Country Paper: Poland[1]

Piotr Kozarzewski, Artur Radziwiłł, Mateusz Walewski
CASE – Center for Social and Economic Research, Warsaw

1. Introduction. Executive summary

On June, 4 1989 first partly free elections were held and the decisive victory of the opposition Solidarity brought the final collapse of the communist regime. Almost exactly 15 years later, on May, 1 Poland joined the European Union. The period between these two dates witnessed the reform of political, social and economic institutions of unprecedented scale and scope. This article describes briefly the major directions for reforms that completed the "transition agenda."

The reform efforts during these 15 years can be decomposed into periods that correspond loosely to the cycle of parliamentary elections. The initial stage corresponds to the political regime change in 1989 and comprehensive program of macroeconomic stabilization and liberalization known as "shock therapy" or "big bang." This stage was completed before 1993 when political parties that emerged from the Solidarity lost parliamentary elections to the post-communist parties. In the subsequent period, the pace of economic reforms was slowed down, while policymakers focused on consolidation of previous achievements and incremental adjustments to the economic policies and institutions. This stage of reforms was completed by the adoption of the State Constitution in 1997 that cemented the fundaments of market economy in Poland. The next distinctive period corresponds to the very ambitious program of the second generation reforms launched by the government created after 1997 elections. These reforms were not longer related strictly to the post-communist transition but rather aimed at increasing efficiency of key institutions in the context of functioning market economy. Accordingly, reforms of education, health and pension systems as well as territorial reform were all launched in 1999. On the contrary, the 2001 parliamentary elections installed the government with the program of consolidation and stabilization. Since that time the process of negotiations of EU membership and implementation of *acquis communitaire* dominated the systematic reform agenda while government was addressing pressing issues, like economic slowdown and its employment consequences in the rather ad hoc manner.

Macroeconomic reforms are one of more successful spheres of post-communist transformation in Poland. The main reason for this was clear vision among Polish policymakers about general direction of change and long-term economic model to be achieved: stable

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and externally open market economy. It distinguishes Poland from countries that delayed stabilization at the cost of hyperinflation.

Macroeconomic reforms were comprehensive and consistent in other reforms, especially in the sphere of microeconomic liberalization, which led to their mutual reinforcement.

Creation of institutions for macroeconomic management was crucial for the reforms success in Poland. It included creating of two tier banking sector with modern central banking unyielding to political pressure; introduction of modern tax system based on CIT, PIT and VAT (although the decisive improvement of the tax system still remains on the agenda of economic reforms); reform of the pension system, which was one the largest and most successful out of the second generation of reforms launched in 1999.

At the same time, fiscal consolidation proved to be one of the most difficult aspects of transition process. Generally speaking, most important difficulties in macroeconomic sphere, which proved to have long-term negative consequences, were in the spheres, where the pace of reforms was insufficient or ad hoc solutions were applied.

Unlike in the sphere of macroeconomic policy, where a large number of spectacular successes have been achieved, the effects of the enterprise sector reform are not so univocal.

The most notable successes were achieved in the sphere of deregulation and (closely related to deregulation) very fast development of the *de novo* private sector, even notwithstanding the efforts to re-establish more tight regulatory constraints starting from 1992-1993.

The specific, unique feature of privatization policy in Poland is heterogeneity of goals (microeconomic, political, fiscal, social etc.) and means, as well as highly consensual character. It led to very uneven results in terms of scope and results with, on the one hand, a number of branches and sectors remaining under control of the State, and numerous very successful cases of privatization, especially with participation of strategic (first of all foreign) investors.

The necessity of government-led restructuring programs for state-controlled sectors of economy was not fully appreciated at the beginning of transition. Later, however, most restructuring programs in practice were aimed at defending enterprises from market forces than to real restructuring aimed at growth of productivity and competitiveness.

The limited success of privatization and inefficiency of most sectoral restructuring programs was not a purely technical issue and was caused also by the emergence (in mid-90s) of powerful interest groups (which consisted of state administration, trade-unions, managers, etc.) that were interested in their own expansion and limitation of competition. It led to strong political bargaining with the government and handicapped further economic reforms. The power of these groups is very high given that other external institutional regulators of companies' behavior (securities market, legal enforcement structures, etc.) are still underdeveloped.

Taking into account very high unemployment level in Poland and relatively high poverty rate the reforms of employment and social protection systems should not be treated as successful. One has to remember however that the process of a deep and rapid economic restructuring as experienced in Poland had to result in strong tensions on the labor market and consequently had to lead to unemployment and poverty.

One has also take into consideration that neither unemployment nor poverty did not formally existed during communist times, therefore the institutions dealing with these problems had to be created practically from scratch. Therefore that fact that after only several years of transition Polish systems of employment policy and social protection are comparable to and work according to the European standards has to be perceived as a big success.

It seems also that the nature of the main reform challenges in the employment and social fields in Poland is similar to corresponding problems in older EU countries. Enhancing the proactive role of employment policy, tightening some excessively generous systems of income support, reforming of minimum wage and labor law are on the agenda in almost all European countries. It is also true however, that the scale and consequently social and political costs of these reforms in Poland are to be much bigger than in old EU member-states.

2. Macroeconomic reforms

Characteristically, the change of governments in Poland never affected the basic course of macroeconomic policies that remained relatively tight an supported macroeconomic stability and disinflation process. This macroeconomic consensus was reflected in the Constitution that contains clauses that specifically relate to macroeconomic prudence, such as maintaining low inflation and containment of debt accumulation. As a result Poland proved remarkably resilient in the face of number of shocks that affected emerging economies during these years, including Russian crisis in 1998 that had devastating impact on many other transition economies.

2.1 Macroeconomic stabilization and "shock therapy"

The macroeconomic reform was particularly prominent in the first stage of reforms launched in 1990. The immediate action was necessitated by dramatic macroeconomic disbalances: very high and accelerating inflation and prevalent market shortages. Also external debt burden was clearly unsustainable and required restructuring. Clearly comprehensive and credible strategy of economic reforms was needed. Fortunately, what distinguished Poland from countries that delayed stabilization at the cost of hyperinflation, was the clear vision among Polish policymakers about general direction of change and long-term economic model to be achieved: stable and externally open market economy. This allowed for the prompt launch of radical program of comprehensive reforms known as "shock therapy" or "big bang." The program was developed with the intellectual support from international experts and was closely consulted with the International Monetary

Fund. What was however essential, the very high general support for the government offered a window of opportunity for implementing difficult reforms in the forceful and credible fashion. This period is sometimes referred to as period of "extraordinary politics."

Macroeconomic stabilization was achieved through combination of many instruments that included the achievement of positive real interest rates and tight control of fiscal deficits, supply of money and incomes. The fixed nominal exchange rate was the nominal anchor that helped to break high inflation expectations and introduce credibility of the stabilization system. At the same time high initial devaluation of the currency at the time of trade liberalization led to increased profitability of exports that temporarily improved budgetary and current account situation. The risk of protracted hyperinflation was avoided.

The macroeconomic stabilization would not be possible without eliminating the fundamental source of disbalance of the economy: widespread shortages. The ambitious program of microeconomic liberalization had essential role in this respect. Joint removal of price and trade controls, introduction of convertibility of the currency and unifying exchange rates allowed for price adjustments and market based allocations. On the other hand, removal of remaining mechanisms of central planning, major barriers to entrepreneurial activity and scaling down of state interventions all had positive impact on supply side what helped to restore the macroeconomic balance of the economy. In this respect the comprehensive reform was the better option than a partial reform in which one set of measures is not consistent with others. Fortunately in Poland, the macroeconomic stabilization and microeconomic liberalization positively reinforced each other in most cases.

Poland was the first country to start comprehensive economic reforms and the first that overcome the initial economic decline. The growth resumed in 1992 and remains positive ever since.

2.2. Institutions for macroeconomic management

Creating institutions for macroeconomic management that support the market economy was the top priority on transition agenda and continuous improvement of these institutions was gaining increasing prominence in the medium period once the macroeconomic stabilization was achieved.

The creation of two tier banking sector with modern central banking was started already in 1989. Strengthening of the independent central bank that opposes the pressures to finance budget deficits by printing money was at the center of macroeconomic stabilization program. Although attempts to pressurize the National Bank of Poland still happen occasionally and NBP was providing financing the budget deficit until the end of 1997, the independence and role of the NBP as the guardian of price stability has been finally and strongly endorsed in the State Constitution of 1997. As a result, the overall goal of monetary policy remained unchallenged: the gradual reduction of inflation. What was changing throughout the decade of nineties was the framework of conduct of monetary policy. Initially, monetary policy was based on pegged exchange rate, later on replaced by crawling peg. This policy framework has been increasingly complicated by large portfolio capital inflows. NBP was intervening in the foreign exchange market to contain the exchange rate pressures and improve the competitiveness of domestic producers. Sterilization of these interventions proved costly and ineffective. As a result there was a trend to move exchange rate regime towards more flexibility. The crowding peg was replaced by crawling band with decreasing rate of crawl. Eventually, as the inflation reached low levels, the crawl was equalized to zero and soon afterwards, the band was removed so that Poland maintains floating exchange rate regime since 1999. This regime corresponds best to the direct inflation targeting, the modern monetary framework introduced by the newly established Council of Monetary Policy of NBP in 1998 that helped to achieve current low rates of inflation.

Poland was also successful in creating financially sound system of commercial banks. This was possible mainly through introduction of well designed prudential regulation and strict supervision by the NBP. This positive development would not be possible without the 1993 program of portfolio restructuring and recapitalization (see also the next section). This program was effective in two important dimensions: first it was comprehensive enough to free banks from the bad loan burden and to allow expansion of the credit action, second it was credible enough so that, unlike in many other transition economies, it never had to be repeated. Moreover, fiscal costs were recovered in the process of bank privatization. Later on, Poland has chosen the strategy of opening of the banking sector to the foreign ownership so that currently the large part of the banking system is owned by large international banks. This strengthens the resilience of the system and facilitates the transfer of best practice in banking operations although occasionally raises concerns about the high exposure of the economy to decisions made outside Poland.

The introduction of modern tax system was another key element of building fundaments of market economy in Poland. Under communist times, revenues of the budget depended disproportionably on state-owned enterprises and turnover taxes. To adjust the tax system to the market economy conditions, the modern Corporate Income Tax was introduced in 1989, Personal Income Tax in 1991 and the Value Added Tax in 1993. Currently revenues from these taxes constitute the vast majority of all budgetary revenues. The tax system was also subject to many subsequent changes. Unfortunately, these changes were quite often implemented on ad hoc basis, what led both to lack of transparency, problems of consistency and instability. The decisive improvement of the tax system still remains on the agenda of economic reforms.

Fiscal consolidation proved to be one of the most difficult aspects of transition process. These difficulties originated in areas in which pace of reforms were insufficient or ad hoc solutions proved to have long-term negative consequences. The best example was the proliferation of the long-term invalidity and pre-retirement benefits. While these benefits alleviated the transition hardship and eased the opposition to enterprise restructuring and pension system reforms, they continue to pose the heavy burden on the budget. As a result Poland has the ratio of social expenditures to GDP that is one of the highest in the world.

The reform of the pension system was one the largest and most successful out of the second generation of reforms launched in 1999. It was necessitated by exploding costs of pensions due to demographic changes and low incentives to contribute to the system. As a result of reform, the Pay-As-You-Go system was replaced by the multipillar system consisting of smaller PAYG component (that nevertheless links size of benefit to the size and length of contribution period), mandatory savings component and voluntary saving component. The last two components are managed by the private sector, what leads to the strengthening of capital markets as a side effect of reform. The reform regained the stability of the pension system in the long run. The transition from the pay as you go to the funded system created however the temporary problem of "double burden". Current contributors not only have to save for their future pensions under the new funded system but they also need to finance benefits of current pensioner under the old system. To address this problem, it was decided that proceeds from privatization will be earmarked to cover the financing gap. This seems to be a very good solution — the privatization proceeds are invested effectively in establishing an institution that will foster faster and more balanced growth in the future. Unfortunately, the health care reform implemented in 1999 did not produce comparable results in containing future costs of the system so that health care system remains the threat to future sustainability of public finance.

3. Enterprise sector reform

3.1. Deregulation

In Poland, central planning and state property never embraced the whole economy. Since 1960s, small scale entrepreneurship was politically tolerated and legally allowed, but the breakthrough was made a year before collapse of Communist rule by adoption of the Law on Economic Activity (December 1988), which introduced the general rule of economic freedom. Besides, limited liberalization of foreign trade and FDI was also introduced. On August 1, 1989, the last Communist government freed most consumer prices and eliminated rationing system. The second breakthrough was made in 1989-1990 by the first two post-Communist governments, which made liberalization and deregulation a cornerstone of economic policy and implemented a wide range of measures aimed at radical facilitation of new entries and liquidation of obstacles for market competition (including opening to competition of foreign entities), in particular:

- liquidation of most licensing and concession requirements;
- creation of uniform tax policy for all ownership sectors;
- acceptance of a new anti-monopoly legislation, deconcentration of some sectors of industry;
- liquidation of all cooperative associations;
- introduction of a customs law corresponding to EEC standards;

- abolition of all remaining forms of trade not based on free market principles;
- further price liberalization;
- ending of traditional central planning, granting greater independence and responsibility to state-owned enterprises;
- acceptation of the new Foreign Investment Law eliminating most of licentioning and allowing a free repatriation of profit and invested capital;
- introduction of current account convertibility of the Polish currency.

This policy resulted in boosting new entries and rapidly growing inflow of FDI (additionally encouraged by privatization of SOEs).

However, starting from 1991, there was a certain reversal of some earlier deregulation reforms by imposing more tight regulatory constraints to entry and growth of private companies (e.g., in 1991-1997, the scope of licensing had been gradually broadened, although the new Business Activity Law in force since 2001 reduced it again) and re-consolidation in some sectors of economy (see below). Such a tendency had a number of sources, the most important at earlier stages being conviction that the market itself has no sufficient regulatory powers and in some spheres tightening of the state control is necessary. But, apart from limiting economic freedom, such a policy gave ground to the set-up of powerful interest groups (which consisted of state administration, trade-unions, managers, etc.) that were interested in their own expansion and limitation of competition. It led to strong political bargaining with the government and handicapped further economic reforms, including demonopolization and restructuring of the so-called “sensitive” sectors (in terms of social and political constraints).

3.2. Privatization

Privatization of state-owned enterprises (SOEs) started in 1990, as a part of a complex program of economic and political reforms of the first post-Communist government. Privatization was meant not only a transfer of state-owned assets to non-state hands, but had to be a means of reaching a large number of (often contradictory) goals of systemic (the change of the economic system through creation of private entities), microeconomic (e.g., solving the problem of microeconomic inefficiency), fiscal (increase in budget revenues), political (creation of powerful pro-reform lobby of actors), and social nature (restoring of “social justice” and resolving the social problems in concrete enterprises). Apart from multiplicity of goals, Polish privatization is characterized by its mostly consensual character (taking into account a wide range of insider and outsider stakeholder interests) and gradualism (which resulted both from the sequence of reforms — first regulation and institutional constraints, then enterprise reform — and resulting from it pursuing quality of ownership transformation). These features of Polish privatization predetermined its highly diversified ways of implementation, which included sales to investors, public offerings, management-employee buyouts and elements of mass privatization.

Highly diversified and consensual character of privatization processes led to very uneven results across sectors and branches. The most rapid privatization took place during the first years of transition, followed by a substantial slowdown of the privatization process, due to depletions of enterprises which were "easy to privatize" (for technical, economic and social reasons) and growing (since mid-90.) political pressure for privatization slowdown and continuation of government's support exerted by newly emerging interest groups, mainly in excavating industries and infrastructure. As a result, the quantitative effects of privatization are rather modest comparing to many other countries of the region (privatization ended only in 66% of SOEs), with whole sectors and branches still left under the state control and numerous cases of suspended privatization, when transformation of an enterprise stopped at the stage of commercialization and the state still holds all its shares. Qualitative results at a company level also proved to be much diversified: different methods of privatization determined emergence of different ownership and corporate governance patterns that led to different strategies and behavioral patterns which in turn resulted in different performance. Generally speaking, the best performers are enterprises sold to strategic, especially foreign, investors (where continental corporate governance model emerged in most undistorted form), while the worst performance is found in suspended privatization cases and enterprises exempt from privatization under a pressure of interest groups.

At the same time, Poland achieved a great degree of success in fast development of *de novo* private sector: since 1989, 200,000 new private companies (and about 2.5 million private businesses not being legal persons) have been created; nevertheless the state sector still employs about 30% of workforce and is responsible for about 25% of the GDP.

3.3. Enterprise restructuring

The gradualist privatization model led to the necessity of a special approach towards enterprise restructuring (whereas in fast models, deep restructuring is expected to happen after privatization and is the new owners' responsibility), which was not fully appreciated at the beginning of transition, because it was believed, that emerging market environment itself would force changes in SOEs' behavior and necessary restructuring. However, in 1990-1992 the situation of SOEs, especially the largest ones, quickly deteriorated; inter-enterprise arrears were growing, as well as bad debts towards banks, which began to seriously threaten the stability of Polish banking system. 1993 marked the beginning of large-scale sectoral restructuring programs. But the only real success so far (albeit partial) was the Enterprise and Bank restructuring program launched in 1993 (see also the previous section), which prevented crisis in Polish banking system with the help of banks' portfolio restructuring and recapitalization and bank-enterprise conciliation agreements, and by improving banks capacity in risk assessment and loan management. However, the second goal of the program — restructuring and privatization of indebted enterprises — in most of the cases was not achieved.

Trying to overcome negative tendencies in the state-owned sector, in 1992-1993 the government started to prepare and implement other sectoral restructuring programs that assumed larger o lesser degree of re-consolidation of sectors deconcentrated at earlier stages of the reforms. Initially, the main goal of such a re-consolidation was prevention of the collapse of those sectors of economy, where state-owned enterprises still prevailed, increase in their competitiveness that would make possible their privatization in future. In 1993-2003, big state-controlled companies and/or holdings were created in coal mining, sugar, petrol, ferrous metallurgy, and banking. At the same time, some sectors were even not previously deconcentrated, or such a deconcentration had only formal character (for example, in railway transport and telecommunications — in the latter case, the national telecom company remained a monopolist even after privatization). Although in certain sectors, restructuring through re-consolidation indeed gave some positive effects (for example in downsizing both in the terms of production and employment, raise in labor productivity etc.), the overall effect of these programs was negative.

First, most of these programs envisaged writing-off the overdue payments to the budget and social security system, as well as other forms of subsidy. It weakened financial discipline and raised expectations of the same debt relieves and financial injections in future. Second, the level of public subsidies is not only too high (1.3% of GDP in 2002, comparing to 1.0% in the EU), but its structure is far from optimal, with predominance of indirect instruments which are hard to monitor and are less effective than subsidies and grants. Third, the essence of restructuring programs more and more often becomes protection of the sectors against the market forces rather than adaptation to them.

The inefficiency of most sectoral restructuring programs is not a purely technical issue and is caused also by the set-up (in mid-90s) of powerful interest groups both within sectors, in new intermediate structures and among the political elite. These groups' activities in many cases stopped both real restructuring of state-owned enterprises and their privatization.

3.4. Securities market

Since the very start of transformation, development of securities market was regarded as one of cornerstones of economic reform. In March 1991, the Law on Securities Market and Mutual Funds was adopted, and in April 1991 the Warsaw Stock Exchange (WSE) was opened. In terms of organization and enforcement, the WSE is probably the best stock exchange in post-Communist countries, and the organized securities market is subject to very strict disclosure and transparency regulations on entries and on listed companies. The WSE played a key role in privatization deals that include public offering, and provided capital for a number of new entrants from *de novo* private sector. At the same, WSE represents merely a small part of the Polish securities market which in certain aspects has a tendency to shrink: there are very few no new entries, and some companies are exiting the market. The total number of companies listed is falling (from 230 by the end of 2001 to 203 by the end of 2002). Fortunately, overall capitalization of the WSE started to grow, but still remains rather small (about 20% of the GDP). At the same time, the organized securities market is still highly concentrated; main players are also big, first of all institutional investors; small individual investors are numerous, but very weak; their total number and share on the stock market is steadily declining.

This situation can be at least partly explained by the fact, that the WSE was established mainly to serve privatization and is still dominated by mostly large companies from the privatized sector, while the most dynamic part of the market are medium-sized listed companies. It becomes a barrier for further development of the WSE, because, strategic investors are often interested in exit of their companies from the WSE; besides, slowing pace of privatization contributes to further fall on the supply side. The situation additionally complicates, because new players are entering the market which produce additional demand (e.g., pension funds). As a result, the WSE does not properly perform two basic functions of a stock exchange: valuation and a source of capital for private sector. The irony is that the Treasury is the largest beneficiary of capital inflow through the WSE.

3.5. Enforcement

Poland has a well-developed legal framework for which regulates enterprise sector functioning. The legal regulations are not flawless, but the main threat is poor enforcement of the existing laws. In Poland, there are a lot of punishable cases both of abuse majority and minority property rights, as well as of managers' opportunism; violation of contracts between companies is becoming more common, the same goes for transfer pricing and other forms of tax evasion. At the same time, the judiciary system proved to be not prepared to fight against violations of this kind. Nor the courts, neither the prosecutors have sufficient capacities or skills to cope with cases of illegal actions in companies, notwithstanding numerous attempts to strengthen law and contract enforcement (such as creation of economic units in courts, of a department of capital market offences within the Warsaw Territorial Public Prosecutor's Office). Some potential have courts of arbitration affiliated to regional chambers of commerce and industry, but they have no executive power.

4. Employment polices

4.1. Unemployment — cost of economic restructuring

Between 1990 and present times the share of agriculture in total employment in Poland decreased from 25.2 to 18 percent. Employment only in coal-mining sector decreased from almost 0.5 million in 1989 to about 150 thousand currently. It all means the enormous pressure on the labor market and has to result in unemployment. Since the very beginning of 90-ties the unemployment rate in Poland exceeds 10 percent (with a short break in 1998) and currently peaked to as much as 20 percent.

Therefore creation of efficient labor market institutions and the effective mix of labor market and social polices has been on the policy agenda since the very beginning of the reforms. This task had to be considered also as the especially demanding since during communist times there had been no unemployment officially hence all institutions had to be created from scratches.

4.2. Unemployment benefits

Emergence of the open unemployment in the beginning of 90-ties resulted in the necessity to create a system of income support for those who lost their jobs. Registration and benefits distribution was at the very beginning the most important task for Public Employment Services (PES) in Poland. Since income protection was the main task of this policy and policymakers had initially underestimated the scale of the unemployment problem, the constructed system of unemployment benefits was quite generous and easily accessible. Benefits were tied to previous wage, and could be even as high as average wage, the duration was practically open ended. It resulted in high coverage rate reaching 80 percent and obviously increasing abuse of benefit rights. This, mainly to fiscal reasons, had to be changed in 1992: wage related benefit was replaced by a flat payment and duration was set to maximum 12 months. It resulted in immediate fall in coverage to 55 percent. Then the benefit system has been undergoing constant reforms of a smaller scale, but all rather tightening the eligibility criteria. Finally in 2003 the coverage was as low as 15 percent and the flat rate was at 60 percent of minimum wage.

4.3. Active labor market polices (ALMPs)

The reforms of unemployment benefits system have been consistent with the ongoing change of understanding of the role of public employment policy. Throughout the 90-ties the role of PES has been evolving from income support and registering to labor intermediation and pro-active polices. On the very beginning of the reforms almost entire budget of Labor Fund was spent on benefits. In 1998 the share of ALMPs and employment intermediation costs in total spending reached its maximum of 32 percent. Then unemployment started to rise and passive spending crowded out active polices again. In 2001 the share of active spending in total was as low as 10 percent. Obviously employment intermediation is the basic objective of PES and one of its most efficient policy tools. Effectiveness of ALMPs, (such as training, public works, subsidized jobs, start-up loans and other special programs) is the other issue. It is an ongoing policy agenda not only in Poland and other transition economies but also in more developed countries. Throughout the 90-ties subsequent PES leaderships tried to effectively measure and increase the effectiveness of ALMPs and also limit its abuse by local PES offices. The exact result of efficiency analysis strictly depends on the applied methodology. All agree however, that training and retraining seems to be the most effective pro-active measure, followed by subsidized jobs in private sector. Public works are the least effective from activation point of view.

4.4. Pre-retirement schemes

As we mentioned in previous paragraph, since the late 90-ties active employment polices have been crowded out by passive measures. This process however was not only related to increasing importance of unemployment benefits, but much more to the pre-retirement schemes – pre-retirement allowances and pre-retirement benefits – initiated in 1997. The aim of these schemes was to ensure the job-losers of older age and longer job tenures with a smooth path to their retirement age. The system however, as originally constructed, was very generous. Facing hard labor market situation both employers and employees started to take advantage of this relatively easy and painless early-retirement option. It resulted not only in massive registrations of these already unemployed but also with additional layoffs of elderly workers, having their incomes till retirement secured. Consequently, public expenditures on these schemes started to peak. In 1997 they constituted 6 percent of total Labor Fund spending, in 1999 already 20 percent and in 2002 as much as 46 percent. The government tried to react to these booming costs since 1999 constantly reforming the system – tightening eligibility criteria and lowering the size of payments. Finally in 2002 only one – unemployment allowance, has replaced the two schemes and rules have been additionally tightened. As a result in 2003 spending on pre-retirement schemes increased by "only" 9 percent, where average annual increase in 1997-2002 was 61 percent (36 percent in 2002).

4.5. Minimum wage and labor code

The set of employment policies implemented by PES are not the only tool authorities influence directly the situation on the labor market. Minimum wage regulations and design of the labor law are the most prominent examples of such policy tools.

Since the very beginning the minimum wage has been set on about 40 percent of average wage which is similar to developed countries. In transition countries however the productivity gaps between skilled and unskilled labor force, between economic sectors and regional labor market diversity are considerably wider than in average advanced economy and therefore downward wage compression has to have stronger impact on labor demand and hence employment. Throughout the entire transition period in Poland this subject has been widely discussed, thus far however it has no real impact on state policies in this respect.

The discussion concerning the need of the labor law reform has been even more vivid, especially in the second half of 90-ties and it did result in series of more and less pronounced reforms. Various changes have been introduced virtually every year throughout the transition period. The law on collective dismissals was passed as early as in 1989, collective agreements have been legalized in 1994, in 1996 first flexible labor time regulations have been introduced on the one hand, but on the other limitations were put on fixed-term contracts. In 2001, when unemployment was already rising rapidly, the entire set of labor code regulations was tightened as the result of the pressure of politically strong trade unions: weekly working time was shortened, minimal break and vacation period was extended and contract modification procedures were additionally complicated. The last big change of the labor code was passed in 2002 and this time most of modifications made labor regulations more flexible: bureaucratic procedures for small enterprises were eased, further working time flexibility was introduced, job rotation procedures were implemented. The declared aim of all modifications was to adapt the old law (labor code originates from 1974) to demands of transition-to-market economy. It is obvious however that not all changes served to flexibilize labor relationships.

5. Social policy reforms

5.1. Pension and disability benefits

Reforms in some areas and lack of these in other areas of social policy have also been the important part of transformation of Polish economy and society in the 90-ties. Open unemployment and official recognition of the poverty problem put much pressure on all elements of the social system. The share of total social expenditure in GDP increased between 1990 and 1999 from 16 to 23 percent. Of that pension expenditures increased from 4 to 8 percent and disability benefits from 2 to 4 percent. Poland's share of disability benefits spending is highest in OECD (not mentioning transition economies) and share of pensions puts Poland to the 13th place among OECD countries.

Large explicit and implicit deficit in the pension system resulted in the big reform implemented in 1999. We describe the details of the reform in the macroeconomic part of this paper, since its current effects are visible mainly in fiscal field and capital market. On the other hand, Polish system of disability benefits has never undergone any serious reform and being very generous and corrupted became a source of substitute or even additional income for large share of mainly less skilled jobless people. In 1996 as much as 25 percent of all disabled were only "legally" and not "biologically" handicapped. Serious steps to limit the new inflows in the system where taken in 2000 and as a result the inflow to the system decreased by 44 between 1999 and 2001. The reform of disability benefits system in Poland is currently on the very top of the policy agenda in Poland as the element of the reform of the Public Finance system.

5.2. Social assistance system

The reform of the social assistance system in Poland started at the very beginning of the transition. The new law on social assistance was passed already in 1990. The new law directed the public assistance to households (families) instead of individuals. Additionally it defined the poverty line, based on household incomes per-capita on adult equivalent scale targeting the financial assistance to well-defined poor population. It defined also other indicators deciding about the household eligibility for public assistance. As the result of the reform the responsibility for social assistance distribution has been given to local authorities. After the administration reform of 1999 this responsibility increased even further, however the share of central budget funds in social assistance financing is still around 70 percent.

6. Assessment (Lessons learned)

The lessons learned from Polish experience of policy and institutional reforms with regard to the pace, sequencing and other implementation issues are both positive and negative.

The most important positive lesson of Polish reforms is that in a historically short period very deep and radical reforms make possible an irreversible turn from centrally-planned economy and authoritarian political system to liberal market economy and democratic society, which eventually leads to integration in world economy and EU membership. This great success of Poland would have been impossible without successes in various spheres of systemic transformation.

At the same time, Poland so far failed to implement a number of very important reforms, or their success was only partial, which resulted in high budget deficit and other economic and social tensions. These are: problems with transparency, consistency and stability in the tax system, lack of control of expenditures in health care system,, still large state sector of economy, preservation of monopolies, insufficient sectoral restructuring, weak capital market, inefficient protection of laws and contracts; high non-wage labor costs and harmfully biding minimum wage regulations, ineffective elements of employment policy and social assistance systems, unreformed disability benefits system, unreformed rural pension system etc. Taking into account the above, we can draw the following lessons f systemic reforms in Poland:

- The clear vision among policymakers about general direction of change is essential in making reforms successful and it is a key factor distinguishing more and less successful transition economies. The genuine consensus among politicians about the need of sustaining macroeconomic leads to the policy outcomes which are remarkably resilient to shocks.

- In order to achieve stabilization, macroeconomic reforms need to be comprehensive and consistent with other measures, especially in the sphere of microeconomic liberalization. Creation of institutions for macroeconomic management is crucial for the sustainability of stabilization in medium term..

- Most important difficulties in macroeconomic management in medium-term, originated in spheres where the pace of reforms was insufficient or ad hoc solutions were applied. Specific problems with fiscal policy adjustment help to quickly identify those spheres.

- When the reforms' pace slows down and large spheres of economic activity are still regulated by the state, it gives concentrated gains to a limited set of actors (bureaucrats, trade unions, entrenched managers and employees, etc.) and a powerful interest groups emerge that try to codify their advantages in the evolving institutional framework, and block further reforms (low-level reform equilibrium trap).

- The state is as a rule worse regulator of economic activity than private owners that act on a level playground defined by laws and institutions of market economy. Quick and deep deregulation at the beginning of transition, combined with comprehensive macroeconomic reforms is very important for enterprise sector reforms, especially in boosting of business activity.

- When reforms in the spheres of regulation and institutional constraints are implemented before the enterprise reform, the latter has more chances to give better results, especially in forming of efficient owners and market behavior of enterprises.

- Privatization gives better results when it pursues quality and not only the quantity-related goals and when privatization goals are well-balanced and do not contradict each other. Too high diversity of goals of privatization of state-owned enterprises and striving for satisfaction of too large set of stakeholder interests leads to distortions in the processes of ownership transformation (delays in privatization, set-up of inefficient corporate governance structures, low performance).

- Continental corporate governance model seems to be most suitable (comparing to Anglo-Saxon one) for at least early stages of post-Communist transition because it ensures more strict internal control over a company and is more efficient in bringing investments, new culture of management, access to new markets etc.

- Restructuring programs are most effective when they address the cause of trouble and lead to self-sustainable development of restructured entity. In order to achieve it, technically sound restructuring program must be accompanied by proper management of most important interest groups involved in order to make them act in favor of restructuring. Sectoral restructuring programs do not bring positive results if they are prepared and implemented under pressure of entrenched interest groups longing for preservation of their positions and soft budget constraints.

- Deep economic restructuring has to result in unemployment and consequently poverty. The scale of this phenomenon should not be underestimated when constructing (or reforming) the systems of employment policy and social assistance.

- It is very important to construct effective, fiscally sustainable and compatible systems of employment policy and social assistance. Assistance to the unemployed while they are searching for job should be the main goal of the Public Employment Services. Income support to the long term unemployed and other person with low employment opportunities should be performed by well targeted Social Assistance System. If both income support and activation of unemployed are objectives of PES, income support tends to crowd out active polices and PES are not able to fulfill their mission properly.

- Systems of income support directed to older unemployed or disabled should be constructed very cautiously. If excessively generous and/or easily accessible they may result with excessive deactivation of related groups of population and additionally may easily become fiscally unsustainable. One has to take into account also the fact, that effects of implementation of defective system are mostly irreversible. The beneficiaries, once in the system are not in position to come back to the labor market even if the general situation improves.

- Setting the minimum wage level one has to take into account the regional diversity and productivity differences between various groups of the workforce. When set too high (and especially when accompanied by high payroll taxes) it may additionally worsen the employment opportunities of poorly skilled workers. It may manifest in high unemployment and/or considerable employment in shadow economy.

- Any reform of the labor code must take into account not only the need to protect employees rights but also its effect on non-wage and non-financial labor costs. It is especially important in transition economies facing unemployment problems and suffering from weak law awareness and enforcement. Excessively rigid and complex law limits employment in legal economy, especially in Small and Medium Enterprise sector.

7. Most critical challenges

- Adjustment in the fiscal position is the most important macroeconomic challenge in medium term. It is necessary for meeting the condition for eurozone membership and this necessity is reinforced by the recent accumulation of debt that is rapidly approaching ceiling outlined in the Constitution. Given, the fact that fiscal adjustment can be realistically achieved only through the reductions of social expenditures that proves exceedingly difficult, generating support for such reductions seems to be the most important task for future governments.

- Specifically, important challenges for reform include: phasing out of the system of pre-retirement benefit, limiting expenditure on disability benefits, regaining control over the expenditures in the health care system and making rural pension system less dependent on state transfers. Tax reform that leads to the more stable, equitable and transparent system that promotes entrepreneurship and growth but discourages tax avoidance and evasion is another crucial challenge for the sustainable improvement in public finance.

- The accession to the eurozone poses also number of challenges for macroeconomic policy. The participation in the European Rate Mechanism, introduction of full capital convertibility, potential problems with the simultaneous fulfillment of all economic accession criteria (especially inflation and exchange rate) will make macroeconomic management much more difficult and policymakers should be prepared for it.

- To overcome the reforms stagnation and address the unfinished agenda (especially in the field of privatization, enterprise restructuring, labor market and social policy reforms) it is necessary to break up the "early winners" interest group coalitions that gain profits from the low-level reform equilibrium trap described above.

- Comprehensive restructuring of "sensitive" sectors should be undertaken followed by their privatization, which will lift the financial burden from the state budget, boost competitiveness of these sectors, and have (in the long run) positive impact on labor market.

- To ensure development of securities market, especially of its organized segment (the Warsaw Stock Exchange), so it would perform its main functions of valuation of companies, source of capital for private companies, as well as contribute to the success of the reforms that envisage the use of securities market, first of all the pension reform.

- Strengthening the pro-active role of the Public Employment Service is the important policy challenge when entering the EU. It is the important requirement of the European Employment Strategy.

- Reforming of the disability benefits system has to be one of the basic elements of Public Finance reform.

- Increasing the employment opportunities of poorly skilled workforce should be one of the most important policy issues. The reform of the minimum wage system and payroll tax reductions should be the main elements of the proposed policy action.

- The labor law has to be constantly adapted to meet the requirements of the modern economy. Issues as working time regulations, role of trade unions, costs of hiring and firing costs and related bureaucratic procedures should be especially monitored.

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