

Kolodko, Grzegorz W.

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A two-thirds rate of success: Polish transformation and economic development, 1989 - 2008

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A Two-thirds Rate of Success

Polish Transformation
and Economic Development, 1989-2008

Grzegorz W. Kolodko*

March 2009

Abstract

Progress in achieving institutional changes should be evaluated through the prism of their influence on the development abilities of the relevant country. In Poland, during 20 years of comprehensive systemic shift, GDP increased more than in any other postsocialist country. To judge the transformation progress, it is not enough to review improvements in competitiveness or in growth in terms of quantity, but also social and cultural aspects should be taken into account. In Poland, there have been five distinct periods from the viewpoint of economic growth. Had there been a better policy coordination of systemic change and socioeconomic development, GDP growth over the periods considered could have increased by more than half. This opportunity was missed because of the intermittent implementation of wrong economic policies based on wrong economic theories. Poland's transformation can be seen as a success, but only to the extent of achieving two-thirds of its potential.

Keywords: transformation, economic growth, development, institutions, economic policy, postcommunist period, Poland

JEL classification: A11, E6, F02, F43, H11, I38, N1, O17

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* Transformation, Integration and Globalization Economic Research (TIGER), Warsaw, email: kolodko@tiger.edu.pl

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Acronyms

EBRD European Bank for Reconstruction and Development

HDI human development index

SWB subjective wellbeing index

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www.wider.unu.edu

publications@wider.unu.edu

UNU World Institute for Development Economics Research (UNU-WIDER)
Katajanokanlaituri 6 B, 00160 Helsinki, Finland

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1 The ill-advised 'Washington consensus'

After 1989, the historic year that significantly changed the face of not only Poland and the region but also the world, came the 'shock therapy' years. Or, 'shock-without-therapy' as others would prefer to describe this period more accurately. Economic policy in 1990-93 was generally based on the neoliberal doctrine, often identified with the so-called Washington consensus, whose usefulness in the complexity of the postsocialist transition was limited. A similar tendency could be observed in other post-socialist countries, albeit not all, as some of these, Slovenia in particular, benefited by resisting the influence of the Washington consensus.

John Williamson, author of the term 'Washington consensus', which has become a worldwide catchphrase, draws attention to its overzealous interpretation. In particular, he distances himself from considering privatization as the overriding priority, as happens mainly in the neophyte version of neoliberalism. He notes (2005: 10):

that privatization remains a desirable objective, but that more attention needs to be paid to the way in which it is achieved than has often been the case in the past. There needs to be more attention to ensuring that privatization is, and is seen to be, squeaky clean. If that restrains the pace at which it is carried out, so be it. The objective should not be 'privatize as fast as you can' (as Kolodko [1998] once claimed the Washington consensus demanded), but to privatize in a way that will increase efficiency without concentrating wealth.

Unfortunately, pressurized by the overwhelming influence of external advice there were political forces that imposed a programme of liberalization and stabilization, which was not relevant to the Polish reality. It turned out to be simple, as it was very easy for political reasons to gain social acceptance for the excesses of the shock-without-therapy. Nowadays, researchers write about the losers of transformation and the defeat of 'Solidarity' (see Ost 2006), pointing out that critical advice and numerous warnings were disregarded at that time. However, despite the discord on the alleged absence of a so-called 'alternative', it must be emphasized that other programmes were also suggested (see, *inter alia*, Laski 1990; Nuti 1990; Kolodko 1989, 1990).

There were distinct warnings that the proposed package of liberalization and stabilization, known as the Sachs-Balcerowicz plan, would cause a 25 per cent drop in industrial production in the first year. This would be followed by mass unemployment. It was not possible that this could result in a monthly inflation rate of 1 per cent, as had been promised. The criticism was ridiculed by government advisors although it was fully justified, as became obvious later. The government had anticipated the recession to last only one year, GDP to drop by 3.1 per cent, and unemployment to affect 400,000 people (which would imply a moderate unemployment rate of less than 2.5 per cent), all to be followed immediately by a period of economic growth (see Program 1989). The reality was dramatically different.

At that time, particularly in 1990-91, efforts at stabilization policy were definitely amiss. Policy was too restrictive, mainly in terms of its monetary and fiscal aspects. Interest rates were too high and instead of being oriented towards the future and towards cooled-down expectations, they were based on earlier inflation rates, a fact which caused their extrapolation. What was worse, they also referred to old debt. Foreign trade

liberalization, from which the government had partially withdrawn already in 1991, went too far. The range of *zloty* devaluation was excessive and the period of its nominal freeze too long. Furthermore, the freeze was based on an inflexible peg to the US dollar and not, as would have been better, to the currencies basket that would have reflected the structure of the balance of payment. For political reasons, the public and cooperative sectors were discriminated against. Particularly devastating for the badly needed restructure of the state companies was the so-called *popiwiek*, a tax on excessive wage increases, its restrictiveness evidently overshooting. The institutional and social aspects of building a market economy had been underestimated.

Of course, the deep financial destabilization, evident from the high inflation rate and extensive shortages,¹ as well as a breakdown of external balance, compounded the situation. Short-term hyperinflation, induced by the simultaneous liberalization of food prices and the irrational, full *ex post* wage indexation forced by ‘Solidarity’ was particularly destructive.

At the same time, the regime’s initial conditions for a breakthrough, due to earlier market reforms and social climate, were quite good. Given the starting point on the one hand, and serious conceptual errors on the other, there should be no doubt that the scope of transitional recession was much greater than the inevitable outcome. It is obvious that more gain could have been achieved at lesser cost but unfortunately, developments were different. The government at that time had assumed a much shorter recession period, faster stabilization results and a prompt general improvement of the macroeconomic situation. The gap between the promised projections and reality was enormous. It had far reaching, negative social and political consequences that have lasted even to the present day.

2 A great success for the ‘strategy for Poland’

The years 1994-97 constitute another, clearly distinctive period, when a complex programme for structural reforms and fast economic growth was implemented. The ‘Strategy for Poland’ continued all the correct strands of transformation previously initiated but without correcting the evident errors of the preceding period. The means of economic policy were not confused with its aims. Neoliberal doctrinarism was abandoned for a pragmatic approach based on economic rationalism.² Taxation of wage increases, based on the labour productivity growth, was eliminated. Commercialization of the public sector was implemented, which meant that state-owned companies were exposed to competitive pressure and subjected to tough budget constraints, similarly to the private sector. The process of privatization was rationalized, mainly to comply with the double goal of improving microeconomic efficiency and maximizing government revenue.

Greater emphasis was attributed to building market economy institutions, and this resulted in Poland’s accession in 1996 to the OECD. The scope of constitutionally

¹ I have proposed to call this syndrome the ‘shortageflation’. See Kolodko and McMahon (1987).

² On the need of a more pragmatic approach towards the issue of economic growth, see Helpman (2004) and Rodrik (2005).

guaranteed independence of the central bank was extended. A system of securing bank deposits was created (Bank Guarantee Fund). The prerogative of supervision over the capital market was increased and an independent insurance supervision established. Monetary convertibility conforming to the IMF definition was accepted. The first ratings, including investment grade, were obtained. The first foreign bonds were issued. Public dialogue and social partnership were basically different than in the preceding period. A tripartite commission composed of the government, trade unions and business organizations were taking joint action.

Public debt was radically reduced from approximately 87 per cent of GDP at the end of 1993 to around 46 per cent at the end of 1997. Inflation dropped by two-thirds, from 37.6 per cent to 13.2 per cent. With respect to fiscal policy, investment allowances were applied to foster development. A reduction of taxes was initiated; in particular, statutory decisions reduced taxes for entrepreneurs by as much as one-fifth, from 40 per cent to 32. Measures to rationalize the budget were introduced, attributing simultaneously to a more pro-development nature to the expenses. The increasing inequality of income distribution was halted and at the end of the period, the Gini coefficient was approximately 0.33 with reference to income and about 0.29 with respect to wages. Overall, social climate improved, and the optimism of consumers and entrepreneurs grew. According to sociological studies, the number of suicides, used to measure the level of social stress, dropped.³ For the first time during the transformation period, more citizens were returning to Poland than leaving it. The benefits, as anticipated with the 'Strategy for Poland', had been achieved, but at less cost than expected.⁴

The success of this transformation phase has been highlighted by many independent authors,⁵ including such prominent economists as Joseph E. Stiglitz. He writes that Poland owes its achievements to the gradual policy of structural reforms and institutional building proposed by Kolodko (and implemented when he was in charge of economic policy) since the onset of transformation. According to Stiglitz (2004: 181):

Poland's former deputy premier and financial minister, Grzegorz W. Kolodko, has argued that the success of his nation was due to its explicit rejection of the doctrines of the Washington consensus. The country did not do what the IMF recommended—it did not engage in rapid privatization, and it did not put reducing inflation to lower and

³ Maria Jarosz (2007: 14), a distinguished Polish sociologist, states:

... certain particular case of coincidence of events ... took place in the second half of the nineties (when Grzegorz W. Kolodko was deputy prime minister and finance minister). An extremely spectacular thing happened then: positive economic growth indexes were accompanied by a significant drop in negative social ratios: in 1997 GDP grew ... [by] as much as 6.9 (which signifies GDP growth of approximately 82 billion *zlotys*), and usually increasing Gini coefficient (measuring inequality of income distribution) was halted at that time. At the same time the unemployment rate ... dropped to 10.3 in 1997 (i.e., unemployment was reduced by over a million people). The above was accompanied by significant temporary reduction of the ever-growing suicide rate: from 14.1 to 13.0 (over 400 people less). And even though it is not easy to interpret the above, there comes the reflection over the unusual situation where what should be growing grew, and what should be dropping dropped.

⁴ For a comprehensive analysis of the assumptions and implementation of the 'Strategy for Poland' against the comparative background of shock therapy, see Kolodko and Nuti (1997).

⁵ See, for instance, North (2002), Nekipelov (2004), Roland (2004) and Popov (2006).

lower levels over all other macroeconomic concerns. But it did emphasize some things to which the IMF had paid insufficient attention—such as the importance of democratic support for the reforms, which entailed trying to keep unemployment low, providing benefits for those who were unemployed and adjusting pensions for inflation, and creating the institutional infrastructure required to make a market economy function.

This is true. The instruments of development policy were not confused with its objectives.

The objective of building a social market economy was moved forward as much as was possible in the presence of both globalization and the strong neoliberal trend in the world's economic thinking and practice.⁶ Creating the basics of a social market economy in a postsocialist country was difficult because of the growing subordination of the economy to the impulsive forces of world economy. Also, the favouring of foreign capital by some political and economic elites, who were not interested in strengthening the institutions of social market economy, was of certain importance. Notwithstanding the weaknesses of economic policy, the main problem was that social market economy is a concept that refers to national economy, yet these day, the world economy is predominant.

Poland would have had an opportunity to create a social market economy if it had subsequently continued with the 'Strategy for Poland' plan for the last 20 years. Unfortunately, this did not happen, partly for doctrinal and ideological reasons and partly because, as happens frequently, economic policy is subordinated to group interests imposed on society as a common goal.

In the context of the undeniable achievements of 1994-97, some of the comments offered as professional forecasts, yet expressed as bad-luck wishes, should be recalled here. They included comments such as:

- a 'forthcoming threat' (L. Balcerowicz, former deputy prime minister and finance minister);
- the phantom of '300 per cent inflation' (J. K. Bielecki, former prime minister); and
- a 'national disaster' (J. Winiecki, former representative of Poland in EBRD).

Unfortunately, in some foreign circles, these prophecies had a negative influence on general opinion with respect to Poland's economic perspectives. However, thanks to hard facts and rational arguments, the situation was soon under control.

Instead of defeat, the Polish economy exhibited spectacular success between 1994 and 1997 and was recognized as the unquestionable leader of postsocialist change. At that time Poland earned the nickname, East European tiger, but regrettably, not for long. The nonorthodox, pragmatic policy, which had triggered the per capita GDP growth of 28

⁶ An important contribution dealing with the influence of neoliberal doctrine on the economic dialogue and thus on the contemporary world economy is Harvey (2005). See also Kolodko (2006).

per cent in 1994-97, was foolishly interrupted. The favourable trends were soon reversed.

3 Overcooling and counteracting its aftermath

Then came the disastrous years, 1998-2001, when there were attempts to combine the returning orthodox liberalism with the populism of 'Solidarity'. The results were even worse than at the beginning of the decade. Despite progress in some sections of institution building and the quickly extending private sector, economic dynamism faded. As a result of the policy of cooling the economic situation with fiscal and monetary instruments, the GDP growth rate dropped from 7.5 per cent in the second quarter of 1997 to 0.2 per cent in the fourth quarter of 2001, and the 1997 level growth rate has not been achieved since then. Unemployment, which had dropped by over a million people during 1994-97, increased by the same number between 1998 and 2001.

Measures had been taken unnecessarily to cool down the economy, as it had not been overheated. Although there had been some tension with regard to the balance of payment, this did not constitute any serious risk until 1997. The current account deficit had been at a manageable level of 3.2 per cent of GDP, of which almost 93 per cent was financed by FDI inflows. The inflow of FDIs reflected the rather positive general economic stance and pointed to the improved competitiveness of the Polish economy. But by 1999 the deficit had already reached 7.4 per cent of GDP, and again a specific perverse effect occurred. Similar to the situation in 1991 when a high budget deficit appeared after the temporary surplus of the previous year, likewise, the current account deficit in 1998-99 was two and a half times higher than in 1996-97. Compared to 1997, the nominal state budget deficit in 1998 had doubled. Apart from 2004, the year 2000 was the only year of significant acceleration of inflation, increasing from 7.3 per cent to 10.1 per cent (see Statistical Appendix for details).

The above development evolved in an environment of the Polish economy opening to external contacts, grassroots businesses flourishing, microeconomic management improving, and progress being made in staff qualifications. How, then, was it possible? The answer is complex, both for psychological and political reasons. With regard to the economy, the answer is simple: wrong economic policy based on the wrong theoretical concept. The Polish neoliberalism, which had been combined with right-wing populism, could have produced no other result except to impede prosperity and to drive the economy to stagnation. Social costs of the overcooling policy were enormous and its economic effects poor.

Then came the fourth period, 2002-05. It was the final and key stage of negotiations of Poland's membership in the European Union (EU). Poland could not stay outside EU, as the country was geopolitically placed within a broader, European context.⁷ However, many important issues, including those relating to fiscal and monetary areas, anti-trust regulations and competition policy, agricultural market, infrastructure and environment

⁷ According to a rather odd comment, it was membership in NATO by East and Central European countries, decided by the USA, that made their subsequent EU accession possible (Brzezinski 2007). It is a classical *post hoc ergo propter hoc* mistake, i.e., 'after this, therefore because of this', clutched with classical Americacentrism.

protection, needed to be negotiated. The second half of 2002, preceding the EU summit in Copenhagen, was crucial and Poland was able to negotiate the maximum extent of all that were achievable. However, with respect to the entire, multi-year negotiation procedure, more benefit could have been achieved through the coordinated efforts of other countries applying for EU accession.

Apart from the favourable conclusion of the EU negotiations and the social support for the accession that succeeded at the June 2003 referendum, the most important issue was to prevent the economy from stagnation, and to steer it again towards fast growth. This was both easier and more difficult than similar action taken eight years earlier after the failed shock-without-therapy measures. Intervention was somewhat easier, as advancement of the market economy was significant, but also more difficult, as policy had fewer instruments available. The measures still at the government's disposal were used as much as was possible, given that the central bank's monetary policy was evidently a hindrance to economic boom. Correcting monetary policy mistakes through fiscal policy adjustments is not a good *modus operandi*. Poland missed out on its potential for economic growth because of insufficient coordination of financial policy—monetary policy of the central bank and fiscal policy of the government.

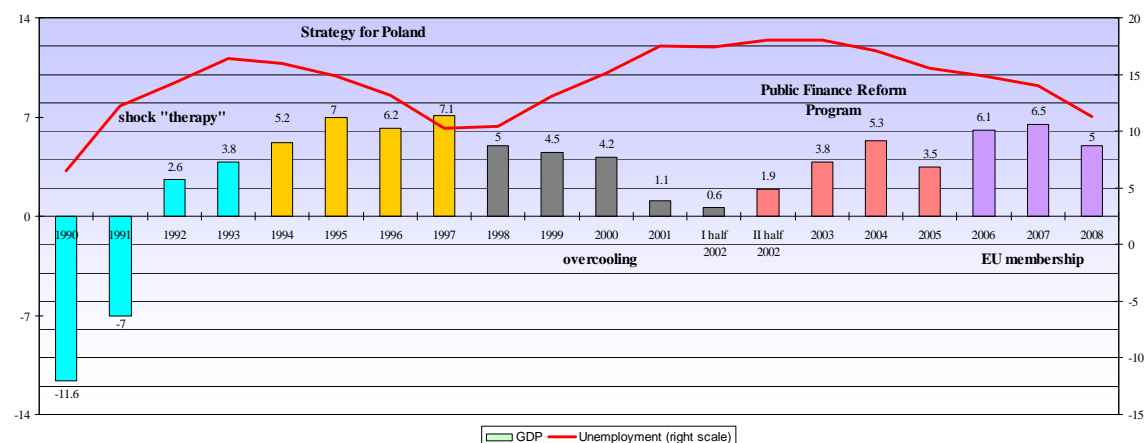
A single, sharp adjustment was made in the second half of 2002 and in the beginning of 2003 in the form of nonorthodox action. The debts of over 60,000 companies, 99 per cent of which were small- and medium-sized private enterprises, were conditionally cancelled. According to independent centres, for instance, the Supreme Technical Organization, NOT, this measure saved approximately 210,000 jobs. Saving thousands of companies from bankruptcy by means of extensive restrictive fiscal and monetary measures (including excessive currency appreciation supported by the National Bank of Poland) soon resulted in a reversal of the unfavourable trends. Production grew increasingly faster, as employment started to grow as well. The government budgetary stance and payment balance improved, and by the middle of 2003, GDP grew by 4.0 per cent, and by as much as 7.0 per cent during the first quarter of 2004. In 2005 this momentum, unfortunately, could not be maintained. GDP dropped temporarily to 3.5 per cent due to the general incoherence of macroeconomic policy.

Notwithstanding the single debt-clearance operation and general increased effectiveness resulting from the continuous improvement of business management quality, the structural reform and institutional progress triggered by the upcoming EU membership were of great importance in accelerating the rate of economic growth. Without a doubt, in this respect, the government and the entire state apparatus was efficient. This facilitated the introduction of many institutional improvements on an on-going basis, without waiting for EU membership.

However, the implementation of the multi-layer programme of structural reforms was of crucial importance. The programme integrated and organized activities in many sectors, although its name, 'Programme of the Reform of Public Finance' could mistakenly suggest coordination in only one sector.⁸ This reform package was not limited only to consolidating public finance, where there was still so much to do, but has been

⁸ See Kolodko (2004) for more details on the assumptions, instruments and initial outcome of the implementation of 'Programme of the Reform of Public Finance'.

Figure 1
Rates of GDP growth and unemployment in Poland, 1990-2008



Note: Unemployment rate is based on conditions comparable with the 1990s data. According to the methodology currently applied, this is approximately 2 percentage points higher.

Source: GUS.

continued under different names until the present times. This refers to another radical reduction in company taxation, which after being decreased by a mere 4 percentage points between 1998 and 2001, was lowered again, this time by 9 percentage points (from 28 per cent in 2002 to 19 per cent from the year 2004 onward).⁹ Although this also contributed to the acceleration of the growth rate, the most important element of the 'Programme' was to reconstruct the financing of public services sphere and to continue with social security reforms. In these fields there was still a lot to do in the following periods.

The years 2006-08 constitute the fifth stage of the 20-year transformation period. Generally, positive economic trends were maintained, and the average annual growth rate was close to 6 per cent (a decent result), although Poland had the potential to reach a growth rate of approximately 7 per cent. At a growth rate of 7.2 per cent, income should double every ten years. The measures adopted were sufficient to maintain the dynamics of the 1997 spring for the next ten years, and GDP would not have been 50 per cent higher but instead, twice as high. Recently, i.e., in 2006-08, this rather good economic situation was sustained not only because of the high quality of macroeconomic policy or further improvement of the institutions, but for four other reasons:

- positive inertia of processes initiated in the preceding period;
- noticeable improvement of the quality of microeconomic management at the company level;
- development of local governments which supported local initiative and stimulated regional development; and

⁹ It should be clearly pointed out that of the 21 percentage-point reduction on corporate income tax amounting to 40 per cent in the beginning of the 1990s, only 4 percentage points were the effect of a government decision in 1998-2001. Measures introduced in the 'Strategy for Poland' and the 'Programme of the Reform of Public Finance' account for 17 percentage points.

- institutional, financial and investment benefits resulting from EU membership, the effect of which is estimated as an additional annual growth of GDP rate of approximately 2 percentage points.

To summarize, of the 80 per cent GDP growth achieved during the 19 years of transformation (1990-200), almost two-thirds (or as much as 47 percentage points) was achieved the eight-year period between 1994-97 and 2002-05. The total span of eight years covering the years 1990-93 and 1998-2001 resulted in zero growth. In terms of economic dynamics, this was the difference between the ‘Strategy for Poland’ and the ‘Programme of the Reform of Public Finance’ on the one hand, and shock therapy and overcooling of the economy on the other.

Thus, the most damaging policy was followed in the four-year period, 1998-2001, and was even worse than in the beginning of the last decade, albeit with a smaller area of uncertainty. It should be emphasized once again that faulty economic theory can only lead to damaging economic policy. Nothing can justify it. Of course, the interests of particular groups were of major importance as well.

4 Different measures of the reforms’ progress, and social and economic development

Evaluation of the transition process is more than a mere assessment of economic growth, measured by GDP increases. There are many other related processes that have both occasional and long-term implications. Consideration of the changes in GDP distribution is not sufficient either. It is true that distribution irregularities evidently intensified during transformation (see IMF 2007b), and social exclusion expanded, resulting in compounded costs: human capital was wasted and additional budget costs incurred, shifting these away from pro-development applications. Also in this case, the situation worsened largely during the period of shock-without-therapy and unnecessary overcooling. The level of the inequality seems to be stabilizing over the last few years, as it can be estimated from minimal changes in the Gini coefficient. General debate, however, refers to the question of whether a level counterproductive to economic growth has already been reached (see Tanzi, Chu and Gupta 1999) and whether the tax changes that shift income from the low-wage groups to the better-paid groups (the so-called ‘flat tax’), proposed by neoliberal circles, would influence growth.

Recently, Poland has been outdistanced by Latvia in terms of income per person. Therefore, with a GDP per capita of approximately US\$17,800 in 2008 (based on the purchasing power parity), Poland outranks only Bulgaria and Romania among the ten postsocialist EU member states. Income in Poland corresponds to half the entire EU average, which fluctuated around US\$34,000 in 2008, or less than half of the USA average of US\$48,000.

At the same time, Poland compares fairly well with respect to the human development index (HDI) compiled by the United Nations Development Programme (see UNDP 2007). Norway ranks the highest with an index of 0.965, Niger with 0.311 the lowest. Poland with HDI of 0.862 was ranked by UNDP in the group of 63 high-index states, whose index exceeds 0.800. It is worth mentioning that this level was also reached by Bosnia and Herzegovina, where the GDP per person is approximately 40 per cent of the

corresponding figure in Poland. This alone highlights how the growth trend is affected if the quantitative index of gross product is overlooked, and consideration given, for instance, to the two parameters that are essential for the quality of social capital.

Given the size of its GDP per capita, Poland ranks 50th in the world (according to a ranking that takes into account the UN member states and Hong Kong). In terms of HDI, it is in 37th position, situated between Argentina and Chile, a position higher than six other postsocialist EU states, including Estonia (0.858), Lithuania (0.857), Slovakia (0.856) and Latvia (0.845), all of which enjoy a higher GDP per capita than Poland. Poland also outranks Bulgaria (0.816) and Romania (0.805). Thus, of the ten postsocialist EU countries, only Slovenia (27th position with HDI of 0.910) the Czech Republic (0.885), and Hungary (0.869) are better off.

Next comes an interesting question. To what extent is this arrangement, so different from the results based on GDP rates, the outcome of postsocialist systemic transformation and to what extent did it result from the general heritage of the previous system? There is no doubt that this time, heritage was an advantage. Under the centrally planned socialist economy, a common public health service existed, and these countries initiated transition supported by societies where illiteracy had been eliminated already in the early stages of socialism. In addition to primary schooling, secondary and tertiary education networks were well developed, and their positive impact has continued to the present. For the same reasons, Cuba (with a GDP per person of only US\$4,000) ranks extremely high in the HDI list with the index of 0.826 (surpassing its neighbour, Mexico, and Bulgaria among postsocialist countries). In comparison, countries at a similar level of average national income, such as Syria or Indonesia, are characterized with an HDI index that is over a hundred basis points less (0.716 and 0.711, respectively).

HDI improved in Poland during the transition years relatively more than in other countries because of the high increase in attendance at the tertiary education level. Dynamic development of private tertiary educational entities—unquestionably relating to transformation—and the significant increase in the number of students (currently almost two million, up from the 400,000 at the start of transition) contributed to the phenomenon. Apart from the quality (often very low) of education offered in many private colleges, the almost fivefold increase in enrolments over a period of less than two decades is impressive, and has had a significant impact on HDI improvement.

It is true that HDI increased during transformation by more than 100 basis points from less than 0.760 to over 0.860 if calculated with a methodology that enables comparison. However, it is also a fact that the main observation is confirmed once again. During 1990-03, the years of failure from the policy of extreme shocks without sufficient therapy, Poland's relative position in the world dropped by as much as a dozen places. The HDI shows only certain amount of growth in 1993, a reflection of the abating crisis and implementation of the governmental programme known as the 'Pact on State Companies in the Course of Transformation' that had been agreed with the trade unions. It was a belated attempt to rescue the rapidly deteriorating situation of workers who were affected by quickly increasing unemployment. It should be mentioned here that unemployment—a fact that obviously influences social condition—is not considered in

Table 1
Human Development Index in Poland in 1990-2004

Year	HDI	Comparable HDI in 1992-96 ^a	Position in the world
1990	0.807		43
1991 ^b	n. d.		n. d.
1992	0.815	0.765	49
1993	0.875 ^c	0.781	56
1994	0.864	0.786	58
1995	0.883	0.796	52
1996	0.886	0.801	44
1997	0.809 ^d		44
1998	0.818		44
1999	0.823		38
2000	0.848		37
2001	0.841		35
2002	0.850		37
2003	0.858		36
2004	0.862		37

Notes: ^a Indexes for 1992-96 were calculated pursuant to the method applied after the change introduced by UNDP in 1997 which enables comparison of the timeseries 1992-2004.
^b n. d. = no data;
^c Change in calculation method applied in 1993;
^d Second change in calculation method becoming effective from 1997 onward.

Source: UNDP (2006).

the HDI. During the period 1998-2001, when policy resulted in a disappointing outcome, the great boom in private tertiary education contributed to the HDI increase, albeit only until the year 2000.

During the last year of overcooling, the situation deteriorated still further and in 2001 HDI dropped in absolute terms. It was the only incident during the entire transformation period of irrational macroeconomic policy bringing down the economic growth rate to zero by the end of the year. Four and a half years—and in favourable external circumstances, at that¹⁰—was sufficient time to plunge a 7.5 per cent growth rate to zero. This was the result of the inability to coordinate policies on institutional reform with those on economic growth. They are complementary policies, and in a country maturing to a full market economy, under no circumstances should measures undertaken for institutional reform be substituted for those that are indispensable for economic progress.

But neither money nor an increasing human development index brings happiness. Interesting research is being carried out at the junctions of economy and psychology. In addition to psychical and physical circumstances, this field of study aims to define and measure people's satisfaction, which is a function of more than the level of income, education and health. Account is being taken of cultural values, as well as the condition

¹⁰ The Russian crisis was of marginal importance for Poland's economic performance. At that time, its significance was exaggerated by pro-governmental economists, analysts and media. The situation in Russia was much worse in 1994-97, but at that time there was no-one who blamed the country's neighbours for difficulties that are inevitable.

of the natural environment, level of satisfaction with the method of exercising power and the functioning of civil institutions. Comparative studies have led to fascinating results, on which the first world happiness map was based.¹¹

Based on detailed statistical data and multi-subject survey research, a compound subjective wellbeing index, ranging between 100-300 points (SWB) was created.¹² Hundred and seventy-eight countries have been classified, and Denmark and Switzerland top the list with 273 points. Next are Austria and Iceland with 260 points, Burundi is in the last place with 100 points. Only Congo and Zimbabwe (each scoring 110 points) separate Ukraine (120) and Moldova (117) from Burundi, which is at the bottom of the list.

With the SWB index, the correlation with GDP is significantly weaker than in the HDI comparison. What is remarkable, however, is that other postsocialist countries are also ranked quite low in the SWB list, even those nations classified by UNDP as belonging to the higher HDI country group. Lithuania and Latvia are in joint 154-155th position, with 157 points; Bulgaria rates the 164th place with 143 points. Russians are as unhappy as the citizens of Pakistan and Swaziland. If these research outcomes are to be believed, then happiness is mainly dependent on non-material living conditions. Even though the wealthiest nations top the list (apart from Bhutan and Costa Rica), a stronger correlation than the income rate is observed with nature as well as with traditional and cultural values. Even Slovenia, the wealthiest country among postsocialist nations and leading all lists with respect to GDP and HDI rates, scores 220 point. This is the same score as Kyrgyzstan, a poor picturesque, mountainous country that is outdistanced by Mongolia with 223 points in 57th place (with Fiji and Israel). Lagging behind is Poland, tied with Croatia, with 197 points (placed in 98th and 99th positions). Poland is also outranked by Iran (200 point) but is slightly better placed than South Korea (193 points). Within the group of socialist and postsocialist countries, the Czech Republic (213 points), China and Cuba (each with 210 points), as well as Tajikistan and Vietnam (203 points each) come before Poland. Kazakhstan (193) and Hungary (190) are behind Poland, but just by a few points.

Whether this ranking can be verified would require further interdisciplinary comparative studies. Such studies are very interesting, as they go beyond the domain of economy. Daniel Kahneman was awarded the Nobel Prize in 2002 in this field. He deals with both behavioural finance and hedonistic psychology, and emphasizes the importance of the exact factors considered in SWB for creating social satisfaction (Kahneman 2003). Although somewhat removed from the presented results, these factors cannot be disregarded. Their oversight would constitute a similar mistake, albeit on a different level, to the one made by neoliberal economy in confusing the means of economic policy with its aims.

Drawing robust conclusions with the SWB index is difficult because of the absence of a timeseries and hence the inability to handle comparisons over time; only comparisons concerning space are possible. However, when taking into account the individual indexes that make up this collective indicator, it could be assumed that also in this field Poland exhibited progress, given the longer timescale. Yet, fluctuations occur here as

¹¹ The world happiness map has been developed at the University of Leicester; see White (2007).

¹² On the methodology of the estimation of SWB index, see Marks et al. (2006).

well. This is obvious in comparing the optimism of the mid-1990s with the periods that immediately preceded and followed. Similar situation was evident for some time from the second half of 2002, but again, not for long. Nevertheless, during the last few years, the SWB level has been adversely affected by the negative attitude with respect to Poland's political life. Its poor quality, if not in absolute terms, then surely in relative terms, erodes the subjective sense of social satisfaction of the Poles.

5 The consequences of economic policy mistakes

Some of the mistakes can never be rectified, not even over a long timeframe. Non-generated income is lost for ever. The only exception are cases when resignation from current income refers to giving up the job that generated the income so that the available time thus obtained is invested in favour of higher education, and labour productivity and production in the future. If one works less—subsequently producing and earning less in a given period—but invests more in study, then the resulting increase in labour productivity may in the future compensate for the loss of the potential, possibly-to-be-generated income. On the other hand, if the extra time is wasted or used unwisely, the loss is irretrievable.

We are getting to the heart of the matter. Thus, when viewed from a strictly economic standpoint, a lot more could have been in Poland achieved during transformation, particularly with respect to the level of production and consumption. Poland missed the opportunity for greater GDP growth. It could have exceeded the level of Portugal, or been equivalent to Slovenia or Greece, totalling over US\$30,000 per person. Reality, at approximately US\$18,000, is just two-thirds of the foregoing: a two-thirds rate of success.

Without resorting to complicated deliberations and complex econometric models, it can be assumed that given the absence of any major exogenous disturbance, it should have been possible for Poland to achieve at least the economic growth rates projected in government programmes. It must be emphasized that criticism from professional circles was limited mainly to the growth rate not being sufficiently high, and not the other way around. Available potential had been overlooked. In the final phase of the second period in 1997, it was suggested that the 7 per cent growth rate was too low, and it was announced that GDP would double within the next 10 years. This could have been possible at that time, but on certain conditions, referring in particular to the elimination of the infrastructural bottleneck. It is an obstacle but at the same time an opportunity, because infrastructural projects, next to exports, should be one of the main flywheels of economic development. Unfortunately, economic policy is a history of missed opportunities.

In retrospect, it is evident that both in the first and in the third periods, much greater momentum had been assumed than was actually achieved. At the turn of the two preceding decades, unrealistic forecasting was quite common. In particular, government economists were generous with optimistic plans, forecasting a GDP growth of 23 per cent (!) for 1991-93, whereas it actually dropped 2 per cent in all.¹³ Estimates by

¹³ See Gomulka (1990). Interestingly enough, the author of this forecast was nominated to the post of deputy minister of finance in the fall of 2007, while another advisor from the shock-without-therapy

independent research centres, both domestic and foreign, were more balanced, but also projected higher growth rates than those achieved. Such assumptions were shared by the experts of international organizations, principally the World Bank and IMF. Considering the prestige of these agencies and their possibilities of applying pressure, which was much greater than at present, their voice had great significance. In fact many of these ambitious plans could have been implemented, but not with the economic policy pursued at that time. The formulation of advice, development of economic programmes and the review thereof is one thing, but having ability to implement them is another matter.

Actual annual growth rates should be compared with the forecasts projected in governmental programmes and by international organizations, as well as by the renowned experts who monitor the Polish economy. This is done by analytical centres, rating institutions, investment banks, and research centres. In a simple model, the year 1990 index applied by the government was adopted, and forecasted for the next three years by the vice-president and chief economist of the World Bank at that time (see Summers 1992) who was working closely with the Polish government. For the years 1998-2003 we conservatively assumed almost half a point less than the projection that could have resulted from continuing the trend of the preceding four-year period, while in the hypothetical variant we maintained the same growth rates for the years 1994-97 as were actually attained.¹⁴ For the years 2004-07, indexes are taken from the 'Programme of the Reform of Public Finance'. It should, in fact, be noted that GDP growth was on average a mere 0.5 points less than the hypothetical and aggregated rate for the entire period of 2004-07, or 2.4 points less in total (the difference between the assumed 25.5 per cent and actual 23.1 per cent growth rate).

This gives an average annual growth rate of 5.5 per cent for the entire 19-year period (1990-2008), taking into account the GDP growth of 4.8 per cent in 2008. Without going into details, it must be emphasized that such assumptions were supported by reliable economic models and econometric forecasts. In each case, comprehensive studies were the basis of the indexes used here. Similarly to the present when government estimates on the average annual GDP growth rates of 5.1 and 5.2 per cent for the years 2006-10 and 2011-15, respectively, are based on comprehensive econometric models,¹⁵ state-of-the-arts requirements were used in the past to prepare plans, scenarios and forecasts. This observation refers to forecasts prepared by both the government and other analytical centres. The estimates were supported by a good survey of the reality of the Polish economy and its external environment. Therefore, if reality is less promising than the forecasts, then we are dealing with policy errors and not forecast errors.

period, who had ridiculed the warning about the 25 per cent drop in industrial output in 1990 was appointed the minister of finance... So, there is policy and there is politics. And, of course, there is feedback between both of them.

¹⁴ 'Strategy for Poland' assumed GDP to grow by a total of 21.8 per cent for 1994-97, which was to be the result of growth of 4.5, 5.0, 5.2, and 5.5 per cent in the subsequent years. In fact GDP in total increased by 6.2 points more and average growth rate (6.4) surpassed the initial forecast of 5.4 per cent by 1 percentage point.

¹⁵ See *Program* (2006).

6 What if...

These forecasts provided the foundation for the decisions made by economic agents as well as by households and companies. Consumers and investors formulated their own expectations based on these forecasts. Consequently, these expectations partially influenced economic behaviour by initiating economic activity, the flow of income and movement of stocks.

The growth rate was almost 1 percentage points less than the annual average observed during the implementation of the 'Strategy for Poland'. For comparison, this was half the growth rate of China for the last two decades. The 5.5 per cent growth rate is also slightly higher than the current rate for the entire world, whose gross product increased between 2005-08 on average by no less than 5.1 per cent.¹⁶

It must be added here that this refers to the global product growth rate, not per capita rate. In Poland's case, the situation is more or less the same. Contrary to global trends and Poland's past, the scale of GDP growth per capita is larger, not smaller, than the GDP overall, reflecting the country's high net emigration in 2005-08. In other words, despite overall GDP stagnation, GDP per person rose by an index equal to net migration rates.

Thus, the assumption of an average annual GDP growth rate of 5.5 per cent was not unreasonable, and could have been achieved. At the time it had appeared that it would have been sufficient to implement an adequate growth strategy for the entire transformation period in junction with a creative policy of system change. Regrettably, during the 18-year postsocialist period, the average rate was a mere 3.0 per cent. Such a disappointing outcome had not been foreseen by anyone in the initial stages of the transition, particularly as production and living standards in the previous period had improved much faster. In the 40-year period covering the years 1950-89, national net income had, on average, expanded at 6.7 per cent per annum (i.e., twice as fast as in the subsequent two decades, 1990-2009).¹⁷

It should be no surprise that also this fact was considered as part of the negative image of the times. Another issue was the fact that the growth path was beset with problems regarding the level of the development process. Consequently, the previous system that had introduced the transformation was abandoned. It is also noteworthy that at that time there were periods of a cyclic nature, with a relative regularity of fluctuations and successive phases of growth rate acceleration and deceleration.¹⁸

The range of unrecoverable losses is huge. It is reflected not only in the difference between the current income, at nearly 180 per cent of the 1989 level, and the hypothetical level of 260 per cent, but by the entire field between the curve of hypothetical GDP growth and its actual trajectory.

¹⁶ For 2005-06, actual data from IMF; for 2007-08, IMF forecast (2007b).

¹⁷ After two subsequent years, average long-term index is anticipated to improve slightly and, assuming the average 2008-09 GDP growth rate of around 5.0 per cent, growth for the first 20 years of transformation (1990-2009) will average between 3.1 and 3.2 per cent

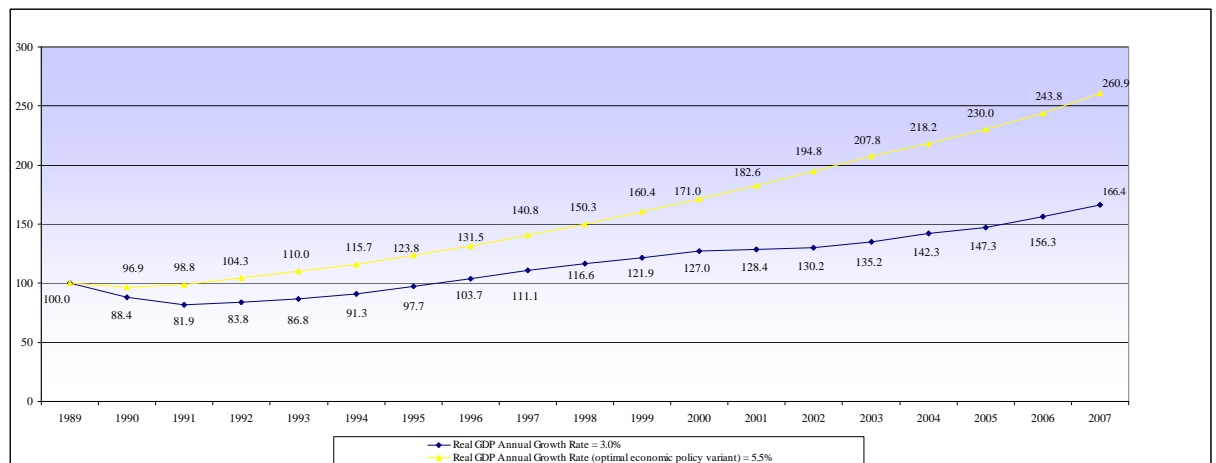
¹⁸ For more details on the subject of cyclical economic growth under socialist planned economy, see Kolodko and Gruszczynski (1975), Bauer (1978) and Kolodko (1979, 2002).

Table 2
Actual and hypothetical GDP growth rate in Poland,
1990-2007 (in per cent)

Year	Actual	What if...	Year	Actual	What if...
1990	-11.6	-3.1	1999	4.5	6.7
1991	-7.3	2.0	2000	4.2	6.7
1992	2.3	5.5	2001	1.1	6.7
1993	3.5	5.5	2002	1.4	6.7
1994	5.2	5.2	2003	3.8	6.7
1995	7.0	7.0	2004	5.3	5.0
1996	6.2	6.2	2005	3.5	5.4
1997	7.1	7.1	2006	6.1	6.0
1998	5.0	6.7	2007	6.5	7.0

Source Actual data obtained from GUS. Hypothetical data obtained as explained in the text.

Figure 2
What if... GDP growth, 1990-2007 (1989=100)
Reality and hypothetical scenario of optimal policy



Source: See Table 2.

Actual gross product is over 17,000 *zlotys* per person less than what could have been achieved; based on conditions in 2007, it is around 30,000 *zlotys* instead of approximately 47,000. However, the loss is much bigger, as negative effects accumulate. Aggregated flows over the years 1990-2007 give the stock of income not generated and therefore not consumed nor invested, with implications for the future totalling a massive 5.7 trillion *zlotys*. This is equivalent to a 5-year period of GDP at the 2007 rate, equivalent to approximately 150,000 *zlotys* per capita (or, the loss per person).

Currently, 20 years after the historic year of 1989, the average income of a typical Pole is almost 80 per cent higher; this also applies to citizens who were born at that time, are now graduating from high school and are looking forward to university. This is a sign of the passing times. It is a pity, then, that it has not always been used wisely. While the improvement is two-thirds more than what the previous generation enjoyed, at the same time it also implies that a third of the potential has been lost. On the one hand, we should be pleased: in a moderate comparison to others and in view of the past, it is a two-thirds success rate in growth. But on the other hand, we should be concerned about the wasted one-third.

In 2008, Polish GDP could have already reached around 260 per cent of the 1989 level. The magnitude could have been slightly more, or perhaps slightly less but is, nevertheless, the order of magnitude we refer to. Following from this, the country's economic and political position within the EU and in the world would have been stronger; international competitiveness of Polish companies better, and subsequently, also the level of consumption and living standards. The quality of social capital and the level of people's satisfaction would correspondingly have been higher as well, but whether people would have been happier, is quite a different matter.

7 Conclusions

In conclusion, I would like to propose seven lessons that other postsocialist transition economies and emerging-market countries should consider from Poland's thorny, yet somewhat successful, road to free market economy, political democracy and civil society.

7.1 Lesson one

Economic reforms that increase the flexibility of markets and contribute at least partially towards building the institutions necessary for efficient functioning and development of a market economy are always a prerequisite when a bolder, more profound structural shift is introduced. Even if extensive changes are not possible for political or cultural reasons, it makes sense to adopt changes gradually because this, in time, is likely to bring the desired results. This is not to imply that partial reforms will gain due recognition later, as they most likely will not, but this does not change the fact that moderate changes have taken place and these may be helpful for long-term development. Politically speaking, certain individuals work to promote political benefits while others reap the rewards, but most important thing is the gain for the society, the economy and the country.

7.2 Lesson two

Only a proper mix of two policies (policies oriented towards a system change and for development oriented towards the accumulation and efficient allocation of capital) offers the opportunity for rapid economic growth and sustainable development. The neglect of either component precludes good outcome. Apart from Poland, this is amply demonstrated by the adverse experience of Russia in the 1990s and the positive developments of China.

7.3 Lesson three

Confusing the means and ends in economic policy can backfire, increasing the social costs of development and reducing the level of attainment. This mistake was common in Poland, among others, and was not restricted to any specific period: mixing up policy goals and instruments is a widespread phenomenon in the modern world. When the means become glorified, they are perceived as the ultimate goals, as was the case in Poland in the late 1990s. The economy stagnated, despite the progress being made in institution building, privatization efforts and the ongoing process of opening up the economy.

7.4 Lesson four

During an attempt at a substantial transformation of a political system, when liberalization and opening up of the economy are linked with integration into the global system, institution building is of fundamental importance. Creation of the new rules of the market economic game and a legal, organizational framework for their implementation is imperative, but so is policy. Ever-improving institutions by themselves do not entail—at least not in the short-term perspective—an ever-improving policy. It may, in fact, be steadily deteriorating. Policy also depends on other factors, such as economic doctrine, dominant political set-up and the skills (or the paucity of skills) of those who conduct economic policy. Institutions matter, but so does policy.

7.5 Lesson five

The main source of development financing in the so-called emerging markets has been, and continues to be, domestic capital accumulation. Therefore, the formation of this capital should be given the necessary priority in macroeconomic policy and in microeconomic incentives. Particularly important in this respect is the appropriate design of financial policy, both fiscal and monetary, which significantly affects the marginal propensity to save and thus has a fundamental influence on the overall rate of capital accumulation, the investment level and dynamics.

7.6 Lesson six

Globalization, unavoidable and seemingly irreversible, creates additional development opportunities but also new challenges. Therefore, the art of economic policymaking today encompasses the apt handling of dilemmas that may emerge in new circumstances. The mini-max rule should be followed: minimize threats, maximize opportunities—or, more precisely, reduce the inevitable costs of participation in the global economic game and increase the benefits thereof.

7.7 Lesson seven

Economic policy is simultaneously a technocratic and social endeavour. The neglect of either aspect automatically decreases the effectiveness of the policy. It is not enough that limited groups of experts know what to do; this knowledge must be shared by broad sectors of society, albeit it then develops into a different type of knowledge. The best results in economic policy are triggered by an appropriate mix of financial and social engineering, technocratic macroeconomic governance and genuine social dialog, professional pragmatism and social sensitivity (Kolodko 2009).

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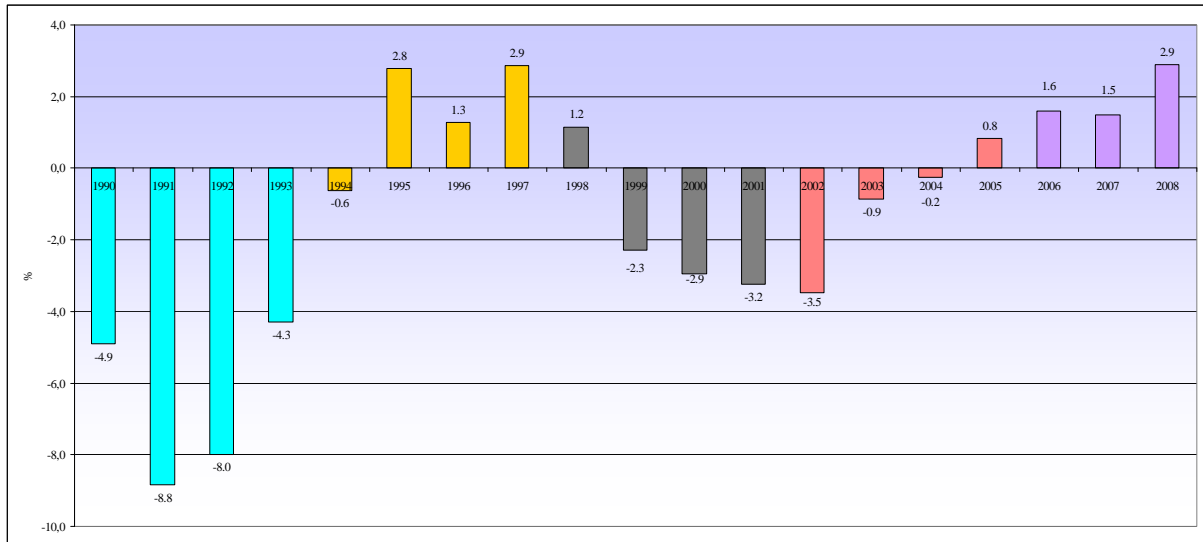
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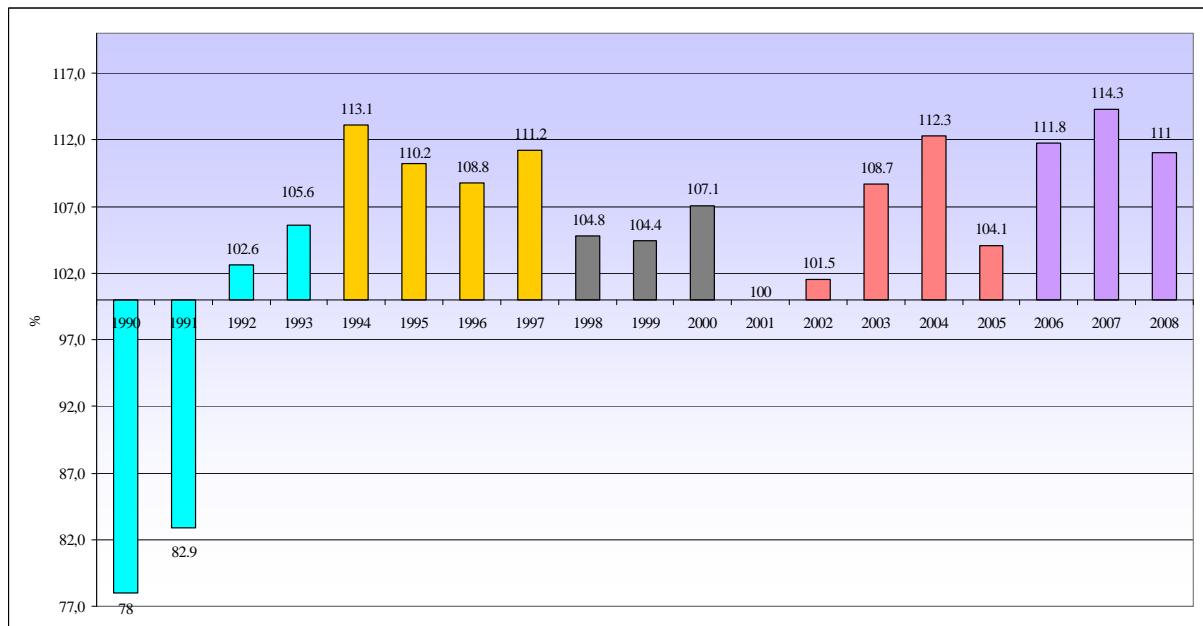
Statistical appendix

Appendix Figure 1
Employment (annual % change), 1990-2008

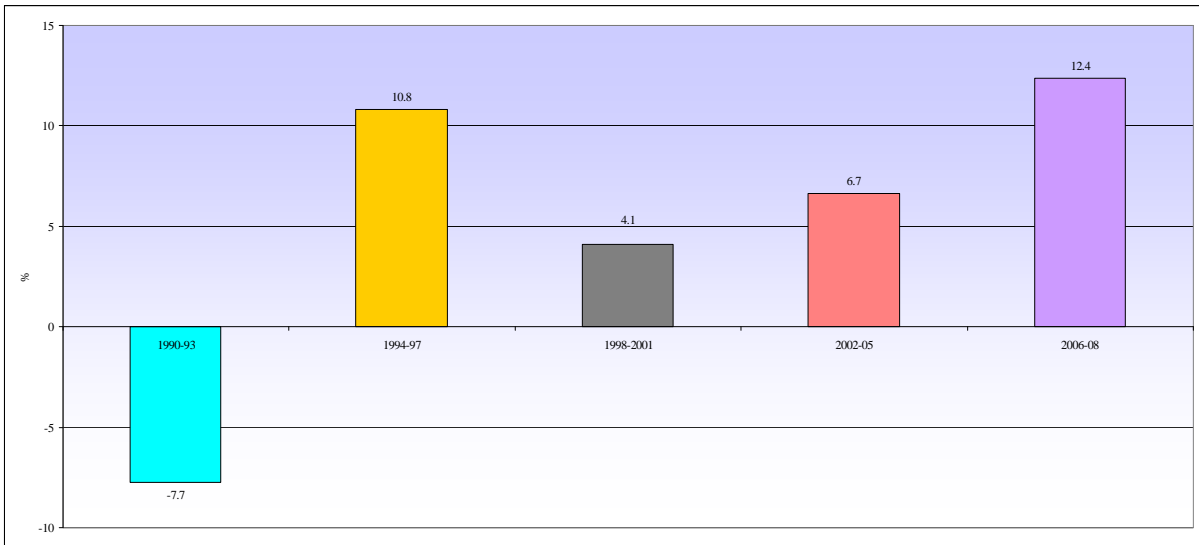


Source for all Appendix Figures: GUS.

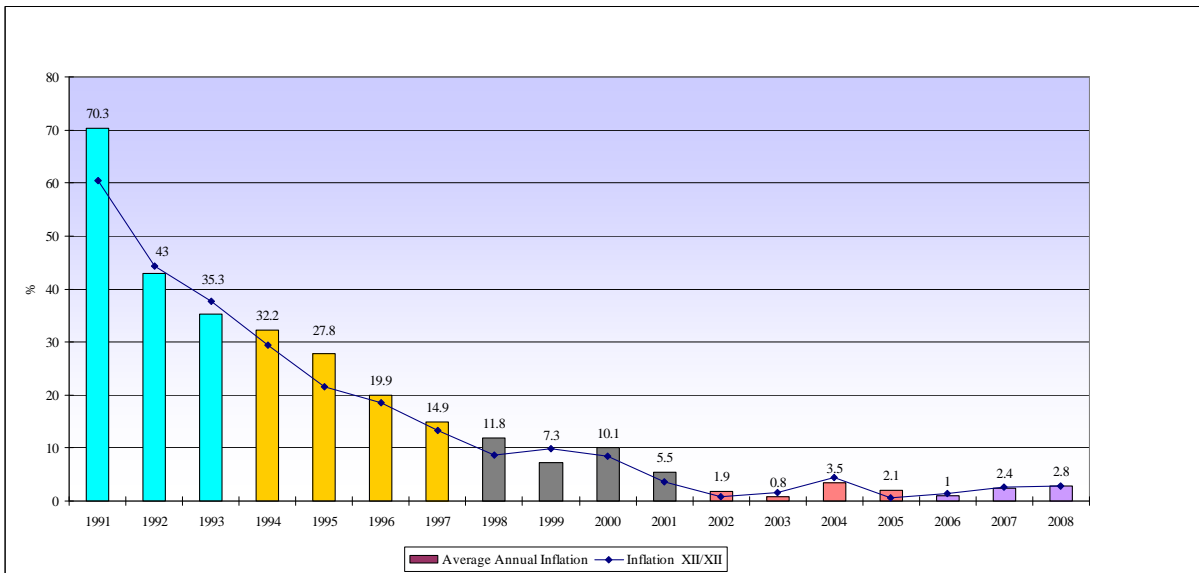
Appendix Figure 2
Industrial production (annual % change), 1990-2008



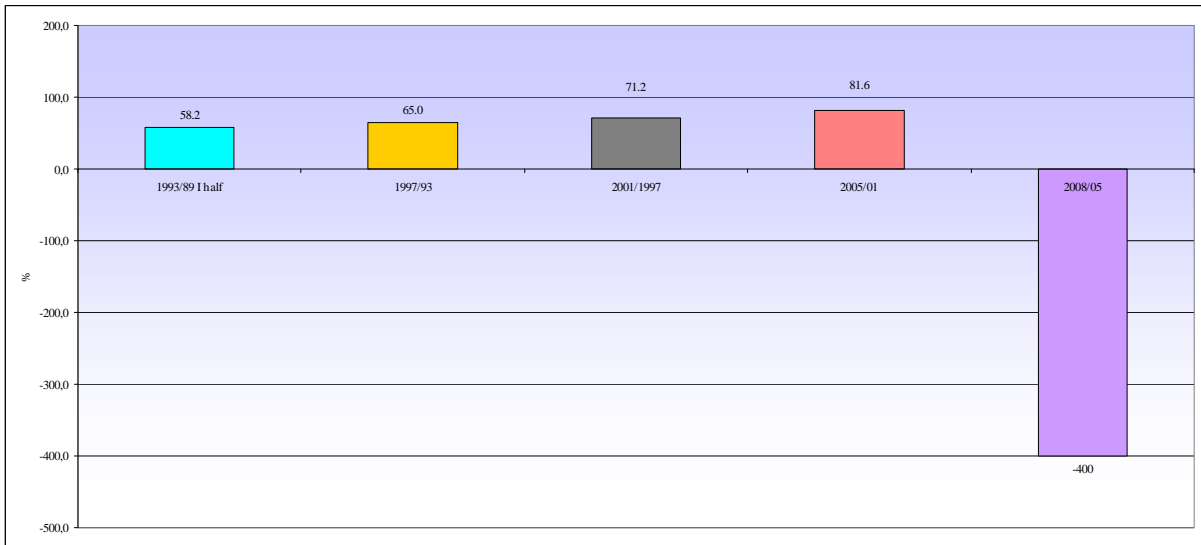
Appendix Figure 3
Industrial production growth in successive periods, 1990-2008



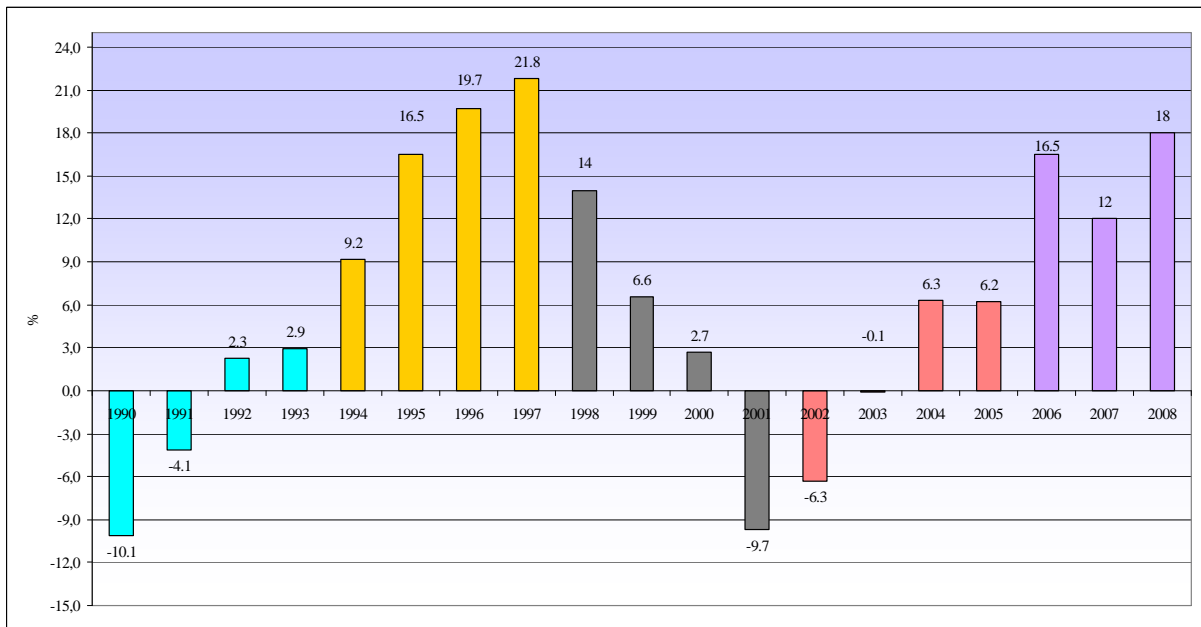
Appendix Figure 4
Inflation (consumer price index), 1991-2008



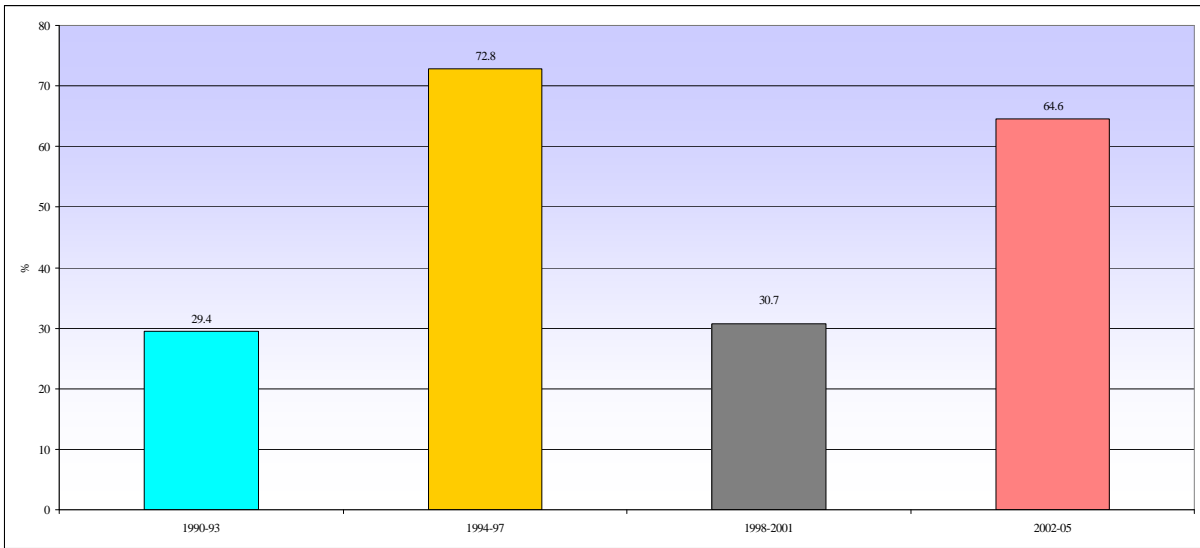
Appendix Figure 5
 Inflation reduction at the end of successive 4-year periods, 1989-2008



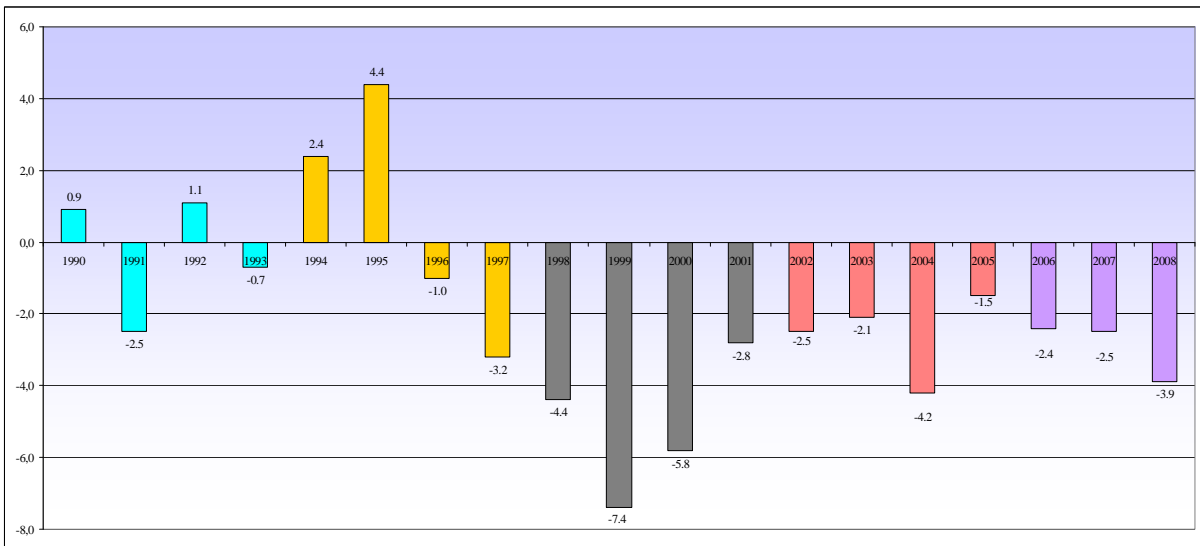
Appendix Figure 6
 Investments (annual rates of growth), 1990-2008



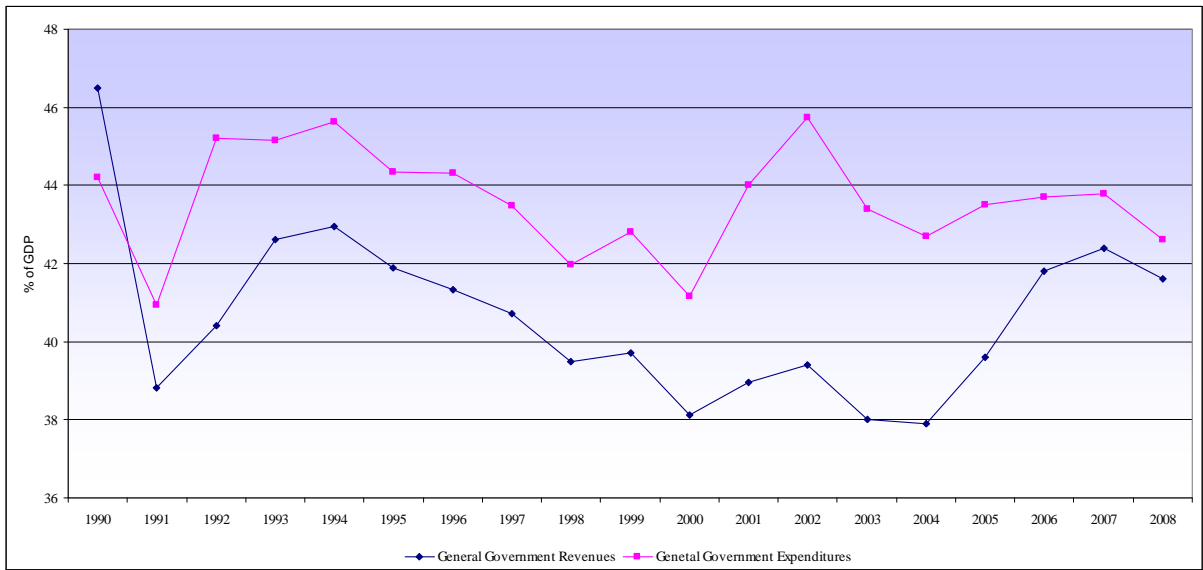
Appendix Figure 7
 Cumulative export growth in successive 4-years periods, 1990-2005



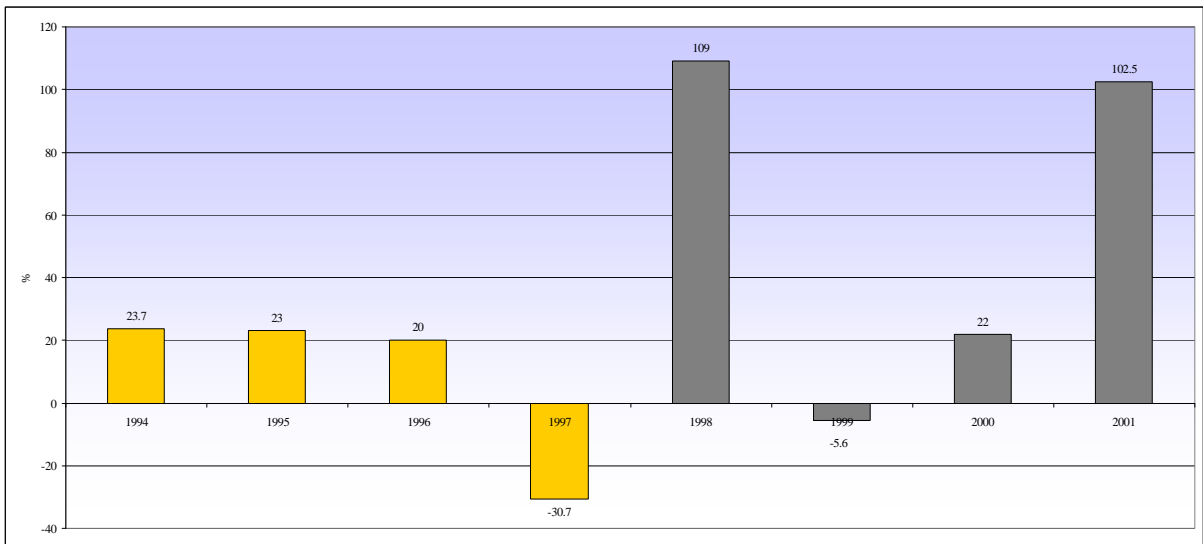
Appendix Figure 8
 Current account balance (% of GDP), 1990-2008



Appendix Figure 9
 General government revenues and expenditures, 1990-2008



Appendix Figure 10
 Public debt (general government) (annual rate of growth), 1997-2001



Appendix Figure 11
Public debt (general government) (% of GDP), 1990-2007

