PERSPECTIVE

A Progressive Growth Strategy for Poland

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November 2013

Introduction

Poland, the largest economy among eleven post-socialist EU member states, with almost a 40 per cent share of the region's GDP, has just experienced probably the best twenty years in the more than one thousand years of its history. Since 1989, when the Solidarity-led social movement spearheaded the collapse of communism, Poland has been the fastest growing economy in Europe and one of the fastest in the world, beating most Asian Tigers and other rapidly growing emerging markets. Poland was also the only European economy to avoid a recession during the current global crisis. In 2012, Poland's GDP was almost 20 per cent higher than in 2007, a peerless performance among all EU27 countries.

In 2013, Poland has achieved levels of income, social well-being and happiness never experienced before.[1] Its GDP per capita (PPP) has reached 61 per cent of that in Western Europe (EU17), an income level last seen in the year 1500, according to historical income statistics.[2]

Poland is also well placed to continue to converge with Western Europe. Long-term projections by the European Commission, the OECD and independent think-tanks suggest that Poland will likely reach up to 80 per cent of the EU15 level of income by 2030. In doing so, Poland will have moved from the economic periphery of Europe, where it languished for centuries, to Europe's economic centre. This achievement would mark the arrival of a new Golden Age for Poland.

However, if this convergence process is to be successful it will need to be supported by adequate policymaking and an adjusted growth model. While cautioning against overconfidence about the ability of economics to precisely pinpoint the future drivers of growth, this paper discusses what a new growth model should look like, reflecting the lessons of long centuries of Polish economic history, the transition period and the most recent global crisis.

The New Growth Model

Despite an impressive economic performance since 1989, especially during the global crisis, and overall fairly optimistic growth projections that suggest that Poland's convergence with Western Europe will continue at least until 2030, the prospects for continued growth are far from certain.

First of all, the projections may simply prove to be wrong: despite many strengths and upside risks,[3] Poland's growth and the speed of convergence may decline much faster than anticipated. This might occur largely because of the slowing labour productivity growth as the easy post-transformation reserves become exhausted[4] and as Poland continues to lag behind in innovation.[5] In addition, growth may be undermined by low saving and investment rates, which place Poland at the bottom of the EU28, a still largely unfriendly business environment, with Poland placed only fifty-fifth in the World Bank's

1. Well-being is defined in this paper in a narrow sense of living standards to contrast it with wider definitions of well-being, which include subjective assessments and emotional reactions.

2. Piatkowski (2009): The Coming Golden Age of New Europe, Center for European Policy Analysis Report No. 26.

3. Piatkowski (2011): Post-Crisis Prospects and a New Growth Model for the EU-10, Center for European Policy Analysis Report No. 33; Piatkowski 2009.

4. Van Ark and Piatkowski (2009): Productivity, Innovation and ICT in Old and New Europe, in: D. W. Jorgenson (ed.) The Economics of Productivity.

5. World Bank (2012): Poland. Enterprise Innovation Support Review.

Doing Business ranking, an inefficient public sector, faster demographic decline driven by continued emigration and low levels of social trust.[6] What, then, would a new growth model that could help ensure Poland's full income convergence with the West look like?

In the short term, the main focus should be on accelerating growth (projected at only around 1 per cent in 2013, the lowest in 20 years), which is now suffering mainly from subdued domestic demand. This could be done (i) by changing the distribution of GDP towards the poorer segments of society with a high marginal propensity to consume, especially locally produced products and services, (ii) by increasing public and private investment and (iii) by further expanding exports.

Specifically, a change in income distribution to bolster effective demand could be achieved by, inter alia, increasing the progressiveness of the personal income tax (which declined following the introduction of two lower tax rates in 2009, 32 and 18 per cent), including by restricting child tax credits to families with three or more children (thus at the same time supporting demographic policy and reducing the incidence of poverty, which is most prevalent among large families); introducing a tax based on the market value of real estate; and raising social assistance thresholds, including for welfare programmes in which payments would be contingent on job search and additional training.

With regard to increasing investment, given the current fiscal constraints, with current public debt close to debt limit of 55 per cent of GDP laid down in the Public Finance Act (and also to the 60 per cent constitutional debt limit), there is only limited room for increased public investment. That said, the existing limit should be used to the maximum, benefiting from the lowest cost of public debt on record. In addition, the government should increase the flexibility of fiscal rules for local governments to ensure that they can use all of the available EU funds to support investment. The major growth boost, however, would come from higher private investment. This could be achieved by introducing a time-bound investment tax credit, fundamentally simplifying the investment process, especially as regards construction permits (on which Poland ranks only in one hundred and sixtieth place in the Doing Business ranking, one of the worst in the world), and expanding the use of public-private partnerships, including expanded use of state guarantees. In addition, the government should promote investment through BGK, the state-development bank, and the recently established Polish Developmental Investment, a state-owned special investment vehicle.

Lastly, but most importantly, the government should focus on further increasing exports, which still represent only about 40 per cent of GDP, below the EU average. The time to promote exports is especially opportune given the super competitive level of the real exchange rate (which turns Poland into the »China of Europe« in terms of price competitiveness) and the ongoing eurozone crisis, which keeps the Polish zloty weak despite its strong fundamentals. The main action should concentrate on strengthening export financing and export insurance, subsidising costs of foreign market entry for SMEs and fundamentally reforming diplomatic services to focus on promoting exports and investment (and performance-based assessment).

The savings ratio has to rise

Poland does not save enough to support high investment rates and to insulate the economy from future crises by lessening reliance on import of foreign capital, especially of the fickle portfolio capital, which can come in and out of the country at the least opportune moments. Countries that have successfully caught up with developed countries, mostly in Asia, saved and invested on average more than 30 per cent of GDP.[7] However, Poland's saving and investment rate is much lower: during 2004–2011, the average saving rate amounted to only 17 per cent of GDP, with investment at only 21 per cent of GDP, below the EU average and most regional peers.

The solution is to raise private and public saving through further pension reforms (reforming the second pension pillar and enhancing the attractiveness of the third, voluntary pillar), imposing stricter long-term fiscal policy to increase public saving (decrease public dissaving),[8]

6. Social Diagnosis (2013): Social Diagnosis. Objective and Subjective Quality of Life in Poland, The Council for Social Monitoring. Available at: http://www.diagnoza.com/.

7. World Bank (2008): The Growth Report: Strategies for Sustained Growth and Inclusive Development.

8. In the long term, the ultimate objective should be to decrease public debt to below 40 per cent of GDP. This would not only help to boost public saving, but also further insulate the country from the vagaries

introducing pan-European tax harmonization, starting from a corporate income tax base and a minimum CIT tax rate among the EU11 countries and eliminating tax havens in Europe and elsewhere. In addition, adoption of the euro at a competitive exchange rate in around 2020 would help to increase macroeconomic stability and thus saving (the current problems of the euro zone notwithstanding). The target should be for the domestic savings rate to amount to at least 25 per cent of GDP, up from around 20 per cent currently. Together with imported savings of up to 5 per cent of GDP, ideally all in the form of FDI, this should allow domestic investment to amount to at least 30 per cent of GDP, in line with the high investment ratios experienced in the past by successful catch-up countries such as Japan, Korea and Taiwan.

Increase of work productivity

As regards labour productivity, the issue is the slowing growth of total factor productivity (TFP), the overall efficiency of the use of the available capital and labour, driven by low spending on R&D and innovation and exhaustion of simple growth reserves. The major part of the solution is to increase the efficiency of the 10 billion euros that will be spent on supporting enterprise innovation in the 2014–2020 EU financial perspective.[9] In addition, it will be crucial to fully open up domestic and EU markets to competition, particularly in the utilities and services sectors, promote high-skilled labour immigration, improve the business climate and promote R&D-intensive FDI. Finally, it will be important to continue to enhance human capital and labour skills through further education reforms.[10]

Fighting social inequality

Finally, Poland needs to keep social inequality in check, as it is a crucial ingredient of both short-term (by supporting effective demand) and long-term economic growth, as well as overall well-being. The issue in Poland is that inequality has risen substantially in the past 20 years and is now above the EU average, as measured by the Gini coefficient (0.34 for Poland relative to the 0.30 average for the EU). The plight of the bottom 10 per cent of society is especially worrying: during 2008–2011 their incomes increased less than those of all other segments of society and much less than the richest 10 per cent. The solution should be to introduce measures – including more progressive taxation, smarter social assistance and an improved system of vocational training – to ensure that the incomes of the bottom 10 per cent and 40 per cent rise more than the incomes of the rest of society and that the Gini coefficient falls below 0.30 (monitored with the same frequency as GDP).

Conclusions and Policy Recommendations

Poland has never had it so good. Its income, quality of life and level of happiness have not been closer to those of the developed countries in Western Europe since the sixteenth century. However, Poland's convergence with the West may slow and then halt altogether as the current model of growth based on imports of technology, non-technological improvements and use of simple post-transition reserves comes to an end. This year's economic slowdown to the slowest pace in the past 20 years and ever weaker economic rebounds suggest that the economic fundamentals may be weakening.

However, a new growth model is needed. Specifically, the government ought to take steps to increase domestic savings to lessen reliance on imported foreign capital and boost investment, further raise labour participation, promote immigration, enhance innovation, maintain strong supervision over the banking sector, improve skills and keep the real exchange rate at a competitive level. In addition, it should also aim to further improve the business environment, with the objective of putting Poland in the top 30 countries worldwide in the Doing Business ranking. Finally, while working to increase the returns on EU-financed investments, Poland should continue to promote further integration of the EU's internal markets, especially in e-commerce and services, and support further enlargement, including by first expanding free trade agreements to countries such as Ukraine and Turkey.

Contrary to the current practice, all specific policies proposed under the new growth model should be assessed against their impact not only on GDP growth, but also

of international financial markets and thus allow Poland to conduct its own, sovereign economic policy in line with the wishes of its population rather than the myopic and often counterproductive demands of the bond markets.

9. World Bank 2012.

10. World Bank (2011): Europe 2020. *Fueling* Growth and Competitiveness in Poland Through Employment, Skills and Innovation.

on social well-being and happiness. Only policies that improve (or at least do not undermine) all three indicators should be implemented.

In the longer term, while the convergence gap between Poland and Western Europe continues to diminish, economic policy should focus increasingly on social well-being and happiness. This should particularly include expanded leisure time, especially if used productively. After all, the whole point of economic growth is to become productive enough to be able to work less and less and have more and more free time. Poles should learn in time that enough is enough and there is life beyond work.

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ISBN 978-3-86498-715-1

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