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**Article**

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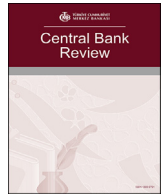
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# Poland's economic and social transformation 1989–2014 and contemporary challenges



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## ABSTRACT

The article has two objectives. The first one is to identify the distinctive features of the Polish transformation, especially those which may explain why the initial, transformational recession was less serious than elsewhere and why the subsequent economic growth was relatively high. It discusses positive as well as negative effects of the transition to the market-based economy. Some popular extremely negative evaluations of the transition are argued to be at variance with facts. The other objective is to discuss the reforms and policies necessary for Poland to continue the process of catching up with the most advanced countries, so that the civilisation gap is further bridged or possibly eliminated.

## 1. Introduction

The transformation of the economic and social system in Poland and other Central European and former USSR countries began when both the governed and governors of these countries almost commonly accepted that the economic system based on central management and state ownership lost in the competition with the system based on private property and individual entrepreneurship, market competition, coordinating role of prices and regulatory role of law.

In this way, the biggest experiment of the 20th century which tested in practice the quality and social usefulness of two globally dominating, and completely different, economic theories has come to an end.

In 1989 the level of macroeconomic destabilisation of the Polish economy was much bigger than that of the economies of other countries of real socialism. It was only Poland that did not service majority of its foreign debt and only in Poland inflation approached the hyperinflation level, undermining the confidence of citizens to its own currency so seriously that in August 1989 the average monthly pay, according to the market exchange rate, declined to 20 US dollars.

In this situation, the restoration of a sustainable macroeconomic equilibrium had to become an urgent priority goal.

The reformers' second key goal was to fully liberalise prices and foreign trade so as to promptly get rid of shortages and queues. In

the new economic system the prices of products and services were to play an important informational role about the real production costs. Thus, they had to be free from severe deformation made by large subsidies and product specific taxes.

The third key goal was to restore the development capacity of the economy to a level enabling Poland the start of a process of gradual bridging, and in a few decades possibly the elimination, of a serious and long-lasting civilisation gap in relation to Western Europe that has arisen in the past few centuries.

Statistical data show that already during the first few years of transformation Poland, to a large extent, managed to achieve these three goals.

## 2. The impact of collapse of the former economic system on the course of transformation

The scholarly literature points to a great similarity of economic systems in nearly all countries of real socialism and to large differences in the ways the transformation was conducted in the Central European countries and the former USSR on the one hand and in China on the other.

One of these differences resulted from the fact that in all the countries but China big systemic reforms were adopted after a few decades of change suppression, but when they finally began, they were fast and in majority of cases radical. In China big systemic changes began in 1979, i.e. 10 years earlier, but they were limited almost entirely to the economic area and except for the initial revolutionary liquidation of communes have been gradual in the last 35 years. The second important difference concerns the state

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financial (fiscal, exchange rate and monetary) policy, which in China was to a large extent subordinated to the achievement of a very rapid economic growth, and also a very high employment growth rate.

However, despite these differences in the course of transformation, the basic systemic reforms were conducted in all countries in response to serious economic failures. In China it was the so-called Cultural Revolution, which lasted for 6 years and was quite destructive. In the USSR and Central Europe it was a significant economic growth slowdown which began about 1975, mass shortages on the domestic market as well as a growing inflation pressure. In Poland it was also a deep recession in the period 1980–1981 and a formal bankruptcy in the foreign financial relations from 1981.

A low level of urbanisation in China enabled the authorities to isolate the economic from political reforms. Inefficient communal agriculture and a dynamic population growth forced the authorities to shift to individual farming already at the end of the 1970s. In much more developed countries of the former USSR and Central Europe the strategy of maintaining a high degree of state control over the economy meant that the social and economic crisis had to become critical to force the authorities to accept the overall transformation of the economic system. However, in the meantime the structural deformation of economies in these countries went very far.

In such circumstances, a fast introduction of market prices together with the elimination of most subsidies and the liberalisation of imports and exports meant a rapid and deep change in the composition of the domestic demand, particularly a considerable decline in the demand for a large number of goods produced domestically. And the collapse of the CMEA trading bloc and a shift to world prices necessitated a quick and in-depth reorientation of foreign trade. Moreover, in the former Soviet Union there was a big decline in its well-developed and large armaments manufacturing. In this situation, from the Elbe to Kamchatka the industrial output had to decline, in certain cases very considerably, giving rise to the so-called transformational recession (Kornai, 1994; Gomulka and Lane, 2001).

Transformational recession, measured in percentages of the decline in industrial output or the whole GDP in the transformation first few years, was smaller in Poland than elsewhere (apart from Slovenia). Also the Polish economy regained its growth capacity sooner than others. Why did it? The extensive literature does not offer a satisfactory theoretical explanation of these two phenomena. The authors (for example Blanchard, 1997; Gomulka, 1998) point to a positive role of reforms before 1989, as a result of which the private sector in 1989 represented a much bigger share in the economy than elsewhere, and to more profound liberalising reforms in the initial period of transformation, which resulted in an extremely dynamic growth of the new private sector.

### 3. General evaluation of the 25-year period. What are the effects of the economic transformation?

Economists are primarily interested in the indicator of the relative economic level, measured in terms of GDP per capita as a percentage of GDP per capita in the most developed countries. In 1992–2013 GDP per capita in Poland grew twice as fast as in the most developed EU countries. As a consequence, this indicator of the relative level of the Polish economy grew from about 30% in 1988 up to about 50% in 2013. Table 1 shows the relative economic level data with reference to the USA for all the countries which went through the social and economic transformation, also for Germany at the beginning and end of the transformation period.

For Poland in 2014 the level of the former Federal Republic of Germany or southern England, not to mention the United States, is still very distant. The country is at the level of Hungary and Greece, and is approaching the level of Portugal. However, the improvement in the relative economic level indicator is so large that it justifies to call the period of the last 25 years a golden quarter century of the last three centuries of the Polish history. This positive assessment is based on GDP per capita, but it may be additionally supported by data on a substantial improvement in ecological indicators, much improved access of households and companies to the latest technologies for processing information, mass scale of travelling of Poles all over the world and a rise of life expectancy by about 10%. In recent years the quality of housing and public infrastructure has also been much improved. All these mean a substantial progress in bridging the civilisation gap in relation to the world's best developed countries.

### 4. Issues which raise argument in public debate on economic transformation

The publicly circulated evaluation of the Polish transformation has always been and still is much diversified. Some critical approaches concern important questions and are well-documented.

Thus, on about 1/3 of the Polish territory, that less urbanised, the unemployment rate is excessive, often amounting to more than 20%.

As a consequence, labour migration has been considerable; the number of emigrants is presently estimated to be about 2 million, or about 10% of the potential labour force. In several important areas, such as health service, public administration, higher education as well as basic research and innovative activity, the progress is notable but the distance to well developed countries still remains substantial.

The level of diversification of incomes and wealth per capita is not as dramatically big as for example in China, Russia or the United States, but the scope of poverty is conspicuous. In 2013, according to data published recently by GUS (the Central Statistical Office of Poland), about 12% of people were eligible to social security support, and about 7% of people had incomes below the official level of subsistence.

What is controversial or simply incomprehensible is the appearance on a large scale of opinions which are extremely critical and ill-founded.

Let me present four of them from among the most popular and the most extreme:

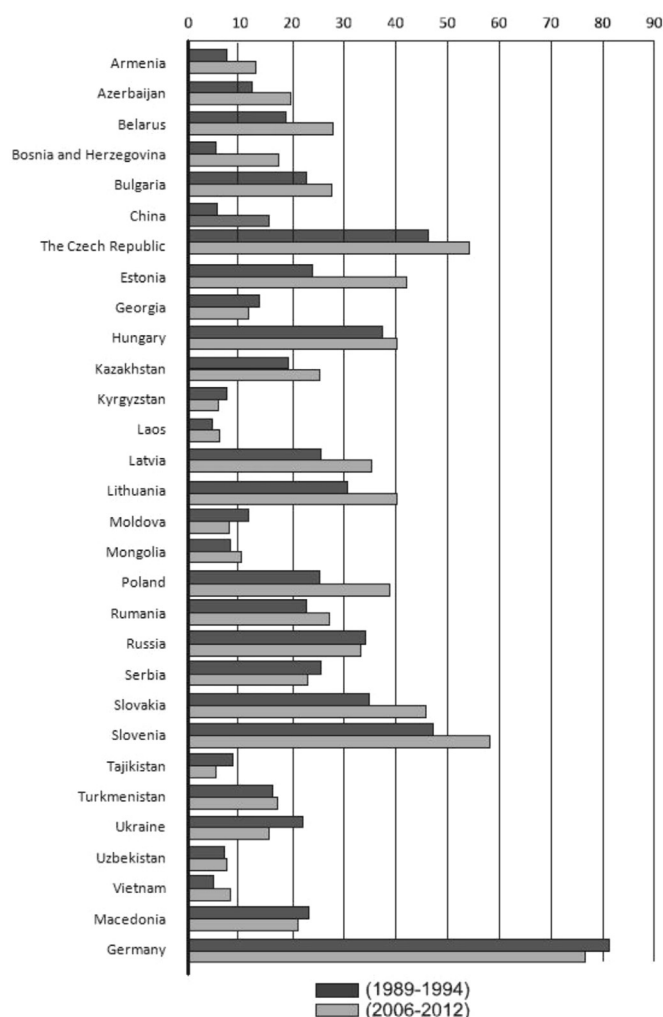
- (a) The initial so-called shock therapy was truly a “shock without therapy”.

This assessment is not based on facts. The liberalisation of prices had to be implemented quickly, but it did not include all prices; about 10% of prices remained regulated. The rate of inflation was reduced gradually; the initial goal – 1% or less per month at the end of 1990 was not achieved until 10 years later. The fiscal policy was not restrictive either. All throughout the transformation, except for 1990, budget deficits have been substantial and in a few years (2009 and 2010) very big. Social transfers were for many years very high and privatisation slow.

Some critics, when talking about the “shock”, refer to a big decline in real wages in 1990. Indeed, according to GUS data, they were 26.7% lower in comparison with the level in 1989. However, 1988 saw an excessive increase in real wages. In comparison with their level in 1987, the decline amounted only to 7.7%.

**Table 1**

GDP per capita (current purchasing power parity with reference to the USA).



Data based on G. Roland, Transition in Historical Perspective, May 6–7 2014 Conference Transition in Perspective, Budapest.

- (b) Economic policy of the 25-year period was to a large extent excessively liberal and insufficiently solidarity minded;

This assessment is not based on facts either. The basic facts include a high, and in the first years even very high, relation of old age and disability pensions to average wages, and an initially large and later fast growing number of old age and disability pensioners. The average pension within the Social Insurance Fund (FUS) system rose in relation to the average wage from about 50% before 1989 up to 65% in 1990 and to 75,6% in 1991. This relation remained at the level of 70–73% in the period of 1992–1994, and gradually declined to the level of 65% in 1998. In the period of transformation Poland introduced on a large scale the so-called bridging pensions, pensions for farmers and sickness pensions. Moreover, in practice a low retirement age was retained. As a result, a joint number of old age and disability pensioners of all kinds rose from the level of about 7 million in 1989 to about 9.5 million 10 years later. GUS research confirms that the lowest standard of living is experienced not by the old age and disability pensioners but by young families, in particular those with many children.

- (c) Privatisation was accompanied by scams, primarily in favour of people privileged by the former communist party

This assessment ignores the facts which positively differentiate Poland from such countries as Russia or Ukraine. The state sector really shrank quickly, but primarily due to the decline in employment and production of companies, and not as a result of bankruptcy or privatisation of these companies. Empirical research proves that the privatisation of large companies was slow and, as a rule, transparent, usually through public auctions. As I have already remarked, in Poland there was a unique phenomenon, not to be found in the other countries undergoing the transformation: a very rapid increase in the number and size of brand new private companies. This explains one of the paradoxes of the Polish transformation, namely fast privatisation of the economy despite slow privatisation of companies (Dabrowski et al., 2001).

- (d) Transformation destroyed a large part of the Polish industry

This assessment is correct with regard to the period 1990–1991. In 2013 the industrial output (manufacturing and mining) in constant prices was 2.5 times higher than in 1989, and about 3.7 times higher than in 1991. There was a change in the composition of industrial production in the right direction: the extraction of raw materials shrank while the production and export of processed goods, including high tech goods, grew many times.

## 5. Special achievements

From among many achievements mentioned, I would consider two to be the most important: firstly the creation, nearly from scratch and relatively quickly, of a thriving sector of new private companies and, secondly, the introduction of legal and institutional reforms of the market economy, which together with other things, enabled Poland to join the European Union in 2004.

A large success of the economic policy includes also the avoidance of a crisis in the financial sector (banks, investment and pension funds, insurance companies and stock exchanges) and no open crisis in public finance. Poland belongs to a small group of countries which have managed to avoid such crises in the last 25 years. A considerable success in the real sphere has been the attraction of foreign direct investment to the export sector (processing industry) and to services (banks, large retail business, telecommunications and hotel industry). . These investments were relatively modest, as in the period 1995–2008 they accounted for about 10% of all investments. However, due to their large concentration in the formerly neglected economic sectors, their impact on the development of exports and the quality of services has been crucial.

The local government reform also proved to be a great success. As expected, it released a large capital of entrepreneurship at a regional level. Probably partly due to this reform, since 2004 the absorption of EU funds has been relatively high for infrastructure investments, which is an essential area for the development of the country. Finally, thanks to a strong expansion of higher education, there was a rise in the number of specialists with new qualifications in deficit areas, such as management, linguistics, finance or information technology.

## 6. Making up for the development backwardness: why only moderately fast?

According to the OECD estimates, in 2013 Poland's GDP was 2.3 times higher than in 1989. The average GDP growth rate in Poland in the years 1989–2013, of about 4% annually, is not particularly high in comparison with the rate achieved by emerging markets in South-East Asia since 1950. A few Polish governments formulated the achievement of a GDP growth rate up to 6% annually as their strategic goal. The implementation of such a goal would require a considerable rise in Poles' employment activity, which at present is about 10% lower than in the most developed part of EU, as well as an increase in the investment rate by about 10% of GDP from the present level of about 20%. Economists know what economic policy (social policy, taxation policy, euro adoption) is necessary to achieve such changes in the value of these two key parameters. However, attempts made by some governments to conduct such policies have not been successful. Possibly, the necessary reforms would have not been supported by the electorate.

## 7. The paradox of high innovativeness of the Polish economy and the middle-income trap

Poland has still a number of serious problems to solve and many important reforms to introduce. The general goal of these reforms should be to sustain the capability of further erosion of the income and wealth gaps in relation to the world's most developed countries. A satisfactory progress in bridging these gaps depends on the economic growth rate in the next 20–30 years being 3–5% annually, not below 3% annually.

It is necessary to present, in this context, a short theoretical commentary on the mechanism of economic growth in the long run. The economic growth rate in the short run depends on a number of factors, e.g. on aggregate demand. A long-term

economic growth rate per capita depends nearly entirely on the rate of qualitative changes, such as technological and institutional innovations as well as employees' skills. In well developed countries these changes result primarily from the innovativeness of the entire world sector of R&D (research and development) and the national level of education. In less developed countries, that is the group of so-called catching-up countries to which Poland belongs, their own innovative activity is marginal and will be insignificant for yet a number of years, while the access to the latest innovation will continue to be strongly limited. Technological changes in economy within this group depend nearly entirely on the absorption of foreign innovations, primarily those easily accessible. This absorption occurs mainly through the channel of investment activity. In the case of high investment in relation to GDP, technological changes in the catching-up countries, in percentages terms, may be for a certain period of time even several times bigger than in the most developed countries. In Poland, as a result of transformation, the access to the world resources of knowledge and technology of older generations as well as the absorption capacity of the economy have considerably increased. This explains the paradox of a high innovativeness of the Polish economy and a low innovativeness of the Polish R&D. However, with the GDP per capita at a level of 50–70% of the most developed countries, further fast technological progress of a catching-up country is becoming more difficult, as access to technologies of newer generations becomes necessary. At this level of development the process of catching-up may be stopped. Economists speak about the so-called middle-development trap or middle-income trap. Further progress in gap bridging is possible, but the pace of catching up as a rule becomes slower.

This pace may be sustained or the pace of the growth slowdown may be reduced in two ways. One way is to strongly raise the country's own innovation and absorption capacity, especially directly by companies. The other is to care more about the factors which increase the attractiveness of the country for investors from the most developed countries. These factors include for example a good quality infrastructure, high quality vocational and university education, stable and entrepreneur-friendly legal and financial system, low political and exchange rate risk, low interest rates and low inflation.

A document concerning Poland issued on 2 July 2014 by the European Commission includes a detailed list of challenges and a long list of necessary reforms. Let me just quote the assessment of Poland's research and innovativeness:

„Poland is among the EU countries with the lowest level of R&D expenditure and is one of the worst performers in broader innovation indicators. Private R&D expenditure is especially low. Low R&D spending is coupled with weak research and innovation activity by companies and an insufficiently innovation-friendly business environment. The innovation support system in Poland has been risk-averse, based mostly on grants, supporting technology absorption and transfer without a big impact on genuinely new innovation. Existing tax incentives for R&D are ineffective in promoting internal R&D by the private sector and are used only by big companies.”

Economic integration favours the diffusion of everything that contributes to a fast economic growth. Poland's escape from the middle-growth trap will therefore also depend on the progress of technological integration within the European Union. Meanwhile, in recent years the risk of collapse of the best integrated EU part, i.e. the euro zone, though not big so far, has grown. It is a worrying phenomenon, particularly if as a result of this collapse the Union itself becomes weak too. Such a weakening would result in the rise

in national competition and different kinds of barriers between countries with regard to the flow of goods, people, capital and technology.

A stronger defence of national identity in the EU countries comes in part in response to the integration progress perceived sometimes as too rapid. In order to avoid the collapse of the euro zone, there have to be reforms in the area of public finance and banking. But the integration processes in the EU will certainly be slow in the nearest future, as they have to include what is called the European identity, i.e. an extremely complex social and cultural sphere. An essential until now internal motive behind the development of a strong economic integration, which is the avoidance of war in Europe, is probably still valid. In the next decades this motive may be reinforced by a growing trade competition, and perhaps even the pressure arising from threats of different kind from two new global economic and military superpowers: China and India, the countries whose own populations are much bigger than the EU, the USA, Canada and Japan jointly.

In its national interest, Poland should be active in the search of recipes for the reduction of the risk of EU collapse down to zero, or close to zero, and it should also itself, in cooperation with others, undertake activities in favour of further economic integration.

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