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POLAND: STAGNATION OR GROWTH?

Jobs, the rule of law, investments and innovations

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SUMMARY

1. What economic growth depends on

— A country's economic performance is the product of extended periods of stable growth and eventual slumps. During periods of relatively stable growth, systematic forces are crucial, creating the right conditions for innovation and affecting economic growth for an extended period or continuously. However, economic performance is also strongly affected by short but deep growth slumps. Their occurrence usually has a negative impact on the average growth rate over the long term, i.e. several years or more.

— Systematic forces of growth are responsible for economic dynamics outside of periods of growth slumps. They operate through changes in employment and labor productivity, which are derived from investment accumulating in capital and changes in total factor productivity (changes in output achieved without changes in employment and investment in expanding productive capacity), and depend primarily on the propelling institutions and the economic policies shaped under their influence.

— The key propelling institutions, in light of the extensive literature on economic growth, include the private sector share of business ownership; the degree of freedom of private enterprise; the level of protection of private property rights, including the stability of taxation and level of tax burden, which depends mainly on the amount of social spending relative to GDP; and the intensity of competition among suppliers. These are reinforced by free-market reforms understood as changes in state activities and structures that foster the growth of the legal free market.

— The risk of slumps and their negative impact on economic growth depend on the design of stabilizing institutions. Good stabilizing institutions increase the economy's resilience to external shocks and minimize shocks generated by domestic economic policies. Stabilizing institutions include: the monetary and exchange rate system (which determines the stability of money and the risk of a currency crisis), constraints on government spending and public debt (which affect the risk of a fiscal crisis), and institutions that determine the risk of financial crises, including banking crises. Ultimately, the shape of stabilizing institutions and their strength depend on the type of political system, or more precisely, on the degree of concentration of political power. The greatest socio-economic crises occur in dictatorships.

2. Poland's development after socialism, the Law and Justice party's government and the pandemic

— Decades of centrally planned economy brought huge losses to the Eastern Bloc countries. There are large discrepancies in income estimates in 1989, but Poland was probably the poorest of all the Eastern Bloc countries that later joined the EU. Despite the slogans about industrialization in the propaganda of the People's Republic of Poland, in 1989 still about

¼ of the working people were employed in agriculture, the value of industrial production was low, and heavy industry emitted a lot of carbon dioxide and pollution. Moreover, services played an insufficient role. In addition, the situation in the declining period of Polish socialism was exacerbated by rampant inflation, massive shortages, and high foreign debt.

— Poland was the first country in the region to introduce a comprehensive and radical plan of economic reform and stabilization (the so-called Balcerowicz Plan). The plan included a large-scale deregulation, understood as the removal of administrative and other regulatory restrictions on economic freedom (among others, rationing and price controls were abolished). As a result, in 1992 Poland was the first transition country to enter the path of economic growth. Starting as the poorest country in the region, Poland overtook Bulgaria, Croatia, Romania, Latvia and Hungary, almost equaled Slovakia and significantly decreased the distance to Lithuania, Estonia, Slovenia and the Czech Republic. Ownership changes, resulting both from the privatization of state-owned enterprises and the emergence of new private firms, have led to an increase in the share of the private sector in the economy. Private enterprises have contributed to changes in the structure of production and employment. The structure of the Polish economy began to resemble that of developed countries.

— Despite radical free market reforms, there are still areas in Poland that require further changes. Such problems include unfinished privatization, overregulation, an inefficient judiciary, high volatility of the law, and a convoluted tax system with numerous exceptions and privileges that complicate it, and which contribute to the fact that the loss of income they cause requires high tax rates for those deprived of privileges. These problems result in low employment and investment rates and high employment in sectors that are less productive but enjoy many preferences: agriculture and microenterprises. The indicated problems were exacerbated after 2015 by the policies of the Law and Justice party.

— In recent years, the Law and Justice party has introduced damaging changes that hit the labor force participation rate of Poles.

   1. It reversed a reform introduced by the previous government that raised the retirement age, as a result of which the employment rate for women aged 60–65 and men aged 65–69 began to decline despite a very good economic situation.

   2. It introduced many changes that weakened the link between the length of work and contributions and the future pension. In addition to lowering the retirement age, increases in the minimum pension, quota adjustments, pensions for mothers, reductions in contributions for the self-employed, and thirteenth and fourteenth pensions, among others, contributed to this.

   3. It introduced the 500+ program, which until 2019 made the payment of the benefit for the first child dependent on a family income threshold, encouraging especially less qualified women to leave the labor market. Although the elimination of the threshold in 2019 reduced the program's direct negative impact on employment, its high costs (the 500+ expansion doubled them to more than 40 billion a year) ultimately fall on the working population.

— The Law and Justice party's policies also hit the potential for labor productivity growth, which creates further barriers to the development of the most efficient companies. Restrictions on competition, state monopolies, problems with the rule of law and unpredictable changes in the law make the development of companies more difficult and risky, which entails a loss for the whole economy.

1. Law and Justice party's policies have contributed to limiting economic freedom in Poland. Firstly, it introduced many harmful sectoral regulations, such as the ban on the sale of agricultural land, the ban on Sunday shopping or restrictions on opening new pharmacies. Secondly, it pursued a policy of renationalization of private companies. The growing role of state ownership in the banking sector is particularly dangerous for the stability of economic growth. After the takeover of Alior Bank and Pekao (the former nationalization was initiated by the PO-PSL government), the Polish state controls over 40% of the banking sector's assets. State ownership of banks leads to politicization of their lending policy by, for example, subordinating lending decisions to political goals.

2. In 2015, the Law and Justice party began anti-reforms of the judiciary, reducing the independence of the Constitutional Court, the National Council of the Judiciary, and the public prosecutor's office in favor of political control. These bad changes have only exacerbated the inefficiency of the justice system. According to the Institute of Justice, in 2011, the average length of proceedings in common courts was 4.1 months. In 2015, the year Law and Justice took power, the time was 4.2 months. In contrast, in 2018, after the implementation of „reforms" in the justice system, the average duration of court proceedings increased to 5.4 months.

3. The problem with the work of the courts is the poor quality and unpredictability of Polish legislation. Laws in Poland are changed much more often than in other countries. In the record-breaking year 2016, over 35,000 pages of legislation were passed. Another record was set by the Law and Justice party in 2018, when 362 pages of amendments to tax laws were published. The ruling party's legislative practice was characterized by extremely hasty enactment of important legislation, abuse of the parliamentary path, for which there is no obligation to prepare regulatory impact assessments and public consultations, and, in the case of formally governmental projects, unreliable preparation of regulatory impact assessments and unjustified shortening of the duration and facade of public consultations.

4. The problem of unpredictability of legislation applies particularly to taxation, where Law and Justice introduced harmful sectoral taxes (especially bank tax and tax on retail trade), additional reliefs (e.g., PIT exemption for persons under 26 years of age, reduced CIT for companies with revenues up to EUR 2 million) and de facto additional tax threshold (so-called solidarity surcharge), as well as many other taxes officially called fees (such as emission, recycling, sugar or power fees). At the same time, the methods used to tighten up the tax system have made it even more repressive.

— Restrictions on economic freedom, unpredictable changes in regulations and the attack on the independence of courts are already having visible negative effects, undermining the trust of entrepreneurs in the Polish state – resulting in the collapse of the investment rate (especially private investment) after 2015 (in 2017 – to the lowest level since 1995) or the decreasing number of small and medium-sized companies (instead, the number of micro-enterprises promoted by the Law and Justice party with tax preferences is growing, which, with a limited scale of activity, cannot be the engine of economic growth).

— Thanks to both the sectoral structure and the relatively small number of infections, the Polish economy was relatively little affected by the first wave of the pandemic. The economic consequences of the second wave of the pandemic, despite the fact that the mortality increase recorded in Poland was among the highest in the European Union, appear to be more limited than in the first wave due to the adaptation of most sectors of to the new, more difficult circumstances.

— The problem, however, is the permanent pressure on the growth of the public finance deficit. The cost of aid packages is one-off, and in subsequent years the state budget will be burdened mainly by the cost of interest on the debt incurred for this purpose. The increase in the deficit in 2020 compared to the previous year is due not so much to the effects of the pandemic, which, along with aid programs, was associated with a decline in revenues, but primarily to the entry into force of "Morawiecki's five" (extension of 500+, reduction of PIT etc.) and other changes (gradual increase in health spending to 6% of GDP, increase in military spending to 2.5% of GDP and fourteenth pensions). In total, by 2024, the public finance deficit will increase by more than 2% of GDP compared to 2019. Combined with growing stresses on the pension system due to low retirement age despite rising life expectancy and an aging population, a high structural deficit will be a growing threat to the sustainability of public finance and economic growth.

3. A warning scenario – why we won't catch up with the West without reforms

— The economy can be expected to rebound strongly in the coming years. The exact timing of the end of the pandemic is difficult to predict at this time, but it will probably be accompanied by rapid economic growth. The unfreezing of currently closed sectors will automatically raise GDP, and we will also benefit from the rebound in the economies of our trading partners and the global economy more broadly. In addition, the inflow of EU funds, primarily from the Reconstruction Fund, will temporarily contribute to faster growth. In its case, the challenge will be to use the funds in such a way that they will not only contribute to growth in the coming years, but will also permanently increase the potential of the Polish economy.

— However, the rebound after the pandemic should not be misleading – according to long-term projections prepared by international organizations, without reforms Poland faces much slower economic growth than in the past. Poorer countries can grow fast by copying technologies and organizational solutions from more developed countries, but as the gap to the world's top performers narrows, maintaining further growth requires increasingly efficient propelling institutions and strengthening stabilizing institutions that help avoid downturns. The pace of Poland's economic growth will be additionally negatively affected by the aging of the population and the decreasing number of people of working age. Therefore, the current level of economic freedom or the rule of law, which has allowed Poland to reach the present state of development, will not be enough to catch up with the richest Western countries. It is possible that if there is no progress in the reforms that determine the rate of growth of innovation and investment, Poland will begin to increase the distance to the West.

— According to OECD projections, growth will slow to 1.8% per year between 2020 and 2050. The European Commission is only slightly more optimistic and predicts that the average growth rate will be 2% per year. Although according to these projections Poland will still grow faster than the USA and Germany for about 15 years, the negative effects of demographic changes and insufficient quality of institutions will stop the convergence later. As a result, the OECD estimates that from the current level of less than 65% of GDP per capita in Germany, we will reach a maximum of just over 73% of GDP. This will happen around 2035, and then Poland's economy will shrink relative to Germany's in the following years – as a result Polish GDP per capita will fall below 70% of Germany's level. The European Commission estimates that we will be able to maintain a faster pace of economic growth until 2040, reaching almost 80% of Germany's GDP per capita. The comparison of projections for Poland and the USA is worse. A comparison of OECD projections for the USA (the European Commission does not prepare projections for this country) with OECD and European Commission projections for Poland shows that we will reach the maximum level of just above 60% of the USA GDP per capita (as compared to over 50% at present).

— These projections are based on mechanistic assumptions about the systematic forces of growth. Therefore, they do not take into account hard-to-predict shocks and breakdowns in growth. Moreover, the projections are made under the assumption of no changes in the economic system and policy, including those negative for growth, e.g. further erosion of safety margins in the pension system or further politicization of the economy. Therefore, it should be considered that these projections underestimate the risk of threats to the future growth of our economy resulting from the lack of appropriate reforms. At present, at least three significant threats to growth can be pointed to: the progressing nationalization of the banking sector, a high public finance deficit and growing tensions in the pension system.

1. Currently, the Polish banking sector is not oversized and is one of the best capitalized in the EU, making it one of the safest in Europe. However, state control over Alior Bank and Pekao dangerously increases the influence of politicians on the credit policy of the banks. Numerous international experiences show that due to the increasing state ownership in banks, political calculus starts to prevail over economic calculation, which leads to granting questionable loans and in time increases the risk of banking crisis. The problem was further exacerbated by the weakened independence and credibility of the regulator (KNF), whose confidence was undermined by corruption allegations against its former chairman. Additional factors threatening the stability of the banking sector include low returns on equity, the prospect of loan losses due to pandemic financial problems of borrowers, legal risks associated with foreign currency lending, a policy of very low interest rates, and the crowding out of bank financing by government funds granted directly to businesses.

2. The public finance deficit falls as tax receipts rise in good times and rises as tax receipts fall and spending rises in bad times. A structural deficit is a measure cleared of such cyclical fluctuations. So far, rapid economic growth has limited the negative consequences of a persistent structural deficit. A high structural deficit implies a sharp increase in the public finance deficit in the event of a sharp slowdown in economic growth. Such a slowdown can be triggered by an external shock, as happened previously in 2008 and 2011 or now during the pandemic, leading to an increase in public debt. Hungary recently ran into fiscal trouble with public debt at

around 65% of GDP, much lower than many Western European economies. We have to remember that countries at the middle level of economic development, such as Poland, are much less resilient to such shocks than developed countries.

3. If the lowered retirement age is maintained, the only way to stabilize pension spending in an aging society will be to gradually reduce the size of the average pension – and that's how Polish Social Security system currently operates. According to the European Commission's 2018 forecast, the average benefit will fall from 45% of the average wage in 2020 to 27% in 2050. In fact, with the lowered retirement age maintained, there will be increasing pressure over next decades to change the way pensions are calculated and, as a result, to increase pension spending. As early as 2031, people of retirement or pre-retirement age will comprise 40% of the electorate. The potential costs of increased pension spending could be very high: we estimate that maintaining the current ratio of average pensions to wages in 2050 would require an increase in public spending and, consequently, taxes by over 6% of GDP.

— From the perspective of GDP per capita, what matters is what percentage of the population is working, which in turn depends on two factors: the demographic structure and the employment rate in particular age groups. The highest percentage of employed is among people of working age. The Polish population is one of the fastest aging in the EU – In the coming decades there will be more and more elderly people, most of whom do not work, while the number of younger people who can work will decrease. According to Eurostat projections, by 2050 the number of people aged 20–69 will decrease by over 5 million, which, according to our estimates, means a decrease in the number of employed by over 2.5 million (assuming that the current retirement age remains unchanged).

— So far Poland has experienced a rapid increase in total factor productivity and consequently labor productivity thanks to the movement of workers from sectors where productivity was low (from agriculture and, in the initial period of transition, from industry) to sectors with higher total factor productivity (market services and some high value-added industries). Due to the depletion of space for the movement of workers to sectors with higher productivity, the growth of aggregate productivity within individual sectors of the economy becomes crucial. The development of more productive firms is currently restricted by a number of regulations that weaken competition, especially the exceptionally wide scope of state ownership of enterprises compared to EU and OECD countries, the volatility of legislation and inefficient courts, as well as tax preferences for the self-employed and the smallest companies. The consequence of the state control over numerous firms and overrepresentation of micro-enterprises may be a permanently lower level of aggregate productivity in Poland than in the USA or Germany.

— Barriers faced by all enterprises in Poland particularly hit the innovative companies, i.e. those introducing new products to the market or applying new production methods. Innovative companies are particularly sensitive to regulations limiting competition, which may outright disallow non-standard ideas or restrict the choice of cooperators. Complicated and changeable tax and other regulations hit harder also companies with a non-repeatable, unconventional business model, where the problem of regulatory interpretation is extremely important. Research by the European Commission indicates that the problem of low innovativeness of firms in Poland is particularly noticeable in smaller firms, which, compared to their counterparts in other EU countries, extremely rarely introduce new products or processes.

— Investments, from which the capital stock is created, allow not only to reproduce and extensively increase the stock of broadly understood machinery and equipment, but also to purchase new generation equipment. Innovations introduced in companies in the form of new generation machinery and equipment are embodied technical progress. In Poland, less capital is used to produce one unit of GDP than in most EU economies.

— The low ratio of capital stock to GDP and the associated low investment rate is yet another manifestation of suboptimal factor utilization. Poor business conditions limit the size of the enterprise sector and its investment rate. The growth of the enterprise sector could lead to an increase in the capital stock and consequently to an increase in GDP, but this would require changes in economic policy: an improvement in the rule of law, an increase in the intensity of competition, and a reduction in tax and contribution preferences for the self-employed and small firms that discourage growth.

4. The reforms scenario – what to do in order for the Polish economy to keep growing fast

— We are not doomed to the scenario resulting from the European Commission and OECD projections. Appropriate reforms may enable the Polish economy to catch up with the West. Below we identify areas that can help strengthen Poland's economic growth.

  — If the share of employed people in particular age groups in 2050 in Poland were as high as in Germany, the number of employed would increase by almost 1.2 million people. This would require making it easier for women to combine family and professional life and lowering taxes on the lowest salaries in order to facilitate entry into the labor market of people currently inactive. In turn, raising the retirement age to 67 would mean an almost 9% higher share of the working population. Consequently, GDP per capita in 2050 could be 11–21% higher than in the warning scenario. Besides, economic growth could be positively influenced by growing immigration.

  — Problems with the rule of law create additional risks for entrepreneurs, especially those seeking to scale up their operations. The effect is further compounded by a tax system that favors smaller entities, punishing growing companies with higher burdens. As a result, workers and capital are stuck in less efficient firms. Removing barriers to the growth of the most efficient and innovative firms by increasing the rule of law, streamlining the courts and creating a stable tax system without discretionary preferences for a select few would raise both aggregate productivity through better use of existing resources and the investment rate, because growing firms invest more. An increase in the capital stock in relation to GDP to the German level (2.2) would raise GDP per capita by 5–7%. An increase in the capital stock in relation to GDP to the OECD average level would raise GDP by 8–12%.

  — Another important factor that hampers innovation, and thus the development of the most productive firms, is competition constraints. According to OECD analyses, deregulation of the Polish economy to the level observed among the five leaders (Netherlands, United Kingdom, Australia, Denmark and New Zealand) would raise productivity by over 6%, and the accompanying adjustments in the capital stock would give an increase of another 3%. In the case of Poland, privatization of state-controlled companies would be responsible for about half of the effect. In addition to privatization, it is necessary to reduce restrictions on competition in services and to facilitate the establishment of companies (especially limited liability companies). The OECD analysis concerns the impact of reforms introduced in 2020–2030 on GDP in 2060, but assuming a faster pace of their implementation, it can be assumed that most effects would materialize by 2050. With appropriate reforms, GDP per capita could be more than 10% higher than in the warning scenario.

— Based on the OECD model, which forms the basis of the warning scenario, we estimate that closing the employment gap, raising the retirement age and removing barriers to the growth of innovative, efficient enterprises through greater market competition, improved rule of law and tax reform would allow Poland to reach between 87 and 98% of GDP per capita in Germany, effectively closing the gap in living standards.

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