OECD Economic Surveys

Poland

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OECD ECONOMIC SURVEYS

2001-2002

Poland



ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

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BASIC STATISTICS OF THE REPUBLIC OF POLAND

(2001 unless noted otherwise)

THE LAND

Area (sq. km)	312 690
Arable land (in per cent of total area)	59

THE PEOPLE

Population (million, end-year)	38.6	Employment (million)	14.2
Rural population (percentage of total)	38	Employment by sector (percentage of total):	
Life expectancy at birth (2000):			
Male	69.7	Agriculture	19
Female	78.0	Industry (including construction)	30
Infant mortality (per thousand)	8.1	Services	51

Registered unemployment (percentage of labour force)	16.2
Labour force survey unemployment (percentage of the labour force)	18.3
Number of pensioners (million)	9.4

PARLIAMENT

Bicameral Parliamentary system	
Sejm membership (lower house)	460
Senate membership (upper house)	100
Number of political parties in Sejm (elections of September 2001)	9
Share of seats in Sejm held by governing party (per cent)	47

PRODUCTION

GDP (Zl billion, current prices)	722
GDP per capita (US$, market exchange rate)	4 560
Gross fixed capital formation (percentage of GDP)	22

PUBLIC FINANCE

General government budget balance (percentage of GDP)	–5.0
General government revenues (percentage of GDP)	40.6
General government expenditures (percentage of GDP)	45.5
State treasury debt (end-year, percentage of GDP)	39.2

FOREIGN TRADE AND FINANCE

Exports of goods and services (percentage of GDP)	30
Imports of goods and services (percentage of GDP)	34
Gross official reserves (US$ billion, end-2001)	26.6
Total external debt (US$ billion, end-2001)	70.2

CURRENCY

Monetary unit: zloty (redenominated in January 1995)	Currency units per US$	
	Average: 2000	4.346
	2001	4.097
	May 2002	4.045

Note: For an international comparison, see the Basic Statistics presented at the end of this Survey.

This Survey is published on the responsibility of the Economic and Development Review Committee of the OECD, which is charged with the examination of the economic situation of Member countries.

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The economic situation and policies of Poland were reviewed by the Committee on 10 June 2002. The draft report was then revised in the light of the discussions and given final approval as the agreed report of the whole Committee on 19 June 2002.

•

The Secretariat's draft report was prepared for the Committee by Andrew Burns, Alessandro Goglio and Kwang-Yeol Yoo under the supervision of Yutaka Imai.

•

The previous Survey of Poland was issued in May 2001.

Update, 28 June 2002

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

Assessment and recommendations

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

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

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

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

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Despite stronger export growth, the pickup in domestic demand should cause imports to expand even faster and, as a result, the current account deficit is likely to deteriorate once again, reaching about 5 per cent of GDP in 2003. The failure of employment to increase during past periods of high growth, the concentration of joblessness among certain groups of individuals and persistently high regional unemployment rates, point to the increasingly structural nature of this problem. Without additional concrete steps to remove impediments to hiring, joblessness is projected to moderate only slightly.

Despite substantial rate cuts, monetary conditions remain tight

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

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

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

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expected if members of the Monetary Policy Committee were to serve overlapping terms instead of all being replaced simultaneously, as is currently the case.

... and its communications strategy improved

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

A sharp relaxation of fiscal policy in 2001 contributed to the poor policy mix, followed by a slight further easing

In contrast to monetary policy, fiscal policy eased sharply in 2001, with the general government deficit rising from 2.1 to an estimated 5 per cent of GDP. About half of the increase reflected fiscally expansionary measures. This, and considerable confusion concerning the overall stance of policy during the course of the year, likely contributed to the reluctance of the monetary authorities to reduce interest rates more quickly. In contrast to 2001, this year's Budget incorporates prudent assumptions concerning inflation, output and revenues. Moreover, in a departure from past practice, the government proposed to follow a 1 per cent real growth expenditure norm for State Budget expenditures. If implemented to cover all central government spending, including that of the extrabudgetary funds, such a spending norm could help eliminate the procyclical bias imposed by the present system's deficit target. As passed the 2002 Budget did not apply the proposed norm. It included 2 per cent real growth in State Budget spending and explicitly procyclical provisions to increase expenditures even further if revenues prove higher than expected. Overall, this represents a slight further loosening of fiscal policy and appears to imply

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a cyclically-adjusted general government deficit of a bit more than 4 per cent of GDP.

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

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

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

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

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through product and labour market reforms. These issues are taken up subsequently.

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

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

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

Moving towards a multiyear budgeting framework would facilitate the integration of the funds into the State Budget by providing the ongoing programmes currently operated by them with a longer planning horizon. Furthermore, if coupled with a revised public-investment management system, it would help preclude the kind of delays and cost overruns that uncertain funding has yielded to date. Over time, a multi-year system could evolve into a fully-fledged, output-oriented, medium-term expenditure framework. The current practice of requiring new programme initiatives to include a three-year budgetary impact assessment goes in the right direction. However, more needs to be done

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to evaluate the effectiveness of government spending. "Sunset clauses" would help but, more fundamentally, programmes should increasingly be designed so that their impacts can be accurately measured, eventually giving policymakers the information they need to choose between competing programmes based on both their costs and their benefits (outputs). Moreover, the existence of such indicators should increase incentives within the bureaucracy to improve programmes, as opposed to simply preserving them.

Tax and benefit programmes need to be more carefully evaluated…

Failure to systematically evaluate the impacts of programmes means that those with perverse effects do not get re-examined and revised as they should. For example, although the zero or low VAT rating of a wide range of goods and services introduces significant price distortions and represents fully 6.5 per cent of GDP in foregone revenues, it has very little redistributive impact. A more efficient mechanism to fight poverty would see the standard VAT rate applied more uniformly and the additional revenues used to reduce payroll taxes, which would stimulate private-sector employment and income growth. Indeed, the recent decision to subject interest income to taxation works in this direction by widening the tax base. Similarly, evidence suggests that housing-related tax expenditures have principally benefited the better off, while high social security benefits and regionally undifferentiated minimum wages are contributing to joblessness among the low-skilled. Moreover, rather than offering a personal income tax credit in the full amount of healthcare payroll taxes paid, both the credit and the payroll tax should be abolished, the current treatment having no budgetary impact.

… and reliance on non-transparent methods of financing reduced

In order to reinforce efforts to facilitate effective public expenditure management, the authorities need to avoid financing policy projects with loan guarantees except in cases where a clear market failure is identified. Moreover, rule-based limits should be instituted that stipulate the volume of new guarantees that can be issued as a share of GDP (or total revenues) and which simultaneously impose a separate risk-weighted ceiling on the total of outstanding guarantees. In addition, existing prudential rules should be applied to all state guarantees. The increasingly common

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practice of exempting guarantees from these rules may artificially understate government expenditure by keeping various forms of spending off-book. Left unchecked, such financing mechanisms, coupled with an optimistic evaluation of associated default risk, may be creating a significant hidden liability.

Meanwhile, more co-operation between local governments and better budgetary co-ordination with the centre is needed

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

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

While a reform of public expenditure management would help the government better control and orient its resources towards its priorities, a wide range of structural reforms need to be put into place if potential output, employment and incomes are to be improved. As noted, the government's E*ntrepreneurship*-D*evelopment*-E*mployment* programme explicitly recognises this need. Thus, a reform of bankruptcy law proposes to reinforce creditor rights and to speed the transfer of resources from unproductive firms to healthy growing ones. These changes should help speed restructuring and aggregate productivity performance but would be more effective if creditors were given a more

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

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

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

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The independence of competition and sectoral regulators could be reinforced…

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

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

Although greatly reduced, the State continues to have an important ownership position in the economy, holding a controlling or larger stake in some 3 000 firms. In order for these companies and their workers to fully exploit their potential for job and output growth, they need to be privatised as quickly as possible. To do so, the authorities will need to eliminate some of the cumbersome processes and conditions attached to privatisation. In this regard, the government should rely much less on social and investment clauses which can impose excessive costs on firms, reducing the sale price or even scaring off potential buyers altogether. To the extent that such clauses are binding, they diminish the long-term ability of the enterprise to expand and provide sustainable jobs. Where significant labour market disruption is likely, this should be dealt with using standard social policy instruments. Indeed, most recently the government indicates it will be more rational in the social and investment conditions that it attaches to privatisation deals. In the case of direct privatisations, the State needs to take a more active role in seeking out buyers. Although it provides no direct support to most firms, their sheer number

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prevents the authorities from providing effective corporate governance and their management and employees tend avoid the kind of painful restructuring sometimes associated with privatisation. As a result, these firms pursue efficiency-enhancing measures with less vigour, pay substantially higher wages and under-perform those in the private sector. Moreover, those that are profitable fail to grow as quickly because they have limited access to private savings. The net result for the economy as a whole is slower growth, weaker employment and lower productivity.

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

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

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An aggressive approach to restructuring and privatisation would help promote growth

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

To sum up

I*n sum*, notwithstanding the progress already made, substantial further efforts are required in order to achieve rapid rates of growth in incomes and employment. Indeed, the moderate pace of the projected recovery reflects the slow pace of restructuring and privatisation, widespread structural non-employment and the continued need for reform. To create the best conditions for sustained high growth, both structural reform and macroeconomic policies should be pursued in a coherent manner. In this regard, the macro policy mix needs to be adjusted through a combination of lower interest rates and tighter fiscal policy. Moreover, a clearer statement of medium-term targets by both authorities would improve the credibility and efficiency of macro policy in general. On the structural front, the government's E*ntrepreneurship*-D*evelopment*-E*mployment* programme correctly focuses on reorienting spending away from transfers and towards growth-enhancing policies aimed at promoting the expansion of entrepreneurial firms, infrastructure

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development and reducing Poland's exceptionally high unemployment rate. To facilitate such a reorientation and in order to enhance the government's ability to manage the macro economy, the State Budget needs to be made more comprehensive by reintegrating into it the extrabudgetary funds. Such changes, combined with a more medium-term budgetary orientation and more comprehensive evaluations of spending programmes would make government expenditure more effective and improve democratic oversight. The government's programme would be even more successful and its employment impacts larger, if it reduced those personal transfers to the able-bodied that contribute to inactivity traps, and if the saving were used to finance a reduction in payroll taxes. This, plus steps aimed at increasing the efficiency of bankruptcy processes and reducing administrative burdens on firms and in labour markets, will help speed private sector restructuring and enhance productivity growth. To achieve similar benefits among the more than 3 000 firms in which the State still has a controlling stake and in order to better mobilise private-sector savings and expertise, the privatisation process needs to be accelerated. In this regard, the authorities should reconsider the current approach of restructuring firms prior to their privatisation and should avoid using their ownership position to pursue industrial and social policy goals. Progress on all these scores is essential to further improving overall productivity performance and helping ensure a rapid and sustainable growth in living standards.

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I. Recent economic developments

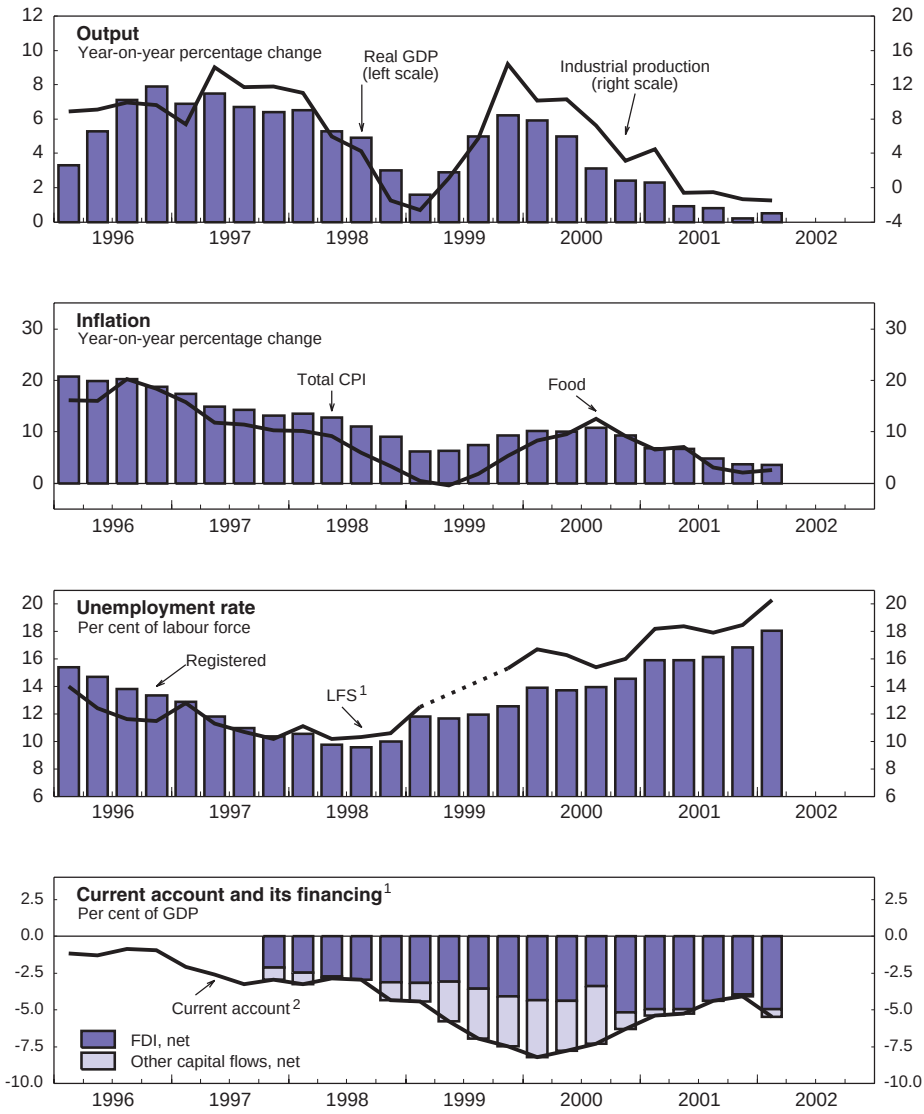
The slowdown in GDP growth that began in 2000 intensified during 2001 and has continued into the first half of 2002 (Figure 1). As indicated in the previous *Economic Survey of Poland* (OECD, 2001a) the cyclical downturn was a necessary and welcome response to the overheated state of the economy following several years of very strong growth and investment performance. Indeed, the slowdown bears the hallmarks of a classical investment cycle, although its impact on activity was exacerbated by the growth slowdown elsewhere in the world. The accompanying deterioration of the Polish labour market is worrisome. At more than 20 per cent of the labour force (on a labour-force survey basis), Poland's unemployment rate is the highest in the OECD and almost half of the working-age population is not working. On the positive side, inflation has come down dramatically and as of May 2002 has been less than 4 per cent for over 6 months. Moreover, there are virtually no indications pointing to a return to higher rates of price increase. In this muted economic climate, indications are that the recovery in output in 2002 and 2003 will be moderate, and unemployment is likely to remain high over the near term. Looking further forward, a number of important reforms will be required in both labour and product markets if unemployment is to be brought down to acceptable levels and the economy is to achieve high rates of growth on a sustainable basis.

A sharp slowdown

Although on average real GDP grew by a healthy 4 per cent in 2000, it began slowing in the middle of that year. That trend persisted throughout 2001, when output increased by only 1 per cent, and into 2002 (Table 1). The driving force behind the slowdown was the drop off in investment activity that began in 2000, with the substantial increases in interest rates effectuated during the course of the previous year playing a major role in this decline. It may also have reflected over investment during the boom years 1998 and 1999 as suggested by the fact that, despite 4 quarters of negative growth, investment still represents 21 per cent of GDP (Figure 2, Panel A). The fall in investment spending was broadly based (Figure 2, Panel B). Both foreign firms (which represent some 37 per cent of all investment) and domestic firms recorded declines and only the water-supply and coal-mining sectors (both dominated by state-controlled companies)

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Figure 1. **Key indicators**
Per cent



1. Cumulated over four quarters.
2. Cash basis.

Source: OECD, Central Statistical Office and National Bank of Poland.

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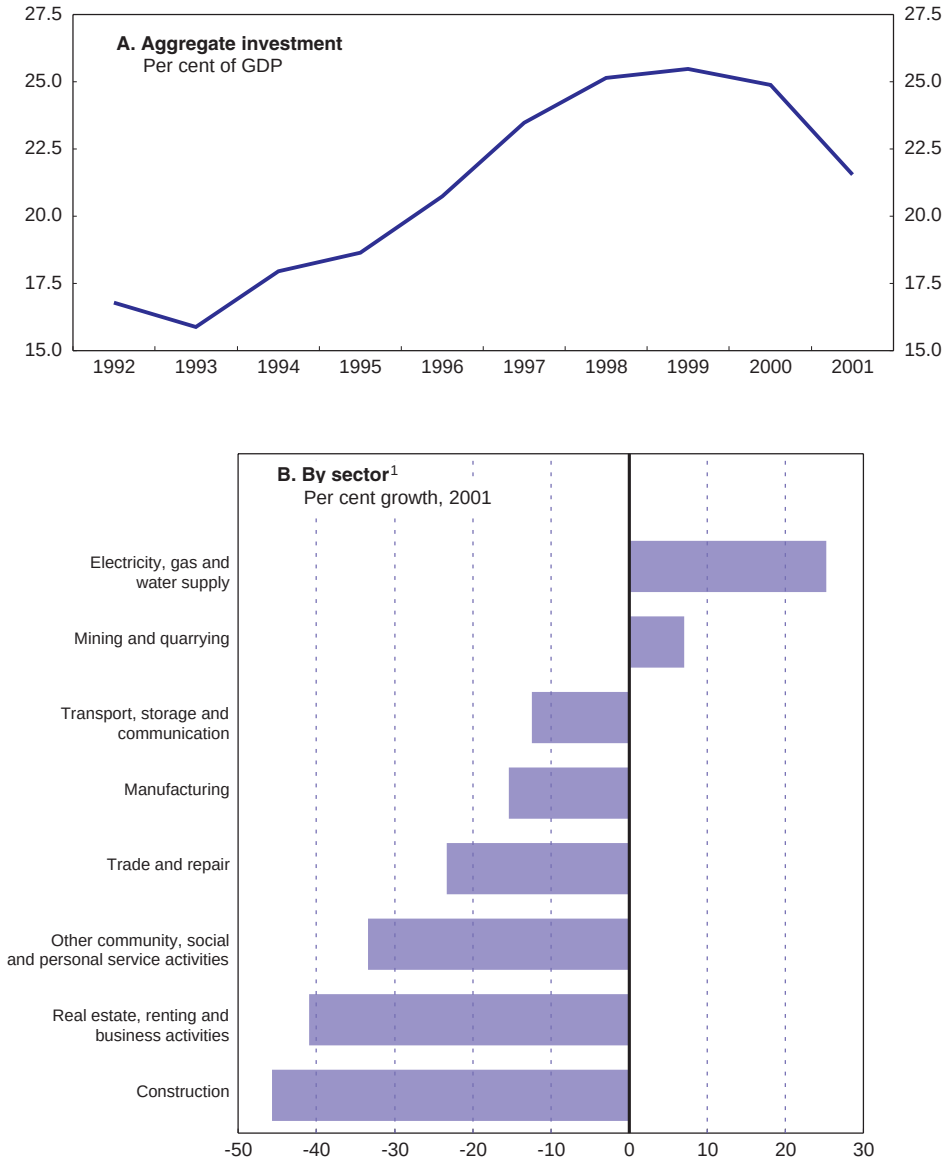
Table 1. **Quarterly gross domestic product**

Volumes, year-on-year percentage changes

	1999					2000					2001					2002
	Q1	Q2	Q3	Q4	Year	Q1	Q2	Q3	Q4	Year	Q1	Q2	Q3	Q4	Year	Q1
GDP	**1.6**	**2.9**	**5.0**	**6.2**	**4.1**	**5.9**	**5.0**	**3.1**	**2.4**	**4.0**	**2.3**	**0.9**	**0.8**	**0.2**	**1.0**	**0.5**
Household consumption expenditure	4.6	5.1	5.6	5.7	5.2	4.9	3.1	1.2	1.7	2.7	1.5	1.6	2.2	3.3	2.1	3.5
Government consumption	1.3	1.2	1.4	1.3	1.3	1.3	1.3	1.6	1.5	1.5	0.2	0.3	0.4	1.6	0.6	. .
Gross fixed capital formation	5.9	6.5	6.8	7.3	6.8	5.4	2.8	2.0	2.1	2.7	1.2	–8.5	–12.5	–13.5	–9.8	–13.3
Domestic demand	**3.4**	**4.6**	**5.5**	**5.7**	**4.8**	**5.2**	**3.3**	**1.4**	**1.7**	**2.8**	**–1.3**	**–1.8**	**–1.7**	**–2.8**	**–1.9**	**0.0**
Exports of goods and services	–9.9	–4.6	2.0	2.7	–2.6	20.8	27.7	22.5	22.1	23.2	10.4	6.9	13.3	12.3	10.8	. .
Imports of goods and services	–3.2	1.6	4.0	1.6	1.0	15.6	17.6	12.7	16.2	15.6	–1.5	–2.1	3.5	–0.4	–0.1	. .

Source: Central Statistical Office.

Figure 2. **Investment performance**



1. In current prices for economic entities employing more than 49 persons.
Source: Central Statistical Office.

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reported positive growth rates.[1] Over half of the total decline in spending concerned buildings and structures, with expenditure on transportation equipment also falling substantially. Cuts to spending on machinery and equipment were more moderate. Personal and government consumption remained relatively robust, and, indeed, show signs of accelerating in the first quarter of 2002. PLZ 1.1 billion in World-War II related compensation payments, a one-time 10 per cent increase in pension benefits and the unexpectedly sharp decline in inflation helped boost disposable income despite falling employment. All told, the fall in investment, the slowdown in consumption, together with a substantial 1.1 per cent of GDP fall in inventories caused domestic demand to decline by 1.9 per cent in 2001.

The world-wide slowdown in economic activity resulted in a dramatic reduction in the rate of growth of exports and imports of goods and services in the course of 2001. Indeed, imports by Poland's trading partners were very weak and actually declined in the second half the year. Nevertheless, notwithstanding a 10 per cent effective appreciation, Polish firms continued to increase their share in world trade – possibly reflecting a substitution away from very weak domestic markets towards stronger foreign ones. The combination of sharply slower export growth and falling investment levels contributed to an outright decline in imports, so that net exports accounted for a large positive contribution to GDP growth.

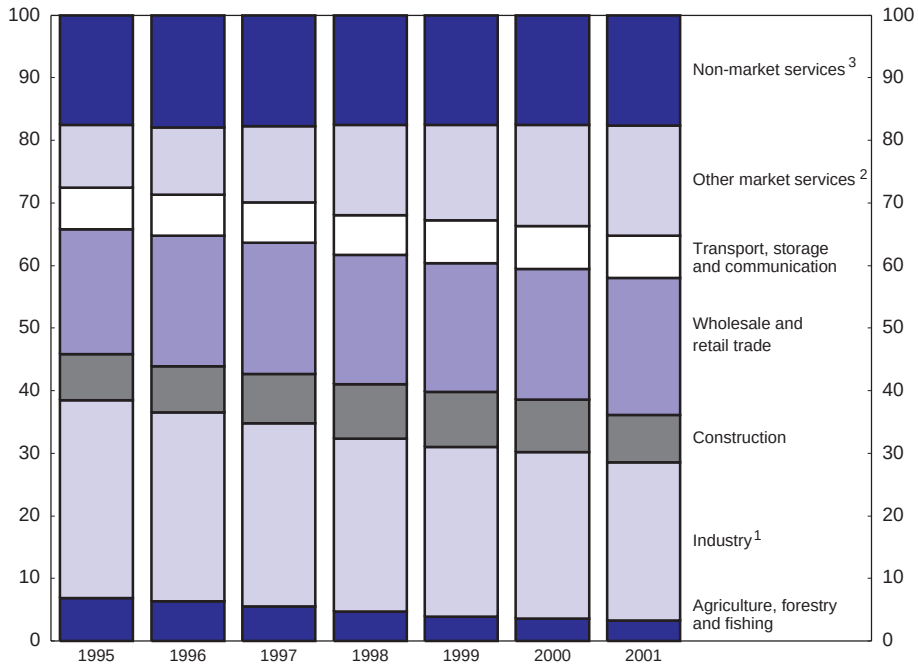
Seen from the production side, the contraction of output has been uneven across sectors. It was sharpest in agriculture, marking the third consecutive year that its value added declined. This reflected not only special factors (bad weather conditions that reduced crop yields, as well as high production costs, declining subsidies and low market prices for animal products), but also a trend decline in the importance of agriculture within the Polish economy (Figure 3). The overall downturn also reflected the results for industry where output declined for the first time since the beginning of the transition, although some manufacturing branches grew relatively strongly.[2] Moreover, activity in the construction sector and particularly building deteriorated sharply in 2001 and early 2002 (Table 2). Growth in the service sector remained robust reflecting both the resilience of consumer demand and a longer-term trend towards an increasing share in value added.

High unemployment

The economic slowdown resulted in a substantial deterioration in the labour market, which was already in poor shape. Indeed, at 20.3 per cent in the first quarter of 2002 Poland's rate of unemployment – based on the Labour Force Survey – is the highest in the OECD and almost three times the area average (Figure 4, Panel A). Statistically, the rise in joblessness since the first quarter of 2001 principally reflected a 3.2 per cent drop in employment levels. However, prolonged difficulties in finding work rather than sudden job-losses are now

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Figure 3. **Sectoral shares in value added**
As a per cent of gross value added



1. Including mining, manufacturing, and electricity, gas and water.
2. Including hotels and restaurants; financial intermediation and real estate.
3. Including public administration and defence, compulsory social security, education, healthcare, social work, and other community social and personal service activities.

Source: Central Statistical Office.

considered the main reasons for involuntary idleness by those who are unemployed (Table 3). Indeed, unemployment is increasingly perceived as a serious structural problem. Almost 50 per cent of the working age population is without work (unemployed or outside the labour force) and a similar proportion of the unemployed have been looking for a job for more than 12 months. Non-employment is becoming more concentrated among the less skilled – notably those with limited educational attainment – whose unemployment rates now exceed 25 per cent. A surge in new entrants following a mini baby boom during the 1980s has exacerbated the chronic problems of limited work experience and poor skills that affect youth and, as a result, more than 45 per cent of them were unemployed at the beginning of 2002.

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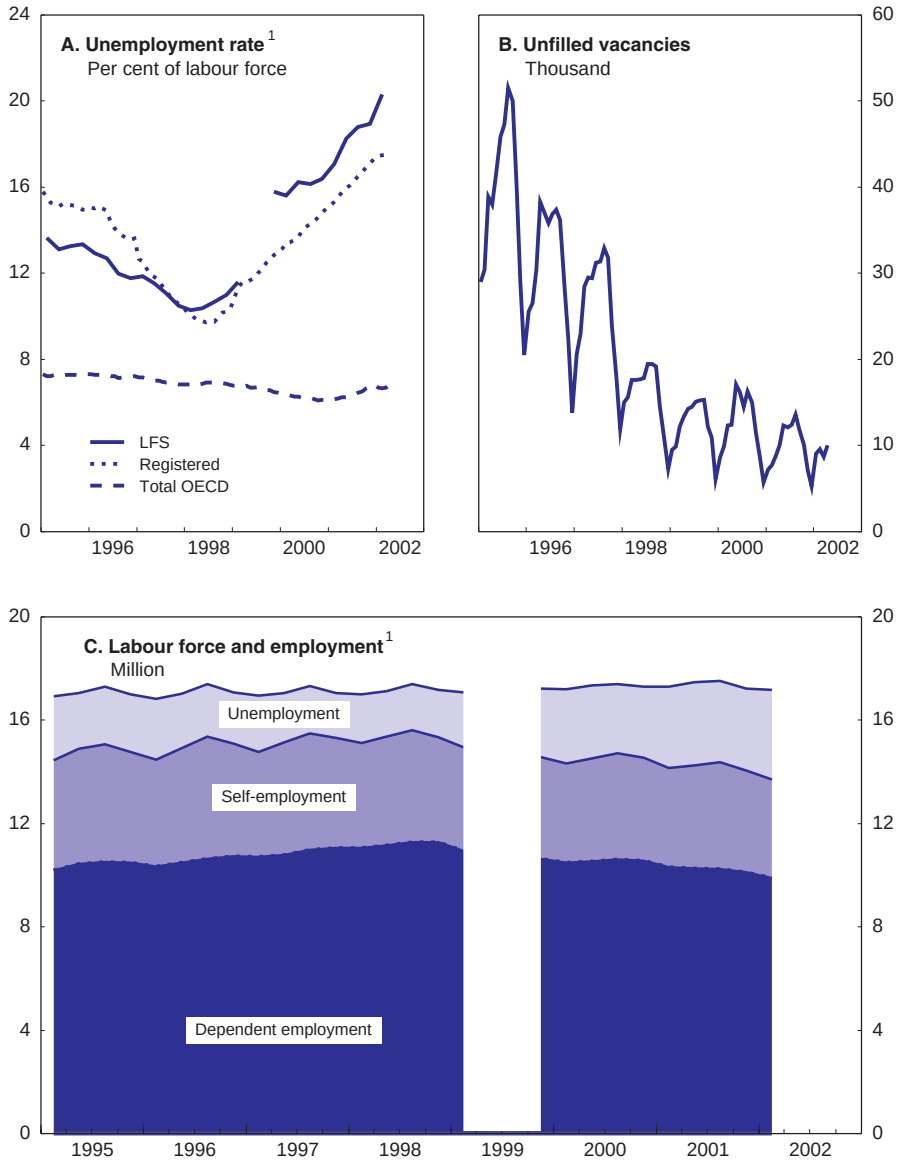
Table 2. **Value added by sector**
Volumes, year-on-year percentage changes

	1999					2000					2001					2002
	Q1	Q2	Q3	Q4	Year	Q1	Q2	Q3	Q4	Year	Q1	Q2	Q3	Q4	Year	Q1
Value added	**1.3**	**2.6**	**4.6**	**5.9**	**3.7**	**5.6**	**4.7**	**2.8**	**2.1**	**3.7**	**2.1**	**0.8**	**0.6**	**0.1**	**0.8**	**0.6**
Agriculture[1]	0.2	–0.9	–0.1	0.4	–0.1	–7.6	–8.3	–7.9	–8.6	–8.1	–7.2	–4.6	–4.3	–16.4	–8.0	. .
Industry and mining[2]	–4.3	–0.3	5.9	9.7	3.0	9.6	9.0	5.9	2.4	6.5	3.3	–1.3	–1.5	–2.5	–0.6	–2.0
Construction	2.0	2.8	3.2	4.9	3.5	4.7	1.4	–1.5	–1.6	0.0	–5.2	–8.0	–8.2	–8.0	–7.6	–12.9
Market services	6.1	6.1	6.5	6.4	6.3	6.0	4.8	2.9	3.8	4.3	3.4	3.5	3.9	4.1	3.8	4.0
Trade and repair	6.3	7.5	7.2	7.2	7.1	7.0	3.0	5.6	0.3	3.9	3.1	5.0	5.2	5.4	4.7	. .
Transport, storage and communication	4.0	12.7	12.8	11.5	10.5	2.2	3.4	0.9	–0.3	3.5	1.1	–2.4	–1.8	0.1	–0.8	. .
Non-market services[3]	–0.4	–0.6	–0.2	1.6	0.2	1.6	2.3	2.9	2.4	2.3	0.9	1.7	1.7	2.3	1.7	. .

1. Including hunting, forestry and fishing.
2. Including manufacturing, electricity, gas and water.
3. Including public administration and defence, compulsory social security, education, healthcare, social works, other community, social and personal service activities.

Source: Central Statistical Office.

Figure 4. **Employment, unemployment and labour force**



1. Figures based on the *Labour Force Survey*, which was not carried out in the second and third quarters of 1999.
Source: OECD and Central Statistical Office.

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Table 3. **Sources of unemployment**
As a per cent of total unemployment[1]

	2000		2002	
Loss of job	52.7		46.5	
Voluntary quit	6.1		4.6	
Can't find work	20.2	41.2	28.0	48.9
Awaiting for job to start	21.0		20.9	

1. Data concern the first quarter of each year.
Source: Central Statistical Office.

Table 4. **Recent unemployment trends**[1]

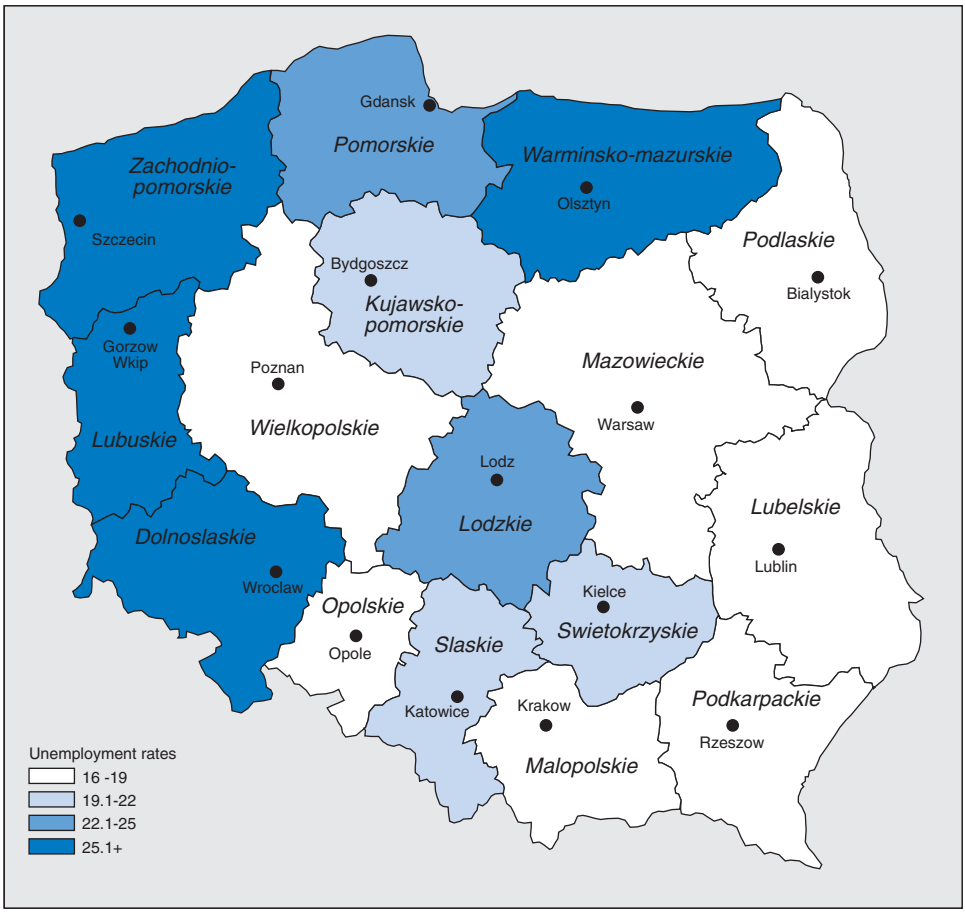
	2000	2001	2002
	Per cent of labour force		
Total unemployment	**16.7**	**18.2**	**20.3**
Males	15.2	17.0	19.6
Femeles	18.5	19.8	21.0
Urban	17.1	19.2	21.2
Rural	16.1	16.7	18.7
By age groups			
15-24	37.9	41.2	45.5
25-34	18.0	19.5	22.2
35-44	14.2	15.4	16.9
45 and over	10.6	11.9	13.5
By education level			
Tertiary	4.8	5.5	6.8
Vocational secondary	13.8	15.0	16.8
General secondary	20.9	21.6	22.8
Basic vocational	20.1	22.7	25.3
Primary	22.1	22.9	26.5
Incidence of long-term unemployment[2] **(per cent of all unemployed)**	35.2	40.2	47.4
	Months		
Average period of job seeking	13.1	13.2	14.7

1. Seasonally unadjusted first quarter figures.
2. Number of workers unemployed for more than 12 months expressed as a percentage of total unemployment.
Source: Central Statistical Office.

The concentration of joblessness among certain classes of worker is mirrored in the geographic distribution of unemployment. Unemployment rates are highest, as they have been for decades, in the relatively sparsely-populated, low-income agricultural regions bordering the Baltic sea and Russia and along the border with the former Democratic Republic of Germany (Figure 5). Notwithstanding

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Figure 5. **Regional unemployment rates**[1]



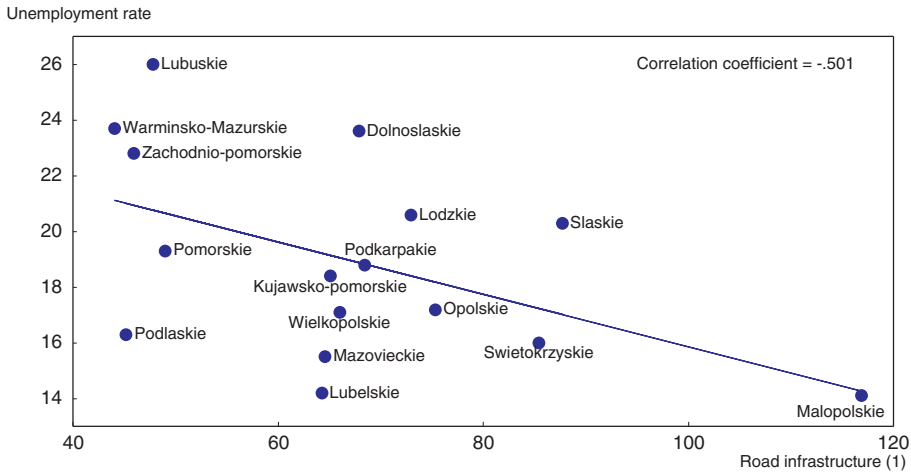
1. Regional unemployment rates (LFS basis) in the first quarter of 2002.
Source: Central Statistics Office.

restructuring in the mining and steel sectors, which has contributed to a worsening of labour market performance in the southern and central regions of Slaskie and Malopolskie, the spatial distribution of unemployment has remained surprisingly stable over time. Those regions characterised by higher than average unemployment in 2002 are broadly the same as those in the 1990s.

To some extent, the concentration of unemployment among certain groups and in particular regions reflects the failure of wages to adjust

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Figure 6. **Regional unemployment and road infrastructure**



1. Kilometers per 100 km^2. Regional unemployment rates (LFS basis) in the fourth quarter of 2001.
Source: OECD calculations based on data from Central Statistical Office.

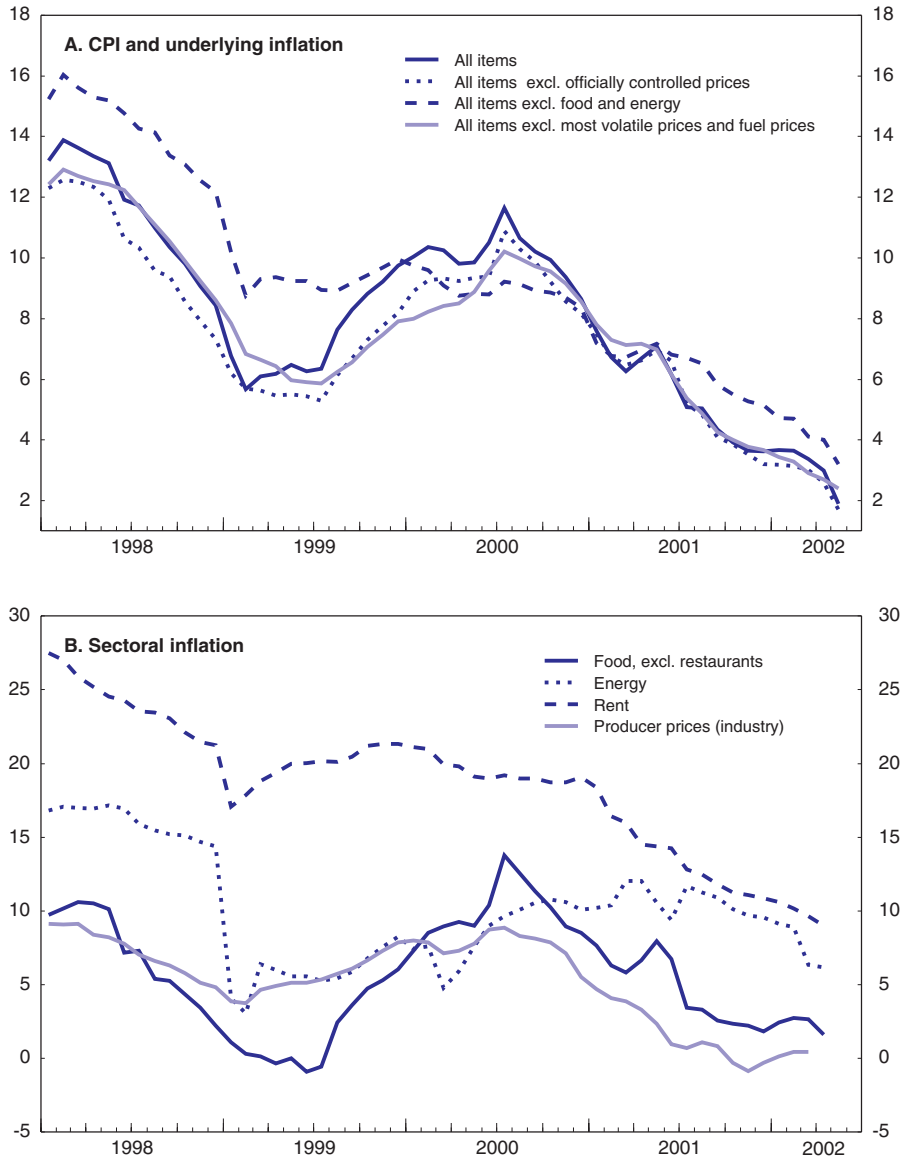
appropriately (see below). However, at least as concerns the regional dimension, it also reflects low internal migration flows (World Bank, 2001) and the uneven market access that Poland's poor roadway system gives to different regions (Figure 6). Experience in both the Czech Republic and Hungary suggests that a well developed motorway with efficient connections to markets in western Europe is a critical element in the success of different regions. Indeed, in Poland regional income and unemployment levels are strongly correlated with roadway density. As compared with the Czech Republic and Hungary, Poland's motorway network remains distressingly underdeveloped with only some 600 kilometres of high-quality roadway.[3]

Declining inflation

The weakness of the economy translated into a substantial fall in inflation during the course of 2001. At 1.9 per cent in May 2002, inflation has been below 4 per cent for more than 6 months, and is well below its previous peak of 11.6 per cent in July 2000 (Figure 7, Panel A). A substantial portion of the disinflationary push came from the weakness in food prices, reflecting both moderate hikes in world prices, a strong harvest in early 2002, and also intensified competition in the retail distribution sector. However, producer inflation was also weak and these prices actually ended 2001 lower than they started it. The sharp decline in

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Figure 7. **Inflation performance**
Year-on-year percentage change



Source: Central Statistical Office and National Bank of Poland.

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Table 5. **Wage and productivity developments**
Year-on-year percentage changes

	1995	1997	1998	1999	2000	2001
Overall nominal wage[1]	31.6	21.9	15.7	12.5	11.1	8.9
Enterprise sector	32.1	21.4	16.1	10.6	11.4	7.1
Budget sector	35.1	23.2	16.8	16.1	15.5	9.6
Overall real wage[1]	3.0	6.1	3.5	4.8	0.9	3.2
Enterprise sector	3.4	5.7	3.8	3.1	1.2	1.5
Budget sector	5.7	7.2	4.5	8.2	4.9	2.5
Labour productivity in the business sector[2]	7.1	6.1	4.0	9.2	6.4	3.9
Output	8.7	7.7	5.5	4.9	4.4	1.1
Employment	1.5	1.5	1.5	–4.0	–1.8	–2.7
Nominal compensation in the business sector[2]	30.8	20.5	5.3	14.1	9.7	7.5
Unit labour costs in the business sector[2]	22.1	13.5	10.9	4.5	3.1	3.5

1. The overall economy index comprises a wider number of activities than the ones covered by the enterprise and budgetary sectors. As a result, the overall growth rate differs from the weighted average of the two components.
2. OECD calculations according to which business sector employment is defined as total employment less public-sector employment as defined in the national accounts.

Source: Central Statistical Office and OECD calculations based on national account figures.

international fuel prices was helpful in this regard. However, their impact on Polish energy costs was masked by delayed hikes in natural gas prices and, as a result, energy inflation remained relatively high (Figure 7, Panel B). The 10.5 per cent effective appreciation of the currency also added to disinflationary pressures by contributing to lower prices for imported goods. This is reflected in the much stronger rate of price growth in the service-sector where imports have a much smaller weight. All told, the Polish National Bank's "net" inflation, which excludes food and energy costs, showed the least tendency to moderate of all the Bank's measures of core inflation and was still at 4 per cent in April 2002.

The rapid drop in inflation in 2001 meant that, notwithstanding some moderation in nominal wages and the weakness of the labour market, they increased substantially in real terms (Table 5). While productivity increased at about the same rate as real wages in the business sector, a more moderate response of real wages would have contributed to a better labour market result. Indeed, data for early 2002 show that private-sector wage growth remains stubbornly high. While not posing an immediate inflationary risk, it does suggest that wage formation is relatively insensitive to market conditions and that it is contributing to the persistence of unemployment both regionally and among certain groups and individuals.

The limited responsiveness of wages to labour conditions partly reflects the substantial difference in bargaining outcomes between the public and private sectors (Table 6). In contrast to many countries, average wages in the public sector are higher than in the private sector and the gap has been growing over the past

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Table 6. **The public-private sector wage gap**

Gross monthly wages and salaries[1]

	1999			2000			2001		
	Average	Public	Public-sector premium[2]	Average	Public	Public-sector premium	Average	Public	Public-sector premium
	PLZ		%	PLZ		%	PLZ		%
Total economy	**1 697**	**1 833**	**115.8**	**1 894**	**2 066**	**117.4**	**2 062**	**2 233**	**114.6**
Agriculture	1 554	1 911	160.6	1 712	2 188	172.4	1 892	2 434	168.7
Industry	1 773	2 257	145.3	1 942	2 468	142.3	2 119	2 685	139.0
Mining and quarrying	2 944	3 001	131.5	3 210	3 193	96.6	3 499	3 489	98.2[3]
Manufacturing	1 599	1 844	119.5	1 756	2 037	119.7	1 925	2 139	113.0
Electricity, gas and water supply	2 305	2 324	115.7	2 563	2 581	113.0	2 797	2 790	97.5[3]
Construction	1 558	1 776	115.8	1 706	1 947	115.7	1 865	2 082	112.7
Trade and repair	1 473	2 303	159.6	1 590	2 453	156.8	1 747	2 610	151.1
Hotels and restaurants	1 209	1 371	116.7	1 301	1 570	125.2	1 412	1 703	124.5
Transport, storage and communication	1 886	1 938	112.9	2 144	2 193	110.0	2 369	2 216	84.7[3]
Financial intermediation	2 690	2 317	77.0	3 258	2 957	86.5	3 648	3 386	90.0

1. Gross monthly wages and salaries. Prior to 2001, monthly wage and salary data include indemnities paid in conjunction with bankruptcy and liquidation procedures. As of 2001 these are excluded.
2. Average public sector wage as a per cent of the average wage in the private sector.
3. The reversals in the public/private sector wage gaps observed in 2000 and 2001 in Mining and quarrying; Electricity, gas and water and Transport, storage and communication respectively, reflect the privatisation of a large copper company, several energy plants and the telecom incumbent (PKT).

Source: Central Statistical Office.

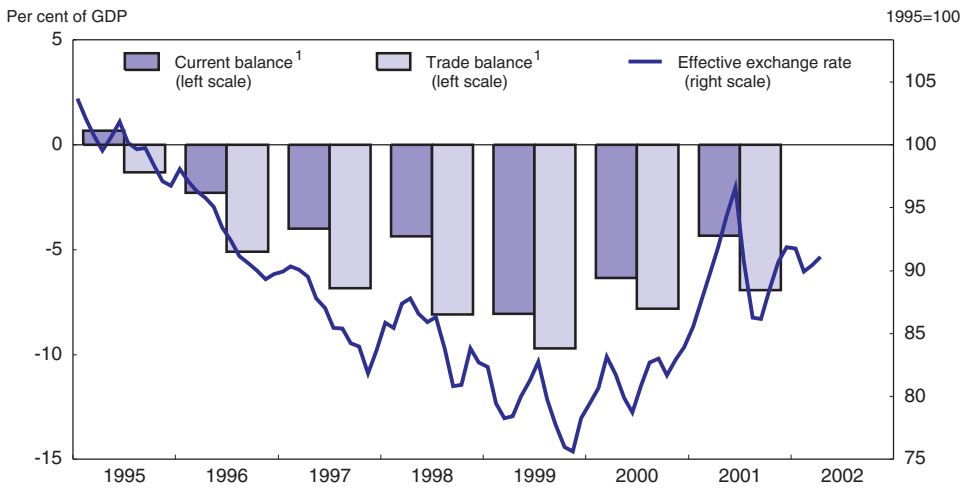
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several years. Moreover, the same pattern is observed within the business sector, with state-owned firms generally paying salaries 15 per cent higher than private-sector ones and offering larger raises. Such a generous remuneration policy adds to inflationary pressures and impedes labour market clearing mechanisms, directly and indirectly, through demonstration effects and competition for workers. Labour is made more expensive for firms, their competitiveness suffers and they are able to hire fewer workers. Indeed, substantial public-sector pay hikes in the run up to the 2001 election were mirrored in the private-sector negotiations that resulted in a 3.5 per cent increase in Polish unit labour costs at a point in the cycle where firms should have been improving their profitability. The 2002 public-sector wage freeze should help unwind some of these effects, although the related gains would be temporary if workers seek to recoup these relative losses at a later stage.

Improving external imbalance

The improvement in net exports on a national accounting basis was reflected in a substantial decline in the Polish current account deficit, which fell by about 2 percentage points to 4.1 per cent of GDP on a cash basis (Figure 8).[4] The trade deficit also improved, coming in at $11.7 billion or 6.6 per cent of GDP as compared with 8.4 per cent the year before (Table 7). Factor income outflows,

Figure 8. **Effective exchange rate, the trade balance and the current account**



1. Transaction basis data; OECD estimates for 2001.
Source: National Bank of Poland and OECD.

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Table 7. **Balance of payments on a cash basis**
USD million

	1997	1998	1999	2000	2001	2001 Jan.-Apr.	2002 Jan.-Apr.
A. CURRENT ACCOUNT	**–4 309**	**–6 841**	**–11 553**	**–9 952**	**–7 166**	**–2 752**	**–3 102**
Trade balance	**–11 320**	**–13 720**	**–14 379**	**–13 168**	**–11 675**	**–3 856**	**–3 324**
Exports	27 229	30 120	26 349	28 255	30 275	9 995	9 713
Imports	38 549	43 840	40 728	41 423	41 950	13 851	13 037
Services: net	**305**	**–488**	**–1 631**	**–1 686**	**–976**	**–412**	**–326**
Credit	3 724	3 683	3 298	3 505	3 988	1 236	1 238
Debit	3 419	4 171	4 929	5 191	4 964	1 648	1 564
Income: net	**–455**	**–569**	**–795**	**–759**	**–896**	**–85**	**–725**
Credit	1 439	2 649	1 877	2 248	2 652	1 068	582
Debit	1 894	3 218	2 672	3 007	3 548	1 153	1 307
Current transfers: net	**1 150**	**1 941**	**1 614**	**1 681**	**1 986**	**487**	**560**
Credit	1 845	2 538	2 209	2 159	2 644	696	776
Debit	695	597	595	478	658	209	216
Unclassified transactions on current account: net	**6 011**	**5 995**	**3 638**	**3 980**	**4 395**	**1 114**	**713**
B. CAPITAL AND FINANCIAL ACCOUNT	**4 864**	**10 991**	**8 241**	**7 660**	**2 980**	**2 260**	**2 510**
Capital account	**90**	**72**	**50**	**13**	**–1**	**–2**	**–4**
Financial account	**4 774**	**10 919**	**8 191**	**7 647**	**2 981**	**2 262**	**2 514**
Direct investment: net	**3 041**	**4 969**	**6 352**	**8 169**	**6 928**	**1 867**	**1 276**
Polish direct investment abroad	–36	–161	–122	–124	–67	–79	10
Foreign direct investment in Poland	3 077	5 130	6 474	8 293	6 995	1 946	1 266
Portfolio investment: net	**1 531**	**1 694**	**867**	**2 591**	**1 109**	**2 182**	**2 025**
Polish portfolio investment abroad (assets)	248	–130	–547	–85	43	204	–109
Equity securities	56	–41	–172	–21	–67	–31	–31
Debt securities	192	–89	–375	–64	110	235	–78
Foreign portfolio investment in Poland (liabilities)	1 283	1 824	1 414	2 676	1 066	1 978	2 134
Equity securities	599	951	882	866	–306	4	–287
Debt securities	684	873	532	1 810	1 372	1 974	2 421
Other investment: net	**–362**	**4 618**	**400**	**–3 382**	**–4 715**	**–1 796**	**–527**
Polish assets	**–872**	**2 168**	**–2 698**	**–2 920**	**–3 500**	**–1 750**	**–315**
Long-term credits extended	–82	–88	–9	126	–21	–40	3
Short-term credits extended	–60	–14	11	26	16	8	27
Other assets	–730	2 270	–2 700	–3 072	–3 495	–1 718	–345
Polish liabilities	**510**	**2 450**	**3 098**	**–462**	**–1 215**	**–46**	**–212**
Long-term credits received	416	1 669	2 057	1 250	–1 567	–430	–328
Short-term credits received	592	–43	441	143	–91	–193	111
Derivatives: net	**564**	**–362**	**572**	**269**	**–341**	**9**	**–260**
C. NET ERRORS AND OMISSIONS	**2 488**	**1 787**	**3 479**	**2 968**	**3 763**	**1 351**	**853**
OVERALL BALANCE	**3 043**	**5 937**	**167**	**676**	**–423**	**859**	**261**
D. FINANCING OF OVERALL BALANCE	**–3 043**	**–5 937**	**–167**	**–676**	**423**	**–859**	**–261**
Official Reserve Assets	–3 044	–5 928	–158	–621	440	–850	–257
Credits from IMF	0	0	0	0	0	0	0
Exceptional financing	1	–9	–9	–55	–17	–9	–4

Source: National Bank of Poland.

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principally interest on foreign loans and the repatriation of profits by local affiliates of multinational corporations, were also up. Early in 2002, merchandise export growth appears to be slowing and, as a result, the current account deficit is rising as compared with the previous year. Foreign direct investment inflows in 2001 were 25 per cent lower than in 2000. Nevertheless, at $6.9 billion, they were sufficient to finance virtually all (96.7 per cent) of the current account shortfall. Much of the slowdown in inflows was due to lower privatisation revenues, which in Poland represent 40 per cent of FDI – a very high ratio as compared with the Czech Republic[5] and Hungary where the privatisation process is virtually finished. Lower privatisation revenues were also reflected in a more than 50 per cent fall in portfolio inflows, which reached $1.1 billion, and a net outflow in equity securities. Meanwhile, lower nominal interest rates helped to reduce the inflow of debt capital, a trend that has persisted in the first few months of 2002.

Potential output

The net result of the slowdown has been to close the large positive output gap observed during the previous four years and to open a sizeable negative one (Figure 9). The rate of increase in potential output has been disappointing. While the estimate presented here is based on a Hodrick-Prescott methodology, the weak growth of potential, notwithstanding the very high rates of investment during the last half of the 90s, likely reflects the weak reaction of employment during this period. As investment levels have dropped in 2001 and 2002, the rate of increase of potential has also decreased, to about 3½ per cent per annum. Unless the Polish economy is able to make better use of available resources by increasing its employment rate and improving total factor productivity, prospects for regaining the fast rates of growth observed during the 1990s on a sustainable basis are bleak.

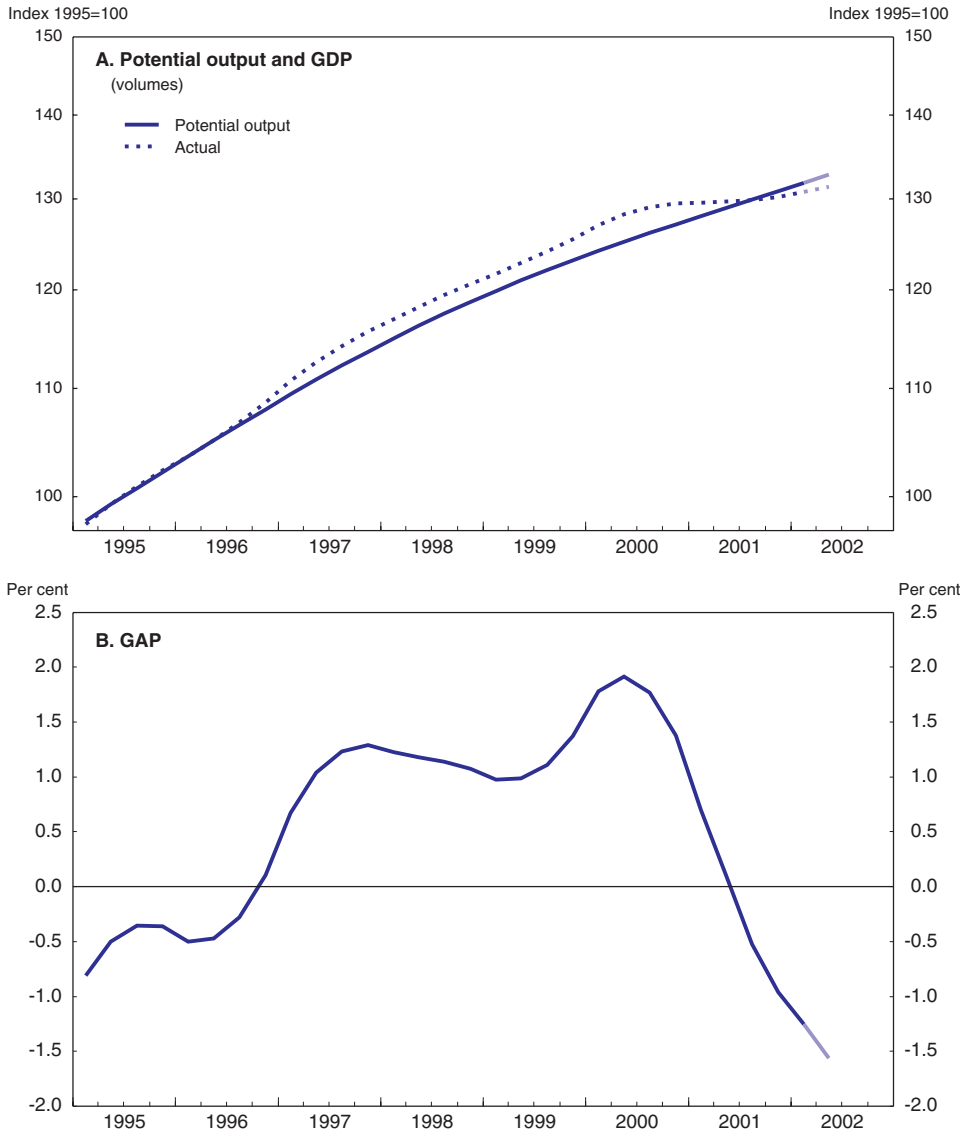
Looking forward

Although the business climate in Poland remains depressed, there are some signs of an upturn. Firms uniformly judge the current situation at historically low levels. Moreover, they expect that domestic demand will deteriorate and increasingly they view the level of their stocks as excessive. In contrast to these judgements, which pertain principally to the current situation, the business sector's perception of future output developments is somewhat rosier mainly because of expectations of increasing export demand (Figure 10).

Given these indicators, GDP growth is projected to remain weak in the first half of 2002 before picking up in the second half and expanding at a relatively moderate 2½ per cent pace in 2003 (Table 8). While consumer demand should remain the foundation for domestic demand in 2002, it is projected to increase less quickly than last year because of lower real wage growth and the absence of special factors such as the World-War II compensatory transfers and last year's

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Figure 9. **Potential output**[1]

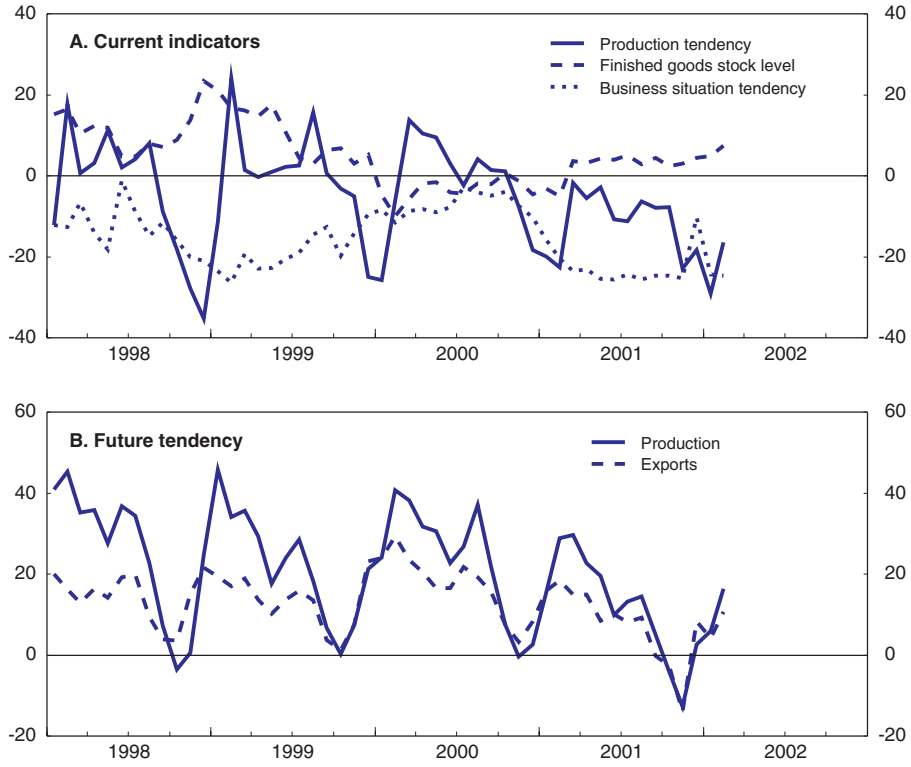


1. Trend real GDP was estimated by applying an Hodrick-Prescott filter to seasonally-adjusted quarterly data. The deviation is calculated as the difference between actual seasonally-adjusted real GDP and the real GDP trend expressed as a percentage of the latter. Data for 2002 Q2 are OECD estimates.

Source: OECD.

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Figure 10. **Business indicators**
Per cent balance



Source: OECD.

exceptional hike in pension benefits. The main impetus for recovery is expected to come from the external sector as recovery elsewhere in the OECD causes Polish exports to accelerate. This turnaround, if accompanied by lower interest rates, is likely to provoke a recovery in investment activity towards the second half of the year. As domestic demand picks up, the destocking process is projected to come to an end prompting a further acceleration in GDP. The recovery in investment and exports should be reflected in stronger import growth, which when combined with higher oil prices, is likely to yield a significant deterioration in the current account balance.

Notwithstanding the improved economic environment, unemployment is expected to continue rising in 2002, before levelling off in 2003. Wages are projected to rise only slowly, which should help reverse last year's rise in unit labour costs and result in improved competitiveness of the Polish economy.

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Table 8. **Short-term projections**

	1998 current prices		2000	2001	2002	2003
	PLZ bil	% GDP	Volumes, percentage change			
Private consumption	346.9	62.8	2.7	2.1	0.8	1.9
Government consumption	90.6	16.4	1.5	0.6	0.4	0.5
Gross fixed investment	139.2	25.6	–2.7	–9.8	0.9	6.2
Final domestic demand	**576.8**	**104.2**	**2.5**	**–0.9**	**0.8**	**2.5**
Stockbuilding[1]	5.8	1.0	0.3	–1.1	–0.0	0.0
Total domestic demand	**582.6**	**105.2**	**2.8**	**–1.9**	**0.8**	**2.6**
Exports of goods and services	155.9	28.2	23.6	10.2	5.8	10.7
Imports of goods and services	184.9	33.4	15.6	–0.1	3.7	9.4
Foreign balance[1]	**–29.0**	**–5.2**	**1.0**	**3.1**	**0.8**	**0.6**
Statistical discrepancy	0.0	0.0	0.6	–0.5	–0.1	0.0
GDP at constant prices			**4.0**	**1.0**	**1.3**	**2.7**
GDP price deflator			7.0	4.3	2.6	3.2
GDP at current prices	553.6	100.0	11.4	5.3	4.0	6.0
Memorandum items						
Private consumption deflator			9.8	5.3	3.5	3.6
Consumption price index			10.1	5.5	3.5	3.6
Underlying price index			10.6	4.8	4.0	3.9
Standardised unemployment rate[2]			16.1	18.2	19.6	19.5
General government financial balance[3]			–2.1	–5.0	–5.4	–5.5
Current account balance[3]			–6.3	–4.1	–4.8	–5.1

1. Contribution to changes in real GDP (per cent of GDP in previous year), actual amount in the first column.
2. Per cent of labour force.
3. As a per cent of GDP.

Source: OECD.

Overall, there appears to be little in the way of incipient inflationary pressures in the economy. As a result, interest rates are projected to fall a further 150 basis points and consumer prices are expected to grow by less than 4 per cent in both 2002 and 2003. At such a level, the central bank's targets for both years would be undershot (see Chapter II).

The timing and the strength of the recovery are subject to uncertainty. If the recovery in the rest of Europe is slower than expected, exports will grow less rapidly, delaying the pick-up in investment spending and the overall recovery of the Polish economy. A similar impact could be observed if interest rates do not ease as projected. This could arise either because the central bank takes a more cautious approach to monetary policy or because fiscal slippage causes market rates to rise as government borrowing absorbs an even larger share of savings. On the upside, if the public-sector wage freeze yields a stronger moderation of private-sector wages than projected, employment and output could respond more quickly, hastening the recovery.

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II. Macroeconomic policies

After 12 years of transition, Poland has succeeded in bringing inflation down to a low rate and has kept it there for 7 months. This is an important accomplishment. Now, the main challenge before both the fiscal and monetary authorities is to ensure the permanence of this achievement, so that the Polish economy and population can reap all of the benefits of price stability. To meet this challenge will require adjustments in the macro policy mix and a more mutually supportive approach on the part of both the monetary and fiscal authorities.

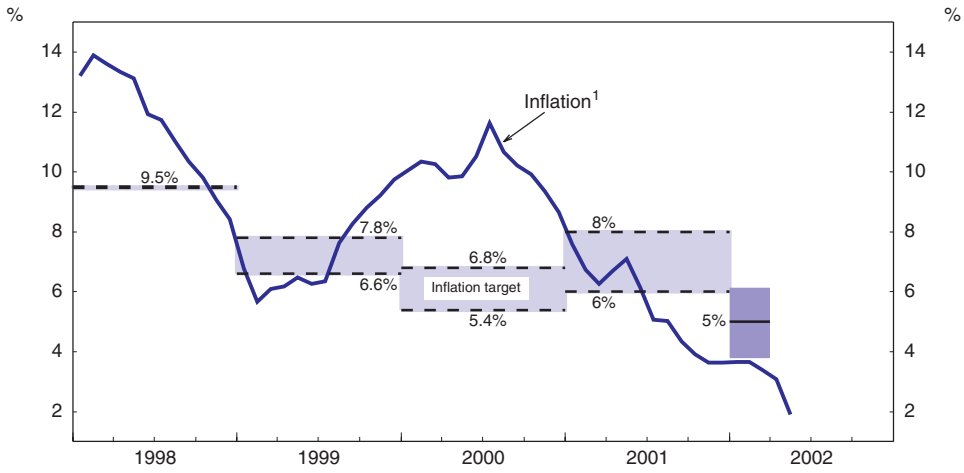
Monetary management

The inflation-targeting framework

The inflation-targeting regime adopted in September 1998 by the National Bank of Poland (NBP) has evolved since. Initially it was operated in the context of a crawling-peg exchange-rate system with wide fluctuation bands but in April 2000 the authorities adopted a floating exchange rate regime. In introducing inflation targeting, the NBP published a *Medium-term Monetary Policy Strategy for the Years* 1999-2003 (NBP, 1998), which set out the goal of bringing inflation down to below 4 per cent by the end of 2003. This strategy has yet to be updated but is supplemented by the Bank's *Monetary Policy Guidelines*, which are published annually, generally in September, and include targets for headline inflation at the end of the following year. Over the past several years, the NBP has announced its short-term inflation target in terms of a 2-percentage-point-wide target band for inflation. However, this year's guidelines broke from this tradition and specified a specific target of 5 per cent, with a permissible fluctuation band of ±1 per cent. The Bank hopes that by emphasising its desire to achieve a specific level of inflation as opposed to an outcome within a range, its communications will be better able to affect expectations. The acceptable range around the target reflects the authorities' recognition that inflation might over or undershoot its target because of factors outside of the control of monetary policy (such as unexpected changes in regulated or world prices, supply shocks, exchange rate fluctuations and unexpected changes in the stance of fiscal policy). Finally, the authorities

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Figure 11. **Inflation and the NBP's inflation targets**



1. Consumer price index: 12-month percentage changes.
Source: Central Statistical Office.

note that if temporary factors cause the inflationary outturn to deviate from their short run targets, monetary policy will react so as to maximise its chances of achieving its medium-term target – rather than the short-term one.

As discussed in the previous *Survey*, Poland's experience with inflation targeting has been mixed. Indeed, while the initial target in 1998 was undershot, inflation exceeded the target band in each of 1999 and 2000, while in 2001 it came in below the band (Figure 11). Moreover, five months into 2002, inflation is still falling and remains well below the official short-term target of 5 per cent as are most measures of underlying or core inflation (see Figure 1).

The substantial difficulties that the Bank has encountered meeting its targets attest to the difficulties of using inflation-targets as an anchor for monetary policy – in a transition economy. *First*, price developments continue to be influenced in a significant manner by non-market forces. Notwithstanding progress in privatisation, the State continues to exercise considerable influence over the economy, both through direct and indirect ownership positions in a large number of privatised firms (see Chapter IV) and because regulated prices constitute a large share of the overall consumer consumption basket. *Second*, as a small-open economy, inflation in Poland is particularly susceptible to external price shocks. *Third*, the changing nature of economic relations as the economy has progressed through the transition and the relatively short time period during which it has

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been dominated by market forces makes predicting inflationary developments particularly challenging. All of these factors make it difficult to select and respect a target for inflation.

Perhaps the principal advantage of an inflation targeting regime over alternative anchors for monetary policy is its capacity to affect expectations. In practice the extent to which expectations can be influenced will depend critically on two factors: the credibility of the Bank (and, as a result, of its targets) and the effectiveness of its communication strategy. In the case of a transition economy like Poland, where the probability of missing a target is perhaps higher than in larger and more stable economies, the Bank's communication strategy is of particular importance in preserving the credibility of its targets. In this respect, its regular publications (*Inflation report*, *Information Bulletin*) and press conferences perform a vital role in disseminating the Bank's view on economic and price developments to both financial markets and the general public. The *Inflation Report* is published quarterly and the more statistically oriented *Information Bulletin* appears twice a quarter.[6] The *Inflation Report*, which in Poland is a publication of the Monetary Policy Council (RPP) as opposed to the Bank's staff, provides an overview of economic events and the RPP's analysis of the main forces acting upon the economy. Typically it is published with a three-month lag reflecting a formal and time-consuming approval process by the RPP and the slowness with which some macroeconomic indicators are made available. Unfortunately, this reduces the timeliness of the analysis that it provides concerning inflation developments, which are typically known with a much shorter delay. This gap is filled somewhat by the pronouncements of the RPP which meets once a month (over a period of two days), discussing administrative issues on the first day and discussing the stance of monetary policy on the second. While the quality of the Bank's printed publications is high, the impact of the *Inflation Report* could be enhanced if it were released in a more timely manner. Moreover, its influence on domestic expectations could be improved if it were to include a more comprehensive but nevertheless approachable executive summary distilling both the conclusions of the report and the evidence that leads the authorities to arrive at them.[7]

More importantly, given the uncertainties surrounding developments and especially given the poor track record of the Bank meeting its targets, more effort needs to be expended in explaining why outturns have deviated from the Bank's expectations. As a first step, the Bank should take steps to publish its own inflation forecasts, perhaps including sensitivity analyses indicating the expected impact that variation in exogenous assumptions (such as world oil or regulated prices) might have upon domestic inflation. Although the *inflation report* provides a qualitative analysis of possible future inflation developments, it should be strengthened by including a more comprehensive discussion of how recent developments compare with previous forecasts and what if any impact these may have on the future conduct of monetary policy. Indeed, somewhat paradoxically, in

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Poland it is the Ministry of Finance not the central bank that makes regular public forecasts of inflation and discusses the implications of developments on prices. In this context it is important for the Bank's medium-term strategy to be kept up to date. The current version dates from four years ago and only extends to the end of next year. Moreover, while the current objective of below 4 per cent may have been sufficiently clear when inflation exceeded 10 per cent, it is too vague in the present context – being consistent with both an increase and a decrease in inflation. A more explicit statement of the Bank's goals over the next several years, perhaps in the form of a target range, would certainly help markets and individuals plan their economic activity in the most rational and efficient manner.

Finally, the credibility of a central bank's policy depends importantly upon its independence and the continuity of its policies. The very public conflict that has broken out between the Bank and the Parliament serves to undermine the credibility of the Bank by raising doubts as to the motivations behind monetary policy decisions and by raising the possibility that future policy will be changed. Thus, as the PNB defines its new objectives, which in the current legal framework are its sole responsibility, it should nevertheless seek to establish a consensus on them with the fiscal authorities. This would not imply any legal or *de facto* reduction in the Bank's independence but would serve to free it and macro policy from the disruptive effects of the recent public feuding.

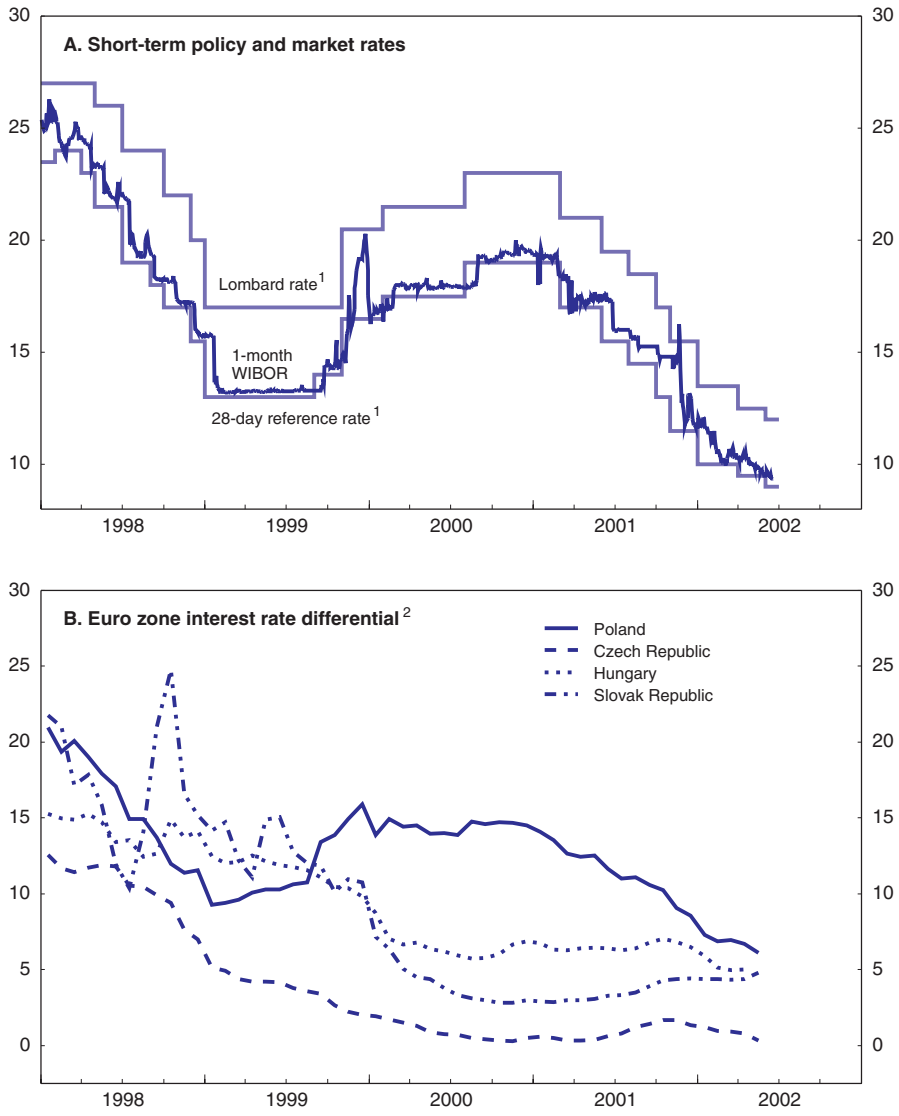
The continuity of monetary policy is also weakened by the fact that the terms of all nine Monetary Policy Council board members expire simultaneously. This raises a systemic risk that the direction of monetary policy will change dramatically each time the council is changed. Moreover, it could introduce an unfortunate political element into the selection process. Indeed, the current Monetary Policy Committee's failure to revise its medium-term strategy may well reflect its reluctance to impose a policy upon its successors. To address these issues and to preclude sudden destabilising and changes in Bank policy, the authorities should revise the constitution so that the terms of Board members overlap. For example, rather than having the entire board replaced once very 6 years, one third of the board could be appointed every two years. As a transition measure, when the current Board's mandate expires one third of the new board members should be appointed for two years, one third for four years and the remainder for six. Indeed, continuity would be best assured if at least some of the short-term appointees were to be chosen from the current board.

The conduct of monetary policy

The rapid rise of inflation in 1999 and 2000 was followed by a substantial hike in short-term interest rates. These remained high well into 2001 even as inflation was falling, reflecting unchanged policy rates (Figure 12). As a result, real interest rates were rising and did not begin

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Figure 12. **Interest rate developments**
Per cent



1. End of month.
2. Three-month interest rate minus 3-month EURIBOR.
Source: National Bank of Poland and Datastream.

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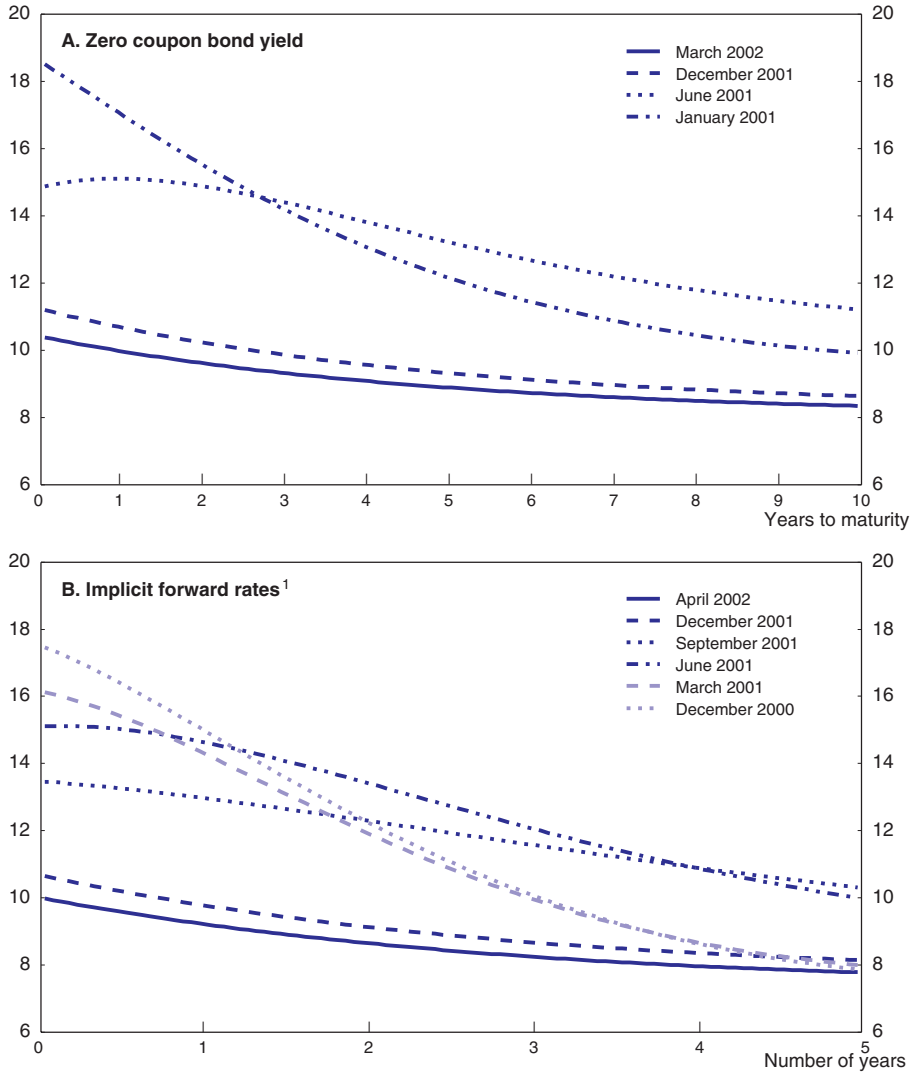
declining until February-March of 2001, when the National Bank of Poland reduced its 28-day reference rate twice. As inflation continued declining the Bank reduced rates a further 5 times. However, real rates remained high at about 9 per cent until the fourth quarter when they too began to decline. Whereas, the 28-day reference rate appears to have been acting as a binding floor on market rates in 2000, during the latter half of 2001 market rates appeared to take fuller advantage of the interest-rate corridor defined by the gap between the NBP's Lombard and 28-day reference rates. As of June 2002, market rates were approximately equal to the reference rates of 9 per cent and the real rate of interest was about 6 per cent. Indeed, in stark contrast to the Czech Republic and Hungary (whose economies are growing much more quickly and in the case of Hungary where inflation is much higher), Poland's interest rate gap with the euro zone remains substantial.

Initially, the fall in policy and market rates saw a flattening of the yield curve as short-term interest rates fell much more than longer-term rates. As a result, implicit 12-month forward rates two or more years ahead actually increased in the second half of 2001 (Figure 13). These developments could have been consistent either with increased expectations for inflation on the part of investors or an increase in the risk premium that they demand for holding zloty denominated assets. Trading evidence suggests the latter explanation as there was a general movement away from longer-term instruments and towards shorter ones during the summer months. Three more or less contemporaneous events might explain these developments: the Argentine financial crisis; the substantial rise in the general government deficit which became public knowledge during the summer (see the next section) and finally generalised uncertainty associated with the terrorist attacks in the United States. By the end of 2001, both short-term and long-term yields had eased further and implicit forward rates five years out had returned to the 8 per cent level. This would appear to be consistent with expectations of a long-term real rate of interest of between 5 and 6 per cent (assuming expected inflation at that time is between 2 and 3 per cent).

The rise in real interest rates during the second half of 2000, was accompanied by an appreciation of the zloty against the euro and to a lesser extent the US dollar Figure 14). This reversed somewhat in the summer as markets reacted to the substantial turmoil surrounding the uncertain stance of fiscal policy in the run up to the fall elections (see the next section). However, by October these concerns and the impact of the September 2001 terrorist attacks in the United States had passed through the market and the zloty once again began appreciating. Overall, the strong real effective appreciation of the currency over the past two years means that notwithstanding the recent cuts in real interest rates, monetary conditions tightened substantially during 2001 and remain relatively tight (Figure 15).

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Figure 13. **Yield curves**
Per cent

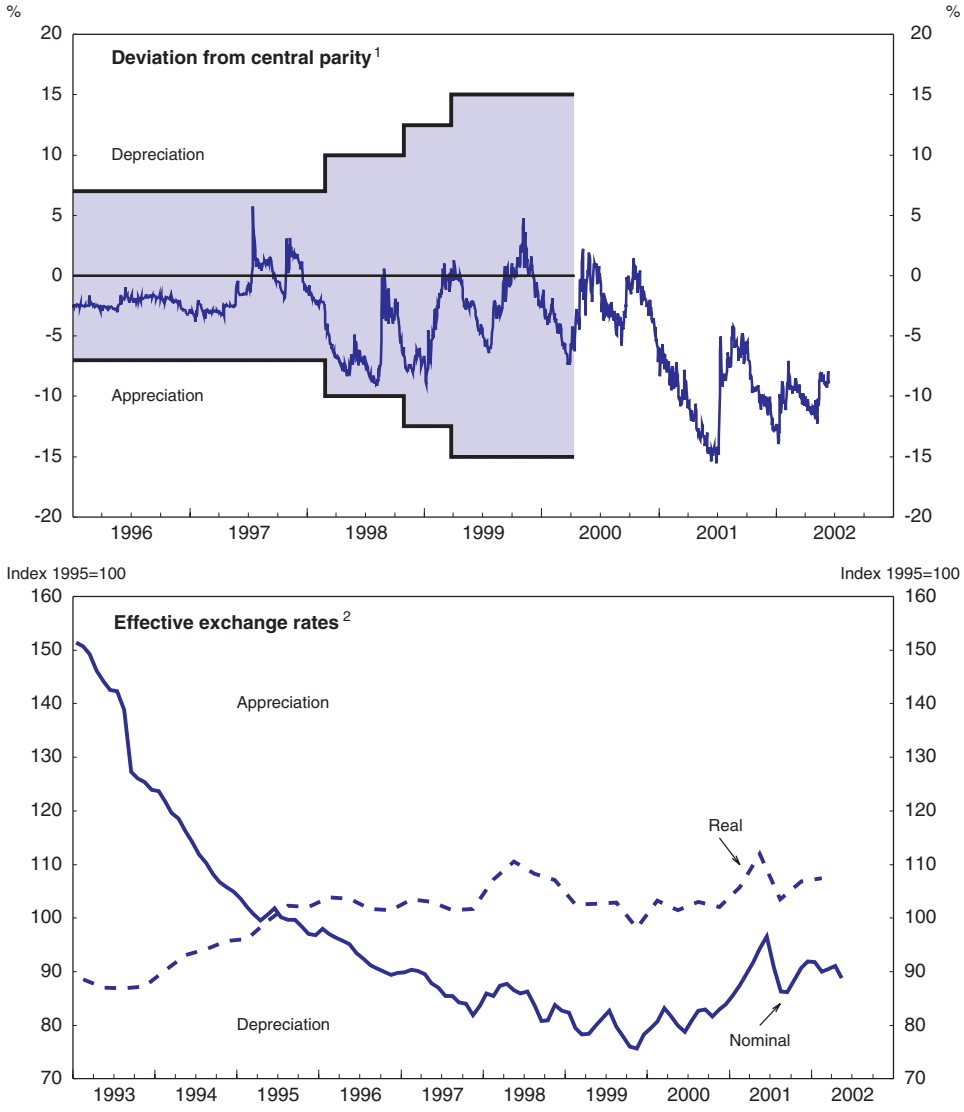


1. The implicit forward rate at time t is the rate of return on a one-year bond issued in year t that would equalise the overall return on a single bond issued at time 0 of maturity t + 1 and the total return on the one-year bond issued at t plus that of a bond issued at time 0 of maturity t. It is, therefore, a proxy for the market's expectation of the one-year rate of interest that would prevail at time t.

Source: National Bank of Poland.

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Figure 14. **Exchange rates**

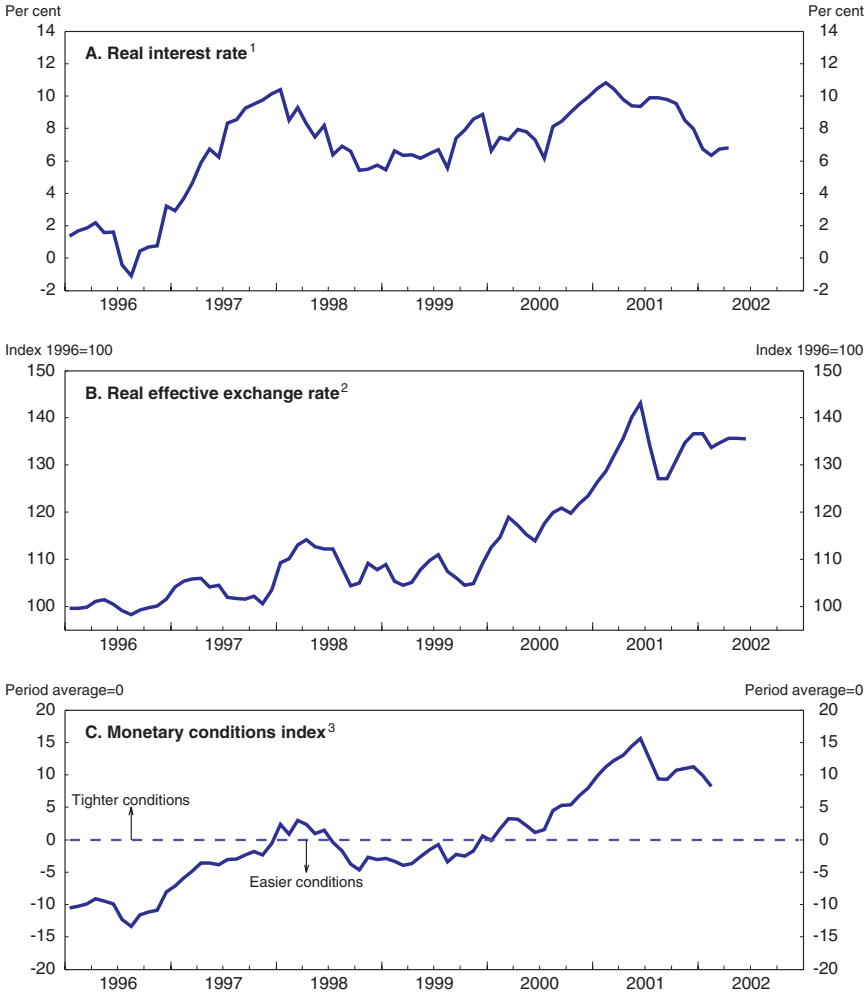


1. Based on data from the National Bank of Poland until 12 April 2000, thereafter OECD calculations. The central parity changed on 29 March 1999 to become a weighted average of the euro (55 per cent) and the US dollar (45 per cent). Beginning April 2000, the zloty has been allowed to float freely.
2. As calculated by the OECD against forty-one other currencies. The real effective rate is calculated using unit labour costs.

Source: National Bank of Poland and OECD.

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Figure 15. **Monetary conditions**

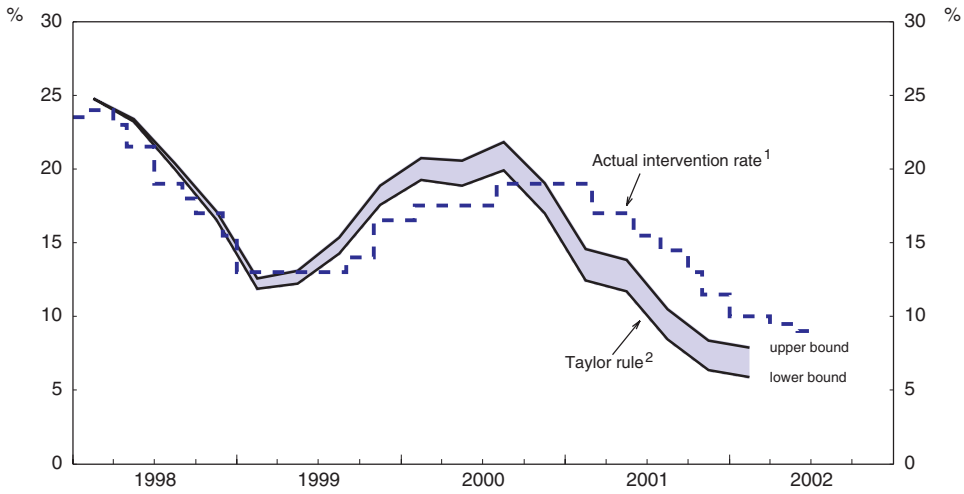


1. Real effective exchange rate calculated with forty-two countries, CPI deflated.
2. Three-month treasury bill, CPI deflated.
3. The monetary conditions index is defined as:
   MCI = MCI(t – 1) * {1 + [r – r(t – 1)] + w * [e/e(t – 1) – 1]},
   where r = real short-term interest rate, CPI deflated;
   e = real effective exchange rate, based on CPI;
   w = weight based on share of imports to GDP.
   The index is shown as a percentage deviation from the period average. A value higher than zero indicates tighter conditions than on average.

Source: OECD.

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Figure 16. **Taylor rule**



1. Intervention rate on 28-day operations.
2. The Taylor rule is calculated as $R + w_1(\Pi_t - \Pi^*_t) + w_2(Y_t - Y^p_t)$, where R is the equilibrium real interest rate, Π^*_t is the target inflation, Π_t is observed year-on-year consumer price inflation, Y^p_t is potential output, Y_t is quarterly real GDP, $w_1 = w_2 = 0.5$. In the upper curve the equilibrium real interest rate equals 7 per cent during the whole period, while in the lower estimates it falls from 7 per cent in 1998 to 5 per cent in 2001.

Source: OECD.

Despite the substantial easing that has already occurred, there is arguably additional room for loosening, given the weak state of the economy. Indeed, a simple Taylor rule suggests that nominal interest rates could fall by a substantial margin (Figure 16). In the current context, however, such a strong decline in policy rates could be counterproductive. Given Poland's experience in 1999, when almost all of the disinflationary gains were dissipated following a substantial relaxation of monetary policy, a cautious approach is probably called for. Indeed, given the importance of consolidating the recent decline in the inflationary expectations of the population, the authorities should probably ease rates rather carefully so as to bring monetary policy to a neutral rather than a clearly expansionary stance. Taking everything into consideration, there probably remains room for a further 150 basis point cut in interest rates and this should be accomplished gradually over the next few months so as to ensure that lower inflationary expectations take a firm hold.

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The fiscal stance

Evaluating the stance of fiscal policy is complicated by the large number of different concepts used to measure the budget balance in Poland. Official measures include:

- The balance of the State Budget, which is reported monthly by the Ministry of Finance (MoF).
- A partially consolidated central government measure (based on IMF methodology) which is widely reported in the press;
- The annual GFS accounts, which are released with a nine month delay (calculated using the IMF Government Financial Statistics methodology).
- Accruals-based general government accounts calculated by the Polish Statistical Office (GUS) following the principles of the System of National Accounts (SNA), which is also released following a 3-quarter delay. And
- The economic deficit, a concept the Polish authorities derive from the cash-flow deficit by removing transfers between the government and the private sector that do not change the overall level of demand.

The authorities argue that changes in the level of the economic deficit best represents the additional demand stimulus resulting from changes in fiscal policy. However, the SNA accounts provide the most comprehensive measure of government spending and revenues, and are the most relevant numbers for evaluating the sustainability of fiscal policy. Moreover, whereas initially the notion of the economic deficit was important in distinguishing between changes in the deficit due to the new pension scheme and other fiscal measures, now these costs are relatively constant and the distinction is of little practical relevance.

The deficits associated with these various measures vary widely (Table 9). While the consolidated central government measure is a more comprehensive measure than that of the State Budget, as indicated in Chapter III, in recent years it has deviated substantially from the end of year results for the central government as recorded in the National Accounts. In particular, since 1997 the monthly data contain recorded expenditures that were not executed and in the last 5 months of 1999 the monthly data from the Social Insurance Fund (FUS) were excluded because of temporary reporting difficulties. In this Survey and for the purposes of analysing public expenditure, the OECD uses the SNA deficit concept. These data indicate that over the past decade, following a substantial decline in public-sector spending as a share of GDP, there has been a tendency for the government to command a larger share of national income and for the general government deficit to rise. Public-sector employment levels have tended to remain about constant (in contrast to both the Czech Republic and Hungary where they have been declining) and have increased as a share of total employment in recent years. These issues and the forces underlying these developments are addressed in much greater detail in the following chapter on public expenditure management.

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Table 9. **Various measures of the stance of fiscal policy**

Per cent of GDP

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
State budget												
Revenues	–	–	–	–	27.5	26.3	24.7	24.0	22.9	20.5	19.8	19.5
Expenditures	–	–	–	–	30.8	29.6	28.1	26.6	25.2	22.5	22.1	24.0
Balance	–	–	–	–	–3.3	–3.3	–3.3	–2.6	–2.4	–2.0	–2.2	–4.5
Consolidated central government[1]												
Revenues	–	–	–	–	–	–	35.3	34.7	33.8	27.1	30.6	29.7
Expenditures	–	–	–	–	–	–	38.4	37.6	36.4	29.5	33.2	34.8
Balance	–	–	–	–	–	–	–3.1	–2.8	–2.5	–2.5	–2.6	–5.1
General government (GFS basis)[2]												
Revenues	–	–	–	–	44.1	43.0	42.3	41.8	40.7	41.1	39.7	. .
Expenditures	–	–	–	–	46.3	44.8	45.3	45.0	43.1	44.0	43.4	. .
Balance	–	–	–	–	–2.2	–1.8	–3.0	–3.2	–2.4	–3.0	–3.8	. .
Economic balance												
Balance	–	–	–	–	–	–	–	–	–3.2	–2.9	–2.1	–4.8
SNA93												
Revenues	51.4	44.1	47.9	49.8	45.9	44.5	43.3	42.8	41.5	41.4	41.6	40.6[3]
Expenditures	59.8	53.4	54.9	54.3	49.4	47.0	46.1	45.6	43.8	43.4	43.7	45.5[3]
Balance	–8.5	–9.4	–7.1	–4.5	–3.5	–2.5	–2.9	–2.8	–2.3	–2.0	–2.1	–5.0[3]
Memorandum items												
Public-sector employment (thousands)	2 033	2 072	2 114	2 197	2 265	2 215	2 247	2 267	2 256	2 177	2 177	2 184
Public-sector employment (% of total)	11.9	12.5	13.6	14.8	15.5	15.0	15.0	14.9	14.7	14.8	15.0	15.4

1. 12 month sum of monthly consolidated central government accounts.
2. Net of privatisation revenues.
3. OECD estimates.

Source: OECD calculations based on data from Ministry of Finance.

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Budget outturns in 2001

The State Budget

The 2001 State Budget was predicated on an assumption of 4.5 per cent growth in GDP and CPI inflation of 7 per cent. In the event, both output and prices grew much less quickly, rising by 1 and 5.5 per cent, respectively. As a result, nominal GDP and the tax base grew by only 6.5 per cent rather than the assumed 10.5 per cent. The Budget foresaw a 20.6 per cent increase in expenditures mainly in the form of a 22 per cent increase in transfers. This was to be met by an almost equally strong 18.7 per cent increase in revenues. As a result, the State Budget deficit was to rise relatively modestly to PLZ 20.5 billion or 2.7 per cent of projected GDP and the so-called economic deficit was expected to be 1.9 per cent of GDP. The Budget contained a number of measures designed to increase revenues, including raising the rate of VAT applied to a number of goods and services, increased revenues from excise taxes, higher profits from the National Bank of Poland and a substantial improvements in the efficiency of tax collection. Working in the other direction, the corporate income tax rate was scheduled to fall from 30 to 28 per cent.

In the course of 2001 it became clear that the original budget was not going to be respected. In part, this resulted from a slower than expected growth and lower inflation but it was also due to a number of fiscally imprudent decisions taken during the course of the year, including the awarding of a 1.1 per cent of GDP increase in old-age pension to compensate for higher than expected inflation in 2001. In reaction to the growing overrun, the authorities passed two supplementary budgets. The first, introduced in July, reduced projected revenues by PLZ 8.6 billion (more than 1 per cent of GDP) and increased the authorised State Budget deficit by the same amount. The second further reduced budgeted revenues and increased the authorised deficit by PLZ 3.8 billion (0.5 per cent of GDP). Moreover, it sought to bolster revenues by allowing the authorities to book as revenues various repayments of arrears to the State Budget, such as the refunding of guarantee premiums and surcharges on interest for housing credits. In addition, the Council of Ministers took steps to slow spending, blocking some PLZ 8.5 billion of authorised expenditures (6.6 billion from programme spending and 1.8 billion from reserves). In the event, GDP expanded by only 1 per cent and final demand, upon which the brunt of taxation falls, actually declined. Moreover, prices increased by only 5½ per cent. As aconsequence, revenues increased by about 3.6 per cent, fully 12.8 per cent less quickly than provided for in the Budget (Table 10). The main sources of revenue shortfall were: a 13.6 per cent lower than expected tax revenues (mainly from indirect taxes and corporate income tax), partly explained by a failure to improve tax compliance to the extent initially hoped. and much higher than budgeted for non-payment of taxes. At the same

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Table 10. **Government accounts**
PLZ billion

	1998	1999	2000	2001[1] Budget	2001[1] Outturn	2002[2] Budget
Revenue of the central government	**126.6**	**125.9**	**135.7**	**161.1**	**140.5**	**145.1**
Direct taxes	49.5	38.2	40.0	43.2	36.7	40.4
PIT	34.7	23.1	23.1	25.6	23.4	26.5
CIT	14.8	15.1	16.9	17.6	13.2	13.8
Indirect taxes	70.5	80.1	84.8	99.3	87.7	94.8
Other taxes and non-tax revenue	6.6	7.6	11.0	18.5	17.4	9.9
Expenditure of the central government	**139.8**	**138.4**	**151.0**	**181.6**	**172.9**	**185.1**
Current expenditure	131.9	133.4	145.7	175.4	169.3	178.9
Goods and services	55.2	47.8	50.9	57.1	53.4	51.4
Transfers and subsidies	58.8	66.8	76.8	96.6	95.0	101.8
Interest payments	17.9	18.8	18.0	21.7	20.9	25.7
Capital expenditure	7.9	5.0	5.3	6.2	3.5	6.2
Balance of the central government (cash)	**–13.2**	**–12.5**	**–15.4**	**–20.5**	**–32.4**	**–40.0**
Balances of other administrations:						
Local governments	–1.4	–1.0	–3.1	–3.1	–3.1	–4.9
Health care sector (cash)	–3.3	–0.8	0.5	0.0	0.5	0.0
Extra-budgetary funds and others	0.2	–5.7	–0.3	0.4	–3.0	–1.1
Financial balance of the general government (cash)	**–17.6**	**–19.9**	**–18.3**	**–23.2**	**–38.0**[1]	**–46.0**
1. Compensations to public sector employees and pensioners	–	–	–3.4	–2.5	–2.5	–2.8
2. Transfers to second pillar pension funds	–	2.3	7.6	14.4	8.7	11.5
3. Other items[2]	–	–	–0.4	–3.1	–3.0	0.2
Economic balance of the general government (Financial balance + 1 + 2 + 3)	**–17.6**	**–17.6**	**–14.5**	**–14.7**	**–34.8**	**–37.0**
Memorandum items:						
Economic deficit in % of GDP	–3.2	–2.9	–2.1	–1.9	–4.8	–5.0
Nominal GDP (Zl billion)	553.6	615.1	684.9	781.7	721.6	746.8

1. Estimates. Totals may differ from sums because of rounding errors.
2. Includes arrears incurred by the health care sector, adjustments to FUS's balance and revenues from the sale of UMTS licences.

Source: Ministry of Finance.

time, expenditures came in about 7 per cent higher than initially envisaged. As a result, the overall deficit of the central government (exclusive of extrabudgetary funds) was PLZ 32.4 billion or 4.5 per cent of GDP and compared with an originally budgeted deficit of PLZ 20.5 billion.

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Social security and extrabudgetary funds

In contrast to the State Budget, the year-end balances of the various extrabudgetary funds operated by the Polish government came in broadly as indicated in the 2001 Budget Act (there are more than 3 000 extrabudgetary bodies in Poland, (see Chapter III). This apparently good performance was achieved principally as a result of a substantial increase in transfers from the State Budget (Table 11), made necessary in part by the continued non-payment of social security contributions by some stateowned enterprises (see Chapters III and IV). Expenditures in the three largest funds (the social insurance fund, FUS; the agricultural social insurance fund, KRUS; and the Labour Fund) increased by more than 10 per cent but their own revenues (principally payroll taxes) increased

Table 11. **Expenditures and revenues of the social security funds**

	2000	2001	2002	2001/2000	2002/2001
	PLZ billion			Growth rates	
FUS					
Revenues	81.3	91.7	98.0	12.8	6.9
Subsidies	15.4	21.2	27.3	37.7	28.9
Own	65.9	70.5	70.7	7.0	0.3
Expenditures	84.9	95.4	99.6	12.4	4.4
Pensions	74.6	84.1	87.9	12.7	4.6
Other	10.3	11.3	11.6	9.7	3.2
KRUS					
Revenues	14.0	15.8	16.3	12.7	3.2
Subsidies	13.2	14.9	15.4	12.6	3.4
Own	0.8	0.9	0.9	13.1	−1.3
Expenditures	14.3	15.8	16.3	10.3	3.1
Pensions	12.1	13.3	13.6	10.0	2.5
Other	2.3	2.5	2.7	12.1	6.1
Labour fund					
Revenues	6.1	8.3	9.8	36.5	18.1
Subsidies	0.8	2.7	3.6	315.9	37.2
Own	5.3	5.7	6.2	7.9	9.2
Expenditures	7.2	8.3	9.8	16.5	17.5
Unemployment insurance	3.5	3.9	4.4	10.3	12.3
Other	3.6	4.4	5.4	22.6	22.1
Total Big Three					
Revenues	101.4	115.8	124.1	14.2	7.2
Subsidies	29.4	38.7	46.3	31.5	19.7
Own	72.0	77.1	77.8	7.1	0.9
Expenditures	106.4	119.5	125.7	12.4	5.1
Pensions	86.7	97.4	101.5	12.3	4.3
Unemployment insurance	3.5	3.9	4.4	10.3	12.3
Other	16.2	18.2	19.7	12.9	8.2

Source: Ministry of Finance.

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by only 7 per cent. As a consequence, budgetary transfers were raised by some 40 per cent and now exceed 35 per cent of the Funds' total revenues. Higher than expected inflation in 2000 prompted a catch-up clause in the pension indexation scheme and, as a result, pension spending by FUS (both disability and old-age spending) increased particularly quickly (17 per cent) squeezing out its other activities, where expenditures fell by more than 40 per cent.

Local governments

At the sub-national government level, the 2001 cash deficit is projected to come in on target – although as of mid May 2002 a definitive accounting of their activities has yet to be made. Their overall deficit is estimated at PLZ 3.1 billion or 0.4 per cent of GDP. Both revenues and expenditures were approximately in line with budgeted values (98 and 95 per cent of original allocations) and the deficit was almost exactly equal to initial projections.

Consolidated general government

Although final year data on a consolidated basis will not be available until September 2002, the general government cash deficit on a GFS basis is expected to be about 5.8 per cent of GDP in 2001, substantially higher than the 2000 result of 3.8 per cent of GDP. The so-called "economic deficit" is estimated to be more than twice as high as in 2000, while the OECD estimates the deficit on a national accounts basis as about 5 per cent. Data constraints prevent the OECD from estimating a fully articulated model of the structural deficit in Poland. Nevertheless, Table 12 presents estimates based on the tax and expenditure elasticities observed in similar economies and trend output. It suggests that fiscal policy relaxed significantly during the high-growth period of 1997-98 as the authorities spent additional revenues rather than allowing automatic stabilisers to

Table 12. **Cyclically adjusted deficit**
As a percentage of GDP

	Deficit	Structural	Cyclical
1994	–3.5	–3.0	–0.5
1995	–2.5	–2.3	–0.2
1996	–2.9	–2.4	–0.5
1997	–2.8	–3.0	0.2
1998	–2.3	–3.0	0.7
1999	–2.0	–2.6	0.6
2000	–2.1	–2.7	0.6
2001	–5.0	–4.0	–0.9

Source: OECD.

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reduce the deficit. As growth slowed in 1999 and 2000, policy tightened somewhat before relaxing significantly in 2001. Overall, it implies that about half of the deterioration of the general government deficit that year was due to cyclical factors and the other half was due to a discretionary relaxation of policy.

The 2002 Budget

The procyclical movements in the general government structural deficit over the last few years raise a number of serious questions about the mechanisms in place to assure the sustainability of public finances. Indeed, unless steps are taken in the near term to reduce expenditure or increase taxes, the national debt will soon exceed its constitutional limit of 60 per cent of GDP and existing imbalances will be substantially exacerbated. In an effort to address this risk, the authorities sought with the 2002 Budget to pave the way towards a future consolidation. In particular, the Minister of Finance announced his intention to adopt an inflation plus 1 per cent expenditure norm, and allow revenues to react to automatic stabilisers instead of targeting a particular level of the deficit. Despite this commitment, last minute changes meant that, as passed, the 2002 State Budget Bill incorporates a 6.4 per cent increase in spending, which is almost 2 percentage points higher than the 4.5 per cent inflation rate assumed in Budget documents. On the revenue side, while tax revenues are expected to increase by 10 per cent almost twice the expected 5.5 per cent increase in nominal GDP (output is assumed to increase by 1 per cent), the Budget anticipates total revenues rising by only 3.3 per cent as compared with 2001. As a consequence, the State Budget deficit is to rise to PLZ 40 billion or about 5.2 per cent of GDP. Finally, as passed by parliament the Budget includes procyclical an obligation to raise spending by 0.5 per cent of GDP if revenues come in higher than projected.

The authorities consider the budget as a prudent one. Indeed, the non-tax revenue shortfall is comprised of a substantial drop in the projected profits of the central bank and in the revenue of budgetary units (together their remittances are expected to decline by PLZ 6.1 billion or 0.8 per cent of GDP). The increase in the projected tax ratio reflects a number of measures to increase resources. These include: subjecting interest and capital gains to a flat 20 per cent personal income tax; holding personal income tax brackets steady; increases to excise taxes; a 7 per cent VAT to be charged on new apartment sales, and a substantial reduction in the generosity of housing-related tax expenditures. All told these measures are expected to increase revenues (as compared to a no change scenario) by more than PLZ 5 billion (0.7 per cent of GDP). The Budget also counts on additional revenues from improved tax compliance.[8]

Much of the projected increase in 2002 spending concerns mandatory expenditures. Overall mandatory social security spending and transfers to the extrabudgetary social security funds represent 84 per cent of State Budget

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spending,[9] with pensions in the pay-as-you-go and disability systems scheduled to increase by a further 6.9 per cent next year or between 2.3 per cent in real terms.[10] The government will also be paying out an additional PLZ 2.8 billion to compensate for public sector wage freezes but this expenditure is accounted below the line in the State Budget.

The 2002 Budget assumes that, after transfers from the State Budget, the Health Funds will be in balance (on a cash basis) and that the deficit of the other Funds will be reduced from –0.5 per cent of GDP in 2001 to –0.1 per cent (the same amount originally built into the 2001) budget. Official government documents indicate that they expect sub-national government overall deficits will remain unchanged from last year. However, local authorities have yet to finalise their budgets. Moreover, the 2002 State Budget sets out the transfers they can expect to receive from the central government and their shared tax revenues. Based on this document, central government transfers to sub-national levels will fall by 5.8 per cent as compared with last year, while shared tax revenues are to increase by 11 per cent. As a result, local government resources can be expected to fall by about 5 per cent in 2002, putting significant pressure on their overall finances. Indeed, local governments indicate that they will likely have to reduce investment plans and resort to deficit financing in 2002.[11]

Debt management

Notwithstanding the deficit of 2 per cent of GDP in 2000, strong privatisation revenues that year allowed the authorities to reduce the general government deficit by 3.5 per cent of GDP. In 2001, the debt increased by 2.9 per cent of GDP reflecting both the large deficit and the much weaker than expected privatisation revenues. At PLZ 6.5 billion (0.9 per cent of GDP) these were significantly lower than the PLZ 18 billion originally planned. According to the 2002 Budget, privatisation revenues should be about PLZ 6.6 billion and taken in conjunction with an expected deficit of about 5 per cent of GDP, this suggests that the debt will rise to about 47 per cent of GDP. Approximately 40 per cent of the debt is denominated in foreign currencies and almost all of that is represented by low-interest Paris and London Club paper. The Ministry of Finance has actively sought to buy back foreign debt, with early repayment of Brady bonds worth some $1.2 billion conducted in 2000 and 2001 and a further $2.5 billion in debt to Brazil redeemed towards the end of 2001 at a 26 per cent discount. These operations and others to be conducted in the future are designed to flatten the repayment profile associated with the maturation of the Paris and London Club debt over the period 2002-2009.

Each year the Council of Ministers submits to the Parliament a Debt Management Strategy for the coming three years, which includes a set of clear goals for debt management, an assessment of the execution of previous strategies

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Table 13. **Public debt and privatisation revenues**
Per cent of GDP

	1997	1998	1999	2000	2001
Public sector	**–**	**–**	**45.8**	**42.3**	**. .**
Central government sector	–	–	43.4	39.6	40.4
State treasury	46.9	42.9	42.8	38.8	39.2
Domestic	22.0	21.9	21.8	21.2	25.5
Foreign	24.9	21.0	21.1	17.6	13.7
Other government	–	–	0.6	0.8	1.2
Local governments	–	–	1.0	1.4	1.5
Expected calls on outstanding state guarantees	–	–	1.3	1.4	1.3
Privatisation revenues	**1.4**	**1.3**	**2.2**	**4.0**	**0.9**

Source: Central Statistical Office.

as well as an analysis of possible scenarios regarding public debt. The 2001 strategy seeks to shift the focus of the government's debt management strategy from reducing costs over the next three years to a longer-term horizon. Operationally it hopes to achieve this by restructuring existing debt, so as to:

– Minimise exchange rate risk by reducing the share of foreign debt.

– Minimise refinancing and interest rate risk by increasing the average maturity of domestic debt and increasing the share of long-term fixed-rate instruments in total debt.

– Increase the flexibility of existing debt by converting non-marketable debt into marketable instruments. And

– Reduce the Treasury Debt's reliance on the banking-sector by increasing the share of other lenders in total public debt.

Medium-term challenges

While the government projects the 2002 budget deficit to actually increase, OECD estimates suggest that there is a strong possibility that revenues will exceed projections. In such an event it will be essential for the authorities to maintain spending at planned levels – even if this requires passing a supplementary budget authorising a lower deficit.[12] Moreover, to be effective the spending norm proposed in the 2002 Budget needs to be applied not just to the State Budget, but also to the various extrabudgetary funds that form part of the consolidated central government. Failure to do so may imperil the medium-term sustainability of fiscal policy. Indeed, based on unchanged policies the general government gross debt is projected by the OECD to rise rapidly over the next

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Table 14. **Policy simulations**
Per cent

	2002	2003	2004	2005	2006	2007
Medium-term base line						
Output growth	1.3	2.7	3.5	3.8	4.3	4.4
Inflation	3.5	3.6	3.5	3.3	3.2	3.1
General government balance[1]	–5.4	–5.5	–5.3	–5.1	–4.8	–4.6
Debt[1]	47.1	50.3	52.5	54.7	56.4	57.8
Current account balance[1]	–4.8	–5.1	–5.0	–4.8	–4.6	–4.4
Unemployment rate	19.6	19.5	18.7	17.3	15.7	14.1
Employment rate	52.3	52.1	52.6	53.4	54.3	55.2
Entrepreneurship-Development-Employment scenario[2]						
Output growth	1.3	3.0	3.9	4.2	4.7	4.8
Inflation	3.5	3.4	3.1	2.9	2.9	2.9
General government balance[1]	–5.4	–5.3	–4.7	–4.3	–3.7	–3.3
Debt[1]	47.1	49.8	51.4	52.8	53.4	53.4
Current account balance[1]	–4.8	–4.7	–4.8	–4.4	–4.1	–3.8
Unemployment rate	19.6	19.3	18.3	16.8	15.1	13.6
Employment rate	52.3	52.3	53.0	54.0	55.1	56.1
Enhanced Entrepreneurship-Development-Employment scenario with expenditure reform[3]						
Output growth	1.3	3.1	4.4	4.9	5.4	5.3
Inflation	3.5	5.8	3.0	2.9	3.1	3.0
General government balance[1]	–5.4	–5.4	–4.5	–3.2	–2.6	–2.2
Debt[1]	47.1	47.8	48.8	49.0	48.5	47.2
Current account balance[1]	–4.8	–4.9	–4.2	–3.5	–2.6	–1.9
Unemployment rate	19.6	18.8	17.2	15.1	12.8	10.5
Employment rate	52.3	52.7	53.6	55.0	56.5	58.0

1. Expressed as a per cent of GDP.
2. Assumes that government employment is reduced by 7 500 persons per year and expenditures on goods and services grows only 1 per cent in real terms. Social expenditures are reduced by 2 per cent of GDP and 60 per cent of the total savings are allocated to infrastructure investment. Efforts to reduce the administrative burden facing firms and increase labour market flexibility result in a 0.25 per cent increase in labour productivity growth rates and a 0.5 percentage point fall in the structural unemployment rate.
3. Assumes that government employment is reduced by 7 500 persons per year and expenditures on goods and services grows only 1 per cent in real terms. Social expenditures are reduced by 4 per cent of GDP. These savings and additional revenues from a 50 per cent reduction in VAT tax expenditures are used to finance a 50 per cent reduction in payroll taxes, infrastructure investment and deficit reduction. Efforts to reduce the administrative burden facing firms and increase labour market flexibility plus the lower payroll taxes result in a 0.5 per cent increase in labour productivity growth rates and a 1.5 percentage point fall in the structural unemployment rate.

Source: OECD.

several years, approaching the 60 per cent of GDP limit set forth in the constitution (Table 14).

In this regard, several elements of the authorities' *Entrepreneurship-Development-Employment* programme may help to alleviate these pressures (Box 1). The programme is designed to improve the functioning of the economy by reducing administrative burdens on small firms, promoting infrastructure investment, and improving

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Box 1. The *Entrepreneurship-Development-Employment* medium term plan

On February 2002, the Council of Ministers approved its medium term economic programme, known as the *Entrepreneurship-Development-Employment*. It seeks to enhance real GDP growth from 1 per cent this year to 5 per cent by 2004. The coverage of the package is broad and ambitious, ranging from tax and labour market measures to administrative simplification. Its principal measures are listed below. Implementing the package necessitates a large number of legislative changes as well as ministerial decrees, some of which have already been introduced, while others are to be presented in the fall.

Fundamental goals of the plan

- To achieve and sustain real GDP growth of 5 per cent by 2004 compared with 3 per cent under a no policy change scenario. Structural reforms would permit inflationary pressures to remain subdued and the current account deficit manageable – while the strong growth will boost employment.
- Public sector reforms (see below) should yield expenditure savings in the order of ½ a per cent of GDP per year. However, the deficit is projected to remain at some 5 per cent of GDP because of increased infrastructure spending.

"Public finance strategy"

- To underpin fiscal discipline, the programme seeks to abandon the State Budget *deficit target* and to replace it with an *expenditure norm* of 1 per cent real growth in State Budget spending.
- To reinforce the credibility of fiscal policy, the plan identifies *measures to shrink the size of the public sector*, most notably through lower public employment, reducing the number of ministries, consolidating extra budgetary funds, liquidating inefficient state agencies and eliminating fringe benefits in some areas.
- The above changes are to be accompanied by *measures to rationalise social transfers*, including tightening disability rules, accelerating the increase in the early retirement age, changing the pension index mechanism, reducing sickness benefits, KRUS reform.

"Entrepreneurship first of All"

Measures to improve the business environment

- Accelerate the *reduction of red tape and administrative obstacles*, by simplifying registration procedures and lowering licence and permit requirements. A major target is to reduce the high levels of discretion currently wielded by local administrators. The authorities are also determined to expand the use of e-devices as tools for public service delivery.

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Box 1. **The *Entrepreneurship-Development-Employment* medium term plan** (*cont.*)

- Pushing ahead the *reform of the tax system*. I*nter alia*, the government is committed to introducing a uniform income tax from all economic activity (personal and business), to offer tax holidays for new entrepreneurs and to lower stamp duties charged to entrepreneurs. One important measure expected to reduce administrative costs is the simplification of social security-related forms and allowing some self-employed workers to file quarterly instead of monthly returns as present.

Restructuring and privatisation

- The authorities are committed to accelerating the *privatisation* process so that the state-owned sector is brought down to about the OECD average by 2005, *i.e.* between 10 and 15 per cent of GDP. It remains committed to its *restructuring-prior-to-privatisation approach* and its special emphasis placed on coal mining, energy, gas, steel, defence, chemical and the railways. It has been explicitly announced that State Treasury will maintain control over four 100 per cent state-owned banks: BGK (specialised in the management of guarantee funds), PKO BP (saving bank), BGZ (agriculture bank) and Bank Pocztowy (postal saving bank).

First Job

- To *lower labour costs and make employment relations more flexible* the programme seeks substantial revisions of the Labour Code, which will be introduced in consultation with the social partners.
- Planned changes include:
  - Removing requirements that even very small firms appoint special work-place health and safety regulations and establish wage rules and work codes.
  - Temporarily, until Poland becomes a member of the EU, increasing the number of successive fixed term contracts permitted before a worker is automatically deemed a permanent employee.
  - Amendments to overtime work premium, which would increase from 2 to 4 the number of hours of overtime that can be paid at the lower overtime premium of 150 per cent.
  - A relaxation of rules regarding work dismissal in small firms are expected and severance pay will be tied to the employee's current tenure of employment, rather than his/her total work history.
  - Finally, the employer's obligation to pay dismissed employees during their job search will be limited.
- Special initiatives destined to improve employment prospects for recent graduates. These include paying part of graduates social security charges from the State Budget; special provisions for graduates that create their own businesses; tax and social security breaks.

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Box 1. **The *Entrepreneurship-Development-Employment* medium term plan** (*cont.*)

Infrastructure – key to development

- To support accelerated real GDP growth, the authorities plan to invest in housing and roads. Between 2002 and 2005, the authorities expect to spend PLZ 180 billion or (25 per cent of GDP) with 60 per cent of the total going to housing and 22 per cent to roads. This expenditure is to be co-financed from the budget, the EU and the private sector – backed by public guarantees.

employment prospects. While these policies should help promote faster growth and thereby alleviate budgetary pressures, they are unlikely by themselves to improve substantially the overall fiscal position of the country. Chapter IV outlines a number of additional reforms that need to be taken to help raise employment levels and increase the efficiency and competitiveness of the economy as a whole.

Table 14 reports the results of OECD simulations that attempt to quantify the impact that some of these reforms might have on output, inflation, unemployment and the current account. The baseline scenario assumes that government policy and the fiscal stance remain unchanged from their current stance and the second assumes that the reforms in the government's programme are introduced. In particular, it assumes a 7 500 per annum decline in public employment, a 1 per cent expenditure norm on general government spending on goods and services, a 0.5 percentage point fall in the structural rate of unemployment and a 0.25 percentage point increase in the rate of growth of labour productivity. The third scenario assumes that in addition to these the authorities move to substantially reduce government expenditures and that the savings from these are used to finance a reduction in the social charges paid by the lowest income workers. In particular, this scenario assumes that access to disability pensions and extended sick-leave benefits is reduced further with a budgetary saving of 4 per cent of GDP, that public-sector employment is gradually reduced by 5 per cent, and that approximately 50 per cent of these goods and services currently subject to a low VAT rate are charged the standard rate. About two thirds of overall savings are used to finance a reduction in social security charges and the implementation of in-work benefits to complement existing social security payments for the non-employed. The remainder being used to reduce the deficit. Overall these changes bear substantial fruits. Employment is projected to increase by 5 per cent as compared with the no change scenario and potential output and incomes by 4 per cent. Moreover, notwithstanding increased debt servicing charges, the trend rise in the government debt is reversed by the end of period.

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Summing up

Fiscal and monetary policies have been pulling in opposite directions in recent times and there is clear need to improve the overall policy mix. The preceding analysis suggests that there is little risk of additional inflationary pressures and with inflation already below the 2003 target and well below the lower bound for the 2002 target, there is unambiguously room for additional interest rate reductions. Nevertheless, in order to break with the past tendency for hysteretical inflation expectations and to reinforce the sentiment of the permanence of the recent fall in the rate of price increases, the National Bank of Poland needs to proceed cautiously and probably should not go beyond a neutral position. Nevertheless, this likely means that policy rates could be safely lowered by as much as 150 basis points over the next several months. The relaxation of fiscal policy in 2001 was regrettable and, at 4 per cent, the structural deficit of the general government is too high. In order to support the proposed relaxation in monetary policy and perhaps more importantly in order to ensure the long-term sustainability of public finances, it is essential that the fiscal authorities restrain spending and take steps to lower the structural deficit. In particular, any excess revenues should be used to reduce the deficit and the onerous tax burden on labour rather than to finance additional spending. Indeed, if the debt is to remain below the constitutional (and Maastricht) limit of 60 per cent, a clear tightening of policy will be required. In this respect, the authorities' announcement last year that they intend to follow an expenditure norm rather than targeting the deficit could be a good technique for achieving such a consolidation. However, in order to be effective it needs to be applied to all central government spending – not just the State Budget as currently – and almost certainly will require a reduction in the rate of growth of mandatory expenditures. Moreover, it would appear that to be operational changes in the constitution or the overall Public Finance Law may be required (see Chapter III).

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III. Improving the efficiency and sustainability of public expenditure

Notwithstanding the decline in public expenditure between 1990 and 1995, government spending has remained a relatively stable and high share of GDP[13] (46 per cent in 2001). Moreover, as discussed in Chapter II, the rapid rise in the general government deficit in 2001 and medium-term spending pressures suggest that a fiscal consolidation will be necessary in order to prevent the debt from reaching its constitutional limit of 60 per cent of GDP. A number of important steps to control the future evolution of spending, such as the 1999 pension and the more recent (and arguably less successful) healthcare sector reform, have already been made but much more needs to be done. A further tax increase appears undesirable given the country's already high tax burden and evidence that associates this with slower growth. Rather, budget consolidation and the government's goal of increasing the economy's potential rate of growth can best be achieved by a far ranging re-evaluation and re-orientation of spending away from personal transfers that contribute to inactivity traps and towards productivity and employment augmenting policies. This, in turn, will require substantial improvements to public expenditure management systems so as to provide the authorities with the tools they need to identify and effectuate needed budgetary reallocations.

Against this background, this chapter begins by briefly examining government spending patterns and trends in Poland, putting them into an international context. It then describes the main features of the current expenditure management system and provides an assessment of public spending outcomes in selected areas. Major policy challenges arising from this review are then identified and reform measures proposed.

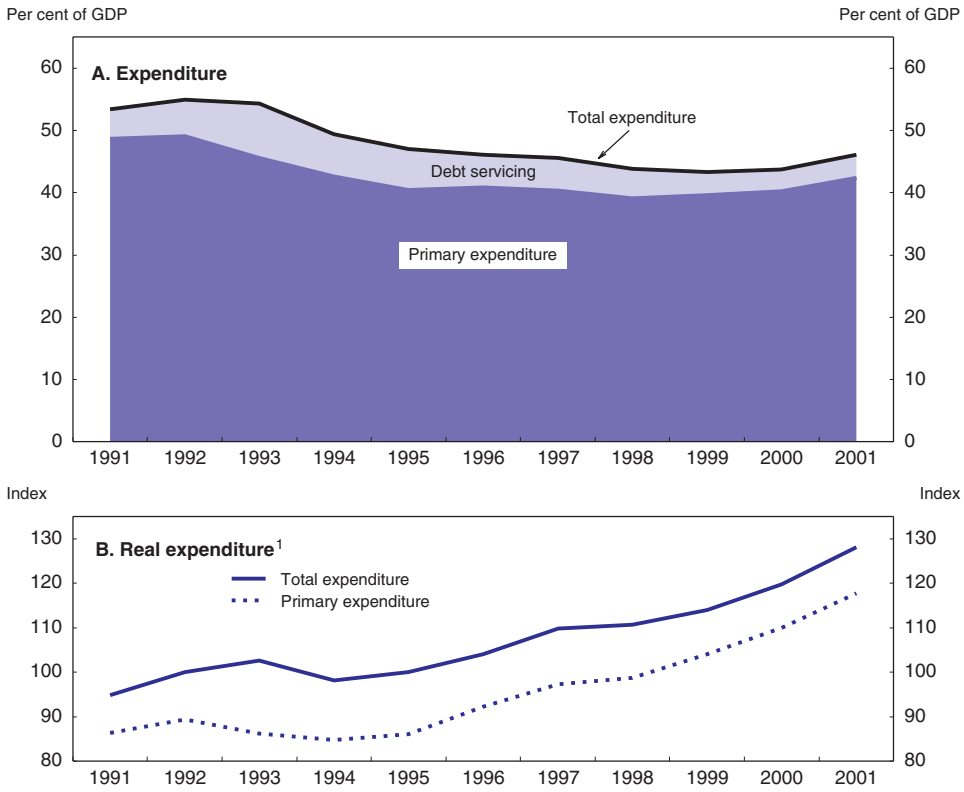
Public expenditure in Poland

International comparisons and expenditure trends

Reflecting the heritage of the previous political regime, Poland entered the 1990s with a large general government sector, whose expenditures were equal to almost 60 per cent of GDP (Figure 17, Panel A). Since then they have declined substantially, falling to 47 per cent by 1995 and to 46 per cent by 2001.[14] Much of

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Figure 17. **Trends in public expenditure**



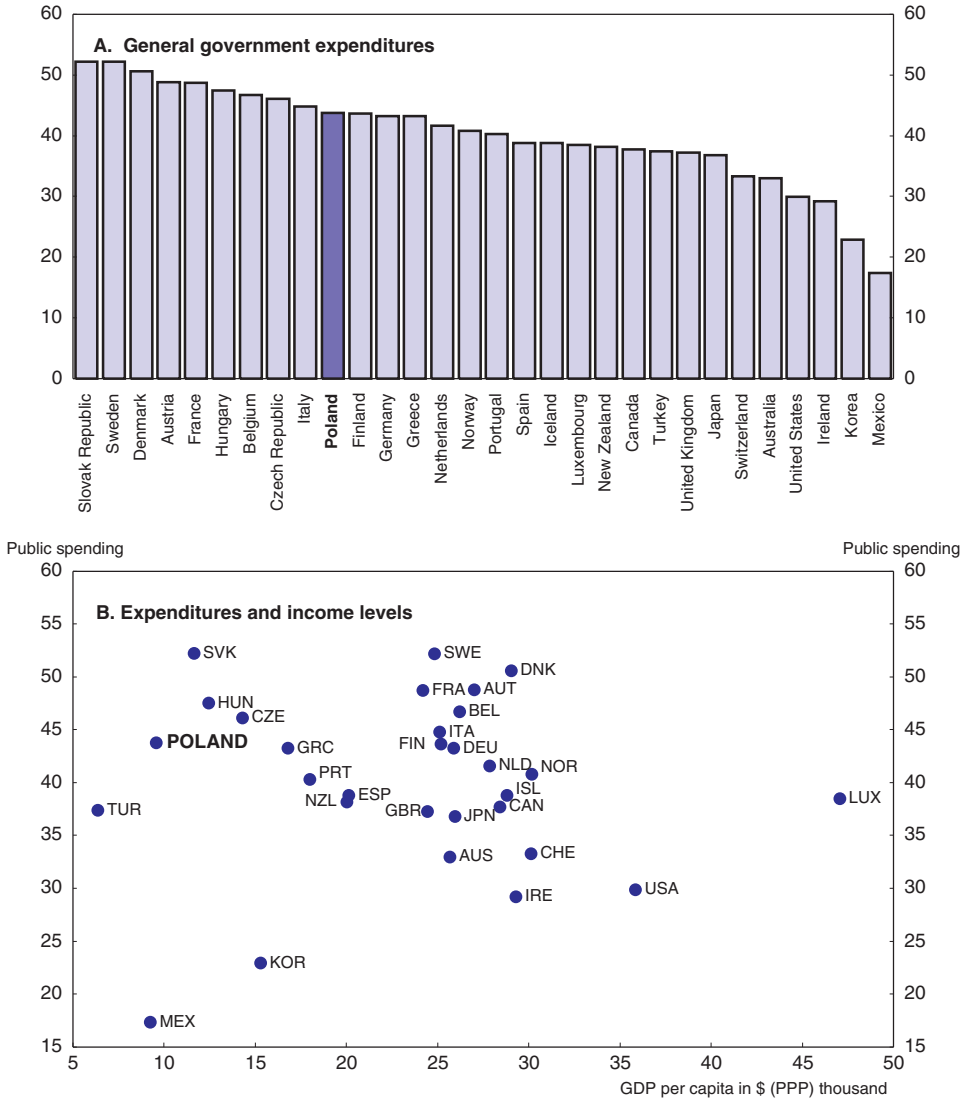
1. Real total expenditure = 100 in 1995, using the implicit GDP deflator.
Source: Central Statistical Office and OECD.

the decline in the first half of the 1990s was due to the restructuring of Poland's debts and the associated 4 percentage points of GDP reduction in interest payments that was observed between 1993 and 1996. Primary expenditures (total spending less interest payments) also declined substantially in the first half of the decade before stabilising at about 40 per cent of GDP since 1995. Notwithstanding the fall in the relative size of the public sector, the rapid increase of GDP over the period meant that the volume of goods and services delivered by the authorities actually increased throughout most of the transition (Figure 17, Panel B).

Moreover, the public sector in Poland represents a larger share of GDP than the OECD average and only somewhat less than the average for the Euro area (Figure 18, Panel A). Indeed, the spending share is much higher than in other

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Figure 18. **Public spending in international comparison**[1]
Per cent of GDP, in 2000



1. Public spending is defined as the sum of current outlays and net capital outlays. Data are based on SNA93/ESA95.

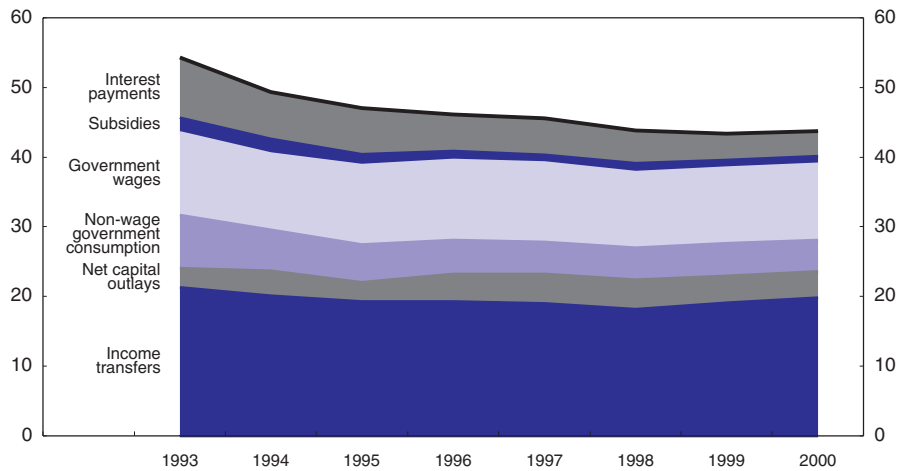
Source: OECD.

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currently lower income OECD countries and much higher than it was in other OECD countries when they were at Poland's level of development (Figure 18, Panel B). A number of studies have emphasised that the high tax burden required to finance a large government sector increases economic distortions and slows growth and the process of income convergence.[15]

Official data suggest that virtually all of the reduction in primary spending came through cuts to non-wage government consumption (Figure 19, Panel A), although there may be some doubt as to the reliability of earlier data.[16] GFS data suggests that on a functional basis, spending levels as a share of GDP have remained more or less constant since 1994. Spending as a share of GDP for merit goods such as health and education, public goods such as defence and police work and economic services are broadly in line with those observed in other OECD countries (Table 15). However, Poland spends substantially more than average on income transfers (more than 18 per cent of GDP in 2000). In particular, it spends a larger share of total output on disability pensions than any other OECD country, more than twice the average.[17] In contrast, the share of considered other transfers to households, including those associated with social assistance and unemployment insurance is about average. Perhaps surprisingly, social assistance spending as a share of GDP has remained broadly constant despite a four fold increase in the unemployment rate and a 50 per cent increase in the incidence of non-employment from 30 to more than 45 per cent of the working-age population.[18]

Figure 19. **General government outlays by economic category**
Per cent of GDP



Source: OECD, revised GFS (Government Financial Statistics) accounts.

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Table 15. **International comparison of public expenditure categories**[1]

Per cent of GDP

	Merit goods				Income transfers									
						Pension					Labour market policies			
	Total	Education	Health	Other social services	Total	Old-age cash	Survivors	Disability	Sickness	Family cash benefits	Active	Passive	Housing benefits	Other benefits
Australia	10.9	4.3	5.4	1.2	10.2	4.0	0.2	2.1	0.0	2.2	0.4	1.0	0.1	0.1
Austria	13.8	6.0	5.8	2.0	19.0	9.9	2.9	2.3	0.2	1.9	0.4	0.9	0.1	0.3
Belgium	11.4	5.0	6.1	0.3	18.1	7.3	2.5	1.7	0.4	2.0	1.4	2.4	. .	0.3
Canada	12.1	5.5	6.6	. .	11.2	5.0	0.5	0.9	0.1	0.8	0.5	0.9	. .	2.6
Czech Republic	11.1	4.1	6.5	0.5	12.7	6.7	0.9	1.8	0.9	1.6	0.2	0.3	0.1	0.2
Denmark	18.8	6.8	6.8	5.2	17.8	6.8	0.0	2.0	0.7	1.5	1.7	3.4	0.7	1.1
Finland	14.0	5.7	5.3	3.0	18.3	7.0	1.0	3.1	0.4	1.9	1.4	2.6	0.4	0.6
France	15.0	5.9	7.3	1.9	19.7	10.6	1.6	1.1	0.5	1.5	1.3	1.8	0.9	0.4
Germany	13.7	4.4	7.8	1.6	18.0	10.5	0.5	1.4	0.3	1.9	1.3	1.3	0.2	0.6
Greece	9.1	3.4	4.7	1.0	16.9	10.2	2.0	1.1	0.8	1.2	0.2	0.5	0.7	0.2
Iceland	16.8	6.5	7.0	3.2	8.2	3.8	0.5	1.5	0.1	1.2	0.1	0.4	0.1	0.4
Ireland	9.5	4.3	4.6	0.5	10.6	2.5	0.9	0.8	0.7	1.6	1.2	1.7	0.5	0.6
Italy	10.8	4.8	5.5	0.5	19.1	12.8	2.6	1.0	0.7	0.6	0.7	0.7	0.0	0.0
Japan	9.8	3.6	5.6	0.6	8.4	5.7	1.1	0.5	0.1	0.2	0.2	0.5	. .	0.2
Korea	6.7	4.1	2.4	0.3	3.3	1.9	0.2	0.4	. .	0.0	0.5	0.2	. .	0.2
Luxembourg	6.3	. .	5.4	0.9	15.2	7.8	0.9	2.4	0.7	2.3	0.2	0.5	0.1	0.2
Mexico	6.3	4.1	2.0	0.2	6.0	4.7	0.1	0.1	. .	0.0	0.1	0.0	0.7	0.3
Netherlands	12.1	4.5	5.9	1.7	16.1	6.2	0.8	2.4	1.0	0.8	1.3	2.6	0.4	0.6
New Zealand	12.3	6.0	6.1	0.1	13.8	5.2	0.1	1.5	1.3	2.4	0.5	1.6	0.9	0.1
Norway	18.6	6.8	7.1	4.7	15.2	6.0	0.4	2.8	1.5	2.2	0.9	0.5	0.2	0.7
POLAND	**10.2**	**5.3**	**4.6**	**0.2**	**18.4**	**8.1**	**2.1**	**4.8**	**1.1**	**0.9**	**0.3**	**0.6**	**0.2**	**0.3**
Portugal	11.3	5.6	5.1	0.6	12.5	6.3	1.4	1.9	0.5	0.6	0.7	0.8	0.0	0.3
Slovak Republic	0.5	. .	. .	0.5	13.3	5.3	1.0	2.0	1.2	1.8	0.0	0.8	0.0	1.2
Spain	10.2	4.4	5.3	0.4	13.9	8.1	0.8	1.3	0.9	0.3	0.6	1.5	0.1	0.1
Sweden	18.6	6.6	6.6	5.4	18.9	7.5	0.7	2.4	1.1	1.6	2.0	1.9	0.8	0.9
Switzerland	13.9	5.4	7.7	0.8	19.9	11.2	1.4	2.9	0.5	1.2	0.8	1.0	0.2	0.7
Turkey	8.2	2.9	5.0	0.2	9.1	5.1	1.2	0.2	0.0	1.0	0.1	0.9	0.0	0.5
United Kingdom	11.6	4.6	5.6	1.3	17.8	9.8	1.0	2.7	0.1	1.7	0.3	0.3	1.6	0.2
United States	11.0	4.8	5.8	0.3	8.2	5.1	0.9	0.9	0.2	0.2	0.2	0.3	. .	0.5

1. Data concern 1999 or 1998, when not available. Education data always concern 1998.

Source: OECD, Social Expenditure Database and OECD, *Education at a Glance*.

Tax expenditures

While not recorded as government spending, tax expenditures – exemptions to standard rates – promote policy objectives similar to those targeted by as traditional expenditure and impose real costs. On the one hand, the revenue forgone by exemptions must be made up either as reduced expenditure or higher tax rates (on a smaller base), and on the other, they can introduce important distortions. Foregone revenues in the personal and corporate income tax accounted for 1.8 per cent of GDP and 4.3 per cent of general government revenue in 2000, while the low and zero rating of a wide range of goods and services in the VAT system cost 6.7 per cent of GDP (Table 16). The largest personal income tax (PIT) expenditure programme is a housing tax deduction, which accounts for 70 per cent of total PIT tax expenditures.

Table 16. **Tax expenditures**

	1993	1997	1998	1999	2000
	Zloty million				
Total tax expenditure	1 835	37 479	43 855	51 058	57 971
PIT	957	4 087	4 690	6 007	6 876
Housing	919	2 712	3 117	4 244	4 843
renovation	369	1 267	1 308	2 001	2 258
new construction	550	1 445	1 810	2 242	2 585
Others	38	1 375	1 573	1 763	269
CIT	878	4 292	4 865	7 049	5 343
Tax free	128	1 228	2 247	4 740	4 123
of which:					
Sale of immovable property			885	2 401	2 570
Income of non-profit organisation			989	1 716	1 541
Exemption or relief	750	3 064	2 618	2 309	1 220
VAT	n.a.	29 100	34 300	38 002	45 752
	Per cent of GDP				
Total tax expenditure	1.2	7.9	7.9	8.3	8.5
PIT	0.6	0.9	0.8	1.0	1.0
Housing	0.6	0.6	0.6	0.7	0.7
renovation	0.2	0.3	0.2	0.3	0.3
new construction	0.4	0.3	0.3	0.4	0.4
Others	0.0	0.3	0.3	0.3	0.0
CIT	0.6	0.9	0.9	1.1	0.8
Tax free	0.1	0.3	0.4	0.8	0.6
of which:					
Sale of immovable property			0.2	0.4	0.4
Income of non-profit organisation			0.2	0.3	0.2
Exemption or relief	0.5	0.6	0.5	0.4	0.2
VAT	n.a.	6.2	6.2	6.2	6.7

Source: Ministry of Finance, OECD.

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State aids

State aids are one of the most complicated components of Polish public expenditure. Although subsidy programs are a relatively small 1.5 per cent of GDP,[19] they represent less than one third of state aids, with tax expenditures, capital transfers, preferential credits and credit guarantees making up the rest (Table 17). The 2001 Act on State Aid brings Polish law into line with European Union regulations, so that support levels should decline. Nevertheless, several exceptions to the Act remain, and the administrative capability to monitor and analyse various forms of state aid seems limited at present.[20] State-owned enterprises in particular continue to receive substantial support in the form of unpaid tax and social security arrears and in the form of price supports.[21] Indeed, accumulated tax and social security arrears in the coal sector are four times larger than their State Budget subsidy. Similarly, intercompany debt represents a mechanism by which these firms have been supported – non-payment of fees by state-owned enterprises in the steel and coal mining sectors, was a principal source of the 0.5 per cent of GDP losses of the State railway in 1999 alone. In addition, the environmental liabilities of these firms, especially in the coal, steel, railway and defence sectors, may be substantial.[22] Finally, on many occasions the authorities have pledged the assets or equity of state-owned and partially privatised firms as collateral for bank loans.

State guarantees have been subject to a well-defined regulatory process since 1997. Each year the Budget specifies a maximum volume of guarantees that may be issued and the official measure of the public debt includes risk-weighted guarantees.[23] While the law contains rules designed to minimise moral hazard in the issuance of guarantees,[24] there has been an increasing tendency to resort to exceptions from the general rules governing their issuance.[25] To a large extent, this reflects conditions imposed by international lending agencies such as the ERBD, IRBD and EBI. Moreover, the number of new guarantees, and, with the exception of 2001, the actual calls upon them, have been rising (Table 17). So much so, that in 2002 the volume of guarantees expected to be issued is 13 times the average during the period 1994-99 and more than twice the total of guarantees issued over the same period. Currently, more than 50 per cent of outstanding guarantees cover 100 per cent of the risk in contrast to the standard rules that would limit the guarantee to a maximum of 60 per cent of the total liability. Moreover, in some cases guarantees are used in lieu of explicit budgetary transfers to subsidise in a non-transparent manner the activities of various financially troubled state-owned enterprises and agencies without affecting the state budget deficit in the current year.[26]

Medium-term spending challenges

Economic and public-expenditure developments over the next decade are likely to continue to be dominated by the process of economic convergence.

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Table 17. **State guarantees**

Zloty million

	1994	1995	1996	1997	1998	1999	2000	2001	2002[1]	
									Projections	Budget
Actual calls	443	475	279	197	132	297	311	199		798
Outstanding guarantees	20 863	18 516	19 641	21 087	19 723	18 565	19 894	27 232		38 513
New	1 439	1 626	1 325	1 841	698	1 580	4 028	11 199	19 000	29 000
of which:										
PKP S.A.	282	902	333	270	0	592	428	1 675	3 066	
Highway construction							3 121		9 546	
Memorandum items:										
Subsidies to PKP S.A.	717	806	951	1 066	798	941	980	1 202		456
Risk by category										
Low (0-30%)							6 524	11 423		
Medium (30-50%)							2 166	8 383		
High (50-80%)							10 390	4 859		
Very high (80-100%)							432	409		
100% risky							382	443		
Other[2]								4 238		

1. 2002 Budget data are legal maxima while projections represent official expectations.
2. Guarantees to airway carriers for damages occurred as a result of war or act of terror (November 2001).

Source: Ministry of Finance.

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Indeed, the current weight of household transfers in total spending reflects past decisions to smooth the adjustment process by subsidising labour force withdrawal. As the data suggest, a significant proportion of this withdrawal was achieved by the generous allocation of early retirement and disability pensions. However, the resulting low rates of employment have set up a vicious circle. Increased social welfare expenditures to the non-employed and reduced tax revenues have forced the authorities to raise tax rates further, thereby exacerbating non-employment. While a serious problem, it also contains the seeds of a cure, as concrete steps to increase employment could set up a virtuous circle whereby increasing employment rates would simultaneously reduce expenditures and increase revenues, creating room to reduce tax rates and further stimulating employment (see Chapter IV).

The coming to maturity of the London and Paris Club debt over the next several years (see Box 2) will place further pressure on the public purse,

Box 2. Debt restructuring and its principal impacts on debt-servicing costs

In 1991, with debt servicing charges rising to 58 per cent of exports in good and services and public debt at almost 90 per cent of GDP (of which foreign debt accounted for 64 per cent), Poland started a debt-restructuring programme. Two separate deals served to substantially reduce the debt servicing and current account burdens represented by these liabilities.

The first, the "Paris Club", deal saw the net present value of the debt owed to Poland's official creditors (among which are many OECD governments) reduced by 50 per cent, principally by lowering from 7 per cent to 1.9 per cent the interest rate payable on this debt. After a series of negotiations, a similar deal was struck in 1994 with the "London club" of some 500 commercial banks, which resulted both in a reduction in the principal of some debt and the issuance of a wide-range of low-interest rate "Brady bonds".

As from December 2001, the average nominal interest rate on outstanding Paris and London Club debt was 2.3 and 5.4 per cent respectively. The "Paris Club" low-interest rate instruments will be coming due over the next several years with the largest tranche of $4.3 billion maturing in 2008. To the extent that this paper is rolled over, the interest charges associated with Poland's debt will increase significantly because market interest rates on Polish sovereign debt are much higher than the nominal rates currently paid on this debt.

As of September 2001, foreign debt constituted 35 per cent of state treasury debt, and the Paris Club and Brady bonds (London Club) accounted, respectively, for 66 and 16 per cent ($20 and $4 billion) of Polish external debt. Loans from international institutions such as the World Bank and the European Investment Bank accounted for another 10 per cent ($2.5 billion).

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increasing expenditures without improving services. While privatisation revenues could be used to pay off some of this debt, progress of late has been slow (see Chapter IV)[27] and, unless the pace of privatisation picks up markedly, total debt-servicing charges are projected to rise by about 1 per cent of GDP by 2009. The ageing of the population and the implications that this will have on health and pension spending are a further sources of medium-term expenditure pressures. Over the longer term, the recent reform of the old-age pension system will help to limit the impact of ageing on government finances. However, for the moment it is actually worsening the general government balance as contributions that would have otherwise helped finance the pay-as-you-go system have been transferred to the new funded insurance pillar.[28] At the same time, the recent reform of the health-sector appears to be experiencing difficulties and, at least for the moment, costs continue to grow more quickly than output (see Chapter IV).

In addition to the above mentioned medium-term pressures, a number of temporary, transition-related costs have been incurred over the past several years, and these have amounted to between 1 and 2 per cent of GDP since 1999 (Table 18). While some of these costs are likely to diminish in the future, they are also likely to be replaced by new demands on the public purse. For example, environmental clean up and investment costs associated with EU accession are expected to exceed $4 billion annually (3 per cent of

Table 18. **Transitory costs**
Per cent of GDP

	1999	2000	2001[1]	2002[2]
Social insurance	**0.6**	**1.5**	**1.6**	**1.9**
of which:				
Premium transfer to individual accounts	0.4	1.1	1.3	1.5
Health insurance	**0.4**	**0.1**	**0.0**	**0.0**
of which:				
Grant to regional health funds	0.3			
Write-off of loans to health fund	0.1			
Restructuring of health care service	0.0	0.1		
Education	**0.0**	**0.2**	**0.2**	**0.0**
Additional spending total	**1.0**	**1.8**	**1.8**	**1.9**
Memorandum items:				
State budget loans to pension funds	0.6	0.3		
State budget loans to health funds		0.1		

1. Preliminary.
2. Based on draft budget (June 2001).
Source: Ministry of Finance.

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GDP) over the next three years (IMF, 2000),[29] while more generally there is an urgent need to invest in public infrastructure to improve growth prospects. Indeed, Poland is very poorly endowed with motorways. Experience in other transition countries indicates that an efficient network of high speed, high volume roadways is an important necessary condition for regional development. By the same token, there is a growing need to expand investment in educational services – especially as concerns the work-to-school transition (World Bank, 2001).

The recently proposed Belka programme (see Chapter II) seeks to meet a number of these challenges. It aims to restrain the real growth of expenditure in the State Budget to 1 per cent per year, to reallocate expenditures from income transfers to growth-enhancing investments and to reduce non-employment. The remainder of this chapter examines the public expenditure process. It begins by discussing expenditure management issues, analysing to what extent existing institutions permit policy makers to exercise effective control over government spending. The next section makes specific recommendations on steps that could be taken to improve the quality of outcomes and the capacity of policy makers to direct resources towards policy priorities.

Expenditure management

Budgetary planning

Poland is a unitary state, which nevertheless has several levels of sub-national government: *gminas* (municipalities), *poviats* (counties) and *voivodships* (provinces or departments). While *gminas* and *voivodships* have a long history in Poland, *poviats* were only recently recreated (after having been abolished for many years) as part of a far ranging reform of the public administration, which also reduced the number and responsibilities of *voivodships* (Box 3). From the point of view of expenditure, the general government is comprised of the state budget, these sub-national groupings and more than 3 000 extra-budgetary funds – both at the national and sub-national levels. Overall the state budget represents only 40 per cent of general government expenditure, while extra budgetary funds (including locally managed extra-budgetary funds) represent a further 40 per cent. The remaining 19 per cent of expenditure is accounted for by the activities of sub-national governments or 28 per cent if one includes the spending of their extrabudgetary funds (Figure 20). Generally speaking the budget process is only weakly integrated across different government levels and between governments and their extrabudgetary funds.[30] The role and activities of the various extrabudgetary funds, agencies and institutions is discussed in more detail below.

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Box 3. Fiscal relations between levels of government in Poland

Poland's governmental structure has undergone a number of changes since the end of the Second World War – although throughout this period it has remained a unitary state. During most of the past decade, there were two levels of government: the central government (central administration and 49 geographical units or *voivodships* and 268 auxiliary local offices) and local governments in the form of 2 489 *gminas*. While numerous, *gminas* are not excessively small. On average they are much larger than municipalities in the Czech Republic and Hungary (only 23 per cent of them have fewer than 5 000 residents, while more than 90 per cent of municipalities in the Czech Republic and Hungary fall below this threshold).

A major reform of the public administration was introduced in 1999, creating two new levels of sub-national government. While the reform retained a central government presence at the regional level with a *voivodship* administration, it reduced the number of *voivodships* from 49 to 16 and created a parallel and distinct *voivodship* level of self-government. In addition, the creation of some 315 *poviats* or county self-governments introduced another new level of government.

The 1999 reform was accompanied by a significant devolution of expenditure responsibilities from the central to sub-national governments in the areas of education, roads and healthcare. *Voivodship* self-governments are responsible for regional development policies, higher vocational schools, larger cultural facilities and specialised regional hospitals. Moreover, they participate in the supervision of autonomous health funds. The *poviats*, as the lower-middle level of sub-national governments, are responsible for special lower secondary schools and high schools, police and fire protection, the operation of larger social assistance facilities and nursing homes, county-level roads and general hospitals. The *gminas*' main responsibilities include primary and lower secondary education; waste disposal; provision of electricity, heat and gas; operation of social assistance facilities; the disbursement of various allowances; maintenance of *gminas*' own housing stocks; primary healthcare clinics and local transport service among others. Even though they are territorially contained within *poviats* and *voivodships*, *gminas* are not financially or politically subordinate to them. However, they are encouraged to co-operate with higher levels of sub-national governments in carrying out certain tasks.

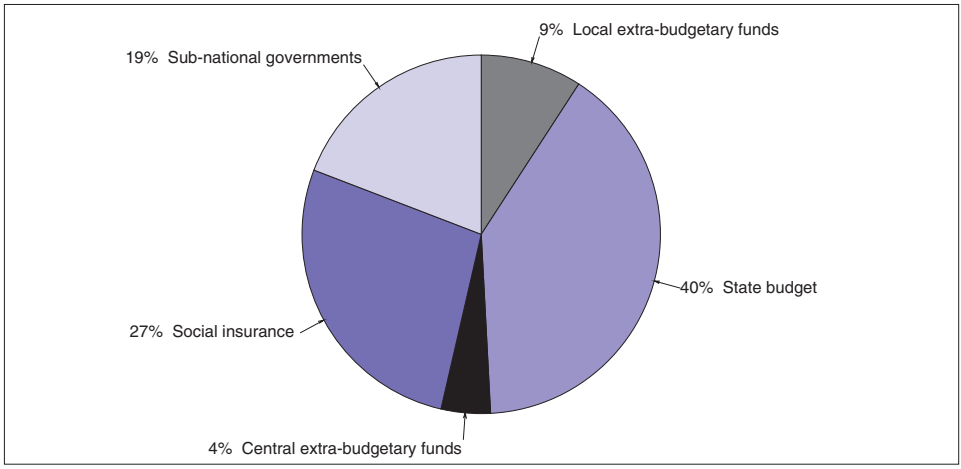
Central government

- The State Budget process

The elaboration of the State Budget follows a process similar to that in most OECD parliamentary democracies. The Ministry of Finance proposes to the Council of Ministers budget guidelines that include spending and revenue aggregates. These are then revised by the cabinet and used as a basis for creating

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Figure 20. **Expenditure shares by level of government**
2000[1]



1. Local extra-budgetary funds include regional healthcare funds.
Source: Ministry of Finance.

a detailed draft budget in conjunction with line ministries. This is aggregated and modified by the Cabinet before being submitted to parliament no later than 30 September for three readings. The Council of Ministers can determine the total amount of State Budget expenditures and revenues. Ministries enjoy substantial autonomy in allocating spending across programmes once their budget envelopes are decided within the more general budget process. If the budget is not approved by the 1st of January, the draft budget bill submitted for first reading serves as a basis for managing spending until the act is passed.

As compared with other OECD countries, budgetary rules are relatively few. The budget period is one year and the balance included in the budget law is binding upon the government. In the 2002 Budget, the government sought to break with this tradition in favour of a spending norm (1 per cent real growth of State Budget spending). Unfortunately, the constitution[31] indicates that it is only the deficit that forms a binding constraint on parliament, and, as a result, parliament passed an amendment adding an extra 1 per cent of expenditure, half of which was made conditional on stronger than expected revenues (see Chapter II). The budget may include a targeted reserve of as much as 5 per cent of expenditure to cover unforeseen liabilities of the State Treasury and a general reserve of up to 2 per cent of State Budget expenditure to cover unexpected spending needs. The Act itself and its annexed documentation contain relatively

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little information about the general government, making indentification of the true stance of fiscal policy and public finances difficult. Only explicit transfers made from the State Budget to extrabudgetary funds and sub-national levels of government are indicated in the Act, although annexes include the budget plans for central government extrabudgetary funds. No information is provided about sub-national governments or their extrabudgetary funds. While the budget includes a 3-year projection of aggregate revenues and expenditures, this is not based upon a bottom-up analysis and no detail on chapters is provided. The projections mainly play an informational role and they do not impact the preparation of the next year's budget as they might in a multiyear framework. Finally, the impacts of policy changes implemented in the course of the year are not systematically included in the budget, nor are they aggregated. However, multiyear budgetary impacts of proposed changes to programmes must be provided when these changes are initially put before Parliament.

The constitution prohibits the public debt from exceeding 60 per cent of GDP. As a result, the Act on Public Finance includes specific mechanisms designed to prevent this limit from being reached (Box 4). In particular, it defines intermediate thresholds of 50 and 55 per cent of GDP and requires the authorities at both the State Budget and local-government levels to take steps to stabilise the debt at less than 50 per cent of GDP. These rules contain escape clauses (when the budgetary consolidation measures they require are deemed impossible), and do not provide explicit mechanisms by which the targets for securing a return to budgetary stability are to be achieved. Nevertheless, their existence does serve to force decision makers to come to terms with a deteriorating budgetary situation. Indeed, with debt fast approaching the lower 50 per cent threshold, the existence of such limits likely played a role in promoting recent efforts at expenditure control.

Extrabudgetary institutions

The existence of a wide range of extrabudgetary institutions contributes to the fragmented structure of the general government in Poland (Figure 21). In addition to the State Budget, the central government consists of 3 social protection funds, 11 other extra-budgetary funds, a number of independent state agencies, 300 budgetary establishments and 400 ancillary budgetary enterprises (Box 5). Sub-national governments (see below) also have more than 3 000 extra-budgetary funds, including separate environmental funds at each level of sub-national government. Moreover, they are also allowed to create budgetary establishments and ancillary budgetary enterprises although detailed data on how many of these may exist are not available. A national and 16 regional health funds have something of a hybrid nature. While they remain central government instruments they have sub-national representatives on their governing boards and enjoy considerable autonomy from the central government.

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Box 4. Enforcing the constitutional limit on public debt

The Act on Public Finance both defines the public debt and the rules designed to ensure that the constitutional limit of 60 per cent of GDP is not exceeded. It specifies that whenever the public debt (general government) exceeds 50 per cent of GDP but is less than 55 per cent, the deficit (surplus), expresses as a per cent of total revenue, included in each of the State and local government budgets of the following year must not exceed (be smaller) than in the year when the limit was breached. Whenever the public debt exceeds 55 per cent the State Budget deficit for the following year must be consistent with a stable or falling State Treasury Debt,[1] after taking account of expected calls on state treasury guarantees. The deficits of sub-national governments must be lowered as compared with the previous year by an amount equal to the extent to which the public debt exceeds 55 per cent of GDP.[2] In addition, the Council of Ministers must present to Parliament a fiscal consolidation plan aimed at lowering the public debt. Finally if the public debt reaches 60 per cent of GDP, no new state guarantees may be issued and the Council of Ministers must submit a fiscal consolidation plan to the Parliament, while sub-national governments must pass balanced budgets.

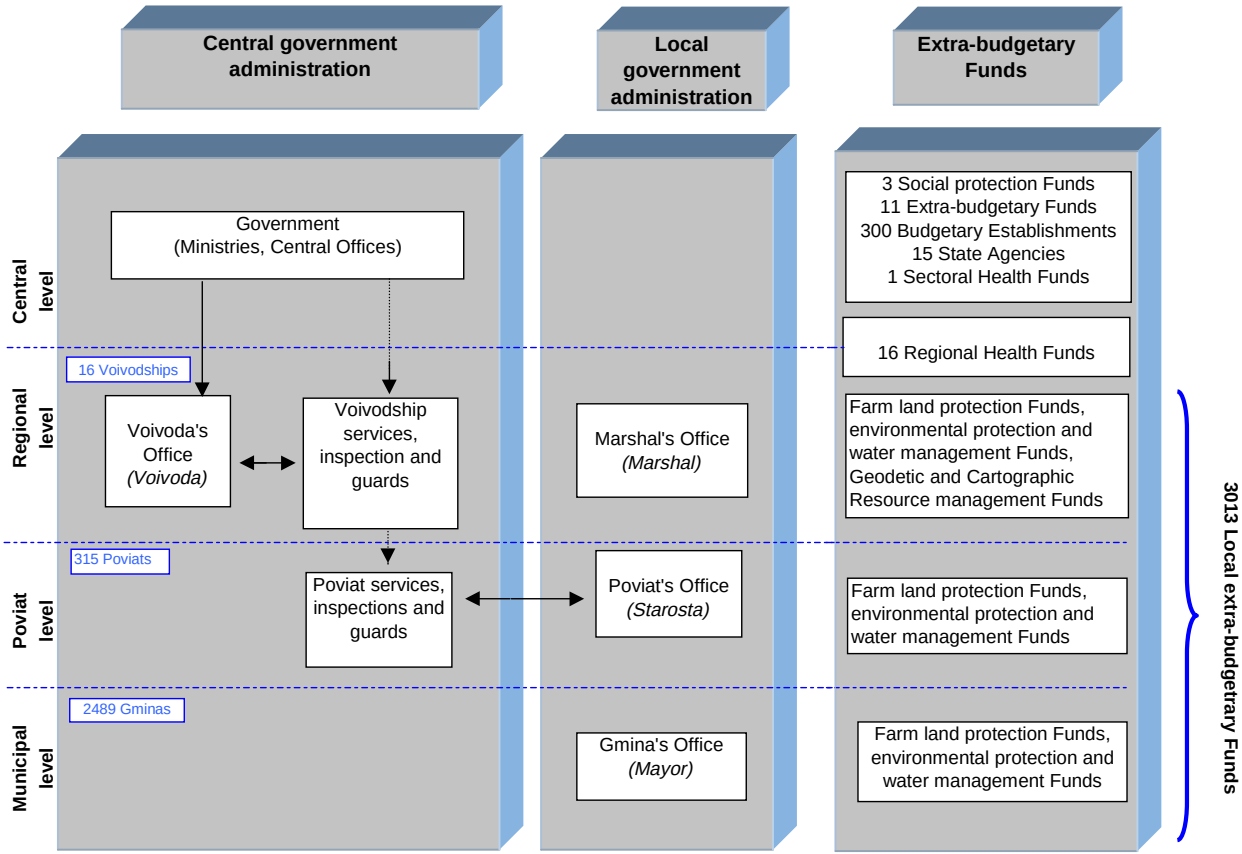
However, there is an escape clause built into the rules allowing the procedure to be bypassed in the case of an emergency where the implementation of fiscal consolidation plan is deemed impossible.

1. The State Treasury Debt is defined as liabilities created by the Ministry of Finance (State Treasury) in order to finance the State Budget deficits and risk-adjusted guarantees. It differs from the notion of the public debt because it excludes the debts of extrabudgetary funds and the commitments of other general government sectors, including that of sub-national governments.
2. Sub-national deficits are to be reduced by a factor R, where R is equal to R = (0.6–public debt/GDP)/0.05, which if applied to all of government spending would ensure that the debt in the following year was equal to 55 per cent of GDP.

Extrabudgetary funds finance a substantial part of central government activities but only a portion of their activities is recorded in the State Budget. Transfers from the State Budget represent 31 per cent of their revenues (27 per cent of state Budget revenues), while the unconsolidated revenues of the social security and other central extrabudgetary funds are equal to almost 90 per cent of State Budget revenues. The programmes administered by extrabudgetary funds are not subject to the same budgetary rules as those operated by ministries within the State Budget. In particular, there is no direct parliamentary supervision of the budgetary process of extrabudgetary funds. Their financial plans are approved by the Council of Ministers and only annexed to the State Budget for information. Thus, although parliament is made aware of their activities it is not given an opportunity

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Figure 21. **Budget structure of general government**



Source: Ministry of Finance.

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Box 5. Extrabudgetary institutions

Extrabudgetary funds

The three largest extrabudgetary funds, the social insurance fund (FUS), the farmers' insurance fund (KRUS) and the Labour fund, account for two-thirds of total extrabudgetary spending, while regional health funds account for a further 15 per cent.

ZUS, the Social Security Institution administers FUS, which receives about 27 per cent of its revenue directly as state subsidies. ZUS is responsible for collecting mandatory contributions, maintaining individual pension accounts in the first-tier, notionally-defined contribution pay-as-you-go pension system; assessing individual's rights to pensions; the payment of benefits and the management of new reserve funds. As of 2006, it will also be responsible for operating a new experience-rated workers' injury-compensation scheme. ZUS also collects contributions for the second-tier fully funded mandatory pension scheme which are then distributed to the credit of individual's accounts at privately managed pension funds.

KRUS provides the same services as FUS but its benefits are directed towards farmers. Typically, the private-sector contributions towards KRUS are about one sixth those going to FUS. As a result, State Budget subsidies represent 95 per cent of its expenditures and this alone represents 8 per cent of State Budget expenditure. For this reason, KRUS is forbidden to borrow. KRUS also finances the Prevention and Rehabilitation Fund (that finances costs associated with prevention of accidents and rehabilitation of incapable farmers) and the Administrative Fund (that finances the administrative costs for social insurance management).

The *Labour Fund* is the main source of unemployment benefits, pre-retirement benefits and active labour market programs. In addition to the 2.45 per cent of gross wages contribution made by employers, State Budget transfers are an important source of financing. Their share in the revenues of the fund is expected to rise from 14 per cent in 1999 to 37 per cent in 2002. The Labour Fund is allowed to borrow from banks and issue debt. In 2000 and 2001, it took on additional obligations equal to 12.5 per cent of its planned revenues in order to pay unemployment benefits and pre-retirement benefits.

The 16 *regional health funds* are partially funded through a 7.75 per cent payroll tax levied on employees and a similar but effectively less onerous tax levied on the self-employed. A 17thfund is open to all workers but most of its adherents are or were state employees working in so-called "uniformed" positions such as medical, police, fire and armed services. Contributions for the unemployed, retired and non-employed are assured via central government transfers to the funds. An equalisation formula ensures that all funds receive equal per capita contributions, but this formula is not risk weighted so those funds with older or sicker participants operate under a disadvantage.

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Box 5. **Extrabudgetary institutions** (*cont.*)

There are an additional 11 central government extrabudgetary funds under the supervision of line ministries. These include the Alimony Fund, the State Veterans' Fund, the National Environment Protection and Water Management Fund, the Farm Land Protection Fund, the State Land Surveying Cartographic Resource Management Fund, the Guaranteed Employee Benefit Fund, the National Fund for Rehabilitation of the Disabled, the Creativity Promotion Fund, the National Fund for Credit Guarantees, the National Housing Fund and National Motorway Fund. Most recently, the National Housing Fund is expected to expand its size as it takes on an expanded house-loan subsidisation scheme, while the newly created National Motorway Fund is expected to facilitate the financing of motorway construction.

Sub-national extrabudgetary funds account for 9 per cent of general government spending and some 22 per cent of total extrabudgetary expenditure, with *regional health funds* accounting for about two-thirds of this amount. Each *voivodship* operates a Farmland Protection Fund, a fund for Geodetic and Cartographic Resources Management and the *Voivodship* Fund for Environmental Protection and Water Economy, which is financed mainly from environmental fees and fines. In turn, each *gmina* and *poviat* operates a Farmland Protection Fund and a fund for Environmental Protection and Water Management.

State agencies

A number of state agencies pursue policy goals with only limited ministerial supervision. These include former extrabudgetary funds that have accomplished their original objectives and institutions that are effectively separate funds, with separate banking accounts, earmarked revenues that they are allowed to carryover into the next fiscal year and in some cases the right to borrow money commercially with an implicit state guarantee.

Extrabudgetary establishments and enterprises

A final group of budget entities whose spending is only partially reflected in the general government account includes budgetary establishments, which provide policy-related services (such as training centres) and ancillary enterprises that provide services directly to the administration (*e.g.* cleaning services). At present there are 300 budgetary establishments and 400 ancillary enterprises within the central government and an unknown number at the sub-national level. These institutions can be established by ministers and heads of central offices as well as by their sub-national counterparts.

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to influence the spending undertaken by extrabudgetary funds on behalf of the government. Furthermore, because of revenue earmarking it has only a limited ability to reallocate resources from or to these programmes as compared with programmes whose financing comes directly from the State Budget.

Moreover, extrabudgetary funds are subject to less stringent budgetary rules than normal programme spending. Most of them, unless specified otherwise, are allowed to carry over their annual surpluses into the next year, issue guarantees and loans and finance their deficits by selling their assets or taking on debt.[32] Their substantial lending operations include implicit subsidies of about 0.1 per cent of GDP[33] and their programme-related expenditures are not subject to public procurement rules although spending for their own use is. Moreover, there is considerable doubt about the quality of their loan portfolios and generally speaking they have yet to work out effective strategies for loan collection. In addition, they are subject to few restraints and can, therefore, allocate revenues across programmes and even create new ones without these decisions being subject to parliamentary oversight.[34] These features, plus their substantial earmarked own revenues means that their expenditures are not constrained by their initial budgets or revenues. These arrangements may have led some funds to pursue activities that lie outside of their official remit[35] and may be a factor linked to the corruption of some government officials.

The activities and budgets of State Agencies are also subject to less rigorous budgetary provisions. Many perform functions similar to extrabudgetary funds, receive direct transfers from the State Budget (about 4 per cent of the State Budget goes to Agencies as transfers) and have earmarked revenues that they can carry over to the next fiscal year.[36] Although their budgets have tended, on aggregate to be in balance, they often make ends meet by drawing loans with implicit state guarantees and using the proceeds from the privatisation of state assets in their care.[37] Moreover, in the past there has been evidence suggesting corruption in the management of some of these agencies.[38] Rules governing the transfer of profits from the wide range of autonomous budgetary establishments and ancillary enterprises to the State Budget are relatively clear.[39] More than 97 per cent of their revenues derive from the fees they charge both private- and public-sector clients and, in total, these revenues represent about 2 per cent of State Budget revenues in 2000. However, as instruments of ministries there is very little political oversight of their activities, with the result that there is a tendency for the administration to use these vehicles to pursue public policy goals without a clear democratic mandate or supervision.

Monitoring and execution of central government expenditure

The Ministry of Finance State Budget Department only monitors and manages the expenditures and revenues of the State Budget. Outside of the State

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Budget these watchdog activities are much less well developed. Centrally-operated extra budgetary funds provide monthly summary reports on their expenditures and revenues and more detailed reports on a quarterly basis with a 3-month delay. Sub-national government reporting is even less frequent. While budget execution data for both the local and central governments is presented to Parliament in May, consolidated general government accounts on a GFS basis are normally not available until August of the following year. This contrasts sharply with the situation in the Czech Republic and Hungary where such estimates are available on a monthly basis with less than a month's delay. Although estimates of the position of the consolidated central government are available monthly, over the years their reliability as an indicator of the overall stance of fiscal policy is variable and regularly differs substantially from that reported in the GFS. Moreover, the volatility of revenues and expenditures during the course of the year makes it difficult to judge the stance of policy at any given point in time (Figure 22).

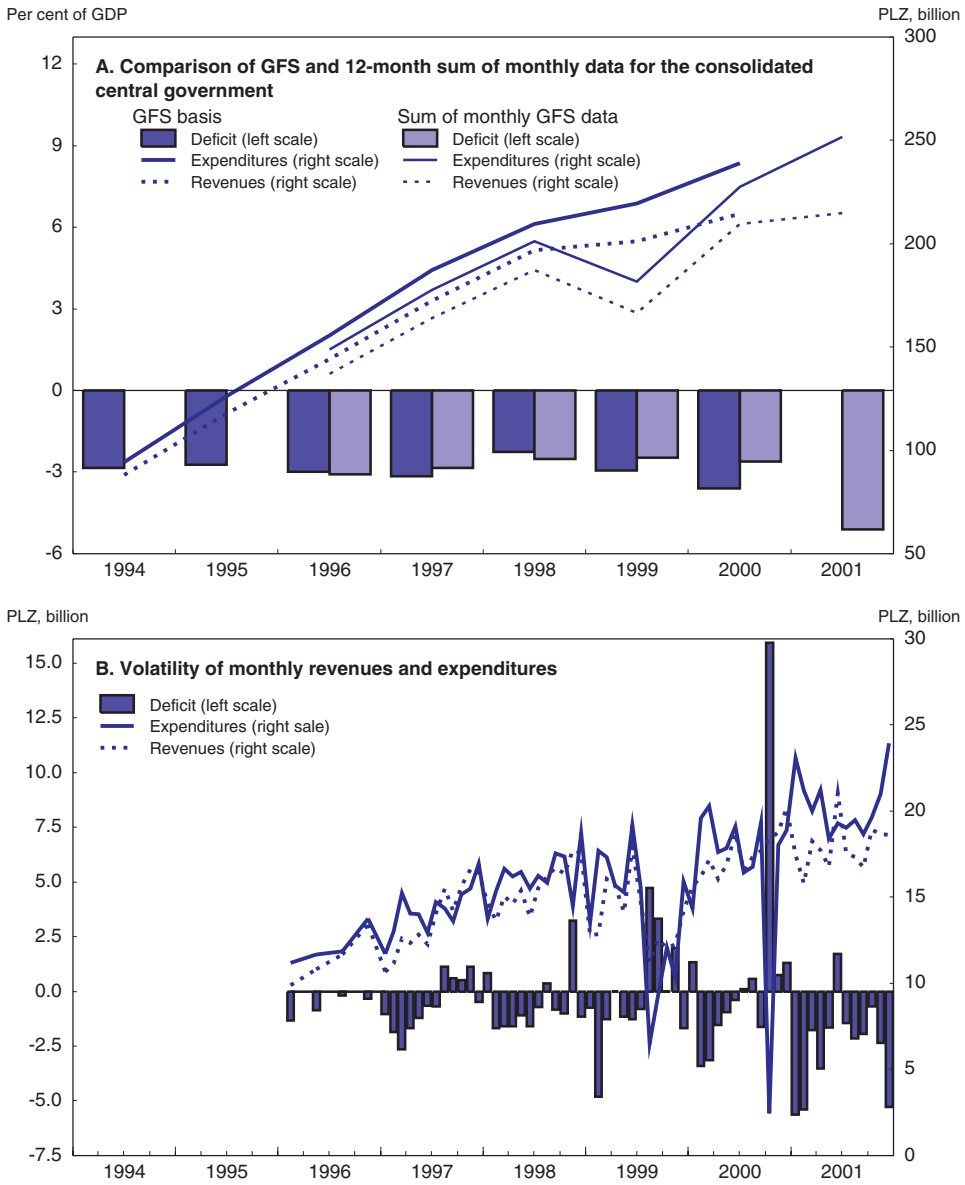
In cases of emerging imbalances, the authorities have limited scope for cutting discretionary expenditures such as investment spending or freezing wages. The Ministry of Finance can recommend that line ministries cut spending or can delay payments of budget allocations to them or other budgetary institutions, but only with their consent. Moreover, line ministries can only reallocate up to 5 per cent of the expenditures of a budgetary chapter or paragraph. Given the binding nature of the State Budget deficit, revenue shortfalls and expenditure overruns in the past have often been met by creative accounting, most typically involving the transfer of expenditures to the extrabudgetary sector. For example, in recent years recorded State Budget expenditures were reduced by extending loans to some extrabudgetary funds (repayment of which has yet to be made) instead of more transparent transfers. Had these expenditures been properly accounted for, the State Budget deficit would have been higher by 0.5 and 0.4 per cent of GDP in 1999 and 2000 respectively.[40] In other instances, extrabudgetary funds with extra financial resources have lent money to independent government agencies to prevent a rise in the deficit of the State Budget.[41] Most recently, compensation paid to public-sector employees for the non-indexation of salaries and pension benefits in 1991-92 was recorded "below the line", therefore reducing the size of the state budget deficit. Finally, the government has systematically resorted to delaying payments in order to minimise the State Budget deficit. This mechanism is allowed by the Act on Public Finance in instances where spending programmes span multiple years,[42] but in recent years it has been frequently used in order to reduce the recorded deficit by as much as some 0.4 to 0.7 per cent of GDP.

Sub-national government

The budgets of sub-national governments are prepared with only limited input from the central government, although important control mechanisms are in

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Figure 22. **Reliability of monthly central government accounts**[1]



1. Annual data exclude privatisation revenues.
Source: Ministry of Finance.

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place. While preparing the State Budget, the Ministry of Finance informs local governments as to the revenues that they can expect from shared taxes and central government transfers by mid-October. However, because these revenues form such a large share of their revenues, local governments only begin preparing their budgets at that time and as a result, these are not finalised until March, *i.e.* three months into the fiscal year. Although local governments have significant budgetary authority, they are required to submit their draft budgets to Regional Clearing Chambers (RIOs), which are instruments of the central government. The RIOs assess the draft budgets to ensure that each sub-national government has the means to finance any proposed deficit and makes an overall assessment of the sustainability of their liabilities. The opinion of the RIO must be published within one month following the submission of a draft budget: if it is negative, the budget in question must be amended as directed by the RIO.

Sub-national governments are also subject to specific limits concerning the size of their deficits and debt loads. In particular, their debt-servicing expenditures and the stock of their debt may not exceed 15 and 60 per cent of their total revenues, respectively. While these limits are welcome, they are not currently binding for most sub-national governments, because the *voivodships* and *poviats* are quite new and, therefore, have limited debt and most *gminas* have not incurred substantial debt in the past (Table 19). As a result, if sub-national governments were to increase spending, these rules could not forestall a significant increase in sub-national and therefore general government debt and (at least temporarily) deficits.[43] Indeed, rising deficits and substantial reliance on one-off privatisation revenues to finance their current expenditures suggests that many sub-national governments may soon be obliged to exploit more fully the borrowing room provided for by the law.[44]

The RIOs also monitor the execution of sub-national governments and are empowered to intervene if lower-level authorities deviate substantially from their approved budgets. While some RIOs report that they now have comprehensive electronic monthly reporting from sub-national governments, this information is not currently integrated into the general government accounts. In Warsaw, quarterly reports on local government finances are only available with a one quarter lag, while their extrabudgetary activities are only reported twice a year, also with a one quarter lag.

The planning horizon

While practice concerning the evaluation of the budgetary impact of draft laws and amendments varies, in general the process takes insufficient care to evaluate the effectiveness and longer-term consequences of programmes. Drafts of new legislative initiatives include estimates of their budgetary impacts but these are by and large restricted to one year, which in the case of programmes with longer-term expenditure implications is inadequate. Longer-term analyses

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Table 19. **Sub-national government revenues by source**

	Voivodships	Poviats	Towns with poviat status	Gminas
	In per cent of local government revenue			
Own revenues	**15.9**	**7.9**	**48.4**	**52.5**
Shared taxes	14.6	1.4	17.3	15.9
CIT	2.5			1.6
PIT	12.1	1.4	17.3	14.3
Own taxes	0.0	0.0	11.6	15.1
Real estate tax			11.0	12.2
Agricultural tax			0.0	2.1
Transportation tax			0.6	0.8
Fees and others	1.4	6.5	0.0	21.5
Stamp duties			3.2	3.8
Others	1.4	6.5	–3.2	17.7
of which: Revenues derived from property	0.4	2.7	9.0	n.a.
Earmarked grants	**46.2**	**44.4**	**20.3**	**13.7**
Delegated tasks	9.6	24.5	13.4	7.2
Own tasks	30.5	15.9	5.9	4.4
Tasks based on the agreement	6.1	4.0	1.0	0.3
General subsidies	**37.7**	**47.7**	**31.2**	**33.7**
	PLZ million			
Memorandum items:				
Total revenues	3 705.0	12 555.0	21 766.0	34 584.0
Budget balance	–2.2	–0.9	–6.0	–4.7
Liabilities	2.8	3.0	17.3	14.8

Source: Ministry of Finance.

are conducted from time to time, for example with the introduction of the old-age pension reform in 1999. For the moment, such budgetary impacts tend to include only the direct costs, and additional analysis of second- and third-round effects is limited. Currently, the Ministry of Finance is improving its capacity to perform more sophisticated budgetary simulations but has yet to develop tools that would allow for a systematic assessment of the distributional consequences of policies. Finally, policies are not subject to systematic *ex post* evaluations, nor is there widespread use of sunset clauses or other tools to ensure that existing programmes are constantly evaluated.

Investment

The budget process for longer-term projects such as investment is also problematic. There is no mechanism for ensuring that funding for projects that

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have begun is continued until their completion. Because investment spending is one of the most important components of discretionary expenditure available to the authorities,[45] there has been a tendency for investment projects to be interrupted repeatedly as the government seeks to meet its deficit targets. While this has kept overall investment spending levels low, it has resulted in substantial delays, a substantial increase in the costs of individual projects and a trend of underinvestment.[46] Moreover, because of cuts in State Budget funding, project managers have resorted to bank loans (with implicit state guarantees) to finance projects. Indeed, 32 per cent of the projects completed in the period 1995-98 were financed in this way, and only PLZ 168 million of the PLZ 2.2 billion (0.3 per cent of GDP) in such guarantees offered over this period was repaid. The remainder had to be refinanced or paid for from the State Budget reserve.

Part of the problem derives from poor initial estimates, preparation and implementation of investment projects. However, a lack of technical and financial expertise and loose monitoring of investment are also to blame for the sub-par record (National Audit Office, 2001). Recently some progress was made to improve the planning and implementation of investment spending. Thus, proposed investments exceeding PLZ 55 million must have specific project descriptions, including estimated costs for the two following years, and these details are attached to the State Budget.

Agenda for public expenditure reform

For most of the transition period the general government deficit has come in at a reasonable 2 per cent of GDP, and the country has so far avoided the large-scale fiscal imbalances that have provoked economic crises in some of its neighbours. However, a number of factors suggest that there is room for improvement. In particular, the significant slippage that occurred in 2001 and the substantial confusion that existed over the actual stance of fiscal policy that year suggest that oversight and control mechanisms need strengthening. Moreover, the limited progress made since 1995 in reducing the size of the government and the inertia that has characterised spending shares suggest that policy makers may be having difficulty influencing the evolution of public spending in line with changing priorities.

In view of a number of looming medium-term fiscal challenges the capacity to plan and implement a multiyear public spending strategy is likely to be of increasing importance to Poland's long-term growth prospects. Pressures on spending from the rising debt-servicing burden, the urgent need to allocate resources towards priority expenditures, such as reducing youth unemployment, infrastructure and human capital investment; and ageing-related cost pressures will all make budgetary management over the medium term more difficult. The following paragraphs propose a number of policy directions that should be pursued to meet these challenges. They seek to give policy makers the tools

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necessary to exercise control, while at the same time continuing to offer an appropriate range of services to its citizens in a cost-effective way.

Improving the efficiency of social policy expenditure

More than one third of general government spending goes towards personal transfers, even more if tax expenditures are included in the total. A large share of this expenditure is financed by payroll taxes, which represent some 60 per cent of labour costs and contribute importantly to the extensive non-employment and hidden activity. At the same time, many of the social benefits offered in Poland exacerbate the problem by making paid-work economically unattractive. As Poland looks forward, one of its most important challenges will be to make better use of its resources, to re-employ those currently out of work and thereby to raise the level of potential output. A reform of social expenditure could help eliminate poverty and unemployment traps and make room for a reorientation of government expenditure towards growth-enhancing programmes such as infrastructure development and education. Indeed, as emphasised in the previous survey, because employment is one of the best cures for poverty, any reform that succeeds in reducing non-employment will likely have important impacts on social welfare – even if it implies a reduction in transfer spending.

The overall efficiency of social spending could be improved by further tightening of the eligibility criteria for disability and pre-retirement pensions as well as sickness allowances and reductions in the level of sickness benefits. Notwithstanding important efforts to restrict access to new disability pensions (inflows were down 44 per cent in 2001 as compared with 1999 and sick days down 32 per cent) currently high overall pension outlays mainly reflect non-employment. In this regard, early retirement and disability pensions continue to be used as mechanisms for absorbing excess labour supply. As a result, disability pensioners represent more than one third of the overall number of pension beneficiaries (Table 20). Indeed, 12 per cent of the working age population are receiving disability benefits, the highest ratio in the OECD and at about twice the modal level (OECD, 2002). Similarly, access to sick leave benefits needs to be more closely monitored. The combination of the benefits they confer and the immunity they provide from lay off has led to an explosion both in terms of expenditure and beneficiaries, which is only now beginning to reverse itself. Not only would further restricting access to these programmes to those genuinely in need permit a more generous treatment of these people, it would allow significant savings to be realised. Indeed, a rough estimate suggests that such savings could finance an almost 50 per cent drop in payroll taxes[47] – even before any second round effects are taken into account.

The efficiency of the overall pension system would almost certainly be enhanced by integrating the farmers' pension system (KRUS) with the general

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Table 20. **Personal transfers, selected indicators**

	1990	1995	1998	1999	2000	2001
	Thousands					
Number of old-age pension beneficiaries	**3 404**	**4 488**	**4 636**	**4 630**	**4 630**	**4 626**
Non-agricultural sector	2 353	3 230	3 497	3 532	3 574	3 612
Agricultural sector (KRUS)	1 051	1 258	1 139	1 098	1 056	1 014
Number of disability pension beneficiaries	**2 628**	**3 391**	**3 531**	**3 536**	**3 472**	**3 353**
Non-agricultural sector	2 187	2 629	2 735	2 740	2 678	2 565
Agricultural sector (KRUS)	441	762	796	796	794	788
Number of survivor pension beneficiaries	**1 029**	**1 179**	**1 268**	**1 287**	**1 311**	**1 331**
Non-agricultural sector	1 015	1 150	1 234	1 252	1 274	1 292
Agricultural sector (KRUS)	14	29	34	35	37	39
	Per cent					
Benefits (per cent of earnings)						
Old-aged pension benefits		72.8	67.8	65.0	62.5	64.5
Disability benefits and family allowances		51.7	48.3	46.5	44.8	46.3
Survivor pension benefits		61.7	58.4	56.0	53.7	55.4
Total spending (per cent of GDP)	**8.8**	**16.6**	**15.6**	**15.7**	**15.1**	**15.9**
Old-aged pension	3.4	6.4	6.4	6.4	6.3	6.6
Disability pension	2.5	3.7	3.5	3.6	3.4	3.4
Survivor pension benefits	1.1	1.9	1.9	2.0	1.9	2.0
Farmers' pension (KRUS)	1.5	2.4	2.2	2.1	2.1	2.1
Sickness benefits	0.1	1.0	1.2	1.1	0.8	0.8
Unemployment benefits	0.2	1.2	0.4	0.5	0.7	0.9

Source: Ministry of Finance, OECD Social Expenditure Database.

system administered by FUS. Indeed, insofar as the programmes administrated by the two systems are similar, important administrative economies could be gained. However, efforts would need to be extended to ensure that during the transition period to the general system, current adherents to the heavily subsidised KRUS system receive equivalent income support via existing social assistance programmes. Integration of the two systems would have the additional important advantage of doing away with some of the worst distortions generated by KRUS. Unlike the general system KRUS is heavy subsidised. It spends about 2 per cent of GDP, 95 per cent of which comes from the State Budget. As a result, contributions towards a KRUS pension are small, relative to benefits, and quite naturally attractive. This, coupled with the requirement that a programme participant own at least 1 hectare of farm land, has forestalled the necessary consolidation of Polish Farm land. Indeed, rather than shrinking, the number of uneconomic small farms during the past decade has increased.[48] So large is the apparent distortion that KRUS benefits account for 35 per cent of farming-related income, although as a share of the total income of farming households it represents only 13 per cent.

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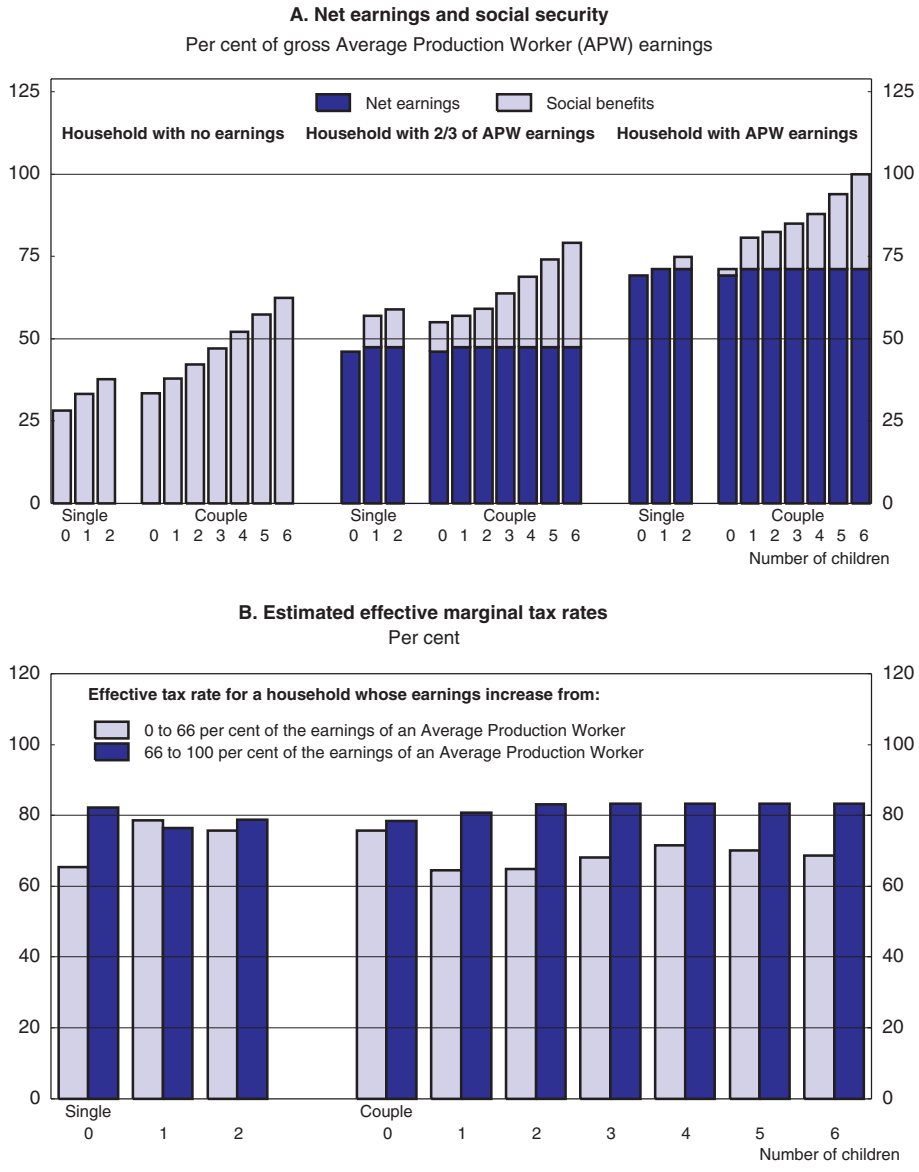
With the unemployment in excess of 20 per cent of the labour force, there is clearly substantial room for improving the performance of Polish labour market policy, a topic dealt with in more detail in Chapter IV. Social assistance programmes need to be revised so as to reduce the unemployment and poverty traps that they form in conjunction with the tax system. The need is most acute for households with children where social security benefits are high as compared with both the minimum and average wages. These ills are not borne by workers alone: high labour costs reduce firms' profitability, and their margins for future investment, and in this manner slow growth overall. Given that employment is probably the most effective means of combating poverty, these generous benefits are triply inefficient. Non-earned income for a household with three children is 135 per cent of the minimum wage and 68 per cent of the average wage (Figure 23). Moving from unemployment to a job paid at minimum salary can imply only a small increase in income once benefit withdrawal and income taxes are taken into consideration and estimates suggest that the effective marginal tax rate could be as high as 83 per cent (OECD, 2000).[49] These high effective tax rates provide strong incentives to underground work. Fully 10 per cent of benefit recipients report working in the underground economy, while using their participation in benefit programmes to maintain their entitlement to pension and social benefits, which they would otherwise lose (Labour Force Survey, 1999). This situation is especially prevalent in rural areas where 14 per cent of old-age pensioners, 19 per cent of disability pensioners and 6 per cent of unemployment benefit recipients reported having worked underground.

Overall tax expenditures and social transfers need to be more closely examined to reduce the extent of unnecessary revenue churning. OECD analysis using the household consumption survey indicates the low or zero-rating of a wide range of goods and services tends to benefit all categories of workers approximately the same in percentage terms but in absolute terms benefits the richest segments of society the most (Figure 24). Similar analyses of the impact of both social and tax expenditure policy indicates that here too targeting could be improved. Previous work (OECD, 2000 and Cavalcanti and Li, 2000) indicates that tax relief programs, notably the housing tax relief program, primarily benefited high-income individuals. Indeed, even though the housing tax deduction represents more than 0.5 per cent of GDP in foregone revenue, prior to the World Bank study the authorities had never assessed its cost effectiveness and income redistribution effects. To some extent this distortion has been addressed by a 2001 reform to the personal income tax system that placed a cap on these deductions.[50]

As in other OECD countries there is scope for more effective use of health expenditure, but exploiting potential benefits is not straightforward. Poland launched a bold reform in 1999 that introduced a social insurance system operated through 17 health funds as the main vehicle for purchasing health services through contracting with healthcare providers.[51] Although presented as a

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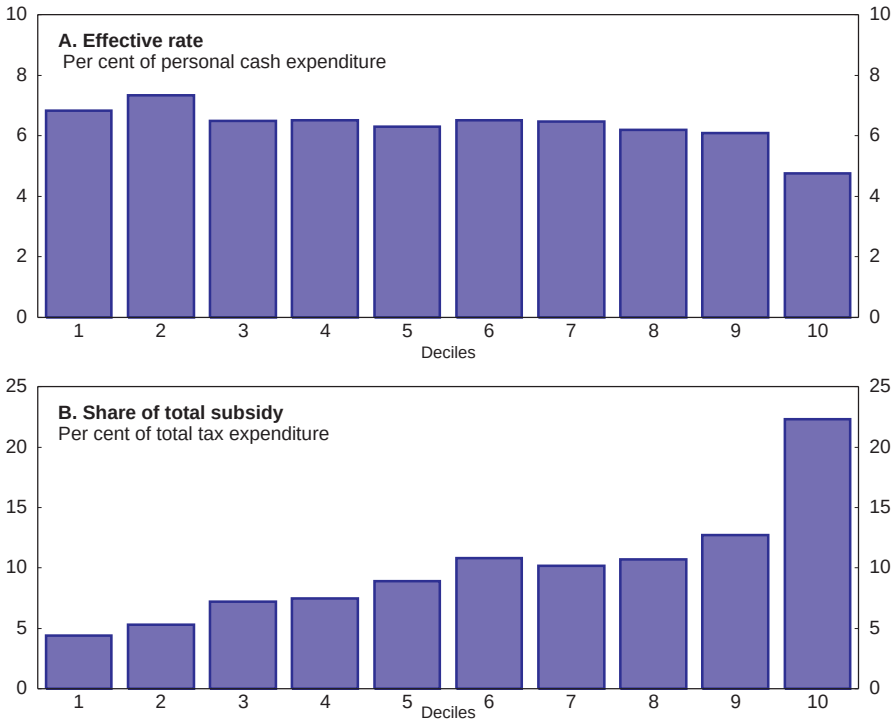
Figure 23. **Social assistance and work incentives**



Source: Ministry of Labour and OECD.

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Figure 24. **Distributional impact of non-standard VAT tax expenditures**[1]



1. Data calculated by the OECD using individual household records from the 2000 Consumer Expenditure Survey and VAT rates supplied by the Ministry of Finance.

Source: Central Statistical Office, Ministry of Finance and OECD.

social insurance system, contributions are levied on employees, pensioners and the self-employed only – with the State paying the contributions of the unemployed and those receiving various benefits. Moreover, contributions are credited against individuals' personal income tax liabilities, implying that the system is almost entirely financed via tax expenditures.

Although overall access has improved and family practitioners are playing a greater role as gatekeepers, the decentralised system of health funds has experienced teething problems. The equalisation mechanism that was put in place does not take into adequate account differences in the health risks of Fund participants. In addition, poor governance of some regional health funds and the

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absence of a clear definition of basic coverage has led to varying degrees of coverage and access to care across funds, which is perceived as unfair. Table 21 (Chapter IV) summarises some of the steps needed to improve the efficiency of the healthcare system. Most important of these, from the point of view of public expenditure would be the introduction of a clear statement of such a minimum services that the regional funds would be obliged to provide. This would not only make the system less arbitrary, but it would also serve to limit future cost pressures and provide an avenue for more private-sector co-financing of healthcare.

Making the budget process more comprehensive

In order to improve the authorities' capacity to evaluate the stance of policy *ex ante*, the government should take steps to raise the profile of the general government within the budget process. Indeed, it is impossible for policy makers to have an accurate sense of the stance of fiscal policy unless budget documents are placed in a general government framework. Given the relatively small share of the State Budget in overall public spending, reliance upon it alone can give a misleading representation of both the stance and direction of fiscal policy. Indeed, the recent emphasis placed on expenditure norms instead of the deficit within the State Budget is unlikely to be an effective constraint on central government spending unless similar restrictions are placed on extrabudgetary funds.

Perhaps more importantly, keeping the activities of various funds like the Labour Market Fund, Social Insurance Fund (FUS), Farmers Pension Fund (KRUS), and the other social assistance funds outside of the budgetary process unnecessarily and undesirably restricts the capacity of parliament to allocate resources according to changing priorities. Including in the Budget a more comprehensive statement of the activities of such extrabudgetary funds[52] would improve overall governance by subjecting their activities to the same level of oversight as other government spending programmes and make it easier to communicate policy priorities to the various funds.

In addition, the comprehensiveness of budgetary reporting should be increased both during the budget process and as outturns are monitored in the course of the year. This would improve the transparency of government operations and perhaps also shed some light on some of the Funds' less transparent activities, such as their borrowing, lending and guarantee activities. Moreover, it would provide parliament with an opportunity to review their activities in a systematic way during the course of the closing of the accounts. While funds might retain some of their current independence they would be directly accountable to parliament for deviations from budgets, and they could be subjected to clearer and more transparent rules. An integrated reporting of Ministerial and extrabudgetary spending would also improve the ability of policy makers to redirect financial resources towards priorities independent of whether they fell

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into the purview of a fund or a ministerial programme. Similar benefits could be obtained by systematically including *ex ante* and *ex post* reports on tax expenditures. While in some cases, tax exemptions are in place in order to promote important social goals or to correct market failures, not discussing them within the annual budget process tends to place them on an unequal footing with other measures that pursue similar goals.

In the same vein, policymakers' appreciation of the overall stance of fiscal policy would be enhanced if the budget processes at the central and sub-national levels were better co-ordinated. While the desire to afford sub-national governments with greater autonomy and thereby the flexibility to respond to local needs precludes the central government dictating budgets to lesser levels, budgets at both different levels should be developed simultaneously so that decisions can be taken in a co-ordinated manner. As a first step, expected tax revenues and transfers to be directed to sub-national levels of government could be communicated in the summer when initial revenue estimates are made, rather than, as at present, in late autumn when estimates are finalised. Local governments would then be in a position to submit preliminary budgets to the RIO in early autumn and these could be revised when the expenditure side of the central government budget is frozen. As a result, local budgets could be finalised shortly after the central one and could be expected to deviate only slightly from the general government spending and revenue estimates that would be included in the Budget.

Extrabudgetary funds could be fully integrated into the State Budget

Dealing more thoroughly with extrabudgetary revenues and expenditures in the State Budget would go a long way to improving the ability of policy makers to visualise the totality of public expenditure. However, three fundamental governance problems would be resolved by abolishing the funds and reintegrating their programmes into the State Budget.

First, abolishing the extrabudgetary funds and fully integrating their activities and revenues into the State Budget would reduce the distortions and inertia that their reliance on earmarked taxes brings with it. For example, reliance on a payroll tax subjects the spending programmes of the Labour Market Fund to procyciclal pressures. During a downturn, revenues decline with employment losses and mandatory expenditures, mainly passive income support for the non-employed, increase. This normal (and countercyclical) operation of automatic stabilisers squeezes the resources available for the Fund's discretionary activities – principally active labour market policies – causing expenditures in this area to shrink. Since the Fund has long since exhausted its initial financial allocation and no longer builds up resources during up turns, unless it receives special cabinet approval to take on debt its overall spending varies procyclically. Moreover, bringing fund programmes on to the same footing as those currently financed from

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within the budget would improve overall resource allocation. It would do so, by ensuring that when expenditures in a specific area decline, the freed resources could be brought to bear anywhere in the full-range of government activity, not just the limited sphere of competence of a given fund.

Second, bringing these activities into the State Budget would subject their programmes to the same degree of parliamentary and ministerial oversight as other programmes. It would require that they compete directly with other government priorities for funding and would increase the authorities capacity to redirect spending towards its most pressing needs. Indeed, rather than subsidising farmers' retirement incomes as the current system does (almost 95 per cent of KRUS expenditures come directly from the State Budget) an amalgamation and equalisation of contributions would open the way for using that money to improve rural infrastructure and productivity. More generally, provision can be made for carrying over funding for those activities where there are clear multi-year commitments, while the funding of deficits generated by mandatory expenditures would follow normal procedures, by passing the current situation where funds sell off assets to cover shortfalls. Under such a governance system, the authorities would have better control over spending levels and the creation of liabilities. They would no longer be able to create new programmes or extend activities just because their budgets permit it. Moreover, bringing the funds into the government would subject their lending and purchasing activities to public procurement and State Aid regulations.

T*hird*, abolishing the funds and integrating their programmes into the State Budget would also help reduce administrative costs. Both FUS and KRUS, respectively the general and farmers pension authorities, provide virtually identical services but operate parallel bureaucracies. By the same token, integrating the tax collection activities of the umbrella extrabudgetary fund organisation ZUS would improve overall efficiency. Currently incentives to declare income to ZUS are relatively strong, because future benefit levels are tied to them. By integrating collections the incentives to understate income in the personal income tax system will be reduced. In addition to reducing labour costs, this would have the further advantage of decreasing opportunities for tax evasion that derive from poor information sharing between the two agencies. This said, the abolition of the Funds as independent Budgetary institutions need not imply important changes in their administrative operations. Indeed, the current structure and responsibilities of their various bureaucracies could well be preserved without diminishing the advantages to be reaped from integrating their activities and their oversight into the State Budget.

The logic in favour of reintegrating health expenditure into the State Budget is reinforced by the fact that, in large measure, the current healthcare system is only notionally insurance-based. Coverage is virtually universal, with the state paying the contributions for large groups of non-workers and practitioners

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receiving payment from the state, whether or not the patient is "covered". Indeed, direct transfers from the State Budget cover 27 per cent of the spending of health funds. Moreover, as indicated above, premia are almost entirely paid for via tax expenditure. A better solution might envisage integrating the financing function into the Ministry of Health and paying health expenditure from general revenues. This could be financed by applying a low tax rate to a wide base (*i.e.* all of personal income) and dropping the health-related payroll tax. The advantage incurred by the visibility of the healthcare tax could be preserved by labelling a portion of the wider-based tax as a healthcare tax – without necessarily earmarking the associated revenues. The argument for abolishing the various PAYG pension funds is even stronger. Although special extrabudgetary pension funds have been created in some countries in order to accumulate temporary surpluses (in isolation from political spending pressures) so as to defray future liabilities, the first-tier system runs a deficit. While the authorities have created special reserve funds, for the moment these are financed from general revenues. Nor would integrating the pensions into the State Budget imply an end continued accumulation of such demographic reserve funds.

Improve the timeliness, quality and comprehensiveness of budget execution data

Independent of whether or not the extrabudgetary funds are integrated into the State Budget process, the authorities need to improve both the quality and timeliness with which public finances are reported. To ensure that policy makers have a clear and timely understanding of fiscal developments, three steps appear necessary. F*irst*, more detail concerning the activities of extrabudgetary funds needs to be included in the monthly accounts of fiscal developments – especially as concerns their reporting of their lending, borrowing and privatisation activities. At least part of the recent turmoil in monthly data appears to derive from problems at this level. S*econd*, as an initial step, the scope of reporting should be increased to cover all the central government extrabudgetary funds. T*hird*, with the increased weight of the sub-national governments in the general government the frequency of their reporting should be increased so that accurate estimates of the stance of the general government can be made.

In this regard, the authorities should consider creating a single government account for all central government activities and establishing a centralised treasury function in order to subject all the revenues and expenditure (both current State Budget and extrabudgetary funds) to comprehensive and up-to-date monitoring. Experience in other OECD countries indicates that such an account can play a critical role in tracking spending and revenue developments and signalling deviations before they become problems. Particular care should be taken to ensure that lending and borrowing activities of the extrabudgetary activities are correctly accounted for – especially in the case where below-market-rate loans are used as a form of implicit state aid by some funds.

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As these steps are pursued, the authorities should consider what model they wish to pursue in data reporting. Currently, central government data are reported on a cash-flow basis while that of the social security funds are recorded on an accruals basis and converted into cashflow terms for the purposes of the GFS and monthly accounts. While many countries report on a cashflow basis, it may be just as easy to move to an accruals-based integrated system as a cashflow system. Indeed, the most recent version of the GFS manual (IMF, 2001) has been made more consistent with accrual-based and SNA accounting practices and the major extrabudgetary funds already report on this basis.[53] This would have the particular advantage of ensuring that the longer-term implications of spending decisions that extend beyond current-year budget appropriations would be included in the accounts when made. As a first step towards such a system, the Budget and execution reports should include complete information on expenditure arrears on both a central- and general-government basis.

Adopting a medium-term economic framework

Placing the annual Budget process within a medium-term framework would enhance fiscal transparency and the ability to reallocate spending towards medium-term priorities. Such a move would have the additional advantage of facilitating the integration of extra-budgetary funds into the State Budget by allowing explicitly for rolling over unspent appropriations for programmes where commitments are multiyear (investments) or very cyclical in nature (labour market programmes). It would also help plan the rational use and absorption of EU structural funds. The planning horizon implicit in a Medium-term economic framework (MTEF) would provide the medium-term budgetary stability that extrabudgetary funds are supposed to provide, while still subjecting programmes to a political process where their expenditures have to be justified and compete with alternative priorities. Although the existing system on spending control has not translated into spending overruns and a tangible threat to sustaining public finance, it has also failed to reduce the size of the spending. The advantages of introducing a multi-year budget framework would be particularly evident in the area of investment by insulating essential investment projects in areas such as infrastructure from the kind of *ad hoc* budgetary cuts that have plagued them to date. Moreover, by including explicit *ex ante* processes for specifying, evaluating and financing large-scale investment projects would along with *ex post* oversight help reduce the risks of substantial costs overruns and inappropriate expenditures.

A MTEF would have the additional advantage of giving policy makers the necessary confidence in the economy's longer-term budgetary sustainability to allow automatic stabilisers to work. Armed with a better sense of future budgetary prospects, politicians would be better positioned to resist temptations to vary spending pro cyclically. As a result, positive surprises could be used to help pay

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down debt, while during negative ones automatic stabilisers could be allowed to work – thereby limiting the precipitous cuts in discretionary expenditures that have characterised such episodes in the past.[54] Similar benefits could accrue to sub-national governments if they too were to adopt elements of MTEF budgeting.[55]

Reducing fiscal risk associated with contingent liabilities

With Poland's public debt approaching the 60 per cent of GDP constitutional limit and given the medium-term cost pressures facing the economy, there is a risk that rather than reallocating expenditure towards priorities, political pressures may lead the authorities to accumulate liabilities off budget. While existing rules covering state guarantees provide for significant levels of disclosure and include reasonable prudential provisions, they are neither sufficiently comprehensive nor binding. As a result, there has been a tendency in recent years to increase the levels of guarantees offered and to use guarantees to finance public-policy goals that would be better more transparently and less expensively addressed through direct subsidies or other measures. Current practice could be improved in three ways.

1. To make limits more binding and reduce the temptation to incur future liabilities for short-term political gain, an annual and binding limit on the size of newly issued guarantees and on the total stock of outstanding guarantees should be included in the act on Public Finances. The limit should be stated as a per cent of GDP or of current revenues and be made to apply to all guarantees whether provided by the government or extrabudgetary funds and agencies. The current practice of setting the limits on guarantees annually means that a government that wishes to pursue policy goals off-budget via guarantees needs only increase provisions for them (as indeed was done in the 2002 budget).
2. The guarantees issued by all government agencies must be subjected to the same procedural and prudential rules as well as and quantitative limits. Currently this is not the case as the guarantees issued by State Budget are subject to relatively tight prudential and procedural rules and quantitative limits, while those offered by a number of extrabudgetary Funds and agencies are not so constrained.
3. The practice of using state guarantees to finance various off-budget public policy goals should be abandoned and proscribed. Guarantees should only be used to counteract clearly identified market failures and, then, only after a careful evaluation of the relevant merits of alternative policy instruments (including subsidies) has been made. A risk assessment should be integrated into this process, and its results made

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public. Too often guarantees are used as a substitute for subsidies to firms (especially state-controlled ones) or to finance other kinds of programme spending.

In this regard, the proposed use of guarantees to help finance the construction of motorways needs to be carefully examined (Box 6). Given the size of the expenditures envisioned, the programme certainly constitutes a possibly serious risk to medium-term fiscal sustainability. At a minimum, the guarantees to be issued by the State Motorway Fund should be subject to the same procedures and prudential rules as other guarantees and included in the overall quota to be provided for in the Public Finance Act. Moreover, a programme placing more emphasis on upgrading and repairing the existing road network would be more cost effective than the current proposals to build multi-lane highways (World Bank, 2002).

Another source of contingent liabilities is represented both by the existing and future debts of the wide range of loss making state-owned enterprises (see Chapter IV). While legally the state is not obliged to cover the debts of state-owned firms, it has already extended significant guarantees to a number of them and several others benefit from implicit guarantees. Moreover, many of these firms have amassed large tax and social security arrears that are unlikely to be collected, and some continue to fail to meet their tax obligations. With a combined debt of around 6 per cent of GDP, the loss-making state-controlled companies in the coal,

Box 6. Concession-based motorway construction

Despite early recognition of the importance of improving its highway infrastructure, since the beginning of the transition Poland has only succeeded in completing some 170 km of the 2 000 km of multi-lane highway originally planned for completion by 2015.

Recognising the failure of the earlier concession-based construction model in 2000, the authorities prepared an amendment to the Toll Motorway Act, which creates a legal basis for private and public-sector partnerships and a state-owned Motorway Fund. The fund is expected to receive revenues from the State Budget, vehicle duties, toll fees and loans taken by the General Directorate for Public Roads and Motorways.. The fund is to provide grants and interest-free loans to private-sector operators who will operate the motorways as concessions, repaying their loans from their profits.

The government has made provisions to provide substantial state guarantees perhaps as much as PLZ 14 billion (about 1.8 per cent of GDP) in 2002 to finance road construction. This could rise to as much as PLZ 38 billion if guarantees are provided for the full amount of foreign and private capital that the government expects to attract to the project.

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steel mill and railway sectors have little chance of long-term survival unless this debt-burden is taken on by the state. As discussed in Chapter IV, unless these firms are privatised quickly, these liabilities can be expected to increase at the same time as the market value of the firms continues to deteriorate – making an acceleration of the privatisation process all the more urgent.

Improving efficiency at the local level

The existing rules governing sub-national government budget preparation and monitoring as well as the limitations placed upon deficits and debts appear comprehensive and should ensure that no important fiscal risks emerge from them over the longer term. Sub-national governments deliver a large share of general government services but there are few mechanisms in place to ensure the quality of the services delivered. In this respect, there appears to be a mismatch between the spending responsibilities of *gminas* and their ability to effectively allocate resources to meet the needs of their population. The problem arises principally because the current grant system is strongly biased towards specific-purpose grants. As a result, sub-national governments have only a limited capacity to reallocate funds according to local requirements and the system provides inadequate incentives to sub-national governments to manage their spending efficiently. Because the resources they have for any given project is determined by formula, they do not feel fully responsible for the services they provide and tend to use inadequate financing as an excuse for poor services.

In response to this problem, the authorities are considering substantially increasing the shared tax revenues made available to sub-national governments, while simultaneously reducing specific-purpose grants.[56] Such a move has the advantage of making local authorities' resources more fungible and should increase local authorities' incentives to reduce programme delivery costs, improve services and concentrate on the programmes that are important to local populations. Such a result could also be achieved by removing the restriction on the uses to which grants can be put. In instances, where national standards are deemed important, performance grants could be instituted that are conditioned on reaching certain levels of service or improvements in performance.

Among the tax sharing options under consideration is one that would give *gminas* a share of corporate income tax revenues from firms in their jurisdiction and the right to charge lower rates in order to attract firms. While such a system would give them another tool for attracting economic activity, the corporate income tax does not seem to be a good instrument for introducing healthy tax competition. The principal problem derives from the fact that corporate income tax is assessed on all of a firms' activity but is paid only by the head office whose location need not bear a strong relationship to where the brunt of its economic activity occurs. As a result, such a regime could result in intra national tax havens where firms

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place fictive head offices in order to benefit from low tax regimes to the detriment of the regions where they are actually active. Moreover, the corporate income tax base tends to be very volatile as compared with personal income. Additionally, if *gminas* are given the opportunity to offer lower tax rates, then it will be important that in calculating the amount of regional equalisation grants, that the total tax base available to a *gmina* is considered instead of its actual revenues. If *gminas* are granted more autonomy in how they spend their shared revenues it will be critical that the resources of the National Audit Office (NIK) be expanded so that it can perform more *ex post* audits at the sub-national level.

Finally, efforts should also be extended to increase the financial and legal incentives for *gminas* to merge or provide services in association with other *gminas*. While there are relatively few very small municipalities in Poland, two thirds have fewer than 10 000 people – much smaller than what is considered a minimum efficient size of 20 000 to 30 000 inhabitants. Although the joint provision of some services is widespread at the *gmina* level (*i.e.* sewage disposal), there are relatively few instances of *gminas* forming joint-venture associations to provide common services and little co-operation at the *poviat* level. Providing such associations with a legal status as contractors would help in this regard. Currently, there are no financial incentives for joint provision of services – except if two *gminas* merge, in which case larger *gminas* receive a greater per capita proportion of shared taxes. Thus it may be necessary to increase incentives or adopt a more coercive approach to promote municipal co-operation. Obviously, the newly created *poviats* could provide an important facilitating role, but for the moment this has not happened to an appreciable degree.

Systematic evaluation of programmes and output-oriented indicators

While some evaluations of spending effectiveness are undertaken, such as active labour market programs, most spending programs are not subject to systematic review, nor are programs designed with an eye toward their evaluation and feedback. Performance is measured only by the extent to which line ministries and agencies respect the expenditure estimates in compliance with legal regulation. Budget chapters do not include result-oriented indicators to monitor and measure the success of programs. E*x post* evaluation mainly takes the form of audits made by the NIK. While in some areas the NIK carry out value-for-money audits, the input-oriented legal and financial compliance audit still dominates its activities and its capacity to perform value-for-money audits is limited both in manpower and legal terms.

In order to shift the focus of the policy formation and budgetary review processes from costs alone to costs and benefits, the government should take steps to systematically integrate output indicators into the budgetary and policy-making processes. Existing ones are too concerned with measuring inputs and too

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little oriented towards monitoring and evaluating the impact of these inputs. Only when elected officials and ministerial policy-makers are armed with concrete information on the effectiveness of alternative programmes will they be able to make rational choices about how to use public money in the most cost-effective way. Although conceptually simple, in practice, measuring the output of government programmes is difficult and demanding of a country's public service. While it is probably not feasible to introduce a full-fledged output-oriented budgeting system in Poland immediately, over the near term a number of relatively simple changes could be introduced that would make such a transition substantially easier in the future.

As a first step, specific-task spending programmes should be introduced with sunset clauses that require them to be abandoned after a set period of time (typically several years), unless parliament renews their mandate. Such a simple measure, which can be introduced retroactively, helps prevent programme and spending inertia from developing. It increases the ability of politicians to re-orient spending as policy priorities change and protects against the development of a culture of *droits acquis*, which can substantially constrain a government's room for manoeuvre. To be most effective, programmes subject to sunset clauses should be designed in such a way that their outputs can be measured. In particular, the performance of specific purpose programmes such as household transfers, tax expenditures, subsidies and labour market programmes should be evaluated regularly and required to justify their continuation. Moreover, legislation governing larger programmes such as pensions and healthcare should be modified to require periodic reviews and regular presentation to parliament of long-term projections of both demands and expected costs.

While measures such as sunset clauses and the more systematic evaluation of programme efficiency will help improve public expenditure, for the process to be truly effective the results of these evaluations need to be included in budgetary materials so that politicians can better weigh spending options. Indicators should be reported *ex ante* in the form of goals and *ex post* as a means of verifying performance. Many Ministries make such evaluations for internal purposes but integrating them into the budgetary process would increase transparency and serve to make budgetary institutions more accountable for their use of public funds and the services they provide. Such integration would imply major changes to the budgetary and policy formation processes, however, and would take some time to implement. Nevertheless, movement in this direction is clearly desirable and feasible, implying that the number and nature of indicators in State Budget chapters will need to be gradually expanded. As outcome-oriented budgeting and policy-making becomes more common, the NIK should be able to place greater emphasis on value for money audits.

Recently the Polish government made a step forward by creating an administrative unit for financial control and internal audit within each government

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administration in order to strengthen financial control and management, on the one hand, and standardise the procedures associated with tendering process on the other hand. Though the primary objective of this institutional change seems the intensification of *ex ante* financial audit, this unit could be developed into the institutional apparatus for introducing the output or outcome-oriented budgeting and *ex post* performance audit at later stage. Indeed the NIK is involved in preparing the standardised manual for financial control and audit from its initial stage and provides an avenue for the development of a fully-fledged output-oriented budgeting system.

Efforts to build in an output orientation into public expenditure management will necessarily require substantial changes in the corporate culture and human resources policies of the government. In this regard, clearer career paths for civil servants and better performance incentives would help. Indeed, poor personnel management in the public sector and nepotism have been identified as sources of inefficiency in some areas of public administration (OECD, 2002a). To be most effective managers and employers need to be rewarded for improving outputs rather than managing inputs. This would require giving discretion to managers on spending within the predetermined totals, setting expected outputs in advance, maintaining comprehensive performance reporting and auditing systems and linking managers' pay to performance. While elements of this kind of flexible management system already exist in the Poland, they need to be expanded and incentives and control mechanisms carefully designed. More immediately, improved remuneration of managers and highly-educated personnel so as to improve the government's capacity to attract and retain high-quality officials should be a priority. In this respect, limiting political appointments to the highest level of the civil service would improve continuity in the provision of services and could be consistent with a more flexible management style. While it is important for a government to be able to trust those who are asked to execute its policies, wholesale changes of personnel down to the director level can be counter-productive. Not only can they hurt staff morale, they make the retention of talented young staff difficult and are destructive of institutional memory.

Summing up

While Poland has avoided the kind of fiscal problems that have contributed to economic instability among its neighbours, the foregoing discussion makes clear that a comprehensive reassessment of the public expenditure system is necessary. Not only could such a step help to improve the efficiency of programmes, it could also be used to help reduce the deficit, thereby contributing to both internal and external balance and making room for a necessary reorientation of spending away from transfers and towards growth enhancing expenditures. The need for such an

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evaluation is made all the more pressing by expected increases in debt-financing costs as well as ageing and EU-integration related costs over the medium term. Given the high tax burden already facing Poles and the implications that this may have on potential growth rates, reducing public expenditure should be a priority. To do so while retaining an adequate level of service will require that the authorities improve the way public expenditure is managed. Box 7 summarises the recommendations of this chapter.

The relevance of these recommendations is attested to by the important degree to which they overlap with a number of the measures being considered within the authorities' E*ntrepreneurship*-D*evelopment*-E*mployment* plan (see Box 1 in Chapter II). As the authorities seek to translate the goals and principles of their plan into concrete policy, it will be important that they combat the fragmented nature of government spending by moving towards a more integrated budgeting of the central government. This implies expanding the scope of the State Budget to include much more of general government spending, abolishing the extrabudgetary funds, repatriating into general revenues their earmarked funds and improving the co-ordination of the budget planning process among different levels of government. Without a more comprehensive notion of government spending, the authorities desire to replace the current deficit target with a spending norm, is unlikely to reduce overall spending and address the medium-term challenges posed by rising debt-servicing charges, the ageing of society and the need to improve the infrastructure.

In order to give themselves the tools necessary to effectuate the kind of reorientation in spending away from transfers and towards programmes that contribute to the economy's growth potential, the authorities need to increasingly move towards a multi-year budgeting framework. Not only will this allow for better management of investment projects, but it will also help policymakers to see more clearly the longer-term consequences of their spending decisions. This would reduce the temptation to make decisions or creative accounting solutions that superficially improve fiscal outturns in the current year but at the expense of future budgetary sustainability. Moreover, a medium-term budgetary system would facilitate the integration of the extrabudgetary funds into the whole of government and could in conjunction with a more resolute focus on the efficiency of programme spending, pave the way towards an output-orientation in government policy.

Indeed, there is a clear need to build into the expenditure oversight process much greater emphasis on the effectiveness of spending. If the governments' new growth-enhancing policy priorities are to be effective, the authorities will need to have measures by which they can judge them and the relative merits of different spending options. Thus, it is essential that the authorities invest in the kind of analytical expertise necessary to conduct cost-benefit studies and that the results of these are included in budgetary

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Box 7. Summary of recommendations

Budgetary reform

- In order to ensure adequate control and monitoring of central government programmes, the financial activities of extrabudgetary funds should be included directly in the State Budget and subjected to the same kind of *ex post* and *ex ante* controls as other programmes.
- To improve policymakers' ability to plan and engineer expenditure restructuring, a medium-term expenditure framework should be introduced.
- The practice of assigning earmarked taxes to extrabudgetary funds should be abandoned in order to combat inertia in public spending and avoid distortions in spending patterns caused by fluctuations in such revenues. All of the activities currently performed by extrabudgetary funds could as easily be managed within budget, especially in the context of a medium-term economic framework.
- Results of programme evaluations should be integrated into budgetary chapters as indicators of programme outputs with an eye to developing an output-oriented budgetary system.
- Local government budgets should be drafted in co-ordination with that of the central government and the reporting of outturns improved so that estimates of the stance of fiscal policy at the general government level can be made in a timely manner.
- The resources of the State Audit Office should be expanded in order to assure better *ex post* monitoring of sub-national public expenditure.
- Incentives for joint-delivery and merger at the *gmina* level should be enhanced so as to promote efficiency in the delivery of programmes at the local level.

Improve the efficiency of social policy expenditure

- The authorities should tighten eligibility criteria and their enforcement for disability and pre-retirement pensions and for the sick leave programme in order to reduce distortions in the labour market and to provide fiscal space for reductions in payroll taxes.
- Health spending and in particular the growth of health spending could be rationalised by introducing a clear statement of minimum services that would be covered by the state system, leaving others to the private sector.
- Specific spending programmes and tax expenditure should be subject to systematic evaluation and sunset clauses should be introduced retroactively to ensure that programmes are regularly reviewed.
- A number of steps could be taken in the near term to improve the efficiency of government expenditure. These include: a review of tax expenditures in general and of the tax treatment of social-security benefits and contributions in particular; a review of the impacts of subsidies and guarantees; and a revision of the minimum *living standard*.

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Box 7. **Summary of recommendations** (*cont.*)

Further steps to improve transparency

- Substantial progress in dealing with and reporting contingent liabilities should be extended by including estimates of the risk of their realisation and adding sub-national liabilities to the inventory.
- Steps need to be taken to combat the worrisome expansion in the use of guarantees and the increasing resort to exemptions from existing prudential rules. A share of GDP or revenue-based limit on the issuance of new and on the total of outstanding guarantees should replace the current *ad hoc* yearly limits. This would eliminate the temptation to use guarantees to hide current expenditure and, thereby, reduce the risk of a potentially destabilising build up of contingent liabilities.
- To overcome temptations to engage in "creative accounting" and to rationalise spending, the authorities should revise the constitutional provision making the governments budget deficit binding. Furthermore, a move to accrual accounting would reduce the scope for papering over budgetary overruns.

documents. Indeed, arguably it is unlikely that parliament would retain the highly distorting exemptions and low-rating of goods and services under the current VAT scheme if it was aware of the limited redistributive impact of the 6.5 per cent of GDP in tax expenditures that the programme represents. Looking at labour market policy and the vicious circle created by high payroll taxes and low employment rates there is a very real necessity to examine closely the effectiveness and desirability of social spending programmes. Some of these appear to be simultaneously contributing to work disincentives by offering out of work benefits that are more financially interesting than paid employment and, contributing to reduced demand for work by forcing the authorities to increase labour taxes to pay for these benefits. In this regard, early retirement programmes, excessive use of disability benefits and high out-of-work benefits for families with many children appear to be contributing to problems rather than their solution.

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IV. Implementing structural reform: a review of progress

As described in previous OECD *Economic Surveys* and the *Review of Regulatory Reform in Poland* (OECD, 2002a), Poland has made substantial progress towards establishing an institutional structure compatible with a well-functioning market economy. The private-sector now produces some 70 per cent of GDP; there are over 3 million independent firms; the Polish stock market is the most active and largest in central Europe and, in recent years, Poland has become a privileged destination for foreign direct investments. This transition has been facilitated by major changes to laws governing capital and product markets, and efforts to improve the regulatory framework. Increasingly industrial policy dictates and over-regulation are giving way to market forces, and economic relations are being governed by law, with independent regulators ensuring that competitive forces help to distribute the fruits of this transformation to the population as a whole. Despite substantial accomplishments over the past decade, problems persist. In product markets, an acceleration of the privatisation process and further strengthening of the regulatory environment are essential to speed up the rate at which Polish incomes rise to western European levels. Progress in improving the functioning of labour markets has been less marked. With unemployment now in excess of 20 per cent (based on the Labour Force Survey) and non-employment looking increasingly structural in nature (Chapter I), there is an urgent need to correct distortions so that market forces can complement efforts to reactivate the population.

This chapter reports on recent progress in all of these areas and makes concrete proposals for further reform. It begins by examining progress in the restructuring of industry, privatisation and the improvements in the regulatory environment. A second section makes recommendations for reform in labour markets. Table 21 summarises past OECD recommendations in these and other areas, recent steps that have been taken and the Organisation's current evaluation of the situation.

Harvesting the benefits of a market-based economy

The extent of the transformation of the Polish economy has been documented elsewhere (see OECD 2000, 2001a) and although the EC (2001) *Report*

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Table 21. **Structural surveillance**

Issues/previous recommendations	*Recent actions taken*	*Assessment*	*Follow-up recommendation*
		Panel A: Labour markets	
Reduce the minimum wage especially in districts where average wages are low.	The government is considering introductory age and regionally differentiated minimum wages.	Generous minimum wages form a binding wage floor and contribute to high structural unemployment.	Go ahead with proposals to differentiate minimum wage.
Allow for more flexible wage outcomes by decentralising the bargaining process.	No action taken.	Central wage guidelines also form a floor for wage negotiations, especially within state controlled firms. This exacerbates the public/private wage gap and slows the adjustment process.	Implement previous recommendations with a view to ensuring that wage bargains are more consistent with productivity outcomes.
Realign incentives in the unemployment benefit system.	No action taken.	Relatively generous benefits for some households create unemployment traps.	Implement previous recommendations.
Reduce payroll taxes, especially for the low skilled.	The government is considering introducing a flat personal- and corporate-income tax rate of 22 per cent.	This step is welcome but does not address the problem posed by high payroll taxes.	
Tighten access, eligibility and duration of benefits for sick.	No action taken.	Sick benefits are an important source of unearned income and delay adjustment. They appear to be used to prevent firms from laying off redundant workers.	Previous recommendations remain pertinent. Make the period during which a firm is required to maintain a post vacant time limited. Institute mandatory and random verifications of the health of beneficiaries by state-appointed physicians.
Establish a legal framework for overtime so that firms can more flexibly adapt to peaks and troughs in their order books.	The government proposes to increase from 2 to 4 the number of overtime hours that can be paid at the lower 50 per cent wage premium as opposed to the standard 100 per cent premium.	Though a step in the right direction, much more needs to be done to reduce the costs of overtime.	Consider the annualisation of working time. Overtime premia should be substantially reduced to bring them more in line with international practice.
Reduce the administrative burden associated with dependent employment.	The authorities are considering raising from 5 to 50 employees the minimum threshold above which firms must follow complicated administrative procedures.	Firms may react by artificially restructuring themselves into smaller units to take advantage of the new system.	A more ambitious solution that would avoid the possibility of distorting the way firms organise themselves would involve simplifying procedures for all firms.

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Table 21. **Structural surveillance** (*cont.*)

Issues/previous recommendations	*Recent actions taken*	*Assessment*	*Follow-up recommendation*
Ease the regulations governing fixed-terms contracts.	The *Entrepreneurship-Development-Employment* programme proposes to increase the number of successive fixed term contracts that a worker may hold before his contract is automatically transformed into a permanent one.	Current rules, restricting to two the number of consecutive fixed term contracts that may be held, increase precarity and raise costs by encouraging firms to let workers go rather than roll their contracts over a third time.	Proceed with the proposed relaxation of rules. Rather than reverting to the current rules in 2005, the authorities should consider permanently adopting a less rigid limitation on fixed-term contracts.
	Panel B. Product markets		
Sectoral restructuring			
Coal-mining	Closed some unprofitable mines, reduced output and the workforce; restructured companies financially. Plans to consolidate remaining mines into three holdings.	Considerable downsizing has occurred, although the sector remains unprofitable. Merging remaining mines risks creating monopolistic rents and cross-subsidising unproductive mines, to the detriment of the competitiveness of firms dependant on coal.	Reconsider the balance of costs and benefits from merging mines. If implemented, vigilance and powers of the competition authority will need to be enhanced.
Iron and steel	Plan to merge four largest steel producers.	Runs similar risks to the coal and mining sector restructuring plan.	Recommendations are the same as for the coal-mining sector.
Gas	The authorities intend to re-focus the activities of the Polish Oil and Gas Company (PGNiG) on transmission, storage and servicing long-term take-or-pay contracts.	The reduced focus of PGNiG is welcome. The programme needs to expand import opportunities for foreign market players. The non-competitive gas market impedes the liberalisation of the electricity and coal sectors, which rely heavily on gas.	Create and privatise to separate owners at least four regional distribution companies. Avoid extension of existing long-term contracts. Widen scope for competition from imports.
Defence	The government plans to create 2 holdings consisting of 22 companies and to sell the remaining 11 companies.	This goal is laudable and necessary to forestall the bankruptcy privatisation of these companies.	Ensure that privatisation is implemented as planned.
Electrical sector: New strategy	The new amended strategy (April 2002) plans to merge three major power plants; a lignite-fuelled power plant with its supplier mine; and several regional distributors.	The envisaged reduction of the role of PSE and the increased exposure of the regional distributors to competition in the retail market are welcome. But bundling may result in reduced value for the firms.	Same recommendations as for coal and steel. If the merger between the lignite-fuelled power plant with its supplier mine is implemented and if other such mergers will follow, ensuing privatisation deals should not include provisions prohibiting the unbundling of the mines and the power stations.

Table 21. **Structural surveillance** (*cont.*)

Issues/previous recommendations	*Recent actions taken*	*Assessment*	*Follow-up recommendation*
Electrical sector: *New strategy* (cont.)	The role of PSE, the national operator, to be restricted to transmission alone. Distributors' monopolies in local power supply will be terminated.		
Electrical sector: *Stranded costs*			
Make long-term supply contracts more flexible so that the electricity exchange and competitive pressures can generate efficient gains and cost savings.	The compensation payment system (SOK) that was proposed in 2001 has never been implemented and there is talk of abandoning it.	The stranded costs prevent the electricity exchange from permitting competitive pressures to improve efficiency and lower costs.	Seek a compromise allowing the SOK solution to be implemented. Barring this, increase the openness of the sector to imported electricity or renegotiate long-term contracts.
Privatisation			
Proceed with privatisation in a transparent and predictable manner.	Progress in 2001 has been disappointing. PLZ 6.5 billion privatisation revenues were raised, equalling just ⅓ of the government's initial target. The 2002 Budget anticipates a similarly limited volume of sales.	Privatisation process, though well defined, is excessively cumbersome, complicated and costly.	Accelerate privatisation by eliminating *de facto* veto power of those involved in consultations; streamlining the decision making process at ministerial level; avoiding complicated social clauses and instead providing direct social and labour market assistance to affected workers; de-politicise the appointment of members of supervisory boards in companies where Treasury holds a stake; and more actively seek buyers for firms.
Direct sales	100 small firms have been bundled recently and sold to an investment bank for subsequent sale.	If used more regularly, this approach would go a long way to speeding the privatisation of firms and ensuring access to private-sector capital to the most promising of them.	Actively promote sale of grouped small firms using the expertise of an investment bank. Consider leasing arrangements to stimulate the interest of insider buyers.
Capital privatisation	The State has blocked several private sector led efforts to re-capitalise jointly-owned firms, which has been a major source of conflict.	Preventing partially privatised firms from increasing their capital base harms their ability to expand, to introduce up to date technologies and ultimately to increase market shares.	The authorities should reconsider their objections to the infusion of capital. In particular, they should welcome a more rapid withdrawal of state participation in these firms.

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Table 21. **Structural surveillance** (*cont.*)

Issues/previous recommendations	*Recent actions taken*	*Assessment*	*Follow-up recommendation*
Introduce policies to deal with the stranded costs problem in the electrical sector.	The planned privatisation of the power industry has been deferred from end 2002 to 2004 and as is standard policy government plans to retain a minimum 25 per cent + 1 share in each privatised distribution company.	The delay is regrettable, while the economic rational for the state retaining a controlling stake is unclear.	Privatisation should be accelerated and the State should not retain controlling stakes.
Panel C: Regulatory reform			
Regulatory framework			
Reinforce the competition policy framework in network industries. Close scrutiny by the Office for Competition and Consumer Protection (UOKIK) and sector regulators is required to ensure that mergers produce net benefits rather than net costs to consumers.	A new Antimonopoly Act abolishes unnecessary procedures, recognises that some forms of co-operative behaviour can spur productivity growth and innovation and provides more flexibility in dealing with mergers and acquisitions.	This progress is welcome, but the UOKIK needs to be more publicly critical of government positions with which it disagrees.	The UOKIK should criticise more openly government decisions with which it disagrees. It is especially important for it to play an active watch dog role over market conditions where market dominating firms are being created.
Independent sector regulators should foster competition along with privatisation.	A number of regulatory agencies were merged. At the same time, the heads the affected agencies were replaced.	To the extent they result in synergistic gains and lower costs these initiatives are welcome. However, the replacement of the leadership of these agencies raises concerns about their independence.	The authorities should consider to integrate the Health Insurance Supervisory Office (UNUZ) into the new Insurance and Pension Funds Supervisory Commission. The authorities need to be sure to preserve both the actual and perceived independence of these watch dog agencies.
Introduce clear rules governing the protection of minority shareholders in the case of conflicts with firm management and on majority owners.	A new commercial code promotes the principle of equitable treatment of all shareholders and, among other rules, sets out stricter requirements concerning general shareholders meetings. Voluntary corporate governance codes are being produced based on OECD guidelines.	These initiatives are welcome. However, temporary exemptions allowing companies in which Treasury is a shareholder to hold extra special voting shares and issue non voting shares, introduces undue special rights and is difficult to justify on either economic or equity grounds.	Government should consider the immediate suspension of temporary privileged voting rights conceded under the new Code.

Table 21. **Structural surveillance** (*cont.*)

Issues/previous recommendations	*Recent actions taken*	*Assessment*	*Follow-up recommendation*
Specific measures			
Simplify registration procedures for new firms.	A unified entrepreneurs' electronic registry for new businesses was implemented in 2001. The *Entrepreneurship-Development-Employment* programme envisages steps to streamline bureaucratic procedures.	The registry can be expected to improve transparency and confidence with which economic agents enter into agreements. Registration typically taking as long as 2 months to complete with administrative requirements being particularly burdensome to small businesses.	Extend the electronic registry system to form a one-stop business registration system.
Reduce administrative burden for existing companies.	The Business Activity Law reduced number of economic areas requiring a licence from 30 to 8.		The effectiveness of the new business registry could be reinforced by adding all existing businesses as rapidly as possible. There is also a pressing need to move towards a fully computerised land register.
Lower the overall tax rate faced by enterprises and streamline tax and regulatory frameworks.	The *Entrepreneurship-Development-Employment* programme seeks to simplify the submission of tax documents, to introduce social security rebates for newly hired graduates, and tax holidays for newly established youth entrepreneurial activities. Measures to reduce the discretion of local tax inspectors are also envisaged.	On top of making the tax system more administratively simple, if implemented as planned, these measures would partially address the current tax bias in favour of unincorporated business. Tax holidays for new entrepreneurs could encourage entrepreneurs to open and close repeatedly the same business.	Proceed with proposed simplification measures. Do not introduce tax holidays for new entrepreneurs. Consider restricting access to VAT rebates until firms have paid their sub contractors for the goods for which the VAT is charged.
Streamline bankruptcy procedures.	A draft proposed reform of the relevant legislation was submitted to Government in 2000 but has not been implemented.	The proposal would strengthen creditor rights, reduce the potential for debtors to delay restructuring and speed court procedures.	Implement proposals immediately and expanding their scope to banks and insurance as quickly as possible.
State aid, both direct and indirect, should address specific market failures and avoid distorting competition by introducing rules and minimise moral hazard and adverse selection risks.	The new State aid law sets out clear conditions for admissibility and defines the rules for granting and supervising state aid to entrepreneurs.	The new law brings Poland closer to international standards in this area, however, too often loan guarantees are exempted from the rules.	Evaluate the ability of the new state aid regulations lower tax and social security arrears. The usefulness of the UOKIK's annual report on state aid would be enhanced if it were submitted earlier in the budget process.

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Table 21. **Structural surveillance** (*cont.*)

Issues/previous recommendations	*Recent actions taken*	*Assessment*	*Follow-up recommendation*
		Panel D: Sustainable development	
Ensure effective integration of environmental considerations in the most sensitive sectoral policies (in particular for industry, mining, transport and agriculture) by including environmental priorities into the regulatory framework.	The 2001 2nd National Environmental Policy provides the basis for integrating environmental concerns into policies at national, regional and local levels and within this context it includes special Action Programmes for air, water and waste.	New effort is welcome, insofar as it can be expected to contribute to re-orienting policies towards a sustainable approach.	Continue to monitor and update programmes as their implementation proceeds.
Provide the legal basis for tradable emission permits; develop regulatory framework for rules and modalities of domestic emission trading systems.	A review draft law for tradable permits has been completed and the phasing in of the new system started in January 2002.	Though a step in the right direction, much more needs to be done to increase the monitoring capacity at the *voivodship* and *poviat* level and to establish an efficient system of communication between them.	Improve the training and extent of communications between relevant staffs.
Formulate a strategy for phasing-out Environment Funds.	While several actions have been taken to make the activities of the Funds more transparent, their phasing out is not part of the government's agenda.	As the availability of market-based sources of financing for environmental protection increases, fund-based subsidises to polluters are less justified.	Implement previous recommendations.
		Panel E: Healthcare reform	
A new law on healthcare is needed to consolidate the weak elements of recent reform (definition of a minimum package of benefits, improvement of payment arrangement, enforcement of a hard budget constraint on regional funds).	The new government envisages integrating the existing 17 healthcare funds into a single fund and strengthening central influence on service providers.	Though a detailed plan remains to be outlined, integration of funds would mark increase central control and would be a departure from the 1999 reform, which envisaged the creation of a system of competing health funds.	In order to ensure that further reform does not destabilise the system, implementation of any significant change in the system should be the outcome of extensive consultation with all stakeholders.

on Poland's Progress Towards Accession is right to conclude that "Poland is a functioning market economy" the process remains incomplete. If Poland is to gain the full advantage of the substantial reforms already in place, it will need to finish the restructuring of remaining state-controlled industries such as coal, steel, electricity and defence. Despite more than ten-years of efforts to restructure these industries, and in some instances significant improvements in productivity, they remain uncompetitive and a drain on the nation's resources. Here an acceleration of their privatisation would be helped by a substantial relaxation of the conditions that have been imposed on previous sales efforts. These conditions, rather than the actual prospects of the firms, appear to have been among the main reasons for the failure of past sales. Finally, before the network industries can be expected to contribute fully to raising Polish living standards the regulatory framework in which both privatised and still state-owned firms operate needs to be clarified and reinforced.

Restructuring of state-owned industries

Various governments in Poland have taken the view that the country's coal and steel sectors need to be restructured before they are privatised. As a result, over the past decade each sector has followed a series of restructuring plans aimed at restoring profitability before proceeding with a sale. The authorities argue that unless the firms are restored to financial health, they will not find a buyer and, indeed, despite repeated tenders and the sale of some individual sites, no private firm has been willing to agree to purchase these firms on the terms demanded by the government. However, it is not obvious that it was the firms' financial conditions as opposed to the additional conditions attached to the sales that was the cause for the deals not going through. Typically these supplementary conditions have included high prices, requiring purchasers to guarantee employment levels for a period of years, to make additional investments and to accept a continued state presence in the ownership of the company. Indeed, press reports suggest that these conditions were among the main reasons for the failure of many privatisations to go through.[57]

The *coal-mining sector* has been subject to several successive restructuring plans (see OECD 2001 for a more complete discussion). Currently, about 70 per cent of Poland's total primary energy is derived from coal, and exports to Europe remain an important source of foreign exchange. Coal reserves and deposits are mainly located in the southern regions of the country (Slaskie, Dolnoslaskie and Lubelskie), where the sector plays a predominant economic and employment role (up to 8.4 per cent of all jobs are coal related in Slaskie). Despite substantial reductions,[58] the sector is still characterised by excess capacity, it is losing money and is burdened by debt. The authorities embarked upon an ambitious four-year coal sector restructuring and downsizing plan in 1998 and with the assistance of the World Bank.[59] The programme has succeeded in further reducing the size of the sector.[60]

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Perhaps most encouraging, the sector as a whole is generating an operating profit following domestic price increases since 2000. However, net of state subsidies, the sector is still making losses and has overall debts of about PLZ 21 billion (2.8 per cent of GDP). Moreover, as described in Chapter III, it is plagued by large arrears to the social security system and is a substantial recipient of various forms of state aid.[61]

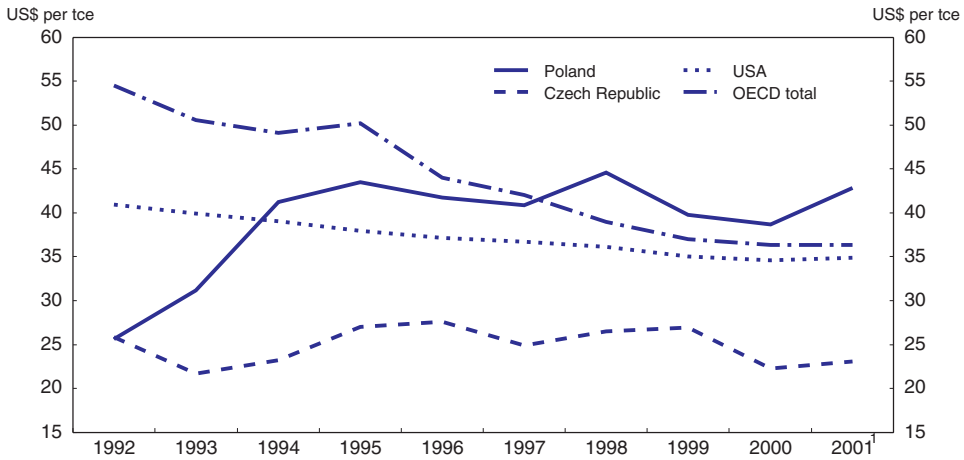
The 1998 coal-sector restructuring plan called for the closing of loss-making mines and the privatisation of profitable ones. Unfortunately the privatisation process of profitable mines has stalled. The government abandoned negotiations on the sale of the KWK *Bogdanka* S.A in October 2001, under pressure from trade unions, while the sale of WKW *Budryk* S.A. is still undergoing pre-privatisation analysis. The authorities are now considering revising the restructuring plan so as to merge the current seven groupings of mines into three larger holdings in the course of 2002. An alternative plan under consideration would see the creation of a single large state agency, which it is hoped would result in a more efficient use of capacity and reduced costs by providing for better overall management of strategic planning, sales, materials, logistics, and environmental protection.

These plans to create just a few large-scale coal companies should be reconsidered. While this might improve the profitability of the mines and allow miners to continue receiving wages substantially higher than the average, it would run the risk of reducing overall efficiency and economic welfare. The same higher prices that would serve to bolster the profitability of the sector and miners' wages would hurt the competitiveness of industries reliant on Polish coal and reduce employment (and wages) in those sectors. Indeed, the rising domestic price of coal, even as world prices have been falling, is the major reason behind the sector's return to operational profitability and suggests that the sector is already extracting monopoly rents from consumers (Figure 25). Moreover, there is a real risk that rather than generating economies of scale as proposed, the integrated structure will be used to cross-subsidise production in loss-making mines.[62] Finally, it is not clear how creating such a concentrated industry will speed the eventual privatisation of the sector. Rather it runs the risk of perpetuating state involvement in the mines, which is not a good solution because it tends to hamper productivity growth by intermingling policy and business considerations, to the detriment of both. In order to allow much needed market forces to operate without delay, privatisation of the coal mines should be given a priority. Consolidation should occur after privatisation through market forces.

The restructuring of the *iron and steel sector* began in the early 1990s and was accelerated in 1998, following the launching of a multiyear programme.[63] Reorganisation, ownership transformation and privatisation were the pillars of the plan, along with the gradual elimination of environmental pollution. The strategy

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Figure 25. **Domestic and international coal prices**
Steam coal prices for electricity generation



1. Estimate based on available quarterly data.
Source: IEA/OECD, IEA Statistics, Coal information 2001.

also included the adoption of a generous social package that facilitated a ⅔ reduction in employment, down from 87 000 at the end of 1997 to 32 000 workers by 2001 and further 10 per cent reduction in capacity. So far explicit aid to the sector has been largely limited to active labour market policies intended to redeploy and retrain dismissed workers.[64]

Notwithstanding this downsizing, the steel sector remains beset by structural weaknesses. It continues to be both highly fragmented and concentrated at the same time. While there are 30 separate steel companies, more than 80 per cent of the output is produced by the five largest firms.[65] Moreover, the sector is heavily indebted and loss-making, owing a total of PLZ 9 billion of which PLZ 1.1 billion to the public sector, with arrears to the social security fund accounting for 70 per cent of the latter sum. Finally, the sector is not competitive, having lost a further 600 million last year and is losing ground in both domestic and international markets. Since 2000, steel imports increased even as industrial production was weakening as domestic producers of manufacturing goods, of motor vehicles, for examples, turned increasingly to foreign auto maker suppliers for high-quality steel.

In response to this deteriorating situation, the authorities adopted a revised restructuring programme in July 2001, which was amended in February 2002. While the ultimate quantitative objectives of the programme are broadly unchanged, the authorities now plan to create a large holding company, *Polskie Huty*

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S*tali* (PHS), encompassing the four largest steel producers, which they hope will facilitate the sale of the best assets to a strategic investor. Under the new scheme, each company will be required to propose a financial debt- and asset-restructuring plan and to submit it to the Ministry of Economy. If approved, repayment of budget-related liabilities (some 15 per cent of total liabilities) would be postponed until the 2006-10 period. Deals concerning remaining liabilities, notably those related to trade and to the banking sector, will have to be negotiated directly with commercial partners and creditors. Initially, companies will not lose their legal identities. Once the consolidation is complete, remaining liabilities will be taken over by the newly created PHS, which will be allowed to issue bonds to its creditors in exchange for debt redemption. The government is confident that because of the companies' own financial restructuring and consolidation, budgetary costs will be limited and restricted to employment restructuring.

Although import penetration in the steel sector is, at 34.3 per cent, higher than in the coal sector (10.3 per cent), domestic firms' share of the market for lower quality steel is much higher. As a result, the authorities will want to be careful to ensure that the creation of a dominant producer in the steel sector does not result in the same kinds of price distortions and negative competitive effects as described with the coal-sector restructuring plan. Indeed, both of these tactics raise important questions about competition. The Office for Competition and Consumer Protection (UOKIK, see below) will need to be vigilant to ensure that these new market-dominating structures do not penalise Polish consumers.

P*ower sector* reform has been underway for more than a decade now, based partly upon de-monopolisation. As part of this process, the industry has been separated into three segments: generation,[66] transmission[67] and distribution.[68] In addition, an independent Energy Regulatory Authority (URE) was created in 1997 which, in conjunction with the legal structure described above, opened the way towards privatising the sector. These are substantial achievements, and should help to create a genuinely competitive market for power. However, further action is needed to accelerate such a development. A major stumbling block is the stranded costs associated with exclusive long term contracts between the generators, which cover around 70 per cent of electricity supplied to final customers, and PSE, the operator of the transmission system. While the Polish Power Exchange and daily and hourly markets in residual power were created in September 2001, the volume of electricity traded there remains negligible, amounting to a mere 1.5 per cent of overall electricity consumption. Overall, about 30 per cent of electricity volume is traded on the free market, with the vast majority of this in the form of direct contracts between power plants and distributors (estimates suggest that the market-based share could be increased to as much as 43 per cent, OECD, 2002a). In this setting, conditions for third party access are limited, while many factors are at play, only 13 of 180 customers eligible to change providers under current regulations have done so and only 50 access agreements have been made.

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The government correctly believes that resolving the stranded cost problem is a necessary precondition for competition in the electricity market. They therefore introduced a new compensation payment system in 2001. It foresaw requiring generators to sell their power on the free market at competitive rates. The difference between the price received and that stipulated in their long-term contracts would be paid to them by SOK S.A. a newly created body owned and controlled by PSE. These costs would be added to the transmission costs paid by all energy consumers and the URE, in its capacity as the energy regulator would be responsible for taking into account this additional element during the tariff approval procedure. In this way providers, including those with long-term contracts, would be motivated to reduce costs and compete for market share. To the extent that firms without long-term contracts gain market share, prices will fall to the benefit of consumers. Unfortunately the programme was never implemented because of VAT-related problems posed by the differences between selling and purchasing prices implicit in the scheme and the authorities are considering abandoning the idea. If that occurs, the authorities should consider increasing market access to foreign based producers of electricity to maximise competitive pressures or renegotiating long-term contracts.

Resolving the problem posed by these long-term contracts remains a priority, but for the benefits of competition to be fully achieved, the privatisation of the electricity sector needs to be stepped up. So far, only 7 central heating plants, 4 power plants, and 1 distribution company (GZE S.A.), have been partly privatised while all state-owned power plants have been transformed into joint-stock companies ("commercialised"). Given this limited progress, the planned privatisation of the power industry by the end of 2002 has been deferred to 2004. The amended strategy calls for the horizontal merger of three major power plants to create a "strategic national energy resource", and one lignite-fuelled power plant will be vertically integrated with its supplier mine prior to its privatisation. Most recently, the government announced plans to merge firms at the distribution level leaving their privatisation for later. Moreover, as is standard policy, the Ministry of Treasury plans to retain a minimum 25 per cent + 1 share in each privatised distribution company, at least until accompanying investment programmes have been implemented. The government feels that its continued ownership position will allow it to exert control over the implementation of the firms' social plan and prevent abuses during the process of liquidation and sale (complete or partial) of company assets. Moreover, the programme calls for a substantial reduction in the role of PSE. Although the relevant timetable has not been defined thus far, ultimately its activities will be limited to operating the transmission system. To enhance competition in the retail market, distributors' monopoly in providing power to residents in specific geographic areas will be abolished and at the same time their obligation to supply customers in their areas will be terminated.

Exposing the energy sector to market forces should remain an important priority for the government. In this regard, a solution to the stranded costs problem

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needs to be found – perhaps by providing for an exception to the VAT rules that derailed last year's efforts. Indeed, it is difficult to see how any solution that yields lower prices to final consumers would not also imply lower VAT revenues. Plans to narrow the role of the PSE and expose the distribution channel to some additional competitive pressure are welcome. However, it is not obvious *a priori* that mines should be bundled with power stations. While private owners might prefer such an arrangement because it provides them with a secure source of supply, they may prefer to buy coal on the open market. If the authorities go forward with their plan to integrate the lignite-mine with a power plant or proceed with similar vertical integrations in the future, following privatisation the new owners should be left free to disintegrate them if this is their preferred solution. If caveats forbidding subsequent disintegration are included in privatisation contracts, it risks raising costs to consumers and reducing the international competitiveness of the sector. Moreover, as discussed in the next section, the co-mingling of economic and social objectives through investments and social conditions attached to privatisation tends to reduce the value of the firms and their subsequent economic performance.

The *gas sector* will also undergo significant restructuring to complement the reform of the coal and electricity sectors. Given the interdependence between the three sectors, a non-competitive gas market would interfere with their liberalisation. For the moment, the reform of the gas sector has not advanced very far. The main market player, Polish Oil and Gas Company (PGNiG), was transformed into a joint stock company in 1996 and since then restructuring has remained mainly focussed on internal separation of different activities, notably extraction, transmission and storage. It is still a vertically integrated monopoly in imports, transmission, storage and distribution of natural gas.

The authorities intend to focus PGNiG activities on transmission, storage and servicing long-term take-or-pay contracts with foreign suppliers (imported gas accounts for as much as 65 per cent of total supply). Exploration and mining, transmission, network development and gas trading will be separated. As they proceed with PGNiG restructuring, the authorities should consider creating a minimum of four distribution companies and selling them to different owners, allowing competition within their respective territories, see OECD (2002a) for a more complete description of recommended restructuring options. The UOKIK will need to effectively monitor future market structure in order to prevent excessive consolidation, while access to the grid and tariff regulation will depend on careful regulation by the URE. Unfortunately, the new programme is silent on whether (and eventually how) prospective demand increases will be accommodated through wider opportunities for foreign market players. Existing take-or-pay long term contracts already provide for significant volume increases and, insofar as they extend 25 years, are difficult to undo. Their further expansion should be avoided (and import sources diversified) if the development of competition is to be encouraged.

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The sizeable *defence industry* is another sector in need of restructuring. It comprises some 35 thousand workers and 37 companies which, unlike other predominantly state owned industries, are highly diversified both in terms of their activities and supply structures. Although most such companies produce technologically sophisticated products such as aircraft and electronic systems, they are generally not competitive internationally, reflecting their organisational and supply rigidities. As a result, they have accumulated high debts, particularly in the form of tax and social security arrears. Although an ambitious defence restructuring programme that was launched in 1999 envisaged the privatisation of 26 companies, only two transactions have been executed up to March 2002. The newly approved "Strategy for the restructuring of the defence industry in the 2002-05 period" proposes the creation of two holdings respectively composed of 16 and 6 defence companies. Of the remaining 15 companies, 4 are undergoing bankruptcy proceedings and 11 are scheduled for privatisation. It is hoped that this new programme will help to ensure the viability of these firms and that these privatisation revenues from firms that are sold can be used to help restructure companies that are to be excluded from the process for strategic reasons.

Privatisation

Both within network industries and elsewhere, the privatisation process began slowly in Poland (OECD, 2001a). Nevertheless, it has progressed substantially (Table 22) and now over 70 per cent of output is produced in the private sector. The strategy followed in Poland emphasised sales to strategic investors, with the state retaining substantial minority stakes in many companies. Globally, privatised firms outperform state-owned firms, partly because following privatisation strategic investors have injected substantial equity capital and know-how into their firms. These factors help explain the large productivity gains and

Table 22. **Size of the private sector**
As a per cent of the whole economy

	Employment		Gross output	
	1995	2000	1995	2000
Agriculture	97.0	98.7	88.3	89.4
Industry	50.5	74.8	47.7	71.6
Mining	3.1	14.0	2.4	29.3
Manufacturing	60.0	85.9	57.5	82.0
Electricity, gas and water	3.7	6.9	2.0	4.4
Transport, storage and communication	26.7	37.6	40.2	49.9
Financial intermediation	36.4	72.2	67.4	82.6
Average of all sectors	**62.8**	**73.7**	**61.1**	**74.4**

Source: Central Statistical Office.

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innovations observed in, among others, the banking, car manufacturing, furniture production and air transportation sectors. Smaller direct privatisation deals also resulted in efficiency gains and high company survival rates.[69]

Notwithstanding these broadly positive outcomes the privatisation process is far from complete. Taken together state-controlled enterprises and the public sector account for some 42 per cent of employment.[70] Moreover, the State has divested itself of less than half its initial portfolio and still either owns or has a majority or controlling stake in some 3 000 firms (see Box 8), worth 17 per cent of GDP. This compares unfavourably with

s of 229 firms valued at about 5 per cent of GDP in the Czech Republic and 172 firms worth less than 6 per cent of GDP in Hungary (Figure 26).[71] Progress in 2001 was disappointing. The postponement of a number of planned sales, notably four large heavy chemical companies, and delays in the execution of several other privatisations plus a depressed market meant that only 64 companies[72] were wholly or partially privatised (less than 3 per cent of the overall stock). As a result, a mere one third of the government's initial expectation was raised (PLZ 6.5 billion).[73] The 2002 budget anticipates only limited further sales, to be achieved mainly through divesting residual stockholdings in already partially privatised firms in the electricity, airline and telecom sectors.

This relatively slow progress reflects the Polish privatisation system's reliance on a well-defined but cumbersome process that includes substantial consultation with social partners; existing management and workers; and ministerial approvals (Table 23). While the process is cumbersome, expensive and slow, it is transparent and has permitted the country to avoid some of the more serious pitfalls associated with more rapid schemes such as voucher privatisation. Nevertheless, the sheer number of firms that remain to be sold suggests that, unless steps are taken to reform the system and expedite sales, it may take as much as 20 years to complete the privatisation programme. Indeed, even if the pace of sales doubles, Poland will still be striving to divest itself of these firms well into the next decade.[74]

Several factors stand in the way of accelerating the speed with which private capital, market incentives and foreign expertise can be brought to bear productivity gains in firms and sectors that for the moment remain relatively unexposed to market pressures. F*irst*, the privatisation process is hampered by special interests within state-controlled enterprises. In the case of indirect privatisations, current rules require that before privatisation negotiations between the Treasury and an eventual purchaser begin, the two parties must agree on a restructuring package for the firm, including an investment plan. A social plan, requiring the agreement of the firms' labour representatives, is also a precondition for negotiations. In the case of direct privatisations, which are managed at the local level, a consultative process is also followed involving the

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Box 8. Status of the privatisation process in Poland

After 12 years of privatisation, the stock of state-owned firms has decreased considerably.[1] Nevertheless, the OECD estimates that the State either owns or has a controlling[2] or majority interest in some 3 073 firms. Of these, 1 020 have not yet been approved for privatisation and 881 are in the process of being liquidated. The remainder have been partially privatised or are in the process of being sold. Most sales have been executed using one of two main methods: *direct* and *indirect* (*capital*) *privatisation*.

D*irect privatisation* involves the direct sale, participation in a joint venture, or long-term finance leasing of the assets of state-owned enterprises. It essentially targets ownership changes in small and medium-seized enterprises (*i.e.* firms with less than 500 employees, SMEs) of regional and local significance. Direct privatisations are mainly managed by the 16 *voivodship* governors, although they are conditional on approval by the Ministry of Treasury. Generally, these have followed a bottom-up process, involving the employees of firms desiring to initiate a management-worker buyout. Direct privatisation was used in 2 084 cases, of which 1 931 have already been completed.

I*ndirect* (*capital*) *privatisations* take place in two stages. In the first stage the company is transformed into a joint stock company fully owned by the Ministry of Treasury (so-called commercialisation). In the next stage, the company's shares are sold to private investors by mean of public offer, tender, or public invitation to negotiations. Capital privatisation has generated the bulk of the revenue and in total 1 515 firms have been commercialised so far and 970 have had at least some shares sold to private sector investors.

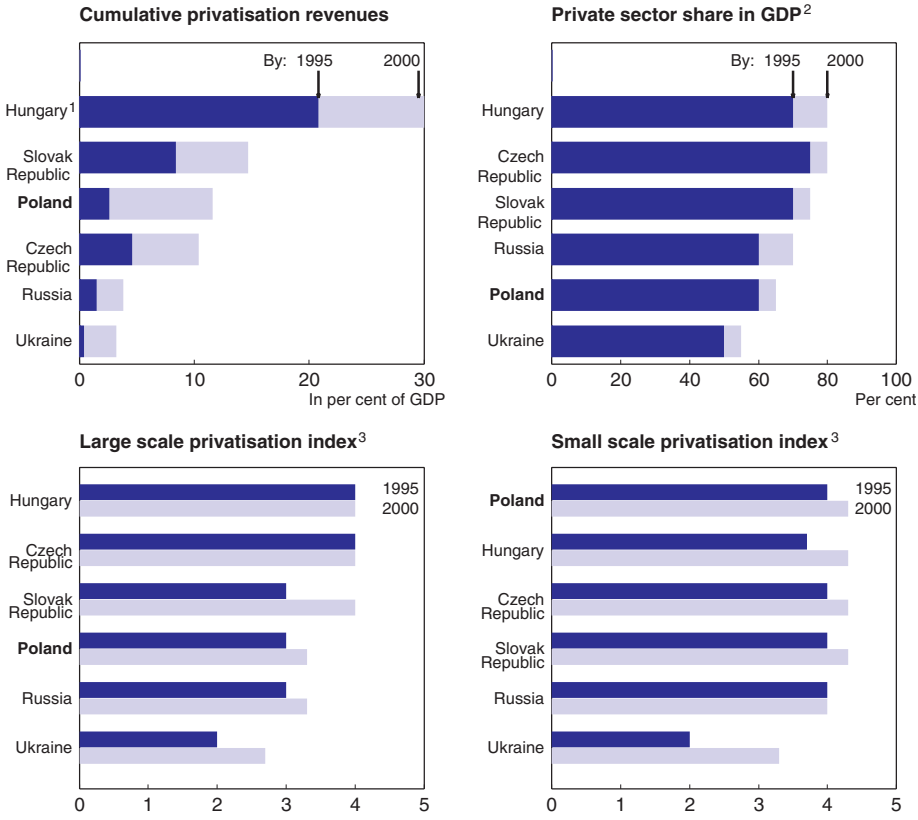
In addition, the State has a stake in a further 247 companies as a result of de-mergers and privatisations that fall into neither the direct nor indirect categories. For example, the transfer of shares in a state-owned firm to a private individuals in lieu of a cash payment. Typically this has been done when a private partner in a privatised company has sought to recapitalise the company. In such cases, the State has frequently ceded a minority stake in a second state-owned company to the private sector partner so as to participate in the recapitalisation and preserve its controlling stake in it.

In summary, of the 3 073 companies in which the state retains whole, majority or controlling interests, 1 762 are joint-stock companies, of which 1 515 were privatised using the indirect method. Of the total, the State owns all of 485 companies, has a majority stake in 103 firms and a controlling (between 25 and 50 per cent) stake in 431. A further 153 companies have been approved for direct privatisation and 881 are undergoing liquidation or bankruptcy procedures. 1 020 state-owned enterprises have yet to be approved for privatisation. Deducting the 881 firms that are undergoing bankruptcy from the total leaves 2 192 apparently viable firms that remain in State hands.

1. Mergers and break-ups of companies since 1990 mean that the total number of firms left to be privatised and those that have been do not equal the original number of firms.
2. Under Polish law a legal individual that owns more than 20 or 25 per cent (depending on the statute) of a company has special rights. Most importantly, if a legal person owns more than 25 per cent of a company he or she can block any change in its statutes, decisions to issue new shares or bonds and decisions to redeem shares or reduce the company's capital.

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Figure 26. **Progress in privatisation in selected transition economies**



1. Figures differ from previous Survey due to data revisions.
2. Based on official GDP data and estimates of receipts generated by private registered companies, as well of informal private entities.
3. The index runs between 1 and 4+ and according to the following legend:
   Large scale privatisation:
   - 1 = Little private ownership.
   - 2 = Comprehensive scheme almost ready for implementation.
   - 3 = More than 25 per cent of enterprises assets in private hands or in the process of being privatised but possibly with major unresolved issues regarding corporate governance.
   - 4 = More than 50 per cent of state-owned enterprises and farm assets in private ownership and significant progress on corporate governance of these entities.
   - 4+= Standards and performance typical of advanced industrial economies: more than 75 per cent of enterprise assets in private ownership with effective corporate governance.

   Small scale privatisation:
   - 1 = Little private ownership.
   - 2 = Substantial shared privatised.
   - 3 = Nearly comprehensive programme implemented.
   - 4 = Complete privatisation of small companies with tradeable ownership rights.
   - 4+= Standards and performance typical of advanced industrial economies: no state ownership of small enterprises; effective tradability of land.

Source: European Bank for Reconstruction and Development, Transition Report 2001.

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Table 23. **Largest privatisations**

As of December 2001

Firm	Activity	Date of privatisation	Method	Strategic investor	Budget revenue (Zl million)	Ownership structure after privatisation, in per cent				
						State	Employees	Strategic investor	Institutional investors	Individual investors
Telekomunikacja Polska (TPSA)	Telecommunications	December 98 October 00 September 01	IPO/Block sale	France Telecom +Kulczyk (Poland)	25 240.5	22.5	15.0	47.5	<– 15.0 –>	
Bank Pekao S.A.	Banking	June 98 June 99 October 00	IPO Block sale IPO	UniCredito Italiano + Allianz Aktiengessellschaft	5 597.5	6.9	n.a.	55.3	EBRD (6.63)	31.2
PKN Orlen	Processing and distribution of petroleum products	November 99 July 00	IPO Secondary offering		3 374.5	28.0	–	–	<– 72.0 –>	
PZU	Insurance	November 99	Block sale	Eureko + BIG Bank Gdanski (Poland)	3 018.0	55.6	14.4	30.0	–	–
Bank Zachodni	Banking	June 99	Block sale	AIB European Investments Ltd	2 284.8	4.3	12.7	81.6	<– 13.4 –>	
Bank Handlowy	Banking	July 97	IPO	Citibank[1]	1 647.2	6.9	n.a.	87.8	<– 5.3 –>	
KGHM	Copper mining	August 97	IPO		1 348.4	44.3	–	–	<– 55.7 –>	
Powszechny Bank Kredytowy	Banking	October 97 June 00	IPO Block sale	Bank Austria Credit A-G[2]	1 342.5	3.7	0.8	56.7	<– –> 38.8 Bank of New York (10.1)	
Elektrocieplownie Warszawskie	Heat and power supply	January 00	Block sale	Vattenfall	959.5	45.0	Distribution ongoing	55.0	–	–
Polfa Poznan	Pharmaceuticals	January 98	Block sale	Glaxo Wellcome	770.3	2.7[3]	0.3	97.0[4]	–	–
Orbis	Hotels	November 97 July 99 July 00	IPO Block sale I Block sale II	Accor (20), FIC (10,4), Globe Trade Centre (5) (Poland)	669.7	6.2	n.a.	42.4[5]	<– 51.4 –>	
Gornolaski Zaklad Electroenergetyzny	Heat supply (distribution sector)	December 2000	Block sale	Vattenfall Aktiebolag	635.0	55.4	12.8	31.8		
Zaklady Przemyslu Tytoniowego Krakow	Tobacco processing	January 96	Block sale	Phillip Morris Holland	579.7	4.5[6]	0.1	95.4	–	–
Elektrownia Rybnik S.A.	Heath and power supply	March 2001 and September 2001 (second stage)	Bloc sale	EDF EnBW AG	I and II stage 693.8	35.4	14.6	50.0 + one share		
Zespol Elektrocieplowni PAK	Heat and power supply	March 99	Block sale	Elektrim (Poland)	359.2	50.0	11.5	38.5	–	–
Polaniec Power Station	Power supply	April 2000	Block sale	Tractabel	350.0	60.0	15.0	25.0	–	–

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Table 23. **Largest privatisations** (*cont.*)

As of December 2001

Firm	Activity	Date of privatisation	Method	Strategic investor	Budget revenue (Zl million)	Ownership structure after privatisation, in per cent				
						State	Employees	Strategic investor	Institutional investors	Individual investors
Elektrocieplownia Krakow	Heat and power supply	October 97	Block sale	Finelex BV	279.1	28.1	8.1	63.8	–	–
Slaska Spolka Cukrowa	Food processing	November 00	Block sale[7]	Saint Louis Sucre	250.5	5.0[8]	–	95.0	–	–
Zespol Elektrociieplowni "Wybrzeze" S.A.	Heath and power supply	June 2000	Block sale	EDF Int. GDF Int.	239.7	37.3	12.7	50.0		
Electrocieplownia Bialistok S.A.	Heath and power supply	February 2001	Block sale	Société Nationale D'électricité et de Thermique	181.5	41.0	14.0	45.0		
Elektrocieplownia "Zielona Gora" S.A.w Zielonej G'orze	Heath and power supply	September 2001	Block sale	Zespól, Elektrocieplowni Wroclawskich KOGENERACJA S.A. And DALKIA Termika S.A.	45.3	38.5	14.9	47.6		
PLL LOT	Air transport	January 00	Block sale	SairGroup	139.5	68.0[9]	6.9	25.1	–	–
DT Centrum	Retail trade	February 98	Block sale	Handlowy Investments Centrum SA (Poland)	106.0	3.8	15.0	80.0	–	–

1. Bank Handlowy was privatised through IPO to three institutional investors (28.5%). Additionally, a stake of 22.2% was held by Bank of New York through GDR issues. In 2000, Citibank became a strategic investor of the Polish insurer PZU by buying convertible bonds and purchasing remaining shares from institutional investors and on the WSE.
2. Bank Austria Creditastalt built its stake gradually purchasing shares on WSE. In June 2000 it bought 10.3% of shares from the State Treasury.
3. Golden share: in case of disagreement in the general meeting of shareholders, the government has a right to sell its single golden share to the strategic investor at a price equivalent to total value of its ordinary shares at the day of privatisation. The option can be exercised also when the strategic investor does not fulfil the privatisation agreement. This right expires in December 2007.
4. Initially, the Treasury sold 80% of shares to a strategic investor and 15% to employees. Later an investor purchased shares from employees and, after new issues of shares, the State Treasury stake dropped to 2.7%.
5. Golden share: in case of disagreement in the general meeting of shareholders, the government has a right to sell its share and the owner of the biggest stake has an obligation to buy it at 300% of total asset book value. This right expires in December 2005.
6. Consortium of Orbis' strategic investors increased their stake in the company to 42.4% (over 35.4% bought from the Treasury in July 2000) through direct purchases on the secondary market in 2001.
7. The sale of the shares of Slaska Spolka Cukrowa has not been completed yet due to legal problems (case between Saint Louis Sucre and the Ministry of the Interior and Administration).
8. Golden share: the government has a veto right in the general meeting of shareholders concerning the following decisions: changes in firm's statutes, initiation of liquidation or merger and acquisitions. When sold to private investors, government share loses special rights.
9. Following a new short issue in November 2001.

Source: Ministry of the Treasury and National Bank of Poland.

voivodship authorities, the purchasers, existing management and labour representatives. While initially conceived as mechanisms to promote transparency and prevent interested parties from engaging in secret agreements, these bodies have often failed to arrive at consensus and, as a result, have served to substantially prolong the overall privatisation process. Some observers argue that public-enterprise insiders (managers and employees, staff of the ministries involved in company affairs) use them to defend their own interests, which they sometimes perceive as being best served by maintaining state-ownership. Indeed, while consulting with those most involved in a sale makes sense, allowing them to effectively veto sales appears excessive, especially in those instances where the existing firm appears profitable and there is no *a priori* reason to expect a subsequent downsizing.

Decision-making is further complicated because several institutions share responsibility for key decisions concerning SOEs. The Ministry of Treasuryand until its recent dissolution (April 2001) the Privatisation Agency, is responsible for privatisation decision. However, insofar as the Ministries of Economy, Infrastructure and Defence can influence the sequence between privatisation and restructuring, this inevitably leads to conflicting agendas and slower progress. The Ministries of Economy and Infrastructure are responsible for restructuring programmes which leads to a natural bias towards strategies that favour restructuring firms prior to sale.

In the case of direct privatisations, this requirement plus the bottom-up nature of the process tends to sap the process of its urgency. The authorities report that managers and workers in many profitable state-owned plants show no interest in taking the company over themselves or in seeing it privatised to an outsider but are content to maintain the status quo. At first glance, as long as these companies are not loss-making or even generating small profits such a strategy appears benign. In reality, it is more pernicious. Because the managers of such firms have no economic incentives to increase profitability and limited access to private-sector capital, they fail to take advantage of the market opportunities available to them and fail to grow. At the macroeconomic level, this translates into slower productivity and employment growth, lower taxes and more demand for social expenditures. Rather than allowing these state-owned firms to continue stagnating in this manner, the authorities should accelerate their privatisation – offering the current management and workers the opportunity to participate – but actively promoting the firms for sale if they are not interested. In this regard, authorities should consider bundling together residual stakes and holdings in smaller firms and selling these to an investment banker for subsequent sales. Recent experience with this technique in the Czech Republic has shown it to be an efficient mechanism for harnessing the interest and expertise of the private sector in the process. Not only would this allow private capital to enter into and expand promising enterprises, it would also help boost

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their and the economy's employment and overall productivity levels as private owners sought to increase profits and market share.

The management and logistical problems posed by the large stock of state-owned firms necessarily weakens the Ministry of Treasury capacity to provide effective governance to firms and precludes it from actively seek new owners for all. This poses a *second* challenge to the authorities and notably to maximise output in the currently state-owned sectors of the economy. The Ministry of Treasury holds positions on the boards of a very large number of companies and is represented by some 4 952 individuals, 381 of whom are Treasury employees, with the remainder being individuals (generally lawyers) who represent the Ministry for a fee. While the qualifications of state representatives are rigorously tested,[75] their remuneration (especially the Treasury employees) is strictly controlled and therefore their incentives are very different from those facing a director in a private company. In particular, for a Ministry employee cumulated fees from representing the State may amount to as much as 100 per cent of the average wage in the overall enterprise sector and are in addition to his or her regular salary. In such an instance, the incentives to actively find a buyer for a company or seek its rapid liquidation may be greatly dampened.

Corporate governance is further clouded by the recent highly visible replacement of directors following the change in government. Although these appointees satisfy the same requirement as other government representatives, the manner by which they have been appointed raises the spectre that political rather than economic considerations may be dominating decisions in boardrooms. This could have potentially unfortunate consequences for the performance of the affected firms and the economy as a whole. A policy option likely to result in more transparent delivery of public decisions would require the implementation of measures to de-politicise the appointment of members of supervisory boards in companies where Treasury still holds a stake.[76] Of interest in this perspective is the experience of the UK which has established an Independent Commissioner for Public Appointments in charge of providing guidance on public appointment processes and monitoring the conduct of government actions in this area. Similar mechanisms of external scrutiny have also been in vigour in New Zealand since 1992.

A *third* source of difficulty derives from the pursuit of industrial and social policy goals, which complicates sales and further slows the privatisation process. In this respect, the repeated delays in the privatisation of the coal, steel and defence sectors at least partly reflect efforts by the authorities to attach conditions to these sales designed to ensure a continued "strong" Polish presence in these fields. Indeed, such arguments have been made by the authorities to support the decision to create market-dominating firms in the steel, coal and energy sectors – despite the negative consequences that such structures may have for competition. Perhaps more importantly, the authorities' insistence on restructuring these sectors prior to

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sale can only make sense if it is presumed that the authorities are in a better position to restructure these firms than would be a private-sector owner. The argument that pre-privatisation restructuring is necessary to maximise the sale price of the firm appears to abstract from the costs (both in terms of direct expenditures, lost market value and opportunity costs) incurred by the government during the restructuring process. In the case of the coal sector, the authorities annual "investment" approaches 1 per cent of GDP in unpaid tax and social security payments, loan guarantees and other associated contingent liabilities. Similarly, the current practice of including social and investment conditions in privatisation contracts raises the costs of buying a firm. Unless they are compensated for, by a reduction in the purchase price, they can be deal breakers. A solution more likely to result in a sustainable conclusion would involve a direct sale of the enterprise with the State providing direct assistance to affected workers. Experience in other countries suggests that if the State relieves the firms of their accumulated debts and other contingent liabilities, then private sector operations are willing to come in – even if they are loss making.

In the case of capital privatisations, conflicts between public policy goals and those of private-sector investors in firms where the State retains an important stake are relatively common. In order to implement their business and investment plans, privatised companies often need substantial injections of fresh capital. However, on several occasions the public shareholder has refused to agree to these capital injections. Moreover, in the few instances where a re-capitalisation has occurred, the amount of capital injected has been insufficient to change the prospect of the beneficiary company.[77] The main reason for refusal appears to be reluctance on the part of the State to see its share in the firm diluted and a tight budget constraint that precludes it from participating in the recapitalisation.[78] The problem is not merely anecdotal since, of the nearly 1 000 companies that have been partially privatised as joint-stock companies, the Ministry of Treasury has a controlling stake[79] in almost half of them. Obviously preventing partially-privatised firms from increasing their capital base defeats one of the main objectives of privatisation, enabling domestic firms to harness world savings so as to expand their activities and take fullest advantage of Poland's comparative advantages. The authorities should therefore seriously reconsider their objections to such infusions of capital.

The regulatory framework

The rationale behind privatisation is that private-owners face natural incentives that promote innovation, employment, growth and rising incomes. While a necessary condition, private ownership is not sufficient to ensure the efficient operation of a market economy. Experience shows that, in the absence of an appropriate regulatory framework, a privately-owned monopoly need not be preferred to a state-owned one. By the same token, unless firms operate in a legal

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environment that ensures the efficient enforcement of contracts (including property rights) and effectively prevents anti-competitive behaviour, growth prospects can suffer. Indeed, the successful expansion of the private sector over the past 10 years owes much to efforts to enhance the legal environment for businesses. Among the most important steps taken were:

- Removing legal barriers to the development of competition in sectors that were previously exempted by law (banking, insurance, the media market, retail trade, telecommunication and more recently energy and the railways);
- Introducing modern statutes about competition, consumer protection, unfair competition and intellectual property;
- Requiring equal legal treatment of private and public entrepreneurs, enforcing rules concerning the abuse of dominant positions and the stipulation of anti-competitive agreements, and requiring state-owned firms to get regulatory approval for mergers; and
- Privatising many sectors and businesses in an environment open to foreign investors.

In order to build upon these achievements and as part of the E*ntrepreneurship*-D*evelopment*-E*mployment* programme, the authorities intend to take steps to reduce administrative burdens by streamlining procedures. In an effort to improve SMEs' access to credit, speed the execution of legal judgements and the payments of intercompany debts, the government established a unified entrepreneurs' electronic registry system for new enterprises. The register grants potential investors, creditors and the courts, access to a comprehensive set of information about an entrepreneur's business, including the legal status of the company, possible liquidation proceedings, possible tax and social security arrears and names of persons deprived of the right to run a business. It is routinely updated and, as its coverage becomes more comprehensive, it should improve transparency and the confidence with which economic agents can enter into agreements. However, to become truly effective the registry needs to be reinforced by including existing businesses as rapidly as possible. There is a similar pressing need to improve the land registry. Currently purchases can take over a year before they are recorded. As a result, it is virtually impossible to establish ownership over land, and, even if one has a certificate, a potential creditor cannot be sure that the property in question has not been sold since it was issued. It is, therefore, very hard to use property holdings as collateral in loans – normally a critical source of funding for SMEs. The problem is most acute in Warsaw where many records were lost during the Second World War. Although the situation is complex, urgent action is needed.[80] Steps that might be taken include computerising the registry and hiking registration fees so as to finance improvements to the system.

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Registration procedures for new businesses are time consuming, typically taking as much as 2 months to complete and there is considerable scope for streamlining obsolete administrative requirements to the creation of small enterprises (Table 24). Currently, a prospective entrepreneur must report to 4 registration offices and complete 6 forms and between 3-5 different administrative procedures, which is relatively high by international standards. Progress to date in simplifying these procedures has been limited, and the government should consider extending its newly introduced electronic registry system to form a one-stop business registration system. Measures taken to reduce administrative hurdles on a day to day basis include the passage of the Business Activity Law, which reduced from 30 to 8 the number of areas of economic activity requiring a licence, and the repeal of compulsory inspections in 11 business areas. While a step forward, the degree to which requirements have been reduced is unclear as, in many cases, licensing requirements have been replaced with permits.[81]

Previous *Surveys* have discussed at length the comprehensive tax reform initiated in 1999 which sought to simultaneously lower tax rates and broaden the tax base. This initiative, which will not be completed until 2004, sought to align Polish personal and corporate income tax rates with those observed in other Central European countries, hence making Poland a more attractive place to work and produce. However, since its passage other countries have proceeded with further cuts and as a consequence even at their planned lower rates, taxes will remain relatively high. Firms perceive the level of taxes, in particular social security charges, as particularly burdensome and view the tax system and its complexity as one of the most significant obstacles to their development (Table 25).

With these problems in mind, the authorities are considering several additional measures. For small firms tax compliance can be administratively complicated. The government's *Enterpreneurship First of All* includes proposals to simplify the monthly preparation and submission of tax documents, which most firms perceive as a significant burden, requiring outside expert assistance. One proposed amendment corrects an important anomaly in the Polish tax system whereby a taxpayer who acts upon an official tax interpretation that is subsequently overruled is subject to penalties and interest payments on the tax due. Perhaps more fundamentally, the Ministry of Finance is considering introducing a flat personal- and corporate-income tax rate of 22 per cent.[82] In addition, there are proposals to more than double the threshold below which businesses can opt for paying lump-sum corporate income tax and increase the number of firms eligible to use the so-called "tax-card", thereby extending the number of businesses entitled to these simpler forms of taxation. These changes would not only make the tax system administratively more simple but would hopefully also address the current bias described in the previous *Survey* in favour of unincorporated businesses.

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Table 24. **Registration procedures**

	Natural person	Other
Step I	Registration in the Business Activity Register maintained by municipal authorities.	Registration in the National Juridical Register (KRS) maintained by registration courts. Registration must be reported to the Judicial and Economic Monitor.
	Since January 2001, registration of all business activities in KRS *is obligatory, except for natural persons, who are allowed to choose whether to register in the Business Activity Register or* KRS *until the end of 2003. Thereafter, the two registers will be unified.* *Registration authorities submit certificate of registration to tax office,* ZUS *and the statistical office.*	
No. of forms required	Not defined by law, in practice one form.	One basic application form.
Other documents required	No additional forms.	Number of accompanying forms depends on size of given entity.
Step II	Registration with statistical office. Entrepreneur receives REGON (statistical identification number).	
No. of forms required	One basic application form.	
Other documents required	None.	
Step III	Registration with tax office. Entrepreneur receives NIP (tax identification number).	
No. of forms required	One basic application form.	One basic application form.
Other documents required	Three additional forms and an optional one depending on the number of outlets.	Four additional forms and an optional one depending on the number of outlets.
Step IV	Registration with ZUS.	
No. of forms required	Two basic application forms (for employer and insured even if the same person).	
Other documents required	Additional in case of natural persons when employer has family (wife, husband, children).	
Step V	Opening of bank account.	
***Memorandum items*:** *A total of six forms are required (excluding banks' forms), plus three to five accompanying documents (excluding* KRS*'s documents).* *Average time for completion of all formalities is about two months.*		

Source: OECD, based upon information provided by the Ministry of Economy.

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Table 25. **Breakdown of social security contributions**
Per cent of total compensation

	2002		
	Employer	Employee	Total
Pension	9.8	9.8	19.5
1st pillar			12.2
2nd pillar			7.3
Disability	6.5	6.5	13.0
Sickness	–	2.5	2.5
Injuries	1.6	–	1.6
Health care[1]	–	6.3	6.3
Labour	2.5	–	2.5
Guaranteed Employee Benefit Fund	0.1	–	0.1
Total	**20.5**	**25.1**	**45.6**

1. The statutory contribution rate for the health care fund is 7.75 per cent. However, the base upon which this rate is calculated is smaller than for other social security contributions because it excludes contributions to old-age, disability and survivor pensions as well as sickness contributions. As a result, its effective rate (on the same base) is lower, 6.3 per cent. The totals in the Table are based upon this lower effective rate.

Source: Ministry of Finance.

The authorities are also considering simplifying the system of quarterly VAT payments and instituting a tax exemption for entrepreneurs operating in regions characterised by serious structural unemployment problems. The existing proposal provides that employers hiring graduates are eligible to be partially reimbursed for pension and on-the-job accident contributions. Special temporary delays in the collection of pension contribution are also planned for all graduate establishing a new business. While the first two measures would be welcome, the third could allow serious abuses. In particular, it could incite entrepreneurs to repeatedly open and close what is effectively the same business in order to permanently benefit from the exemption. While such activity could be monitored, to do so would be very expensive administratively and, perhaps, largely ineffective. Another VAT reform that is strongly supported by the employers' association would modify fiscal regulations so that VAT rebates are only paid out after purchasers have paid their sub-contractors or suppliers. Such a solution would have the advantage of improving the accounts payable position of small firms and reduce their dependence on expensive bridge loans. Moreover, it could reduce the strain on the judicial system by reducing the incentives to delay payments. As simple as such a change appears, however, it would be complicated to administrate, and these costs should be weighed against any advantages before a decision is made.

In any country, the legal environment for business is an essential ingredient shaping the economy's ability to adapt quickly and efficiently to changing demand and supply conditions. In particular, the process and efficiency with which contracts and debts are enforced can have important effects on productivity by ensuring that

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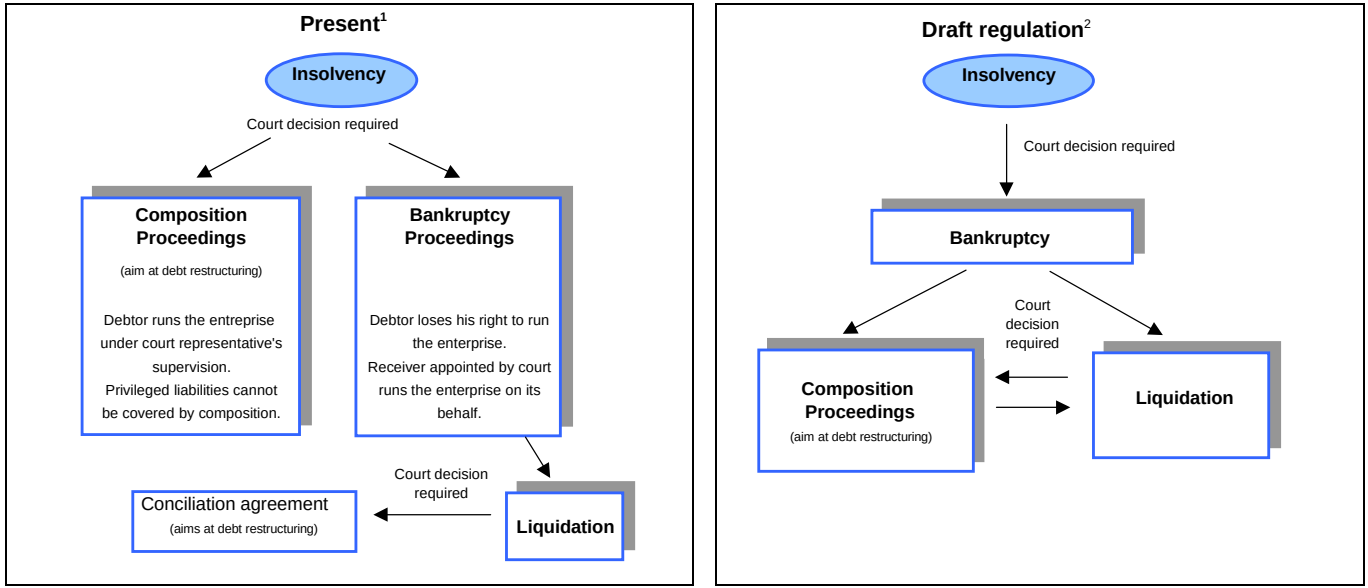
the assets and resources allocated to inefficient and loss-making firms are quickly transferred to more efficient ones with stronger growth opportunities. The existing bankruptcy and liquidation framework is based on laws that are over 65 years old and which have evolved little. The current system is slow and costly and places an excessive emphasis on protecting the debtor (Figure 27). Rather than seeing bankruptcy and dissolution as a normal part of the life cycle of a firm in a modern market economy, the current legislation seeks above all to avoid firm closures and provides only limited opportunity for creditor-led restructuring of debtor firms. Moreover, foreign creditors are concerned that Poland is not a signatory to any treaty on international insolvency or on the recognition of foreign judgements.

The government moved in 1999 to establish a commission to prepare a new and unified insolvency law. The commission's work was finished in April 2002 with the extension of its scope to include the operations of banks and insurance companies having contributed to the lengthy process. The commission has proposed a new unified insolvency law, which it hopes to present to the government by the end of 2002. The proposal seeks to make the law better suited to a modern economy and bring it into line with international practice. If passed it would emphasise protecting creditor rights, as opposed to those of debtors, and seek to make the best use of the remaining assets of an insolvent firm. In particular the commission proposes that the insolvency process be split into two, the first being concerned with determining the existence of insolvency and the second, the main bankruptcy process, seeking to liquidate assets or distribute them among creditors. The proposal considerably strengthens creditors rights, permitting them to petition the courts for an involuntary insolvency in a much wider range of situations. Even if the court agrees to a restructuring programme, creditors will be allowed at any time to petition for the liquidation of the debtor firm. It is hoped that these changes will yield a more efficient disposal of debtor's assets and reduce the potential for debtors to delay restructuring and use the intervening period to strip assets. Moreover, in an attempt to speed court procedures, the proposed law lowers the number of district court judges in charge of any insolvency case from three to one per case and more importantly eliminate the existing exemption from bankruptcy law of major state-owned enterprises.

These changes would, if implemented, go a long way to improving the balance of power between creditors and debtors and in so doing reduce the risks associated with bank lending to small and medium enterprises. The draft law has been submitted to the Ministry of Justice which has started the consultation process with the other Ministries. However, the law is not expected to enter into force before 2004. Such a further protracted delay is unfortunate. While the proposed law is not perfect, it is an important improvement on the existing rules and passing it now need not preclude making further changes.In particular, the proposed draft law could be improved upon by providing more explicitly for a creditor-led bankruptcy process with the role of judges limited to ensuring that

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Figure 27. **Insolvency in Poland**



1. At present, the insolvency regulation framework is confused. Although composition and bankruptcy procedures are separated, they overlap in parts. To open a composition procedure the economic condition and credibility of a debtor must be strong enough to ensure that the liabilities are repaid. If the court considers that a debtor cannot satisfy creditors under composition, the bankruptcy procedure applies. Despite the fact that debt restructuring is also allowed under bankruptcy proceedings, it is seldom implemented, because debtors' economic condition rarely improves enough to allow them to move from liquidation to conciliation. On the other hand, creditors are not entitled to call for bankruptcy once a composition has begun if the debtor does not fulfil the composition agreement.
2. New regulations increase the flexibility of bankruptcy and composition procedures, providing the opportunity to move from the declaration of bankruptcy with a view of liquidation to bankruptcy with the option to compromise. In addition, they allow changing the terms of conciliation, at any time, provided certain conditions are met.

Source: OECD.

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due process is followed. This would be an improvement over the current situation where the judge directly supervises the bankruptcy process which is conducted by appointed administrators. Such a change would explicitly recognise that the creditors (as owners of a bankrupt firms assets) have the strongest incentive to maximise the value that can be wrought from them and would relieve the court system of a heavy administrative burden.

Managing the market

As part of its preparation for EU accession, Poland has created a number of regulatory agencies, including the Office of Competition and Consumer Protection (UOKIK, operational since 1990), the Securities and Exchange Commission (KPWIG, from 1991), the Energy Regulatory Authority (URE, from 1997) and the Office of Telecommunication Regulation (URT, since 2001). While each has substantial autonomy and has contributed to improving the competitive environment in Poland, more could be done.

Among these Polish regulators the UOKIK plays a central role in assuring the smooth operation of competitive markets. The Antimonopoly Act that has been in force since April 2001 further aligns Polish competition law with international and EU standards,[83] abolishes unnecessary procedures and more importantly recognises explicitly that some forms of cooperative behaviour among firms can enhance growth in productivity and innovation.[84] The new Act provides the authorities with more flexibility in dealing with mergers and acquisitions. It allows the Council of Ministers to authorise generally applicable "block" exemptions to agreements that contribute to production, distribution, technical and economic progress under certain conditions – if the agreements ensure consumers a fair share of the benefits, do not impose unnecessary restrictions, and do not permit the parties to eliminate competition for a substantial part of the market. The new Act also introduces so called *de minimis* exemptions, permitting small horizontal and vertical agreements involving collective market shares below 5 and 10 per cent, respectively and raises the excessively low threshold requiring UOKIK notification in merger cases.[85] In addition, the new Antimonopoly Act strengthens substantially the investigative powers of the UOKIK, which should result in more accurate information gathering and better analysis, and explicitly defines its areas of competence concerning liberal professions.[86]

These changes are welcome. In general, they serve to make Polish competition law more flexible and recognise that in an increasingly integrated world market where economies of scale can bring advantages to consumers, a more qualitative rather than quantitative anti-monopoly law is required. While the Act strictly limits the ability of the Prime Minister to recall the UOKIK's President,[87] further improvements are needed to grant the organisation's full independence. The UOKIK is closely involved in the policy making process and, in practice, this

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restricts its capacity to criticise decisions that are uncompetitive. Thus, for competition-related matters, the President of the UOKIK participates directly in the policy-making process at the Cabinet level. At the same time, the office contributes actively at the working level in the context of special *ad hoc* task groups on competition-related issues appointed by the Council of Ministers.[88] Critics argue that this close relationship with the executive constrains the organisation's ability to challenge *ex post* competition policy decisions, with which it has disagreed but was overruled. They argue that a better solution would have the UOKIK report to the legislature, while retaining a more arms length consultative and advisory role during the policy formation process. Indeed, while the office has objected *ex ante* to some of the measures taken to consolidate the steel, coal and energy sectors prior to their privatisation, it has not challenged these steps once taken. Here its reports on reform of network industries and public monopolies (telecommunication, solid, liquid and gas fuels, the energy sector, road, rail and air transport, the postal services) are examples that might be usefully emulated in the future.

The UOKIK also has a well defined monitoring and supervisory role and it has vigorously pursued anti-competitive behaviour in a number of areas, most notably the telecom sector where the former monopolist, *Telekomunikacja Polska* (TPSA), has been repeatedly found guilty of using its dominant position to the disadvantage of competitors. In 2001 it issued the highest fine in its history (PLZ 54 million) against TPSA and it is pursuing additional proceedings against TPSA for imposing excessively onerous contractual terms on competitors. Similar cases in the electricity market[89] have also resulted in fines. At the local level, most cases involve sub-national governments refusing newly licensed companies access to municipal waste dumps or prohibiting private entrants from using municipal bus stops, typically with the intention of protecting an incumbent (usually publicly owned) service provider.

In addition to the Competition authority there are a variety of sectoral regulators in Poland with varying degrees of independence. Their role is discussed in some detail in the forthcoming *Review of Regulatory Reform in Poland* (OECD, 2002a), which notes a need to increase their independence and to ensure close and consistent co-operation between them and the UOKIK. For the moment, the problem of shared authority has not led to major disagreements over jurisdiction, but it may do so as regulators seek to define the extent of their authority. In order to deal with such a conflict, some sort of formal conflict resolution mechanism should be established now – before it is necessary.

Most recently the government has sought to reduce from 20 to 10 the number of extra-budgetary state agencies it operates, an initiative that will have an impact on the activities of several important sector regulators. In this context, the National Office for Insurance Supervision (PUNU) and the Pension Funds Supervisory Office (UNFE) were merged in January 2002 to form the Insurance and

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Pension Funds Supervisory CommissionInsofar as the pension and insurance management markets overlap in many respects, the unification of their supervisory authorities may result in lower costs and improve the authorities' ability to oversee activity in those two inter-related markets. A similar logic resulted in the replacement of the URT, the telecom regulator, with a new combined watchdog agency for postal and telecommunication services (URTiP). However, it is not clear why the Health Insurance Supervisory Office (UNUZ), the entity responsible for supervising third pillar health insurance funds, was not also integrated into the new Insurance and Pension Funds regulator.

The authorities decision to replace the heads of the URT and the Pension Fund regulator with its own appointees, even though their terms had not expired, has led some observers to argue that the amalgamations were designed to reduce the independence of these sectoral regulators. The government has fiercely denied such a motivation. Nevertheless, one of the first initiatives of the new telecom regulator was to overturn the decision by his predecessor to impose a PLZ 350 million fine on TPSA for failure to respect previous decisions requiring it to provide its competitors with access to its lines. This new regulator argued that course of action was desirable because in return TPSA dropped all of its court challenges against the URT and its previous rulings. Unfortunately, the decision to rescind the fine may end up reducing the authority of the regulator by leading others to challenge fines in the courts in a similar effort to have them reduced.

The market for corporate governance

Capital markets perform a critical function by directing personal savings to their most productive uses, ensuring that profitable firms can expand and that aggregate productivity grows as rapidly as possible. As described in past OECD *Surveys*, Poland's well developed regulatory framework for the capital market created the conditions that enabled the Warsaw Stock Exchange to become the largest in Central Europe. Since then additional steps have been taken to further improve the environment for conducting business and to strengthen corporate governance. In particular, a new Commercial Company Code entered into force, affirming the principle of equitable treatment of all shareholders and restoring the right for any shareholder to lay a claim in court against a resolution taken at the general shareholders meeting (GSM). Previously only a shareholder (or group of shareholders) possessing more than 1 per cent of votes could challenge a decision in this way. In addition, stricter requirements concerning the timing of GSMs have been implemented in order to limit the practice of postponing the GSM as a means of bypassing minority shareholders.

Generally speaking, rules covering disclosure and transparency are reasonable,[90] although there is room for improvement. Indeed, both the Warsaw Stock Exchange and the Gdansk Institute for Market Economics (a private think

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tank) have been simultaneously attempting to draft a set of corporate governance principles based on OECD guidelines.[91] Both drafts emphasise the need for a governance framework that protects minority shareholders' rights,[92] ensures their equitable treatment, the timely disclosure of information and the strategic guidance of the company in conformity with applicable laws. While broadly similar, the two proposals differ in emphasis. The Stock Exchange proposals favour a client-oriented approach based on the identification of best governance practices and their subsequent publicity among listed firms. The second group seeks to create a corporate governance rating of firms, so that investors would be able to judge the relative reliability of firms' information and their respect of minority shareholder rights. Both Codes recommend the observance of certain criteria, most notably the definition in the statute of the requirement to appoint independent members to the supervisory board, securing the availability of the Statute and disclosure of up to date information about the performance of the company.

These initiatives are welcome and should help improve transparency in the conduct of capital markets in Poland and thereby make investments there more attractive to foreign portfolio investors. However, more needs to be done. In particular, the commercial Code should provide mechanisms for the settling of disputes at the corporate board level between large shareholding groups. Moreover, provisions that reduce from 5 to 2 the maximum number of votes that a single share can exercise and that prohibit the issuance of non-voting shares should also be applied to companies in which the State Treasury is a shareholder. Currently these are exempt until 2005 and the shares held by the Treasury can carry up to five votes. Though temporary, such a privileged voting right jeopardises strategic direction, future growth and the long-term viability of companies whose supervisory boards are in conflict (see above).

The corporate governance of firms privatised by the capitalisation method has been complicated because many firms now have more than one large shareholder (generally a private purchaser and the State) and many smaller shareholders. As indicated earlier, in more than one case this has resulted in very public disputes between the State and private-sector stakeholders concerning the expansion of a company's capital or other issues of strategic importance. Such conflicts peaked in 2002 when the government renounced its obligation to sell its remaining stake in PZU, the country's largest insurer, to the privatisation owner.[93] While these kinds of conflicts occur throughout the world, their profile and seemingly high incidence, as well as the involvement of the State as a protagonist in many of them, may be hurting investor confidence in Poland.[94] Here, indeed, the cumulative effects of the replacement of board members, refusal to allow private-sector partners to increase their stakes and efforts to renegotiate privatisation agreements may cause some investors to reassess the advisability of entering into a privatisation agreement where the state retains a blocking shareholding. Moreover, the state's use of shares in other firms to finance its re-capitalisation is not without

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difficulty, effectively forcing the "re-capitalised" firm to sell large blocks of shares into a thin market. Such conflicts have adversely affected firms' prospects through limiting their ability to conduct much needed financial and organisational restructuring. The authorities argue that these steps have been taken to ensure that government policy is appropriately executed and have reiterated their desire to rapidly proceed with privatisation. In order to demonstrate their intentions in this regard, they should proceed rapidly to resolve the disputes in which they are currently involved and as already suggested accelerate the sale of their residual stock holdings in these and other companies.

Other steps to promote the business sector

As elsewhere, small and medium sized enterprises (SMEs) in Poland complain about their disadvantageous position in accessing commercial loans for business financing. A number of specific factors conspire to make this generic SME problem more severe. *First*, as discussed above problems with the land registry limit the collateral that firms can bring to bear. *Second*, the high interest rates available on relatively safe government securities tend to crowd out the supply of zloty denominated credits. *Third*, SME loans tend to be particularly small in Poland, typically ranging between 2 500 and 12 500 dollars, which raises the share of fixed costs in the total loan cost and forces banks to charge particularly high rates. *Fourth*, these problems are compounded by the common practice of under declaring business activity in order to avoid high taxes, which means that firms' books do not reflect their real financial position. While policy cannot resolve all of these problems a number of the remedies described elsewhere in this *Survey* would help here. Thus, reducing public expenditures and the public sector borrowing requirement would allow interest rates to fall. Similarly, resolving problems with the land registry and rationalising the tax system would improve firms' ability to qualify for loans by reducing incentives to avoid tax and falsify books and increasing the effective value of collaterals.

A recent sample survey concluded that 80 per cent of SME start-up capital comes from own sources, while bank credit also plays a modest role in the financing of their working capital and investment needs.[95] Doubtless this reliance on retained earnings helps explain the precipitous fall in investment spending in 2001. Government action to ease the financing constraints of SMEs has concentrated on loan guarantees and direct subsidies. Guarantee programmes focus mainly on local and sub-local development. Currently there are 26 local and regional funds, of which the large majority were constituted by domestic and foreign non-bank entities (both public and private), while a handful of them were established using the assets of large commercial banks (backed by local authorities). In addition, there is the National Credit Guarantee Fund (KFPK), which covers the entire territory of Poland and is funded directly from the budget.

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The fund is managed by BGK Bank in co-operation with 45 commercial banks and the Ministry of Finance. Both fixed investment and raw material purchases of SMEs can benefit from a guarantee equal to as much as 70 per cent of each loan guarantee programme. By end 2001, a total of 4 809 SME guarantees had been issued, almost equally split between the local and national funds and with a total value of PLZ 375 million. There continue to remain widespread calls for more broadly available SME support loan schemes and one additional programme currently stands before Parliament.

The Polish Agency for Enterprise Development is the principal source of direct subsidies for SMEs. It participates in the implementation of local development programmes, especially those supporting the expansion of small firms, the adoption of new technologies, promoting social cohesion and exports. It also provides indirect support to SMEs by co-financing the activities of other organisations, such as the EU, in the area of training, advisory and expert services. The agency grants loans, takes equity positions in firms and purchases bonds issued for firms in specific sectors. Spending levels are relatively low (about 1.1 per cent of GDP spread out over the period 2002-09[96]), although total spending levels will approach 0.4 per cent of GDP annually thanks to EU cofinancing. Past subsidy programmes have been criticised as being non-transparent and distorting of competition. New regulations on public aid attempt to address this issue by establishing ceilings for state aid in supported projects and requiring the UOKIK to evaluate the competitive effects of granted aid. Although such action should help improve the economic benefits derived from this aid, the usefulness of the UOKIK's annual report on state aid would be enhanced if it were submitted earlier, *e.g.* at the beginning of the budget process.[97]

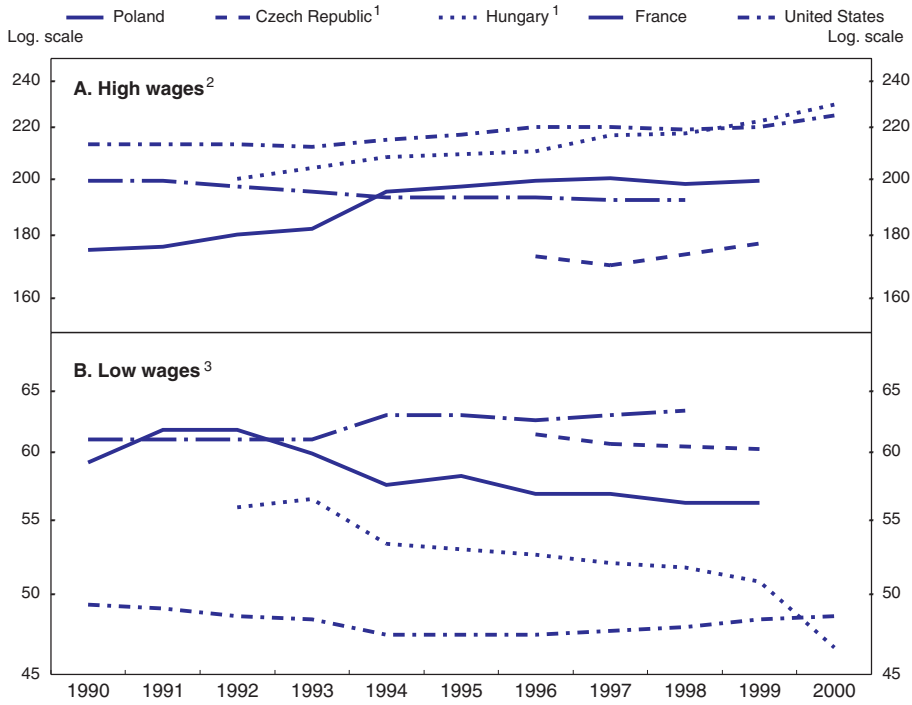
Fostering employment expansion

With unemployment now in excess of 20 per cent of the labour force (the highest rate in the OECD) and almost half of the working-age population without jobs (second worst among member countries), improving the performance of the Polish labour market is a massive priority. As stressed in the previous *Survey*, raising employment levels is likely to be the most effective means of alleviating poverty. Moreover, as the discussion in Chapter III makes clear, the speed of Poland's convergence towards European income levels will depend importantly upon its ability to reorient government spending away from personal transfers and towards productivity-enhancing investments in both human and physical capital. Reducing non-employment will help achieve both goals by increasing revenues, reducing demand on social assistance, and increasing output by making fuller use of available resources.

Previous surveys have highlighted the need to increase wage flexibility, both at the macroeconomic and the microeconomic level. Adjustment in a market

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Figure 28. **Earning distribution in selected OECD countries**
Per cent of average wages



1. Data were interpolated for Hungary in 1995 and for Czech Republic in 1998.
2. Earnings of the 90th percentile divided by those of the 50th.
3. Earnings of the 10th percentile divided by those of the 50th.

Source: OECD.

economy can occur either through prices or by quantities. In the case of the Polish labour market, wage-setting institutions have tended to place the brunt of the adjustment process on employment (Chapter I). Indeed as compared with Hungary, which underwent similar shocks as the transition began, the distribution of wages in Poland remains relatively flat (Figure 28). While the ratio of earnings between the 9th and 1st deciles increased from 3.0 to 3.5, most of this reflected improved earnings at the upper end of the distribution.

The combination of a flat income distribution and a high minimum wage (relative to the average wage) can be particularly harmful because, to the extent that the wage-floor is binding, it hits a larger proportion of the workforce. At some 35 per cent of the average wage, the minimum wage is high in comparison

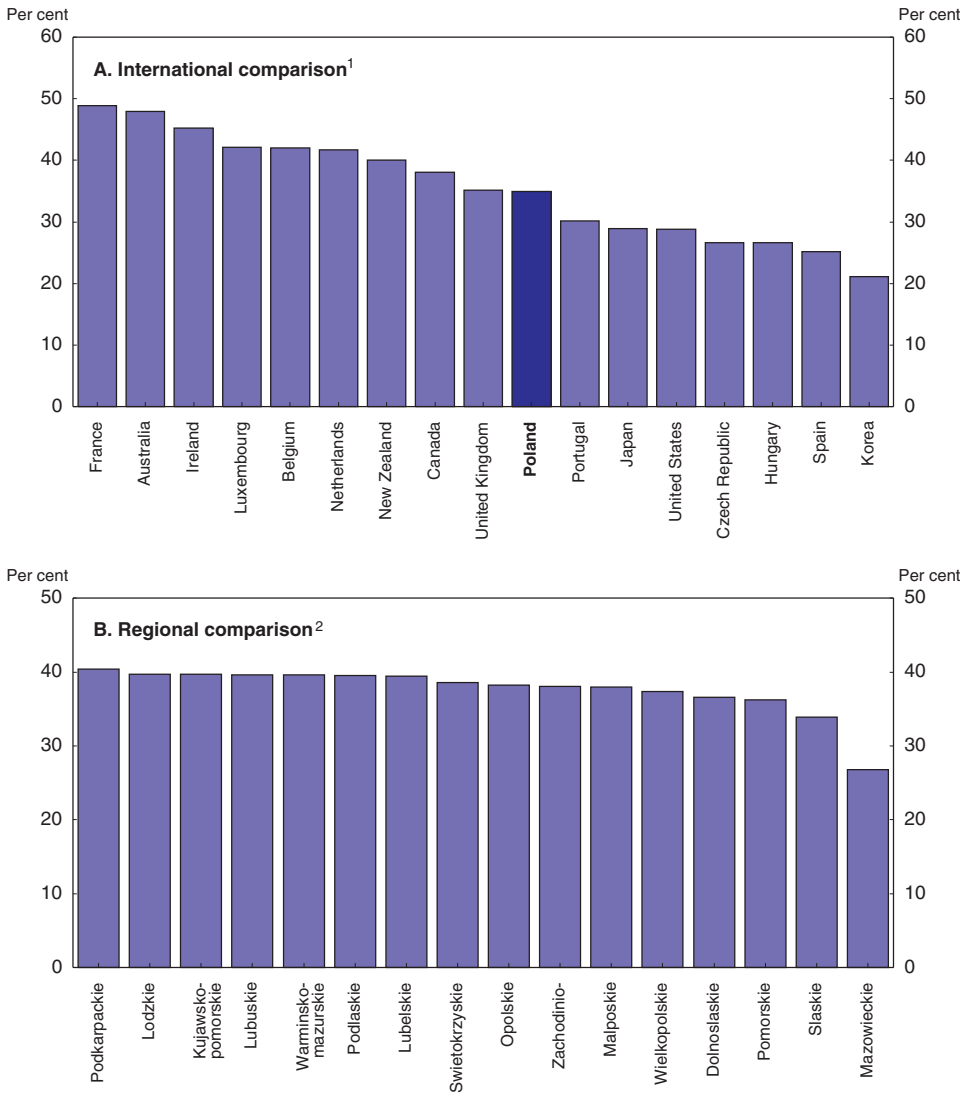
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with other European countries in transition and the extent to which it is binding varies by region. Indeed, in some high-wage *voivodships* the ratio is relatively low, while in others it reaches as much as 41 per cent of average wages (Figure 29). For the low-skilled the problem is even more acute. In the poorest regions the minimum wage is equal to 95 per cent of the average wage of the lowest paid 20 per cent of workers (World Bank, 2001). The government has proposed legislation to the Sejm that would make the determination of the minimum wage the subject of tripartite negotiations. The bill also proposes to temporarily introduce a lower minimum until 2005. Under this proposal the minimum wage for new entrants at 80 per cent of the minimum in their first year of work and 90 per cent in the second. A plan to offer a regionally differentiated minimum wage was abandoned because it was thought to conflict with the constitution (this latter option has been under consideration for many years now.[98] While lowering minimum wages for new entrants should improve their job prospects, the measure is relatively marginal and may be difficult to determine whether or not individuals truly are new entrants. Moreover, the bill does not address the problem of a high minimum wage for experienced workers or those in lower wage regions. Here the authorities should consider using their moral authority to allow the minimum wage to fall with respect to average wages throughout the economy and use in-work benefits, such as an earned-income tax credit, to address income distribution concerns.

At least part of the slowness with which the wage distribution has adjusted to the underlying productivity distribution lies with the wage bargaining system and the important insider power of employed workers. Bargaining is conducted following a two-tier system. A tripartite commission, composed of representatives of the government, employers' associations and trade unions, defines sector-wide maximum annual wage increases.[99] In principle, these are supposed to define a ceiling for wage increases, allowing enterprises to negotiate individual accords that conform to their own conditions, but which do not imperil macroeconomic performance. In practice, however, and notwithstanding disciplinary and financial sanctions that could be enforced, these maxima tend to serve as a floor for wage increases. This is especially true for state-controlled enterprises, which frequently award increases in excess of these limits. Partly as a result and in contrast to experience in the Czech Republic and Hungary,[100] wage growth among state-controlled enterprises and the public-sector is in general higher than in the private sector (Chapter I). Not only does this tendency contribute to the financial difficulties of these companies and, presumably, the difficulties the State has encountered in privatising them, it also adds to wage pressure more generally. Furthermore, the 15 per cent public-sector wage premium in Poland rises to as much as 20 per cent for lower skilled workers, contributing to the flatness of the overall income distribution (both directly and indirectly via market mechanisms).[101]

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Figure 29. **Minimum wages**[1]
In per cent of full-time average wages



1. Data are for 2000 and concern full-time workers.
2. The ratio of average wages of all workers to those of full-time workers were assumed to be the same in all regions.

Source: Ministry of Finance.

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As discussed in Chapter III and previous *Surveys*, social benefits also tend to act as a floor on wages and reduce effective labour supply. Moreover, by providing non-earned incomes that compare favourably with the minimum wage they also reduce the wage pressure that unemployment can be expected to produce and impede the adjustment process. Here little has been done to reduce inactivity traps, and effective marginal tax rates exceed 80 per cent for large subsections of the labour force. Although unemployment insurance is time-limited and not particularly generous, social benefits provide a substantial replacement income and for a potentially unlimited time horizon particularly for families with children. More than 80 per cent of the earnings that the head of a non-employed family of three would receive by taking a job at 2/3 the average wage would be foregone through a combination of income tax and benefit withdrawal (see Figure 23 in Chapter III). For families with two or more children, the problem is even more severe although, empirically, it is unclear how serious the problem is. Social security benefits are means-tested and provided on a discretionary basis. Moreover, only 200 000 or about 6 per cent of the unemployed (as distinct from the non-employed) received some kind of benefit, the average duration of which was short (3 months) and the amount small.

High taxes and in particular high payroll taxes in the form of obligatory social security contributions also affect incentives. Working in combination with the benefit system they are particularly onerous for someone seeking to make the transition from non-employment to work. They also play a role in perpetuating the underground economy. Indeed, the high proportion of workers who report themselves as self-employed reflects a tax avoidance strategy on the part of firms. Increasingly companies offer or require their staff to move from a formal employee/employer relationship to a virtually identical role, but as an "independent" subcontractor. In exchange the firm often offers a somewhat higher take home pay but saves overall because it no longer pays social security charges. While such workers must then make these payments themselves, they often underdeclare their insurable earnings, thereby enjoying a net increase in take home pay. Unfortunately this practice tends to reduce the future benefits upon which these workers can draw and at the same time the tax base – forcing the government to raise tax rates further, thereby increasing distortions and the incentives to tax avoidance. The authorities are considering tightening rules in this regard, by requiring both firms and individuals working in these "virtual" contracting relations to pay the same taxes and charges as a "normal" employee. Such a move would be a step forward. It would bring Polish regulations into line with practice in other OECD countries, and should help discourage this form of tax avoidance. To the extent that it increases revenues, these should be used to reduce payroll taxes so as to reduce the incentive to evade taxes. Here, the recent decision to tax interest income should, by effectively widening the tax base, help alleviate tax pressure and perhaps pave the way for a reduction in payroll taxes.

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The reform of the Labour Code

In order to reduce the risk and costs associated with hiring workers in a period of uncertain demand, some of the most restrictive elements of Poland's Labour Code need to be relaxed. While many labour code provisions are designed to improve job security and safeguard workers from *unfair* layoffs, they can if they become too constraining make firms reluctant to hire. Moreover, although imposing a large fixed cost on layoffs can encourage labour hoarding during slowdowns, they will not prevent them. Indeed, such regulations tend to impose a fixed-cost that makes firms favour large-scale firings over a more gradual labour market adjustment process.[102] Moreover, as signs of recovery emerge, such costs make firms more reluctant to hire because of the high fixed costs and the uncertainty of demand prospects. Indeed, such factors may go some of the way to explaining the increasing importance given to problems of finding a job as an explanation for unemployment (see Chapter I).

The provision prohibiting the termination of a working relationship during periods of excused absence, which can last up to nine months (notably for sickness), is subject to frequent abuse and explains part of the surprisingly high incidence of sick-leave and associated costs. Here, a much more severe screening of individuals seeking sick leave is clearly required. Not only would this free up jobs at firms for those genuinely seeking work, it would also increase work incentives and speed economic adjustment by eliminating an inappropriate source of non-earned income.

The authorities recognise the need to reduce some of the bureaucratic impediments to smooth labour force adjustment, both to reduce the costs of hiring riskier workers such as unproven youth or those already unemployed and to reduce the overall administrative burden on SMEs. Several steps being considered would help increase labour market flexibility without increasing precarity. Thus, relaxing administrative requirements for firms (especially small ones) hiring new workers, in particular those surrounding the employment contract,[103] would likely help reduce underground employment, thereby improving tax collections and allowing for a reduction in payroll taxes. In this regard, the authorities are considering raising from 5 to 50 employees the minimum threshold at which a firm must follow more complicated administrative procedures.[104] Although the initiative goes in the right direction the authorities will want to take care that it does not lead to firms artificially restructuring themselves into several smaller units so as to take advantage of the more relaxed regime. A better solution might involve simplifying procedures for all firms. Similarly, labour costs could be reduced (and employment increased) for firms facing uncertain or fluctuating demand by allowing fixed-term contracts to be renewed more than twice without being automatically converted into indefinite contracts. Indeed, such a change would help employers and employees maintain

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longer-term relations (currently firms tend to not renew such contracts and instead hire a new employee on a fixed-term contract). The most recent draft amendment to the Labour Code proposes temporarily suspending restrictions on the repeated use of fixed-term contracts. Unfortunately, it also confirms the authorities intention to reinstate such restrictions upon EU accession. Finally, creating a legal framework that would allow substitute employees to replace pregnant or temporarily absent employees would increase opportunities for unemployed workers and new-entrants to gain work experience, while increasing firms' ability to efficiently manage their labour resources.

By the same token, proposals to reduce the costs of overtime payments could be helpful. Notwithstanding recent changes, introduced as part of the E*ntrepreneurship*-D*evelopment*-E*mployment* programme, overtime rules in Poland remain particularly binding and out of line with international practices. The overtime premium is 50 per cent for the first four hours (previously two) and 100 per cent for any subsequent hour at night, Sundays and other days of rest. Although significant cross-country differences exist in such rules, reducing the overtime premium to between 25 and 50 per cent and fixing some reasonable limits on overtime would bring Polish law closer to international practices. Indeed, as recommended in the previous S*urvey* permitting firms to annualise working hours would enhance substantially their ability to react flexibly to fluctuations in demand without resorting to layoffs. While the benefits for firms of such a move, in terms of increased flexibility and lower costs are evident, workers too would benefit. Reduced costs would improve firms' competitiveness, leaving room for additional hiring and business expansion – especially among firms whose order books are typically subject to frequent peaks and troughs.

As indicated in Chapter I the significant increased inflow of youth into the labour force likely has contributed to the increase in their unemployment and at the same time has highlighted problems in the school to work transition in Poland. Here the structural problems with the Labour Market Fund described in Chapter III, which cause the funds available for active labour market policies to vary pro-cyclically, are particularly problematical. Not only has funding for the kinds of labour intensive (but effective) programmes such as jobs-clubs and closely targeted training programmes dried up. Moreover, the employees of the public employment service (PES) are too busy administering benefits to attend to these tasks. In addition, to bringing these activities back into the State Budget so that resources can be properly directed towards them, the authorities should consider separating the administrative and job counselling activities of the PES so that during periods of high unemployment, crucial job matching activities do not get crowded out by passive income support.

Recent proposal to discourage disabled individuals and those of pensionable age from combining benefits and labour market activity go in the

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wrong direction by reducing work incentives and contributing to non-employment. Rather than requiring employers of such workers to pay labour market contributions higher than those of ordinary workers and preventing older workers from simultaneously working and collecting benefits, the authorities should consider modifying the pension system to make work pay by actuarially adjusting the benefits of workers who stay active beyond working age or allow them to accumulate wages with their pensions.

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Notes

1. Based on a finer breakdown of industry the following sectors recorded positive growth in investment expenditures: coal mining (up 17.2 per cent), textile manufactures (up 11.9 per cent), wood straw and wicker manufacturing (16.9 per cent), electricity and hot water supply (23.5 per cent), water purification and distribution (41.9 per cent).
2. Among these are metal products, rubber and plastics, mechanical and electrical appliances. These sectors mainly serve exports and private consumption and account for about 35 per cent of Polish exports.
3. Comprised of 400 km of double-laned highway and 200 km of so-called "express ways", two-lane roads with a third passing lane.
4. Poland reports its balance of payments on both accruals and cash terms but the accruals data is normally announced with a considerable delay.
5. Only about 5 per cent of foreign direct investment inflows are privatisation related in the Czech Republic and Hungary.
6. The *Information Bulletin* is released in two formats. The first appears at the end of each quarter and contains a commentary of developments, while the second appears following the first two months of the quarter and includes only data.
7. The 2001 Q3 issue of the *Inflation Report* runs to some 123 pages in English covering a wide range of relevant economic issues, and the text of the executive summary is less than 3 pages long.
8. Measures to be taken include: increased monitoring of tax arrears; improved exploitation of new IT systems; implementation of improved controls against transfer pricing by estimating tax burdens of sub-units and improving international co-operation; and improving the excise tax-take from the sale of diesel to farmers.
9. Comprised of: PLZ 27 billion for FUS; PLZ 15.4 billion for KRUS; PLZ 7.931,9 million benefits for retired armed services; police, customs and legal personnel (judges and prosecutors) Subsidy for the Maintenance Fund – PLZ 1 210,6 million; PLZ 1.2 billion to cover social insurance premia for specific groups (*i.e.* persons on child care leaves, collecting maternity allowances).
10. Other mandatory rises include: a PLZ 4.4 billion increase in debt servicing charges (up 23.5 per cent from 2001); a PLZ 5 billion (11.6 per cent increase) in transfers to cover expected shortfalls in the Social Security Funds; and PLZ 2.1 billion to cover other social welfare expenditures.
11. Polish Business News *Special Report* No. 6, December 2001.
12. As explained in Chapter III, the Polish constitution makes the deficit projected in the Budget law binding upon the government and unless it (or the constitution) is changed

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the authorities would be obliged to increase spending or reduce taxes in the event of better than anticipated performance.

13. Unless otherwise indicated government accounts in this chapter are based on those derived from SNA93 definitions. Data for 2001 are OECD estimates.

14. Since the beginning of the 1990s the manner in which government spending is accounted for has changed dramatically, making comparisons over long time periods particularly difficult.

15. These include: King and Rebelo (1990), Englander and Gurney (1994), Slemrod (1995), Leibrfritz *et al.* (1997) and Bleaney, M. *et al.* (2001). While some have found an insignificant relationship, recent work suggests a non-linear relationship between the impact of the tax burden and the level of development of a country.

16. Data before 1995 are based on an earlier National Accounts methodology. Moreover, experience with national income accounting was limited at that time, increasing the chances of misclassifications during this period.

17. In part, this reflects the fact that Poland extends disability pensions to those over 65. Nevertheless, it pays much more than countries with a similar programme profile and the incidence of disability pension receipt among those of working age is almost twice the OECD average (OECD, 2002c).

18. Although it is difficult to be sure this apparent anomaly may reflect a statistical artefact due to the recategorisation of spending overtime, rather than any fundamental change in expenditures.

19. State aid according to the Office for Competition and Consumer Protection represents 1.5 per cent of GDP, however, this excludes arrears on tax and social security contributions and environmental liabilities. Moreover, the state aid report on tax expenditures is not comprehensive (VAT exemption is not included and housing tax expenditure is not fully reflected) and the risk assessment of credit guarantees seems generous.

20. For example, the Act on State Aid is not applied to the infrastructure development, defence and agricultural sectors. Since entering into effect in 2001, all new state aids must conform to the act, although those passed before, have until 2003 to meet its requirements.

21. The state-owned enterprises' arrears to the Social Insurance Fund (FUS) amounted to 15 per cent of their total arrears, and, in the coal sector, 40 per cent of arrears are to the pension system.

22. Given that Poland, on a GDP weighted basis, still produces nearly three times as much carbon dioxide as the European Union, associated environmental liabilities are predicted to be sizeable. Moreover, high coal price supports give the coal a further advantage.

23. The recently passed Act on State Aid harmonises rules with those of the European Union. Each budget law sets a limit on the number of new state guarantees (so-called targeted reserves) that can be issued during that year, and conformity with these limits is monitored on a regular basis. During the 1990s actual outlays on calls amounted to only 0.2 per cent of state budget expenditure and, as of the end of December 2001, the outstanding state guarantees amount to PLZ 27.2 billion, 3.8 per cent of GDP. One-fifth of outstanding guarantees are classified as high risk (a more than 50 per cent chance of default).

24. Guarantee recipients are supposed to provide collateral and pay a 2 per cent commission fee. In principle, the guaranteed portion of a credit or bond is limited to 60 per cent of the total.

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25. At present a half of outstanding guarantees cover 100 per cent of risk including that from credit and interest payments. These include 100 per cent guarantees issued: to the Polish State Railways in 2000 and 2001; to banks to cover the repayment of housing credits provided to housing co-operatives; and to iron and steel industries for the repayment of credits drawn by the Agency for Industrial Development (up to 600 million – expected in 2002). In addition, highway construction companies operating concessions were allowed to draw bank credits with state guarantees in 2000. Counter-guarantees issued to the Corporation for Credit Insurance (KUKE) for the repayment of its bank loans to support Polish exporters are not subject to the Act on Guarantees. Most recently the airway carriers were given the state guarantees for the damage occurred as a result of war or act of terror if the value of damage exceeds the US $1 billion. Similarly, bonds issued by the Bank of national economy (BGK) to finance the housing credit facility are exempt from the commission fee.

26. Beneficiaries of such non-transparent state aids include firms in the mining, energy, food-trade, transport and environmental-protection sectors as a means of providing extrabudgetary support. Recently, the ratio of calls upon existing guarantees to newly granted ones is 12-13 per cent in the steel sector.

27. Privatisation revenue grew gradually from less than 1 per cent of GDP in 1995 to 2.2 per cent in 1999 and 3.9 per cent in 2000 when the size of privatisation revenues peaked. As a substantial part of major profitable state-owned companies were sold and the government intends to use privatisation as a subset of industrial policies, the privatisation receipts are expected to dwindle. Privatisation revenue in 2001 recorded 1.4 per cent of GDP (PLZ 10 billion), short of the originally projected 2.5 per cent of GDP. The authorities forecast that the privatisation revenue will fall further to 0.8 per cent of GDP (PLZ 6.6 billion) and become negligible thereafter. Since 1998, privatisation revenue has been more or less earmarked, among others, to finance premium transfers to the newly created individual pension reform, modernisation of defence system, court-ordered compensation programs for employees and pensioners working in state-owned enterprises whose salaries and pensions were not indexed in 1990 and 1991.

28. The authorities' so-called "Economic deficit" attempts to correct for this factor. However, as an indicator of fiscal sustainability it is not very helpful because the transferred contributions represent a real loss for the government that has to be made up *via* increased debt, reduced expenditure or higher taxes.

29. Environmental clean up is estimated at to cost about $3.5 billion per year until 2005, while operational and maintenance cost of environmental investments is estimated to reach US$1.2-US$4.7 billion over the same period. For details on environmental policies in Poland, see OECD (2001a).

30. The 1998 Act on Public Finances describes the overall institutional framework governing the preparation, implementation and reporting of public-sector budgets. It outlines the relationships between the four levels of government in Poland and their various responsibilities.

31. Article 220 of the Constitution.

32. The deficit of those central extrabudgetary funds (1 per cent of GDP) is less than a half of that of the State Budget (2.2 per cent of GDP deficit) and accounts for one-fourth of general government deficit. Creative accounting (*e.g.* loans from the State budget to the Social Insurance Fund) can reduces the official deficit figure of the State Budget and improves the cash-flow balance of the extrabudgetary funds. However, on a general government and accruals basis the transaction has no effect. Because the political

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and popular discourse revolves around the cash-based measures, this is an effective mechanism for reducing the apparent extent of budgetary shortfall.

33. The Office for Competition and Consumer Protection (2001) estimates that the total amount of implicit aid provided by various ministries, extrabudgetary funds and extrabudgetary agencies through low-interest loans was equal to PLZ 666 million or about 0.1 per cent of GDP.

34. For example, the Labour Fund has authority to allocate its revenues between passive or active labour market measures at its sole discretion. However, as indicated in the main text, in reality this power is circumscribed in the present situation by the mandatory nature of unemployment insurance expenditures which effectively crowds out all other programme spending.

35. For example, *voivodship*-level environmental funds often use their resources to purchase shares of companies at above market prices, sometimes without the approval of supervisory board. In addition, audits indicate that they have subsidised projects not associated with environmental protection. At the National Environmental Fund, similar problems were identified by the National Audit Office (2001).

36. For example, the Agricultural Marketing Agency intervenes in agricultural product markets in an effort to smooth farm-gate price fluctuations, using its surpluses in boom years to offset deficits in lean years.

37. The Agricultural Property Agency, the Military Property Agency and the Military Housing Agencies regularly supplement their current revenues with privatisation receipts, which are not recorded as a part of state budget revenue. While such spending shows up in the general government accounts it is neither reported nor controlled within the political process.

38. The National Audit Office reports that frequent cases of unjustifiable increase in salaries (by 60-90 per cent) and substantial losses from share purchases. The reports does not indicate whether this is a result of incompetence or inadequate supervision or if some form of self-dealing might be involved.

39. The Act on Pubic Finance limits central government transfers to budgetary establishments and ancillary enterprises to less than 50 per cent of their income and they are supposed to pay half of their profits into the budget. The Act allows over-spending by those organisations only when revenues are higher than projected and repayments to the State Budget are not affected. However, it prohibits spending overruns when revenues fall short of expenditures or repayment into the budget is diminished.

40. In 1999, a PLZ 0.8 billion loan was extended (and then written-off) from the state budget to regional health funds and 1 billion additional loan was provided in 2000. The Social Insurance Fund (FUS) also received from the state budget, loans of 4 and 2 billion in 1999 and 2000 respectively. See Center for Social and Economic Research Foundation (2001).

41. For example, to pay higher-than-budgeted amounts of miners' severance payments in 1999, the Labour Fund provided the necessary financing to the Industrial Restructuring Agency which then made the severance payments.

42. According to the Act on Public Finance, the expenditure that does not expire at the end of year includes the expenditure financed from foreign credits and expenditure allocated for cofinancing of programs whose implementation is financed by foreign loans. Moreover the Council of Ministers may, in consultation with relevant committee in the *Sejm*, establish a list of the expenditures that can be carried over to the next fiscal year.

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43. If they were to take on debt equal to that provided for in the legislation the general government debt would rise by 6.3 per cent of GDP. Assuming that this process took place over a period of 10 years, the general government deficit would on average be 0.6 per cent of GDP higher.
44. Sub-national governments disposed of PLZ 2 billion assets during 2000 (0.3 per cent of GDP) up from 66 million in 1995.
45. The authorities estimate that the share of mandatory expenditure amounts to 70 per cent of state budget expenditure (including subsides to the extrabudgetary funds).
46. A review of 21 investment projects undertaken in the period 1994–1997 revealed that none was completed according to its original timetable and that their final cost was three times that originally estimated (National Audit Office, 2001). In the case of the creation of regional hospitals at the *voivodship* level, project deadlines were postponed 17 to 20 times, and the original 3-5 year plans actually took from 13 to 18 years to complete.
47. On average personal transfers represent 10.3 per cent of GDP in the OECD as compared with 18.1 in Poland. The implied saving from reduced transfers would be PLZ 25 billion or 18.5 per cent of the wage bill.
48. The share of farms with 1 to 5 ha of land increased from 53 to 56 per cent of all farms between 1990 and 1998, while that of farms with more than 10 ha increased somewhat less from 17 to 19 per cent over the same period. The share of mid-sized farms (5-10 ha) declined from 30 to 25 per cent (World Bank, 2002).
49. Calculated as income tax paid on minimum wage plus benefits lost because of taking up employment divided by pre-tax earned income.
50. The authority expects the budgetary saving of 198 million and PLZ 1 billion in 2002, and 2003 respectively.
51. See OECD, 1999 for more details.
52. FUS and the labour market fund prepare annual financial plans, which are annexed to the State Budget as well as *ex post* financial statements.
53. A revised version of the GFS manual (2001) changes its accounting principle from the cash-basis (in 1986 GFS manual) to the accrual-basis in order to better harmonise it with SNA93.
54. The budget estimates under the MTEF should be derived as baseline estimates from the explicit macroeconomic assumptions, current policy commitments and government policy priorities. These baseline estimates could be rolled forward and revised in line with changes in macroeconomic conditions and policy priorities during the preparation of the later budgets. For technical details of the MTEF, see OECD (2001b).
55. Not all the countries include the sub-national governments under the MTEF. However a number of the OECD countries found that the MTEF on a general government basis improves fiscal planning and control. For example, Austria where a substantial amount of transfers are provided to the sub-national governments uses the MTEF to improve overall spending control. In Germany where fiscal decentralisation is substantial, the MTEF is used as an instrument to reach an agreement on the distribution of deficit targets between the different levels of governments.
56. A new draft law on local budgets calls for raising *gminas*' share in personal income tax revenue from 27.6 to 44 per cent and in corporate income tax from 5 to 8.5 per cent. For *proviat's* the shares would rise from 1 to 8.7 per cent of PIT revenues and zero to 1.5 per cent of CIT. Finally among *voivodships*' share in PIT revenues are proposed to rise from 1.5 to 7 per cent and its CIT from 0.5 to 9.2 per cent.

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57. For a recent press discussion of the pervasive role played by the trade unions in privatisation and public corporate restructuring, see The Economist, March 21st, 2002.

58. Restructuring efforts have concentrated on reducing capacity, which at 180 million tons in the mid 1990s was already down by 100 million as compared with the period prior to the transition.

59. Restructuring was focussed on: closures of unprofitable mines; reductions in output and the workforce, the latter based on early retirement benefits, lump sum redundancy payments, re-qualification training and job-placement services; financial restructuring; strengthened management and better environmental standards. The goal was that each mine would yield a financial surplus by end of 2000 and that the surplus would be used to pay accumulated arrears to the national insurance fund (ZUS), along with outstanding environmental and supplier liabilities. In the event, a shortfall of demand and lower than expected prices, forced the authorities to move the deadline for achieving these tasks to 2002. Overall the programme cost an estimated PLZ 7.2 billion (1 per cent of GDP) in 2001 and costs in 2002 are expected to be an additional PLZ 5.3 billion.

60. Employment has been cut by more than 50 per cent since 1998 reaching 141 thousand in 2001. It is expected to fall and additional 5 per cent in 2002, ultimately reaching a target level of 128 thousand. Capacity in 2002 is projected to have fallen to 34.1 million tons per year and the number of mines has fallen from 72 to 42, reflecting both closures and mergers.

61. As of September 2001, PLZ 1.03 billion in debt to ZUS had been written off and a further PLZ 2.6 billion was to be paid off in instalments.

62. The Economist (2001) estimates that such transfers could rise to as much as 25 per cent of the weaker mines' revenues.

63. During the period between 1990 and 2001, capacity was reduced by 8.5 million of tonnes, roughly 45 per cent of the initial level of capacity. Currently, Polish crude steel capacity equals 12.4 million tons.

64. Between 1999 and 2001 the Ministry of Economy spent PLZ 102.6 million in this regard, roughly a quarter of the total the government expects to pay. These instruments have been used in co-operation with the EU and have been co-financed by the PHARE programme (20 million euros, of which 60 per cent have already been spent). Indirect aid has been more important and has taken the form of tax and social security arrears, loan guaranties and various other forms of state aid (see Chapter III).

65. *Huta Katowice*, *Huta Florian*, *Huta Czestochowa*, *Huta Cedler* and *Huta Sendzimira*.

66. Generation comprises 17 power stations and 19 combined heat-and-power-stations (CHP).

67. The transmission network is owned by the operator of the transmission system, *Polskie Sieci Elektroenergetyczne* (PSE). At present, PSE is state-owned and reports to the Ministry of Economy. It acts both as the provider of transmission services and is the dominant electricity trader.

68. The distribution network has been organised into 33 local electricity companies, all state-owned except the largest one in the south.

69. See Annex IV in OECD (2001a).

70. Official statistics indicates that 4 053 thousand individuals work in the public ownership sector in 2000 as compared with 5 557 thousand in the private ownership sphere. Total employment in the "budgetary sphere" was 1.8 million.

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71. Data for the Czech Republic are for 2000 (see OECD, 2001b), while those for Hungary are for 2001 (see Table 26 in OECD 2002d).

72. Capital privatisation proceedings were begun in 32 companies and continued in 70 others while an additional 72 were sold under the direct privatisation method.

73. The 2001 Budget called for PLZ 18 billion in privatisation revenues. This was revised down to 11.5 billion by mid year.

74. In value terms, if the 2002 pace is maintained indefinitely, it will take twenty years to sell the totality of existing holdings (assuming no deterioration in their value). In terms of the number of firms in State hands, the process would likely take even longer. Indeed the authorities consider that as many as half of its holdings are unsellable.

75. The Ministry of Treasury runs the selection which is based on knowledge in such areas as economics, law, management and marketing. The examination comprises two tests, one written multiple choice and one oral examination, with the second test being conditional upon achieving at least 50 per cent in the first. Successful applicants are registered in the Treasury database of candidates eligible to sit on a supervisory board.

76. Brumby, Hyndman and Sheperd (1997).

77. Since 1 January 2001, 20 cases where a private sector partner has sought to increase a firms' capital have occurred. In 10 cases the State supported this effort and in 10 it resisted. Where recapitalisation did occur, the State maintained its percentage share by transferring other assets to the firm, typically by contribution shares in other partially privatised firms. Among the cases where it resisted, it was succesful in blocking the increase 4 times.

78. In the case of *Ciech*, the largest chemical holding company in Poland, the Treasury is blocking the re-capitalisation of the firm because of disagreement with the management on key strategic matters. For similar reasons, in 2001 the Treasury did not agree to a 75 per cent capital increase of KGHM, one of the biggest mining companies (copper and silver). But in two cases, *Cegielnic Bidgoskic* (construction) and *Senit* S.A. (mining), the private shareholders were able to increase their firms' capital despite Treasury objection.

79. Under the Commercial Company Code, the approval of all decisions involving a change in the company's statute is contingent upon gaining the support of 75 per cent of the voters attending the shareholding meeting.

80. The problem affects the construction and real-estate sectors most directly. Most new properties are built using mortgage-backed securities, and the concession of a mortgage on a house is conditional upon meeting the obligation to declare an ownership of land – or a right of perpetual usufruct – in the Land and Mortgage Register.

81. The list of businesses which have recently exempt from licence include the movie industry (both production and distribution), maritime services (both transport and civil port activities), and retail of certain consumer electronic devices (including CDs). Most activities subject to special safety and quality standards (production and sale of drugs, for example) require a permit, along with airport management.

82. While there is a general consensus that these measures are needed, the identification of the common tax rate is controversial. The representatives of the small firms claim that a levelling at 22 per cent would entail a higher tax burden for their associates, many of whom currently pay the personal income tax, with a bottom rate of 19 per cent.

83. See EC (2001) and OECD (2002a).

84. Harding and Kepinski (2001) provide a useful and in-depth discussion of the weaknesses of the old law.

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85. With this, the legislator recognised that vertical agreements may often be efficient and thus require less enforcement oversight than horizontal agreements.

86. Proceedings against anti-competitive agreements or practices in liberal professions were already conducted on the basis of the 1990 Act on counteracting antimonopolistic practices. However, the new Anti Monopoly Act law includes a broader definition of "entrepreneur", which, in practice, eliminates pre-existing actual or implied exemptions for various liberal professional services.

87. The President is appointed by, and responds to, the Prime Minister. The President's term of office is fixed at 5 years. Under the new rules, the Prime Minister may not recall the President except for specified causes, including accepting other employment, undertaking business activity or board membership, criminal conviction, "flagrant infringement of responsibilities", or resignation. The new act also requires that the selection for appointment is made by contest, with candidates screened by a contest board. The board, which is appointed by the Prime Minister, must not include parties with obvious interests. (OECD, 2002a, Chapter II).

88. In 2001, such committees and the UOKIK were involved in the abolition of the import-licensing system on liquid fuel and in removing from the list of controlled prices various goods and services, including for some fixed network telephone and rail transport services.

89. Several cases were discovered where local power utilities imposed onerous conditions on individual customers that differed significantly from those signed by other clients using the same connection.

90. It is important to observe, on top of the new rules, that under the Polish law a shareholder crossing 10, 20, 33, 50, 66 and 75 per cent ownership stakes has to publicly disclose his ownership. In the Czech Republic, the lack of disclosure of minority shareholdings has enabled anonymous large shareholders in several enterprises to collude with management and expropriate minority shareholders. See Glaeser, Johnson and Shleifer (2001) for a comparison between regulation of financial markets in Poland and the Czech Republic. Also see for a background discussion Hashi (2000).

91. OECD (1999).

92. According to recent estimates, 40 per cent of companies have an investor who owns more than 50 per cent of voting rights and in 50 per cent of companies there is an investor owning more than 39.5 per cent voting right. See Tamowicz and Dzierzanowski (2001).

93. PZU waited seven years before the Treasury provided funding (in the form of shares in another formerly state-owned firm), in 1999 and again in 2001, enabling it to expand its capital while keeping the state's share constant.

94. Nevertheless, a recent roport of the Polish Agency for Foreign Investment suggests that foreign investors continue to perceive Poland as a favourable destination for investment.

95. See Bratkowski, Grosfeld and Rostowski (1998).

96. *Pre-accession Economic Programme*, October 2001.

97. Currently it is submitted in October, a point in time when the Budget is already well defined (see Chapter III).

98. See OECD (2001a).

99. When, as in 1997 and, the Commission fails to reach an agreement the Council of Ministers unilaterally decides the maximum wage rates compatible with the budget law.

100. See OECD (2001b, 2001c).

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101. For 1999, for example, the average public sector wage premium equalled 6 per cent. However, this amount concealed wide variations between public and private wage earners according to their educational attainments. The public sector wage premium amounted to between 10 and 20 per cent for the workers with a vocational and primary education. At the high end of the education distribution, private sector workers with a post-secondary degree or even a university degree earned between 25 and 60 per cent more than their public sector counterparts.

102. Regulated delays, consultations, administrative procedures and job-search assistance requirements tend to create fixed costs for firms and generate threshold effects. If the cost of conducting a layoff equals the benefit of reducing employment by 100 workers, the firm will wait until it needs to reduce staff by this amount and then will proceed with a large-scale layoff. Indeed, perhaps the layoff will exceed 100 employees so as to ensure that it need not incur the fixed cost again soon.

103. All companies employing more than 5 workers and not covered by a collective agreement (an increasingly large share of firms) must register each new employee with 6 agencies and go through 10.

104. These include obligations to create health and safety commissions with extensive responsibilities in all enterprises, to write down detailed employee remuneration standards, facilitate the activities of multiple unions, secure job protections to concurrent union leaders, and guarantee generous leave rights to parents.

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Glossary of acronyms

BGK	National Guarantee Bank
EC	European Commission
EU	European Union
FDI	Foreign Direct Investment
FUS	Social Insurance Fund
GDP	Gross Domestic Product
GFS	Government Financial Statistics
GSM	General Shareholders Meeting
GUS	Central Statistical Office
IMF	International Monetary Fund
KFPK	National Credit Guarantee Fund
KPWIG	Securities and Exchange Commission
KRUS	Farmers' Insurance Fund
KUKE	Corporation for Credit Insurance
MTEF	Medium-Term Economic Framework
NBP	National Bank of Poland
NIK	National Audit Office
PAYG	Pay-As-You-Go pension system
PES	Public Employment Service
PGNiG	Polish Oil and Gas Company
PHARE	Poland, Hungary Assistance for Restructuring of the Economy
PHS	Polish steel holding company
PIT	Personal Income Tax
PLZ	Zloty, Polish currency unit
PSE	National Power Operator
PUNU	National Office for Insurance Supervision (now merged with UNFE)
PZU	Polish largest insurance company
RIO	Regional Clearing Chamber
SMEs	Small and Medium Sized Enterprises
SNA	System of National Accounts
SOK	Compensation Payment System
TPSA	Polish telecom historical operator
UNFE	Pension Funds Supervisory Office (now merged with PUNU)
UNUZ	Health Insurance Supervisory Office
UOKIK	Office for Competition and Consumer Protection
URE	Polish Energy Regulatory Authority
URT	Office for Telecommunication Regulation

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URTiP	Office for Telecommunication and Postal Services Regulation (replaces URT)
VAT	Value Added Tax
ZUS	National Insurance Fund which acts as the umbrella extra-budgetary fund organisation

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Annex

Chronology of main economic events

2001

January

Governor of the National Bank of Poland appointed.

The *Sejm* approves a controversial ownership-restitution bill.

The new Commercial Companies Code enters into force.

February

The National Bank of Poland reduces its benchmark policy rates by 100 basis points bringing the rediscount rate to 20.5 per cent, the lombard rate to 22 per cent for and the money market intervention rate to 18 per cent.

Parliament approves the 2001 budget law.

The Government approves a new medium-term strategy for the restructuring of the coal sector.

March

The National Bank of Poland reduces its benchmark policy rates by 100 basis points bringing the rediscount rate to 19.5 per cent, the lombard rate to 21 per cent for and the money market intervention rate to 17 per cent. change in credits rates.

April

Government approves the new Antimonopoly Act intended to further align Polish competition law with international standards.

The Privatisation Agency is dissolved.

May

The economic deficit out-turn for 2000 is revised downward to 2 per cent of GDP (PLZ 13.9 billion) from a preliminary 2.7 per cent of GDP (PLZ 19 billion).

The *Sejm* approves new legislation gradually increasing the health care contribution rate from 7.75 at that point to 9 per cent by 2005.

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June

Parliament approves an act, setting the stage for the reorganisation and commercialisation of the Polish State Railways (PKP).

July

World Bank issues a new loan to assist the restructuring of the hard coal mining sector.

The Government approves a new medium-term strategy for the restructuring of the steel sector.

August

The National Bank of Poland reduces its benchmark policy rates by 250 basis points bringing the rediscount rate to 17.0 per cent, the lombard rate to 18.5 per cent for and the money market intervention rate to 14.5 per cent.

Finance Minister Bauc resigns. Ms. H. Wasilewska – Trenkner becomes the new Finance Minister.

The energy regulator refuses to approve new gas charges proposed by PGNiG.

September

The National Power Operator inaugurates a daily and hourly residual market in electricity as a mean to favour the development of an exchange trading market for electricity.

October

The National Bank of Poland reduces its benchmark policy rates by 150 basis points bringing the rediscount rate to 15.5 per cent, the lombard rate to 17.0 per cent for and the money market intervention rate to 13.0 per cent.

The Government announces the introduction of a tax on yields from bank savings, government papers and investment funds.

November

The National Bank of Poland reduces its benchmark policy rates by 150 basis points bringing the rediscount rate to 14.0 per cent, the lombard rate to 15.5 per cent for and the money market intervention rate to 11.5 per cent.

December

The Monetary Policy Council lowers the mandatory reserve ratio by 50 basis point to 4.5 per cent.

Parliament adopts an act that rescinds the previous obligation for the Council of Ministries to invite the President of Central Bank and the President of Supreme Audit Office to its meetings.

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January

The National Bank of Poland reduces its benchmark policy rates by 200 basis points bringing the rediscount rate to 12.0 per cent, the lombard rate to 13.5 per cent for and the money market intervention rate to 9.5 per cent.

The National Office for Insurance Supervision (PUNU) and the Pension Funds Supervisory Office (UNFE) are united to form the Insurance and Pension Funds Supervisory Commission.

February

The Government approves the new medium-term growth programme E*ntrepreneurship-Development-Employment*.

Parliament approves the 2002 budget law.

The Government approves amendments to the medium-term strategy for the restructuring of the steel sector.

March

Parliament passes an act that reorganises the activities of various public agencies.

The Government submits to Parliament a draft law intended to revise the rules for setting the foreign exchange regime.

April

The Government submits to Parliament a draft law intended to revise the Labour Code.

May

The Constitutional Court overrules an appeal against the October 2001 tax on yields from bank savings.

Governmental submits to Parliament a proposal containing changes in the act on National Bank of Poland.

Monetary Policy Council reduces its benchmark policy rates by 50 basis points bringing the rediscount rate to 10.5 per cent, the lombard rate to 12 per cent and the deposit rate from to 6 per cent.

June

President Aleksander Kwaniewski offers to act as a mediator between the government and central bank on key issues concerning monetary policy. Cabinet meets to discuss the issue.

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