Economic transformation of Poland

Basic Problems and Opportunities

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Abstract

The goal of this paper is to contribute to the discussion about the way to transform the Polish economy from a centrally planned to a decentralized market system. This is worthnote that no formal theory of such a transition exists. The following paper should be viewed only as an illustration of problems and opportunities on the way of transformation. In other words, this article analyzes the specific distortions in Polish economy which involve the process of transition, presents the problems which is faced by Poland and main opportunities.

Hitherto existing experiences show that reforms are going to take a very long time and their social and economic costs appear to be greater than original anticipated. This article claims that one of the most important barrier for reforms and growth is inadequately developed services in general and knowledge – intensive ones in particular and a low level of enterprises’ efficiency. Also specific policy proposals stem from the analysis.

Περίληψη

Αντικείμενο του άρθρου είναι ο τρόπος μετάβασης της πολωνικής οικονομίας από το κεντρικά διευθυνόμενο σύστημα προς την οικονομία της αγοράς. Το άρθρο

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Basic Problems and Opportunities

Hitherto existing experiences show that the path of reform in Poland and other countries of Eastern Europe will be longer and more difficult that the most of people first thought. The following article analyzes the specific distortions in Polish economy which involve the process of transition, presents the problems which is faced by Poland and main opportunities.

In the new political setting, the old problems come to the fore. After the excitement of 1989 and early 1990, with the collapse of the old communist regime and its replacement with elected, non-communist government, it is understandable that there should have been feeling of disappointment at the apparent lack of real change in Poland, especially at the microeconomic level. The legacy of the central planning system is central to understanding both the pressure for radical reforms and why any solution – global or gradual – is disproportionately more difficult than historical presents, relating to non-Socialist economies, might suggest. Also, initial starting conditions existing in each country dictate the pace and sequencing of economic and institutional changes in economies emerging from decades of state control [Fischer, Gelb, 1990].

The economic strategy applied by Poland and others East and Central European countries, since the late 1940’s was the extreme example of inward-looking policy, systematically oriented towards import substitution. Its specific feature, however, was
to pressure its autarkic goal at a regional (Council for Mutual Economic Assistance (CMEA)), rather than national level, which in practice meant for the East and Central European countries that a large sector of their economy had to be geared to the priority needs of the USSR, with little concern for the exploitation of national comparative advantages. Intra-CMEA trade was conducted and settled in transferable rubles, a unit of account that was neither convertible nor transferable. Trade had to be bilaterally balanced. There was no point in generating a surplus whose value was uncertain, since it could be settled only by future shipments by the debtor [Holzman, 1976; Brown, Neuberger, 1968]. The CMEA group’s trade moved largely under long-term contracts and provided a certainty of production runs, and, therefore, also of employment. This in turn produced managerial attitudes not well adapted to facing the uncertainties inherent in a competitive situation. Moreover, even though in most countries the price structure floated on low-priced raw material inputs, a large part of output, because of design and quality problems, could not have obtained in Western markets.

Due to the highly centralized system of management obligatory in the years 1949-1981, State-own and cooperative enterprises in Poland were treated as executive units and possessed their autonomy in decision-taking in regard to some secondary issues. Only the private sector wasn’t directly subordinated to command-type management system of the economy. Despite that its development was hampered by numerous limitations, above all by the tax and fiscal system. For many years this sector was considered marginal and it was assumed that it should be liquidated.

In the command-type system State and cooperative firms used their information advantage in relation to the planning authorities to obtain generous input allocations that helped them to easily fulfil the qualtitative targets of the state plans [Ellman, 1989, p. 27; Asselain, 1984]. Naturally, socialist “managers” were eager to overfulfill the plan, so that wage premium could be paid. If wage increases exceeded productivity gains, the rise in unit costs translated into higher prices, or, much more often, into higher required subsidies that would cover the difference between costs incurred and prices obtained. Socialist enterprises in Poland, in which such elements as a level of prices, costs, wages, technology and quality of products were separated from market criteria, were considerably overmanned, and provide a number of social benefits to employees. This has resulted in low level of efficiency and competitiveness in settings where many enterprises enjoy monopolistic market position.

The poor results of the traditional model in Poland led to attempts at economic reforms [For the main features of the traditional model see: Brus, 1972, chapter 3].

In the early 1960s there was a widespread discussion throughout the CMEA about the limitations of the traditional system and the need for reforms. This found its echo in Poland in the form of limited changes announced in 1964-65. These were also partly a response to the low growth of real wages in the early 1960s. The changes were “within
system” changes rather than radical reform, and failed to have any significant impact [Ellman, 1989, p. 61].

The next attempt at reform came in the mid 1970s when Poland had embarked upon a modernization strategy financed by Western capital inflows. High inflation rates greatly encouraged foreign indebtedness. This tendency was reinforced by political pressure or “encouragement” to extend loans to Eastern Europe. A sudden inflow of borrowed foreign capital resulted in a temporary surge of import-led growth, with a rising debt burden.

The more staying power than the previous two has had the attempt in 1982. The reform shared the emphasis on trade liberalization, some price decontrol and more independence for enterprises with the reform slogan of “the three Ss” (self-dependence, self-financing, self-management). The root of the conception of “the three Ss” is conditions propitious for entrepreneurship on the basis of state ownership. [Brus, Laski, 1989, pp. 144-145]. Enterprise councils, freely elected by the work force, were to decide on the directors, vote on corporate strategy, and dispose of the firm’s assets. The imposition of martial law caused the modification of the original reform plans and gave the ministries more control than the councils [Nuti, 1982; Lipinski, Wojciechowska, 1987]. At the 1989 rapidly accelerated the rate of money creation [Gomulka, 1990]. This was caused by a number of factors: a mistaken macroeconomic framework, populist tendencies, instability attributable to the electoral campaign, as well as across the board indexation of wages forced through by Solidarnosc and the National Council of Trade Unions during the “round table” discussions. All these measures—in terms of systemic considerations—had not led to a rational synthesis of central planning and market. In other words, in Poland was created a partially reformed economic system with numerous relics from the planned economy but also with a number of market-type institutions and mechanisms (or at least their beginnings). The economic system of Poland at the end of 1989 was comparable to those of Hungary and Yugoslavia and was markedly different from those of the GDR, Czechoslovakia and the Soviet Union.

As a result of the long existence of an centrally planned economic system and inefficacious of undertaken reforms, the Polish economy in the end of 80s was characterized by the following processes:

- obsolete economic structure (excessive share of heavy industries and industries based on high consumption of raw materials, characteristic for the introductory phase of industrialization and underdevelopment of service, which accounted in 1988 for a share of 35% in GNP in Poland [OECD, 1991], while in OECD countries recorded shares of 47-65% [World Bank, 1990],
- low level of enterprises’ efficiency and competitiveness,
- high degree of monopolization of most branches of economy,
– shortages of products,
– constant growth of inflation,
– inferior participation in the international division of labor, and particularly in international trade (see Table 1)
– growing indebtedness in the West and in the East; net interest payments in 1989 amounted to 49% of the value of dollar exports in Poland [GUS, 1990].

Table 1

**Openness and Trade Orientation of Poland in 1989 (in %)**

<table>
<thead>
<tr>
<th>Regional Shares</th>
<th>Imports</th>
<th>Exports</th>
</tr>
</thead>
<tbody>
<tr>
<td>Eastern Europe and USSR¹</td>
<td>40,6</td>
<td>40,7</td>
</tr>
<tr>
<td>Industrial Market Economies</td>
<td>45,7</td>
<td>43,3</td>
</tr>
<tr>
<td>Developing Countries</td>
<td>7,1</td>
<td>10,2</td>
</tr>
<tr>
<td>Others²</td>
<td>6,6</td>
<td>5,8</td>
</tr>
<tr>
<td>Share of Exports in GNP</td>
<td></td>
<td>17</td>
</tr>
</tbody>
</table>

¹ CMEA-6 (incl. GDR)
² Includes PR China


**The Structure of Ownership and Employment**

From the ownership’s point of view, Polish economy in divided into three sectors: state, cooperative and private. The existence of three sectors is not equivalent to the fact that all of them are equal concerning their economic potential - assets, turnover and employment. In general, the state and cooperative sector predominates over the private one. On the other hand private farms remain the dominant form of agriculture in Poland covering approximately 70% of the total areas of farms. The share of the private sector in other spheres of economy was much smaller then in agriculture. An example may be some date concerning industry (see Table 2)
Table 2.

<table>
<thead>
<tr>
<th>Sector</th>
<th>Gross output</th>
<th>Value of assets</th>
<th>Employment</th>
</tr>
</thead>
<tbody>
<tr>
<td>State and cooperative</td>
<td>95,2</td>
<td>93,6</td>
<td>90,0</td>
</tr>
<tr>
<td>Private</td>
<td>4,8</td>
<td>6,4</td>
<td>10,0</td>
</tr>
</tbody>
</table>

Source: Informacja Statystyczna GUS, 1990, p. 388

In state sector predominate big enterprises employing over 200 people. Approximately 20 per cent of employees in 1989 worked in enterprises employing more than 5000 people and 60 per cent in those having more than 1000 employees. A more favorable situation was in the cooperative sector - about 85 per cent of employees worked in enterprises having 50-500 employees, although it should be taken into consideration that state industrial enterprises employed approximately seven times more people than the cooperative ones. The relation was similiar in the case of state and private sectors. This partly resulted from the law, obligatory till the end of 1988, that private enterprises could employ at the maximum 50 persons. The only exception were foreign enterprises (Polish-foreign joint venture) which could employ up to 100 people. These limitations have been abolished since 23rd December 1988.

The 1980s were marked by a steady growth of the private sector. A significant rise in its growth occurred in 1989, when the government removed the majority of administrative barriers preventing private firms from entering the market. Further changes in economic environment caused next increase of the number of private firms. In 1990 the number of private firms increased by 250%, while the number of State enterprises grew by 3%. In 1990 industrial output of the private sector increased by about 8%. At the same time industrial output in State-sector fall by 23%. As a result private firm’s share in total industrial output is estimated to have been over 11% in 1990, as against only 4,8% in 1989. Some estimates put its importance at about 20%. This difference is caused by the existence of shadow economy in Poland. Employment in the private sector outside agriculture reached about 16% of total employment in 1990 [GUS, 1991].

Shadow Economy

The consequence of a system that offered neither the amount, nor the variety, nor the quality of goods and services desired was growing consumer dissatisfaction.
Shortages in the official system generated a rapidly growing shadow economy [On Poland’s shadow economy see also: Gikas, 1992, pp. 21-25; Wisniewski, 1985, pp. 913-936; Landau, Z., 1987; Charemza, Gronicki, Quandt, 1988, pp. 861-884]. Contrary to certain groups of the populations which had privileged access to goods at low state-administered prices, many people had to buy goods and services in the price-flexible shadow economy with its high market-clearing prices. The shadow economy absorbed part of the excess money supply that was created as a consequence of the government budget deficits covered by printing money at a pace exceeding output growth. The illegal nature of most shadow-economy activities - necessary and useful as they were - nurtured a growing system of bribery and profit-shared schemes that undermined the material incentive system applied in the official economy.

The reduction of economic growth of the official net material product, increasing shortages and the gap between the structure of output as provided by the socialist system and the preferences of people has stimulated activities in the shadow economy. The last estimations of the range of this phenomena in Polish economy are presented in the Table 3.

Table 3

<table>
<thead>
<tr>
<th>Year</th>
<th>Absolute Value (mld zl)</th>
<th>Share in the total nominal incomes (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1977</td>
<td>61,3</td>
<td>4,4</td>
</tr>
<tr>
<td>1978</td>
<td>40,3</td>
<td>2,7</td>
</tr>
<tr>
<td>1979</td>
<td>58,0</td>
<td>3,5</td>
</tr>
<tr>
<td>1980</td>
<td>85,6</td>
<td>4,6</td>
</tr>
<tr>
<td>1981</td>
<td>292,5</td>
<td>12,1</td>
</tr>
<tr>
<td>1982</td>
<td>214,1</td>
<td>5,3</td>
</tr>
<tr>
<td>1983</td>
<td>455,7</td>
<td>9,1</td>
</tr>
<tr>
<td>1984</td>
<td>908,6</td>
<td>15,2</td>
</tr>
<tr>
<td>1985</td>
<td>1570,1</td>
<td>21,4</td>
</tr>
</tbody>
</table>

Source: Bednarski, M. Kokoszcynski, R. Stopyra, J., Drugi obieg s Polsce w latach 1977-88, Wektory, No 8, 1987

Hitherto existing analysis on the second economies in both socialist systems and in market economies has shown that the shadow economy contributes to the structural
flexibility of the overall system and, to the extent that it momentarily reduces the political pressure for reforms, it has a considerable social-mollifier function [Cassel, Cichy, 1986, pp. 415-428]. In the transition phase to a market economy the shadow economy might again become a welcome kind of social shock absorber.

Stabilization Program

The dramatic nature of the economic situation in Poland in 1989 forced the government to focus on a stabilization package. The economic programme, which was enacted on 1 January 1990, was made up of two key components: an anti-inflationary stabilization programme and a fundamental privatization scheme.

The objectives of the stabilization programme were to stifle high inflation and to eliminate shortages; to open the economy to foreign competitions; to liberalize the structure of prices and to bring it closer to the free market (the decontrol of price formation didn’t apply to the prices of coal, coke and electricity and prices for some services; flat rental, communal services and transportation rates). In general the operation was meant to create a macroeconomic basis for the restructuring of the economic system. Coal, coke and electricity prices were administratively raised to a level covering production costs plus a certain margin of profit: the coal price by 400% in wholesale trade and 600% in retail trade, the price of electricity by 300%. Almost all price subsidies, even for basic foot-stuffs, were abolished. Tax redemptions for exports were to be eliminated; import customs were to be used to cover budget outlays in general, and not, as hitherto, especially for subsidizing exports. At the same time the zloty was devalued by about 50% to 9500 zlotys per US dollar [See: Lipton, Sachs, 1990, 75-147; Rosati, 1990]. The introduction of internal convertibility was accompanied by the abandoning of all quantitative import restrictions and by a strict limitation of the list of goods needing an export licence. It’s worth to note that the process of import and export liberalization began in Poland in the 1970’s. In December 1988 was passed a new law stating that every type of business is permitted that is not explicitly forbidden. In January 1990, virtually all remaining elements of the state monopoly of foreign trade were eliminated.

The results of the stabilization program, on the positive side: first, there has been a practical elimination of shortages, second, substantial export boom to convertible currency markets accompanied by a decline in imports, third, the stabilization of the exchange rate fourth, the inflation rate has been substantially reduced from its preprogram peak of 50% per month to 4% - 5% per month and in the next two years the rate of inflation decreased and amounted in 1992 –43% and 1993 – 36% [CUP, 1993], On the negative side: measured output dropped 24.2% over the year as compared with an anticipated drop of about 5%. Only in 1992 after three years of output decreasing
(1989 – 0.5%, 1990 – 24.2%, 1991 – 11.9%) was noted increase 4.2% [CUP, 1992]. In terms of social costs we need to list the following: unemployment and higher than expected decrease in real wages. Unemployment of about 400,000 persons was originally anticipated and it was above 1 million, it means 6.3% of the labor force, and climbed significantly higher at the next years. In the beginning of 1991 2.2 millions people leave without job (11.8% of the labor force), 1992 – 2.5 millions and 13.6% respectively [GUC, 1992] and 1993 - 2.8 and 15.5% [The Economist, 1994, p. 36]. The decreases in real wages recorded in January 1990 in relation to December 1989 were 41% and in 1992 real wages maintained 26.6% lower than in 1989.

The specification of main factors, which are responsible for the depth of the recession in Poland seems to be very important for further considerations. There were a lot of signs which indicate lack of flexibility of Polish enterprises, its limited ability to adapt and a rigidity in response to demand signals [Jorgensen, Gelb, Singh, 1990]. It seems to be the result of:

- the structure of ownership and the nature of enterprises,

- the continuing expectation of a resurgence of inflation,

- habits resulting from years of a shortage and command economy: inability to market goods and to adjust production to market demand on the one hand and expectations of administrative paternalism on the other.

- lack of faith in the consequences of the government’s policy, based on the experience of the last few reforms.

This situation shows that Polish recession of 90’s should be fighted by other means then the great depression of early 1930’s. The maintaining of the restrictive monetary, fiscal and wage policies seems to be necessary while a Keynesian approach seems to be completely inadequate for the situation of Poland. The great depression of early 30’s affected countries with market economies, with the majority of enterprises in private hands, and it lasted only a few years. Government regulation of the economy was much less extensive than in today’s market economies, not to mention Poland’s. A great reservoir of unutilised production capacity waited for any sign of demand and were ready to reach flexibly to any such impulse. All these show that the recession in Poland has completely different nature.

**Privatization**

As a key condition for transformation into market economy privatization has gained major importance in the reform efforts in Poland. Without private owners interested in the returns of capital, there will be little incentive for the dominant state enterprise sectors to vigorously pursue profit maximalization, cut costs, and otherwise restructure their
overmanned and inefficient enterprises [See: Kornai, 1990]. It is necessary to emphasize that the main aim of privatization is the restoration of the entrepreneurial functions – risk-taking, responsibility, profit-making orientations – in order to make economic activities efficient. And it’s not an end in itself, to be reached as quickly as possible.

There exist many factors in Poland, which make difficult or even make impossible raid privatization and in particular denationalization [Mujzel, 1990]. First of all its lack of entrepreneurial elite, which creation and development have to take considerable time. Second, the prevailing slight interest in the taking over of large enterprises, when most of them need a capital reconstruction. That lack of interest is due to the fact that people in Poland are interested rather in saving mainly in tangible, physical assets and not used to save by means of investment in securities. In additional, the fact that the know-how needed for the reconstruction of state firms does not exist, but must be imported – in ideal case with foreign capital. All those cause that a long period of time is needed for the development of truly competition promoting market structure [Brabant, 1990; Rychard, 1990]. A complementary measure to increase competitive pressure is to encourage the foundation of new firms which are so important for Schumpeterian innovation processes. The economic measures ought to include the availability of capital at competitive interest rates and through relatively simple approval procedures, favourable tax treatments, especially an income tax system that favours reinvestment and thus postpones high consumption. In creating competitive market structure foreign investment may play very important role, too [Bloomerstein, Marrese, 1990]. Poland has liberalized legislation governing foreign investment may play very important role, too [Bloomerstein, Marrese, 1990]. Poland has liberalized legislation governing foreign investment and actively promote joint venture. At the same time offers important attractions to international business: it is close to major market, possess a skilled labour force, offer low wage rates, competitive even with certain East Asian countries.

The Role of the Service Sector in Polish Reforms

Despite of radical reforms the Polish economy still differs greatly from a typical market economy. Market economies are complex, well regulated systems in which infrastructural facilities, financial institutions (bank, insurance, stock exchanges) and human value (entrepreneurship, knowledge) are especially important. These are the very features lacking in Poland. Circumstantial evidence points to the conclusions that there is excess demand for services in Poland. Transport [See: Tismer, Ambler, Symons, 1987], a lack of telephones and low quality of existing lines [See: The Economist, 1990, p. 81], extremely low employment figures for some services, obsolete banking structure,
and most of all, lack of certain (especially knowledge-intensive) services as well as generally poor quality of services all show underdevelopment in these respects.

Experiences from the development economies of Western Europe, America and Asia, in the past decades, has showed that the rate of economic growth and the share of services are closely-related. The rising share of services has had such far-reaching consequences that economists has started to use the term "service economy" in preference to the older "post-industrial" [For the importance of the rising share of the service sector see: Gommmel, 1986]. In spite of many differences between the present Polish economic structure and the developed economies it have to be emphasize that Poland – in the process of economic transition – should to use as much others experiences as possible. It’s refers especially to the developmental features experienced by the developed countries.

The policy requirements for major growth of services are not the same for all kinds of them. Improvement in private consumer services can largely be left to the market. Their supply can expand in the relatively short run, this is because they are labour-intensive, frequently operated as small enterprises and they need little capital to start. Such favourable circumstances don’t exist in the producer services, which can most effectively act as engine of growth. These services are capital-intensive either regarding equipment\(^1\) and regarding human capital. Therefore the time required to expand their supply is longer than in the case of consumer services and producer services usually need state support. The more so as many of them are clearly non-tradable.

Finally, it is worth to emphasize the crucial role of knowledge-intensive producer services in promoting growth. These services should play an outstanding role in the marketisation and privatisation. Without a highly skilled legal profession it is impossible to develop a contractual economy, without financial services it is impossible to operate capital markets and modern banking, without information processing it is impossible to organize a modern economy or participate in the world economy.

**Final Remarks**

The 1990 Polish experiences are characterized as a "leap in the dark", since, for the first time, the transition to an open market economy was not approached as a distant goal, subordinate to the previous elimination of existing distortions, but as a direct once-for-all transformation of the economic regime. Despite the shortcoming

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1 According to some recent estimates about US$30 billion should be sent in the next 10 years in East European and Soviet on telecom equipment (East European ..., op. cit., The Economist, 24 March 1990, p. 81)
of the reforms, they appear to have given Poland a leg up in the process of transformation, in part because of the institutions necessary for functioning market economy had already been partially created. But the high hopes for quick reforms and quick turnarounds in economic performance do not appear to be realistic. The past experience of Poland suggests that reform is going to take a very long time - probably much more longer than it took for the transition from the market economy to the command system, during which market structures were destroyed - and reform efforts will need to be sustained over many years. This is enough to realize that restructuring of enterprises, privatization, establishment of new legal system and generating behavioral changes in populations need much more time than price liberalization and the dismantling of central coordination. Moreover, the Polish experience suggest that the social and economic costs of reform now appear to be greater than originally anticipated.

A number of conclusions might be attempt from the considerations outlined above:

First of all, a stable monetary and financial policy is of particular importance if the benefits of market economy are to be realized. Its efficiency is based upon the interaction of competitive forces and relative price incentives as well as creative long-term entrepreneurial activities.

Secondly, privatization of socialist industry is the key to the transition to a market economy, because it assuring economic efficiency by creating a new strata of Schumpeterian capital-owners that put resources to their best use and contribute to profitable structural adjustment by innovation and investment. The stimulating of efficient productive activity is very important goal for Polish economy. This policy on the one hand may provide new and diverse job opportunities and helps to solve the problem problem of unemployment and - on the other - may provide healthy competition for the existing state and collective firm.

Thirdly, inadequately developed services in Poland are important barrier for growth. In promoting growth producer services in general, and knowledge-intensive ones in particular, have a special place. The small share of the latter is not representative of their importance. This sector of economy may be the engine for growth for Polish economy.

Fourthly, as reforms in Poland are in the interest of Western countries the transition should be assisted through the gain of the possibility of free trade with the EC’ countries and future European Union membership.

Finally, Polish politicians have to both: educate populations about the magnitude of the difficulties and the reasons for policies, while avoiding the temptations of populism.
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