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# **Fiscal Performance and Fiscal Implications of the EU Accession in Poland**

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## **Fiscal Performance and Fiscal Implications of the EU Accession in Poland\***

### **1. Introductory remarks**

The fiscal stability, as defined in the Maastricht Treaty, has ranked among the most important policy objectives of the European Union. Its role further increased after 1997: the Stability and Growth Pact ratified in the Treaty of Amsterdam established that the Maastricht fiscal criteria would not merely be entry conditions for EMU membership but would continue to apply after candidate countries joined the monetary union.

The fiscal criteria envisaged that budget deficits must not be excessive, i.e. not exceeding 3 per cent of GDP; and that the debt to GDP ratio should not be over 60 per cent. Tight fiscal policy would mean, among other things, that there was little pressure on the central bank to bail out fiscal authorities.

The fiscal stability was also used to set standards of ‘nominal convergence’ for the new EU member countries, mostly transition economies from East-Central Europe, who joined the European Union in 2004 and will subsequently become the EMU members.<sup>1</sup> These standards were aimed to impose some discipline in macroeconomic policies pursued in these countries and to make their growth pattern more balanced prior to their entry to this organization. In particular, it was believed that in the quest of fiscal stability the governments in the EU accession countries would make more rational spending decisions, which would enhance economic growth and increased international competitiveness (i.e. real convergence towards the EU levels), while simultaneously diminishing the distortionary effects of taxes and making the tax system simpler and more business-friendly. In more general terms, the ‘hard budget constraint’ was also expected to be conducive to much needed fiscal reforms and become the key driver of a more transparent and accountable system of public finances.

This paper seeks to explore the fiscal performance in Poland - one of the top reformer transition economies and simultaneously the largest of ten new EU member countries. At the same time it aims to highlight major fiscal implications of country’s accession to the

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\* A revised and updated version of the article “Major Challenges to Fiscal Discipline in Poland on the Eve of its EU Accession” (in Polish), *Studia Ekonomiczne*, vol. XXXVI-XXXVII, no. 1-2, 2003.

<sup>1</sup> Although the Maastricht criteria were originally set as entry conditions for EMU membership, in the case of the new EU member countries they have been binding as early as since 2004, that is from the very date of their accession.

European Union. If not properly addressed, some of these implications or challenges may endanger Poland's fiscal stability and by the same token – adversely affect the speed and smoothness of country's integration process with the European Union. If persisting, they may in the longer run also jeopardize (or at least delay) Poland's membership in the EMU.

For the purpose of the ensuing discussion we will use a definition of fiscal stability or fiscal discipline which is broader than the standard set in the Maastricht Treaty. Apart of the very size of the budget deficit and the public debt we will also emphasize the importance of the relative level of public expenditure and revenue (as a proportion of GDP) as well as the composition of both the expenditure and revenue sides. This is because we believe that the focus on budget deficit (or public debt) as the key gauge of fiscal stability may be misleading as it bundles together economies with high levels of taxes and public expenditure ('big-government' countries) and those with the small size of the government sector.<sup>2</sup> Similarly, it may also conceal the real nature of challenges to fiscal discipline, especially those related to the very size of government, excessive scale of transfer payments (or redistribution) in public expenditure, the distortionary effects of taxes on microeconomic incentives, growing imbalances in the pension systems and rigidity of the labor market.

Accordingly, in the discussion that follows we will also distinguish short-term and long-term challenges to fiscal stability in Poland. While the former lay mostly on the demand-side, the latter are due to supply-side constraints that may endanger the sustainability of economic growth and by the same token – undermine country's fiscal equilibrium.

The paper has been organized as follows. Section two provides an overview of fiscal performance in Poland during the first eleven years of systemic transformation, i.e. 1990-2000. We argue there that some of the most crucial challenges to Poland's present and (possibly) future fiscal stability are deeply rooted in the past trends. The latter - due to their persistence and inertia – tend to substantially constrain the Polish government both in its attempts to meet the EU nominal convergence criteria and to embark on more in-depth reforms of the public finance. In section three we bring up new trends that emerged in 2001-2004 and resulted in a marked deterioration of the fiscal stance of the government. They are also likely to carry forward new threats to Poland's fiscal stability into the early period of its EU membership. Based on the findings in the preceding sections, section four aims to provide a summary of the major short- and long-term challenges to fiscal discipline in Poland, with special emphasis fiscal implications of Poland's membership in the European Union.

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<sup>2</sup> Provided both groups display a similar size of budget deficits. See also an interesting discussion of the pitfalls to fiscal discipline enshrined in the Maastricht and Amsterdam Treaties in Alesina and Giavazzi [2002].

## 2. Fiscal performance, 1990-2000

The early years of systemic transformation in Poland saw a comprehensive fiscal reform and overhaul of the entire financial system. The fiscal reform comprised both the revenue and expenditure side; in the first place direct subsidies were dramatically cut or eliminated and the tax system inherited from the command economy radically overhauled. As a result, by 1998 the central government budget was financed by taxes that, for the most part, did not exist during the era of central planning [Kemme and Rapacki, 2000].

Tables 1 and 2 below compile key aggregate indicators illustrating the fiscal performance of the Polish economy in the 1990s. While looking only at two ‘Maastricht’ criteria of nominal convergence, i.e. general government deficit and public debt as proportions of GDP, one is tempted to conclude that the successive Polish governments seem to have pursued basically sound and responsible fiscal policy. The data in the tables do show that for most part of the last decade (exception being only 1992) the budget deficit was either below the ceiling of 3 per cent of GDP or only slightly exceeded this level. Simultaneously the debt/GDP ratio was sharply reduced in the first half of the 1990s and since 1995 it has been steadily kept below the 60 per cent level.

**Table 1. Key fiscal indicators in Poland, 1990-2000 (% of GDP)**

Item	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
Public revenue	47.9	43.9	45.1	47.6	46.9	46.3	42.2	41.7	40.5	40.9	39.6
Public expenditure	45.1	45.8	50.0	49.9	49.2	48.4	45.3	44.6	43.1	44.1	42.7
Balance	2.8	-2.0	-4.9	-2.3	-2.2	-2.1	-3.1	-2.9	-2.6	-3.2	-3.1
Public debt	90	80	86	86	69	55	48	47	43	43	41
Domestic	12	16	20	23	24	22	20	22	22	22	23
External	78	64	66	63	45	33	28	25	21	21	18

Source: Ministry of Finance [2002], *Poland: Government Finance Statistics 1994-2001*, Warsaw, September; OECD [1997], *OECD Economic Surveys 1997 – Poland*; OECD [2001], *OECD Economic Surveys 2000-2001 – Poland*, Paris; own calculations.

These general findings call for three comments. First, even meeting the Maastricht criteria in terms of the relative size of budget deficit does not change the fact that throughout the 1990s the general government sector in Poland displayed a *deficit*, which is equivalent to say that fiscal policy being pursued in the last decade remained in essence expansionary.

From a longer run (or supply-side) perspective this may have adversely affected some key macroeconomic variables such as domestic private savings and investment (crowding out), the cost of borrowing for the private sector, inflationary expectations and growth rate of the potential output.

Second, due to methodological differences in fiscal accounting between Poland and the EU countries the size of budget deficit, as shown by Polish official statistics, has occasionally displayed significant discrepancies as compared to figures derived once the approach prevailing in the EU (ESA'95) was applied. The most important difference boils down to the fact that while budget revenues and expenditures in Poland are being recorded on cash basis the ESA'95 method accounts fiscal flows on accrual basis (net borrowing). As a matter of illustration, the deficit of the central government – estimated according to the ESA'95 method - exceeded in 1992 and 1993 20 per cent of GDP, compared to 6% and 2.8%, respectively, reported by Polish fiscal authorities. In turn in 1994 and 1995 it amounted to approximately 3 per cent, that is much closer to figures obtained on cash basis [Wernik, 1996].

**Table 2. The size and composition of the general government balance, 1990-2000**  
(balances as % of GDP)

Item	1990	1995	1996	1997	1998	1999	2000
Central government <sup>a</sup>	7.9 <sup>b</sup>	-2.6	-2.8	-2.8	-2.4	-2.0	-2.2
Local governments	..	-0.9	-1.3	-0.1	-0.2	-0.2	-0.4
Extra budgetary funds	-5.0	-8.1	-8.1	0.0	0.1	-1.0	-0.5
Health funds	-	-	-	-	-0.1	-0.1	-0.1
Extra-budgetary units	-0.2	-0.4	-0.8	0.0	0.0	0.1	0.1
General government	2.8	-2.1	-3.1	-2.9	-2.6	-3.2	-3.1

a – including transfers between central budget, local budgets and extra-budgetary funds (units),

b – excluding transfers between central budget, local budgets and extra-budgetary funds (units),

Source: OECD [1997], *OECD Economic Surveys 1997 – Poland*; OECD [2001], *OECD Economic Surveys 2000-2001 – Poland*, Paris; Ministry of Finance, *Budget Blueprint for 2003*.

Another source of discrepancy in fiscal statistics between Poland and the EU stems from the different status of transfers to pension funds: while in the EU countries they are treated as part of fiscal revenues in Poland the employee contributions to private pension funds via extra-budgetary funds (FUS or Social Insurance Fund) are not accounted for as a factor diminishing the deficit of general government. With this problem in mind the Polish fiscal

authorities have started to apply since 1998 a new, broader concept of fiscal balance – the so called ‘economic deficit’. Table 3 below gives details on the size and composition of the ‘economic deficit’ in 1998-2003. Although this latter category – compared to general government balance on cash basis - is a more precise measure of the fiscal stance of the government and in particular - its impact on domestic savings, it is still not fully compatible with the EU notion of ‘net borrowing’;<sup>3</sup> this calls for some caution in assessing Poland’s progress in meeting the Maastricht fiscal criteria of nominal convergence.

**Table 3. The size and composition of government ‘economic deficit’, 1998-2003  
(balances as % of GDP)**

Item	1998	1999	2000	2001	2002	2003
Central government <sup>a</sup>	-2.4	-2.0	-2.2	-4.5	-5.4	-4.6
Local governments	-0.2	-0.2	-0.4	-0.5	-0.4	-0.4
Extra budgetary funds	0.1	-1.0	-0.5	-0.6	-0.6	-0.6
Health funds	-0.1	-0.1	-0.1	0.0	0.0	-1.0
Extra-budgetary units	0.0	0.1	0.1	0.1	-0.3	-0.3
General government	-2.6	-3.2	-3.1	-5.5	-6.7	-6.9
Compensation arrears	-	-	-0.5	-0.3	-0.4	-0.4
Transfers to pension funds	-	0.5	1.1	1.8	1.3	1.5
Other sources <sup>b</sup>	-0.6	-	-	-	0.3	0.3
Economic deficit	-3.2	-2.7	-2.5	-4.0	-5.1	-5.5

a – including transfers between central budget, local budgets and extra-budgetary funds (units),

b – includes, inter alia, Demographic Reserve Fund and proceeds from sales of UMTS licences.

\* - preliminary,

Source: Ministry of Finance, *Budget Blueprint for 2003*; EBRD, *Transition Report Update* [2005].

The third comment refers to the behavior of the public debt. Compared to the early 1990s its relative size dramatically shrank by the middle of the last decade – from 80-90 per cent of GDP to only half of this level. The primary reason for this should be seen in the decisions of Poland’s official and private creditors (Paris and London Clubs) taken in 1992-93 to forgive up to 40 per cent of country’s external debt inherited from the command economy. The outcomes of the debt relief appeared in official statistics as both a substantial decrease in the volume and share of the foreign debt in Poland’s GDP (table 1). Since the mid-1990s the

<sup>3</sup> The concept of ‘economic deficit’, partly due to its shortcomings and ambiguous status, was abandoned in 2004.

ratio of foreign debt to GDP has been steadily falling while the share of the domestic debt has increased.

As we pointed out earlier in the text, a broader definition of fiscal stability encompasses – apart of the budget deficit/GDP and public debt/GDP ratios – also the relative levels and composition of public expenditure and revenue. Seen from this perspective, Poland was undoubtedly a ‘big-government’ country – the share of both expenditure and revenue tended to considerably exceed 40 per cent of GDP for the most part of the 1990s (table 1). The average ratios for the entire 1990-2000 period amounted to 46.2 and 43.9 per cent, respectively. The level of public expenditure as a proportion of GDP in Poland was above the mean for OECD countries (44.1% in 1999 and 42.7% in 2000 vs. 37.9% in 2000) and slightly below the EU average (46.4% in 2000) [Wernik, 2001]. Within OECD and EU only the EMU members exhibited a substantially higher relative level of public expenditure (48.6% in 1999 and 50.7% of GDP for the 1990-99 period) [Reviglio, 2001].<sup>4</sup>

However, it seems appropriate to stress in this context that there is some empirical evidence on a positive correlation between the level of economic development (GDP per capita) and the relative size of public expenditure. In particular one study, covering 102 countries, has found that in 1997 the average ratio of public spending to GDP in countries with similar development level to Poland (GDP per capita in the range of 2,500-5,000 US dollars) amounted to 23.4 per cent while for the most advanced countries (20,000-25,000 dollars) it was 40.3 per cent [Polarczyk, 2000]. It may be argued, therefore, that the size of the government in Poland, measured in terms of the relative levels of public expenditure (and revenue) has been excessive as for its development status.<sup>5</sup> The need for financing all pertinent functions of the government required in turn raising sufficient tax revenues. High level of taxes might have been conducive to some undesired micro- and macroeconomic side effects, especially from the longer-term, supply-side perspective, jeopardizing the future fiscal

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<sup>4</sup> It may be interesting to note the differences in the political context of fiscal decisions between the European Union and the USA. While in the EU (and in particular, in the EMU) countries politicians are more ‘electable’ if they promise to provide more public goods or transfer payments without asking to raise taxes in the United States the opposite is true – the chances of being (re)elected are enhanced if a candidate promises to cut taxes. For an interesting comparison of the public expenditure-tax revenue mix between the EMU members and the USA, see Reviglio [2001].

<sup>5</sup> On the other hand, the persistently high relative levels of public expenditure and revenue in Poland may be also seen as a part of the command economy legacy with the omnipotent role of the state, as well as a cushion against high social cost of systemic transformation. This argument gains indirect support if similar ratios for other transition economies at similar development level are compared. For example, the share of public spending in GDP increased in the Czech Republic from 41.2% in 1993 to 44.6% in 2000 whereas in Hungary it went down from 57.5% to 43.3% [*Transition Report Update 2001*, EBRD, London 2001].



stability of the country. Indeed, there is also a wide body of empirical evidence suggesting a negative correlation between the size of the government (the ratio of public spending and/or tax revenues to GDP), on the one hand and the dynamic of economic growth, on the other [see for instance, Levine and Renelt, 1992; Barro 1991].

As far as the composition of public expenditure in Poland is concerned the following most salient trends in the 1990s are worth highlighting. The findings discussed below are based on two other studies of the author [Kemme and Rapacki, 2000; Rapacki, 2002].

1. The 1990s witnessed – in the broadest terms – an unequivocal reprioritization of public expenditure towards redistributive objectives. The scale of redistribution significantly increased in Poland throughout the 1990s, both with regard to GDP and central government expenditure. While in 1991 transfer payments represented 20.5% of the latter in 1995 this proportion augmented to 26.1% and in 2000 – to 32.2%. Simultaneously, the share of transfer payments from the central budget in GDP amounted in 1991 to 6.1% and in 1995 it grew to 7.7%. In the second half of the last decade some 20% of GDP or 45% to 50% of total public spending was disbursed for transfer payments. The overwhelming majority of transfers were channeled towards the social safety net, i.e. social security and welfare programs. In 1999 the social safety net accounted for 44.3% of the consolidated public expenditure, a level comparable with much richer western countries and above that prevailing in Central European transition economies. Apart of the rising burden of unemployment benefits, the major underlying cause of the high share of social security expenditure should be seen in the generosity of the pension system in force. In Poland, pensions as a percentage of GDP amounted in 2000 to nearly 14%, the highest level of all of the Central European countries and above the average for both OECD and the EU.<sup>6</sup> One of the possible explanations of this trend are lax eligibility rules for disability and family pensions and the resulting excessive proportion of this category of beneficiaries in the total number of pensioners.

2. The redistributive ‘bias’ discussed above may be best understood in terms of the strategic choice made by Polish policy-makers while resolving the equity-efficiency trade off. The by-product of this choice entailed constrained supply of most of the public and merit goods and their declining quality as well as creating perverse incentives discouraging a self-sustained, long-run economic growth. If we assume that public goods are the extreme case of

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<sup>6</sup> In Slovenia pensions amounted to nearly 13% of GDP, but in the Czech Republic, Slovakia, Hungary and Romania this proportion is substantially less than 10% of GDP [Kemme and Rapacki, 2000]. According to the most recent OECD statistics, based on more stringent criteria of beneficiaries of a pension system, the average share of pensions in GDP in OECD countries totaled 7.4% in 2000; the same ratio for Poland was 10.8% while for the Czech Republic and Hungary – 7.8% and 6.0%, respectively [Dang, Antolin and Auxley, 2001].

externalities (see e.g. Stiglitz, 2000) then the provision of the former (in adequate quantity and quality) may be regarded as a means to enhance positive externalities for the private sector and by the same token – an efficiency driver. Seen from this perspective, the equity or redistribution ‘bias’ tended to adversely affect both the available aggregate supply and quality of public and merit goods in Poland. This general conclusion is not inconsistent with diverging trends that can be traced in public expenditures with regard to particular categories of those goods. For example, the 1990s saw a decline in relative spending on national defence and on R&D. At the same time, the proportion of public money allocated to such areas as public safety, education, health care, justice and public administration increased. However, the growth in financing the provision of public goods does not automatically safeguard their greater availability and adequate quality (the problem of weak incentives for operational efficiency in the public sector). Indeed, according to anecdotal evidence the late 1990s saw deterioration in the availability and quality of a number of public goods. These comprised declining yardsticks measuring the level of public safety, poor standard of health care services<sup>7</sup>, rising ineffectiveness of the judiciary power, low enforcement of the law and incompatibility of educational curricula at primary and secondary levels with the needs of a market economy [Blazyca and Rapacki, 2001].

3. It is also fair to say that successive Polish governments, while deciding on the priorities in public expenditures and faced with the trade off between short- and long-term goals, tended to be biased towards the former. In particular, they appear to have neglected the importance of policies aimed at actively creating or enhancing positive externalities for the private sector, as a key precondition for a long-term, sustainable economic growth. As a matter of example, it suffices to mention unsatisfactory government support for the domestic R&D effort and low investment in physical infrastructure (especially roads). Although the government funding of R&D has steadily increased in the 1990s in nominal terms its share in both state budget expenditures and in Poland’s GDP has consistently fallen. Its ratio to GDP reached in 2000 its lowest level after the war (0.35%).<sup>8</sup> If the private sector R&D outlays were included this ratio would increase to 0.7%, which is still well below the OECD (2.15%) and EU averages (1.93%) and also ranks among the lowest in the group of new EU member

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<sup>7</sup> The health care system reform implemented in 1999, due to serious shortcomings in its very design, has not solved this problem.

<sup>8</sup> A similar trend was recorded in Polish industry: the share of R&D expenditure in the value of output decreased from 0.43% in 1991 to 0.42% in 1999 [Rot, 2001].

countries.<sup>9</sup> As a result, the 1990s brought a marked deterioration of key indicators illustrating the innovative capability of the Polish economy. They include data on inventive and patent activities, licence trade and the share of new and improved products in industrial output [Blazyca and Rapacki, 2001]. The government failure in encouraging the indigenous R&D effort, developing domestic science and technology base and in generating new knowledge and technological innovations may impede the further growth of productive and allocative efficiency and by the same token adversely affect the competitive position of Polish firms in the global environment.

4. As was documented earlier in the text, Poland's fiscal policy had not been excessively expansionary for the most part of the 1990s. This trend was reverted in 1999 – since that time the general government deficit has exceeded the Maastricht ceiling (table 1). The major shock came from extra-budgetary funds – their expenditure in 1999-2000 increased much faster than revenue and the resulting deficit rose to 1% of GDP. The single most important source of these developments lied in the endangered liquidity of the Social Insurance Fund (FUS) – its surplus from earlier years turned to deficit amounting to 0.8% of Poland's GDP. The deterioration in the fiscal stance of the government led to two unfavorable macroeconomic effects. First, it diminished the stock of domestic savings available for investment. One of the peculiarities of Poland's economic growth path in the 1990s, compared to other Central European countries, was the combination of fastest GDP growth and the lowest savings rate (some 20% of GDP in average) [Rapacki, 2002a]. Depressed domestic savings should be seen as a potential supply-side barrier to long-run economic growth. Second, growing fiscal deficit was eventually conducive to crowding out of private investment. Available statistics seem to support this assertion. In 1999 the growth rate of gross fixed investment halved, compared to 1998 (6.9% and 14.1%, respectively). In 2000 it grew only by 3.1% and in 2001 it recorded a deep slump [Maly Rocznik Statystyczny, 2001].<sup>10</sup>

5. A more expansionary fiscal policy has also put in motion a chain reaction in terms of adjustments in monetary policy that in turn gave birth to induced macroeconomic effects. Since 1999 the monetary policy has undergone a sharp tightening; as a result real interest rates have been running at double-digit levels (14%-15% for business loans and 10% for bank

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<sup>9</sup> By 2003 the share of R&D outlays in Poland's GDP further declined to 0.59%, which unfavorably compares with similar indices in e.g. Slovenia (1.53%), Czech Republic (1.22%), Hungary (1.02%) or Estonia 0.75 (0.75%). See World Bank [2005].

<sup>10</sup> One of the important channels of this mechanism is through expectations. Econometric studies conducted in Poland have shown that expectations on the magnitude of budget deficit tended to affect the index of investors' optimism with a time-lead of several months. For details, see Kluza and Slawinski [2002].

deposits). Although excessively restrictive monetary policy was very effective in disinflating the Polish economy (CPI was only 3.6% in 2001, down from 8.5% in 2000) it is simultaneously to be blamed (at least partly) for a dramatic slow down of economic growth in Poland (from 4.0% in 2000 to 1.0% in 2001). Seen from a long-run economic growth perspective the combination of the expansionary fiscal and restrictive monetary policies is the worse policy-mix possible. If continued it would entail: /1/ a fall in the average efficiency of resource allocation, /2/ discouragement of private investment and /3/ a slower growth of potential output [Rapacki, 2002a].

6. In the second half of the 1990s some other unfavorable trends unfolded leading to increased rigidity of public expenditure, restricting the scope of control of the central government over fiscal policy while simultaneously adversely affecting the transparency of all public finance and accountability of fiscal authorities. As a consequence of institutional arrangements embedded in the central budget and aimed to ensure fulfillment of the redistribution priority (e.g. indexation mechanisms built-in in the transfer payments) the share of rigid items in total state budget expenditures has steadily grown to reach 63.2% in 2001, compared to 57.7% in 1999 [Ministry of Finance]. This tendency left little room for maneuver in allocating public funds for 'pro-growth' purposes. At the same time, the late 1990s witnessed a sharp increase in the number of various extra-budgetary entities and in the associated volume of off-budget financial flows. This included in particular 'inflation' of different government agencies, auxiliary units of budgetary entities and their special funds. Such a policy facilitated, on the one hand, concealing the actual fiscal stance of the government (e.g. via moving some state budget expenditures to extra-budgetary funds) but on the other – it was conducive to declining transparency of fiscal policy and its lower effectiveness.<sup>11</sup>

As a concluding remark in this section we will attempt to briefly hypothesize on possible determinants of the major trends and effects of fiscal policy, outlined earlier, applying the public choice framework. First, it should be noted that the Polish governments since 1993 – due, inter alia, to their coalition nature – have been particularly susceptible to the pressure of special interests. This holds true especially in the case of trade unions whose political influence by much exceeded their real significance at factory level. One of the most detrimental effects of their political power, the outbreak of unemployment in end-1990s, stemmed in large part from their resistance to reform the labor code with a view to make the

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<sup>11</sup> According to some estimates, off-budget fiscal flows (government agencies, extra-budgetary funds and units) may account for as much as 40 per cent of annual public expenditure in Poland [Misiąg, 2001].

labor market more flexible. Similar pressures were coming from other powerful special interest groups – regional, sectoral, professional, etc. Second, the ruling coalitions appear to have embarked on a policy aimed at maximizing the volume of ‘political goods’ and at redistribution of the ‘economic pie’ rather than increasing the size of the latter. This gave birth to political favoritism and the development of ‘crony capitalism’ – Polish politicians tended to trade off efficiency goals for political perks. The widespread rent-seeking, as a symptom of government failure, was the obvious outcome. Third, the above developments entailed strengthening of the ‘short-sightedness’ effect. This would explain the strong bias of public expenditures towards short-term goals and negligence of positive externalities that might enhance the long-run growth potential of the Polish economy and its international competitiveness in the global marketplace [Rapacki, 2002].

### 3. New trends in 2001-2004

The year 2001 saw a dramatic worsening of the fiscal stance of the Polish government – due to a negative synergy between various, both anticipated and unanticipated factors, the deficit of the central government more than doubled (to 4.5% of GDP, up from 2.2% in 2000); simultaneously both the general government deficit and the economic deficit skyrocketed. Table 4 below gives account of these developments.

**Table 4. Basic indicators of fiscal equilibrium in Poland, 2001-2004**  
(% GDP)

	<b>Public revenue</b>	<b>Public expenditure</b>	<b>Balance</b>	<b>Public debt</b>
<b>2001</b>	38.1	43.6	-5.5	43.2
<b>2002</b>	37.4	44.1	-6.7	47.2
<b>2003</b>	37.9	44.8	-6.9	51.6
<b>2004*</b>	39.9	44.7	-4.8	50.8

\* - preliminary.

Source: EBRD [2004], *Transition Report 2003*; EBRD [2005], *Transition Report Update*.

Three factors in particular seem responsible for the threat of a fiscal crunch the Polish economy faced in mid-2001. They include: (i) slow down of economic growth, (ii) cumulative effects of past government failures in fiscal policy<sup>12</sup> and (iii) imprudent decisions to excessively increase public expenditures taken by the outgoing, AWS-dominated parliament

<sup>12</sup> One of them being too optimistic assumptions for GDP growth in 2001 made by the Ministry of Finance and the resulting overestimation of budget revenues in 2001; these errors in assumptions were subsequently carried forward while designing the budget for 2002. For more details see Gomulka [2001].

during 2001. Given no countervailing action had been undertaken the pertinent deficit would have risen to 11% of GDP in 2002. The SLD-led (or post-communist-party) government, that took the office in October 2001, had to resort to unpopular measures including spending cuts and higher or new taxes. Some of these measures (e.g. new tax on deposit interests and capital gains) may prove detrimental to domestic savings and future growth prospects.

Despite these austerity measures the situation in Poland's public finances further aggravated in 2002 – the general government deficit rose to 6.7 per cent of GDP whereas the economic deficit reached the 5.1 per cent level. Due to certain inertia inherent in fiscal decisions and rigidity embedded in the budget, by the time Poland joined the European Union and beyond, this adversely affected the fiscal stability of the country, let alone the fulfillment of the Maastricht nominal convergence criteria. As can be seen from tables 3 and 4, in 2003-04 both the central and general government deficits tended to slightly narrow; nevertheless the latter tended to considerably exceed the Maastricht ceiling.

On the other hand, it is important to stress that the actual deficit of the general government may have overstated the scale of fiscal imbalances in Poland during 2001-02 period, as it neglected the impact of the business cycle. The years 2001-02 saw a significant deceleration of GDP growth – to 1.0 and 1.4 per cent, respectively, down from 4.0 per cent in 2000 and 5.0 per cent average for the 1992-2000 period. Adjusting the actual general government deficit downwards for the effects of the business cycle, the level of structural or full-employment deficit may be estimated at some 3.2 per cent of GDP in 2001 and 3.4 per cent in 2002.<sup>13</sup>

These figures seem to better reflect the scale of fiscal disequilibrium in Poland at the beginning of the present decade. Nevertheless they leave a vast room for concern with regard to country's fiscal stability even after its entry to the European Union. This concern is exacerbated by the fact that throughout 2001-2005, despite loudly heralded government pledges (the so called Hausner Plan), no essential changes took place in the prevailing pattern of public revenue and expenditure, described in the previous section, and Poland continued to remain a 'big-government' country. Hence, it can be argued that the persistent fiscal gap in Poland has been determined by factors of predominantly structural nature.<sup>14</sup> According to the most recent estimates, the structural deficit in Poland significantly widened after 2002: in 2003 it amounted to 5.0 % of GDP [UN ECE, 2005] and in 2004 it further rose to 5.5% [IMF, 2005].

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<sup>13</sup> For details, see Rapacki [2003].

<sup>14</sup> This view has gained support in the recent literature [see, e.g. Corricelli and Ercolani, 2003; UN ECE 2005].

Moreover, two other new trends emerged after 2001; they add new dimensions to the existing list of factors that may undermine fiscal stability of the country. The first consisted in the growth of public debt as a proportion of GDP. In 2001 this ratio rose, for the first time since 1992, to 43 per cent (table 3) and has displayed a steady upward trend after that date. If government guarantees and warranties for state-owned enterprises and business borrowing are included public debt would then exceed the ceiling of 50 per cent of GDP.<sup>15</sup> This by law would call for launching special precautionary procedures in the design and implementation of the central budget and would further constrain the flexibility of fiscal policy.<sup>16</sup>

Second, the years 2002-04 witnessed a sharp decrease in the volume of privatization proceeds. For the most part of the 1990s receipts from divestitures of state-owned firms and assets tended to provide a considerable part of financing of the budget deficit. Shrinking privatization revenues will by necessity entail more difficulties in financing the deficit and will be conducive to higher public sector borrowing requirements, increased government borrowing on the capital markets and rising cost of public debt servicing.

#### 4. Major challenges

As the foregoing analysis clearly demonstrated, the fiscal policy being pursued in Poland in the 1990s and at the beginning of the present decade was far from flawless; indeed, most (if not all) of its drawbacks and shortcomings pointed out earlier in the text have been carried forward to pose a threat to the present and future fiscal stability of the Polish economy. Capitalizing on our findings below we discuss the major short- and longer-term challenges to fiscal discipline in Poland.

For our purposes we will define the short-term perspective as that of end-2005 that is the time horizon determined by the budget blueprint for 2006. The short-term challenges to fiscal discipline are therefore those directly embedded in the budget for the coming year as well as those due to a possible cumulative impact of the past trends that constrain the freedom of maneuver of the fiscal authority and raise the costs of future reforms of the public finance. The following major **short-term** challenges deserve highlighting in particular.

1. The budget draft for 2006 displays much the same structural drawbacks as the past budgets. In particular:

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<sup>15</sup> In 2003 the pertinent ratio amounted to 51.6 per cent of GDP and slightly declined in 2004.

<sup>16</sup> It is to borne in mind, however, that the EU methodology is less stringent in this respect: it excludes government guarantees and warranties as components of the public debt. If calculated in accordance with the ESA'95 standard the public debt, as a proportion of GDP, amounted in 2002 to 44.7% versus 50.8% under the current statistical methodology [UBS Warburg, 2002]. Similarly, in 2003 the respective ratios were 44 and 51.6 per cent.

- It reveals a similar ‘redistributive bias’ as was the case in 1990-2004.
- It neglects the creation of potential positive externalities for private entrepreneurship and fails to enhance sustainable economic growth.
- Very little attempt was made to embark on a comprehensive, in-depth reform of the public finance.

2. The emphasis put by the outgoing SLD government, both in 2002-05 budgets and in the blueprint for 2006, on bailing out persistently inefficient SOEs rather than supporting the efficient private business entails distortions in the microeconomic incentives and discourages expansion of private enterprise. The macroeconomic consequences may be summarized in terms of weakening the sustainable growth potential of the Polish economy, depressing the available tax base and by the same token - jeopardizing the future fiscal stability of the country.

3. The years 2002-2005 witnessed an accelerated growth of government guarantees and warranties for both the business sector (especially SOEs) and budget-funded sphere (e.g. public hospitals). With the victory of the Law and Justice party (or PIS) in the recent parliamentary elections this trend seems quite likely to continue through 2006 since the new, PIS-led government shows an equally high, compared to its predecessor, willingness to rely on government intervention rather than on market forces. This contributes to raise the level of uncertainty embedded in fiscal policy as the magnitude of future government spending on this account is hard to predict.

4. The above trend is mostly due to the government failure to address the problem of (mostly uncontrolled) accumulation of debt in extra-budgetary entities (local governments, government agencies, funds, schools, hospitals and health care system in general). These debts give rise to the government’s off-balance commitments, which add to the risk of future fiscal instability and should be included to the measure of fiscal gap.

5. The fiscal discipline in Poland in 2006 may additionally suffer from two recent parliamentary initiatives that entail extra spending commitments for the new government. They include special pension schemes that privilege one particular interest group, i.e. coal miners, and reimbursement of value-added tax levied on building materials.

In the **medium- and longer-run perspective** the genuine challenge for Poland boils down to its ability and willingness to embark on a package of comprehensive, in-depth reforms and overhaul of its public finance system aimed to make it simpler, more transparent, effective and ‘development-friendly’. A key precondition for such a reform is the redefinition



of the new role and functions of the government in a maturing market economy. As far as fiscal reform is concerned, the following changes seem the most desirable [Rapacki, 2002]:

- Consolidation of extra-budgetary agencies, special funds and entities into the state budget or local governments budgets, which would allow a stronger control of fiscal authorities over public expenditures.
- Simplification of the tax code and the subsequent reduction of tax rates (stronger supply-side incentives for private entrepreneurship).
- Fine-tuning of the social safety net (means-tested approach) to reduce the burden of transfer payments on public expenditures.
- Reprioritization of public expenditure towards provision of public goods at the cost of redistributive objective.
- While ranking public (merit) goods top priority should be given to those expenditure items that create or enhance positive externalities for private markets, such as e.g. spending on R&D, human capital, new opportunities that improve access to information-communication technology, and investment in physical infrastructure.

The second challenge stems from the fast growing burden of servicing Poland's external debt after 2002. The repayment of principal alone scheduled in country's agreements with Paris and London Clubs is to steadily rise from USD 1.4 billion in 2002 to reach its maximum (4.1 bn) in 2008. This will no doubt compound the problem of fiscal liquidity since 2004, i.e. once Poland started paying its membership dues to the EU budget.

**Table 5. EU net transfers to Poland, 2004-2006  
(euro million, 1999 prices)**

	<b>2004</b>	<b>2005</b>	<b>2006</b>
Market interventions	130	341	367
Direct subsidies	0	557	675
Development of rural areas	290	605	882
<b>A. Agriculture, sub-total</b>	<b>421</b>	<b>1,505</b>	<b>1,924</b>
Structural funds	938	1,667	1,775
Cohesion funds	26	295	529
<b>B. Structural and cohesion funds</b>	<b>964</b>	<b>1,962</b>	<b>2,305</b>
<b>C. Intra-UE programs/initiatives</b>	<b>249</b>	<b>371</b>	<b>462</b>
<b>I. Total transfers</b>	<b>1,633</b>	<b>3,838</b>	<b>4,691</b>
II Pre-accession transfers	970	823	509
<b>III Gross transfers (I+II)</b>	<b>2,603</b>	<b>4,661</b>	<b>5,200</b>
IV Contribution to EU budget	1,558	2,407	2,492
<b>Net transfers (III – IV)</b>	<b>1,045</b>	<b>2,254</b>	<b>2,708</b>

Source: Ministry of Finance.

A special challenge of strategic significance is a derivative of Poland's EU accession in 2004. Among its medium- and longer-run fiscal implications the following deserve highlighting:

1. It is expected that financial transfers from the UE (the structural and cohesion funds, direct subsidies to farmers, etc.) should as a rule increase the funding potential of the Polish government and enhance its allocative function in pursuing important developmental goals. Table 5 provides data on the level and composition of EU funds committed to Poland in 2004-2006.

However, several factors may challenge this assumption, at least in the first few years of Poland's EU membership.

- Poland is to pay its dues to the EU budget right from the beginning of its membership. The annual amount of this contribution amounts to approximately 2.4 billion euro (200 million monthly) that is some 6-7 per cent of budget expenditure.
- UE-financed projects require co-funding by the host country (so called additionality clause). The domestic contribution (from the central or local government budgets) should amount to 15-25%, depending on the kind of projects. It is estimated that during 2004-2006 the annual allocations from the central budget to this end will equal at least 1 billion euro [Chojna-Duch, 2002].
- The direct fiscal implications of Poland's EU accession should also take account of the loss of a part of hitherto proceeds from import duties.
- Additional budget funds will have to be allocated to ensure harmonization of the Polish law and regulatory framework with the EU standards.
- Similarly, higher public expenditures will be also necessary to support various projects aimed to transform the Polish economy and to meet stringent UE norms (e.g. in the field of environmental protection).
- Given the time inconsistency of the EU-related fiscal inflows and outflows (most of EU transfers are subject to considerable time-lags compared to pertinent Polish disbursements) one may reasonably expect some liquidity problems for Poland's budget and the resulting constraints on fiscal discipline, at least in the early years of UE membership. It may be even claimed that – under the most pessimistic scenario - in the early years of its membership Poland will become a net payee to the common budget (i.e. its membership dues will exceed, on cash basis, transfers from the EU). This argument is based on three additional premises. First, according to the agreement

reached during the Copenhagen summit (November 2003) direct EU support for agriculture in the new member countries was substantially reduced (by 50 per cent in the first year of accession) and will be disbursed since 2005. Second, Poland's absorptive capacity of the EU funds tends to be quite low, which will further broaden the gap between the amount of funds 'committed' and those effectively absorbed.<sup>17</sup> Third, a part of the EU transfers will flow directly to target beneficiaries including those in the private sector (farmers, firms, etc.) rather than through the budget. Examples of such flows include transfers from the EU Structural Fund - their level during 2004-2006 may be estimated in average at some 1.5 billion euro annually. Although they are bound to take place entirely outside the state budget, the latter is expected to contribute its part to comply with the additionality principle.

**Table 6. Fiscal implications of Poland's EU membership**

(in % of GDP, annual averages for 2004-2006)

<u>Direct effects</u>	
Contribution to EU budget	-1.25
Structural Fund transfers	-1.5
Cohesion Fund transfers	0.5
Reform of public administration	-1.5
Phase-out of production subsidies	2
Realignment of custom duties	-0.5
Tax harmonization	0.25
Infrastructure expenditure	-1.5
Extraordinary liquidity cushions	0.5
<b>Total</b>	<b>-3.0</b>
<u>Indirect effects</u>	
Structural reforms	(+)
Tax competition	(+)
Tax revenue windfall	(+)
Decline in interest rates	(+)
Dynamic multiplier effects	(+)

Source: Own estimates.

2. If the above scenarios came true then their aggregate, direct budgetary effects (including co-financing of direct farmer subsidies from the budget) in 2004-2006 would translate into an extra deficit of the general government equal to some 2.5-3.0 per cent of GDP

<sup>17</sup> If the pre-accession absorptive capacity of EU funds in Poland (50-75%, depending on the project) were to be extrapolated for 2004-2006, the effective inflow of EU funds would amount to only 7.5-8.5 billion euro instead of some 11.4 billion committed.

annually. Table 6 summarizes the results of these estimates.<sup>18</sup> However, the deficit in question may prove smaller if – apart of direct effects induced by Poland’s EU membership – one also takes account of indirect, dynamic consequences of the inflow of EU funds, such as e.g. expansion and increased competitiveness of private entities, effects of structural reforms being undertaken, tax ‘competition’ between incumbent and new EU members, a general decline in interest rate levels in the latter countries resulting from the nominal convergence process, etc.

3. As a result of the above trends, a growing inflow of EU funds may give rise (at least temporarily) to an even faster increase in the UE-related items of the domestic public expenditures. This would in turn produce a sort of a ‘crowding out’ of other spending items within the budget and be conducive to significant changes in the composition of government expenditure. Under the most likely scenario, however, the changes in question will entail a growing proportion of public investment and other ‘development-oriented’ expenditures at the cost of social transfers and public consumption. If this is the case, the EU-induced reprioritization of public expenditure should be welcome as a vehicle of increased and more sustainable fiscal stability of the country. Simultaneously, it would bring Poland closer to meeting the ‘golden rule’ of public finance.<sup>19</sup>
4. Poland is expected to join the EMU by 2009-2010. According to some estimates, the extra costs of preparing the country to adopt the common currency may total some 1-1.5 per cent of GDP [Chojna-Duch, 2002].
5. Yet, it is also worth noting that a substantial part (if not most) of public expenditures on EU-related projects would have to be undertaken anyway, i.e. under the scenario of non-accession. Even without the inflow of EU assistance funds a similar level of public spending would be then required to finance much needed investment aimed at upgrading Poland’s physical infrastructure, enhancing country’s innovative capacity and overhauling its technological base, fostering the development of human capital, and in general – increasing competitiveness of the Polish economy in the global marketplace.

As a final remark in this section it ought to be also noted that Poland has an important shock absorber or long-term fiscal stabilizer built-in in its system of public finance. It is due to the innovative design of the pension system implemented in 1999. The new system

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<sup>18</sup> This finding is consistent with similar results obtained by Kopits and Szekely [2003]; their estimate for Poland is 3.5% of GDP.

<sup>19</sup> This rule requires that the fiscal deficit (or more precisely – government borrowing requirement) is used for financing public investment. For more details, see UN ECE [2005].

provides an effective shield against the threat of explosion of the public debt (including its hidden part resulting from today's government promises of future retirement benefits). As a consequence, in the next twenty years or so Poland will not have to generate any primary surplus in its budget as a precondition for stabilizing the level of its public debt below the Maastricht ceiling. This is not the case of the other EU-8 countries and most of the 'old' EU members with their traditional pension systems based on the 'pay-as-you-go' scheme. For example, in its recent study OECD has estimated that – in order to avoid the explosion of its public debt and ensure its systematic servicing – Germany would have to generate a primary budget surplus amounting to 4.7 per cent of GDP annually. The same figures for France and Spain have been estimated at 6.6 per cent and 5.2 per cent, respectively [Dang, Antolin and Auxley, 2001].

## **5. Concluding remarks**

With the benefit of hindsight it can be claimed that in 2004 the basic scenario outlined in the preceding section seems to have essentially come true. As a new member of the European Union since May 2004 Poland received gross transfers from the EU amounting to 2.7 billion euro while its dues to the common budget totaled 1.3 billion euro [European Commission]. Thus the country has become a net beneficiary of the EU budget: the net inflow of funds was equal to 1.4 billion euro that is above the target figure projected in table 5. At the same time, however, Poland experienced an extra fiscal deficit due to its EU membership. Its size may be estimated at some 0.4 billion euro, which is well below the most pessimistic projections developed in the previous section.

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