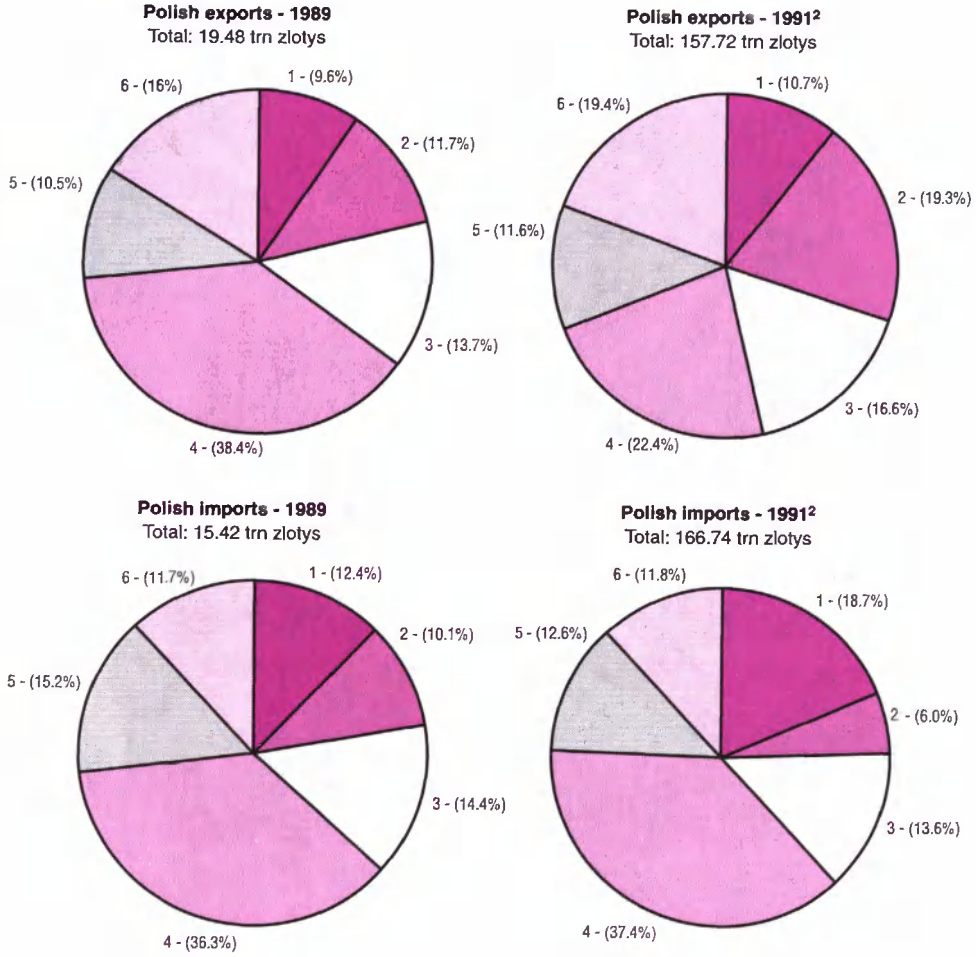


1. Fuels
2. Minerals and metals
3. Food and agriculture
4. Electrical engineering
5. Chemicals
6. Manufactures (includes wood and paper products, textiles, wearing apparel and leather goods, construction, forestry and other industries)

1. Polish nomenclature; refers to state and private trade.
2. f.o.b.
3. c.i.f.

Source: Polish Central Statistical Office.

Chart 18. **OVERALL COMMODITY COMPOSITION OF POLISH EXPORTS AND IMPORTS[1]**



1. Fuels
2. Minerals and metals
3. Food and agriculture
4. Electrical engineering
5. Chemicals
6. Manufactures (includes wood and paper products, textiles, wearing apparel and leather goods, construction, forestry and other industries)

1. Polish nomenclature; exports f.o.b., imports c.i.f.
2. Refers to state and private sector trade

Source: Polish Central Statistical Office.

Table 17. **Distribution of exports by factor intensity, 1990**

	Poland[1]	FRG (1987)	DAEs (1988)
	% of total exports		
Raw material-intensive	34.6	9.1	11.0
Labour-intensive	19.2	20.8	43.2
Capital-intensive	21.9	28.5	6.4
Easily transferable R&D-intensive	8.0	15.2	20.0
Not easily transferable R&D-intensive	12.8	27.4	18.0
Other[2]	3.4	–	–

1. 1990 exports with OECD only.
2. SITC 9.

Sources: Poland: national sources; OECD calculations; for a description of the commodity classifications see J. Stehn and H. Schmieding, "Specialisierungsmuster und Wettbewerbsfähigkeit: Eine Bestandsaufnahne de DDR-Aussenhandels", in Die Weltwirtschaft, Vol. 1, Kiel, FRG, 1990.

capital-intensive, etc. is based on input weights characteristic of the world economy as a whole, rather than those applying in particular countries.

Three features stand out from this table.

- First, the heavy concentration of Polish exports in raw-material intensive products (which includes energy inputs) is unlikely to be sustainable. Polish capacity was built up under conditions of very low prices for energy and raw materials. As these prices move to world levels the likelihood must be that many sectors in this group will face growing difficulties in establishing competitiveness. Indeed, data for 1991 already suggests a significant decline in the share of this category of exports.
- Second, the share of capital-intensive exports is not much lower for Poland than it is for Germany. But Germany is abundant in capital. Perhaps, in a sense, Poland was too in the past to the extent that under central planning high rates of investment were often achieved. But much of this capital needs to be scrapped; and in the face of strong competing demands for savings, relatively low domestic savings rates, and limited access to foreign capital, the cost of capital is likely to remain very high. This suggests that this specialisation may not be sustainable.

- Third, the share of labour-intensive exports in the total is very low compared, in particular, with the DAEs. Poland is, by international standards, a low-wage country (the average wage is currently about $200 per month – well below levels in, for example, Korea). Of course, the expectation must be that real wages will rise over time, but the high rates of structural unemployment associated with the economic reconstruction of Poland would tend to argue that real wage increases will remain modest for some considerable time.

It is, of course, not justified to apply this kind of quite general analysis to making judgements about where Poland's future comparative advantage will lie, and even less to base a sectoral industrial policy on such considerations. But prudence would suggest that the government should refrain from a policy of selectively supporting enterprises or sectors solely because they are important exporters at present. While exports need to develop, it is far from certain that present exporters are the ones best placed, on comparative advantage grounds, to promote this development.

Assessment

Viewed against the objectives set for trade liberalisation in 1990, significant successes have been achieved. A new price structure has been imported and domestic competition has increased. And some Polish enterprises have responded: exports have increased to Western markets and the commodity composition has begun to alter. An unexpected flexibility on the part of some Polish enterprises has emerged, although the weakness of many others has also been highlighted. Imports have increased and have undoubtedly contributed to improved welfare and efficiency. Of considerable importance for the future, the new trade structure has been associated with a substantially increased participation of the private sector. Substantial barriers to important Polish exports remain, however, notwithstanding significant liberalisation on the part of OECD countries and especially the EC. It will be important in the future that such liberalisation not be undone through the use of instruments such as anti-dumping actions and tightened rules of origin. While the maintenance of a liberal trade system on the side of the OECD is vital, Polish trade performance will have to rely increasingly on improvements in competitiveness by Polish enterprises. To this end, domestic import barriers have proved counter-productive in many countries.

VI. Conclusions

In assessing the Polish experience in the two years since the introduction of the path-breaking Economic Transformation Programme in January 1990, it is important to stand back from present problems and recognise the extraordinary amount that has been accomplished: many of the institutional foundations for functioning markets have been put in place, and this process is continuing. Privatisation, despite slow beginnings, is gathering pace. The development of macroeconomic policy instruments suitable to a market economy is proceeding steadily. And, despite falling output and rising unemployment, hardship has been to some extent contained by social safety-net provisions, while at the same time new opportunities have opened up to Polish citizens in private activities. Most fundamentally, Poland has crossed a watershed: while time and further intense efforts will be needed to create an efficient market economy, this is the direction in which Poland is headed. A reversal of direction is out of the question.

Comparing the situation now to that prevailing when the transformation process began, a number of dramatic improvements can be observed. To cite five of the most obvious ones:

- Shortages, and with them the inefficient and demoralising queues that they engendered, have been eliminated. The range of goods that Polish citizens can buy has expanded dramatically. New shops have altered the landscape of most Polish cities.
- Inflation has been brought down from hyper-inflationary peaks of near 600 per cent in 1989 to something around 40 per cent currently.
- Convertibility of the zloty has been established and maintained. Reflecting this, Polish trade with the West, based on largely liberalised market signals, has grown dramatically. Integration into the world economy has developed not only through trade, but by substantially increased travel

between Poland and the West, and through the emergence of a large number of new joint venture firms in Poland.

- The zloty has become a viable store of savings. Even though inflation remains high, households are compensated via high nominal interest rates on their deposits, so that the continuous erosion of their savings that characterised the 1980s has stopped.
- The private sector has become pervasively present in many parts of the Polish economy, and a dominant force in some. Its dynamic development is continuing.

Nevertheless, the Polish economy continues to face difficult problems. These will have to be addressed if the continuing fall in output is to be reversed and Poland to enter into the "high growth phase" that could be expected, in view of its large human capital potential, once the policies and structures for marshalling this potential through efficient markets are in place.

The heart of the problem is on the supply side. Poland is not at present in a recession, as that term is usually used in the West, i.e., a cyclical downturn largely amenable to correction by more accommodating demand policies. Rather, while demand factors clearly are one element of overall performance, the fundamental challenge facing Poland is one of reconstruction. For the medium term, this will require high savings and high investment to recreate a viable capital base. Incentives for households to increase their savings are thus important, and public consumption will need to be restrained. It is equally essential to establish conditions in which the savings resources of the economy are utilised efficiently. This requires completion of the reform agenda to establish clear market-oriented incentives in all spheres of the economy, including the state sector.

Reconstruction is inevitably a lengthy process. Its forward momentum must be maintained, and in the meantime policies have to assure a reasonably stable framework. "Managing the transition" is a very difficult task. Up to now, stabilisation policies have been relatively successful in bringing inflation under control, but macro-economic equilibrium has not yet been durably established. Difficulties can be traced to three factors:

- The instruments of macroeconomic policy have themselves been beset with problems. Budget control has been hard to maintain in part because of the slow development of adequate tax instruments; and monetary

policy has had to rely on direct administrative controls over bank lending, with all the distortions in the allocation of credit that these entail because indirect instruments have proved inadequate in the face of underdeveloped money markets.

- The impact of macroeconomic policies on the economy is not felt in the same ways as in mature market economies, and perverse results can arise because state enterprises are not sufficiently driven to earn profits: for example, high interest rates do not discourage borrowing by those enterprises that do not expect to have to service their debt, and wage taxes do not discourage wage increases when firms can build up tax arrears, etc.
- State enterprises (still the predominant actors on the supply side of the economy) have failed thus far to respond adequately to stabilisation policies by adjusting to the new conditions and adapting their behaviour. The incentives for them to do so remain weak.

All three of these factors can in turn be directly related to the fact that it has proved to be impossible to put in place many structural reforms rapidly enough to establish the conditions for fully successful stabilisation. Instead, under conditions of still incomplete transformation to a market economy, it is the stabilisation effort itself that is proving increasingly difficult to sustain.

In these circumstances, there is relatively little choice about what broad strategy to pursue – though clearly there are many issues of specific implementation where different views are possible. In broad terms, it is necessary to accelerate the structural transformation of the economy along market principles. At the same time, and whatever the problem posed by this, macroeconomic stabilisation has to be pursued because a loss of control here would endanger the whole process of structural change. These two elements are clearly interdependent: neither can succeed without the other. The remaining paragraphs of these conclusions provide more specific recommendations concerning how this broad strategy could best be implemented.

Macroeconomic issues

Control over the budget is essential. The deficit of 3.8 per cent of GDP in 1991, and even the 5 per cent set as a target for 1992 is not unusually high in

comparison to many OECD countries in situations of cyclical weak demand. Nevertheless, in the situation in Poland today, a deficit of the size projected gives serious cause for concern for four reasons.

- The savings rate in Poland is insufficient, and access to foreign saving is limited. Budget deficits, by drawing scarce savings from the economy, squeeze its investment possibilities.
- Given still-underdeveloped financial markets, the financing of budget deficits of necessity passes largely through the banking system, endangering monetary control and directly crowding-out credit to productive enterprises.
- The interaction between deficits and debt, and consequently higher debt interest in the future, is potentially explosive in conditions of stagnant output growth and positive real interest rates. Such an unstable debt-accumulation path must be avoided.
- The previous point is reinforced by the fact that the government will be obliged to take on additional long-term debt at some stage, as part of the process of dealing with the unsustainable financial situation of many state-owned enterprises and banks (see below). While some of such debts could ultimately be liquidated by privatisation receipts, room to absorb and service extra long-term debt has to be created.

In view of these considerations, the budget deficit targeted for this year needs to be seen as an absolute maximum, and additional measures to bring the deficit down need to be considered urgently. Any slippage from the target would not only be problematic in itself but would be extremely costly in terms of its impact on expectations and loss of government credibility vis-à-vis both domestic agents and potential international investors.

The government objective of bringing the inflation rate down to 36.5 per cent in 1992 (December over December), if achieved, would mark progress with respect to 1991, particularly in view of the further mandated increases in energy prices. However, the question of whether greater ambition with respect to inflation is possible needs to be addressed. Certainly a more rapid disinflation would yield important benefits in terms of lower interest rates, reduced uncertainty, lesser likelihood of speculative behaviour, and a reduction of inflation-induced distortions in financial markets. The principal constraint on achieving a more

rapid disinflation would appear to be the inadequacy of instruments: tighter monetary policy, given the requirements of financing the budget deficit and the present inefficiencies in credit allocation, would risk starving many potentially productive enterprises of funds. A more rigorous use of exchange rate policy to contain price rises (for instance by lowering the rate of monthly depreciation built into the crawling peg) would risk squeezing the trade competitiveness of the Polish economy and so prevent output from stabilising – defeating a central objective of the government which is to at least halt the decline in output in 1992.

Nevertheless, a lower inflation objective seems called for, and better outcomes would be achieved by putting together a range of measures to tackle the underlying mechanisms that keep inflationary pressure strongly entrenched: monthly indexation of wages and lack of incentives in state-owned enterprises to curb costs and raise efficiency. The following measures should be considered in this context:

- Giving workers and managers in state-owned enterprises a real incentive to improve profitability by giving them a stake in eventual privatisation that is directly linked to the value of the enterprise when privatised. Current incentives are in some cases perverse in this regard.
- Continuing to reduce the high mandated severance payments for workers in the case of mass layoffs, and otherwise facilitating such layoffs. General unemployment benefit provisions and other social safety-net programmes, as well as manpower policies, would provide a more satisfactory framework for dealing with unemployment than the present bias to "hidden" unemployment in the form of extensive over-manning.
- Encouraging the development of labour-management relations in enterprises in a way that clearly brings home to workers the inevitable trade-off between wage levels, the viability of the enterprise, and future employment possibilities, so that wage bargains can be struck that adequately reflect the situation of the enterprise. The development of institutions for negotiating labour contracts at the enterprise level could be a useful vehicle for this; and such contracts would obviate the need for present indexation mechanisms. Labour contracts should also be encouraged for the private sector.
- Underlying all of these, making bankruptcy a credible instrument so that enterprises internalise the reality that the choice is between becoming

profitable or ceasing to exist. Developing mechanisms to speed up bankruptcy proceedings – for instance through special courts – is a high priority in this regard.

Such a "structural" agenda for reform is essential in its own right, as well as for generating better conditions for bringing inflation down. Inevitably such reforms take time to implement and to bear fruit, and in the interim, other instruments to control the development of wages remain necessary. The present instrument for limiting wage growth – the Excess Wage Tax – has not been performing adequately in this regard even as, perversely, it has become an important source of government revenue. Furthermore, this tax, like any other incomes policy, acts as an impediment to the development of efficient systems of wage determination, and so should be seen as a temporary measure. Nevertheless, it probably needs to be retained for a time. The tax could be improved by restructuring it so as to give firms (and workers) the incentive to keep wages low by shifting a larger share of compensation toward profit-linked bonus payments which would be partially or totally exempt from the excess wage tax. Alternatively, dividend payouts could be shared between workers, management, and the state. Even if such arrangements did not, in the end, result in lower total compensation, they would at least provide an incentive to maximise profits. The tax would function more effectively if its parameters were set for longer periods and not subject to frequent renegotiations.

Once the measures listed above were put in place, both the crawling-peg exchange-rate mechanism and targets for credit expansion would need to be tightened in order to sustain disinflation; this could be done without squeezing the economy substantially further since inflation would be decelerating more quickly as well.

Apart from the issue of reducing nominal wage growth is the question of *real* wage levels. The government's assumption is that real wage growth will be zero this year. This objective would be consistent with the need to strengthen the competitiveness of Polish enterprises only if labour productivity can be raised substantially. There is a clear trade-off here – either to keep real wages at their present levels for the employed, but to shed substantial amounts of labour; or to aim for real wage cuts in order to moderate unemployment growth. Ideally, such trade-offs should be assessed within each enterprise; but social cohesion might be

better preserved to the extent that the rise in unemployment can be contained, arguing for an objective of some decline in average real wage levels.

In whatever way the relationship between real wage levels and unemployment is to evolve in coming years, Poland will clearly face high unemployment for some time. Labour market policies can attenuate this problem up to a point, but not resolve it. Perhaps the most important goal for such policies is to limit the rise in long-term unemployment, both by active labour market policies and by such measures as enlarging the scope for part-time work. Also, in dealing with specific regions where unemployment rates are highest, thought should be given to replacing present incentives that primarily encourage new investment with incentives that reduce labour costs for firms in these regions – for example by some alleviation of social security charges.

As regards the balance of payments, Poland's external debt constraint has been substantially reduced as a result of the debt reduction arrangements negotiated with the Paris Club of official creditors. These arrangements assure a moderate debt servicing burden for Poland until the end of 1993. This "breathing space" has to be used to strengthen trade performance and encourage the growth of foreign direct investment inflows. The cash-flow benefits of the debt-reduction package will have largely run their course by 1994, and if the "breathing space" is wasted, Poland could quickly find itself back in a debt trap at that time. Budget policies have to take into account the need to finance larger amounts of foreign debt service from 1994 onward.

Other reform policies

The government, in its 1992 budget, has taken a number of useful steps to reform certain expenditure programmes to make them durably more cost-efficient by focussing on the achievement of well-defined objectives at minimum cost. This process needs to continue, and indeed accelerate. Two areas in particular demand urgent attention. First, pension reform is essential to arrest the prospective explosive deficits of the Social Security Funds. Some important measures have already been taken, but more will need to be done. Eligibility conditions for full pensions need to be tightened further, through more stringent control over disability pensions; and a compression of the pension structure needs to be achieved by progressively lowering maximum pensions paid for by

the State, so as to encourage individuals to save more for retirement directly or through supplementary private pension or insurance programmes. Agricultural pensions represent a particular problem because they are only to a small extent based on contributions. As agricultural consolidation takes place, this pension scheme will need to be reviewed in order to reduce its costs to the budget over time.

Second, the present system for financing housing construction needs to be further modified because its budget costs are too high. These costs arise not because mortgages are still subsidised directly (they are not), but because repayments by the borrowers to the Savings Bank (PKO BP) are limited in relation to a share of the borrower's income, with automatic capitalisation of interest due if it exceeds this limit. Seventy per cent of such capitalised interest is in turn rediscounted in the budget. This feature should be eliminated: a greater share of the financing of housing should be carried by the Savings Bank. This would require the Savings Bank to operate more independently, moderating the terms and conditions of its lending for housing construction in light of its own liquidity position. To the extent that present liquidity or solvency problems of the Savings Bank are a constraint, these problems need to be addressed directly, rather than by providing a call on government assistance that risks in practice to be open ended. Housing construction could be supported by encouraging all banks, not just the PKO BP, to develop savings instruments that households would find attractive as a means of accumulting the necessary capital to fund house purchase. At the same time, more needs to be done to encourage a market in existing housing, which current schemes do not address at all.

On the revenue side, the most pressing issues are to introduce the VAT as quickly as possible, and no later than 1 January 1993; and to improve tax enforcement of both direct and indirect taxes. The government has announced steps in this regard, including the building-up of a specialised tax-enforcement department within the Ministry of Finance. Inevitably it will take some years for tax enforcement procedures to become fully effective. Nevertheless, immediate steps that could be taken would be to review the monetary and non-monetary penalties that apply to tax non-compliance to ensure that these are sufficiently high to deter potential tax evaders. The principle that tax arrears are subject to market rates of interest should be rigorously enforced to encourage taxpayers to pay their taxes within the prescribed time limits. At the same time, a selected

audit programme could be implemented which would enable the tax authorities to direct their limited resources to those sectors or groups of taxpayers where there is the highest risk of non-compliance. These control programmes could be accompanied by a taxpayers' charter setting out the rights and obligations of taxpayers. This package of measures could significantly reduce tax evasion.

Improving the functioning of monetary instruments is in large part an incremental process linked to the development of new instruments and of financial markets more generally. Progress is being made. The new Amendment to the Banking Law provides a legal framework which will facilitate the task of the central bank (NBP) in developing and enforcing the procedures and techniques for indirect monetary control. But for monetary policy to become effective it is also essential to strengthen the banking system. Three lines of action need to be pursued: *a)* The powers of regulation and supervision over the commercial banks accorded the NBP by the Amendment to the Banking Law need to be actively used to promote sound banking practices. *b)* Restructuring of the banks themselves through mergers or acquisitions would be desirable to create a simpler structure of banks operating across the country, rather than in regions, and so more in competition with each other. This could most easily be done in the context of preparing the banks for privatisation. Re-structuring the Savings Bank (PKO-BP), so as to promote its development as a universal bank, should also be considered. *c)* A recapitalisation of the banking system will be necessary. The essential requirements for such a recapitalisation to be successful are the following:

i) Whatever the techniques employed, it should be done on a sufficient scale as to be credibly "once and for all". Partial recapitalisations that still leave the banks insolvent only create the presumption in the banks that further recapitalisation will be forthcoming, and thereby weaken the incentive to avoid new bad loans. This will entail taking off the balance sheets of the banks the non-performing assets corresponding to the debts of the biggest loss-making enterprises.

ii) Management practices within the banks as well as bank supervision functions in the NBP must be tightened to ensure that current practices of capitalising interest for, or extending new credits to insolvent borrowers are not continued. Bankruptcy proceedings need to be in place, and banks need to invoke them when the situation warrants it.

iii) Following recapitalisation, banks must be left to "sink or swim" on their credit decisions. If the government has its own objectives for credit allocation, these should be realised directly through the budget, and not by encouraging the banks to lend to certain borrowers.

Preferential credits, guarantees. and other inducements are not only distortive, but mean that banks that get into difficulty will have claims on the government for assistance on the grounds that they were only carrying out government policy. Such measures need to be strictly limited.

Privatisation is clearly a key in the longer term to a more productive, efficient economy. The framework for privatisation that is now in place is generally adequate, providing a range of approaches that can be applied in particular cases. The emphasis is rightly placed, in all these approaches, on promoting effective owner-control over the enterprises after privatisation. A general problem has been that the various mechanisms and procedures are not well understood by the population, with resulting confusion. Privatisation could be made substantially easier to implement if the Ministry of Ownership Changes could provide clearer information to the public on what it is doing and why. Another general problem is that, up to now, the process relies on the voluntary decisions of managers and workers to privatise. It can be argued that the state, as owner, should have a stronger voice in this decision. There are, in addition, specific issues of implementation that need to be addressed:

- In the case of so-called "sector privatisation" where the Ministry of Ownership Changes seeks to develop a strategy for privatising a number of enterprises in a given sector simultaneously, on the basis of studies that seek to assess what kind of industry structure might prove viable for the sector as a whole, a major strength has been the possibility of using competitive tendering, rather than *ex ante* valuation, as a basis for concluding agreements. Unclear lines of authority are, however, often a problem – particularly in the case of potentially large foreign investors who have generally sought to negotiate directly through the Council of Ministers. No doubt there will always be "exceptional cases" where a more political approach to a privatisation project will be necessary, but the emphasis should be on achieving clearer "rules of the game" and on

greater transparency in the procedures and conditions set by the Ministry of Ownership Changes.

- The mass privatisation project, which seeks to transfer ownership of some 400 enterprises to investment funds whose ownership will subsequently be vested in the population at large through a share distribution, is also promising. Delays, however, have been a problem. It is particularly costly to delay implementation of this project once the firms have been identified, because such firms are then in a "limbo" situation until the transfer of ownership to the investment funds is completed. For this reason, it may be desirable to proceed to distribute the shares to the investment funds of those enterprises (some 200 in number) that have already been identified for mass privatisation and not hold this up until the remaining enterprises have been identified. Every effort should be made to avoid further slippages in the timetable, to settle as quickly as possible the practical details of the operation of the investment funds, and to have Parliament pass the needed legislation quickly.
- In the case of privatisation through the so-called "liquidation procedure" whereby managers and workers can arrange to buy or lease the assets of existing state enterprises, simplification of the procedures is needed so as to shorten the lag from initial application to completion. Clarification of property rights is a prerequisite in this regard, because uncertainties about this are a major source of delay. Implementation would also be accelerated by giving the Ministry of Ownership Changes the mandate to take an executive, rather than a bureaucratic approach to valuation. For this, they must be given adequate authority to stand up to political pressure, and to have the confidence that they will not be subjected to harassment in the inevitable cases when their judgements concerning valuation or other matters are called into question.
- Finally, it should be noted that the government intends to transfer formal ownership of state assets from the "founding bodies" to a State Treasury that is to be created. Many aspects of this operation still need to be defined, and so an overall judgement on it is unwarranted. Insofar as the intention is to transfer ownership rights primarily for those enterprises that are due to remain in state hands for a considerable time (as well as state-owned shares in already privatised companies), this approach may serve as one useful element in a package of measures to improve the

management of state-owned enterprises. But if a larger transfer of rights is envisaged, there is a serious risk that privatisation will be further delayed – if only because it would entail re-organisation of several aspects of existing privatisation mechanisms. This needs to be avoided.

More broadly, the development of the private sector requires a rapid resolution of the reprivatisation issue since, until this is settled, clear property rights, which are in many respects the foundation of a market economy system, cannot be established. Poland does not face the major problem of agricultural land restitution which has proved politically most difficult in other reforming countries, because much of the land has remained in private hands. It should thus be possible to reach final, clear guidelines concerning conditions and modalities of restitution quickly. The principle of financial restitution rather than restitution in kind needs to be retained and strengthened.

Attracting a larger inflow of foreign direct investment into Poland is crucial to achieving stronger productivity growth and easing external (and domestic savings) constraints. The present foreign direct investment law provides an adequate legal framework, and prospects are good that accelerated privatisation will attract growing foreign interest. What is needed to encourage investment is, above all, the confidence of the investor, which is fostered by stable ''rules of the game'', consistency in carrying through on stabilisation policies, and a minimum of bureaucratic intervention in investment decisions.

Investors, foreign or domestic, will typically seek special favours from government in return for investing. In fact such favours are rarely – if ever – the decisive element in investment decisions. But special discriminatory provisions – such as exceptional tariff protection or preferential quotas – once accorded to one investor, will be sought by others, and become increasingly difficult to resist as precedents are set. Preferences for all would be preferences for none, and so totally self-defeating. Pressures to subvert the present, broadly liberal trade regime in Poland into a non-transparent tool for discriminatory special treatment for favoured sectors or enterprises must be resisted.

The present situation in Poland is disquieting in some respects. But this should not give rise to undue pessimism. Indeed, the recovery in industrial production in recent months, though fragile, may be an indicator that adjustment is beginning to bear fruit. A great deal has been accomplished during the past two

years, and prospects are surely good that in due course Poland will enter into a phase of dynamic development as the skills and capacities of the Polish people are given scope within a market framework. For this result, it is necessary to keep to the fundamental principles that have guided the reconstruction process up to now, while taking a pragmatic approach to solving problems as they emerge. This is indeed the direction in which the Polish government is at present proceeding; its efforts in this regard deserve international recognition and support.

Notes and References

1. In 1990, short-term indicators referred only to socialised industry. From 1991, short term indicators referred to sales by industrial firms employing more than 50 workers.
2. This very short period has given rise to a number of theories variously emphasising the steep fall in real credit and demand, or monopoly whereby a revenue target in the face of price increases will lead to a fall in output. For an outline of various approaches see T. Lane, *Inflation, stabilisation and economic stabilisation in Poland,* IMF Working Paper, WP/91/70
3. F. Coricelli and A. Revenga, *Wages and unemployment in Poland: Recent Developments and Policy Issues,* WPS821. World Bank, 1992.
4. The case of transport illustrates the danger of equating output with welfare in economies in transition such as Poland. A significant volume of measured transport output was simply a waste of resources as goods were transported with little purpose. The same may also be true of industry when goods, which had been made internally at high cost, are now purchased from lower cost producers. The impact will be a lowering of measured output but an increase in unmeasured economic welfare. For some examples see J. Winiecki, "The inevitability of a fall in output in the early stages of transition to the market: theoretical underpinnings", *Soviet Studies,* 43, 1991.
5. Stockbuilding had been very high in 1989. In 1990, stocks of raw materials and intermediate products fell, while finished goods inventories rose.
6. The Polish national account statistics include in private consumption government expenditures directly benefiting individual consumers, such as benefits in kind, as well as personal consumption expenditures paid from household income.
7. It is probable that some of this measured increase actually corresponds to investment by individual entrepreneurs.
8. Small private units contributed most to this modernisation activity.
9. These trade volume estimates are uncertain. There is considerable controversy in Poland concerning the extent to which official statistics for trade prices are reliable. See also Chapter V.
10. G. Corrochano and L. Barbone, *Poland – Recent Developments in the Private Sector,* World Bank, mimeo, Washington, October 1991.
11. The rapid increase in private sector activity can be ascribed to two different processes (Chapter IV): on the one hand, the increase in output by entities that were previously

private, and on the other, the increase in the number of private firms, either through establishment or through privatisation. In addition, from 1991 official statistics show as private a number of cooperatives and foundations which were previously considered as belonging to the "socialised sector". This reclassification was accompanied by a tightened definition of the size of membership funds for the co-operative to be classed as private rather than "socialist".

12. The price and wage statistics cited do not refer to state enterprises as such, but as they are still dominant in industry, the statistics reflect closely developments in the state sector. Moreover, the excess wages tax applies only to the state sector. While private sector wages are higher than those in the state sector, with a few exceptions such as banking, there is little evidence of wage leadership from the private side.

13. It should also be noted that Poland was affected significantly by the United Nations embargo on Iraq.

14. The low level of unemployment prior to 1990 was partly illusory due to over-manning in industry. Moreover, in the 1980s, an active labour-force reduction policy was implemented and early retirement was encouraged. In the period 1980-1989, the number of recipients of retirement and disability pensions grew by more than 2.4 million. Owing to this policy, open unemployment was avoided until 1989.

    The number of registered unemployed surged in the first half of 1990. This has been partially ascribed to the registration of "voluntary unemployed" who had never worked but wished to exploit liberal and imprecise regulations to draw unemployment benefits and social allowances. Following an amendment to the Unemployment Law in July 1990, the situation improved. See Chapter III.

15. Unemployment has risen less than employment has declined because of the rise of unrecorded private sector employment and the large number of early retirements. See J. Dabrowski *et al, Report on Polish state enterprises in 1990,* Warsaw, 1991.

16. In assessing the degree of over-manning it is dangerous to make comparisons with western firms which have an entirely different structure of productivity and wage costs. Polish firms should remain more labour intensive than their western counterparts. Over-manning must rather be assessed by reference to the profitability and viability of the enterprise under domestic cost and price conditions.

17. H. Sopniewska in "Some economic problems of unemployment in Poland in the transition to a market economy", *Institute of Finance Working Papers,* No. 19, Warsaw, 1991, attributes complicated administrative procedures for this situation. Advance notice of 45 days must be given, unions have substantial veto powers and severance payments are extremely large, all of which constitutes an obstacle to restructuring. See Chapter III for a further discussion.

18. Potentially alarming is the situation in southern Poland, due to the excessive concentration of now seriously de-capitalised and technologically obsolete metallurgical, chemical and coal-mining industries. The region suffers from widespread environmental damage. The unavoidable restructuring of the region's economy threatens the workers with mass unemployment. Elimination of a large portion of the energy-consuming metallurgy and coal-mining will release more workers than can be absorbed by newly created jobs and, at the

same time, the employees being laid off (miners, metallurgists) will have to be retrained: see Grzeszczak, T. (1990), "Przestr Zenna Struktura bezrobocia w Polsce" (Territorial Structure of Unemployment in Poland), *Gospodarka Narodowa No. 9.*

19. I. Dryll, "Bezrobocie fikija czy dramat?" (Unemployment, fiction or drama?), *Zycie Gospodarcze No. 5,* Warsaw, 1991.

20. The labour market is examined in more detail in Chapters III and IV.

21. The number of unemployed women per vacancy is 2.4 to 4 times higher than that of men, and the trend is worsening. Thus, while in January 1990 there was one man and three unemployed women per vacancy, in December there were already 14 unemployed men and 40 unemployed women per one vacancy.

22. M. Gmytrasiewicz, "Bezrobocie a edukacja", (Unemployment and education), *Politika Spoleczna,* No. 2, Warsaw, 1991.

23. For example A. Berg and J. Sachs, *Structural Adjustment and International Trade in Eastern Europe: the case of Poland,* Economic Policy Panel, Prague, October 1991.

24. This point should not be overdone, as it often seems to be in the Polish press. It is true that foreign commitments to Poland are substantial: about $2.6 billion in commitments from international financial institutions, and at least as much again in bilateral export-credit guarantees. But substantial conditionality attaches to all of these sources of funds; and they are not free, carrying positive real interest rates. Faster disbursement on these credits than has been the case recently might be possible in some cases, but generally will be dependent on significant efforts by Polish private and public entities to meet the various conditions. It is of course essential that such funds be used efficiently and generate a return sufficient to cover future interest obligations.

25. The jumps in both expenditures and revenues in the final quarter of each year are largely seasonal: double corporate tax payments are due in December. Deferred expenditures are also paid. This is also the reason for the apparent rise in tax revenues at the end of 1991 and the rise in expenditures despite an emergency budget.

26. The National Bank of Poland is not independent of the government on many points of policy. The new Act approved in February 1992 changes this to some extent.

27. The notion that March 1990 represented some sort of monetary "equilibrium" is not easy to substantiate, and indeed the concept is not easy to define precisely. But it would clearly be misleading to consider the development of monetary aggregates using an earlier point in time as the base, since prior to March money holdings were by all indicators grossly excessive. Whether March 1990 also represented a credit market "equilibrium" is even more difficult to assess. Working capital for enterprises was no doubt substantially reduced in real terms relative to earlier periods, which should have had as a counterpart a reduction of excess stocks (as indeed occurred to some extent). However, the sharp increase in inter-enterprise arrears at the beginning of 1990 may suggest that a certain credit squeeze was operating at that time.

28. Despite the lower growth of real credit in 1991, targets for the nominal expansion were exceeded. The original target for credit to the economy set with the IMF was for an expansion of 80 million zloty. In the event it turned out to be around 112 trillion zloty, mainly owing to large deficit overruns.

29. The formula is: Wnorm = W^{t-1}norm (1 + Inf•A) where Wnorm is the maximum average monthly wage that is not liable to the wage tax, Inf is the expected inflation rate and A is the indexation coefficient. In 1990, the indexation coefficient was 0.3 for January, 0.2 for February to April, 1.0 in June and 0.6 for all other months. The initial base was chosen as the total wage bill for September 1989.

30. The following rates have been used: 100 per cent for payments exceeding the norm by up to 3 per cent; 200 per cent for increases between 3 to 5 per cent; and 500 per cent for increases above 5 per cent.

31. In particular, firms which increased wages above the ceiling during 1990 received a proportionately higher ceiling in 1991; firms which increased wages below the norm could pay the unused norm in 1991.

32. In 1990 about 800 firms were charged with avoiding wage restrictions by increasing allowances and housing benefits and financing these expenditures from social and housing funds allocated to the enterprise.

33. In addition to a share of corporate taxes, the Gminas also receive 15 per cent of personal income tax receipts. To the extent that this source of revenue exceeds the revenues that Gminas earlier obtained from the labour taxes that were abolished when the income tax was introduced, the squeeze on Gmina resources may be less severe than suggested by the numbers in the text.

34. To give an example of just the legislative efforts required, in the period before the October 1991 election to the Sejm, over 60 major laws were awaiting discussion: approximately one a day. If Poland wishes eventually to become a member of the European Community, around 7 000 pieces of legislation will need to be harmonised over a ten-year period.

35. In particular, Article 7 was amended to read that the Polish state "protects and fully guarantees private property".

36. It is important to bear in mind that under the old system ownership belonged indivisibly to the state so that neither a state enterprise nor local government owned the assets they used.

37. It should also be noted that state enterprises have typically built large, low buildings, and held substantial amounts of vacant land.

38. At least in one respect restitution is already underway. A law passed by the Sejm (the Polish parliament) in May 1989 allows the Catholic Church to regain land and buildings expropriated by the state while an amendment, passed by the Sejm in October 1991, specifies that church institutions may regain up to 50 hectares of land. As of January 1992, about 3 000 applications have been received by the government and episcopate property commission which was established to help implement the law.

39. Small enterprises were nationalised in 1958 using a 1918 decree which is now argued to be illegal. Large enterprises on the other hand were nationalised in 1946 but compensation was never paid. For land the situation varies across the country. Land holdings above a certain size limit were nationalised and this will stand. However a great deal of land under these limits was also nationalised and this will either be restituted or, in the case of land already distributed to peasants, compensation will be paid. For housing the situation is even more complicated but the general principle (i.e. that where the nationalisation was illegal restitution will be made or compensation paid) also applies.

40. *Information Guide to the Ministry of Privatisation,* Warsaw, September 1991.

41. For example, it routinely takes six months to register a transfer. The problem also extends to the registration of companies and partnerships.

42. Many OECD countries operate systems whereby the Registry is completely independent of the court system. This type of institutional system provides for a relatively simple framework for registering transactions whose validity is linked to their formal and public character.

43. In particular, Poland lacks a functioning foreclosure and eviction system which prevents the emergence of a private rental sector and constrains the development of commercial real estate and housing finance.

44. The two corporate forms allowed by the Commercial Code are the limited liability company and the joint stock company, although there is relatively little difference between the two. State-owned firms fall under the provisions of the code only after they have been corporatised (See Chapter IV).

45. However, the process of establishing a company continues to require excessive time and expense, this being particularly so outside of Warsaw. In particular, civil law notaries are difficult to find and the fees (3 per cent of equity capital) quite high. These factors may needlessly inhibit the formation of small and medium scale enterprises (SMEs).

46. A supervisory board is mandatory in companies with over 50 shareholders and 250 million zlotys in capital.

47. The Office is based in Warsaw but has 7 small regional offices. The overall staff level is around 100, primarily economists and lawyers.

48. To a great extent, the existing legislation will be transitional given the commitment by Poland in the Association Agreement to adopt a great deal of Community competition laws and regulations. See Annex I.

49. For clarification of this and other competition terms see, *Glossary of industrial organisation, economics, competition law and policy terms,* OECD, Paris, 1992.

50. Thus "monopolistic practices" are prohibited "unless they are indispensable to the conduct of economic activity and do not cause significant curtailment of competition". For this interpretation see World Bank, *The legal framework for private sector development in Poland,* WPS 800, November 1991.

51. Until September 1991 the criteria was a market share of 30 per cent. Adoption of the higher threshold decreased the number of "dominant positions" only marginally. The motive for changing the threshold was concern for international comparability.

52. In contrast to many other ex-socialist economies, Poland was not dominated by a small number of giant monopolies. In 1987, only 13 of the 500 largest enterprises had a market share (at the three digit *branch* level) in excess of 50 per cent and two-thirds had a market share of 10 per cent or less. M.E. Schaffer, "State-owned enterprises in Poland: taxation, subsidisation and competition policies", *European Economy,* No. 43, March 1990.

53. This is due to the definition of an "arrangement" as "agreements in any form between two or more economic entities or their unions": the competitive relationship of the parties is excluded.

54. For detailed arguments on this point see *Competition Policy and Vertical Restraints: the Case of Franchising Agreements,* OECD, Paris, 1992.

55. By and large, this type of restriction is adopted by suppliers to deal with "free rider" problems – situations where a distributor, were it free of constraints, could act in such a way as to degrade the services it provides to consumers of a product, thus ultimately eroding the suppliers' market position. By limiting the distributors' actions, the need for a supplier to own its distribution outlets directly or to engage in detailed monitoring is reduced – allowing an expansion in the number and geographical coverage of distributors. This is of clear relevance to Poland where, as in other formally centrally planned economies, distribution channels are extremely under-developed.

56. With the passing of the Act on Narodowy Bank Polski of 31 January 1989, and the Banking Act of 31 January 1989 (Dziennik Ustaw No. 4/89 items 21 and 22).

57. It should be noted that banks now often seek collateral two or three times the value of the loan.

58. The most important other financial institution was the national savings bank (the PKO-BP) which collects private savings and finances housing construction. There were, additionally, three specialised banks operating on a national scale: Bank Handlowy, for foreign trade, Bank PKO SA, for foreign currency operations of private persons, and Bank Gospodarki Zywnosciowej (Bank for Food Economy), for agriculture. BGZ incorporated around 1 500 small co-operative banks.

59. The minimum capital requirement has been raised recently from 10 to 70 billion zloty (10 million dollars for a bank with foreign participation). When the share of foreign capital is small, i.e. less than 20 per cent of capital stock, the bank is considered domestic.

60. For housing credit, the borrower paid 8 per cent, the budget 32 per cent and 60 per cent was capitalised; for agriculture the borrower paid 20 per cent, the budget 20 per cent and 60 per cent was also capitalised; for central investment all interest was capitalised until the project was completed.

61. Some other factors may have played a role, such as the reluctance of the banks to lend to newly-established firms or the inexperience of new entrepreneurs in applying for credits.

62. Unfortunately, a measure of the rate of return on funds employed is not available.

63. The banks were obliged to sell the foreign exchange to the central bank (keeping a cash reserve) and, to meet their obligations, had the right to purchase the necessary foreign currency from the central bank at the prevailing rate. With the exchange rate of the zloty to the dollar kept at an unchanged level (and some 80 per cent of foreign exchange savings were dollar-denominated), this resulted in significant profits for those banks which used these funds for their zloty credit operations.

64. The method of calculating the capital ratio is related to the absence of formal provisioning. A weighted average of all loans is used, where the weights are set according to the risk associated with the loan. (For instance doubtful assets have a risk weight of 300 per cent). The methodology used now has moved away from BIS procedures, and it may be difficult to return to international conventions if this is considered desirable.

65. Overall profits after tax of the state-owned enterprises were negative during the second half of 1991.

66. The situation is probably worse that it appears due to a taxation anomaly: penalty interest 150 per cent of the normal interest rate was due on unpaid loans, and taxes were payable on accrued interest regardless of whether it had actually been paid. This led banks to lower their estimate of loans in arrears. The law was changed on 25 January 1992, and only interest received are now taxable.

67. There have been cases when insolvent enterprises could not be put in receivership because of the lack of a receiver.

68. Previously the ratio was calculated in relation to pure credit, excluding off-balance sheet items, but now the total real exposure of the bank has to be taken into account. Before the ratio was relative to all the capital including deposits; under the new rules it is just the bank's equity.

69. Although state banks are exempted from the Act on Privatisation of State-owned Enterprises of July 1990, the procedure for privatising them will be similar to that applied to state-owned enterprises.

70. Mass layoffs are deemed to have occurred where layoffs over a 90 day period exceed 10 per cent of the workforce.

71. The Labour Fund assumed a proportion of these costs.

72. There is another important reason. As argued in Chapter IV, the state-owned enterprises are to a great extent worker managed. There has thus been a tendency to "hold on" as long as possible in the hope that the situation will improve. Equally, where the situation of a firm appears desperate, there is a strong incentive to initiate a mass lay-off even where there may be some prospects for part of the firm to survive.

73. For evidence on this point see J. Dabrowski *et al., Report on Polish state enterprises in 1990,* Warsaw, 1991.

74. This is widely observed in market economies: wages follow aggregate productivity trends but have only a very weak relation to firm specific factors. See W. Salter, *Productivity and Technical Change,* Cambridge, 1970.

75. Since January 1991, the minimum wage has been calculated as per capita consumption of foodstuffs in a four-person household, multiplied by a factor of 1.9. In July 1991 a revised complex formula, negotiated with the Trade Unions, was introduced. The end result is similar.

76. Those who took part in training/retraining programmes received 80 per cent of previous earnings for six months. In the case of mass layoffs, benefits during the first three months were 75 per cent of previous earnings (100 per cent if re-training). University graduates received 125 per cent of the minimum wage and other school leavers 110 per cent.

77. See *Poland – Income Support and the Social Safety Net: Policies for the Transition,* World Bank, September 1991.

78. This is a very high tax by OECD standards and must discourage employment. Moreover, a split contribution between employers and employees improves transparency and makes the alternative of private provision more attractive.

79. Under the new rules the value of the pension is related to the average wage in the economy in the previous quarter according to an individual coefficient. The value of the coefficient depends on the number of working years and the relation between personal earnings and the average wage in the economy in three selected years from the last twelve years before retirement (starting from 1993 this period will be increased each year by adding one year up to 10 years selected sequentially from the last 20 working years). The maximum pension can be equal to 250 per cent of the average wage in the economy which is the basis for calculating the pensions level and the minimum 35 per cent.

80. Every pensioner can apply to change her/his accounting period taking into account a continuous period of three years from the last twelve years.

81. For a detailed and comparative presentation of tax issues see *The role of tax reform in Central and Eastern European countries,* OECD, Paris, 1991.

82. In replacing these taxes revenue neutrality was sought. In addition, all wages and salaries were increased in order to maintain their after-tax value.

83. The law is quite unclear whether the exemption will also apply to private securities.

84. Prior to that the rate had been 65 per cent for the state sector and 85 per cent for the private sector. However, given the system of subsidies, charges etc. it was not strictly correct to talk about a tax system for state firms.

85. From May 1990 to January 1991, newly created firms (mainly private firms in the trade and service sector; see Chapter IV) received relief from corporate and sales tax for one to three years. In 1990 and 1991 new firms in the construction materials sector were granted ten years enterprise tax relief; in medical equipment production five years and; in construction services three years.

86. Exemption may be granted, provided that the foreign partner contributes no less than ECU 2 million and the company operates in regions affected by structural unemployment, introduces new technology or exports no less than 20 per cent of output.

87. A cross-country comparison of the treatment of dividends is presented in *Economies in Transition,* OECD, Paris, 1989, Table 5.13.

88. This important point was overlooked in the only study on effective tax rates in Poland: K. Andersson, *Taxation and the cost of capital in Hungary and Poland: A comparison with selected European countries,* IMF Working Paper, WP/90/123.

89. Three basic rates have been established: 20 per cent for goods, 5 per cent for services, and now 1 per cent for trade activities. The Ministry of Finance is empowered to adjust rates for particular items. Thus, rates of 25 per cent have been established for electronic goods and certain luxury items.

90. Excise duties are also applied to some luxury and "monopoly" goods.

91. This will affect lower income families in particular and has led to concern about increased poverty.

92. J. Fiszer, *Tax Reform in Poland,* Friedrich Ebert Foundation, Economic and Social Policy Series, No. 9, Warsaw, 1991.

93. In the past depreciation allowances, or part of them, were transferred from the firms to special state funds or the budget.

94. The possibility of after-tax losses despite pre-tax profits arises from non-profit related taxes such as excess wage tax and a tax on fixed assets or capital.

95. Low investment activity is also related to the concentration of the private sector in activities requiring only low capital inputs.

96. Industrial policies and the structure of Polish industry are considered in greater detail in *Industrial Review of Poland,* OECD, Paris, 1992.

97. The development in the price structure thus represents an unwinding of the approach from the central planning period when services and food prices were maintained at low levels while consumer industrial goods prices were kept high.

98. In 1988 total subsidies to enterprises amounted to 4 197 billion zloty, of which only 46 billion were enterprise specific. *Rocznik Statystyczny,* 1989, p. 103.

99. M.E. Schaffer, "State-owned enterprises in Poland: taxation, subsidization, and competition policies", *European Economy,* No. 43, March 1990.

100. International Energy Agency, *Energy Policies: Poland,* Paris, 1992, p. 11.

101. G. Hughes and P. Hare, "Competitiveness and industrial restructuring in Czechoslovakia, Hungary and Poland", *European Economy,* No. 2, 1991.

102. In 1988 the average ratio of labour cost (including social security and similar taxes) to value-added at world prices was 127.9. That is, labour costs alone exceeded value-added at world prices for the industrial sector as a whole at the official exchange rate then prevailing. Allowing for the cost of capital would show Poland to have been even less competitive. See Hughes and Hare, *op. cit.*

103. Moreover, the high proportion under five years of age in earlier years would indicate that a considerable proportion of the capital stock must now be more than ten years of age.

104. It is exceedingly difficult to judge the level of technology in a country at any time and even more difficult to judge whether it is being utilised efficiently. Indicators of R & D inputs are probably highly misleading in Poland given that firms were seldom under a tight budget restriction and there was prestige in R & D activities. On the other hand, education indicators point to a significant technology potential, though considerable time and organisational efforts will be needed to marshall this potential effectively.

105. It must be stressed that this was often economically rational. High transactions costs, substantial supply uncertainty and the lack of need to respond quickly to market forces all pointed to high vertical integration. This is in addition to the preference of planners for larger more easily overseen enterprises.

106. For industry, the proportion of assets accounted for by social facilities was 7 per cent in 1990 (book value). However, in the coal industry the proportion was 20 per cent and in metallurgy 15 per cent.

107. See International Road Federation, *International Road Statistics,* 1984-1988, Washington 1989.

108. See *Industrial Review of Poland,* OECD, Paris, 1992, for more details.

109. The judgment must be qualified. As noted above, industrial enterprises provide a wide range of services which are not classified as services in the statistics.

110. There was also another argument: restructuring should come last because its social cost will be so high that unless firms already had private owners the state will be forced to assume the social costs of adjustment and privatisation will be blocked.

111. There are 49 regional governments (voivods) the remainder being different ministries. The Ministry of Industry is the largest of this latter group.

112. This does not imply that enterprises have not been subject to tighter financial restrictions; direct subsidies have been all but eliminated. However, as noted above, inter-enterprise credits and capitalisation of interest on bank loans point to remaining softness in budget restraints.

113. On this point which is as difficult to measure as it is important see L. Biegunski and Wawrzyniak, B., *Poland's restructuring: corporate behaviour in the process of change,* Freidrich Ebert Foundation, Warsaw, 1991.

114. B. Piasecki, *The creation of small business in Poland as a great step towards a market economy,* Economic Transformation, No. 17, Gdansk, July 1991.

115. Piasecki, *op. cit.,* p. 10.

116. In May 1990 the government introduced a 1-3 year income tax holiday for newly established private firms, mainly in the commercial but also partly in the service sectors. In addition, there was a reduction in the turnover tax for certain products. The measures were implemented to accelerate the process of privatisation in the trade sector.

117. M. Grabowski and Kulawczuk, P., *Small firms in the last decade and now,* Economic Transformation, No. 17, Gdansk, July 1991.

118. State-owned farms are to be privatised using other procedures. See Appendix IV for details.

119. In the case of joint ventures, the contract is closely examined to see whether the partner has a strategic stake.

120. On this point it should be noted that the Treuhandanstalt in Germany has tried to check business plans for their enterprises. However, they have a staff around 1 000 highly experienced businessmen and supervisory boards comprising 20 000 part time but also highly experienced executives.

121. Where the new firm does not acquire ownership it will be important that the contract has clauses and incentives to prevent misuse of the assets in question. This is particularly important where the terms are concessionary. It appears that most of the leases in fact involve eventual ownership so that this problem of incentive structure is less important although still a residual risk.

122. This corresponds to experience in OECD countries where there has often been widespread interest only in issues thought to be highly undervalued. Experience shows that such shares are often held for quite a short period. Widespread share ownership is generally not achieved.

123. *Privatisation in Poland: Program and Achievements,* Ministry of Ownership Changes, Warsaw, December 1991.

124. L. Biegunski and B. Wawrzyniak, *op. cit.*

125. J. Dabrowski, M. Federowicz and A. Levitas, *Report on Polish State enterprises in 1990,* The Research Centre for Marketisation and Property Reform, Warsaw, February, 1991.

126. It has to be borne in mind that the criteria for bankruptcy is failure to pay state taxes rather than the more general definition of solvency in the bankruptcy law.

127. Very often the arguments have referred to the regional concentration of any employment effects arising from closure, a particularly difficult problem given the industrial geography in Poland.

128. See L. Biegunski and B. Wawrzyniak, op.cit.

129. J. Dabrowski, M. Federowicz and Levitas, A., *Report on Polish State enterprises in 1990,* The Research Centre for Marketisation and Property Reform, Warsaw, February, 1991.

130. Dabrowski *op. cit.* See also Dabrowski et al *Zapasc sektora panstwowego-Etap prawdy 1 polowa 1991 roku,* Gdansk, No. 18, 1991.

131. The comparison with Yugoslavian style labour management is misleading.

132. Expectation of removal of the capital "tax" also promotes the idea that capital is costless and that resources will become available for wage increases.

133. This is an important point, for the experience in many countries is that big productivity and performance gains occur in the period prior to privatisation when the management is concerned with a successful sale (and with future career prospects).

134. The former option suffers from its own incentive and equity problem since only employees at the time of the sale would receive the proceeds. Thus there would be a tendency to put off dismissals, and there would be even more controversy about the sale price than at present. The latter plan is more complex but would help compensate employees who lost their jobs in the restructuring process prior to privatisation. Another possibility is to issue some free but non-voting shares to employees.

135. This has often been the case in OECD countries but was especially marked in countries such as Mexico. Reforms have focused on clarifying and strengthening the economic objectives (i.e. putting the firms on a commercial footing).

136. It was a successor organisation to the Industrial Restructuring Fund and inherited its resources of around $84 million.

137. S. Lipinski, *Gazeta Bankowa,* No. 3, January 1992.

138. It must be acknowledged that earmarked schemes such as preferential terms for energy conservation are common in OECD countries. They are, however, usually marginal in the context of the overall economy and are furthermore justified in terms of a potential high rate of return. There is often a great deal of scepticism about effectiveness.

139. This argument is based on the capital tax being a fixed cost not a variable one. Output by a firm facing normal incentives should therefore be increased if it is marginally profitable regardless of the tax.

140. Dabrowski *et al.* present evidence of the problems firms have encountered in seeking to rationalise their wage structures.

141. Flexibility cannot be taken too far and would have to remain conditional. Otherwise a bargaining process would once again be established and with it, a soft budget constraint.

142. See local initiatives For Employment Creation, *Implementing change: entrepreneurship and local initiative,* OECD, Paris, 1990.

143. Given the evidently imperfect state of the Polish financial system this argument could, on the face of it, be used to support almost any action. However, the meaning here is much more restrictive: a capital market is imperfect in the sense that an incontrovertibly profitable project promising a market rate of return is not being supported.

144. Under the terms of the Association Agreement, any state aid to restructure the steel industry is contingent on Poland cutting capacity.

145. Such policies include selective tax breaks of one kind or another, credit allocation, subsidies and trade protection. Horizontal policies can also be made so restrictive that they become *de facto* sector specific policies.

146. For a review of arguments and evidence for promoting new industrial activities see G. Grossman, "Promoting new industrial activities: A survey of recent arguments and evidence", *OECD Economic Studies,* No. 14, 1990.

147. See for example M. Bell, B. Ross-Larson and L. Westphal, "Assessing the performance of infant industries" *Journal of Development Economics,* 16 1984. For OECD see *Economies in Transition: Structural Adjustment in OECD countries,* Paris, 1989, Chapter 4.

148. For the important case of South Korea see L. Westphal "Industrial policy in an export-propelled economy: Lessons from South Korea's experience", *Journal of Economic Perspectives,* 4, 1990. For a description of how policy with respect to heavy industries failed in the 1970s see Sang-Woo Nam, *The Korean economy at a crossroads,* Korea Development Institute, 1991.

149. For descriptions of this see OECD Economic Surveys of Spain, Italy, Greece and France.

150. In industrialising economies the arguments usually refer to infant industries and, where justified at all on economic grounds, are therefore heavily based on assumptions about capital market imperfections, and technological externalities. These are debatable. However, in the Polish case the issue is different: Poland already has a very wide industrial base which should be shrunk and rationalised: the question is not what to establish but what to discard and what to retain.

151. Although the Association Council may decide on a different schedule.

152. This was made possible through the Law on Economic Activity which came into force in December 1988. The right to engage in foreign trade is now granted to all types of enterprises. Firms are simply required to register for statistical purposes.

153. GATT, *Accession of Poland: Report of the Working Party,* BISD 15th Supplement, 1968, pp. 109-112.

154. The figures for the CSFR and Hungary were 6.3 and 18.3 per cent respectively. All three countries were subject to more barriers than industrialising countries in general. See U. Moebius and D. Schumacher, *DIW Wochen Bericht,* 35/90, Berlin.

155. U. Moebius and D. Schumacher, *Eastern Europe and the EC: Trade relations and trade policy with regard to industrial products,* Berlin, DIW, 1991.

156. This quantitative assessment of the implementation of the AA was made by EC officials. A GATT submission on the compatibility of the Agreement with the provisions of Article XXIV will be presented sometime in 1992.

157. The original agreement in fact envisaged that over a transition period of two to three years payments would be via clearing dollars. However, decrees introduced by the USSR quickly stopped this plan.

158. The indicative list provided for imports of $1 288 million from the former USSR composed of raw materials and natural gas and exports of $1 655 million composed of electrical engineering, pharmaceutical and foods products. Excluded from the indicative list was an agreement for the delivery of 4.5 million tonnes of crude oil from the former USSR in exchange for hard currency.

159. In December 1991, a clearing payments arrangement was signed with the Republic of Russia and provided for trade of so-called strategic deliveries, i.e., imports of natural gas and crude oil, and exports of raw materials, pharmaceutical and agricultural products. All transactions would have been carried out through the Bank Handlowy. However, the arrangement was later dismissed by Russian authorities on the grounds that Russian enterprises are free to engage in trade with who they want.

160. Under the previous Customs Tariff, commercial and non-commercial imports were subject to a different rate of duty and exports were subject to export duties. Imports from CMEA countries were also exempt from customs duties.

161. Poland extended a uniform margin of preference for imports from non-European countries and regions with GDP per capita lower than Poland's: 30 per cent of the MFN rate is payable for most goods covered. All imports from least developed countries are duty free. The authorities estimate that in 1990, GSP preferences were applied to approximately 5 per cent of total imports.

162. Total suspension of duties was applied to natural gas, crude oil, pharmaceutical and medical equipment. Partial suspension was applied to fish and fish products, parts for electronic equipment, parts not produced in Poland for rail equipment and aircraft, citrus and bananas.

163. The tariff system also changed with the introduction of the Combined Nomenclature, the number of tariff items almost doubling.

164. The proper basis for comparison is debatable. The tariff reductions in 1990 were suspensions so that, from the legal perspective, the tariff policy should be assessed with reference to the formal customs schedule of 1989. In this case there was a net liberalisation for industrial goods (the average tariff falling from 18.7 to 16.3 per cent) offset by increases in agricultural tariffs. From the economic policy perspective, however, the August increases also should be assessed with reference to the 1990 suspensions.

165. Likewise, the phasing out of all temporary suspensions of duties at the end of February 1992 reflects a tactical consideration. The Interim Agreement with the EC provides for the early implementation of the Association Agreement (AA) prior to the full ratification. The AA specifies that tariff concessions apply to the rate of duty in effect at the date of entry of the Interim Agreement, which was 28 February 1992.

166. Effective protection attempts to measure the net protective effect of tariffs on the final good taking into account the reduced protection resulting from tariffs levied on inputs in its

production. For an example of the application of the concept see OECD Economic Surveys, *Turkey*, 1990/1991.

167. It is argued in Poland that tariff restitution is available for inputs used by exporters thereby alleviating this problem. This argument is only partially valid to the extent that the tariff on inputs results in higher domestic prices for substitute Polish goods.

168. Import licences are required for imports covered by international agreements, imports on a temporary basis of machinery and transportation equipment, and for military uses and radioactive materials. Whereas export licences are required for exports covered by international agreements, for goods subject to domestic rationing, and exports on a temporary basis of machinery and transportation equipment. At the end of 1991, import licences were applied on 172 tariff items (beers, wines, spirits, dairy products, gas, oil and military items) for which notifications were made to the GATT.

169. At the end of 1991, import prohibitions applied to 58 tariff items covering contaminated alcohols, car older than ten years, and two stroke cars. Quantitative restrictions applied on 26 tariff items covering alcohol products.

170. In early 1990, 22 tariff items were subject to export quotas due to domestic shortages but in May 1990 the quotas for most of these items were replaced by licence requirements. In December 1990, export quotas were imposed on 20 groups of articles, mainly raw materials, and in May 1991 the list was reduced to goods covered by international obligations: sheep and mutton exported to the EC; metallurgical products to the EC and the United States; and textiles to MFA signatories.

Annex I

The Association Agreement with the European Community

The Association Agreement signed with the European Community on the 15 December 1991 aims to provide an appropriate framework for Poland's gradual integration into the EC. The agreement is wide-ranging, covering almost all aspects of relations between Poland and the EC, and supersedes previous trade and co-operation pacts. Given its breadth, it covers areas within the competence of the member states as well as matters such as trade which is within the competence of the Commission. Ratification will therefore be required from all member states so that entry into force of the full agreement will take some time. Trade matters which are under the competence of the Commission came into force in March 1992 through an interim agreement.

A key obligation of the Agreement is that existing and future legislation will approximate that of the EC; this obligation is binding on future governments. An implication is that Poland will have to harmonise some 7 000 acts and regulations over a ten year period. However, the implementation will be phased. Thus with respect to competition policy, within three years of the entry into force of the agreement the Association Council will adopt the necessary rules for enforcing Articles 85 and 86 of the Treaty of Rome (concerning abuse of dominant position and restrictive agreements). For the first five years, public aid granted by Poland to enterprises will be assessed as if Poland constituted a development region within the EC. After five years the status will be reviewed. There are also phased commitments with respect to standards, financial services and banking and the free movement of capital.

The Agreement emphasises the free movement of goods but transition is based on "asymmetry": the EC and member states have indicated a willingness to offer concessions during the first five years of the ten year transitional period on the basis of concessions to be made by Poland predominantly in the second five year period. A distinction has been made between sensitive products and general industrial products.

There are six protocols attached to the Agreement of which four provide for special conditions: textile and clothing products; products covered by the Treaty establishing the European Coal and Steel Community (ECSC); trade arrangements for processed agricultural products; and trade between Poland and Spain and Portugal. For textile and clothing, the Protocol provides for the elimination of EC tariffs over a six year period. The elimination of EC quantitative restrictions has been linked to the outcome of the multilateral negotiations of the Uruguay Round (UR): the EC will eliminate them in half the

phasing-out period agreed in the UR but not less than five years. In 1990, textile and clothing accounted for 12.8 per cent of the EC imports from Poland.

For steel products, the Protocol provides for the elimination of quantitative restrictions by both parties upon entry into force of the Agreement. There will be a phased reduction of tariffs by the EC during the first five years and by Poland in the second five year period. For coal, tariffs and quantitative restrictions by the EC will be phased-out upon either a one-year or four-year schedule as specified in annexes and Poland's tariffs will be phased-out during the second five year period. The Protocol also specifies that Poland may grant financial support for restructuring its steel sector during the first five year period but conditional upon reduction in capacity. Such assistance may be reviewed by the Association Council and a safeguard clause is included in instances of material injury to respective domestic industry. In 1990, coal and steel products accounted for 13.7 per cent of EC imports from Poland.

For agricultural and processed agricultural products, the provisions of the Agreement are dispersed throughout a package of eight annexes, one Protocol, specific references to EC regulations and specific provisions concerning trade between Poland and Spain and Portugal. Summarising the net effect of these provisions is very difficult indeed.

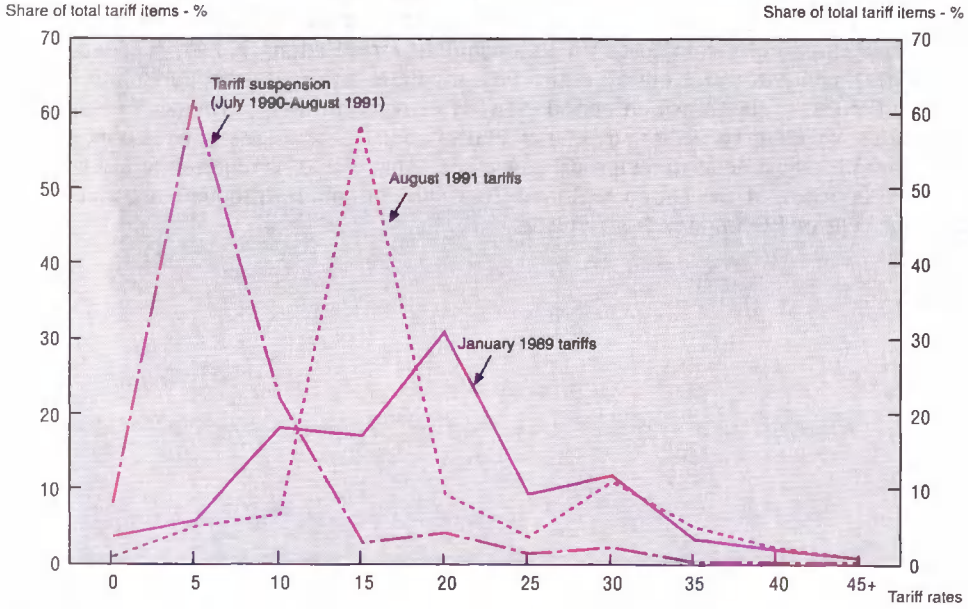
In practice, a very complex system of variable levies is applied by the EC to imports from Poland of processed agriculture products. Duties on the value added at the processing stage are to be gradually eliminated whereas duties and quantitative restrictions will still apply on raw agriculture inputs after the transition period. On the other hand, Poland eliminated upon entry into force all its quantitative restrictions it had, (i.e. alcoholic beverages), and will phase out all duties on agriculture and processed agriculture products by the end of the transition period. The Agreement, however, provides for bilateral safeguards which may be initiated after consultations. The Association Council will decide on the adjustments to reciprocal concessions that would be required following any eventual adoption of the Uruguay Round. In 1990, agricultural products accounted for 21.8 per cent of EC imports from Poland.

Annex II

Customs Tariffs

In comparison with 1989, there has been a considerable equalisation of rates: 58.1 per cent of all tariff items are set at a level of 15 per cent compared with only 14.8 per cent under the 1989 Customs Tariff which was more widely scattered, the median being 20 per cent. This concentration was partly achieved by reducing the

Annex II, Chart 1. **COMPARISON OF THE DISTRIBUTION OF POLISH CUSTOMS TARIFFS**



Note: For the 1989 customs tariffs and the suspended tariffs, the rate referred to is in effect a range (e.g., the 5% rate includes all items between 0.5% and 5%; the 10% rate includes all items between 5.1% and 10%, etc.).
Source: Polish Ministry of Foreign Economic Relations and OECD calculations.

proportion in lower tariff rates: the proportion of tariff items at a rate of 10 per cent and below fell from 26.7 per cent of all tariff items in the 1989 Customs Tariff to 11.3 per cent in the 1991 Customs Tariff. The incidence of low tariff rates declined particularly in the machinery, metals and chemical sectors. Further compressing the schedule, the proportion of tariff items at and below the level of 20 per cent increased from 73.9 to 78.5 per cent under the revised tariff structure. Excluding agriculture, the average tariff rate declined from 18.7 to 16.3 per cent with an uneven distribution by sectors. In summary, while the overall average tariff rate changed only marginally between 1989 and 1991, the average industrial rate declined by 2.4 percentage points and the decline has been more pronounced for some intermediate products (plastic, wood and paper products) and investment goods (machinery, transport equipment and precision instruments). However, there are now fewer low tariff items in proportion to the total.

Annex III

Transition to Market-Based Agriculture

Agriculture is a key sector of the Polish economy: its share of the national income and of employment is around 27 per cent[1] while the associated agro-industries have accounted for 15 per cent of total exports over the last two years. The linkages to both upstream and downstream industries are correspondingly important: about 20 per cent of industrial production is directly or indirectly associated with agriculture. In comparison to other post-socialist countries, the structure of the sector is unique: it is dominated by small scale private farms. There are around 2.1 million private farms which occupy 72 per cent of the arable land; in 1990 they accounted for about 86 per cent of total production. The average size of private family farms is particularly small: 7 hectares, while 53 per cent of farms are below 5 hectares[2]. This private sector coexists with large state-owned farms and a few collectives. There are around 2 260 state-owned farms which employ nearly 400 000 workers and cultivate 19 per cent of the arable land[3]. Paralleling the situation in industry, directors of state-owned farms emphasised production targets to the neglect of costs and profitability.

In line with other sectors of the economy, agriculture has had to adjust not only to the macroeconomic situation (i.e. high and variable inflation, positive real interest rates, tightened credit conditions and nominal demand) but also to structural reforms as evidenced in particular by marked changes in relative prices and trade liberalisation. However, the adjustment problems facing the agricultural sector are somewhat different for two reasons, although the unique problems facing the sector should not be overdrawn. First, the long production cycle (i.e. the long period between cash inputs and cash flows) makes agriculture especially vulnerable to changes in macroeconomic conditions and to structural reforms. Second, in contrast to the service and industrial branches, it is the small private sector which must bear the primary burden of adjusting production costs from existing capacity to the new conditions. The private sector in industry and trade could also face similar adjustment pressures in the future as shake-outs begin.

In response to the adjustment pressures facing agriculture, as well as to the socio-economic problems of rural Poland more generally, policy has been evolving. The options for agricultural policy are, however, severely constrained. A significant percentage of the population will probably be dependent on agriculture for some time to come; agriculture is already highly labour intensive but industry is also characterised by over-manning. Thus a policy to "transfer" population from agriculture to industry or even

services does not seem viable over anything but the longer term. Moreover, policy instruments will have to be carefully considered for Poland cannot afford the high cost of agricultural policies pursued in most OECD countries[4].This Annex briefly describes the adjustment experience to date before considering the policy issues and policy measures.

Difficulties of adjustment

Agriculture was the first sector to be liberalised. In August 1989, prices were freed, purchase guarantees and other administrative controls abolished and consumer subsidies terminated. As a result, the price of foodstuffs for consumers increased: in 1989, the price of foodstuffs rose 20 percentage points more than overall consumer prices. While the price increase was primarily due to the termination of subsidies, farm-gate prices also rose leading to increased profitability of farming. Towards the end of 1989 and early 1990, expectations that these profits might be sustainable led a number of farmers (mainly larger ones) to take out loans for modernisation and expansion.

In 1990, economy-wide price liberalisation and macroeconomic stabilisation caught farmers in a ''scissors'': the cost of inputs soared while selling prices stabilised. The need for adjustment became apparent and a number of underlying weaknesses were highlighted. The increase of relative prices for consumers and the fall in real incomes during the last months of 1989 and the opening months of 1990 resulted in a sharp decrease of domestic demand[5] which was not compensated by increased exports. At the same time, 1990 produced a good harvest. These two factors combined to place downward pressure on farm-gate prices. Weakness of the procurement/wholesaling system also became apparent. The market was dominated by monopsonistic and inefficient ''cooperatives'' which on both accounts led to large distribution and processing margins[6]. In addition to the generalised increase in costs of farm inputs, the burden of debt service rose in line with interest rates; in the first half of 1991 it reached on average 30 per cent of receipts. Overall, the pressure from both prices and costs resulted in the agricultural terms of trade falling by 50 per cent in 1990[7].

The agricultural sector was influenced by conflicting trade developments in 1990 and 1991. The substantial depreciation of the zloty in early 1990 stimulated exports which expanded throughout 1990 and 1991. The growth of exports to Western Europe slowed in the course of 1991 partly in response to the increasing real appreciation of the zloty (see Chapter II). Trade liberalisation and current account convertibility created new possibilities for consumers which were eagerly taken up: imports of processed foodstuffs increased strongly throughout 1990 and 1991. However, almost 60 per cent of agricultural imports were exotic fruit and other food not produced in Poland. Finally, during 1991 the collapse of imports by the former USSR further exacerbated the problems facing farmers by adding to domestic supply. In combination with only a moderate growth in domestic demand, relative agricultural prices declined further (e.g. consumer prices rose by 70 per cent in 1991, foodstuffs by 46 per cent) although the situation improved towards the end of 1991.

First estimates for 1991 indicate that, for the second year in succession, total agricultural production may have decreased (by around 2 per cent on 1990)[8]. But real value added in agriculture appears to have increased quite significantly. This increase is due to a lowering of production inputs: fertiliser use has fallen from 164 kg/ha in 1990 to 95 kg/ha in 1991 while in the first half of 1991, purchases of tractors and harvesters have fallen 14.5 and 86 per cent respectively. The decreased application of production inputs, including investment, may represent increased efficiency on the part of farmers as they adjust to a new pattern of relative prices. But it is also likely to reflect adjustment to uncertain market conditions whereby many small farmers have simply decided to reduce all cash inputs to a minimum and to diversify production so as to spread risks. In the circumstances this is a rational survival strategy. However, the further development of agriculture will invariably require a greater level of cash inputs (including capital) and also improved efficiency to maintain real incomes. Although not too much should be read into the outcomes over one or two years, farmers' real incomes (with respect to consumer prices) decreased further by around 20 per cent between the first three quarters of 1990 and the equivalent period of 1991.

In addition to lower real incomes there are several indicators which suggest that the agricultural sector is having difficulty in adjusting costs to the new pattern of relative prices and market conditions. The problems of the state-owned farms are reflected in their financial condition: as of January 1992, 525 farms had lost their credit worthiness (i.e. about a third of state-owned farms) and 84 were in the process of liquidation[9]. Of greater significance, a number of farms have taken to selling mobile assets in order to pay wages[10]. Private farmers have also experienced increasing financial difficulties but this mostly relates to the larger farms (i.e. those most dependent on cash inputs): in early 1992, about 200 000 farmers owed a total of 3.5 trillion zloty of which at least 10 per cent was overdue. Under pressure from farmers' protests, the government and banks agreed in November 1991 to discontinue debt-collecting proceedings against farmers in arrears. To the extent that this represents a policy decision, there is the danger of an open ended budget commitment and moral hazard, both on the part of changed behaviour by farmers as well as in other sectors of the economy. Such a danger has been exacerbated by the founding of the Fund for the Restructuring of Agricultural Debts, which is to commence operations in July 1992 (see Annex IV). The Fund will receive around 2.3 trillion zloty in 1992 and will purchase farmers' debts from the banks. At the time of writing no further details of how this fund will operate are available.

The evolving policy response

The policy response to the structural and transitional difficulties of the sector has been evolving over the last two years and this process is still not complete. Emphasis has been given to the need to change the structure of agriculture (including both up-stream and downstream industries) but policy has also sought to directly influence market outcomes. In addition, increased sums have been devoted to rural infrastructure. However, by far the greatest commitment of resources to the sector has been in the form of pensions and other welfare benefits for farmers.

Changing the structure of agriculture

The fragmentation and small scale of private farms has been viewed as a major barrier for the development of the sector. Accordingly, restrictions on the maximum size of farms have been abolished, and the regulations covering transfer of property relaxed[11]. Preferential credit and the possibility to buy land on instalments have also been extended to promote the emergence of larger farms but these facilities have been little used. In addition, the restructuring of farms is being supported by the budget through subsidised interest rates for modernisation loans based on individual plans; in 1991 1.5 trillion zloty was budgeted for this purpose (Table 1). To the extent that consolidation is a key to improving efficiency, another factor is important: over half the farmers are near the age of retirement. During 1990 a new retirement scheme was introduced for farmers, paid predominantly by the budget (budgetary subsidies to pension payments account for around 4 per cent of total budget outlays) and special social security provisions for farmers strengthened[12]. For retired farmers, land can be transferred free or sold without affecting pension rights. This is the main source of land transfer at present. Nevertheless, despite the policy initiatives there has as yet been little tendency for farms to consolidate.

Restructuring of state owned farms has been disappointing from both the perspective of ownership change and reorganisation. The Privatisation Act of 1990 excluded state agriculture from its provisions. As a result, action has awaited the Act on Economy of the State Treasury's Agricultural Real Estate which was passed on the 19 October 1991. Under this legislation, an Agency for Agricultural Property of the State Treasury has been established which will take over the ownership, liabilities and commitments of the state farms and will furthermore be responsible for the sale, leasing and management of the farms. Revenue from the sale of state farms will accrue to the agency which in addition will receive 30 billion zloty in subsidies during 1992. Treasury approval for the Agency to issue credit guarantees is limited. Although the Agency is still in its formative stages,

Table 1. **Budget appropriations for agriculture: 1991, 1992***

Trillion Zloty

Structural development, investment subsidies	1.5	0.2
Subsidies for fertiliser and pesticides	0.6	1.3
Preferential credits for fertilisers	1.8	
Preferential credits for storage and processing	1.2	not available
Biological and veterinary services	0.8	2.2
Agricultural Marketing Agency	1.9	1.9
Farmers' pensions	13.6	26.0

* Unofficial: *Rzeczpospolita*, No 70, 23 March 1992

initial policy declarations point to a low priority being given to privatisation and a greater weight to management reforms (tenant and management agreements) as a way of re-invigorating these enterprises. The strategy for dealing with insolvent enterprises and for the enforcement of budget limits is, at the time of writing, unclear.

Policy initiatives to improve the structure of agriculture have also extended to the associated industries. The objective has been to create competitive markets for both agricultural inputs and outputs through deconcentration and privatisation. Results have to date been mixed. Privatisation is well advanced in retailing, but in the food processing industry and wholesaling, progress has been limited. With respect to input industries, privatisation has been slow as have improvements in efficiency. Barring rapid improvements in this area, it is important to maintain an open import policy. Recent tariff changes discussed in Chapter V may not go in this direction but, by increasing the price of inputs, serves to tax agriculture.

Supporting current operations

Another strand of agricultural policy has sought to offset the negative consequences of macroeconomic stabilisation by preferential credits and operating subsidies. An important policy instrument has been the subsidisation of production through preferential credits at half the NBP refinancing rate. These credits have been for the purchase of inputs such as fertilisers and pesticides and for the storage and processing of agricultural products; in 1991 they amounted to around 3.6 trillion zloty[13] (Table 1). At first the credits were automatically granted to eligible farmers which meant a lack of budgetary control and of refinancing on the part of the NBP. However, recently the total interest subsidy has been limited, which implies that the efficiency of the programme hinges on the rationing system put in place by the banks. While such subsidies are often only of limited use, they have remained restricted in scale. More significant from the perspective of resource allocation is the volume of credits which are pre-empted for the agricultural sector and which are therefore not tested against the claims of competing sectors (Chapter III).

Increased market intervention

Falling domestic demand, a sharp contraction of imports by the ex-USSR, increasing imports and difficult access to protected Western markets have all come together to hold down agricultural prices and farmers incomes. One response has been to seek better market access. The Association Agreement with the EC goes some way in this direction (see Annex I) but market access is still constrained by the overall constraints of the CAP. Triangular trade with the CIS (see Chapter V) has also been promoted but little has materialised to date. A second response has been to replace the liberal import regime established for agricultural products in 1990 by an active tariff policy. Tariffs were raised in April 1991 and again in August and are now in the range of 25-30 per cent. The increases have been justified by reference to the practice of the European Community subsidising exports and therefore of the need to countervail. However, a key policy issue is whether import protection will serve to increase exports. The experience of other countries is that protection often taxes exports leading in turn to demands for export

subsidies[14]. A highly inefficient and distortionary instrument is therefore being used to counteract what may well be a wider problem: the real appreciation of the zloty.

''Stabilisation'' measures have also been introduced including some guaranteed minimum prices but cost compensation schemes and output quotas are not at present planned. An Agricultural Market Agency (Agencja Rynku Rolnego) was established in June 1990 with the task of ''stabilising and stimulating, where necessary, the situation of the agricultural markets through purchasing and storing of commodities which could not be placed on domestic or international markets''. The Agency conducts traditional stabilisation activities in a number of products and these have also involved some limited export support grants. Until now the stocks acquired by the agency have not been large enough to pose a major risk to its finances[15]. Under conditions of major structural change in commodity markets some stabilising intervention can be useful[16]. More questionable are guaranteed minimum prices which have now been set for milk, wheat and rye. Despite the limited nature of the programme to date, in 1991 1.8 trillion zloty was still required from the budget. Prices have been set with reference to both the budget allocation (in 1992 there are no budget allocations for minimum prices) and import and export prices depending on whether Poland is an exporter or importer of the commodity in question. Although Poland has avoided the worst features of a CAP type of policy involving an open-ended price guarantee and export subsidies, the pressures are clearly in this direction. This must be avoided for it is very expensive, and does not go in the direction of a market system. Direct support of farmers' incomes, which is at present undertaken via generous pension subsidies, is in fact more efficient. Structural adjustment, as elsewhere in the economy, will be painful, so that it is necessary that it at least be effective and market-oriented. To this end improved market access would be useful.

Annex IV

The Instruments of Monetary Policy

Introduction

In the process of moving away from the centrally planned economy, the NBP in its central bank role has sought to control the growth of monetary aggregates, and to set a framework for the efficient allocation of credit. It has encountered difficulties on both counts, reflecting the time required to develop effective control instruments, but also institutional conditions more generally. The choice of instruments by the NBP for implementing monetary policy has evolved over time, with the aim of abandoning direct credit limits on individual banks in favour of more indirect instruments[17]. However, despite the increased importance of indirect tools of monetary policy, their shortcomings have meant that that the NBP has also had to resort to administrative measures. Over the last two years much has been accomplished, but much more needs to be done to improve instruments of monetary control.

Indirect instruments

The main indirect tools of monetary policy have been control over mandatory reserves; regulating the volume of refinancing credits; adjustments to administered interest rates; and, to a limited extent, open market operations.

Mandatory reserves

Given that the capacity for open market operations is still curtailed by the narrow scope of the market for short-term securities, changes in the mandatory reserves ratios[18] have been a basic monetary instrument used by the NBP. The scope for pursuing an active reserves policy is however limited at present. During 1990 banks developed high liquidity (importantly as a result of the build-up of foreign exchange reserves and transferable rouble balances following the shift in the trade account to a large surplus), and reserve ratios were raised to offset this and so constrain the growth of credit. However, once these ratios rose to the maximum level allowed by the 1989 Banking Act, this tool became non-operational.

There are some drawbacks in relying too heavily on changes in reserve ratios in order to exercise monetary control, as such actions can create problems for banks in the management of their assets and liquidity. In addition, until the passing of the amendment to the Bank Act in March 1992, no interest was paid by the NBP on the obligatory reserves; and to compensate for this forgone revenue, banks were under pressure to maintain large spreads between deposit and lending rates. The Amendment to the Banking Act passed in March 1992 did introduce the payment of interest on those reserves, but – at least for a time – the interest is to be paid into the Fund for the Restructuring of Agricultural Debts (see Annex III). While funding agriculture in this way may meet political or social needs, it reduces transparency, and perpetuates an implicit tax on the banking system whose incidence is ultimately on savings and investment.

The volume of refinancing credit

At the end of 1989 direct refinancing of the banks by the NBP amounted to 65 per cent of total credit, as a result of the large amounts of credit that had been funnelled to central investment projects, agriculture[19], and projects inherited by the newly created banks. The NBP had been obliged to refinance 100 per cent of central investment credits and inherited loans, and also filled the gap in agriculture and housing for political and social reasons. Under these conditions, very little credit was allocated according to market criteria.

In 1990, the NBP decided to reduce the role of refinancing credit in the system. Existing credits were to be converted[20], and new forms – rediscount and Lombard credit – were introduced.

- *Rediscount credit* was first used in 1990. Bills payable for up to three months are accepted for rediscounting[21]. In order to increase the use of this instrument, the central bank offers a lower rate of interest on these than on refinancing credit.
- *Lombard credit* allows banks to obtain credit for up to 12 months against the collateral of securities (NBP and Treasury bills)[22]. However, the low volume of securities and high liquidity of banks have meant that up to now utilisation of such credit has been small.

Over the last two years the importance of refinancing credit has decreased significantly: by the end of 1990 it was 63 per cent lower in real terms than one year earlier. The high liquidity which banks enjoyed throughout 1990 and early 1991 contributed to diminish their demand. Moreover, inflation eroded the value of the inherited portfolio of central investment loans. Therefore refinancing credit is becoming a less important source of finance for the banking system. Nonetheless, it still amounts to about 20 per cent of the total volume of credit in the economy.

The aim of restricting access to refinancing credit as a means of controlling overall credit expansion is undercut to an important extent by the continued existence of privileged channels of credit. Following the introduction in August 1990 of unlimited refinancing credit for agricultural loans, these credits grew rapidly. Indeed, at the end of 1990 refinancing credits to BGZ accounted for over 90 per cent of the total. Privileged credit for agriculture continues, though the form of awarding credits has been changing:

basic credit is being replaced by rediscount of agricultural bills issued by state and cooperative enterprises engaging in the procurement and storage of farm products (in 1990, this form of credit bore interest lower than the market rate, and the Treasury covered the difference)[23]. It is obvious that this way of financing agriculture cannot go on indefinitely, but social and political pressures render reform extremely difficult. Similar preferential schemes are also still in place for housing and central investment.

Interest rates

At the present stage of financial market development in Poland, market-determined interest rates play only a limited role as yet[24]. Furthermore, lack of competition in the banking sector means that administrative decisions, rather than market forces tend to shape deposit and lending rates. The interest rate on refinancing credit, which is adjusted relatively infrequently, (it was last changed from 44 to 40 per cent in September 1991) remains the main determinant of the general level of interest rates, as about 80 per cent of credits in the economy are linked to it. This linkage is due in part to the policy of the PKO BP bank, which finances housing construction, and which sets its interest rate two percentage points above the base rate on refinancing credit. Because this bank occupies a dominant position in the market (it still accounts for 30 per cent of all deposits and 20 per cent of all credit), the rates it adopts are an indicator followed by other banks, including private ones. While in principle, the group of nine state commercial banks (which account for 45 per cent of all deposits and 50 per cent of credits), could pursue an independent interest rate policy, they have not done so to a great extent, partly because they face moral suasion from the NBP to limit increases in lending rates, and to maintain minimum deposit rates for some types of deposits[25]. Banks have also come to regard the interest rate on refinancing credit as an official inflation forecast. Setting their interest rates on that basis, they hope to preserve their positive real value and, at the same time, are spared the need to make their own inflation forecasts.

Open market operations

NBP bills

The 1990 budget surplus precluded the issue of Treasury bills. Therefore, in order to mop up the excess liquidity of the banks and to open the possibility of open market operations, the NBP decided to issue its own bills from April 1990. These were originally 30 days bills – there are now 91 and 182 days bills – and had a face value of 10 billion, 1 billion and 100 million zloty. The bills, sold at a discount, are offered to domestic banks, economic subjects and to natural persons at weekly auctions. The buyer may sell these bills back to the issuer before they mature, at a price announced by NBP at weekly intervals.

The market for NBP bills is too small for open market operations, but served its purpose of absorbing excess bank liquidity in 1990. However, any expansion of issues could be misguided for several reasons. First, lower-denomination issues to private holders make them an alternative store of savings, thus making the NBP compete with commercial banks. Second, the interest payments could lead to a substantial expansion of

the money supply. Finally, the automatic buying back of the NBP bills at the request of the investor implies that the NBP loses control over the monetary base. It is important, therefore, that if NBP bills are not withdrawn, they should be limited to a sterilisation instrument, and that there should be a secondary market, with the NBP acting exclusively as a broker.

Treasury bills

Beginning in 1989, and continuing up until April 1991, the Treasury had a programme to issue securities to the public. Two instruments were developed: 6-month bonds and longer-term (5½ year) bonds that could eventually be converted into shares in privatised enterprises. Bonds worth five hundred billion zloty were sold, 50 per cent of which are still in circulation. In April 1991 the emission of Treasury Bills started. These are sold at weekly auctions organised by the NBP, and have maturities of 4, 8 and 26 weeks, with demand greater for the shorter maturities[26]. To the end of 1991 over 10 billion zloty were sold (89 per cent of which to the banking system). There are plans to change the system, so that from 1992 the NBP would stop selling bills and there would only be Treasury Bills. The Central Bank will organise the secondary market, but will be forbidden from buying them directly. The market has at times been slack and supply has exceeded demand, due mainly to the insufficiency of domestic savings[27], but also to fears of a rekindling of inflation, so that preference has always been toward shorter-term maturities.

Henceforth it may become possible to undertake larger-scale open market operations because domestic debt is due to increase substantially. This is partly a consequence of the growing budget deficits and concomitant servicing costs, but also reflects the need to issue paper to cover the Treasury overdraft with the NBP (about 18 trillion zloty in 1991), pay arrears to PKO BP on account of the capitalisation of mortgage payments and settle the foreign currency debt of Bank Handlowy *vis-à-vis* the banking system[28]. In the near future it is also likely that the Treasury will have to issue longer-term bonds in order to recapitalise the banking system and undertake the financial restructuring of the state-owned enterprises.

Direct methods of controlling liquidity

The high liquidity of the banking sector throughout 1990 (measured in terms of the banks' deposits with NBP above the level of mandatory reserves) and the faster than expected growth of the volume of credit made it clear that the indirect instruments of monetary control that had been relied on up to then needed to be re-enforced. In order not to exceed its targets for Net Domestic Assets growth the NBP therefore introduced administrative guidance over credit expansion by the commercial banks beginning in late 1990[29]. This guidance, which continued in 1991, is applied in the form of quantitative targets for credit growth, and directly affects the individual 14 main banks (the nine state banks, PKO BP, Bank of Food Economy (BGZ), PKO SA, BH SA, Bank for the Development of Exports SA) which grant about 90 per cent of total credit. Furthermore,

since deposits from these 14 banks are the main source of financing for the other small commercial banks, indirect control over credit expansion by these banks has been enforced since mid-1991 by including such deposits within the overall credit ceilings set for the 14 banks. Long-term loans from foreign institutions are excluded from the credit ceilings.

Policy response

In order to strengthen the effectiveness of monetary policy tools in the control of monetary aggregates and allow more efficient credit allocation, some important reforms are necessary, and in some cases steps have already been taken. On a general level, increased competition in the banking sector remains essential, and to this end the envisaged privatisation of the nine state commercial banks is a welcome step. However, the precariousness of their financial situation may delay the process. Second, the NBP should take action to accelerate the emergence of an interbank money market. To this end, it should continue to reduce the scale of automatic refinancing. It could also increase the frequency of checks on the level of mandatory reserves, which would lead to the emergence of demand for very short-term inter-bank deposits (and the NBP could act as a clearing and transfer agent for these). Finally, in view of the inadequacies of inter-bank clearing arrangements, the NBP could undertake to act as an intermediary between the banks, matching those with excess liquidity with those which are experiencing liquidity problems.

The recently passed Amendment to the Banking Act provides the NBP with additional tools. It includes the introduction of a two-tier mandatory reserve system. The first ten per cent would be in a non-interest-bearing account. The second tier would be in the form of interest-bearing deposits at the central bank or of treasury bills. Concomitantly, the abolition of the 30 per cent limit on mandatory reserves should make this tool operational again. On the other hand, the payment of interest on mandatory reserves, in itself welcome, is marred by the fact that the revenue will be directed to subsidise agriculture. Also, the institutionalisation of the NBP's authority to impose credit ceilings on individual banks, while more transparent than the previous administrative guidance, may in practice slow the pace of reform toward relying on indirect instruments.

The proposed phasing out of NBP bills and a greater scope and variety of Treasury securities will contribute to increasing the impact of open-market operations. It is to be hoped that Treasury overdrafts with the NBP will not continue to occur, and that credit of the banking sector to the government can also be brought under control. Otherwise the NBP will continue to experience difficulties in controlling the monetary base. Moreover, the structure of interest rates will have to be set free, reflecting the opportunity cost of funds and expected returns on assets. Finally, so long as large and not-controllable amounts of funds are pre-empted by some privileged sectors, it is likely that the NBP will face continuing difficulties in controlling the money supply; and if this in turn necessitates continued reliance on direct controls, credit will also continue to be allocated inefficiently.

Annex V

Financing Housing Construction

Along with subsidies to the pension fund and debt servicing obligations, the budget has important long term commitments with respect to housing construction which could be very costly and make management of the budget difficult. In 1992 around 20 trillion zloty have been budgeted for the various schemes (around 5 per cent of expenditures) including 10 trillion for interest capitalisation which is discussed below. Poland, along with other ex-socialist countries, is characterised by a chronic housing shortage: there is a deficit of around 1.3 million flats at present while, until the year 2000, it is estimated that about 3.6 million flats need to be built. The present programme for financing dwelling construction was initiated in October 1991 to contain rising budget costs[30]. It seeks to stimulate construction by providing a low and secure level of repayments. However, the system presents substantial dangers for the budget so that security for house builders may have been achieved at a high social cost. In addition, the programme may be inequitable in its incidence and inefficient in stimulating construction and does not appear to effectively address the overall housing problem in Poland.

The new system

The system of new housing finance is based on variable interest rate mortgages with no fixed term (''dual index mortgages''). Under conditions of high and variable interest rates and inflation, a great deal of risk would normally be born by house builders (mainly cooperatives and private owners). To offset this, the new programme seeks to establish a minimum monthly repayment in relation to household income. Any interest which cannot be paid under these limits is to be added to the outstanding capital thereby lengthening the loan repayment period. Under such conditions, banks would face severe liquidity problems. To ameliorate this situation, the budget will repurchase 70 per cent of the ''unpaid interest'', leaving the banks[31] to finance 30 per cent. As the household will repay the full loan over an unlimited period, no subsidy in the narrow sense is involved. The fundamental question to be posed about the programme is whether the ''capital fund'' can be financed and indeed whether it is limited in scale.

The budget will repurchase 70 per cent of unpaid interest for the building of new houses and flats or for the reconditioning of some older buildings for housing purposes provided that mortgages have been granted under the following terms:

- the interest rate is no more than 25 percentage points higher than the refinancing interest rate;
- the mortgage does not exceed 36 times the monthly income of the household in the last quarter before receiving the credit and represents no more than 80 per cent of the total cost of the construction;
- during the first quarter of interest and principal repayments, the household pays 25 per cent of its income in the previous quarter;
- in each subsequent quarter, the minimum repayment is indexed to the average nominal wage growth but the borrower must pay at least 25 per cent of his household monthly income to service the loan.

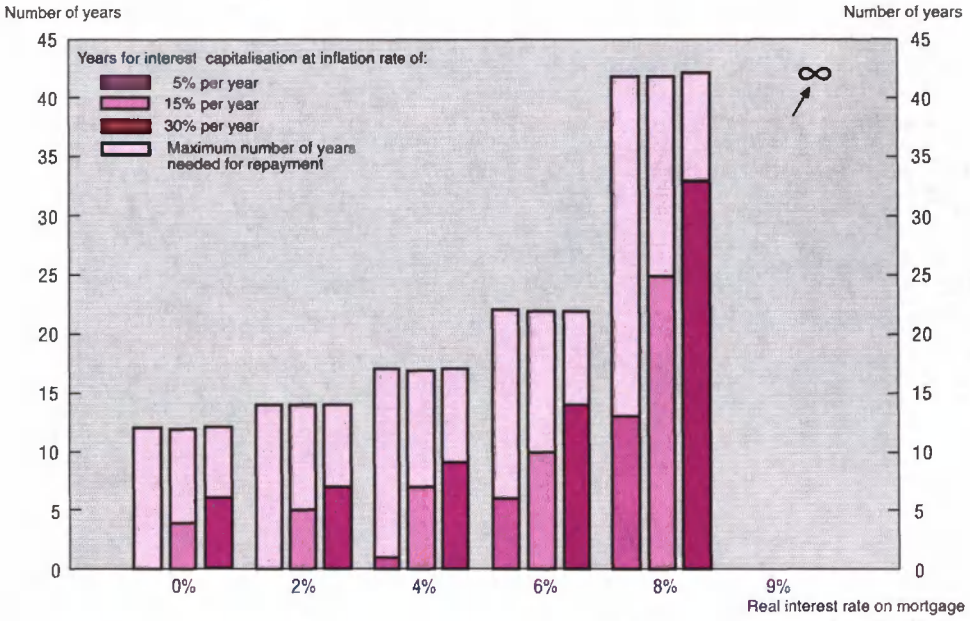
Implications for the Budget

Subject to a number of simplifying assumptions[32], Chart I reports the implications of different combinations of inflation and real interest rates for both the length of the repayment period and the number of years for which interest capitalisation, and therefore budget support, is necessary. For real rates of interest above 8.3 per cent the programme is unstable[33]: unless a household has a positive growth rate of real income it will be unable to ever repay the mortgage. As a result, the debt will increase continually and with it contributions by the budget. This is not simply a theoretical oddity: at present the real rate of interest on housing loans is around 10 per cent while the more general conditions for the programme (i.e. a 25 percentage point limit on the refinance rate) also encompasses this zone. Moreover, if real incomes should ever have to fall the point could be reached where the budget would be subject to almost unlimited demands.

The support required from the budget is a function of the level of inflation (and thereby the level of nominal interest rates) and the real interest rate: an increase in either will lengthen the period for which interest capitalisation will be necessary. The actual impact on the budget, however, is also a function of the cohort effect or the number of years the programme has been in operation: with every year new borrowers will be added to the potential liability of the budget. Some simulations which illustrate this effect are presented in Chart II[34]. In the case of simulation B, there is a continuous increase in budget payments until the ninth year when they account for around 10 per cent of budget revenues (in 1992 10 trillion zloty or around 3 per cent of revenues are allocated for interest capitalisation), at which point the scheme will become increasingly self-financed. Assuming a lower rate of construction (Simulation A), and one which would not alleviate housing shortages, the budget contributions attain a maximum of 3 per cent after 11 years[35]. Under less favourable conditions the burden on the budget attains even higher levels (Simulations C, D, E).

The simulations only report the implications of steady inflation and constant real interest rates over the simulation period on the budget – and on the assumption of no debt

Annex V, Chart 1. **PERIOD OF MORTGAGE REPAYMENT ACCORDING TO REAL INTEREST RATE**



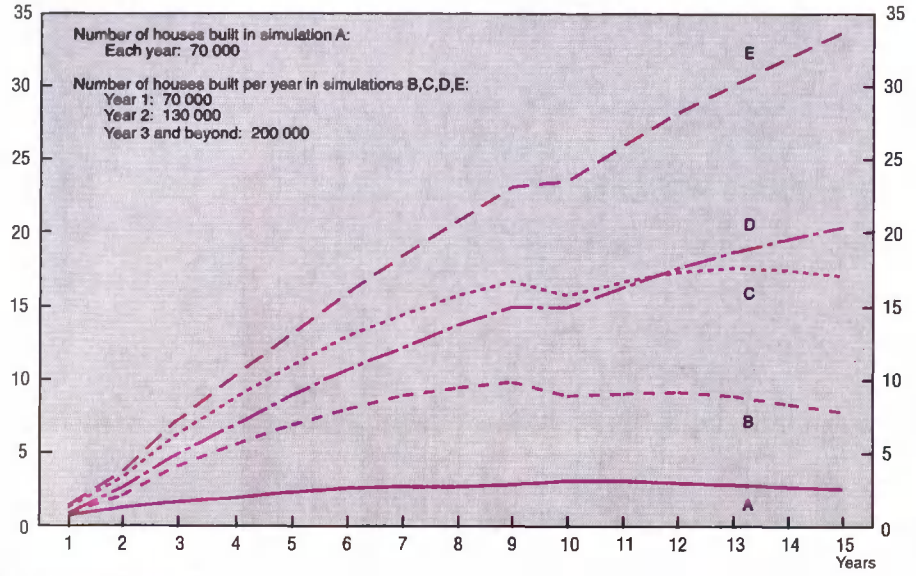
Source: OECD calculations.

defaults. Of equal significance is the potential effect of any short term surge in either inflation or the real interest rate, as well as a decline in income. Under these conditions, and depending on the number of years the programme has been in operation, the liability of the budget for interest capitalisation could increase dramatically. For example, after fifteen years of the programme in which inflation is zero and the real interest rate is 7 per cent, no interest capitalisation would be payable. However, if inflation were to surge to 50 per cent in this fifteenth year, the budget would be liable for payments which would amount to 35 per cent of revenue. The system would therefore appear to be more suitable for a country with a stable and predictable macroeconomic environment than for a country in transition such as Poland.

In order to control such eventualities, the programme specifies that repurchase from the banks will be dependent on the amount provided in the budget. However, such control may in practice be difficult to exercise. For example, in the face of a surge in inflation banks would come under severe liquidity pressure as increasing amounts of interest would have to be capitalised. If the budget refused to co-operate, the banks could well be faced with bankruptcy.

Annex V, Chart 2. **THE BURDEN OF INTEREST CAPITALISATION OF MORTGAGES ON THE GOVERNMENT BUDGET**

Ratio of interest capitalisation paid by budget / budget revenue



Simulation assumptions:

A. 30% inflation; 4% real interest rate on mortgage
B. 30% inflation; 4% real interest rate on mortgage
C. 50% inflation; 4% real interest rate on mortgage
D. 30% inflation; 7% real interest rate on mortgage
E. 50% inflation; 7% real interest rate on mortgage
Borrower income =125% of average monthly household income

Source: OECD calculations.

Interest capitalisation can also imply cash flow problems for the banks and in particular the PKO BP: they must provide 30 per cent of interest capitalisation from their own funds. Under normal conditions, cash flow would be managed by adjusting interest rates on both deposits and loans. However, the latter is effectively capped by the scheme so that most adjustment would have to fall on deposit rates.

Equity and efficiency

In its overall impact the system could be regressive for at least two reasons: access and taxation. Given the high cost of construction and the linkage of loans to income levels, many households with average or below-average incomes will find that the initial investment is so high that they will be effectively excluded from the programme[36]. Moreover, households with higher than average growth in incomes benefit while those

with below-average growth, having met the initial 25 per cent repayment quota, will find that indexation to average wage growth will result in an increasing proportion of income being devoted to debt servicing. While similar situations occur in many countries, it is also often the case that public funds for housing are spread over a wide range of schemes targeted at different income groups. The taxation system would also appear to provide a substantial subsidy to high income house builders: a tax credit allows deductions for both interest and capital repayments. Imputed rentals for owner-occupied housing are not taxed and neither are realised capital gains if reinvested in housing. In addition, although a tax credit is preferable to tax allowances, the progressive schedule of tax rates (20, 30 and 40 per cent) still implies that the value of the subsidy increases with income and is therefore regressive.

There are also grounds for concluding that the system is not efficient. Household saving for new housing is not particularly encouraged while capitalised interest may account for a large share of new credit. Thus other uses of credit will be crowded-out without the benefit of a rational comparison of relative returns. Moreover, the system addresses neither the fundamental question of the reason for the low efficiency of building nor the problems arising in establishing and financing a market in existing housing. Even under conditions of housing shortage, it is not at all evident that construction should be supported rather than housing finance more generally.

Annex VI

Environment

The pattern of economic development in Poland has resulted in serious harm to human health and the natural environment. Recently conducted epidemiological studies implicate environmental factors in reduced life expectancy in the major urban and industrial centres. Water resources have degraded to the extent that they are frequently unfit not only for human consumption but also for industrial usage. Unique ecosystems have suffered or are threatened by irreversible changes.

The World Bank has estimated that the overall income losses associated with this pattern of environmental degradation are in the range of 2.5-3.0 per cent of GDP. While this is considerably less than some figures which had been widely quoted immediately after 1989, it is still two to three times higher than equivalent estimates for OECD countries.

The environmental picture of Poland which is now emerging is one of severe environmental problems in the highly populated urban/industrial centres, coexisting with large tracts of land (about 27 per cent of the land area) in a pristine or close-to-natural state. This suggests that priority actions should be targeted on the major pollution centres in the industrial areas and on preserving the natural heritage.

The primary source of Poland's environmental problems is low quality coal and lignite. Coal accounts for 79 per cent of primary energy consumption, compared with 25 per cent for Western Europe. The high level of subsidies, and the low price of coal, combined with the absence of effective measures for environmental protection, led to an inefficient and highly polluting usage of coal resources. Related to this, the low price of energy underpinned the development of an energy-and resource-intensive industrial structure which also was highly polluting; the iron, steel and chemical industries being the best (or worst) examples. Energy use in Poland as a share of GDP is nearly twice the OECD average.

Emissions of particulates from the combustion of coal have been linked with the major part of the environmentally-related health impacts and the associated economic costs. Reducing such emissions is relatively inexpensive and efforts targeted on emissions from "low stacks" (e.g., domestic heating, small boilers etc.) promise to alleviate a high priority problem in a cost-effective manner. Similarly, a relatively few coal mines are responsible for the bulk of saline discharges which render most of the two major

rivers in Poland (the Vistula and the Odra) unfit for industrial consumption. Measures targeted on the responsible mines, therefore, could have a major impact on environmental conditions.

Poland faces an unprecedented challenge in making the transition to a market economy, restructuring industry and improving environmental conditions, all at the same time. The Polish government has shown imagination and courage in adopting a national Environmental Policy and for insisting that environmental considerations be factored into the restructuring process. The Policy, the first of its kind to have been developed in the region, has the merit of identifying specific objectives in the short (3-4 years), medium (10 years), and long (25 years) term. However, the worsening economic situation is placing even more pressure on enterprises and public funds, and making it even more difficult to achieve the Policy's objectives.

In these circumstances, there is even more pressure to target resources on to priority problems, particularly those where human health is adversely affected, and to find low cost solutions.

The introduction of a functioning market economy should, in itself, provide substantial environmental benefits. In particular, the movement of energy prices toward world market levels will help to reduce air pollution in the short-term and promote an industrial structure in the longer-term which will exert less pressure on the environment. These policy reforms are necessary but not sufficient conditions for achieving environmental improvement: additional investments and institutional reforms also are needed to bring about a sustained improvement in environmental conditions.

Above all, strengthened efforts are needed to integrate environmental considerations more effectively into the reform process. Environmental "rules-of-the-game" need to be clarified in their implementation so as to provide a stable regulatory environment for private sector development. Such clarity is urgently needed in connection with environmental liabilities which may be acquired in the process of privatisation and foreign direct investment. Similarly, standard-setting and enforcement need to be established on a transparent basis.

The regional disparities in environmental conditions reinforce the general political imperative for decentralised environmental management. Decentralisation is also an important consideration in the financing of environmental measures. The environmental benefits of proposed measures can be most effectively assessed against the economic, social and other costs at the local level. Equally, the financing of environmental services, such as water, should be provided by the communities affected. Financing arrangements based on pollution charges have been developed, even in the pre-reform regime, but the levels of charges have been inadequate to match investment requirements. Innovative financing measures have been developed such as eco-banks and debt-for-environment swaps. However, care must be taken that such schemes do not become substitute soft-budget loans and, in the case of debt-for-environment swaps, that they actually provide a real, additional source of finance.

Notes and References

1. In previous years the measured contribution to income was on average 12 per cent. However, given the distorted relative prices existing at that time, it is not possible to make a meaningful comparison with the present.
2. *Rzeczpospolita,* No. 302, 30 December 1991.
3. It should also be noted that state farms are concentrated in particular regions of Poland and are quite heterogeneous in size and structure.
4. For a review of the unintended costs of agricultural policies in OECD countries see OECD Economic Studies, *Modelling the effects of agricultural policies,* No. 13, 1989-1990.
5. As in other areas there is considerable uncertainty with the statistics. Food industry sales show a fall of 30-40 per cent during the first half of 1990 relative to December 1989. The Household Expenditure Survey for April 1990, by contrast, only indicates a fall of around 11 per cent.
6. One author has observed that the ratio of costs and profits to sales price for meat processing plants is 35-40 per cent. In Germany the comparable ratio is 10 per cent. M. Iwanek, *Issues of Institutional Transformation and Ownership change in Poland,* Paper presented to the 9th International Seminar on the New Institutional Economics, 5-7 June 1991, Saarbrucken, Germany.
7. The index in 1989 was 104, 1987 (101) and in 1988, 107 (previous year is equal to 100). Partly in consequence, incomes in agriculture were on par with incomes in other sectors of the economy.
8. The decline is particularly marked in some areas of animal husbandry.
9. The state owned farms have debts to the banking system of Zl 5 trillion. This is small in relation to fixed assets but high in relation to cash flow. The problem is also regionally concentrated.
10. State farms are owners only of mobile assets. Land and buildings are owned by the Treasury.
11. For example, land can be consolidated between two or more farmers free of charge and there is no restriction on who can buy land – only that the land be used for agricultural purposes.
12. In particular, farmers whose income does not exceed the income from two standardised hectares, will be able to receive family benefits for their children.
13. There is uncertainty as to the actual liability incurred since many payments were delayed until fiscal 1992.
14. As import competing farmers may be a different group from exporters, tariff policy is used as an inefficient and non-transparent incomes policy.
15. The Agency aims to limit support buying and selling to no more than 30-40 per cent of the market (interview with Mr. W. Rembisz, *Zycie Gospodarcze,* No. 1, 5 January 1992).

16. It must be noted that many stabilising market mechanisms and traders are absent in Poland. The Agency is promoting the establishment of some of these institutions, including commodity exchanges.
17. For a detailed description see P. Wyczanski and Nowinski, K., *Poland's banking system, current developments and prospects,* Friedrich Ebert Foundation, Economics and Social Policy Series No. 4, Poland 1991.
18. The ratios are currently 25 per cent on savings deposits, 10 per cent on fixed time deposits and 30 per cent on demand deposits. Up to 50 per cent of the amount can be in the form of cash in banks' vaults.
19. In 1989, refinancing credit was the source of 80 per cent of credit awarded by the agricultural bank (BGZ), since deposits were scarce.
20. The conversion of refinancing credit was arranged in the following manner. One tranche was converted immediately into rediscount credit so as to bring the stock of refinancing credit down to 50 per cent of the level of total bank indebtedness that existed at the end of 1989. The remaining refinancing credit was transferred to two separate accounts – 40 per cent to a current account and 60 per cent to a "reserve credit" account that could be mobilised by the banks at their request. The balances in these accounts are to be repaid by the banks in six annual instalments until the end of 1995. Thus, after 1995 the NBP will no longer be providing refinancing credits.
21. The bills must be properly issued and taxed and approved by the rediscount committees of district NBP branches.
22. The credit may not not be more than 90 per cent on the collateral for credits under three months and 80 per cent over three months.
23. See Chapter III for more details.
24. K. Kalicki, *op. cit.,* argues that the inability of the interest rates to reflect return differentials of different assets, both domestic and foreign, increases the variability of velocity and makes more difficult the forecast of the behaviour of monetary aggregates and hence the conduct of policy.
25. Although officially there are no minimum deposit rates set by the NBP.
26. In order to avoid competition between NBP and Treasury Bills, the NBP's have a maturity of 13 and 16 weeks, while the Treasury Bills have maturity of 4, 8 and 26 weeks.
27. On this matter, see J. Czekaj and A. Sopocko, "Financial Markets in the Period of Transition: Determinants, Perils, Prospects", *Institute of Finance Working Papers* No. 20, 1991.
28. Long-term foreign liabilities were on the books of Bank Handlowy, although they had been acknowledged as a liability of the budget and were being serviced through the Fund for the Servicing of Foreign Debt (FOZZ). In May 1990, these liabilities were removed from the books of Bank Handlowy, and explicitly accepted as a government liability. There had also been a long-standing commitment of the government to indemnify the banks for the losses incurred in their domestic liabilities denominated in foreign currency resulting from devaluations of the zloty. In late 1990, the decision was made to give the banks dollar denominated bonds to indemnify them for these losses. In order to provide the banks with a hedge for their outstanding dollar-denominated deposits liabilities, an issue of $5.5 billion was made at the end of 1991.
29. The control of the expected and actual credit in every bank is generally provided monthly.
30. Until 1989, despite rising inflation, households only paid an interest rate of 1-3 per cent on mortgages; the balance was paid by the budget. In 1990, high interest rates (around 100 per

cent) forced a change in the system so that the budget paid 60 per cent of the interest cost, 32 per cent was capitalised and the household paid 8 per cent. In 1990, subsidies from the budget accounted for 4.4 trillion zloty. For mortgages granted before the end of 1990, the system was once again changed in 1991 with the budget partly paying interest capitalisation. In 1991 the budget payments amounted to 2.5 trillion zloty.

31. In practice this is predominantly a problem for the savings bank, PKO BP, which accounts for around 90 per cent of mortgage financing.
32. Budget revenue is held constant in real terms. Over the simulated time horizon the nominal wage, and household income, grows at the same rate as prices (i.e. constant real income) and the real interest rate remains constant. Moreover the real price of housing does not change and loan possibilities are fully utilised by borrowers.
33. More precisely, a real rate of interest which exceeds the growth of real household incomes by 8.3 percentage points. In the simulations reported here, real incomes are taken as constant.
34. For the simulations, it is assumed that real housing prices remain constant. Simulations B, C and D assume that in the first year 70 000 houses are built, 130 000 in the second year, and 200 000 thereafter. This assumption is closer to the rate required to solve the housing shortage. Simulation A assumes a rate of construction at 70 000 dwellings per year which would not contribute to alleviating the housing shortage. Some experts expect effective housing demand to remain at this level.
35. Allowing for the fact that actual payments in 1992 are already expected to total around 3 per cent of revenues, the forecast budget contribution after 11 years would be around 6 per cent.
36. Households with lower incomes will have to save proportionally more than higher income households to make use of the scheme. It is thus important for overall effects whether the incidence of taxation falls on savings or consumption.

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