FOR CIVIL DEVELOPMENT FORUM
www.for.org.pl

MORE FREE MARKET OR MORE GOVERNMENT?

How to strengthen post-pandemic recovery?

Sławomir Dudek, Marcin Zieliński

Based on the FOR Report: *Poland: stagnation or growth? Jobs, the rule of law, investments and innovations*

The COVID-19 pandemic was accompanied by unprecedented state interventions – from restrictions on basic individual freedoms to significant increases in public spending, among others, to compensate companies for the effects of the shutdown. In discussions of post-crisis recovery, we often hear about the need to "stimulate the economy." This is usually understood as increasing state interventionism and further increases in public spending. In reality, however, economic development is determined by private entrepreneurship within the free market. It is the countries with greater economic freedom that grow faster in the long term. The state may provide a short-term boost to growth, but it will be at the expense of lowering the economy's potential in the future. Therefore, we need extensive deregulation – the elimination of regulations that hinder companies, the denationalization of state-owned behemoths and the simplification of the tax system.

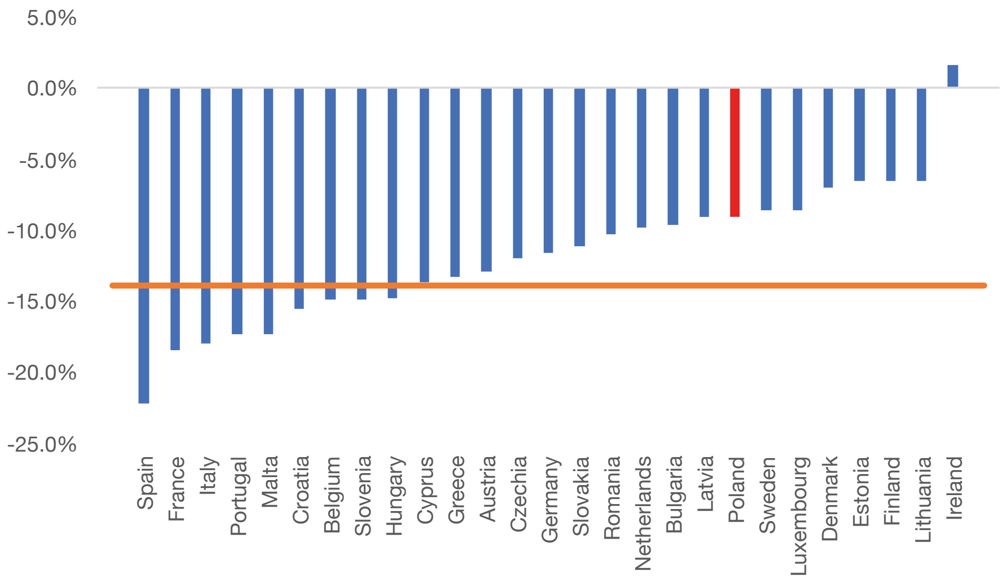
In January 2020, we looked with some concern at reports of a new coronavirus emerging in China. The problem, however, seemed remote and few people in Poland or the West expected what followed. By February, the situation was becoming more serious in Italy, making people in Europe aware of the dangers of a developing pandemic. The uncertainty accompanying the phenomena occurring then brought about serious plummets on stock exchanges in the last week of February, also in Poland, where the WIG index of all companies fell by over 14% (later, after a few days of calm in the first days of March, there were further plummets – by another 25%).

March brought about the first restrictions in Poland. On 12 March educational institutions and higher schools were shut down, on 13 March 2020 restrictions were introduced in shopping malls, restaurants were banned from serving food on the premises, and gyms, swimming pools, dance clubs, fitness clubs, museums, libraries and cinemas were closed. Beginning on March 24, restrictions were placed on movement except for subsistence, health and work purposes. A week later, the government closed hotels, hairdressers, beauty salons, tattoo and piercing salons (as well as construction big box stores, but only at weekends), and banned access to green areas such as parks and forests. Poland was of course not the only country that decided on a lockdown, but the restrictions introduced by the Polish government should be assessed as relatively strict in comparison with other EU countries. According to the Oxford COVID-19 Government Response Tracker scale, in the period from the beginning of April to the end of May, Polish restrictions were rated at 83.3 points (out of a possible 100). This result placed Poland in 10th place in the EU, with the EU average at around 80 points.

The effect of globally introduced restrictions (as well as changes in citizens' behavior not resulting from state coercion) was the collapse of the economy. Poland experienced its first recession since the transformation (the one in the early 1990s was caused by the bankruptcy of socialism). Although for the first two quarters

Polish GDP fell by as much as 9.1%, compared to other countries the slump was small. The EU economy contracted by 14 per cent, and in the countries most affected by the crisis accompanying the pandemic, the decline oscillated around 20 per cent.

DECLINE IN REAL GDP IN 2Q 2020 COMPARED TO 4Q 2019



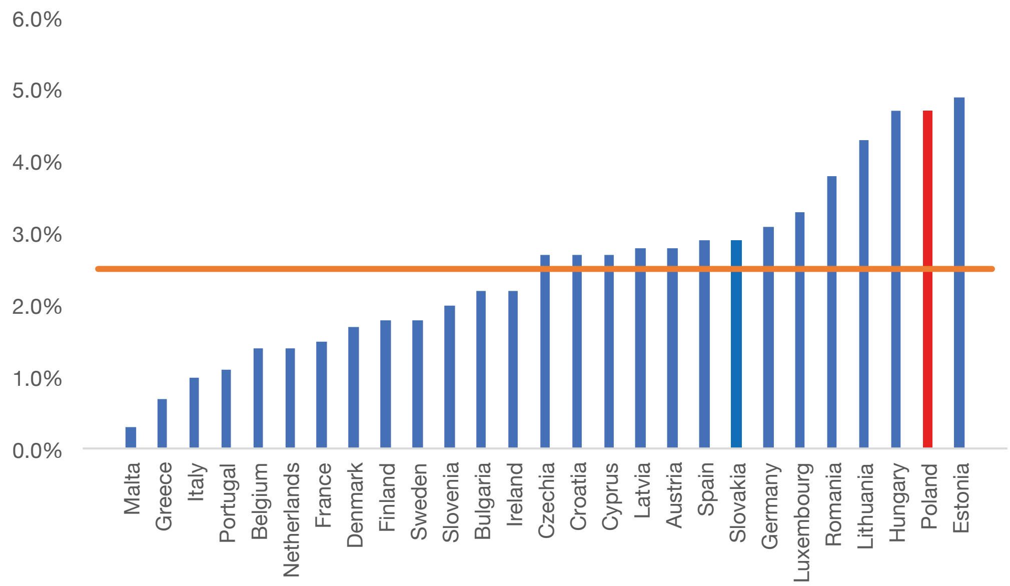
Source: FOR's own study based on Eurostat data

This was primarily due to the sectoral structure of the Polish economy. In Europe, the sectors that were most affected by the pandemic were accommodation and food service activities (section I), manufacture of cars and other transport equipment (section C, groups 29-30) and air transport (section H, group 51). And while the automobile industry in Poland plays an important role, the share of accommodation and food services is low.

Countries around the world – in addition to lockdowns – have taken two types of action. Firstly, governments have directed unprecedented amounts of funding to businesses to compensate them for losses resulting from the closure of their economies. However, the gigantic programs went not only to companies directly affected by the pandemic, but also to those that had long had problems with profitability, or those that qualified for subsidies due to natural seasonality. In Poland, the basic criterion for most aid instruments was a decline in monthly revenues. As a result, subsidies were also received by companies which in subsequent months recovered their losses and even increased their sales. As FOR, in March of 2020, we proposed that the support should be settled *ex post* together with the tax return. Then, those seasonal companies or those that did well in subsequent months would have to return the aid in a large part or even in full. The finance minister even referred to the financial aid in the first wave as "dropping money from a helicopter". With this approach, it is almost certain that some of the funds will be wasted and will not necessarily go to those most in need. Even in quasi-war times, funds should be spent wisely. In fact, it seems that even the finance minister himself understood this, because later, in the face of the second wave of the pandemic, he admitted that “we can think about supporting companies, but it has to be an operation done with surgical precision”.

Secondly, central banks around the world decided to cut interest rates further and introduce or enlarge asset purchase programs. The National Bank of Poland cut its reference rate in three rounds from 1.5% to 0.1%. In addition, it launched a constitutionally questionable purchase of Treasury bonds and bonds guaranteed by the State Treasury on the secondary market. Almost 15 months after the last rate cut, when the central banks of other countries in the region – the Czech Republic and Hungary – have already raised rates twice, the NBP is sticking to its policy of low interest rates, recently under the pretext of uncertainty about the economic recovery. Meanwhile, inflation started to exceed the upper limits of deviation from the inflation target already in the first months of 2020 and since then Poland has been one of the inflation leaders in the European Union.

HICP INFLATION YEAR-ON-YEAR IN JULY 2021



Source: FOR’s own study based on Eurostat data

Once again, the fears of the NBP President have not come true. In April 2020, he threatened that Poland was facing deflation. In the following months, however, Poland experienced at most a temporary decline in inflation, but still remained among the EU leaders in this infamous respect. Now, according to a quick estimate by Statistics Poland, Polish GDP has already returned to the level of Q1 2019, i.e. before the pandemic. So for now, the Polish economic recovery is doing well and does not require ad hoc support from the central bank.

The economic crisis caused by the COVID-19 pandemic, both in Poland and in many other countries, turned out to be shallower than previously expected. The crisis was also sectoral. It hit some industries. Many companies felt the effects of the crisis to a small extent or not at all. There were even industries that multiplied their turnover. Moreover, in many areas we were dealing only with deferred demand – companies had a bad situation during the lockdown, but then quickly made up for the losses, because current and deferred demand were handled at the same time.

This crisis was completely different from the previous ones, it cannot be compared with the financial crisis of 2008. From this perspective, the reaction of fiscal and monetary policy may have been too large and badly targeted. This requires deep analysis. With this approach, the drawbacks of state interventions reveal themselves with the greatest force. We are in danger of sustaining high inflation for a long period, zombification of the economy and the deterioration of the fiscal situation in the medium term.

However, it is worth asking what will occur in the long run. On September 2, 2021, the European Commission blocked the Polish National Reconstruction Plan for fear of the independence of the courts and free media, and therefore the transfer of billions of euros from the EU Reconstruction Fund was suspended. It seems that the very idea is exaggerated. It is true that economies around the world have suffered supply and demand shocks due to lockdowns, and are still struggling to cope with problems resulting from disrupted supply chains, but – and this needs to be emphasized – fixed assets, buildings and machinery, have not been destroyed. A pandemic is not a war: once the temporary disruption accompanying an epidemic is overcome, it no longer threatens economic development. Spending under the EU Recovery Plan will provide a short-term boost, but without reforms it will not increase long-term economic potential. The Polish government, meanwhile, is neglecting necessary reforms in its national recovery plan, instead focusing only on spending. Such actions, however, will translate into a relative increase in inflation.

In addition, both the shields and low interest rates are also, or even primarily, supporting inefficient companies. When such companies are allowed to continue operating even though they should fail, they lock up factors of production in less efficient uses. As a result, the productivity of the economy grows more slowly, and in extreme cases it may even fall. Also, central bank policy-induced high inflation supports over-indebted companies – by making the real value of their liabilities decline. All of this threatens economic growth in the long term. And while the central bank can stimulate growth in the short term with its policy of low interest rates, in the long term such actions can only do harm.

Another problem is the growing public debt. According to the EU methodology (i.e. including the Treasury-guaranteed PFR [Polish Development Fund] and BGK [Bank Gospodarstwa Krajowego] debt outside the national definition), Polish public debt increased by 13.5% GDP compared to Q4 2019 (data for the Q1 2021), approaching 60% GDP. However, the government is not presenting any recovery plans, moreover, it is dismantling the stabilizing spending rule and taking steps to make the state of Polish public finance less transparent, announcing as part of its flagship plan – the so-called "Polish Deal" – the establishment of a dozen new extra-budgetary funds out of parliamentary control. Although Poland's public debt may seem small compared to other EU countries, it should be remembered that Poland does not enjoy the same creditor confidence as the "old" EU countries. It is also worth recalling that Hungary ran into fiscal problems with a public debt of around 65% GDP, which is significantly lower than that of many Western European economies. As a consequence, Hungary's GDP fell by 6.6% in 2009, and between 2008 and 2010, public debt increased by 8.9% GDP. The slump has translated strongly into living standards. In 2001-2008, the price-adjusted per capita income in Hungary was on average 17% higher than in Poland. Since 2011, it has been equal to the Polish one.

According to available European Commission and OECD projections, Poland will not be able to achieve the same level of economic development as Germany. The OECD estimates that from the current level of just under 65% GDP per capita in Germany, we will reach a maximum of just over 73% GDP. This will happen around 2035, after which the Polish economy will shrink in the following years in relation to the German one – as a result the Polish GDP per capita will fall below 70% of the German level. The European Commission estimates that we will be able to maintain faster economic growth until 2040, reaching almost 80% of Germany's GDP per capita. These projections are based on existing demographic forecasts. Moreover, they assume no institutional changes. Thus, they do not take shocks and breakdowns in growth that are difficult to predict into account. And because they are based on the assumption of no changes in the economic system and policy, they do not take the risk of negative changes for growth, such as further erosion of safety nets in the pension system or further politicization of the economy into account.

— At present, at least three significant risks to growth can be identified:

- Progressive nationalization of the banking sector. At present, the Polish banking sector is not oversized and is one of the best capitalized in the EU, making it one of the safest in Europe. However, the state takeover of Alior Bank and Pekao dangerously increases the influence of politicians on the banks' lending policies. The problem is further exacerbated by the weakening independence and credibility of the regulator (KNF) [Financial Supervision Commission], whose confidence was undermined by corruption allegations against its former chairman.

- High general government deficit. Over the past 20 years, nominal GDP growth has lowered the public debt-to-GDP ratio by 2.8 p.p. on average, thus slowing the growth of public debt despite persistent deficits. In the projections, however, as long-term economic growth slows, this effect will fall below 2 p.p. in the next decades, limiting the possibility of maintaining high deficits without an increase in public debt to GDP.

- Growing tensions in the pension system. According to ZUS [Social Insurance Institution] projections even before the pandemic, from 2025 the pension fund deficit is expected to gradually decline from about 2.5% GDP in the 2020s to 0.5% GDP in 2080. The EC, in its cyclical forecast of pension expenditures in Poland, expects them to remain at around 10% GDP in the coming years (this does not include the 13th and 14th pensions introduced after its publication). If the lowered retirement age is maintained, the only way to stabilize pension spending in an aging society will be to gradually reduce the average pension, which is how ZUS currently operates. According to the EC's forecast, the average benefit will drop from 45% of the average salary in 2020 to 27% in 2050. If the lowered retirement age is maintained, the pressure to change the way pensions are calculated will grow in the following decades, which could mean an increase in pension expenditures. In 2031, people of retirement or pre-retirement age will make up 40% of the electorate. Based on EC calculations, we estimate that maintaining the current ratio of average pension and salary in 2050 would require an increase in public spending by over 6% GDP.

— The policy of the Law and Justice government does not support economic growth in the long term, even threatening the implementation of the baseline scenario resulting from the projections. The government's growth projections until 2030, presented either in the NAP or in the so-called Polish Order, are inconsistent. For example, in the NAP the government assumes – once again, despite the fact that the previous time, when the same was promised as part of the so-called Morawiecki Plan, it had the opposite effect to that announced – an increase in the investment rate to 25% GDP. In turn, labor productivity would reach 50% of the EU average (in constant 2015 euro prices). Achieving such an investment rate would mean that capital outlays per employed person in 2030 would be half as high as in the EC projection. At the same time, this projection shows that Poland will reach labor productivity at 50% of the EU average in 2030 even without any additional reforms.

— In light of the latest European Commission projection, in 2030 we will reach only 89% of the EU average GDP per capita. Therefore, reforms are needed to meet the government's 95% target. Unfortunately, looking for them in the KPO [National Recovery Plan] or the so-called Polish Order is in vain.

In the FOR report, Poland: stagnation or development? Jobs, the Rule of Law, Investment, Innovation, we proposed a package of reforms whose implementation in the 2030 perspective would enable Poland to reach even 99.5% of the EU average GDP per capita. Our reforms are expected to boost growth by increasing the number of employed people, productivity, investments and innovations, while strengthening the stability of the economy.

Increase in the number of employees

— **Reduce the taxation of labor contracts.** We propose to reduce taxes on labor by:

- **Eliminating preferences and lowering labor taxation.**
  The current taxation and contributions to employment contracts at the average level of about 40%, with numerous exemptions and preferences both in PIT and ZUS contributions, we propose to replace this with a lower flat tax not exceeding 35% and also including other income from work regardless of the type of contract. An important source of financing the reduction of labor taxation could be the liquidation of thirteenth and fourteenth pensions.

- **A decisive reduction in taxation of the lowest earners.**
  This effect could be achieved by increasing the tax-free amount or deductible costs under the current tax system or by subsidizing the lowest salaries.

— **Increasing the profitability of work.** The social welfare system should be aligned with the tax system in such a way as to avoid "social traps," i.e., a situation in which an increase in labor income too quickly deprives one of entitlement to benefits and leads to a decline in total income. At the same time, regulations that prohibit benefit recipients from making extra money should be reviewed. Social benefits should be withdrawn together with an increase in income at a pace at which an increase in income from work would always lead to an increase in disposable income (e.g., an increase in income by PLN 1 would reduce the benefit by PLN 0.50, while in the first months after starting work the pace of withdrawal could be even slower). Allowances should be limited only to those who really need support. Therefore, we also recommend limiting the 500+ program to less wealthy families.

— **Labor law reform to encourage job creation.** Employment contracts for an indefinite period remain unattractive for employers and employees in Poland not only because of higher taxation than in other forms of employment, but also because of their more restrictive regulation.

— **Facilitate combining work with childcare and elderly care.** In addition to the state subsidization of child and elderly care, further regulatory easing of the establishment of private nurseries or the employment of foreigners as caregivers (and their immigration) would be helpful.

— **Raising the effective retirement age.** In view of increasing life expectancy, we postulate:

- **Raising the retirement age to 67 for men and women, and then linking it to life expectancy.**
- **Reviewing all retirement privileges and other programs allowing for early retirement and limiting them.** In addition to the pension privileges themselves, changes are needed in the case of survivors' pensions, which enable the spouse of the deceased to leave the labor market quickly, and the possibility to draw 80% of the pension of a deceased husband (or in rarer cases of a wife). This possibility should either be limited or taken into account when determining the pension, which would allow the principle that the granted pension corresponds to the previously paid contributions to be restored.
- **Change the way the minimum pension is determined.** The fixed amount of the minimum pension should be replaced with a formula based on the Chilean solution, where the state guarantees a certain minimum amount, but at the same time each additional year of contributions increases the value of the future pension.

— **Naturalization of foreigners.** From the perspective of long-term development, it is crucial that foreigners who work, pay taxes and obey the law in Poland are provided with a clear path to obtain a permanent residence permit and naturalization. In addition, we call for transferring the responsibility for labor immigration from the Ministry of the Interior and Administration to the Ministry of Development, Labor and Technology. In addition, reforms that can be introduced immediately are:

- **Changing the nature of work permits (type A and B) from a work permit for a specific employer to work in Poland in general.** At present, third-country nationals are required to apply for a new work permit each time not only when they change employers, but even when they are promoted in their current company, which hinders their career and pushes them into the informal economy.
- **Introducing an automatic right to work for spouses of third-country nationals who have work permits.**

- **Extending the seasonal work permit from nine months to a non-specified period of time if the third-country national complies with Polish law.** At present, the same third-country nationals often work seasonally in Poland each year and are forced to ask for a new permit each year.

Faster growth in total productivity

— **More competition.** OECD measures of barriers to product market competition in Poland indicate significant restrictions compared to other countries, in particular due to the extremely high prevalence of the state ownership of enterprises. At the same time, under the influence of lobbying, further restrictions on competition, such as the pharmacy for a pharmacist, the ban on the sale of agricultural land, ban on trading on Sundays, are being introduced and should be lifted as soon as possible. Our recommendations include:

- **Privatization of state-owned enterprises.** We recommend the privatization of state-owned enterprises, e.g. through the stock market or transferring their shares to citizens as part of the capital pillar of the pension system, the reconstruction of which we advocate on the basis of the remnants of the OFE [Open Pension Funds] and PPK [Employee Capital Plans].
- **Certification instead of licensing of professions.** In Poland, in 2020, there will be as many as 360 regulated professions, which is the third largest number in the EU, and the large number of regulations combined with the lack of clarity of existing regulations results in conflicts and uncertainty for people who can potentially perform activities reserved for regulated professions.
- **Introduction of the term of office and the irrevocability of the OCCP [Office of Competition and Consumer Protection] President.**

— **Removing barriers to the flow of labor and capital to growing sectors and the most productive companies.** The main sources of productivity growth are the movement of workers from less to more productive sectors and the growth of the most productive firms within particular sectors. These processes in Poland are slowed down by various preferences and regulations. Therefore, we postulate:

- **Removal of barriers discouraging the transition from agriculture to other sectors.** Farmers should be included in the general pension system of ZUS and the EU subsidies should go to farms that actually produce food for the market and not only those that own agricultural land.

  - **Review the regulation of micro-enterprises.** We recommend a comprehensive review of any regulatory thresholds to eliminate situations where companies will avoid hiring an additional employee to avoid being subject to stricter regulations.

  - **Review tax and contribution preferences for the self-employed and microenterprises.**

— **Restoring and strengthening the rule of law.** In particular, it is necessary to:

  - **Restoring the independence of the courts.**

  - **Streamline the activities of the courts.**

  - **Reduce legal uncertainty.**

— **Improve the predictability and quality of legislation.** It is necessary to introduce an obligation to actually analyze the effects of regulations *ex post*. Already at the time of enacting new legislation, the time for its verification, the criteria for evaluation and the data needed should be defined. We postulate:

  - **Longer consultations and *vacatio legis*.**

  - **Collection of data on the number of people regulated.** To this end, the IT system and the system for reporting, collecting and storing data in ZUS, KRUS [Agricultural Social Insurance Fund] and tax offices should be redesigned or modernized to enable reliable assessment of the number of people covered by particular regulations.

  - **Modernization of evaluation standards.** They should be modernized, taking advantage of the progress made by statistics and econometrics in this area in the last 20 years.

  - **Allowing for the collection of necessary data after anonymization.** As it stands, the Data Protection Act prevents the use of individual data by government employees and ordinary citizens. The law should be amended to include regulations that set standards for anonymizing individual data.

  - **Enabling the automatic expiration of laws (sunset clauses).** This would mean that after a certain period of time, existing laws would expire unless voted on again by parliament to extend them.

Larger investments and innovations

- **A reduction in preferential tax rates combined with a reduction in basic rates.** Rather than trying to catalog and detail all the exceptions and preferences in the tax and social security system, we propose their limitation combined with a reduction in tax rates. Such a solution – by eliminating one of the major sources of volatility in the tax code – should create a more predictable business environment, which will encourage companies to invest.
- **Incentives to invest.** In the case of limited companies, we propose the introduction of a true Estonian CIT, which means that the company's profits are taxed only when they are distributed to the owner. For sole proprietorships and partnerships, a simpler solution may be to extend the possibility of one-time depreciation, which will significantly reduce the effective taxation of investments.
- **Improved access to financing.** Our recommendations include:
    - **Elimination of the bank tax.**
    - **Rebuilding the funded pillar of the pension system.** We postulate that the reconstruction of the capital pillar should be based on merging the remnants of OFEs with the currently created PPK. We propose that the contribution be fully voluntary (i.e., no obligatory contribution on the employer's side), and the funds accumulated in the new pillar be private. For those willing, whose funds accumulated in Open Pension Funds were forcibly transferred to ZUS in 2014, we propose a possibility to receive their equivalent in shares of companies currently controlled by the State Treasury to an account in the new pension pillar. Such a solution will not only increase retirement security through diversification of savings, but will also depoliticize state-owned companies and reduce ZUS' pension liabilities.

Stable growth

- **Strengthening spending rules.** The introduction of a rule requiring slower growth in public spending when public expenditures exceed, for example, 35 or 40 percent GDP could promote faster economic growth. The fiscal rules in Poland should be strengthened by linking them to the debt definitions used by Eurostat. It is also necessary to reverse changes that weaken the functioning of the stabilizing expenditure rule, such as the exclusion of investment spending from it.

— **Introducing safety nets in the pension system.** First of all, negative indexation of pension liabilities in ZUS should be allowed. The lack of such indexation in case of a recession leads to a decrease in ZUS revenues, which is not accompanied by a corresponding decrease in the institution's liabilities. Secondly, the retirement age should be automatically linked to increasing life expectancy. Recognizing that as life expectancy increases, the length of working life should also increase. This will avoid further politically difficult debates about the retirement age.

— **Greater independence of banking supervision.**

— **Privatization of state-controlled banks.**

Economic policy should be long-term, going beyond one term of office or even beyond one decade. We estimate that closing the employment gap, raising the retirement age and removing barriers to the growth of innovative, efficient enterprises through greater market competition and improved rule of law would allow Poland to reach between 87 and 98% of Germany's GDP per capita, effectively closing the gap in living standards.

Fundacja Forum Obywatelskiego Rozwoju – FOR
ul. Ignacego Krasickiego 9A
02-628 Warszawa
tel. +48 22 628 85 11
e-mail: info@for.org.pl
www.for.org.pl