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ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

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BASIC STATISTICS OF THE REPUBLIC OF POLAND
(2003 unless noted)

THE LAND

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

THE PEOPLE

Population (million, end-year)		38.2	Employment (million)	13.7
Rural population (percentage of total)		38	Employment by sector (percentage of total):	
Life expectancy at birth (2001):	Male	70.2	Agriculture	18
	Female	78.4	Industry (including construction)	29
Infant mortality (per thousand)		7.7	Services	52

Registered unemployment (percentage of labour force)	18.0
Labour force survey unemployment (percentage of the labour force)	19.7
Number of pensioners (million)	9.2

PARLIAMENT

Bicameral Parliamentary system	
Sejm membership (lower house)	460
Senate membership (upper house)	100
Number of political parties in Sejm	15
Share of seats in Sejm held by governing party (per cent)	34

PRODUCTION

GDP (Zl billion, current prices)	815
GDP per capita (US$, market exchange rate)	5 487
Gross fixed capital formation (percentage of GDP)	18

PUBLIC FINANCE

General government budget balance (percentage of GDP)	–4.2
General government revenues (percentage of GDP)	42.0
General government expenditures (percentage of GDP)	46.2
State treasury debt (end-year, percentage of GDP)	46.5

FOREIGN TRADE AND FINANCE

Exports of goods and services (percentage of GDP)	34
Imports of goods and services (percentage of GDP)	36
Gross official reserves (US$ billion, end-2003)	34.0
Total external debt (US$ billion, end-2003)	103.8

CURRENCY

Monetary unit: zloty	Currency units per US$	
(redenominated in January 1995)	Average: 2002	4.0816
	2003	3.8884
	April 2004	3.9623

Note: An international comparison of certain basic statistics is given in an annex table.

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.

•

The economic situation and policies of Poland were reviewed by the Committee on 1 April 2004. 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 11 May 2004.

•

The Secretariat's draft report was prepared for the Committee by Andrew Burns, Przemyslaw Kowalski, Stéphanie Jamet, Boris Cournède and Line Vogt under the supervision of Willi Leibfritz.

•

The previous Survey of Poland was issued in June 2002.

Assessment and recommendations

EU accession is a major accomplishment, but incomes remain well below OECD levels

Poland's accession to the European Union on 1st May 2004 marks a turning point in its economic and political history. It follows 15 years of profound change and accomplishment. More than 75 per cent of GDP is now produced in the private sector, the economy is well integrated with those of western European nations and inflation has been brought down to low levels. After an initial fall, output has been growing continuously for more than 10 years and, on average, Poles are much better off now than they were then. However, the striking drop in employment since 1998 is suggestive of serious remaining problems. To address these, much more needs to be done, notably in terms of raising productivity, expanding employment and increasing per capita income, which is 41 per cent of OECD levels.

To speed convergence, policy needs to focus on:

Indeed, unless the pace of improvement picks up, Poland's convergence with the rest of the OECD is likely to be disappointingly slow. So as to accelerate this process and ensure that its fruits are widely shared, policy needs to address four main challenges:

achieving a more balanced policy mix

– In the short-run it will be critical to re-establish an appropriate balance between fiscal and monetary policy. A stable macroeconomic framework, characterised by low inflation and sustainable public finances is an essential pre-requisite to healthy economic growth. Currently, fiscal policy is too relaxed, requiring higher than desirable real interest rates, with adverse consequences for investment, activity and potential output.

increasing employment markedly

– Over the medium to long term, increasing employment especially among young and older workers represents the most important challenge facing the Polish

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economy. With only slightly more than one in two Poles of working-age employed and an unemployment rate of 19 per cent, getting people back into productive work will be critical both to re-establishing a fast growth path and ensuring that all of society benefits from convergence.

creating a more investment-friendly climate

– Investment conditions need to be improved so as to increase economic activity and the demand for labour. Higher investment levels would also serve to raise productivity, international competitiveness and the pace at which incomes converge with those in the rest of the OECD.

and speeding rural restructuring

– Finally, with 19 per cent of employment in agriculture producing only 3 per cent of GDP and with 30 per cent of the population in rural areas, speeding the pace of rural restructuring must form a central component of any development strategy for Poland. Over the long-run, such restructuring could result in a 30 per cent increase in GDP.

This requires an ambitious and encompassing programme of reform

Each of these challenges is critical, and progress is needed in meeting all of them so as to move onto a more dynamic growth path that combines rising employment with better and more productive jobs. The challenges are also interdependent, with success in any area requiring progress in others. Policy reforms are therefore needed across a broad front and should be implemented coherently to take advantage of the synergies among them. Efforts to reduce dependency traps and increase financial incentives to take up work need to be matched by policies to raise flexibility and reduce costs in order to stimulate hiring by firms. Likewise, reforms in product markets that promote investment and job creation need to go hand-in-hand with policies to accelerate rural restructuring so as to facilitate the shift from lower to higher productivity jobs. Finally, because many of the required measures involve increasing the targeting of government expenditures in certain areas, they should help fiscal consolidation. This, plus the resulting stronger growth and employment will in turn help generate the additional resources necessary to finance a sustainable increase in the level of public investment in infrastructure and human capital.

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Growth is projected to remain strong, which could cause inflation to accelerate

Addressing these challenges will be facilitated by the ongoing recovery, which saw GDP expand by 3.7 per cent in 2003 following two years of slow growth. Activity is expected to continue strengthening in 2004 and 2005, increasing by more than 4½ per cent a year allowing the output gap to close towards the end of the period. The global recovery suggests that export growth will remain strong. Nevertheless, reflecting a 1.7 per cent of GDP addition to fiscal stimulus programmed for this year and the past relaxation of monetary conditions, growth should be increasingly driven by domestic demand. In particular, investment activity is expected to pick up due to improved profitability, emerging capacity constraints and EU-accession related opportunities. Despite stronger growth, deep-seated problems in the labour market (see below) mean that employment growth will be weak and unemployment is projected to fall rather little. While increases in the prices of imported goods will generate some inflationary pressures, high unemployment and a negative output gap should ensure that headline inflation remains within the central banks revised target range for inflation of 2.5 ± 1 per cent. However, if domestic demand reacts more quickly to the fiscal and monetary stimulus, there is a risk that the economy may overheat, pushing up inflation and the current account deficit, provoking an increase in the risk premium on the zloty, even higher interest rates and choking off the recovery.

Monetary policy may need to tighten unless strong fiscal measures are taken

The recent pickup in demand owes much to the substantial relaxation of monetary policy since the end of 2001. With inflation reduced to less than 2 per cent, the National Bank's monetary policy strategy now appropriately focuses on maintaining inflation at low levels. In order to maximise the Bank's capacity to meet this objective and influence expectations, it should proceed with plans to release its quarterly Inflation Report more quickly and include in it projections for inflation. Moreover, it would be desirable for the Monetary Policy Council to regularly indicate how policy is likely to react to projected increases or decreases in inflation as it did following its February and March meetings. Although real interest rates remain high, the strong depreciation of the currency means that monetary conditions have eased below the levels observed in 1998, just prior to the

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re-acceleration of inflation. In this context, and especially given the very relaxed stance of fiscal policy and already strong growth, policy rates should not be relaxed any further. Rather, monetary authorities need to watch inflation and wage developments carefully and be prepared to raise rates, if necessary, so as to prevent any resurgence in inflation or financial market jitters. Once fiscal policy is significantly tightened, inflationary pressures should ease – opening the way for a further easing of monetary policy. As concerns the adoption of the euro, fiscal consolidation will also be essential to ensure that nominal convergence criteria are met. In assessing the optimal path towards meeting the criteria for euro area membership, the Polish authorities will want to evaluate the advantages that a rapid adoption of the euro would entail in terms of increased credibility and reduced uncertainty for international transactions, versus the potential disadvantages of an early move in terms of the loss of an independent monetary policy and the loss of exchange-rate flexibility.

Fiscal consolidation is required to contain public-sector debt and to avoid more painful adjustment later

Steps need to be taken immediately to slow expenditure growth, both in order to adjust the overall mix of macroeconomic policy and to ensure the medium-term sustainability of public finances. Recently, the public debt has been increasing by 4 per cent of GDP per annum. Moreover, with the general government deficit expected to reach 5.7 per cent of GDP in 2004, the pace of debt accumulation is likely to accelerate further. Here, the measures outlined in the authorities' Public Expenditure Reform, which would imply an eventual permanent 1.3 per cent of GDP improvement in the structural balance, will help. Unfortunately, because most of the savings will not come on line until 2005 and 2006, there is a real risk that the planned reform will not prevent the 60 per cent barrier from being broken, legally constraining the government to pass balanced State and local government budgets the following budgetary year (two years following the breach). To avoid such a draconian tightening and the painful macroeconomic consequences it would entail, it is essential that significant fiscal consolidation begin now, before these statutory thresholds are broken. The authorities should, therefore, put in place additional permanent savings now. A more aggressive consolida-

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tion strategy would have the further advantage of obviating the need for additional cuts to spending when privatisation revenues eventually dry up. Finally, the authorities should resist the temptation to replace the current Polish definition of debt with the lower ESA 95 definition until fiscal consolidation is complete. While such a move would delay hitting the 60 per cent mark by a year, it would send a disturbing message to financial markets and could hurt Poland's long-term credibility.

More transparent, comprehensive and forward-looking budgetary processes are necessary

Even if the proposed fiscal consolidation programme is passed into law, the authorities will need to take steps to improve medium-term budgetary planning and control mechanisms in order to ensure that these plans are executed and that overall savings are realised. Introduction of a binding medium-term expenditure rule and the requirement that additions to spending be accompanied by offsetting reductions would help to reduce the likelihood that policymakers take short-sighted decisions that permanently affect the sustainability of public finances. Moreover, budgetary systems need to take into better account all of government spending, in particular that of the various extrabudgetary funds. In this regard, the recent decision to make the Ministry of Economy, Labour and Social Policy responsible for the Labour Fund is a step in the right direction. It should be reinforced by requiring much more comprehensive information about this and other extra budgetary funds in the State Budget. Moreover, monitoring and parliamentary oversight of extrabudgetary programmes should be raised to the same level as for programmes financed directly from the State Budget. Finally, the authorities need to face the issue of the accounting treatment of compulsory private pension funds. Recent practice includes contributions to these funds in government revenues but excludes from expenditures the transfer of these funds to individuals' pension accounts. The argument that excluding such revenues would make Poland's deficit position look bad relative to countries that have not passed a similar pension reform is valid. However, recording only the revenues in the general government balance causes it to understate the extent of the financing shortfall in current government operations. Even though the associated liability is included

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in debt figures, this approach may contribute to complacency concerning public finances, which could incite policy makers to spend more than would otherwise have been the case. Indeed, insofar as the projected deficit excluding these revenues for 2004 exceeds 7 per cent of GDP, current practice may be preventing the pension reform from improving the government's long-term budgetary position as it was originally meant to do.

Comprehensive structural reforms are required to increase potential growth

Tighter fiscal policy as recommended above, by providing a more stable macroeconomic environment and allowing interest rates to fall, should make investment more affordable, thereby speeding capital accumulation and contributing to increasing the rate of growth of potential output. Nevertheless, additional and far reaching structural reforms will also be required to raise employment and productivity levels and speed the pace of convergence. The potential benefits from reform are enormous. Unless policies change, the OECD estimates that even 50 years from now, Poland will not have achieved average OECD income levels. In contrast, if Poland adopts the kind of reforms described below, convergence could be achieved as early as 2030.

Widespread joblessness is largely structural in nature,…

With almost 50 per cent of working age individuals out of work, improving labour market performance represents an essential and daunting challenge for Poland. While some of today's joblessness is cyclical in nature, most of it is structural. Fast growth during the mid 1990s served to partially mask high structural unemployment, whose full extent only became clear during the recent growth slowdown. Implementing reform on the scale required to relieve this burden will be extremely difficult and will require that measures be taken simultaneously to increase individuals' willingness to take up available jobs, and to reduce firms' costs so as to increase overall labour demand at given activity levels.

… requiring a diminution of inactivity traps…

In order to increase effective labour supply, policy needs to sharply reduce the passive income support provided to able-bodied individuals through the disability system and various premature labour-market withdrawal schemes. A number of existing proposals and initiatives are designed to rationalise personal transfer spending and

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reduce inactivity traps, which are impeding labour market adjustment. These include plans to roll-back early-retirement schemes; restrain access to the disability system and rationalise its benefits; increase resources to more targeted schemes such as social assistance and harmonise financial incentives between the farmers' and general social insurance schemes. While all of these are appropriate directions for reform, if Poland is to successfully break the current dependency cycle, these first steps will have to be extended by more substantial reforms. In particular, plans to reassess disability pensioners and limit new access to such programmes need to be strengthened so that only those who really have a diminished working capacity continue receiving benefits. Moreover, as planned, benefit levels should be realigned with individuals' *ex ante* earnings capacity. Beneficiaries currently comprise more than 13 per cent of the working-age population – more than twice the OECD average – and their after-tax benefits, when combined with other forms of social assistance, are, in many cases, twice as high as the after-tax earnings from a minimum wage job. In order to ease the adjustment of those who lose access to benefits, a transitional and time-limited scheme should be implemented, including reduced benefit levels, training and placement assistance as well as in-work benefits. Such a system should be supplemented by a reinforced and means-tested social assistance scheme, capable of providing those who fail to find work following the expiration of the transitional scheme with a socially and fiscally acceptable level of support.

… and measures to make low-skilled employees more attractive to firms

Ongoing efforts to reduce the cost to firms of hiring low-skilled workers also need to be extended so that the additional effective labour supply is met with increased employment opportunities. Here, existing schemes allowing firms to hire youth and new entrants at a discount to the minimum wage, which is a binding constraint for low-skilled and young workers, should be opened up to the long-term unemployed and those coming off disability pensions. In-work benefits could be used to ensure that low-paid workers receive adequate incomes. Labour costs would also be made less of an impediment to hiring the low-skilled, if the tax wedge on low-paid workers were reduced by cutting

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earmarked payroll contributions and financing associated programmes from general revenues. Revenue shortfalls could be made up by a restructured personal income tax, which kept average rates paid by low-income earners low, thereby reducing the tax wedge on the low-skilled. Such a move would also eliminate the pro-cyclical bias in the financing of active labour market policy, thereby facilitating a necessary increase in the quality, targeting and number of places that are offered. In combination with welcome proposals to improve the national coordination of local public employment offices and a more stringent enforcement of job-search requirements, such steps could go along way to improving the systems' overall job-matching record and overcome the tendency for local job markets to be isolated from each other.

Reducing red-tape and employment protection rules would also improve hiring

Firms' willingness to take on additional workers would also be enhanced if rules and regulations governing employment contracts and remuneration were made more flexible. Here, recent reductions in obligatory overtime pay premia go in the right direction, but at between 50 and 100 per cent they remain too high. Similarly, required notice periods for economic layoffs are among the longest in the OECD and rules governing who may be let go are among the most constraining. While originally designed to deter layoffs, such rules raise labour costs, prolong unemployment spells, reduce employment and increase the inherent risk associated with hiring new and untried staff, thereby slowing employment growth and contributing to the development of a dualistic labour market.

Educational opportunities need to be more evenly distributed

Over the longer run, the employability and incomes of the Polish labour force will depend on the extent to which all students receive a quality general education that confers upon them the skills necessary to adapt to an ever changing market place. In this regard, great strides have been made in reducing streaming and increasing the overall quality of education. However, more could be done, particularly in rural areas, where student achievement levels lie well below the national average and the school system tends to be underfunded – a factor that tends to perpetuate regional differences in labour market outcomes and incomes.

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Resources need to be focussed on improving the quality of education in these regions and in supporting the efforts of students to reach higher education. Making regional funding mechanisms reflect localities ability to pay would help. The current mechanism corrects for differences in costs only, indirectly contributing to the underfunding of rural schools. Finally, state-owned universities should follow their private-sector counterparts by relying more heavily on fees accompanied by student loans for the financing of full-time courses. Although this might require a constitutional amendment to implement, such a change would not only increase their resources, it would also serve to equalise the rate of subsidy between private and State schools, which are the most prestigious and mainly attended by the children of relatively wealthy parents.

Product-market reforms should help raise investment and productivity levels

Such efforts to overcome low employment need to be supplemented by measures in product markets to raise investment levels, which are only two thirds those observed in other emerging economies, and raise productivity levels which are among the lowest in the OECD. Policy needs to concentrate on: legal and administrative reforms that make banks more willing to lend and firms to invest; speeding the restructuring and privatisation of state-owned enterprises; and improving the country's productive infrastructure. Such policies, by raising overall activity rates should also durably increase demand for labour and in conjunction with labour market reform speed the transition to higher employment rates.

Recent steps to improve the legal environment for business and lower costs in the banking-sector should help

This year's reduction in the corporate income tax rate to 19 per cent and steps to improve the capacity of the Polish foreign investment agency should help the country regain some of the ground lost in the competition for foreign investment. However, more could probably be done to improve the agency's effectiveness by making it a real one-stop investment shop, able to offer and sign investment deals. More generally, delays and administrative costs associated with building or expanding a site need to be radically curtailed so as to facilitate greenfield investments. On the domestic front, recent decisions to relax very strict banking regulations, notably as concerns the provisioning of loans, should help lower lending costs and, as such, improve

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aggregate investment performance. Similarly, improvements in the bankruptcy law and in the administration of real-estate registries should help increase banks' capacity to collect on collateral and therefore their willingness to lend. However, excessively long judicial processes continue to pose a problem. Proposals to speed these up are welcome and should be given priority.

Accelerating privatisation would reduce public debt, boost productivity and enhance investor confidence

Picking up the pace of privatisation would not only help limit the accumulation of public debt, it would also help raise overall productivity growth. This will require a much more pragmatic and active approach to asset sales (especially among smaller firms) that places less emphasis on the sale price and more on the total cost/benefit to society. In particular, the authorities should reconsider the strategy of consolidating sectors prior to sale in order to create dominant players. Not only does it slow the sales process, any advantage in terms of higher sale prices may be more than offset by consumer losses due to higher prices that the consolidated firms' enhanced market power allows them to charge. Efforts to accelerate privatisation would be helped by current proposals to extend the process by more actively selling residual stakes in those firms where, following past sales, the State retains a majority or controlling interest. The State's continued presence in such companies (virtually all those sold as joint-stock companies), denies them much needed capital and slows hiring, and likely has played a role in the low offer prices and lack of interest in companies currently on sale. The authorities should also rethink the selling of minority stakes in several large State-owned firms through stock offerings. This approach risks perpetuating an ownership structure dominated by the State and the interests of politically appointed managers. In order to forcefully signal their commitment towards privatisation, the authorities should seek strategic investors for the remaining State-held companies. Taken together, these moves would have the dual impact of spurring risk taking and improving the corporate governance framework. Using the State's controlling-stakes in firms is an inappropriate mechanism for pursuing industrial or social policies. Poland's limited economic resources would be better used to create the overall conditions in which private firms could prosper.

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Improved transport and housing infrastructure would help spur development and mobility

Liberated resources could be used to increase financing of infrastructure projects, spending on which, to a large extent, is crowded out by personal transfers on the one hand and subsidies to ailing state-owned companies. Areas where infrastructure investments are likely to generate the largest externalities include transportation and rental accommodation.

– With only 600 kilometers of motorway and a rail system that is in an advanced stage of disrepair, Poland arguably has the sparsest transportation infrastructure in the OECD. Plans to triple the size of the road network and improve rail connections between major centres are laudable, but significant political and administrative resolve will be required to avoid repeating past failures to meet similar objectives.

– Construction of and improvement of framework conditions for rental accommodation represents a further priority area for infrastructure development. Currently rent controls, excessively strong tenants rights and the absence of a rental culture limit labour mobility. A draft law, proposing to delay from 2005 until 2008 the elimination of rent controls because of concerns about protected rentor's ability to pay should be amended so that the process of bringing protected rents up to market levels begins immediately. While protected rentors may have difficulty meeting a one-step hike implemented in 2005, there is no reason to expect that this will be any easier in 2008. More positively, the proposed draft law allows for a free market as concerns new contracts, thereby increasing incentives to add to the overall rental stock. However, the grandfathering of existing units risks creating a dual market. In addition, to be effective any liberalisation of rent controls will need to be supplemented with a relaxation of rules preventing landowners from evicting non-paying tenants. Finally, to level the playing field, housing-related tax incentives should be extended to include the for-profit rental sector.

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Dependency traps created by the farmers' social insurance scheme need to be reduced

Such steps, by increasing the stock of affordable rental housing should help reduce the financial risk that an employee takes in moving from a low-productivity low-employment area where living costs are relatively low, to one characterised by higher paying work but much higher housing costs. As such, it (like improvements to the transportation infrastructure) should help overcome some of the transactions costs that are limiting labour mobility in general and rural restructuring in particular. However, more needs to be done to reduce the substantial poverty traps in agriculture. In particular, the financial incentives to be considered a member of a farm household embodied in the special farmers' social insurance scheme need to be reduced substantially. Proposals to increase contribution rates in the system, particularly for wealthier farming households, so as to decrease its current 95 per cent subsidisation rate go in this direction. However, to more directly impact dependency traps for low income farmers, such steps need to be extended so as to harmonise both benefits and contributions in the system with those available to non-farm workers. This could be achieved by raising contribution rates towards those in the general scheme or by introducing into the general system provisions for very low income earners that are similar to those in the farmers' scheme. Such an option would have the additional advantage of lowering labour costs, and therefore the employability, of the low-skilled in the non-farm sector.

Consolidation of small farms will be essential to raising rural income levels

A harmonisation of benefits would also eliminate the relevance of land ownership requirements in the farmers' system, thereby helping to remove a critical barrier to rural restructuring and productivity growth. Current rules require a farm household to have at least one hectare of land in order to access benefits (and less than two in order to have free access to unemployment insurance). This is a major factor explaining why the vast majority of farms are uneconomically small, which in turn explains why the rural population has become dependent on government transfers that, on average, represent one third of their income. The problem is all the more severe because as a result of land ownership rules, small holders are unwilling to sell their farms – preventing the consolidation that will be essential if agri-

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cultural productivity levels are to improve. Indeed, although the number of farms in excess of 15 hectares has been rising, the total number of smaller and uneconomic holdings has actually been increasing. In order to promote their consolidation policy should:

- make registration of agricultural land obligatory and free (legal title for 30 per cent of agricultural land is not established, in part because costs for small holdings are prohibitive)
- help develop a market in agricultural properties by reducing restrictions on the ownership of such land. While agricultural land prices may rise, these will increase the wealth of farmers, facilitate their access to financing for additional land purchases and make the purchase of an apartment in an urban area more affordable – thereby increasing urban-rural mobility
- eliminate the financial incentive to retain small farms, by harmonising benefits as outlined above.

Climate change policy should ensure that targets are met as cost effectively as possible

Poland should be able to achieve the greenhouse gas ceiling embedded in the Kyoto Protocol relatively easily. Nevertheless, by exceeding these commitments Poland could reap additional economic and environmental gains by taking up opportunities for trading emission permits, notably under the forthcoming EU trading scheme for carbon dioxide. In contrast, satisfying EU air pollution directives could entail large costs, particularly if reductions were to be achieved through command-and-control regulations. Instead, the Polish authorities should take advantage of the option to achieve the same level of overall emission reductions by other means and introduce a national cap-and-trade scheme for air pollutants. This solution would reduce compliance costs significantly, principally by avoiding having to install scrubbers on all old coal-fired plants when many of then them are likely to close down as the price of carbon dioxide emissions rises.

Summing up

I*n sum*, in order to speed the convergence process and consolidate the impressive progress made in the transformation of the Polish economy, substantial further efforts will be required. Restoring public finances to a sustainable path

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represents a key element to any reform strategy, both to prevent the debt from breaching the 60 per cent constitutional limit and also to improve the overall policy mix so that interest rates can be safely lowered. Tackling joblessness will require policies that increase both effective labour supply and demand. Rationalising the personal transfer system, by restricting access to the disability system to persons who are actually physically unable to work, while increasing means-tested support in the social assistance system for those in need, would be a start. Meanwhile reductions in the minimum wage targeted on youth and new entrants, cuts in the tax wedge for low-paid workers and an enhanced system of in-work benefits would help make hiring unskilled and inexperienced workers, the bulk of the unemployed, more attractive for firms. At the same time, well designed and carefully evaluated active labour market policies need to be extended and more stable funding mechanisms established. Over the longer term, better educational opportunities could improve labour market outcomes and incomes. Demand for labour would also be stimulated by policies that promote investment and reduce firms' cost of doing business more generally. Further efforts to lower compliance costs in banking supervision, improve protection of property rights and speed legal execution in business cases, so as to reduce banks' lending costs, would help as would an acceleration of the privatisation process and more infrastructure development. Finally, benefits and contributions from the special farmers and general social assistance systems need to be harmonised both to promote rural-urban migration and so as to facilitate farm consolidation, an essential component to any strategy to address rural poverty in Poland. Progress on all these scores is essential to further improving overall productivity performance and helping ensure rapid and sustainable growth in living standards.

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1. The challenge of regaining sustainable and fast growth

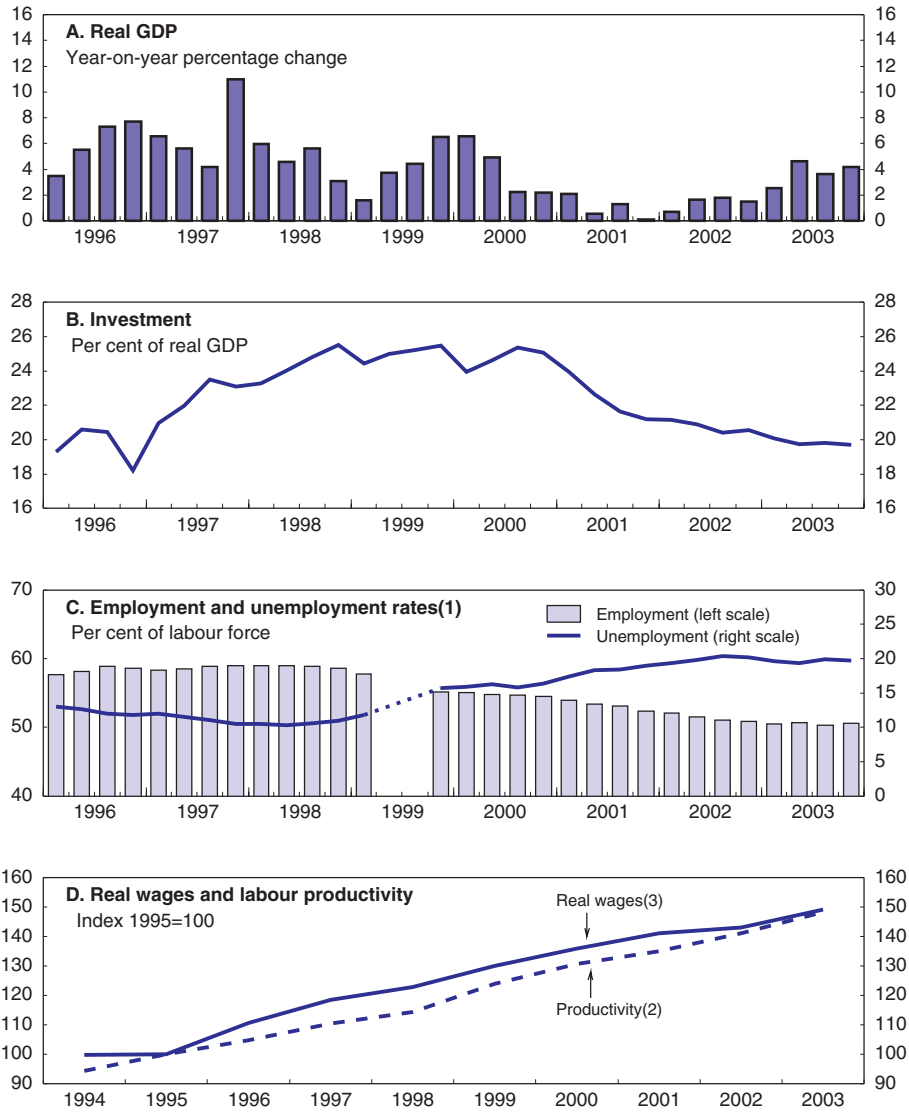
Poland acceded to the European Union on 1 May 2004, following 15 years of economic and political transition. Its achievements over this period are many, both on the legal/institutional and economic fronts. In addition to the EU, it has gained membership in NATO, the WTO and the OECD; trade with western Europe and the rest of the OECD has flourished, increasing 300 per cent since 1990; a booming service sector has emerged, where virtually none existed before; price stability has begun settling-in after years of double digit inflation; and, most recently, the deficit of the current account has been reduced to sustainable levels. Notwithstanding these achievements, as Poland embraces to EU membership a number of challenges remain: ensuring the sustainability of public finances, increasing employment from current excessively low levels, restoring investor's confidence in the economy and speeding restructuring, notably within the agricultural sector. Meeting each of these challenges will not only help the economy recover, but will also be essential to Poland's efforts to raise incomes and speed the convergence process with the rest of the OECD. Moreover, while the difficulty of meeting them should not be minimised, it is worth noting that in many respects the steps required are mutually reinforcing and success in one area will facilitate and in some cases be essential to success in others. The remainder of this chapter discusses recent economic developments and these challenges in more detail and elaborates some of the benefits to be expected from successfully meeting them. Chapter 2 discusses the important role to be played by macroeconomic polices, while Chapters 3 and 4 provide detailed policy recommendations to improve performance in labour and product markets respectively. Chapter 5 focuses on selected issues surrounding the economic and social sustainability of growth.

An export-led recovery

Following several quarters of falling domestic demand and slow GDP growth, a recovery started to materialise during the course of 2002. Since then, it

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Figure 1.1. **Recent economic developments**



1. The LFS Survey was not carried out in Q2 and Q3 1999.
2. Real GDP per worker.
3. Nominal gross wages divided by the GDP deflator.

Source: Central Statistical Office and OECD.

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has been gathering strength, with real GDP increasing by 4.7 per cent in the fourth quarter of 2003 as compared with the same period the year before and by 3.7 per cent for the year as a whole[1] (Table 1.1). To a large extent, the pick up has been export led, the international competitiveness of Polish goods having been boosted by an 18 per cent real effective depreciation of the zloty, the coming on-line of past investments and strong trend improvements in market share (Figure 1.2). As a result, exports of goods and services were up 12 per cent (year-over-year) in 2003 Q4, although, given the high import content of Polish exports, import demand also picked up strongly. Overall, net exports contributed 1.3 percentage points to growth. Domestic demand also expanded rapidly, growing by some 2.4 per cent, mainly reflecting an acceleration in consumer demand and a progressive end to the fall in investment activity, which, after declining for 9 straight quarters by a total of 13 per cent, stabilised during the second half of 2003.

Strong export performance reflecting increased capacity following past investments and the depreciation of the currency, plus weak domestic demand have translated into a substantial improvement in Poland's current account balance deficit, which fell from 7.6 per cent of GDP in 1999 to about 2 per cent in 2003 (Table 1.2). On the financial account, inflows of foreign direct investment (FDI) continued to slow. However, given the recent decline in the current account, they nevertheless covered almost all of its deficit (up from half in 2002). While the decline in inflows was close to the one observed in the OECD area as a whole, where FDI flows fell by 22 per cent in 2002, Poland underperformed other central and eastern European economies where FDI inflows were both larger as a share of GDP and increasing (particularly rapidly in the case of the Czech and Slovak Republics). Favourable corporate tax regimes, very welcoming policies towards foreign firms, better infrastructure and more liberal regulatory regimes are among the explanations commonly given for their superior performance.

Reflecting the structure of demand, the strongest increases in activity occurred in the more export oriented industrial sector (Table 1.3) where intensive labour shedding contributed to large productivity improvements and falling unit labour costs. While the construction sector had been sharply affected by the downturn, increasingly signs of recovery are emerging. On the downside, agricultural output was very weak. Although a drought in 2003 partly explains this weakness, output in the sector has been falling rapidly since 1995. More positively, the agricultural sector showed some signs of picking up towards the end of 2003. Currently it represents about 3 per cent of value added, about average for the OECD, but less than half its 1995 share. Not withstanding these declines, employment in the sector as measured by the national accounts has been broadly stable, implying substantial losses in productivity.

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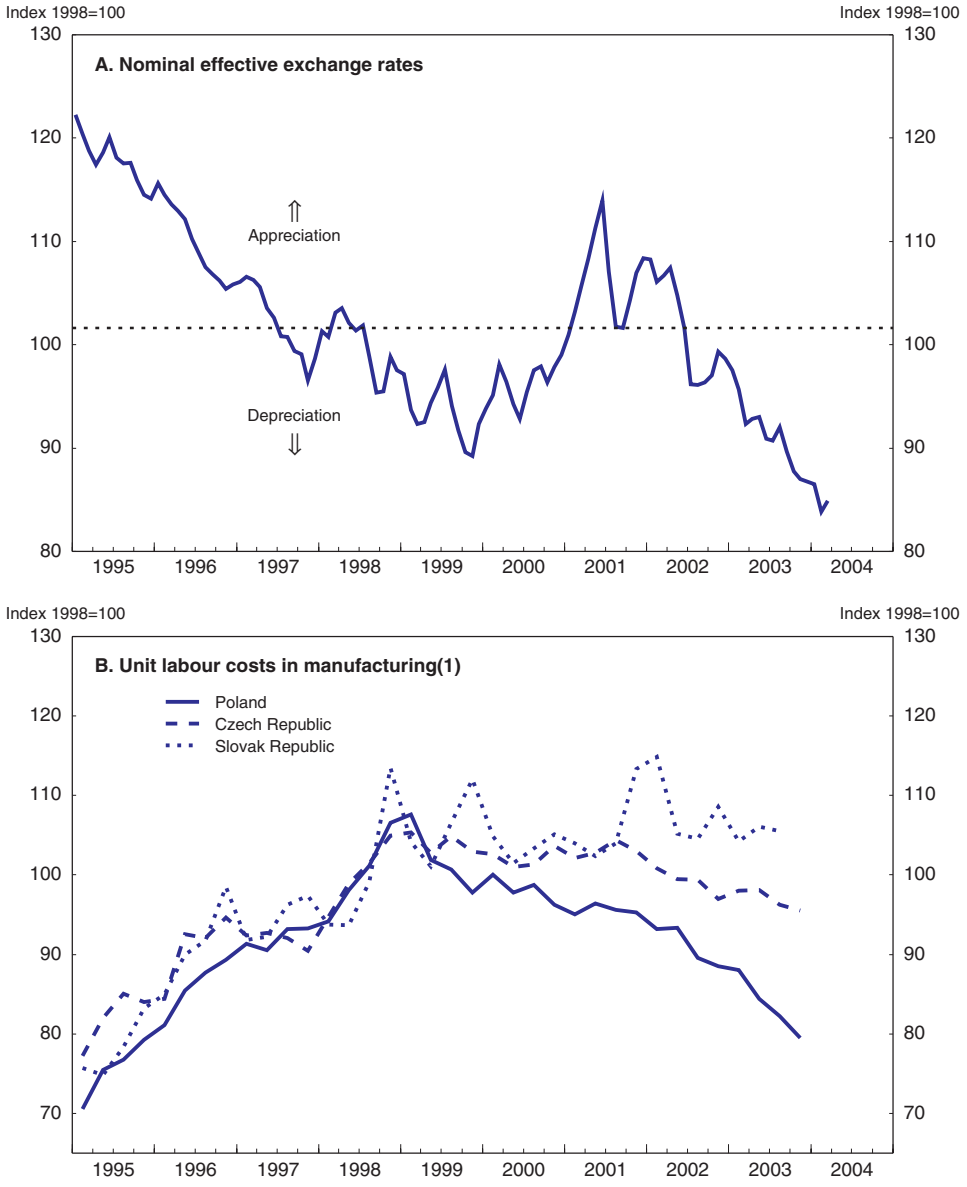
Table 1.1. **Quarterly gross domestic product**
Real growth rates

	2001				2002				2003				2000	2001	2002	2003
	I	II	III	IV	I	II	III	IV	I	II	III	IV				
	Year-on-year percentage changes at 1995 prices												Average year growth			
GDP	**2.2**	**0.9**	**0.8**	**0.3**	**0.6**	**0.9**	**1.8**	**2.2**	**2.3**	**3.9**	**4.0**	**4.7**	**4.0**	**1.0**	**1.4**	**3.7**
Household consumption expenditure	1.5	1.5	2.1	3.2	3.6	3.0	3.2	3.6	1.4	3.8	3.5	3.9	2.8	2.1	3.3	3.1
Government consumption	0.5	0.1	0.4	1.3	–0.2	1.0	1.2	1.5	–0.2	–0.4	1.1	1.2	1.6	0.6	0.9	0.4
Gross fixed capital formation	2.1	–8.0	–11.7	–12.0	–11.9	–7.0	–5.0	–2.7	–3.6	–1.7	0.4	0.1	2.7	–8.8	–5.8	–0.9
Domestic demand	**–1.0**	**–1.6**	**–1.4**	**–2.2**	**–0.1**	**1.0**	**1.1**	**1.2**	**2.4**	**2.1**	**2.4**	**2.7**	**2.8**	**–1.6**	**0.9**	**2.4**
Exports of goods and services	3.2	0.8	5.3	3.2	–0.5	7.3	6.5	5.5	6.7	13.5	19.8	11.7	23.2	3.1	4.8	13.0
Imports of goods and services	–6.5	–6.9	–2.2	–5.9	–2.4	7.0	3.8	1.8	6.7	6.6	13.4	5.0	15.6	–5.3	2.6	7.9

Source: Central Statistical Office.

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Figure 1.2. **The exchange rate and industrial competitiveness**



1. In local currency.
Source: National Bank of Poland and OECD.

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Table 1.2. **Balance of payments on a transaction basis**
Euro million

	1997	1998	1999	2000	2001	2002	2003
Current account	–5 082	–6 154	–11 719	–10 796	–5 994	–5 404	–3 660
Exports	27 194	28 951	28 215	39 022	46 537	49 338	53 836
Imports	35 885	40 397	42 361	52 349	55 094	57 039	58 913
Trade balance	–8 691	–11 446	–14 146	–13 327	–8 557	–7 701	–5 077
Non-factor services, credits	7 889	9 666	7 850	11 311	10 913	10 543	9 844
Non-factor services, debits	5 082	5 907	6 553	9 771	10 007	9 690	9 408
Balance of non-factor services	2 807	3 759	1 297	1 540	906	853	436
Factor income, credits	1 298	1 985	1 724	2 448	2 923	2 053	1 876
Factor income, debits	2 297	3 035	2 672	4 055	4 500	4 045	4 627
Balance of factor income	–999	–1 050	–948	–1 607	–1 577	–1 992	–2 751
Transfers, net	1 801	2 583	2 078	2 598	3 234	3 436	3 732
Capital account	59	56	51	39	84	–7	–40
Financial capital	3 867	6 560	9 670	10 559	4 037	6 720	6 078
Direct investment, net	4 303	5 394	6 795	10 316	6 469	4 143	3 413
Direct investment abroad	–40	–282	–29	–18	97	–228	–343
Direct investment in Poland	4 343	5 676	6 824	10 334	6 372	4 371	3 756
Portfolio investment, net	1 868	1 513	134	3 611	1 140	1 908	2 234
Other investment, net	401	4 938	2 356	–2 878	–3 751	2 367	2 295
Financial derivatives	–11	0	534	313	–364	–1 022	–757
Official reserve assets	–2 694	–5 285	–149	–803	543	–676	–1 107
Errors and omissions	1 156	–462	1 998	198	1 873	1 309	–2 378

Source: National Bank of Poland.

The standardised unemployment rate in the first quarter of 2004 at 19.1 per cent was down slightly from its level a year before (Figure 1.3). This improvement was largely due to a decline in labour force participation. Although labour-shedding continued in 2003, there are some signs of a recovery in job markets, with employment levels remaining close to stable towards the end of 2003. Most of the improvement was in the business-sector where for the year as a whole employment is estimated to have fallen by 1.2 per cent as compared with 2.5 per cent decline the year before.[2] In addition, registered job vacancies have begun rising and the incidence of job-loss for economic reasons among the registered unemployed is falling, reinforcing the suggestion that the worst of labour shedding may be over.

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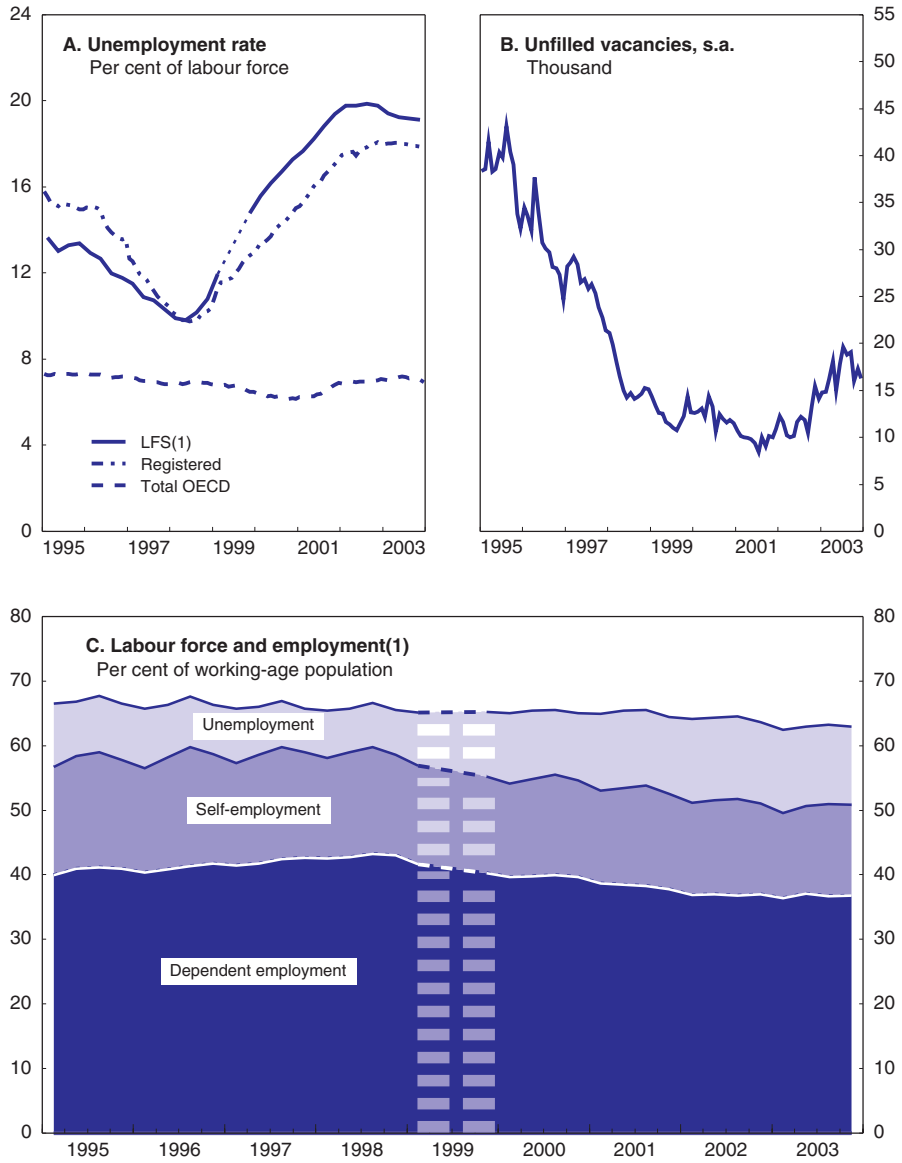
Table 1.3. **Value added by sector**
Real growth rates

	2001				2002				2003				2000	2001	2002	2003
	I	II	III	IV	I	II	III	IV	I	II	III	IV				
	Year-on-year percentage changes at 1995 prices												Average year growth			
Value added	**2.2**	**1.0**	**1.0**	**0.2**	**0.4**	**0.8**	**1.8**	**1.9**	**2.0**	**3.6**	**3.6**	**4.1**	**3.7**	**1.1**	**1.3**	**3.4**
Agriculture[1]	11.6	13.2	12.0	–0.1	–5.6	–1.2	0.9	8.5	–0.5	–0.8	0.5	3.6	–7.9	9.2	1.1	0.7
Industry and mining[2]	3.7	–1.1	–1.5	–2.1	–3.3	–2.1	1.7	2.8	4.1	8.1	8.0	9.7	6.5	–0.3	–0.2	7.6
Construction	–5.6	–8.3	–8.5	–8.3	–14.4	–12.1	–4.5	–7.0	–19.6	–7.4	–2.0	–0.1	0.3	–7.9	–8.6	–5.1
Market services	2.6	2.6	3.2	3.0	4.5	3.9	3.9	3.6	3.4	4.6	4.2	4.2	4.1	2.8	4.0	4.1
Trade and repair	2.2	4.2	4.2	4.9	7.8	4.7	5.2	6.1	2.4	9.1	5.9	8.6	4.1	3.9	5.9	6.5
Transport, storage and communication	4.7	1.8	2.9	4.3	3.2	12.7	8.3	7.5	8.5	3.4	3.8	3.3	3.4	3.4	8.1	4.6
Non-market services[3]	0.3	0.6	1.2	1.8	0.0	0.5	–1.2	–0.5	0.8	0.0	0.3	–0.8	2.4	1.0	–0.3	0.1

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.

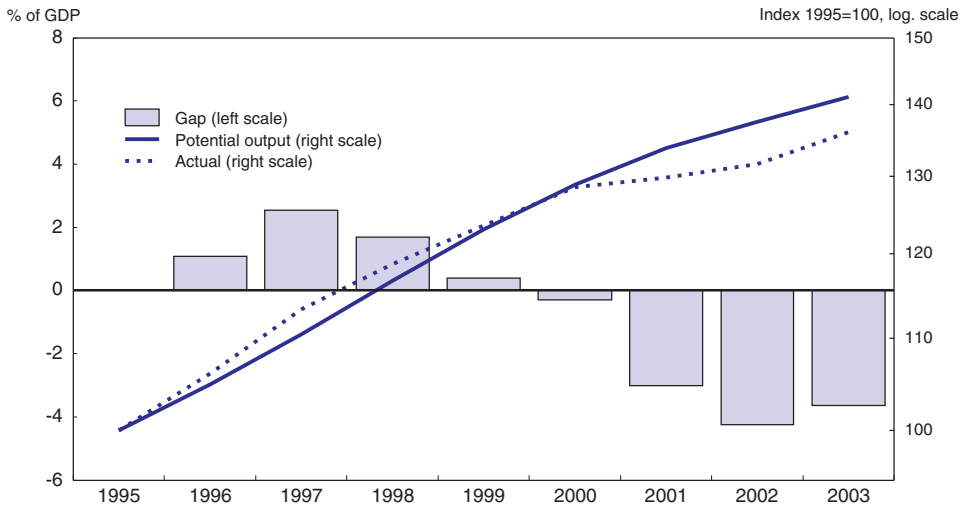
Figure 1.3. **Labour market developments**



1. Figures based on the Labour Force Survey, which was not carried out in the 2nd and 3rd quarters of 1999.
Source: OECD and Central Statistical Office

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Figure 1.4. **Potential output**



Source: OECD.

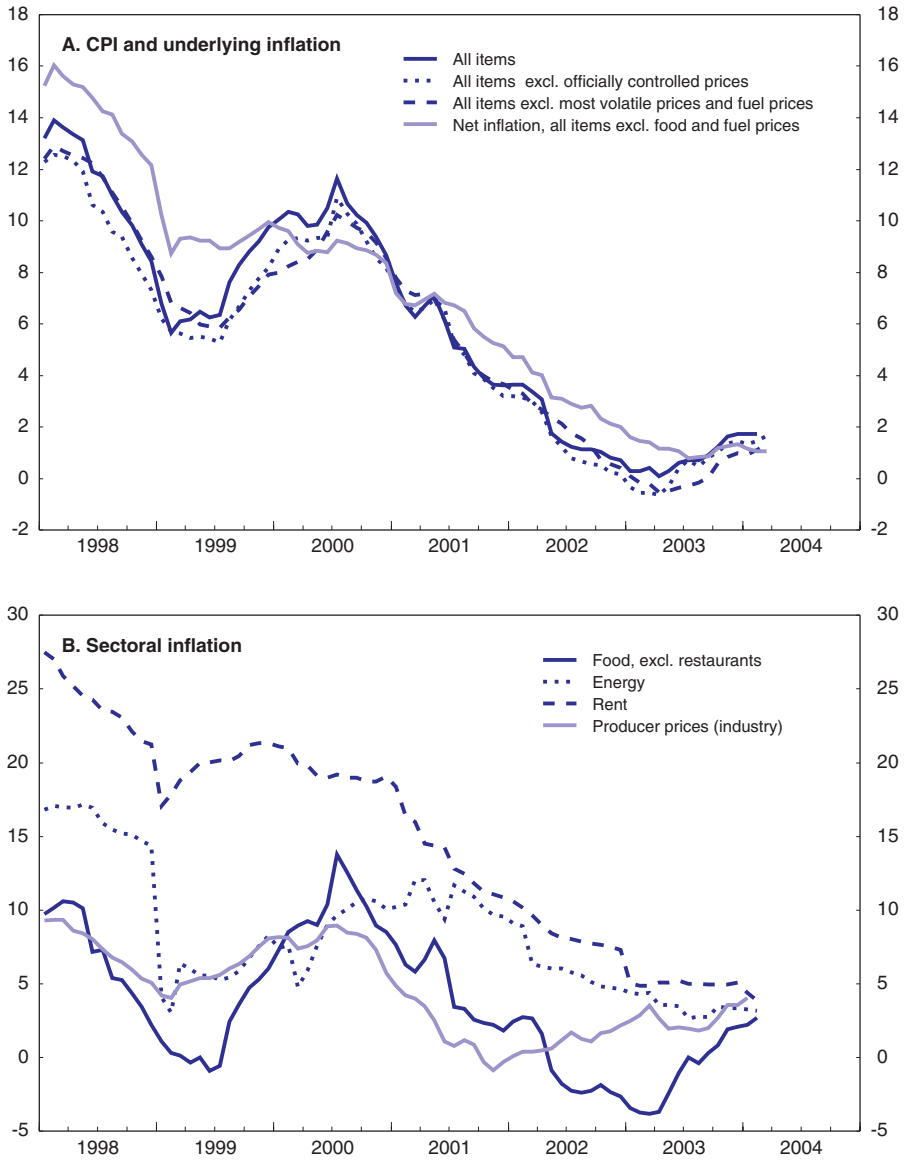
Slowing potential output growth and a large output gap

The slowdown of the economy caused the output gap to move from highly positive in 1998 to strongly negative in 2003 (Figure 1.4). The deceleration in aggregate demand was accompanied by a slowing in the rate of growth of potential output due to rising structural unemployment and falling investment levels. As a result, the rate of growth of potential output fell from more than 5 per cent towards the end of the 1990s to about 3 per cent currently and is expected to average 3½-4 per cent rate in the decade to come.[3]

The dramatic decline in inflation since 2000 owes much to the opening up of this output gap and the tight monetary policy exercised by the National Bank of Poland (see Chapter 2) and stands as one of the most important achievements of the transition period. Although headline inflation has picked up somewhat over the course of the last 12 months, it rose from 0.5 per cent (year-over-year) in January 2003 to 1.7 per cent in March 2004, it remains low and core inflation, notably the Polish National bank's measure of net inflation, has been stable (Figure 1.5). Indeed, much of the increase in headline inflation was due to rising oil prices and an end to falling food prices, reflecting the effect of a drought in 2003 and an abatement of the price effects from increased competition in the sector.[4]

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Figure 1.5. **Inflation developments**
Year-on-year percentage change



Source: Central Statistical Office and National Bank of Poland.

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For the moment, increased prices for imported consumer goods, following the depreciation of the zloty have not shown up in a marked pick-up in aggregate inflation. This weak pass through may partly reflect a substitution away from euro denominated consumer goods towards those from other central and eastern European economies.[5] Indeed, imports from these countries rose more than 1½ times as quickly as those from the European Union. In contrast to consumer prices, industrial prices have accelerated, but this mainly reflects stable world prices for Polish products and the depreciation of the zloty.

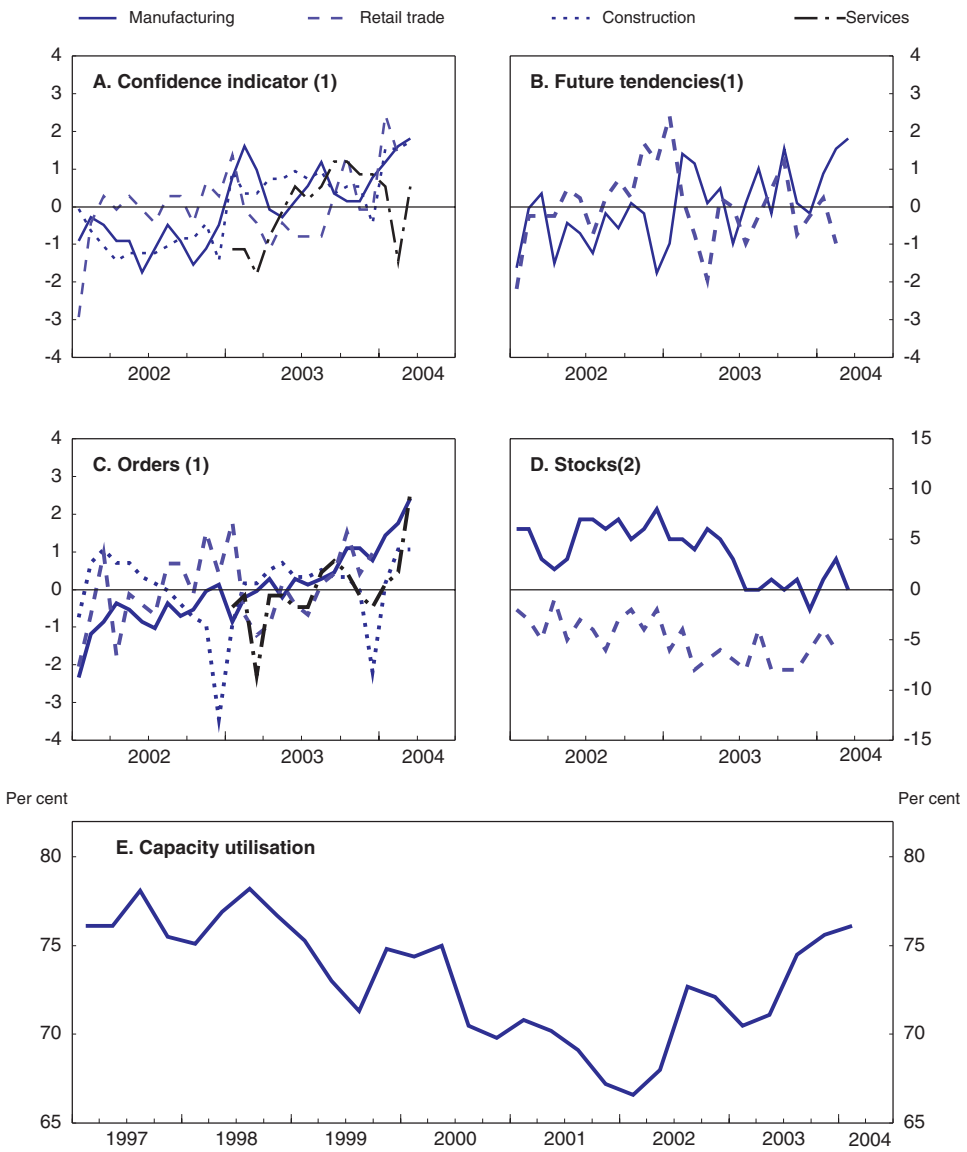
The short-term outlook

High frequency indicators such as industrial production (up 19 per cent in 2004 Q1) and retail trade data suggest that the economy has continued to gain strength, landing many commentators to predict first quarter of 2004 GDP growth of more than 5 per cent (year-over-year). Moreover, business confidence indicators suggest that the recovery will continue to gain strength (Figure 1.6). Business leaders foresee further increases in output and feel that the general economic climate has improved. They indicate that stock levels are satisfactory or falling and that order books are increasing. Moreover, notwithstanding the strong increase in exports already registered, they continue to foresee a strengthening of foreign sales. Finally, capital utilisation rates are rising and by the end of 2003 were approaching the levels recorded in the boom years of 1996, 1997 and early 1998, suggesting that capacity constraints may be making themselves felt.

Looking forward, real GDP is projected to continue growing rapidly, increasing by 4.7 per cent in 2004 and by some 4.5 per cent in 2005 (Table 1.4). A sharp relaxation of fiscal policy in 2004, the deficit is projected to reach 5.7 per cent of GDP (up 1.0 percentage point in cyclically adjusted terms, see Chapter 2) will help bolster domestic demand in 2004. On the external side, net exports performance should continue to contribute to growth supported by the international recovery, gains in market share and the (although diminishing) effects of the exchange rate depreciation. Notwithstanding a tendency for interest rates to rise due to an increased risk premium on the zloty as the public-debt rises rapidly, improved profitability in export-sectors, increasingly binding capacity constraints and further EU-accession related business opportunities are expected to fuel a gradual pick up in investment and a broadening of the basis of the recovery. Despite heightened activity, employment is expected to respond only slowly. As a result, and with unemployment close to 20 per cent of the labour force, the pick-up in consumer demand should be less strong in 2004. As the recovery takes hold in 2005, rising employment should translate into a further broadening in the basis for growth and some strengthening of consumer spending. However, the fiscal consolidation announced by the government (see below and Chapter 2) is expected to slow the acceleration in domestic demand. Nevertheless, import growth is also

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Figure 1.6. **Business indicators**



1. Data are per cent balances indexed to period average = 0 and normalised by their standard deviation.
2. Per cent balance.

Source: OECD.

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Table 1.4. **Short-term outlook**
Percentage change

	2002	2003	2004	2005
Private final consumption expenditure	3.3	3.1	3.7	4.3
Government final consumption expenditure	0.9	0.4	0.2	–2.1
Gross total fixed capital formation	–5.8	–0.9	5.7	7.5
Increase in stocks, volume	–0.2	0.6	0.0	0.1
Exports of goods and services	4.8	13.0	13.8	10.3
Imports of goods and services	2.6	7.9	9.6	8.6
Statistical discrepancy of GDP	–0.1	–0.1	0.0	0.0
Gross domestic product, volume	1.4	3.7	4.7	4.5
Private final consumption expenditure, deflator	1.6	0.7	2.2	2.1
Consumer price index	1.9	0.8	1.8	2.4
Core inflation	2.5	0.7	1.4	1.9
Unemployment rate	19.9	19.6	19.7	19.2
General government balance	–3.9	–4.2	–5.7	–5.5

Source: OECD, Economic Outlook (May, 2004).

expected to be strong, reflecting the high import-content of both investment and export goods and stronger domestic demand more generally. As a consequence, the overall contribution to growth of the foreign sector will diminish and the current account deficit is expected to rise. While increases in the prices of imported goods and a tendency for wages to accelerate will generate some inflationary pressures, the still large output gap should ensure that headline inflation will remain below or within the central bank's revised inflation target of 2.5 ± 1 per cent.

The main risk pertaining to this projection concerns the possibly of an overheating of the economy. This could arise either because the reaction of domestic demand to the simultaneous loosening of fiscal policy in 2004 and more relaxed monetary conditions at a time when demand is already expanding rapidly turns out to be stronger than projected or because the fiscal consolidation planned for 2005 fails to materialise. Under either scenario, recent signs of a pick-up in wage growth could intensify, reflecting speed-limit effects. Such an eventuality could forestall the hoped for recovery in employment and fall in unemployment. Moreover, the implied increase in labour costs would reduce profitability, investment and output growth. A further risk derives from the current account and the relaxation of fiscal policy. To date, most of the decline in the current account deficit has been attributable to the depreciation of the currency, the coming on-line of past investments, weak domestic demand and uncertain factors affecting "suitcase trade". As these factors cease to play a role in 2004 and 2005 and especially if domestic demand increases more rapidly than projected, the current

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account could once again become a source of concern for investors, provoking a further increase in the risk premium on the zloty, raising interest rates and weakening the recovery.

Challenges

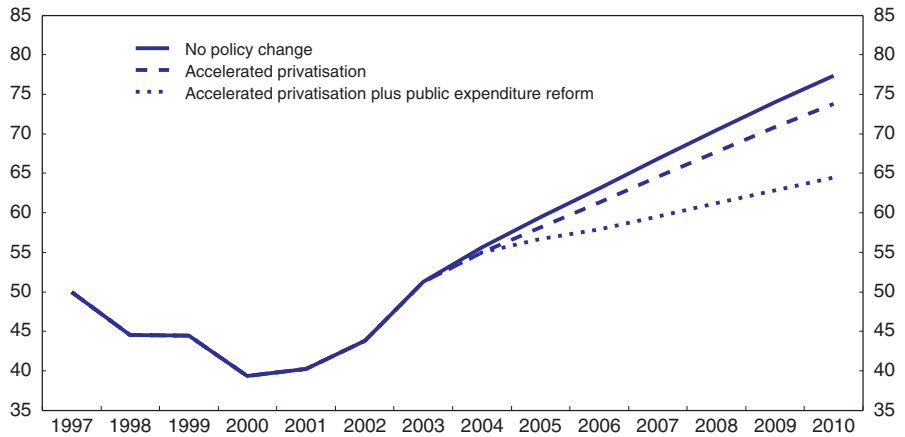
The acceleration of output in 2003 marked an end to the growth slowdown that began in 1998, which had followed several years of strong investment-led growth. While this growth recession bore many of the hallmarks of a normal investment cycle, the brutal reaction of labour markets to the slowdown (employment fell 11 per cent and the unemployment rate almost doubled between 1998 and 2003) is almost without precedent both within Poland and in the OECD.[6] Moreover, both this fall and the rapid decline in investment stand in sharp contrast to events in other emerging OECD countries. These developments have imposed immense hardship on individual Poles and de-railed Poland's hitherto impressive record as an emerging economy. The ongoing upturn should offer some relief. However, putting the economy back on a sustainable and fast growth track represents a massive economic and policy challenge. This is particularly so, as the remainder of this *Survey* illustrates, because those features of the Polish economy that underlay the severity of the labour (and product) market response to the slowdown also represent the most important hurdles to achieving sustainable high rates of growth.

Restoring public finances to a sustainable path

The most immediate challenge facing Poland is to slow and even reverse the very rapid rise in the public debt observed since 2000. The substantial easing of fiscal policy observed over the past several years has resulted in a rapid accumulation of public debt, which has already breached the 50 per cent of GDP mark, the first of three thresholds laid out in the Public Finances Act. Indeed, allowing for the permanent increases in spending included in the 2004 budget, recurrent public expenditures exceed revenues by more than 7 per cent of GDP on a cyclically adjusted basis. Assuming that privatisation revenues remain at current levels and that fiscal policies are left unchanged, the OECD projects that the public debt will expand by about 5 per cent of GDP a year, rapidly exceeding the next two limits of 55 and 60 per cent of GDP (Figure 1.7). While the authorities' proposed Public Expenditure Reform, if passed, will help slow the progression of the debt, unless it is complemented by additional measures it will only delay the point in time when the constitutional limit is broken. Moreover, if this unsustainable path of public finances is left unchecked and the debt allowed to cross over the 60 per cent threshold, the government will be obliged by the constitution to take draconian steps to bring the overall budget into balance the following year. These

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Figure 1.7. **Medium-term debt dynamics**
Public debt as a per cent of GDP[1]



1. Data for 1997 and 1998 are estimated using data for the State Treasury debt.
Source: OECD.

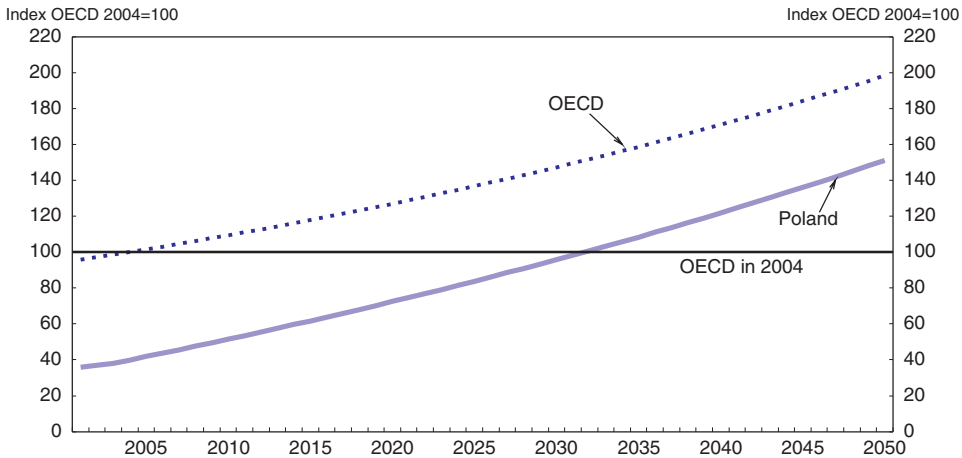
will be very difficult to achieve and could have very disruptive consequences for the economy, particularly if the initial consolidation is composed of unsustainable measures, such as wage freezes or cuts in public investment and must be repeated at a later date.

Speeding the convergence process

Closing the substantial income gap between Poland and the rest of the OECD (Figure 1.8) represents the most important medium- to long-term challenge facing the country and along with political and security considerations is among the most important drivers behind Poland's efforts to integrate into western international institutions, including most recently the European Union. In this regard, the return to stronger growth is very welcome. Given the accumulated increase in the output gap and abstracting from short run "speed-limit effects", there is good reason to expect that the economy can continue to grow at a 4.5 per cent pace for some time without generating substantial inflationary pressures. Nevertheless, over the longer term the pace of convergence will be slow unless substantial steps are taken to increase potential output growth. Indeed, notwithstanding the progress that has been made towards establishing market institutions and economic integration with the more developed OECD countries, trend growth and progress in terms of income convergence over the past decade have been

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Figure 1.8. **Potential output and catching up**
Output per capita at PPP



Note: Annex A explains the methodology employed in calculating these estimates.
Source: OECD.

disappointing in many respects. Currently Polish GDP per capita is only 41 per cent of OECD levels. If growth differentials between Poland and the rest of the OECD remain at the level of the past decade, it will take several more decades before income levels in Poland converge with the average of the OECD – although considerably less time to reach the current OECD average.

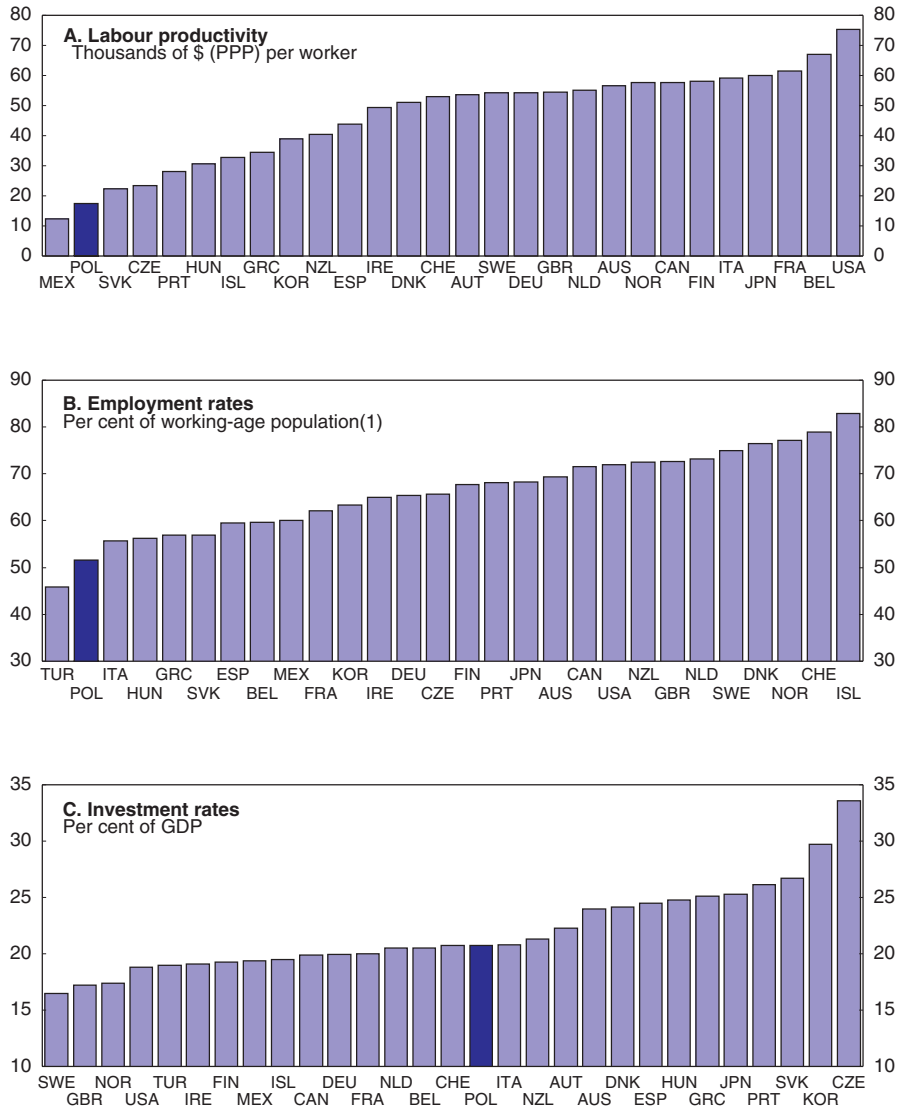
Speeding convergence implies increasing the rate of growth of potential output. This can be achieved by increasing the rate of growth of total factor productivity, by raising the stock of capital and by making more extensive use of the potential labour force. In all of these areas Poland has substantial scope for improvement (Figure 1.9). Aggregate productivity levels are half those of other OECD countries, and with only one in two individuals working, the employment rate is (51 per cent) is well below the area average of 65 per cent. Moreover, while precise data on the stock of capital are unavailable it is estimated to be low and its rate of increase (as proxied by the investment rate) is only average – well below the rates observed in other emerging OECD economies.

Raising employment

Perhaps the most fundamental sub-challenge facing Poland is to put in place a set of policies that ensure that those who wish to work can. With an

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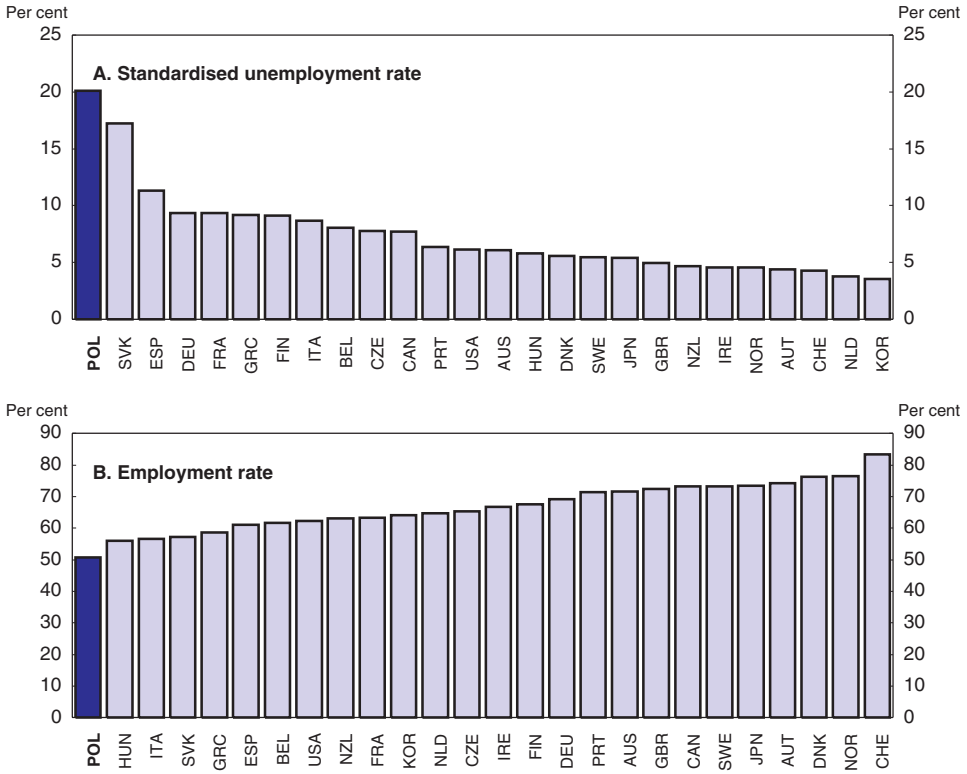
Figure 1.9. **Factors underlying potential output**
2002



1. 15 to 64 years.
Source: OECD.

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Figure 1.10. **International comparison of labour market performance**
2003 Q2



Source: OECD.

employment rate of 51 per cent and 20 per cent of the labour force looking for work, Polish labour market performance is the worst in the OECD (Figure 1.10). In addition to addressing the social and individual trauma that these aggregate statistics suggest, redressing these shortcomings would go a long way towards raising incomes, reducing inequality and increasing potential output. To do so, policy will need to address both the inactivity traps that reduce individuals' financial incentives to take up formal employment and the administrative and regulatory burdens that contribute to raising labour costs and make firms less willing to hire workers at a given level of activity. While putting in place the right kind of reforms will be both technically and politically difficult, inaction is not a viable option.

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Recent developments suggest that existing labour market institutions have, to a large extent, hobbled labour market adjustment mechanisms and impeded job creation. As a result, unless bold steps are taken only limited spontaneous improvement in employment can be expected as aggregate demand picks up.

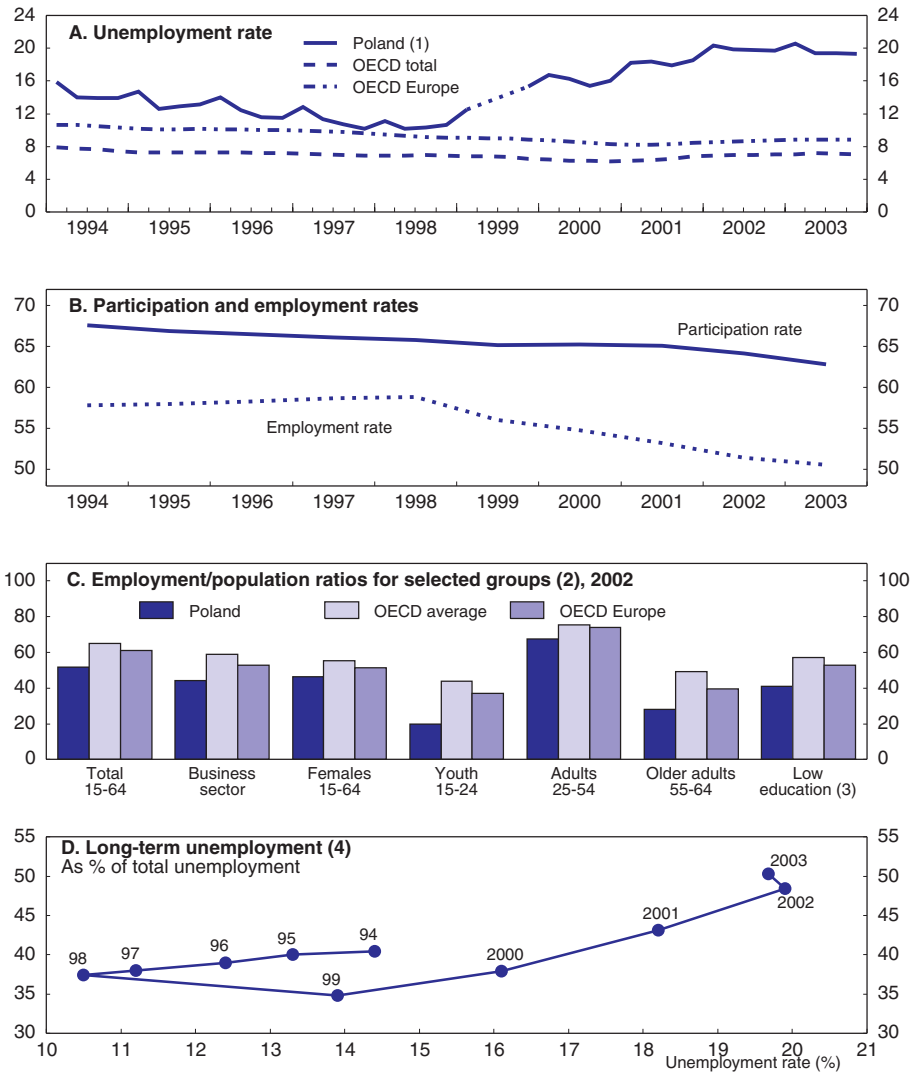
While the growth slowdown contributed to the rise in joblessness, much of Poland's current labour market difficulties appear structural in nature. Over the past decade, the rate of employment seems to have been on a declining trend. Rising only modestly during the high growth years of the mid-1990s, it fell markedly during the economic slowdown of the early 2000s (Figure 1.11). Even more suggestive is the fact that almost half of the total 11 per cent fall in employment since 1998 occurred in the period 1998-2000 when GDP was expanding robustly at more than 4 per cent a year. Thus, although unemployment declined through much of the 1990s, these apparent improvements were driven by favourable cyclical developments, with the true magnitude of underlying structural unemployment, only to be revealed when output slowed, beginning in 2000. Restructuring in the state-owned heavy industry and mining sectors; the expiration of the social plan components in privatisation deals; the contraction of the agricultural sector; the Russian crisis and the slowdown in world trade towards the end of the decade were all factors contributing to job restructuring but do not explain the failure of other sectors to create more jobs.

A further challenge will be to put in place reforms that restore financial incentives to take up work and others that make it easier for workers to price themselves into the labour market. In this regard, the limited wage moderation that accompanied the rise in unemployment (Estevao, 2003; Golinowska, 2003) supports the view that structural unemployment remains very high. Indeed, notwithstanding very high and rising unemployment, the real wages continued increasing by more than 2.5 per cent in 2001 through early 2004, suggesting that the unemployed were having little impact on real wages. This, coupled with strong insider-power, a binding minimum wage and a truncated wage distribution for many groups (Figure 1.12) resulted in low-wage earners, principally inexperienced youth and those with the lowest levels of educational attainment, bearing the brunt of the adjustment – their employment rates fell by more than 25 per cent between 1997 and 2003. In contrast, employment among individuals with a secondary education or better fell by only 1 per cent between 1997 and 2001. As a result, while employment rates for workers 25-54 years of age are not that dissimilar from those in the rest of the OECD, those for youth and workers with low educational attainment are sharply lower, with less than one in 5 persons with low-education working (see Figure 1.11).[7]

As a result of this accumulation of joblessness, policy makers now must also face the related problem of getting youth and older workers back into the labour market. Currently their employment rates are among the lowest in the OECD

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Figure 1.11. **Key labour market indicators**
Per cent

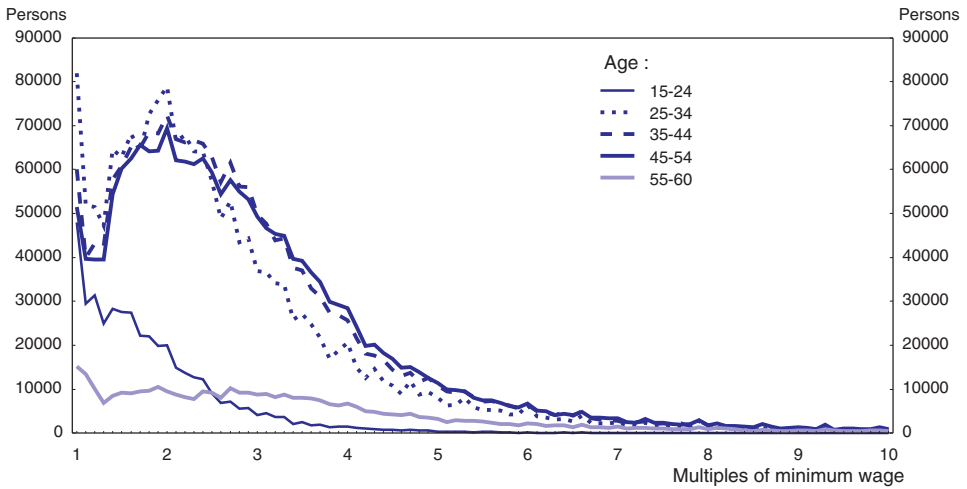


1. The Labour Force Survey was not carried out in Q2 and Q3 1999.
2. Per cent of persons employed in each sub-group of the working population.
3. Completed less than upper secondary education, 2001.
4. Long-term unemployment is defined as individuals looking for work for one year or more.

Source: Central Statistical Office and OECD.

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Figure 1.12. **The wage distribution**

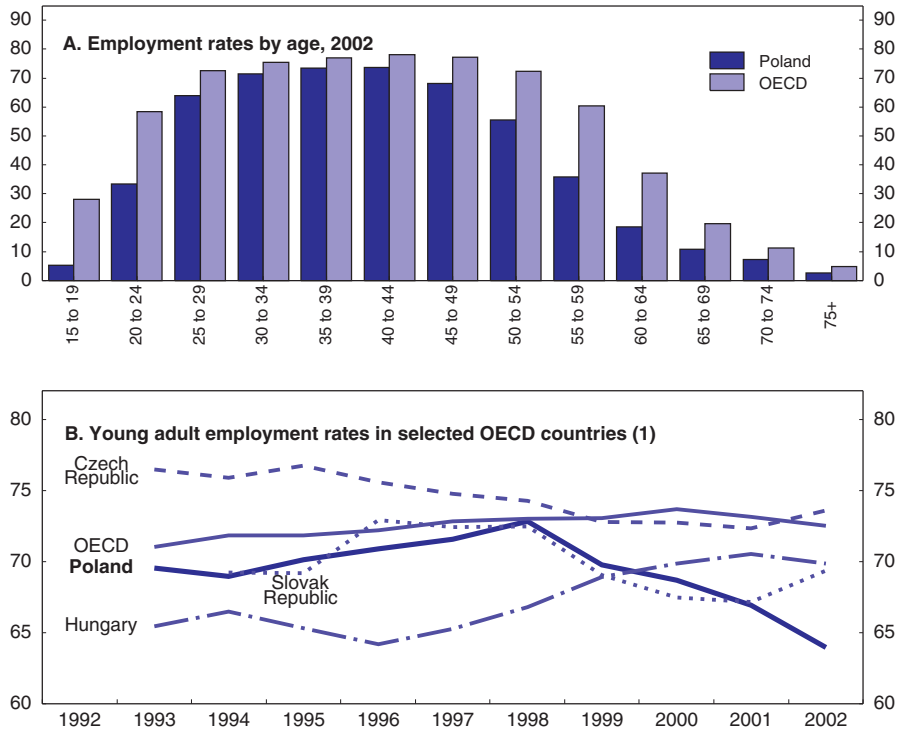


Source: Central Statistical Office.

(Panel A, Figure 1.13). The relatively poor performance of youth contrasts somewhat with other transition countries, where demand for workers with more market-oriented educations and attitudes has bolstered the labour market position of younger workers (Panel B, Figure 1.13).[8] One explanation offered for these difficulties is the coming-of-age of a mini-baby boom, which increased the share of youth (20-29 years of age) in the working-age population by 3 percentage points between 1995 and 2003. A second explanation is an increase in educational enrolment rates since the beginning of the transition. While these phenomena have doubtlessly played a role, they have also been observed in other OECD transition countries – without the same strong negative impacts on youth jobs.[9] Moreover, employment rates for young adults (25-29 years of age) who have mostly finished schooling are also low and falling. This is in contrast to the upward or stable trend observed for such individuals in other transition countries offering additional evidence that the employment prospects of less well educated workers are impinged upon by high labour costs on the one hand and stringent labour market rules that increase the risk to employers of hiring such unproved workers. For workers over 55 years of age, low rates of employment reflect both the concentration of individuals with low educational attainment in this age group and past policies that have sought to lower measured unemployment by encouraging early labour force withdrawal, initially through early-retirement programmes and subsequently via easy access to disability pensions. The cumulative

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Figure 1.13. **Employment rates by age**
Per cent of population age group



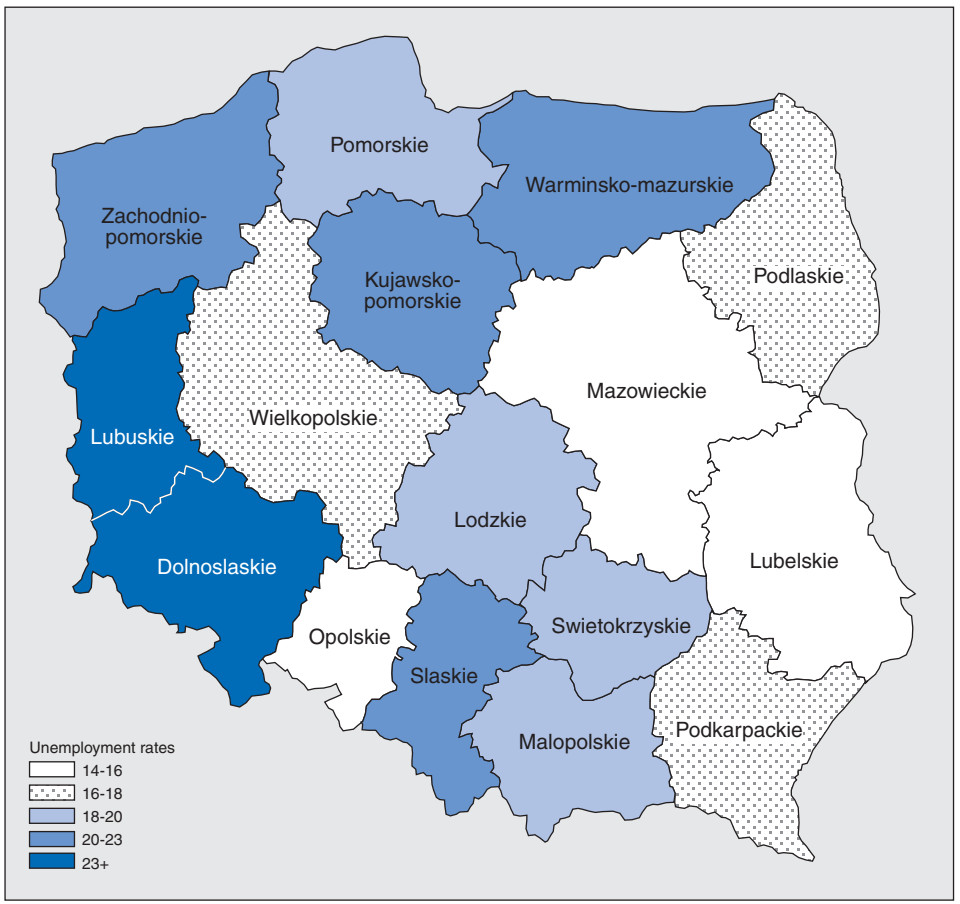
1. Individuals aged 25-29.
Source: OECD.

impact of those policies has been to virtually eradicate financial incentives to work beyond 60 and greatly reduce them for those over 55.

Finally, reactivating labour market adjustment mechanisms will require promoting labour mobility. The concentration of joblessness among certain classes of workers is mirrored in the geographic distribution of unemployment, which has remained surprisingly stable over time. Thus, notwithstanding restructuring in the heavy-industry sector, which has contributed to a worsening of labour market performance in the southern and central regions of Slaskie, Swietokrzyskie and Malopolskie, those regions characterised by higher than average unemployment in 2003 are broadly the same as those at the beginning of 1990s. Unemployment

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Figure 1.14. **Regional distribution of unemployment**[1]



1. Regional unemployment rates (LFS basis) in the fourth quarter of 2003.
Source: Central Statistical Office.

rates are highest in the relatively sparsely populated, low income and low education agricultural regions in the North and North-East of Poland and lowest in the regions surrounding Warsaw and in the South-East (Figure 1.14). Despite the substantial problems associated with the rural economy and agriculture in particular (see Chapter 4), aggregate labour market outcomes (employment and unemployment) for rural regions considered together are not that dissimilar from those for the urban economy. However, as discussed below this masks profound differences

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in terms of earnings and productivity. Indeed, notwithstanding many Polish farms that perform at high levels of efficiency, for the sector as a whole agricultural productivity levels are less than one tenth of those of the whole economy, which has important implications for rural earnings.

Chapter 3 enumerates a number of policies that would serve to help reduce wage rigidity and the concentration of joblessness among youth, the unskilled and residents of some regions. The policies it describes are designed to overcome inactivity traps, to lower the cost of hiring unskilled or inexperienced workers and to reduce implicit labour costs that may be preventing firms from hiring as many workers as they would otherwise.

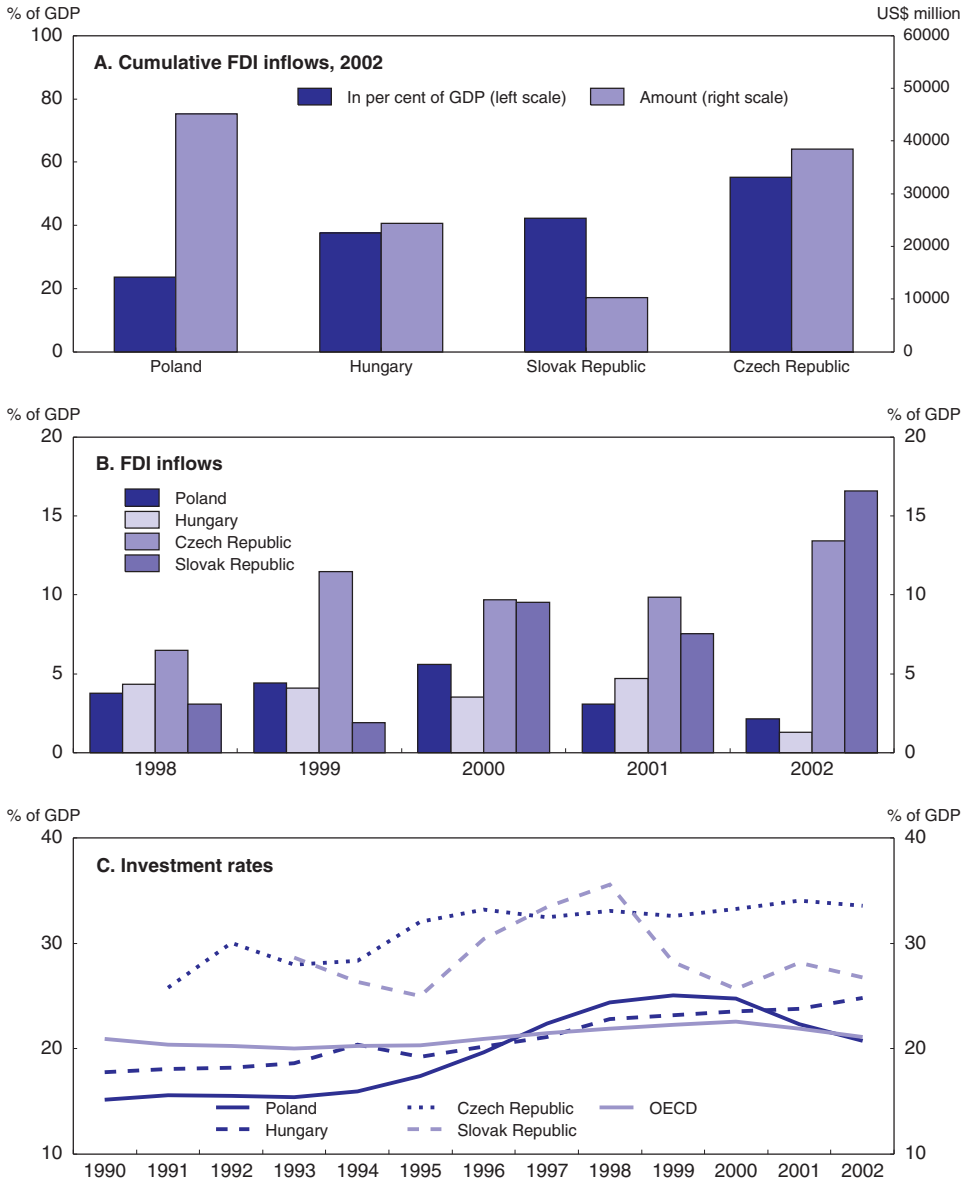
Increasing investment

While removing labour market distortions should go a long way to getting the population back to work, it will not be sufficient. Substantial efforts will also need to be made to increase the demand for labour by enhancing activity. A critical task in this respect will be raising investment rates. Higher rates of investment would not only contribute to an increase in the stock of capital and faster growth, they would also increase demand for labour by raising productive capacity. During the mid 1990s Poland outperformed most of its neighbours, recording double-digit growth rates for both domestic and foreign-direct investment. This good performance reflected investor enthusiasm and confidence in the country following a period of strong and courageous reforms. Since then, both levels of investment activity and growth rates have fallen off sharply. Business-sector investment is down from a peak of 25 per cent of GDP in 1999 to 20 per cent in 2003 – much lower than the levels observed in other emerging economies (Figure 1.15). Moreover, while Poland, owing to its size, has retained its overall lead in terms of accumulated foreign direct investment,[10] inflows are way down and, measured on a per capita or GDP-weighted basis, even Poland's cumulative record is significantly weaker than that of Hungary and the Czech and Slovak Republics.[11] Indeed, although the fall in both foreign and domestic investment activity since 1999 partly reflects the economic downturn and a drop in worldwide FDI inflows, the more than 50 per cent fall in FDI recorded in Poland between 2000 and 2002 stands in stark contrast to the still strong performance observed in other central European economies and appears to point towards a more serious problem.

To the extent that new investment brings with it new technologies and production techniques, it can also be expected to have important impacts on the rate of productivity growth – over and above those normally associated with adopting a more capital intensive production approach. Output would also benefit from policies that raise the level of productivity, while those that lead to a permanent increase in trend productivity growth would have a continuous pay off, principally in the form of higher standards of living for future generations. Chapter 4

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Figure 1.15. **Investment performance**



Source: OECD.

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discusses a series of policy initiatives that together can be expected to improve the investment climate in Poland and, as a result, boost productivity growth and the speed of convergence. Issues discussed include policies required to improve the effectiveness of the banking-sector and other financial markets in channelling private-sector saving towards the most effective investment projects; policies to improve the enforcement of property rights; tax policies; policies that seek to reduce the impediments posed by government regulations and associated administrative obligations; and investment promotion policies.

Speeding rural restructuring

Speeding the rural-urban transition should be an essential goal of any programme to raise productivity growth and improve labour market performance in Poland. In contrast with every other OECD economy, official statistics indicate that as much as 20 per cent of the Polish work force is employed in agriculture – where it produces only 3 per cent of value added. Thus, while many larger Polish farms are competitive with those in western European countries, on average agricultural productivity is very low, less than one tenth that of the rest of the economy. These low levels are partly the result of a sharp 50 per cent fall in agriculture's share in GDP since 1995, which to some extent reflects the competitive difficulties faced by Poland's agricultural sector following the opening of markets. While these were partly due to the relatively low levels of aid received by Polish farmers as compared with those in the rest of the OECD,[12] the uneconomically small size of most Polish farms is a principal factor explaining the sector's lack of competitiveness. Currently, the vast majority of farms are too small to support a family, let alone generate a surplus large enough to support the kinds of investment necessary to bring productivity levels towards western European levels. Instead, most rural households live a near subsistence existence combining in equal measure a very moderate farm income with various income transfers and earnings from low-productivity formal-sector and underground work.

Chapter 4 outlines a number of policies that, if implemented, would help to improve agricultural productivity, notably by removing existing impediments to farm consolidation. It also describes reforms that would improve incentives for agricultural workers to take on more productive work in other sectors. The challenge here is complicated because a major factor behind low measured agricultural productivity is a tendency for agricultural employment to form a type of hidden unemployment with displaced workers from other sectors returning to family farms so as to benefit from lower living costs on the one hand, and a preferential system of social security on the other. As a result, in addition to improving incentives to accept higher productivity work, Chapter 4 also outlines policies that if put in place would help ensure that such jobs are available for rural workers, while at the same time eliminating institutional features that make low-productivity agricultural work an attractive alternative to higher-paid and more productive off-farm work.

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Addressing the challenges

To a large extent, both recent and current policy initiatives have focussed on redressing these shortcomings. Reforms are under preparation or in place that seek to increase the level and the rate of growth of potential output by increasing labour supply, upping the rate of investment and raising the pace of productivity improvements. The government's recently proposed Public Expenditure Reform plan and other initiatives represent important positive steps in such a process. They not only seek to contain the rate of growth of public expenditures and place the debt on a more sustainable path which should contribute to higher rates of investment and growth due to a fall in the interest rate risk premium and a lower tax burden, but also seek to do so by targeting those spending programmes that, in and of themselves, impede growth and promote inequality because of the serious distortions that they generate. More broadly, the government's reform package seeks to:

- reform the special farmers social insurance scheme (KRUS) in an effort to restore incentives both for labour mobility and agricultural restructuring;
- rationalise both corporate and personal income taxes so as to increase the overall attractiveness of Poland as a destination for investment;
- reduce the administrative burden that the state places on firms;
- lower the labour costs of low-skilled, youth and long-term unemployed workers;
- relax further employment protection and working-time rules.

The details of these efforts and proposals by which they could be reinforced are discussed in Chapter 2 (macro policy and public expenditure reform), 3 (reform of the social assistance disability and special farmers' systems, policies to promote employment) and 4 (policies to increase investment and enhance restructuring, notably among state-owned firms and within the rural sector). The remainder of this chapter attempts to provide a sense of the macroeconomic and fiscal consequences of progress in these areas.

The simulations reported in Table 1.5 attempt to illustrate the possible medium and long-term impacts on potential output and public finances of successfully implementing the kind of structural measures discussed elsewhere in this Survey (see Annex A for details). They are by their nature crude projections and should not be viewed as predictions of the future. Rather they are presented to illustrate the unsustainability of the current stance of fiscal and structural policy on the one hand, and so as to give an indication of the order of magnitude of the benefits that could be expected from the successful implementation of the kinds of reforms discussed below. While actual outturns will doubtless differ substantially, the simulations should provide an accurate representation of both the direction and broad path of macroeconomic aggregates.

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Table 1.5. **Simulated impact of various reforms**[1]

	2005	Decade beginning 2010	2020	2030	2040	2050
		Per cent				
A. Unchanged policy scenario						
GDP growth	4.7	3.4	2.6	2.0	1.6	1.5
GDP per capita growth	4.8	3.6	2.9	2.5	2.2	2.1
GDP per capita relative to OECD 2005	41	60	82	106	133	149
GDP per capita relative to OECD (same year)	41	52	61	68	74	76
Capital output ratio	203	203	203	203	203	203
Labour productivity growth	4.7	4.0	3.5	3.3	3.3	2.8
Participation rate	62.7	62.8	63.7	61.2	58.6	58.9
Employment rate	51.1	53.2	53.9	51.8	49.7	49.9
Unemployment rate	18.5	15.3	15.3	15.3	15.3	15.3
General government account (per cent of GDP)						
Primary balance	–2.1	–2.1	–2.1	–2.1	–2.1	–2.1
General government balance	–5.5	–7.9	–11.3	–15.8	–22.1	–26.4
Primary balance consistent with debt sustainability	–0.2	0.3	0.7	1.0	1.2	1.3
B. Labour market reform						
GDP growth	4.7	3.8	3.0	2.5	1.8	1.5
GDP per capita growth	4.8	3.9	3.3	2.9	2.3	2.1
GDP per capita relative to OECD 2005	41	62	87	118	152	171
GDP per capita relative to OECD (same year)	41	53	65	76	84	88
Capital output ratio	203	203	203	203	203	203
Labour productivity growth	4.7	4.0	3.5	3.3	3.3	2.8
Participation rate	62.7	63.6	66.1	65.4	64.1	64.6
Employment rate	51.1	54.7	57.6	57.8	57.0	57.5
Unemployment rate	18.5	14.0	12.8	11.8	11.0	11.0
General government account (per cent of GDP)						
Primary balance	–2.1	–0.8	2.1	4.3	5.8	6.7
General government balance	–5.5	–6.3	–4.6	–2.5	–0.3	1.2
Primary balance consistent with debt sustainability	–0.2	–0.3	0.1	0.3	0.7	0.8
Growth dividend	0.0	1.8	4.7	6.7	8.0	8.8
C. Labour and product market reform						
GDP growth	4.7	4.1	3.4	2.8	2.3	2.1
GDP per capita growth	4.8	4.2	3.7	3.3	2.9	2.8
GDP per capita relative to OECD 2005	41	62	91	128	173	201
GDP per capita relative to OECD (same year)	41	54	68	82	96	103
Capital output ratio	203	205	211	215	220	224
Labour productivity growth	4.7	4.0	3.6	3.4	3.4	3.0
Participation rate	62.7	64.3	67.9	68.6	68.9	70.3
Employment rate	51.1	55.1	59.5	61.5	63.2	65.2
Unemployment rate	18.5	14.3	12.4	10.3	8.3	7.3
General government account (per cent of GDP)						
Primary balance	–2.1	–0.4	3.7	6.8	9.3	10.8
General government balance	–5.5	–5.7	–1.9	2.8	8.5	10.8
Primary balance consistent with debt sustainability	–0.2	–0.4	–0.1	0.2	0.4	0.5
Growth dividend	0.0	2.3	6.3	9.2	11.4	12.7

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Table 1.5. **Simulated impact of various reforms**[1] (*cont.*)

	2005	Decade beginning 2010	2020	2030	2040	2050
		Per cent				
D. Labour and product market reform plus rural restructuring						
GDP growth	4.7	4.2	3.5	3.0	2.5	2.3
GDP per capita growth	4.8	4.4	3.8	3.5	3.1	2.9
GDP per capita relative to OECD 2005	41	63	94	134	184	216
GDP per capita relative to OECD (same year)	41	54	70	86	102	111
Capital output ratio	203	204	206	206	207	208
Labour productivity growth	4.7	4.2	3.8	3.6	3.6	3.2
Participation rate	62.7	64.3	67.9	68.6	68.9	70.3
Employment rate	51.1	55.1	59.5	61.5	63.2	65.2
Unemployment rate	18.5	14.3	12.4	10.3	8.3	7.3
General government account (per cent of GDP)						
Primary balance	–2.1	–0.2	4.2	7.5	10.2	11.6
General government balance	–5.5	–5.4	–1.0	4.4	10.0	11.6
Primary balance consistent with debt sustainability	–0.2	–0.5	–0.2	0.1	0.3	0.4
Growth dividend	0.0	2.6	6.8	9.8	12.2	13.5

1. For details please see Annex A.
Source: OECD.

The first scenario reports a base case "no-policy change" projection, in which productivity continues to converge at the same pace as in the recent past and structural problems on the labour market persist. In particular, the natural rate of unemployment remains at 15 per cent and age and sex specific employment rates remain unchanged. As a result, potential output continues to increase only moderately, growing about 3½ per cent during the first two decades of this century and slowing afterwards both because of demographic developments and lower productivity growth as the economy catches up to the rest of the OECD.[13] The income gap with the rest of the OECD closes somewhat, with Polish per capita incomes reaching 76 per cent of concurrent OECD incomes by 2050. In terms of present day OECD incomes, the simulation suggests that these will be reached around 2030. The scenario incorporates the unrealistic assumption that the authorities fail to meaningfully reform public expenditure. As a result, while the public-sector deficit is expected to decline over the next few years as the output gap closes, the overall debt continues to climb rapidly. Notwithstanding an assumed stable primary balance (the difference between current revenues and expenditures excluding interest payments), the growing debt and associated interest payments cause the overall deficit to increase rapidly. Left unchecked, these debt dynamics would see the public debt quadruple by 2030, exceeding 200 per cent of GDP, with debt-servicing charges exceeding 10 per cent of GDP at that time. Further into the future, the situation rapidly becomes unstable.

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The authorities proposed Public Expenditure Reform, complemented by the additional measures outlined in Chapter 2 would, if implemented, help ensure that public finances remain on a sustainable path even if measures to improve potential growth are not taken. The following scenarios illustrate the additional benefits that might be expected if structural reforms are put in place to improve both labour and product market performance. The second set of results (scenario B) show the estimated impact on the same macroeconomic aggregates of reforms that succeed in reducing the structural unemployment rate to 11 per cent. In the scenario, the introduction of policies like those discussed in Chapter 3 is assumed to succeed in raising youth and older worker employment rates towards OECD average levels. This would raise potential output by 15 per cent by 2050 and employment by about the same amount, temporarily increasing the rate of growth by about 0.4 percentage point during the period 2010-2040. Improved resource utilisation means that the catch up process is accelerated with income levels reaching 85 per cent of contemporaneous OECD levels by 2045, about fifteen years more quickly than in the base case. Better labour market conditions improve fiscal prospects significantly, mainly because of higher tax revenues and lower social security expenditures associated with increased employment. Assuming no change in expenditures except the savings related to the fall in unemployment, the fiscal position of the general government is expected to improve by 8.8 per cent of GDP (the line labelled Growth Dividend). Assuming that these net savings are initially applied towards deficit reduction, such a reform would, over the longer-term, allow the volume of government services to increase by about 10 per cent as compared with the base-case scenario, while simultaneously allowing the overall tax burden to fall by about the same amount.

The third set of results shows the combined impact of the same labour market reforms and a set of structural policies that succeed in raising investment rates in the business sector by 4 percentage points and reducing firm-side employment barriers. A more rapid accumulation of capital is reflected in a faster increase in potential output, which at the end of the simulation period is 35 per cent higher than in the base case. The combination of faster growth and more favourable labour market conditions translates into a more rapid and profound improvement in labour market conditions, with employment 30 per cent higher than in the no-policy change scenario, reflecting substantially higher employment and participation rates as well as lower structural unemployment. Overall, convergence occurs much more quickly, with Polish incomes reaching 85 per cent of OECD levels by the middle of the 30s and current OECD levels in the next decade. Both better output and employment performance result in a higher growth dividend as compared with the second scenario.

The final scenario (D) adds to the previous by assuming that reforms spur a more rapid transition of the rural sector. This translates into a productivity boost, attributable to the movement of workers from the low-productivity rural sector to the industrial and service sectors. This improvement in productivity takes two forms, the

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first reflects an improvement in agricultural output to levels consistent with other European economies and the second reflects the improvement in productivity on the assumption that each worker moving from the agricultural sector to the non-agricultural sector exchanges average rural productivity level for the level associated with a minimum wage job. Notwithstanding the prudent nature of the assumption concerning the future productivity of the excess agricultural labour supply that is absorbed into the non-farm economy, the transformation adds between 1 and 0.2 percentage point to aggregate annual productivity growth over the whole period. Overall this serves to further accelerate income convergence, with income levels increasing by about 7 per cent as compared with the previous scenario – actually exceeding the OECD average (where somewhat unrealistically no structural reforms are assumed to occur). Poland reaches 85 per cent of OECD income levels by the middle of the 2030s and current OECD income levels by about 2030. All told, the growth dividend, in terms of the government's ability to expand programme spending or lower tax rates as compared with the base case, is estimated to be about 13.5 per cent of GDP.

Simultaneous reform in both product and labour markets is essential to success

The preceding simulations make clear the importance of taking steps to increase the rate of growth of potential output. Indeed, the potential gains from concerted action are large. However, an overly cautious approach to implementing reforms, some of which are likely to be politically difficult in the short run, risks slowing convergence and sapping political support for the transition. Moreover, the sequencing of reform is important. Critical priority needs to be attached to efforts to consolidate public expenditure. As long as the debt is increasing at current rates, it will be extremely difficult for the authorities to maintain a stable economic environment – an essential condition for placing the economy on a higher growth path. Not only would a rising debt ratio imply increasing international external disequilibrium and enhanced risk of exchange rate volatility, higher interest rates would slow the pace of investment and growth. By the same token, while reducing unemployment is likely to be the most effective strategy for increasing both economy-wide and individual incomes, labour market reform alone will not suffice. Product market and supply-side reforms aimed at spurring profitability, investment and activity must accompany those that seek to increase effective labour supply and reduce labour costs. An unequal path towards reform is unlikely to succeed. In the absence of substantial product market reforms, it is unlikely that adequate labour demand would be available to absorb the millions of people currently out of work, in underground employment or working in low-productivity activities in the rural sector. By the same token, unless steps are taken to reduce poverty and unemployment traps, the risk is that an increase in demand for labour, following product market reforms, is likely to be met by rising wages and persistently high unemployment instead of decreased joblessness and improved living conditions for currently out-of-work Poles.

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Notes

1. The Polish statistics office does not produce seasonally adjusted national accounts data. As a result, sub-annual growth rates are expressed as per cent changes of a given period over the same period the year before.
2. Public-sector employment which has decreased by 2.3 per cent in 2002 fell by an estimated 0.9 per cent in 2003.
3. See OECD *Economic Outlook*, 75.
4. Retail food prices have been falling for several years as a result of the competitive and efficiency pressures associated with the implantation in Poland of modern distribution and large-scale retailing enterprises.
5. While the zloty has also depreciated against many of these, the fact that price levels in these countries are lower than in the EU tends to reduce pass through.
6. The closest equivalent was the 18 per cent fall in employment and quintupling of the unemployment rate in Finland between 1990 and 1995.
7. While the causality is not clear, these developments are reflected in the pattern of restructuring in recent years where the bulk of job destruction has taken place in the low-skill, low-productivity sectors and most of the job creation is in high-productivity skilled-labour-intensive sectors.
8. The employment rates of Poles 15-24 years of age and 20-24 years of age are 33 and 55 per cent of the average for older workers (25-64 years old) as compared with much higher ratios of 45 and 77 per cent in the other transition countries.
9. The share of youth 20-29 in the working-age population increased by 2.4 percentage points in Poland between 1992 and 2003, by approximately the same amount in Slovakia and the Czech Republic and by substantially more in Hungary, 4.3 percentage points.
10. In terms of the accumulated stock of FDI, Poland remains the most important regional destination, with the majority of investments having been concentrated in the transport-equipment manufacturing, food-products, financial-services and trade and repair sectors.
11. Overall, in period 1994-2002 Poland has achieved an average rate of annual growth of FDI inflows of 17 per cent which was lower than in Czech Republic (57 per cent) or Slovakia (86 per cent) and Hungary (25 per cent). Moreover, despite the sluggish domestic investment, Polish ratio of FDI inflows to gross fixed capital formation was only around 11 per cent in 2002 as compared to a high 60 per cent in the Czech Republic, 56 per cent in Slovakia and 20 per cent in Hungary.
12. Polish agricultural producer support is estimated at 14 per cent as compared with 45 per cent for the EU and 38 per cent for the OECD as a whole.

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13. Both the base case and the other scenarios employ a calibrated Barro convergence model to capture the impact of catchup effects on total factor productivity.
14. Capital stock series has been rebuilt using the gross value of fixed assets in 2000 (Statistical Yearbook), investment series and an estimated capital stock scrapping rate close to that of Greece (8 per cent).
15. Detailed quinquennial data of labour force participation rates and population levels differentiated by sex are used to calculate the aggregate participation rate. Male and female participation rates are assumed to remain constant in each cohort at the 2001 levels. The participation rates are then combined with projections of population shares in each cohort to calculate the aggregate participation rate.
16. A larger share of the population reaches the 55-65 year age bracket, which is characterised by low participation rates, thereby reducing the average participation rate even though age-specific ones are held constant or even rising.
17. Employment and output data Poland have been very volatile, making difficult the calculation of a Polish employment to GDP elasticity in Poland. The OECD average used here is likely to be consistent with what would be observed under the modified institutional structure being modelled.

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Annex A

Long-term simulations

This appendix provides detail on the simulations discussed in Chapter 1. Assumptions employed to project potential output over the next 50 years are first discussed, followed by descriptions of the modelling of alternative measures that might be taken to improve long-term potential growth and fiscal positions.

Potential output

Potential output is calculated using the production function approach described in Giorno *et al.* (1995). Potential employment, total factor productivity (TFP) and the capital stock[1] are combined using Cobb-Douglas production technology to calculate potential output. The path for potential output until the end of 2003 is taken from the OECD *Economic Outlook* 74.

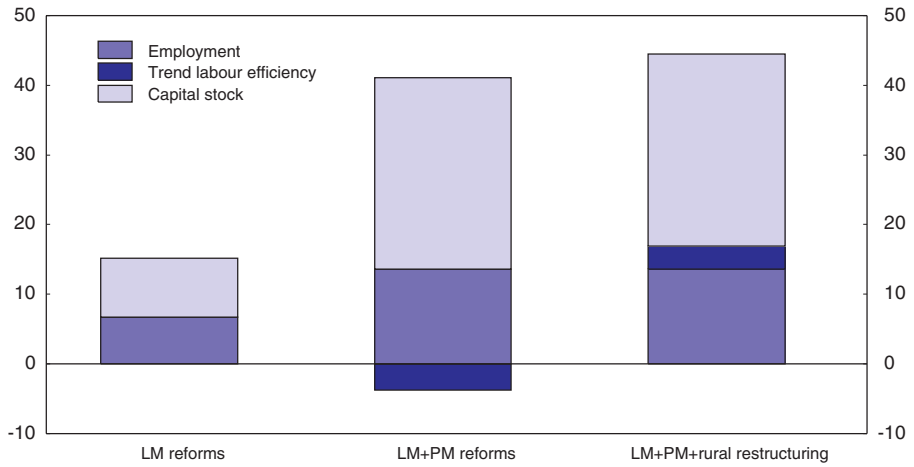
Unchanged policy scenario

Beyond 2003, for the base case "no policy change" scenario it is assumed that:

- Business investment will grow at a rate that keeps the business sector capital-to-output ratio stable.
- Population growth will turn negative in 2011 and remain so until 2050 as per the latest "medium variant" of the United Nations population projections.
- Trend unemployment (the NAIRU) will remain constant at the 2003 level of 15.3 per cent.
- Trend employment will be almost stable until 2010 and will decrease by 1 per cent per year until 2032 and then by 1.5 per cent until 2050 as a consequence of the population ageing effect that occurs from lower levels of participation in older age cohorts.[2]
- Trend labour productivity is deduced from a calibrated Barro convergence model to capture the impact of catch-up effects on total factor productivity. More precisely, trend labour productivity increases in line with OECD productivity plus a catch-up factor determined by the difference between Polish and OECD productivity levels. As a result, Polish productivity grows rapidly initially (4.5 per cent during the first five years) but as income converges to the OECD average, Poland productivity growth slows progressively to reach 3.0 per cent in 2050. The beta convergence coefficient (equal to 0.023) has been calibrated using 1997 data when growth reached 5.7 per cent, and thus corresponds to a rather fast catch-up scenario.
- No reforms are implemented in the OECD area so that income per capita increases by 1.5 per cent per year all along the period.

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Figure 1.A1.1. **Sources of additional potential output**
Per cent of base-case output



Source: OECD.

The alternative potential output scenarios shown in Table 1.5 maintain the same assumptions as the base case with respect to population growth but relax others. Figure 1.A1.1 illustrates the sources of additional growth in each scenario as compared with the base-case scenario.

Labour market reform scenario

To examine the impact of labour market reforms on potential growth (scenario B), the following changes to the assumption of the base case scenario are introduced:

- The structural unemployment rate is arbitrarily reduced to reach 11 per cent in 2050.
- Male and female participation rates are raised and the gap between male and female participation is closed somewhat.

As a result, the overall participation rate reaches 66 per cent in 2030 and then decreases due to population ageing[3] while employment rate approaches 60 per cent (a 20 per cent improvement over the status quo). Overall, these reforms bring Poland gets closer to the Lisbon objectives.

Labour and product market reform scenario

To examine the impact of a simultaneous implementation of labour and product market reforms (scenario C), the following assumptions are added to scenario B:

- The capital-to-output ratio is permanently increased by 20 points of percentage compared to scenario B, which corresponds to a temporary increase in the investment-to-output ratio of 4 points of percentage and a permanent one of 2 points.

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– The additional economic growth coming from stronger investment is shared between employment and labour productivity growth. An elasticity of 0.3 for the labour response to the additional productive activity is assumed.[4]

As a result of the further increase in employment induced by stronger investment, the NAIRU decreases to 7 per cent and the participation rate increases since more people are brought back to the labour market. Trend labour productivity gains slow down somewhat even though individual productivity growth rates remain unchanged because unskilled workers with lower than average productivity are re-absorbed into the labour market.

Labour market and product market reform plus rural restructuring scenario

Scenario D adds rural restructuring to scenario C. The impact of rural restructuring takes two forms. First, productivity gains are enhanced in the agricultural sector. Second, labour mobility is improved through infrastructure investments in rural areas so that the share of employment in the business sector with higher productivity increases. As a result, the negative impact on trend labour productivity growth of bringing people back to the labour market is more than offset and trend labour productivity in the economy as a whole grows 0.2 percentage point faster than in the base case, which leads to higher economic growth and faster income convergence.

Projection of fiscal positions

Fiscal scenarios are projected from 2005 taking the Ministry of Finance deficit projection for 2004. Beyond 2005, it is assumed that:

– Government expenditures and receipts are kept constant relative to potential output in the base case fiscal projections.

– In scenarios B to D, income tax rates are kept equal to the ones of the base case scenario. The share of social security expenditures in GDP decreases as non employment reduces. Other expenditures are kept constant relative to potential output.

– The interest rate on debt is held constant at its value in 2003. This is a relatively benign assumption, which abstracts from the expected increase in the risk premium on the Polish zloty as the debt rises.

– Following current Polish methodology, the compulsory contributions of individuals to privately managed fully-funded pension accounts are included in the revenue side of the government deficit and the associated transfers to individuals' accounts are excluded from the expenditure side of the deficit. However, those additional expenditures are added to the debt accumulation. It is assumed that contributions to Open Pension Fund represent 2 per cent of GDP.

– Privatisations revenues are set to 3 billion zloty per year until 2013.

As a result of those assumptions, in the base case scenario the primary deficit-to-GDP ratio remains constant while the deficit-to-GDP ratio increases because of the growing debt-servicing burden.

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Notes

1. Capital stock series has been rebuilt using the gross value of fixed assets in 2000 (Statistical Yearbook), investment series and an estimated capital stock scrapping rate close to that of Greece (8 per cent).
2. Detailed quinquennial data of labour force participation rates and population levels differentiated by sex are used to calculate the aggregate participation rate. Male and female participation rates are assumed to remain constant in each cohort at the 2001 levels. The participation rates are then combined with projections of population shares in each cohort to calculate the aggregate participation rate.
3. A larger share of the population reaches the 55-65 year age bracket, which is characterised by low participation rates, thereby reducing the average participation rate even though age-specific ones are held constant or even rising.
4. Employment and output data Poland have been very volatile, making difficult the calculation of a Polish employment to GDP elasticity in Poland. The OECD average used here is likely to be consistent with what would be observed under the modified institutional structure being modelled.

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2. Towards a sounder macroeconomic policy mix

Macroeconomic policy has played a key role in Poland's economic transition by helping to establish the kind of stability and predictability that are essential to economic growth. As a result, high inflation has been brought down to low levels and kept there for several years. On the fiscal front, after successfully negotiating a restructuring of its debt, Poland has successfully avoided generating the kind of major crises experienced by many other transition economies. As a consequence, viewed over the whole transition period, the exchange rate has remained relatively stable and the value of domestic savings and foreign investments have been preserved. Notwithstanding these achievements repeated budgetary overruns have led to a steady build up of debt, which is approaching the constitutional limit of 60 per cent. Moreover, the mix of policy has been unfortunate with very high real interest rates offsetting a persistently loose fiscal policy to the detriment of investment and economic convergence. Looking forward, the main challenges facing macroeconomic policy are to maintain inflation at a low level and to slow the pace of public expenditures so as to bring the debt under control. To meet these challenges will require further adjustments to the macroeconomic policy mix and additional improvements to the efficiency, targeting and medium-term management of public expenditure.

Monetary management

The inflation-targeting framework

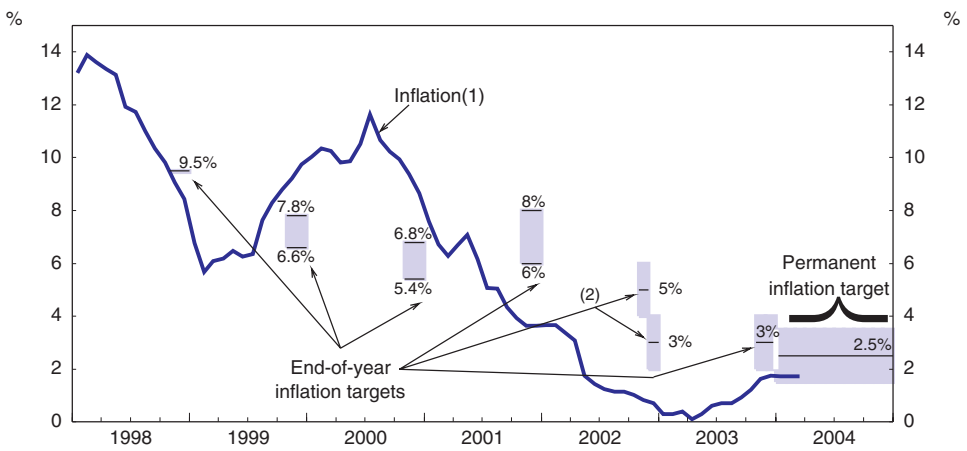
The National Bank of Poland (NBP) has operated an inflation-targeting regime since September 1998. While initially it was coupled with a crawling-peg exchange rate system with wide fluctuation bands, since April 2000 the authorities have adopted a floating exchange-rate regime. The basis for policy making was originally outlined in the NBP's (1998) *Medium-term Monetary Policy Strategy* (1999-2003), which set out the goal of reducing inflation to a level below 4 per cent annually by 2003. This strategy was regularly supplemented by the Bank's *Monetary Policy Guidelines*, which set out short-term targets for end-of-year inflation, the last of which was 3 ± 1 per cent for December 2003. Most recently, a revised strategy document (NBP, 2003b) was published. It recognises that the disinflationary challenge that shaped the previous strategy has ended and that the Bank's main challenge is now

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to keep inflation low, a challenge it correctly considers to be qualitatively different than the previous one of reducing inflation. As a result, the new strategy does away with annual targets, replacing them with a permanent medium-term inflation target of 2.5 per cent surrounded by a permissible volatility band of ± 1 per cent. The Bank judges that this is a level that is consistent both with strong economic growth and the euro reference rate of inflation, which since 1998 has fluctuated between 1.8 and 3.4 per cent. The acceptable range around the target reflects the authorities' recognition that inflation might over or undershoot its objective because of factors that it considers 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. The strategy explicitly notes that if such factors cause the inflationary outturn to temporarily deviate from the target band, then monetary policy will react so as to maximise its chance of achieving its target in the medium term. Finally, the new strategy sets out the adoption of the *euro* as a core medium-term monetary-policy goal, indicating 2007 as an earliest possible date and recognising that the achievement of only some of the criteria for membership in the euro zone can be influenced by monetary policy.

Poland's experience with inflation targeting has been mixed (Figure 2.1). Although the Bank's inflation objective has been undershot for three consecutive years, the policy has successfully brought inflation down to (below) levels in other

Figure 2.1. **Inflation and the NBP's inflation targets**



1. Consumer price index: 12-month percentage changes.
2. The 2002 end of year inflation target was changed to 3 ± 1 per cent on 26 June 2002.

Source: Central Statistical Office.

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OECD countries and, perhaps more importantly, inflationary expectations appear to have moderated permanently. As discussed in the previous *survey*, the effectiveness of an inflation targeting strategy does not depend solely on the extent to which targets are achieved (although obviously meeting targets helps). Especially in the case of a small, open and emerging economy, uncontrollable external factors can affect headline inflation and the monetary authority's ability to achieve its objectives. Indeed, as the Bank notes, to a large extent the past undershooting of the Bank's target was due to such factors beyond the capacity of monetary policy to influence (NBP, 2003b), notably falling food prices (see Chapter 1), and lower than announced increases in administratively regulated prices – which represent 28 per cent of the overall consumption basket in Poland. Indeed, the bank's indicators of core inflation, although not targeted, have tracked the Bank's inflation objectives much more closely than the headline measure.

Given that headline inflation is subject to substantial volatility, the overall success of the Bank's inflation targeting regime depends importantly on the effectiveness and transparency of its communication strategy. In this regard, the Bank disposes of a number of publications, including its quarterly I*nflation* Report, its monthly S*tatistical* B*ulletin*,as well as regular press conferences following meetings of the Monetary Policy Council. Notwithstanding the high quality of its analysis, the Bank recognises that the extent to which NBP's I*nflation* R*eport* serves as an effective tool for explaining recent price and exchange rate developments to markets and the public would be improved if the report were released in a more timely fashion. The substantial delays between the events described and the report's publication reduce its relevance and its capacity to influence expectations. In particular, delays of more than 6 months in the release of the English language version of the NBP's I*nflation* R*eport* are far too long and even the two month delay preceding the publication of the Polish version should be shortened.[1] As a result, officials are considering accelerating the publication process. Here, the publication of a condensed version or even a preliminary translation and less finished presentation (similar to that of the early version of the Polish language version) would help keep both financial markets and the public abreast of conditions in Poland and factors influencing monetary policy decision making. This would reduce uncertainty, perceptions of risk and speculation, while increasing levels of investment. Moreover, the report's influence on expectations could be improved if it were to include a more comprehensive but nevertheless approachable executive summary distilling both its conclusions and the evidence that led the authorities to arrive at them.

In an effort to enhance its ability to influence expectations and improve communications the Bank is also considering publishing the inflation forecasts that underlie its decisions as well as more explicit information on how projections are arrived at and how the authorities would react to various kinds of deviations from that projection. Such steps would be particularly welcome as a more regular

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and rigorous exposition of the Bank's views concerning inflation, including an analysis of the sensitivity of the forecast to exogenous assumptions would help market-players evaluate the expected future stance of policy. An effort in this regard is included in the Monetary Policy Guidelines for 2004 (NBP, 2003a), which explicitly indicate the Bank's expectation for food and administered price inflation.[2] As welcome as this is, it needs to be made more systematic, supplemented by projections for other elements in the CPI and kept up to date. Such a step would also facilitate *ex post* explanations as to why the inflation target was missed, should that happen. Moreover, it would correct the current somewhat unusual situation, where it is the Ministry of Finance – not the central bank – that makes regular public forecasts of inflation. Once its forecasts are made public, the Bank will probably want to signal more clearly how these forecasts may impact the future stance of policy perhaps by more actively indicating the direction of possible future changes in policy following its regular monetary policy council meetings. Indeed, the new monetary council has made several such announcements since February 2004. These are welcome and have helped dissipate some of the uncertainty over the future stance of policy.

As indicated in the previous *Survey*, the credibility of the Bank depends on the continuity of its policy. Here, the current practice of replacing the entire council once every 6 years could introduce unhealthy swings in, and uncertainty as to, the conduct of monetary policy. In this regard, the recent wholesale replacement of the Monetary Policy Council (MPC) was achieved relatively smoothly. However, speculation over the eventual composition of the council, and the possibility of a radical change in policy, occupied a considerable amount of financial markets attention. While there is only limited evidence that this had measurable impacts on the operation of markets,[3] the risk that it would in the future is real.[4] To guard against this and in order to ensure continuity in the conduct of monetary policy, the statutes of the MPC should be revised so that the council members are appointed to overlapping terms. To facilitate the transition to such a new regime, some current members could volunteer to resign before the expiration of the current term,[5] or, the first time the new council is selected under these rules one third of its members could be selected for terms of 2, 4 and 6 years each. The need for overlapping terms is all the more necessary given the politicised manner in which they are currently selected (one third of the MPC being appointed by the Sejm [the lower house of Parliament], Senate and President respectively).

The conduct of monetary policy

Since the previous *Economic Survey* in July 2002, the National Bank of Poland has continued its programme of gradual reductions in interest rates but most recently has signalled that it may begin raising them in the future. It lowered rates a total of 6 times during the first half of 2003, bringing its reference rate from

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6.75 per cent in January to 5.25 per cent in June, since then no additional changes have been made (Figure 2.2). Following its April 2004 meeting, the MPC indicated it had adopted an upward bias towards interest rates.

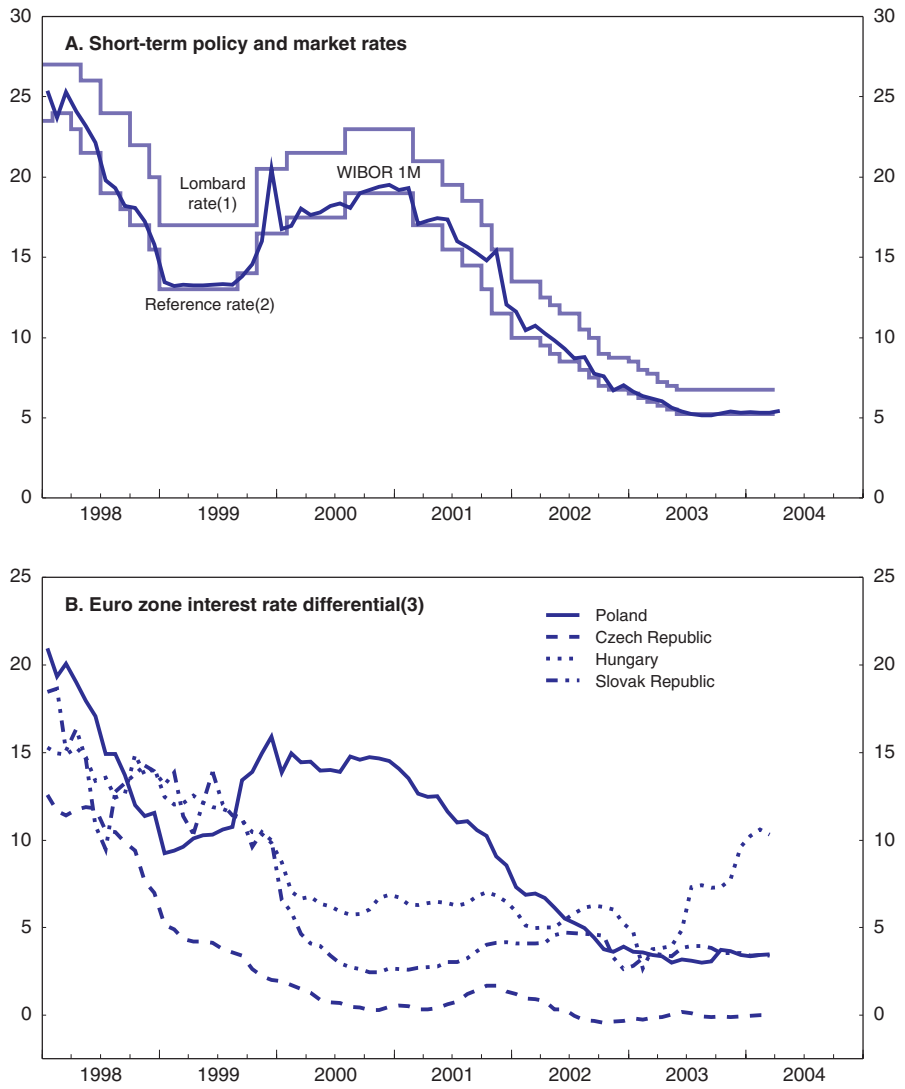
As was the case when the programme of gradual declining policy rates was initiated, the reduction in rates was accompanied by falling inflation, so that the net impact on short-term real interest rates was less sharp. However, since June, headline inflation has shown a tendency to rise. As a result, and notwithstanding stable nominal rates, short-term real interest rates have continued falling. This decline has greatly reduced the interest-rate premium *vis-à-vis* the euro, which now stands below the premium in Hungary and about on a par with that in Slovakia, but nevertheless much higher than in the Czech Republic where it is close to zero. Moreover, real rates at 4.2 per cent remain high.

Beginning in mid 2002, falling real interest rates were accompanied by a sharp depreciation of the currency *vis-à-vis* the euro. In contrast, Poland's US dollar exchange rate initially remained broadly stable before appreciating against the dollar towards the end of 2002. Overall on a trade-weighted basis the currency has lost 23 per cent of its value since the second quarter of 2001. The combination of falling real interest rates and the sharp effective depreciation of the currency led to a substantial easing of monetary conditions, which are now below their average 1996-2003 level (Figure 2.3). Although not a factor used in the calculation of the MCI, the reduction in banks' obligatory reserve requirement from 4.5 per cent to 3.5 per cent of deposits should increase banks' liquidity and by reducing lending costs likely eased financial conditions further.

Since the previous survey, the gradual fall and flattening in the yield curve that characterised the disinflationary period has been reversed (Figure 2.4). Beginning in June 2003 (the date of the most recent reduction in short-term interest rates) the yield curve for maturities of one and more years began to rise, with the 10 year zero-coupon yield increasing by more than 170 basis points. The implied forward rate of interest suggests that markets now expect an almost 100 basis point increase in rates over the next 12 months and some 150 basis points over the next three years. Interpretation of these developments is difficult. On the one hand, the development of a positively sloped yield curve is consistent with an end to the disinflationary period and the onset of the economic recovery. On the other hand, the extent of the reversal and the still high risk premium on zloty-denominated assets suggests that events have caused markets to re-evaluate the likelihood of either a resurgence of inflation or a further depreciation of the currency. This latter interpretation is given more credence by the relatively short-time period during which the changes occurred, a period characterised by rising inflation, exchange rate depreciation as well as uncertainty over both the composition and future conduct of the new monetary policy council (as discussed above) and the likelihood that the government's public expenditure reform would be passed.

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Figure 2.2. **Interest rate developments**
Per cent

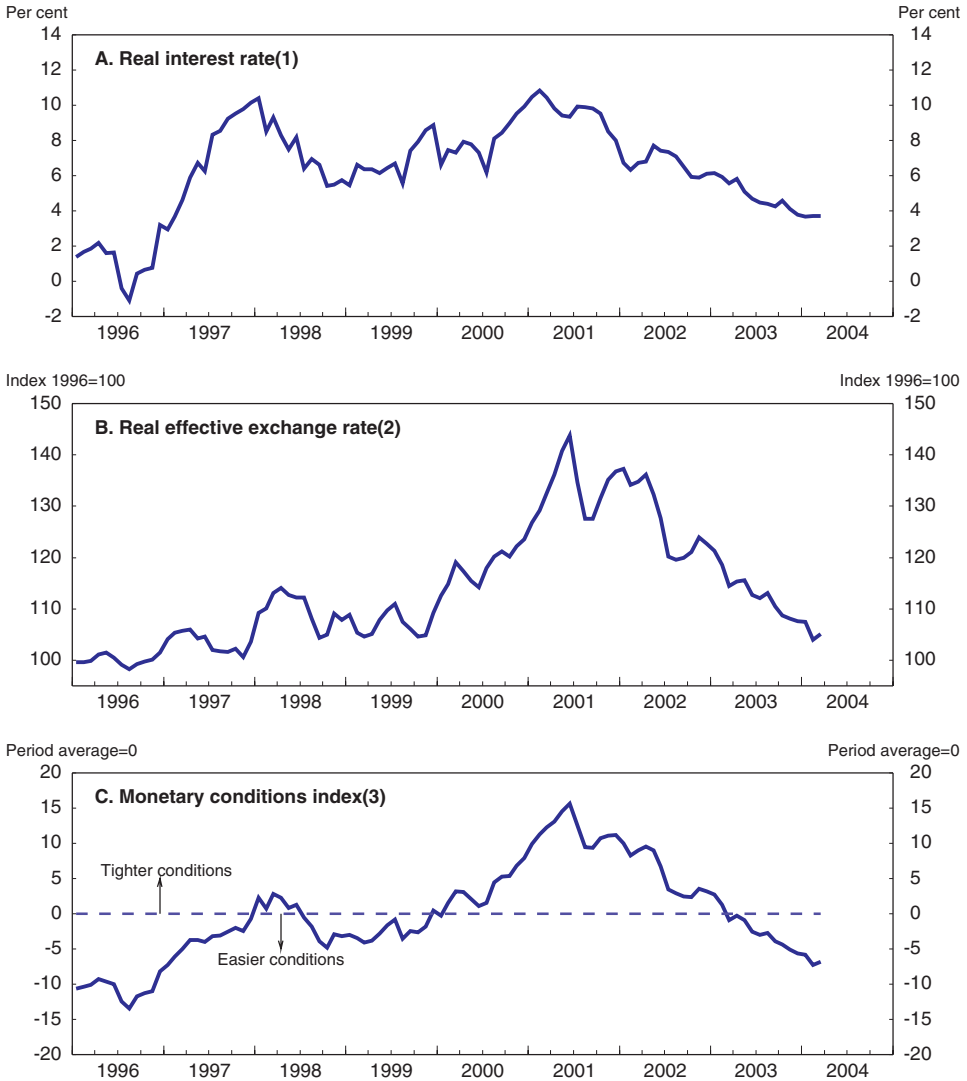


1. End of month.
2. Prior to January 2003, the reference rate has a 28-day maturity. Since then it is 14 days.
3. Three-month interest rate minus 3-month EURIBOR.

Source: National Bank of Poland and Datastream.

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Figure 2.3. **Monetary conditions**

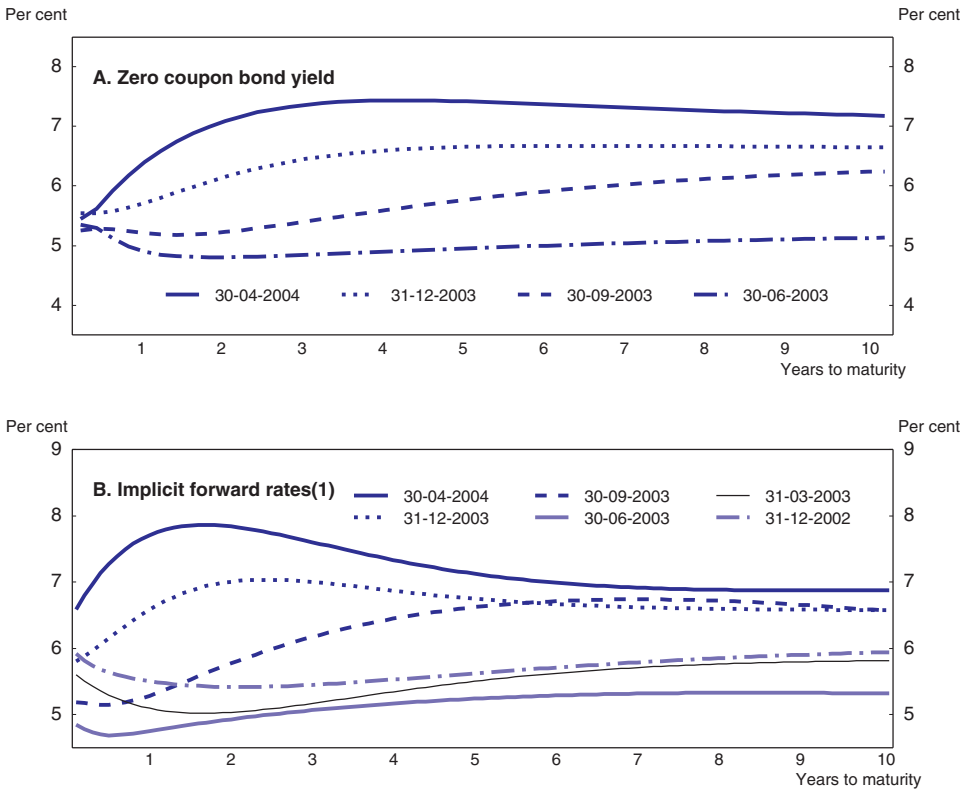


1. Three-month treasury bill, CPI deflated.
2. Real effective exchange rate calculated with forty-two countries, based on CPI.
3. The monetary conditions index is defined as
   MCI = MCI[t-1] * (1+(r-r[t-1]) + w *(e/e[t-1] –1))
   r = real short-term interest rate, CPI deflated
   e = real effective 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 2.4. **Yield curves**



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.

Reflecting the generalised easing of conditions, the money supply (M3) began increasing once again during the course of 2003. The turnaround was driven mainly by a 9 per cent (year-over-year) increase in lending activity as of the end of the year. Recorded deposits continued to fall but less quickly, although interpretation of these data are clouded by regulatory changes introduced at the end of 2002 that gave banking clients strong financial incentives to move into other saving vehicles. While corporate lending is up only 2.2 per cent, loans to households

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Table 2.1. **Monetary aggregates**

	1997	1998	1999	2000	2001	2002	2003[1]
	Annual growth, end of period						
Money growth							
M1	16.8	13.5	23.9	–4.4	11.1	15.5	15.7
M2	28.1	24.7	20.1	11.8	9.2	–2.4	5.5
M3	27.9	24.7	20.1	11.9	9.2	–2.0	5.6
Deposits							
Household	36.0	26.4	15.2	20.0	6.7	–3.7	–2.2
Non-financial corporations	22.5	33.7	23.2	–1.5	16.4	1.4	24.1
Loans to							
Household	49.9	24.8	40.2	27.4	14.7	7.9	14.0
Non-financial corporations	28.4	27.7	18.3	12.8	3.2	0.4	2.2

1. December 2003.
Source: National Bank of Poland.

have increased by 14 per cent, with the bulk of this increased activity coming in the form of new housing loans[6] – which represent 30 per cent of all household lending, up from less than 5 per cent in 1997.

Evaluating the current stance of monetary policy

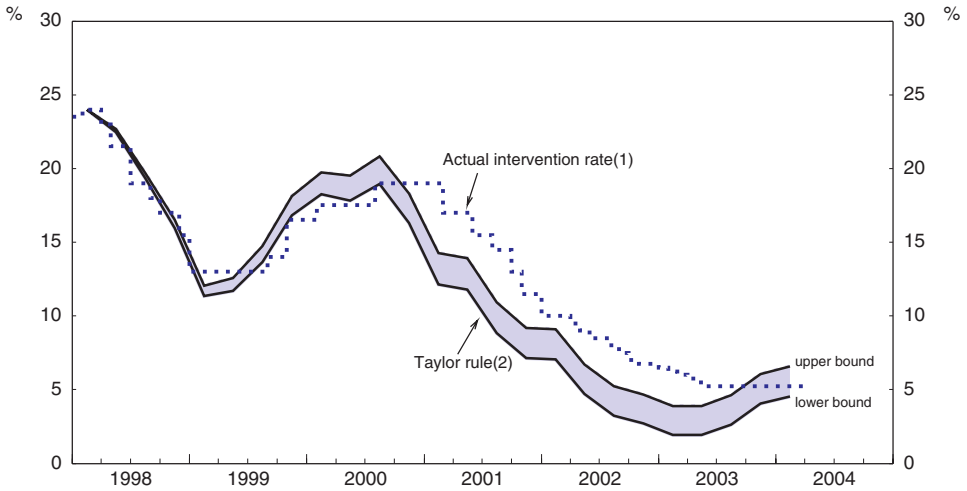
Overall, the stance of monetary policy appears to be broadly appropriate. The Taylor rule no longer suggests that there is additional room for monetary easing (Figure 2.5). Moreover, it does not take into consideration the influence of the strong depreciation of the currency, which has contributed importantly to the strong relaxation of monetary conditions over the past year. As a result, even with stable (or even rising) interest rates, monetary conditions will continue to exercise a stimulative effect on the economy throughout the next year. In this context and given the very expansionary stance of fiscal policy (see below) and already strong growth, the Bank's recent announcement that it expects its next move to be one of raising interest rate appears consistent with its inflation target and economic conditions. Indeed, developments on the yield curve and the tendency for the currency to depreciate as nominal interest rates decline suggests that further cuts to short-term interest rates would be counter-productive, stimulating concerns of a further fall in the currency and adding to the risk premium on longer-term paper and the currency in general.

Adopting the euro

The second major challenge set out in the NBP's strategy is the adoption of the euro. From a monetary policy point of view Poland appears to be relatively

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Figure 2.5. **Taylor rule**



1. Intervention rate on 28-day operations until end of 2002, 14 days afterwards.
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. From 2002, the equilibrium interest rate used in both the upper and lower bands decline by 25 basis points per quarter until they reach 5.5 and 3.5 per cent respectively in 2003 Q3 – levels broadly consistent with estimates by Brzoza-Brzezina (2004).

Source: OECD.

well placed to meet the Maastricht Treaty requirements for such a move. Until the recent rise in long-term rates, the inflation and interest rate criteria had been met and need only have been maintained (see Box 2.1 and Figure 2.6). On the other hand, Poland's adoption of a floating exchange-rate system (as opposed to the managed float around a central parity called for in the European exchange-rate mechanism) makes evaluating Poland's performance with respect to the exchange rate criterion more problematic. Nevertheless, it is worth noting that Poland's exchange rate has remained broadly stable *vis-à-vis* its former currency basket, over a period of almost ten years (Panel C, Figure 2.6). Against the euro it has shown more volatility (Panel D, Figure 2.6). Finally, as is discussed in the following section, Poland will need to exercise much closer control over public expenditures if it is to meet the fiscal policy requirements of the Treaty.

The authorities argue that the potential advantages of adopting the euro appear to outweigh the disadvantages (NBP, 2004). The former include:

– Intensified trade activities with the euro-zone arising from the elimination of foreign exchange rate risk and reduced transactions costs;

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Box 2.1. Poland's position with respect to the Maastricht Criteria for euro adoption

The Maastricht agreement specifies convergence criteria for euro-zone candidates with respect to: inflation; long-term interest rates; stability of the exchange rate; and the general government deficit and debt. Poland seems to be well positioned to meet those criteria directly dependent on monetary policy. Thus, inflation is currently and has been for some time within the permissible range under the treaty[1] (Figure 2.6). Similarly, long-term interest rates are approaching the upper limit of the Maastricht reference value[2] (Panel B. Figure 2.6). Meeting the exchange rate criterion may pose more difficulty.

The exchange rate criterion is judged upon the performance of a country's currency within the European exchange rate mechanism (ERM II), which consists of a fixed exchange rate regime comprising a central parity surrounded by ± 15 per cent permissible fluctuation band. The criterion requires that a currency has participated in the mechanism for a period of at least two years prior to the convergence assessment without experiencing severe exchange-rate market tensions, in particular without devaluing against the euro. The European authorities indicate that the assessment of exchange rate stability will focus on the exchange rate being close to the central rate, after having taken into account factors that may have led to an appreciation. Over the past three years, within the context of Poland's free float regime, the zloty has been relatively stable against its former currency basket, but has been fairly volatile with respect to the euro.

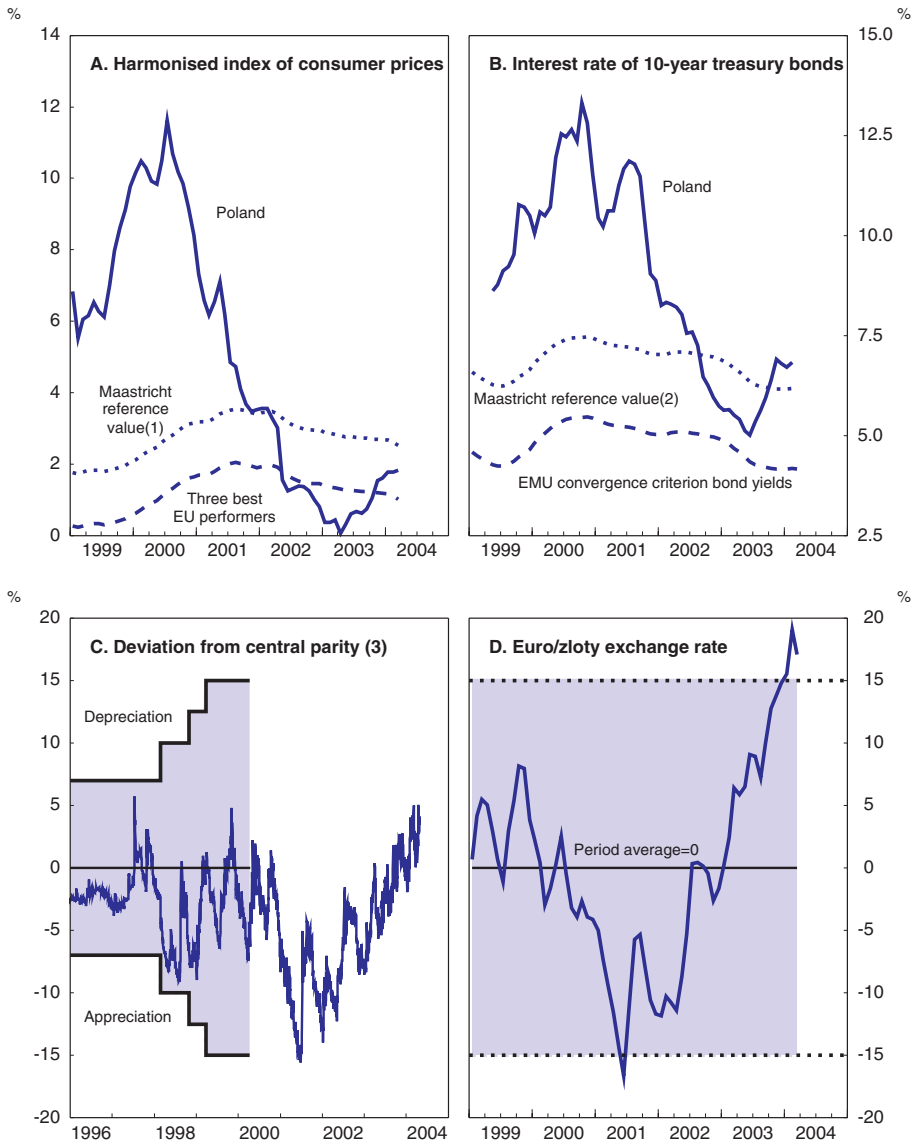
The other two criteria concern fiscal policy, maintaining a general government deficit of less than 3 per cent of GDP and a debt to GDP ratio of less than 60 per cent. For the moment, Poland's deficit exceeds the Maastricht level and although its debt (as measured under the terms of the Treaty) is well below the 60 per cent limit it is rising quickly.

1. The inflation criterion is fulfilled when the annual average inflation rate, as measured by the Harmonised Index of Consumer Prices, as used in the European Union, upon verification does not exceed the average inflation of the three EU states with the lowest price growth ratio by more than 1.5 percentage points.
2. The long-term interest rate criterion is fulfilled when the average annual nominal interest rate on long-term (typically 10-year) treasury bonds does not exceed the average calculated for the three best performing EU states in terms of price stability by more than 2 percentage points.

– Faster interest rate convergence with the euro-zone, which should yield higher levels of investment rates as capital costs fall;
– Elimination of exchange-rate and interest-rate risk should also spur foreign direct investment;
– Increased efficiency because of additional competitive pressure in domestic markets as trade and price comparability are enhanced.

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Figure 2.6. **Poland's position with respect to the Maastricht criteria**



1. The Maastricht reference value is the twelve-month moving average of the inflation of the three best EU performers plus 1.5 per cent.
2. Average of the convergence bond yields of the three best performing euro member states in terms of price stability plus 2 per cent.
3. 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 averaged of the euro (55%) and the US dollar (45%).

Source: National Bank of Poland and OECD.

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Disadvantages mainly concern the loss of an independent monetary policy. Here, the significant differences between the structure of the Polish and present euro-zone economies mean that in the presence of some external shocks (such as an economic crisis or overheating in eastern Europe), monetary policy appropriate for the euro-area as a whole may not meet the needs of the Polish economy. The loss of the macroeconomic price flexibility provided by a floating exchange rate could force employment and growth to bear a disproportionate share of the adjustment to external shocks especially if domestic prices and wages show signs of rigidity – where a national exchange rate would have provided for a smoother reaction. Under the current regime, such shocks are at least partially dampened by exchange rate movements, which affect all prices and therefore competitiveness simultaneously. Finally, the absence of a made-in Poland monetary policy will make the economy much more reliant on the good conduct of domestic fiscal policy.

Fiscal policy

Evaluating the stance of fiscal policy is complicated by the large number of different concepts used to measure the budget balance in Poland (Table 2.2). Official measures include:

- The balance of the State Budget, which is reported monthly on a cash-flow basis by the Ministry of Finance (MoF).
- A partially consolidated central government cash-flow measure (based on IMF methodology) which is widely reported in the press.
- The annual GFS accounts, which are released with a nine month delay on a cash-flow basis (calculated using the IMF Government Financial Statistics methodology).
- An accruals-based account following national accounting methodology which is also released with a nine-month delay.

The deficits associated with these various measures vary widely (Table 2.2). The OECD's preferred measure for fiscal policy analysis is the broad general government concept on an accruals basis, which permits greater comparability across countries. As indicated, Poland produces such a measure, but with the publication of its 2002 accounts in August 2003, there has been a significant change in how Poland calculates it, which has important ramifications for policy. In particular, the authorities revised the parameters of what they consider to be the general government, including as a government revenue the compulsory contributions to individuals' privately managed fully-funded pension accounts, but excluding from expenditures the associated transfers to individuals' accounts. As a result of this accounting change, the official estimate of the overall deficit for 2003 fell by some 1.6 per cent of GDP as compared with the earlier method. As indicated in

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Table 2.2. **Various measures of the stance of fiscal policy**
Per cent of GDP

	1994	1995	1996	1997	1998	1999	2000	2001	2002	2002[1]	2003[2]
State budget											
Revenues	27.5	26.3	24.7	24.0	22.9	20.5	19.0	18.7	18.6	–	18.9
Expenditures	30.8	29.6	28.1	26.6	25.2	22.5	21.2	23.0	23.7	–	23.7
Balance	–3.3	–3.3	–3.3	–2.6	–2.4	–2.0	–2.2	–4.3	–5.1	–	–4.8
Consolidated central government											
Revenues	39.4	38.3	37.2	36.5	35.6	32.7	30.0	29.9	29.2	30.6	–
Expenditures	41.5	40.2	39.3	38.3	36.6	33.5	29.8	34.1	34.6	34.5	–
Balance	–2.1	–1.9	–2.0	–1.8	–1.0	–0.8	0.3	–4.3	–5.4	–3.9	–
General government (GFS basis)											
Revenues	44.1	43.0	42.3	41.8	40.7	41.1	38.1	38.0	37.3	38.6	–
Expenditures	46.3	44.8	44.4	43.7	41.8	41.9	37.9	42.5	43.2	42.9	–
Balance	–2.2	–1.8	–2.1	–1.9	–1.1	–0.8	0.1	–4.5	–5.8	–4.3	–
Economic balance											
Balance	–	–	–	–	–3.2	–2.9	–1.9	–4.5	–4.9	–	–5.2
SNA93 (including revenues of Open Pension Funds)											
Revenues	45.8	51.4	43.1	42.9	41.5	41.4	42.8	43.2	42.8	–	42.6
Expenditures	49.3	54.2	45.9	45.6	43.8	43.4	45.2	46.2	46.5	–	46.8
Balance	–3.5	–2.8	–2.9	–2.8	–2.3	–2.0	–2.5	–3.5	–3.6	–	–4.1
SNA93 (excluding revenues of Open Pension Funds)											
Balance	–3.5	–2.8	–2.9	–2.8	–2.3	–2.4	–3.9	–5.0	–5.5	–	–5.7
Memorandum items											
Public-sector employment (thousands)	2 265	2 215	2 247	2 267	2 256	2 180	2 140	2 006	2 077	–	2 058
Public-sector employment (% of total)	15.5	15.0	15.0	14.9	14.7	14.8	14.7	14.1	15.1	–	15.1

1. In 2002 a new methodology for calculating the central and general government accounts on a GFS basis was adopted, which includes transactions involving the Open Pension Funds.
2. Budget data for the State Budget, OECD estimate for SNA93 data.

Source: OECD calculations based on data from Ministry of Finance and the Central Statistical Office.

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Box 2.2. Accounting for the private pension scheme

With the release of its 2002 general government accounts on an ESA95 basis, the Polish authorities revised their treatment of the compulsory contributions to the fully-funded private pension scheme. Previously both the revenues and expenditures (in the form of transfers to the privately administered full-funded pension funds) from this scheme were recorded outside of the government sector. The new treatment includes the contributions as a government revenue but excludes the transfer of money to the funds from current expenditures – instead recording this as a capital transfer below the line. By the same token, it excludes the interest paid on government debt held by the private pension funds from current spending, although both feed into the calculation of the debt. As a result, the officially recorded deficit is lower according to this treatment as compared with the past – by an estimated 1.6 per cent of GDP in 2003.

The authorities argue that because of the compulsory nature of the pension scheme, its revenues (and presumably its future expenditures) should be considered within the government sphere. Moreover, they argue that excluding the scheme from the government sector would penalise Poland in international comparisons as compared with other countries that have not implemented a pension system reform and whose recorded deficit does not take into account the annual increment to their unfunded pension liabilities. While this argument has merit, the problem of international comparability derives from the failure of standard national accounting technique to count as part of the deficit the annual change in the net present value of the pension liabilities of countries that have not reformed their pension systems. While steps should likely be taken to address this shortcoming, its existence should not be used as a justification for Poland to adopt a less prudent approach.

Indeed, the revised Polish treatment has the serious disadvantage of causing the official deficit to substantially underestimate the contribution of the general government's current activities to the public debt. Moreover, by presenting a lower deficit number it risks lulling policy makers into a false sense of security with the result that they might spend more than otherwise. At the limit, if they were shortsighted and targeted a nominal deficit number (independent of the accounting scheme used) the rate of debt accumulation under the Polish method of accounting would be exactly the same as if the pension scheme were not funded but operated on pay-as-you-go principals. Instead of pre-paying a portion of the future pension liability as originally envisaged in the pension reform, the government would spend it considerably reducing the benefits of the reform from a public finance point of view.

Overall, if a prudent fiscal policy would require that Poland's cyclically-adjusted deficit not exceed 2 per cent of GDP under the old definition, under this new definition a balanced budget would be required.

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Box 2.2, the revised measure underestimates the extent to which the current activities of the general government contribute to the accumulation of the public debt. As a consequence, its utilisation carries with it the important risk of generating complacency on the part of policy makers as to the position of public finances, which could undo the positive impacts, from a public finances point of view, of the 1998 pension reform. Unless otherwise stated, this *Survey* uses these numbers, which are the official ESA95 numbers currently reported to the European Union. While no decision has been made as concerns this new treatment, a recent Eurostat framework decision appears to conclude that among pension schemes that may be managed by government, a defined contributions funded scheme cannot be classified as a social security scheme.[7] As such it appears to suggest that both the contributions to Poland's privately managed Open Pension Funds and the associated transfers should be excluded from the government sector. Should this interpretation be confirmed in the case of Poland, it would imply that the deficit for 2003 was about 5.7 per cent of GDP as opposed to 4.1 per cent according to the current methodology. Independent of the measure used, Poland's public finance 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. Moreover, 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.

The fiscal stance

The economic slowdown of the past several years was reflected in a substantial increase in the government deficit, which rose on a revised Polish national accounting basis from 2.5 to an estimated 4.1 per cent of GDP between 2000 and 2003. In 2004, the authorities foresee a further relaxation of fiscal policy, with the general government deficit projected to reach 5.7 per cent of GDP. Excluding the open pension funds from the government sector, this reflects an increase from 3.9 per cent in 2000 to an estimated 7.5 per cent of GDP in 2004. While much of the increase in 2002 and 2003 reflected cyclical developments, the structural deficit is estimated to have increased by 0.9 per cent of GDP between 2001 and 2003 (Table 2.3), and the projected rise for 2004 corresponds to an estimated 2.0 per cent of GDP further relaxation of fiscal policy (on a cyclically-adjusted basis), which would bring the structural deficit to almost 4.7 per cent of GDP or 6.5 per cent if the pension scheme is excluded from the government sector.

The accumulation of repeated deficits has caused the public-sector debt to rise to almost 51 per cent of GDP in 2003. Unless policy is tightened, the debt ratio is expected to breach the 55 per cent level during the course of 2004 or 2005 and the 60 per cent level the following year, triggering the relatively draconian

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Table 2.3. **Cyclically adjusted deficit**
Per cent of GDP

	Deficit	Cyclically adjusted deficit	Cyclical
1995	–2.3	–3.0	0.7
1996	–3.0	–4.2	1.2
1997	–2.8	–4.5	1.7
1998	–2.4	–3.7	1.2
1999	–1.7	–2.2	0.6
2000	–2.9	–3.0	0.1
2001	–2.9	–1.8	–1.1
2002	–3.9	–2.1	–1.7
2003	–4.1	–2.7	–1.5
2004	–5.7	–4.7	–1.0

Source: OECD.

expenditure restraints provided for in the Public Finances Act, which would in turn likely provoke a serious and unwelcome recession. In order to preclude such an eventuality and enable the economy to fulfil the technical conditions necessary for adoption of the euro, it is critical that steps be taken soon to restrain public spending. Here the measures proposed in the government's public expenditure reform represent an important first step, but would likely need to be supplemented. Just as importantly, however, more long-term changes are required to expenditure management systems to ensure that spending levels can be brought down to levels consistent with medium-term sustainability.

Budget outturns in 2002 *and* 2003

Fiscal policy was somewhat expansionary on a cyclically adjusted basis in 2002 and 2003, which stood in sharp contrast to the fiscal consolidation objectives set out by the authorities in each of Poland's pre-accession economic programmes. Whereas economic growth and labour market outturns were broadly in line with the assumptions laid out in the preceding year's plan, spending levels were substantially higher. Moreover, inflation assumptions laid out in the relevant budgets were consistently higher than consensus at the same time, and also higher than outturns. While this bias should have contributed to a shortfall in revenues, overall deficits were not larger only because of additional revenue measures, both in terms of increasing tax rates but also heightened efforts to improve tax compliance and base widening (Box 2.3).

Although Poland is giving increasing visibility to the general government notion of the public sector, most of the public discourse and budgeting is still confined to the State Budget, which represents only 40 per cent of public spending. On this basis, the 2002 deficit outturn was in line with the original budget largely because smaller than

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Box 2.3. Major measures in the 2002 and 2003 budgets

The 2002 and 2003 budgets included a number of important policy measures affecting both revenues and expenditures.

Tax changes included:

2002

- Introduction of a 20 per cent income tax on capital gains and interest payments.
- Increases to excise taxes.
- Introduction of a 7 per cent VAT rate on new apartment sales.
- Reductions in housing-related tax expenditures.

2003

- More generous depreciation rules in the personal and corporate income tax systems.
- A 1 percentage point cut in the corporate income tax rate, from 28 to 27 per cent.
- Many smaller changes aimed at simplifying the tax system.
- Improved tax administration was assumed to yield a 7.3 per cent improvement in VAT revenues and a 13.5 per cent increase in personal income tax receipts.

Major initiatives on the expenditure side included:

2002

- A 37 per cent increase in the subsidy to Labour Fund.
- A 28 per cent increase of subsidy to the social insurance fund (FUS).
- A 15 per cent increase in the cost of debt servicing.
- An 11 per cent increases in spending on road construction and of subsidies to alimony fund.

2003

- A 7 per cent increase in transfers to local governments.
- A 0.4 per cent decrease in the cost of debt servicing.
- A 17 per cent increase in family and child allowances.

expected revenues were compensated by reduced transfers to the social security funds, lower debt servicing charges, lower capital expenditures, lower current expenditures and non-use of reserves. In 2003, State Budget revenues also came in below target, but budgetary overshooting was minimised in a similar manner. The reallocation of the shortfall towards the extrabudgetary sector reflects Polish law that requires the authorities to meet their State Budget deficit target. As discussed in the previous E*conomic*

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Table 2.4. **Government accounts**
PLZ billion

	1998	1999	2000	2001	2002		2003		2004
					Budget	Outturn	Budget	Outturn[1]	Budget
Revenue of the state budget	**126.6**	**125.9**	**135.7**	**140.5**	**145.1**	**143.5**	**155.7**	**152.7**	**154.6**
Direct taxes	49.5	38.2	40.0	36.7	40.4	39.1	41.8	39.8	31.6
PIT	34.7	23.1	23.1	23.4	26.5	24.1	27.4	26.0	22.1
CIT	14.8	15.1	16.9	13.2	13.8	15.0	14.4	13.8	9.6
Indirect taxes	70.5	80.1	84.8	86.5	94.8	93.4	100.7	98.6	105.6
Other taxes and non-tax revenue	6.6	7.6	11.0	17.4	9.9	11.0	13.2	13.6	17.3
Expenditure of the state budget	**139.8**	**138.4**	**151.1**	**172.9**	**185.1**	**182.9**	**194.4**	**189.2**	**199.9**
Current expenditure	131.9	133.4	145.7	169.3	178.9	177.0	187.5	n.a.	n.a.
Goods and services	55.2	47.8	50.9	53.4	51.4	50.1	56.4	n.a.	n.a.
Transfers and subsidies	58.8	66.8	76.8	95.0	101.8	102.7	103.9	n.a.	n.a.
Interest payments	17.9	18.8	18.0	20.9	25.7	24.2	27.2	n.a.	n.a.
Capital expenditure	7.9	5.3	5.3	3.5	6.2	5.9	6.9	n.a.	n.a.
Balance of the state budget (cash)	**–13.2**	**–12.5**	**–15.4**	**–32.4**	**–40.0**	**–39.4**	**–38.7**	**–36.5**	**–45.3**
Balances of other administrations									
Local government	–1.4	–1.0	–3.1	–3.1	–4.9	–3.1	–3.3	–3.0	–3.2
Health care sector (cash)	–3.3	–0.8	0.5	0.5	0.0	–2.0	0.4	0.0	0.0
Extrabudgetary funds and others	0.2	–5.7	–0.3	–3.2	–1.1	–1.8	–6.4	–8.9	–6.1
Financial balance of the general government (cash)	**–17.6**	**–19.9**	**–18.3**	**–38.2**	**–46.0**	**–46.3**	**–48.0**	**–50.6**	**–54.6**
Compensations to public sector employees and pensioners			–3.4	–2.5	–2.8	–2.7	–3.3	–3.2	–1.5
Transfers to open pension funds		2.3	7.6	8.7	11.5	9.5	11.4	10.2	
Other items[2]		0.1	0.2	–1.6	2.0	1.4	2.7	1.8	2.1
Economic balance of the general government	**–17.6**	**–17.5**	**–13.9**	**–33.6**	**–35.2**	**–38.1**	**–37.1**	**–41.7**	**–54.0**
Memorandum items:									
Economic deficit in % of GDP	–3.0	–2.7	–1.9	–4.4	–4.6	–4.9	–4.7	–5.1	–6.3
Nominal GDP (Zl billion)	589.4	652.5	723.9	760.6	764.8	780.4	784.1	815.0	861.5

Note: Total may differ from sums because of rounding errors.
1. Estimate.
2. Includes debt servicing costs paid to open pension funds, state budget revenue from UMTS and corrected payments from the special fund of the Ministry of the State Treasury.
Source: Ministry of Finance.

Survey, refocusing budget discussions on the general government concept and replacing the deficit rule with a binding expenditure framework would both improve overall transparency and help combat the procyclical bias implicit in the deficit rule.

The 2004 *Budget*

The 2004 State Budget was predicated on the assumption of 5 per cent real GDP growth and 2 per cent CPI inflation. Based on the authorities' pre-accession programme, the Budget appears to be consistent with a 0.5 per cent of GDP increase in general government expenditure and a 0.2 per cent of GDP decline in taxes, yielding a general government deficit according to the new Polish methodology of 5.0 per cent of GDP. However, the Ministry of Finance has revised its projections and now expects the deficit to reach some 5.7 per cent of GDP in 2004 or 7.5 per cent of GDP excluding the privately managed fully-funded pension system from the government sector. Overall, the OECD estimates that the Budget represents a 2.0 per cent of GDP relaxation of fiscal policy on a cyclically-adjusted basis (see Table 2.3).

The 2004 budget incorporates a number of important changes on both the revenue and expenditure sides. These include:

- reduction in the corporate income tax rate from 27 to 19 per cent;
- introduction of an option whereby entrepreneurs may pay a flat 19 per cent personal income tax rate;
- elimination of several income tax deductions;
- increases of VAT rate paid on various items from the reduced 7 per cent rate to the standard 22 per cent rate;
- higher excise taxes on petrol (increase in the tax rate by 1.1 per cent), alcohol and tobacco products (increase in the tax rate by 9.1 per cent);
- raising the share of local authorities in total personal and corporate income tax revenues;
- costs associated with EU membership, amounting to 5.8 billion zloty;
- increasing expenditure on justice (7.7 per cent), defence (12.3 per cent), controlling agencies (15.7 per cent), public administration (17 per cent), education and health (6.3 per cent);
- reductions in expenditure on infrastructure, environment, housing and agriculture by 4.8 per cent.

At least part of the relaxation in 2004 may be connected with EU accession. While Poland is expected to continue to be a net recipient of transfers from the EU (see Box 2.4), the budgetary impact of accession is less certain (Table 2.5). If it is assumed that the only additional expenditures incurred by the Polish government are those associated with rural development and structural actions – so-called "additionality" programmes in the jargon of the European commission

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Box 2.4. Impact of EU accession on Poland and the budget

Prior to accession to the European Union, Poland received three kinds of aid from the EU: PHARE funds (to support institutional building measures and *acquis* related investment); ISPA funds (for environment and transportation investment); and SAPARD funds (aimed at agricultural and rural development). Following accession no further allocations from these sources will be made, although money will continue to be paid out from previous commitments.

As a new member, Poland is eligible for assistance from the Agricultural, Structural and Cohesion funds. The EU Commission estimates that Poland will be entitled to about half of the funds made available to new members (50 per cent of structural funds; 45 per cent of Common Agricultural Policy aids; 50 per cent of rural development funds).

Structural funds seek to promote development and structural adjustment in regions in structural difficulty, those whose per capita GDP is less than ¾ of the EU average (all Polish regions); and to prompt human resource development. These are used to co-finance national programmes consistent with these aims and Commission guidelines. Because programmes are co-financed and must be approved by the Commission actual disbursements will depend on the capacity of countries to absorb the funding made available. It is assumed that Poland will absorb only half of the structural fund appropriation for commitment and 58 per cent of total allocations during the whole period from 2004 to 2006. Moreover, as stressed in the "Third Report on Economic and Social Cohesion", the issue of improving the country's administrative capacity is likely to remain a major concern.

Cohesion funds are used to finance specific projects that seek to fulfill the same goals as structural funds. Projects proposals are submitted to the Commission by member states, managed by the national authorities and supervised by a monitoring committee.

Agriculture support

In advance of EU expansion, the Common Agricultural Policy (CAP) was reformed so as to de-link support from production levels. Polish farmers will therefore receive a single payment, which will be conditional on respect of various environmental, food safety, animal and plant health standards. As a transition measure, initially only 15 per cent of total agricultural aid will be paid directly to Polish farmers (only through market measures in 2004, compensatory direct aid being equal to 0), with the remainder going to rural development projects. The share of CAP payments in the total is to increase to 50 per cent in 2005 and 2006, with compensatory direct aid representing 65 per cent of CAP.

Impact of EU transfers on Poland economy and budget

The fiscal and economic impact of EU transfers on Poland will depend on the capacity of the country to absorb funds. EU transfers to Poland could represent 1.3, 2.3, 2.6 per cent of GDP in each of 2004, 2005 and 2006, while Polish budgetary contributions to the EU and EU institutions are expected to equal 0.7 per cent of GDP in 2004 and 1.0 in 2005 and 2006. As a result, the net transfer to the economy in each year should be about 0.6, 1.3 and 1.6 per cent of GDP This compares with pre-accession transfers of less than 1 per cent of GDP.

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Box 2.4. **Impact of EU accession on Poland and the budget** (*cont.*)

Because most EU transfers will go directly to the private sector, the net impact on the Polish Budget is expected to be negative – although the extent of the shortfall is difficult to estimate in so far as it is unknown what share of programmes will be absorbed by public sector entities.

Rural development and structural policy transfers are subject to "additionality", an EU requirement that Polish spending levels must increase by at least the amount of the EU contribution. As a result, these transfers are unambiguously neutral for Polish public finances although they could have a positive impact on the budget if the additional spending they finance were to have occurred anyway. Other transfers (CAP, pre-accession aid and internal policies) can be used to finance pre-existing expenditures as long as they are approved by the Commission. As a result, these too could have a net positive impact on the public purse if the authorities are able to channel them into existing programmes. However, if the transfers go to new spending programmes if they will be neutral for the budget.

Finally, between 20 and 25 per cent of programme spending financed with structural and cohesion funds must be paid from the Polish Budget (co-financed). As a consequence the cost to the Budget of implementing such programmes could be significant if they cannot be designed to replace existing programmes.

All told, the budgetary cost for Poland of EU accession could be broadly neutral if all spending associated with non-"additional" transfers replaces pre-existing programmes. Conversly if the authorities are unable to re-arrange programmes, taking advantage of the additional funding offered by the EU could result in a 1 per cent of GDP increase in the general government deficit in 2006

(programmes that explicitly require Poland to increase spending) – then accession will be neutral for the Polish budget. If, however, on top of expenditures associated with "additionality" programmes, new spending arises as a result of common agriculture policy transfers and other non-"additional" programmes, then the budgetary impact of accession would be negative – especially if co-financing costs associated with structural and cohesion funds represent net additions to spending. At the limit, if all such spending is additional to pre-existing programmes the net negative impact on the Polish deficit could be as much as 1 per cent of GDP. The precise impact on public finances will depend to a large degree on the success with which the Polish authorities are able to reconfigure existing programmes so that they conform to the requirements of the European Union (all spending programmes financed by EU funds must be approved by the European authorities). Indeed, even among so-called "additionally" programmes such as structural funds, there may be scope for substituting EU funds for domestic funds, if the additional spending (say the construction of a bridge) was going to occur anyway.

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Table 2.5. **Estimated net impact of EU transfers to Poland**

	2004	2005	2006
	Per cent of GDP		
A. Contribution to EU budget and institutions	**0.7**	**1.0**	**1.0**
B. EU transfers to Poland	**1.3**	**2.3**	**2.6**
1. *Transfers subject to "additionality"*	0.7	1.3	1.5
Rural development	0.2	0.3	0.5
Structural actions	0.5	1.0	1.1
2. *Other transfers*	0.7	1.0	1.1
CAP	0.1	0.5	0.5
Pre-accession aid	0.4	0.3	0.3
Internal policies	0.2	0.2	0.3
3. *Special Compensation*	0.3	0.3	0.2
C. Net impact on Poland	**0.6**	**1.3**	**1.6**
D. Estimated total co-financing costs	**0.1**	**0.2**	**0.3**
Structural fund 25%	0.1	0.2	0.2
Cohesion fund 20%	0.0	0.0	0.1
E. Net impact on Budget			
Assuming that all spending financed by EU transfers would have occurred anyway	0.5	1.1	1.3
Assuming that only transfers subject to "additionality" entrain an increase in government spending	0.0	0.1	0.0
Assuming that all transfers entrain offsetting increases in spending	–0.5	–0.7	–0.8
Assuming that all transfers entrain offsetting increases in spending and that co-financing costs are a net addition to spending	–0.6	–1.0	–1.1

Source: OECD using data from the Copenhagen package, pre-accession aid and Poland's contribution are from European Commission services from the 2004 EU preliminary draft general budget, and OECD forecasts for GDP.

In such a case, the impact of EU funds on the Polish budget could be positive. However, the expected 1.5 per cent of GDP increase in the deficit for 2004 (see above) suggests that the authorities have had only limited success in taking advantage of opportunities to minimise the budgetary impacts of new programmes and cost-sharing arrangements.

Whatever its eventual size, economically any addition to the deficit due to Poland's relations with the EU should be considered in the same way as any other form of government expenditure. In particular, the increase in net public expenditures will contribute to debt accumulation and therefore needs to be considered when looking at the sustainability of public finances. The impact of accession in terms of domestic demand could be as much as 2.4 per cent of GDP in 2006, 0.8 percentage point of which are in the form of a transfer from the Polish State Budget to the private sector via the intermediary of the EU and the rest in the form of a transfer from the EU to the Polish private sector.[8]

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Fiscal policy challenges

Globally Polish macropolicy over the period 2002-2003 was characterised by an inappropriate policy mix comprised of tight, although loosening monetary policy, and a relatively relaxed fiscal policy. The 2004 Budget implies a significant further relaxation of the fiscal stance. Coming on the tail of the substantial easing of monetary conditions during 2002-2003 and in the context of an already strong economic recovery with quarterly growth rates already well in excess of potential, this additional fiscal stimulus runs the real risk of overheating the economy due to speed-limit effects – even before the output gap is entirely closed. To counteract this risk, it is essential that specific measures be put in place as of 2004 so as to mitigate the impact of fiscal loosening this year. These should include advancing the implementation of measures associated with the recently proposed plan for public expenditure reform (see below) so that significant savings are felt even this year. Moreover, as discussed in the previous *Economic Survey*, for medium and long-term sustainability to be achieved the authorities will need to put into place institutions and structures that will enable them to exercise adequate control over the entirety of public spending over the medium-term.

The combination of successive large deficits and falling privatisation revenues has resulted in a significant accumulation of public debt. Since 1999, it has increased from 43 per cent to an estimated 52 per cent of GDP at the end of 2003 (Table 2.6). The debt according to Maastricht definitions is smaller[9] but has followed a similar path, increasing from less than 40 per cent of GDP in 2000 to approximately 45 per cent in 2003. According to the authorities' medium-term

Table 2.6. **Public debt and privatisation revenues**
Per cent of GDP

	1997	1998	1999	2000	2001	2002	2003[2]
Public sector (1 + 2 + 3)	**–**	**–**	**41.9**	**38.7**	**39.7**	**45.2**	**51.5**
1. Government sector	–	–	40.9	37.5	38.3	43.4	48.1
1.1. State Treasury	44.0	40.3	40.4	36.7	37.2	41.9	46.4
1.1.1. Domestic	20.6	20.6	20.5	20.0	24.2	28.0	30.8
1.1.2. Foreign	23.3	19.7	19.9	16.7	13.0	13.9	15.7
1.2. Other government	–	–	0.6	0.7	1.1	1.5	1.6
2. Local government sector	–	–	0.9	1.3	1.4	1.8	2.0
2.1. Local governments	–	–	0.9	1.3	1.2	1.5	1.7
2.2. Other local government sector	–	–	–	–	0.2	0.3	0.3
3. Expected calls on outstanding state guaranties[1]	–	–	1.3	1.3	1.2	1.6	1.4
4. Privatisation revenues	1.3	1.3	2.0	3.7	0.9	0.3	0.4

1. Data for 2003 OECD are an estimate.
2. Preliminary data based on OECD estimates for GDP.
Source: Ministry of Finance, Central Statistical Office.

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economic projections, the public-debt to GDP ratio will reach almost 55 per cent in 2004 and approach the constitutional limit of 60 per cent in 2005.

These developments have important implications for public policy in Poland. In order to prevent debt from breaching the 60 per cent limit set out in the constitution the Polish Public Finances Act stipulates specific actions that the government must undertake if the public debt exceeds 50 and 55 per cent of GDP and further steps when it crosses the thresholds of 55 and 60 per cent of GDP. The required response following the breach of the 50 per cent limit is relatively benign. Whenever the public debt exceeds 50 per cent of GDP but is less than 55 per cent, the deficit (surplus), expressed 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. Those envisioned for breaching the 55 per cent threshold are more severe. In this case, the State Budget deficit for the following year must be consistent with a stable or falling State Treasury Debt,[10] after taking account of expected calls on state treasury guarantees. Moreover, the balances of sub-national governments must be improved as compared with the previous year by an amount proportionate to the extent by which the public debt exceeds 55 per cent of GDP.[11] 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, sub-national governments must pass balanced budgets, the Council of Ministers must submit a fiscal consolidation plan to the parliament and it would be legally impossible to pass a resolution authorising a State Budget deficit.[12] Under such crisis-like situations, spending cuts and tax increases would have to be draconian and likely involve much more serious social and economic costs than would a more gradual implementation of expenditure restraint.

Recognising the necessity of bringing public expenditures under control, the authorities have proposed a public expenditure reform (Box 2.5), which seeks to slow the pace of expenditure growth and to make more efficient use of the government's limited resources. In addition supplementary measures are envisaged to slow the accumulation of debt, including increasing privatisation revenues and improving tax compliance. The reform envisages a gradual reduction in personal transfers, amounting to 10 billion zloty (1 per cent of GDP) per annum by 2007. An additional economy of 5.9 billion zloly (0.6 per cent of GDP) per year beginning in 2005 is to be achieved from administrative savings (Table 2.7). The largest reduction in spending are expected to derive from changes in the indexation of pensions, partial reform of the disability and farmers' social security systems, increased efficiency in the health system – with most measures not to be enacted until 2006 – following the next election.

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Box 2.5. The Public Expenditure Reform plan

The government adopted a Public Expenditure Reform (PER) plan in January 2004. As of early April 2004, most elements of the plan had yet to be enacted. The reform plan comprised three classes of measures: 1) savings from public administration; 2) savings in the personal transfer system and 3) increases in tax revenues. In addition to reducing public expenditure, planned reforms improve the management of public services, the structure and efficiency of personal transfers and the functioning of the labour market (see Chapter 3).

Public administration savings are expected to reach 5.9 billion zloty annually. Some 0.3 billion are to be achieved through liquidation or consolidation of a number of state institutions; job cuts; and better management of extra-budgetary funds and state agencies. An acceleration of the restructuring of state owned coal, railway and health-sector companies is expected to permit subsidies to these sectors to be reduced by 1 billion a year. Additional savings of 1.3 billion are to come from slow growth in military expenditure.

Social security related savings are to reach some 10 billion zloty annually. Reforms can be divided into five main reform areas:

- Gradual equalisation of retirement age for women with that for males (65) and introduction of flexible partial early retirement for individuals aged 62-65.
- Improved labour market performance among older workers, by:
  - augmenting active labour market policies targeted specifically at workers over 50;
  - phasing out some early-retirement schemes and improving incentives to stay in work;
  - gradual elimination of special pensions and introduction of actuarially neutral mechanisms for professions currently benefiting from special pension rights.
- Reform of social security benefits through:
  - a revised indexation system for old-age and disability pensions;
  - reduction of spending on survivor pensions by increasing the age at which benefits can be received to the normal retirement age, except in very specific cases;
  - tightening of eligibility conditions for existing and new disability pensions.
- New legislation concerning the employment of disabled workers.
- Reform of the farmers' social security system (KRUS) by:
  - reduction of expenditure associated with the sckiness spending;
  - clarifying the definition of farmer status;
  - clarification of rules on calculating of farming income;
  - replacing pension subsidies with in-work benefits;
  - eliminating mis-use in the KRUS system;
  - organisational and financial simplification.

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Box 2.5. **The Public Expenditure Reform plan** (*cont.*)

Tax measures include a planned increase in the contribution base for self-employed high-income earners; increasing social security contributions of disability pensioners and the self-employed; and raising contribution levels in the KRUS system.

In addition, the reform proposes creation of a national actuary office responsible for medium and long term projections related to the Polish social security system and introduction of a comprehensive system of quantitative and qualitative evaluation of effectiveness of social expenditure.

Table 2.7. **Proposed expenditure savings in the government's Public Expenditure Reform**

	2004	2005	2006	2007	2004-2007
	PLZ billion				
Administration and economy	–	5.9	5.9	5.9	17.7
of which:					
Public administration	–	0.3	0.3	0.3	0.9
State aid	–	1.0	1.0	1.0	3.0
Military spending	–	1.3	1.5	1.6	4.4
O/w tax measures					
Increased tax revenue	–	3.1	3.1	3.1	9.3
Social expenditure	0.8	7.0	11.4	10.2	29.4
of which:					
Indexation of pensions	–	2.0	4.8	2.0	9.6
Early retirement and activation of older workers	–	0.6	1.3	2.0	3.9
– Early retirement	–	0.5	1.1	1.8	3.4
– Activation of older workers (fin rewards)	–	0.1	0.2	0.2	0.5
Disability pensions	–	1.1	1.5	2.0	4.6
– Verification of already acquired permanent pension rights	–	0.2	0.6	1.0	1.8
– Changes to rules on employment of disabled	–	0.2	0.2	0.2	0.6
Changes to rules on sick allowances	–	0.2	0.3	0.3	0.8
Subsidised disabled employment	0.8	0.9	0.9	1.0	3.6
Activation of disabled	–	0.4	0.6	0.7	1.7
Farmers social security system	–	1.7	1.8	1.8	5.3
O/w tax measures					
Disability pensions					
– Equalization of contributions of disabled in self and dependant employment	–	0.1	0.1	0.1	0.3
– Expansion of contribution base for self-employed with income	–	0.6	0.6	0.7	1.9
Memorandum item					
Sum of tax measures		3.8	3.8	3.9	11.5

Source: Ministry of Finance.

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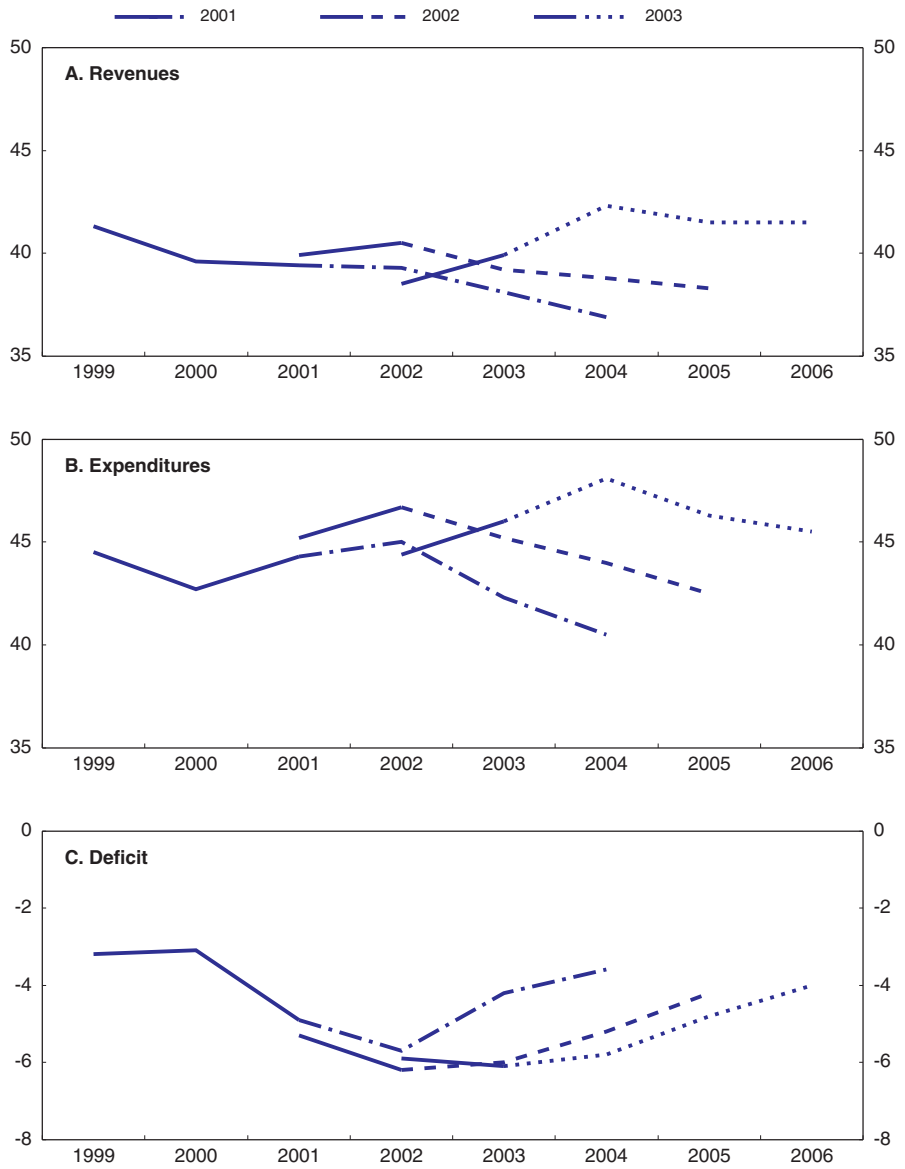
Achieving this kind of expenditure reform represents a critical step towards placing Poland back on a sustainable fiscal policy path. In particular, the authorities plan, if achieved, could just prevent the 60 per cent of GDP debt ceiling from being breached. However, the margin for error is very small – especially if the doubling in privatisation revenues that forms a critical component of the overall plan is not achieved. In order to allow for slippage in various targets, including privatisation revenues, additional measures should be adopted. Moreover, as discussed in the special chapter on public expenditure management in the previous *Economic Survey*, to minimise the extent of such slippage the authorities will need to substantially improve expenditure management and medium-term budgeting mechanisms. Indeed, while each of the three most recent pre-accession economic programmes have elaborated the authorities intention at that time to pursue significant reductions in government spending levels (Figure 2.7), these objectives have not been met. Instead, spending and tax levels have tended to ratchet up in each year, with this year's medium-term programme implying that spending will be fully 4 per cent of GDP higher in 2005-2006 than had been projected just one year earlier.

A vital step towards improving expenditure management would be the adoption of a medium-term budgetary framework. Systematically taking into consideration the out-year consequences of legislative and administrative decisions in any given year would go a long way towards avoiding the kind of expenditure drift that has prevented expenditure objectives from being met. In particular, by confronting decision makers with the longer-term fiscal consequences of decisions it would reduce the possibility that decisions are made whose benefits, political or otherwise, are front-loaded but whose costs are delayed and potentially significant. Moreover, in a context where the medium-term goal of public expenditure policy is to reduce overall spending levels, more prudent assumptions for growth and inflation would help improve the chances that both this and short-term objectives are successfully achieved. Indeed, arguably, much of the overshoot in the general government deficit in 2002 and 2003 reflected overly optimistic assumptions (from a revenue point of view) for inflation. While the Budget assumption for inflation in 2004 is more realistic than in previous years, the 5 per cent growth rate assumption is still higher than the consensus forecast of 4.6 per cent.

The constitutional requirement that makes the State Budget deficit binding on the government should be replaced to make overall general government spending levels the binding factor. Such a change would help eliminate the upward bias inherent in the current system whereby in periods of strong economic growth and strong revenues, there is a tendency to increase expenditure levels so as to achieve the originally budgeted deficit but when revenues are weaker than anticipated a revised budget law is passed raising the permissible deficit. Indeed, while in preparing successive Budgets the authorities have recognised the wisdom of such a spending rule and ascribed to the principle as concerns the State

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Figure 2.7. **Slippage in medium-term budgeting**[1]
Projections from successive pre-accession economic programmes



1. Data are according to Polish accounting standards.
Source: Poland's pre-accesion economic programmes for 2001, 2002 and 2003.

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Budget, they have yet to put such a rule into practice. To be effective, the adoption of an expenditure rule would have to encompass extrabudgetary funds. In this regard, the decision to return administrative control of the Labour Fund to the Ministry of Economy, Labour and Social Policy and the amalgamation of various regional health funds into a centrally managed one should help improve the authorities' ability to influence the path of spending in these areas.

In order to improve transparency and to facilitate the communication of budgetary objectives and progress, efforts should be extended to raise further the profile of the general government concept. Indeed, given the shrinking size of the State Budget in public expenditure such a move is essential if observers are to have an accurate sense of the stance of fiscal policy. Progress in this regard could be extended by accelerating the movement towards using general government measures both in budgetary documents but also when reporting on progress. In addition to improving information flows, such a move would help reinforce budgetary discipline by reducing the political attraction of transferring budgetary shortfalls from the State Budget to that of the extrabudgetary funds. It would also help to emphasise the tradeoffs that exist between so-called mandatory expenditures – found mainly in the off-budget accounts – and those more readily controlled in the context of the State Budget. In addition to re-adopting a more standard definition of the deficit, overall budgetary transparency would be enhanced if the activities and budgets of the extra-budgetary funds were better integrated into the budget process. Indeed, as indicated in Table 2.8 these funds are almost wholly dependent on the State Budget to meet their expenditures.

Finally there is a need to improve the efficiency of spending. Here the additional revisions outlined in Chapters 3 and 4 to the Farmers' pension system, the disability system and a restructuring of the Health system could help free up substantial resources that could be used both for deficit reduction and to improve the targeting of government transfers. To help in this process it is essential that steps be made to institutionalise a culture of evaluation within the policy making process. For too long, budget monitoring and supervision have been too focused on ensuring legal and financial execution of plans and have placed too little emphasis on analysing the effectiveness of spending and the results attained. Efforts to build up a team capable of undertaking such analyses and to provide medium and long-term projections within the Ministry of Economy, Labour and Social Policy is a welcome development which should be pursued.

Conclusions

As the foregoing discussion suggests, both fiscal and monetary policy face several serious medium-term challenges. Most obvious of these from a political point of view is the creation of the macroeconomic conditions that would allow adoption of the euro. Independent of the decision taken by the authorities on this

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Table 2.8. **Expenditures and revenues of some extrabudgetary funds**

	2000	2001	2002	2003 Expected	2001/2000	2002/2001	2003/2002
	PLZ billion				Per cent growth		
FUS							
Revenues	81.3	91.6	95.4	97.0	12.7	4.1	1.7
Subsidies	15.4	21.2	27.1	28.0	37.7	27.8	3.3
Own	65.9	70.4	68.3	69.0	6.8	–3.0	1.0
Expenditures	84.9	95.9	98.5	102.4	13.0	2.7	4.0
Pensions	74.6	84.1	87.3	91.7	12.7	3.8	5.0
Other	10.3	11.8	11.2	10.7	14.6	–5.1	–4.5
KRUS							
Revenues	14.0	15.8	16.4	16.0	12.9	3.8	–2.4
Subsidies	13.2	14.9	15.4	15.0	12.9	3.4	–2.6
Own	0.8	0.9	1.0	1.0	12.5	11.1	0.0
Expenditures	14.3	15.8	16.0	16.3	10.5	1.3	1.9
Pensions	12.1	13.3	13.4	13.6	9.9	0.8	1.5
Other	2.2	2.5	2.6	2.7	13.6	4.0	3.8
Labour fund							
Revenues	6.1	8.3	9.3	9.7	36.1	12.0	4.3
Subsidies	0.8	2.6	3.6	3.9	225.0	38.5	8.3
Own	5.3	5.7	5.7	5.8	7.5	0.0	1.8
Expenditures	7.2	8.3	9.8	11.0	15.3	18.1	12.2
Unemployment insurance	3.5	3.9	4.3	4.0	11.4	10.3	–7.0
Other	3.7	4.4	5.5	7.0	18.9	25.0	27.3
Total Big Three							
Revenues	101.4	115.7	121.1	122.7	14.1	4.7	1.3
Subsidies	29.4	38.7	46.1	46.9	31.6	19.1	1.7
Own	72.0	77.0	75.0	75.8	6.9	–2.6	1.1
Expenditures	106.4	120.0	124.3	129.7	12.8	3.6	4.3
Pensions	86.7	97.4	100.7	105.3	12.3	3.4	4.6
Unemployment insurance	3.5	3.9	4.3	4.0	11.4	10.3	–7.0
Other	16.2	18.7	19.3	20.4	15.4	3.2	5.7

Source: Ministry of Finance.

issue, achieving and maintaining the so-called Maastricht conditions is in itself a worthy objective for macro policy in the coming years. In this regard, the Bank's revised Monetary Policy Strategy should be helpful in maintaining the low inflation rates already achieved and ensuring exchange rate stability. Its emphasis on medium-term inflation developments is particularly welcome. It should help reduce the likelihood that monetary policy is driven by short-run fluctuations and thereby avoid excessive policy volatility (see IMF, 2002; Drew and Orr, 1999). Moreover, it should facilitate a more transparent communication strategy for monetary policy involving explicit forecasts and more complete information on the Bank's reaction function. As concerns the stance of monetary policy, the opportunity

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for further interest rate cuts has probably run its course – especially given the current stance of fiscal policy. Indeed, the depreciation of the zloty, the evolution of the yield curve and rising inflation all suggest that further declines in interest rates would only be met with reductions in capital inflows, a further depreciation and even stronger expectations of increased inflation. If anything, given the stance of fiscal policy and the strength of the economy, the prospective path for interest rates is probably upwards. However, once the expenditure reform is implemented and fiscal policy adopts a more clearly restrictive stance, it may be possible to lower interest rates even further without spurring inflationary or speculative forces. Until then, such moves should be avoided.

The main medium-term challenge for fiscal policy consists of durably reducing the deficit so as to restore a sustainable path for public finances. The government's public expenditure reform is an essential first step in this process and needs to be instituted as quickly as possible. However, its implementation needs to be accelerated and additional measures taken in order to provide an adequate safety margin. Moreover, in order to ensure that objectives to reduce the share of expenditure in output, lower the tax burden and restore medium and long-term sustainability are achieved, the authorities will need to put into place institutions and structures that will enable them to exercise adequate control over the entirety of public spending over the medium-term. Further steps will be required if the deficit is to be brought down to a level where it would remain within Maastricht levels during a cyclical downturn and which would allow the debt to GDP ratio to stabilise at a level below the 50 per cent threshold above which specific measures must be taken to restrain the deficit. In this regard, the current statistical treatment of the deficit is unhelpful to the extent that it causes policy makers to underestimate the extent to which current government activity is contributing to debt accumulation. Moves to restore public finances to a sustainable track would also create conditions in which a further reduction of interest rates could be contemplated by the central bank without the risk of overly stimulating the economy or provoking external instability. Not only would lower interest rates have important positive impact for growth (see Chapter 1), reductions in the share of public sector spending in GDP might enable the overall tax burden to be reduced. Such a step could contribute towards a virtuous circle where lower taxes help to raise the economy's output potential and reduce disincentives to formal work, thereby contributing to improved revenues and the ability to expand government services, where needed, even as taxes moderate.

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Notes

1. The English language version of the Inflation Report for the second quarter of 2003 was only published in February 2004. In contrast, Hungary's quarterly Inflation Report appears in English within 6 weeks of the end of the quarter to which it refers.
2. Similarly the release of a number of working papers in the recent period outlining the Bank's research concerning transmission mechanisms (Lyziak, 2002; Wrobel and Pawlowska), the economy's interest-rate sensitivity (Brzoza-Brzezina, 2002), the importance of exchange-rate fluctuations to economic activity and inflation (Przystupa, 2002) among others help to clarify Bank thinking.
3. Increases in the yield curve and substantial rises in the forward interests rates (see below), during the period during which the council was being replaced are consistent with a hypothesis that speculation as to the future conduct of monetary policy contributed to increased perceptions of currency or inflation risk.
4. Indeed, declarations by candidates for the Monetary Policy Council that interest rates should be immediately cut by 100 or more basis points, coupled with an expected transformation in the orientation of the council as a whole from one being broadly concerned with reducing inflation ("hawkish"), to one placing much more emphasis on stimulating growth ("dovish") could well have influenced economic developments – including the depreciation of the currency.
5. Under current legislation, there is some uncertainty that council members could resign and that their replacements' terms extend beyond the life of the current council. Provision should be made for this possibility in the amended law.
6. The increase in the stock of housing-related loans is equal to 90 per cent of the total increase in lending to households.
7. See *http://europa.eu.int/comm/eurostat/Public/datashop/print-product/*EN?*catalogue*=E*urostat*&*product*=2-02032004-EN-BP-EN&*mode=download*.
8. Total annual transfers from the EU to Poland are expected to equal 2.6 per cent of GDP in 2006, 0.23 percentage point of which is a transfer to the Polish government implying transfers of about 2.4 per cent of GDP to the population. The Polish government will pay 1.0 per cent of GDP into EU coffers, less the 0.23 per cent that is returned. This leaves a net payment on the part of the Polish government of 0.8 per cent of GDP and a 1.6 per cent of GDP net contribution of the EU to Poland.
9. The Maastricht definition differs in several respects from the public debt used for purposes of the constitutional limit. In particular, it excludes risk-adjusted guaranties as well as different treatment of the matured liabilities of the public sector.
10. 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 guaran-

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tees. It differs from the notion of the public debt because it excludesthe debts of extrabudgetary funds and the commitments of other general government sectors, including that of sub-national governments.

11. Sub-national deficits are to be reduced by a factor R, where 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.

12. See Ministry of Finance (2003).

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3. Policies to raise employment

As the discussion in Chapter 1 indicated, improving the functioning of the labour market is a top economic and social priority for Poland. To increase employment levels policy will need to focus on reducing significantly the inactivity traps inherent in the Polish personal transfer system, while improving the efficiency and targeting of social transfers to ensure resources flow to those truly in need. Simultaneously, efforts must be extended to increase firms' propensity to hire the out of work, by lowering the costs of low-skill labour, reducing associated administrative and regulatory costs and in the longer term by providing graduates with more relevant skills. Finally, as discussed in Chapter 4, product-market reforms are required to raise investment rates and thereby stimulate overall demand for labour. The remainder of this chapter outlines reforms in each of these labour-market areas, which if implemented, would serve to reverse the recent decline in employment and improve the fairness of income distribution, thereby reducing poverty, raising the rate of growth of incomes, and speeding economic convergence with the rest of the OECD.

Social benefits, unemployment insurance, poverty and employment

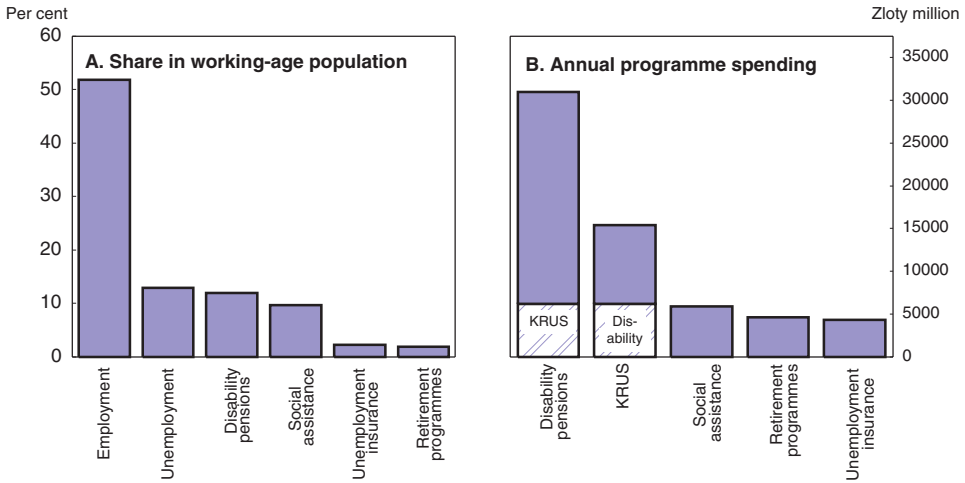
To improve the functioning of labour markets and job creation, policy needs to focus on three issues: 1) reducing the unemployment and poverty traps associated with current benefit systems; 2) targeting more effectively social transfers; 3) eliminating administrative and regulatory distortions that favour non-employment, low-productivity agricultural work and involvement in the underground economy.

Personal transfer systems

Abstracting from old-age pensions, about one in 5 Poles of working age receive some form of social transfer. The most important social benefit schemes in Poland are the disability pension system and the special farmers' social insurance programme (KRUS) – both in terms of expenditures and beneficiaries. Spending on disability programmes equals about 3½ per cent of GDP and although access to benefits has been restricted in recent years, beneficiaries represent 13 per cent of the working-age population or 25 per cent of employment (Figure 3.1). The

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Figure 3.1. **Relative importance of different personal transfers**
2002



Source: Central Statistical Office and OECD.

economic consequences of the non-disability components of the KRUS system are less easy to measure. KRUS offers to individuals associated with a farming household virtually the same benefits (and more) as the general system, but at a 95 per cent rate of subsidy. As such it serves as a potent incentive for individuals to remain in low-productivity agricultural work and explains to a significant degree why over 30 per cent of the Polish population remains in rural areas. Moreover, it helps explain why measured agriculture employment represents as much as 19 per cent of total employment, even though the sector produces less than 3 per cent of GDP. In contrast to these two programmes, social assistance and unemployment insurance programmes are small both in terms of spending levels and the number of beneficiaries. Moreover, as described below, they are not as generous, are relatively well targeted and generate smaller work disincentives. The following paragraphs provide some detail on the various systems and conclude with a discussion of the authorities' current reform plans and some recommendations as to how these could be extended.

The disability systems and premature labour-market withdrawal programmes

As of 2002, over 2.4 million people were receiving a disability pension, about half of which were in the form of permanent disability pensions (Box 3.1).

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Box 3.1. The disability pension schemes

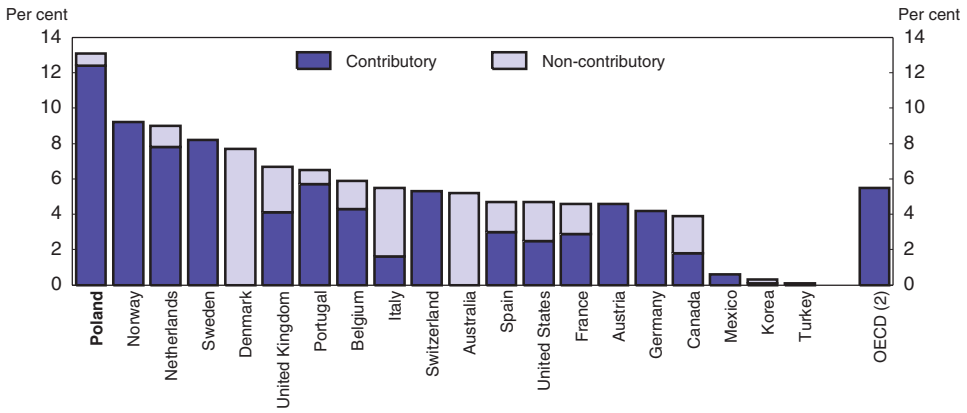
Disability pension systems are operated by the State social insurance institution (ZUS) and funded by the social insurance fund (FUS) and the special farmers social insurance fund (KRUS). Disability pensions can only be authorised by a doctor and, since 1997, are awarded on the basis of an individual's physical incapacity to work. Beneficiaries must have at least 5 years of insurance (contributory and non-contributory combined) unless the beneficiary is under 30 and the disability must arise while the individual is employed, unemployed or in the 18 months following employment. The benefit is equal to that of an old-age pension under the old system, except in the case of a partial disability in which case it is ¾ of that amount. In 2002, there were 3.2 million people on disability pensions or 14 per cent of the working-age population, the highest incidence of disability pension in the OECD by a factor of two. Of these 2.4 million were receiving a pension from the general ZUS system and 0.8 million from the special system. As concerns the ZUS system, more than 50 per cent of disability pensioners are between 40 and 55 years of age. Within this age group, 18 per cent of the population is benefiting from a disability pension. Approximately half of disability pensions are permanent.

The share of working-age persons receiving a disability pension, 13 per cent, is by far the highest in the OECD – more than double the modal level of 6 per cent (Figure 3.2). Assuming that the distribution of disability in Poland is roughly similar to that in other OECD countries, this suggests that as many as two-thirds of disability pensioners are using the system as an early-retirement scheme. Indeed, the share of the working-age population that is both disabled and working is roughly the same in Poland as in the rest of the OECD – but the share of non-working pensioners is more than three times as high.[1] Although the value of the average pension has been reduced from 51 to 47 per cent of the average wage between 1995 and 2002, net income from it can be twice as high as that associated with a minimum wage job. As such it represents an attractive source of unearned income especially as it is legally possible to work while receiving the pension.

Recent steps to restrict access to the disability system have succeeded in reducing inflows by requiring beneficiaries to visit approved doctors and by introducing a more restrictive approach to granting permanent disabilities. This tightening of the system has contributed to a 300 thousand person decline in the stock of disability pensioners from its peak in 1997. As a result, inflow rates have fallen substantially at least for the ZUS system (Table 3.1). Nevertheless, the stock of disability pensioners remains very high and unless steps are taken to re-evaluate individuals already receiving disability pensions future declines in the stock of

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Figure 3.2. **Disability benefit recipiency rate**[1]
Percentage of population 20-64, 1999



1. Data are corrected for persons receiving both contributory and non-contributory benefits, except for Canada (unknown).
2. Average of contributory and non-contributory benefits for the 20 OECD countries for which data are available.
Source: OECD database on programmes for disabled persons.

Table 3.1. **Age-specific disability benefit inflow rates**
1999

	Inflows per 1 000, by age group				
	20-34	35-44	45-54	55-59	60-64
Australia	3.2	5.1	8.6	17.7	14.6
Austria	0.7	2.2	9.5	34.9	5.1
Denmark	1.6	3.1	7.0	11.1	11.1
Germany	0.6	2.3	6.9	18.5	16.6
Mexico	0.0	0.1	0.3	0.7	4.1
Netherlands	8.3	11.6	15.6	12.0	12.5
Norway	3.3	8.5	18.2	36.9	60.0
Poland (1999)	1.6	7.1	18.1	11.7	2.7
Poland (ZUS only, 1999)	1.6	6.8	14.5	8.5	2.2
Poland (ZUS only, 2003)	0.9	3.0	6.3	4.1	1.4
Portugal	1.2	2.0	7.7	19.8	30.5
Sweden	1.9	5.0	9.6	19.8	31.6
Switzerland	2.4	4.4	8.5	14.1	12.4
United Kingdom	9.7	12.4	17.8	22.3	11.8
United States	2.7	4.5	7.8	13.9	12.8
OECD (13)	3.0	5.1	9.8	18.5	18.6

Source: Ministry of Economy, Labour and Social Policy, OECD database on programmes for disabled persons.

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Box 3.2. Other labour force withdrawal schemes

Separate early-retirement and pre-retirement programmes are operated by ZUS and labour offices respectively. The ZUS programme is available to workers in certain "difficult" professions, among which teachers, miners, and steel and railway workers. This system is set to expire in 2006. The pre-retirement programme is available to unemployed individuals with 20 years or more work experience who are 58 (women) or 63 (years of age). Individuals who are unemployed for "economic" reasons with at least 6 months in their last job and 35 (women) or 40 (men) years job tenure qualify as of age 50 (women) or 55 (men). It is also available to unemployed former employees of state farms over 50 years of age (55 for men), having worked at least 20 years for a state farm living in a region with high unemployment. The amount of the pre-retirement pension is set at 80 per cent of the amount the individual's old-age pension but cannot be less than 120 or more than 200 per cent of the unemployment insurance benefit. In 2002, there were some 500 000 individuals receiving such benefits.

disability pensioners are unlikely to be sufficient to overcome the distortions the system currently imposes on the labour market.

In addition to the disability pension system Poland operates two separate early-retirement programmes, *early-retirement pensions* offered by the social insurance fund and *pre-retirement benefits* offered by the unemployment insurance scheme (Box 3.2). For individuals between 45 and 65 years of age, enrolment in these two programmes represents more than one third of total employment (Figure 3.3). Currently, there are 400 000 individuals receiving these benefits, the after-tax level of which can exceed the minimum wage[2] – making them attractive for less skilled individuals. Moreover, inflows into the programme have been rapid, with the share of individuals receiving such benefits reaching about 10 per cent of the eligible population in three years. The authorities have moved to reduce the disincentive effects of these benefits by allowing beneficiaries to combine income from other sources (including work) with receipt of the benefit. Under the new rules combined benefits and earnings can reach twice the minimum wage before the benefit is entirely extinguished. While this reform increases employment incentives substantially, it would appear to introduce an important moral hazard that could encourage individuals to leave employment so as to qualify for the benefit and then take on work to increase overall income.

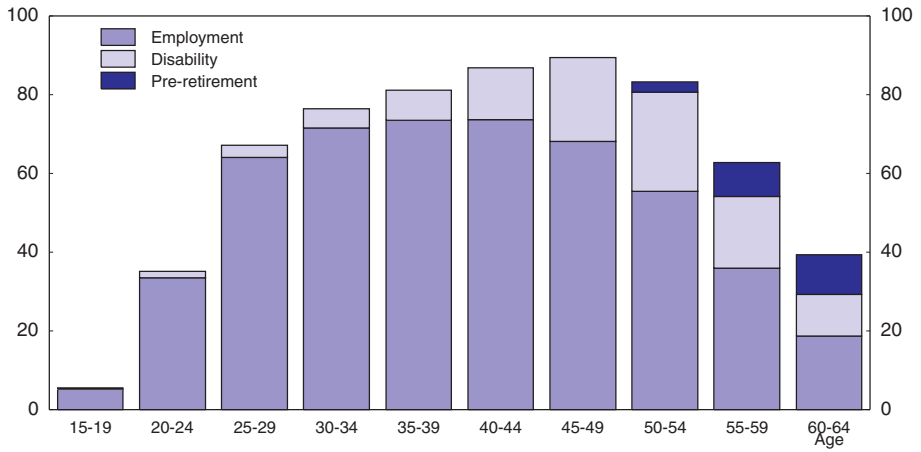
Farmers pension system

The special farmers social insurance system was set up towards the end of the 1970s. It was seen as a mechanism of social cohesion, providing often very

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Figure 3.3. **Population shares of the employed and disability and pre-retirement pensioners**

Per cent



Source: Central Statistical Office, Ministry of Economy, Labour and Social Policy; and OECD.

poor farmers with the same level of pension and other social benefits as individuals subscribed to the general system (ZUS), but for a much lower fixed fee. While it probably made the early phases of the transition easier it has contributed significantly to slowing the pace of restructuring in rural areas (see Chapter 4). Moreover, its special provisions, by offering a substantial implicit subsidy to individuals involved in agricultural and rural employment (see Box 3.3), have hobbled labour market adjustment and contributed to substantial employment and poverty traps, which go part of the way to explaining the very low rates of agricultural productivity. Rather than being a temporary transition measure, the KRUS has become a permanent source of dependency and membership has actually increased 15 per cent since 1996.

Unemployment benefit system

The unemployment benefit system is financed, along with active labour market programmes, by a payroll tax equal to 2.45 per cent of the gross wage bill of a company, which is used, in combination with transfers from the State Budget to maintain the Labour Fund.[3] Eligibility is limited to individuals having been

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Box 3.3. The special farmers pension system (KRUS)

The special farmers pension system (KRUS) offers farmers and their extended families a range of social insurance benefits (health, sickness and accident insurance, old-age and disability pensions) roughly comparable to those offered by the general regime (ZUS).

The KRUS system differs from the ZUS system in several respects:

– To be eligible for benefits an individual must be:
  - a farmer owning at least one hectare of land; or
  - a member of a such a farmer's household who derives his or her income from farming, or from a non-farm activity nevertheless related to the agricultural land; or
  - be inactive and a dependent of a qualified farmer.

– Old age and disability pension contributions are 165.8 zloty per quarter per member of the household and sickcare and workman's compensation contributions are 54 zloty – less than ⅓ of the contributions that would be paid by a minimum wage earner in the general system.

– Members of the household who work off the farm must pay into the general pension system but receive health insurance as a result of their association with the KRUS system and therefore do not need to pay health insurance premia.

Eligible individuals whose farm is less than 2 hectares do not have to pay contributions to the unemployment benefit system but are eligible for benefits.

The range of benefits in the farmers' system are generally lower than in the general system but high relative to contributions. As a result, the farmers' system operates a large deficit. Since 1996, registration in the system has been increasing each year – having increased by 15 per cent since that time. In 2002, all told KRUS spending amounted to 2.1 per cent of GDP in 2002, with contributions covering only 5 per cent of this amount.

under contract for 365 days (including holidays and weekends) in the previous 1½ years. Benefit levels are independent of previous income but depend on lifetime work experience. Maximum duration ranges from 6 to 18 months depending on regional unemployment rates (see Box 3.4). Overall spending levels on unemployment insurance are low and as a result of the rising incidence of long-term unemployment only 15 per cent of the unemployed were receiving benefits during 2003. Nevertheless, because the level of benefits depend on one's employment duration, not salary, replacement rates for the low-skilled can be very high (see Figure 3.6 below).

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Box 3.4. The unemployment benefit and social assistance systems

The unemployment benefit system provides short-term revenue replacement to jobless individuals, independent of their means. Unemployed individuals having worked 365 days in the preceding 18 months are eligible for UI benefits, the amount of which are independent of previous earnings but increases as a function of life-time work experience. Net of tax, benefits equal 62, 77 and 90 per cent of the minimum wage for someone with less than 6, between 6 and 20 and more than 20 years work experience. Including additional housing benefits to which the unemployed are entitled, replacement rates increase to 82, 106 and 120 per cent for individuals with similar work histories. Maximum benefit durations depend on regional unemployment rates, ranging from 6 to 18 months (in regions where the unemployment rate is twice that of the country average). Recent school leavers who are without work are also entitled to benefits equal to those of unemployment benefits, subject to the same regionally-based duration rules. The rising incidence of long-term unemployment and short employment histories among new job seekers means that in 2003 only 15 per cent of the unemployed were receiving benefits.* Spending on benefits represents more than half of all labour market programme spending, but, at 1 per cent of GDP, it is much less than spent by other OECD countries.

The social assistance system comprises three basic forms of assistance: income-tested temporary benefits, which are available to individuals independent of labour market status; permanent income-tested benefits available to single parents; and means-tested specific benefits to pay for special costs. The temporary and special benefits are time-limited with benefit duration typically not exceeding 5 months and averaging less than three months. Taken in combination with the housing benefit, replacement rates for a minimum wage earner are about 54 per cent – although for single parents they approach 70 per cent. In 2002, on average there were some 400 000 social assistance beneficiaries or 2.8 per cent of total employment.

* Chlon-Dominczak *et al.* (forthcoming).

Other social assistance schemes

The various social assistance programmes in Poland are also described in Box 3.4. As indicated earlier, total spending on these transfers is limited and, by and large, they are well targeted on the poorest households. A notable exception is the family or survivor's pension, both the absolute value of which and its share in household revenues rises with income levels.

The transfer system considered as a whole

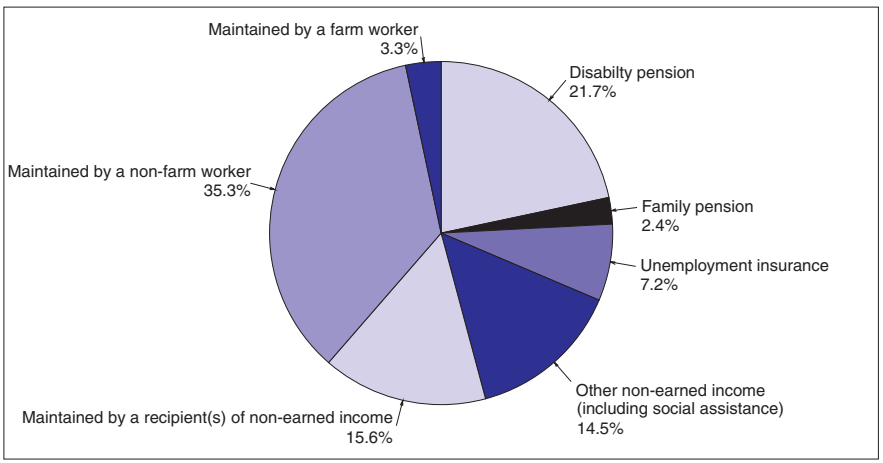
Overall, the benefit system tends to be relatively poorly targeted. The extensiveness and relative generosity of the disability pension system and the

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limited resources provided to the social assistance schemes means that state-financed income redistribution is mainly being accomplished through the extended family, with old-age and disability pensioners of the general (ZUS) and special farmers (KRUS) social insurance schemes supplementing household earnings with their pensions.[4] Only 12 per cent of the public transfers received by the poorest 10 per cent of households come in the form of social assistance.[5] Moreover, the principal source of income for 80 per cent of the non-employed derives from other sources (Figure 3.4). Excluding old-age pensions the transfer system is redistributive in the sense that transfers represent a larger share of household income for lower deciles than for high deciles (Panel B, Figure 3.5). However, in terms of per capita transfers, the reverse is true with wealthier households receiving substantially more than poorer ones. Here, the major culprits are so-called "family pensions" or survivor's pensions and the disability pension system (Panel C, Figure 1.5). The main social assistance programmes,[6] while consuming much less in terms of resources, are better targeted on the poorest households.

Not only do most benefits accrue to the richest households, they are concentrated in precisely those transfers that generate the most important labour market distortions. Like the pre-retirement scheme, permanent disability pension benefit durations are unlimited and can be extended without limit in the case of temporary

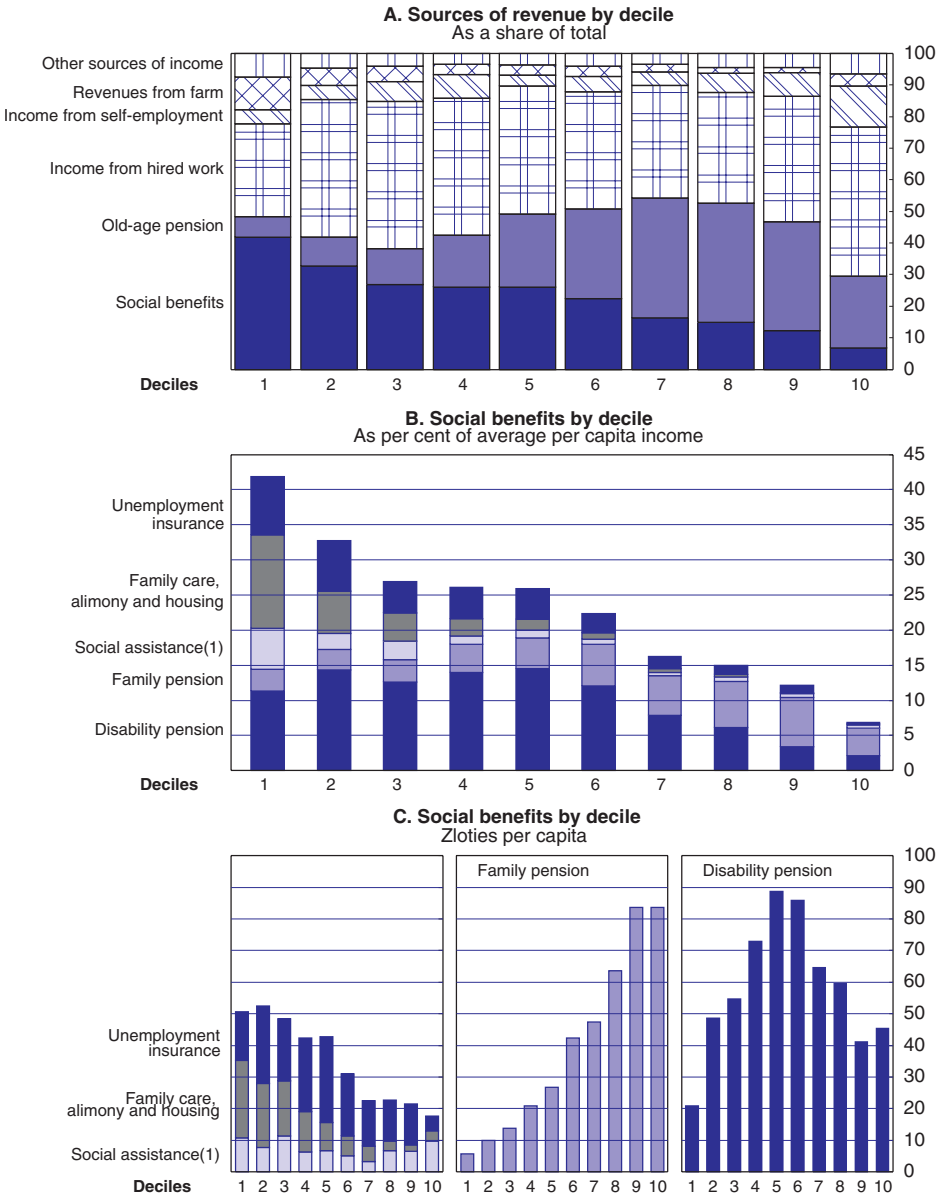
Figure 3.4. **Income sources of the non-employed**
2000



Source: OECD, calculated on the basis of data in Table 2.7 of Pietka (2002).

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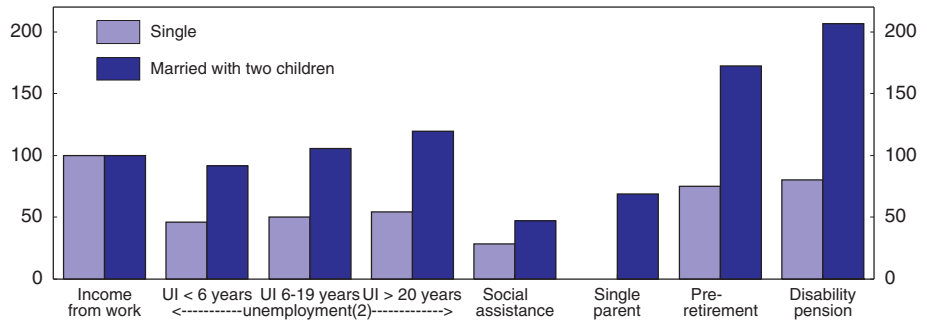
Figure 3.5. **Social transfers and the distribution of income**



1. Permanent and temporary allowances plus other transfers.
Source: Central Statistical Office, 2002 Household Budget Survey, and OECD calculations.

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Figure 3.6. **Net replacement rates**[1]
Per cent of minimum wage, 2003



1. Replacement rates are calculated including other social benefits, such as a 160 zloty housing benefit and family benefits for households with children.
2. Pre-tax unemployment insurance benefits vary with the life-time work record of the beneficiary, rising from 49 per cent of the minimum wage for someone with less than 6 years of experience to 73 per cent for someone with 20 or more years of experience.

Source: Central Statistical Office and OECD.

pensions, while net replacements are close to 200 per cent as compared with a minimum wage job (Figure 3.6) – greatly reducing financial incentives to take up work. Replacement rates in the unemployment insurance and social assistance programme are significantly lower (and in the case of social assistance means-tested), while benefit durations are time-limited, reducing their impact on work incentives. Nevertheless, with after tax replacement rates close to 100 per cent, unless these systems are also reformed, their benefits will appear much more attractive following a tightening of the disability system and they may take that scheme's place as the most important source of dependency traps. The labour-market impacts of the disability and KRUS systems extend beyond their direct beneficiaries because of benefit sharing. The problem is especially serious within the KRUS system, where the opportunity cost for an individual leaving the farm and taking employment in an urban environment should also include the costs to members of his or her household that are non-working or working in the underground economy but who are dependent on his or her KRUS membership for access to health-care and unemployment benefits.

Improving the effectiveness of personal transfer spending

Reforming Poland's personal transfer system will not be easy politically. The existing transfer system has created a serious dependency trap for a large and politically important share of the population. However, improving labour market

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performance is more than an option for Poland – it is a clear social and economic necessity. The rapid fall in employment levels during the recent growth slowdown has brought into sharp relief the weaknesses of existing institutions. Indeed, Golinowska *et al.* (2003) provide estimates that in some regions social and family assistance levels are such that a large proportion of those, out of work would not accept a job offer unless the wage were significantly higher than the average wage – let alone the minimum wage. These kinds of results, and the evidence from the past decade and a half, suggest that unless steps are taken to provide the 50 per cent of the working-aged population that are currently not participating in the formal economy with both opportunities (see Chapter 4 for policies in this regard) and financial incentives to take up work, Poland may continue to plod along in a low-growth, low-employment equilibrium.

The authorities recognise the need for fundamental reform and have recently proposed a wide range of changes designed to reduce the distortions caused by the transfer system (see Box 3.5). In this context, the proposed Public Expenditure Reform, which encompasses many of these changes, constitutes a critical first step in the reform process. Overall, the proposed reforms are ambitious as befits the seriousness of the problem in Poland. The following paragraphs attempt to present them and propose some additional complementary measures that, if implemented, would further improve outcomes.

The proposals for reform of the disability system outlined in Box 3.5, are far reaching and go in the right direction. Nevertheless, much more is required. Indeed, the potential benefits from bringing the disability pension scheme under control are large. Reducing the stock of beneficiaries by restricting benefits to those truly physically unable to work could save as much as 2 per cent of GDP in government spending.[7] Furthermore, a reassessment of benefit levels taking into consideration individuals' earnings potential before and after the disability could generate additional savings. However, achieving a substantial reduction in disability pensioners will not be easy, either technically or politically. Given the number of people involved and the extended period of time they have been out of work, it will be important to ensure that any reform includes measures to ease the transition of these people back into the labour force. Here, four principles, elements of which are included in current proposals, might be worth including in the reform:

1. Increase dramatically the strictness of eligibility requirements for the disability system and re-evaluate existing beneficiaries with an eye to rapidly bringing the stock of disabled pensioners down to OECD average or best practice levels.

2. Simultaneously introduce a time-limited and means-tested post-disability-pension social-assistance benefit coupled with a strict job-search obligation to ensure that those removed from the disability rolls are provided with income support during their transition back to activity.

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Box 3.5. Labour market reforms currently under consideration by the Polish authorities

The authorities are currently considering a number of reforms which, if implemented, could have a substantial impact on labour markets. The most important of these call for:

Disability pensions:

- A rationalisation of the number and categories of disability and associated pensions.
- A dramatic reduction in the stock of disability pensioners and a return to a system whose benefits are dependent on his or her past earnings and more clearly related to the extent that a physical disability limits a workers earning potential.
- The automatic transfer from disability to the less generous old-age pension scheme of individuals having reached retirement age (currently, almost 1/3 of disability pensioners).
- A one-time re-evaluation of all disability pensioners below the age of 55 for men and 50 for women who have been receiving a pension for less than 10 years or who have ever worked.
- Introduction of a requirement that temporary-disability pension beneficiaries be re-examined at least once every 5 years, and a strengthening of monitoring systems.
- A proposal to realign benefits with individual's earning potential.

The Farmers' pension system (KRUS):

- Redefinition of eligibility criteria.
- Reduction of the differences in the premiums and benefits as between the KRUS and ZUS systems, implying a reduction in benefit levels and an increase in contribution rates to the KRUS system.
- Introduction of contribution subsidies for those with lower earnings.
- Elimination of misuse within the system.
- Elimination of associated early-retirement programmes.
- Creation of a rehabilitation allowance to help farmers return to work after prolonged periods of sickness.

Unemployment benefit system:

- Replacing the dependence of unemployment benefit duration on regional unemployment rates with a length of work criteria.
- Reducing the unemployment insurance benefit and introducing a temporary job-finding benefit equal to half the unemployment insurance benefit to be paid to beneficiaries who find work, with the length of this benefit to be linked to the duration of the contract.

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Box 3.5. **Labour market reforms currently under consideration by the Polish authorities** (*cont.*)

Social assistance system:

- A reallocation of some of savings from reforms to the disability system to bolster targeted social assistance spending.
- A revision and harmonisation of criteria for family benefits and a streamlining of their financing.
- A reduction in sick leave compensation to 70 per cent of wages.

Old-age pension system:

- Gradual equalisation of the retirement age of women with that of men (65).
- The replacement of automatic indexation of old-age pension benefits social benefits with a system of periodic increases approved by parliament triggered by a 5 per cent cumulative increase in the consumer price index.
- Leveling of retirement age across occupational groups with earlier retirement ultimately restricted to cases where continued work would endanger an employee's health. In such cases an additional optional insurance fee would be assessed on firms to encourage them to diminish unhealthy positions.
- Gradual elimination of the existing pre-retirement benefit system by 2006.
- Introduction of special activation programmes aimed re-integration of older workers into the labour market.
- Introduction of a partial retirement pension with part-time work from age of 62.
- Restriction of access to survivor's pensions in most cases to individuals who have already reached retirement age.

3. Ensure that benefit levels in this programme are adequate to provide for individuals needs but that they do not constitute a serious barrier to employment at the minimum wage.
4. Make greater use of in-work benefits and earned-income tax credits to increase financial incentives to take on work and increase active labour market measures to support insertion.

The reform of KRUS currently being discussed by the authorities seeks to redesign the system's benefits and contributions. Existing arrangements impede labour market mobility between the agricultural and non-agricultural sectors and prompt mis-use of the system by inducing individuals to participate in underground activities or remain in low-productivity agricultural or rural activities. As

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part of their reform efforts, the authorities are considering replacing the flat-rate contributions in the current system with a combination of a flat rate and a contribution that increases with income. Depending on implementation, this could serve to equalise the overall contribution rates of the KRUS and ZUS systems, thereby eliminating the substantial implicit subsidy that the current system affords rural-based and agricultural work. Not only would such a reform bring in much needed revenues it would be much more equitable both as concerns the treatment of farmers and non-farmers (currently the implicit per capita subsidy of the KRUS system is 7 times that of the general system). Indeed, a reform that equalised contributions with those of the ZUS system would imply no or very little net increase in contributions for poor farmers.

Reform efforts should not stop here however. Once equality in terms of benefits and contributions is established between the ZUS and KRUS systems, the need for special eligibility rules for the KRUS system based on land ownership and the nature of one's activity will be gone and should be dropped.[8] By encouraging individuals to retain uneconomically small farms, these rules have prevented the consolidation of the agricultural sector (see Chapter 4). As a result, the majority of farms do not earn enough of a surplus to finance the kind of investments and expansions that would allow agricultural productivity to increase. Not only does this condemn farmers to continued poverty, it is holding back rural development and diversification. It is only as agricultural productivity and incomes increase that a sustainable demand for rural services will arise that could support non-agricultural rural activities and employment that would yield acceptable standards of living. Proposals to grandfather existing farmers rights to the system, independent of whether they continue to hold land is a step in this direction, which should both promote mobility and permit a more socially acceptable transition towards a more equal system.

Finally, more needs to be done to equalise treatment under the two systems and thereby eliminate the incentives for members of farmers' extended families to remain on the farm, even though earnings opportunities are limited. In order to eliminate the incentive deriving from the extension of health insurance coverage to all members of farming household, health coverage should be made universal (see OECD [1999, 2002a] for more detailed discussions of the health system) and financed from general revenues.[9] Such a move would require raising the take from either the VAT or personal income taxes. It could be coupled with the elimination of ownership requirements and the equalisation of the contribution rates between the ZUS and KRUS system for individuals whose principal earnings come from non-farm work so as to promote labour mobility. As indicated below, if combined with a reduction in the associated social security contributions, such a reform would lower labour costs and boost employment prospects, particularly for the low-skilled.

The public expenditure reform programme includes several proposals to change the unemployment insurance system. Among these, the proposal to elimi-

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nate the dependence of benefits on regional unemployment rates would, if implemented, help to reduce the system's tendency to perpetuate non-employment in disadvantaged areas. Incentives to accept work would be further enhanced if benefit levels were made to reflect individuals' previous earnings. Such a step would reduce work disincentives for low-wage workers with long careers for whom a high fixed unemployment insurance benefit, combined with housing benefits, results in an after-tax benefit 20 per cent higher than the minimum wage (see Figure 3.8). Similarly, proposals to make benefit duration depend on work history could help increase incentives to take up work, but only if duration is made dependent on recent job history as opposed to an individual's lifetime work history. Combined with high replacement rates, increasing the duration of benefits for individuals with long work histories could create a serious poverty trap by encouraging the development of a dependency cycle, where workers with a significant work history effectively share jobs, working for 12 months followed by 18 months of inactivity during which they actually earn more than when working.[10] Finally, the idea to transform some of unemployment benefits into a temporary employment subsidy is an appealing reform that would help shift the balance of incentives towards activity, although the relative advantages of using funds in this way as compared with more targeted active measures should be evaluated.

The family pension or survivors benefit is something of a special case as its benefits combine a social insurance and a social assistance component. The benefit is extended to the families of disability pensioners who die. If one were to assume that the household were the production unit insured, then a survivor's benefit makes sense. However, the benefit, which ranges from 85-95 per cent of a full pension is out of line with generally accepted equivalency scales, which would provide for benefits ranging from 59-81 per cent of the original – depending on household size.[11] Here, plans to restrict access to these benefits to survivors of retirement age should help reduce labour market distortions and could generate substantial savings. In addition to adjusting the parameters of this benefit system, the authorities may wish to re-assess the overall usefulness of the funeral benefit (equal to 8 months unemployment insurance), the alimony fund and other benefits given Poland's overall capacity to pay and the seriousness of the social need being addressed. For the moment, limits on the duration of social assistance benefits and their low levels imply that they make little direct contribution to unemployment and poverty traps. However, their failure to address poverty effectively, both among the employed and the unemployed, has most certainly contributed to society's current reliance on other transfers.

Systemic reform

Implementation of the above reforms would serve to improve work incentives and the number of individuals willing to accept work at wages commensurate

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with their productivity levels, helping to reinvigorate market adjustment mechanisms. However, if limited to these changes, they would also imply a substantial reduction in income support to poor Polish households. In order to ensure that appropriate levels of assistance are provided to the least fortunate without unnecessarily disrupting the functioning of labour markets, resources need to be transferred from pre-retirement and disability pensions to bolster targeted income support for those of working age. Given the state of public finances, this need not and should not imply additional spending.

Making social assistance an effective and employment-friendly mechanism for dealing with poverty will be an essential condition for any reform of the other transfer systems. What form assistance should take will depend importantly on the resources that are liberated to finance it. Nevertheless, experience in other OECD countries suggests that support for the physically able who are not at work should be kept to a minimum, while resources are concentrated on programmes that support employment prospects and the incomes of the working poor. To maximize the probability that current beneficiaries reintegrate successfully into the labour market, care must be taken to avoid generating new benefit traps. As discussed below, programmes need to be put into place, which provide transitional income support on the basis of mutual obligations (especially for younger clients). Here, it will be important to make benefit receipt conditional on job-search and active participation in labour market policies (job-matching, training, work-experience placements). In exchange, the authorities should provide adequate job-search support. While some form of extended benefit might be imagined for former disability pensioners who have been out of the labour market for an extended period of time, such special aid should be time-limited and also subject to conditionality. In this context, a reduced minimum wage combined with an earned-income tax credit (see next section) could be an effective means of helping low-skill workers price themselves into the labour market and ensuring that low-skill households maximise their potential in the labour market. This would provide them with opportunities for personal advancement, while at the same time ensuring that their incomes meet social expectations.

In conjunction with the establishment of a better targeted social assistance scheme and earned-income tax credit, the pre-pension benefit scheme should be abolished, perhaps by initially scaling back benefits to levels less likely to interfere with work incentives for those already receiving benefits and by ceasing to accept new beneficiaries (as is being done for early-retirement pensions). Moreover, if so-called bridge pensions are to be introduced for certain professional groups who in the earlier system could retire early, then contributions should be increased for these individuals so as to retain the system's actuarial neutrality.

Experience with social assistance systems in other countries indicates that coherence in policy implementation among employment and benefit agencies is

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crucial. For the new system to work effectively, it is essential that employment authorities have (financial) incentives to carry out their employment re-integration task for social assistance clients. Here the separation of the PES system and financial responsibility for the unemployment insurance system could pose a problem. One solution might be for the Labour Fund to extend its current practice of sub-contracting job placement activities, perhaps allowing private providers to compete directly for a share in *poviat*'s allotments. To further combat poverty traps, special efforts need to be extended to help individuals from disfavoured environments better themselves. Here resources might be redirected towards helping finance transportation and accommodation costs of secondary students from rural areas.

Improving job prospects of the out-of-work

To improve employment prospects for youth and individuals with limited skills, policy needs to focus on three issues. In the near term, further efforts are needed focusing on reducing the labour cost of young and other low-skilled workers so that they can price themselves into the job market. The combination of high taxes, a relatively high minimum wage and strict employment protection rules prevents such individuals from overcoming the inherent risk that hiring inexperienced and untried workers represents to firms. Over the medium-term, policy needs to focus on improving the quality and relevance of the skills transmitted to new graduates. For those that have already finished formal education, resources need to be reallocated towards the implementation and evaluation of training and learning schemes that yield concrete results in terms of improved employability, wages and poverty reduction.

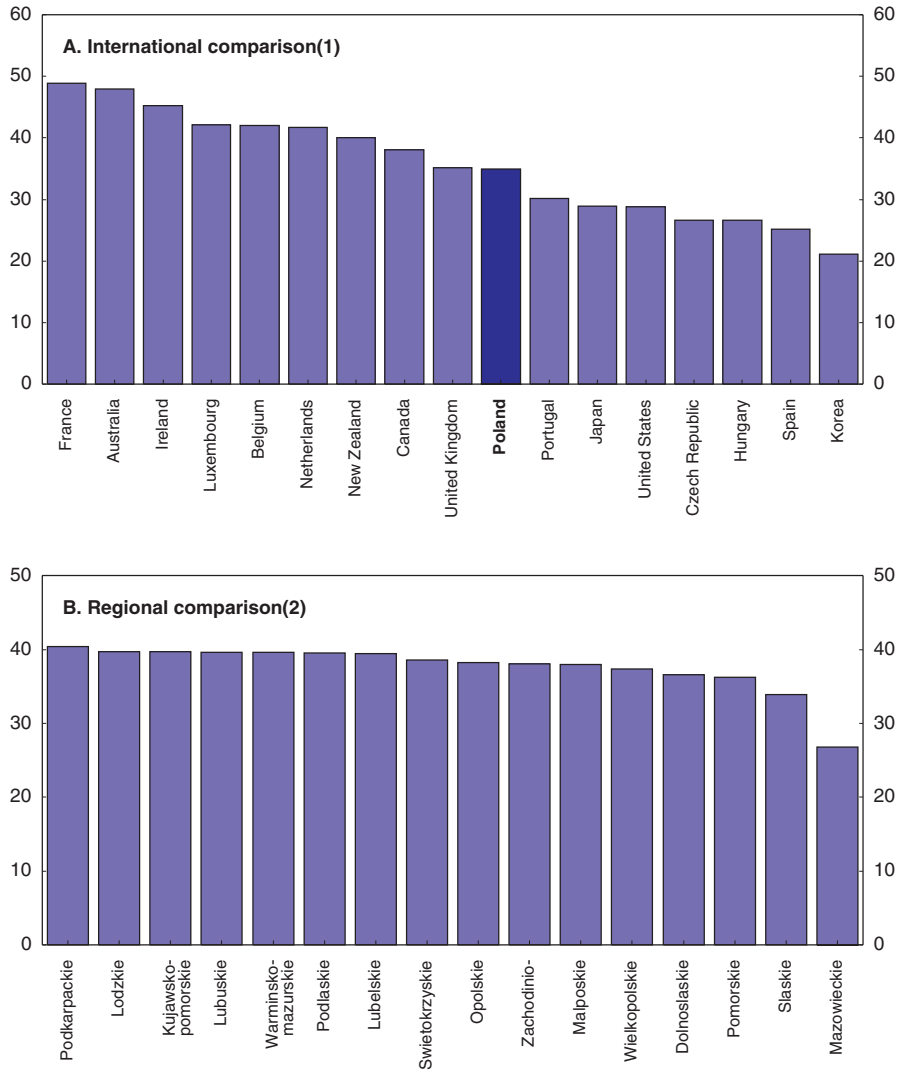
Lower labour costs

In order to address the high incidence of non-employment among all youth, even those with high educational attainments, policy needs to make young job-seekers more attractive as employees. Taking further steps to reduce the streaming and specific skills-orientation of the school curriculum would help improve the weak school-to-work transition (see below). However, efforts also need to be extended to reduce the labour cost of unskilled and inexperienced workers.

At 37 per cent of the average wage, the minimum wage is less high (in relative terms) than in some OECD countries (Figure 3.7), but on average 6½ per cent of employed workers are earning the minimum wage. However, in many regions, the minimum wage is much higher relative to average wages, making it particularly hard for job entrants, the low-skilled and the long-term unemployed to price themselves into the labour market. Indeed, in some regions, the incidence of minimum-wage work rises to between 20 and 25 per cent among employed youth and 40 per cent for those with low-levels of educational attainment (Figure 3.8). The

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Figure 3.7. **Minimum wages and the distribution of wages**
Per cent of full-time average wages

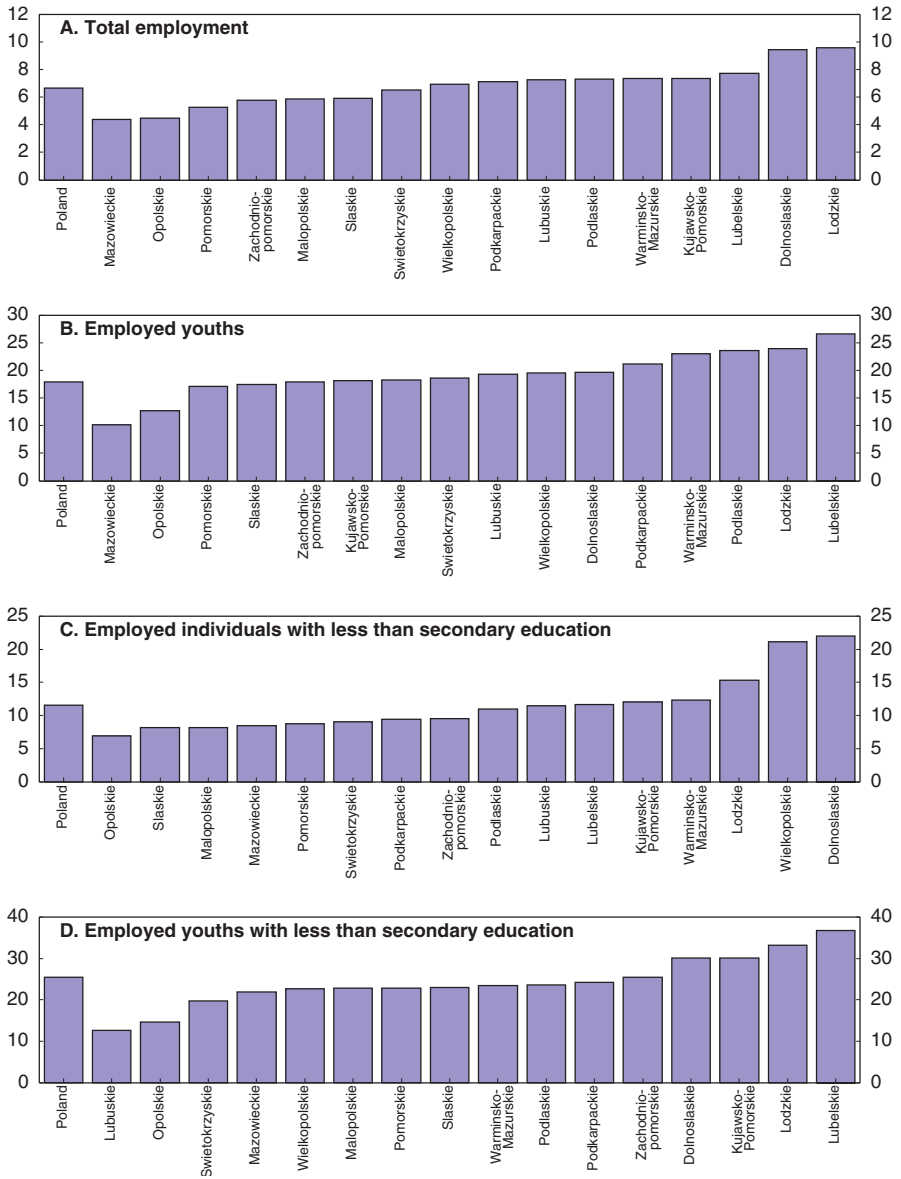


1. Data are for 2000 and concern full-time workers.
2. The ratio of average wages of all workers to those of full-time workers were assumed to be the same in all regions.

Source: Ministry of Finance.

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Figure 3.8. **Regional incidence of the minimum wage**[1]



1. Per cent of employed within population group earning less than 110 per cent of the minimum wage.
Source: OECD calculations based on Central Statistical Office data.

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coexistence of very high youth unemployment, the very high incidence of minimum-wage work among those that do have jobs and a highly skewed wage distribution suggests very strongly that the minimum wage is forming a binding constraint, preventing a significant proportion of young and low-skilled job seekers from finding work commensurate with their productivity levels. Among certain social groups the minimum wage is virtually equal to average wages (Czapinski and Panek, 2003) suggesting that a reduction could have significant impacts on employment.

While OECD research suggests that a minimum wage can be helpful in preventing firms from taking advantage of the weak bargaining position of some segments of the labour force, it is essential that the minimum be set at a level where labour market distortions are minimised. This is not currently the case in Poland. Parliament's recent decision to allow enterprises to pay new entrants 80 per cent of the minimum wage in the first year of a new job and 90 per cent during the second year lowers labour costs for new hires. While the outcomes of this policy have yet to be assessed, it should help make the minimum wage less binding and improve the employment prospects of new entrants with low qualifications, especially in those regions where the minimum wage is high compared with average wages. Indeed, eligibility to the programme should be extended to the long-term unemployed and individuals removed from the disability pension rolls. An even steeper discounting of this minimum for first-time workers, coupled with a monitored obligation to provide on-the-job training, could be envisaged. Over the longer term, the minimum wage should be allowed to decline relative to average wages so as to reduce the distortions it causes. Where there are concerns about the living standard that can be supported by the minimum wage, earnings could be coupled with means-tested in-work benefits to ensure that such jobs remain attractive and households incomes are maintained at socially and fiscally acceptable levels.

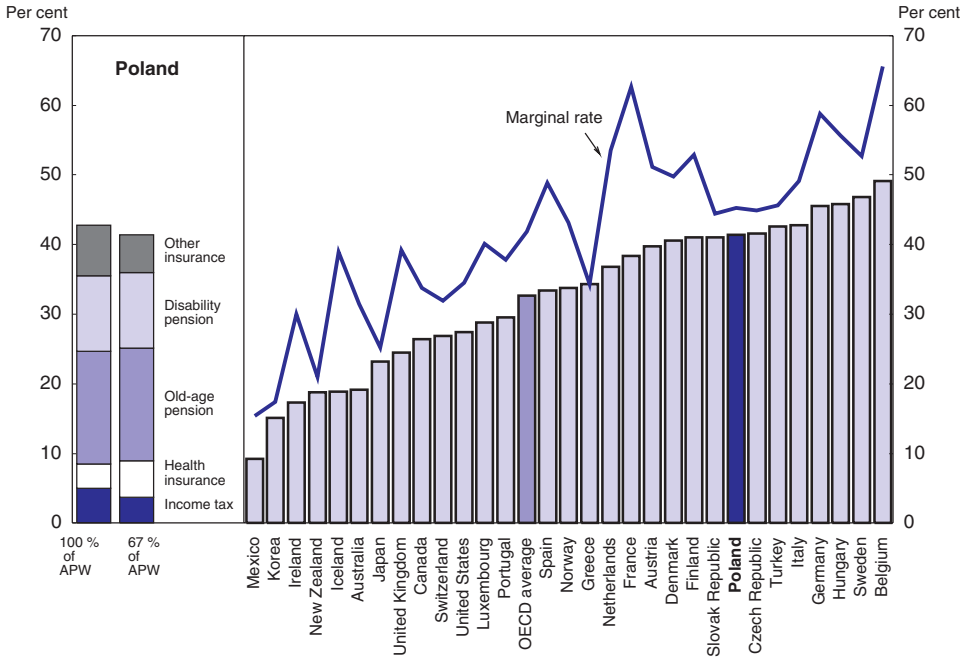
Reduce the tax wedge

Such efforts to moderate the labour costs of lower-skilled workers, and thereby enhance their employment prospects, should be accompanied by efforts to reduce the disemployment effects of the tax system. The 43 per cent wedge that taxes and social security contributions drive between individuals' take-home pay and firms' labour costs (the 8th highest wedge in the OECD) is an important deterrent to employment and job creation (Figure 3.9) – particularly when combined with a binding minimum wage. Fully 21 percentage points of this wedge is accounted for by employees' social security contributions, 17 percentage points by employers' social security contributions and only 5 percentage points come from personal income tax.

Several European OECD countries have sought to mitigate the impacts of high minimum wages and high social security charges by reducing the latter for individuals earning wages in the neighbourhood of the minimum. While such a

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Figure 3.9. **The tax wedge on labour in the OECD**[1]
Single person receiving 67 per cent of an average production worker's income



1. Data refer to 2001. The average wedge is the sum of employees' and employers' social security contributions and personal income tax as a percentage of gross labour costs, *i.e.* gross wages plus employers' social security contributions. The marginal tax wedge is the percentage of gross labour costs represented by increased employees' and employers' social security and income tax contributions, following a rise in net wages.

Source: OECD, *Taxing wages 2001-2002*.

policy can be effective, it can also be very expensive, costing the public purse as much as 2 per cent of GDP – an expenditure that Poland can ill afford at this juncture. A less expensive alternative might be to cut earmarked social security contributions and finance various extrabudgetary activities from general revenues.

Funding shortfalls could be made up by simultaneously reforming the personal income tax system using its potential for progressiveness to reduce the tax wedge for low income earners. A reform that reduced substantially deductions and exemptions so as to widen this tax base could allow marginal tax rates to fall even as average rates increased. Moreover, if tax brackets were revised, the system could be designed to ensure greater effective progressiveness and in particular low average tax rates, and a lower overall tax wedge, for low income workers.[12]

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As indicated above, one option in this regard would involve eliminating healthcare social security contributions, which are currently collected at a constant *ad valorem* rate from wages and raising personal income taxes in a revenue neutral manner. Such a step would reduce labour costs by 2.5 per cent and, if adjustments to personal income tax parameters were made, it could also reduce the tax wedge on low-paid labour by as much as 10 per cent.[13] As proposed in OECD (2002a) and reiterated in Chapter 4, this should be combined with a reform granting universal access to healthcare. Such a step would have the further benefit of reducing one of the important financial incentives to be associated with the KRUS system both for those not working and those active in the underground economy. It will do so by eliminating the 7.8 per cent of wages that ZUS adherents must pay in order to be entitled to heath coverage but which members of KRUS households receive automatically. As a result, an individual would no longer need to remain attached to a farm household in order to benefit from health insurance.

Increase the effectiveness of active labour market policy

If active labour market policy is to play an important role in reactivating the 50 per cent of the working-age population that are not working, spending levels will need to be increased. Indeed, despite having the highest unemployment rate and the lowest employment rate in the OECD, Poland spends less than one fourth of 1 per cent of GDP on active labour market policy – one of the lowest ratios among member countries (OECD, 2003b). While the 2003 Budget authorised the Labour Fund to run a larger than normal deficit, with the hope that the share of active measures' in total spending would increase to some 8.2 per cent, much more needs to be done to support individuals in their efforts to re-establish a connection with the labour market. Indeed, even if this goal were met, spending levels would be well below past levels and those observed in other OECD countries. Moreover, while such a stop gap measure might reverse the decline in spending on active measures, it does not address the systemic problem that results from the financing of both active and passive labour market policy through the extra-budgetary Labour Fund. Because the principal revenue source of the fund is an earmarked payroll tax, its revenues tend to fluctuate pro-cyclically. In contrast, its mandatory expenditures (essentially unemployment insurance benefits) move counter cyclically and as a result funding for active labour market policy falls precisely at the point in time when it is most needed, squeezed by both lower revenues and high passive costs (Table 3.2). Indeed, between 1998 and 2002 the share of active programmes in total labour market programme spending declined from 19.2 to 5.4 per cent. During the same period, spending on passive measures almost doubled, with almost all of the increase coming in the form of increased spending on pre-retirement pensions.

As proposed in the previous *Economic Survey*, in order to enable a refocusing of spending on active programmes, the programmes financed by the Labour

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Table 3.2. **The structure of Labour Fund expenditures**

	1999	2000	2001	2002	2003[1]
	Per cent of total				
Passive labour market policies	69.2	82.8	84.8	89	85.6
O/w pre-retirement benefits	6.4	13.2	20.3	33.0	46.1
Active labour market policies	19.2	11.1	7.0	5.4	8.2
Youth labour market policies	5.5	3.6	4.6	3.4	3.5
Other	6	2.6	3.5	2.2	2.6

1. Forecast by the Ministry of Economy, Labour and Social Policy
Source: Ministry of Economy, Labour and Social Policy.

Fund should be re-integrated into the State Budget. Such a move, would both eliminate the pro-cyclical variation in revenues available for active programmes and also create a further opportunity for reducing the tax wedge on labour, by transferring financial responsibility to general revenues and making use of more broadly-based taxes.

Give co-financing a larger role in active programmes

The importance of ensuring that labour market spending actually improves participants' employment and labour market prospects will only increase as more resources are brought to bear. Poland operates a wide range of active labour market programmes (see Box 3.6), which tend to be oriented towards wage subsidies. Although little recent research has been done to examine the net impact of these programmes, OECD studies suggest that targeted subsidies, like the school leaver programme, can have a positive impact on participants' employment prospects, but that more general programmes, like the public works programmes, tend either to lower the employment chances of participants or to generate substantial deadweight losses by subsidising jobs that would have been filled anyway. Indeed, one of the few studies to examine Polish active labour market programmes, controlling for various form of selection bias found that participation in Polish public works programmes actually hurt individual's job prospects (O'Leary, 1998).

The combination of limited funding and programmes that offset a substantial share of labour costs (between 100 and 40 per cent) means that relatively few spots can be offered and that they tend to be of short duration. Increased reliance on co-financing by both employers and employees might overcome these weaknesses by encouraging a longer-term commitment on their part and at the same time reducing the budgetary cost of each programme post and opening up

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Box 3.6. Active labour market policies in Poland

Programmes include, individual counselling, group counselling, career information, job seeking workshops, job exchanges and fairs, and job clubs, training, training loans, loans to set up a business, loans to created new jobs, grants to individuals continuing education, intervention works, public works, special programs, work of public benefit, refunds of commuting costs.

Recent initiatives include the "First Job" programme introduced in 2002 by labour offices. It is aimed at improving the school-to-work transition by providing targeted advice and concrete financial incentives for both job seekers and employers. These include low interest loans equal to as much as 20 times the average monthly wage to enterprises creating new work places and maintaining them for at least 24 months.

As compared with other countries, active labour market measures in Poland, have concentrated on various wage subsidy programmes. These include:

- Public works programmes (75 per cent wage subsidy) available to sub-national governments.
- So-called intervention programmes discount the wage cost of hiring unemployed workers by as much as their unemployment insurance benefit and can offer a further signing bonus if their employer signs them on after the expiration of the 12 month programme.
- Special school leaver programmes that pay firms hiring eligible individuals the labour and social security costs of a worker up to those associated with the minimum wage.
- Apprenticeship programmes that provide recent graduates with a scholarship equal to the amount of the unemployment benefit if they are accepted in an employment-office certified programme. Social security contributions are also covered by the office, while a designated mentor receives an honorarium equal to 10 per cent of the scholarship value.
- Subsidised loans for individuals hiring the long-term unemployed and for unemployed individuals that start their own business.

While their share in total active labour market spending addressed at the able bodied has declined from more than 50 per cent in 1999 to about 40 per cent in 2001, spending on labour subsidies continues to consume a disproportionate share of active labour market spending.

the possibility of extending their duration or increasing their number. Instead of subsidising the cost of hiring apprentices or individuals receiving on-the-job training for a short period of time, the authorities might authorise firms to hire such workers at a discount from the minimum wage in exchange for on-the-job training. Programmes of this nature elsewhere in the OECD allow firms to pay workers as little as half the minimum wage in exchange for providing apprentices with a well

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defined training programme. In addition to minimising budgetary cost, such programmes tend to be more successful than subsidies because the apprentice, who foregoes a higher salary, and the employer, who must make a real commitment in terms of training, have significant stakes in the programmes' success. A 2003 initiative that allows youth to work for free, but which provides them with health and accident insurance as well as remuneration of the travel and other work related expenses, incorporates substantial co-financing on the part of participants, but much less so for employers. Rather than having the state pay (implicitly or explicitly) the insurance and travel costs of "volunteers", an alternative that would better leverage firms' interests would see them pay these costs. Such a change would have the advantage of opening the programme to more of the unemployed by eliminating the implicit constraint on its overall size imposed by the public-sector's financial contribution.

Increase the central government's ability to monitor and coordinate labour market policy

Coordination and management of active programmes is complicated by the fact that since 2000, the public employment service function has been decentralised and is now assured at the poviat and voivodship level. A National Labour Office retains authority for planning, evaluating and monitoring of programmes but programme delivery is provided locally. Moreover, because half of active labour market policy funds are provided directly to local governments, the ability of the central authorities to direct policy is restricted. For the 50 per cent of spending that the national office controls, it signs contracts with local offices on programme delivery and performance indicators. The other half is transferred directly to local governments on the basis of a formula that takes into account local conditions and the number of unemployed, long-term unemployed and school leavers. While this has the advantage of bringing service providers closer to clients and at least offering the possibility that programmes will better reflect both the needs of employers and those out of work, it has also resulted in a lack of coordination and introduced special challenges in establishing nation-wide jobs programmes.

To overcome these difficulties and to ensure that local governments do not conduct policy so as to maximise funding levels instead of employment, efforts will be required to rationalise the incentives associated with the decentralised management of the public employment service. Current programmes provide more resources to local governments with higher unemployment rates and better raw labour market effectiveness data. Unfortunately, making funding levels dependent on unemployment levels creates a perverse incentive that could be a factor in the persistence of high unemployment levels in rural areas. By the same token, concentrating on raw employment effectiveness data (*i.e.* unadjusted for *ex ante* probabilities of re-employment) likely reduces programme efficiency and increases deadweight losses. This is because local governments are confronted

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with a substantial financial incentive to place individuals most likely to find employment (with or without the programme) into programmes rather than those who are most likely to benefit from them in terms of an improvement in their employment chances. Moreover, because performance indicators are based on raw data there may be a tendency for offices that are efficient, given very difficult conditions, to be under-funded as compared with those where employment possibilities and, therefore, placement performance are better. Studies from other OECD countries suggest that the deadweight loss from this kind of behaviour can exceed 90 per cent. Few such studies have been conducted concerning Poland. The most recent (O'Leary, 1998) may be out of date. Nevertheless, it indicated that intervention programmes, loans for retraining and loans for the self-employed are the most effective policies, while the employment services and public works programmes operated at that time had a zero or negative impact on participants' employment chances.

Increase the flexibility of working-rules

In order to reduce the risk and costs associated with hiring workers, some of the most restrictive elements of Poland's Labour Code need to be further relaxed. A recent survey of Polish small and medium enterprises (PKPP, 2004) indicates that rules concerning maximum working hours, sick-leave rules, restrictions pertaining to work during holiday periods and rules governing layoffs are among those with the most serious impact on employment. In terms of rigidities associated with layoffs, Polish legislation is among the most restrictive in the OECD. In particular, administrative procedures associated with layoffs, for "economic reasons" should be made less burdensome. These rules require firms to provide unions with advance notice informing them of the scope and reasons for intended layoffs; detailed plans regarding the future level and structure of employment as well as reports on the economic and financial situation of the firm. They also require enterprises to enter into consultations with trade unions, discuss with them union-proposed alternatives and negotiate with them the sequencing and criteria for selecting the workers to be laid off. Research suggests that while such rules can encourage labour hoarding during slowdowns by slowing and imposing a large fixed cost on layoffs, they will not prevent them. Rather, by imposing a high fixed-cost on layoffs they tend to make firms favour large-scale firings over a more gradual labour market adjustment process.[14] Indeed, the substantial labour shedding that has been observed in Poland over the past several years would seem to bear witness to the ineffectiveness of such rules in preventing layoffs. In the context of the ongoing recovery, a substantial relaxation of such rules is unlikely to provoke more layoffs. Rather it may help promote hiring by reducing the implicit liability represented by the possibility of having to lay off a newly hired worker in the future.

In general, other elements of Polish employment protection legislation are less rigid. Notice requirements for dismissals with cause and required sever-

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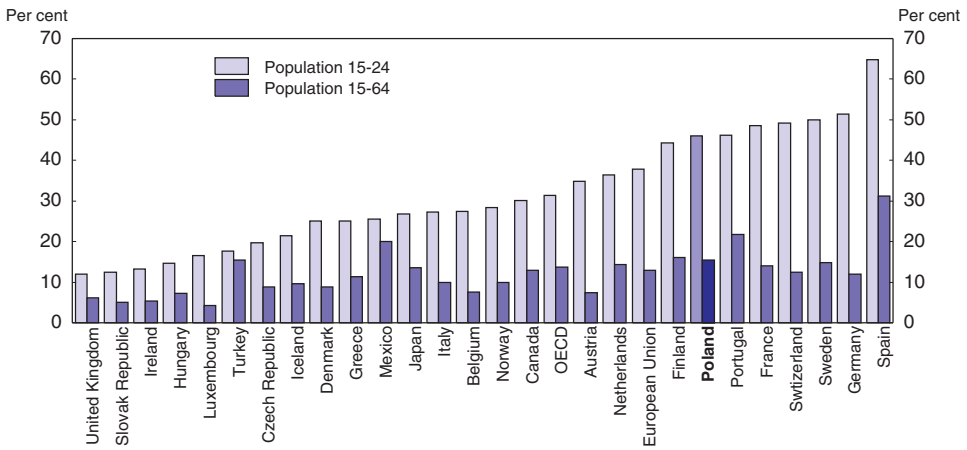
ance payments are about average as compared with other OECD countries.[15] A recent reform allowing firms to hire individuals on a fixed-term contract to replace someone on an excused absence was an important positive step. The previous regulation denied the unemployed the opportunity of such jobs, while forcing firms to keep such posts unfilled. Indeed, the application of these rules to cases of maternity leave may have contributed to a reluctance of firms to hire women of child-bearing age. Nevertheless, some additional areas also require attention. As indicated in earlier OECD *Surveys*, rules prohibiting the termination of a working relationship during periods of excused absence need to be revised and a much more severe screening of individuals seeking sick leave implemented. Sick-leave, which can last up to nine months, is subject to frequent abuse. Anecdotal evidence suggests that individuals frequently "become sick" during the compulsory consultation period that precedes economic lay offs and thereby safeguard themselves from layoff. Such practices explain in part the very high incidence of sick-leave in Poland (on average each Polish employee is sick 17 days a year) and have a very high budgetary (extended sick leave is at the charge of the state) and economic cost, both in terms of foregone employment and output but also in terms of higher taxes and slower growth.

As compared with other OECD countries the incidence of fixed term contracts is relatively low with only 6 per cent of employees signed to such a contract in 2000 (Figure 3.10). Since then, this ratio has been rising and, including temporary work contracts, approximately 17 per cent of the employed have temporary contracts, a ratio that rises to 28 per cent for individuals without a secondary diploma. Unfortunately, rules concerning fixed-term contracts are about to change. A recent reform of the Labour Code included a provision automatically transforming into a permanent contract a fixed-term contract (whose duration is limited by law to two years) if the employee had two such contracts with the same employer with less than a month's break between them. Prior to 1 May 2004 this provision was suspended but now it has come into force and can be expected to slow the expansion of fixed-term contracts. Indeed, such restrictions on fixed-term contracts risk reducing employment levels. Experience in many OECD countries, which like Poland have relatively stringent rules concerning layoffs shows that more flexible job forms, such as fixed term contracts, can play an important role in increasing youth and low-skilled employment by providing firms (and inexperienced workers) with an opportunity to gain on-the-job work experience without firms incurring the substantial costs implicit in a permanent contract. Indeed, during the period the law was suspended the share of fixed term and temporary work contracts increased by more than 70 per cent. Thus, the authorities should give serious consideration to cancelling the regulation.

Recent efforts to reduce rigid controls over working time and the remuneration of overtime have been positive developments that should bear fruit in terms of higher levels of employment. In particular, the recent increase from two to

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Figure 3.10. **Part-time and fixed-term contracts**
2002



Source: OECD.

four hours overtime before higher overtime premia must be paid has helped firms better react to fluctuations in demand, while controlling costs – a reform that should improve their competitive position and ability to take on more staff. Similarly, a number of changes have increased the flexibility with which firms can account for total time worked. These include increasing the period during which working-time can be averaged when calculating compliance with limitations on the total number of hours (including overtime) that can be worked,[16] a widening of the range of activities where task-based working time could be used and a relaxation of rules concerning what constitutes working time.[17] In addition, the authorities have proposed a draft amendment to the Labour Code to relax some rules concerning working time. In particular, the reform proposes introducing the possibility of allowing full-time workers to follow a non-standard work schedule if they request one in writing and their employer agrees. The reform would also allow part-time employees to work fewer days but longer hours in a week as long as no more than 12 hours were worked in a given day.

Notwithstanding these improvements more needs to be done. In particular, despite the above mentioned relaxation, 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

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cross-country differences exist in such rules, reducing the overtime premium to between 25 and 50 per cent and introducing more flexible rules on overtime would bring Polish law closer to international practices. 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.

Finally a number of steps have been taken to reduce the employment-related administrative burden of firms. In particular,

- The employment threshold after which firms must meet heavier reporting requirements was increased from 5 to 20 workers.
- Requirements to establish and negotiate with unions employees' leave schedules were relaxed, but remain.
- The obligation to engage in a two-stage consultation with trade unions before terminating a permanent contract was reduced to a one stage consultation.
- Firms were given more leeway to transfer unused leave to a new contract.
- The paper work associated with renewing a contract was reduced.
- The possibility to hire individuals on a fixed-term contract to replace someone on leave was introduced.

All of these reforms should, by reducing the administrative costs associated with formal employment, serve both to boost employment and reduce the size of the underground economy.

Improve the level and relevance of formal education

The authorities' Strategy for Youth seeks to provide a blueprint for government action to strengthen the labour-market relevance of the educational system. It explicitly recognises that existing inequalities in access to quality education are partly responsible for uneven educational outcomes. While inequalities exist along many dimensions, rural-urban differences are some of the most striking and likely play an important role in limiting the speed of labour market and economic restructuring. The rural-urban divide in educational achievement has existed for some time. Not only is the incidence of low educational attainment in the rural population 40 per cent higher than the urban (Table 3.3), the severity of deficiencies is large, with as many as 25 per cent of adults without a secondary diploma functionally illiterate. Moreover, huge disparity persists: urban students are almost twice as likely as rural ones to be following an educational stream that

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Table 3.3. **Rural *vs.* urban educational performance**

A. Educational attainment rates

	Higher	Secondary and post-secondary	Basic vocational	Primary	Incomplete primary
			Per cent		
Rural areas	4.3	22.4	29.2	38.3	5.0
Urban areas	13.7	38.6	21.1	22.2	1.5

B. Distribution of students with high and low scores in standardised tests

	Standardised test scores			
	Primary		Gymnasium	
	Low	High	Low	High
	Per cent of students		Per cent of students	
Rural areas	25.4	18.7	26.1	20.2
Urban areas	18.9	24.9	12.7	33.5

Source: Panel A: National Census, Central Statistical Office (GUS), 2002. Panel B: Central Examination Board, Ministry of National Education and Sport.

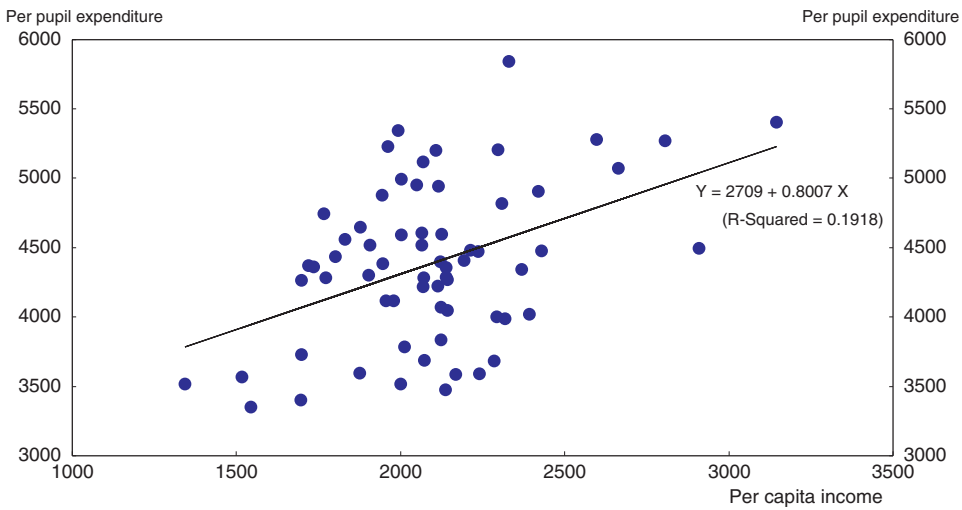
could lead to university-entry; and the share of rural students with low grades in standardised tests is twice that of urban students. While the differential levels of pupil achievement reflect a wide range of socio-economic factors, uneven and inefficient financing of compulsory education likely plays an important role.

In order to ensure that unequal access to quality education ceases to perpetuate income and labour market inequalities, the authorities need to revise the basis upon which primary and secondary schools are financed. Following the decentralisation of funding of primary education between 1996 and 1999,[18] the share in total educational spending controlled by local governments' increased substantially but so did the share for which they were responsible from their own revenues.[19] While this decentralisation may have resulted in a better targeting of expenditure and more efficiency, it also resulted in a dramatic inequality in the level of per capita government spending on primary and secondary education, with the richest *poviats* spending almost 60 per cent more on a per student basis than the poorer ones (Figure 3.11) and attracting the best teachers by paying them a premium over national pay scales.

In order to promote the quality of education at the local level the authorities should revise the formula[20] that determines the level of local government subsidy by taking into better account each units capacity to pay. The current algorithm does so only partially by varying funding on the basis of a formula designed to reflect costs. However, as on average local level governments pay 30 per cent of

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Figure 3.11. **Regional per pupil primary-school spending by income level**



Source: Ministry of Education.

educational costs from their own revenue, the current equalisation system fails to ensure that students have equivalent public resources available to support their schooling. Financing problems are not confined to equalisation. Formulae governing the allocation of resources across levels of education need to be made more flexible so that school financing keeps up with demographic changes. Existing rigidities, which are partly the result of using historic funding levels to determine current ones, mean that per-pupil pre-school funding levels are twice the OECD average, while per student secondary education spending is lower than per capita expenditures at the primary level. The World Bank indicates that in Poland maintenance and school supply expenditure are underfunded, frequently being squeezed out by wages.

In addition, more resources need to be devoted to ensuring that accommodation and transportation costs do not prevent rural students from pursuing educational streams that give them access to university. Currently only one in ten university students come from rural areas. Here there might be an opportunity for expanding the special scholarship programme operated by the state Agricultural Property Agency[21] for the children of former employees of state-owned farms. This programme helps bridge the gap in access to education between rural children and urban youth, by offsetting the transport and accommodation costs of children studying for the maturity exam certificate.[22] The current programme provides

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funding that averaged about one third of the minimum wage or half of the per capita income of rural households. A more broadly based programme, perhaps involving a smaller per student subsidy and a reimbursable student loan, might prove an effective way of co-financing an expanded programme.

Finally, the authorities need to look more closely at possibilities for co-financing in education. Some observers argue that in the Polish context, offering private primary and secondary-level schools the same level of subsidy as state schools represents an unwarranted subsidisation of wealthy families' decision to provide their children with a better education and as such contributes to inequality (World Bank 2003). More generally, given the strong positive private returns to tertiary education, the authorities may wish to re-examine rules concerning its financing, by allowing tuition fees to play a larger role. Currently, 46 per cent of all university-level students (those following full-time studies at state-owned universities), pay no tuition fees reflecting a constitutional provision guaranteeing access to free university-level education. In contrast, the remainder of university students, including full-time students at private tertiary institutions (28 per cent of the total) and part-time and night students at both state-owned and private schools pay fees. Allowing state-owned universities to charge fees for full-time courses would not only increase these schools resources, thereby allowing them. Although such a move may require constitutional amendment, it is warranted all the more because state-financed schools tend to be the most prestigious schools, where the private returns to education are highest and which tend to be attended by better-off students.

Improving the quality of rural education will require that recent efforts to reduce streaming and the specific-skill orientation of vocational programmes be expanded. While excessive streaming into non-academic specialisations is a problem throughout the Polish educational system, it is more severe in the rural sector. Here, the quality and relevance of secondary education and the employment prospects of secondary students would be enhanced by a further reduction in the variety of upper-secondary schools leading to a university-admission maturity certificate. The authorities should consider eliminating the distinction between more exclusively academically oriented schools (lycea) and the 14 different strains of more professionally-oriented schools. The co-existence of purely academic and more applied schools, which nevertheless offer virtually the same curriculum, works to the detriment of the latter, whose degrees and accomplishments continue to be viewed as inferior. A better alternative would be to unify the secondary schools offering university-admission level programmes, allowing students that wish to specialise to do so via the elective courses they choose. Moreover, the authorities should consider abandoning the basic vocational stream. There is an enormous gap between the quality of education it offers and that offered by the general secondary education schools (OECD, 2003c). Indeed, while only 13 per cent of secondary students follow the basic stream, their graduates accounted for

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Box 3.7. The strategy for youth

The authorities adopted in July 2003, a ten year *Strategy for the Youth*, which addresses the important link between the unequal educational opportunities and unequal labour market performance. It sets out a ten year programme during which, in addition to other objectives, reforms are supposed to equalize educational opportunities and improve the labour market relevance of the education system. The strategy seeks to improve results for four specific target groups.

- Youth in rural areas.
- Disabled youth.
- Youth in areas with high unemployment.
- Youth from disadvantaged backgrounds.

The specific actions identified in the *Strategy* seek mainly to minimise the differences in the quality of education between rural and urban areas as well as between general and vocational secondary schools. A particular area where differences are pronounced is English as a foreign language education, where enrollments ranges from 90.6 of pupils in general secondary to 12 per cent of basic vocational education.

41 per cent of their cohort's unemployment. Although the better labour market performance of students following the general secondary education reflects selection bias, it also reflects the more general and problem-solving oriented education that these students receive, which is better suited to today's modern and rapidly changing labour market.

Conclusion

The challenge represented by reducing joblessness in Poland is enormous, as are the potential benefits in terms of higher incomes, reduced poverty, faster growth and more rapid convergence. As daunting as the task may be, it is not impossible – a number of OECD countries have succeeded in putting into place sometimes very difficult structural reforms that have enabled overall employment rates to increase by 10 or more percentage points.[23] While the nature of the pre-reform problems in these countries was different in each case, the striking improvement in recorded labour market outcomes reflected the results of deep-seated and fundamental labour-market reform. Moreover, while strong growth helped in many cases, this was generally a consequence of the improved labour market performance following structural changes. Box 3.8 summarises the recommendations of this chapter as concerns labour market policy.

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Box 3.8. Summary of labour market recommendations

Rationalise personal transfers to reduce poverty and unemployment traps

Disability system

- In order to increase incentives to work, continued access to disability benefits should be restricted to people who are truly unable to work and early-retirement schemes should be abolished.
- In conjunction with a re-evaluation of the extent of disability of existing beneficiaries, a time-limited post-disability-pension benefit should be introduced to provide income support during individual's transition back into the labour force. Benefits should be lower than in the disability pension and conditional on job-search so as to ensure financial incentives to job search.
- In exchange, job-search services and targeted active labour market programmes should be reinforced.

Farmers social insurance system

- Contributions and benefits to the general (ZUS) and special farmers' (KRUS) social insurance schemes should be harmonised so as to eliminate incentives to remain in low productivity agricultural jobs.
- Land-ownership requirements for the KRUS system should be abandoned so as to facilitate rural-urban migration and eliminate incentives to retain uneconomically small farms.

Labour market withdrawal programmes

- Plans to eliminate the early-retirement pension scheme should be carried through with access to the pre-pension unemployment benefits more closely monitored.

Unemployment insurance

- The dependence of unemployment benefits on regional unemployment rates should be eliminated to reduce the risk of region-specific unemployment and dependency traps.
- Work disincentives from unemployment insurance benefit should be reduced by making these reflect individuals' previous earnings and the possibility to transform benefits into an in-work benefit should be introduced.

Social assistance

- As resources into the disability scheme are reduced, those of the social assistance system will need to be reinforced to ensure that adequate means-tested income support is provided to those who have difficulty finding work.
- For those who are able-bodied, benefit receipt should be made conditional on active job-search.

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Box 3.8. **Summary of labour market recommendations** (*cont.*)

Increasing labour demand – especially for the young, long-term unemployed and unskilled

- So as to help low-skilled workers to price themselves into the labour market, the labour cost of a worker paid at the minimum wage should be reduced by allowing the minimum wage to decline relative to average wages and by re-ducing the tax wedge for low income workers. For this purpose, healthcare social security contributions should be collected from a reformed personal income tax system instead of a constant ad valorem rate from wages.
- In order to increase the incentive to work and to avoid poverty of low paid workers, greater use should be made of in-work benefits.
- To make better use of limited resources and to ensure a stronger commitment between employer and employee, special employment promotion programmes (such as apprentices and on-the-job programmes, and subsidised labour schemes) should make greater use of co-financing mechanisms.
- Active labour market policy and public employment services should be made more effective by increasing funding, rationalising the mechanisms for determining central government payments, more comprehensive evaluations and by improving coordination between independent local offices.
- The pro-cyclical financing of active labour market programmes should be eliminated by reintegrating these programmes into the State Budget.

Increase the flexibility of working-rules to promote hiring under uncertainty

- Administrative procedures associated with layoff for "economic reasons" should be made less burdensome.
- The authorities should cancel the provision that came into force on 1 May 2004, which automatically transforms a fixed-term contract into a permanent one if the employee had two such contracts with the same employer.
- The overtime premium should be reduced and annualised working hours introduced so as to increase firms' capacity to react to fluctuations in demand.

Improve the level and relevance of formal education

- Regional inequalities in access to quality education should be reduced by taking into account local governments' ability to finance primary schools.
- Allocation of resources across levels of education should be made more flexible so as to adapt to demographic changes.
- More resources should be devoted to facilitating the access of rural students to university.
- Existing efforts to reduce the extent of streaming should be reinforced.
- Both for equity reasons and in order to enhance revenues and help state-financed universities grow and develop, tuition fees (and student loans) should be introduced for full-time day courses.

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Achieving similar such employment improvements in Poland will require actions on three broad fronts.

- Ongoing efforts to reduce inactivity traps will need to be pursued forcibly and extended. Work incentives for too large a share of the potential work force are seriously reduced by various social transfers, notably disability pensions. In general, access to social benefits needs to be restricted to those in genuine need and benefit levels revised to better reflect labour market considerations. Here, a combination of greater use of in-work benefits and much more stringent enforcement of job-search requirements and means-testing would help.
- The labour costs of hiring low-skilled and younger workers need to be brought into line with their underlying productivity. Reducing the minimum wage and payroll taxes would make hiring such workers more economical for many firms. Similarly their willingness to hire at given activity levels would be further increased by reducing burdensome administrative and regulatory requirements, notably as concerns layoffs and overtime.
- Over the long-term, continuing efforts to increase the relevance and quality of the education of school leavers would both serve to improve their employment prospects but also their incomes. Here, educational outcomes in rural areas are of particular concern.

Reform in all of these areas should help restore labour market adjustment mechanisms and help move Poland away from its current low-employment, low-productivity equilibrium. In addition, if product-market reforms like those outlined in Chapter 4 are pursued simultaneously, they will serve to shorten the overall transition period by boosting activity rates and the overall demand for labour.

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Notes

1. Only 20 per cent of Polish disability pensioners work as compared with 45 per cent in the rest of the OECD (OECD, 2003d). However, given the higher incidence of disability pensioners expressed as a per cent of the population the incidence of work and disability pension receipt is about the same in Poland and the rest of the OECD, 2.6 per cent. On the other hand, the share of the population receiving a disability pension and not working (10.4 per cent in Poland) is 3.2 times as large as the share in the OECD as a whole, 3.3 per cent.
2. The legal limit is twice the minimum old age pension, which as indicated in Figure 3.13 exceeds the minimum wage.
3. The unemployment insurance scheme's share in them is 2.45 percentage points.
4. Indeed, 80 per cent of cash transfers are in the form of old-age, disability and family pensions as compared with only 2 per cent in the form of social assistance benefits.
5. Permanent and temporary social assistance payments as a share of total transfers, including old-age pension.
6. Permanent and temporary social assistance allowances, family care, alimony and housing allowances and to a lower extent unemployment insurance.
7. Disability pension expenditures in 2002 represented 4 per cent of GDP. Assuming that the incidence of true physical disability in Poland is the same as in other OECD countries, then the number of pensioners and the level of spending could likely be reduced by more than 50 per cent.
8. Indeed, the current definition of what constitutes an eligible activity are relatively vague and contribute importantly to the sense that the system is being abused by those for whom it was not intended.
9. OECD (2002) provides additional arguments in favour of such a step. The VAT has the advantage of being relatively easy to collect and covering a wide tax base. The personal income tax system on the other hand, if amended to increase its progressivity, would offer the possibility of reducing the overall tax wedge on low-skilled workers.
10. Such forms of implicit job sharing have been observed in a number of communities, notably in Canada.
11. Based on the so-called OECD equivalency scale, which assumes a second adult adds 70 per cent to a household's expenditure, which a child 50 per cent as compared with a single adult. According to this scale, therefore, a two-person household receiving a 170 benefit could fall to 100 if one person were to die and a 3 persons (2 adults, one child) would fall from 220 zloty to 170 zloty while still preserving the same effective levels of income.

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12. Currently, parameters in the system are such that virtually everyone pays the same low average rate of personal income tax, about 5 per cent. Marginal rates are in contrast high, equal to a virtually identical at 45 per cent for individuals earnings earning ⅔, 100 per cent and 167 per cent of the average wage.

13. Assuming that a minimum wage earner pays no personal income tax. Employers pay a 2.5 per cent Labour Fund contribution and employees a 7.75 per cent Health Fund contribution.

14. 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.

15. Notice periods range from two weeks to three months depending on the type of contract and the length of employment.

16. From 3 to 4 months in January 2003 for all firms, to 6 months in construction, agriculture, property, public utilities and personal-security services and to 12 months if justified by specific organizational or technical conditions influencing the course of work.

17. Firms can now deduct up to 60 minutes a day from paid working time for time spent by employees eating or attending to personal affairs. Previously, such break time was obligatorily included in remunerated work time.

18. The central government's overall contribution to sub-tertiary education fell to 75 per cent and takes the form of subsidies and earmarked grants. The increased reliance on sub-national governments' own revenues has led to an increase in the disparity of per student expenditures across *poviats*.

19. Currently, some 45 per cent of current expenditure on education is financed from the State Budget, mainly in the form of the educational component of the general subsidy for local government units, which is used to finance the expenditures on the activities of public and non-public schools, including schools for children, youth, and adults. Additionally, the subsidy may be used for financing of tasks related to the further education and professional improvement of teachers, tasks related to individual education, and expenditure related to the rationalization if the school network.

20. The educational component of the general subsidy is distributed according to a formula that is updated on an annual basis. In the design of the algorithm, the amount of the subsidy allocated is dependent on the scale and structure of the tasks assigned to a local government. The scale of such tasks is measured by the number of students and other participants of educational activities. Funding is determined as a function of the number of students in schools operating in rural areas or small towns (up to 5 000 inhabitants), transportation needs and the number of disabled children.

21. Formerly Agricultural Property Agency of the State Treasury.

22. Maturity exam certificate is a condition of progression to tertiary education.

23. Over the past 30 years, the following OECD countries have succeeded in raising overall employment rates by 10 or more percentage points: Australia, Spain, Luxembourg, the Netherlands, Norway, the United States.

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4. Policies to speed convergence

Poland has made substantial progress towards establishing a vibrant economy, where private entrepreneurs are able to pursue opportunities with growing support from legal institutions and in an environment where regulatory and administrative burdens are declining. The private-sector now produces some 75 per cent of GDP; there are over 1.7 million active independent firms and the Polish stock market is the most active and largest in Central Europe. The transition to a market economy has been facilitated by major changes to laws governing capital and product markets, and efforts to improve the regulatory framework. However, despite substantial accomplishments over the past decade and a half, problems persist. Investment levels, though rising rapidly in recent years, are low relative to other emerging economies and have been declining, productivity levels are low and a large and stagnant agricultural sector represents a persistent drag on the economy. All these factors raise costs, lower activity and limit aggregate demand for labour. As a result, policies aimed at improving the investment environment, speeding up productivity growth and restructuring of the agricultural sector should be seen as complementary to the labour – market reforms described in Chapter 3, in that they increase the long-term demand for labour and should, therefore, speed the transition to higher employment rates. The first section of this chapter focuses on factors affecting the attractiveness of Poland as a site for investment, a second on policies susceptible to speed productivity growth and a third which deals with issues more directly related to rural development.

Policies to improve the environment for investment

The attractiveness of an economy as a site for investment depends on a wide range of factors: the productivity of its labour force, wages and other labour costs, the tax treatment afforded to business activity, predictability of the regulatory environment, administrative burdens associated with business activity and the extent to which existing laws and their execution enforce property rights. This *Survey's* special chapter on the labour market (Chapter 3) deals with a number of factors affecting labour productivity and labour costs that are relevant in this regard, not least among these payroll taxes, employment protection legislation

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and the minimum wage. This section deals with those affecting product markets more directly.

Improving the economy's capacity to attract high quality foreign direct investment and to direct domestic savings towards productive projects is among the most important challenges facing the Polish economy. Raising investment levels will serve to increase potential output in general. Foreign direct investment, in addition to serving as a complement to domestic savings in the financing of investment, is often associated with enhanced global economic integration and accelerated productivity growth as a result of transfers of technology, skills and know-how. Indeed, over 50 per cent of Polish exports are produced by firms with foreign participation. While the government has an important role to play in the funding and organisation of investment in public goods (see below), the private-sector is the source of the bulk of investment in Poland, as indeed is the case in every OECD country. Here, the government's role is to create framework conditions in terms of infrastructure, labour force quality, and legal and regulatory environments that make investors – both foreign and domestic – want to undertake projects in Poland.

Investment performance

Poland is the largest and the most geographically and industrially diversified economy of the emerging former-communist OECD countries. Nevertheless, because of similar comparative advantages – especially *vis-à-vis* more developed OECD countries – Poland competes very naturally with other emerging economies as an investment destination – both as concerns foreign and domestic investors. It shares with them a number of weakness – principally, low stocks of quality physical capital and know-how, an underdeveloped services sector and a relatively weak institutional structure. However, it also shares with them a number of strengths, including membership in the European Union (as of May 2004), a well educated and relatively inexpensive labour force, and strong commercial links with the markets of both the former Soviet Union and the EU.

As discussed in Chapter 1, while investment and foreign direct investment were very strong in the mid-1990s, they have since weakened considerably. Moreover, even in the good years Poland's performance on a GDP or per capita basis was less strong than in other emerging economies. The remainder of this section discusses a series of policy initiatives that together can be expected to improve the investment climate in Poland and, as a result, boost productivity growth and the speed of convergence. Issues discussed include policies required to improve the effectiveness of the banking-sector and other financial markets in channelling private-sector saving towards the most effective investment projects; policies to improve the enforcement of property rights; tax policies; and investment promotion policies.

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Making more productive use of domestic savings

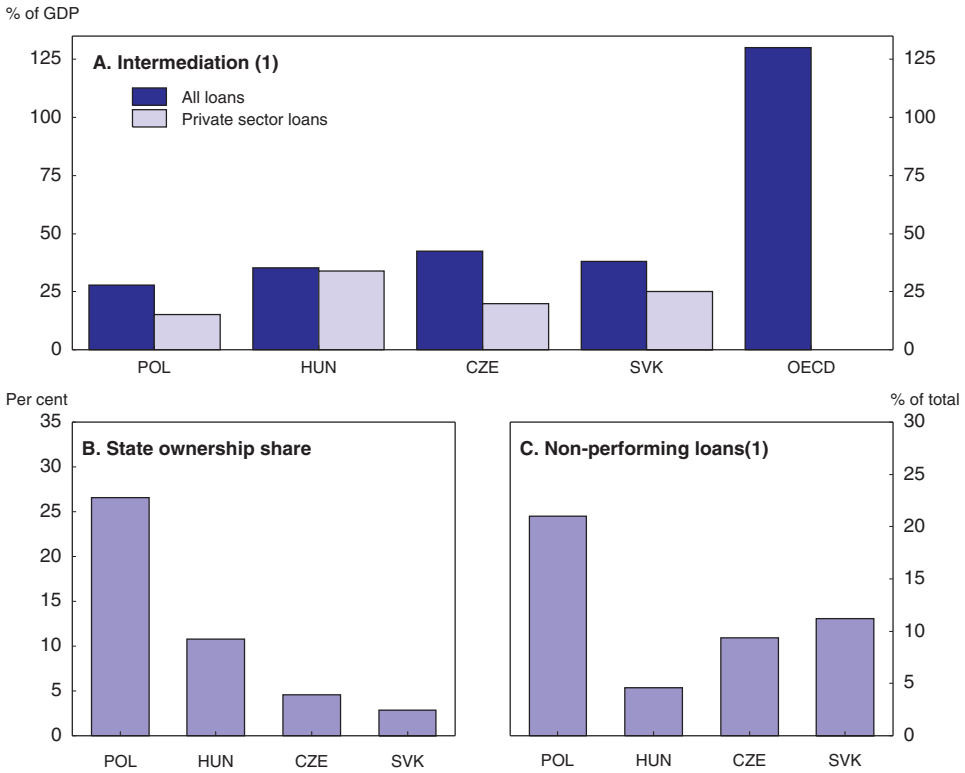
Financial markets play a critical role in supporting investment activity and productivity growth by channelling domestic and foreign savings towards worthy investment projects. While Poland's banking sector is generally considered to be stable and poses no systemic risk, having received favourable evaluations recently by the IMF and enjoying positive ratings from private-sector agencies, it does not perform this critical intermediation function very well. Only 17 per cent of corporate investment spending is bank financed in Poland as compared with 42 per cent in the Euro zone and bank-financing of current operations is similarly weak. Overall, total loans represent only 28 per cent of GDP (NBP, 2003), about a quarter of the OECD average and lower than the intermediation rates observed in other OECD emerging economies (Figure 4.1). Moreover, 21 per cent of loans are classified as substandard[1] and 11 per cent are non-performing.[2] As a result, the extent of disintermediation is even greater, with active loans representing less than 25 per cent of GDP as compared with deposits of 37 per cent of GDP.

To a certain extent weak banking-sector intermediation reflects transitional issues common to the banking sector in all emerging economies. Pre-existing banks tended to be over-staffed and excessively specialised, resulting in weak competition in sub-markets and high costs. Client markets tend to be characterised by many very small and, therefore, risky domestic firms or very large international firms with easy access to financing from external sources. Finally, property and creditor rights and their enforcement tend to be weak, adding to the risks inherent in lending. Taken together, risky clients, high costs and a lack of competition have been reflected in large interest-rate spreads between deposits and loans and low loan volumes. While initial conditions varied across transition countries and the paths they have taken since then have diverged, the Polish banking-sector lies behind others in the region in terms of: intermediation, privatisation, interest-rate spreads and the quality of loan portfolios.

In order to speed progress, efforts need to concentrate on reducing bank costs on the one hand and increasing competitive pressures on the other. For the moment the sector remains relatively fragmented with the five largest banks holding less than half of assets as compared with much higher concentration ratios in other emerging economies.[3] While the large number of active banks reflects easy entry conditions during the beginning of the transition, the small size of most of them may be preventing the exploitation of potential economies of scale. Indeed, the financing of even medium-size projects frequently requires establishing a syndicate of banks. Unfortunately, the State's apparent reluctance to exit the sector may be preventing any single private-sector lender from achieving the necessary critical size that would provoke a wider-scale restructuring. Banking-sector privatisation in Poland lags progress in other emerging economies[4] and the 25 per cent of banking assets still controlled by the State exercise an important influence on

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Figure 4.1. **Banking sector: comparative statistics**



1. Financial sector data for Poland concern 2003 and were provided by the NBP. Data for other countries concern 2002 and were taken from (EBRD, 2003) except for total loans (OECD, 2003).

Source: EBRD, Transition Report 2003, NPB (2003) and OECD (2003).

the overall market. Moreover, uncertainty over the final ownership structure of the sector may be slowing consolidation as strategic owners of smaller banks wait to see whether their aspirations to gain market share can be met through future privatisation deals.

For the moment, the State has only limited plans for further privatisation in the banking sector (Box 4.1), preferring to retain majority stakes in the three largest banks that it owns so as to keep control of their activities, which are concentrated in the retail banking and rural finance fields. A more aggressive privatisation strategy could be expected to reduce costs more rapidly and lower real lending rates by increasing competitive forces, which would likely result in higher levels of investment.

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Box 4.1. Banking-sector privatisation

Currently, the State owns or controls 7 banks,[1] representing about 25 per cent of the sector's assets. Two of these provide standard commercial banking services: PKO B*ank Polski*, (PKO BP), which is one of the country's leading retail banks, and Bank Pocztoy (BP), which is operated by the post office, providing retail banking services. B*ank Gospodarki ywnociowej* (BGZ) is a more specialised bank, with a strong position in the rural market. B*ank Gospodarstwa Krajowego* (BGK) is a state bank, which acts as a clearing house for payments between the state and the private sector.

The authorities intend to retain control over PKO BP and BGZ. They hope to float minority stakes in PKO BP and BGZ via public offerings on the Warsaw Stock exchange during the course of 2004. Prior to any sale, the restructuring of BGZ will need to be completed. The hope is to transform BGZ into a universal commercial bank, providing services to agriculture and food processing industry. In recent years, the bank has encountered significant difficulties and does not currently meet PNB minimum reserve and capitalisation requirements. In October 2002, a restructuring plan was adopted,[2] which if executed, would require BGZ to increase its shareholders' equity by 1 billion zloty, in two tranches, one to be concluded by 30 June 2004 and the second a year later. To this end, the Ministry of Treasury would like to attract a strategic investor who would inject capital in the amount of 1 billion zloty. Moreover, it is felt that the entrance of a strategic investor would increase interest in an eventual share offering on the Warsaw Stock exchange.

1. PKO B*ank Polski* (PKO BP), B*ank Gospodarki ywnociowej* (BGZ), and B*ank Gospodarstwa Krajowego* (BGK) (which has the status of a state bank), BankPocztowy S.A. (controlled by Poczta Polska, the national postal service), B*ank Ochrony rodowiska* (BOS). And B*ank Inicjatyw Spoeczno-Ekonomicznych* (BISE).
2. "Program for the Development of BG S.A. as a Universal Commercial Bank and Program for Increasing the Bank's Shareholders' Equity". The Banking Supervision Commission signed off the Program and passed Resolution No. 366/KNB/02 amending Resolution No. 74/KNB/2001 of 6 August 2001, changing the dates and amounts of external recapitalisation to the benefit of BG S.A.

Partly as a result of this ownership structure and notwithstanding some progress towards bringing them down, costs remain high. This may reflect the restrictions that were placed on private-sector purchasers in terms of labour force adjustments may have limited the extent to which they have been able to lower costs, thereby contributing to high spreads. Operating costs represent 54 per cent of gross interest income and over 109 per cent of net interest income (Table 4.1). Expressed as a share of assets and notwithstanding low wages, labour and other costs are about double the rates observed in the euro zone. As a result, the spread between lending and borrowing rates exceeds 10 percentage points in the retail market and 6 percentage points in the corporate

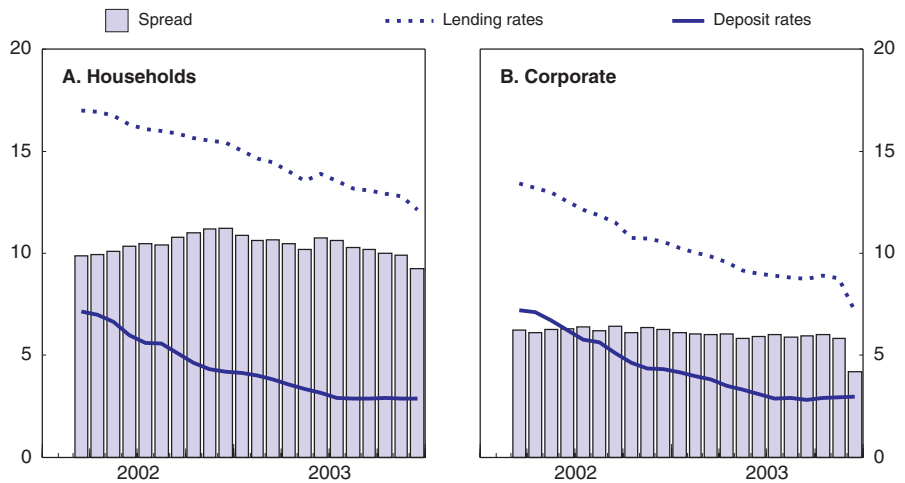
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Table 4.1. **Key bank performance indicators, commercial banks**

	Dec. 1998	Dec. 1999	2000	2001	2002	June 2003
Number of banks analysed	79	75	73	66	60	56
	Per cent of average total assets					
Earning assets	83.4	86.9	87.6	82.1	86.3	87.1
Performing assets	82.4	85.0	74.9	78.9	82.4	82.8
Interest received	14.7	11.2	12.9	11.7	7.7	5.9
Interest paid	10.0	7.1	8.8	8.3	4.4	2.9
Net interest income	4.7	4.1	4.0	3.3	3.3	3.0
Net income from core activity	6.6	6.0	6.2	6.0	5.9	5.3
Operating costs	3.7	3.6	3.7	3.5	3.4	3.2
Pre-tax earnings	1.7	1.7	1.5	1.4	0.8	1.3
ROA (net earnings)	0.7	1.0	1.1	1.0	0.5	0.9
ROE (net earnings)	9.2	14.2	14.5	12.9	5.3	10.3

Source: National Bank of Poland, OECD calculations.

Figure 4.2. **Interest-rate spreads**
Per cent



Source: National Bank of Poland.

sector (Figure 4.2) – much higher than in other transition countries. As a consequence, banking deposits lack appeal as compared with other instruments, such as low-risk government debt, and loans are prohibitive for borrowers, with the result that domestic lending tends to get crowded out.[5] Indeed, subsidised

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agricultural loans by the State-owned BGZ bank represents as much as 54 per cent of all corporate lending (EBRD, 2002). In an effort to improve bank profitability and allow a reduction in spreads, the authorities recently reduced reserve requirements and as of 1 May 2004 have begun remunerating reserves. Nevertheless, they may wish to do more, perhaps by bringing reserve requirements down to levels in the Eurosystem.

To a certain extent the high costs of Polish banks also reflect very tight prudential regulations. Until the end of 2003, banks were obliged to provision up to 100 per cent of loans that were as a little as 90 or more days past due (there were classified as loss loans). While such rules have helped to ensure overall stability, the sector has likely achieved sufficient maturity so that a relaxation of rules would not place stability at risk while allowing banks to provide more financing at lower cost. As of January 2004 provisioning rules were relaxed and harmonized with international practice. As a result, loans now fall into *loss* category and require 100 per cent provisioning only after 360 days of arrears (180 days for consumer loans). Similarly, Polish loan classification rules have been brought closer into line with international norms, which should reduce the share of loans recorded as classified. Moreover, a revision to the tax treatment of non-performing loans should incite banks to right them off more quickly, further helping to make Polish data on non-performing loans more internationally comparable.

Enforcing property rights and facilitating restructuring

The difficulties that creditors have experienced in securing assets offered as collateral for loans represents another important factor contributing to low intermediation rates and high spreads. On average it takes 18 separate legal procedures and more than 3 years to recover a debt in Poland (World Bank, 2003), which compares unfavourably with average recovery periods of 1¼, 1 and ¾ of a year in Slovakia, Hungary and the Czech Republic respectively. These long delays, which result from lengthy and administratively heavy procedures, have reduced significantly the value that creditors are able to recover from liquidated companies. In so doing, they have contributed to the overall low level of intermediation in the economy and indirectly denied financing to fast-growing high productivity firms – with negative impacts on overall growth. Moreover, the absence of an effective work-out law has effectively precluded viable firms facing short-term liquidity problems from restructuring their debt and re-emerging as healthy firms. The problem extends beyond the banking sector because similar difficulties in executing legal judgements for intercompany debt have made firms reluctant to extend credit to Polish clients (or suppliers), thereby slowing the pace with which activity expands. Moreover, the additional uncertainty concerning payments, both in terms of getting legal judgements and executing them once rendered, represents an independent factor contributing to entrepreneur's reluctance to invest in Poland.

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The introduction of a new bankruptcy law in October 2003, replacing the previous law that dated from the 1930s, represents an important step in redressing these shortcomings. The new legislation, which is inspired by current best practices, recognises insolvency as a natural outcome in a competitive market economy and seeks to simultaneously better protect creditor's rights and ensure as efficient as possible reallocation of assets from less to more productive uses within the economy. It includes "Chapter 11"-like provisions[6] that enable debtors to restructure their debt before they actually default, as well as allowing for pure bankruptcies that can end either in an insolvency arrangement or liquidation. Moreover, the new law includes provisions for the resolution of international bankruptcy, including those set out under EU law.[7] These changes represent a major improvement over previous rules and should help improve investors' confidence both by offering a more familiar legal treatment of debt recovery and by harmonising treatment of international bankruptcies.

Notwithstanding these very welcome legal changes, the extent to which these reforms will improve the resolution of bankruptcies will depend importantly on its implementation. Raising awareness and capacity building among judges and insolvency professionals, including through adequate training programmes, will help. The ability of the court system to adapt to a less interventionist role is another issue that needs to be addressed. In particular, how effective the reform is in maximising the value that creditors are able to extract from a defunct firm will depend on whether the courts take advantage of the additional flexibility provided for in the legislation to speed the process. Thus, while the new law allows creditors to play a larger role in bankruptcy and liquidation cases, it also allows the courts considerable latitude in determining the form that administration takes. To the extent court-appointed administrators continue to be the most common form of administration the reform may fall short of its potential. Indeed, in the past, court-appointed administrators were largely responsible for very slow debt recovery periods and loss of firm value. In this regard, provisions that require the administrator in liquidation cases to attempt to sell a bankrupt enterprise as a whole rather than breaking it up into pieces that maximise its value should be revoked. Such provisions are likely to slow the restructuring process, reduce creditors' returns and, perhaps cause the firms' value to deteriorate further, ultimately resulting in greater job loss than would have occurred had restructuring begun immediately.

Uncertainty over the credit worthiness of borrowers is also a major factor limiting lending. With more than 2 million companies in Poland, most of which have existed less than 10 years, most firms do not have adequate credit histories to guide banks in their lending decisions. The creation of a central registry of borrowers, an initiative of the Polish Banking Association, for both individuals and corporate borrowers, will as information is built up help to overcome this problem. Similarly, the creation of a central registry of real-estate transactions – including

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information on sale prices should help banks better evaluate the value of proposed collateral and increase loan volumes.

Improving the land registry

The rising share of mortgage-backed loans in total lending likely reflects both improvements to the land and mortgage registration process and legal changes facilitating access to such loans and relaxing restriction on the use that banks can make of pledged collaterals.

Significant recent efforts to improve the speed with which the land registry is updated have likely helped promote lending by reducing uncertainty surrounding the ownership of offered collateral. Considerable progress has been made towards introducing a computerised registry in the 15 per cent of registry divisions that cover major urban areas. Although this work will not be completed until the end of 2005, positive impacts are already being felt as the average time to settle a land or mortgage registration has fallen from 3.8 months in 1999 to about 2 months in the middle of 2003. Similarly, an abstract from the registry can now be retrieved within 10 days. As a result, uncertainty over ownership arising from incomplete or out-of-date registers, which in the past resulted in instances of mortgages being taken out on land that had already been sold or multiple sales of the same property, should be greatly reduced. Notwithstanding the improvements already made, progress needs to be continued. Delays remain problematic in large centres, such as Warsaw, Wroclaw, Poznan and Bydgoszcz. Moreover, as discussed in the section on rural development (see below), as much as one third of agricultural land has never been registered and ownership is therefore unclear.

By the same token, recent efforts to relax restrictions on the use that banks can make of pledged collateral have likely contributed to reducing banking costs, lowering spreads and thereby increasing lending and investment. For mortgage banks in particular, the value share of a given property that could be mortgaged was increased from 80 to 100 per cent in 2002, while for a bank's whole portfolio the loan-to-value ratio was raised from 63 per cent of the value of the mortgaged property plus 10 per cent of additionally pledged collateral to 60 per cent plus 30 per cent of the additional collateral. Mortgage banks have also been provided with greater freedom to securitise mortgage-backed loan portfolios, allowing them to hedge foreign currency denominated loans and tripling the pre-existing limit on the emission of mortgage-backed securities to a maximum of twice the banks own capital. Recent amendments have also permitted mortgage banks to grant loans to local government institutions (if they are endorsed or guaranteed by these institutions), allowing them to offer loans prior to the termination of mortgage registration proceedings. These moves may have eased access to credits to borrowers with established credit records. However, it is unlikely to improve access for new borrowers because banks run the risk that a mortgage reg-

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istration will be refused. To extend the benefits of this reform to all potential borrowers, the mortgage-registration process will need to be streamlined and land-registry problems resolved.

Increasing the efficiency of capital markets

Although the Warsaw Stock exchange (WSE) is the largest in the region[8], the Polish capital market plays only a limited role as a source of enterprise financing. The market capitalisation of the WSE is equal to only 21 per cent of GDP and most shares are relatively illiquid. Global disillusionment with capital markets and reduced interest in capital market financing have played a role in limiting the markets growth.[9] Nevertheless, market capitalisation is expected to increase over time as assets held in Poland's funded insurance and pension schemes rise. While these currently represent less than 6 per cent of GDP, they are projected to increase to some 210 per cent by the middle of the century (EU, 2003). Moreover, the accession experience of other EU countries suggests that joining the union will result in important inflows of capital. In order to facilitate portfolio inflows, the authorities have moved to improve the integration of the Polish and European markets. An agreement was signed granting cross-membership and cross-access agreement to members of the WSE and the E*uronext* stock exchange (the entity created following the merger of the Paris, Amsterdam and Brussels exchanges). This should reduce transaction costs for foreign traders seeking to take a position in Poland and facilitate the floating of shares on the WSE by international firms with important operations in the region.

Efforts have also been extended to improve transparency and reliability in Polish capital markets. The WSE has adopted a written code and compulsory set of Corporate Governance Principles[10] (see the previous S*urvey*) and plans regulatory changes to strengthen disclosure requirements.[11] In addition, draft legislation has been prepared re-enforcing prohibitions on insider-trading, market manipulation and introduces rules governing conflicts of interest. It also provides clearer definitions of price manipulation, rules governing firms' buy-back of their own shares and better codifies issuers' rights and obligations *vis-à-vis* the exchange.[12] These steps should increase transparency and reduce perceptions of risk that might be associated with investing in an emerging economy market. In this regard, the authorities might wish to implement rules prohibiting firms from hiring the same audit and consulting firms as well as requiring a more regular rotation of auditors.

In order to expand the role that quasi-public funds can play in developing the capital market, the authorities are seeking to widen the range of assets that investment-fund societies and pension funds may hold. Thus for open investment funds, the scope of permissible investments has been expanded to include money market instruments and bank deposits, and the permissible range and

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Box 4.2. Open Pension Funds

The so-called Open Pension Funds (OFE) manage the accumulated contributions of Polish workers under the compulsory fully-funded defined-contribution component of the country's multi-tiered pension system. The Polish authorities consider the contributions to these funds an element of central government finance and the range of investments the OFEs are authorised to make is restricted by law in order to ensure the preservation of future pensioners' principal assets. As of June 2003, there were 16 open pension funds operating in Poland, which reflects a substantial consolidation following several mergers and acquisitions. Contrary to initial expectations, the market is heavily concentrated with the four largest funds managing over 73 per cent of net assets. The net assets of OFE amounted to 41.6 billion zloty (5 per cent of GDP) as of 30 September 2003 and are projected to rise to some 160 billion zloty by 2010. Pensions will only begin to be paid out as of 2009, by which time a legal basis for governing of the payments will have to be created. Initially the scale of disbursements will be small and the growth rate of fund assets should not decrease substantially. The system is expected to reach maturity in 2034, when all new retirees will be covered by the new multi-tiered system.

extent to which derivatives, including non-standardized derivatives, can be used by open funds has been expanded. Moreover, restrictions on funds that emulate market or bond indices have been relaxed.

Finally, the authorities have recently passed legislation expanding the range and share of assets that Open Pension Fund managers could place in more profitable albeit riskier instruments such as equity markets and private bond portfolios (Chapter 5 presents a wider analysis of the Polish pension system, focussing on its long-term sustainability). Concerns that competition among fund managers was inadequate, lowering their handling fees led the authorities to introduce rule charges. While such a measure may increase returns to fund holders in the short-term, it is likely to dissuade managers from competing on the basis of returns. Indeed, existing performance rules, which punish firms whose quarterly returns deviate form the average of all funds may already be provoking management firms into following very similar strategies. In addition since November 2003, the State has assumed the liability arising from the delayed transfer of contributions to the various Open Pension Funds by the Social Insurance Agency (ZUS) mostly caused by technical problems during the introduction of the new system. The assumed debt has been financed by 10-year floating interest-rate government bonds.

Given the size of the assets that the Open Pension Funds are to be called upon to manage in the future, the extent to which they impact positively the

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behaviour of the firms in which they hold shares may have important consequences on overall corporate governance. Here the relative passivity, both in Poland and elsewhere in the OECD, of institutional investors, such as pensions funds, that hold shares on behalf of others could contribute to weaken overall performance. A regime that requires institutional investors to disclose their overall corporate governance policies, as well as how they vote shares they hold, could contribute to them taking a more active and positive role. In addition, corporate governance rules for such funds should require fund managers to indicate explicitly how they manage their own conflicts of interest.

Tax administration and tax policy

Taxes and tax administration form an important part of the overall regulatory environment. Indeed, as discussed in the previous *Economic Survey* there is substantial scope for reducing the extent to which the tax system and its administration impinge negatively on enterprise profitability, investment behaviour and public finances. In this regard, the authorities could go a long way to reducing the scope for arbitrary decision making and thereby increase the certainty with which firms make investment decisions as well as tax compliance by setting up a centralized tax authority to which firms could refer for binding or at least exculpatory *ex ante* tax rulings. For the moment, although tax offices offer opinions, these are not binding nor does the fact of having received a favourable *ex ante* ruling affect the penalties imposed if it should be subsequently overturned. Not only does this make it difficult for entrepreneurs to determine the future profitability of investment projects, but honest firms that receive a favourable *ex ante* tax ruling only to have it overturned subsequently are found guilty of "tax fraud" and lose their credit-rating. A proposed law that would oblige the authorities to provide, free of charge *ex ante* and binding tax rulings as well as similar rulings (for a fee) on issues of transfer pricing would, if enacted, help firms evaluate the potential after tax profitability of projects, an important first step towards reducing investment uncertainty. To ensure that the new rule has the maximum positive effect, it will be important that a national registry of such rulings be established to act as jurisprudence. In addition, while such a registry would help, it might be necessary for a central office to be given responsibility for making rulings in order to prevent firms shopping around among local tax offices for more favourable rulings.

The lack of a centralised jurisprudence means that frequently two separate local offices interpret and apply the tax law in a different manner. Given the local tax authorities' power to immediately freeze firm's financial assets and the extended time required for courts to reach decisions, a less arbitrary mechanism is required to deal with such disputes. In the area of value added taxes, the need for such a mechanism appears particularly acute. The complexity of VAT rules coupled with the discretion allowed local tax offices means that VAT filings are partic-

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ularly prone to error. Penalties (30 per cent) may be large for some firms and are asymmetric, overpayment is not refunded but credited, while payments are due immediately. Moreover, a lack of clarity concerning VAT liabilities in the case of the sale of an enterprise has been cited as a factor inhibit restructuring (PKPP, 2004), although because following EU entry firms can now refer to EU case law in such instances, the issue may have become less problematic.

Finally, firms' ability to plan and evaluate investment projects would be greatly enhanced if tax law were enacted in a more timely manner. Currently the lags between the passage of legislation and its entering into force can be very long, in many cases extending to several years. As a result, firms do not always know what tax law will apply – a factor that can make the difference between going through with a project or not.

Efforts at reducing the cost of tax compliance have concentrated on increasing the firm-size threshold for simplified payroll taxes (see above) and the introduction of a new category of a small taxpayer[13] who may submit their monthly tax return forms and VAT accounts on the basis of non-accrual method on a quarterly rather than monthly basis. In addition, several changes to the personal income tax system were introduced in 2003 with the aim of creating favourable conditions for rapid economic development. These include allowing owners of new start-ups to be exempted for a period of one year from: the obligation to submit a monthly tax return, paying income tax advances (or the lump-sum tax) and, in the case of natural persons, from the requirement that they combine their income from business operations with income from other sources. The unpaid tax is to be repaid over the following 5 years. Moreover, purchasers of new investment goods can apply accelerated depreciation rates to these goods as long as they respect the minimum depreciation periods set out in the applicable regulations. While many of these reforms go in the right direction, the main thrust of reform has been towards the harmonisation of the Polish law with the EU legislation and exempting smaller firms from complicated provisions. More effort needs to be expended towards reducing administrative complexity and compliance costs for all tax filers. By the same token, substantial progress remains to be made in terms of reducing the costs to the public purse of administering the tax system, both in terms of foregone revenues from poor compliance and a poorly organised and costly administration. In this regard, there is likely significant economies to be made by merging the ZUS and personal income tax collection systems.

While tax administration can be an important source of uncertainty and as such alter the balance in firms' investment decisions, so can tax policy and tax rates themselves. In this regard, the decision to reduce the corporate income tax rate from 27 to 19 per cent should go a long way to improving the relative attractiveness of Poland-based investments. The new rate aligns Polish tax treatment of corporate earnings with that of other transition countries[14] and brings it substan-

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tially below that of the Czech Republic (31 per cent). The revised law also includes provisions allowing individual entrepreneurs to file under a flat 19 per cent personal income tax regime, although given that tax reductions reduce average personal income tax rates to less than 10 per cent for most individuals, the attractiveness of this regime is uncertain.

Towards modern foreign direct investment promotion strategy

On a legal basis Poland foreign and domestic firms are on an equal footing. However, the complexity and unpredictability of the legal and regulatory environment for business puts outsiders in a disadvantageous position (OECD, 2001b). Among the most frequently cited obstacles to investing in Poland are the lack of transparency and consistency of the legal system as well as weak law enforcement at the local level precisely among the most important factors in determining a healthy investment environment (OECD, 2001a). While the authorities should continue efforts to improve the execution of business law so as to reduce uncertainty (see above), if Poland wishes to enjoy the success of its neighbours in terms of attracting investment projects it should offer more pro-active assistance to firms or entrepreneurs seeking to invest so as to allow them to find their way through the existing system (OECD, 2001a).

In particular, Poland should seek to reinforce existing foreign investment structures so as to develop a comprehensive framework for investment promotion and servicing. OECD (2003b) outlines a number of principles that should be followed.[15] Currently, funding and responsibility for promotion services are dispersed among several authorities and legal and financial constraints prevent the national investment promotion organisation (PAIiIZ) from fulfilling a role similar to that of the Czech investment promotion agency. The Czech agency offers one-stop-shop services where potential foreign investors are advised free-of-charge as to potential investments, choices of local suppliers and are helped with recruitment and evaluation of the skills of the local workforce as well as with immigration procedures for their foreign staff. While PAIiIZ does provide information concerning opportunities and principles surrounding 14 special economic zones (Box 4.3), it does not maintain a database of current investment opportunities, nor of local economic and legal conditions for investment. Moreover, its role with respect to the economic zones is limited to directing prospective investors towards them. The overall effectiveness of the agency would be enhanced if it were able to make binding offers of support to potential investors. Currently, any such incentive proposal can be made but responsibility for approval lies with various Ministries. Moreover, investment incentives are only approved once the investment has been made. As a result, uncertainty as to whether aids will be forthcoming poses a serious problem for investors. Investment agencies in other countries are able to make binding offers, which places PAIiIZ (and Poland) at an important competitive

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Box 4.3. Special economic zones

National legislation provides for the creation of special economic zones, of which there are currently 14. These zones are operated autonomously and provide specific services to potential investors in the form of assistance with formalities. Moreover, they offer a wide range of national and regional investment incentives such as exemptions from PIT, CIT and real estate tax, equipped investment sites offered at attractive price, investment grants as well as grants for employee training and job creation.

Firms investing in these zones and receiving these incentives are obliged in return to follow an agreed business plan specifying employment and investment levels for a period of at least 5 years. Since enabling legislation was passed 10 years ago, the special economic zones have attracted more than 13 billion zloty worth of investment (1.6 per cent of GDP) and 50 thousands jobs.

disadvantage. Recent efforts within the government to delegate to PAIiIZ some of the decision making power as regard specific aids should be reinforced.

The authorities may also wish to examine more closely the overall effectiveness of the investment incentives that are being offered. Here, OECD (2003a) provides a checklist for government in assessing the cost effectiveness of tax and other incentives. In general, tax incentives run a particularly high risk of generating significant deadweight losses – *i.e.* being granted to firms that would have undertaken an investment anyway. Overall, associated tax expenditures are estimated by the Ministry of Finance to equal 0.7 per cent of GDP. These resources might be more usefully employed in improving the overall investment climate especially given the risk of high deadweight losses. In particular, while tax holidays and other reliefs can cause an investor to favour one site over another, research suggests that these are rarely the major determinants of firms' location decisions. Rather, the quality of local infrastructure and human capital, market access, administrative burdens and the overall stability of the business environment are determining factors (Ernst & Young, 2002)

Policies to improve productivity and profitability

OECD's product-market indicators suggest that Poland has the most restrictive set of business-sector regulations among member countries. Reducing these administrative burdens could generate substantial savings both directly in terms of reduced compliance costs, but also indirectly. Fewer regulations and a more predictable regulatory regime would help to reduce the incidence of corrup-

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tion and associated business costs [Poland is estimated to have the highest incidence of corruption among OECD countries (Transparency International, 2003)]. Indeed, the existence of such costs represents incentives for firms and individuals to participate in the underground economy, which is already estimated to represent 15 per cent of GDP. To the extent that streamlined administrative procedures helped bring firms and individuals back into the formal economy, it could generate an important virtuous circle. More formal employment and activity would generate more tax revenues, leaving open the possibility of reducing tax rates, which would tend in turn to further reduce underground activity, generating more employment and activity.

Policy can also contribute to increasing the growth potential of the economy by making a given level of capital stock more productive. While policies that promote innovation and technological change can play an important role in this regard, in an emerging economy such as Poland, much can be achieved via regulatory reforms that reduce the costs of doing business; by putting into place a productive infrastructure that enhances private-sector firms' profitability; and by increasing competitive conditions within the economy. Moreover, such moves, by reducing the costs of doing business, make investment opportunities more attractive. These new investments, both foreign and domestic, often embody with them improvements in the technology of production but also, just as importantly, improvements in terms of know-how and management technique that can significantly enhance domestic productivity.

In order to facilitate the creation of new companies and jobs and to increase survival rates of those already established, the authorities have included a number of initiatives within the overall "E*ntrepreneurship* F*irst*" package with a view to reducing administrative burdens for both new and existing firms. Recognising that burdensome administrative procedures are an impediment to investment and, more generally, entrepreneurship in Poland, the plan enumerates a legislative agenda, covering among other reforms, a simplification of administrative procedures, a simplification of the social insurance system and a reform of the tax system.[16] Already a number of elements of the overall programme have been implemented.

Among the initiatives underway is a new draft L*aw on the freedom of business operations* adopted by the government in October 2003. In addition to proposing a number of specific measures designed to improve the business environment, the bill is viewed as a framework law for entrepreneurship, setting-out for the first time an explicit public-sector obligation to support entrepreneurial activities. While largely a symbolic gesture, it is nevertheless important especially because the administration continues to exercise substantial powers and institutions of public accountability are, as yet, underdeveloped. Some of the most important initiatives of the draft law are aimed at restricting the possibility for the abusive or

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even corrupt exercise of public power. Recognising that multiple, time consuming and activity-paralyzing controls by often incompetent but still powerful public offices can lead to undue financial losses or even bankruptcies of firms, the bill proposes limiting the frequency of controls that can be made on a given firm and the number of separate ones that can be conducted simultaneously.

So as to streamline the firm creation process and thereby spur job-creation, a new "One-Stop Shop" enterprise register is to be created to replace the current 12 separate procedures, a number that compares unfavourably with other OECD countries (ten procedures for other emerging member countries and 7 for the OECD group as a whole). It is hoped, that these changes will reduce the time required to register a firm by almost two thirds from some 58 days now to about 20 days. For existing firms, the most important initiative involves raising from 5 to 20 employees the size limit for firms operating under simplified labour-market administration rules (see Chapter 3) – a step which could have important positive impacts for new and smaller firms who are least able to amortise the fixed costs associated with excess regulations.

In addition to broader regulatory reforms aimed at reducing the administrative burden on SMEs, the government is pursuing its programme to facilitate their access to external financing. The programme "Capital for Entrepreneurs 2002-2006" offers loan guarantees and actual loans and is being modified to take advantage of EU structural funds. Such programmes can play an important role in helping small firms access capital. However, care must be taken to ensure that such guarantees do not entirely eliminate the risk to lenders. Here, a system of interest rate subsidy or partial loan guarantee might be more effective and may help leverage the lending institutions' own self-interest in ensuring that prospects for loan repayment are acceptable.

Infrastructure

As indicated above, the overall business environment and the available infrastructure are among the most important factors influencing business location decisions. Moreover, by facilitating the transport of merchandise and the flow of information, a high-quality infrastructure can drastically reduce transaction costs – thereby contributing to higher productivity. Not only is Poland's infrastructure underdeveloped, as indicated in Chapter 1, but Poland is only investing between 0.5-0.7 per cent of GDP in infrastructure, less than half the average rate for other OECD economies (between 1-2 per cent of GDP).

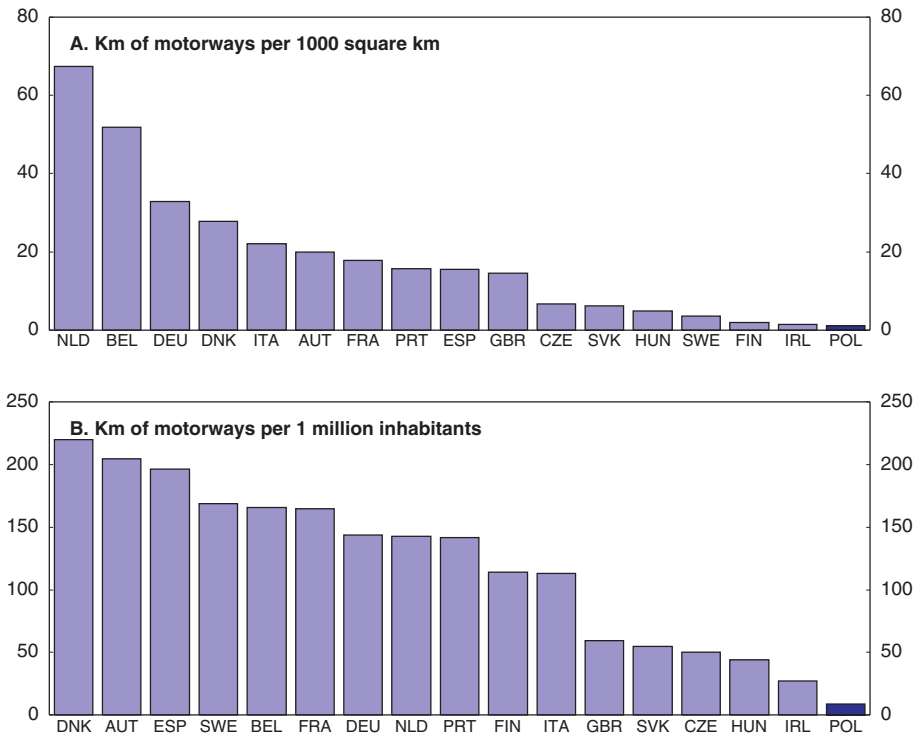
Transportation

Investment decisions and the productivity of firms depend importantly upon the speed, reliability, and cost-effectiveness with which products can be brought to market and with which supplies can be brought to production facilities.

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As discussed in the previous *Economic Survey*, the poor quality of the road system in Poland and its Warsaw-centric orientation represents a real deficiency. It prevents Poland from reaping the benefits of its favourable geographical location in the centre of the main transport corridors between Western and Eastern Europe and between Scandinavian countries and Poland's landlocked neighbours to the South. Indeed, in a country with an area of 313 thousand square kilometres, there are only some 600 kilometres of high-quality roadway[17], with both the density of motorways per square kilometre and per inhabitant substantially less than in any other European Union or accession member country (Figure 4.3). Furthermore Poland's position has been deteriorating as other countries have made more rapid

Figure 4.3. **Motorway densities**
2002[1]



1. Except for Ireland (2001), Portugal (2000) and Spain (1999).
Source: European Conference of Ministers of Transport and World Bank.

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progress.[18] Finally, the uneven market access that Poland's poor roadway system gives to different regions contributes to a large extent to regional development differences (OECD, 2002a). In both the Czech Republic and Hungary, the development of motorways with efficient connections to markets in western Europe has been a critical element in the success of different regions.

Enabling legislation was passed in 2003 to increase the financing options available for new roadways. An amendment to the Motorway Act creates a Motorway Fund that will be funded from excise duty on fuel toll fees and loans taken by the General Directorate for National Roads and Motorways. The Fund is to provide grants and interest-free loans to private-sector firms that will build roads, whose ownership will remain with the state, in exchange for an operations concession. Concessionaires are to repay their loans from their profits. The authorities expect that by the end of 2006 an additional 630 kilometres of high-quality motor, 481 kilometres of improved roads and 35 ringroads totaling 177 kilometers in length will be built. Given Poland's past record in organising road construction this is a very ambitious target. If achieved, it would represent a doubling of the existing stock of improved roadways, but also more than a quarter of the 2 000 kilometres of improved motorway that Poland plans to complete by 2015. The work is to be partially funded via EU structural funds and will seek to connect the country's major cities, with one road planned from the German border to Krakow, and further to Tarnow and Rzeszow, and a second motorway from Swiecko (on the German border) to Warsaw through Poznan.[19]

The rail system also represents a source of concern. Notwithstanding its extensiveness, poor maintenance and other inefficiencies conspire to make rail transport expensive in Poland. Overall less than 25 per cent of track is in good condition and long transit times, as much as two weeks, and high costs have been cited as a factor that reduces the competitiveness of the Polish coal mining sector. Demand for rail transport between main agglomerations is relatively high and improvements to infrastructure on these lines could be economically viable if the transit times were lowered and quality of service improved. In contrast, local lines are in very bad shape and, given low demand, may be economically unviable. Here some steps at liberalisation are helping, including the privatisation of some branch lines and the legal separation of the State rail company into separate entities managing the fixed and rolling stock. The Railways Transport Office was created in June 2003 with a mandate to provide oversight of a more competitive and efficient sector.

The authorities' strategy appropriately concentrates on the modernisation of both rolling and fixed stock on 12 000 km of lines of national importance. In this regard the European Union has been participating in improving rail routes, reducing the Warsaw-Berlin link to some 4¼ hours and with plans to upgrade the link between Katowice and Brno in the Czech Republic. More generally a restructuring

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programme is underway that seeks to increase speeds, lower costs and increase the competitiveness of rail transport, with a particular eye towards improving sea-rail connections. Financial responsibility for operating trains on the remaining 9 000 kilometres of lines of local importance is to be left with subnational governments. Such subsidiarity should help rationalise decision making concerning local lines by internalising costs. However, given the size and political importance of the rail system's labour force, it is not clear to what extent the authorities will succeed in delegating decision making to the local level.

Progress in developing air transport has been better although Poland's aircraft departure per inhabitant ratio is still 50-60 per cent lower than in the Czech Republic and Hungary who have opened up their markets to low cost operators. The construction of a new airport terminal at the Warsaw airport as well as planned future construction of new airports should considerably extend the capacity. Nevertheless, the benefits of these investments can only be fully realized if the monopolies within the Polish aviation sector are broken up, prices of connections are lowered and the range of available services is extended.

ICT *technology investment and infrastructure*

Information and communications technology is recognised as an important driver of technological progress in all OECD countries. While Poland lags in most indicators, this reflects to a large extent low income levels and a weak starting point. Thus, although there are only 31 fixed lines per 100 inhabitants the mobile-phone sector had developed relatively quickly with 45.1 numbers per 100 inhabitants. Official policy seeks to increase access to telephony throughout the territory and has placed a particular emphasis on expanding access to telephone and internet services to rural areas including a recent decision to maintain a VAT free policy for internet services. The fixed-line market remains dominated by the historic monopolist, TPSA – majority owned by France Telecom and although there have been a number of complaints and ruling concerning unfair competition, the independent regulator and overall regulatory environment have generally succeeded in promoting competition in the sector.[20]

H*ousing*

In order to promote labour force mobility the authorities should expand programmes that help create and maintain low-cost rental housing. Currently, there are 308 inhabited dwellings[21] per 1 000 persons giving Poland a relatively low housing density. Official estimates indicate a housing shortage of about 1.5 million units. Moreover, as many as 1 million existing units could be destroyed for safety reasons during the next six years. As indicated in Chapter 3, overall internal mobility rates are very low – a factor generally attributed to the lack of a rental market and large regional differences in owner-occupied housing prices.

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To date, the bulk of State assistance has come in the form of interest subsidies on home-owner loans and tax expenditures equal to 0.6 per cent of GDP to offset owner-occupied housing expenditures. While this programme has been successful in promoting the creation of owner-occupied units (new starts have increased by almost 60 per cent since 1995), they have done little to promote the construction of low-cost rental housing. Indeed, the share of rental housing in the overall stock has declined from 52 per cent in 1990 to less than 28 per cent, mainly reflecting a policy of privatisation of rental and cooperative housing at favourable prices but also a system of rent controls[22] and strong tenants' rights which makes private investors (and municipalities) reluctant to invest in tenant housing (Zawislak, 2002). In particular, the combination of regulations that prevent landlords from evicting tenants who fail to pay if there is no state-supplied replacement housing available and a severe shortage of such housing makes private investors (and even municipalities) very reluctant to invest in rental housing.

The authorities intend expanding the supply of such temporary shelter and eliminating administrative barriers to their construction. While such moves are a step in the right direction they need to be complemented by a rebalancing of tenant-landlord rights in favour of the latter so as to increase the private supply of low-cost rental housing. The recent decision to delay the planned elimination of rent controls on accommodations subject to such rules until 2008 is unfortunate. The proposed draft goes part of the way to liberating the market by allowing new contracts to be free of controls. While this should increase incentives to invest in rental accommodation, the co-existence of free market and rent controlled units will likely result in serious distortions. Moreover, such a partial reform only delays and increases the price adjustment that will eventually have to be made. In order to accelerate liberalisation, the process of raising controlled rents towards market levels should begin immediately. Such a step should help to make rental accommodation a more attractive alternative for both investors and potential renters and should thereby contribute to the progressive revitalisation of the commercial real-estate sector. As the stock of such housing rises, renting would increasingly become a viable low-cost and low-risk alternative to still expensive owner-occupied housing and should thereby help promote labour mobility (see Chapter 3).

Given the relative supply of rental and owner-occupied housing, the authorities might also wish to consider reassessing the structure of aids – perhaps affording similar kinds of subsided loans to individuals and firms investing in rental properties. In particular, the authorities should extend to lower-income individuals the housing support offered to middle and upper income individuals through tax expenditures. This could be accomplished indirectly by reducing such expenditures and creating new incentives for the private production of low-cost housing in areas of relatively high labour demand. Such a solution would have the advantage over the alternative of direct subsidies to the construction of state-owned housing because it would harness private savings to speed the construction process. Indeed,

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rental and co-operative housing co-financed by the National Housing Fund (a programme introduced in 1995) now constitutes approximately 10 per cent of the total output of housing construction. At a minimum, income-tax reliefs currently afforded to home owners should be transformed from tax deductions to capped tax credits so as to eliminate the current bias in favour of wealthier individuals.

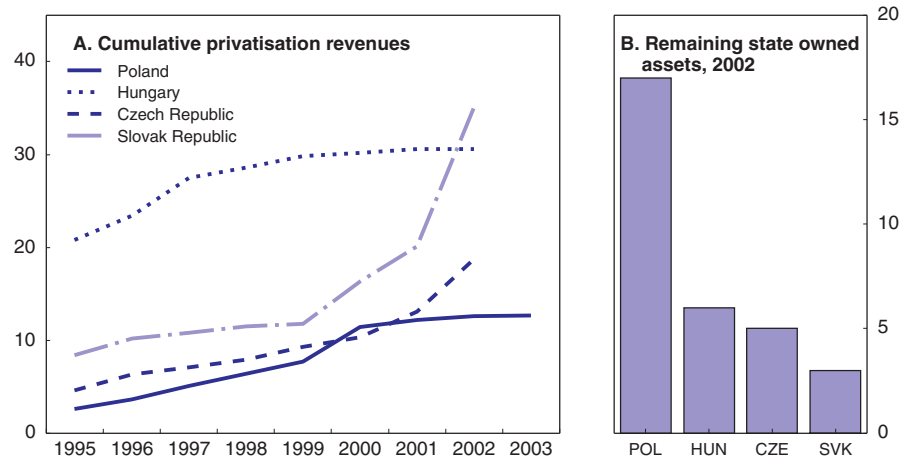
Privatisation and restructuring

Privatisation *per se* does not guarantee better economic performance. However, in generalprivatised firms outperform state-owned firms, partly because whereas unproductive and loss-making private-sector firms go out of business or are taken over, such State-owned firms too often continue to be propped up by their public-sector owner both lowering average productivity and preventing resources from moving to more productive activities. Indeed, up to 15 per cent of privatisation revenues are used in this way (Ministry of Treasury, 2003). Moreover, in a low-productivity country such as Poland, privatisation (especially to a strategic international investor) can often lead to substantial technological and know-how transfers. This can generate significant positive externalities, as parent firms train their locally hired workforces, share production and quality control techniques with local suppliers and produce demonstration and competitive emulation effects (OECD, 2001a). Indeed, to some degree it is precisely such factors that help explain the large productivity gains and innovations observed in, among others, the banking, car manufacturing, furniture production and air transportation sectors.[23] Finally, in countries such as Poland, where public finances are an issue, the State may be unable to muster the funds necessary to take full advantage of the potential of a company. In these cases, privatisation creates a channel through which domestic and foreign private-sector savings can be brought to bear.

While the privatisation process in Poland is well advanced, progress to date lags behind that observed in other central European member countries over a wide-range of indicators (Figure 4.4). Nevertheless, the Polish authorities are committed to pursuing the privatisation process. In particular, the 2004 Budget calls for a doubling of revenues. More generally, they indicate that they intend to reduce the State's ownership share in the economy from 25 per cent currently to between 10 and 15 per cent by 2006. At this stage they indicate that they would consider the core of the privatisation process complete – in part because by their estimation this represents the average level of state-ownership within the European Union. Nevertheless, even after completion of this next planned phase, the Polish State would still control three or four times as much of the overall economy as in other transition member countries such as Hungary and the Czech Republic. Moreover, given plans to proceed with further privatisation in most major European countries, even if today's objective were achieved, Poland would likely remain with a larger than average State-owned sector.

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Figure 4.4. **Privatisation progress in selected transition economies**
Per cent of GDP



Source: EBRD, Transition Report 2003 and OECD.

Notwithstanding the modesty of official privatisation goals, meeting them will call for a substantial acceleration in the process, requiring a tripling or quadrupling in the pace of privatisation over the period 2004-2006.[24] To a large degree the relatively slow pace of privatisation in Poland reflects an uneven process, with privatisation in several sectors nearly complete but with progress having been particularly slow in others (notably, the mining, steel, defence industry, heavy chemical and rail transport). Overall, the State continues to have stakes in some 3 000 firms (Table 4.2) of which controlling positions in some 1 100 firms (13 per cent of the total value of firms in 1990). Moreover, since 2001 Poland has made very little progress in closing the gap with other central European member countries, with total sales consistently undershooting objectives by as much as two thirds. The authorities have enumerated specific privatisation programmes for firms operating in the mining, energy and heavy chemical sectors (Box 4.4). In addition, they hope to float minority stakes in two of the seven banks that they directly or indirectly control (see above). Longer-term objectives have been laid out for progress in the pharmaceutical and defence industry. In general, privatisation plans are to be preceded by a sectoral consolidation involving the agglomeration of profitable firms and units into a larger company with significant market power. This larger entity would then be privatised with purchasers undertaking various commitments as concerns future investment and employment levels.

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Table 4.2. **State-owned and controlled enterprises**

	1990	2002	2003[1]
Total Joint-stock companies with state ownership	8 453	1 630	1 716
100 per cent state-owned		417	475
50-100 per cent state owned		99	109
25-50 per cent state owned		420	449
Less than 25 per cent		694	683
Undergoing bankruptcy or liquidation		783	689
State-owned enterprises not yet approved for privatisation		603	531
Total firms with State participation		3 016	2 936
Total (with controlling interest including ongoing liquidations)		2 322	2 253
Total (with controlling interest less ongoing liquidations)		1 539	1 564

1. Data pertain to September 2003, except for the number of joint-stock firms in which the state share is less than 25 per cent, where data concern 28 October 2003.

Source: Ministry of Treasury.

Accelerating the transformation to a smaller state-presence will require a less rigid approach to privatisation. In the past, the process placed a strong emphasis on sales to strategic investors, with the state retaining substantial minority stakes in many companies and on limiting the short-term social disruption caused by the transfer of ownership. Thus, prospective purchasers have been obliged to undertake extensive obligations in terms of investment and employment plans and have had to negotiate their approval with unions in the to-be-privatised firm. These requirements, plus the authorities desire to maximise revenues from sales have slowed and on more than one occasion resulted in the abandonment of sales. Most recently, such considerations caused the authorities to refuse an offer for a 75 per cent stake *Rafineria Gdanska*, a large refinery that they have been attempting to sell for several years.[25] While in the case of the PKO BP bank a variety of such factors have led the authorities to re-launch the search for a privatisation advisor 5 separate times.

In contrast, a more flexible attitude taken as regards the sale in 2003 of the steel conglomerate, PHS (a company created in 2002 by the merger of four large loss-making steel mills). The firm was sold for 1.8 billion zloty,mainly in the form of the discounted purchase of existing debts. In addition to the relatively low sale price, the deal was reached more quickly than in the past partly because it was confirmed notwithstanding the fact that the purchaser had not agreed a social package with trade unions.[26] While care must be taken to ensure that sales continue to be characterised by transparency, more realistic expectations as concerns revenues and fewer restrictions on the behaviour of firms would help both to speed privatisation and to improve aggregate productivity performance.

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Box 4.4. The status of privatisation and restructuring in the industrial sector

As indicated in the previous survey the relatively slow pace of privatisation in Poland reflects the authorities' conscious decision to restructure some state-owned firms before proceeding with their sale. Over the past few years, restructuring has, in several instances, taken the form of merging existing firms into larger entities that the authorities hoped would have sufficient economic weight as to be economically viable, even though their component parts had been loss-making. In addition, firms have been generally obliged to agree investment and business plans as well as agree social plans restricting layoffs for a significant period. Most recently the authorities have sought to sell minority stakes, on the Warsaw Stock Exchange, in an apparent effort to retain control of firms whose capital is opened in this manner.

The energy generation sector remains largely in state hands and recent progress has been slow, overall. Despite several firms having been on the privatisation agenda for several years, relatively few generation, distribution or thermal-electric plants have been sold. Within the generation and distributions sectors, the authorities are merging existing firms into larger vertically and horizontally integrated entities before proceeding further with a sale of a miniority stake in the Warsaw Stock Exchange, At the same time, they seek to separate out the energy trading system and other non-core activities from PSE, the Polish Power Grid operator. Such a move is to be combined with a recapitalisation of PSE by transferring to it shares in other State-owned firms, which it is hoped will allow the firm to borrow under more favourable terms. Privatisation of PSE will not begin before 2005 and will require finding a solution to the stranded cost problem arising as a result of long-term contracts that have left the firm with an uneconomic cost structure. A draft law proposing annulling the contracts, and compensating suppliers with a one-time payment equal to the difference in the market value (as calculated by the energy regulator) of the firms before and after the annulment of the contracts. The problem is particularly complex as many of the loans in the sector were secured by these contracts.

The restructuring of the coal sector has been an ongoing problem, involving substantial financial and technical assistance from the World Bank and European Union among others. While large reductions in capacity and employment in the sector have been achieved, the sector continues to be characterised by excess supply and an uneconomic cost structure, which for exports is influenced by excessive transportation costs.* Some privatisation initiatives are currently underway and, as in other sectors, coal sector restructuring has also sought to create a market-dominating producer. In 2003, the authorities combined 23 mines into the conglomerate *Kompania Weglowa* S.A and intend folding-in a further 5 profitable pits in 2004 prior to an eventual privatisation.

* Transportation costs average 12-13$ per tonne from mine to port (World Energy Council *www.worldenergy.org/wec-geis/publications/reports/current_cls/Cls*COAL.*asp*).

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Box 4.4. **The status of privatisation and restructuring in the industrial sector** (*cont.*)

Restructuring plans in the heavy chemical sector are at the earliest stages. A restructuring strategy has been adopted by the government. Here too, the strategy proposes merging existing firms into a larger entity that will be sufficiently large to be economically stable and able to compete in international markets. Existing non-core activities are to be spun off as independent business units, which are to be privatised at some future date and unused plant sites transformed into industrial parks that are to help spawn the establishment of local businesses in a supplier relationship with the larger chemical firms. Plans are contingent upon ensuring that the new conglomerate can get access to natural gas at competitive prices and include the possibility of merging a gas production company or a company having access to natural gas deposits to the new concern so as to provide it with security of supply.

The previous *Economic Survey* made several recommendations (Chapter 4, OECD 2002a) to accelerate the privatisation and speed the process by which private capital, market incentives and foreign expertise can be brought to bear in terms of productivity gains to firms and sectors that for the moment remain relatively unexposed to market pressures. These recommendations remain relevant and include:

- Reducing the influence of special interests (management and staff) within the privatisation process, by giving them less of a decisive role in approving sales.
- Streamlining the decision-making process by reducing the number of governmental institutions with responsibility over privatisations. In particular, the important role played by the Ministry of Economy, Labour and Social Policy and the Ministry of Infrastructure, which are also responsible for re-structuring programmes, leads to a natural bias that favours a necessarily slower strategy of restructuring firms prior to sale.The authorities' insistence on restructuring prior to sale can only make sense if it is presumed that they are in a better position to restructure these firms than a private-sector owner would be.[27]
- Being more proactive in direct privatisations. Currently, these generally occur at the initiative of management or local governments, who in many cases have no economic incentives to increase profitability and limited access to private-sector capital. As a result firms fail to take advantage of

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the market opportunities and fail to grow, which translates into slower productivity and employment growth, lower taxes and more demand for social expenditures.

– Freeing privatisation deals from industrial policy goals that complicate and slow sales. 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 create market-dominating firms – despite the negative consequences that such structures may have for competition. A simpler strategy would involve relieving firms of their accumulated debts and other contingent liabilities and then proceeding with their sale. Experience in other countries indicates that private sector operators are willing to come in under such conditions even if the firm remains loss making.

– Reducing the constraints imposed on purchasers' ability to manage their labour force, by making greater use of strengthened active-labour market measures (see Chapter 3) and, where appropriate, an enhanced social assistance system. Job retention contracts merely raise the cost of buying a firm and delay the inevitable job losses. Moreover, if not compensated for by a reduction in the purchase price they can be deal breakers.

While speeding the privatisation process should help productivity in the medium-term, attention nevertheless needs to be paid to improving the governance of those firms that the authorities intend retaining, those that have yet to be sold and the more than 900 partially privatised firms in which the State retains a controlling stake (a 25 per cent or larger share).[28] As indicated in the previous Survey, the authorities' apparent reluctance to allow private-sector partners to increase their participation in the capital of such firms, and thereby infringe upon the State's ability to influence corporate policy, 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. Moreover, the very public disputes that have arisen,[29] including the decision to annul long-term energy contacts, risk jeopardising other privatisations by creating doubts about the authorities' willingness to relinquish their controlling interests and respect contracts freely entered into. Rather than second-guessing the decisions and strategies of its private-sector partners, the State should relinquish its remaining shares and concentrate its energy and resources in creating the kinds of framework conditions that would incite firms to undertake the kinds of activities that policy makers desire.

More recently, the State has indicated that it will proceed with the sale of a minority block of share on the Warsaw Stock Exchange in the case of a number of large companies, while retaining a majority or controlling state interest. Such a strategy runs the risk of saddling firms sold in this manner with a weak corporate

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governance structure. Indeed, it forgoes the significant advantages of selling to a strategic investor whose interests would be clearly linked to those of the firm. It also risks creating a defused ownership structure dominated by State, employee and management interests – a structure that, in emerging markets, tends to under perform ones dominated by a single investor.

Rural development[30]

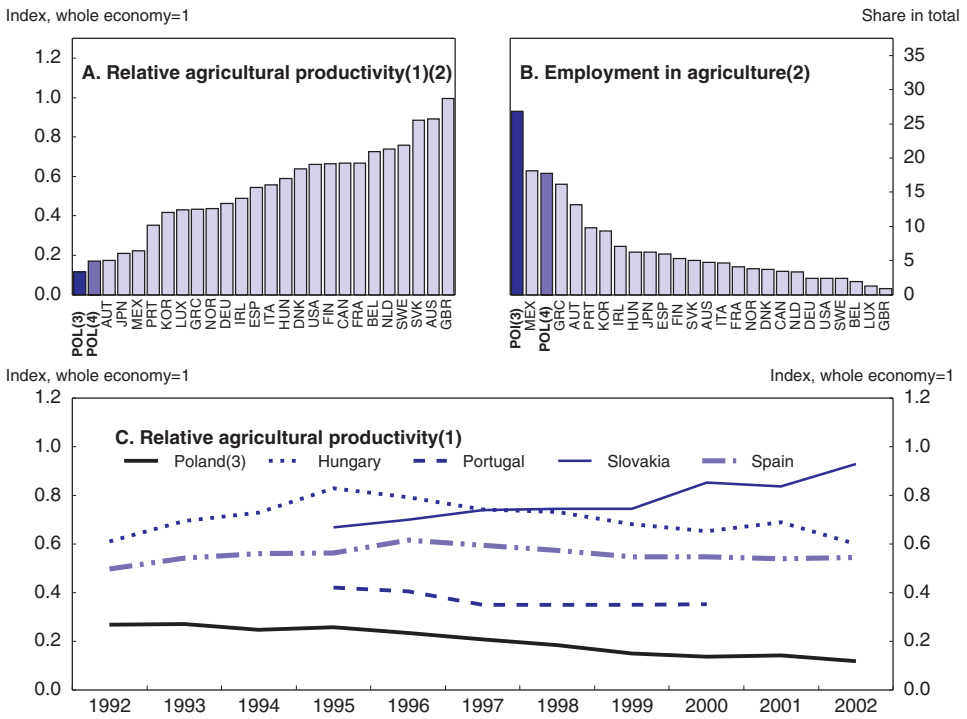
In order to spur more rapid productivity and income growth, the authorities will need to provide a framework for faster restructuring in the agricultural sector. Unlike most OECD countries, a substantial proportion of the Polish population continues to live on the farm. Indeed, official statistics indicate 40 per cent of the population and 35 per cent of the working-age population live in rural areas. Moreover, between 16 and 25 per cent of the total work force[31] is employed on private farms, where they produce less than 3 per cent of GDP (Figure 4.5). Even adjusting this for part-time work, rural productivity remains low.[32] While many Polish forms achieve productivity levels comparable to those in western Europe, the vast majority are too small and over endowed in terms of labour – reflecting in part widespread hidden unemployment. Overcoming this very low productivity performance will be key to reducing poverty and joblessness among the rural population and by extension within the economy as a whole. The seriousness of the problem is only exacerbated by the size of the sector and the fact that in contrast to other transition countries within the OECD, agricultural productivity has not been improving. The lack of any significant adjustment in the agricultural employment since 1993[33] stands in stark contrast to the sharp fall in the sector's share in GDP and, more substantial restructuring in terms of the output of the sector.

The lack of urban rural mobility and the resulting poor agricultural productivity reflects several factors:

- the relatively low cost of living in rural areas, which makes low productivity farm-based activity relatively attractive;
- a preponderance of small and uneconomic farms, and a lack of consolidation among such holdings;
- substantial government transfers (a significant share of which are farm-specific) that interfere with market adjustment mechanisms, supporting a low-productivity poverty trap;
- land-ownership rules and transfer-based financial incentives that have prevented the consolidation of uneconomic small holdings;
- underdeveloped institutions to support a market for agricultural land;
- poor educational outcomes for rural students; and
- poor infrastructure.

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Figure 4.5. **Indicators of rural development**



1. Agricultural value-added per agricultural worker divided by whole economy value-added divided by total employment.
2. Data concern 2002, except for Australia, Belgium, Ireland, Japan, Mexico and USA: 2001; Canada and Portugal: 2000.
3. Based on national accounts data including all agricultural workers.
4. Based on Agricultural census data, including only those agricultural workers whose primary activity is farming.

Source: OECD.

The farmers' social security system and small-farm consolidation

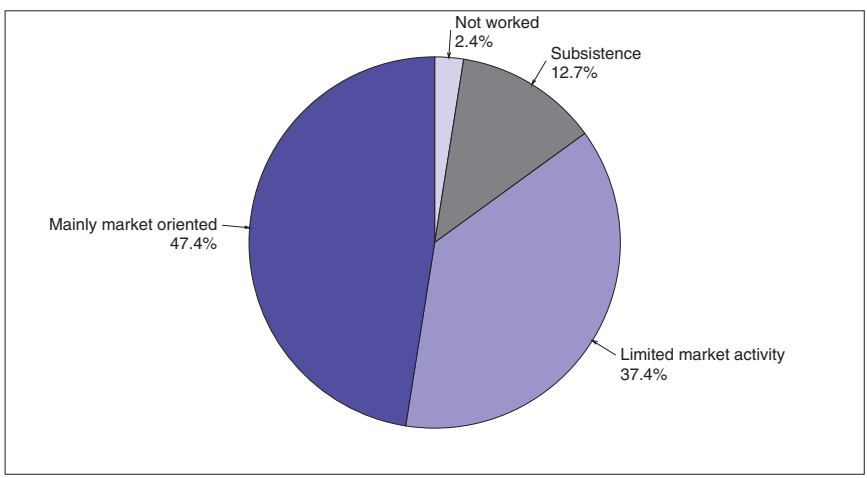
In order to promote restructuring in agriculture, the authorities need to reform the special farmers' social security system (KRUS, for more on the labour market implications of this system see Chapter 3). As compared with the general system, ZUS, the KRUS system offers three important advantages: 1) contribution scales are substantially lower than for ZUS but offer comparable benefits (contributions only cover 5 per cent of expenditures); 2) all members of a farmer's household are entitled to coverage and in particular, all receive health insurance coverage, whereas under the ZUS system only beneficiaries (retirees and the disabled) and contributors (the employed and self-employed and their dependents)

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have health insurance coverage; 3) contributions do not rise with incomes. These features constitute a substantial implicit subsidy (95 per cent) to the KRUS system and represent a real financial incentive to remain in a rural environment and under the KRUS umbrella.

Access to the system is restricted by several eligibility criteria, most relevant of which are the need to own at least 1 hectare of agricultural land. This, plus a second condition providing unemployment benefits to KRUS householders that lose a non-farm job if their farm is smaller than 2 hectares contribute to a very high incidence of uneconomically small farms. Partly as a result, subsistence farms represent a substantial proportion of all Polish farms and less than half are significantly engaged in market activities (Figure 4.6). Moreover, because of the implicit KRUS subsidy, the necessary process whereby small unproductive farms are consolidated into larger ones has not been occurring. Indeed, while there has been an increase in larger farms at the expense of medium-sized ones, both the share and absolute number of small uneconomic farms have been increasing (Table 4.3). Twenty per cent of all farms produce only for own-consumption. For 70 per cent of these households, farming represents only 10 per cent of their total income (inclusive of own consumption). However, for 5 per cent of subsistence farmers, agricultural activity represents 90 per cent of household income. Even among households

Figure 4.6. **Market orientation of Polish farms**



Source: Ministry of Agriculture.

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Table 4.3. **Number of private farms by size**
1990-2000

	1990	1995	2000	2002	2002/1990
	Thousands				Per cent change
Size of farm (in hectares)					
1-2	378	428	448	517	36.8
2-5	750	690	613	629	–16.1
5-7	319	274	224	217	–32.0
7-10	319	272	224	210	–34.2
10-15	242	219	186	183	–24.4
15+	130	164	186	196	50.8
Total	2 138	2 048	1 881	1 952	–8.7
	Share in total, per cent				Change
1-2	18	21	24	27	8.8
2-5	35	34	33	32	–2.9
5-7	15	13	12	11	–4.0
7-10	15	13	12	11	–4.0
10-15	11	11	10	9	–2.0
15+	6	8	10	10	4.0
Memorandum items					
5 or less	1 129	1 118	1 061	1 146	1.5
Average size	6.3	6.7	7.2	7.4	17.5
Arable land	10 941	11 722	11 845	11 485	5.0
Privately-held agricultural land	14 228	15 205	15 456	14 858	4.4
Total arable land	1 4228	15 205	15 456	15 734	10.6
Total area of plots larger than 1 ha[1]	13 469	13 722	13 543	14 445	7.2
Total area of plots less than 1 ha[1]	759	1 483	1 913	1 289	69.9
Share of land owned by State	24.0	18.3	16.1	16.1	–33.1

1. OECD estimates based on data from Central Statistical Office.
Source: Central Statistical Office.

producing mainly for the market, agricultural activity represents less than 10 per cent of total income.

The potential productivity returns from farm consolidation are large (see Chapter 1). Data suggests that farms smaller than 15 hectares cannot support a household and that returns to labour are close to zero for farms of up to 30 hectares – implying that more than 90 per cent of Polish farms are overmanned. Because of low productivity, farmers have not been in a position to invest in their farms and as a consequence the sector has suffered from years of underinvestment. This, plus farmers' generally low-level of educational attainment, partly explains their failure to make effective use of technology. Polish farmers employ only one third the level of fertilisers used elsewhere in the EU and one seventh the level of pesticides (Lisztwan and Dalton, 2001). Consolidation of small scale

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farms could yield increases of 12 to 25 times as much output per worker (on a full-time equivalent basis). As indicated in Chapter 1 economy-wide returns from agricultural restructuring could yield an increase in potential output growth as high as 1 per cent per annum for a period of several decades or more.[34]

Notwithstanding the importance of the KRUS system as an explanation for the slow pace of rural restructuring, before consolidation can be expected to progress significantly, much needs to be done to clarify property rights in the agricultural land market, reduce transaction costs and eliminate ownership restrictions. Indeed, while Poland has made substantial progress in its transition towards a market economy, institutions in the agricultural land market have lagged behind. Dale and Baldwin (2000) estimate that, as of 1998, Poland had made only about one third of the progress to reach levels observed in developed market economies.

In this regard, efforts should be made to spur farm consolidation by eliminating the 5 per cent land-transfer tax, lowering the costs of land registration and eliminating other impediments to land purchase. Currently the 5 per cent land-transaction tax and fees associated with registering and transferring of land ownership combine with notary fees to raise sales costs to as much as 12.5 per cent of the total sale price for small holdings.[35] The problem is particularly acute for the 30-40 per cent of agricultural land, mainly small plots, that is not yet registered (registration is only obligatory at the time of sale). By making land-registration obligatory but free, at least during the transition period when the remaining stock of land is brought into the registry, the authorities would help to make the agricultural land market more liquid, thereby increasing the likelihood of consolidating purchases being concluded. Moreover, once the registry is completed, there appears to be substantial scope for simplifying and streamlining the process, which should contribute to reduced costs and lower fees even in the long run.

Completing the registry would also help clarify property rights and would, in combination with a recent decision to raise the priority of mortgage claims from 6th to 3rd during foreclosure procedures (after outstanding wages and taxes), increase the willingness of financial institutions to extend credits to farmers. Indeed, over 50 per cent of non-farm business investments are financed from private savings, and only 17 per cent are intermediated by banks and cooperative banks. Here, recent changes raising the share of land's value that can be mortgaged and the recent reform of the bankruptcy law (see above) may help to increase both land consolidation efforts but also investments that could promote rural employment and productivity.

In addition to helping speed the restructuring of the agricultural sector, such steps would also likely improve rural wealth. Currently, Polish land prices are one fifth of the levels in eastern Germany and one tenth those in western Germany. Moreover, land prices in Poland have been stagnant in real terms – in contrast to prices in other transition countries with more liberal regimes. A thin

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land market, poor land productivity and ownership restrictions (see Box 4.5) keep land prices low. While this benefits young Poles who might wish to enter the market, it deprives those that are in it (and their children) from deriving the maximum value from their land should they wish to leave and as such slows consolidation. Contrary to popular thinking, in the context of functioning credit markets, a generally higher price level would not reduce opportunities for purchasing because it would increase the value of the purchaser's existing assets and those that he purchases, both of which could be used to secure credits. Moreover, higher rural land prices would make the purchase of an apartment in an urban area more affordable, thereby increasing urban-rural mobility.

Privatisation of the remaining 16 per cent of agricultural land held by the State (down from 25 per cent in 1990) would also help develop the market for agricultural land. Although collectivisation was less pervasive in Poland than in other former communist countries, the process of restitution and privatisation of state-owned lands has been slow, mainly because of multiple claims on the same property

Box 4.5. Ownership restrictions on agricultural property

Polish law requires that a purchaser of agricultural land have "practical and theoretical agricultural qualifications", either vocational secondary vocational or tertiary training or be resident on a farm. The Ministry of Treasury can prevent a sale if following the purchase the new owner would have more than 500 hectares of land; if he does not live in the commune where the purchase is being made; or does not declare that he will work the land himself.

Beyond these regulations, foreigners are not legally prohibited from owning agricultural land. However, for a period of 12 years following EU accession in order to make a purchase foreigners must apply for and receive approval from the Ministries of the Interior, Defence and Minister of Agriculture and Rural Development. Leases do not require permits. Moreover, a foreigner having leased land for between 3 and 7 years (depending on the region) may purchase it on the same basis as a Polish citizen. A recent amendment to the act on the management of State Treasury Agrarian property only allows individual or firms that are already in agriculture or who are repatriates or who fulfil the requirements of the agricultural settlement programme from participating in tenders for the sale or lease of agricultural land (Chaplin, 2001).

In the context of EU accession, Poland has been able to preserve these restrictions for a period of between 3 and 7 years, depending upon the region.

All told, the Agricultural Property Agency has sold an estimated 39 000 hectares to foreigners since 1990 and leased 114 000 hectares to foreigners and a further 60 000 ha to companies with foreign participation.

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arising from the manner in which land was initially collectivised. Rather than privatise under uncertainty, the State has opted to lease land[36] in about equal proportion to local farmers and private companies.[37] In order to get around the problem of multiple claims on the same land, a restitution/privatisation plan that gave individuals with valid claims a share of the total revenues (or land) rather than a specific plot would allow progress to be made more quickly. More generally, the leasing of State land has had a positive impact on agricultural productivity. On average parcels of leased land are 15 hectares in size and farms including some leased land are on average more than three times as large as those without. Among private owners, leasing is much less common, 83 per cent of farmers do not lease land and those that do tend to be older farmers, who rent out significant parts of their land because they are no longer able to farm it. Taken together, these facts suggest that a significant proportion of larger farms in Poland are in fact ones either operating wholly or significantly based on leased land State land.

Rural income transfers

Official statistics indicate that the per capita income of farming households is only three quarters of the economy-wide average. However, this does not take into consideration the consumption of own-production goods, estimated to equal 9 per cent of total rural household income[38] or the generally lower cost of living in rural areas, which Paci and Sasin (2003) estimate to be 13 per cent lower than in urban areas. A special rural household income survey conducted by the World Bank suggests that non-farm wage income may be higher than recorded in the household budget survey. On the basis of this data, per capita farm incomes uncorrected for rural prices are only 8 per cent lower than the national average (Table 4.4). Independent of which data source is used, the low cost of living in rural areas combined with substantial sources of non-earned income makes low-productivity rural activity a viable alternative to looking for better-paid work in an urban environment. This is a factor, which in addition to the difficult labour market situation in urban areas helps explain why, notwithstanding very low rural productivity levels, rural out migration has declined from 113 000 per annum in 1990 to only 9 000 in 1998 and actually had reversed itself in 2002 with some 18 000 individuals net moving from urban to rural areas. Farming households are heavily reliant on government transfers for their income, with on average one third of total revenue coming in the form of government transfers, one third from off-farm work and only one third from farming itself. Among smaller farms, the share represented by farm income in total income is even smaller and that of transfer income larger.

Recognising the problem, the authorities are proposing to substantially reduce incentives to stay in rural-based low productivity work by requiring farmers to pay contributions to the KRUS system more in line with their incomes and at

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Table 4.4. **Sources of farm household income by farm size**

	0-1 ha	1-7 ha	7-15 ha	15+ ha	Average	Farmers[1]	Whole economy[1]
				Zlotys			
Household annual income	20 140	18 189	18 621	53 198	28 313	23 160	22 855
Per capita	6 794	4 381	4 734	11 751	6 737	5 472	7 326
Net farm income	2 189	1 295	8 203	39 034	13 577	16 716	
Net income from non-farm business	348	1 773	183	4 757	2 134		
Non-farm wage income	8 609	7 839	4 116	3 057	5 706	382	
Income from transfers	9 300	6 949	5 622	5 776	6 428	5 280	2 295
KRUS	2 827	2 842	3 851	4 580	3 560		
ZUS	4 937	3 418	1 372	815	2 343		
Other	694	333	497	574	468	782	
				Per cent of national average earnings[2]			
Household annual income	88	80	81	233	124	101	100
Per capita	93	60	65	160	92	24	32
				Per cent of household earnings[3]			
Net farm income	11	7	44	73	48	73	
Net income from non-farm business	2	10	1	9	8		
Non-farm wage income	43	43	22	6	20	2	
Income from transfers	46	38	30	11	23	23	10
KRUS	14	16	21	9	13		
ZUS	25	19	7	2	8		
Other	3	2	3	1	2	3	

1. Data are taken from Table (207) Central Statistical Office (CSO) (2002), *Statistical yearbook of Poland*, monthly average data multiplied by 12.
2. World Bank rural household survey data divided by CSO whole economy data.
3. World Bank rural household survey data divided by World Bank Rural household survey data.

Source: OECD, calculations using data from World Bank (2001), CSO (2002).

rates closer to those that would be paid by participants in the general system (ZUS). While likely to be unpopular, such a reform is essential if market incentives to move to higher productivity work are to be effective in promoting migration. To be most effective, this initiative should be supplemented by a reform of the way in which individuals' qualify for health insurance. Under the current system, all members of a KRUS enrolled farmers' household qualify for health insurance even if they have no income. The same is not the case for ZUS households. Here, given the severe financial difficulties experienced by the healthcare system a better solution might be to make access to the healthcare system universal and transfer its financing to general revenues. This would have the simultaneous advantages of: allowing for a reduction in payroll taxes, with beneficial impacts for the labour

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market; providing for clearer governance of the healthcare system (see OECD, 2002a); and making individuals indifferent (at least from the point of view of healthcare) as between working inside and outside of the farming sector.[39]

Rural development projects

At least some of the net savings generated from making benefits and contributions in the two systems more similar should be used to enhance current efforts to promote regional development. Here an augmented agricultural outreach programme that emphasises the possibilities and benefits from small farm consolidation should be considered. Indeed, while the current emphasis on helping teach farmers how to apply for EU funding may help restructuring in the long run by providing successful farmers with the resources to finance consolidation, in the short-run it will be counterproductive to the extent it encourages farmers to see EU funding as a further source of unearned income support.

There seems to be opportunity for refocusing the assistance already given. Milczarek (2003) argues that too much money is going to production subsidies in the form of subsidised loans and not enough to infrastructure development. The Agency for Reconstruction and Modernisation of Agriculture (ARMA) spends about 0.2 per cent of GDP on rural development, with almost 70 per cent of that amount going to cover subsidised interest payments. Less than one tenth of the total goes to rural infrastructure and human capital enhancing projects (Table 4.5).[40] By value, more than 30 per cent of expenditures is made in the form of interest subsidies for loans covering operating costs (purchases of agricultural inputs and the storage of surpluses). In volume and presumably administrative effort, these represent 78 per cent of all loans.[41] Not only does such support not contribute to improving agricultural

Table 4.5. **Expenditures of the Agency for reconstruction and modernisation of agriculture**

	1995	2000	2002
	Share in total, per cent		
Subsidised loans:			
For investments	25.1	59.0	41.3
For working capital	52.2	31.6	27.2
Co-financing technical infrastructure development	12.7	0.7	0.0
Job-creation loans	2.4	1.3	2.6
Vocational qualifications and on-the-job training programmes	1.4	0.5	1.1
Other (of which SAPARD loans)	6.2	7.0	27.7
Total Zloty, 1995 prices	597 718	832 715	808 503

Source: Ministry of Agriculture, OECD calculations.

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productivity, research suggests that it is also ineffective as an anti-poverty measure (Milczarek, 2003) – mainly because it is only better off farmers producing for the market that qualify for loans (85 per cent of loans go to farms larger than 7 hectares). Very little money is spent on human capital improvement spending. The fast growth in spending the "other" category reflects loans to support agricultural and rural development (SAPARD) (see Box 4.6).

Efforts at upgrading infrastructure may have an important effect on contributing to improved rural productivity. The EBRD (2002) reports that improvements to the quality of rural roadways can generate social returns in excess of 35 per cent and are beneficial to rural communities because they both improve market access for rural products and they reduce costs of goods sold in outlying areas. Similarly, efforts at improving the distribution network for farm goods and supplies can have important positive effects. The creation of a central Warsaw market helped improve transparency by bringing sellers and buyers together, thereby ensuring that sellers received a fair price but also forcing them to compete more effectively in terms of quality and price.

Finally, as indicated in the Chapter 3 rural educational outcomes are low (44 per cent of the rural population has less than basic vocational education) and

Box 4.6. The Special Accession Programme for Agriculture and Rural Development – (SAPARD)

In the case of Poland the SAPARD programme has fixed itself two principal objectives: 1) improving the efficiency of the agri-food sector (30 per cent of funds will go towards supporting the processing and marketing of agricultural products and 15 per cent towards bringing beef an dairy operations into line with EU *acquis*) and 2) improving the conditions for economic development and job creation (around 30 per cent of funds to go towards infrastructure development, 15-20 per cent towards to support diversification of farm incomes and collective marketing efforts). A final 3 per cent of the funds are destined to provide technical support to the programme.

Limited funding (only 170 million euros over seven years, 2000-2006) means that the programme will be able to affect only a small portion of all enterprises in target areas, (¼ of dairies and less than 10 per cent of dairy farms. Moreover, the net benefit of the programme will depend importantly on the quality of programmes it finances. Because the financing is to be made as a complement to national programmes, to be effective these programmes will need to be better targeted in the past so as to ensure that they do not just displace private investment that would have occurred anyway.

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have been for sometime.[42] While the steps outlined there to improve resources at the local level and to make curricula in non-academic streams more appropriate should be helpful, effort also needs to concentrate on practical adult education. Here making smallholders more aware of opportunities for expanding their holdings or of leasing would be useful. Moreover, as indicated by Leiprecht (1999), labour mobility is strongly correlated with educational attainment. For future generations this is important, although for those currently on the land there is no obvious policy solution.

Summing up

Increasing investment rates and raising productivity growth rates must be critical elements of any strategy to raising the incomes of Polish workers to the level of individuals in other more developed OECD countries. Both investment and productivity are the result of a complex series of economic decisions and actions and neither can be directly influenced by government policy. Nevertheless, as outlined above, government can influence investment and productivity developments by pursuing a set of policies that seek to lower the barriers to bank lending, spur privatisation and private ownership, streamline the functioning of the judicial system as it applies to firms, remove roadblocks to firm activity and invest in the fundamental public infrastructure that facilitates business activity. Table 4.6 summarises the recommendations of this chapter and updates implementation efforts in other areas addressed in earlier *Surveys*. Progress in these areas coupled with the kind of reforms liberating effective labour supply and demand outlined in Chapter 3, would go a long way to creating the kind of dynamic and sustainable growth needed to rapidly reabsorb the vast pool of currently unemployed individual in Poland.

Rural restructuring and the freeing up of labour currently occupied in low-productivity, low income agricultural and rural activities has a central role to play in the process. For that potential to be realised will require that a number of difficult reforms be launched, principally aimed at those features of the farmers pension scheme that serve to block farm consolidation on the one hand and labour mobility on the other. While such a reform is likely to impose costs on some parts of society, doing nothing is not an option. The past 15 years suggest quite clearly that with existing institutions the sector will not evolve and that human and productive potential will continue to be wasted. Here, how the funds made available following Poland's adhesion to the European Union are used will play an important role in determining the future course of rural restructuring. While these could be used to help improve the level education, develop infrastructure to both upgrade the rural economy and facilitate communication with urban centres, there is a risk that they will become another income transfer that further increases the opportunity cost of leaving the farm, thereby slowing the necessary and inevitable transformation of the rural economy.

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Table 4.6. **Structural surveillance**

Panel A: Labour markets			
Issues/previous recommendations	Recent action taken	Assessment	Follow-up recommendation
Chapter 3 deals with labour market issues in detail and a summary of its recommendations is presented in Box 3.8			
Panel B. Product and financial markets			
Sectoral restructuring			
Coal-mining Reconsider the balance of costs and benefits from merging mines. Enhance surveillance to ensure competition in the sector.	Remaining mines were consolidated into three holdings, output and the workforce were reduced further: financial restructuring and injection of additional capital were pursued. Some privatisations are planned for 2004.	Despite considerable downsizing the sector remains unprofitable. Merged mines could create monopolistic rents and cross-subsidise unproductive mines to the detriment of the competitiveness of customers that are dependant on coal.	To ensure low prices for consumers, the competition authority will need to follow developments closely.
Iron and steel Reconsider plans to merge steel mines, if proceeded with reinforce regulatory surveillance.	Four largest steel producers (80 per cent of production) were merged and sold. Consolidation within product groups and financial restructuring of the remaining entities is underway.	The privatisation of the consolidated steel producer may represent a model for faster sales, but market dominance remains an issue.	Reinforce competition vigilance.
Gas Proceed with sale of regional distributors. Widen scope for competition from imported gas.	Sales of regional distributors continue to be stalled.	Restructuring of the gas sector is proceeding too slowly. Import opportunities for foreign market players need to be expanded. The non-competitive gas market impedes the liberalisation of the electricity and coal sectors.	Implement previous recommendation.
Defence sector Implement privatisation plans.	The government created 2 holdings and plans to contribute the shares of a number of remaining companies after their restructuring. The remaining companies will be sold following restructuring.	The sector remains weak and plans to consolidate disparate firms may not bring the desired privatisation revenues.	Proceed with privatisation, but reconsider the consolidation-before-privatisation approach.

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Table 4.6. **Structural surveillance** (*cont.*)

Panel B. Product and financial markets			
Electrical sector: Reconsider the balance of costs and benefits from merging power plants.	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 role of PSE, the national operator, to be restricted to transmission alone. Distributors' monopolies in local power supply will be terminated. Privatisation of PSE will not begin before 2005.	The envisaged reduction of the role of PSE and the increased exposure of the regional distributors to competition in the retail market are welcome. Recent progress has been slow, due to plans to merge firms before privatisation.	If the merger of 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.
Electrical sector:*Stranded costs* Attempt to adopt the compensation payment system and increase the openness of the sector to imports.	Long term contracts were declared void by law, with proposed compensation equal to the difference of the value of firms before and after liquidation of contracts. Estimates of compensation to be made energy Regulator and financed by securities emitted by PSE.	The liquidation of long-term contracts allows competition to influence domestic prices. However, if the proposed compensation is not seen as fair, the process could be viewed negatively by markets.	Both for equity reasons and to maintain investor confidence, the proposed compensation must do justice to companies that have made investments based on the long-term contracts.
Banking sector Expand the plans for privatisation in the sector.	A restructuring plan of BGZ has been adopted in October 2002, including plans to increase shareholders' equity through partial privatisation on the Warsaw Stock exchange.	A large State presence in the sector contributes to low efficiency and may distort resource allocation.	Instead of a partial sale of BGZ shares, the bank should be sold to a strategic investor.

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Table 4.6. **Structural surveillance** (*cont.*)

Panel B. Product and financial markets			
Privatisation			
Accelerate privatisation in a transparent and predictable manner.	Progress in 2003 has been disappointing. 4.5 billion zloty in privatisation revenues were raised. 3 000 companies still remain in State hands. The 2004 Budget anticipates 8.8 billion zloty in privatisation revenues.	Privatisation process is excessively cumbersome, complicated and costly. Current process places too large an emphasis on sales price.	Reduce the number of governmental institutions with responsibility over privatisations; avoid complicated social clauses and instead providing direct social and labour market assistance to affected workers. Adopt a more pragmatic and active approach placing less emphasis on the sale-price and more on the total cost/ benefit.
Actively promote the sale of small firms and minority stakes using the expertise of an investment bank.	Some small firms have been bundled recently and sold to an investment bank for subsequent sale.	The pace of sales remains very slow.	Implement the previous recommendation and extend the use of bulk sales.
The State should accelerate its withdrawal from firms in which it holds a controlling or minority stake.	The State continues to hold controlling or significant minority stakes in the vast majority of formerly wholly state-owned companies.	Plans to sell minority stakes on the stock exchange risks creating a weak corporate governance structure and denying firms access to necessary capital and guidance from a strategic investor.	Implement the previous recommendation.
Panel C: Regulatory reform			
Regulatory framework			
The competition authority 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.	No specific actions.	The competition authority needs to be more publicly critical of government positions with which it disagrees.	Implement the previous recommendation.

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Table 4.6. **Structural surveillance** (*cont.*)

Panel C: Regulatory reform			
Introduce clear rules governing the protection of minority shareholders in the case of conflicts with firm management and on majority owners.	Voluntary corporate governance codes based on OECD guidelines were made compulsory for listed firms.	This development is 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.
Improve the efficiency of capital markets.	Signature of agreement between WSE and Euronext stock exchange of conferring on each mutual trading rights. Increased instruments available to Open Pension Funds and the share of assets in risky instruments.	Efforts have reduced transactions costs for foreign traders, improved the reliability in Polish capital markets. However, the Polish market remains thin.	Continue efforts to expand liquidity on Polish markets.
Improve infrastructure.	Enabling legislation for motorway construction and financing passed; creation of the "Railways Transport Office" in June 2003; plans to upgrade rail access between major urban centres; creation of a new airport.	Poland's infrastructure remain underdeveloped, which impedes investment and curbs productivity growth.	Increase expenditures in infrastructure, taking advantage of EU funds. Speed up privatisations in the transport sector so as to improve its competitiveness.
Expand housing rental market.	Plans to eliminate rent controls by the State in 2005.	Lack of rental housing limits opportunities for labour mobility; excessive tenants rights and rent controls are among the most serious problems.	Include rental housing in home renovation and construction loan programmes; eliminate rent controls; improve the balance between tenant and owner's rights.

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Table 4.6. **Structural surveillance** (*cont.*)

Panel C: Regulatory reform			
Specific measures			
Extend the electronic registry system to form a one-stop business registration system.	Proposals have been floored to create of a one-stop shop enterprise register and further reduce administrative burdens.	If implemented, these changes can be expected to facilitate the conduct of business and improve transparency and confidence with which economic agents enter into agreements.	Continue efforts to simplify red tape. The effectiveness of the new business registry would be reinforced by adding all existing businesses as rapidly as possible.
Eliminate impediments to real-estate transactions.	Time to register property has been reduced. A computerised registry that covers major urban areas has been created.	Institutions in the agricultural land market lag behind the urban property market impeding land sales and purchases. Lags in updating registries remain large in some large urban centres.	Rural land registration should be made obligatory and free, including the temporary suspension of the land transfer tax. Existing restrictions on land purchases should be liquidated. Real-estate remaining in State hands should be fully privatised.
Be more proactive in promoting FDI.	The national investment promotion organization (PAIiIZ) was strengthened.	The effectiveness of PAIiIZ would be enhanced if it were given authority to negotiate binding *ex ante* agreements and if it were able to offer one-stop shop services to investors.	Offer more pro-active assistance to firms seeking to invest by creating a one-stop shop investment agency maintaining an up-to-date investment site database, able to make binding offers and providing more comprehensive administrative help.
Reduce uncertainty in the tax system.	A draft law, if passed, would oblige the tax authorities to provide free of charge *ex ante* exculpatory tax rulings.	This proposal is welcome as tax administration is a major source of uncertainty that curbs investment. However, the problem of different interpretations at local tax offices remains.	Implement the proposed reform and set up a centralised authority for *ex ante* tax rulings; reduce the lag between the passage of a tax law and its enactment; reduce administrative complexity and compliance costs for all tax filers.

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Table 4.6. **Structural surveillance** (*cont.*)

Panel C: Regulatory reform			
Lower the overall tax rate faced by enterprises and streamline tax and regulatory frameworks.	Corporate income tax has been reduced from 27 per cent to 19 per cent. Submission of tax documents has been simplified for smaller firms, social security rebates for newly hired graduates and tax holidays for newly established youth entrepreneurial activities have been introduced.	The introduced changes should support Polish competitiveness but the tax system remains very complex.	Simplify tax and regulatory environment.
Streamline bankruptcy procedures.	Introduction of a new bankruptcy law in October inspired by current best practices.	The new law should contribute to the strengthening of creditor rights, reduce the potential for debtors to delay restructuring and speed court procedures. Execution remains a serious problem.	Improve the quality and efficiency of judicial processes; make use of potential in law to speed bankruptcies and give a greater role to creditors; reconsider provisions that require the administrator to attempt to sell a bankrupt enterprise as a whole rather than breaking it up.
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 competition authority's annual report on state aid would be enhanced if it were submitted earlier in the budget process.

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Table 4.6. **Structural surveillance** (*cont.*)

Panel D: Sustainable development			
Ensure effective integration of environmental considerations in sectoral policies 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 domestic emission trading systems.	A 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 training concerning tradable emission permits and the 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 Survey 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 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 should help assert control over the system.	In order to ensure that further reform does not destabilise the system, implementation of any significant change in the system should be undertaken carefully and in consultation with stakeholders.

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Table 4.6. **Structural surveillance** (*cont.*)

Panel F: Efficiency and sustainability of public expenditures			
Make the annual Budget process more comprehensive by integrating into it the activities of the extrabudgetary funds.	The Ministry of Economy, Labour and Social Policy has been made responsible for administering the Labour Fund.	Including extrabudgetary funds in the Budget would ensure a better adequate control and monitoring of central government programmes.	The Labour Fund should be integrated into the State Budget and the Health Fund could be as well.
Adopt a medium term budgetary framework with an explicit expenditure rule.	A "Medium-term growth and fiscal strategy" is produced regularly. Officials talk of an expenditure rule for the State Budget but it is not binding.	These medium-term projections are only very weakly integrated into the budget process. The expenditure rule is not respected and only concerns the State Budget.	Implement the recommendation.
Increase the transparency of public finance at local and central government level.	To support enhanced local government powers, a larger share of personal and corporate income tax revenues are being transferred to sub-national levels of government, partially offset by reduced cash transfers.	This reform is an important step in the process of decentralisation. However, because transfer formulae are based on costs not ability to pay, services in low income regions are underfunded.	Local-level budgetary reporting needs to be improved. Financing rules for sub-national levels of government should take into consideration their capacity to pay co-financed programmes such as education.
Panel G: Encourage rural development			
Reform rural income transfers.	Planned reforms would reduce the extent to which the farmers' social security system is subsidised as compared with the general system.	A 95 per cent subsidy rate creates a significant dependency trap, impeding labour mobility and keeping individuals in low-productivity work in rural areas.	Harmonize fully the benefits and contributions of the two systems, while augmenting social assistance support for the poorest farmers.
Eliminate land-ownership requirements in the farmers' social insurance system.	No measures planned.	Most Polish farms are uneconomically small and consolidation is not occurring, because access to the farmers' pension system is contingent on holding at least 1 hectare of farm land.	Harmonising benefits as suggested above would render land-ownership rules irrelevant.

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Table 4.6. **Structural surveillance** (*cont.*)

Panel G: Encourage rural development			
Eliminate ownership restrictions on rural land.	No measures planned.	Ownership restrictions on farm land depress prices and farmers' wealth – indirectly slowing land consolidation and rural-urban migration.	Implement this new recommendation.
Promote rural restructuring by improving infrastructure.	Current programmes designed in cooperation with international agencies seek to promote infrastructure development and improvements in rural educational outcomes.	Poor infrastructure and high transportation costs, reduces rural profitability and incomes. Education outcomes are low.	Focus on improving infrastructure (quality of rural roadways).
Improve educational outcomes in rural areas.	No specific measures planned.	Rural educational outcomes are poor, partly due to funding mechanisms and excessive streaming.	Make educational funding reflect local governments' ability to pay not just costs. Reduce the extent of streaming in rural education.

Source: OECD.

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Notes

1. These loans are provisioned and therefore pose less risk to the financial system than the numbers would suggest. Moreover, the Polish classification system is more stringent than that in other countries.
2. In the Polish classification system, prior to 1 January 2004, loans were classified as substandard if payments were between 30 and 90 days overdue or the financial condition of the borrower was in doubt. They were classified as doubtful if payments were between 3 and 6 months overdue or the financial condition of the borrower had deteriorated substantially. They were classified as loss loans if payment was 6 or more months overdue or the financial condition of the borrower was so deteriorated as to preclude repayment.
3. In 2000, the share of assets held by five largest banks in Poland at 46.7 per cent is significantly lower than in Hungary (66.7), the Czech Republic (59) or Slovenia (62.5). As of 2003, this ratio has increased to 53 per cent in Poland.
4. Of the 56 commercial banks operating in the Polish market 43 are foreign controlled and 7, representing 25 per cent of assets, remain state owned. In addition, there are some 601 co-operative banks, virtually all associated with one of three affiliating banks, which together represented only 5 per cent of banking assets and activity.
5. As of June 2003, government securities represented 19 per cent of banks overall assets as opposed to a 41 per cent share for loans.
6. Under the voluntary restructuring provisions of the new law a firm upon realising that it is illiquid, although not yet in default, can petition the court for protection from its creditors (similar to US Chapter 11 protection). It then is granted a period to continue operations while it determines a restructuring deal. During this period, creditors may not foreclose on debts and the debtor may not take on new debts or new encumbrances on existing assets. Once a restructuring deal is arrived upon, it is to be presented to creditors and will be accepted if a majority of them representing ⅔ of the debt agrees to it. The court then will be called upon to approve the agreement. If an agreement is not reached the court must order bankruptcy or liquidation procedures to be undertaken.
7. The new law ensures that if an EU firm whose principal business activity lies in an EU country other than Poland files for bankruptcy under the provisions of this second country, then the bankruptcy proceedings of the Polish assets will be governed by the laws of the other EU country. Similar provisions exist for bankruptcies initiated in non-EU countries, but here the recognition of the foreign bankruptcy law is not automatic. Moreover, a decision to recognise a foreign process can be revoked if the grounds for its granting are subsequently found to not exist. Finally the recognition of a foreign

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bankruptcy procedure does not preclude the initiation of a Polish procedure for the assets located in Poland.

8. Market capitalization in 2003 was almost equal to the combined market value of the next three largest stock emerging-market exchanges in the region (the Budapest, Prague and Ljubljana exchanges).

9. The value of public offerings decreased by 40 per cent between 1999 and 2001.

10. All WSE issuers are required to observe the Principles since July 2003. They define best practices in the area of the operation of listed companies and their governing bodies (management boards, supervisory boards, general shareholders' meetings), thus strengthening ownership supervision over public companies.

11. Major envisaged changes for 2004 include ensuring higher investor security and improving supervision over capital market, introducing new solutions in the procedure for admitting securities into public trading (mutual recognition of prospectuses by EU member states), launching new trading instruments and platforms (alternative trading system and internal transactions), as well as expanding investment options for investment funds, launching new types of funds and implementing principles for mutual recognition of companies managing UCITS funds.

12. In particular, the draft contains provisions on the mutual recognition in the case of parallel offers; provides the issuers with recourse before the courts if the PSEC refers them access to the exchange; renders more explicit the regulations prohibiting the disclosure of restricted information by the exchange; and refines the definition of the scope of such restricted information.

13. Firms whose sales and exports of goods and services may not exceed the EUR 800 000 in the preceding fiscal year. Special pensions already allow very small submitters to file on a quarterly basis.

14. Hungary's corporate tax rate is 18 per cent and since January 2004 Slovakia's is 19 per cent.

15. The Strategic Guidelines on Investment Promotion, developed in the context of the South East Europe Stability Pact, among other things propose the following priority areas for policy action: *i*) ensure consistency of other government policies with agreed FDI policy so that efforts to attract FDI are not undermined or obstructed by conflicting laws and regulations; *ii*) establish an investment promotion agency with a clear legal structure and powers to carry out its mandate; *iii*) ensure that the mandate of the agency is clear, transparent and modifiable only by government decision; *iv*) ensure that all management and staff are appointed based on industry experience, skills and personal qualities; and *v*) Identify administrative barriers to FDI and undertake regular reviews of the investment climate in the country.

16. The whole package comprises five thematic blocks, including: simplification of the tax system; reduction of the costs of labour; increased labour relation flexibility; simplification of the social insurance system and simplification of administrative procedures.

17. Comprised of 400 km of double-laned highway and 200 km of so-called "express ways", two-lane roads with a third passing lane.

18. Despite the lowest initial density of motorways as compared to other Central European markets (1/5th of the Czech Republic level), Poland road investment performance has lagged other central European countries. While road densities in the Czech Republic, Slovakia and Hungary increased by 45, 51 and 69 per cent respectively between 1994 and 2002, in Poland they increased by only 37 per cent.

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19. 25 September issue of *Rzeczpospolita*, p B3 reported in Polish News Bulletin 2003, September, 25.
20. The regulatory environment reflects best practices, with full competition in the provision of long distance services (Summer 2003), liberalisation of local loop provision, definition of universal service and number transferability. Since 1st January 2002, potential operators may freely apply for permits enabling them to provide local and long-distance telephone services and, since 1st January 2003, the market of international connections has also been liberated.
21. Including owner-occupied and rented apartments, detached and semi-detached dwellings.
22. Rents cannot exceed 3 per cent of the market value of a dwelling.
23. Smaller direct privatisation deals also resulted in efficiency gains and high company survival rates, see Annex IV in OECD (2001a).
24. For instance, for State-owned enterprises share in GDP to reach French levels, Poland would have to sell about half of its assets (or about 8 per cent of GDP) over the next three years, approximately twice the amount sold during the period 2001-2003.
25. The authorities now indicate that they will merge the refinery with some other smaller ones before attempting to sell it again.
26. Following this merger a special privatisation procedure, bypassing the normal public procedures, was initiated which terminated with a decision to enter into exclusive negotiations with the LNM Group of India in July 2003 and the reaching of a tentative privatisation agreement, contingent on LNM agreeing a social plan with PHS unions. The privatisation agreement requires the purchaser to increase the company's capital, purchase its outstanding debt (following debt equity swaps), to respect the investment and business plan created by the government and submitted to the European Union and provide the Polish company with bridge financing. The State Treasury intends maintaining a 25 per cent stake in the company, which the investor will be permitted to purchase by the end of 2007.
27. 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.
28. 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.
29. The privatisation process has also been disturbed by a number of litigations brought against the Ministry of Treasury by purchasers of state-owned firms following what they interpret as arbitrary changes to privatisation agreements. In the case of PZU, an insurance company, the strategic investor (eureko) initially purchased 30 per cent of the company. It was subsequently prevented from exercising its right, as per a second agreement with the government, to purchase a further 21 per cent of the company's stock because it failed to acquire the required permit from the Ministry of the Interior. The case is now in arbitration, with Eureko requesting to be allowed to complete its purchase of the company. A similar case involves, Hachette Distribution Services, which claims the right to purchase 40 per cent of Ruch SA, Poland's largest press distribution company. In each case, the Ministry of Treasury appears to have backed of initial agreements to sell to the strategic investor a subsequent tranche of shares that

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would allow it to become a majority owner. Instead, it has argued that offering these shares on the Warsaw stock exchange affords the firms in question the possibility to acquire the shares and therefore respects the original agreements.

30. This section draws heavily on the World Bank (2001) special report P*oland*: T*he functioning of the labor, land and* F*inancial markets*: O*pportunities and constraints for farming sector restructuring*.
31. Official national accounts data indicate that in 2002 25 per cent of workers were involved in agriculture, including those whose main job was not in agriculture. In contrast, the labour force survey places this raito at about 20 per cent based on a person's main job. Most recently a new rural census suggests that in 2003 17.4 per cent of the work force was employed in agriculture.
32. Lisztwan and Dalton (2000) report that on average14.2 per cent of rural farmers work 2 or fewer hours, 26.4 per cent work between 3 and 5 hours, 29.1 work 6-8 hours and 30 per cent work 8 or more hours. On this basis, full time equivalent employment levels in agriculture are about ¾ of nominal employment levels. Similar data are not available for the whole economy.
33. Agricultural employment fell sharply between 1990 and 1993 but then actually picked up between then and 1995 after which it has been broadly stable.
34. Microeconomic studies of Polish agriculture indicate that land productivity is constant – independent of the amount of labour applied to it – for farms between 1 and 30 hectares in size (World Bank, 2001). Assuming consolidation led to average relative productivity levels in agriculture, some 25 per cent of the labour force would be freed up. Assuming the process occurs gradually and that liberated workers found productive employment at the minimum wage, potential GDP and incomes would increase by about 12 per cent. Of course, if the value added generated by these workers were higher then the impact on potential output would be higher. At the opposite extreme, if none were to find work then the impact on potential output would be zero.
35. These values were taken from a real transaction for 3 hectares of land, with a sale price of 9 000 euros (World Bank, 2001).
36. In many instances, lease agreements are conditional on lessees employing a certain number of workers or contain special employment-related rebate clauses (Chaplin, 2001).
37. Precise data as to who the State leases land is not available. However, in 1997 it owned 2.6 million hectares more than it farmed and 1.2 million hectares were leased by private companies. As leasing of land by private individual sis relatively rare, this suggests that this land was leased from the state.
38. World Bank cited in EBRD (2002).
39. Work that looks at the link between migration and unemployment suggest a weak positive correlation. Data cited in World Bank (2001) indicates that between 20 and 31 per cent of rural workers are employed in urban areas, although on average commuting distances are moderate averaging between 12 and 19 kilometres.
40. Of subsidies to support capital expenditures, 34 per cent support land purchases, 30 per cent the purchase of agricultural machinery and 25 per cent covers the modernisation of livestock buildings.
41. Alinska (2001) reports that 42 per cent of loans extended to farming households are used to finance the day-to-day operation of the farm and that interest payments on 93 per cent of these loans are subsidised.
42. In 2002, 44 per cent of the rural population had less than basic vocational education, an additional 30 per cent had basic vocational qualifications, 22 per cent had a secondary education and only 4 per cent had a tertiary degree.

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5. Sustainable development in Poland

There is growing concern that long-run sustainable development may be compromised unless measures are taken to achieve balance between economic, environmental and social outcomes. This chapter looks at three specific issues of sustainable development that are of particular importance for Poland: climate change, air pollution and sustainable retirement income. In each case, indicators are presented to measure progress and the evolution of potential problems, and an assessment is made of government policies that affect each issue. The chapter also considers institutional arrangements in place to integrate policy-making across the different elements of sustainable development (see Box 5.1).

Climate change

Main issues

The Kyoto Protocol commits Poland to reducing its aggregate emissions of greenhouse gases (GHG) by 2008-2012 to an annual average 6 per cent lower than the 1988 level. Poland will keep its own emission target under the Kyoto Protocol for 2008-2012[1] even after its entry to the European Union in May 2004. Due to the restructuring of the Polish economy in the 1990s, the target is expected to be reached easily. Nonetheless, participation in the EU carbon-dioxide trading scheme, as well as the possibility to use the Kyoto flexible mechanisms, means that reducing emissions further could have a positive economic value. The main issue is to ensure that abatement efforts are allocated efficiently, so as to maximise the net benefit of selling permits for the Polish economy.

Performance

Both in absolute terms and relative to GDP, the reduction in national GHG emissions between 1990 and 2000 was more pronounced than in most other OECD countries (Table 5.1). In the manufacturing sector, the closing down of old emission-intensive factories resulted in carbon-dioxide emissions per unit of industrial production diminishing more rapidly than the OECD average, although more slowly than in some other OECD transition countries (Table 5.2). Large decreases in emission intensities were also recorded in residential heating and road transport.

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Box 5.1. The integration of policies across sustainable development areas

The integration of policies across different sustainable development areas has been pursued over the past ten years. The principal framework for integration of environmental policies with other policies is contained in the official publication *Sustainable Development Strategy for Poland till the year* 2025. This document indicates reform directions needed to minimise pressure on the environment and reduce social problems. The priorities identified are the elimination of economic activities harmful to the environment and human health, the promotion of environmental-friendly means of economic management and the acceleration of the process of cleaning up environmentally-damaged sites. Other important measures are contained in *The Second National Environmental Policy*, which was passed in 2000. It seeks to define the measures required for assuring ecological safety for Polish citizens in the 21st century.

A *Board on Sustainable Development* was established in September 2002 as a consultative body attached to the Prime Minister's office. The members of the Board, which is chaired by the Minister of Environment, are mainly ministers, undersecretaries of state and representatives from non-governmental organisations. In addition to being an advisory unit to the Prime Minister, the Board is entrusted with monitoring the implementation of the *Sustainable Development Strategy* and legislative activities relevant to sustainable development. The Board has so far only had a few meetings and the scope of its activities is not yet finalised.

Cost-benefit or cost-efficiency analyses are not used as regular policy integration tools. Even though the authorities have done some evaluation of costs before implementing new projects, the lack of attention to cost-benefit analysis is a serious weakness in integrating the different dimensions of sustainable development into the policy making process.

By contrast, the emission intensity of electricity generation rose, although the impact on emissions was more than offset by the decline in electricity use per unit of GDP. Notwithstanding the reduced economy-wide emission intensity since 1990, Poland is still estimated to release more greenhouse gases per unit of output than any other OECD country, mainly because of the extensive use of carbon-rich coal in power generation.

Policies

The Polish authorities have adopted a three-pronged approach to reducing GHG emissions: *i*) improving energy efficiency, *ii*) favouring the use of fuels with lower emissions, and *iii*) promoting renewable energy sources.[2] Prompted by objectives set at the level of the European Union, ambitious targets have been set for

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Table 5.1. **Main indicators: climate change**

Indicators of greenhouse gas (GHG) emission intensity, grammes of CO_2 equivalent per $PPP of GDP, in 1995 prices

	Total GHG emissions	CO_2 emissions, electricity	CO_2 emissions, transport	Other GHG emissions	Total GHG emissions	CO_2 emissions, electricity	CO_2 emissions, transport	Other GHG emissions
	Level, 2000				Average annual percentage change 1990-2000			
Australia	1 061	360	159	542	–1.82	–0.46	–1.52	–2.70
Austria	403	66	96	241	–2.05	–3.20	–0.02	–2.42
Belgium	600	105	97	398	–1.47	–1.27	–0.19	–1.81
Canada	888	156	183	549	–0.94	0.24	–0.85	–1.28
Czech Republic	1 082	468	100	514	–2.77	2.54	6.33	–6.58
Denmark	501	171	88	242	–2.38	–2.73	–0.84	–2.64
Finland	597	178	99	321	–2.56	–0.17	–1.83	–3.84
France	402	30	102	271	–2.00	–2.60	–0.02	–2.57
Germany	519	168	91	260	–3.92	–3.57	–1.05	–4.95
Greece	819	275	122	422	–0.16	0.07	–0.02	–0.34
Hungary	747	192	79	476	–2.60	–1.30	–0.24	–3.40
Iceland	398	0	84	314	–1.82	..	–2.47	..
Ireland	643	152	98	392	–4.63	–2.97	0.23	–6.03
Italy	432	108	89	235	–1.06	–0.43	0.01	–1.70
Japan	441	132	81	229	–0.34	0.13	0.89	–0.99
Luxembourg	314	6	249	59	–12.47	–27.09	0.62	–23.13
Netherlands	553	138	80	335	–2.49	–0.95	–1.09	–3.34
New Zealand	1 078	82	179	817	–2.21	2.87	0.80	–3.12
Norway	454	3	97	354	–2.91	–1.57	–2.86	–2.93
Poland	**1 109**	**458**	**74**	**576**	**–5.19**	**–6.48**	**–1.39**	**–4.46**
Portugal	516	129	111	276	–0.06	0.85	3.47	–1.51
Slovakia	846	249	70	526	–5.21	0.98	1.98	–7.60
Spain	536	130	127	278	0.35	1.21	0.97	–0.28
Sweden	340	35	110	195	–1.91	–1.52	–0.77	–2.56
Switzerland	267	2	78	187	–0.94	–3.82	–0.40	–1.11
United Kingdom	512	137	106	268	–3.58	–4.30	–1.41	–3.94
United States	779	273	192	315	–1.86	–0.73	–1.30	–3.04
OECD total	639	201	137	307	–1.81	–0.79	–0.58	–2.76
EU	491	120	100	272	–2.43	–2.36	–0.40	–3.10

Source: Greenhouse gas emissions: national submissions to the UNFCCC and national publications. Carbon dioxide emissions for electricity and transport: IEA. GDP: OECD, SNA database.

Table 5.2. **Greenhouse gas emissions and sectoral indicators**

	Total GHG emissions		CO_2 emissions per Kwh electricity	Manufacturing CO_2 emissions per unit of output	Residential CO_2 emissions per unit of private consumption	Road transport CO_2 emissions per vehicle-kilometre	Electricity use per unit of GDP	Manufacturing output per unit of GDP
	Level million tonnes CO_2 equivalent 2000	Annual average percentage change						
		1990-2000	1990-2000	1990-2000[1]	1990-2000[2]	1990-1999	1990-2000	1990-2000[1]
Australia	502	1.7	0.1	–0.7	–1.1	–0.8	–0.6	–1.6
Austria	80	0.3	–3.3	–1.7	–2.4	–1.8	0.1	0.3
Belgium	152	0.7	–1.1	–0.2	–1.1	–0.8	–0.2	–0.5
Canada	726	1.8	0.7	–2.6	–2.0	–0.4	–0.5	1.0
Czech Republic	147	–2.7	–0.2	–7.7	–15.4	4.1	2.8	0.2
Denmark	69	–0.1	–3.4	–1.7	–4.0	–0.2	0.7	–0.6
Finland	74	–0.4	–0.9	–7.2	–7.0	–1.4	0.7	3.2
France	550	–0.2	–3.2	–2.4	–1.7	–0.5	0.6	0.3
Germany	991	–2.1	–1.5	–1.1	–4.0	0.7	–2.1	–1.8
Greece	130	2.2	–2.0	–0.4	2.6	–4.4	2.1	–1.7
Hungary	84	–1.8	–1.5	–12.7	–5.4	–3.3	0.2	5.3
Iceland	3	0.7	–4.9	..	–7.7	0.3	2.6	..
Ireland	67	2.2	–1.1	..	–6.2	4.8	–1.8	..
Italy	547	0.5	–1.2	–2.0	–1.4	–1.1	0.8	–0.2
Japan	1 386	1.1	–0.9	–0.8	0.1	0.3	1.0	–0.2
Luxembourg	6	–7.8	–24.6	–13.0	–2.3	3.8	–3.4	–2.2
Netherlands	218	0.4	–2.7	–1.8	–2.9	–0.1	1.8	–0.6
New Zealand	77	0.5	3.7	..	–3.2	–2.1	–0.8	..
Norway	55	0.6	0.5	0.8	–8.8	0.5	–1.9	–2.7
Poland	**386**	**–1.7**	**0.5**	**–5.8**	**–6.7**	**–6.4**	**–6.9**	**4.4**
Portugal	85	2.7	–0.9	0.7	–1.0	–0.4	1.8	–0.6
Slovakia	49	–4.0	0.8	–4.7	–7.4	2.3	0.2	2.4
Spain	386	3.0	0.0	–0.6	0.4	–0.3	1.2	–0.1

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Table 5.2. **Greenhouse gas emissions and sectoral indicators** (*cont.*)

	Total GHG emissions		CO_2 emissions per Kwh electricity	Manufacturing CO_2 emissions per unit of output	Residential CO_2 emissions per unit of private consumption	Road transport CO_2 emissions per vehicle-kilometre	Electricity use per unit of GDP	Manufacturing output per unit of GDP
	Level million tonnes CO_2 equivalent 2000	Annual average percentage change						
		1990-2000	1990-2000	1990-2000[1]	1990-2000[2]	1990-1999	1990-2000	1990-2000[1]
Sweden	69	–0.2	1.0	–4.7	–4.1	–1.4	–0.5	2.5
Switzerland	53	–0.1	–4.7	..	–1.7	–0.3	1.1	..
United Kingdom	649	–1.3	–3.6	–2.1	–1.9	–0.5	–0.7	–1.6
United States	7 001	1.3	–0.3	–4.0	–1.9	–0.2	–0.4	0.4
Total of above OECD countries	14 543	0.6	–0.8	–2.2	–1.8	–0.3	–0.2	0.0
OECD excluding US	**7 542**	**–0.1**	**–1.2**	**–1.5**	**–1.7**	**–0.4**	**0.0**	**–0.3**
EU countries	4 073	–0.3	–2.0	–1.8	–2.4	–0.4	–0.2	–0.7

1. 1991-2000 for Germany and Hungary; 1992-2000 for Poland; 1993-2000 for Slovakia; 1990-1999 for Portugal; no data for Iceland, Ireland, New Zealand and Switzerland.
2. 1991-2000 for Czech Republic; 1993-2000 for Slovakia.

Source: GHG National submissions to UNFCCC, national sources and UNFCCC; carbon dioxide data, IEA; manufacturing output, private consumption, OECD.

raising the share of renewable sources in total primary energy supply, from 3.0 per cent in 2000 to 7.5 per cent by 2010 and 14 per cent by 2020. Until now, costs have been relatively low compared with projects using renewable sources in other OECD countries. However, they could rise substantially in the pursuit of the future targets.[3] Direct regulations and financial support through environmental funds have been the most important tools to reduce greenhouse gases, while other instruments have been used to a very little extent. Furthermore, little effort has been made to identify the costs of abatement efforts, posing a risk that some measures may have costs that exceed international permit prices and thus entail a net loss for the Polish economy.

In the 1990s energy prices increased substantially as a result of government policy to cover costs through market liberalisation. The increase in energy prices for householdswas dramatic, with prices (in real terms) 66 per cent higher in 2001 for electricity and 179 per cent higher for natural gas than in 1991. Such price hikes have given households a strong incentive to use energy more efficiently. In contrast, real end-use energy prices for industry were only 0.3 per cent above their 1991 levels in 2001 mainly due to long-term contracts for coal. The limited extent to which energy prices have been adjusted for industry has likely contributed to Poland's energy intensity remaining comparatively high. In addition, direct subsidies for coal used in electricity production increased from EUR 1.7 per tonne in 1998 to EUR 3.8 per tonne in 2001 while the price of Polish coal was EUR 33 per tonne for domestic customers in 1999 (OECD, 2003). Even if these subsidies are primarily aimed at supporting domestic production and exports and not consumption, they still contributed to reducing domestic prices by about 5 per cent in 2001.As the majority of coal mines areineconomically depressed areas where unemployment is very high, there has been strong resistance to lower subsidies even though it is recognised that they are harmful for the environment. In addition to damaging the environment, the subsidies tend to depress total economic activity, and slow economic re-structuring.

As a new member of the European Union, Poland will be a member of the EU trading scheme that is scheduled to begin operating in January 2005. The trading scheme will regulate emissions of carbon dioxide from large sources in the electricity sector, in other energy activities and in some branches of industry (ferrous metals, minerals, pulp and paper). Since it will not cover emissions from all greenhouse gases regulated by the Kyoto Protocol and because it includes only a limited part of emitting activities, the EU scheme will not alone ensure that Poland's Kyoto target is achieved in a cost-efficient manner. Implementation of this scheme can, however, accelerate the shift towards less carbon-intensive energy sources in a cost-efficient way. Such a shift will be most effective if the setting of coal prices is left to market forces. As coal-fired plants currently account for 95 per cent of electricity generation, the induced switch from coal to gas could reduce emissions considerably.

The directive compels member states to allocate 95 per cent of all permits free of charge in the period 2005-2007 (90 per cent in the period 2008-2012),

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thus implying that companies will capture most of the scarcity rent associated with the carbon constraint. However, the EU directive on the taxation of energy products passed in October 2003 offers an opportunity for the government to recapture part, or all, of this rent. while it requires EU countries to apply minimum rates of excise taxation on fuels, if these rates are aligned across fuels so as to correspond to a single rate of carbon-dioxide tax, the excise tax could be used to recapture part of the scarcity rent without distorting the market for emission permits.[4]

The possibility, offered by the Kyoto protocol, to sell project-based emission-reduction credits represents another mechanism for achieving a cost-efficient reduction in emissions. Poland has the opportunity to use the Kyoto flexible mechanisms for greenhouse gas emission even after joining the EU trading system. Poland has participated in a number of emission reduction pilot projectsin the framework of the Kyoto Protocol's Joint Implementation (JI) mechanism, in co-operation with Annex A parties (*e.g.* Japan, Norway, Canada, Finland and the Netherlands). However, there is still a long way to go before a true market for emissions credits is established, since transaction costs are still high and self-regulating market forces are lacking. In an effort to address these problems, the Polish authorities have started the process of establishing routine procedures for project initiation, certification and verification.

Conclusions

Although the Kyoto target will be reached, Poland, as a net seller of Kyoto permits, stands to gain from implementing policies that further reduce GHG emissions at a cost below the international price of greenhouse gas emission. Conversely, introducing and continuing with projects where costs exceed the market price of carbon will come at a net loss to the economy. The EU trading scheme can be a powerful tool to reduce emissions, and coal subsidies should be withdrawn or reformed so as to avoid any depressive effect on coal prices. In addition the 95 per cent free-of-charge allocation of emission allowances under the EU trading scheme should be accompanied by the taxation of the associated rents. Furthermore, if the approval process were to be streamlined the selling of project-based carbon credits under the Kyoto protocol could help identify and achieve emission reductions at costs below the international permit price. Finally, the support measures for investing in renewable energy sources should be periodically re-evaluated by comparing their costs with international permit prices.

Reducing air pollution

Main issues

Air pollution damages human health and ecosystems, and the associated economic costs are estimated to be substantial.[5] Notwithstanding an improve-

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ment since the 1980s, air quality is relatively bad in Poland and continued reduction in air pollution could yield significant benefits. In this regard, accession to the European Union will impose stricter standards than in the past with corresponding benefits. However, the main issue is to achieve the further reductions required by EU regulations in a cost-efficient manner.

Performance

Air pollutant emissions have fallen significantly over the past decade. Emission intensities for sulphur and nitrogen dioxides and for volatile organic compounds (VOCs) have diminished more rapidly between 1990 and 2001 than in both the OECD and EU considered as a whole (Table 5.3). In the early 1990s, emission reductions were primarily a result of industrial restructuring but also, though to a lesser extent, due to the closure of plants for environmental reasons.[6] Despite this progress, Poland's high starting point meant that emission intensities were still comparatively high in 2001. This is particularly striking for GDP weighted sulphur-dioxide emissions, which are more than three times the OECD average. As a result, air quality is still poor in some cities. For instance, in the Upper-Silesian coal basin, Walbrzych, Opole and sometimes even in Krakow or Torun, excessive concentration of suspended dust and sulphur regularly generate winter smog (Pezco and Lenain, 2001).

Policies

Although industrial restructuring and rising energy prices associated with the economic transition have been the main drivers of reductions in the emission of air pollutants, specific policies have also been put in place to spur further cuts. Poland adopted national emission reduction targets for SO_2, NO_x and dust to be attained by 2000 as part of its *First National Environmental Policy* (1991). The *Second National Environmental Policy* (2000) widened the range of regulated air pollutants and set emission targets for 2010. Poland has not yet ratified any of the protocols requiring emission reductions under the 1979 Geneva Convention on Long-range Transboundary Air Pollution (LRTAP). However, it has met most of the targets of these protocols and is well on its way to meeting the 2010 targets in LRTAP protocols, which have been embedded in the EU accession treaty.

Command-and-control regulations have played a central role in policies directed at large stationary sources of air pollution but probably have not delivered emission reductions at lowest cost. New combustion plants have been subject to caps on the quantity of pollutions per unit of exhaust since 1990. A number of EU directives on air quality have reinforced the importance of the regulatory approach in curbing emissions from large stationary sources. Amongst those, the 1996 directive on integrated pollution prevention and control (IPPC) and the 2001 revision of the directive on large combustion plants (LCP) are particularly

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Table 5.3. **Main indicators: air pollution**

	Change in emissions per unit of GDP, 1990-99[1]			Level of emissions , 1999[2]		
	Sulphur dioxide	Nitrogen dioxide	VOCs	Sulphur dioxide	Nitrogen dioxide	VOCs
	Per cent per year			Grams per dollar of GDP		
Australia	3.1	–1.9	–2.9	3.9	5.5	4.1
Austria	–10.2	–3.5	–6.5	0.2	0.9	1.2
Belgium	–9.2	–3.6	–4.8	0.8	1.2	1.1
Canada	–5.3	–2.8	–2.9	3.2	2.6	3.5
Czech Republic	–19.1	–6.6	–5.7	2.1	3.0	1.9
Denmark	–14.2	–4.9	–5.2	0.4	1.6	1.0
Finland	–13.0	–3.8	–4.1	0.7	2.1	1.4
France	–8.3	–3.8	–5.1	0.5	1.2	1.4
Germany	–20.1	–7.1	–8.8	0.4	0.9	0.9
Greece	–1.4	–0.3	–0.2	3.6	2.5	2.6
Hungary	–6.1	–1.1	–3.8	5.5	2.1	1.4
Iceland	–1.1	–1.7	–4.9	3.7	3.9	1.4
Ireland	–8.1	–6.3	–7.9	1.7	1.3	1.0
Italy	–7.6	–4.3	–4.4	0.8	1.2	1.4
Japan	–1.7	–1.3	–2.4	0.3	0.5	0.6
Korea	–8.9	–3.3	–9.7	1.6	1.9	0.2
Luxembourg	–18.7	–9.1	–7.9	0.2	0.9	0.9
Mexico	–0.4	–0.9	–9.3	1.6	1.6	1.4
Netherlands	–10.1	–6.5	–8.8	0.3	1.1	0.7
New Zealand	–0.4	–0.5	–1.6	0.7	3.0	2.6
Norway	–9.7	–2.8	–1.8	0.2	2.0	3.0
Poland	**–10.0**	**–6.6**	**–4.8**	**5.1**	**2.8**	**2.2**
Portugal	–2.1	–0.9	0.1	2.4	2.3	3.1
Slovakia	–13.7	–7.4	–5.6	3.3	2.4	2.0
Spain	–5.8	–2.1	–3.5	2.2	1.7	3.6
Sweden	–8.3	–4.3	–3.9	0.3	1.3	2.1
Switzerland	–6.0	–5.4	–6.3	0.1	0.5	0.9
Turkey	3.2	1.0	0.0	3.4	2.3	1.6
United Kingdom	–13.9	–7.9	–6.6	1.0	1.3	1.4
United States	–5.5	–2.5	–4.7	2.0	2.7	1.9
European Union	–11.1	–5.0	–5.3	0.8	1.2	1.5
OECD Europe	–10.1	–4.8	–5.0	1.2	1.4	1.5
OECD	–6.7	–2.9	–4.4	1.5	1.9	1.6

Note: For the OECD average data for countries with missing data for either 1990 or 1999, data for the latest year has been substituted. Estimated data for 1999 represents about 5 per cent of the area total. GDP is measured in 1995 prices. Cross-country aggregations use 1995 purchasing power parity exchange rates.

1. Australia: 1995-99 for sulphur dioxide; New Zealand: 1990-98; Mexico: 1994-98 for sulphur dioxide and VOCs and 1990-98 for nitrogen dioxide; Slovakia: 1990-98 for sulphur dioxide and nitrogen dioxide and 1990-97 for VOCs.
2. 1998 for Mexico, New Zealand and sulphur dioxide and nitrogen dioxide in Slovakia; 1997 for VOCs in Slovakia.

Source: Cooperative Programme for Monitoring and Evaluating of Long-Range Transmission of Air Pollutants in Europe (EMEP); World Health Organisation; OECD (2002a).

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important. The IPPC directive considerably tightens the permit process and gives discretionary powers to environmental regulators for instance by allowing them to apply stricter environmental standards to more profitable plants. The 2001 LCP directive lowers the emission limit values (ELV) for both existing and new boilers with a specific grace period until 2017 for Poland. Direct compliance costs of meeting the ELVs embedded in the directive, which would reduce SO_2 emissions from power plants to less than 15 per cent of present levels, are officially estimated to lie between EUR 10-13 billion over the period 2004-2017 or an average of 0.4 to 0.5 per cent of GDP per annum, cut in (Cofala and Amann, 2001). The LCP directive contains a clause that allows countries to obtain the same overall reduction in emissions by other means than the ELVs. So far, the Polish authorities have not taken advantage of this clause.

Emission fees have been in place since 1980 for 62 air pollutants. The fees are earmarked for environmental funds and are used to financially support environmental projects. Rates are several times lower than the estimated levels of corresponding externalities (Table 5.4) and below those applied in countries that have designed emission taxes for incentive purposes. As such, they do not appear to be aimed at creating incentives to reduce emissions. However, if raised substantially, those emission fees could be used to attain emission reduction targets in a cost-effective way and represent an economically beneficial alternative mechanism for complying with the LCP directive.

For vehicles, the past decade has been marked by several waves of regulations and fuel standards. The associated reductions in emissions have been significant, both relative to the distance travelled and in absolute terms. However, cars still tend to be old and further emission reductions could be achieved by accelerating the renewal of the car fleet so as to take advantage of new standards.

Table 5.4. **Emission fees and estimated benefits of reducing emissions**

EUR per tonne

	Emission fee	Estimated benefit of reducing emissions
NO_x	100	1 545
SO_2	100	2 300
VOC	225	1 055

Note: The benefit estimates are based on the conclusions of the EU ExternE project as reported in Holland and Watkiss (2000), As the ExternE project did not produce specific values for Poland, the estimates presented in the table have been derived from ExternE values for Germany by adjusting for differences in income levels.
Source: OECD calculations estimates on Holland and Watkiss (2000).

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Annual fees based on environmental standards of the vehicles could help remedy this problem by creating a direct incentive to use cleaner vehicles.

Policies to reduce greenhouse gases may also lower air pollution. This is especially the case where greenhouse gas policies encourage switching from coal to natural gas in power generation. Air quality objectives are, however, better served by policies that are specifically targeted at air pollution since air-related ancillary benefits can vary considerably from one GHG-mitigation measure to the next. For instance, the induced air quality benefits of avoiding the emission of one tonne of carbon dioxide from a typical coal power plant exceed EUR 16.6. However, if the coal plant used state-of-the-art pollution scrubbers, the estimated air quality benefits would drop to EUR 1.8. Taking a longer view, were the plant to generate power using cost-efficient technology (such as combined-cycle gas turbines), avoiding one tonne of CO_2 would imply only EUR 0.72 in air quality benefits.

Conclusions

Since 1990 Poland has significantly reduced its air pollutant emissions as a result of industrial restructuring but also, albeit to a lesser extent, through regulations aimed at limiting air pollution. The command-and-control approach followed so far is unlikely to deliver emission reductions at the lowest cost. This problem is becoming increasingly important following accession to the EU and adoption of its very ambitious emission reduction targets. In particular, implementing the LCP directive will be very costly unless Poland invokes the clause allowing alternative means to attaining the emission limit values and uses permit-trading or fees to reduce emissions. In the transport sector, vehicle standards have delivered tangible results in reducing emissions. However a shift to emission- (and ultimately mileage) based charges, would yield additional reductions at lower costs as compared with the continuation of the current standards-based approach.

Providing sustainable retirement incomes

Main issues

Poland introduced an extensive pension reform five years ago that in many respects represents a model that could be followed by other OECD countries whose pay-as-you-go (PAYG) pension schemes are expected to come under substantial fiscal pressure as their populations age. The Polish reform introduced a multi-tier system comprised of a state-run notionally defined contribution scheme, a compulsory, privately managed fully-funded system and the possibility of subscribing to voluntary private pensions. The reform was designed to significantly reduce ageing-related spending pressures in the future without compromising the income adequacy of the elderly. However, it has run into implementation

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problems. Moreover, while its longer term costs will be lower than the PAYG system it replaced, the financing of its fully-funded component through the build up of State debt appears to be bypassing a significant portion of the longer-term fiscal benefits the reform could have generated.

Performance

The pension reform of 1999 sought to replace the very generous pre-existing defined-benefit scheme with a defined-contribution system, combining a pay-as-you-go (PAYG) notionally-defined-contribution pension scheme with a compulsory privately-managed fully-funded one (the so-called "open pension funds"). As a consequence of the reform, and notwithstanding that the old-age dependency ratio is forecast to rise from 20 per cent now to 55 per cent by mid-century (Casey *et al.*, 2003), public spending on the PAYG component of the scheme as a share of GDP is expected to fall to 9.6 per cent in 2050 against 12.2 per cent in 2000 (Table 5.5).[7] Official estimates suggest that taking into account the expenditures of the Open Pension Funds (OFE) total public spending on pensions will be higher by 1.7 per cent of GDP.[8] The principal source of savings is to derive from the transformation of the PAYG system from a defined benefit to a notionally defined contribution scheme and is reflected in the gradual reduction of the implicit replacement rate of the scheme. Gross benefits under the PAYG public pension scheme are projected to fall from 73 per cent of average wages currently to 43 per cent in 2025 and to 24 per cent in 2050 (Gomulka and Styczen, 1999).[9] Indeed, some such reduction is implicitly required in all pension schemes so as to ensure their long-term fiscal viability (OECD, forthcoming).The overall impact on income adequacy will be mitigated by income deriving from individuals' Open Pension Fund accounts, which is estimated to equal an additional 15 per cent of average earnings bringing the end-of-period replacement rate to about 39 per cent. To ensure overall income adequacy, individuals above the retirement age who have a record of 20 years (women) or 25 years (men) of contributions and whose pensions from the defined contribution system are below a minimum level will receive top-up payments (financed from the State budget) to make up the difference.[10] Finally, a social safety net provides elderly people who are not eligible to the minimum pension with a subsistence allowance.

Policy

The reform of the state pension system in 1999 was applicable to all workers below 50 years of age except for farmers. For workers less than 50 years of age pensions paid under the new system will gradually replace "old" pensions (Figure 5.1). Workers older than 50 remained in the pre-existing PAYG system. Workers between 30 and 50 years of age were given the option either of joining the two-tier scheme or transferring their accrued contributions to the notionally

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Table 5.5. **Performance indicators: sustainable retirement income**

	Projected increases in old age pension spending	Low income rate of the elderly[1]	Relative disposable income of the elderly[1]	Private pension funds 1999	Age of withdrawal, 1994-1999		Participation rate, 2001, per cent		
								Aged 55-64	
	Change in per cent of GDP 2000-2050	Per cent of the elderly with income less than 50 per cent of median disposable income	Per cent of the disposable income of all individuals	Per cent of GDP	Male	Female	Aged over 65	Male	Female
Australia	1.6	16.1	67.6	63.8	59.7	61.3	6.0	60.0	36.9
Austria	2.2	14.9	86.6	3.6			2.8[1]	42.1[1]	17.5[1]
Belgium	3.3	13.8	77.9	6.1			1.3	36.6	15.7
Canada	5.8	2.5	97.4	45.7	62.6	61.1	6.0	61.3	41.7
Czech Republic	6.8			3.8			4.0	55.0	24.5
Denmark	2.7	9.2	73.0	24.4	62.4	61.5	4.6	65.5	51.8
Finland	4.8	7.5	79.0	10.7	59.8	60.0	3.7	51.2	49.5
France	3.9[2]	10.7	89.7	6.3	59.3	59.8	1.2	43.8	34.1
Germany	5.0	10.4	85.6	3.2	60.5	60.8	3.0	50.6	32.4
Greece		29.2	76.8	4.6	61.7	62.2	5.0	57.0	23.6
Hungary	1.2	6.0	85.2	2.2			3.1	36.3	15.4
Iceland				86.0			19.9	92.8	81.7
Ireland		16.7	74.6	57.8			7.9	66.1	29.5
Italy	–0.3	15.3	84.1	3.0	59.3	58.4	3.4	57.8	26.6
Japan	0.6			18.7	69.1	66.0	21.8	83.4	49.2
Korea	8.0			3.2	67.1	67.5	29.6	71.3	47.9
Luxembourg		6.7[3]		..			0.0	38.1	14.3
Mexico		32.9	85.3	2.4			30.5	80.5	27.6
Netherlands	4.8	1.9	86.3	119.3	61.6	60.1	3.1	52.0	26.9
New Zealand	5.7			..			8.6	74.6	51.7

Table 5.5. **Performance indicators: sustainable retirement income** (*cont.*)

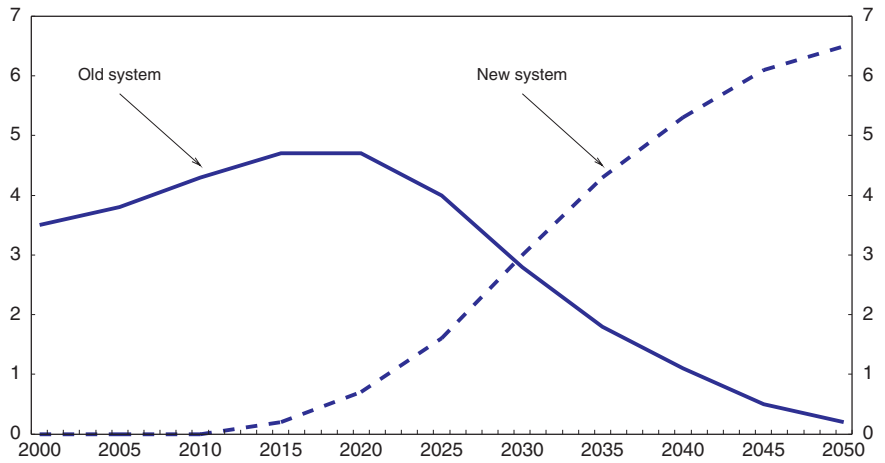
	Projected increases in old age pension spending	Low income rate of the elderly[1]	Relative disposable income of the elderly[1]	Private pension funds 1999	Age of withdrawal, 1994-1999		Participation rate, 2001, per cent		
								Aged 55-64	
	Change in per cent of GDP 2000-2050	Per cent of the elderly with income less than 50 per cent of median disposable income	Per cent of the disposable income of all individuals	Per cent of GDP	Male	Female	Aged over 65	Male	Female
Norway	8.0	19.1	74.1	7.4	64.2	64.7	13.2	73.6	63.2
Poland	**–2.5**	**8.4**[3]		**..**			**7.5**	**41.5**	**24.1**
Portugal				11.4	65.3	66.5	19.0	63.7	41.9
Slovak Republic							1.1	43.0	11.2
Spain	8.0	11.3[3]		2.3	61.1	61.1	1.6	61.4	23.6
Sweden	1.6	3.0	89.2	..	63.3	61.8	9.4	73.5	67.4
Switzerland		8.4[3]		97.3[4]			11.4	82.4	56.1
Turkey		23.1	92.7	..			18.1	50.8	18.4
United Kingdom	–0.7	11.6	77.8	84.1	62.0	61.2	4.8	64.4	44.6
United States	1.8	20.3	91.7	74.4	65.1	64.2	13.1	68.1	53.0

1. Förster and Pellizzari (2000).
2. Secretariat estimate in OECD (2001). Official reports suggest a 4.4 per cent increase on unchanged labour market policies for the period 2000 = 2040 (COR, 2001).
3. Smeeding (2002).
4. 1998.

Source: Förster and Pellizzari (2000); Jesuit and Smeeding (2002), *Luxembourg Income Study*; OECD Labour Force Statistics, Scherer (2002).

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Figure 5.1. **Number of individuals receiving pensions under the old and new systems**



Source: CASE-CEU Working Series No. 27.

defined contribution scheme and having all of their additional compulsory contributions accrue to that single pillar. Workers younger than 30 were obliged to enrol in both the notionally defined contribution scheme and the fully funded one. As a result of these reforms, workers of all ages are also free to subscribe to voluntary private schemes.

For those enrolled in both systems, out of a 19½ per cent total pension contribution levied on wages, 7¼ per cent accrues to individual accounts managed by private sector asset managers. The remaining 12¼ per cent are allocated to an individual notional account held by the public-sector social security agency (ZUS). Pension rights acquired in the previous pension scheme were also supposed to be allocated to the same account. Originally the money value of the account was to be increased each year by the inflation rate plus three quarters of the growth in the real wage bill. However, an amendment passed in 2004 increased the notional rate of return to the rate of growth nominal wages – implying a significantly higher level of pensions and pension expenditures. At retirement, the notional value of an individual's account is to be converted into an annuity based on life expectancy of the whole population at the time of retirement, with a similar treatment planned for the privately managed pension accounts.

In addition to reducing the share of state pensions in GDP, the reforms should also have positive effects on the economy in the long term. By 2010, older

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workers will face markedly reduced incentives to retire, as pensions will depend on life expectancy and accumulated contributions. Thus, deferring retirement will no longer be penalised because pension benefits will adjust in an actuarially neutral manner. In effect, the disincentive will be limited to the impact of the difference between the rate of return on notional accounts and the rate of return in financial markets. The new system could also result in an increase in labour supply for younger age groups to the extent they consider their pension contributions as savings and not a pure tax. Finally, by forcing some low-income workers to save who would otherwise not have done so, the reforms may increase private and national savings, with beneficial impact on the income-generating capacity of the economy.

In the short term, however, the reforms have been marred by implementation problems.

- The transfer of part of social security contributions to the Open Pension Funds has been financed by increased public borrowing, thus offsetting higher private pension saving. Indeed, as discussed in Chapter 2, the government has transferred part of the fiscal problem of increased pension payments into a higher level of public debt. While, a demographic reserve fund to deal with revenue shortfalls in the transition period was created, the planned 1 per cent of GDP annual transfer to this fund has not materialised and the current balance of the fund at the end of 2003 was only 0.6 per cent of GDP.
- Moreover, the government's recent decision to consider compulsory contributions to open pension funds as government revenue (see Chapter 2) and a ramping up of the deficit excluding those revenues suggest that the government is financing the funded schemes through debt accumulation rather than savings. As a result, the pre-financing of future pension liabilities initially envisaged in the reform is being only partially observed.
- Ownership uncertainty has weakened potentially beneficial labour supply effects. Five years after the entry into force of the new system, workers have still not been informed of the value of their notional account. As of early 2004, notional account statements only show contributions made in 2002. As yet, they do not reflect those paid in 1999, 2000 and 2001 nor the rights acquired under the previous scheme.[11] Moreover, administrative difficulties with the identification of payments have meant that an estimated 15 per cent of the contributions that were paid under the funded scheme have yet to be transferred by ZUS to individual pension fund accounts. While the extent of the problem has diminished since the period 1999-2001, in line with a 20 per cent increase in ZUS staff levels, some 4½ per cent of all individual accounts are known to still contain errors.

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The pension scheme for farmers has been left largely unchanged and could put strain on public finances. For individuals, the scheme financially is attractive (see Chapter 3) because the implicit rate of return on contributions is high (95 per cent of the expenditure on farmers' pensions is paid from the state budget), and entitlement rights can be easily acquired.

The reduced disincentives to continued work at older ages in the pension system may not be effective in lengthening working lives in the face of alternative early retirement routes, which may also threaten the capacity of the reform to contain public expenditure. Although inflows into these programmes have been reduced (see Chapter 3), the stock of individuals many of whom are relatively young receiving substantial unearned incomes represents a real problem for the labour market.

– D*isability pensions* are paid to a very large number of beneficiaries – 3.35 million in 2003 down from 3.4 million in 2001 *i.e.* about one quarter of total employment – for a total expenditure amounting to 3.5 per cent of GDP in the same year. The attractiveness of disability pensions stems in particular from the possibility to draw a benefit even if the person is only lightly disabled and capable of employment or education and does not require another person to fulfil social roles. Moreover, reports suggest that certificates for permanent disability might be available for sale from some medical practitioners (Shahriari *et al.*, 2001). Receiving disability benefits can be combined with earning income from work, which lowers the negative impact of disability pensions on the labour market but at the same time increases the attractiveness of the scheme and the associated negative fiscal consequences. The government tightened eligibility criteria and the number of disability pensioners has been decreasing since 2000. Further legislative proposals have been introduced to better link the allowance with the degree of disability and to re-assess existing beneficiaries with savings expected to reach 1.4 billion zloty per annum by 2007 or 0.2 per cent of GDP.

– E*arly-labour-force withdrawal* benefits are paid to half a million people at a cost of 1.3 per cent of GDP (in 2002). In addition, almost one million people draw old-age pensions even though they are younger than the standard pension entitlement age, due to special provisions for miners, teachers, railway workers, people in a list of specific occupations and women. Overall, the number of people receiving such benefits is equivalent to 8 per cent of the labour force. Pre-retirement benefits are scheduled to be fully phased out by end 2006 and a draft law is in place to phase out pre-pension payments under the unemployment insurance scheme. However, pressure is building up to extend at least part of these programmes beyond that date.

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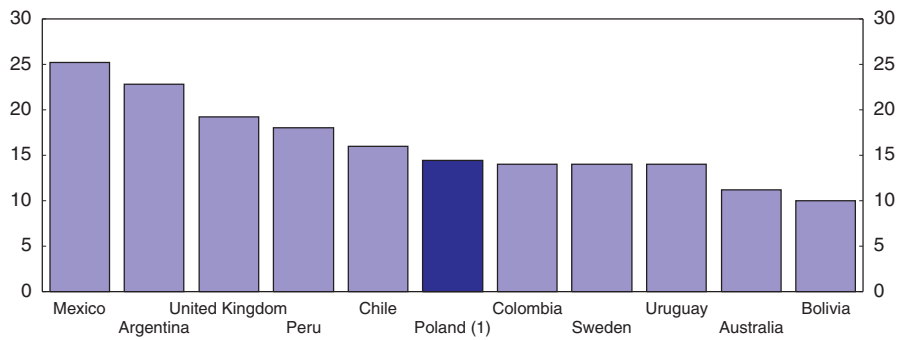
As concerns the open pension funds, the strategy to rely on a competitive market of retail funds may have resulted in unnecessary costs. Marketing and sales expenditures account for one-third of the initial 6 to 10 per cent charge made by the management company on the individual's monthly contribution.[12] Here, significant costs are also imposed by daily reporting to the regulator, the requirement to send account statements by registered post to all account holders and the 0.8 per cent handling charge claimed by ZUS for transferring the funds to the private companies. Legislation passed in 2003 has lowered the maximum charges that can be applied by open pension funds, reducing the lifetime administrative charge on assets from 18.2 to 14.4 per cent (inclusive of the 0.8 per cent charge claimed by ZUS).[13] Notwithstanding these changes, overall administrative charges are high as compared with schemes based on collective rather than retail funds, such as Australia's industry funds and those in Bolivia (Figure 5.2). However, as compared with countries that rely on individual choice, the total costs borne by individuals for their privately managed pension accounts are about average.

Moreover, the performance of Open Pension Funds may be limited in the long run by the following regulations:

– Each pension fund is required to yield a real rate of return not lower than half of the industry average or 4 percentage points below the industry's

Figure 5.2. **Total administrative charges and costs to pensioners in privately managed funds**

As per cent of retirement accumulation



1. Based on the current parameters of the second-tier fully-funded pension system, the total life-time fees charged on pension contributions by private pension fund managers is expected to equal 14.4 per cent of total contributions. Of this amount, 0.8 percentage point is paid by the fund managers to the state social insurance agency ZUS as a fee for collecting the contributions.

Source: Bateman (2002).

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average for each three year period (whichever is lower) measured every six months. In case of non-compliance, the company that manages the fund must make up for the difference from its own assets. Conversely, there is very little reward for the management company if the fund outperforms the industry's average.[14] This asymmetric regulation gives little incentive to try to obtain above-average returns and is likely to result in a herding effect.

– The composition of the asset portfolio is strictly controlled, especially as regards the share of foreign securities (Table 5.6). While the limit on equity investment does not appear to be a barrier to investment choice, the very low limit on foreign investment may represent a significant barrier to portfolio diversification.[15]

These provisions are likely to be key factors behind the strong correlation that is observed among Open Pension Fund returns (Stanko, 2003).

At present, the issue of how to transform fund assets at the time of retirement into an annual pension has not been settled. Pension laws forbid any differentiation in the annuitisation rates on the basis of sex despite differences in life expectancy between men and women. As a consequence, annuities cannot be provided on a market basis as open pension funds would seek to attract males and exclude females in order to minimise their costs. An outright ban on gender differentiation could not work in practice as only women will retire from 2009 to 2012 under the new system and companies providing annuities on the basis of unisex life expectancy would be bound to make losses and thus would not enter

Table 5.6. **Limitations on open pension fund portfolios**

Government bonds	No limit
Corporate bonds	10 per cent (publicly traded) 5 per cent (non-publicly traded)
Equity	40 per cent listed companies 10 per cent (not listed, but allowed for public trading) 10 per cent – – NFI shares
Private equity/investment funds/mutual funds	10 per cent closed funds 15 per cent open funds
Municipal bonds	15 per cent publicly traded 5 per cent others
Short-term bank deposits	20 per cent
Derivatives	Only for hedging purposes
Real estate	Not allowed
Foreign investments	5 per cent

Source: Country submission.

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the market. The authorities have contemplated the idea of creating a specific public-sector institution to pay annuities from retirees' accumulated pension fund assets. Given the major implementation problems encountered by the existing social security agency (ZUS) in handling previous reforms, this option does not seem advisable. On the other hand, the supply of annuities could be left to market forces with no gender-related restrictions and, if the same rate of conversion from assets to annuities is deemed desirable for men and women, a tax could be levied on male annuities and transferred to female annuities.

Conclusions

The reform of the Polish pension system was one of the most far-reaching introduced within the OECD area. It has established a sound basis for facing the fiscal consequences of ageing by making benefits depend directly on contributions and by allowing the replacement rate to fall over time. Moreover, in so doing it has improved incentives to work at older ages, which should help raise employment rate and contribute to speedy the economic process (see Chapters 1 and 3). Its success, however, will depend on continuing to remedy the serious implementation problems encountered by ZUS. It is critical that record-keeping problems in the notional accounts be corrected before the first pensions under the notional defined contribution scheme are paid in 2009. In addition, fiscal sustainability will require reducing access to disability benefits by able-bodied persons, abolishing early retirement possibilities and restricting access to the farmers' pension scheme (see Chapter 3). A degree of reform is also called for in the management of the open pension funds. In particular, to the extent that the reform was designed to relieve future fiscal pressures, the authorities will need to rethink the current strategy whereby public debt has been the principal mechanism for accumulation of wealth in individual's "fully-funded" pension accounts. With regard to asset holdings and the funds' regulation changes are necessary in two directions. The proportion of assets that can be invested abroad should be raised so as to allow better diversification. In addition, the method by which a minimum guaranteed return is calculated should be changed, by making the reference rate of return external to the Polish open pension fund system. Ideally, the guarantee should be set in terms that could be covered by the purchase of an appropriate financial derivative, thereby making the cost transparent. Indeed, there is a case that individuals should be given a degree of freedom to vary the risk profile of their account as they age. More attention also needs to given the cost structure of the funds. The current regulatory burden on funds, including daily reporting, may be too high. The fee charged by the social security organisation for transferring funds to the open pension funds also seems high.

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Notes

1. New member states are excluded from the EU's joint target by Article 4 of the Kyoto Protocol.
2. Reflected in First national Environmental Policy (1991), Second Environmental Policies (2000), Assumptions for Poland's Energy policy until 2020 (2000) and Sustainable Development Strategy for Poland till the year 2025 (2000).
3. Average subsidy is EUR 10.7 per tonne of CO_2 avoided for existing projects.
4. Such taxation of CO_2 would reduce the EU-wide price of permits by an amount equal to the rate of the CO_2 tax. But the price will remain unique, thereby ensuring an efficient allocation of abatement efforts. Moreover, when emitting CO_2, each participating firm would face a marginal cost equal to the sum of the permit price and the CO_2 tax, *i.e.* the same price as in the absence of the tax. The CO_2 tax in effect recaptures part of the scarcity rent and perturbs neither the allocation of abatement efforts nor their extent.
5. For example, the cost of air pollution in the EU countries was estimated to be as high as 4 per cent of GDP in 1994 (Barker and Rosendahl, 2000).
6. In the period 1992-1998, the State Environmental Inspectorate shut down the operations of 136 plants (Wajda, 2000).
7. Pension spending includes expenditure on early retirement programmes. The old-age dependency ratio is equal to the number of people aged 65 and more divided by those aged 20-64.
8. As described in Chapter 2, the Polish authorities consider that these funds form part of the general government.
9. The figures of 43 per cent, 24 per cent and 15 per cent are *estimates*, which depend on the assumptions that are made on real rates of return in notional accounts and pension funds, wage growth and life expectancy.
10. The minimum pension level is equal to 562 zloty per month from 1 March 2004 (30 per cent of the average wage) and according to the draft law will be indexed only to inflation as from 2005.
11. The initial legislation foresaw this calculation, on administratively complicated task, being completed by end of 2003.
12. The average was 8.5 per cent in the first three years of operation, 6.5 per cent in 2002 and 6.2 per cent in 2003 Upfront charges will be limited by law to 7 per cent as from 2005. The annual charge is limited to 0.6 per cent.
13. The 0.8 per cent is charged to the fund manager not the client. To the extent it is reflected in fund managers overall costs it is included in the overall 15.2 per cent.

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14. Each month, ten per cent of the management fee (equal to 0.005 per cent of fund assets) is set aside in a special, "premium" account. Every six months, the balance accumulated in the premium account is shared between the management company and pension fund holders on the basis of the fund's performance relative to the industry. The management company of the pension fund with the best rate of return (calculated over the last 36 months) recoups 100 per cent of the balance in its premium account while, at the other extreme, the worst performer transfers the balance entirely to pension fund members. In between, the balance is shared depending on the ranking of the fund.
15. The pension funds own 17 per cent of freely tradable shares on the Warsaw market and a higher proportion of blue chips, even though total assets of the fund represent 4 per cent of GDP.

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Annex A

Chronology of main economic events

2002

July

The Minister of Finance resigns and is replaced.

Parliament passes an amended Labor Code that increases hiring flexibility and reduces administrative burdens on firms.

August

National Bank of Poland reduces the rediscount rate to 9 per cent, the lombard rate to 10.5 per cent and the money market reference rate to 8 per cent.

September

National Bank of Poland reduces the rediscount rate to 8.5 per cent, the lombard rate to 10 per cent and the money market reference rate to 7.5 per cent.

October

New Law on Foreign Exchange enters into force, lifting remaining foreign exchange restrictions on transactions with the EU and OECD countries.

National Bank of Poland reduces its benchmark policy rates bringing the rediscount rate to 7.00 per cent, the lombard rate to 9 per cent and the money market reference rate to 7.75 per cent.

November

National Bank of Poland reduces the rediscount rate to 7.5 per cent, the lombard rate to 8.75 per cent and the money market reference rate to 6.75 per cent.

December

Parliament passes the 2003 Budget.

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2003

January

The Ministry of Economy, Labour and Social Policy led by Mr. Jerzy Hausner is created, following the merger of the Ministry of Economy and the Ministry of Labor and Social Affairs.

A cabinet shuffle replaces the Ministers of Treasury and Health.

National Bank of Poland reduces rediscount rate to 7.25 per cent, the lombard rate to 8.50 per cent and the money market reference rate to 6.50 per cent.

February

EU 15 Ambassadors approve the Accession Treaty.

The Peasant's Party (PSL) leaves the governing coalition and the Social Democratic party (SLD) forms a minority government with the Union of Labor (UP).

A cabinet shuffle replaces the Ministers of Agriculture and Environment.

The National Bank of Poland reduces its rediscount rate to 6.75 per cent, the lombard rate to 8 per cent and the money market reference rate to 6.25 per cent.

March

Finance Minister Mr. Grzegorz Kolodko presents his program of public expenditure reform. The plan is broadly endorsed by the Council of Ministers.

Minister of Economy, Labour and Social Policy Mr Jerzy Hausner announces an alternative program of public expenditure reform.

The Ministers of Health and Treasury resign and are replaced.

National Bank of Poland reduces its rediscount rate to 6.50 per cent, the lombard rate to 7.75 per cent and the money market reference rate to 6.00 per cent.

April

EU 15 and the ten accession countries sign the Accession Treaty in Athens on 16 April.

National Bank of Poland reduces the rediscount rate to 6.25 per cent, the lombard rate to 7.25 per cent and the money market reference rate to 5.75 per cent.

May

Prime Minister Mr. Leszek Miller shifts the function of the Deputy Prime Minister from the Minister of Finance to the Minister of Economy, Labour and Social Policy.

The Minister of Finance resigns and is replaced.

The National Bank of Poland reduces the rediscount rate to 6.00 per cent, the lombard rate to 7.00 per cent and the money market reference rate to 5.50 per cent.

June

Poles vote to join the European Union in a public referendum.

The National Bank of Poland reduces the rediscount rate to 5.75 per cent, the lombard rate to 6.75 per cent and the money market reference rate to 5.25 per cent.

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September

Cabinet approves the draft Public Expenditure Reform.

October

The Government launches a public debate on the Public Expenditure Reform.

Cabinet approves a draft Law on Economic Freedom.

November

The European Commission releases its report on Poland's economy.

2004

January

Parliament passes 2004 Budget.

February

The Minister of Treasury is changed in a cabinet shuffle.

A new Monetary Policy Committee meets and leaves policy rates unchanged.

Government presents first draft laws implementing the revised Public Expenditure Reform.

April

The Prime Minister Mr. Leszek Miller resigns effective 2 May. The president calls upon Mr. Marek Belka to form a new government.

Cabinet adopts the Agenda Warsaw City with an aim of establishing in Warsaw a leading Central European capital market centre.

May

Poland joins the European Union on 1 May.

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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
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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