# OECD Economic Surveys

# Poland

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# Poland

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ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

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*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 26 April 2006. 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 2006.*

*The Secretariat's draft report was prepared for the Committee by Paul O'Brien and Stéphanie Jamet under the supervision of Peter Jarrett.*

*The previous Survey of Poland was issued in June 2004.*

# BASIC STATISTICS OF THE REPUBLIC OF POLAND
(2005 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) | 14.1 |
| Rural population (percentage of total, 2003) | 38.4 | Employment by sector (percentage of total): | |
| Life expectancy at birth (2004): Male | 70.7 | Agriculture (2004) | 17 |
| Female | 79.2 | Industry (including construction, 2004) | 28 |
| Infant mortality (per thousand, 2003) | 6.8 | Services (2004) | 55 |

| | |
|---|---|
| Registered unemployment (percentage of labour force) | 18.2 |
| Labour force survey unemployment (percentage of the labour force) | 17.7 |
| 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 | 7 |

## PRODUCTION

| | |
|---|---|
| GDP (Zl billion, current prices) | 979.2 |
| GDP per capita (US$, market exchange rate) | 7 934 |
| Gross fixed capital formation (percentage of GDP) | 18.1 |

## PUBLIC FINANCE

| | |
|---|---|
| General government budget balance (percentage of GDP) | –2.5 |
| General government revenues (percentage of GDP) | 40.3 |
| General government expenditures (percentage of GDP) | 42.8 |
| State treasury debt (end-year, percentage of GDP) | 50.7 |

## FOREIGN TRADE AND FINANCE

| | |
|---|---|
| Exports of goods and services (percentage of GDP) | 37.0 |
| Imports of goods and services (percentage of GDP) | 37.3 |
| Official reserves assets (US$ billion, end-2005) | 42.6 |
| Total external debt (US$ billion, end-2005) | 130.0 |

## CURRENCY

| | | | |
|---|---|---|---|
| Monetary unit: zloty | Currency units per: | US$ | Euro |
| | Average: 2005 | 3.2348 | 4.0254 |
| | April 2006 | 3.1982 | 3.9194 |

# *Executive summary*

*Poland's growth performance since 2004 suggests that the process of catch-up with higher-income countries has been renewed. But an improved balance of macroeconomic policies and further efforts to improve structural policies are needed to sustain and accelerate convergence.*

- *Monetary policy may have temporarily been somewhat too cautious, but it would be easier for the central bank to relax if fiscal policy were put on a sustainable footing, with consolidation focused on social transfers, which have many adverse work incentive effects.*
- *Links between the education system and the labour market are still insufficient, and the financing of tertiary education is leading to both inequity and inefficiency.*
- *Weak performance on adult training, reliance on passive income support and too little attention to job-search or mobility requirements contribute to the high level of structural unemployment.*
- *Growth has been held back by poor framework conditions for entrepreneurship and innovation.*

## Seek a better balance of monetary and fiscal policies

*The National Bank of Poland has acquired a reputation for inflation aversion. It may no longer need to be quite so cautious and could afford to do more in the future to test the limits of available capacity. Although the budget deficit improved in 2005, this was partly due to one-off factors. Clear expenditure priorities need to be defined and enforced, preferably within a multi-year planning framework. Social transfer payments absorb too large a share of public spending and GDP and should be better controlled.*

## Consolidate and extend the education reforms

*Reforms of compulsory education have decentralised education management to local governments. Further steps are needed to align financial and management responsibility with accountability for performance and to ensure flexibility in allocating resources as needs change. Expansion of tertiary education has increased human capital formation, but it is inefficient to prevent public institutions charging fees; a concomitant reform of student grants and loans could increase equity and overall resources.*

## Boost employment with active labour market policies and by making work pay

*Poland's very poor labour market performance is partly due to the costs of structural change, but many social transfer payments and the large tax wedge act to reduce employment. They need to be changed to strengthen incentives to work. The public employment service must increase its emphasis on job-activation, making more use of adult training as well as job-search requirements for benefit recipients.*


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## Raise investment and growth by reducing regulation and improving conditions for entrepreneurs

*Sluggish investment and low innovation activity are related to Poland's high degree of regulation; this is due mainly to high public ownership, perceptions of an ambivalent attitude to foreign investment and a considerable burden of bureaucracy, though progress has been made in recent years. Without improvements in all these areas, measures to improve flows of finance and information to small companies and innovators will be less effective.*

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# Assessment and recommendations

*EU entry has improved outcomes and prospects…*

Entering the European Union in May 2004 gave an important boost to the Polish economy. GDP per head is currently under 45% of the EU average, but the long process of convergence has resumed. Although growth waned somewhat during 2005 when real GDP rose by only 3.2%, current prospects are for annual growth of 4½ per cent during 2006-07. EU funds will make an important contribution to improving public infrastructure and support policy in several other areas, provided they are used effectively.

*… but continued reforms are needed*

However, numerous underlying economic problems remain. Employment rates are very low: the level of recorded unemployment is high, and there are substantial numbers of economically inactive people (although many of these may be active in the informal economy) even before population ageing really takes hold. In fact, labour market performance in Poland is arguably the worst in the OECD. Despite the need for faster capital accumulation if economic convergence is to continue, let alone accelerate, the share of investment in GDP has remained stubbornly low. Budgetary policy has been rather erratic, with something of a blow-out in 2004, followed by an unexpectedly large improvement in 2005 and uncertain prospects for 2006. These problems require the attention of policymakers, beginning with the maintenance of a strong and stable macroeconomic framework, for both fiscal and monetary policy.

*The central bank has a good reputation for controlling inflation and could afford to test the supply response of the economy*

Monetary policy has been criticised for excessive caution, as inflation has frequently undershot its target range. The National Bank of Poland (NBP) tightened policy in mid-2004, in a justifiable response to a surge in inflation; this prompt action, permitted by its independence and determined by its price stability mandate, played a part in preventing any second round effects from the inflation surge. Subsequently, the NBP maintained official rates at their higher level for several months after quarter-on-quarter inflation had subsided in late 2004 and waited until early 2006 before further cutting rates, although headline inflation was declining and core inflation low. The NBP was probably influenced partly by consumers' inflation expectations, which tend to closely follow historical

inflation with little relation to future outcomes. *The central bank should put more weight on genuine forward-looking indicators, including its own inflation forecasts.*

The mandate, and even the independence, of the central bank has been under some threat recently. *The government should reaffirm the independence of the National Bank, and the autonomy of any new financial market supervision agency should also be clearly guaranteed. The credibility of monetary policy would also benefit from explicit government endorsement of the NBP's current objective of targeting inflation at the mid-point of the 1.5 to 3.5% range.*

However, inflation below the bottom end of this range may be a sign that monetary conditions have been too tight. While monetary reflation is not the answer to Poland's growth and employment problems, if inflation were to remain persistently below euro-area rates this would be likely to restrict output and employment unnecessarily. *The NBP should ensure symmetry in its approach to inflation targeting and be willing to probe the limits of the economy's supply responsiveness by cutting interest rates when inflation is below the target range, even if there is some probability that it may rise above 2.5% in two years' time.*

### *Any delay in joining the euro area should be used to enhance the economy's flexibility*

Movements in the exchange rate have had an important effect on monetary conditions. Joining the euro area would reduce this source of volatility and uncertainty. After three years of depreciation, the economy nevertheless weathered substantial appreciation in 2004-05, which accentuated the relatively tight monetary policy settings. EU membership requires eventual adoption of the euro, which has to be preceded by participation in the exchange rate mechanism (ERM II), but the current government is reluctant to commit to any target date for entry. With sound monetary policy, the cost of delay may be small, mainly in the form of an additional currency risk premium. Yet, a delay gives the government more time to improve flexibility in product and labour markets and put public finances on a sustainable footing; it is important that this time should not be squandered by putting off these necessary reforms.

### *Fiscal policy should be progressively tightened, notwithstanding some confusion over measuring the state of public finances*

Public finances are not yet in a sustainable condition: the current level of the general government deficit is too high, and the government's plans as described in its Convergence Programme are not very ambitious. General government debt is not excessively high (at the end of 2005 it was about 48% of GDP, according to national definitions), but it is increasing. *The government should work towards a declining target for the debt-to-GDP ratio.* The constitution contains strong debt-limitation provisions, with mild constraints on policy kicking in when the share reaches 50% and a ratio over 60% requiring severe restraint. The force of these constraints was somewhat diminished by data revisions and methodological changes which recently reduced the official measure of the ratio. According to the January 2006 update of the convergence programme, the general government deficit – 4.7% of GDP in 2005, on the most appropriate definition (and recorded as 4.4% in recent revised data) – is planned to fall only to 3.7% by 2008; more progress than this should be feasible on the reasonable assumption of annual real growth averaging 4 to 5%.

However, revised national figures present a different picture, since the deficit was only 2.5% of GDP (and debt about 43%) in 2005. The gap is due to differences in the accounting treatment of contributions to open pension funds (OFE), after a major reform in 1999, which significantly improved public finances by both recognising implicit pension liabilities and taking steps to reduce them. But the reform would worsen the published deficit figure without a special temporary dispensation which, in the context of EU fiscal surveillance, treats contributions to OFE as government revenue. The dispensation expires in 2007. Therefore, despite the official deficit of 2.5% in 2005 and plans to cut it in the future, the EU Commission considers that Poland will have an excessive budget deficit, of nearly 4% of GDP, in 2007. The frustration for Poland is that few other EU countries have made such a pension reform, and, if they did, most would show deficits larger than Poland's. Yet the higher figure is a more realistic assessment of its budget deficit.

### *Better planning and spending control is needed*

Nevertheless, underlying economic growth is likely to provide sufficient revenue for some combination of faster deficit reduction, moderate but well-targeted increases in growth-enhancing public spending and tax cuts over time. The government *should identify clear expenditure priorities within a multi-year planning framework that includes limits on overall spending. Tax measures should be financed by paring low-priority spending, rather than slowing the pace of deficit reduction.* While the aforementioned pension reform improved the long-term fiscal position substantially, the gains have already been eroded by a concession to the miners. This was a step back which should not be repeated.

A large part of public spending is on social transfers, which are expensive, poorly targeted and have negative incentive effects on labour market behaviour, discussed further below. They have also proved politically difficult to change and, in the current fragile context for reform, may be even harder to amend. *Nevertheless, spending on social transfers should be reduced to make room for other priorities, such as health and long-term care, child care and education, and active labour market measures.*

Sufficient spending restraint would permit reductions in overall taxation without compromising deficit reduction efforts. This *Survey* does not offer any detailed suggestions for such reform, but three principles should be followed, for both social security and general taxes: *the tax system should be simplified to increase transparency and reduce administration costs for both taxpayers and collectors; the tax base should be as broad as possible – i.e. special provisions and exemptions for particular groups should be curtailed – to keep tax rates low; and every effort should be made to whittle down the tax wedge, especially for low income-earners, so as to reduce disincentives to taking up employment.*

### *Faster economic convergence requires action on human capital, in the labour market and on entrepreneurship*

Sound fiscal and monetary frameworks will be needed to ensure that income per head can continue to grow more rapidly than in most OECD countries. This convergence will require many structural changes in the economy, if labour and capital resources are to move to

areas where they are best used. For this process to accelerate, and for it to occur without too many people emigrating in the meantime, steps are needed to

- improve labour market functioning, increasing internal mobility and raising Poland's very low employment rate; and
- encourage Polish entrepreneurs to develop and expand their businesses so that innovation and investment flourish.

Pursuing these aims concerns many policies, and human capital development is vital to underpin them.

### *The education system needs both consolidation and development at the pre-primary, primary and secondary levels*

Important changes in many aspects of education were made in the 1990s. As far as compulsory education is concerned, performance (as measured by the PISA study) improved between 2000, when Polish performance appeared very poor relative to nearly all OECD countries, and 2003, when Poland moved into the group of middle ranking countries. This improvement can be at least partially ascribed to the effects of the reforms, notably the introduction of common national examinations and the change in the role of so-called basic vocational schools. A key motivation was to decentralise schooling to local government; *this new system should be further consolidated, with the emphasis on establishing clear lines of responsibility for the different agencies involved*.

An important component of successful education systems seems to be an appropriate balance between giving sufficient autonomy and responsibility to school principals and ensuring that they are pursuing the aims of national education policy. *Thus, principals should be given more administrative and financial autonomy to find ways to improve their schools' results, monitored by an independent, national, quality-control agency*. Because not enough is known about what kind of education produces the best results in particular circumstances, there should continue to be room for experimental approaches. *Measures of "value added" in individual schools should be calculated so that those responsible can assess the results of their policies.*

Primary education currently starts at age 7, with one year of pre-primary education only recently made compulsory. In view of the increasing international evidence of the importance of early childhood education for social development and educational attainment, *priority should be given to increasing participation in pre-school education at even earlier ages;* this would also help to raise female labour supply. For children over 15, vocational schools have become less popular, at the same time as employers continue to feel that many young adults finish school with insufficient skills. *Both the general and the vocational streams must improve their responses to their graduates' perceived difficulties on the labour market.*

### *Flexible re-allocation of teaching resources will be necessary*

Further improving the education system requires flexibility: some schools need to close, and some subjects or age groups need more teachers, others less. Falling student numbers

should theoretically free up teaching resources that can be re-allocated. The Teachers Charter, as modified in 2000, improved the career structure for teachers, *but employment security aspects of the Charter should not be allowed to obstruct restructuring*. Also, *the government should ensure that schools have sufficient flexibility to vary teachers' salaries according to teaching performance and recruitment needs*.

### *Following the rapid expansion of tertiary education, its financing needs to be re-organised…*

In 1991 there were about 400 000 tertiary students in under 90 higher education institutions (HEIs), all of which were in the public sector, but by 2005 there were 1.9 million students in over 400 HEIs, most of which are private. All private-sector students and part-time students in the public sector pay tuition fees, while the constitution prevents public HEIs from charging fees to full-time students. This asymmetry, especially in a period of budgetary stringency, makes it difficult for resources to be directed to where there is a need for public provision, and is a source of vertical and horizontal inequity. Many studies show that, although there are important social returns to tertiary education, the main benefits accrue to students themselves in the form of higher earnings. *Hence, an advisable reform would allow public HEIs to charge cost-related fees (not necessarily full-cost recovery) for all students, at the same time increasing the provision of grants to maintain accessibility. The student loan scheme should also be expanded, to be managed by commercial banks, but with the credit underwritten by the government and income-contingent repayment made through the income tax system*.

### *… and quality control and incentives further developed*

The growth in the number of private HEIs also left a gap in the accreditation and quality-control system. While the University Accreditation Commission concentrates on a relatively small number of elite institutions, the more recently established State Accreditation Committee (SAC) covers the rest. The SAC attempts to do more than simply verify compliance with technical requirements. Where a HEI receives direct budgetary support, SAC quality assessment is important; for wholly private-sector institutions there may be less need for much more than certification of basic standards. *SAC assessments should be widely publicised and kept up to date to help potential students in their choice of course of study*.

Maintaining and improving teaching quality relies on adequately motivated teachers. In many public-sector HEIs career structures are opaque and do not depend closely on either teaching ability or research output. This is self-defeating for the institutions concerned and may also discourage the young and able from choosing this career or remaining in Poland. *Career structures in tertiary education should be based on open competition and transparent promotion criteria*. To encourage high-quality researchers, *commercial links between HEIs and companies should be facilitated, including permitting flexible intellectual property rights arrangements*.

### *Adult training is insufficient…*

Polish companies do less training activity than those in most OECD countries, and a high proportion of it is financed by the employees themselves. This may be because, with the high level of unemployment, firms find they can generally recruit people with additional skills, or perhaps they do not appreciate the benefits of employee training for the company itself. Furthermore, a very high proportion of training is of people who are young and highly educated, suggesting a cleavage between a relatively small group of motivated people and the rest. Many international studies show that training leads to improved labour market outcomes. Hence, *public awareness campaigns to increase the take-up of training would be useful*, although public subsidy or other incentives to train the employed in general may not be justified. Companies in Poland have nevertheless recently been given a small tax incentive to set up training funds for their workers, but this legislation is too recent for its impact to be assessed.

### *… most particularly for the unemployed*

However, where Poland really stands out is in its meagre provision of training for the unemployed. This is one aspect of its more general under-use of active labour market policies (ALMPs). Appropriately targeted training is an effective way to increase employability. *Training programmes for the unemployed should be enriched*. Many unemployed – those over the age of about 40 and with few skills or skills for which the demand has fallen drastically (in mining and steel, for example) – are vulnerable, because their low level of general education makes retraining more difficult and the economic return from training harder to demonstrate. *However, in order to try to minimise the extent to which a "lost generation" is created, more effort should be devoted to looking for ways to help these people develop skills that will allow them to re-enter the labour market*. This will depend in particular on stimulating local labour offices, who are responsible for training of the unemployed, to look for such solutions. *Pilot training projects should be encouraged and carefully assessed for their impact*.

### *Policies are also needed to make work pay…*

While training will improve job prospects for many unemployed, they also need to have the right incentives to look for jobs. A large part of the population receives social transfers, some of which are generous relative to the average wage, with no job-search requirement. The disability pension scheme, which covers a significant share of the inactive, used to be a major culprit. Access has been tightened, and re-assessment of those previously given temporary pensions has succeeded in substantially lowering the stock of beneficiaries. However, nothing has been done to re-evaluate the condition of those who were previously given permanent pensions, even though many may be capable of some sort of work. *Recipients of disability benefits should be subject to regular monitoring of their work capacity. The right to social benefits for those who are able to work should be linked to the obligation to look for a job and to accept retraining when offered; for the longer-term unemployed, this may include willingness to move to another location where jobs are available*. These measures require a more active and responsible role for the public employment service (PES). *PES staff themselves should be better trained and be given incentives to improve performance*.

Access to other benefits, such as survivors' pensions, has not been touched, and pre-retirement schemes have grown rapidly, offsetting some of the positive impact of the reform of the disability scheme on labour supply; the average effective retirement age has actually fallen in recent years. *Pre- and early-retirement programmes should be fully phased out as previously intended.*

### *… and to increase incentives for mobility*

Other aspects of the social transfer system are also problematic for structural adjustment. The separate system of social security for farmers and their dependants (KRUS) is one of these. The high level of subsidy to KRUS creates a disincentive to leave the agricultural sector, despite its extremely low productivity. Even if farmers previously merited exceptional treatment, because of their low incomes or special position in society, this is no longer justifiable, particularly as subsidies from the EU Common Agricultural Policy are beginning to bolster agricultural incomes. *Farmers should receive treatment equal to, but no better than, those in the general scheme; in the longer run the two should be merged. At a minimum the fixed contribution approach used in KRUS should be replaced by a system of contributions proportional to income so that affluent farmers would pay more relative to their benefits.*

Neither employment protection legislation (EPL) nor the minimum wage are the major cause of high unemployment, but the popularity of short-term contracts and the probable extent of informal employment suggest that they can be obstacles for specific groups, such as the low-skilled and older workers, to price themselves into jobs. Moreover, given the likely magnitude and pace of structural change, Poland cannot content itself with *average* labour market flexibility; it needs to be *more* flexible than most:

- *The government should consider further easing EPL on both indefinite and fixed-term contracts. The prohibition on dismissing workers within four years of retirement should be abolished*, as it will serve to discourage employers from hiring older workers.
- The minimum wage, which has fallen to around 34% of average wages over the past decade, will increase substantially under a new indexation rule. Even though it is unlikely to reach the long-term target of 50% of the average wage in the near future, any substantial increase, combined with the high tax wedge, will keep many low-skilled workers out of a job. *The government should revise the rule so as to avoid an increase in the cost of unskilled labour. The current exemption allowing some young workers to be paid less than the minimum wage could be extended to apply to other groups, notably the long-term unemployed.*

### *The housing market is an important factor in geographical mobility*

Though labour market incentives are crucial in encouraging geographical mobility, the cost of finding accommodation can offset even quite significant income incentives to move. In the past, rent controls, security of tenure legislation and limited supply of new housing in areas of growing demand meant that these costs were indeed high. Most rent controls have now been abolished, but security of tenure legislation and legal delays if a landlord wishes to take court action are still a disincentive for owners to rent out their property. *While reasonable protection against abusive landlord behaviour should be retained, the level of tenant protection should be reduced and treatment of disputes by the courts accelerated. New housing*

*supply should be encouraged by allowing well planned urban development, not by subsidising mortgages, which will benefit mostly the already relatively well-off and further increase prices.*

### *The business environment has improved, but more should be done*

Previous *Surveys* have repeatedly criticised Poland for high levels of product market regulation (PMR) and other barriers to competition. Much has been done to improve the situation, especially in terms of reducing the costs of setting up businesses. Some of these changes were implemented after 2003 when the latest indicators showed Poland with the highest overall level of PMR, but it remains among the highest: the business environment is still not sufficiently conducive to entrepreneurship. The low share of investment in GDP is further evidence of a lack of confidence and obstacles to business activity. *Further reductions in regulatory and administrative barriers to entrepreneurship must be given priority.* Although corruption indicators do not form part of the PMR comparisons, Poland has the worst reputation for corruption among OECD countries on the more informal indicators published by respected non-governmental organisations. *The government should persevere with attempts to eliminate corruption, as it is a disincentive to both domestic entrepreneurs and potential foreign investors.*

OECD indicators show that Poland's product market competition suffers especially from the high level of public ownership. Privatisation policy has been dilatory in recent years, and a recently resolved dispute about a banking merger between two foreign-owned banks has encouraged the view that the current government favours retaining a major State influence in this and possibly other sectors; this has unfortunately also created perceptions of an ambivalent attitude to foreign investment. *Privatisation should be pursued more vigorously, retaining public stakes only where there is a genuine public or security concern based on consumer welfare, not on protecting producer interests.*

### *Innovation benefits from openness to ideas and foreign investment…*

Business expansion and technical progress are often thought to depend on high levels of research and development (R&D) expenditure, and indeed this is how the frontiers of technology are pushed out. R&D in Poland represents a smaller share of GDP than in any other OECD country. Not all countries with low shares of R&D grow slowly, however. Although, for a low-income country like Poland, targeting increases in R&D expenditure on basic research would be a mistake, studies show that R&D activity can help existing technologies to be absorbed more easily. But most Polish R&D is currently undertaken in the public sector, especially in specialised research institutes. *Public unconditional finance for these institutes should be reduced, and they should be increasingly required to finance themselves through competitive project selection and commercial joint ventures; similar methods should be applied to the research side of HEI activities.*

New ideas need not mean new technology; improvements can often be achieved with innovation in design, marketing or work organisation. In addition to investment in human capital that improves absorption and dissemination of innovative ideas, discussed earlier,

this means ensuring that Poland is open to new ideas from abroad. *The government should re-affirm its commitment to the involvement of foreign enterprise on equal terms.*

*… while public initiatives may stimulate private funding of innovation*

Ideas also need to circulate freely within Poland, and the regional networks operated by or linked to PARP, the agency for enterprise development, are a good tool for giving access to information and advice to the many Polish SMEs. *PARP should be encouraged to develop its networks, and they should be co-ordinated or preferably merged with other similar networks – those related to agriculture, for example.*

The 2005 law on support for innovation has a number of useful ideas for improving the flow of finance to potential innovating companies. In putting it into operation, *the authorities should try to leverage private finance, involving venture capital companies, and take care to monitor different approaches for their effectiveness, retaining what works and discarding what does not.*

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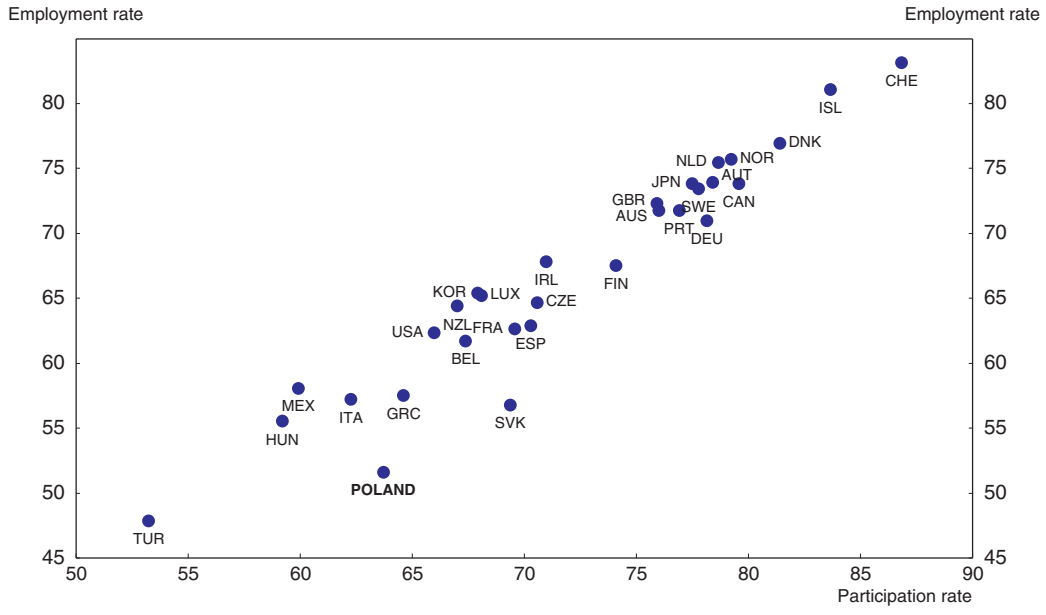
*Chapter 1*

# Key challenges

*Although inflation appears to have been controlled, and at least moderate economic growth has resumed, Poland faces important macroeconomic challenges in ensuring fiscal sustainability and aligning fiscal and monetary policy with the requirements for adoption of the euro. Its labour market performance is the worst in the OECD, with both low participation and high unemployment. Aspects of social and labour market policy and a poor business environment, including pervasive public ownership and weak framework conditions for entrepreneurship and innovation, seem to be behind this sub-standard performance. Although the education system has seen important progress over the last 15 years, there remain a number of areas where pursuing further reform in human capital development could contribute to improved labour market outcomes, faster productivity growth and greater equity.*

Poland has the second lowest ratio of employment to working-age population in the OECD, when measured by official statistics, and only four Member countries have lower overall participation rates (Figure 1.1); the result is that it also has the highest unemployment rate, at around 18% of the labour force. All the main policy targets of the current government, formed after elections in late 2005, are to some extent either dependent on increasing activity rates or linked with policies that influence labour force participation. Securing long-term sustainability in public finances will be difficult without raising employment levels both to provide a larger revenue base and to reduce social transfer commitments. Improving per capita income levels and closing the gap with euro-area standards of living requires increasing trend productivity growth, but in the short to medium term large gains could also be made if a greater proportion of the population were involved in productive activity. This chapter provides an overview of these issues, and Annex 1.A1 summarises steps that Poland has taken in the context of recommendations in previous *Surveys*, while subsequent chapters consider in more detail the challenges for fiscal and monetary policy, for education and training, and finally for policies related to improving the allocation of resources and increasing their productivity.

Figure 1.1. **Employment and participation rates in OECD countries**
2004 or latest year available[1]




1. 2003 for the Netherlands.

*Source:* OECD, Analytical database.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## Growth has strengthened again

After two years of very slow growth and rising unemployment up to 2003, GDP accelerated in 2004 with demand supported both by exports and by the expansion of public consumption (Table 1.1). For some time, increasing output growth was not reflected in labour market outcomes, and by the time employment started rising at the end of 2004, output growth itself was slowing again. Although this came after the monetary tightening of mid-2004, it is likely that it represented a "technical" slowdown after the boost to activity around the time of EU accession (May 2004); the monetary tightening may nevertheless have slightly delayed a recovery in growth, which seems to have started coming through in the second half of 2005. At 3.2%, GDP growth in 2005 fell short of potential (which is growing at about 4% per year, maybe a little more, according to most estimates). Potential growth has been restrained by sluggish investment, despite increased profits and the booming stock market (which rose over 90% between the end of 2003 and March 2006). However, there may have been a pick-up late in 2005.[1]

Table 1.1. **Recent trends**
Year-on-year percentage change, volume

| | Average 1995-2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 |
|---|---|---|---|---|---|---|---|---|
| Private consumption | 5.9 | 2.1 | 3.3 | 1.9 | 3.9 | 2.1 | 3.0 | 3.7 |
| Government consumption | 2.4 | 2.7 | 1.3 | 4.9 | 4.2 | 4.2 | 3.8 | 3.8 |
| Gross fixed capital formation | 12.8 | –9.7 | –6.3 | –0.1 | 6.3 | 6.2 | 9.0 | 8.5 |
| **Final domestic expenditure** | **6.7** | **–0.3** | **1.1** | **2.1** | **4.4** | **3.2** | **4.2** | **4.6** |
| **Total domestic expenditure** | **6.7** | **–1.4** | **1.0** | **2.7** | **5.9** | **2.1** | **4.4** | **4.6** |
| Exports of goods and services | 11.5 | 3.1 | 4.8 | 14.2 | 14.0 | 8.1 | 9.0 | 9.2 |
| Imports of goods and services | 16.6 | –5.3 | 2.7 | 9.3 | 15.2 | 4.9 | 8.7 | 9.1 |
| **Foreign balance**[1] | **–1.2** | **2.6** | **0.5** | **1.1** | **–0.8** | **1.1** | **0.1** | **0.0** |
| **GDP at market prices** | **5.4** | **1.1** | **1.4** | **3.8** | **5.3** | **3.3** | **4.4** | **4.6** |
| Consumer price | 12.6 | 5.4 | 1.9 | 0.7 | 3.4 | 2.2 | 1.0 | 1.7 |
| Unemployment rate | 12.9 | 18.2 | 19.9 | 19.6 | 19.0 | 17.7 | 16.8 | 15.7 |
| Total employment | –0.4 | –2.2 | –3.0 | –1.2 | 1.3 | 2.3 | 2.3 | 2.4 |
| Labour productivity | 5.8 | 3.4 | 4.5 | 5.1 | 3.9 | 0.9 | 2.0 | 2.1 |
| Current account (per cent of GDP) | –3.7 | –2.8 | –2.5 | –2.1 | –4.2 | –1.5 | –1.6 | –1.7 |

1. Contribution to GDP volume growth.
*Source:* OECD (2006), *Economic Outlook No. 79*.

Prospects for 2006 seem brighter. Industrial production accelerated during 2005, rising almost 10% in the year to December, though the annual average increase was still under 5%, and employment growth appears to have continued into early 2006. Although the profitability of non-financial companies declined somewhat in 2005, falling interest rates and still adequate rates of return have meant healthy cash flows, and it seems likely that this will boost investment in coming quarters. Similar hopes at the beginning of 2005 were unfulfilled, however, as enterprises preferred to accumulate short-term financial assets and pay off debt. However, the fact that employment has been rising fairly consistently since late 2004 may reflect improving optimism among firms, who may therefore be more likely to expand capacity.

The good performance of exports, which rose 6% in zloty terms in 2005, occurred despite exchange rate appreciation – they rose almost 20% in euro terms. Imports rose almost equally fast, reflecting both the substantial import content of Polish exports and,

despite high unemployment, less spare capacity than one might think. Most categories of trade have grown at similar rates. Entry into the EU does not seem to have had much impact on the product composition of trade (at an aggregate, 1-digit SITC, level): for example, the export share of food products has risen slightly but remains below its 1995 level. The current account deficit has tended to diminish, aided by transfers from the European Union but also by a shrinking shortfall in net exports of goods and services.

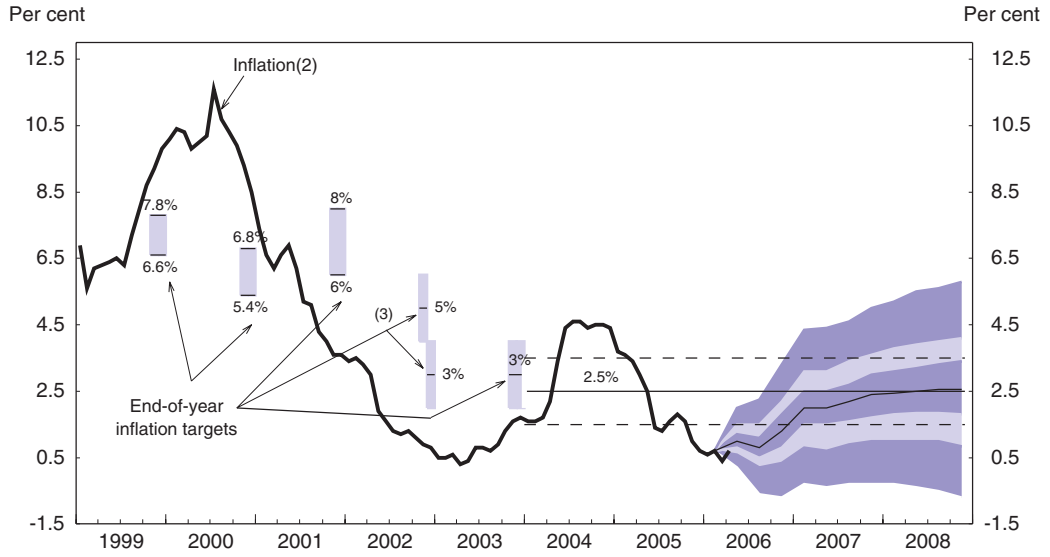
### *Inflation has been low, in part because of tight monetary settings*

Inflation developments have been particularly interesting. Monthly inflation rose in the spring of 2004, prompting calls from many commentators, including the OECD, for some monetary tightening, even though the exchange rate had recently begun a recovery from the decline that had started in 2001. The National Bank of Poland (NBP) monetary policy committee took the same view and increased interest rates by 1.25 percentage points between May and August; the increase in inflation turned out to be temporary, and "headline" inflation, measured over the previous 12 months, has been below the lower end of the NBP's 1.5-3.5% target since mid-2005. It has been quite difficult to interpret underlying price inflation, with the inflation outturns undershooting most forecasts, notably those of the NBP, for most of 2005. This is due partly to a succession of special factors, especially for food prices – such as Russia banning imports of food from Poland in November. Yet underlying inflation has been very low, too, with the two main "core" inflation indicators monitored by the NBP growing only 1% in the year to December 2005, and by only 0.7% in the year to March 2006.

While price inflation has been unexpectedly low, wage data are more mixed. Data for the second half of 2005 were distorted by unusual bonus payments in certain industries, and there is considerable variation across industries and sectors (and between the two main statistical series published by the CSO), so it is difficult to be certain about the underlying rate. But, ignoring those industries with data difficulties,[2] average wages rose by over 4% in the year to December, meaning real increases of 3% or more. This pick-up in wage growth in industry during 2005 initially coincided with very low productivity growth, so that unit labour costs (which had been falling since mid-2002) picked up noticeably in the first quarter. Experience varies in other sectors but, overall, unit labour costs have been growing substantially since mid-2004, slowing somewhat in late 2005.

The share of wages in GDP, though probably not well measured in official statistics, had declined between 2002 and 2004, considerably improving average profitability in Polish companies. Although this did not lead to the anticipated increase in investment, it may have helped fuel the stock market boom which continued into 2006, despite declining inflation and increasing wage growth. Difficulty in reconciling this apparent pick-up in wage pressure with low price inflation may be one of the reasons why the NBP, having reduced interest rates in mid-2005 by more than they were increased in 2004,[3] made no further reductions until early 2006, when it became convinced that underlying inflation really was likely to remain below 1.5% for some time (Figure 1.2). The apparent focus on keeping inflation very low, rather than allowing it to vary around the mid-point of the inflation target, makes it look as though the NBP may be treating its inflation target asymmetrically, showing more concern about overshooting than undershooting. There has been much public debate as to whether the central bank's mandate, or even its independence, should be modified. This is taken up in Chapter 2, along with discussion on the timing of adoption of the euro; while the new government has given this a low priority, the NBP believes that early adoption would be beneficial.

Figure 1.2. **Inflation and inflation targets**[1]




1. Figures for the inflation forecast "fan" chart are taken from the April Inflation Report but are approximate because the National Bank of Poland does not release precise data.
2. Consumer price index: 12-month percentage changes.
3. The 2002 end-of-year inflation target was changed to 3 ±1 per cent on 26 June 2002.

*Source:* National Bank of Poland, Central Statistics Office and OECD estimates.

### *Efforts to control spending and rein in the budget deficit could be more ambitious*

Slowing growth and declining inflation in 2005 suggest that the economy was falling further behind its potential growth rate. This is often bad news for the fiscal position, as cyclically sensitive revenues slow and expenditure usually rises. In fact, the budget deficit improved, and to a greater extent than projections made by the government in early 2005 which were thought by many at the time to be rather optimistic. If this performance were repeated in 2006, it might seem that long-term sustainability of government finances was within relatively easy reach, with a debt/GDP ratio below that of many other European countries and the deficit/GDP ratio on a declining path, even with growth about 1 percentage point below potential.

It might be premature to be optimistic, however, although it is certainly true that the fundamental pension reform introduced in 1999 substantially improved the long-term financial situation. Although the deficit was lower than expected in 2005, one reason for this is the surge in tax revenues, which is not expected to continue. Moreover, public expenditure is dominated by social transfer programmes, and past attempts to control these have not been very successful. EU funds require careful treatment: although they are a major benefit to the economy, they can worsen the budget deficit (due to the need for matching funds), if overall expenditure is not carefully managed. The Convergence Programme to 2008 projects a declining share of public expenditure in GDP over the next three years, but expenditure planning is still made on a year-to-year basis. Some plans are being made to move to a more forward-looking approach, but measures have yet to be announced that are sufficient to achieve the necessary control of expenditure.

Without better control of public expenditure, the government's plans to reduce the overall level of taxation, which could also help to reduce their adverse effects on

incentives, especially in the labour market, cannot be achieved without threatening the chances of reducing debt levels. Quite apart from the overall level of taxation, the current tax system is complicated and administratively expensive; without more room for fiscal manoeuvre, tax reform is difficult. Chapter 3 looks at these fiscal issues. Discussion of policy making in general, not just as regards macroeconomic policy, could be improved by more accessible official statistics (Box 1.1).

### Box 1.1. **The flow of information: Official statistics**

A different aspect of the flow of information is the provision of official statistics. Poland's statistical collection system is comprehensive, and underlying statistics are generally reliable. Getting a complete picture from *published* statistics is, however, more difficult than in many OECD member countries, even taking account of language differences; and it is the OECD Secretariat's impression that some of these difficulties apply not only to outsiders but also to policymakers themselves, when looking for information from other ministries or agencies, for example. A full analysis of these problems will not be a priority in this *Survey*, but the following examples may be noted:

**Presentation.** Publications and bulletins often present rather short time series, with a preference for presenting derived statistics (rates of growth of various kinds) rather than the underlying data. Where longer time series could easily be supplied, as in on-line publications, they are generally provided in a not very user-friendly manner, such as separate files for each year of data or awkward formats within individual files.

**Revisions.** Revisions to some kinds of data are inevitable. But the amount of revision in public finance data, especially relating to accounting for changes in the stock of debt, which are rarely presented with the same breakdown from one occasion to the next, are excessive. Also, following revisions in the 2001 census, there are two ways of estimating the numbers employed in agriculture; one is about 2 million lower than the other. At least one publication presents a related series, the number of people earning their living in agriculture, showing a fall of over 2 million between 1998 and 2002, with no note of a change in definition.

**Availability.** Clearly some information is confidential, and not all that is not confidential needs to be published. But not publishing data on "core" price inflation at the same time and in the same publications as standard consumer price data is surprising (the Central Statistical Office publishes "headline" inflation data but no core series, the NBP publishes core series only). Nor is it clear why NBP inflation forecast data used to present the published "fan chart" should be confidential (see Figure 1.2). Separately, the Finance Ministry released data necessary for understanding the evolution of the government debt stock in the Convergence Programme for only one year, 2006, limiting the ability of the discussion in Chapter 3 to assess this issue.

## Faster growth requires higher rates of investment…

As argued above, unit labour costs give a different picture from prices in interpreting the level of capacity utilisation. Estimates by the Finance Ministry and by the central bank suggest that the level of potential output is only about 1-1½ per cent above the current level of GDP. This would probably be consistent with the low underlying rate of inflation, which might also be expected given high albeit moderately declining unemployment. But it is less easy to reconcile with accelerating real wage costs, suggesting that even the current high level of unemployment is, at best, not far above the NAWRU. Other data on capacity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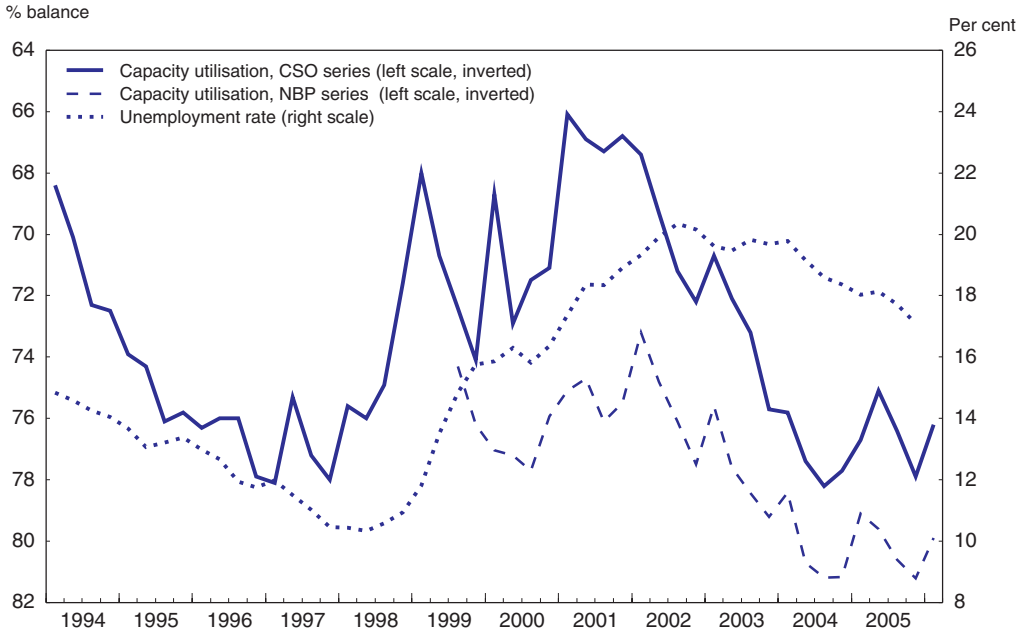
utilisation in industry also suggests more pressure on supply potential, in fact more than at any time since 1997 (Figure 1.3). Excessive product market regulation (see Chapter 5) is also probably inhibiting investment (Figure 1.4), contributing to a lack of capacity.

Figure 1.3. **Capacity utilisation and unemployment**

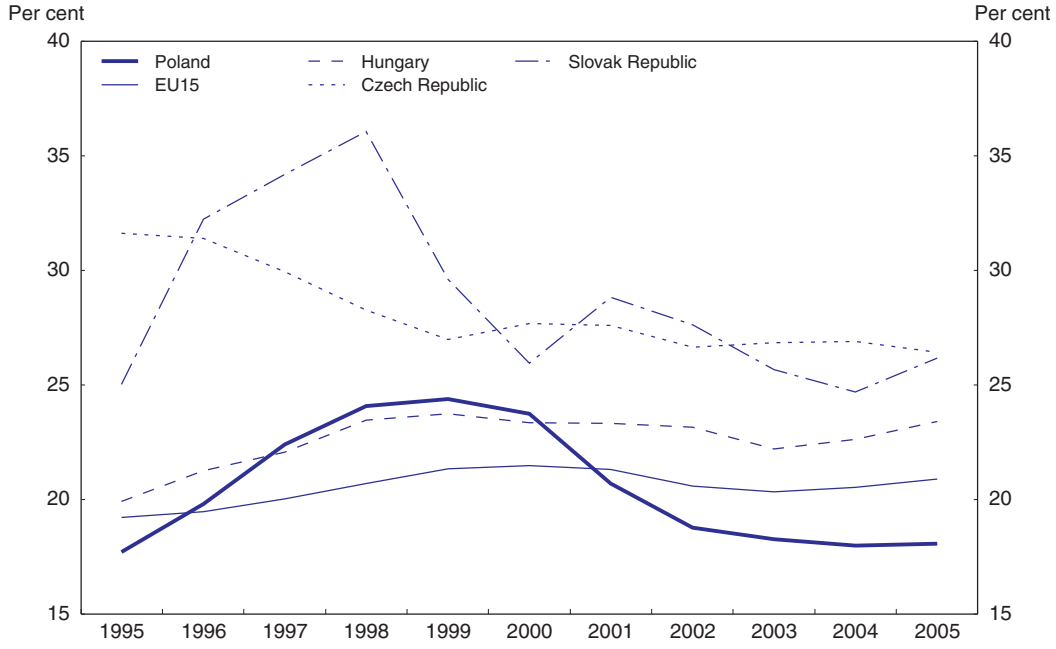



*Source:* Central Statistical Office, National Bank of Poland and OECD Analytical Database.

The simplest conclusion to draw from the different evidence is that pressures on capacity vary considerably in different parts of the economy, so a single overall measure of potential output is bound to be misleading. This would not be surprising for Poland. After nearly two decades of "transition", the broad structure of output has changed substantially (Figure 1.5). But structural change will continue, as analysis of the sectoral allocation of labour indicates. Most EU15 countries have fairly similar sectoral patterns of employment, and measures of the "distance" of one country's sectoral structure of output and employment from another's show that Poland's is still quite a long way from the typical pattern (Table 1.2).

The index of restructuring shown in Table 1.2 calculates the proportion of the labour force that would have to change sector to make the sectoral allocation identical to that in the reference country (the United Kingdom in this case). Such rather crude calculations (they cover only nine broad sectors) do not imply that the current structure is inappropriate but show that a considerable amount of restructuring has occurred. The index of restructuring for the Netherlands, whose employment structure might not be expected to be very similar to the United Kingdom, is very low. This suggests that more restructuring is likely in Poland if its convergence process is to bring its structure towards those of the United Kingdom and the Netherlands.

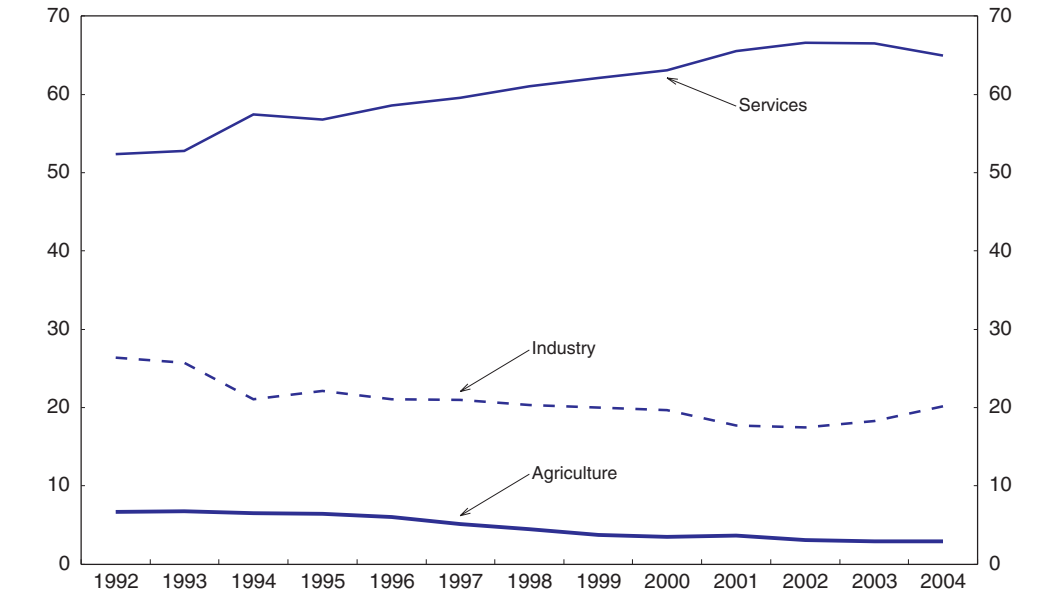
Figure 1.4. **Fixed investment as a share of GDP in selected countries**




*Source:* OECD Economic Outlook 79 database.

Figure 1.5. **The structure of value added**

Per cent of total




*Source:* OECD, Annual National Accounts database and OECD estimates.


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Table 1.2. **Structural differences in employment**

Per cent

| | Poland | | Czech Republic | | Slovak Republic | | Slovenia | | Hungary | | The Netherlands | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | 1994 | 2002 | 1994 | 2002 | 1994 | 2002 | 1994 | 2002 | 1994 | 2002 | 1995 | 2002 |
| Indicator of distance from UK structure | 53.7 | 39.1 | 48.3 | 41.1 | 48.4 | 42.0 | 58.3 | 46.9 | 41.2 | 32.8 | 17.6 | 13.1 |
| Excluding agriculture | 39.2 | 27.0 | 46.1 | 40.1 | 44.5 | 40.4 | 51.9 | 41.0 | 37.6 | 30.5 | 16.2 | 13.2 |
| Index of restructuring | 30.1 | 22.1 | 22.9 | 18.4 | 23.8 | 18.6 | 28.6 | 22.6 | 20.0 | 15.2 | 6.5 | 1.6 |
| Excluding agriculture | 16.5 | 10.5 | 20.7 | 17.3 | 20.1 | 16.8 | 23.1 | 17.7 | 16.6 | 13.0 | 5.4 | 1.5 |

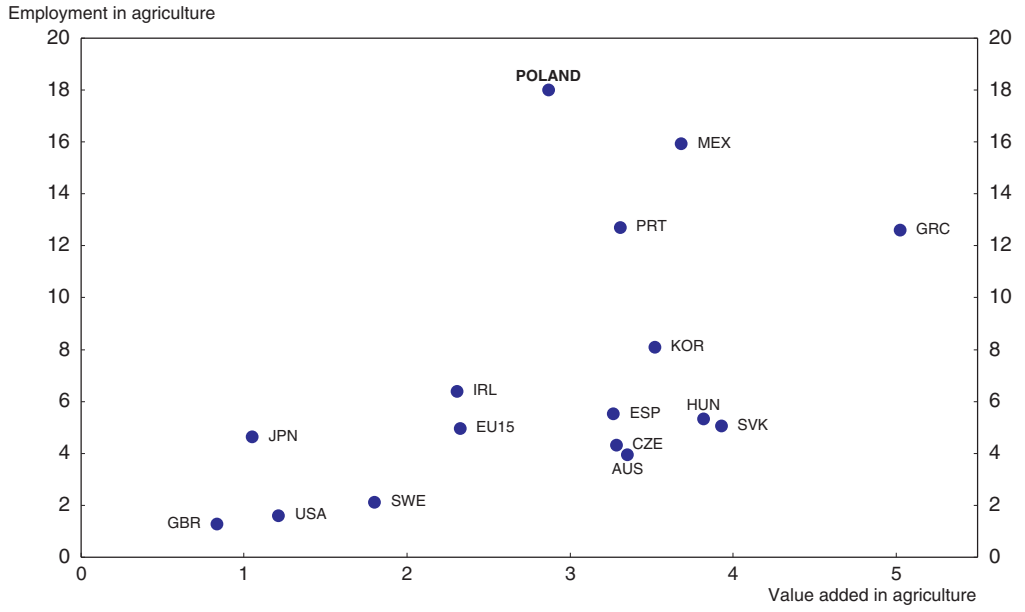
*Note:* The distance measures shown in the table give an indication of the size of the difference in the sectoral allocation of labour in the countries shown from a reference country, in this case the United Kingdom. Choosing other reference countries among the major EU member countries made little practical difference, and data availability made it difficult to use an EU average.
*Source:* ILO database, OECD calculations.

## ... and further structural change

This restructuring should help to increase overall productivity growth, as labour (as well as entrepreneurial and capital resources) moves to higher productivity sectors. In Poland, the share of the labour force occupied in agriculture is exceptionally high – almost 17%, excluding those not producing mainly for the market (who may be another 10%), though including many smallholders (about 3% of the labour force) – while its contribution to GDP is only 3% (Figure 1.6). It would therefore seem that shifts out of agriculture could increase average productivity significantly. In the five years after Portugal and Spain (which also had a large share of the population in agriculture) joined the European Union, shifts between broad sectors contributed less than 1% to average annual productivity growth; between 1996 and 2002 the figure in the used four Visegrad countries[4] was about half a per cent. While this is much more than in countries such as France and the

Figure 1.6. **Employment and value added in agriculture, selected countries**

Share of total, 2004 or latest year available,[1] per cent




1. 2003 for Australia, EU15, Japan and Portugal.

*Source:* OECD, Annual National Accounts database, OECD, Annual Labour Force database and Eurostat database.

United Kingdom, intra-sectoral productivity growth contributed six or seven times more. Some intra-sectoral growth is itself due, of course, to people moving from one firm to another more efficient firm within the same industry.

For Polish living standards to continue to catch up with those of the better off EU member countries, in addition to a good balance of macroeconomic policies, a combination of other policies will be required. Relevant policies include those acting directly on the labour market, through fiscal or regulatory measures; on labour quality, through education and training; product market regulation that can affect competition and entrepreneurship; research and development and innovation policies; sectoral and

### Box 1.2. **Structural adjustment and the environment**

Between 1990 and 2002 environmental indicators in Poland improved, notably those relating to air pollution, including greenhouse gases (GHG). The most recent OECD Environmental Performance Review (OECD, 2003) noted that in the late 1990s Poland successfully "decoupled" economic growth from pollution emissions. This is not because environmental concerns have been particularly well embedded into economic policy settings, but because some of the most polluting firms have been among the least profitable, and many have closed or shrunk. However, although overall pollution levels *per capita* have fallen to moderate levels, they are less so when compared with average incomes. Considering carbon dioxide ($CO_2$) emissions, for example, although per capita emissions are about the same as in France, and lower than in countries such as Germany, the United Kingdom and Spain, emissions per unit of GDP (measured at purchasing power parity exchange rates) in Poland are much higher than in any of these countries and among the highest in the OECD. With rapid economic growth it will be important that regulatory and – preferably – price signals are set so as to avoid emission levels rising sharply.

This is not yet the case in the energy sector. Coal mining, the source of the most heavily polluting fuel currently used in Poland, is still subsidised. Recent increases in coal prices have allowed many mines to move into operating profit, and the more efficient ones could probably expect to expand output if prices stay high. Poland is unlikely to exceed its GHG emissions limit under the Kyoto Protocol, with current emissions about 20% below the allowed level for 2008-12, but it could do more to prepare to participate in emissions trading; recent prices in the fledgling market for $CO_2$ emission allowances were around $25 per tonne, equivalent to around $80 per tonne of coal, higher than the price at which Poland exports coal.* This price for emission allowances may be part of a speculative bubble, but even at half this level it probably exceeds the profit from mining coal and selling it to domestic users.

Little has yet been done to align the economic incentives of either consumers or producers of energy to the implications of the Kyoto Protocol. The domestic trading scheme has not yet been established, allowances have not been allocated to enterprises, and there are no plans for a $CO_2$ tax on sectors not allocated emission allowances. The National Reform Programme for 2006-08 discusses energy and the environment in the context of innovation and R&D, noting the lack of resources for research, but does not propose measures to internalise the environmental cost of emissions in order to generate incentives for such research.

* The export price was $50 to $55 per tonne in 2005. The emission allowance price was observed in the European Trading System, in which Poland is not in fact eligible to participate.

regional policies. These are discussed in two further chapters: Chapter 4 provides an in-depth view of education and training, while Chapter 5 covers a range of other issues. The environment is not given specific attention in this *Survey*; structural change has been environmentally beneficial in general, but more could be made of the opportunities, as well as the constraints, provided by, for example, the Kyoto Protocol (Box 1.2).

## Labour market performance suffers from inappropriate policy settings

As mentioned, labour market outcomes remain poor as seen in high unemployment and low participation, resulting in the second lowest employment rate in the OECD. The low employment rate has various origins: structural transformation in the 1990s, the collapse of important markets after the Russian crisis at the end of the 1990s and the period of weak growth in many OECD countries after 2001. While the impact effects of these events have run their course, the labour force structure and labour market and other policies have made it difficult to reduce unemployment. It stood at nearly 18% at the end of 2005, down from over 19% in 2004 but still very high. This is partly due to employment protection legislation (EPL), although this is about average for European countries, and may also be affected by the minimum wage, though this too is not (yet) particularly high. The marked regional variation in wages may make the minimum wage a significant constraint in some regions, even if it is not binding in more prosperous areas. But neither EPL nor the minimum wage is probably the main source of the problem.

Rather, performance seems particularly harmed by some aspects of the social security and benefit system that have a particularly negative impact on work incentives – disability pensions and benefits, and early retirement schemes; furthermore, partly because of a lack of training but also because the legislation provides few incentives, the public employment service is not very effective in helping benefit recipients to find work or in ensuring that they make efforts to do so. Reform of the disability schemes has greatly reduced inflows and should also increase outflows, as benefits are no longer granted permanently. But many people remain on permanent disability pensions who are able to work; the system is both a disincentive to work and a fiscal burden. Legislation restricting subsidised early retirement was passed in 2004, to take effect in 2006, but implementation was subsequently delayed until 2007. The miners protested vigorously against the section of the legislation that reduced their rights to special treatment and this part was withdrawn by the parliament, allowing them to continue to retire after 25 years underground. After the government withdrew its challenge to this in the constitutional court, it was taken up by an employers' organisation, but the constitutional court ruled that it had no standing in the matter. Other social groups are now claiming similar rights to the miners. Policies related to the labour market are discussed in Chapter 5.

A separate social security system (KRUS) applies to farmers, or those who claim attachment to farming. Its generosity has long been criticised, and the previous government introduced a reform plan, which unfortunately did not get through parliament. Agriculture is important both because of the number of people in it and because it is attracting substantial EU funding. Direct payments encourage farmers to stay on the land, and other EU funds for rural development will need to be spent carefully, so as to promote general rural development and not be channelled into unnecessary support for agriculture. Polish agriculture has a bright future as a low-cost supplier, provided its wage cost advantage is not more than offset by poor productivity trends.

Many people may eventually be displaced from agriculture – in Ireland and Spain, the sector's share of employment halved between 1988 and 2000. Farming is often thought of as a buffer for labour displaced from other industries. Furthermore, in most rural areas, where unemployment is generally higher than in urban areas, recorded unemployment among those attached to the land is *lower* than among the non-agricultural population. The links between agriculture and the rest of the economy are thus complicated. Policies need to focus not on the sector itself, but on improving the ability of people to move to other sectors or to other parts of the country, while at the same time offering farmers who want to expand the same kind of support networks available to entrepreneurs more generally (see below).

## The education system needs strengthened quality control and more focus on the labour market

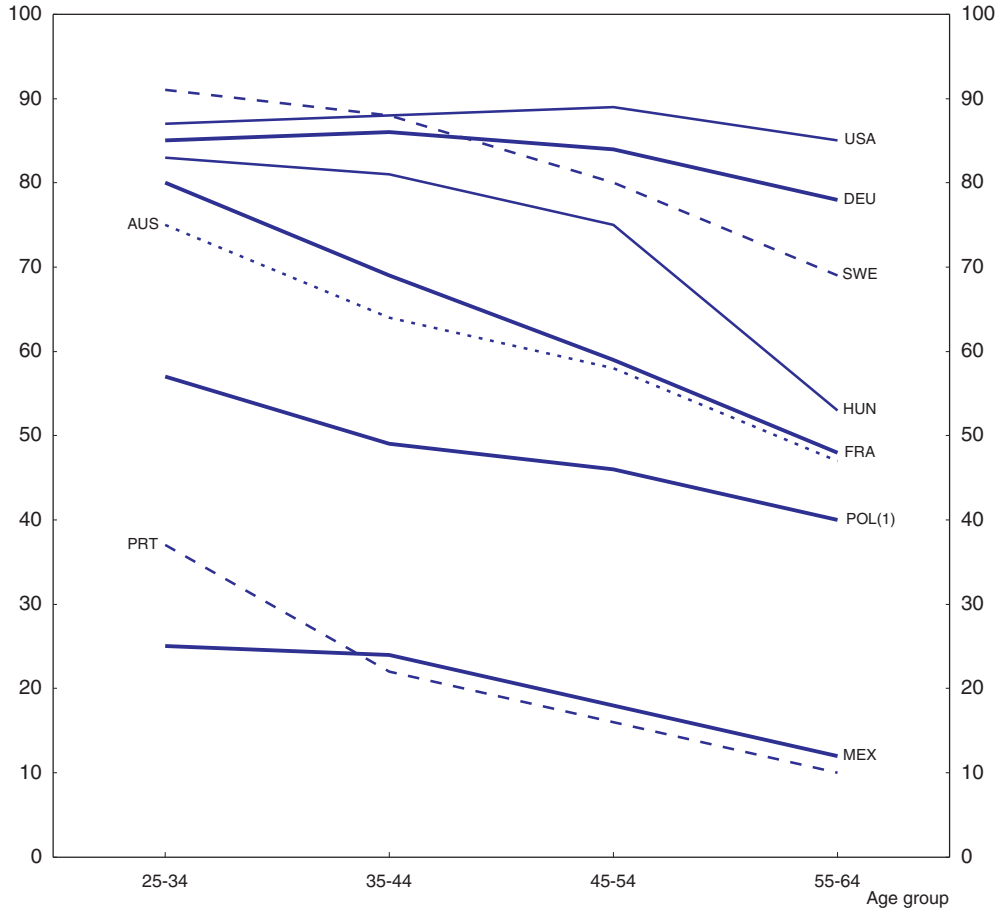
An important problem is that people "attached" to agriculture are difficult to re-employ in other sectors if their level of education or training is too low or inappropriate. This is a problem for most unemployed and for many who are currently employed but working for firms that may close or shed labour as part of sectoral restructuring. The education system previously aimed at producing workers who were well trained for particular industries, but the value of general education and flexible problem-solving ability was less appreciated. Despite the major educational reforms in the 1990s, many workers over 40 are particularly vulnerable to unemployment through their lack of general educational attainments (Figure 1.7) and, in particular, of skills needed for jobs in expanding sectors.

At the other end of the scale, fewer children are following the vocational stream in secondary schooling, preferring what is often thought to be the better education provided in "general" schools. But employers' organisations argue that graduates from the general secondary schools often have too few of the skills they would like to see in young recruits. One reason the vocational schools have become less attractive is that many were mainly directed towards providing workers for industries (*e.g.* coal mining) that are now shedding labour rather than hiring; the facilities of many such schools were provided through enterprises that may now have shrunk or closed: equipment is frequently out of date or inappropriate.

For its part tertiary education has expanded enormously, with nearly 2 million students and over 400 higher education institutions (HEIs) compared with about 400 000 students in under 90 HEIs 15 years ago. This expansion has created a striking gap between the educational levels of the younger working-age population and their older counterparts. This is also the case in a number of other OECD countries, and Poland still lags behind even in the younger cohorts (Figure 1.8). The rapid expansion has led to debate on the balance between quality and quantity and on the structure of tertiary-level financing.

Since most of the expansion has come in new private-sector HEIs, a majority of students pay tuition fees. In the public sector, which includes the majority of the most sought-after institutions, the constitution prevents tuition fees being charged for full-time students (though part-time students do pay fees). The more prestigious institutions are therefore oversubscribed and select the most qualified students who usually come from more affluent backgrounds, but at the same time they are constrained in funding expansion or quality improvements. There is strong resistance to charging fees where

Figure 1.7. **Educational attainment by age**
Population that has attained at least upper secondary education
Percentage, by age group, 2003




1. Data for Poland do not include students who completed only basic vocational schools (Szko a zasadnicza dia m odzie y), classified as ISCED 3C programmes.

*Source:* OECD (2005), *Education at a Glance.*

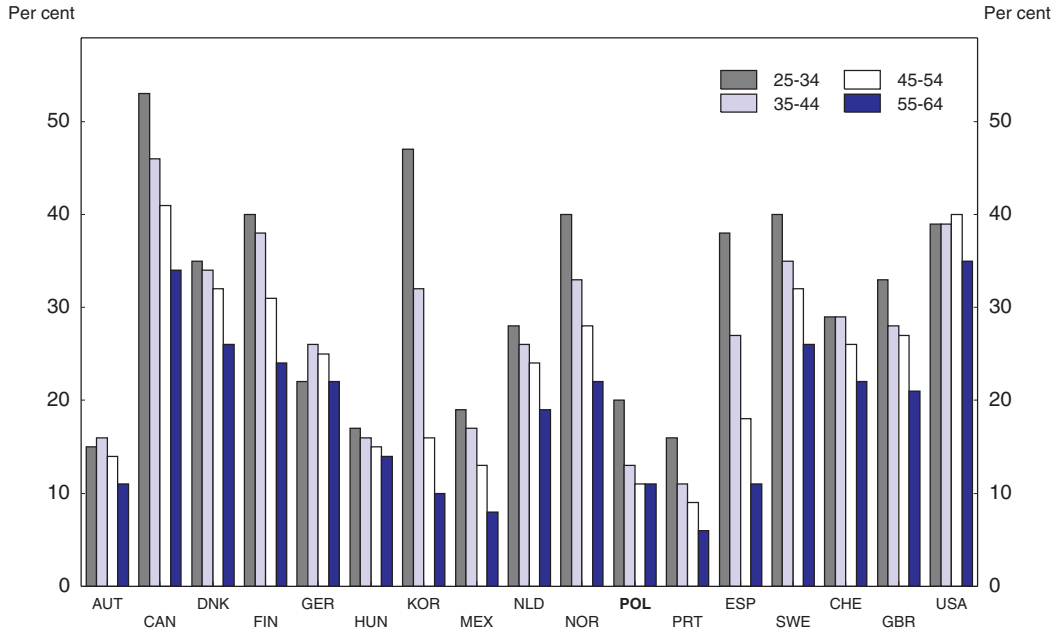
tuition has traditionally been free. Fees would be more acceptable if the system of student support were better developed. Maintenance grants are already available, and there is a student loan scheme, but neither seem to function very well: take-up of loans is minimal.

A recurring theme at all levels of education – whether at primary and secondary schools, or in the tertiary sector – is the need to improve (and define) quality and value for money. While this is easier said than done, Chapter 4 provides an in-depth discussion of the evolution of the Polish education system, with particular attention focused on quality and on its links with the labour market.

## Adult training is insufficient, especially for the unemployed

Chapter 4 also discusses adult *training*, which often overlaps with the formal education system. The groups with the highest probability of undergoing training are relatively young, well educated and employed. The first two, though not the third, of these

Figure 1.8. **Tertiary education by age group**
Proportion of population with tertiary education, 2003




*Source:* OECD (2005), *Education at a Glance.*

observations are common among OECD countries, but the differentiation is much more marked in Poland (see Figure 4.6). Many countries emphasise training or re-training for the unemployed, and it is increasingly an obligation if they wish to continue to receive full social benefits. This is not the case in Poland, partly because resources are absorbed by passive social benefits such as the disability allowances and early retirement pensions mentioned earlier. To some extent, it might seem that Poland has made the choice – but it is not clear that it has been a deliberate choice – to concentrate training resources on those who are already more employable, while accepting that a significant proportion of the older population will never be employable, so that it is not worth using scarce resources to retrain them.

## Is entrepreneurship lacking, or is it suffering from a poor business environment?

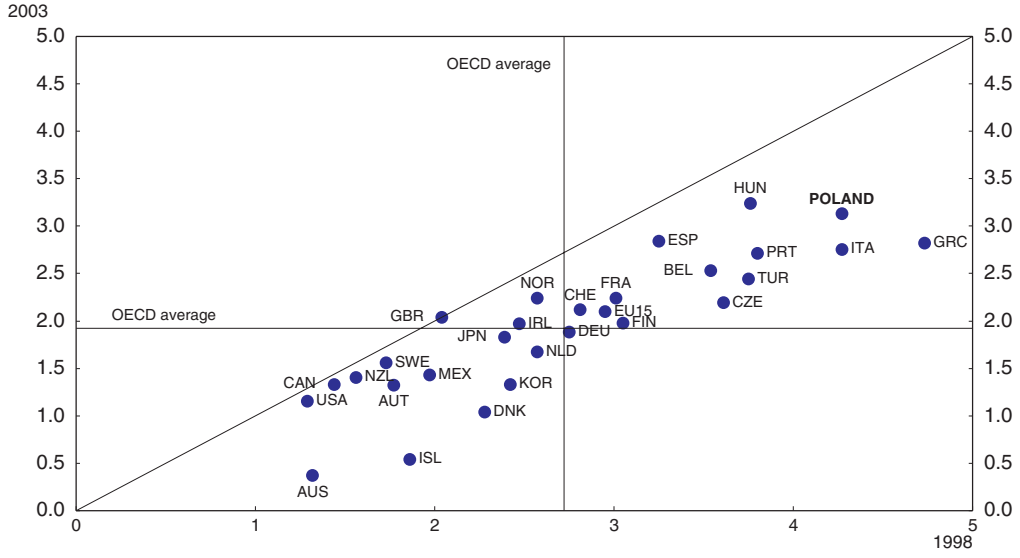
There are some indications that the "supply" of entrepreneurship is lacking. The low level of investment has been mentioned and, while inflows of foreign direct investment (FDI) have been substantial, since 2000 they have been lower than in other former transition countries. FDI inflows have averaged 3.5% of GDP in Poland over this period, compared with 5% in Hungary and over 7% in the Czech and Slovak Republics. Recent investments in the car industry have increasingly gone to the Czech and Slovak Republics, and the Polish share of automobile output in the region has declined; 2005 nevertheless saw a number of announcements of inward investment by technology related companies. At the same time, although domestic mobility of labour appears to be rather limited, many Poles have been emigrating,[5] successfully finding jobs in other European countries. This suggests considerable mobility and entrepreneurial spirit – either Poland is not short of entrepreneurs, or many of them have by now emigrated.

The optimistic view of emigration is that Poles who go abroad to work may return later, with improved financial and human capital, which can be used in existing companies or in new start-ups. There is little that governments can do actively either to restrain emigration or to encourage emigrants to return. The state of the labour market is a key factor in migrants' decisions, so there is an element of chicken and egg in the hope that return migrants will boost entrepreneurship and improve the labour market situation. But another element is likely to be the legal, regulatory and financial environment that entrepreneurs face, and here there are indications that there is a great deal of work to be done.

OECD indicators of product market regulation (PMR) show that Polish regulation is being eased over time. Since this is happening in other countries too, Poland remained one of the most restrictive countries in 2003 (Figure 1.9). This high score on PMR indicators was mainly due to public ownership, still the highest among OECD countries. Administrative burdens were also higher than in most countries; while legal barriers to entry were among the lowest. Significant improvements have been made since 2003, notably in making important reductions in administrative burdens on all companies, and in simplifying procedures for foreign investors. However, although privatisation has continued, rapid reduction in public ownership has not been given a high priority, and there seems to be a continued reluctance to relinquish direct state control over at least a part of important industries ranging from banking to the energy sector.

Figure 1.9. **Restrictiveness of regulation having an impact on economic behaviour**[1, 2]

Index scale of 0-6 from least to most restrictive




1. EU15, excluding Luxembourg.
2. Economic regulation includes all domestic regulatory provisions affecting private governance and product market competition such as state control and legal barriers to entry in competitive markets.

*Source:* OECD (2006), *Economic Policy Reforms: Going for Growth*.

With such a high degree of regulation by OECD standards, it is not surprising that innovative activity, as measured by expenditure on R&D and related indicators, is low in Poland. OECD work has shown that less burdensome PMR tends to be associated with

higher R&D expenditure and innovation (Pain and Jaumotte, 2005a and b). Innovation and R&D (at least of the sort that accompanies or enables innovation, not so much that which "pushes the frontiers") are essential to close the productivity gap between Poland and high-income OECD economies more quickly, and most innovation will need to occur in the private sector. At the moment, most R&D expenditure is in the public sector. Much R&D activity is likely to be linked with universities and other higher educational institutions; this is another reason why their financing needs to reviewed, and links between them and the business sector encouraged.

Not all innovation concerns the introduction of "cutting-edge" technology or advanced scientific research. In Poland catch-up can be based on introducing techniques that are standard elsewhere, without needing research at the frontiers of knowledge. Financial services, distribution, food production and other sectors can benefit from such innovation. The role of foreign enterprises in all sectors is thus likely to be important in bringing new ideas, and encouraging and enabling a more competitive approach in Polish enterprises would complement this and help to diffuse new methods more quickly.

A striking aspect of the size distribution of enterprises in Poland is the large share of very small companies. Agricultural enterprises are overwhelmingly small, but this is true in many other sectors, too. Small and medium-sized firms are often an important source of flexibility and innovation in an economy, so this is potentially an important asset, but when innovation relies on small firms a number of other factors become relatively more important, in particular finance and information networks.

The availability of external finance is important because small firms have insufficient internal resources to make significant investment – in equipment, in hiring new employees, or training existing employees to use new methods – without borrowing. And it is a perennial complaint in all countries that banks are insensitive to the needs of small companies. This may also be linked to legal and regulatory issues, such as the ease with which loan collateral can be reclaimed, or the speed with which courts deal with disputes. It is not clear that this issue is especially acute in Poland; but the sluggish response of investment to improved profitability, despite growing company deposits with banks, may be indicative.

### *Notes*

1. Fixed investment grew 8.4% in nominal terms in the fourth quarter, compared with a year earlier. While this represented only 2.8% volume growth in 2000 prices, it was 9.8% in 2005 prices. This difference and a similar one in both import and export volumes contribute to a substantial difference between base- and chain-weighted GDP growth for the fourth quarter, too, of 2.8% and 4.2%, respectively, compared with a year earlier.
2. According to calculations by NBP staff.
3. The rediscount rate was reduced by 1.25 percentage points, but other policy rates were reduced by 2 points.
4. The Czech and Slovak Republics, Hungary and Poland comprise the Visegrad countries.
5. It is notoriously difficult to track emigrant numbers. According to the OECD database on foreign-born and expatriates, where the latest data refer to 2000, perhaps 5% of the Polish working-age population was abroad, similar to Hungary. These data (based on national censuses) recorded only about 25 000 Poles in the United Kingdom (although this would probably understate the true number), where there are now estimated to be at least 150 000.

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# ANNEX 1.A1

## *Progress in structural reform*

This annex reviews action taken on recommendations from previous *Surveys*. Recommendations that are new in this *Survey* are listed in the relevant chapter.

| Recommendations | Action taken since the previous *Survey* (June 2004) |
|---|---|
| PRODUCT MARKET COMPETITION | |
| Increase the pace of privatisations: | Privatisation continues but remains slow and subject to unchanged processes. |
| • Accelerate State's withdrawal from firms in which it holds a stake. | No action. |
| • Reduce the influence of special interests within the privatisation process. | No action. |
| • Reduce the number of governmental institutions with responsibility over privatisations. | No action. |
| • Be more proactive in direct privatisations. | No action. |
| • Free privatisation deals from industrial policy goals. | No action. |
| • Reduce the constraints imposed on purchasers' ability to manage their labour force. | No action. |
| Increase competition in specific sectors and reconsider actions to restructure the sector before its opening to competition: | |
| • Mining | No action. |
| • Energy | The monopoly gas company (PGNIG) and some small electricity companies have been privatised. No action in the electricity sector. Privatisation of the main Polish power company, ZE Dolna Odra, has been postponed (the government refused Endesa's offer to buy it). The government has announced plans to restructure the whole sector, merging distributors with producers in order to set up four large energy groups before starting privatisations. |
| • Defence | No action. |
| • Banking | The bank PKO PB has been privatised. |
| • Avoid creating distortions to competition with State aid. | On-going. |
| Create a business-friendly environment: | |
| • Create a one-stop shop services for starting a business. | On-going: electronic registration has been developed. |
| • Reduce uncertainty in the tax system; set up a centralised authority for *ex ante* tax rulings and reduce administrative tax complexity. | On-going: possibility for Tax Offices to publish binding interpretations of the Law since January 2005. |
| • Streamline the bankruptcy procedures; improve the quality and efficiency of judicial processes. | Reforms introduced in 2003 are helping. |
| • Improve land registry. | On-going: electronic registration has been created. |
| • Improve the efficiency of capital markets. | It is proposed to set up a single financial market supervisor, thereby removing substantial authority from the central bank. |
| • Be more proactive in promoting FDI. | Extensions to Special Economic Zones and improvements to the Polish Agency for Trade and Investment planned for 2006. |

| Recommendations | Action taken since the previous *Survey* (June 2004) |
|---|---|
| • Competition authority should criticise more openly government decisions with which it disagrees. | In progress. The authority was willing to oppose the government in the banking sector merger case. |
| LABOUR MARKETS | |
| Rationalise personal transfers to reduce poverty and unemployment traps: | |
| • Restrict access to the disability system to those who are truly disabled, re-evaluate the stock of beneficiaries and introduce a time limited pension. | Fully implemented for new applicants. |
| • Implement plans to eliminate early-retirement schemes. | Partial implementation, some groups of workers exempted. |
| • Reform the unemployment insurance system to increase incentives to look for a job. | Mandatory "activation" interview within 6 months of new claim. |
| • Make social assistance benefits conditional on active job-search for those who are able to work. | Ongoing. |
| Increase labour demand: | |
| • Reduce the labour cost at the level of the minimum wage. | A new indexation rule will gradually *increase* the relative minimum wage. |
| • Develop in-work benefits. | No action. |
| • Develop ALMPs and their evaluation. | No action. |
| Increase the flexibility of working rules by making administrative procedures for layoff less burdensome and reducing overtime premium. | No action. |
| Improve the level and relevance of formal education: | |
| • Reduce inequalities in access to quality education by taking into account local government's ability to finance primary school. | No action. |
| • Increase the flexibility of the allocation of resources among levels of education. | No action. |
| • Increase resources to facilitate the access of rural students to universities. | Some funds available for housing assistance. |
| • Introduce tuition fees for full-time day courses. | No action. |
| ENCOURAGING RURAL DEVELOPMENT AND GEOGRAPHIC MOBILITY | |
| Reform the farmers' social insurance system. | 2004 legislation abandoned. |
| Eliminate ownership restrictions on rural land. | No action. |
| Improve infrastructure. | On-going, through the use of EU funds. |
| Expand rental housing market. | Rent controls on new tenancies have been abolished, but laws and lengthy court proceedings still make it difficult for owners to remove tenants, even if they are in default. |
| FISCAL SUSTAINABILITY | |
| Adopt a medium-term budgetary framework with an explicit expenditure rule. | Medium-term framework sets central government deficit, but with no expenditure targets. |
| Raise further the profile of the general government concept when establishing budgetary objectives. | No action. The rule for the 2006 budget was set at the level of the central budget. |
| Implement the public expenditure reform plan (Hausner Plan). | The plan was only partly implemented, implying that half of the expected savings will not be achieved. |
| Improve the efficiency of spending by reforming the transfer system. | See section above. |
| MONETARY POLICY MANAGEMENT | |
| Improve communication the NBP. | |
| • Accelerate the publication process of documents | Much progress. |
| • Publish inflation forecasts | Done. Some forecast data are unnecessarily treated as confidential. |
| Introduce overlapping terms in appointments of MPC members to ensure the continuity of monetary policy. | No action. |

| Recommendations | Action taken since the previous *Survey* (June 2004) |
|---|---|
| SUSTAINABLE DEVELOPMENT | |
| Reduce emissions of greenhouse gases. | No action; GHG trading system behind schedule. |
| Reduce air pollution. | Ongoing; insufficient use of economic instruments. |
| Ease regulation on private pension funds. | No action. |
| In the calculation of the required rate of return to be provided by pension fund management companies, use a reference rate external to the OFE sector. | No action. |
| HEALTHCARE | |
| Continue the healthcare reform. | Some fiscal incentives for restructuring health care institutions. |

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*Chapter 2*

# Monetary and exchange rate policies

*Monetary policymakers have successfully consolidated a low-inflation environment in Poland, ridding it of a major problem. The inflation-targeting regime is now well established, and both the economy and policy-making arrangements have shown a strong degree of resilience in the face of sharp swings in the real exchange rate. With the benefit of hindsight it seems that monetary settings may have been temporarily too tight in reaction to what turned out to be a short-lived increase in inflation after EU accession. However, the basic framework for policy formation is appropriate, provided that the symmetrical nature of the current target is reaffirmed and that continuing attention is paid to maintaining the transparency of policy setting. Provided that sound policies are implemented, Poland is well placed to meet the conditions for entry into the euro in the medium term. Challenges in the run-up to euro adoption include fiscal consolidation and structural reforms to enhance flexibility and adaptability, where determined policy efforts are needed regardless of the specific timetable for euro entry.*

Monetary policy in Poland has rightly been considered as relatively successful in first achieving disinflation and then ensuring price stability. The current arrangements have been in place since 1998, during which time the economy has been through a major growth slowdown and significant swings in the nominal exchange rate, which fell significantly between 2001 and 2004 before recovering much of those losses since then. Apart from a brief spurt upon accession to the European Union, inflation has been 2% year-on-year or less since mid-2002, a lower rate than the euro-area average. Real short-term official interest rates remained rather high until early 2004 before falling to below 3%, but as inflation has fallen real rates have tended to rise again. The monetary authorities were quick to raise interest rates when inflation rose in mid-2004, but rates were subsequently lowered after it became clear that inflation was subsiding again in early 2005. This success suggests that Poland would be ready to embark on a fast track to joining the Economic and Monetary Union (EMU), though the new government attaches a low priority to this at the moment.

The credibility of the National Bank of Poland (NBP) and the current monetary policy arrangements have been important in this success, and the rapidity with which interest rates were increased in 2004 was clearly partly designed to maintain and reinforce this credibility. Although headline inflation rose briefly to over 4%, this increasingly appears as a temporary interruption in a period of several years since mid-2002 with inflation substantially below the official 2.5% central target; it has been below the lower bound of the target range (1.5 to 3.5%) almost continuously since June 2005. This raises the question as to whether monetary policy has been set with a view to keeping inflation below the target in practice, rather than close to it, thereby maintaining tighter monetary conditions than necessary. To put it in another way, have policy-makers reacted asymmetrically to incoming information? This chapter looks at this issue in more detail, concluding that while the NBP probably raised interest rates faster than necessary in 2004, it was right to act quickly while it was unclear whether an underlying increase in inflation was under way in response to higher food and energy prices, but it could have lowered rates earlier during 2005. In the future it can afford to be more relaxed about allowing inflation moving above the target rate following such negative supply shocks, in the absence of clear signs of second-round effects on wage costs.

With a floating exchange rate Poland has avoided external crises, although the currency has fluctuated fairly widely, partly in response to fiscal developments. Another section of this chapter looks at the likely delay in Poland becoming a full member of the EMU, compared with the alternative of aiming for early membership. Such a delay is unlikely to destabilise the economy, provided a determined fiscal consolidation programme is followed and monetary policy remains transparent and focused on maintaining low and stable inflation. The chapter, nevertheless, stresses the importance of public debate on adopting the euro and the continuation of preparations for its adoption.

## Monetary policy strategy

The NBP has operated an inflation-targeting regime since 1998. Since 2000, this has been in an environment of a freely floating exchange rate – exchange rate intervention, while not excluded from the menu of options available to the monetary authorities, has not been used. The current form of medium-term inflation-targeting dates from January 2004 (NBP, 2003). The document that initially described the strategy recognised that after successful disinflation (until 2002), the primary objective was "to stabilise inflation at a low level". It set the medium-term consumer price inflation target at 2.5% per year with a permissible volatility band of ±1 percentage point. The Monetary Policy Council (MPC)[1] deemed such a choice of a numerical target consistent with strong economic growth but also explicitly motivated it by linking it with the convergence conditions required for adoption of the euro (Box 2.1). The strategy clearly stated that the MPC considered early adoption of the euro to be beneficial for Poland and thus an important medium-term monetary policy goal, although the law reserves the determination of exchange rate policy for the government, "in consultation with the [monetary policy] council." The MPC committed itself to "foster conditions for the introduction of the euro in 2007", which the strategy identified as the earliest possible date for such action.

The medium-term strategy is regularly supplemented by annual *Monetary Policy Guidelines*. The most recent document with guidelines for 2006 was published in September 2005 (NBP, 2005). The 2006 guidelines, when compared with earlier such documents, put stronger emphasis on the symmetry of the inflation target and its point character, emphasising that the goal is to keep inflation close to 2.5%, rather than just within the band. The guidelines also highlight the importance of real exchange-rate developments as a factor determining monetary conditions in addition to real interest rates. The MPC has also declared that it wishes to maintain the floating exchange-rate regime until the moment when Poland joins the exchange-rate mechanism (ERM II), while explicitly allowing for exchange-rate intervention, should this be necessary for the achievement of the inflation objective. The MPC argues that the period in ERM II should be as short as possible before full conversion to the euro, in order to minimise exposure to possible shocks, so the decision to join the exchange-rate mechanism should be taken only when there is sufficient assurance that the Maastricht criteria and all other conditions (including necessary legislative changes) can be met by the second year of membership. While the MPC has maintained its position that early euro adoption would be beneficial for Poland, the new government is less enthusiastic: at one point the prime minister ruled out any decision before the next elections (due at the latest in 2009), while the minister of finance recently argued (in mid-February) that it would be possible to join ERM II by 2009.

### *Credibility and communication with the market*

It is well understood that overall success of the direct inflation-targeting regime depends on the effectiveness of the Bank's communication strategy. The major instruments that the MPC uses in explaining its decisions and reasons behind them to the market comprise quarterly *Inflation Reports*, press releases and press conferences following the MPC meetings. Since August 2004, *Inflation Reports* include inflation projections in the form of fan charts (similar to the exposition by the Bank of England, for example). Inflation projections have already become an important element of the Bank's communication strategy and can be expected to play an increasingly important role as underlying econometric models become better tuned to explain inflation developments. On the other

### Box 2.1. **Choosing inflation targets**

The strategy of direct inflation targeting requires setting a numerical target for inflation. Numerical reference values are also part of the strategies of some central banks that do not formally operate an inflation-targeting regime, such as the European Central Bank. Numerical targets are normally defined taking into account a number of factors (Issing, 2004). First, there is a fairly broad consensus that high inflation is harmful for long-term growth prospects, although it is difficult to find a specific threshold value at which the effect begins to take effect. Also, there is a large literature suggesting that even moderate inflation can have substantial welfare costs [see Rodriguez-Palenzuela *et al.* (2003) for a review]. In practice, central banks are reluctant to allow inflation higher than 3 to 4%. The lower bound for inflation targets is related to a number of factors. The zero bound on nominal interest rates on cash in circulation complicates monetary policy if prices are falling and suggests that target setting should minimise the risk of deflation. Additionally, there is a risk of upward measurement bias in the calculation of consumer price indices, related to improvements in the quality of goods entering the basket. Another argument is related to downward nominal rigidity of wages and prices: an excessively low inflation target could hinder certain relative price adjustments from taking place. A similar argument can be coupled with the Harrod-Balassa-Samuelson (HBS) effect of international inflation differentials due to varying productivity growth rates. Countries with higher productivity growth in the tradeables sector because of such an effect may prefer to operate somewhat higher inflation targets to allow for easier relative price adjustments.

The Polish institutional arrangements are similar to those in the euro area. The constitution and the law on the National Bank of Poland define the Bank's responsibilities for price stability, while the Bank defines specific numerical targets and selects the price index to be targeted. It is not necessary for the government to agree to these, though in practice there has been no disagreement so far, despite recent criticism levelled at the sub-target outcomes achieved and at the idea of non-NBP membership of the Monetary Policy Council.

The 2.5% inflation target adopted in Poland in 2004 is similar to those chosen by other new EU member states running an independent monetary policy. The Czech National Bank has just implemented a 3% target for the CPI to replace a previous target band (2-4%) from January 2006. The targets of the National Bank of Slovakia are now primarily driven by the desire to fulfil the Maastricht inflation criteria for euro adoption. It is intended that inflation stay below 2.5% at end-2006 and below 2% at end-2007 and end-2008. The Hungarian central bank has announced a 3% inflation target to be operational from 2007.

hand, given the relatively higher share of items characterised by volatile price behaviour (food and energy, for example) in the CPI basket, the model projections will remain subject to substantial error margins.

While the 2005 schedule of *Inflation Report* publications implied substantial lags relative to publication of major statistical data by the CSO, the change in the publication schedule that has been announced for 2006 implies that *Inflation Report*s and inflation projections will be released around two months after publication of quarterly GDP data. In 2004 and 2005, the bank used announcements of a "policy bias" as a new communication instrument. Apart from interest-rate decisions, each MPC meeting ended with an announcement of a tightening, neutral or easing bias. The MPC wanted these announcements to be interpreted as signalling probabilities of future policy changes. The

evaluation of the usefulness of this instrument has been mixed, and it was dropped as from January 2006. The guidelines highlight the importance of the balance of risks concerning future inflationary developments for MPC decisions. While balance-of-risk assessments have already become an important element of the Bank's publications, it would be advisable to make these assessments more explicit. Explicit discussion of risks has been used by the US Federal Open Market Committee (FOMC) since 1999 and has been found by some to improve the market's ability to foresee policy changes (Ehrmann and Fratzscher, 2005). But the FOMC also renounced regular announcement of policy bias some time ago. More generally, the NBP, as with all other central banks, should be encouraged to continue in the quest for more efficient ways to communicate with market participants and the general public.[2]

As indicated in the two previous *Surveys*, the credibility of the Bank depends on the continuity of its policy. Here, the current practice of replacing the entire council once every six years could introduce unpredictable swings in the conduct of monetary policy. In 2004, wholesale replacement of the MPC was nevertheless in fact achieved relatively smoothly. However, speculation over the eventual composition of the Council, and the possibility of a radical change in policy, occupied financial markets' attention to a considerable extent. Moreover, the timing of the next MPC replacement is such that it may be accompanied by much greater uncertainty and therefore a stronger impact on markets. MPC members are currently selected by different elected bodies: one third each by the Sejm (the lower house of Parliament), the Senate and the President. The term of the current MPC will expire in January/February 2010, a few months after the parliamentary elections (provided the current parliament lasts for the whole four-year term). This may result in monetary policy strategy becoming an issue in the electoral campaign, one of the least conducive environments for an informed debate on such a complicated and technical matter. Moreover, if no decision on euro accession is taken during the current term of the parliament (in line with the declarations of the government), adoption of the euro might well become one of the key themes of the electoral campaign. To reduce uncertainty and provide more continuity in the conduct of monetary and exchange-rate policies, the statutes of the MPC could be revised so that the Council members are appointed to overlapping terms, just as is the case in the Executive Board of the European Central Bank, for example. To facilitate the transition to such a new regime, following the necessary changes in the law, some of the current MPC members could volunteer to resign before the expiration of their current terms.[3]

Whether or not there is a significant delay in the euro adoption process, the efficient functioning of monetary policy will be important in securing macroeconomic stability and preparing Poland to join the euro area sometime in the next decade. The government has not yet made any definite proposals for changing the status or responsibilities of the central bank, but a number of proposals are in the air. Some of these have called NBP independence and responsibilities into question, although partly for issues related to bank and financial market supervision, rather than for monetary policy. It is important that any changes do not raise doubts about central bank independence or its central commitment to price stability; undermining the hard-won credibility of monetary arrangements at this point would be likely to increase the risk premium in both money and foreign-exchange markets, leading to unnecessarily high interest rates to meet any given target combination of output growth and inflation. As for financial market supervision, a well-implemented merger of the present three separate agencies should improve regulatory transparency and

market efficiency. But the current plan to have the new agency subordinated directly to the prime minister's office, and with certain ministers sitting on the decision-making committee, is likely to present conflicts of interest which will offset some of these benefits. In no other country is financial market regulation so closely linked with the workings of government. An agency with operational independence would be better.

### *Price and interest-rate developments*

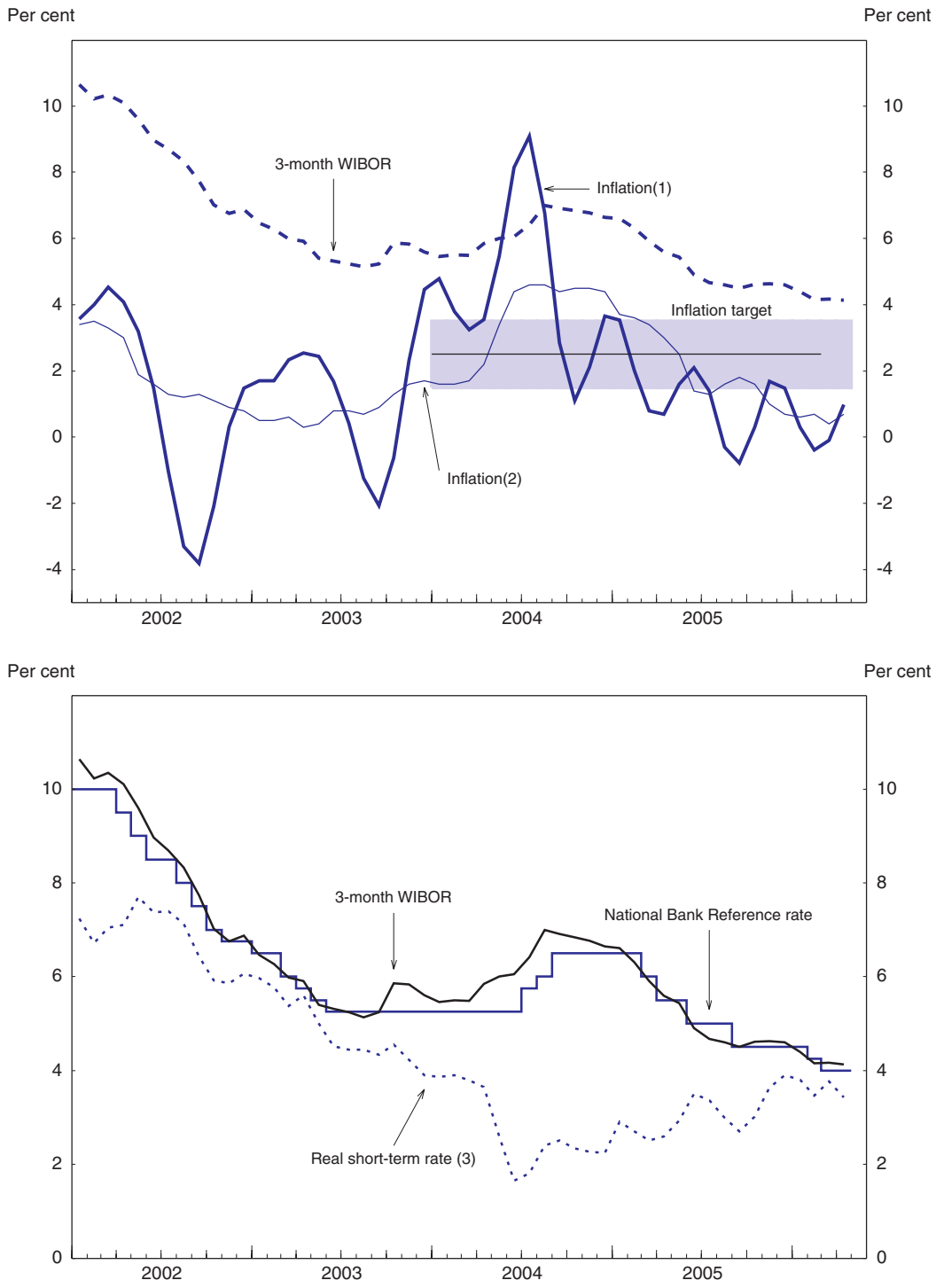
Since the previous *Economic Survey* was finalised in the spring of 2004, the NBP has been faced with a difficult challenge of responding to the price shock related to the EU accession and to sharp rises in international oil prices, in an environment of strong nominal appreciation of the zloty. Prices surged temporarily in April-June 2004 before inflation subsided to low levels in mid-2005 (Figure 2.1). Monetary policy was first tightened in three steps in July-August 2004 by a total of 125 basis points, followed by a series of five rate cuts during March-August 2005 totalling 200 basis points in total.

The period before EU accession in May 2004 was marked by uncertainty as to its likely effect on the price level. Predictions at the time suggested the impact would be small (NBP and UOKiK, 2004).[4] In the first quarter of 2004 year-over-year inflation remained stable, oscillating around 1.5%, but inflation expectations started to rise, with around half of respondents expecting higher inflation over the next 12 months. Fears of price increases after accession helped to stimulate an unprecedented boom in retail sales and industrial production. Other data confirmed the sharp pickup in economic growth, especially resulting from accelerating domestic demand, but also strong export dynamics. In view of such developments, at the end of April the MPC announced a change in the policy bias from neutral to tightening. In April, food and fuel price increases brought the annual rise in the CPI to 2.2%, while May (the first month of the EU membership) witnessed another significant increase in prices, this time also in core inflation: excluding food and fuels, prices rose by 0.9% relative to April. Accordingly, May's annual rate stood at 3.4%, close to the ceiling of the target band. Faced with such a combination of factors the MPC decided to increase policy rates by 50 basis points. In the communication after the decision, the MPC stated clearly that the observed hike in inflation could be expected to be temporary, provided inflation expectations and consequently wages were not affected. The increase in policy rates was meant just to prevent a more persistent increase in inflation. Outside commentators, including the OECD, had also been arguing for some precautionary tightening.

June CPI data (4.4% year on year), rising inflation expectations and other information confirming strong economic activity prompted the MPC to another ¼ percentage point rate increase at the end of July. The August *Inflation Report* from the NBP saw the release of the first inflation projection, now a regular part of these quarterly publications. The August 2004 projection indicated that, on the assumption of unchanged policy rates, the CPI would be unlikely to return to the target band before end-2005 and to the 2.5% target before mid-2006. The MPC pointed to this projection and rising inflation expectations as the main motivation for another 50 basis point increase in policy rates at its end-August meeting. The MPC statement made particular reference to the importance of inflation expectations and to the role that monetary policy has in shaping them (Box 2.2).

Following the April-June period, monthly price increases returned to the modest rates observed during the period before EU accession, so that annual inflation stabilised for a time at around 4.5%. Projections published in the November 2004 *Inflation Report* indicated

Figure 2.1. **Inflation**




1. Consumer price index: 3-month moving average, 3-month percentage changes at annual rate.
2. Consumer price index: 12-month percentage changes.
3. Defined as 3-month WIBOR (Warsaw inter-bank offer rate) less 12-month increase in consumer prices.

*Source:* National Bank of Poland and Central Statistical Office.

### Box 2.2. **Measures of inflation expectations**

The NBP, just as most other central banks, particularly those following direct inflation-targeting regimes, uses inflation expectations as an informational input for monetary policy-making. Regular bank publications refer to inflation expectations of financial market analysts and of consumers. This box concentrates on the latter measure, given the MPC's references to it during the 2004 wave of monetary tightening.

Consumer inflation expectations published by the NBP are based on a survey of about 1 000 individuals carried out on a monthly basis. The survey questions are qualitative in nature. Respondents can choose one answer to the following questions: "Given what is currently happening, do you believe that over the next 12 months prices will: *i*) rise faster than at present; *ii*) rise at the same rate; *iii*) rise more slowly; *iv*) stay at their present level; *v*) go down; *vi*) difficult to say". The distribution of responses to the question is then combined with the most recent actual inflation figure that was announced before the survey. These form an input to a probabilistic model which, by making some assumptions, allows a quantitative estimate of inflation expectations. A detailed description of the applied methodology and its limitations can be found in Lyziak (2003).

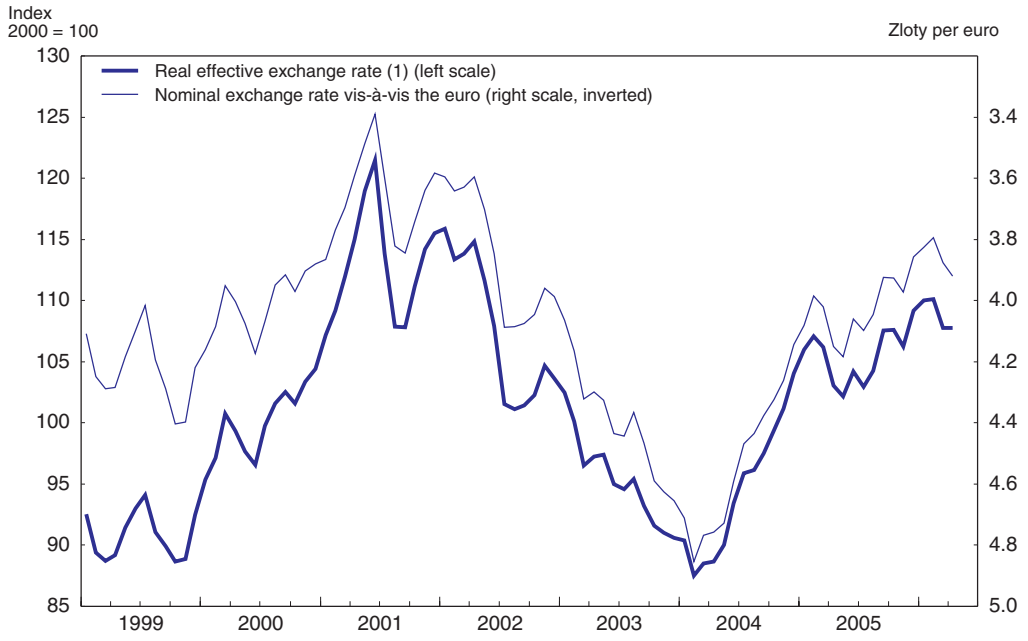
While producing a quantitative point estimate of inflation expectations is certainly useful, its interpretation requires caution. Numerical values of expectations are affected by two factors: the relative size of groups of survey respondents expecting faster/slower price increases and the recent inflation figures. In an environment of stable inflation, changes in numerical values of inflation expectations can be interpreted easily. This, however, is not necessarily the case when inflation levels are volatile, because the *level* of current inflation on which respondents are basing their statement about *changes* in inflation is less clear. Under such conditions, the share of respondents expecting price acceleration to those expecting deceleration should also be closely monitored. This is because respondents may not be aware of the latest published figures and relate their assessment to some average inflation outcomes of the recent past.

Early 2004 witnessed a slow and gradual increase in the observed inflation rate and a substantial increase in consumer pessimism regarding price developments. The share of those expecting inflation to pick up increased significantly, before then starting to decline already in May 2004. Thus, it could be argued that increases in inflation expectations to which MPC statements were referring from June onwards resulted mainly from rises in observed annual inflation that had already taken place. The interpretation of such developments as signalling a continued threat to price stability would appear unwarranted, especially since inflation expectations constructed in such a way on Polish data seem to have been persistently biased upwards (Lyziak, 2003).

that in the most likely scenario inflation would return to the target range around the second quarter of 2005, but stay just above the 2.5% target until end-2006. In early 2005 the MPC noticed signs of weakening economic activity and the zloty was appreciating more than was earlier expected. Inflation projections from February 2005 suggested a significantly earlier-than-previously-expected return of inflation to the target, which, together with the assessment of an improved balance of risks (mainly stronger appreciation of the zloty and lower food prices), prompted a change in the MPC policy bias from restrictive to easing. However, it was only at the end of March that the first cut in interest rates was announced. Gradual easing then continued until August 2005, when the reference rate was cut to 4.5%, an all-time low in nominal terms. Nevertheless, the

currency resumed its trend appreciation (Figure 2.2), and inflation measured year on year quickly fell through the bottom of the target range. Further cuts of 0.25% each then took place at the end of January and February 2006, with NBP inflation forecasts predicting below-target outcomes until 2008.

Figure 2.2. **Exchange rate developments**




1. Real effective exchange rate calculated against forty-two countries, based on CPI.

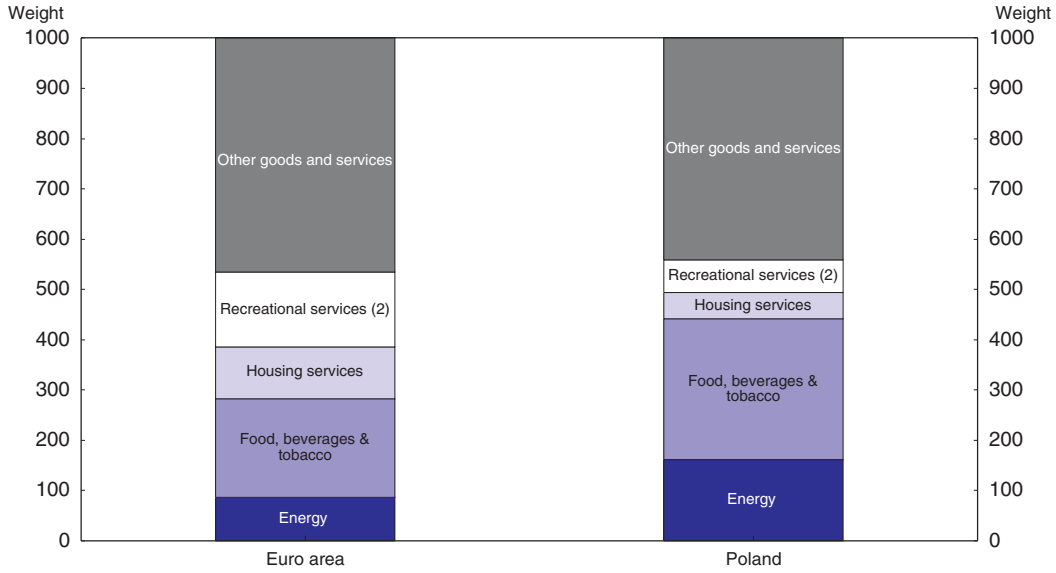
*Source:* National Bank of Poland and OECD calculations.

### *Evaluating the recent stance of monetary policy*

Experience in Poland with inflation targeting or any similar policy regime is quite brief; the period of sustained low inflation is even shorter; and comparable historical macroeconomic data series are very short, making the task of building forecasting models difficult. The economy is still undergoing structural changes affecting, *inter alia*, monetary policy transmission channels. Additionally, the consumption basket comprises a relatively large share of items such as food and energy, the prices of which are highly volatile and primarily influenced by factors beyond the control of the monetary authorities (Figure 2.3). Although there is no sure way of assessing the success of monetary policy, even *ex post*, several analysts have argued that monetary policy has been too tight.

Pushing inflation substantially below the target suggests that unnecessary output losses may have been incurred. However, an initial period of (excessive) inflation aversion on the part of a central bank may be needed to build credibility and therefore improve the sacrifice ratio – the reduction in output or employment necessary to achieve a given reduction in inflation – in the future. Inflation is also affected by shocks beyond the control of the monetary authorities, so whether or not the target is met is not a reliable way to judge policymaking, especially over short periods. However, too low inflation over a longer period means that costs may result not only from lost output but from nominal stickiness of prices and wages, making it more difficult for necessary relative price changes to occur

Figure 2.3. **Composition of the consumption baskets**[1]
2005




1. Weights sum up to 1000.
2. Repairs and personal care included.

*Source:* Eurostat database.

(see also Box 2.1); such nominal stickiness is also likely to contribute to output and employment losses.

From the *ex post* perspective it would appear that the MPC reaction to the price shock related to EU accession might have been stronger than necessary. Price adjustment appears to have been completed by June 2004 and is not thought to have fed into wage pressures. Wage growth had risen substantially to between 4 and 5% (year-on-year) in the first half of 2004. By early 2005 it was back down to 1 or 2%, though underlying gains through the year reached about 4% by December.[5] Month-on-month inflation figures can be quite volatile, but inflation clearly dropped markedly after June 2004, with quarterly growth persistently below the target from the beginning of 2005 (see Figure 2.1). The headline 12-month rate fell below the upper bound of the target range only in April 2005 and the centre of the range in the following month, since when it has remained between 0.6 and 1.8%. Monetary tightening most likely delayed a rebound from the growth slowdown that, rather unexpectedly, occurred in the last months of 2004 and the first half of 2005. On the other hand, taking an *ex ante* perspective (which is more appropriate for evaluation of MPC actions), one is reminded that in 2004 there was substantial uncertainty as to the actual impact of EU accession. Second, the buoyancy of international oil prices has been creating difficult decisions for central banks all over the world, given their stagflationary effects. Third, the period of lower growth experienced by the economy was largely unexpected. Fourth, the zloty appreciated strongly in the course of 2004 and in the first quarter of 2005. Finally, money and credit figures have not been very helpful in assessing economic developments.[6]

As far as interest rates and inflation are concerned, Polish experience with EU accession was different from that of the other new central European EU member states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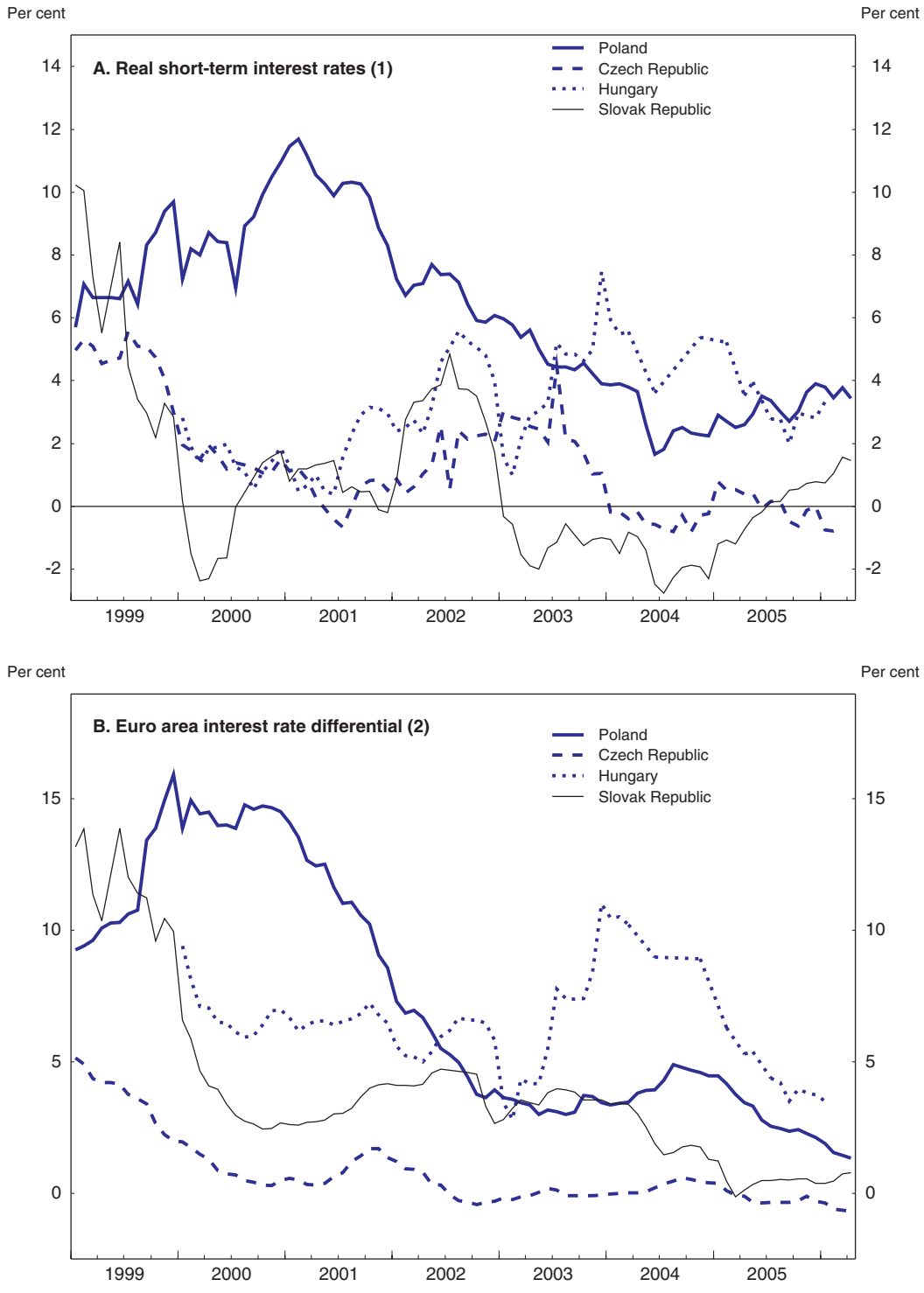
that are in the OECD (the so-called Visegrad countries). The situation in these countries differed substantially on the eve of EU accession. Hungary was slowly recovering after a mini currency crisis in late 2003, with rising inflation and policy interest rates well above 10%. The Czech Republic by contrast had only just recovered from a prolonged period of deflation with policy interest rates brought down to 2% in late 2003, and EU accession passed without much concern as to its effect on the price level; policy rates were raised by just 50 basis points and were cut again as early as January 2005, while inflation dropped below 2% and remained there for most of 2005. In the Slovak Republic, price developments until early 2005 were dominated by adjustments in regulated prices, while 2004 EU-related price adjustment in tradeables did not materialise.

In 2005, real short-term interest rates in Poland were near or below 3%, the lowest level since the mid-1990s. This is also on a par with or below most estimates of the long-run natural rate of interest. However, it is likely that the natural rate of interest might have (perhaps temporarily) declined in this period, just as apparently was the case in the euro area and several other European countries (OECD, 2004). Real interest rate developments suggest an emergence of two groups among the Visegrad countries (Figure 2.4). The Czech and Slovak Republics have been characterised by real interest rates close to zero for most of the period since 2000, while in Poland and Hungary real rates stayed above 2.5%. Nominal interest-rate differentials with the euro area have declined to historically low levels in Poland, though they remain substantial – above 1½ percentage points in March 2006 (though this was down from over 2 percentage points in December). It is nevertheless difficult to decide on the relevant benchmark. The Czech Republic, for example had lower interest rates than the euro area in early 2006.

Yet other insights into the question of the tightness of monetary policy can be provided by current and capital account developments, although short-term volatility, not least in errors and omissions, make balance of payments data more suited to assessing long-term trends rather than policy over just a few quarters. In particular, analysis of the structure of capital flows can be important, as interest rates – to the extent that they are affected by central bank policy rates – are one of the principal factors determining short-term capital flows. The year 2004 and the first half of 2005 witnessed a rise in portfolio capital inflows, perhaps a sign that relatively high interest rates and expectations of continuing tight policy and exchange rate appreciation were attractive. Some might be related to banks borrowing to cover the increasingly important flows of foreign-currency-denominated housing loans they have been extending (Table 2.1). If the fall in these flows in the third quarter were linked to interest rate cuts over the previous few months (and not just to data volatility), this might be taken as weakly corroborating the idea of temporarily over-tight policy in the first half of 2005.

An *ex post* analysis of MPC policies suggests that until now it may have been reacting asymmetrically to inflation deviations above and below the target. The reaction to the price shock of April-June 2004 was somewhat similar to the reaction to the reversal of the disinflation trend in the second half of 1999 and early 2000. Policy interest rates were increased sharply and subsequently kept at a high level for a longer period – until current inflation returned to around the target band. In both cases the pickup in inflation proved short-lived, and subsequently inflation declined significantly – well below target levels. In contrast, the MPC was not so vigorous in counteracting significant undershooting of inflation: from mid-2002 to early 2004 and since mid-2005. The main explanation is probably linked to credibility issues. With a short history of inflation targeting and a brief

Figure 2.4. **Interest rate developments in selected new EU members**




1. Three-month interest rate minus 12-month increase in consumer prices.
2. Three-month interest rate minus 3-month EURIBOR.

*Source:* Central Statistical Office and OECD, *Main Economic Indicators*.


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Table 2.1. **Balance of payments**
Million euros

| | | Current account | Capital account | Financial account | *of which:* | | | | Overall balance | Net errors and omissions |
|---|---|---|---|---|---|---|---|---|---|---|
| | | | | | FDI | Portfolio | MFI[1] | Other | | |
| 2000 | | –10 788 | 39 | 11 191 | 10 316 | 3 435 | –3 902 | 1 342 | 804 | 362 |
| 2001 | | –6 006 | 84 | 3 495 | 6 469 | 1 140 | –3 439 | –675 | –543 | 1 884 |
| 2002 | | –5 399 | –7 | 7 646 | 4 143 | 2 159 | 2 694 | –1 350 | 676 | –1 564 |
| 2003 | | –4 108 | –40 | 7 707 | 3 798 | 2 232 | 2 151 | –474 | 1 107 | –2 452 |
| 2004 | | –8 542 | 808 | 6 782 | 9 643 | 7 465 | –7 379 | –2 947 | 685 | 1 63587 |
| 2005 | | –3 503 | 786 | 11 326 | 4 952 | 9 899 | –142 | –3 383 | 6 454 | –2 155 |
| 2005 | Q1 | –1 043 | 413 | 3 667 | 2 265 | 4 400 | –348 | –2 650 | 1 901 | –1 136 |
| 2005 | Q2 | –500 | 69 | 3 562 | 531 | 5 387 | –862 | –1 828 | 3 076 | –55 |
| 2005 | Q3 | –861 | 103 | 1 534 | 1 804 | 458 | –871 | 134 | 8 | –768 |
| 2005 | Q4 | –1 099 | 201 | 2 563 | 352 | –346 | 1 596 | 961 | 1 469 | –196 |

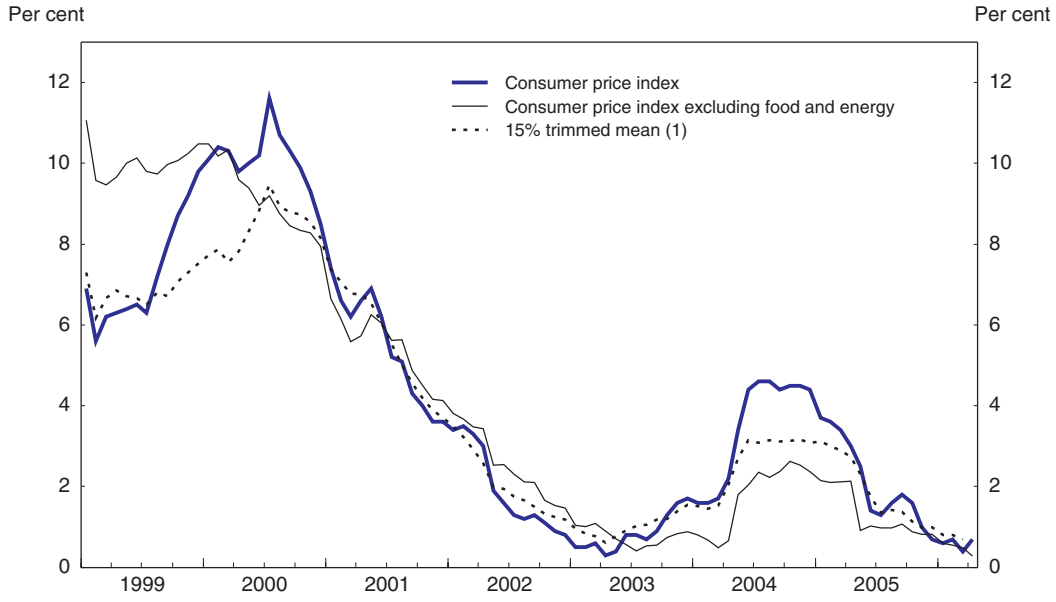
1. Net monetary and financial institutions, excluding central bank.
*Source:* National Bank of Poland.

period of price stability, the MPC was presumably trying to build its credibility and more strongly anchor inflation expectations at low levels, allowing for more efficient monetary management in the future.[7] The fact that inflation came under control so quickly in 2004-05 and has remained low may suggest that the NBP has acquired more than sufficient credibility and may instead suggest that the MPC was overestimating the amount of inflation momentum in the economy. If this is the case, some attention may need to be paid to improving the Bank's inflation forecasting.

One interesting lesson emerging from the analysis of inflation dynamics over the last few years is that core inflation measures have been sending useful signals for future price developments. Headline inflation has tended to fluctuate around core measures (Figure 2.5). Both the 2000 and 2004 hikes in headline inflation were much more pronounced than in core measures. Similarly, the inflation slowdown from mid-2001 was to a substantial extent driven by food price dynamics. While prices of food, energy and other volatile items are not irrelevant, as they can feed into wages and other prices, recent experience suggests that such second-round effects appear to have been rather weak; monetary policy-makers could afford to largely "look through" shocks to these prices and put more emphasis on core inflation. The MPC has affirmed the importance of developments in core inflation measures on several occasions, but there still might be room for these data to be used more intensively to guide monetary policy and to explain policy decisions to the market. This could be helped by careful selection and clearer presentation of the core inflation measures on the NBP website. In particular, the core measure "excluding most volatile prices" (which overshot headline inflation in 2004) could usefully be discontinued, as the exclusion rules are based on the variance of prices in the second half of 1990s when the economy was still adjusting to the liberalisation following the Communist era. Limiting the authorities' and the public's attention to a smaller number of more robust core measures could improve MPC communication with the markets.

Evaluation of monetary policy must take into account the time horizon at which it operates. The MPC believes that the impact of official interest rates on inflation reaches its peak five to seven quarters after interest-rate changes (NBP, 2005). Thus, very low inflation since the middle of 2005 could be partly attributed to policy tightening from mid-2004,

Figure 2.5. **Core and headline measures of consumer price inflation**
12-month changes




1. Defined by removing 30% of items for which the prices were most volatile.
*Source:* National Bank of Poland, Central Statistical Office and OECD, *Main Economic Indicators*.

apart from numerous other factors. On the other hand, the policy easings of mid-2005 should be impacting price dynamics around the second half of 2006. The projection that was prepared for the April 2006 *Inflation Report* suggested that inflation was likely to stay at or below the target until the end of 2008, even after the cuts in interest rates at the beginning of February and March, although the confidence limits are quite wide (see Figure 2.1).

Monetary conditions at the beginning of 2006 still appeared to be relatively tight, although uncertainty as to the fiscal stance after the election period, volatile energy prices, and uncertainty as to the transmission of the past energy price increases can explain the MPC's cautious approach to further easing.[8] But the forecast in the April *Inflation Report*, suggests that further easing would be unlikely to put price stability at risk. A monetary conditions index (MCI) shows that the combined effect of interest-rate and exchange-rate changes appears to have been close to zero throughout 2005 and thus far in 2006 (on the assumption that conditions have been neutral on average over the period 1998-2005) (Figure 2.6). Fiscal policy may also be important in determining the room for manoeuvre of monetary policy. While there was a sizeable fiscal improvement between 2004 and 2005, the prospects for subsequent years look uncertain (see Chapter 3). Tighter fiscal policy would permit a more expansionary monetary stance and almost certainly constitute a better policy mix.


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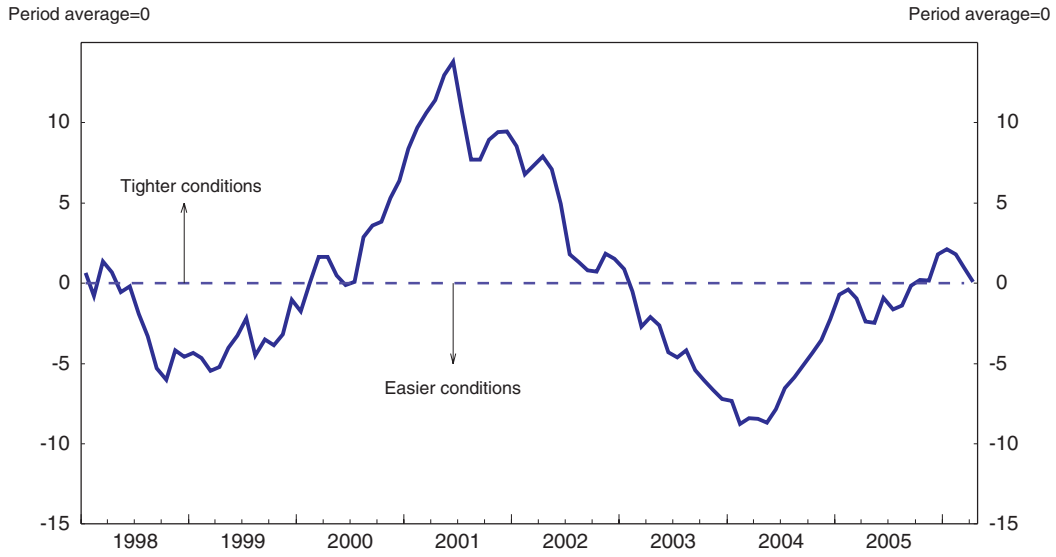
Figure 2.6. **Monetary conditions index**[1]




1. 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.

*Source:* OECD calculations.

## The road to euro adoption

By ratifying the EU Accession Treaty Poland has committed itself to eventually also becoming a full member of the EMU. However, there is no target date for this, and in practice a country may choose not to fulfil the criteria for membership for a prolonged period. While adopting the euro clearly has advantages and disadvantages, existing work by the Polish authorities (NBP, 2004; Ministry of Finance, 2005), international organisations (Schadler *et al.*, 2005) and the research community (Dabrowski and Rostowski, 2005) suggest that Poland would realise substantial net gains from joining the euro area.[9] Adopting the euro implies elimination of the exchange rate risk and convergence of interest rates with the euro area with ensuing favourable effects on trade, investment and efficiency forced by increased competitive pressures. The risks of replacing the zloty with the euro are primarily linked to potential divergence of economic conditions in Poland from those elsewhere in the euro area, which would make the European Central Bank's policy rate not well suited for local needs, both in a short-run perspective – in the event of country-specific shocks – and in the longer term, as the equilibrium real exchange rate rises during the catch-up process with the leading EU countries. The negative implications of inflexible labour markets[10] and fiscal policy failures could indeed be magnified, as monetary instruments will no longer be available to at least partly offset any idiosyncratic shocks or budgetary difficulties.

The two important policy issues are when Poland should adopt the euro and how best to prepare for membership so that the net gains are maximised. The change in the monetary and exchange-rate regime will require close co-operation between the government and monetary authorities. A much broader political consensus is needed, since the switch will require legislative changes, including a modification of the constitution. Furthermore, the whole process will take several years and might well be

carried out by different governments, parliaments and monetary authorities. Public support for the whole process is essential, not only to avoid a situation where elections during the preparatory phase result in the emergence of a new government with very different views on the euro, but also to lower the costs and complications related to the very moment of changeover. The October 2005 Eurobarometer survey showed that more people thought that adopting the euro would be a bad thing for themselves than that it would be good (52% compared with 31%, the gap having widened by about 5 percentage points over the previous year) (Eurobarometer, 2005). Some 85% of Poles are "afraid of abuses and cheating on prices during the changeover", suggesting they are not convinced by the statistical evidence that there was little overall impact of euro adoption on the price level in euro area countries.[11]

### *Early adoption no longer likely*

For some years now the National Bank of Poland has promoted the view that early adoption of the euro would be beneficial for Poland (NBP, 2003 and 2004).[12] While never officially confirmed, the implicit target date for euro adoption of the previous government seemed to be around 2009. In August 2005, the Ministry of Finance published a report outlining the technical preparations that were needed on the road to euro adoption (Ministry of Finance, 2005). The new government has declared that euro adoption will not be among its priorities, however, and markets have adjusted expectations to incorporate a significant delay.

A decision on euro adoption may thus be effectively postponed until after the next parliamentary elections, due at the latest in 2009, in which case realistic dates for euro adoption could be as late as 2012-14. Once the new government has established itself, in a difficult parliamentary situation, it would be a shame if there were no public debate on the economic and other issues involved. The absence of such a debate would be particularly worrisome if the underlying reasons for delaying preparations were rooted in a less ambitious agenda for fiscal consolidation and enhancing labour- and product-market flexibility; these are policy aims which are desirable, regardless of when Poland adopts the euro.

The likelihood of successful participation in a monetary union is often assessed in terms of the conditions that the literature has labelled optimum currency area (OCA) criteria. These include: synchronisation of business cycles; symmetry of shocks; trade integration; mobility of factors of production (including labour); and political consensus on how to deal with shocks and on the long-term gains from membership in the union. In some of these areas, adopting the euro might itself be a way of meeting the criteria, though others are not obviously met even by some existing members of the monetary union; the continuing, albeit gradual, integration of labour and product markets with other EU countries should increase the likelihood that these conditions will be fulfilled.[13] At any rate, the large body of empirical work looking at OCA conditions in Europe confirms that Poland, along with other new EU member states, meets the criteria for participation in a monetary union to no lesser an extent than many of the current euro-area members (Blaszkiewicz-Schwartzman and Wozniak, 2005).

### *Poland meets nearly all of the Maastricht criteria to begin the process of euro adoption*

Full membership in the EMU is conditional upon meeting the formal criteria set up in the EU Treaties and other legal acts that are discussed in detail in Ministry of Finance (2005). The so-called Maastricht criteria refer to inflation, long-term interest rates, fiscal deficit, public debt and exchange rate stability. Additionally, legislation related to monetary and exchange-rate management has to be aligned.

The monetary policy strategy has been designed so as to meet those criteria for euro adoption that are the responsibility of the central bank, and apart from the short period following the price adjustment related to EU accession, Poland has been meeting the inflation criterion since early 2003.[14] In fact, because of the trend increase in the equilibrium real exchange rate mentioned above, Poland would almost certainly experience somewhat higher inflation than average in the euro area once it irrevocably fixed its exchange rate, but it seems unlikely that the differential would exceed 1 or 2 percentage points per year (Brook, 2005).[15] This would be unlikely to be a serious problem for Poland once it was in the union, but until the exchange rate is fixed there may be a tendency for it to appreciate so long as the NBP inflation target is only half a point or so above that of the ECB, since then the required real appreciation may be achievable only through some nominal appreciation. Appreciation at such a moderate rate should not in itself pose a major problem after entry into ERM II, provided uncertainty did not lead to wide fluctuations in the rate. Continued trend nominal exchange-rate appreciation would give average domestic inflation lower on average but potentially more variable. As for long-term interest rates, Poland first complied with the condition for monetary union in early 2003, when 10-year bond rates fell below 6% and their 12-month average was less than 2 percentage points above those of low-inflation euro-area countries. From late 2003 and during 2004, however, rising inflation, rising short-term rates and perhaps political uncertainty contributed to rising long rates, with a peak at over 7½ per cent in August 2004. Since then, they have declined fairly steadily, apart from a brief interruption around the time of the election, and satisfied the Maastricht criterion again as from October 2005. The fall has continued, and the rate on 10-year government bonds stood at only just over 4½ per cent in February, a mere 1 percentage point above the corresponding German rate.

Fulfilment of the debt criterion is assured by the strict fiscal rules embedded in the Polish constitution, even though debt levels have been rising, as discussed in Chapter 1. In practice, it is the limit of 3% of GDP on the general government deficit that has been creating problems. Satisfying this had seemed some way off until recently, when surprisingly strong budget revenues allowed the deficit criterion to be met in 2005. An update of the Convergence Programme published in January 2006 foresees a steady, yet slow reduction of fiscal deficits up to the forecast horizon of 2008. But unless the special treatment of open pension funds is extended, the general government deficit in 2007 (when open pension funds would be correctly treated as being entirely in the private sector) will turn out well above 3% of GDP, even if on a declining trend. This would be ironic, since the pension reform which created these funds and put them in the private sector has made Poland's long-run fiscal position substantially better than in a number of the existing members of the euro area. This is discussed in more detail in Chapter 3.

The NBP and the government have jointly declared that participation in ERM II should be as short as possible, largely to avoid any major misalignment of the real exchange rate that can result from fixing the nominal exchange rate at the same time as pursuing an

inflation target; though it is not of course for the Polish authorites to decide how long before full adoption of the euro would be possible. At some point, a specific nominal exchange rate will have to be chosen, and it may be useful if there were a body of empirical work on the appropriate equilibrium rate available to guide market expectations in the run up to ERM II.[16] This would improve the chances of moving to full euro adoption immediately after the second year in ERM II, as the authorities hope (Ministry of Finance, 2005).

Implementation of the required legislative changes, including the change in the constitution, will require a broad political consensus. Finally, adoption of the new currency is a major technical and logistical operation affecting all members of society and requiring a carefully designed plan and sufficient institutional backing. The experience of the current euro area members suggests that various technical preparations can be quite lengthy, and Poland has not yet advanced very far.

***To summarise***

The decision of the timing of euro adoption is far from being irrelevant. It is therefore useful to review major issues that should be taken into account in the debate. Broadly speaking, the choice of the date needs to be guided by the evolution of the costs and benefits of the euro over time. The relevant questions include: whether one can expect that Polish and euro area business cycles will become more synchronised over time as integration and convergence occurs; whether the risks of asymmetric shocks decline if Poland stays outside the euro for a few more years; whether the properly accounted fiscal cost of staying outside EMU are higher or lower than those of joining earlier; when one can expect to achieve enough flexibility in the labour market; whether it is better to allow a few more years of exchange-rate flexibility (with trend appreciation most likely to occur) or fix the exchange rate earlier and live with slightly higher inflation than in the euro area; and whether the fact that most other new EU member states will likely be adopting the euro during 2007-09 makes the option to continue with an independent monetary policy less attractive. With respect to technical and legislative preconditions for the euro, delaying the preparations simply limits the authorities' room for manoeuvre with little to be gained.

One additional argument suggesting that it may pay off to be well prepared for euro adoption, even if there is no officially declared target date for changeover, relates to the functioning of ERM II. As pointed out by several authors (Dabrowski and Rostowski, 2005; Brook, 2005), combining exchange-rate targeting with control over inflation can be quite difficult to achieve for an economy that is still catching up like Poland's, even in the relatively short period of ERM II participation that is required. In order to avoid unnecessary output costs related to measures that could be needed to curb inflation, the specific moment for entering ERM II needs to be chosen carefully. Being ready to take advantage of an advantageous combination of external and internal factors could increase the chances of a relatively smooth period of participation in the exchange-rate mechanism. Fulfilment of other criteria and sufficient advancement with technical preparations can increase the room for manoeuvre in choosing the most propitious moment.

### Box 2.3. **Recommendations on monetary policy**

**Institutional setting**

Any revisions to the law on monetary policy arrangements should maintain the independence of the operation of monetary policy from the government and the primacy of maintaining low and stable inflation. Strengthening the credibility of National Bank of Poland (NBP) policies and thus its effectiveness becomes even more important if the expected moment of the euro adoption is substantially delayed.

The current inflation target remains appropriate, and its credibility would be reinforced if the government were to explicitly endorse it. The NBP should continually monitor its forecasting models and communications strategy to minimise the risk of basing policy on biased indicators.

The law on rotation of positions in the Monetary Policy Council should be reconsidered so as to avoid changing the whole council at the same time.

**Implementation and communication**

The inflation target should be treated symmetrically; in particular, policy-makers should avoid undershooting the target for prolonged periods. In the face of uncertainty about margins of spare capacity in the economy, the NBP should be willing to reduce interest rates to test these limits whenever risks to price stability in the medium term appear particularly low.

There should be a stronger focus on forward-looking indicators, and continued work on developing the models behind the forecasts and minimising their vulnerability to bias.

Core inflation statistics should be more widely disseminated, preferably being published along with the details of "headline" inflation. The measure of core inflation described as "excluding most volatile prices" should be dropped or its methodological underpinnings improved.

**Euro adoption**

The dialogue and co-operation between the monetary authorities and the government on the options for euro adoption and institutional preparations for EMU accession should continue.

Public debate on this should be with dispassionate statistics and analysis of the issues.

## *Notes*

1. In what follows, "MPC" is used largely interchangeably with "NBP" as far as discussion of monetary and exchange rate policy is concerned; the MPC makes the decisions that the central bank implements.
2. The 2006 monetary policy guidelines include the promise that "the Council will use its best efforts to ensure transparency and unambiguity" of the publications and announcements that form the core of its communication strategy. The debate on the communication strategy is also ongoing at other central banks. For example, the strategy of issuing policy statements was discussed during the US Federal Open Market Committee meeting on 1 November 2005.
3. A change in the law on the National Bank of Poland prior to possible voluntary resignation of some of the MPC members would be necessary, given that, under the current provisions, voluntary resignation of MPC members would result only in replacing that member by another person until the end of the term of the whole MPC (Constitutional Tribunal, 2003; Pilat and Wlodek, 2004).
4. The combination of price adjustments, mostly in food products, related to EU accession was expected to lead to some increase in the CPI, but the maximum effect was estimated at 0.9%.

5. Based on figures from the National Bank of Poland that adjust published wage data for unusual timing of bonus payments in certain industries, which caused actual wages to increase by over 7% in the year to November and December.

6. Money and credit aggregates are not easy to interpret as indicators of the monetary stance. While narrow money has been growing at rates over 15% since 2002, broad money fell in 2002 and subsequently accelerated only slowly, growing 10% in the year to January 2006. Among their counterparts, movements in outstanding credit to the company sector as a whole are strongly influenced by changes in the exchange rate, because of its interaction with foreign currency borrowing (concentrated in a few dozen largely foreign-owned enterprises). The zloty value of total credit to non-financial enterprises was little different in 2005 to what it had been in 2001. Zloty-denominated borrowing appears to follow the cycle more closely, however. Household borrowing was higher than non-financial enterprise borrowing at the end of 2005, and has been rising faster (at an annual rate around 25%), with growth since mid-2004 dominated by mortgage lending, of which 80% or more has been in foreign currency (almost entirely Swiss francs) since mid-2005.

7. This last factor was underlined in the MPC communications on several occasions allowing for more efficient monetary management in the future. For instance the 2006 Monetary Policy Guidelines claimed that "stronger anchoring of the inflation expectations would facilitate the pursuit of the inflation target in the future with lower interest rate volatility and output fluctuations" (NBP, 2005, p. 8).

8. Uncertainty as to the impact of energy prices has been a general problem facing all central banks. Relative to euro area countries, zloty appreciation and lowering of excise tax on fuels (in September 2005) might have being restraining the impact of energy prices in Poland, but energy's higher relative share in the consumption basket acted in the opposite direction.

9. These gains are believed to be yet larger in other new EU member states, mainly due to their smaller size and greater openness to trade.

10. It should be well known by now that while the benefits from a monetary union are those mentioned above, flexible labour and product markets are especially important for realising them when exchange-rate depreciation is no longer an option. Lack of flexibility is a contributory factor to unemployment in several of the larger EU economies. The Polish government has itself drawn attention to the importance of labour market flexibility in this context (Ministry of Finance, 2005).

11. The President of Poland mentioned this in an interview in February: "Euro implementation today would spark off unavoidable prices hikes and deteriorate people's standard of living" (Polish News Bulletin, 24/2/06, quoting AFP).

12. Although exchange rate policy is not the NBP's sole responsibility, the National Bank Law nevertheless invites the central bank to make its views on economic policy issues known to the government and the public.

13. The OCA theory dates back to the work of Mundell (1961). The endogeneity argument has been gaining support since the work of Frankel and Rose (1998).

14. The definition of the inflation criterion (and some others as well) is not clear and leaves room for interpretation. Protocol on the convergence criteria in the Treaty states that the criterion is met provided consumer price inflation in the country in question "does not exceed by more than 1½ percentage points that of, at most, the three best performing Member States in terms of price stability". The three "best performing" countries were initially identified with those with the lowest inflation. One recent ECB convergence report (ECB, 2004) excluded a country with a negative inflation rate as an "outlier", so that reference inflation value was based on inflation in three EU member states with the lowest positive inflation rate. In principle, however, an argument can be made that "best performing" countries could be identified as those being the closest to the ECB target of inflation below, but close to, 2%.

15. Higher inflation after euro adoption would likely stem from both internal pressure due to wage gains in high productivity tradable sectors being matched through the labour market by similar wage inflation in non-traded, lower productivity-growth sectors, where prices would have to increase (the Harrod-Balassa-Samuelson effect, see Box 2.2), and through more direct price-level convergence. Comparative price-level data published by the OECD indicate that the price of a representative basket of consumer goods and services in Poland was in the range of 55-59% of the price level in four largest EU economies (Germany, United Kingdom, France and Italy) as of end-2005. There is a substantial variation in price-level differences for various product groups. For example, Poland's price level index for clothing and footwear was at 72% of the EU25 average as of 2004, whereas the relative housing rents index stood at 26% (Eurostat, 2005).

16. Some contributions are being made. Citibank handlowy recently estimated the equilibrium rate against the euro to be between 3.60 and 3.76 (Kalisz, 2006), indicating that the zloty is still undervalued.

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*Chapter 3*

# Achieving fiscal sustainability

*Although Poland's fiscal position has improved in recent years, public expenditure is not well controlled. Moreover, despite an important earlier reform of the pension scheme, significant population ageing will generate upward pressure on spending. Expenditure on social transfers is particularly high, and the taxes required to finance them create a tax wedge that is one of the highest among OECD countries. Since EU accession, transfers to Poland have increased; this is an opportunity for the country but also a challenge for the budget. This chapter discusses: i) how to improve the fiscal framework in order to achieve fiscal sustainability; ii) means of reducing public expenditures so as to lower the tax wedge; iii) ways to efficiently absorb transfers from the EU.*

Poland's fiscal position has improved in recent years. The deficit was brought below 3% in 2005, and the debt-to-GDP ratio, according to Maastricht methodology, has stabilised since 2003. An important reform of the pension scheme was legislated in 1999, replacing the old pay-as-you-go system by a mixed public and private defined contribution system. This was a significant step towards achieving fiscal sustainability. In the short term, however, the shift of part of the nation's retirement savings to private pension funds results in an increase in the deficit and in the debt which, with Eurostat agreement, is not reflected in the "headline" deficit figures. Hence, the underlying fiscal position of the country is somewhat flattered by current data, although it is true that, thanks to the pension reform, the future fiscal position is markedly improved. A large part of public expenditure is accounted for by social transfers, and difficulties in reforming them partly explain why the government failed in its goal of reducing the ratio of public expenditure to GDP in 2005. A high level of taxes and social contributions is therefore needed to finance expenditure and, as a result, the tax wedge in Poland is among the largest in the OECD, which is a serious deterrent to employment. Being a new member of the EU, Poland is receiving large transfers, but this will not be sufficient to escape the medium-term problem of financing social expenditure.

This chapter discusses how the fiscal framework should be improved in order to reduce public expenditure in the future and to absorb transfers from the EU as efficiently as possible from a fiscal perspective. This is needed in order to achieve fiscal sustainability but also to reduce the tax wedge by containing social expenditure. The chapter starts by presenting Poland's fiscal position. It then turns to a discussion of how an improvement in the fiscal framework could help to achieve fiscal sustainability. Next, ways to reduce public expenditure and to lower the tax wedge are examined. The last section deals with the impact of EU funds on the budget and on ways to absorb them efficiently.

Figures quoted for the fiscal deficit in this chapter are – for the most part – based on the methodology used by Eurostat and (consequently) the OECD Statistics Department; they are different from but consistent with those used by the International Monetary Fund (and, for internal purposes, by the Polish finance ministry). This is due to the different accounting treatment of pension funds. This difference is scheduled to be eliminated in 2007. The issue is discussed in Box 3.2 and the text below.

## Poland's fiscal position has improved...

After several revisions to the debt and GDP data (Box 3.1), the debt-to-GDP ratio (according to Maastricht definitions) reached 42.5% in 2005 (Figure 3.1). Compared with other OECD countries, this is not especially high. However, according to a broader definition of general government gross financial liabilities, debt is higher and is estimated to have approached 50% of GDP. The Polish constitution requires that, on this definition, debt should never exceed 60% of GDP. In order to prevent the debt from reaching this level, the Public Finances Act stipulates that if public debt exceeds 50% of GDP, the State deficit

### Box 3.1. **Government finance statistics definitions, data availability and revisions**

As in many European countries, there exist two definitions of the general government debt in Poland: one according to the Maastricht methodology and the broader concept of the whole general government gross financial liabilities. The former is calculated according to the ESA95 methodology while the latter is calculated according rules stated in the Polish Act on Public Finance. In order to obtain the figure corresponding to the broader concept of the Polish public debt starting from that based on the Maastricht methodology, government debt held by private pension funds (4.0% of GDP in 2004, see Box 3.2) and some other liabilities that are not in the Maastricht debt (1.0% of GDP in 2004) must be included. Before 2006, another item, the risk-weighted stock of outstanding State guarantees, was also added. But in 2005, the government decided to exclude this item from the Polish definition, reducing this measure of the debt by around 1.5 percentage points of GDP. Although changes in definition are sometimes necessary, recent revisions have been excessively frequent and accompanied by insufficient explanation, and comprehensive information about their impact has been difficult to obtain, with no publication of comparative time series data on new and old definitions, for example.

Adding to the fact that there exist different definitions of the debt, the assessment of the fiscal stance is complicated by some other data issues:

- State-level statistics are often discussed in Poland, especially for the deficit. Since the broader general government concept gives a more accurate picture of the fiscal situation and the impact of policy measures on the State deficit may differ from that on general government, the reporting of annual fiscal data at this more aggregated level should be as frequent as possible.
- Revisions of GDP and government finance statistics are frequent and can be large, which makes it difficult to evaluate Poland's fiscal position. For instance, regarding forecasts and estimates for 2004 and 2005, between the convergence programmes of April 2004 and January 2006, the debt-to-GDP ratio was lowered by more than 7 and 9 percentage points, for 2004 and 2005 respectively, and these revisions were only partly due to GDP revisions (Table 3.1). As the quality of data improves, such revisions should become less frequent, but they need to be properly communicated and explained.

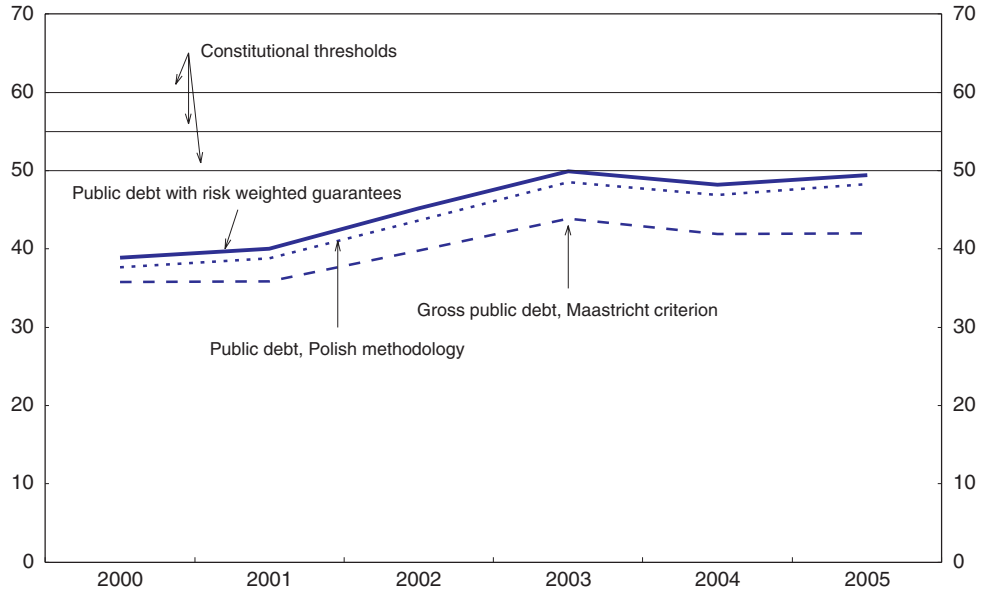
Table 3.1. **Revisions of government finance statistics**

| Per cent of GDP | General government | | | | | |
|---|---|---|---|---|---|---|
| | Deficit | | | Debt | | |
| | 2003 | 2004 | 2005 | 2003 | 2004 | 2005 |
| Convergence Programme | | | | | | |
| April 2004 | –4.1 | –5.7 | –4.2 | 45.3 | 49 | 51.9 |
| November 2004 | –3.9 | –5.4 | –3.9 | 45.4 | 45.9 | 47.6 |
| January 2006 | –4.7 | –3.8 | –2.9 | 43.9 | 41.9 | 42.5 |

*Source:* Ministry of Finance, Convergence Programmes.

expressed as a per cent of total revenue of the following year must not exceed the revenue share in the year when the limit was breached. The 55% threshold triggers more severe measures: the State budget deficit for the following year must be consistent with a stable or falling ratio of State Treasury debt to GDP. Up to now, the debt has remained below the

Figure 3.1. **Debt accumulation and the constitutional thresholds**
Gross debt, per cent of GDP



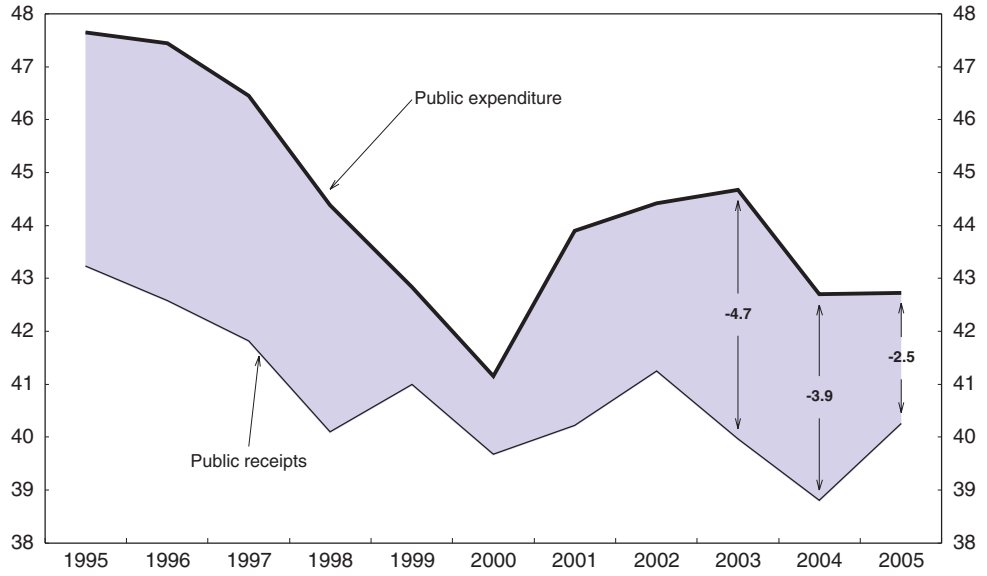

*Source:* Eurostat for the debt according to Maastricht criterion and Ministry of Finance for the two other definitions of the debt.

55% threshold, although it reached the first threshold in 2003 before the debt methodology was changed and the data revised.

Poland's general government deficit shrank in both 2004 and in 2005, falling from 4.7% of GDP in 2003 to 2.5% in 2005 (Figure 3.2).However, this improvement is only partly attributable to a reduction in the structural deficit; part of it was achieved through one-off effects. The deficit reduction in 2004 came from a significant diminution in the expenditure-to-GDP ratio, while revenues as a percentage of GDP decreased less strongly. There was a reduction of social spending and a slight fall in interest payments and government consumption, while subsidies remained stable. The reasons for the better budget outcome in 2005 are markedly different and mainly relate to revenues which, even though GDP growth in 2005 was below potential and much weaker than in 2004, rose strongly. According to the Ministry of Finance, this came from the shift of VAT and excise tax revenues from 2004 to 2005 as a consequence of the adoption of EU accountancy methodology and thus, the increase in the tax-to-GDP ratio would be temporary. EU accession, which led to important flows between the EU and Poland in both directions, also had an impact on the budget, but it is difficult to evaluate it precisely (see below). Expenditures as a percentage of GDP remained almost stable. While government consumption increased markedly (by 9.8% in nominal terms), social expenditure and subsidies continued to decrease as a percentage of GDP.

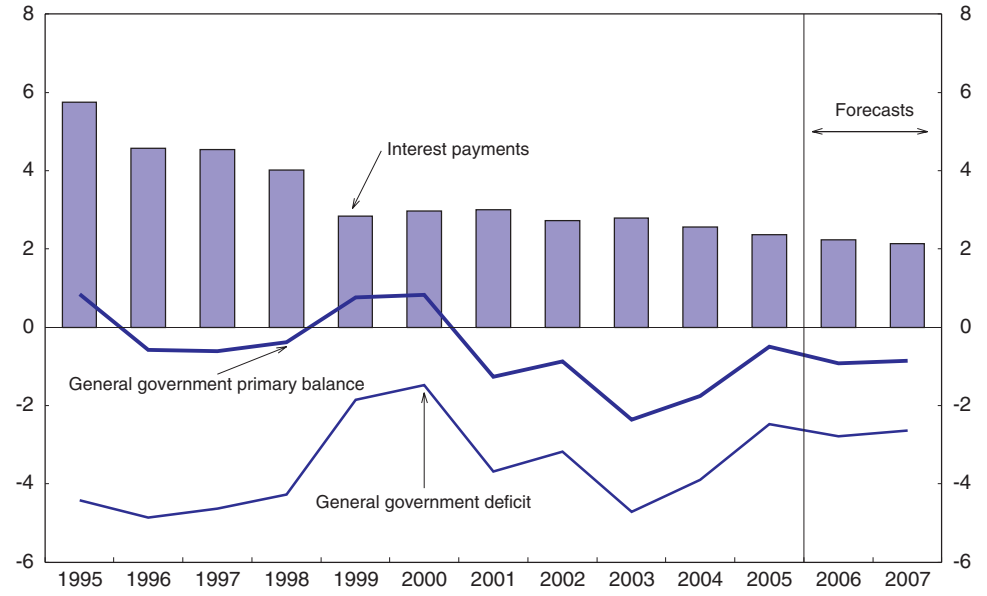
Interest payments fell markedly until 1999 as a result of lower interest rates (Figure 3.3). Since 2000, the burden of interest payments has remained unchanged at a not especially high level of around 2.5% of GDP. Overall, therefore, Poland did take advantage of the lower burden of interest payments to reduce the deficit, but could have done better on the primary balance, which has remained in small deficit for most of the last 10 years.

Figure 3.2. **General government deficit**
Per cent of GDP




*Source:* OECD, Economic Outlook 79 database.

Figure 3.3. **General government primary balance and interest payments**
Per cent of GDP




*Source:* OECD, Economic Outlook 79 database.

## ... but the upward trend in debt has not been definitely reversed

The accumulation of debt – measured by the gross debt-to-GDP ratio – depends on both the general government deficit and the level of GDP as well as various (below-the-line) financial transactions and valuation changes. The impact of GDP growth on the change of the debt-to-GDP ratio depends on the current ratio. With a debt-to-GDP ratio of 42.5% in 2005, GDP growth of 5% in value would lower the debt-to-GDP ratio by 2 percentage points in 2006.[1] This means that, because Poland is expected to grow quite strongly, a deficit of 2% of GDP in 2006, and more than that in 2007, would be consistent with a stable debt-to-GDP ratio. However, other factors also play a role:

- Revenues that are generated by the privatisation process are not taken into account in the calculation of the deficit, but they do reduce the level of debt. These revenues are expected to amount to 0.4% of GDP in 2006 and to decrease to 0.2% in 2008 (having been more than 0.8% of GDP in 2004).
- Since part of the debt is denominated in foreign currency, the exchange rate also plays a role. For instance, in 2004, as the Polish currency strengthened, the value of foreign-currency-denominated debt decreased. Partly as a result of this, but also through early repayment, the share of foreign debt fell to 29% by mid-2005, compared with nearly 50% in 2000. On the whole, according to the Ministry of Finance estimates, the exchange rate effect cut the debt-to-GDP ratio by 2.3 percentage points in 2004. Falling foreign debt reduces the gain from further appreciation but reduces exposure to exchange rate risk. The Ministry of Finance estimates that the exchange rate had a limited effect on the debt in 2005 (–0.3% of GDP) and that it will continue to be the case in the future (+ 0.3% in 2006 and –0.2% in each of 2007 and 2008).
- Other factors also play a role, including loans granted by the government to entities outside the general government sector and changes in some assets of the government such as bank deposits of certain general government entities. On the whole, the Ministry of Finance expects these factors to increase the debt in 2006 by 1.5% of GDP. This, along with accrual adjustments, explains why the debt-to-GDP ratio is projected to increase by 2.5 percentage points in 2006 despite the fact that the GDP growth and privatisation revenues should fully compensate for the deficit.

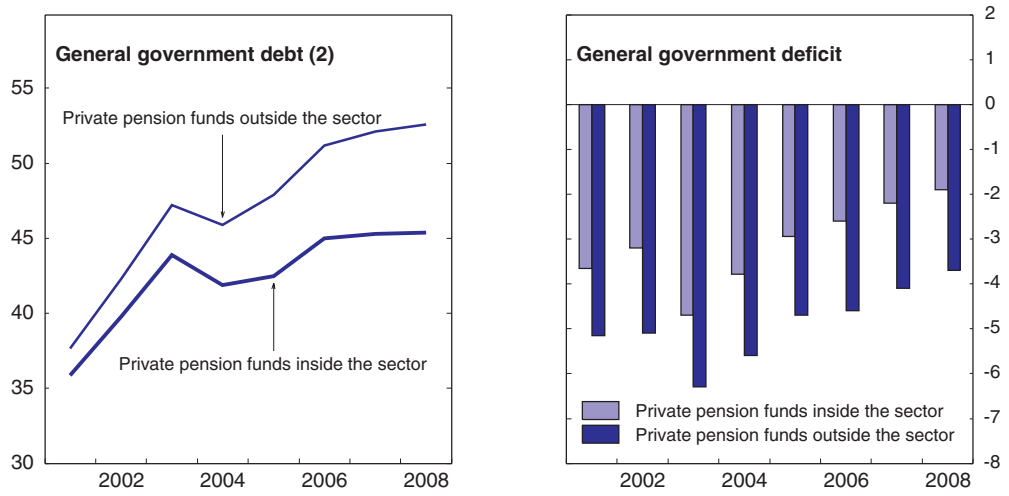
Because of these factors, it could be argued that the current general government deficit is not very far from the level that would be consistent with a stable debt-to-GDP ratio. The government is planning to reduce the deficit slightly further from 2.9% of GDP in 2005 (this was at the time of the publication of the Convergence Programme, before the revision of the deficit down to 2.5%) to 2.6% in 2006 and to 1.9% in 2008. Debt is expected to rise to 45% of GDP in 2006 (Maastricht definition) and then to remain almost stable though at its highest level since at least 1997 (Figure 3.4).

According to an agreement with Eurostat, as from March 2007 the Polish private pension funds (OFE) will have to be classified outside the general government sector, increasing the recorded debt-to-GDP ratio (Box 3.2). The impact of this re-classification will be to raise the general government deficit and debt (Figure 3.4). Moreover, on a definition that excludes these funds from the general government sector, the upward trend of the debt-to-GDP ratio is more marked.

Poland also decided to revise its own methodology to exclude the risk-weighted stock of outstanding guarantees from total debt (Box 3.1). Although this decision has the advantage of reducing the differences between the two definitions of the debt, it was taken

Figure 3.4. **Impact of the classification of Polish private pension funds (OFE) on the debt and deficit**[1]

Per cent of GDP




1. Data do not include the revisions published after the publication of the Convergence Programme (January 2006). However, the revisions do not affect the impact of the classification of open pension funds on the debt and the deficit.
2. On the basis of Maastricht definitions of the debt.

*Source:* OECD calculation using the Eurostat estimates of the impact of the classification of the Polish private pension schemes before 2004; Ministry of Finance (2006) from 2004.

at a time when the debt-to-GDP ratio was approaching the 55% limit and thus might be interpreted as a way of avoiding the constraints that face the government when the debt limit is exceeded. Rather than introducing such a change in the definition, Poland should seek to increase financial market confidence by improving the transparency of budgetary data and publishing comprehensive timely figures based on the different concepts of the debt.

Apart from 2004, when a large bank privatisation took place, privatisation revenue has been much lower than the originally intended 1% of GDP per year over the period 2003-06. This is frequently treated in press comment in Poland as a problem for fiscal policy. Although these revenues can (and should) be used to reduce government debt, privatisation policy is much more important for its impact on improving competition in the economy, removing government influence from areas where it is not appropriate, as discussed in Chapter 5. Shortfalls of revenue due, for example, to the proceeds from planned sales failing to meet expectations, should not be treated as a failure by the State Treasury to implement policy. On the other hand, a failure by the Treasury to sell its holdings because it *fears* that not enough revenue will be raised, *is* such a failure generally speaking. In practice, government discretion over individual privatisation decisions is the main reason why the pace of the process has been slower than expected. The government should put more weight on the positive impact that privatisations would have on sectoral restructuring and business behaviour, announce clear objectives for the process and stick to them. Plans to stabilise or lower the debt-to-GDP ratio should rely above all on containing the deficit.

### Box 3.2. **Impact of the classification of Polish private pension funds on debt and deficit**

Since the 1999 pension reform, a mixed private-public pension system has been introduced in Poland (OECD, 2004). This system consists partly of a privately managed fully-funded scheme, the so-called "Open pension funds", to which contributions are compulsory. The question is whether these specific private pension funds should be classified inside or outside the general government sector, since they include both private and public characteristics. Although they are compulsory, these schemes are fully funded and entirely managed in the private sector, so Eurostat decided that they should be considered to be outside the general government sector. However, for a transitional period (until March 2007), Poland obtained the right to classify them inside the general government sector, along with Hungary, Slovakia and Sweden who also have mandatory funded schemes.

The classification of the private pension funds affects both the deficit and the debt:

- Since the schemes have been established recently, and excluded those who were over 50 in 1999, they are not yet mature (payments to beneficiaries will start in 2009). As a result, the balance of the schemes is positive, and including them in the general government sector improves the general government deficit.
- If classified inside the general government, assets and liabilities of the pension funds should be consolidated with those of the general government. As a result, the government bonds held by the pension funds are deducted from general government debt. The general government debt does not benefit from other assets of the open pension funds, because Maastricht methodology uses gross liabilities, not net (which would make more sense, if assets could be measured properly). On the other hand, the liabilities should, in theory, be added, but because pension liabilities are not included in the definition of the debt (according neither to the Maastricht methodology nor to Poland's), they are not. On the whole, the classification of the open pension funds as part of the general government therefore improves the general government debt position.
- Although this transitional arrangement gives an inaccurate picture of public finances, it parallels that used implicitly by countries that have not made such a comprehensive pension reform and avoids penalising Poland for using an accounting method that shows a higher (but more informative, as it is similar to using accruals accounting) level of public debt. The higher level is, however, the appropriate measure for policy, and Poland would do better to switch to that measure, perhaps publishing in parallel figures on the other basis.
- In March 2006, the European Commission announced that it would be taking further measures under the excessive deficit procedure because the deficit for 2007 of 4.1% and 3.7% for 2008 projected in Poland's Convergence Programme exceed the 3% of GDP limit when the open pension funds are excluded, although it is projected at 2.2% on the definition that includes them.

## In order to achieve fiscal sustainability, the fiscal framework should be changed

The government does not plan any significant reduction in the deficit for 2006 in either absolute or cyclically adjusted terms. According to its forecasts, the expenditure-to-GDP ratio would decrease only very slightly, while the revenues-to-GDP ratio would stabilise. Given that the government expects real GDP to increase by more than 4% in 2006, the budget for 2006 does not appear very ambitious. It nevertheless relies on a significant

slowdown in spending following last year's rapid increase and on an increase in the tax-to-GDP ratio despite the fact that strong revenues growth in 2005 was thought to be due to one-off effects by the Ministry of Finance. However, the budget for 2006 does not include any specific measures to significantly slow the pace of expenditure growth. Although unemployment is expected to continue to decline, social transfers, which represent a high share of public expenditure in Poland, are not expected to fall in 2006, partly because pensions will be indexed on the cumulated inflation of the two previous years (see below). A stronger reduction of the deficit is intended for 2007, which would come from a more substantial decrease in the expenditure-to-GDP ratio; the cyclically-adjusted primary balance is expected to improve markedly and to turn positive. So far, no specific measures to achieve this goal have been announced. The EU Commission already declared that Poland had an excessive deficit in 2004,[2] and current plans are not sufficient to meet the deadline set in 2004 of a 3% of GDP deficit in 2007 (with open pension funds outside the general government sector, see Box 3.2). Therefore, the EU Commission announced in March 2006 that it intends to take further steps under the excessive deficit procedure.

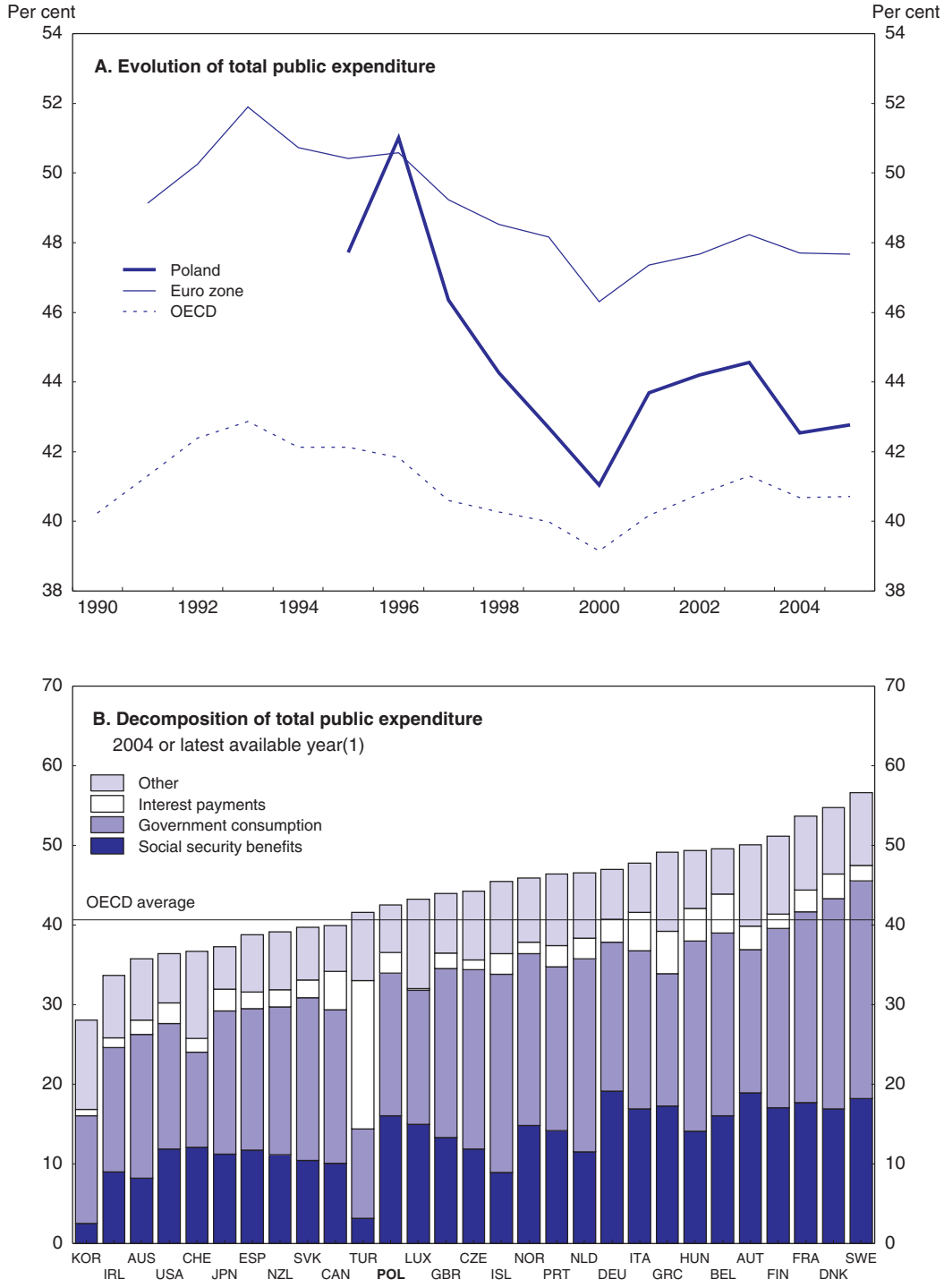
The post-election parliamentary debate on the budget for 2006 was conducted under the condition that the central government deficit should not be more than PLN 30.5 billion (3% of GDP). Therefore, it has chosen to adopt a nominal anchor for the State budget deficit. Such a rule is helpful but has at least two drawbacks. *First*, because the ceiling has been set on the deficit rather than on expenditures, it has been possible to introduce new spending during the process – such as the "baby birth bonuses" – because some new resources (extra revenues from the central bank) were used to finance them rather than to reduce the deficit. *Second*, because the ceiling concerns the State budget deficit but not the general government deficit, the rule will not necessarily prevent fiscal slippage at that more aggregated level. In particular, since social security funds are separated from the central budget, there is an incentive for the government to reduce subsidies to these funds in order to meet the target on the central level deficit, despite the lack of any impact on general government. Indeed, these extra-budgetary funds are highly subsidised – to the tune of 4% of GDP in 2004 and 30% of their revenues – and they show recurrent and increasing deficits.

One way to improve progress towards fiscal sustainability is to introduce an expenditure rule in the form of a multi-year ceiling on general government expenditure, including that of the social security funds. Such a rule would avoid taking decisions that bring benefits today but would generate costs in the future. It is also necessary because some sources of future increase in expenditures are already known, and the government should already be working on how to cope with them. This is the case for instance for the increase in expenditures generated by the ageing of the population. Moreover, the targets should not be set in terms of share of GDP as is the case in the convergence programme. Since GDP developments are unknown, the government should commit itself not to exceed a certain rate of growth of expenditures in volume. Where revenue-increasing measures are required, those that broaden the tax base (rather than increasing marginal tax rates) should be favoured; in any case, taxation should be increased only when there is no longer any room to reduce low-priority expenditure (see below).

## Expenditure needs to be controlled by setting priorities

Although government expenditure as a share of GDP was declining until 2000, since then it has stabilised at a relatively high level (Figure 3.5). The average in 2005 for OECD countries was 41% of GDP compared with 42.5% in Poland. The correspondingly high level of

Figure 3.5. **Public expenditure in OECD countries**
As a per cent of GDP




1. 2001 for New Zealand; 2002 for Turkey; 2003 for Australia and Switzerland.

*Source:* OECD, Economic Outlook 79 database.


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Table 3.2. **Savings from the implementation of the Hausner plan**

PLN billion

| | 2004 | 2005 | 2006[1] | 2007[1] | 2004-07 |
|---|---|---|---|---|---|
| Administration and economy | 0.11 | 0.38 | 0.46 | 0.45 | 1.40 |
| *of which:* | | | | | |
| Public administration | 0.01 | 0.06 | 0.05 | 0.05 | 0.17 |
| State aid | 0.08 | 0.05 | 0.05 | 0.05 | 0.22 |
| Military spending | 0.00 | 0.13 | 0.13 | 0.13 | 0.39 |
| Tax measures | 0.01 | 0.14 | 0.23 | 0.22 | 0.59 |
| Decrease the level of national economic reserves | 0.01 | 0.00 | 0.00 | 0.00 | 0.01 |
| Social expenditures | 0.01 | 0.47 | 0.24 | 0.63 | 1.36 |
| *of which:* | | | | | |
| Early retirement | 0.00 | 0.01 | 0.07 | 0.12 | 0.20 |
| Change to rule on pensions indexation | 0.00 | 0.41 | 0.10 | 0.42 | 0.93 |
| Change to rule on sickness allowances | 0.00 | 0.03 | 0.03 | 0.03 | 0.09 |
| Disability | 0.01 | 0.02 | 0.05 | 0.06 | 0.15 |
| Total savings now expected (A) | 0.13 | 0.85 | 0.71 | 1.07 | 2.76 |
| Originally forecasted savings (B) | | | | | 5.02 |
| Implementation in per cent (A/B) | | | | | 55.00 |

1. Savings that will be realised as a consequence of measures passed in 2004 and 2005.

*Source:* Report on realisation of the "Plan for the Rationalisation of Social Expenditures", Council of Ministers, Warsaw, May 2005; OECD calculations.

taxes that is needed to finance this expenditure is bound to distort behaviour of both households and firms. Recognising the need to bring public expenditure under control, the previous government proposed a public expenditure reform, known as the Hausner plan, which sought to improve the fiscal position from 2004 until 2007 by introducing savings from public administration and the social transfer system, as well as proposing revenue-enhancing measures. Only part of the plan was passed by parliament, and so not more than half of the savings have yet been realised (Table 3.2). The main measure was the modification of the system of old-age pension indexation: while pensions used to be indexed every year on inflation, they are now indexed only when cumulated inflation reaches 5%. No other significant measure has been introduced to control expenditure since 2004.

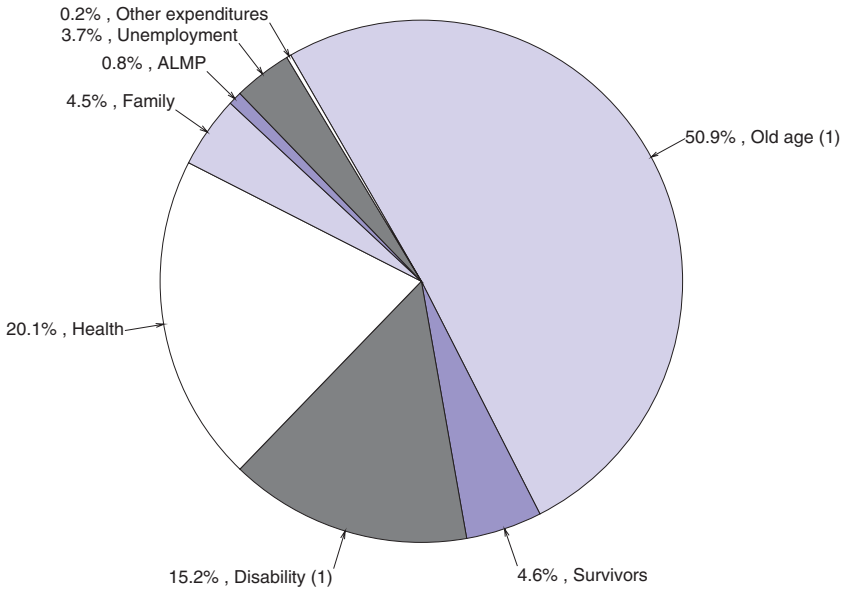
It is often argued in Poland that the level of expenditure cannot be changed because most of it (70% according to the Ministry of Finance) is fixed in the sense of being legally determined. The authorities consider interest payments on the debt, contributions to the budgets of the EU institutions, and old-age and other pension and health expenditures as mandatory. In fact, only some of these are essentially immutable, but it is true that a decrease even in pension and health expenditures requires undertaking painful structural reforms. While such reforms are called for, introducing outcome-oriented performance evaluation into the budget process could help. Poland has started to work on this issue. *Ex ante*, each item of spending should be connected with an outcome and a measure of performance. *Ex post*, a transparent performance assessment should be worked out. In addition, policy objectives could be prioritised more clearly, so that expenditure that does not have high-priority objectives would be a candidate for cuts. Expenditure whose goals are not achieved should be reconsidered. This would help the government to: *i*) set its priorities, *ii*) evaluate whether goals are being efficiently achieved, and, *iii*) inform the public of the fact that expenditure priorities are being set on the basis of clear analysis.

The high level of Polish public expenditure results mainly from spending on social transfers (Figure 3.6). The fact that the government spends a lot on social policy is not very

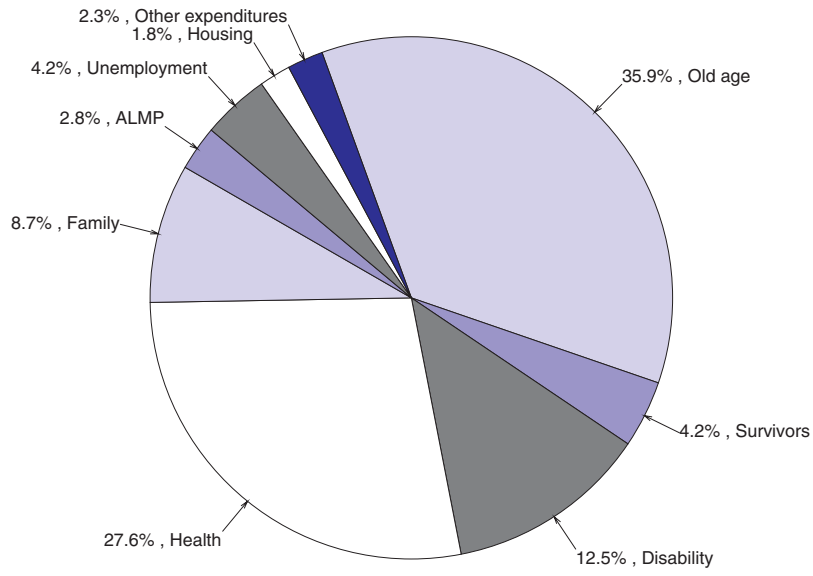
## Figure 3.6. **Sources of public social expenditures**

Percentage of total public social expenditure

**A. Poland, 2003**




**B. OECD, 2001**




1. Revisions to the data have reclassified a large part of what was previously classified as expenditure on disability to that on old age.

*Source:* OECD, 2006 (forthcoming), Social expenditure database 1980-2003.

surprising in a country with an 18% unemployment rate. However, contrary to what might be expected, rather little is spent on unemployment policies as such: indeed, the share of total public social expenditure spent on unemployment benefit in 2001 was identical to the OECD average (Figure 3.6). Most of the spending goes on providing non-employed with revenues without requiring an active job search. Moreover, it is also poorly targeted, providing social help to people who are not necessarily those who need it most (OECD, 2004). On the other hand, Poland's expenditure on health is relatively low but is expected to increase in the medium term as a consequence of the ageing process.

On the whole, not only is the social transfer system very costly, but it is also at the origin of distortions that partly contribute to the low employment problem, encouraging people to be inactive. Because the system is costly, contributions that are needed to finance it are high; furthermore, because labour participation is low, and the contribution of some groups to social security (self-employed, farmers) is not at all or only weakly linked to incomes, the burden of it is borne by a small fraction of the population. As a result, the tax wedge is high, which also contributes to the low level of employment. In order to break this vicious circle and to make room for future expenditure that will be generated by the ageing process, reform of the social transfer system needs to continue. The following sections examine ways to contain social expenditure in several areas.

## Social expenditure should be contained

### *Disability*

The disability pension scheme used to be a very large source of spending, representing 6% of GDP in the 1990s, although this percentage may include some spending on old age.[3] But, since 1999, the authorities have restricted access to the system by tightening eligibility conditions for new disability pensions – medical assessment is performed by doctors employed by the social security system – and by no longer offering pensions of indefinite duration. These new rules were put in place by the general social security system (ZUS), but no significant changes have been made to the farmers' special social security system (KRUS, see below). The ZUS reforms have reduced the inflows of disabled pensioners but also the evolution of the stock. Whatever source is used, there has been slight decrease in spending as a share of GDP since 2000. According to the Ministry of Labour and Social Affairs, expenditure on disability pensions fell from 3.6% of GDP in 2000 to 2.9% in 2004. Overall expenditure on disability (including non-pension measures) was estimated to still represent 3.6% of GDP in 2004 (Table 3.3). As a result of continued high spending on disability, the contribution rate to finance disability pensions (as well as survivors' pensions) is still 13% of wages, split evenly between employers and employees, contributing substantially to the magnitude of the tax wedge.

Table 3.3. **Public expenditure on disability as a share of GDP**

| | General social insurance system | Farmers' social insurance system | Total |
|---|---|---|---|
| 1995 | 4.0 | 0.9 | 4.9 |
| 2000 | 3.6 | 0.8 | 4.4 |
| 2004 | 2.9 | 0.7 | 3.6 |

*Source:* Ministry of Labour and Social Affairs.

In order to lower this contribution rate and hence the tax wedge, inflows should be closely monitored to make sure that they remain at a low level, especially after the phasing out of the early retirement schemes (see below). It is not easy to find the right balance between the risk of refusing benefits to people who need them and that of granting benefits to people who do not. The way the medical assessment is done is thus very important. Experience from other countries shows that the assessment, especially for long-term beneficiaries, should be made by specialised doctors, rather than by the applicant's own doctor (Rae, 2005). In order to achieve an unbiased assessment, the final decision to grant a disability benefit should be taken at central rather than local level (OECD, 2003). At the moment, the right to receive a pension in Poland is still decided at the local level, though certificates are delivered by ZUS or KRUS certified physicians, while pension entitlements – mainly the duration and the amount of the pension as well as conditions for rehabilitation – are determined at the central level. To reduce the stock of disability pensioners, their capacity to work should be re-assessed periodically when disability is not permanent. In some countries, for instance, a review takes place every two or three years (Rae, 2005). An earlier plan to re-examine the stock of beneficiaries who were granted a pension for life before the introduction of the new rules in Poland was abandoned and is no longer being considered. Efforts should also be made to integrate those with only partial or moderate disabilities into the labour market (OECD, 2006a). Efforts to restrict access to the system should also continue.

### *Pre-retirement benefits*

As inflows to the disability pension scheme have diminished, inflows into pre-retirement schemes have increased sharply since 2000 (Ministry of Economy and Labour, 2005). Until 2004, pre-retirement benefits were granted to workers who were made redundant with 30 years of insurance contributions for women and 35 years for men. However, for those employed in special conditions, it was enough to have been covered during 15 years to be eligible for pre-retirement benefits. As a result of these generous eligibility conditions, public expenditure on these programmes reached 2.6% of GDP in 2003, offsetting a large part of the savings due to the reduced access to the disability system (Table 3.4).

Table 3.4. **Public expenditure on early-retirement schemes as a share of GDP**

| | EU25 | Poland |
|---|---|---|
| 2000 | 0.6 | 2.0 |
| 2001 | 0.6 | 2.2 |
| 2002 | 0.7 | 2.4 |
| 2003 | 0.7 | 2.6 |

*Source:* Eurostat database.

The Hausner plan (2004) included measures to restrict access to pre-retirement schemes, but some of these measures, that should have been put in place in 2006, have been postponed to the end of 2007. In order to increase labour market participation of workers over 45, the government needs to follow plans to restrict access to programmes encouraging early withdrawal from the labour market. Restriction of access to pre-retirement

schemes as well as to the disability system needs to be accompanied by measures to increase employability, such as in-work benefits and training (see Chapter 5).

### *The special farmers' social security system*

The special farmers' social security system (KRUS) is another important source of social spending. Government subsidies to the farmers' system represented 1.7% of GDP in 2004 and more than 90% of KRUS revenues. The high level of subsidies is a consequence of the low level of contributions to the system. Contributions do not depend on income of the subscriber but on the level of the minimum retirement pension paid by the general social security system. Benefits are lower than those paid by the general system but, because for most people the saving on contributions easily exceeds the shortfall in benefits, there is an incentive for people who should be in the general system to (fraudently) join KRUS (Ministry of Labour, 2005). Another incentive to be affiliated to this system comes from the fact that it is less strict than the general system in granting disability pensions. Indeed, the disability pension reform introduced in 1999 does not cover farmers. (This difference of strictness is illustrated by the fact that 25% of the number of disability pensions are paid by the KRUS, while only 19% of employment is in the agriculture sector.)

Some measures have been taken both to restrict the benefits of the system and to increase the contributions of people conducting non-farming activities. However, it is still relatively easy to be covered by the system. For instance, "members" of the household – in fact, anyone close but not necessarily related to the farmer – that permanently work on the farm, even if farming is not their main source of income, can join. A reform of the KRUS would not only improve the fiscal situation but would also reduce impediments to sectoral adjustment and the inequalities that exist between farmers and the rest of the population (see Chapter 5 and OECD (2004)). It should include closing KRUS to new entrants, an increase in contributions by linking them to income and the tightening of eligibility requirements, while nevertheless protecting people whose revenues might fall below subsistence level. A further reform should be to include farmers in the new old-age pension scheme. These reforms are politically difficult. However, because the rural sector is now receiving substantially greater income from the EU Common Agricultural Policy, this should be an opportunity to reform the special farmers' system. However, the 2006 budget has changed the criteria for the allocation of social transfers for farmers and has further increased the generosity of the system. This measure goes in the wrong direction, increasing public expenditure by 0.1% of GDP each year and continuing to impede sectoral adjustments by providing incentives to remain in the agricultural sector.

### *Health*

Both public and total health expenditure in Poland are among the lowest in OECD countries, public health spending amounting to only 4.5% of GDP, and the two series have shown only a very slight upward trend since 2000 (OECD, 2005a). However, public health expenditure is expected to grow more rapidly than in the average OECD country mainly because of a marked pure ageing effect. It is estimated to increase by 1.8 percentage points of GDP by 2025 and 2.7 percentage points by 2050 (OECD, 2006b). Although it is difficult to estimate the optimal amount that the government should spend on health, Poland public health spending is much below the OECD average (6.4% in 2003). As a result, the government should expect to face growing demand for expenditure.

The current health care system was largely reformed in 1999. The state monopoly was abolished, and relatively strong decentralisation and financial and management responsibility of municipalities and regions were introduced (OECD, 2000). Some regional health funds were created, but they performed badly. They appeared to be inefficient and incapable of managing the health budget. As a result, a return to centralisation occurred in 2003 with the creation of the National Health Fund. This fund receives the contributions collected by the ZUS and some subsidies from the State. Through regional branches, the fund contracts services with local healthcare providers. The National Health Fund has shown recurrent, albeit not very large, deficits from 2000 to 2003 and little surplus since then. However, according to the Green Book, a document from the Ministry of Health that evaluates the impact of ageing on health expenditure, the situation of the Fund is expected to deteriorate and the deficit could reach 0.5% of GDP in 2015. The major sources of public expenditure on health are drugs (which represent more than 20 per cent of public healthcare expenditure) and hospital care. Salaries of medical personnel are the main source of expenditure of healthcare units.

Healthcare providers are independent units, either public or private. Public hospitals' debt is large and is mainly held by the public sector. It comes from the fact that public hospitals are required to provide services irrespective of the contract concluded with the National Health Fund. They bear the cost of expenditure that is not refunded by the State budget. Furthermore, prices offered by the Fund are often below the real cost of services, and hospitals have little incentive to reduce costs and to improve financial management. In the past, some increases in wages of the staff of public hospitals were decided at the State level, although hospitals did not have the resources to finance them, which created budget pressures and increased their debt (salaries represent 50 to 90% of the costs of operation of health care units). The fact that the system is under-funded partly explains why public expenditure on health as a share of GDP is so low. The government introduced a law in April 2005 to help public hospitals to restructure their debt. It allows public hospitals to contract loans with the State budget, on condition that they undertake some action to improve their financial situation. Provided that this law does indeed give effective incentives to hospitals to modernise and reorganise, including measures to improve the allocation of expenditure, it would help to ensure that any additional resources – which are needed in many areas – are used effectively. Otherwise, the risk is that they remain mere accounting changes which do little to improve the underlying problems.

In order to improve the quality of health care and to avoid expenditure slippages, the government should continue to reform the system by providing incentives to health providers to introduce new techniques and efficient management, as well as to patients to rationalise their demand for health care. The government should closely monitor the impact of the law introduced in 2005 on public hospitals' debt. More detailed reforms of the health care system to increase the efficiency of public spending were given by the World Bank (Box 3.3).

### *Old-age pensions*

Poland also undertook a fundamental reform of its pension system in 1999. The old pay-as-you-go system is being phased out and a mixed private-public pension system was introduced (OECD, 2004). The new system rests on three pillars: a state-run notionally defined contribution scheme, a compulsory privately managed fully-funded defined contribution system and the possibility of subscribing to voluntary private pensions. There

Box 3.3. **Measures proposed by the World Bank to increase the efficiency of public spending on health care**

- Introduce meaningful competition among health service providers.
- Establish a direct linkage between hospital payments and patient services.
- Strengthen incentives for improved hospital financial management.
- Promote use of generic drugs and rationalise prescription practices.
- Extend the system of family medicine (a system which provides personalised and comprehensive primary and specialist consultation services in well equipped clinics in order to restrain the number of consultations of specialists) to cover 100% of the population.

*Source:* World Bank (2006a).

is also a minimum pension guarantee. Thanks to this reform, the long-term sustainability of the State-managed part of the old-age pension system is secured. European Commission projections show that public old-age pension outlays should fall from 13.9% of GDP in 2004 to 8% in 2050 while they would have increased substantially without the reform (European Commission, 2006). The main source of savings comes from the gradual reduction of the average public pension relative to output per employed person, but the increase of the share of employed in the working age population and the "eligibility effect"[4] would also play a role. Nevertheless, because of the development of the second pillar, the gross replacement rate for an average-wage worker starting its career in 2005 would stay at the level of the average of the OECD (56.9%, OECD 2005b).

During the transition period, since contributions to the State-managed part of the system are reduced while expenditure on old-age pensions under the old system will decrease only progressively, the budget still shows a deficit on pension finance. Official projections at the time of the reform suggested that the balance of the State-managed part of the system should turn positive by 2012. However, according to an IMF report (2005) based on information from the ZUS, the position of the State-managed pension system is much worse than projected for the transition period and is not expected to improve as much as in the initial projections. This comes from unfavourable labour market developments, a rapid shift to self-employment, which is outside the system, generous pension increases since 1999, and delays in phasing out special entitlements to early retirement for certain groups (see below). Taking into account these changes, the IMF report assesses that the system will now show a deficit until 2036. Moreover, since the coverage of the mandatory pension system has declined, there is a risk that claims on budget to support those with low replacement rates may emerge in the future.

The accumulated pension savings in the compulsory private (open) pension funds (second pillar) have remained moderate, at about 2.6 months of salary (IMF, 2005), but the performance of the funds has been very good because the Polish stock market has boomed. Since the replacement rate provided by the State-managed part of the system might be low, private pension fund performance will play an important role in providing the retired with decent revenues. If the rates of return on the funds are high, contributions could be lowered in order either to compensate for an increase of the contributions that finance the State-managed part or to decrease the tax wedge. Some aspects of pension fund regulation may limit their performance (OECD, 2004). Each pension fund is required to yield a real rate

of return not lower than half of the industry average. In case of non-compliance, the company that manages the fund must make up for the difference from its own assets. On the other hand, there is very little in the way of rewards for companies whose funds outperform the industry average. This asymmetric regulation gives little incentive to try to obtain above-average returns and encourages herd behaviour. This may explain why the share of foreign assets in the funds' portfolio is very low, around 2%, much below the regulatory limit of 5%, which is itself probably lower than necessary. There is also a limit on the share of equities, which must not represent more than 40% of the portfolio, and which are permitted only in quoted companies, limiting any potential role for these funds in expanding entrepreneurship (see Chapter 5). Forty per cent may seem low for immature funds, but it is not out of line with industry practice in other countries.

Quite a large number of people are not covered by the new pension system and belong to more favourable specific pension schemes. Farmers are not covered by the new system. Miners should have been covered, but, under the pressure of demonstrations organised by the miners' trade unions in front of the parliament, an amendment to the law on old-age pensions that grants the miners the right to retirement after 25 years of underground work independently of age was finally voted. According to an estimate by the Ministry of Social Policy and Labour, this would cost around 0.3% of GDP in 2020. These kinds of exceptions not only create inequalities between workers but also prevent mobility between sectors that is needed for increasing both employment and productivity. Moreover, they are at the origin of large subsidies from the government to finance these specific schemes. The government should work on plans to progressively eliminate all special schemes.

### *Public employment services*

Finance for labour market policies in Poland comes from the Labour Fund, which is part of the social insurance system, from taxes paid by employers as well as from subsidies from the State budget. Subsidies to the Fund have been irregular, and the Fund has shown recurrent and increasing deficits. In theory, the Ministry of Labour decides the share of resources attributed to active and passive labour market policies, but, in practice, labour offices have substantial discretion over the use of resources. The Ministry also sets labour market policy guidelines and decides the sources of financing for the various programmes. Resources are transferred to regional public employment services, which are in charge of labour market policies. Hence, the system is partly decentralised, with policy guidelines and resources set at the national level, while implementation is at a regional or local level.

The organisation of the public employment services is complex. There are 16 regional labour offices and 350 labour offices at a more decentralised level. Moreover, some services are offered in towns by information centres and other institutions. There is little co-ordination between these institutions (Republic of Poland, 2005). Experience in other countries shows that the efficiency of labour market policies is increased when the non-employed have access to one-stop-shop services. In order to improve the efficiency of expenditure on employment, Poland should seek to simplify the overall system, to increase the co-ordination between institutions and to avoid having several institutions providing the same service.

Although the government has been trying to promote active labour market policies (ALMP) instead of passive ones, the share of resources spent on ALMP programmes is still particularly low (Figure 3.6). It represents less than 20% of overall labour market spending, compared to an OECD average of 40%. A large part of the task of the public employment

service (PES) has consisted of paying unemployment and pre-retirement benefits and providing some subsidised public jobs. As a result, the staff of the PES is not sufficiently trained or motivated to promote policies in favour of employment such as counselling the unemployed and monitoring job search. Some of the staff of labour offices have few qualifications themselves, the quality of their management is poor, and personnel turnover is very high. Moreover, there are very few incentives for the staff to actively help the unemployed to find a job. In order to improve the efficiency of the PES, its employees need to be trained to propose appropriate active measures, and their salaries should be partly linked to performance. The Act on employment and labour market institutions of 2004, which opens up the possibility of giving the staff bonuses linked with their performance, goes in the right direction. The shift of pre-retirement benefits financing from the Labour Fund to ZUS introduced in 2005 should be an opportunity for the Labour Fund to concentrate on ALMP.

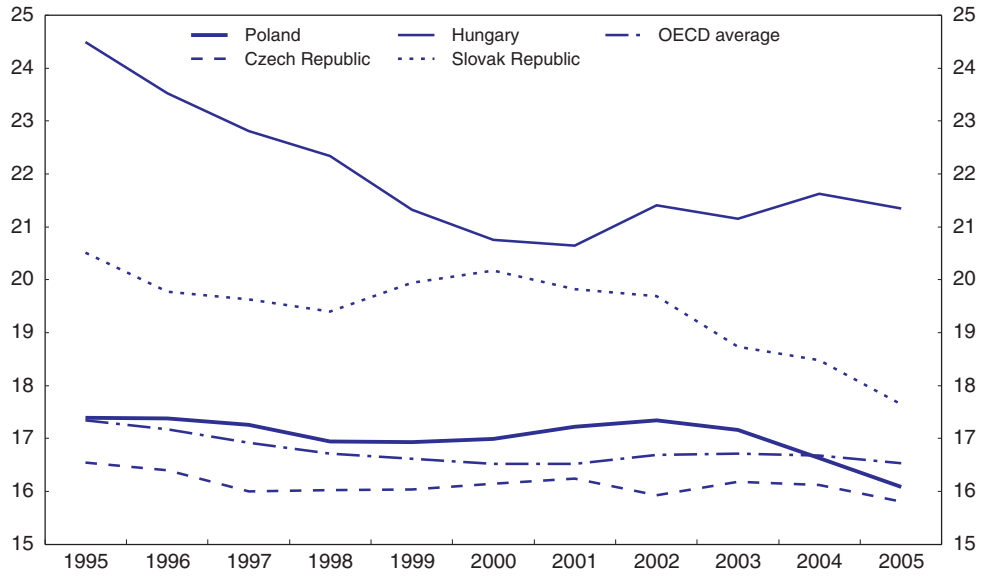
Because labour market policies are implemented at the regional level, the quality of information on programmes and on their evaluation varies between regions. Programmes should be systematically evaluated. Policies that do not appear to help people to find a job – as is the case of policies that merely give income to the non-employed – should be progressively replaced by those that raise employment possibilities.

## Expenditure on public sector wages and state aids is high

Government wage consumption is another important component of public spending. Public employment as a share of total employment has been decreasing in recent years and has now reached the OECD average (Figure 3.7). However, employment in the more restricted sphere of public administration and defence has continued to increase both in

Figure 3.7. **Share of public employment in total employment**

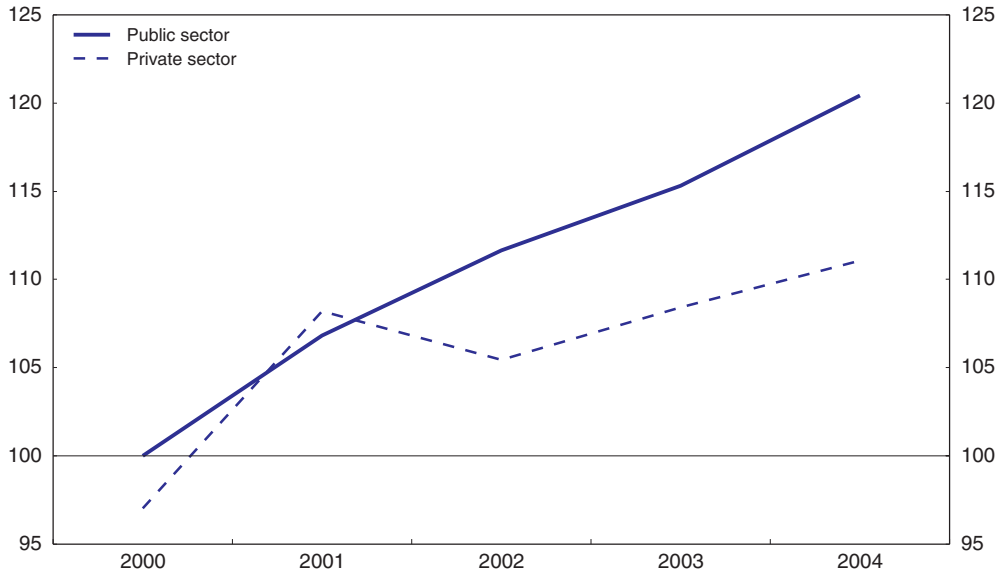
Percentage




*Source:* OECD, Economic Outlook 79 database.

absolute terms and as a share of total employment. Public-sector wages are higher than their private-sector counterparts and have been growing relatively strongly (Figure 3.8), pushing up the gap between the two. Although it is very difficult to measure productivity in the public sector, this wage differential is very unlikely to reflect inter-sectoral differences in productivity. However, at least for the more highly skilled, the level of wages in the public sector does not seem to be too high, since high-skilled new entrants into the labour market most often choose the private sector. It is more likely that wages in the public sector are not sufficiently linked to individual performance and qualifications. Although it is important that salaries in public administration attract competent employees, this is not sufficient to ensure efficiency. The government should try to introduce schemes linking individual wages to performance and limit general increases in wages. Continuing the policy to decrease public employment and at the same time introducing such rules on wages would not only help to contain public expenditure but would also improve public-sector efficiency by attracting more highly-skilled workers and better motivating them.

Figure 3.8. **Wage growth in the public and private sectors**
Public sector = 100 in the year 2000




*Source:* OECD calculations on the basis of data from Central Statistical Office, *Statistical Yearbook*.

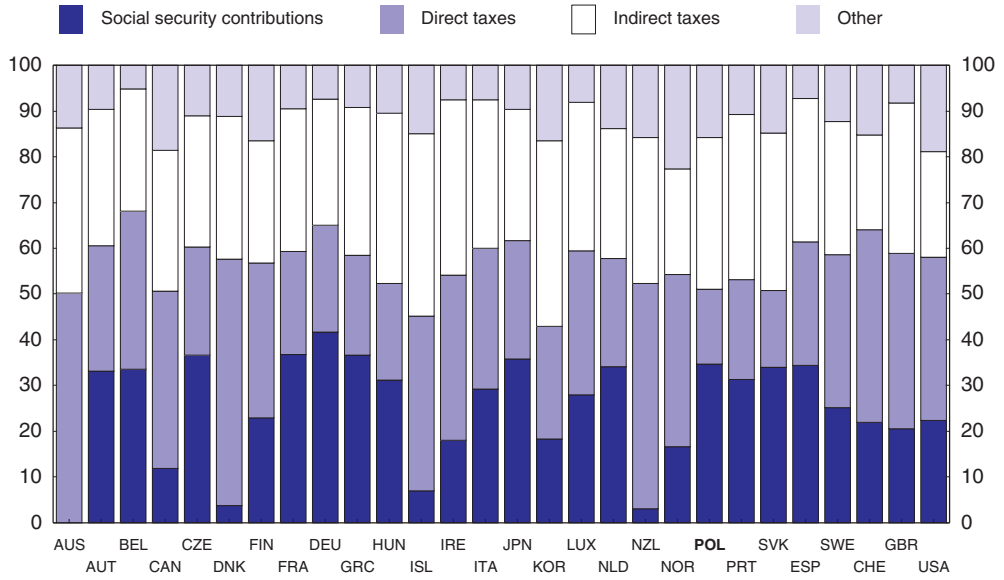
Poland is one of the European countries where state aids as a percentage of GDP are the highest, reaching 1.5% in 2004 (excluding state aids to railways; European Commission, 2005a). Much of this aid is given without precise objectives and is directed mainly to the manufacturing and agriculture sectors. As for other expenditure, setting clear objectives and evaluating outcomes would help to improve public spending efficiency. Since it is impossible to avoid sectoral reallocations in the long run, the government should work to eliminate state aid that has no precise goal other than to maintain particular sectors in existence. Government plans to reduce state aid for industrial restructuring while increasing "horizontal" aid – whose objective is not related

to a specific industry such as support for innovation – are to be welcomed, but they could go further (see Chapter 5). The decision taken in the 2006 budget to increase subsidies for fuel for farmers is a clear step in the wrong direction.

## Simplifying the tax system

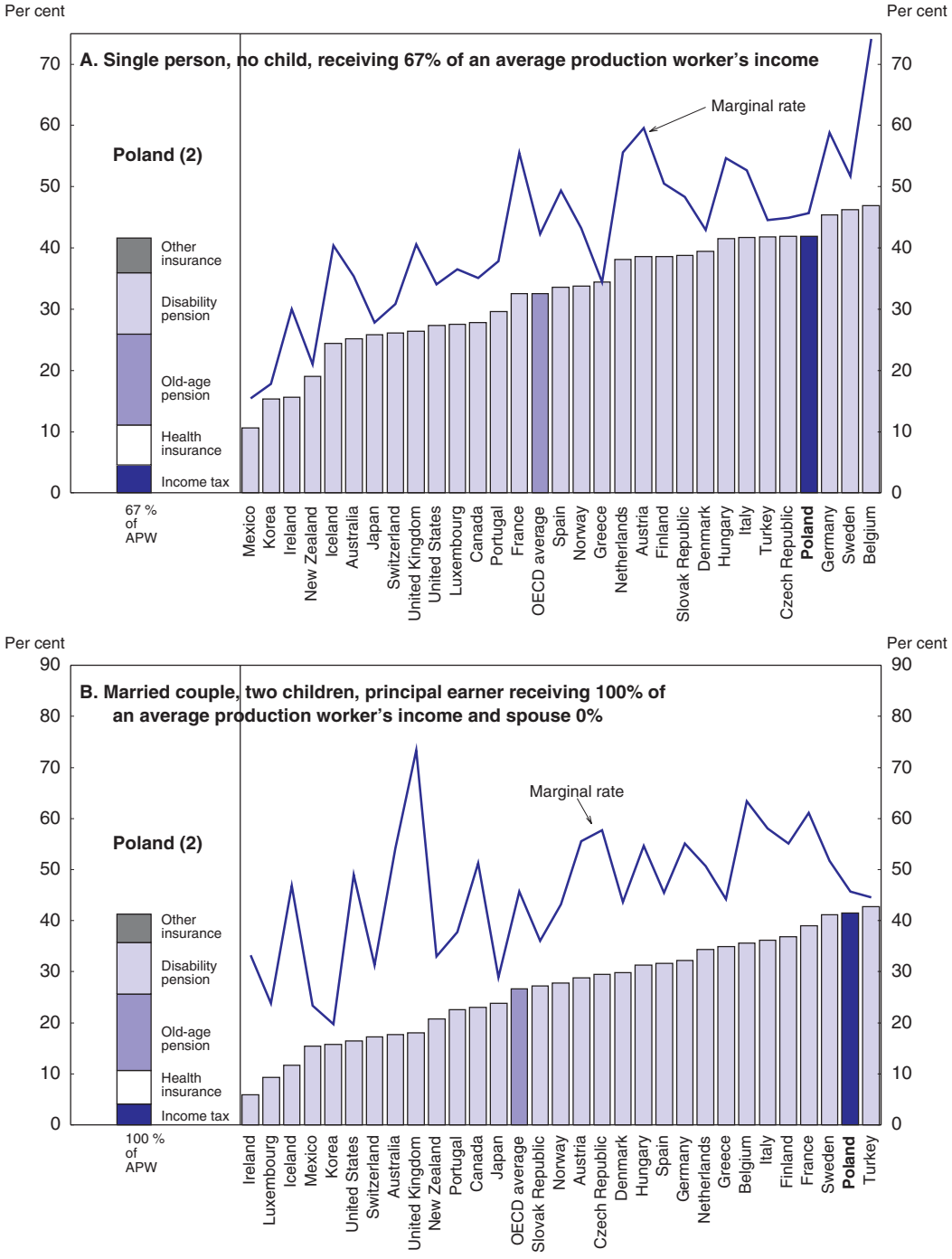
Achieving fiscal sustainability at the cost of an increase in the burden of taxes is not a good solution for Poland. Indeed, although it is difficult to determine the optimal tax rates for a country, the literature suggests that the tax level is already too high in Poland, as in many other new EU member countries (Mitra and Stern, 2003; Bernardi and Chandler, 2004). The tax-to-GDP ratio is below the EU-25 average but not those of other new EU Member States (European Commission, 2005b). During the last decade, Poland has introduced several changes in the tax system. Personal income tax (PIT) and corporate income tax (CIT) rates were reduced, while the tax bases were broadened. In particular, the top statutory tax rate on corporate income was decreased to 19%, which is among the lowest of EU countries, but again, not that low compared to other new EU member States. Indirect tax rates were increased to bring them closer to EU levels. Social security contributions were raised. On the whole, Poland's tax system is characterised by one of the highest shares of social contributions among OECD countries, while direct taxes represent a small share of government revenues (Figure 3.9). The result is a very high level of the tax wedge (Figure 3.10),[5] which is an important deterrent to employment and job creation (OECD, 2004). A large part of the tax wedge comes from certain social security contributions, such as that for disability pensions, which, as discussed above, could be reduced by a deeper reform of the system.

Figure 3.9. **Structure of tax revenues by major type of taxes**
Per cent of current receipts, 2004[1]




1. 2001 for New Zealand; 2003 for Switzerland.
*Source:* OECD, Economic Outlook 79 database.

Figure 3.10. **The tax wedge on labour in OECD countries**[1]
2004




1. 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.
2. OECD estimates.

*Source:* OECD, Taxing wages database and OECD estimates.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The tax system not only creates significant economic distortions, it is also very complex. Despite the reforms of recent years, many exemptions and tax reductions still exist, although the PIT has only three income tax brackets and three marginal tax rates. This complexity has at least three implications. *First*, it generates uncertainty about the outcomes of agents' decisions (consumption, investment and labour supply). *Second*, it might be partly at the origin of the high administrative costs in tax revenue collection (Table 3.5). *Third*, the tax base is narrowed. In this regard, the possibility for Tax Offices to publish binding interpretations of the Law since January 2005 is to be welcomed. Nevertheless, although reducing some of the uncertainties, this decision does not diminish the overall complexity of the system and could even increase administrative costs, if legal conflicts were to develop over such binding interpretations of the still-complex laws.

Table 3.5. **Indicators of administrative costs in tax revenue collection**

| | Administrative costs as a percentage of collected revenue | Number of citizens per full-time staff | Number of labour force per full-time staff | Reported gross tax arrears as a percentage of net tax collections |
|---|---|---|---|---|
| | 2002 | 2003 | 2003 | 2002 |
| Australia | 1.19 | 1 016 | 512 | 9.3 |
| Austria | 0.72 | 929 | 450 | 9.6 |
| Belgium | 1.00 | 476 | 207 | 14.6 |
| Canada | 1.20 | 810 | 425 | 8.4 |
| Czech Republic | 2.08 | 700 | 351 | 49.7 |
| Denmark | 0.73 | 651 | 348 | 4.9 |
| Finland | 0.67[1] | 820 | 415 | 6.6 |
| France | 1.44 | 788 | 358 | 16.1 |
| Germany | .. | 665 | 324 | 2.6 |
| Hungary | 1.35 | 768 | 309 | .. |
| Ireland | 0.95[1] | 625 | 282 | 4.5 |
| Italy | .. | 1 202 | 510 | .. |
| Japan | 1.62 | 2 260 | 1 199 | .. |
| Korea | 0.85 | 2 804 | 1 359 | 3.0 |
| Netherlands | 1.76[1] | 629 | 320 | .. |
| New Zealand | 1.17 | 853 | 425 | 4.0 |
| Norway | 0.59[1] | 716 | 374 | 4.0 |
| **Poland** | **1.32** | **751** | **339** | **8.6** |
| Portugal | 1.68 | 778 | 402 | 43.5 |
| Slovak Republic | 1.46 | 929 | 458 | 39.7 |
| Spain | 0.78 | 1 680 | 745 | 5.9 (2001) |
| Sweden | 0.42[1] | 985 | 494 | 1.9 |
| United Kingdom | 1.15[1,2] | 730[3] | 360[3] | 17.2[2] |
| United States | 0.52[1] | 2 261 | 1 445 | 16.1 |

1. Revenue base includes social contributions.
2. Inland Revenue Data (IRD).
3. IRD and Custom and Excise (C&E).

*Source:* Tax Administration in OECD Countries: Comparative Information Series (2004), Centre for Tax Policy and Administration.

Tax reforms have been under discussion in Poland. The Ministry of Finance has announced plans to simplify the tax code and to lower pension contributions (disability, survivor and death grant pensions, see Chapter 5) from 13% to 9% and sickness contribution from 2.45% to 1.8%. Plans of the majority party in the coalition to simplify and decrease PIT rates have not been detailed so far and will have to be agreed by the

government as a whole to be implemented. Because of legal procedures, any change to social security contributions would require at least a one year minimum delay. Changes should aim at simplifying the system and reducing distortions without increasing the burden of taxes. Priority should be given to reforming the social insurance system in order to reduce the tax wedge. Such a reform reduces administrative costs and has a positive impact on growth through a reduction in distortions, especially those that harm incentives to work, save and invest. Any reform will need to go hand in hand with a reform of the transfer system, as discussed above and in Chapter 5, and must avoid increasing the deficit.

## Absorbing EU funds

Since its accession to the European Union in May 2004, transfers from the EU to Poland have increased markedly. The amount of funds to which Poland is entitled was set in the so-called Copenhagen Package. The amount of transfers that Poland will effectively "absorb", however, depends on the capacity of the country: *i*) to present programmes that the EU agrees to finance, *ii*) to implement them, and *iii*) to pay the final beneficiaries. Regarding the first two points, available data suggest that Poland has performed slightly below expectations, since it has received 40% of the 2004 allocation, while the European Commission expected it to use 50% of the allocation (although part of the envelope is direct payments). The process of transferring funds to final beneficiaries has been slower: 13.1% of the allocation of structural funds for 2004 and 2005 has been effectively spent (7.4% of the global envelope for 2004-06), which sounds rather little but is explained by the fact that the process of absorption necessarily takes time. Apart from Estonia and Latvia, absorption has also been slow in other new EU members (World Bank, 2006b). In order to increase the pace of absorption, a ministry in charge of EU funds management (the Ministry of Regional Development) has been created. Following its creation, the pace of absorption has indeed increased with 9% of the global envelope for 2004-2006 having been used at the end of February 2006. The amount of money actually transferred to Poland so far is much higher because, once the EU has agreed to finance a project, advance payments are made that need to be reimbursed if the money is not spent. Moreover, some of the transfers are direct payments. Overall, cumulative transfers (from accession to the end of 2005) from the EU were 1.7% of GDP, whereas Poland's contribution to the own resources payments of the EU budget was 1% of GDP (Table 3.6). Although the net financial impact of European Union accession on Poland is clearly positive, the budgetary impact of accession is less certain because:

- Only part of the transfers (transfers not subject to "additionality", CAP and Schengen facility) can be used to finance pre-existing expenditure. Transfers subject to "additionality" cannot substitute for existing expenditure; rather, they should finance new projects. This is the case for transfers for rural development and structural funds, which means that, in theory, Polish spending should increase at least by the amount of the EU contribution. In practice however, this requirement is not always fully met, because it is not easy to ensure that transfers are not used to finance existing expenditure, especially for rural development spending. Transfers that are subject to "additionality" are neutral for the budget if Polish spending is of the same amount as the transfers; but they could have a negative impact if Polish spending is higher than transfers, or, on the other hand, a positive impact on the budget if at least some of this spending would have occurred anyway.

Table 3.6. **Estimated net impact of cumulated EU transfers to Poland**
End 2005, percentage of GDP

| | Cumulated flows from May 2004 to December 2005[1] |
|---|---|
| **A. Contribution to EU budget and institutions** | **1.01** |
| **B. EU transfers to Poland** | **1.74** |
| 1. Transfers subject to additionality" | 1.01 |
| *Rural development* | *0.26* |
| *Structural funds* | *0.44* |
| *Pre-accession aid* | *0.31* |
| 2. Other transfers | 0.42 |
| *CAP* | *0.24* |
| *Internal policies* | *0.06* |
| *Cohesion funds* | *0.12* |
| 3. Compensations | 0.31 |
| **C. Net impact on Poland (B-A)** | **0.73** |
| **D. Estimated total co-financing costs** | **0.22** |
| **E. Net impact on budget** | |
| Assuming that all spending financed by EU transfers would have occurred anyway (B-A) | 0.73 |
| Assuming that only transfers subject to "additionality" bring about an increase in government spending (B.2+B.3-A) | –0.28 |
| Assuming that all transfers bring about offsetting increases in spending (B.3-A) | –0.70 |
| Assuming that all transfers bring about offsetting increases in spending and that co-financing costs are a net addition to spending (B.3-A-D) | –0.92 |

1. Cumulated flows as a share of an estimated GDP from May 2004 to December 2005, in value terms.
*Source:* OECD calculations based on data on financial flows from the Ministry of Finance, December 2005.

- Many programmes must be co-financed, either by public or private sources. EU funds can be used to finance up to 75% or 85% of a project, depending on the fund. Co-financing expenditure can come from existing budget lines.
- Although EU funds are transferred through the State level budget to local government budgets, they do not affect the State level budget. However, they may affect local government cash flows because of the system of pre-financing. Once the programme has been accepted by the Commission, an advance payment of 16% is paid, but the rest of the cost of the programme is reimbursed only after expenditure has actually occurred. As a result, there is a need to pre-finance the programmes. This is done in Poland by funding from a Polish bank (BGK). This system implies that local government may experience temporary pressures when expenditure has occurred, but the local government is waiting for reimbursement.

If funds have been used to finance existing or new expenditure that would have occurred anyway, the total impact on the deficit (from May 2004 to December 2005) may be of +¾ per cent of GDP. In the worst-case scenario, *i.e.* if funds have been used to finance expenditure that would not have occurred otherwise, and if co-financing has been a net addition to spending, then the negative impact could have reached almost 1% of GDP.

The impact of financial transfers from the EU depends not only on the capacity of the country to efficiently absorb the funds, but also on how effectively they are spent. EU funds should be subject to the same discipline as other government resources, *i.e.* by clearly defining objectives and prioritising needs. Ideally, discussions on the use of these funds would be integrated into the process of a multi-year general government budget. Since there is no multi-year budget in Poland, the use of EU funds has been decided separately

### Box 3.4. **Summary of recommendations to achieve fiscal sustainability**

**Achieving medium-term fiscal sustainability**

Introduce multi-year targets for the general government deficit and a rule on the evolution of public expenditure.

Make sure that regulations do not impede the accumulation of assets in the open pension funds. Reconsider special pension treatment for certain groups, and avoid the creation of new exceptions.

Continue reforms of the health care system, and improve hospital financial management.

Clarify the different concepts used for the deficit and the debt. Publish timely and transparent information on the various concepts.

**Controlling public expenditure**

Set priorities on expenditure. Use resources, including those provided by EU transfers, to finance only those with high priority. Make greater efforts to evaluate their outcomes.

Assess state aids as stringently as other public expenditure, and eliminate those that are not efficient. Reduce vertical state aids. Reduce subsidies to the KRUS and work towards merging it with the general system.

Continue reforming the social insurance system. Improve further the link between the degree of work incapacity and the level of disability benefit, and implement plans to phase out early retirement schemes. Increase the efficiency of public employment services by developing systematic evaluation of policies and improving the efficiency of the staff.

Continue policies to lower public employment, especially in public administration. Contain wage growth in the public sector by limiting general increases and linking individual rises to performance.

**Improving the tax system**

Reduce distortions by reducing the tax wedge mainly through focusing tax cuts on social security contributions. Make sure that any plans to reform the tax system have this as their core objective.

Simplify the tax system in order to reduce administrative and compliance costs.

from that of government resources in a document elaborated by the Ministry of Economy with the co-operation of the European Commission. As a result, some expenditure that has been decided may have relatively low priority, given the overall budget constraint. This problem is all the more acute since expenditure that is partly financed by EU funds is very likely to generate extra expenditure on the part of the government, either because of co-financing, or if the final cost of the programme is under-estimated. In order to mitigate this problem, the government should set priorities and use funds not subject to "additionality" to finance existing high-priority commitments (or to finance existing expenditure commitments where resources released can be transferred to high-priority commitments). Funds subject to "additionality" should be used to finance high-priority new expenditure. The fact that expenditure is financed by EU funds and that some funds cannot be used to finance existing expenditure should not be a reason to undertake spending that is not of high priority or that has unclear goals.

## Notes

1. The debt-to-GDP ratio figure refers to the definition according to Maastricht methodology. The Ministry of Finance projection of GDP growth in value terms for 2006 is 5.4%.
2. The decision was taken in 2004 when the deficit was expected to reach more than 5% of GDP.
3. The Ministry of Labour and Social Affairs classifies spending on disability and survivors pensions for people over the retirement age as expenditure on disability and survivors, while Eurostat classifies them as expenditure on old age. OECD database on social expenditure used to be based on the Ministry of Labour and Social Affairs data but has switched to Eurostat data for the 2006 database.
4. This effect measures changes in the share of pensioners relative to the population aged 65 and over.
5. Indirect taxes also represent a high share of government revenues.

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*Chapter 4*

# Education and training: Boosting and adapting human capital

*An effective system of education and training is important for both social and economic reasons. Its role in the Polish economy is to provide the current and future labour force with skills to facilitate both continuing productivity growth and reallocation of resources as structural adjustment proceeds. Important reforms to decentralise primary and secondary education in the late 1990s are now reaching maturity, as cohort sizes decline steeply. These reforms and PISA results have focused attention on quality control and the place of vocational education. Both are important in the tertiary sector, too, which has seen a four-fold expansion in 15 years, mushrooming of private-sector provision and questions on the appropriate balance of public and private funding. Participation in adult training is low too and, as elsewhere, seems to be concentrated among already relatively highly-educated groups but does not seem to be having much impact on improving the human capital of older and less skilled groups.*

The major changes in the Polish economy and society over the last two decades mean that the education system operates in a very different world from that of 20 years ago. While societies have a range of aims that education policy should pursue, for present purposes this means most notably preparing people for economic life – in particular by contributing to providing the best match possible between supply and demand on the labour market. But it also means investing in skills and knowledge needed for promoting and pursuing necessary structural changes, innovation and growth, as well as encouraging and enabling people to learn and to adapt to economic change through their own working lives.

As discussed elsewhere in Chapters 1 to 5, the high level of unemployment represents a crucial challenge for economic policy in Poland. There is a clear link between educational outcomes and some of the groups that are most severely affected now by unemployment or low labour market participation. This includes both people over 45 or 50, many of whom may have now "withdrawn" from the labour force, and younger people, in their first years after completing education, where unemployment rates are also high.

For the younger of these groups an important issue is to what extent their labour market experience is explained by educational background and achievement, as opposed to more general labour market conditions, legislation and institutional arrangements. How can the evolving education system best improve the labour market prospects of future members of the labour force? Furthermore, even if educational attainment is at the root of the problem for many, what kind of education or training policy response is appropriate, both for the unemployed and for those currently in employment but perhaps in vulnerable sectors or regions? For the older group, how can they be drawn back into the labour force, if the particular skills that were relevant in their last occupation are now obsolete, and their general educational background (including their level of literacy) is perhaps insufficient even for low-skill jobs?

The education system in Poland has not been static but, on the contrary, has evolved enormously since 1990 and has experienced three important developments. *First*, it has already had to cope with a rapid decline in school enrolments now moving through the system, after the steep fall in birth rates after 1990. *Second*, the major re-organisation of primary and secondary education in 1998-99 introduced a decentralised organisational structure of management. *Third*, enrolment in tertiary education has increased at least four-fold, much of the increase being in hundreds of new private-sector institutions, raising questions of quality control and finance. These questions may also be relevant for privately financed adult training, while its publicly financed counterpart appears to have taken a back seat to passive labour market policies as far as the most vulnerable labour market groups are concerned.

This chapter discusses the returns to education and provides an overview of the structure of the education system in Poland; it then discusses its organisation and performance, taking the different levels of education and training in turn. The

performance of the education system is a complicated function of many variables (and is not to be measured only in economic terms), not all of which can be covered adequately in this *Survey*; hence the recommendations (see Box 4.4, at the end of the chapter) cover general factors such as resource allocation, organisation and quality control, rather than more precise recommendations on teaching methods and training, curriculum evaluation methods and so on that a more detailed investigation might provide.[1]

## The returns to education

All OECD countries provide a substantial amount of education for free, because it provides enormous benefits to society in addition to private returns to individuals. In Poland, the private returns to education have probably increased over the past 15 years. In 1993, 76% of respondents to an opinion poll felt that education was worthwhile; in 2004 the affirmative response to the same question had grown to 93% (CBOS, 2004). Over this same period, the returns to education appear to have increased as well, at least on the relatively crude measure of differentials between the earnings and employment rates of people with different levels of education and in different professions.[2] In fact, the widening of differentials by occupation is much more pronounced than that by education level (Table 4.1). Two factors are probably involved: the labour market itself has become more competitive, with greater rewards for differences in performance rather than differences in qualifications. And the rapid expansion of tertiary education means that people who in the past would have had only general secondary or post-secondary vocational qualifications now have tertiary education, so that differentiation within the tertiary group has increased.

Table 4.1. **Earnings by occupational group and education**

| | 1996 | 2002 |
|---|---|---|
| | Per cent of average earnings | |
| By professional group: | | |
| Senior staff and managers | 182 | 233 |
| Professionals | 118 | 133 |
| Technicians and other middle management | 102 | 102 |
| Office workers | 91 | 89 |
| Operators and installers of plant and machinery | 98 | 89 |
| Industrial labourers and craftsmen | 96 | 84 |
| Farmers and gardeners | 78 | 67 |
| Providers of personal services, traders | 70 | 60 |
| Unskilled labour | 68 | 59 |
| By level of education reached: | | |
| Tertiary | 144 | 151 |
| Post-secondary and secondary vocational | 99 | 91 |
| Secondary general | 99 | 94 |
| Basic vocational | 89 | 77 |
| Primary | 83 | 71 |

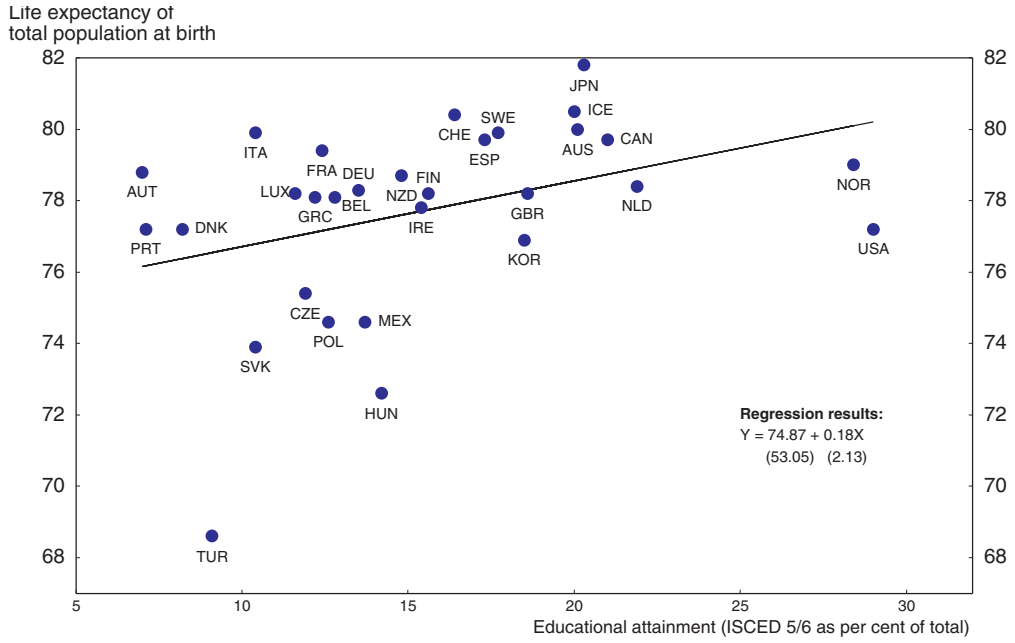
*Source:* Central Statistics Office and World Bank (2004), *Tertiary Education Poland*.

It is harder to measure the social benefits from education in Poland. In pre-primary, primary and secondary-level education, most research shows that social benefits exceed the private returns, though this is less clear for tertiary education (Blöndal *et al.*, 2002). Benefits arise from spillovers both on public finance, as higher earners pay a higher

proportion of their income in taxes, and in productive efficiency, as an increase in the general level of education results in higher output and contributes to productivity growth. Societies usually value education for non-economic reasons also, and there are often observed correlations between education and health outcomes such as life expectancy (although the extent to which these are causal or work through income effects is not clear – see Doyle *et al.*, 2005) (Figure 4.1). The difficulty in applying market rules to education provision reinforces the need to look for appropriate incentives and organisational structures.

Figure 4.1. **Life expectancy and educational attainment**

2002




*Source:* OECD, Health database.

## The structure of the education system in Poland

Compulsory full-time education in Poland runs from age 6 to 16, through one year of pre-school, then primary and lower secondary. Above the age of 16 full-time education is not compulsory, but since 1997 the constitution has required that, up to age 18, at least part-time education should continue, either in school or out of school. Less than 40% of children aged 3-5 attend pre-school, almost all of them in the larger urban areas. At upper secondary level children may go to a "general" school or to a vocational or technical school. The proportion of children going to general rather than vocational upper secondary schools has increased, because the general schools are thought to provide better preparation for the *Matura* exam, typically taken when the student is 19, and which is a condition for entry to tertiary education. This structure of primary and secondary education is relatively new: there were major reforms in 1991 and in 1998. An important change implemented in 1999 was the ending of selection between vocational and general streams at the end of primary school, with the creation of the undifferentiated lower secondary schools and delaying selection until age 15/16 (up to 1998 "primary" school continued until age 14/15). The current system of national examinations at the end of

primary and lower secondary levels dates only from 2002 (prior to that there were no national examinations before the *Matura*), and 2005 saw the written part of the *Matura* based on an external exam for the first time; in addition, vocational qualifications awarded by basic vocational and technical schools are now certified by external examinations, of which the first was conducted in 2004. The change in selection for the vocational stream and the introduction of national examinations may have helped overall educational performance to improve (Box 4.1).

Total expenditure on education in Poland is fairly typical among OECD countries when measured as a proportion of GDP (Table 4.3). As in most countries, the share of private expenditure in education is insignificant except at the tertiary level. At primary and secondary level, teachers' relative salaries are very low by international standards. As a proportion of per capita GDP, they are lower only in Iceland and Slovakia (OECD, 2005d, p. 356). Another unusual feature is the absence of significant differentiation between salaries for primary, lower and upper secondary schools: in Poland they are largely identical (allowing for length of service and other factors), whereas in most countries they vary by 20 to 30%. Teaching hours are somewhat lower than the OECD average but around the average for European countries, except at primary level where they are among the lowest.

In contrast to their low earnings, teachers are well protected in terms of their employment contract by the Teachers Charter (Box 4.2), which originally dates from 1982, but which was substantially modified in the 1998 reforms to improve the career structure (this was one of the recommendations of the 1995 *OECD Review of National Policies for Education in Poland*). As a result, teachers now work within a four-grade structure where (on application) they get automatic promotion and salary increases on meeting certain requirements for qualification and length of service. Teachers' pay can be varied for certain other reasons such as for extra work and for work in certain locations or subjects. Supplements can also be paid based on teachers' performance, and to teachers in rural areas. Supplements are not paid to compensate for cost-of-living variations across the country, although such variation is large, nor are they paid specifically to attract teachers in subjects or locations where they are in short supply.

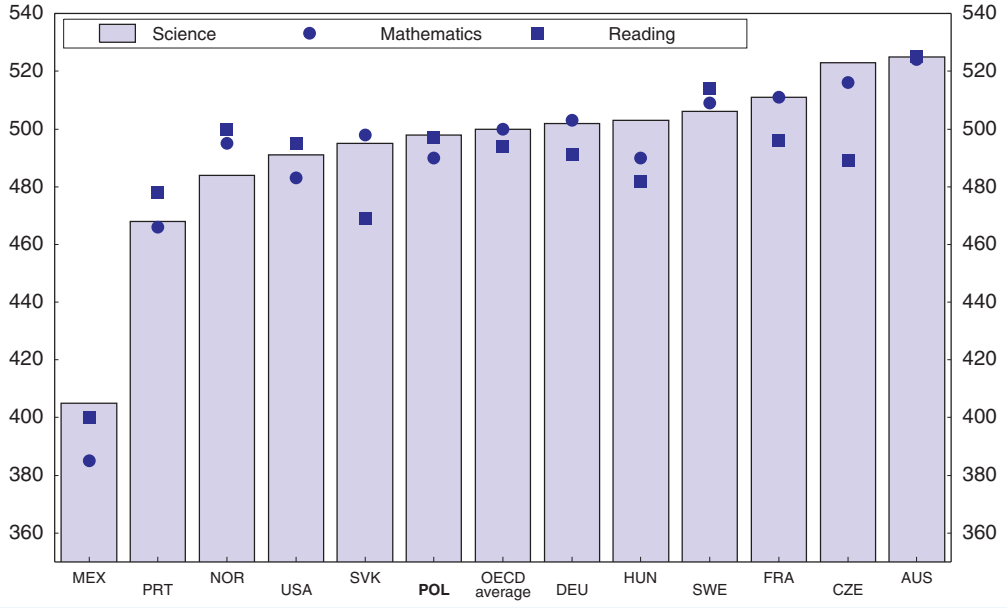
There has been a considerable move towards decentralisation of the organisation and financing of education. Financing for compulsory school education is provided by local governments out of the non-earmarked grant they receive from central government. Under this system, in operation since 2000, the grant is allocated according to a number of quantitative education-related indicators. It does not take into account average school size, teacher-pupil ratios and intensity of school transportation for pupils, all of which are found to influence the costs of educational provision (Swianiewicz *et al.*, 2005). The algorithm details are announced each year in an ordinance of the Minister of Education.[3] Some anomalies exist, in particular, the indicator of resources required for special-needs education is the number of children in special schools for such children, rather than the number of children with special needs; this produces an incentive to move such children into special schools, whereas this may often not be the best way to educate them. The algorithm includes no indicator for pre-school education before the age of 6, making it more difficult for local government to respond to any strong local demand for such pre-school facilities.

### Box 4.1. **Educational performance**

The OECD's Programme for International Student Assessment (PISA) provides international comparisons of children aged 15 in terms of their ability in mathematics, science and reading; the tests focus particularly on students' problem-solving ability in each of these domains. Performance in Poland is similar to the OECD average in all the subject areas tested (Figure 4.2). These statistics refer to national averages: variation within countries is high compared with variation between countries – more than a third of Polish children scored higher than the average mathematics score for Switzerland, the highest ranked country, and a third of Swiss children scored below the Polish average.

Figure 4.2. **Comparative educational performance**

Mean score in student performance, all students, 2003




*Source:* OECD (2004), Learning for Tomorrow's World, First results from PISA 2003 (Annex B, Tables 2.5c, 6.2, 6.6).

This performance is significantly better than obtained by Poland in the first PISA exercise, which took place in 2000. Many other countries improved too, and Poland's ranking moved up less than the increases in absolute scores might indicate (Table 4.2). PISA procedures are designed to minimise the impact of changes in structure and organisation of education on observed outcomes, so there are good reasons for thinking that this is a real improvement at least in part linked to earlier policy changes. The improvement was mainly a result of many fewer low scores, rather than an increase in scores all the way up the scale, and variation between schools fell.

These changes seem to be linked with the introduction of lower secondary schools in 1999 and the increase in the age of selection for secondary vocational schools. In 2000, many of the low PISA scores were obtained by children in basic vocational schools, who, before the 1999 changes, were not expected to continue through to the *Matura* exam; these low expectations appear to have been reflected in their performance. Now, at age 15, such

Box 4.1. **Educational performance** *(cont.)*

Table 4.2. **Changes in PISA education performance measures, 2000 to 2003**

| | Reading | | Mathematics: space and shape scale | | Mathematics: change and relationship scale | |
|---|---|---|---|---|---|---|
| | PISA 2000 | PISA 2003 | PISA 2000 | PISA 2003 | PISA 2000 | PISA 2003 |
| Australia | 528 | 525 | 520 | 521 | 522 | 525 |
| Czech Republic | 492 | 489 | 510 | 527 | 484 | 515 |
| France | 505 | 496 | 501 | 508 | 515 | 520 |
| Germany | 484 | 491 | 486 | 500 | 485 | 507 |
| Hungary | 480 | 482 | 478 | 479 | 479 | 495 |
| Mexico | 422 | 400 | 400 | 382 | 358 | 364 |
| Norway | 505 | 500 | 490 | 483 | 494 | 488 |
| **Poland** | **479** | **497** | **470** | **490** | **451** | **484** |
| Portugal | 470 | 478 | 440 | 450 | 448 | 468 |
| Sweden | 516 | 514 | 510 | 498 | 502 | 505 |
| United States | 504 | 495 | 461 | 472 | 486 | 486 |
| OECD average[1] | 499 | 494 | 494 | 498 | 487 | 499 |

1. Excluding the Netherlands, Slovak Republic, Turkey and the United Kingdom.
*Source:* OECD (2001), OECD (2004), PISA 2000 and PISA 2003.

children are still in general schools, where expectations are higher, and they may have responded by performing better. This is not the only explanation, since the improvement in the science ranking was due to better results from better performing children.

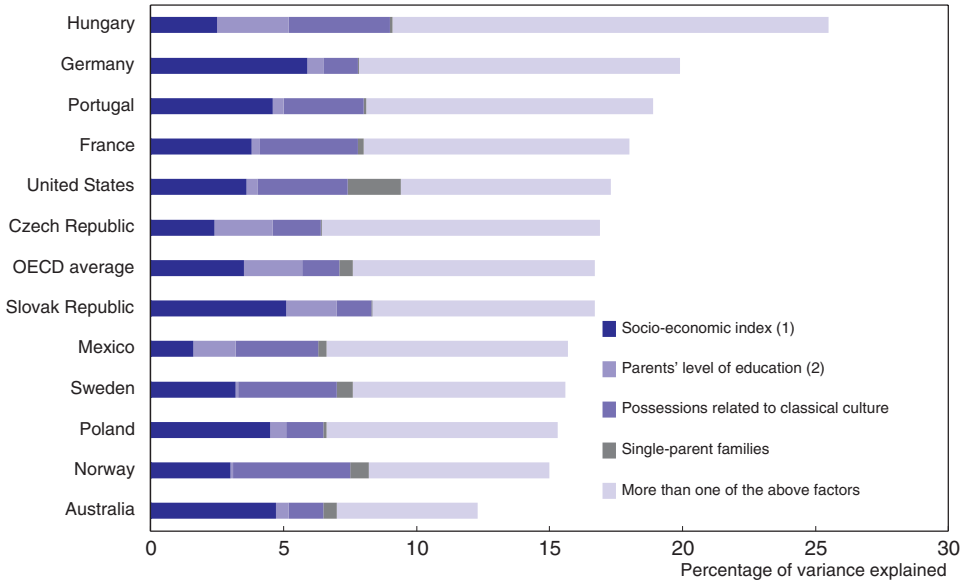
In 2002 selection for lower secondary schools was switched to a residence basis – schools are obliged to take any student from within their catchment area who wishes to attend, and this may also have played a role in improving scores among lower-ability children (Bialecki, 2005). Parental occupational status affects educational performance as much if not more in Poland than in most other OECD countries (Figure 4.3). But this impact is not transmitted through schools themselves, where the contribution of variations in the average socio-economic make-up of schools to PISA scores is smaller than all OECD countries other than Norway, Iceland and Finland (OECD, 2004, Figure 4.11, p. 188).[1] Other possible factors in the improvement in overall Polish performance between 2000 and 2003 include the introduction of nationwide assessments and the gradual improvement in student-teacher ratios that the demographic changes have permitted. However, such contributions may only be inferred rather than demonstrated, since it is extremely difficult to identify statistically at an aggregate level which factors contribute to educational success. In particular, while smaller class size is practically universally cited, by teachers and parents, as highly desirable, many studies conclude that there is little or no impact on learning in statistical terms.[2]

1. More generally, in the Polish 2003 PISA results between-school variation was smaller relative to within-school variation than it had been in 2000 and than in most OECD countries.
2. There are a number of possible reasons why class size may appear statistically insignificant when it is actually important. For example, in Poland, smaller schools in rural areas may have low class sizes, but also have poor levels of equipment. In all countries, if schools seek to avoid too much variation among students' performances, there is likely to be a tendency for difficult children to be put in smaller classes and/or for better or more experienced teachers to be allocated more difficult and/or larger classes. Swianiewicz *et al.* (2005) find for Poland that in rural areas *larger* class sizes are associated with *better* results.

Box 4.1. **Educational performance** *(cont.)*

Figure 4.3. **Influences on education outcomes**

Explained variance in student performance, 2003




1. The highest international socio-economic index of occupational status between both parents.
2. The highest level of education between both parents.

*Source:* OECD (2004), Learning for Tomorrow's World, First Results from PISA 2003 (Table 4.2).

Table 4.3. **Expenditure on education by level of education, selected countries**

As a percentage of GDP, 2002

| | Pre-primary education | All primary, secondary and post-secondary non-tertiary education | All tertiary education | Total |
|---|---|---|---|---|
| Australia | 0.1 | 4.2 | 1.6 | 6.0 |
| Czech Republic | 0.5 | 2.9 | 0.9 | 4.4 |
| France | 0.7 | 4.2 | 1.1 | 6.1 |
| Germany | 0.5 | 3.6 | 1.1 | 5.3 |
| Hungary | 0.8 | 3.3 | 1.2 | 5.6 |
| Mexico | 0.6 | 4.1 | 1.4 | 6.3 |
| Norway | 1.0 | 4.3 | 1.5 | 6.9 |
| **Poland** | **0.5** | **4.1** | **1.5** | **6.1** |
| Portugal | 0.3 | 4.2 | 1.0 | 5.8 |
| Slovak Republic | 0.5 | 2.8 | 0.9 | 4.2 |
| Sweden | 0.5 | 4.6 | 1.8 | 6.9 |
| United States | 0.5 | 4.1 | 2.6 | 7.2 |

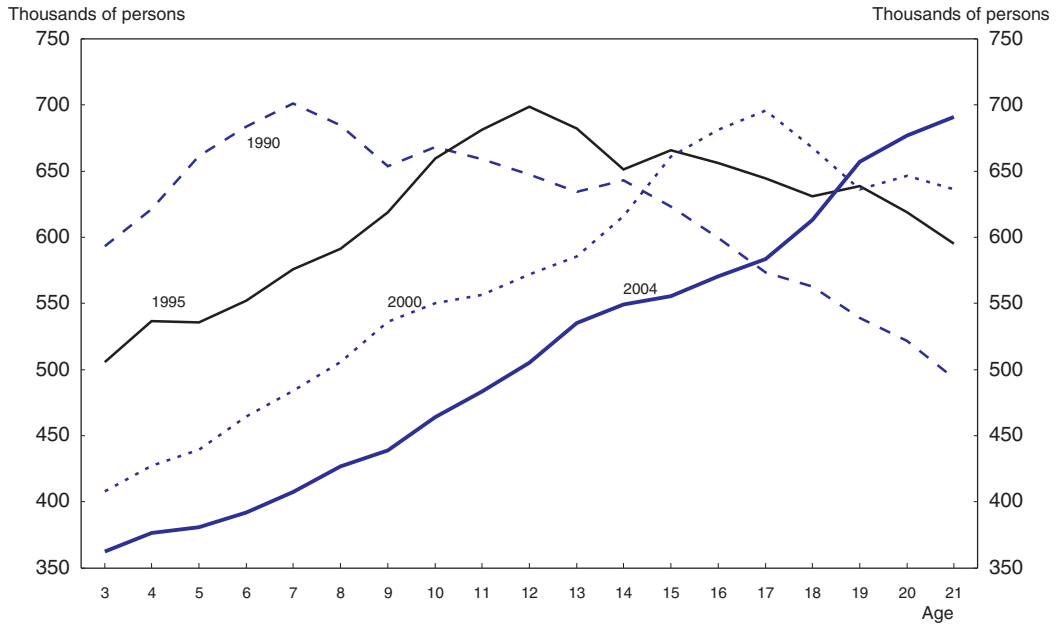
*Source:* OECD (2005), *Education at a Glance.*

Decentralised responsibility for provision of compulsory school education has passed to two levels. *Gmina,* the lowest level of local government (with a mean population of around 7 300), are responsible for primary and lower secondary (*gimnazjum*) education, while the *Powiat* level (mean population about 75 000) looks after upper secondary, as well

as post-secondary non-tertiary education and public special schools. In the early 1990s, the grant for educational expenditure amounted to 15% of total local government income (taking *Gminas* and *Powiats* together) and had risen to 30% by 2004. Local government is free to use these resources as it wishes, *i.e.* not necessarily on education, but actual expenditure is at least as high as the algorithm implies in all parts of the country; overall, local government spends up to 20% more than this level out of its own resources (Swianiewicz *et al.*, 2005).

At the same time as the education system has been adjusting to the reforms of the 1990s it has also been facing a major demographic change, of a similar magnitude to that in other formerly centrally planned central European countries, but more severe than experienced in other OECD economies. In the 1980s the birth rate began to fall and has declined further since. In 1990, approximately 700 000 children entered the first year of primary school but by 2004 only 400 000 did so, and the cohort size is still diminishing (Figure 4.4). Falling numbers should ideally make reforming the system easier, since it implies increasing resources per student, even if overall expenditure does not rise. It should allow for retraining teachers and concentrating more resources in areas or subjects that need them.

Figure 4.4. **School-age population by age**
1990-2004




*Source:* GUS (2005), Education in the School Year 2004/2005.

However, reallocating resources is difficult if it involves closing schools or moving teachers from one area to another: local political pressure may prevent school closures, for example. One response to local objections to closures has been to set up non-public so-called "small schools", normally only for the first three grades. A major advantage they have is the fact that some of the Teachers' Charter regulations concerning teachers' wages do not apply (see Box 4.2). Some of these initiatives have been very successful. If their

### Box 4.2. **The Teachers Charter**

The professional status and employment rights of teachers are defined in the *Teachers Charter*, first adopted in 1982 with recent important amendments in 2000, 2001 and 2004. The Charter provisions apply to pedagogical staff of almost all public and non-public institutions from pre-school to secondary level as well as teachers with higher professional grades working in several other institutions where pedagogical qualifications are needed.

The Charter sets the requirements for the profession (relevant higher education degree or degree from teacher training college) and defines four grades of professional career: trainee, contract, appointed and chartered teacher. The Charter also defines minimum remuneration levels for teachers at all career stages, which are linked to average wages in the public sector. There is a steep progression with trainee teachers guaranteed to receive an amount proportional to the basic rate set in the budget law and contract teachers receiving 125% of the trainee salary, with corresponding figures for appointed and chartered teachers at 175% and 225%. These minimum rates are composed of several elements, with the Ministry of Education defining minimum basic rates and agencies running schools obliged to define annual rules for granting bonuses so as to achieve, on average, minimum remuneration levels for teachers at all stages of the professional career. Theoretically, it is possible for teachers to go through all career stages within 10 years. In 2004, the average salary of teachers was just above the average in the public sector. An important observation is that in practice there is very little geographic variation in teachers' salaries in contrast to strong regional variation in average wages and labour market conditions in general. Additionally, in contrast to other OECD countries there is practically no variation in teachers' salaries according to the level of education at which they teach.

Maximum working time is defined as 40 hours per week, including 18 hours (actually 18 units of 45 minutes) of teaching, for teachers in most categories of schools. School principals have limited powers to demand specific actions from teachers beyond the teaching load. The Charter also provides substantial employment protection for teachers, particularly those at later career stages.

Problems with the Teachers Charter that have been mentioned by many stakeholders, including local authorities running schools, are primarily related to the fact that current regulations make the labour market for teachers very rigid and limit the room to manoeuvre of bodies running the schools. The combination of obligatory steep wage increases related to teachers obtaining higher qualifications (but not necessarily linked to teaching performance), strong employment protection, limited options for increasing work load (which is among the lowest among the OECD countries) and/or changing responsibilities of employed teachers make the management of schools very difficult in an environment of rapidly declining school-age cohorts. Additionally, existing rigidities in rules governing teachers' employment and incentives built in to the Charter provide no monetary motivation for competition among teachers that could lead to improved quality of educational provision. Teachers' wages are determined almost entirely by their formal qualification level, rather than by their actual work effort and teaching achievements.

success is due to efficient organisation rather than relying on short-term goodwill from teachers, parents or local government (in some cases school premises are provided free of charge by local government, for example), this is a good indication that the Teachers Charter itself can be an obstacle to improved cost-effectiveness.

While finance and general management of schools is the responsibility of *Gmina* and *Powiat* levels of government, the Voivod level still plays an important role. Each Voivod has a *Kurator*, or schools superintendent, whose secretariat (*Kuratoria*) is responsible for ensuring that national education policy is implemented and for monitoring the quality of education. *Kuratoria* also retain some powers to intervene in management or strategic decisions at local level, having some say in decisions about school closures, for example, and they are also involved in other tasks such as the provision and organisation of teacher training. Some schools have been closed, but their numbers fell by only 2% between 2001 and 2004, though the number of children fell by almost 7%.

However, it is not easy to determine the optimal structure for organising education. Economies of scale and relatively sparse populations may necessitate, at a minimum, coordination above the level of the *Powiats*. In particular, this may be the case for planning upper secondary technical and post-secondary non-tertiary provision, even though *Powiats* have legal responsibility for such schools. While the *Kuratoria* could fulfil such a role, it may be sufficient for central government to ensure that regulations and financial rules facilitate co-operation between neighbouring *Powiats*. As local governments acquire further experience in running education, the role of the *Kuratoria* may need to evolve further.

First of all, the position of the *Kuratoria* in the governance of education is ambiguous: although responsible for implementing national education policy, they are appointed by the Voivods and answer to them, not to the national education authorities. In order to avoid conflicts of interest in their assessments of outcomes, quality-control bodies should – arguably – have no ability to directly influence the management of individual schools or decisions on closure; in addition, if the quality control body is responsible for *national* education policy, it should not be under local or regional political control. This would imply separating quality control (*i.e.* both direct monitoring of school performance and the dissemination of assessments of results and methods to schools and local government) from other potentially useful functions of regional bodies, perhaps by separating this function from the *Kuratoria* and bringing it more directly under the education ministry (even if it retained some regional structure).[4]

Secondly, the *Kuratoria's* approach to monitoring school quality and performance is sometimes criticised as too centred on "box ticking", verifying formal respect of criteria on teacher qualifications, equipment and so on, to the neglect of more careful evaluation of teaching performance and educational outcomes. It is not clear how widespread such a problem may be; *Kuratoria* employees are required to be well qualified and to have teaching experience. Whether or not responsibility for quality control should be reassigned, it seems clear that it is currently under-exploiting some of the objective information on school performance that the new system of national examinations has made available.

## Pre-primary schooling

Effective early childhood education (*i.e.* from ages 3-5) can be very important in preparing children for more formal school education (see, *e.g.* Heckman, 2000; Goodman and Sianesi, 2005),[5] especially for children of poorer families (Murawska, 2004). Poland stands out among OECD countries with its low participation rates in pre-school education. In 2004/2005, 38% of children aged 3-5 participated in pre-school education, compared with an average of over 60% in EU countries. Out of the sample of Polish children in the PISA 2003, 44% had had pre-school education; since these were children who were 15 years

old in 2003, pre-school participation in Poland may even have fallen during the 1990s. In view of this, the introduction of compulsory pre-school education at the age of 6, prior to starting primary school at aged 7, from 2004/05 was a welcome decision, and it indeed brought the participation rate of 6 year-olds close to 100%.

Participation in pre-school education is much higher in urban than rural areas.[6] In poor, remote areas with high unemployment and social problems, small *Gminas* may have no kindergartens, and participation rates among 3-5 year-olds are close to zero (Herbst, 2004). Such a substantial variation clearly does not help to remove the differences in educational outcomes among regions and between rural and urban areas (irrespective of the sources of these disparities) and may help to perpetuate the economic and social disparities too.

Provision of pre-school education is currently the sole responsibility of the *Gminas*, which need to find financial resources for this in their general budgets, as pre-school education is not included in the educational subsidy. This is likely to have limited the availability of pre-school education in less affluent *Gminas*. But this is not the only reason for lack of provision. *Gminas* are formally obliged to provide kindergarten for free (not including meals) for up to 5 hours a day to all children (3-5 years of age) whose parents ask for this. While there is some evidence that this right has not been respected,[7] there is clearly also a constraint on the demand side too – many parents, especially in rural areas, do not recognise the gains from pre-school education and prefer to have their children at home, even if such facilities are available.

It seems clear that educational performance would improve if more children attended pre-school, and the government's intention to introduce general pre-school education for 5 year-olds is a step in the right direction. To ensure that finance is available the number of pre-school children should be included as one of the indicators in the algorithm for the grant to local government, and parents should be encouraged to send their children. If the current lack of demand from parents is due to strong opposition, rather than lack of awareness of the benefits, it may not make sense to make pre-school education compulsory immediately, but first to disseminate information and encourage participation by imitation.[8]

## Compulsory school education

Since the changes introduced in 1999, the broad structure of compulsory education in Poland now resembles that of the "comprehensive school" found in many OECD countries. For some years, while schools and teachers adjusted to the changes, judging the reformed system has been difficult, although the improvements in PISA scores are encouraging. However, by now the system should have settled down, and it is important to look for further improvements, in terms of quality, equity of outcomes and cost-efficiency.

As discussed above, the introduction of lower secondary schools and the change in organisation of and selection for the vocational tracks significantly reduced attendance at vocational schools (Table 4.4) and have probably contributed to improved educational performance. But employer surveys show that they still find new entrants to the labour market lacking in certain important skills, such as analytical thinking, communication, IT and information processing, foreign languages and teamwork.[9] This is perhaps especially important for those children who would previously have been in basic vocational schools (and would have left before age 19 without reaching the *Matura* exam): anecdotal evidence

Table 4.4. **Secondary school students by school type**

Per cent

| School year | General secondary | Basic vocational | Specialist secondary | Technical secondary |
|---|---|---|---|---|
| 1990/1991 | 23.47 | 42.96 | .. | 33.57 |
| 1995/1996 | 30.34 | 32.07 | .. | 37.60 |
| 1998/1999 | 34.09 | 26.55 | .. | 39.36 |
| 2002/2003 | 40.83 | 14.52 | 5.16 | 39.49 |
| 2003/2004 | 41.59 | 11.28 | 9.41 | 37.72 |

*Source:* Central Statistical Office.

suggests that some do indeed now remain in school, but they do not accomplish much in the final years, leaving at 19 unable to go on to tertiary education but ill-equipped for the labour market.

One of the reasons for the decline in enrolment at vocational schools is that many of them were previously attached to or dependent upon major industrial employers in their catchment areas, companies which have now closed or shrunk dramatically, and which are in any case in declining industries. On the other hand, if they can be designed to follow the evolving needs of the labour market, there should be a role for modernised vocational schools. They are unlikely to be able to rebuild the same relations with industry as previously but will have to pay attention to labour market developments and create links with local companies. International experience shows that many countries are struggling to find the most effective way to prepare young people for the labour market, particularly those who are unlikely to get tertiary-level qualifications.

Within the organisational framework described earlier in this chapter, the autonomy of headmasters appears to be substantial compared with that in other OECD countries (OECD, 2004). However, the Education Ministry has recently expressed concern that more recent legislative changes subjecting headmasters to financial constraints imposed by local authorities and binding recommendations made by *Kuratoria* may have limited their freedom (MENS, 2005). While overall financial constraints obviously have to be respected, and there is a role for feedback from the *Kuratoria* on teaching methods, the evolving nature of the labour market and educational environment suggests that it is also important to allow individual schools freedom to innovate, both in terms of pedagogical approach and organisation.

But such innovation needs to be subject to monitoring and assessment, which seems to be quite a severe weakness in educational policy – and in other policy areas – in Poland. The introduction of the system of common national exams at the end of each level of education was an important reform. The exams take place at the end of each level of primary and secondary education. The results of the test at the end of primary school are used only for informational purposes and do not play a role in selection for lower secondary schools, where admission is based on catchment areas. The results of a test taken at the end of lower secondary school might determine pupils' chances for acceptance in certain types of upper secondary school. The new *Matura* exam at the end of upper secondary education, which started in 2005, mostly replaced the entrance exams for tertiary education. International evidence points to the existence of external exams as vital for ensuring efficiency in a decentralised educational system such as Poland's (Wößmann, 2003). First, comparability of results introduces a simple and effective quality check to motivate providers of educational services. Second, test results provide a powerful

tool for analysis of educational policies and should play a part in devising and assessing policy initiatives.

### *Use of performance indicators in education*

The tests not only provide information on how individual students perform compared with national averages but also allow comparisons between schools to be made, including calculation of "value-added" indicators (*i.e.* which look at overall school results taking account of the performance of the same students when they entered the school). So far, such indicators are rarely available to schools or local authorities in Poland.[10] However, some local authorities (in Krakow, for example) have implemented experimental projects, and the Central Examination Commission is also evaluating alternative methods for calculating value added indicators.

Availability of test results has spurred some academic research into the determinants of spatial variation of test results (Swianiewicz *et al.*, 2005; Herczynski and Herbst, 2005; Sleszynski, 2004). There is a visible gap between rural and urban areas. The best average results are recorded in large cities, with somewhat inferior outcomes in smaller cities; rural areas are characterised by the worst performance. Strong regional patterns also emerge.

Empirical work does not yet provide good explanations for all of these phenomena, nor does it show whether the educational system works to reduce inequalities in outcomes or increases them. Analyses of determinants of average test results in primary and lower secondary schools at the *Gmina* level confirm the importance of local human capital and economic conditions. Regions with higher average education of adults and with lower unemployment and lower social spending tend to perform better. But there is no consensus on how to explain variation in test results among schools with similar student populations and background conditions. The link between various measures of overall local spending on education and test results is a complicated one. If anything, there appears to be evidence suggesting a *negative* impact of higher spending. The overall conclusion, not a very surprising one, appears to be that what matters most is how the money is spent. The link with available measures of teacher qualifications (numbers of teachers with higher formal qualifications) is not robust. In the case of rural *Gminas*, regions with larger schools appear to be performing better on average, but *Gminas* where many children need to rely on school transport to get to schools tend to perform less well.

Performance indicators cannot tell the whole story, since education is about more than exam results. Nevertheless, making "value-added" indicators available to schools, local and national education authorities and researchers should help to improve understanding. Care would have to be taken with publication to avoid unjustified stampedes of parents towards good or away from bad schools (in practice this would also be limited by the catchment area policy, but this in turn could lead to tensions); it might be limited to identifying the most poorly performing schools, but combined with a policy which guaranteed special intervention at the same time. In the United Kingdom and the United States (the No Child Left Behind initiative), for example, measures are in place to identify severely underperforming schools and to take action to improve their performance, with the possibility of closing them if improvements are not forthcoming.

As already mentioned, teachers' salaries are not a function of educational outcomes, although in theory school heads have the power to vary pay as a function of performance. This power appears mainly to be used to reward teachers for additional tasks they might

perform, rather than a function of their teaching results. Teachers are often opposed to more explicit links between pay and performance, since performance is so hard to measure. Because the quality of teaching is so dependent on attracting the best people, and encouraging the weakest to improve or perhaps leave the profession (Rivkin *et al.*, 2005; OECD, 2005b), this should not be allowed to prevent experimentation and innovation. It would be useful to review employment protection and promotion rules as defined by the Teachers Charter, while investing in teacher training and setting incentives for teachers to raise their qualifications continuously. Efforts aimed at improving the prestige of the profession and preventing weakening of the position of teachers *vis-à-vis* pupils and parents may also be important.

## Tertiary education

In 1991 there were some 400 000 students studying for tertiary degrees in public-sector Higher Education Institutions (HEIs). Fifteen years later there are nearly two million students, 30% of whom are studying in private-sector HEIs, which did not exist in 1991 (Table 4.5). The number and variety of HEIs is now considerable.

Table 4.5. **Tertiary education in Poland**

Characteristics of selected types of HEIs

| | Number of HEIs | Number of students (thousands) | Students in full-time day studies (thousands) | Number of students in 1990/91 (thousands) | Number of academic teachers (full-time) | Number of students granted masters degree | Total costs (2004) (million PLN) | Per cent of revenue from research | Main source of revenues from teaching activities | Unit costs (thousand PLN per student equivalent) |
|---|---|---|---|---|---|---|---|---|---|---|
| Public HEIs | 126 | 1 337.0 | 777.7 | 403.8 | 74 687 | Ca. 67% of graduates | 10 851 | 12.5 | 71% from state budget | 8 977 |
| Private HEIs | 301 | 580.1 | 137.9 | 0 | 11 075 | Ca. 30% of graduates (25% of HEIs) | 1 948 | 0.4 | 97% from fees | 5 358 |
| *of which*: | | | | | | | | | | |
| Public universities | 17 | 531.3 | 285.1 | 141.1 | 27 116 | Ca. 80% of graduates | 3 773 | 10.6 | 65% from state budget | 7 538 |
| Public technical HEIs | 22 | 329.9 | 220.2 | 75.7 | 18 453 | Ca. 67% of graduates | 2 925 | 20.5 | 78% from state budget | 10 249 |
| Private economic HEIs | n/a | 308.9 | 62.4 | 0 | 6 670 | Ca. 40% of graduates | 1 108 | 0.4 | 97% from fees | 5 738 |
| Pedagogical HEIs (public and private) | 17 | 133.8 | 49.6 | 47.6 | 4 398 | No | 596* | 2.5** | | 5 755** |
| Vocational HEIs (public and private) | 181 | 206.8 | 94.5 | 0 | – | | 662 | 0.1 | | 4 189 |

*Notes:* Nearly 80% of all students in 2004/05 studied in HEIs belonging to the types described in the table.
Figures for Masters degrees refer to HEI graduates of 2004.
Of all masters degrees granted in 2004, 50% were granted to students of single stage (usually 5 years) courses and 50% to second stage – postgraduate (usually 2 years) courses.
* estimate based on public pedagogical HEIs figure and equal costs assumption in public and private HEIs.
** only public pedagogical HEIs.
*Source:* GUS (2005), Szkoly wyzsze i ich finanse 2004 (HEIs and their finances in 2004), Central Statistical Office, *www.stat.gov.pl*.

This section will not attempt to analyse in detail the whole of this structure, which ranges from language schools to technical universities. Instead, it will focus on two aspects of policy which have arguably not kept up with this extremely rapid expansion and which currently seem somewhat chaotic: quality of education and financing for both institutions

and students.[11] The quality of education is partly a question of the multiplication of the number and type of HEIs and partly a (related) question of staffing.

### *Monitoring the expanding higher education sector*

Very rapid expansion of tertiary education might be expected to cause some dilution of quality. The physical infrastructure of HEIs has been lagging behind – resulting in overcrowded lecture rooms and insufficient numbers of adequately equipped laboratories, for example. Tertiary education is now serving students with a broader spectrum of interests, and it may also be the case that the average level of secondary school graduates entering tertiary education has declined. If so, this would primarily affect HEIs offering fee-based courses, because public HEIs charge no tuition fees for full-time students and are therefore able to select the best students. Another trend has been for students to be focused on obtaining diplomas or other certificates, rather than learning for its own sake, so that demand for less challenging courses has increased. Non-public HEIs were most active in responding to such demand, with many of them offering poorly taught and undemanding degrees in popular and cheap-to-run fields of studies.

With all these changes, it is hard for anyone – in particular for prospective students – to have good information on the quality of different courses or institutions. Nevertheless, market forces have been working, as the number of students enrolled in different kinds of courses has changed substantially in response to information about labour market outcomes associated with different types of qualification. Between 2001 and 2004 there was a considerable increase in demand for courses on IT and engineering, but also international relations and sociology, while demand for courses on commerce or management and marketing plummeted. These falls appear to have been the consequence of unemployment among earlier graduates from such courses, which had been very popular in the 1990s but which often turned out to be of little value on the labour market. Better information might avoid so many people having to learn from their mistakes.

As far as private institutions are concerned, it could be argued that a variety of levels of quality is to be expected and that, provided that competition ensures that the "value added" is related to the price paid, there is no problem. However, for competition to be beneficial to all parties, there needs to be some rules, and, in particular, readily available information on quality should be available. This has been lacking in the case of the new private HEIs, although there are certainly a number of successful non-public HEIs offering high-quality education (which are often first choices for candidates), showing that it is not a simple distinction between low-quality private and high-quality public institutions.

Quality control is currently carried out by two main institutions, the University Accreditation Commission (UAC) and the State Accreditation Committee (SAC), which address separate issues. The UAC is a non-governmental organisation established by the 17 leading public universities in 1997. One of its main activities is to grant accreditation to fields of studies at HEIs (*i.e.* to departments, not to institutions as a whole). The system is based on voluntary applications by HEIs, and the aim is to select departments offering the best standards in particular fields of study. Accreditation is valid for up to five years, and in 2005 the number of accredited departments oscillated around 250; only 33 HEIs out of over 400 received at least one accreditation. Although such voluntary schemes can help the best HEIs ensure recognition and can be a useful tool to help the best secondary school graduates select among HEIs, there is a risk of insider bias in such a system of self-

regulation, although according to Macukow and Chojnacka (2003) this bias has been avoided.

The SAC was established in 2002, incorporating a number of pre-existing sector-specific agencies, with a somewhat wider role than that of the UAC.[12] Its primary objective is to ensure that all new and existing HEIs meet quality criteria in teaching particular fields of studies. SAC aims at evaluating all degree programmes; once an institution is selected by the SAC it cannot refuse to be evaluated. SAC evaluations lead to degree programmes receiving grades (outstanding/positive/conditional approval/negative). Conditional approval is accompanied by specific recommendations and deadlines for implementing them. A negative opinion would normally lead to the Minister of Education revoking or suspending the relevant licence.

The size of the SAC's task means that its evaluations may have a tendency to be too narrowly focused on specific standards and lead to a culture of compliance rather than one that seeks to improve quality, a point made in a recent World Bank report (World Bank, 2004). As that report suggests, the SAC should seek to develop the current approach from one of evaluation alone to one that encourages improvement by working in cooperation with organisations already involved in this, such as the UAC. The SAC itself argues that its assessments do focus on improving quality and do not just test compliance with legal standards, but many observers believe it needs to do more.

### *The quality of teaching staff*

The availability and competencies of the teaching staff greatly influences the quality of tertiary provision. The increase in the number of academic teachers has been lagging behind the boom in student admissions, resulting in an increasing average student-teacher ratio. Academic staff have increasingly taken multiple jobs, as mushrooming private HEIs were struggling to meet formal criteria related to academic staff. This problem has been partially resolved by regulations limiting the scope for multiple employment that were included in the 2005 law on higher education. Along with regulations on maximum student-teacher ratios this may constrain the increase in the number of HEIs.

It is therefore important that HEIs become attractive workplaces for able teachers and researchers. Partly this is a question of salaries, which need to be related to market demand for different kinds of teachers. In the more academically oriented HEIs, it is also a function of the career structure. The current system is widely perceived as not offering enough flexibility and thus not conducive to mobility (particularly international mobility) of academic staff. It is not open to external competition and often promotes average people rather than those who are most competitive in the global market. Such a system has a tendency to be self-perpetuating. More transparency, in particular the disclosure of the scientific record (publications) by HEIs, departments and professors is a prerequisite for any reform. Such disclosure (*e.g.* making the publication lists available on websites) might emerge spontaneously, but given the apparent weakness of this mechanism up to now, more public and/or administrative pressure would be useful.

This could also make the work of the State Accreditation Committee easier, and the SAC itself might be in a good position to apply the necessary pressure. Openings for academic positions should be advertised widely so as to eliminate the practice of organising contests suited for pre-selected candidates, often from the same institution. Another solution that might help in making the career paths more elastic would be

changing the character of the *habilitation* degree (a pre-requisite for professorship). It could even be abolished, though premature abolition, without a competitive career mechanism already in place, would be harmful, removing the only existing method of quality control (even if mostly formal) on promotion. A survey by the General Council for Higher Education suggests that there is support for such reform from an increasing number of academics themselves (GCHE, 2005). Academic wage levels and wage differentiation probably need to increase as well and to take into account the increasingly international labour market for good academics, if mobile top performers are to be induced to stay at Polish HEIs.

### *Financing the tertiary sector*

Even if some efficiency gains may be available, wage costs in HEIs, especially some in the public sector, will have to increase if quality is to be maintained and improved, and in many more technical subjects higher expenditure on non-wage items is necessary to provide modern equipment and facilities. Despite these pressures, full-time students in public sector HEIs are still not expected to make any contribution to tuition costs (the Polish constitution states that full-time education in public institutions should be free, though this does not apply to part-time and evening courses, of which many exist and for which fees are charged), while those in private-sector HEIs pay the full cost, resulting in horizontal inequities. In the medium term, economic growth should mean that the state can devote increasing resources to higher education, and this may also be one use for funds from the European Union, but over the next few years significant publicly funded general expansion is not feasible.

This situation is almost certainly resulting both in under-funding and under-provision of many types of tertiary education and research, notably where per-student costs are high, such as equipment-intensive subjects. At the same time it is creating inequities among students. Some poorer students who might attend the more prestigious public institutions do not do so because they cannot easily finance living expenses even if tuition is free. Maintenance grants are available, some based on means-testing, some on academic results, at the discretion of the HEIs using funding provided by the state, and some from EU funds; about one in five students is in receipt of such support. Although there is a student-loan scheme, take-up is extremely low, probably because repayment has to start two years after the loan is taken out (*i.e.* often before studies have terminated) and because a bank guarantee is required for the students from the poorest families. Studies show that in many OECD countries much of the overall social benefit from tertiary education accrues to the students themselves, and so, despite the availability of maintenance grants, higher education finance in Poland is probably regressive. There is thus a case, both on efficiency and equity grounds, for requiring public HEIs to charge cost-related fees, while at the same time switching more of the public finance available for higher education from direct subsidies for HEIs to means-tested support for students.

Furthermore, the student loan scheme appears dysfunctional. The objective of such a scheme is partly to overcome the reluctance of risk-averse young people to borrow, as well as market-failure and transactions-cost problems that result from a lack of credit-worthiness for those from less well-off families. Such difficulties cannot be overcome by a wholly private scheme, especially if loans have to be paid back before the investment is complete. More promising are programmes such as those adopted in Australia, New Zealand and the United Kingdom where loans may be granted by private-sector banks, but the risk is largely carried by the state, and where reimbursement is conditional

on labour-market success – so-called income-contingent loans. Reimbursement can also be facilitated by provisions to collect it through the income-tax system. One potential difficulty here is "leakage" from graduates who may leave the country to avoid repaying loans, a particular concern for New Zealand, for example. This is a real problem, but should not prevent the introduction of a scheme, perhaps initially limiting overall loan size so that such temptations are not too great. The government could also accept that some losses from a small number of people who never intend to return to Poland might be a reasonable price to pay for greater efficiency. This is best mitigated by co-operation at the EU level and through tax-treaty agreements with other countries to allow loans to be collected from incomes earned abroad.

## Adult learning

Several studies have found that adult education and training have a significant impact on earnings (Box 4.3). Productivity, wage levels and employment prospects all benefit, even though it can be difficult to identify the effects of training relative to other factors, and the best results are achieved by young and highly educated workers (OECD, 2004). This points to one of the dilemmas faced in Poland: whether to concentrate training resources on those who might need them the most – notably older, unskilled people – or on younger, already more highly-trained, people where returns appear to be higher.

### Box 4.3. **The impact of adult learning on earnings**

Several studies have found that adult education and training have a significant impact on earnings. Ok and Tergeist (2003) present evidence that reveals the positive association between training and worker productivity and between training and wage levels in countries such as the United Kingdom, the United States, France, the Netherlands, Spain and Germany. In the United Kingdom, Loewenstein and Spletzer (1999) estimated that one week of employer-paid training of newly hired workers led to 1.4% higher wage growth after two years. Similarly, Booth and Bryan (2002) found that one week of accredited formal training in Britain led to about 1% greater wages from subsequent employers.

A more recent study undertaken by the OECD also finds wage premiums in a number of Member countries (Austria, Belgium, Denmark, Finland, Germany, Greece, Ireland, Italy, the Netherlands, Portugal and Spain) when comparing wage growth for those who have and have not received training. Based on European and national panel data, wage premiums through participation in education and training courses in the latter half of the 1990s ranged from an apparently negligible effect in France to 2.5% annually in Germany and 5% in Portugal (OECD, 2004). This study also shows that workers usually get a lower wage premium if they stay with their employer after receiving training. There seem to be higher returns to learning taken with previous employers, with best results achieved by young and highly educated workers. Trained workers also enjoy a lower probability of unemployment than their non-trained counterparts, and better re-employment chances after lay-off. However, some researchers question the scale of returns presented in different studies, which may be overstated due to the difficulties in clearly identifying the effects of training relative to other factors, because of selection bias, for example (Leuven, 2004).

*Source:* OECD (2005a), Thematic Review of Adult learning.

Given these benefits, participation in adult vocational training in Poland is probably too low. Measures that take account of both the frequency with which people take training courses and the length of those courses show that Poland is at the bottom of a range of countries in overall provision, similar to Hungary but well below Nordic countries as well as others such as the United States and the United Kingdom (Table 4.6). This low ranking is due to the low frequency with which Poles participate in training, rather than shorter periods of training.

Table 4.6. **Participation in adult learning, selected OECD countries**

2002

| | Adjusted participation rate[1] |
|---|---|
| United Kingdom | 6.9 |
| Denmark | 6.7 |
| Switzerland | 6.2 |
| Sweden | 5.5 |
| Finland | 4.5 |
| Norway | 4.3 |
| Unites States | 3.3 |
| Germany | 3.3 |
| Canada | 2.9 |
| Netherlands | 2.9 |
| Austria | 2.8 |
| Spain | 2.6 |
| Korea | 2.4 |
| Portugal | 1.8 |
| Hungary | 1.4 |
| **Poland** | **1.4** |
| Mexico | 1.0 |

1. The adjusted participation rate (APR) is calculated to take into account the frequency with which adults participate in learning and the length of courses they attend. If all adults spent 35 hours per week for 52 weeks in such courses the APR would be 100.

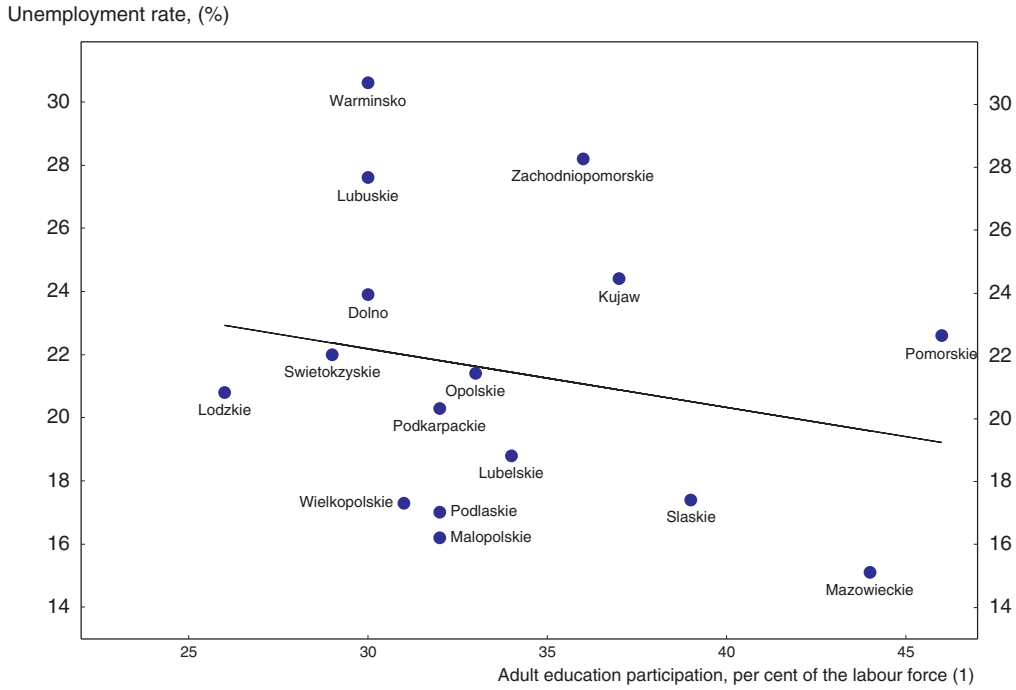
*Source:* OECD (2005c), *Promoting Adult Learning*.

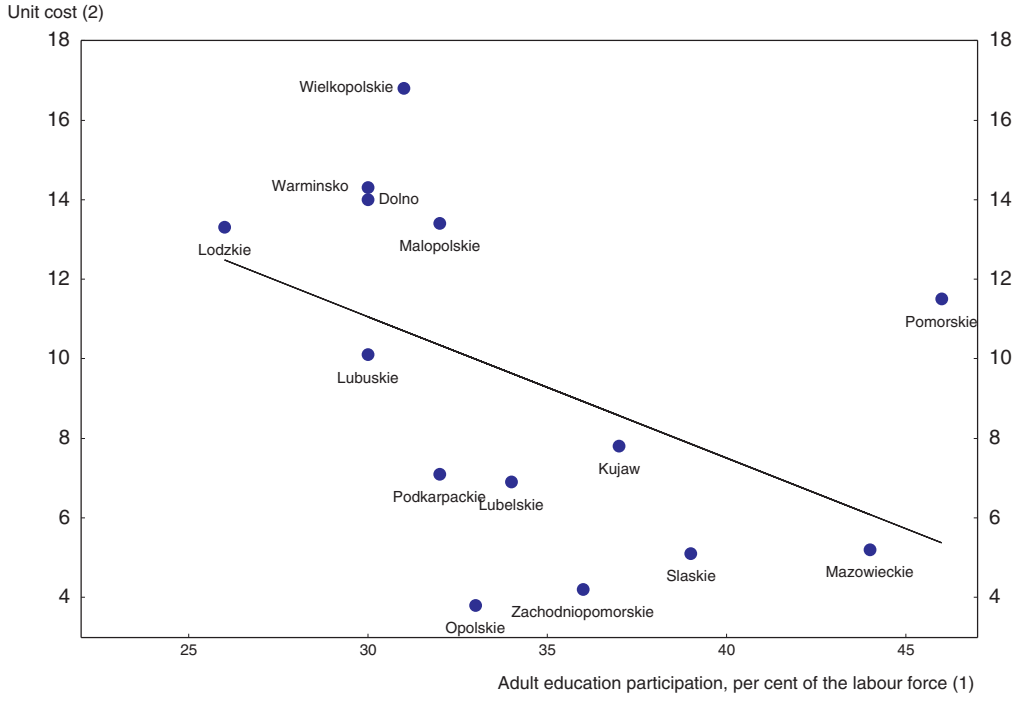
Regional variation in participation in adult training is also quite considerable. It is highest in the voivodship of Mazowiecke and Pomorskie, almost twice as high as in Łódzkie at the other extreme (Figure 4.5). Because of the heterogeneity of the types of training and education included under this heading, it is unclear whether this variation reflects differences in provision or costs of training, or differences in demand from either individuals themselves or from their employers. If anything, training also appears to be more frequent in regions with low unemployment (though this is not strong evidence and may be entirely due to Mazowieckie, which contains Warsaw). Indeed, no more than 4% of the unemployed receive any labour-office-provided training in a given year, even though labour offices can finance training for an unemployed person for up to 12 months, or 24 months for the unskilled.

Not only is participation in adult learning rather low by international comparison, and with considerable regional variation, it is also rather more skewed in other dimensions. Thus, while it is the case for most OECD countries that the employed participate more frequently than the unemployed, the higher educated more than the lower educated, the

## Figure 4.5. **Adult training, unemployment and unit costs**

By voivodship, 2003




1. This shows the proportion of workers who participated in at least one training programme in 2003.
2. Average price in euro of one hour's training in Continuing and Practical Education Centers in 2002.

*Source:* OECD (2005a), Thematic Review on Adult Learning.

young more than the old, and employees of large enterprises more than those of SMEs, all these tendencies are more extreme in Poland than elsewhere (Figure 4.6). For example, considering participation by employment status, an employed person is twice as likely to receive some training in any given period as an unemployed person in Poland, whereas in the United Kingdom (where unemployment is close to one quarter of the Polish level) the gap is only about 10%, and the relation is reversed in the Nordic countries, the Netherlands and Germany, and especially in Spain and Portugal. Perhaps even more striking is the link with educational attainment where it is observed that people with tertiary qualifications are 30 or 40 times as likely to be engaged in adult learning as those with few or no qualifications.

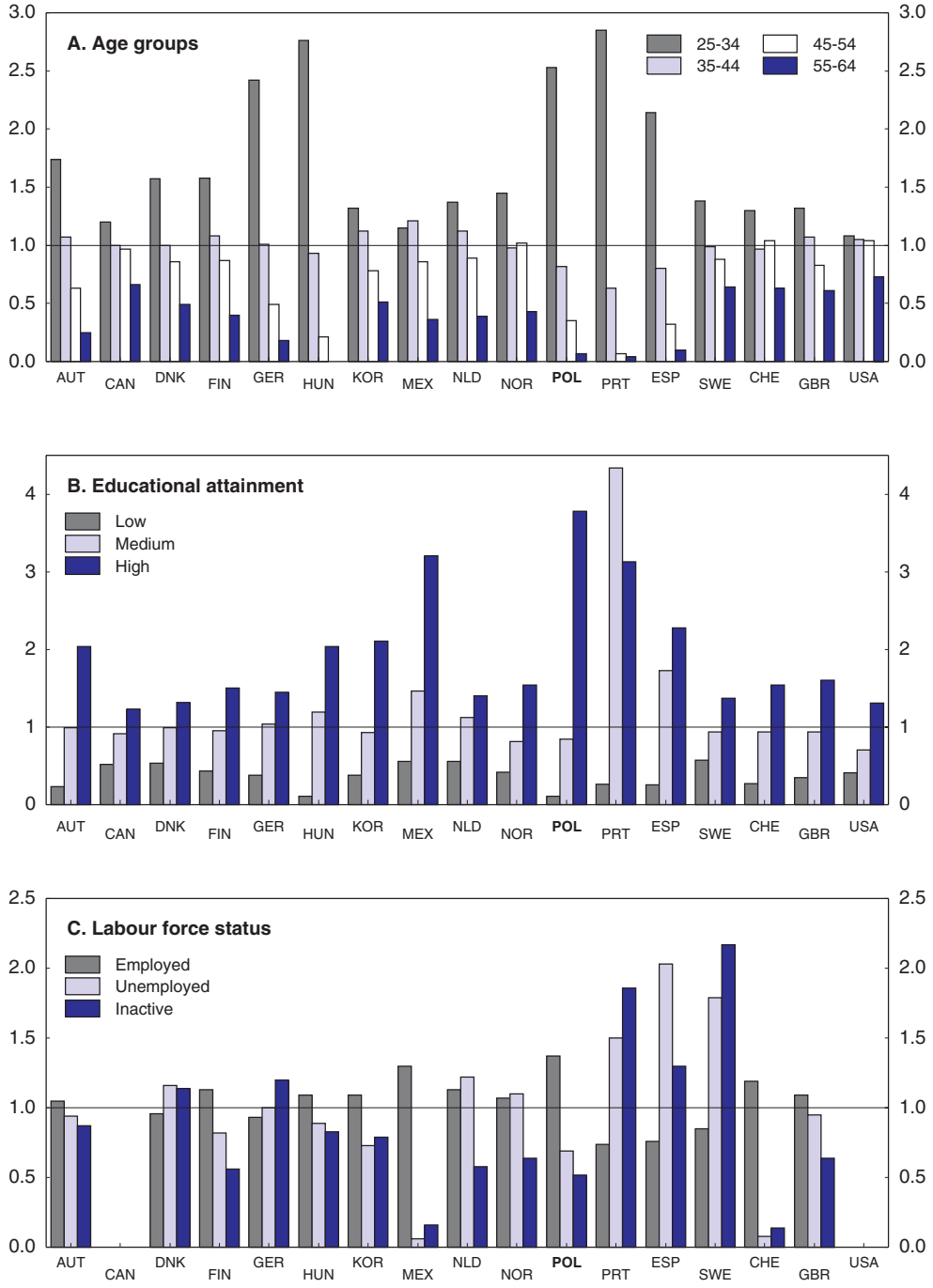
It is clear from these data that adult learning is not very strongly targeted towards improving labour-market outcomes for those least well placed in the labour market – older workers, the unskilled and the unemployed. This does not necessarily mean that training provision is misdirected, as far as aggregate efficiency is concerned – it may be that the rate of return on training such people, comparing their likely productivity after training with what it would otherwise have been and the cost of the training, is much less than that for young, more highly qualified, workers, and might even be negative. If such rates of return were the only criterion, the conclusion might be to abandon trying to train older unskilled people and to deal with the employment consequences through labour market measures, such as allowing the minimum wage to fall enough that they remain employed, and to deal with the distributional consequences through in-work benefits.

In fact, evidence on the rate of return on adult training in Poland is very sparse. A recent study does suggest, however, that adult learning tends to be most effective in reducing unemployment in the case of older and less educated people (Liwinski, 2005). Since unemployment, as much as low earnings, is perhaps the main consideration in Poland, this provides support for arguments in favour of trying to target this group. There are a number of obstacles to be dealt with, both on the part of potential trainees and of employers.

Companies, when asked the reasons for not providing training themselves, point to adequate skill levels among current employees, too high costs associated with training and a preference for recruiting people who already possess the required skills (MEAL, 2004). In other words, the high level of unemployment and currently adequate supply of new, more highly educated entrants to the labour market reduces the incentive for individual employers to train. This serves to emphasise the importance of other policies to improve the labour market, discussed in Chapter 5, if adult training is to be successful. But there is also limited interest in training on the part of the disadvantaged groups who should be able to benefit from them, for several reasons. Firstly, the lifelong learning culture has not yet been accepted by older and less educated generations. The understanding of the importance of education in shaping life paths is now much wider than a few years ago, but older adults still tend to believe that this is important for their children, not for themselves (CBOS, 2004). Least qualified and older people tend to be rather passive, lack self-motivation, do not see much sense in training and refer to financial and time constraints. When workers do participate in training, it is often due to some form of external pressure, such as an employer's instruction (in the case of training for employees) or fear of losing one's current job (ITE, 2005). It also seems to be the case that access to information on training availability can be a problem.

Figure 4.6. **Adult learning participation rate by socio-economic characteristics**[1]

Ratios of participation rates for each subgroup to the national average participation rate
25 to 64 year-olds, 2002




1. A ratio above 1 implies that the proportion of those in adult learning in a specific category is above the country average participation rate; a ratio between 0 and 1 implies that it is below the average rate.

*Source:* OECD (2005c), Promoting Adult Learning.

As in the case of higher education generally, there has been an explosion of entities that offer training of various sorts. There are now some 12 000 organisations offering adult training, ranging from large companies to individuals. The public-sector institutions mostly operate under the Ministry of Education, such as the Continuous Education Centres, Schools for Adults (which concentrate on general education) and Practical Training Centres (often formed from former basic vocational schools), which are more likely to provide labour-market-related training in cooperation with labour offices.[13] Private and public HEIs also offer training, where employers may co-finance the costs of their employees' training. In addition to these there are many smaller training centres, skill improvement centres, associations, foundations, companies, cooperatives and other entities providing training. Some of these fall within the education sector, either public or private, while a significant number are not governed by legislation on education but are commercial businesses.

Up to 2004 there were no controls and very little information on most of these private-sector business providers of training services. Since then, a voluntary accreditation system has been set up with a register of accredited entities maintained by the voivodship labour office. For the moment registration is largely formal, being based on meeting certain basic standards but not on quality of services provided, although it is intended that the system should act to improve quality. Registration is also voluntary, but there is some incentive to register because labour offices are not entitled to employ agencies that are not on the register.

It is hard to provide a clear picture of financing for training. Rather little public subsidy appears to be available for adult vocational training (as opposed to continuous school-type education). Labour offices finance some training for the unemployed, but it seems that almost as many of the unemployed finance their own training as employed people (OECD, 2005a). Since 2004, companies that set up training funds and establish training plans have been entitled to receive public subsidies in respect of employee training. The available subsidy is greater for tertiary-type than for secondary-level training, an incentive that probably reinforces the bias in favour of the more highly educated noted above. Prior to the introduction of the training fund approach in 2004, companies spent rather little money on training – equivalent to about 0.8% of their labour costs, compared with an average of about 2% in the European Union (OECD, 2005a). The impact of the training fund initiative on spending is not yet known.

Clear information on the kinds of training that are being offered is available only for that small proportion that is directed through labour offices, mostly for the unemployed. The more popular subjects include: training for sales and trade, computer operation, driver training, accounting and financial services, and administrative support. The popularity of training in the operation of machinery and equipment is continuously growing. Over the last three to four years, the most successful courses in terms of getting jobs for those completing them were on operation of machines and equipment and courses for professional driving licenses; after such courses more than 40% of trainees found jobs. Overall success rates were around 30%. Least effective was training in computer operation, accounting, administrative support and sales – two of which were the most popular subjects. This may mean that some progress on matching training to labour market requirements is necessary, or it may reflect the poor standard of training in areas, such as computer operation, that one might expect to be important. There may also be a link with

existing levels of education – computer training for an adult with limited formal education may not be very productive without some reinforcement of other skills.

Polish governments have recognised that adult training is important and have increased the importance attached to it. European Social Fund project resources have played a part in this and it is one of the remits of the new Ministry for Regional Development.[14] However, ensuring that any additional finance is spent effectively will be difficult, since there is little information on the effectiveness of existing training and experience in other countries. Eurostat (2002) points out, however, that one problem in Poland is the lack of co-ordination between different ministries, and that decentralisation of the operation of labour offices has not helped either. Some studies are becoming available that indicate which kinds of training are effective, however (such as Liwinski (2005) and the data from labour offices just discussed), and it is important to encourage such studies, combining them with information on the cost of training to target the most cost-efficient options. Where the older unskilled are concerned, it is important to establish whether cost-efficiency considerations could justify increasing the rather low share of training and educational resources devoted to them at the moment, since it would be unfortunate if an implicit choice to leave them as a kind of lost generation as far as labour market outcomes are concerned was made on the basis of a mistaken assessment. In the meantime, it might be sensible to devote resources both to increasing the availability of training for them and to encourage them to see it as worthwhile. This should attempt to target not only the unemployed but also those at risk of becoming unemployed as industrial restructuring proceeds (see Chapter 5).

### Box 4.4. **Recommendations on education and training**

**Governance**

- Give school principals appropriate incentives and autonomy to implement measures to improve standards, and clearly distinguish the respective responsibilities of individual schools and local government. In the longer run, restrict the *Kuratoria's* normal role to providing quality assessment information to schools and local and central government, with no executive or veto powers.
- Do not allow employment security aspects of the Teachers Charter to obstruct the restructuring required in response to demographic changes. Introduce additional headings under which teachers' salaries can be supplemented to include teaching performance and subjects where there is a shortage of teachers.
- Ensure that career structures in tertiary education are based on open competition and transparent promotion criteria.
- Develop closer coordination between labour market and education policy, both at central and local levels.

**Quality control**

- Improve the collection of data on educational outcomes over and above those captured by PISA. Stimulate research on the links between these outcomes and educational and other policies. New policies or pilot schemes should be subject to careful results-based evaluation. Ensure that measures of "value added" in secondary schools, derived from the new system of standard national testing, are available to the schools and education authorities; give consideration to their eventual publication.

Box 4.4. **Recommendations on education and training** *(cont.)*

- Ensure that quality control of primary and secondary education by the *Kuratoria* takes into account the teaching practices as well as more mechanical checks on qualification and equipment levels, etc. Make teacher promotions conditional on more than meeting formal conditions, but also on practical outcomes.
- Reinforce quality assessment of higher education institutions (HEIs) through the State Accreditation Commission. Publicise widely the on-line availability of its assessments and keep the reports up to date. Encourage the development and dissemination of labour market information relevant for students' choice of courses.
- Ensure that labour offices' choices of providers for adult training courses are based on available performance information, including feedback from previous users. Ensure that labour offices evaluate the effectiveness of training programmes they have supplied or organised.

**Financing education**

- Ensure that the "algorithm" used for allocating central government finance for education covers appropriate measures of needs and avoids measuring needs by current levels of provision – which can result in poor incentives and inequitable outcomes. In particular, the algorithm should include needs for pre-school education which should be financed through the central government education allocation.
- Make finance available for expansion of pre-primary education from resources freed by falling numbers of children in primary and secondary education.
- Consider allowing public HEIs to introduce cost-related tuition fees for all students. In parallel, part of the subsidy to higher education could be delivered through expanding the means-tested grants system.
- Reform the system of student loans to allow repayment along with income tax once graduates are employed and their income exceeds an appropriate threshold; abolish the requirement for a bank guarantee for students from low income families, replacing it by a state guarantee for all eligible loans.

**Provision of education and training**

- Expand provision of free pre-school education at ages 3 to 5, focusing particularly on poor and rural areas. This could be accompanied by awareness campaigns that explain the long-term gains from pre-school education to parents who may see little benefit from it.
- Use analysis of both educational and labour market outcomes to help determine the balance of provision between general and vocational education. In the light of this, and where necessary, upgrade the quality of equipment and teaching in upper secondary vocational education.
- Focus public provision of adult education on improving labour market outcomes, not on increasing the level of general education among adults, except where this is relevant for the labour market.
- Use evaluation and analysis of the labour market outcomes of pilot projects to identify cost-effective methods of targeting increased take-up of training by older, less qualified adults to improve their skills and ability to switch to new jobs or sectors.

## Notes

1. For some countries, reports by the OECD Education Committee have tackled this task. No such review has yet been requested by Poland.
2. No studies which calculate economic rates of return on investment in education are available for Poland.
3. The 2005 version covers about 50 items, based on the number of "standardised" pupils, calculated with different weights for students of various categories, including ethnic minorities, disabled and those with special education needs, and also the number entitled to extra curricular activities. It differentiates between public and non-public schools and includes different allowances for specialised schools in small towns (under 5 000 people) or rural areas, and for certain specific types of specialised schools – music, dance, sport, bilingual. There is also a factor intended to take into account the number of teachers in each category of professional career employed in the *Gmina/Powiat* and whether they are in rural or urban schools.
4. See RPO (2003) for discussion of the importance of clear lines of responsibility in education.
5. Aggregate data do not always provide strong support for this in the general case. For some countries there appears to be no impact of pre-school attendance on PISA results for 15 year-old children, although the impact is positive for the majority of countries, including Poland. The effect of attending pre-school for at least one year on the 2003 PISA maths score in Poland is to increase it by 38, compared with a standard deviation of around 100. When corrected for the socio-economic background of the children, the impact is only 25 points, statistically significant but a rather smaller impact than that of about two-thirds of the OECD countries. It is of the same magnitude as the improvement in average maths scores between 2000 and 2003.
6. In 2004/05, urban area participation was 55% among 3-5 year-olds, compared with under 18% in rural areas (GUS, 2005). Furthermore, the urban participation rate increased by 6.7 percentage points from 2001, compared with an increase of only 2.4 points in rural areas. Some parents living in rural areas and commuting to work in cities send their children to kindergartens in cities, as is evident from an apparent urban participation rate above 100% for children aged 6 in 2004/05. But this is not the main explanation for the rural-urban gap.
7. The Ombudsman for the Rights of Children has been asked to investigate this.
8. One programme run by an NGO consisted of providing pre-school education by "travelling teachers" – well trained teachers travelling from one village to another. Organising classes for children for a few hours a day, a few days per week, is reported by its organiser to have had good results; this might be a cheap way both to raise standards for participating children and to encourage parents to demand more permanent facilities. See *Comenuis Foundation*: *www.frd.org.pl/ankieta.html*.
9. These were identified in telephone research by the Polish Confederation of Private Employers, Lewiatan.
10. In France, even although the authorities believe that the school is not the appropriate unit of analysis for educational outcomes, such indicators are published each year for individual schools.
11. The Education Directorate of the OECD is undertaking a review of tertiary education in Poland during 2006.
12. There are also a number of specialised accreditation bodies.
13. There are some 250 Continuous Education Centres and Practical Training Centres, about 300 Schools for Adults and nearly 400 HEIs participating in adult education or training.
14. OECD (2005a) notes that one employers association recommends to its members that they conduct training on "how to apply for EU funds".

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*Chapter 5*

# Encouraging structural adjustment

*GDP growth has been below potential for several years, with the exception of 2004. Structural change has continued, but in order to reduce unemployment and increase both actual and potential growth, adjustment will need to proceed more quickly. Labour force flexibility is restricted more by the social transfer system than by labour market policies themselves, although these and other factors such as the housing market and education do play a role. Adjustment and potential growth are also hindered by some features of the business environment, particularly aspects of product market regulation and the still-important role of the public sector in the economy, while policies to increase innovation have yet to produce significant results.*

With low levels of both employment and productivity, GDP per head in Poland is among the lowest in the OECD (Figure 5.1). Even though *per capita* incomes have consistently grown more rapidly than the OECD average since the mid-1990s, catch-up has slowed in the last few years. A necessary foundation to faster growth will be the appropriate macroeconomic policies and improved human capital formation discussed in previous chapters, while labour market and other reforms will be needed to increase employment. Further accelerating the convergence process will require improved performance in both labour and product markets and will rely on a dynamic innovation process, where innovation is to be understood in a broad sense. This would range from the introduction of new production processes or new products through increased investment, switching capital and labour resources from low- to high-productivity sectors, to innovative management techniques whether related to marketing, financial planning or human resources.

This chapter discusses a range of these issues, focusing particularly on the labour market, and on the links between innovation and product market policies. Future growth will come partly from inter-sectoral reallocation of resources and partly from productivity growth within industries and firms. Inter-sectoral movement will depend particularly on flexible labour and product markets, while intra-sectoral growth will rely on product and process innovation, with the education system being important for providing human capital resources for both kinds of adjustment. Recommendations across each of these areas are summarised at the end of the chapter (Box 5.6).

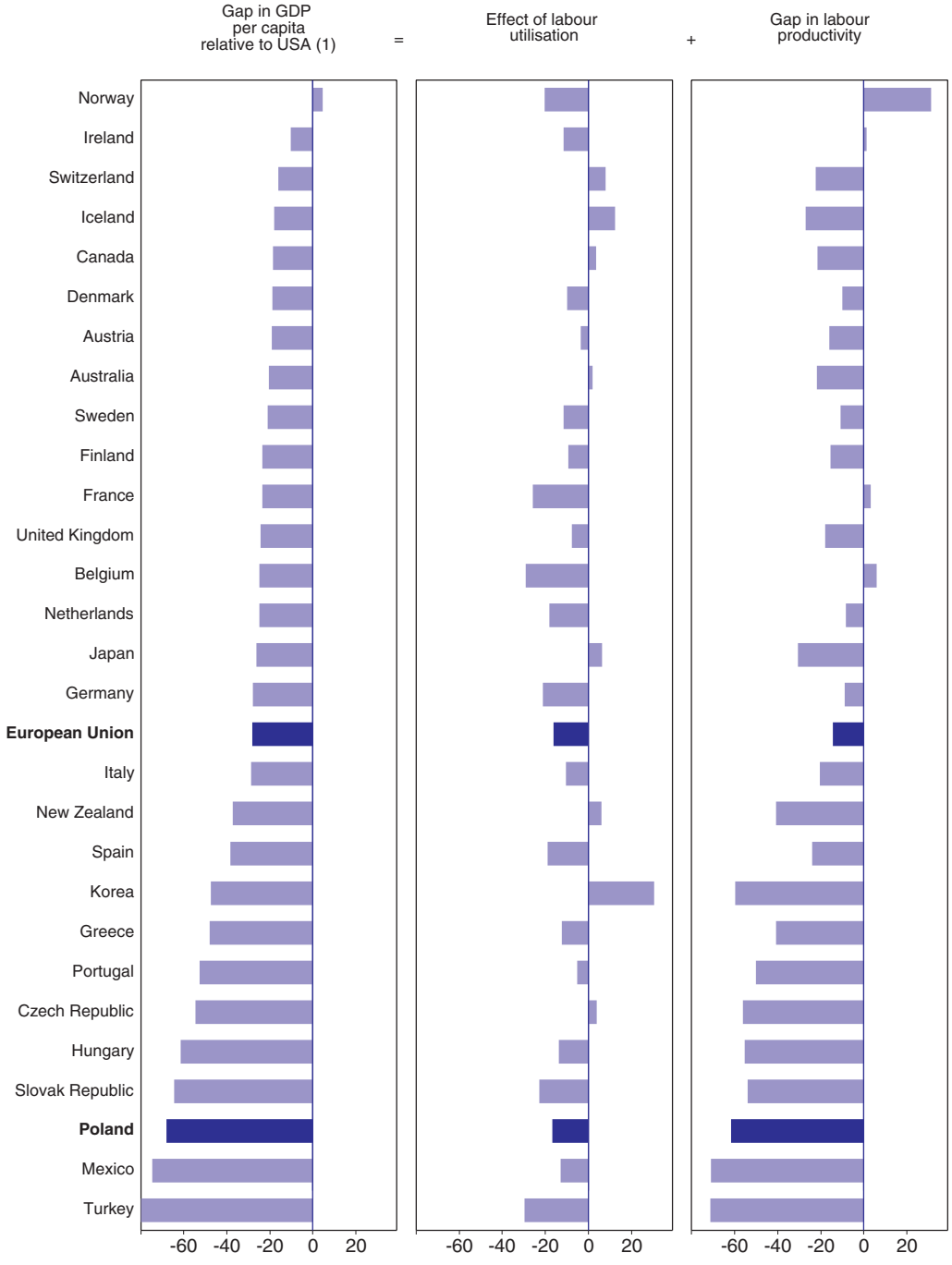
## Growth through sectoral reallocation

An important characteristic of the Polish economy is the high share of employment in agriculture, and the very low recorded productivity of that labour. About 17% of the labour force is attached to agriculture, producing only 3% of GDP. It might be that shifting labour away from this sector, and from other low-productivity activities, could produce significant gains in overall productivity and growth in the short term without requiring much in the way of faster productivity growth in individual industries. While the availability of a "pool" of surplus agricultural labour has been credited with facilitating overall productivity growth in the transition to industrial economies in the past, this process usually covered many decades. Experience with a small number of OECD countries which had similar shares of the labour force involved in agriculture until relatively recently shows that the impact of sectoral reallocation on overall productivity growth is important, although not decisive.

Portugal, Spain and Ireland are examples of countries where agricultural employment has recently contracted considerably, a contraction which Poland may face in the future. But while the decline in the share of agriculture in these economies coincided with a period of quite rapid productivity growth, the part of the overall gains in productivity that was due to an inter-sectoral shift of labour between broad sectors was, except in Spain,

## Figure 5.1. **Decomposition of GDP per head**

Percentage point differences in GDP per person in USD (PPPs) relative to the United States, 2004

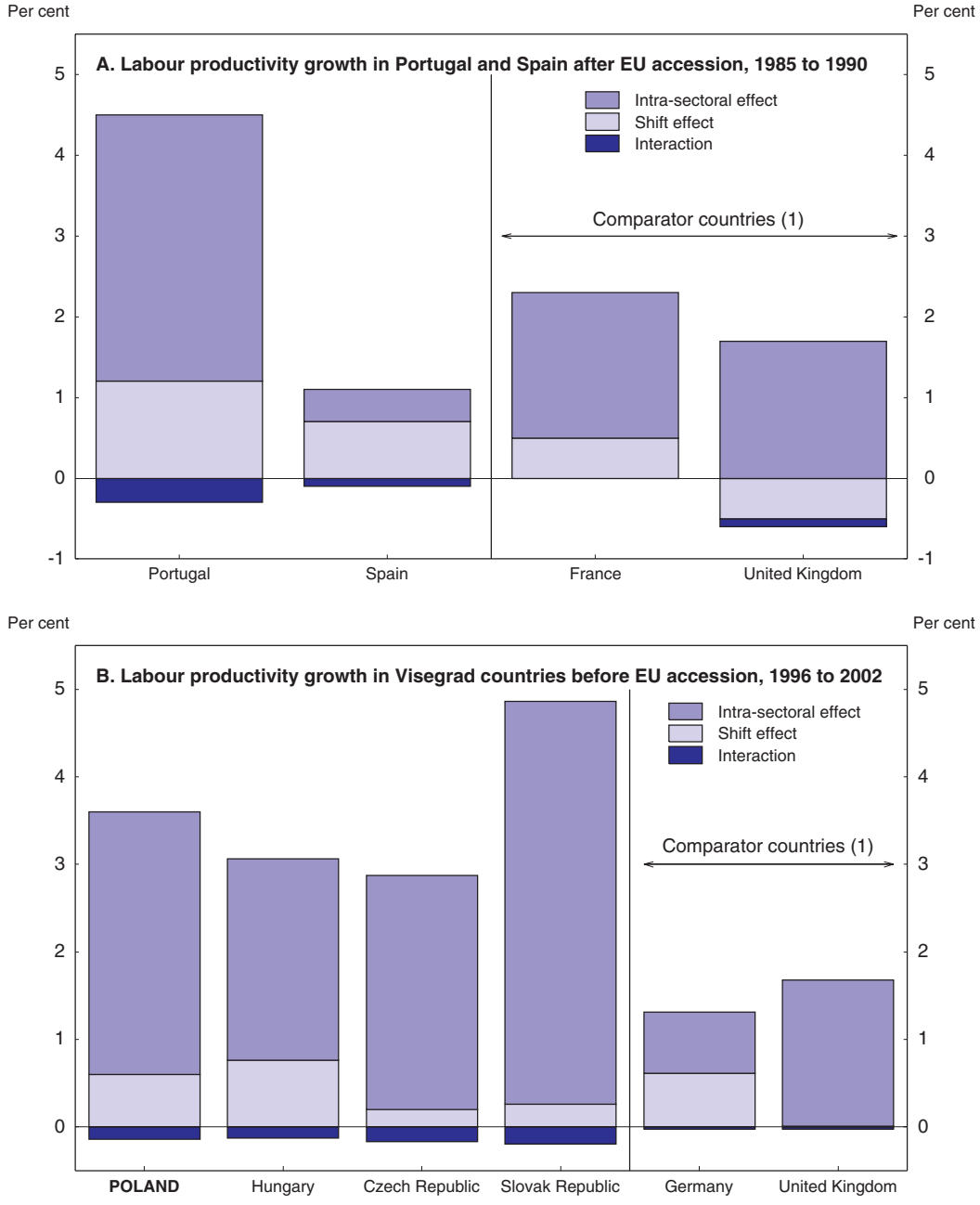



1. The gap in GDP per capita is equal to the sum of the two components shown. The effect of labour utilisation is based on total hours worked per capita. Productivity is measured on a per-hour basis.

*Source:* OECD (2006a), *Economic Policy Reforms: Going for Growth*.

small compared with the gains that came from intra-sectoral productivity growth. Nonetheless, the "shift" contribution was not negligible, amounting to between 0.5 and 1% per annum to productivity growth (Figure 5.2, Panel A). In fact, another unusual aspect of

Figure 5.2. **Decomposition of labour productivity growth in some EU countries**[1]




1. The choice of comparator or benchmark countries is difficult because data problems prevent the use of an EU average. France and Germany were used because they are close to the countries of interest, and the United Kingdom as an example of a country with a very different industrial structure. The intra-sectoral effect captures the impact of a change in sectoral productivity levels, employment shares being held constant. The shift effect measures the gain in productivity of a change in labour allocation under the assumption that no changes in productivity level occur. The interaction effect is positive when labour shifts towards sectors where productivity growth is higher than average.

*Source:* STAN database and OECD calculations.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Poland's recent experience is that, despite the very low productivity of the agricultural sector, employment was recorded as actually increasing in absolute terms in some years in the late 1990s, as many people laid off from industries that lost traditional markets following the crisis in Russia came back to the land. Whether this apparent increase in employment was really due to agriculture acting as a buffer for labour market adjustment, which is how many see it in Poland, is not clear, since the statistics on agricultural employment, like many others, seem to have been somewhat uncertain (see Box 5.4 below); the movement may also have been generated by the generous welfare system for farmers discussed in Chapter 3. This is not the whole story, however, since many industrial workers also had small agricultural holdings, and a large proportion of those occupied in agriculture are subsistence farmers, with little output that is formally marketed. Activity on those holdings did increase when unemployment rose, and much of the extra output may have been unrecorded.

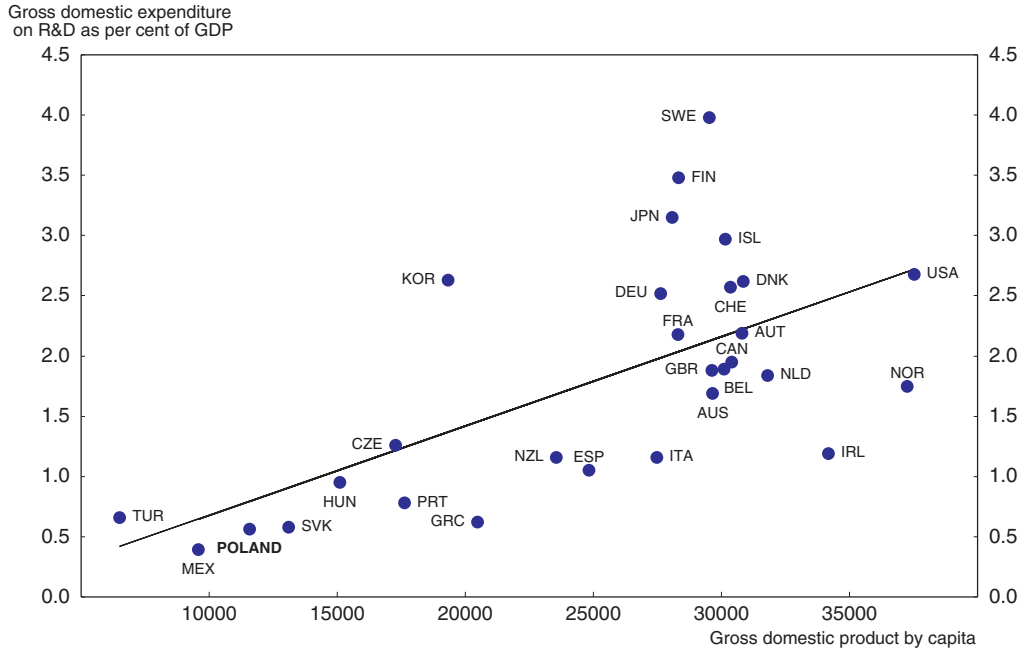
Poland's post-communist development has therefore seen little benefit from a broad movement of labour out of low-productivity sectors like agriculture (Figure 5.2, Panel B). The idea that agriculture has acted as a buffer is not strongly supported by studies that show that flows in and out of employment in agriculture were rather modest, even in the second half of the 1990s, when, until the Russian crisis, unemployment was well below today's level (Ingham and Ingham, 2005). Rather than a reservoir of labour that can be absorbed by other sectors to improve overall performance, agriculture looks more like a stable low productivity island in the economy. One reason for this may be the poor level of educational attainment in agricultural areas, especially among older people, discussed in Chapter 4, so that their productivity in other sectors would be very low too. Another factor hindering adjustment is certainly KRUS, the farmers' welfare system already discussed in Chapter 3 and further below.

The sectoral decomposition used to derive Figure 5.2 is not very detailed – only nine broad sectors are distinguished – so that it may underestimate the degree of shifting from one industry to another and the contribution of such moves to growth. In fact, other studies, at a somewhat greater level of disaggregation, confirm the impression that productivity growth comes more from progress within individual industries than from shifts between them (Kolasa, 2005).[1] Poland is unlikely to be an exception. Hence, productivity growth is likely to be ultimately dependent on efficiency improvement, of various kinds, within firms and industries.

## Entrepreneurship and innovation[2]

The primary means of achieving such efficiency gains is through the innovation process. Innovation is hard to quantify, but on those measures that are available Poland performs poorly. Plans under different governments to increase R&D expenditures as a share of GDP have had little effect, and they remain almost the lowest among OECD countries, although poorer countries do tend to have lower shares (Figure 5.3). In 2000 the government adopted a programme entitled "Increasing Innovativeness of the Polish Economy to 2006," and the National Development Plan for 2004-06 targeted an increase in R&D spending to 1.5% of GDP by 2006. Yet the share in 2006 is unlikely to exceed 0.7% (it was only 0.58% in 2004, compared with an OECD average of about 2%, and below where it had been a decade earlier). On this measure, Poland ranks below all other OECD countries except Mexico. The National Reform Programme for 2005-08 plans that the share will rise to 1.85% in 2008. Figures for patents granted also show that Poland ranks very poorly,

Figure 5.3. **GDP per capita and R&D expenditure**
2003 or latest year available




*Source:* OECD, National Accounts database and OECD, Main Science and Technology Indicators database.

although not compared with other former centrally planned economies. Patent applications have been increasing, but much of the increase appears to be applications to file foreign patents in the Polish system.

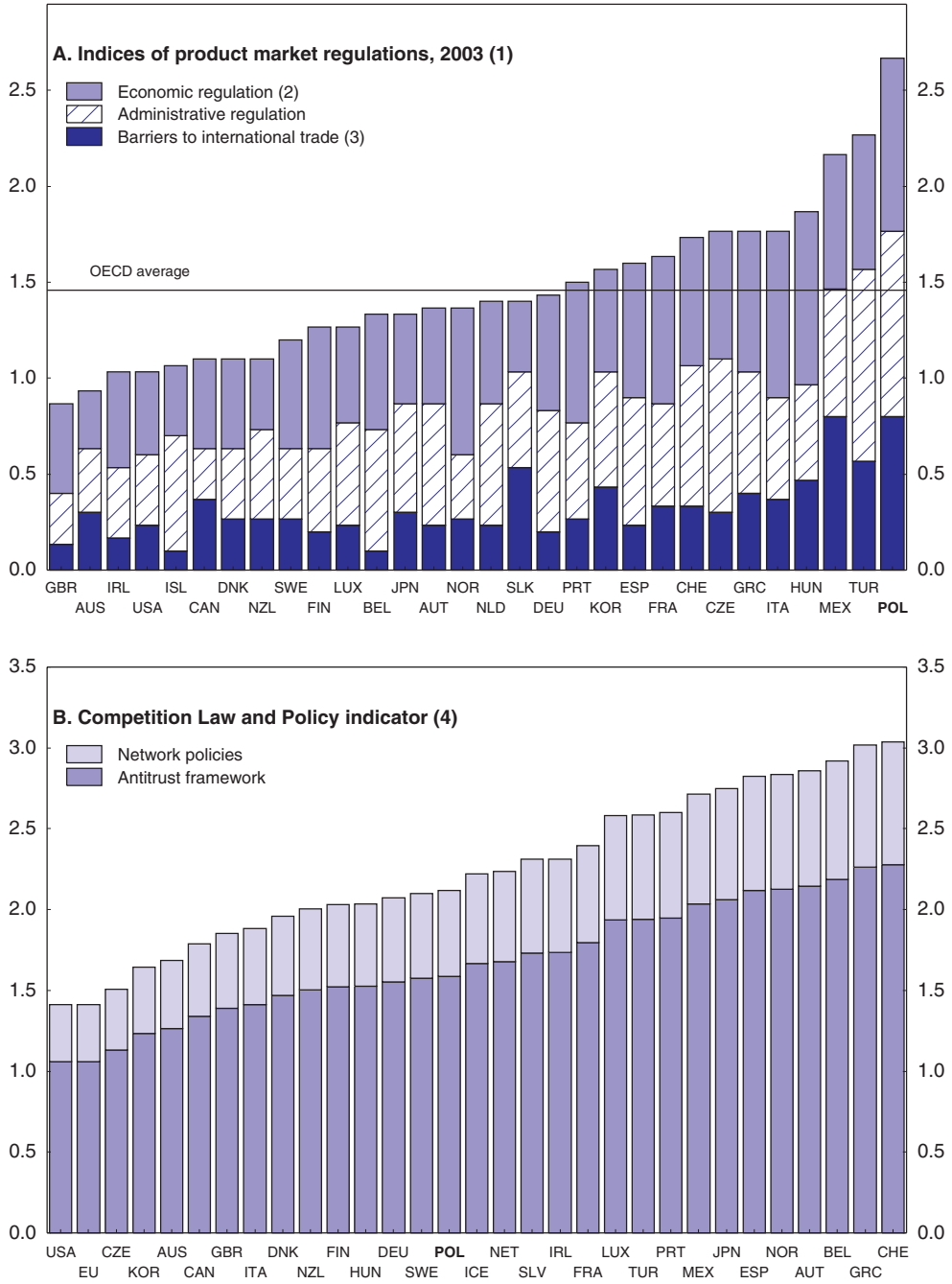
Harder than measuring innovative activity is understanding what policies will best improve it. By and large, Polish industry is so far behind "cutting-edge" technology or practices that productivity can increase enormously just by adopting best-practice methods and existing technologies. This would imply that a high level of pure research expenditure is unnecessary; it would suffice to import machines or methods. This kind of innovation nevertheless requires a good deal of entrepreneurial activity, and it follows that one of the most important objects of policy should be to ensure that "framework conditions" are favourable to entrepreneurial activity. But this may not be sufficient either, since even if Poland can make enormous progress without necessarily pushing back the frontiers of science or technology, studies show that the diffusion of existing knowledge is favoured by the presence of the right kind of human capital (see also Chapter 4). Policy therefore needs to consider both the framework conditions and more specific "supply" factors.

### *Framework conditions*

#### *Product market regulation and competition*

Among such conditions the degree of competition on domestic product markets is most important (Jaumotte and Pain, 2005). OECD indicators show that barriers to competition in Poland are the highest in the OECD, although competition laws and policies themselves are not underdeveloped (Figure 5.4). Poland's score on product market regulation (PMR) results partly from the relatively high share of public ownership in the

## Figure 5.4. **Competition indicators**




1. The index scores range from 0 to 6. The higher the score, the greater the restrictions.
2. Includes barriers to competition and state control.
3. Includes trade and FDI restrictions.
4. The CLP indicator measures the strength of overall competition policies. Lower figures imply more pro-competition policies.

*Source:* OECD Economics Department Working Paper No. 419 and OECD calculations.

economy and partly from some remaining restrictions on the degree of foreign ownership. On the other hand, competition law itself is relatively conducive to competition, though there may be some doubts as to how strongly it is enforced in some areas. A recent case, now resolved, appeared to illustrate some of these issues. Unicredito, an Italian bank, wished to merge a Polish bank it acquired in a privatisation deal with another Polish bank which is wholly-owned by another foreign company which Unicredito also recently took over, thus creating the largest bank in Poland. The Polish government initially blocked the merger, on the grounds that the original privatisation deal prevented Unicredito from acquiring another bank in Poland. The merger does not in itself appear to break any Polish or European competition guidelines and the government's action was legally challenged by the European Commission, which has jurisdiction over such mergers and had approved it. The government and Unicredito subsequently agreed on a settlement whereby the latter would sell about 40% of the branches of the newly-acquired bank, within 18 months. While the government rightly argues that its action was in line with the terms of the original privatisation, some commentators argue that the government was acting partly to protect the interests of the state-owned bank. The case also illustrates the potential pitfalls of privatisation deals that include side-commitments from the purchaser.

Another sector where competition problems may be slowing innovation is telecommunications. TPSA, the dominant fixed-line telecoms operator is still partially state-owned, though the largest shareholder is France Telecom. Like France Telecom, where the French state still holds one third of the shares, TPSA too has been strongly criticised for anti-competitive practices. TPSA's behaviour appears to be inhibiting the development of the telecoms sector, including broad-band internet access, the spread of which is linked with innovation and productivity growth. The competition authority has successfully won actions against TPSA in the past, but, with still over 90% of the fixed line market in Poland, the company seems to continue to be tempted to abuse its dominant position. The number of lines with broad-band access has begun to increase quite rapidly but still lags behind many European countries.

### *Privatisation*

Privatisation policy has another link with innovation, through the criteria used to choose among competing purchasers for companies being privatised. Policy focuses on "seeking investors who guarantee capital involvement in the development of privatised companies, which should have a stabilising effect on the labour market". In other words, purchasers are expected to avoid making changes that might lead to large-scale redundancies. While this may not discourage innovation in terms of new technology or new products, it is likely to discourage risk-taking and *organisational* innovation and may well lead to self-selection among potential purchasers against those who are the most dynamic innovators. Indeed, although foreign direct investment ought to be one of the main routes by which organisational and technological know-how is brought into Poland, Woodward (2005) notes that foreign-owned companies are not especially innovative in Poland (and do not engage in much staff training either).

Privatisation policy also often seems to focus on meeting revenue targets for the budget (even though privatisation revenues do not affect the Maastricht and national accounts definitions of the deficit, though they do reduce gross debt), and minority state shareholdings are frequently retained. Even when all the share capital is sold, Poland frequently resorted to retaining state control through special shares more often than any

other country, this still being the case for over 70 firms in early 2005. While it might be claimed that some of these are strategic companies, the list includes a bank and firms dealing in food products, catering, alcohol, tobacco, textiles, pharmaceuticals and construction, so it seems that the net is cast extremely wide. Membership of the European Union imposes more stringent requirements for the use of such special shares, and under the previous government it was decided, in mid-2005, to reduce the number of companies in which special shares would be retained to 14; this has not yet been fully implemented, though the Treasury held special rights in only 41 companies by the end of the year. Previous *Economic Surveys* have recommended that privatisation be pursued more vigorously, that less attention be paid to "social" clauses, and that special shares and residual shareholdings should be largely done away with. If anything, however, privatisation appears to have slowed down in recent years and may slow further in the future (see also Chapter 3). It should be noted that at end-2005 the State Treasury still had some interest in 1 072 active commercial code enterprises (down from over 1 100 a year earlier), and there were a separate 303 active state-owned enterprises (where oversight is the responsibility of the voivodships), down from 393 a year earlier. Besides hindering innovation, public ownership is likely to slow sectoral adjustment.

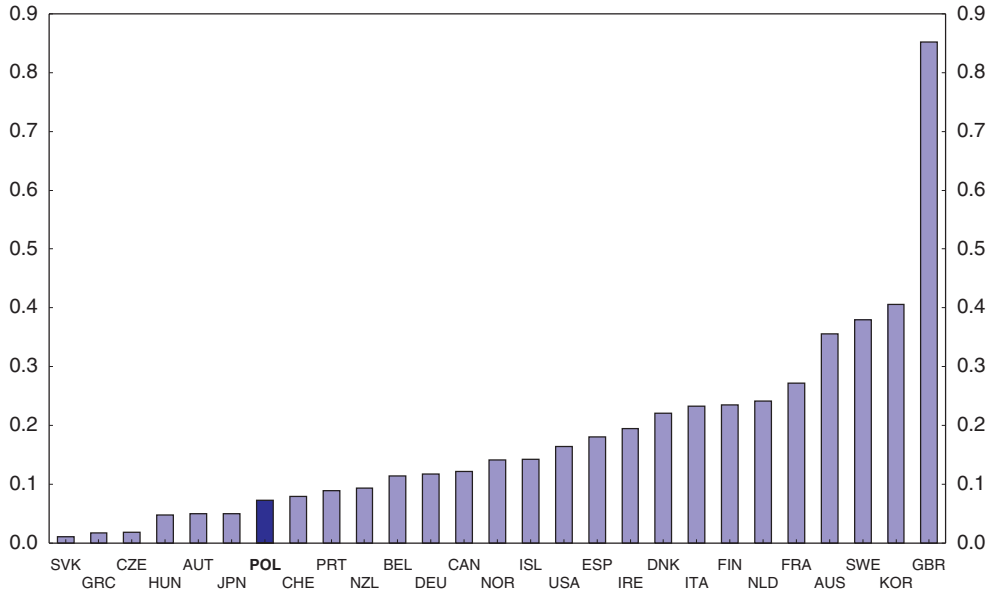
### *The cost of doing business*

Other aspects of the framework conditions in which entrepreneurs operate have been improving, in some cases too recently to be reflected in the latest PMR indicators, which refer to 2003. The new bankruptcy law, introduced in 2003, should also improve framework conditions (OECD, 2004) but the short period since its entry into force does not yet allow a thorough analysis of its practical impact. Measures, as proposed in the National Reform Programme, to increase the efficiency of the judiciary system would also help to shorten the duration of bankruptcy procedures. In 2004, the "Act on the freedom of enterprise" took steps to alleviate the administrative burden on firms by simplifying the registration and decreasing the number of procedures involved. When the provisions of this act are fully implemented the burden should be substantially reduced, but the full one-stop-shop system envisaged in this law is not yet in operation. The World Bank indicator on "Doing Business" shows that the overall administrative burden on firms is still heavy. For start-ups this was more a function of the time that things take than the monetary cost involved, although for setting up a *limited liability* company the cost was significant, more than 10 times that of a simple start-up (Goldberg, 2004).

### *Finance, incentives and intellectual property rights*

The functioning of capital markets is an important issue, not only for financing innovation but also for funding any kind of expansion. In a number of OECD countries venture capital funds have expanded considerably in recent years; they can act to provide start-up capital or fund expansion when personal or family equity from the entrepreneur is insufficient but the business is too small or not sufficiently mature to finance investment from retained profits, bank loans or public share issues. But while venture funds exist to make investments that would be too risky for banks or too large for individuals, they are nevertheless subject to economies of scale, which largely rules them out as a source of finance for most Polish firms. Despite this, there appears to be more activity by venture capital funds in Poland than in a number of neighbouring countries (Figure 5.5). The fact that many companies are very small and yet venture capital is finding

Figure 5.5. **Venture capital investments**
Per cent of GDP, 2003 or latest available year



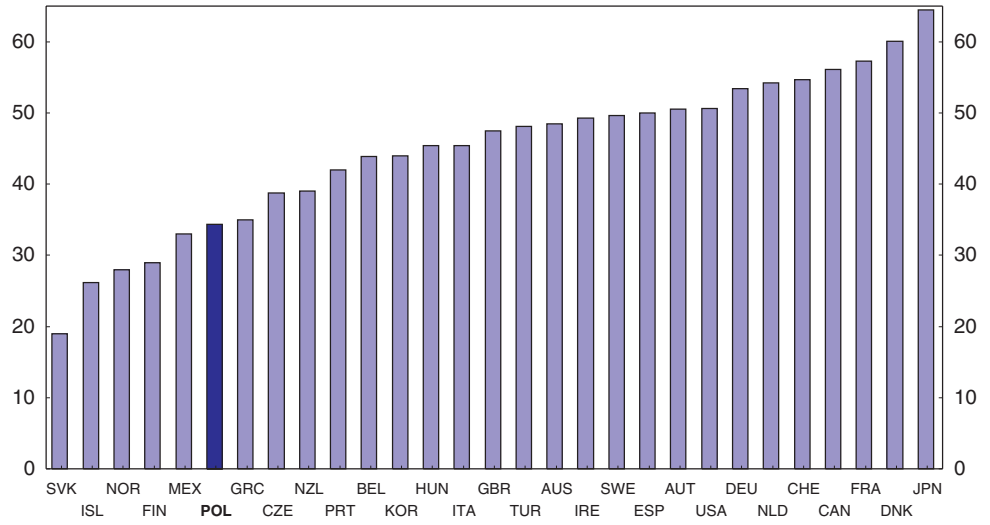

*Source:* OECD, Sciences, Technology and Industry database.

its way in to Poland suggests that there may be a way to leverage capital by setting up local venture funds which are financed by larger-scale venture capital investors.

Taxation in Poland is now relatively favourable to entrepreneurship, at least for companies paying the standard corporate tax. Since 2004 the corporate tax rate has been only 19%, down from 27% in 2003 (and 40% in 1996). The top personal tax rate is 40%, but although dividend payments are taxed twice, being paid out of post-tax corporate earnings, they are also taxed at only 19% in the personal tax, making for a combined rate of 34.4% on distributed corporate profits. This is lower than in nearly all OECD countries – only five countries had lower rates in 2004 (Figure 5.6).

While the taxation of income affects incentives to work and to expand businesses, important incentives when it comes to innovation and research and development concern intellectual property rights (IPRs). Nearly all people classified as "researchers" in Poland work for public-sector higher educational institutions or sectoral research units (called JBRs), of which there are some 200, developed to serve different industrial branches under communism. The rights to the patent or other rewards from research output are the property of the institution for which the researcher is working, and although the law on IPRs permits institutions to make profit-sharing agreements with their employees, it would seem that this is very rare. Commercial links between any of these institutions and private companies are unusual, and even in the JBRs, which were previously concerned with practical developments in the sectors for which they were responsible, the incentive structure has become more academic, with researchers being rewarded for academic papers rather than practical results. With these restrictions on links between public-sector researchers and companies, it is perhaps surprising that more R&D is not done in the private sector. Changing the incentive structure in the public institutions, especially in the

Figure 5.6. **Overall tax rates on distributed profits in OECD countries**[1]
2004




1. Effective statutory tax rates on distributions of domestic source income to resident individual shareholders, taking account of corporate income tax, personal income tax and any type of integration or relief to reduce the effect of double taxation.

*Source:* OECD, Tax Revenue database.

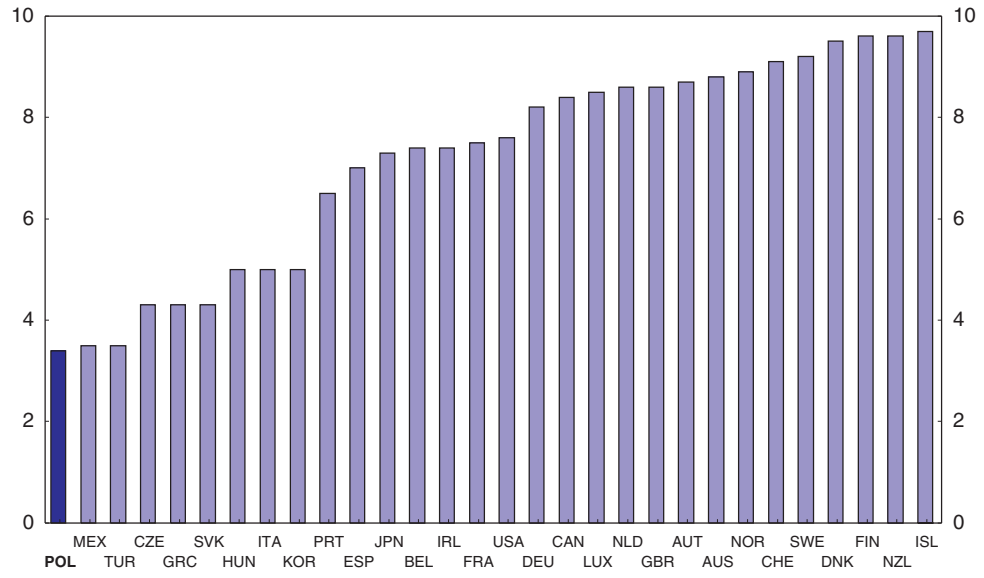
JBRs [which, despite their limitations, are valued in certain industries (Woodward, 2005)], could produce useful results quite quickly and would complement the measures being taken in the Act on supporting innovation, discussed below.

### *Corruption*

One of the most important framework conditions in creating a climate favourable to business in general, and thus to innovation in particular, is for the tax and regulatory systems to be relatively simple, but especially for them to be clear and predictable. As already mentioned here and in Chapter 3, an important step forward has been the setting up of a system whereby companies can get clear statements of their tax position. The absence of this in the past has been due partly to complexity and rapid change and partly to a lack of consistent interpretation of the rules in different parts of the administration. This kind of situation, where the rules are sufficiently unclear to allow different interpretations, is one in which corruption is likely to flourish. According to Transparency International, Poland is perceived as being more corrupt than 73 other countries in the world, including all other OECD countries (Figure 5.7). Although Poland is above the level that Transparency International describes as "indicating rampant corruption",[3] having such a level of perceived corruption, even if such measures are highly subjective, indicates a serious problem that is unlikely to favour growth or innovation generally.

According to a public opinion survey in 1999, the most corrupt area of Polish life is the health care system (67% of respondents), followed by the judicial system (49%), local (39%) and central (25%) administration (quoted in Goldberg, 2004, p. 36). Corruption was a major issue in the 2005 elections as well, where it was alleged that corruption among politicians themselves was an important issue. While corruption in the health care system is probably not in itself the major problem for entrepreneurship, the other areas mentioned give a

Figure 5.7. **Corruption perceptions index**
2005




1. The scale of the index 0-10 runs from the most to the least corrupt.
*Source:* Transparency International.

clear sign that it is likely to be an important source of extra costs for doing business in Poland. And the origin of corruption in the health care system may give a clue to at least part of the problem elsewhere. The public-sector earnings of doctors and other health care professionals are quite low (see Chapter 3), and it is common practice to have to make "under-the-table" payments in order to get adequate treatment.[4] This example of market forces in action – but in areas where the market is supposed to be circumscribed – is what creates the impression of corruption.

Eradicating entrenched corruption, much of which may be relatively petty and probably accepted without too much complaint, will be a long process. Apart from clear laws against corruption and pro-active enforcement in order to combat it, it will depend on legislation being relatively simple, effective and unambiguous, on clear lines of responsibility in the public administration, and on a reasonable balance of responsibility and salaries in the public sector. Effective detection and reporting mechanisms within the public and private sectors, with pro-active enforcement (investigation and prosecution), are also essential parts of anti-corruption policy.

### *Active support for entrepreneurship and innovation*

The main institution supplying active support for entrepreneurs is the Polish Agency for Enterprise Development (PARP), set up in 2000 reporting to the Minister of Economy. Its main function is managing funds for entrepreneurship both from the state budget and from EU Structural Fund sources; it channels these into grants for business advisory services, training services and micro-credit and guarantees as well as implementing a number of programmes directly. It has an overall budget of about PLN 1 billion (about 0.1% of GDP). An important weakness is in the nature of the "*ex post*" evaluations of the economic impact of its programmes. *Ex post* studies evaluations are carried out, and

provide valuable information on whether internal programme objectives have been achieved, but they are generally limited in their ability to assess the impacts against a counterfactual, though this is admittedly a difficult task. For instance, there are no studies related to survival, profitability or growth rates of firms which have used its services compared with those that have not. It has recently expanded the resources devoted to evaluation, partly because this is a requirement for EU funding. More in-depth assessments are due to begin during 2006.

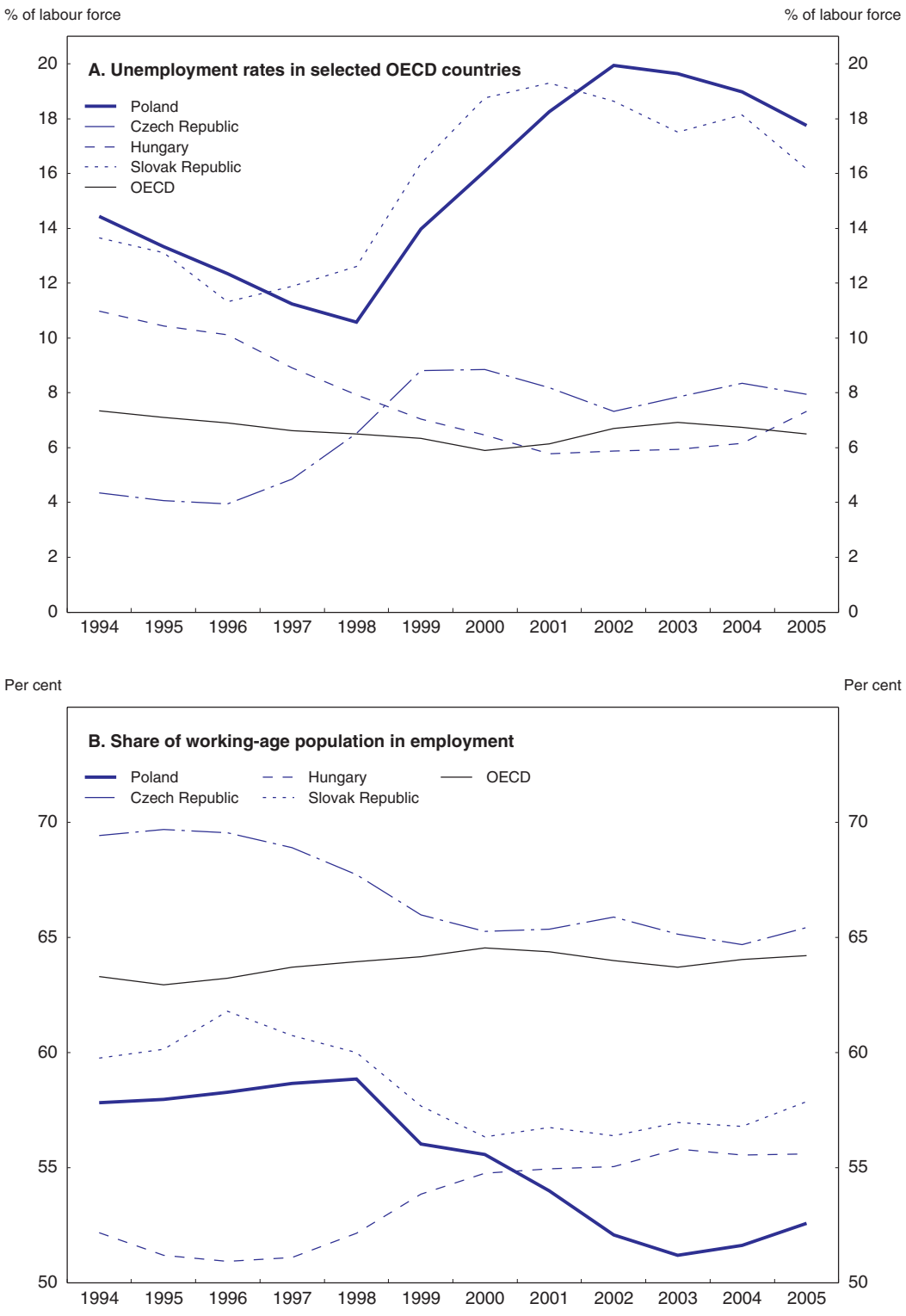
Notwithstanding the limitations of *ex post* evaluation, the structure of PARP and its mode of operation do seem to meet a number of *a priori* criteria for efficiency. With 300 staff, it operates a number of regional centres, avoiding concentrating its resources in the capital, and acts through links with NGO-run non-profit support centres of which there are now about 150. Some of the staff (it is not clear what proportion) have business experience themselves, and the supervisory board includes representatives from business organisations and chambers of commerce. Grants are allocated on a competitive basis. Training is quite an important part of its activity. PARP reports that while vocational training for employees is not particularly popular, general management skills training is in demand, and in particular one of the most frequent demands is for language training. Vocational training support is delivered, however, through a number of grant schemes to improve individual vocational schools, in partnership with local employers.

PARP also used to deal with start-ups and still has one centre (in Warsaw) where would-be entrepreneurs can go to have their ideas assessed, but responsibility for start-up support and for firms of less than 10 employees has now been given to regional (voivodship) organisations. Further fragmentation comes from the fact that support for agriculture-related enterprises is delivered through an entirely separate network run by the Ministry of Agriculture. Provided that there is no unnecessary duplication of services, or of administration costs, this may not be a problem. However, to facilitate the flow of resources out of agriculture (although it is true that more resources may be appropriate in upstream and downstream services to agriculture), good coordination between the different networks is essential.

Apart from support for entrepreneurship in general, a recent law, "on some forms of support for innovation activity", with a number of measures intended to stimulate innovation directly, was passed in July 2005 and came into force in September. It is largely focused on increasing the supply of finance for innovation in SMEs. One of the main new instruments is the establishment of a fund run by the state-owned bank of national economy (Bank Gospodarstwa Krajowego, BGK, which is already involved in lending to young people for start-ups). The fund would lend up to 75% of the cost of a project, up to PLN 2 million, with the company supplying the rest. Applications will be assessed periodically, according to their "innovativeness" and provided they are expected to be competitive with other products, services or processes on the market. The loans would be at market interest rates, so the main subsidy would be in the form of the willingness to lend for projects that commercial banks generally consider too risky, and the BGK fund may write off up to 50% of loans granted to entrepreneurs to support the launch of production of innovative products.

Since, as mentioned earlier, there is a legitimate case to be made that conventional capital markets are too risk averse when it comes to financing expansion or innovation in small firms, this scheme may play a useful role, and since it is not planned to spend more

Figure 5.8. **Labour market developments**




*Source:* OECD, Economic Outlook 79 database.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than PLN 200 million per year it will be a useful experiment. Although the requirement that the business put up part of the money means that it has an incentive to propose sensible projects, other measures could be envisaged to further align incentives, for example by involving commercial banks or venture capital funds in the selection decisions in return for a stake in chosen projects; this would both help to make better selection decisions and establish links between the borrower and private-sector finance for further development of the business. Furthermore, it is not so clear that "innovativeness" *per se* should be a criterion. Quite apart from the difficulty in defining innovativeness, what the economy needs is not projects that can be defined as innovative in some way, but projects which profitably increase output and employment. For the most part these will necessarily involve some form of innovation (otherwise they would not be more profitable than existing methods), so selecting on the basis of anticipated rates of return would likely be just as effective as looking for innovativeness.

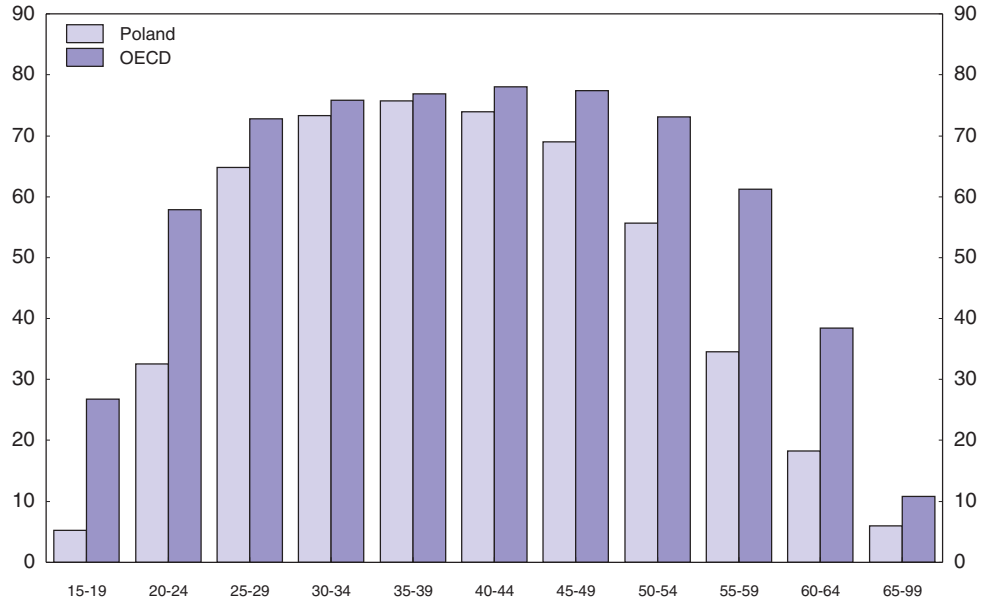
Other parts of the 2005 law to support innovation consist of extending various tax concessions to innovation expenditure, mainly allowing accelerated or 100% depreciation for technology investment. Investment under the BGK loan scheme would attract a 50% allowance. Again, if there is some kind of capital market "failure" in providing investment funds, this may be a useful measure. However, there is a strong likelihood of large deadweight losses, as entrepreneurs get benefits from investment they would have carried out anyway and seek to reclassify various forms of expenditure as R&D or "innovative". As with the PARP programmes, there has been very little *ex post* assessment of the effectiveness of these kinds of measures in Poland. Unlike in the case of PARP, however, it does not seem that much in the way of accompanying assessment of the measures in the 2005 law is planned for the future.

## Labour market policies to increase mobility and boost employment

Labour market performance in Poland is arguably the worst in the OECD and the situation has deteriorated strongly between 1998 and 2003. The unemployment rate is the highest, reaching around 18% at the beginning of 2006. Nearly half of the unemployed have been without a job for over a year. This proportion has been slightly decreasing since 2003, but the average duration of unemployment, reaching 16 months, has remained higher than in the OECD (10 months in 2004). Since 2002, when it reached 20%, the unemployment rate has been continuously decreasing, even though growth has not often been above its estimated potential rate, but still not much more than half of the working-age population has a job. The employment rate is the lowest in the OECD, and it has only increased slightly in recent years, less than the average rise in other OECD countries (Figure 5.8). An important feature of the Polish labour market is that workers withdraw from employment at a very early age (Figure 5.9). The employment rate starts to decrease at age 40, especially for men, while elsewhere it is more often the case at the age of 50. Women tend to withdraw later from the labour market.

Regional disparities within the country are also very strong in Poland. Variation in employment rates is among the largest in the OECD, although disparities in unemployment appear less marked (OECD, 2005). The regional variations are only partly explained by variations in sector performance (Estevao, 2003 and Box 5.1). They appear to be mainly due to region-specific factors rather than to the sectoral structure of regional output. This suggests that policy should target region-specific labour-market problems as well as to improve labour mobility between regions. Another implication is that in order to

Figure 5.9. **Employment rates by age**
Percentage, 2004




*Source:* OECD, Labour Force Statistics database.

benefit fully from the gains from an "optimal" reallocation of the labour force among sectors, policies need first to work on eliminating those regional characteristics that hinder job creation. Chapter 4 has discussed education and training policies that would help the labour force to adapt to structural changes. This section focuses on other policies to encourage and facilitate structural adjustment in the labour market.

While disparities between regions are strong in Poland, inter-regional migration is low compared with other OECD countries, although interpretation of cross-country comparisons on inter-regional migration flows requires caution (Figure 5.10 and OECD, 2005). This pattern of weak mobility partly explains why disparities are persistent. However, inter-regional migration flows take place in the "right" direction in the sense that working-age migrants tend to move to regions with relatively higher employment and lower unemployment rates. Mobility between regions is nevertheless not sufficient to significantly reduce labour market disparities between regions and to improve the overall labour market situation. This strongly suggests some imperfections in the functioning of the labour market.

### *Wage flexibility*

In order to increase the pace of restructuring and to increase mobility between regions, wages need to adjust without any significant obstacles. There is quite a lot of variation between sectors' employment and wage growth rates. This suggests that restructuring is indeed taking place and that wage flexibility is not a strong barrier. However, in some sectors such as health and public administration wage growth seems to have been strong compared with employment developments (see Chapter 3). Empirical studies also tend to show that there might be a lack of wage flexibility (Estevao, 2003). Individual wages have been found to be elastic with respect to the regional unemployment

### Box 5.1. **Policies to improve the allocation of the labour force by sector or by region?**

Reaching an optimal allocation of the labour force requires mobility between regions and between sectors of activity. Some of the factors that ease mobility are the same for mobility along the two dimensions, geographical and sectoral. This is the case with most aspects of labour market and product market flexibility. Others work more specifically in favour of one particular type of mobility. For instance, infrastructure, transport and housing policy are mainly linked to geographical mobility, while retraining is more likely to improve sectoral mobility.

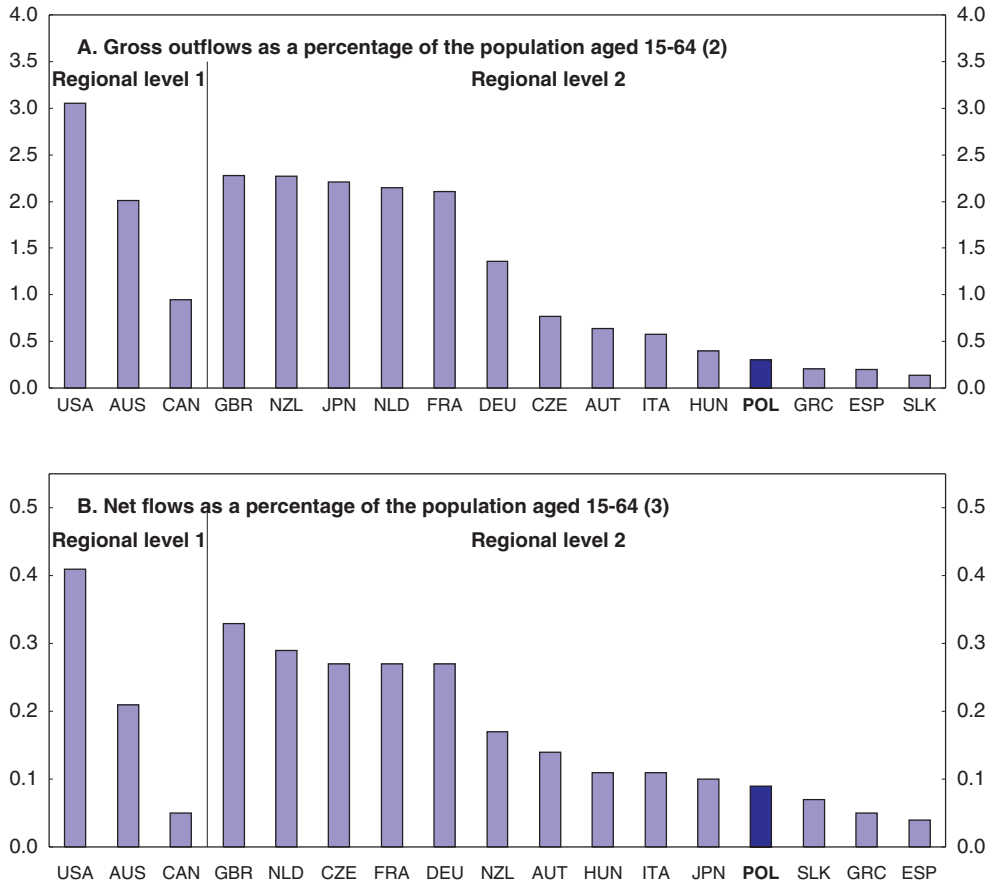
In a hypothetical country where each region is fully specialised in one sector, policies should concentrate on helping workers to move from declining to growing sectors. Active industrial policy at the regional level could also have an impact on job creation, although this kind of policy is difficult to sustain in the long run and thus needs to be used only in order to facilitate the transition. On the other hand, in a hypothetical country where each region has the same sectoral structure, variation in regional performance would result only from region-specific effects. Policies should then focus on the characteristics of a region that explain why employment is low and try to facilitate mobility between regions. In reality, the truth is very likely to be between these two polar cases, but it is important to know how much sectoral and geographical variations coincide in order to know what kinds of policies should be implemented in the first place.

Estevao (2003) tries to estimate to what extent variations in regional employment growth is linked to variations in the sectoral structures of Polish regions. He distinguishes between three factors: a structural factor, which is the degree to which a region is specialised in industries with strong or weak employment growth; a region-specific effect, which is a measure of how much employment growth in the predominant industries of the region is higher than on average in the same industry; and, finally, an allocative component, which is the covariance between the two factors and can be interpreted as regional growth deriving from its specialisation in those activities where the region is most competitive. He finds that the variance of regional growth in employment is mainly explained by the second component: region-specific performance. This implies that an active industrial policy at the regional level would not have an important impact on job creation. This result is not completely confirmed by OECD (2005), which using a more detailed industry classification finds that the initial sectoral-specialisation explains a significant part of the variation in regional employment growth, mainly in countries where regional disparities are high.

rate when the unemployment rate is low but show some rigidities when the unemployment rate is high (Yamaguchi, 2005). Moreover, the distribution of changes in nominal wages is skewed and has a spike at zero, which is a sign of nominal rigidities. Finally, it appears that nominal rigidities were not a problem before 1998, because, with high inflation, real wages could fall even as nominal wages increased or remained the same. But, since 1998 and especially most recently, with much lower inflation, rapid real wage adjustment has become more difficult.

The wage bargaining system does not appear to be at the origin of any strong rigidities. Wage setting in Poland is decentralised and occurs mainly at the company level. The number of collective agreements has been decreasing since 1995, and collective bargaining

Figure 5.10. **Internal migration rates**[1]
2003




1. 1999 for Netherlands, 2001 for Greece, Japan and New Zealand, 2002 for Austria, France and Italy.
2. Total population for Australia and Italy; population aged more than 5-years for Japan.
3. Calculated as the ratio of the sum of the absolute values of regional net flows divided by two, to the total population aged 15-64.

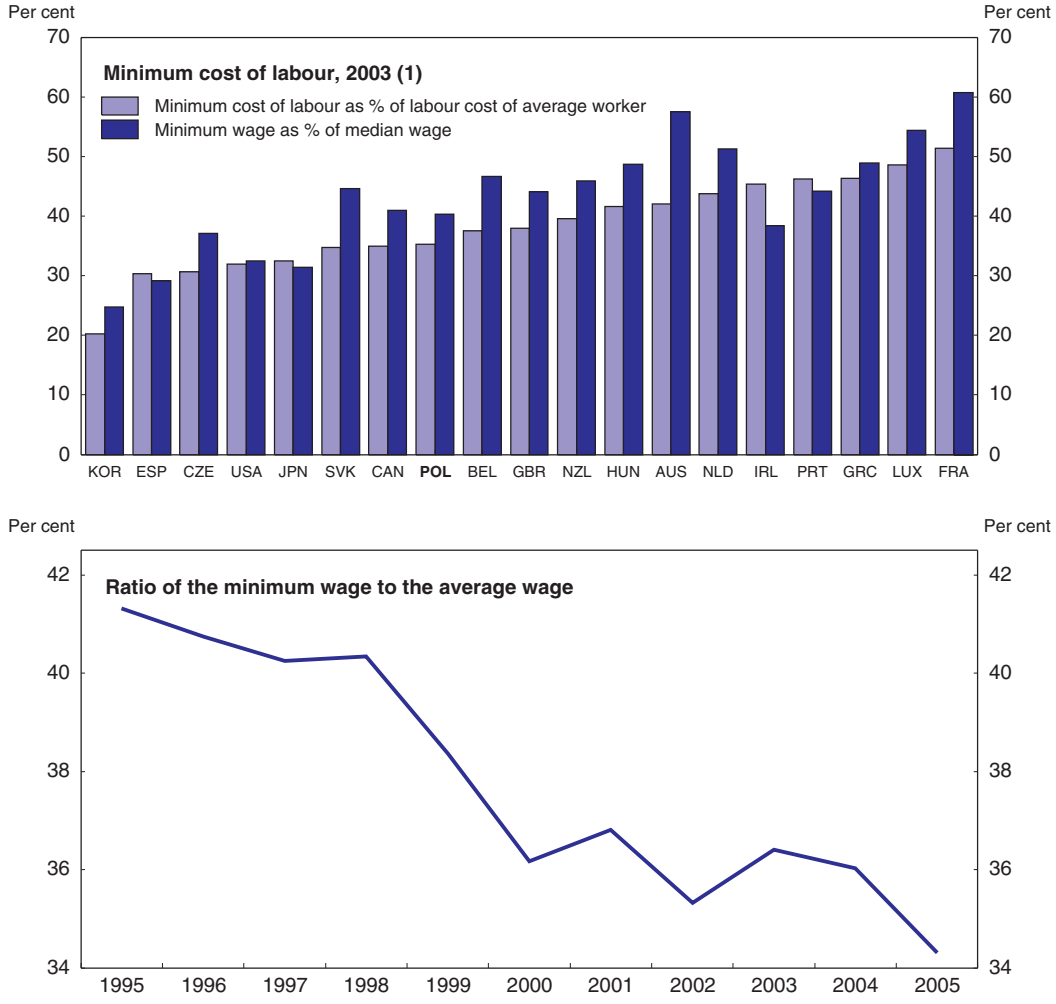
*Source:* OECD (2005), *OECD Employment Outlook*.

coverage is not especially high (around 40%), although procedures for extending collective agreements exist.

The minimum wage is probably the source of some rigidity at the bottom of the wage distribution. It is set at the national level, in terms of the minimum monthly wage for a full-time worker. Since 2002 it has been indexed each year on forecast inflation and is less than 35% of the average wage (Figure 5.11). Compared with other OECD countries, this is not especially high, but, because the wage distribution is skewed, it is around 40% of the median wage. Moreover, in some low-wage regions, it reaches 40% of the average wage (and therefore perhaps 45% of the median wage), which may be an obstacle for low-skilled workers and long-term unemployed to price themselves into jobs. This is all the more true, since variation in wages within regions is often greater than that between regions.

In 2005 parliament (against the advice of the then government) changed the indexation rule for the minimum wage. Henceforth, it is to be increased by not less than forecast inflation plus two-thirds of forecast real GDP growth, until it reaches 50% of the

Figure 5.11. **The minimum wage relative to the average wage**




1. Or latest available year.

*Source:* Ministry of Labour and OECD (2006a), *Economic Policy Reforms: Going for Growth*.

average wage. This would put Poland on a par with the top few countries in the OECD (Hungary, France and Greece). Empirical evidence on the likely consequences of this decision is mixed, since the adverse impact of the minimum wage on labour demand is mitigated by the fact that it encourages participation (OECD, 2006b). However, too high a minimum wage also magnifies the negative impact of the labour tax wedge on employment. Since the tax wedge is already high in Poland, especially for low paid workers (Chapter 3), the government should carefully monitor the impact of the new indexation rule on relative labour costs. Although the minimum wage will take some time to rise to a level where it will constitute a serious problem across the whole country, under the new indexation rule it will inevitably get there. Unless the government succeeds in reducing public expenditure sufficiently to allow the tax wedge on low incomes to be reduced at least enough to offset the increase in the labour cost generated by the new formula, the new indexation rule will need to be reconsidered. The policy that allows companies to pay workers with little experience only 80% of the minimum wage does mitigate the negative

impact of the minimum wage on certain groups; the government could consider extending this programme to the long-term unemployed. While the authorities are aware of the fiscal cost of social assistance payments and are seeking to reduce them, they should beware of trying to shift the burden of achieving social goals on to firms, since such moves would very likely reduce the demand for labour and hence be counterproductive.

### *Replacement revenues*

In many OECD countries, disparities between regional unemployment rates are more marked than between regional employment rates, meaning that disparities are more driven by the capacity of regional labour markets to generate new jobs, rather than by labour supply or demographic factors (OECD, 2005). This is not the case in Poland, where disparities between regional employment rates are very large. This suggests that labour supply and thus replacement revenues play an important role.

The reservation wage in Poland seems to be high; this would explain why wage data show some rigidity even though wage setting is decentralised and the minimum wage is not very high. Although they are not fully reliable, data from the labour force survey tend to show that a significant part of the unemployed would not accept a job at the minimum wage. Either other income or revenues from the informal economy must be high (Box 5.2); otherwise it is difficult to explain how people can afford to be inactive rather than looking for a job in another sector or region.

The Polish system of social transfers is relatively generous for the disabled and certain specific groups, especially those with children (Box 5.3 and Table 5.1). Help for the unemployed is not especially generous for the childless – significantly lower than the minimum wage – and should not, on its own, be an important disincentive to taking a job.[5] Unemployment benefit duration is higher in regions with higher unemployment rates and, while this has some justification from the social policy point of view (since it is very likely to take more time to find a job in depressed regions), it is a clear disincentive to job search, particularly to geographic mobility. Fulfilment of job-search requirements should be strictly monitored (see below). Eligibility criteria for unemployment benefits should include requirements on commuting distance and, in depressed regions, the longer period of benefit entitlement should be used as an opportunity to encourage the unemployed to look for a job in another region.

The disability scheme is much more important in explaining the high level of inactivity and of the reservation wage. The disability pension is nearly half the average wage, substantially higher than the minimum wage. In some circumstances, it is higher than the retirement pension and although the disabled have had to switch to the old-age pension system on retirement since the beginning of 2006, they keep their higher benefit. Survivors' pensions are also very high and granted to a large number of people. In poor regions where the cost of living is low and unemployment is high, receiving this kind of pension makes people sufficiently comfortable that they have little incentive to move to find a job. Indeed, in all regions, the average pension is much higher than the minimum wage. These transfers are also an obstacle to restructuring, since dismissed people who used to work in a declining sector may prefer these benefits to retraining and trying to find a job in another sector.

The government has taken steps to reform the system by, for instance, restricting access to the disability scheme (see Chapter 3). But, despite these changes, the stock of

### Box 5.2. **The informal economy in Poland**

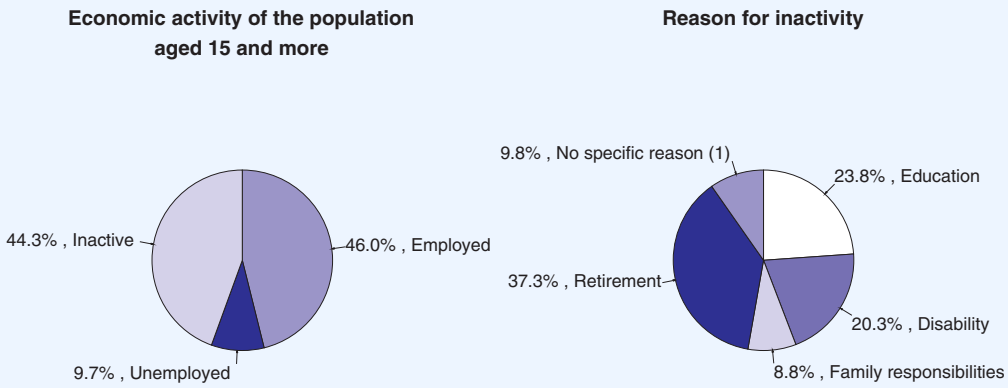
It is difficult to assess the extent of the informal economy and informal employment in Poland at the moment. Estimates dating from 1998 showed that 7.5% or 9.2% (depending on the definition) of total employment was in the informal sector (ILO, 2002). Informal employment was higher in rural areas than in urban areas, for men and especially for those with low educational attainment and few skills. According to the CSO, the share of GDP produced in the informal economy reached 13.2% in 2003, compared to 14.3% in 2000, which means that, except if productivity grew rapidly, employment in the informal economy has not decreased strongly since 2000. Indeed, the growth performance of the economy has been much weaker since 2000 than in the earlier period, raising the relative attractiveness of the informal sector

Comparing number of persons that are non-employed (Figure 5.12) and the beneficiaries of replacement revenues (Table 5.1), it seems that some of them do not have an explicit source of income that is sufficient to live on. People inactive for retirement or disability reasons have such an income. However:

- 10% of the population aged 15 and more is unemployed, but since only 14% of the registered unemployed receive unemployment benefits, 8.6% of the adult population is unemployed without any unemployment benefit.
- 10% of the inactive, and thus 4.4% of the adult population, are inactive for a reason that does not give right to a specific benefit.
- 9% of the inactive and thus 4% of the adult population is inactive because of family responsibilities, but family benefits are not sufficient to live on.

Figure 5.12. **Economic activity of the population aged 15 and more and reasons for inactivity**

2005, third quarter




1. Persons seeking a job but not ready to take it on and discouragement by inefficiency of job search included.

*Source:* Central Statistics Office, Labour Force Survey in Poland.

disability pensioners was still over 9% of the population over 15 in 2005. This is high compared with other OECD countries[6] and strongly suggests that many people receiving the pension are in fact capable of work. Therefore, policies should focus on developing

### Box 5.2. **The informal economy in Poland** *(cont.)*

Adding these together, 17% of the adult population appears to be non-employed without any clear source of income. Some receive social assistance, but this accounts for only 5.7% of the adult population. Moreover, its level is relatively low. Some poor families may receive additional mean-tested benefits. Some of them (7% of the adult population) may be farmers who produce only for their own need. Finally, others may be living with parents or relatives. Hence, there is a relatively large range of people who are non-employed and who seem to have only very low income. Moreover, some people are reported as being employed in agriculture but actually working elsewhere. This suggests that informal employment is still high.

The fact that there may be a significant share of the population working in the informal economy has some positive aspects. It means that the overall labour market situation is in fact less serious than it appears and that fewer people than one would have thought are living in poverty. On the other hand, the informal economy generates a certain number of problems (OECD, 2004). *First*, there is a vicious circle: because taxes (on wage income) and social security contribution rates are high, the informal economy develops. But this means that the cost of social protection is borne by a narrow range of the population. *Second*, the informal economy makes it difficult for the government to target social protection since there is a gap between official and actual incomes. It is also at the origin of unfair competition between firms that pay tax and those that do not. *Finally*, informality hampers productivity in various ways: firms face more uncertainty because of the absence of a legal framework, workers too face more uncertainty than in the formal sector, access to credit is more limited, etc.

### Table 5.1. **Main transfers by the social insurance system**[1]

2004

| | Average monthly benefit (Per cent of average net wage) | | Number of beneficiaries (Per cent of the over 15 population) | |
|---|---|---|---|---|
| | ZUS | KRUS | ZUS | KRUS |
| **Pensions** | | | | |
| Old-age | 67.7 | 41.3 | 12.9 | 3.1 |
| Survivors | 57.3 | 38.8 | 4.3 | 0.1 |
| Disability | 47.2 | 36.6 | 6.9 | 2.2 |
| **Pre-retirement benefit** | 42.5 | | 1.9 | |
| **Social assistance benefit** | 22.2 | | 5.7 | |
| **Alimony benefit** | 12.9 | | 1.8 | |
| **Family benefit for having a child, per child** | 2.9 | | 9.9 | |
| **Unemployment benefit** | 26.0 | | 1.4 | |
| *Memorandum item:* | | | | |
| Minimum wage | 36.2 | | – | |

1. The system comprises a general regime (ZUS) and a regime specific to farmers (KRUS).
*Source:* OECD calculations based on CSO (2005), Statistical Yearbook.

partial disability pensions for this group and helping them to find a job. Furthermore, while the changes have been successful in reducing inflows to the disability pension scheme, inflows into pre-retirement schemes have increased sharply since 2000 (Ministry of Economy and Labour, 2005). As a result, the average actual retirement age has decreased since 1999 (Table 5.2). It is not clear whether this trend will reverse in the near future since:

### Box 5.3. **Main aspects of the social security and social assistance system**

In addition to old-age pensions, various pensions and benefits are provided to the population. They are financed either by the general social insurance system (ZUS) or by the special farmers' system (KRUS). The range of benefits in the two systems is almost the same, but levels of pensions and benefits and criteria for eligibility differ substantially (KRUS benefits are lower). The main transfers are:

**Unemployment benefit**

- Unemployment benefit is a fixed share of the average wage (about a quarter), irrespective of the previous wage of the unemployed. However, it is 20% higher for someone with 20 years of work experience or more. The length of the unemployed insurance benefit period varies between 6 and 18 months depending on the level of unemployment in the region and on age. Being registered as unemployed gives the right to social security. On average in 2004, 14.4% of the unemployed received unemployment benefit. This low proportion mainly comes from the fact that nearly 50% of them are long-term unemployed.

**Benefits for the inactive**

- Disability pensions are granted to an insured person who is incapable of work and has contributed to the system for at least five years (less for someone under 30). The pension may be either permanent or temporary; in the ZUS scheme, whereas permanent pensions used to be the rule, nearly all new disability pensions are now granted for a temporary period, up to five years, for example. The pension may also be full or partial, depending on the ability to work of the person. In 2004 more than half of the disabled received a partial pension. A pension also exists for disabled people who have never worked.
- Survivors' pensions are granted to children after the death of one parent and to widows and widowers or other persons that the deceased was responsible for. It is possible to receive this pension and to continue working. Around 55% of the beneficiaries are older than 65 and mainly female. One-quarter are under 24.
- The right to early-retirement at the age of 55 for women and 60 for men for people covered by ZUS is granted to employed workers born before 1 January 1949, with 30 (women, 20 for those considered completely unable to work) or 25 (men, but only for those considered completely unable to work) years of insurance coverage. For those born after 1 January 1949 and before 1 January 1969, the right to early retirement was granted only to workers who fulfill the above conditions before 31 December 2007, who have not joined any open pension fund scheme and whose employment contract has been terminated. The right to early-retirement even for the latter group of workers should have stopped in 2006 but this has been postponed until the end of 2007. Early-retirement pensions are financed by the social insurance system and their level depends on the number of years of contribution to the system. The right to early retirement does not exist in the new pension system. However, early retirement pensions are to be replaced, in a way, by "bridging pensions" that will be granted to a limited number of specific groups, but the shape of these schemes and the concerned specific groups have not been decided yet. Miners are not covered by the pension reform and still have the right to early retirement with favourable conditions (having worked 25 years including 5 years underground for miners for instance).

### Box 5.3. **Main aspects of the social security and social assistance system** *(cont.)*

- Pre-retirement programmes (in forms of pre-retirement "benefits" and "allowances") were introduced in 1997 (pre-retirement benefits were abolished in 2002). Before 2004, pre-retirement allowances played a sheltering role for dismissed older workers who did not have the right to early-retirement. Since 2004, the requirements to be met by beneficiaries have been made stricter and a 6-month period has been introduced during which the worker has to look for a job and to accept any suitable job offer; during this period an unemployed person is entitled to unemployment benefit. The average amount of the allowance has also been reduced.
- Social assistance is granted to people having insufficient means or meeting some social criteria (homelessness, unemployment, disability, etc.). It includes monetary benefits, either temporary or permanent, and non-monetary assistance (meals, clothes, etc.). People in need may also be entitled to housing.

Other kinds of income maintenance include sickness allowances, maternity allowances that are paid for 16 weeks for the first child and 18 weeks for subsequent children, family benefits to help families with low income to bring up a child, and nursing allowances that are paid to households with a disabled child. Some housing benefits are also paid by local authorities to low-income households.

Table 5.2. **Average actual retirement age**

| | Average actual retirement age | | | | | |
|---|---|---|---|---|---|---|
| | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 |
| Women | 56.7 | 55.9 | 56.0 | 56.1 | 56.4 | 56.0 |
| Men | 59.2 | 58.9 | 59.4 | 59.4 | 60.5 | 58.7 |

*Source:* Ministry of Economy and Labour (2005).

i) those born before 1949 still have the right to early retirement pension; and ii) the right to early-retirement for those born after 1949 but who stayed in the old pension system should have stopped in 2006 but this has been postponed until the end of 2007. Furthermore, early-retirement schemes for specific group were supposed to be replaced in the new pension system by less generous "bridging pensions"; these give rights to early retirement, but in a limited number of specific occupations with difficult working conditions, and cannot be combined with employment (contrary to the previous system). However, their implementation has been slowed by strong opposition from those concerned (see Chapter 3). Finally, there is no plan to phase out pre-retirement schemes.

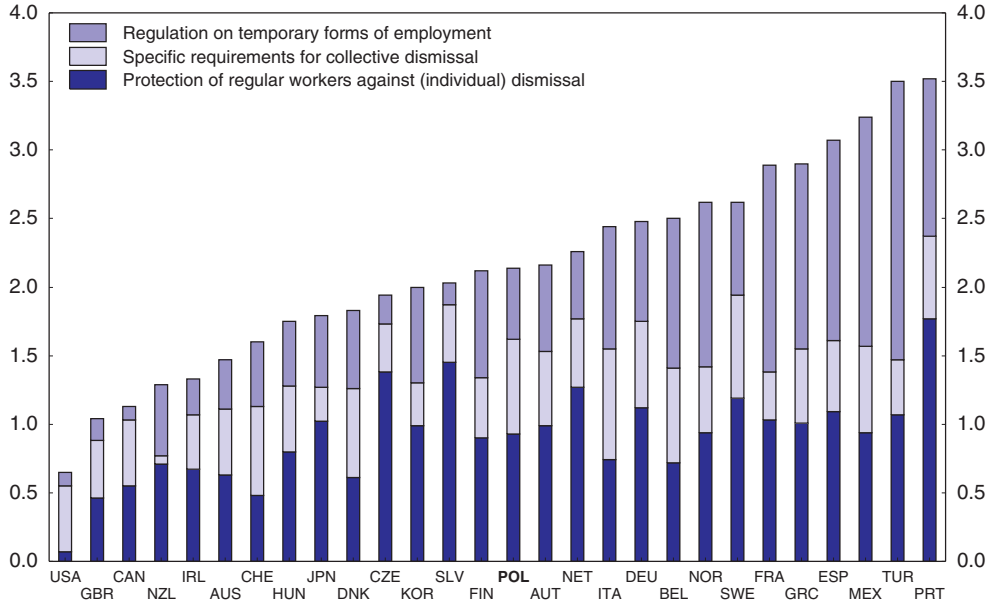
The transfer system is also poorly targeted, since some go to relatively wealthy households (OECD, 2004). A reform of the transfer system should aim not only to restore incentives to take a job, to move region and to change sector of activity, but also to improve its targeting and to reduce its cost. The main features of an appropriate reform of the transfer system are presented in Box 5.6 below.

### *Employment protection legislation*

Employment protection legislation (EPL) can be another obstacle to structural adjustment, hindering labour force reallocation. In Poland, the strictness of EPL is around

the OECD average, though somewhat higher than in the other Visegrad countries; but it is much higher than most of the countries with good labour market performance (Figure 5.13). The current EPL rules date from a 2002 reform that modified some provisions so as to increase labour market flexibility, especially for small businesses; in some areas EPL was tightened, partly in order to harmonise with EU provisions. The strictness of EPL on regular contracts in Poland is mainly due to the procedures required to dismiss workers and the regulations on collective dismissals. Other aspects of EPL on regular contracts, such as the definition of justified dismissal and severance payments, are not particularly strict. Moreover, arrangements dealing with working hours constitute a significant source of flexibility: the overtime pay premium has been cut to a relatively low level, and it is possible to adjust weekly working hours to firms' planned activity levels.

Figure 5.13. **Strictness of employment protection legislation**
2003




*Source:* OECD (2004), *OECD Employment Outlook*.

Temporary jobs have developed markedly in Poland: 26% of the workforce had a temporary contract in 2004, while their share was less than 5% in 1999. This proportion reached nearly 60% for youths in 2004. Restrictions on the use of temporary contracts through temporary work agencies (TWAs) are now greater than those on fixed-term contracts. The latter are subject to almost no regulation except that they cannot be renewed more than twice, a regulation introduced to meet EU requirements. Since 2004, however, the use of contracts through TWAs has been restricted to seasonal or periodic replacements and when a temporary worker is indispensable for completing the task; their duration is limited to 12 months. This is very likely to restrict the development of these agencies.

Empirical evidence tends to show that the impact of EPL on overall unemployment is small but that strict EPL compromises employment prospects for groups facing entry

problems such as youths, women and the long-term unemployed (OECD, 2006b). Moreover, it can be argued that EPL should be less strict in countries where ongoing and large labour reallocation is likely to be needed than in those with less rapid structural change. In Poland, overall EPL does not seem to be a major source of problems, but simplifying dismissal procedures on regular contracts could reduce an important source of delay and uncertainty, helping to improve labour reallocation. The rapid growth in temporary contracts is, however, strongly suggestive that EPL on regular contracts is costly.

One particularly restrictive aspect of the labour code is that it is impossible to dismiss a worker who is less than four years from the retirement age. That period was extended from two to four years in 2004. Experience from other countries, such as France, shows that stronger EPL for older workers has, in the end, a negative impact on their employment prospects: it creates a serious barrier to entry for older workers and the unemployed and should be phased out.

### *Public employment services*

In order to help workers to move between sectors or regions, public employment services (PES) need to be efficient. Experience from other countries shows that returns to different programmes vary widely and that similar schemes can yield very different outcomes in different countries (OECD, 2006b). Hence, the details of programme design are very important. Moreover, public job-creation and wage-subsidy measures often fail to bring the unemployed back into unsubsidised work. Job-search assistance gets better results. It is also important to "activate" the unemployed – unemployment benefit should be conditional on work availability and active job search. PES action then consists of encouraging jobseekers to become more active in their efforts to find work by providing job-search support and at the same time monitoring their job search (requiring regular contacts and participation in programmes when necessary).

Up to now, such activation strategies have not been developed at all in Poland. Expenditure on active labour market policies (ALMPs) is very low (see Figure 3.7 in Chapter 3), and a large part of expenditure is still for public job creation and wage subsidies. In the framework of the Lisbon Strategy, the government has proposed measures to improve the efficiency of the PES and to develop ALMPs. The main proposals for the PES include identical service standards in all labour offices, improving the quality of the staff and linking the financing of institutions with performance. Proposed ALMPs include development of job placement, the reorientation of efforts towards less-skilled workers as well as the activation of the disabled who are able to work. These all go in the right direction.

### *Incentives to remain in the agricultural sector*

A large part of the population is still working in the agricultural sector, although it is difficult to make a precise evaluation (Box 5.4). Employment in agriculture was estimated to be 17% in 2004, which is very high compared with other OECD countries (see Chapter 1), but the definition is broad enough that some people are considered as employed even though the product of their work is minimal. The fact that there is much hidden unemployment in the agricultural sector is reflected in its very low level of productivity (see also Chapter 1).

The special farmers' social insurance system (KRUS) provides some incentives to remain in rural areas and to work on a farm rather than to move to other activities. Benefits

### Box 5.4. **Definition of employment in agriculture**

Data on employment in agriculture are based on National Agricultural Census. The methodology used in that of 2002 considers someone as "employed in the agricultural sector" in any of the following cases:

- People employed solely or mainly in individual farms above 1 ha except for farms producing for internal needs only;
- People employed in plots below 1 ha except for plots producing mainly for internal needs;
- Owners of farming animals except for those producing only or mainly for internal needs.

Before 2002, data was based on the 1996 Census, which, contrary to the 2002 Census, considered people producing only for internal needs as employed in agriculture. This change of definition has led to the exclusion of more than 2 million of people from employment in agriculture. These people have been classified as inactive.

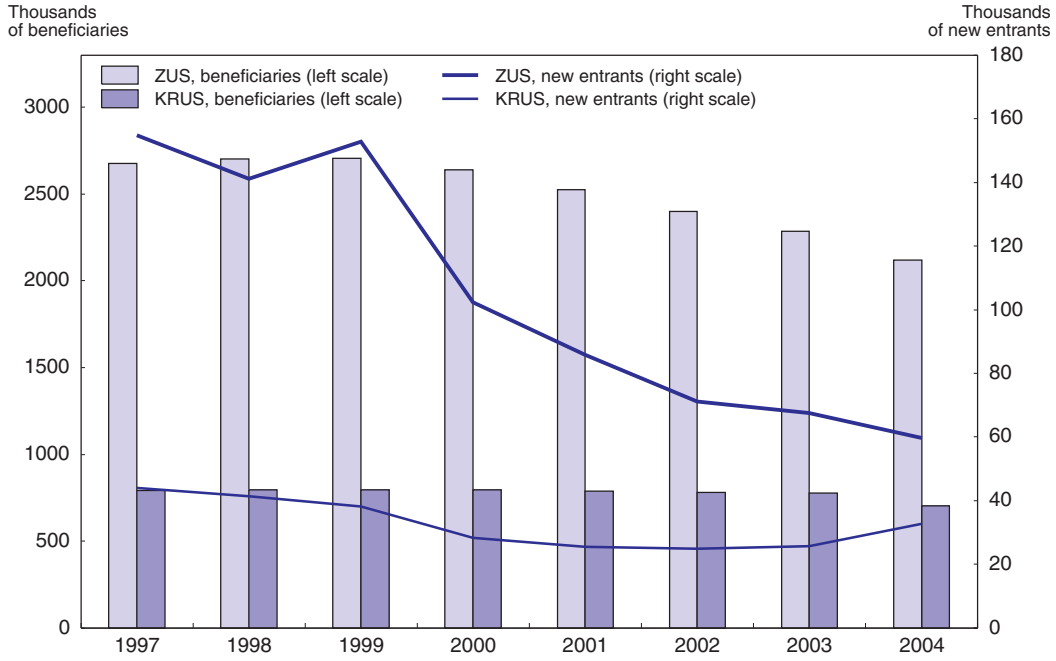
Despite the change in definition, it is still very broad. There is no limit on the amount of land farmed to be classified as employed in the agricultural sector. The only limit is that people do not produce only for internal needs.

from the KRUS are lower than that of the general insurance system, but contributions are only about one tenth on average and are independent of the income of the insured person. Therefore, it is more advantageous for some people to be part of the KRUS rather than belong to ZUS (see Chapter 3). This is all the more true since the ZUS has been reformed so as to restrict access to its principal benefits, while reforms to the KRUS have been only marginal up to now (Figure 5.14). For instance, it is much easier to gain access to a disability benefit for someone belonging to the KRUS than for those in the general system. The number of disability pensions granted by the KRUS decreased between 1997 and 2002 but has since increased sharply.

This system has been strongly criticised for some time, but the previous government failed to implement its plan to reform it. Apart from its cost (see Chapter 3), the system gives little incentive to farmers who work on low-productivity farms to move to other sectors. It also encourages young low-skilled workers to enter the agricultural sector instead of other more productive sectors when it is difficult to find a job elsewhere. Although working on a farm and benefiting from the KRUS may appear as a way to escape poverty in the short term, it may not be the case from a longer-term perspective since income per household is very low in this sector. The government should work on eliminating differences between the special farmers' social insurance scheme and its general counterpart in order both to avoid distortions that are caused by the system and to improve fairness. As proposed in Chapter 3, reforming the KRUS should include closing KRUS to new entrants and an increase in contributions by linking them to income and tightening eligibility requirements. At the same time, training should be developed in order to help people to engage in other activities outside agriculture (see Chapter 4). People whose revenues might fall below subsistence level should be protected by developing social assistance.

With accession to the European Union (EU), Polish agriculture can now look forward to an increasing level of support from the Common Agricultural Policy (CAP) (Box 5.5). As

Figure 5.14. **Disability pensions: number of beneficiaries and new entrants**




*Source:* General (ZUS) and farmers (KRUS) social security systems.

reform of the CAP has weakened the link between subsidies and output, it has reduced though not eliminated distortions in product markets. But the CAP may still have a more significant impact on the labour market in Poland, with its high share of agricultural employment, than in other EU countries. Anyone owning at least 1 hectare of agricultural land is entitled to direct payments from the CAP; under the terms of accession, these payments were introduced at a reduced rate but are set to increase steadily in the future. This should provide an opportunity for reforming KRUS, since as income support for landowners' increases, irrespective of effort, it becomes less and less justifiable to maintain a special social security scheme where the ratio of contributions to benefits is only one tenth of that in the general scheme. Other support from the CAP is directed into rural development finance, and it is important that this be used wisely, and in coordination with other resources for regional development, as discussed further below.

### *Housing*

Housing is also a potential obstacle to regional mobility. Housing and much other physical infrastructure is still dominated by the consequences of the combination of Poland's relatively low per capita incomes and the legacy of the central planning period with its marked underinvestment in these areas. National reform priorities are focused on improving standards and increasing the overall supply. Substantial progress is being made on standards,[7] but the high cost of new or existing housing and the comparative lack of social housing still attract attention. High purchase prices and high rents are largely the result of rising incomes (and perhaps a changing distribution of income), and policies such as subsidies to mortgage loans (which ran from 2002 to early 2006) will not make a lot of difference except to benefit the relatively well-off (mortgage loans are still relatively rare in Poland) and raise the tax burden and house prices; a new system of targeted mortgage

### Box 5.5. **Poland and the Common Agriculture Policy**

Before the 2003 reform, the CAP was based on a series of direct aids linked to area, production and number of livestock units. The key feature of the reform was the elimination of the link between support and production – so-called "decoupling" – and the introduction of a single payment scheme, independent of the type of production but linked to respect for environmental, food safety and animal welfare standards. The new additional premiums (direct payments or aid schemes) are being applied only gradually in the new member States, starting from 25% of the full amount in 2004 and reaching the full amount in 2013. For farmers in "old" member States, the single payment is based on their entitlement over the 2000-02 reference period. For farmers in new member States, it is based on a regionalised per hectare payment.

In Poland, the eligibility condition for the single direct payment is to own total arable land over 1 hectare provided that the individual arable plot is no less than 0.1 ha. The area payment rate per hectare was PLN 210.52 (46.4 euros) in 2005. Poland received the right to increase the level of payments for years 2004, 2005 and 2006 and to partly use funds for Rural Development for the top up (Table 5.3). These additional direct payments are applicable only to eligible crops (similar to those in the EU15). They amounted to PLN 292.78 (64.6 euros) per hectare. The combined per hectare direct payment was therefore PLN 503.31 (111 euros).

Table 5.3. **Direct payments to Polish farmers financing during the transition period**

As a per cent of total direct payments[1]

| | 2004 | 2005 | 2006 | 2007[2] | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 |
|---|---|---|---|---|---|---|---|---|---|---|
| Single direct payment from the EU | 25 | 30 | 35 | 40 | 50 | 60 | 70 | 80 | 90 | 100 |
| Rural development[3] | 11 | 9 | 7 | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. |
| Top up paid by the Polish government | 14 | 21 | 23 | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. |
| **Total** | **50** | **60** | **65** | ***40*** | ***50*** | ***60*** | ***70*** | ***80*** | ***90*** | ***100*** |

1. Payments that farmers would have had without the transition period.
2. From 2007, top ups (financed by rural development funds or the government) have not been decided yet.
3. EU funds used as a top up to direct payments.

*Source:* United States Department of Agriculture, Foreign Agriculture Service, "GAIN report" (2005), PL5W1.

subsidies is currently under consideration. More important are policies to eliminate artificial restrictions to supply such as excessively bureaucratic planning procedures, lack of zoning plans or even a shortage of notaries to witness necessary legal transactions.[8] Recent legislative changes should have the effect of accelerating the preparation of zoning plans. The shortage of social housing[9] is largely a consequence of privatisation and fiscal stringency, and the result is not only a quantitative shortage but a large proportion of sub-standard housing as well; a pilot programme on social housing was run from 2004-05 and is to form the basis of a new programme currently under preparation.

The problem of housing is not only one of supply but also of flexibility. It is an important contributor to the relative lack of geographical mobility in Poland. A shortage of social housing is often blamed for low mobility, but social housing itself is often a barrier to mobility compared with the private rented sector (OECD, 2005). Owner-occupancy is quite

### Box 5.6. **Summary of recommendations**

**Competition policy and product market regulation**

- Further simplify product market regulation, for example in professional services; ensure the "binding assessments" on tax liabilities are operative soon, but simplify the tax system so that such assessments become superfluous.
- Reduce public ownership, giving much less weight to employment and social guarantees as factors in selecting buyers.
- Ensure that competition law applies equally to public and private enterprises, and maintain the clear rules that prevent discrimination against foreign companies.
- Continue to facilitate foreign direct investment.

**Entrepreneurship and innovation**

- Use a range of incentives for innovation and SME development, but ensure maximum leverage for public finance; encourage the participation of private venture capital; weed out ineffective schemes.
- Ensure intellectual property rights legislation and the statutes of, and employment conditions in, public and private universities and other research institutions favour collaboration between the private and public sectors on research and innovation.
- Rationalise and coordinate SME, micro-enterprise and agriculture-related support networks so as to avoid duplication and waste of resources.

**Labour market policy and mobility**

- Ensure that the new indexation rule of the minimum wage does not lead to an increase in labour cost. Expand programmes to pay specific groups with high unemployment risk at less than the minimum wage.
- Continue to reform the transfer system to ensure that replacement revenues are not a barrier to labour mobility:
  - work towards an integration of regional labour markets; ensure that PES facilitate matching of labour supply and demand between regions and not only inside regions. Once this will be achieved, introduce geographic mobility as a requirement to receive unemployment benefit;
  - restrict the disability schemes to those who are truly incapable of work;
  - enforce existing mutual obligations, requiring job search by those who receive a benefit and are capable of work, and linking the right to receive benefit to the obligation to accept retraining when offered;
  - phase out early- and pre-retirement schemes.
- Reform the special farmers' insurance system; restrict access to it; introduce a system of contributions proportional to income and eventually merge it with the general scheme. Ease EPL further to ensure that it is not an obstacle to job creation nor to employment of specific groups:
  - simplify dismissal procedures further;
  - phase out special rules for older workers.
- Improve the efficiency of the PES:
  - progressively replace public-job and wage-subsidy policies by activation strategies of the non-employed. Develop job search monitoring;
  - improve the quality of PES staff.

Box 5.6. **Summary of recommendations** *(cont.)*

- Housing policy:
  - reduce unnecessary supply restrictions by streamlining bureaucracy, accelerating the development of zoning plans;
  - ensure that security of tenure laws do not give excessive protection to tenants, either in the private sector (*e.g.* if they do not pay their rent) or the public sector (if they no longer meet the eligibility conditions for social housing);
  - phase out mortgage subsidies and use the resources for social housing.

high in Poland. This form of tenure tends to reduce mobility more than social housing, and this effect may well be stronger in Poland than elsewhere because of the relative lack of a developed market for housing loans. Finally, the private rental market, which presents the least barriers to mobility (except for employer-provided housing; OECD, 2005) has suffered from both rent controls and security of tenure laws which put tenants in a favoured position. Rent controls on new lettings have been abolished (though limitations on rent increases[10] will still ensure that existing tenants will be protected from significant increases in property prices, a potential disincentive to investors), but both the law and practice in courts still make it difficult for owners to remove tenants, even if they are in default.

Some other aspects of the infrastructure shortage are also relevant to mobility, even if the first concern in upgrading the infrastructure is to improve cost-competitiveness. Improving transport and communications infrastructure – both by physically upgrading it and by ensuring competitive provision of services – may also contribute to increasing labour mobility.

### *Notes*

1. Kolasa (2005) looks at multi-factor productivity growth over 1994 to 2002 in two-digit manufacturing industries, comparing Germany and Poland. In Germany, shifts between industries actually made a negative contribution to overall growth. See Kolasa (2005, Table 4). See also Van Ark *et al.* (2003), comparing the European Union and the United States.
2. Part of the material in this section is based on a World Bank report (Goldberg, 2004).
3. Transparency International (TI) derives its figures from compiling figures from various surveys of opinion and scaling the result on a scale of 0-10 where 10 is "clean." Poland comes out at 3.5, whereas TI puts the "rampant corruption" threshold at 3. TI's Web site is *www.transparency.org*.
4. Another survey showed that 66% of respondents thought that giving a gift of "flowers, cognac or sweets" to a doctor after treatment was not at all corrupt, and very few thought it was more than a little bit corrupt (Fundacja Batorego, 2001).
5. OECD figures for 2004 show the average net replacement rates over a five-year spell of unemployment for those with earnings at or below the average production worker wage is below the OECD average for those without children (about 50% including social assistance), but much higher for those with two children (about 75%).
6. It is possible that most of this margin over the OECD average is attributable to the stock of disability pensioners over the retirement age.
7. For example, according to data from the Ministry of Transport and Infrastructure, although about a quarter of rural dwellings were without a flush toilet in 2002, this was down from over half in 1988. The average usable floor space per dwelling rose by 16% over the same period.

8. Note that this does not mean that zoning and urban plans should be thought of as unnecessary obstructions to housing development. On the contrary, in a period where rapid urban development is likely, sensible urban planning is required to permit rational provisional of transport services, commerce, schools and so on, to avoid later problems that are common in areas of earlier rapid urban expansion in many countries. But such plans need to be feasible, publicly accepted, transparent and not surrounded by excessive bureaucracy.
9. Just over 9% of all dwellings are owned by local government. In the United Kingdom, despite its strong encouragement of the private sector and a major privatisation programme during the 1980s, the corresponding figure is about 12%.
10. Rent increases of more than 10%, where the rent itself is over 3% of the reconstruction value of the property, can be challenged and may be overruled by a court.

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## Glossary of acronyms

| | |
|---|---|
| **ALMP** | Active Labour Market Policies |
| **CAP** | Common Agriculture Policy |
| **CPI** | Consumer Price Index |
| **EC** | European Commission |
| **ECB** | European Central Bank |
| **EMU** | European Monetary Union |
| **EPL** | Employment Protection Legislation |
| **ERM II** | European Exchange Rate Mechanism |
| **ESA** | European System of National Accounts |
| **EU** | European Union |
| **FDI** | Foreign Direct Investment |
| **FOMC** | Foreign Open Market Committee |
| **GDP** | Gross Domestic Product |
| **GHG** | Greenhouse Gas |
| **GUS** | Central Statistical Office |
| **HEI** | Higher Education Institutions |
| **IMF** | International Monetary Fund |
| **KRUS** | Farmers' Social Security System |
| **MoF** | Ministry of Finance |
| **MCI** | Monetary Conditions Index |
| **MPC** | Monetary Policy Council |
| **NAWRU** | Non Accelerating Wage Rate of Unemployment |
| **NBP** | National Bank of Poland |
| **OCA** | Optimum Currency Area |
| **OFE** | Open Pension Funds |
| **PES** | Public Employment Service |
| **PISA** | Programme for International Student Assessment |
| **PKOBP** | State own retail bank formed by PKO and Bank Polski |
| **PLN** | Zloty, Polish currency unit |
| **PMR** | Product market regulation |
| **PSE** | National Power Operator |
| **SAC** | State Accreditation Committee |
| **SMEs** | Small and Medium Sized Enterprises |
| **SNA** | System of National Accounts |
| **TPSA** | Polish telecom historical operator |
| **TWA** | Temporary Work Agencies |
| **UAC** | University Accreditation Commission |
| **VAT** | Value Added Tax |
| **ZUS** | National Insurance Fund |

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