# showCASE
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**Overview**: This week's showCASE takes an in-depth look at how the Polish PiS government has performed over the past year. This two-page special in particular covers how the government is reshaping national institutions and provides insight on how this could impact the economic outlook moving forward.

## Perils of the "good change"


*By:* Krzysztof Głowacki

*Fourteen months since the PiS government came to power in Poland under the slogan of a "good change", the country has seen more institutional turmoil than in the previous twenty-eight years.*

As demonstrated by leading economists and advocated by CASE, sound institutions – formal and informal rules that govern social interaction – are the backbone of sustainable economic growth. They encode rules for increasing trust and reducing uncertainty, which are crucial to the contract – an arrangement at the core of every market economy and every modern society. Depending on the mix of incentives and penalties they entail, institutions can either promote development or stifle progress, a case well illustrated by the divergent economic paths walked by neighbors Poland and Ukraine. In general, decentralization of power, inclusive institutions, and civil and economic rights create incentives for economic agents to save, invest, and trade, while the opposite leads to inefficient, non-market forms of economic exchange (including corruption).

The conservative Polish government of the Law and Justice party (*Prawo i Sprawiedliwość*, or PiS), in power since late-2015, has appeared to attach more importance to short-run whims than to the institutional framework, including the rule of law, which had previously appeared deep-rooted in the country. Almost immediately after entering office, PiS began the dismantling of the Constitutional Tribunal, the only authority that can judge the legality of legislation in the country. PiS also increased the centralization of power by merging the functions of the Minister of Justice and Attorney General and abolishing the competition procedure for directorial posts in public administration. In fact, the legislative and executive branches of the government have been de facto concentrated in the hands of a single person, PiS' president Mr. Jarosław Kaczyński, putting in doubt the democratic system of checks and balances. The party now proposes to remodel the remaining branch of the government, the judiciary, to make it less independent from the other two. It also plans to revise the electoral law, including at the level of regional governments, which are mostly controlled by the opposition.

In the meantime, the government has rewarded its supporters through lavish social spending, including the 500+ program (cash grants of PLN 500, or EUR 115, for every child beginning with the second, regardless of the parents' income), lowering of the retirement age, introduction of a minimum pension, and subsidization of medicines for citizens over 75 years old. The inevitable result is a drastic increase in public expenditures, which the government has promised to finance by closing the tax gap. To do this, it has introduced the so-called fuel package (a set of stricter VAT rules for fuel trade within the EU Single Market), which has proved moderately successful but is nowhere near to making up the revenue shortfall.

More new measures entered into force on January 1st, including a more complex procedure of VAT registration and a fee (amounting to PLN 20,000, or EUR 4,590) on tax law interpretations provided by the Ministry of Finance to businesses at their request. Both changes are going to be burdensome to the private sector. The tax authority has also increased the intensity of controls, and some of them have been reported to involve repressive and unlawful means. Finally, there has been an attempt to raise revenue through sectoral taxes modelled on Hungary. Up to date, the so-called bank tax has been introduced, a 0.44% fee charged on the assets of banks and insurance companies, and a supermarket tax has long been planned. All these changes substantially increase the unpredictability of fiscal policy, which is a source of inefficiency and may itself contribute to tax avoidance. Similarly, the frequent changes in the boards of state-owned enterprises disturb the business of those companies and their trade partners.


*Values calculated from the beginning of the year until the end of the reference period. No data available for Q1 2008, Q1 2009, and Q1 2010.
Source: Central Statistical Office of Poland http://stat.gov.pl/wskazniki-makroekonomiczne/

There have been other changes that, while not necessarily linked to economy or the rule of law, still fuel the climate of uncertainty. These include subordinating state media entirely to the government, restructuring the system of public education, drastically limiting support to NGOs, and promising to drastically alter socially sensitive issues. The underlying rhetoric of PiS is a divorce with nearly all of the heritage of the modern Polish state, a heritage which has delivered growth and made Poland the envy of the region. A case in point might be the remark made by Vice Prime Minister and Minister of Development Mr. Mateusz Morawiecki last week that the calculation of the national GDP had been overestimated in the previous years, and the country's economic growth had actually been lower than publicly announced (we breathlessly await such downward revisions in the future).

Seeing the rules of the game modified at a rapid pace and faced with the climate of uncertainty in the country and beyond, economic agents succumb to risk aversion and conservatism. According to Prof. Jerzy Hausner, former Vice Prime Minister of Economy, businesses are still optimistic about the short run, but increasingly concerned about the long run, which leads them to postpone investments. Indeed, investment in Poland underperformed throughout 2016, and extravagant fiscal policy, outdated interventionist economic policy, and an uncertain institutional environment continue to create a hazardous mix that will dominate Poland's economic outlook

## At a glance

CASE experts forecast that Poland's flash GDP growth estimate for 2016, which will be published on January 31, will amount to 2.8 % y/y. While private consumption has increased, investment activity remains subdued. Moreover, import growth has been stronger than export growth, dragging down the current account balance. January industrial output decreased (on a y/y basis). Unemployment increased slightly compared to the previous month, reaching 8.3%. The economy may accelerate slightly above 3% growth in 2017. However, high deficit levels caused by inflated social spending could likely lead to deficits exceeding three percent threshold, which, together with increasing policy uncertainty, may hamper future GDP growth.

Unemployment increased by 0.1 p.p. to 8.3% in December 2016

| Real GDP forecast (%) | 2017 | 2018 |
|---|---|---|
| CASE | 3.2 | - |
| IMF WEO | 3.4 | 3.3 |
| OECD | 3.2 | 3.1 |

Recent OECD forecasts show that, following two years of recession, Russia's economy is expected to experience growth in 2017. According to the World Bank's specialists, the essential part of Russia's way back to sustainable and inclusive economic growth is investments in human capital and services, as well as increases in productivity. Russian GDP contracted by 0.4% in Q3 y/y, the smallest contraction in 7 quarters. Its recent growth, according to Rosstat, is due mainly to high net exports. Inflation continues to decrease and reached 5.4% in December 2016, reflecting the lowest rate since June 2012.

Unemployment declined by 0.1 p.p to 5.3% in December 2016

| Real GDP forecast (%) | 2017 | 2018 |
|---|---|---|
| IMF WEO | 1.1 | 1.2 |
| OECD | 0.8 | 1.0 |

Following this week's publication of the IFO business survey, Germany remains an anchor of economic stability for the Eurozone. The IFO Current Conditions Index rose to 116.90 in January from 116.70 in December. In 2016, the country recorded 1.9% GDP growth rate, zero new government borrowing and a public sector budget surplus of EUR6.2bn. However, economic expectations and business climate indexes present a less positive picture, as German businesses become increasingly worried about negative economic outlook implications linked to Brexit and the Trump presidency. Within the economy, one source for concern appears to be associated with the housing market, where a strong turn towards home-ownership, in response to falling interest rates and record-low unemployment, is introducing fears of a looming property price bubble.

Jan. IFO Business Climate index down to 109.8 from 111.0 in Dec.

Jan. IFO Expectations index down to 103.2 from 105.5 in Dec.

| Real GDP forecast (%) | 2017 | 2018 |
|---|---|---|
| IMF WEO | 1.4 | 1.4 |
| OECD | 1.7 | 1.7 |

## At a glance

The Board of Ukraine's Central Bank has announced that it will not change its key policy rate, which is currently at 14%, in a continued attempt to mitigate inflation. So far, headline inflation decelerated from 43.3% in 2015 to 12.4% in 2016. This was possible thanks to a high supply of raw foods, the government's effort to keep the fiscal deficit in check, and limited volatility of the hryvnia's exchange rate. Revised macroeconomic data for Q3 2016 released in December revealed a 2.0% real growth (y-o-y). This is a better result than the data previously released by the National Bank of Ukraine (1.8%). Investments were the key driver of growth in the reference period, with gross fixed capital formation reaching 25% y-o-y.

Interest rate unchanged, at 14%

| Real GDP forecast (%) | 2017 | 2018 |
|---|---|---|
| IMF WEO | 2.5 | 3.0 |
| OECD | - | - |

The Czech National Bank (CNB) announced that, according to its analyses, the economy is currently running close to full potential and will continue to grow at around 3% in both 2017 and 2018. Since the beginning of the year, overall confidence in the Czech Republic's economy has remained mostly unchanged, with indicators for entrepreneurs' confidence decreasingly marginally by 0.1 point m-o-m and that of consumers' – increasing by 1.3 point m-o-m. The CNB's inflation forecasts remain unchanged, with 2.3% for Q4 2017 and 2.4% for Q1 2018, and the Bank is expected to continue with its policy of maintaining a fixed lower limit on the CZK/EUR exchange rate, at least until Q2 2017.

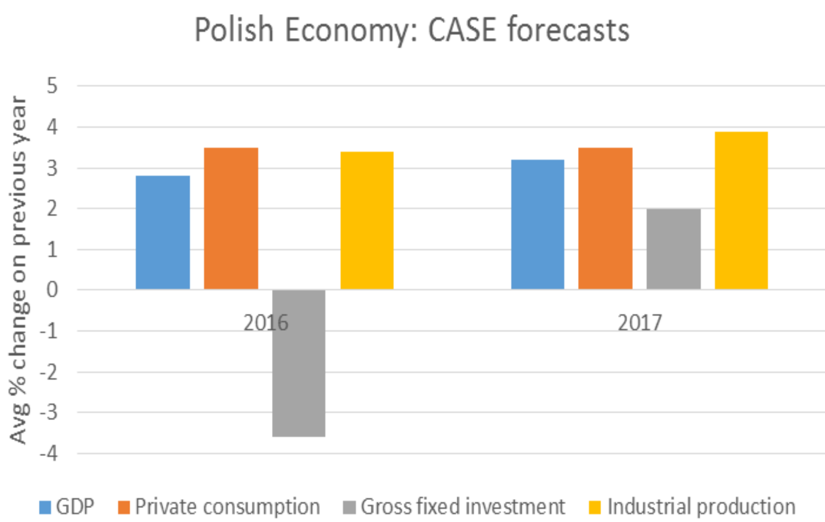
Business confidence index increased from 14.6 to 14.7 in December 2016

| Real GDP forecast (%) | 2017 | 2018 |
|---|---|---|
| IMF WEO | 2.7 | 2.4 |
| OECD | 2.5 | 2.6 |

This week, the National Bank of Hungary decided to keep its base rate unchanged at 0.9%. Bank officials calmed investors by releasing a statement saying that they intend to keep the base rate on hold for "an extended period" and indicating that they remain prepared to ease monetary conditions with unconventional instruments if necessary. The Hungarian economy is expected continue low but steady growth in 2017, estimated by both the IMF and OECD to be 2.5%. The main drivers of growth are expected to be EU structural funding, declining government debt burdens and waning external vulnerabilities.

NBH base rate unchanged at 0.9%

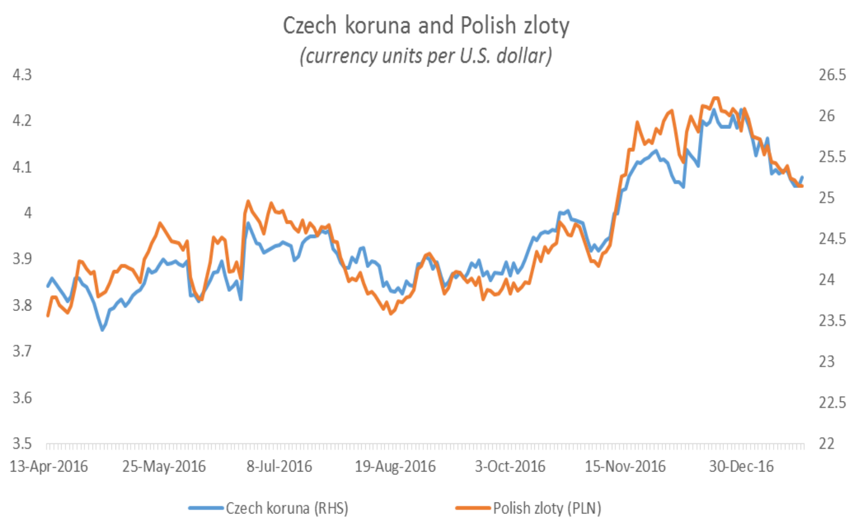
| Real GDP forecast (%) | 2017 | 2018 |
|---|---|---|
| IMF WEO | 2.5 | 2.4 |
| OECD | 2.5 | 2.2 |

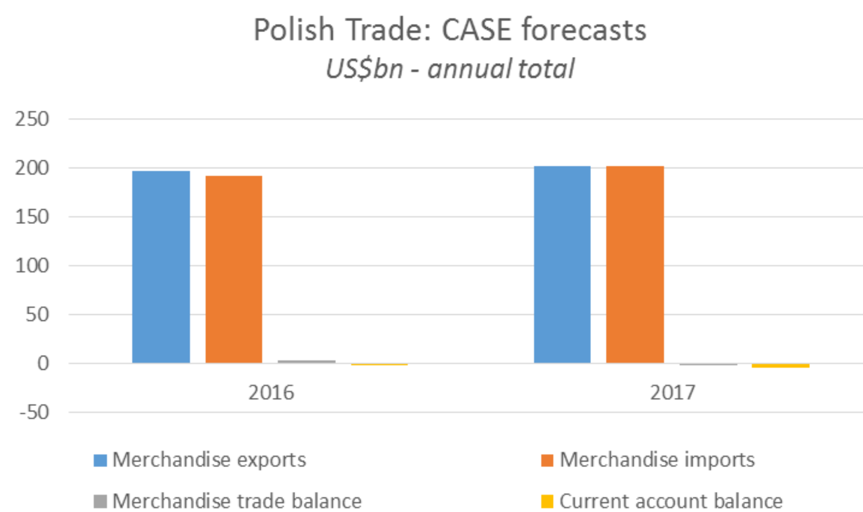




*Source: CASE forecasts, forecast updated December 23, 2016*

*Source: CASE, most recent observation December 19, 2016*




*Source: IMF, most recent observation January 26, 2017*

*Source: CASE forecasts, forecast updated December 23, 2016*

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